A TECHNICAL APPROACH TO TREND ANALYSIS

Practical Trade Timing for Enhanced Profits

MICHAEL C. THOMSETT

A Technical Approach to Trend Analysis

This page intentionally left blank

A Technical Approach to Trend Analysis

Practical Trade Timing for Enhanced Profits

Michael C. Thomsett

Publisher: Paul Boger
Editor-in-Chief: Amy Neidlinger
Executive Editor: Jeanne Glasser Levine
Operations Specialist: Jodi Kemper
Cover Designer: Alan Clements
Managing Editor: Kristy Hart
Senior Project Editor: Betsy Gratner
Copy Editor: Deadline Driven Publishing
Proofreader: Chuck Hutchinson
Compositor: Nonie Ratcliff
Manufacturing Buyer: Dan Uhrig

Publishing as FT Press
Old Tappan, New Jersey 07675

Printed in the United States of America

First Printing July 2015

ISBN-10: 0-13-419065-3
ISBN-13: 978-0-13-419065-5

Pearson Education LTD.
Pearson Education Australia PTY, Limited
Pearson Education Singapore, Pte. Ltd.
Pearson Education Asia, Ltd.
Pearson Education Canada, Ltd.
Pearson Educación de Mexico, S.A. de C.V.
Pearson Education—Japan
Pearson Education Malaysia, Pte. Ltd.

Library of Congress Control Number: 2015939508

Contents

Acknowledgments

Many thanks to all of the excellent staff at Pearson Education and FT Press, notably Executive Editor Jeanne Glasser Levine, whose long-time support for this and many other projects means so much; also thanks to Editor-in-Chief Amy Neidlinger, Managing Editor Kristy Hart, and a special note of deep thanks to Betsy Gratner, Senior Project Editor, who worked closely with me during production. Finally, I extend my gratitude to all of the readers who have written to me with expressions of appreciation for the books I have written with FT Press.

About the Author

Michael C. Thomsett is the author of more than 80 books, including many FT Press projects (*Profiting from Technical Analysis and Candlestick Indicators, Stock Profits: Getting to the Core*, *Put Option Strategies*, *The Options Trading Body of Knowledge*, *Options Trading for the Conservative Investor*, *Options Trading for the Institutional Investor*, and *Trading with Candlesticks*). He also has written several other books on the topics of technical analysis, candlesticks, and options trading. Thomsett is the cofounder of the education site ThomsettOptions.com, where he publishes articles on the topics of fundamental and technical analysis, chart reading, and more. He is a frequent speaker at investment and trading conventions and trade shows, and he teaches several classes for Moody's and the New York Institute of Finance. Thomsett lives in Nashville, Tennessee.

Introduction: Defining the Trend

Efficiency or randomness? What defines the market?

Experienced professional traders realize that the market is neither efficient nor random. Even the Dow Theory, the basis of traditional technical analysis, does not agree on identification of changes in primary trends. The meaning of trends is debated endlessly among technicians. Is a change in direction a new primary trend, a secondary trend, or merely a retracement? The debate is ceaseless and there appears to be more disagreement than agreement on the basic question of how trends behave.

In this uncertain trading environment, how do professional traders manage effectively? This book offers methods for trend analysis based on a few sound principles. These include the essential observation of the trading range; reversal, continuation, and consolidation; confirmation methods; gaps; and non-price signals confirming or forecasting changes in the current trend.

Every experienced trader who relies on a short list of reversal and continuation signals, who understands how chart analysis is performed, and who wants to recognize changes in the price pattern already understands how uncertain a trend can be and how difficult it is to quantify signals in the moment. Every trader deals with conflicting and contradictory signals and may easily overlook the larger picture of movement in the trend.

These movements may be simplified and classified as reversal, continuation, or consolidation. However, this identification is never 100 percent clear or precise. Experienced traders may not be certain about the current status of individual stock trends, even with an advanced level of knowledge. And those who do know also understand that the current status of a trend is likely to change at any moment. A trend in an individual stock is likely to be easier to track and predict than a trend in an index. The index contains many different stocks, so the trend is itself the sum of net increases and decreases in price levels for all of the components. Furthermore, the index itself, such as the Dow Jones Industrial Average—the favorite gauge of the market—may be weighted so that a few stocks account for a large portion of a total trend movement.

This makes trends of indexes less certain. Even though many stocks track the market closely, this book focuses on individual stock trends. In these cases, it is more reliable to associate trend activity with both fundamental and technical causes and responses.

This book is intended as a serious study of trends for experienced investors and traders. These individuals know how trends behave but also need to solidify the analytical tools for trend analysis. There are no simple answers to predicting trend direction, strength, or duration. However, specific tools technicians favor can be used in combination to anticipate trend reversal or continuation, and to confirm those moves.

Chapter 1, "The Theory of Trends—Dow, EMH, and RMH in Context," reviews the basic theories about trends and examines whether or not those theories offer reliable intelligence traders can use to time entry or exit. Chapter 2, "Statistically Speaking—Trends by the Numbers," expands that discussion by introducing statistical observations traders might use to improve accuracy of both trend analysis and price pattern analysis. Chapter 3, "Resistance and Support—A Trend's Moment of Truth," provides in-depth analysis of how resistance and support play an essential role in trend analysis and how these trading range borders may be used to test the strength of the trend. Chapter 4, "Trendlines and Channel Lines—The Shape of Things to Come," expands on the discussion with a study of trendlines and channel lines.

Chapter 5, "Reversal Patterns—End of the Trend," and Chapter 6, "Continuation Patterns—A Bend in the Trend," are exhaustive studies of reversal and continuation patterns, and Chapter 7, "Confirmation Signals—Turning the Odds in Your Favor," provides the same in-depth analysis of confirmation. In Chapter 8, "Consolidation Patterns—The Sideways Pause," the nature of consolidation is examined and its effect on trends. Chapter 9, "Volume Signals—Tracking Price Trends," takes a look at volume. In Chapter 10, "Mind the Gap—When Price Jumps Signal Change," gaps describe how trend movement can be anticipated in the near future and how these might be revealing or confusing. Chapter 11, "Moving Averages—Order in the Change," examines the role of loving averages and how these impact and anticipate changes in trends. In Chapter 12, "Momentum Oscillators—Duration and Speed of a Trend," momentum oscillators are examined and how they affect not only price, but also the larger trends. Chapter 13, "Volatility—Marking Risk within the Trend," addresses the topic of volatility in the trend, and Chapter 14, "Fundamentals—Connecting the Two Sides," shows how fundamental trends contribute to technical trends. Wrapping up the entire discussion, Chapter 15, "Overview—Putting It All Together," puts together multiple indicators to track how trends continue and change over time.

A distinction has to be made throughout this book between price patterns and trend attributes. The study of price charts is normally focused on short-term trends and likely reversal or continuation. This is based primarily on patterns found in candlestick charts or in application of well-known technical signals. The key here is that price analysis is short term. However, beyond those day-to-day and week-to-week analyses and swing-trading decisions, the longer-term trend might be revealing in many more ways than the price trend can possibly provide. For example, in a short-term price trend, assumed levels of resistance and support and, most notably, violations above resistance or below support, often are used as the basis for timing of trades. And in fact, movement through these all-important price levels is invariably the point at which reversal or continuation signals have the greatest meaning. However, there is a problem in basing decisions on resistance and support that are short term in nature.

These levels may exist momentarily, but the bigger picture is found in how resistance and support provide structure for a longer-term trend. In terms of technical trading, this can mean a matter months rather than of days or weeks. However, the reliable identification of resistance and support (as well as other trend attributes) becomes reliable only when the chart looks at this bigger picture. So, a few standards are applied in this book with these concerns in mind. First, analysis of trends is focused on individual stocks and not as much on index or marketwide movement. Second, trends are studied as longer-term (three months or more), a departure from the swing-trading approach based on price patterns and identification of reversal signals as a primary signal. The degree to which reversal and continuation signals are analyzed is based not on the immediate price pattern, but on how the trend behaves over time. The concept here is that traders expect short-term price movement to be chaotic and fast, but longer-term trends often are far more reliable in terms of where prices are heading. This is reflected in the trend and articulated by the technical analyses described in upcoming chapters.

Even though nothing can ever be 100 percent certain or clear, the tools presented in this book will help to improve confidence in timing of trades and also in longer-term decisions to buy, hold, or sell shares of stock. The quantification of "confidence" may be described as existing between 50 percent (random likelihood of a trend moving upward or downward) and 100 percent (certainty of what will occur next). The study of a trend will always fall somewhere in between these levels, never quite falling to a completely random 50 percent, and never rising all the way to 100 percent. However, in that range, you will be able to define confidence in degrees that help manage a portfolio of equities and to determine levels of risk. For trend analysis, risk can be defined as a level of confidence in the current policy. For example, if you hold stock that has appreciated over several months, where does your confidence reside today? Is the trend continuing or leveling out? What do these patterns mean in terms of confidence?

This theory of portfolio management—basing concepts of risk on levels of confidence in the current trend—might help you improve timing not only of entry, but also of exit from a current position. This can be thought of not as swing trading in the short term, but of risk management for the long-term portfolio. It all relies on the trend.

Index of Topics

I-J-K

L

M-N

O

P-Q

R

S

T-U

V

W-X-Y-Z

Index of Companies

E

F

G

H

I

J

K

L

M

N

O-P-Q

R

S

T

U

V

W-X-Y-Z