Forex For All
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A Beginner's Guide

TECHNICAL ANALYSIS

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CHAPTER 4:

TECHNICAL ANALYSIS

Part 1: What is Technical Analysis?

You just learned that fundamental analysis is the study of the causes that lead to price changes on the FOREX market. Technical analysis is also a study of price movements, but it is the study of the effects of market movement based on what has already happened. Traders use both types of analysis to predict how the market is going to move. Essentially, traders who use technical analysis believe that all market variables come down to price movement, so there is no need to use other means of analysis to trade FOREX.

When you are performing technical analysis on a currency, you are looking for patterns on a chart that repeat themselves. The basic belief is that because price movement is dictated by humans, the patterns will continue to repeat as long as humans run the market. Humans make repetitive actions based on repetitive emotions and those repetitions can be analyzed to predict price movement.

Technical analysts study trends, support and resistance levels and FOREX indicators to forecast the direction in which a price is going to move. You can use these factors to your advantage, since when you know what signals to look for you can time your trades in the best way possible to make a tidy profit.

Part 2: FOREX Charts

FOREX charts are the basis of technical analysis. They provide the information traders need to evaluate and manage currency movements. As mentioned in Chapter 2, Part 1, all currencies are quoted in pairs with one currency expressed in value relative to another currency. All FOREX charts will consist of two currencies and their relative values.

Monitoring currency movements is critical if you want to be able to time your trade to maximize your profit. You will need to study price quotes over a single day, several days, a month, several months, a year and even several years. This will allow you to get the overall picture of a currency's movement. You won't be distracted by abnormal fluctuations.

The other types of FOREX charts include line charts, bar charts and candlestick charts as discussed in Chapter 2, part 3. You will want to learn how to analyze chart patterns that represent price movement. At that point, you can then apply the technical indicators you have chosen to use and be able to make a successful trade. If you didn't get these live feeds on the charts, you would be trading blind, which is never a good idea. You always want to make informed trading decisions and FOREX charts are one way to get informed.

Part 3: Price Trends

FOREX price trends are simply identified price movement patterns. When you watch prices over a time period, you will begin to see patterns emerge. You can examine these patterns and learn to predict price movement. You can time your trade to take advantage of a repeating pattern, or price trend. You are looking to predict areas of value that will help you earn a profit.

Your goal is to identify a price trend as early as possible, make your trade and then exit your trade as soon as the trend starts reversing. Remember that you are using past price movements to predict where the price is going to go in the future. You are not using external factors, such as news, to forecast the future price.

You are making assumptions that a price is going to move in a specific direction. Your assumption could very well be wrong; however, the better you get at technical analysis, the better your odds are of making a correct prediction based on price trends. You need to expect that you will make some losing trades, but if you learn from them, you can make better trades in the future.

Part 4: Support and Resistance

Technical analysis relies on support and resistance more than any other concept. Essentially, it means that the movement of a price will stop and reverse at certain levels. Resistance is the top level of a currency that the price will reach, but not break. Support is the bottom level of a currency that the price will reach, but not break. Usually, a price moves between support and resistance levels, which allow traders to buy a currency at support (when it is cheapest) and sell it at resistance (when it is most expensive).

When you are trying to determine entry and exit into a trade based on support or resistance levels, you will want to select a FOREX chart that shows a price interval period that is in line with your trading strategy and timeframe. If you are trading short-term, you will use a one-minute chart and if you are trading long-term, you will use an hourly, daily, weekly or monthly chart. When you are analyzing support and resistance, you will take indicators into account to determine when a trend is going to reverse.

Some of the methods used to analyze support and resistance include proactive methods such as Measured Moves, Dynamic or Fibonacci, Projection/Confluence (Static or Square of

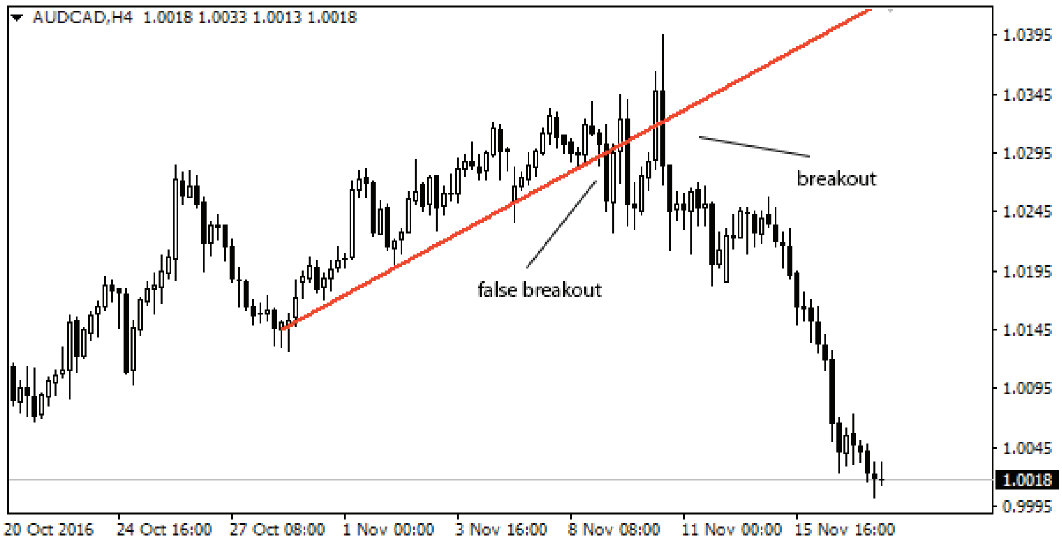
Nine), Trend Lines and Moving Averages, Volatility Based, Market Profile, Calculated Pivots and VWAP. There are also reactive methods that include Price Swing Lows/Highs, Open Gaps, Volume Profile, Candle Patterns and OHLC. Some of these methods will be discussed later.

Part 5: Breakouts

As discussed earlier, breakouts occur when prices pass through support or resistance. Your job during technical analysis is to try to predict when a breakout is going to happen. There are three types of chart breakouts that happen most often:

1. A breakout that comes after a period of price consolidation
2. A breakout the comes after a period of narrowing price variation
3. A breakout that comes from within a rising or falling trend

Breakouts happen because of the varied opinions of what traders believe fair value is for a specific currency. Traders will cause the price to move up and down, hitting levels of support and resistance, but eventually one side of the trade is going to win, causing the price to move past either support or resistance and take the currency higher and lower. A breakout is usually the start of a new trend. The key to profiting on a breakout is to use technical analysis to predict when a breakout is going to occur and time your trade at the start of the breakout.



Sample breakout

Part 6: Trend Lines

Trend lines are used by technical analysts to determine entry and exit trading points. Sometimes, trend lines are referred to as Dutch lines since they were first put in use in Holland. Trend lines are formed by drawing a diagonal line between at least two price points. A support trend line is drawn below the line between points of support and a resistance trend line is drawn above the line between points of resistance. Again, when analyzing trend lines, you need to choose a chart that represents a timeframe that is consistent with your trading strategy.

The goal when using trend lines is to buy a currency at support and sell at resistance. The reason for this is that when the price goes back to a trend line, you might have a chance to open a new trade in that direction if you believe that the trend is going to continue in that direction. Analyzing trend lines also allows you to better pinpoint breakouts, when you would place a trade in the opposite direction of the existing trend and closing trades that are in the direction of the existing trend.

Part 7: Channel Lines

Channel lines are very similar to trend lines, but are often used by traders who are trading on a short timeframe. They are attempting to make a profit on small price movements. A channel line is drawn parallel to the trend line and when the price of the currency gets close to the trend line, a trader buys the currency. When it gets close to the channel line, a trader sells the currency. Some traders use channel lines to trade against the trend, but there is a greater risk when doing so.

Channel lines are often used to identify the weakening of a trend. If a price does not meet the channel line at the next high or low, it can be an early signal of a trend reversal. Although this is not always true, traders who are basing their technical analysis on channel lines will often attempt to exploit that tendency.

Sample channel lines

Part 8: Timeframes

The timeframe refers to the type of chart you are analyzing. For example, if you are analyzing an hourly chart, you are looking at prices over each hour. However, for technical analysis purposes, your hourly chart might cover several days, weeks or even months. You will simply have a price point at each hour to analyze. This is the way in which an analyst can look at the FOREX market and identify long-term trading opportunities.

It is often recommended that you study long-term timeframes first and then move to short-term timeframes as you get deeper into your analysis. On long-term charts, you are going to see less movement, so there will be less to distract you. As you move closer to the minute charts, you will start to see a lot of movement and you will have more information to study. When you have studied all of these charts, you will be able to determine your point of entry into the FOREX market. The more you study, the more precisely you can find your entry.

Part 9: Types of Traders Who Use Technical Analysis

There are many types of traders who use technical analysis. You won't know which kind of trader you are until you really get started trading on FOREX. Some strategies you will not feel comfortable with, as there is a lot of risk involved. You might become comfortable with these strategies at some point, but if you are looking just to get your feet wet, you will want to start out with a conservative strategy to hone your skills. Here are some of the types of traders who use technical analysis.

1. Trend Traders

These are traders who try to purchase a currency that is on the rise. They hold onto the currency until it starts moving downward. Then they sell it. If you are this kind of trader, you won't have to spend a lot of time managing your trades. You simply ride out the trend, which could last for days, weeks or even years. Your profits, however, are limited in the short-term.

2. Day Traders

These are traders who want to take advantage of small fluctuations in price. You have to be actively monitoring your account at all times and you must pay close attention to patterns and indicators. You can make significant profits quickly as a day trader, but you can also lose a lot of money quickly as well.

3. Range Traders

These are traders who are most comfortable trading between areas of support and resistance. They want to exit before a breakout and they usually put stop orders just outside of support and resistance so they can't lose too much money if a breakout does occur. You aren't going to make a boatload of cash as a range trader, but you also don't have to worry about technical analysis as much either.

4. Mean Reversion Traders

These traders use statistical tools to predict whether a price is too far away from its average and therefore, likely to return to it. These traders use Bollinger Bands extensively to calculate standard deviations. They trade on the likelihood that a price always returns to its average price.

5. Pullback Traders

These traders analyze various indicators and use various methods to make their trades. Basically, when a price sends a currency to a new high, the price generally pulls back a bit before going higher. The pullback trader buys the currency with the intent to sell it after the price moves back toward the current trend.

6. Breakout Traders

These traders are looking for potential breakouts so that they can take advantage of low-risk entries in exchange for potentially high profits. This type of trading is extremely popular because you can analyze charts for potential trades well in advance of making your trade. You can place buy or sell stop orders early and you don't have to keep constant vigil over your currencies.

Part 10: Fibonacci Retracements

Technical analysts use Fibonacci retracements to predict the length of corrections during a trend. They are expressed in percentage values, which 38.2%, 50% and 61.8% being the most popular retracement levels for FOREX trading.

Fibonacci retracements are named after the mathematic sequence that was discovered by a 12-century mathematician named Fibonacci. The sequence has been found in numerous situations in nature and essentially says that each successive number is the sum of the two numbers before it. So, in a sequence 1,1,2,3,5, it would mean that 1+1=2, 1+2=3, 2+3=5 and so on. Any number is about 1.618 times the number before it and 0.618 times the number following it. Also, if we divide any number by the number that is found two places to the right, we get a ratio approximate to 0.382. This is where the percentages 38.2 and 61.8% come from.

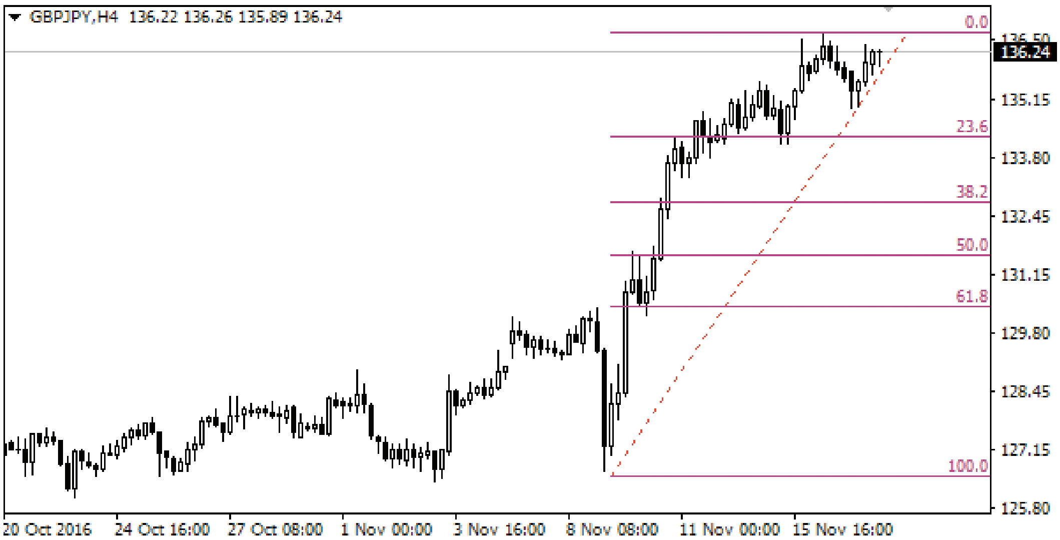
Since FOREX is the biggest market in the world, it is the market that comes closest to operating as a natural mechanism. Therefore, the way it behaves can be explained by laws that work in other natural situations. For this reason, Fibonacci retracements work well in technical analysis. The larger currency movements are naturally going to be followed by corrections of 38.2%, 50% or 61.8%.

Currency prices will retrace a minimum of 38.2% in a strong trend. In a weak trend, corrections may trace as far as 61.8%. The 50% retracement level is the most commonly monitored level and is where many traders buy during uptrends and sell during downtrends.

To draw Fibonacci retracements, you will want to calculate the pip distance between several recent high levels and low levels. Then find the percentage of this distance that corresponds to each retracement level. For example, if you have measured the pop distance at 200 pips, 38% of 200 would be 76 pips, 50% of 200 would be 100 pips and 61.8% of 200 would be 124 pips. Then subtract those pip numbers from the high point for an upward move or add them to the low point for a downward move.

Traders use Fibonacci retracements to either add to their current trade or to start new trades based on the current underlying trend. When analyzing charts, you can see when prices become either overbought or oversold, which tells you a correction is imminent. There is a high chance that when the price starts to correct, it will stop at one of the Fibonacci retracement levels. This gives you a fairly low-risk trading opportunity that has the potential for huge rewards.

Most FOREX traders use a combination of technical analysis tools and Fibonacci retracements to confirm their predictions. When more than one indicator is telling you the same thing, you will want to listen and make your trade.



Sample Fibonacci Retracements

Part 11: Benefits of Technical Analysis

Traders who trade solely on technical analysis believe that there is no way to reliably trade on news the way that fundamental analysts attempt to do. The reason they think this is because the market moves quickly and that any news that comes out will be reflected on the charts, so ignoring them is a huge risk. Fundamental analysts believe that technical analysts are behind the times because they are analyzing what has already happened instead of what will happen. They believe that the news is the only thing that moves the market. It is up to you to decide which camp you fall into; however, here are some benefits of using technical analysis to make your trades.

First, you will be able to pinpoint entry and exit points, which is difficult to do if you are simply waiting for news to be announced. Analyzing charts will allow you to identify trends at the same time as other traders, since everyone is watching the same data. This means that because of the large number of FOREX traders that are analyzing the same information, they can actually create a self-fulfilling prophecy by making prices go in a certain direction.

Charts and indicators are not some kind of fad. They have been around since FOREX began and traders have been using them to make profits for that entire time. If they didn't work, it would have been discovered long ago. Not only that, anyone can learn to read charts, which means you can learn to read them and trade off of them too. In fact, you can use charts to plan your profits and losses with more accuracy than you can if you trade on news alone.

No matter what, you still need to pay attention to other signals that could affect a trend. Charts are providing you with lagging indicators, so you should never rely completely on the assumption that the current price of a currency is going to tell you what the future price will be. That will often be the case, but it doesn't always happen that way.