Technical analysis explained – II

In the last article, we saw how technicals are helpful in identifying profitable opportunities and some simplistic rules were listed. In this piece, I would want my readers to upgrade their skills and know about a few common patterns which are reliable indicators in making price forecasts. If a market player is to keep these patterns in mind, one's profitability can simply be multiplied by a factor of 3 overnight !!

Patterns indicate three phases in the market movement – breakout (beginning of a bull run), continuation patterns (which confirm the ongoing up / down trend) and exhaustion patterns (indicate end of the trend). Readers may note that charts in 2003 showed many breakout patterns when the bull market began in earnest. Currently, we see a lot of continuation patterns as bull markets unfold. Though we are yet to near the end of the bullish trend, I would still want readers to know how to spot signals of trend exhaustion. Forewarned, as they say, is forearmed.

Breakout patterns –

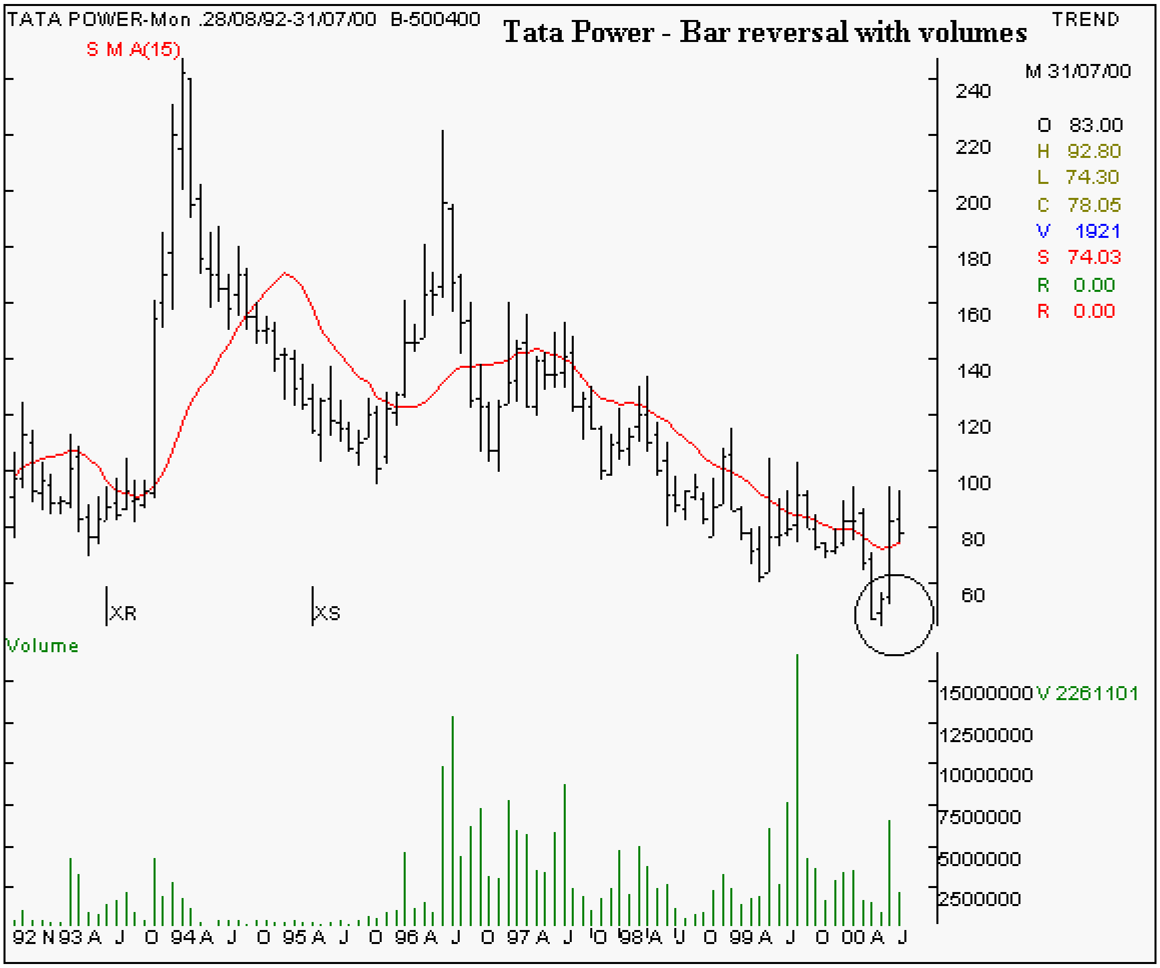
Gaps

Gaps are the first sign that the markets are attempting to break free from the lethargic sideways / downward moves. Invariably, a gap up opening will be an early indicator of a bullish pattern evolving. Traded volumes will show unusual activity as stock prices rally against gravity on buying by informed circles. As momentum builds up, the rally advances with bigger moves. Gaps are of three types – breakaway gaps (beginning of the uptrend), continuation gaps (trend confirmation) and exhaustion gaps (stock prices making their final attempt to rally against gravity / profit taking.

Bar reversals

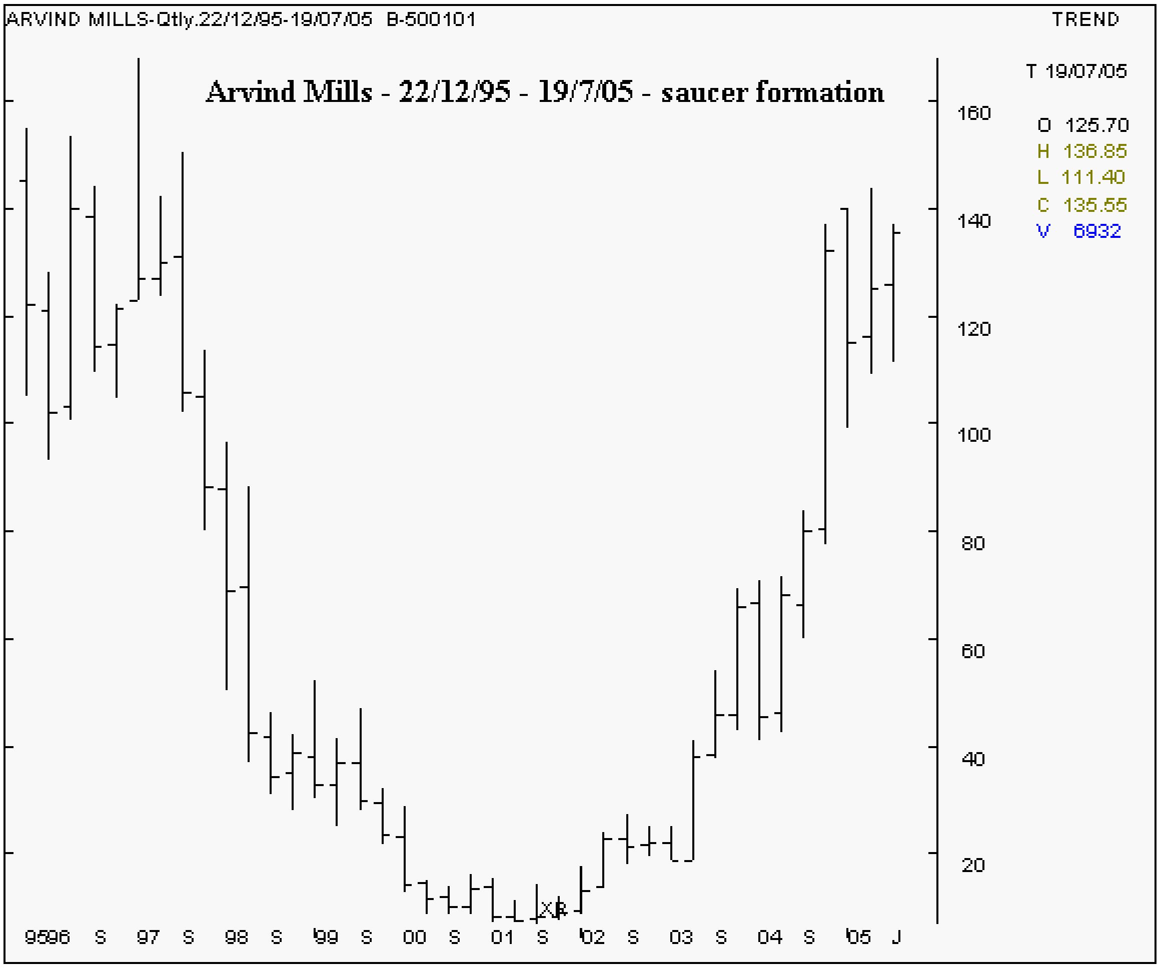
As the name suggests, it is a classic reversal pattern. The validity of the bar reversal can be gauged from the duration of the trend **prior** to the bar reversal. If there is a reversal after a prolonged fall, a long tern bearishness maybe ending and therefore a major upmove can be anticipated. A bar reversal is signaled when the closing tick of the trading bar is against the main trend. For example – a bear market is in progress and lower tops and bottoms are in formation. Markets open near / below previous close and close even lower everyday. A bar reversal is signaled when the intraday low is a new significant low point of the range and the closing is higher than the opening. The higher the closing to the intraday high, the move valid is the pattern. Traded volumes play an important part in bar reversals. The bulls and bears fight for domination and bears attempt to beat down prices, bulls on the other hand refuse to give up and continue to buy. A large churning can take place and traded volumes will spiral higher. Bar reversals are often early signs of a bull / bear market emerging.

Inverted head & shoulders – as the name h&s suggests, the price movement resembles a head flanked by shoulders along a neckline. The noticeable thing is that the pattern is inverted and must be formed after a significant fall. As a reversal pattern, I would rate this indicator as the most powerful indicator of all. Volumes play a very large part of a valid inverted h&s and must rise with the prices to sustain the uptrend. One of the most dangerous mistakes that a trader can make is to pre-empt a h&s formation and get caught on the wrong foot ! Let the pattern evolve and initiate a trade with confirmation of the neckline piercing is received.



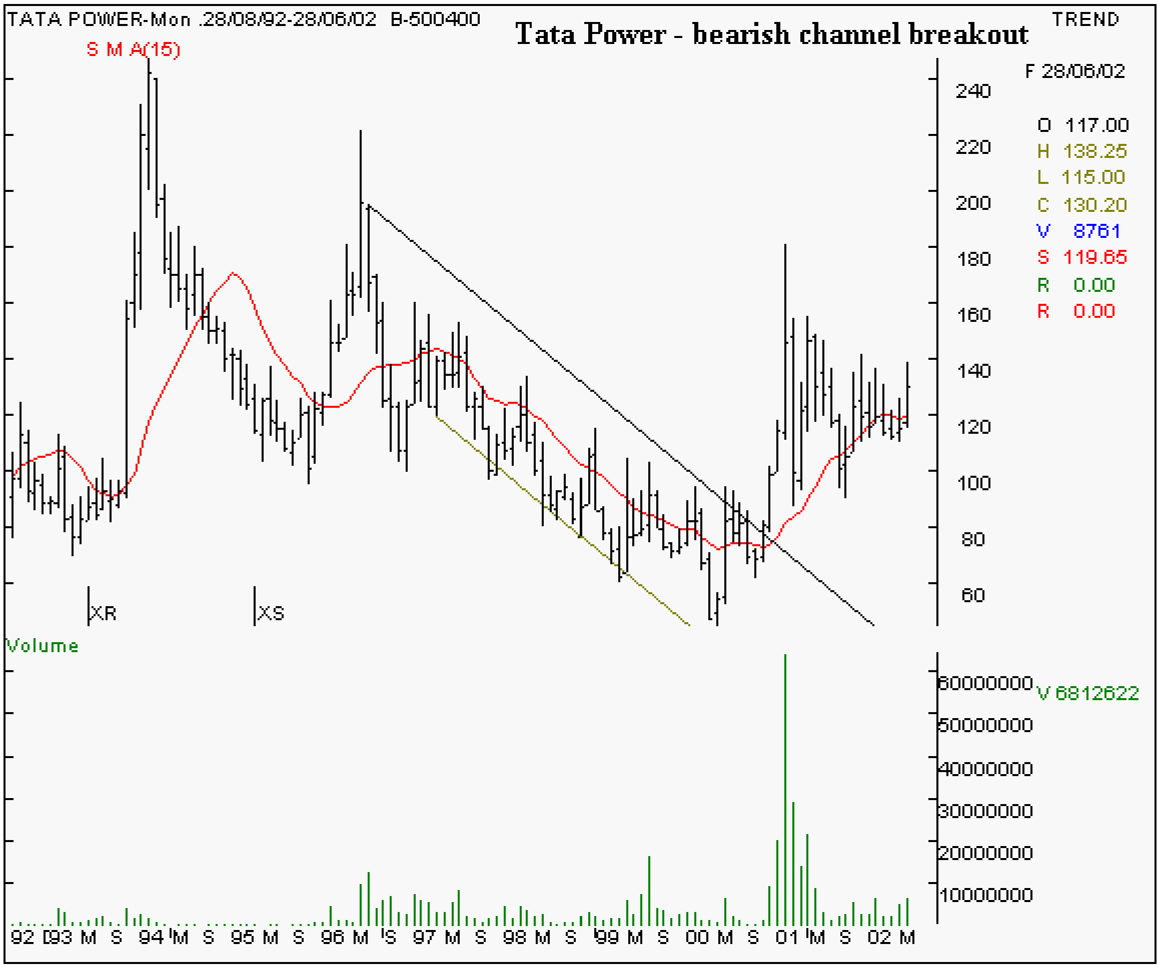
Rounding bottoms / saucer formation –

This pattern resembles a semi circle / saucer and therefore the name – saucer formation. After a prolonged fall, the chart shows a bottoming out and that too with lower volumes. Trader activity is low and any concerted effort by bears to hammer prices lower will fail. During the down move of the saucer, lower tops and bottoms will be seen, during the bottoming out, lateral movement (probably with short term channels / rectangles) will be seen. On the right hand side (rising / breakout formation, volumes will rise and the price will spurt past many weeks' highs. A slight pullback maybe seen as short term traders lock in profits, only to regret as the uptrend continues with renewed vigour. It should be noted that many stocks currently display a saucer formation.



Trendlines – these are the simplest indicator and a traders best friend. As the name itself suggests, these are lines that are derived from connecting tops (to forecast resistance levels) and bottoms (to forecast support levels). The most important thing to remember about trendlines is their duration. The longer the duration of a trendline without it being violated, the more is it's validity. For example, a trendline drawn on daily charts and spanning a fortnight is not as affective as a trendline drawn on a weekly chart and spans 8 weeks !! Once a trendline is drawn, it has room for modification as the markets are not perfect and a proper trendline is the one which covers as many tops / bottoms as possible. A trader should stick to his long / short position as long as a trendline is not violated. In a breakout trendline for example, the lower tops and bottoms formation will see a sudden reversal as prices breakout above the falling trend trendline. Traded volumes will be higher and the upmove gathers momentum.

Channels – these are simple formations where two parallel lines can be drawn and within which the scrip moves. As with a trendline, the longer the duration, the more significant is it's validity. A breakout above / below a channel with high volumes signals a breakout / breakdown in the direction of the underlying security. A channel is useful for traders and investors alike. Traders can buy at the lower trendline and sell near the upper trend, short at the higher end and go long again at the lower trendline. Investors can buy once a breakout / breakdown as the case maybe. The longer the duration of the channel, the higher will be the price swing in the security.



Now that you have mastered some of these rudimentary yet effective techniques, discipline and dedication is needed in avoiding temptations to pre-empt the pattern and act only **after** the pattern is confirmed by a breakout / breakdown is achieved. Many a profitable trade has turned into a disaster because the trader succumbed to the temptation of taking a short cut to profits. Then again the wisdom of keeping stop losses cannot be emphasized enough. Next piece will discuss continuation and exhaustion patterns.

Till then, have a profitable day !!

Vijay L Bhambwani
Ceo – Bsplindia.com

The author is a Mumbai bases investment consultant and invites feedback at Vijay@bsplindia.com or (022) 23400345 / 23438482.