Technical Analysis

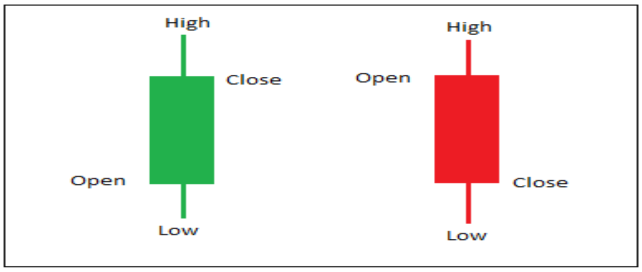
What Is Technical Analysis

Technical analysis is a trading discipline employed to evaluate investments and identify trading opportunities by analysing statistical trends gathered from trading activity, such as price movement and volume. Unlike fundamental analysis, which attempts to evaluate a security's value based on business results such as sales and earnings, technical analysis focuses on the study of price and volume.

Main Segments of Technical Analysis

The main concept of technical analysis deals with the reading of stock charts or the price action of a particular stock. To perform chart reading, several tools or techniques are used. Some of them are "**Candlesticks**", "**Resistance and Support**", "**Trendline Theory**", "**Price Patterns**", "**Fibonacci Theory**", "**Gap Theory**", "**Technical Indicators**" etc. Now let's understand them a bit more deeply.

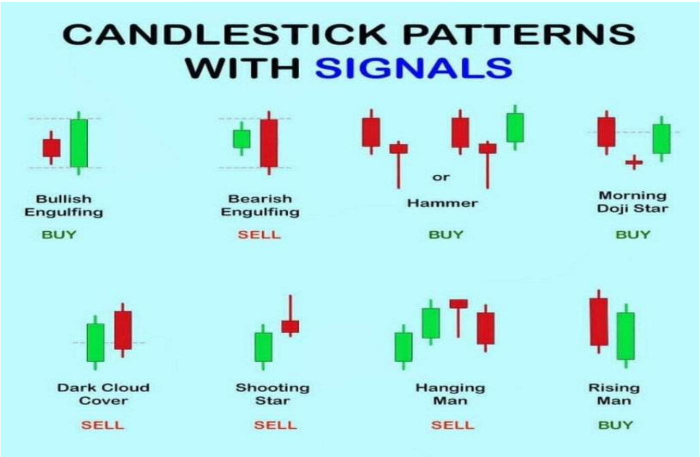
Candlesticks:



A candlestick is a type of price chart used in technical analysis that displays the high, low, open, and closing prices of a security for a specific period. It originated from Japanese rice merchants and traders to track market prices and daily momentum hundreds of years before becoming popularized in the United States. The wide part of the candlestick is called the "Real Body" and tells investors whether the closing price was higher or lower than the opening price (black/red if the stock closed lower, white/green if the stock closed higher).

Depending upon the price movement there are a several types of candlesticks. Some of them are mentioned below.

Bullish/Bearish Engulfing, Doji, Hammer, Inverted Hammer, Shooting Star, Hanging Man, Bullish Harami, Harami Pattern etc.



These candlesticks are the basics of price reading.

Resistance and Support:

The concept of trading level support and resistance are undoubtedly two of the most highly discussed attributes of technical analysis. Support is a price level where a downtrend can be expected to pause due to a concentration of demand or buying interest. As the price of the stock drops, demand for the shares increases, thus forming the support line. Meanwhile, resistance zones arise due to selling interest when prices have increased.

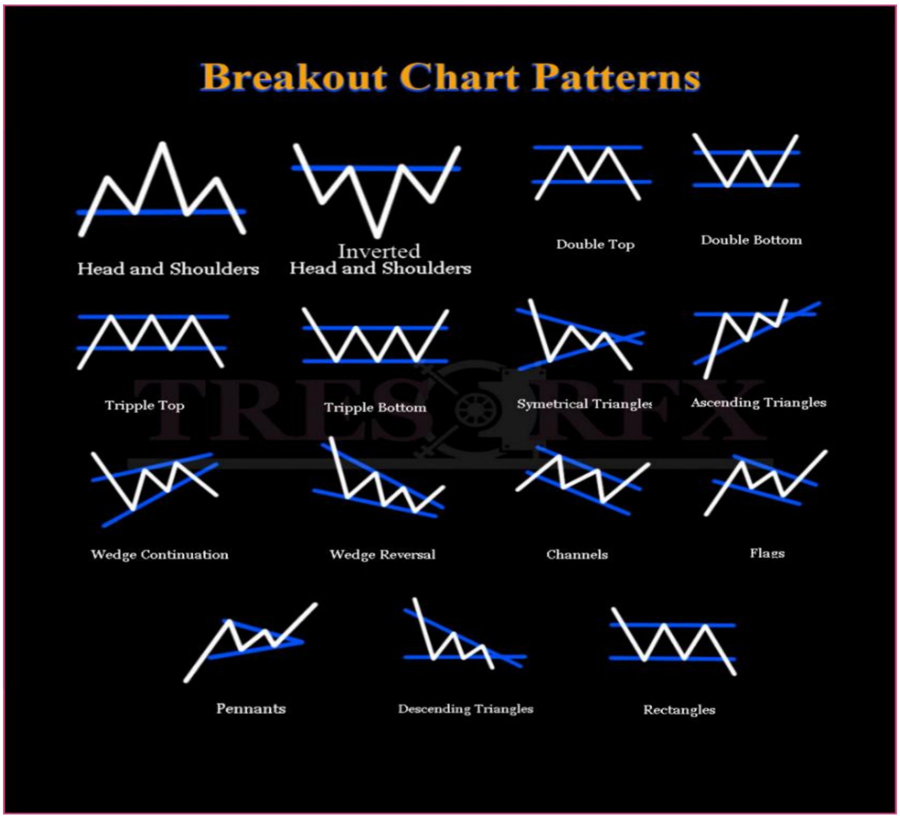
Trendline Theory:

Trendlines are easily recognizable lines that traders draw on charts to connect a series of prices together or show some data's best fit. A trendline is a line drawn over pivot highs or under pivot lows to show the prevailing direction of price. Trendlines are a visual representation of support and resistance in any time frame. They show direction and speed of price, and also describe patterns during periods of price contraction.

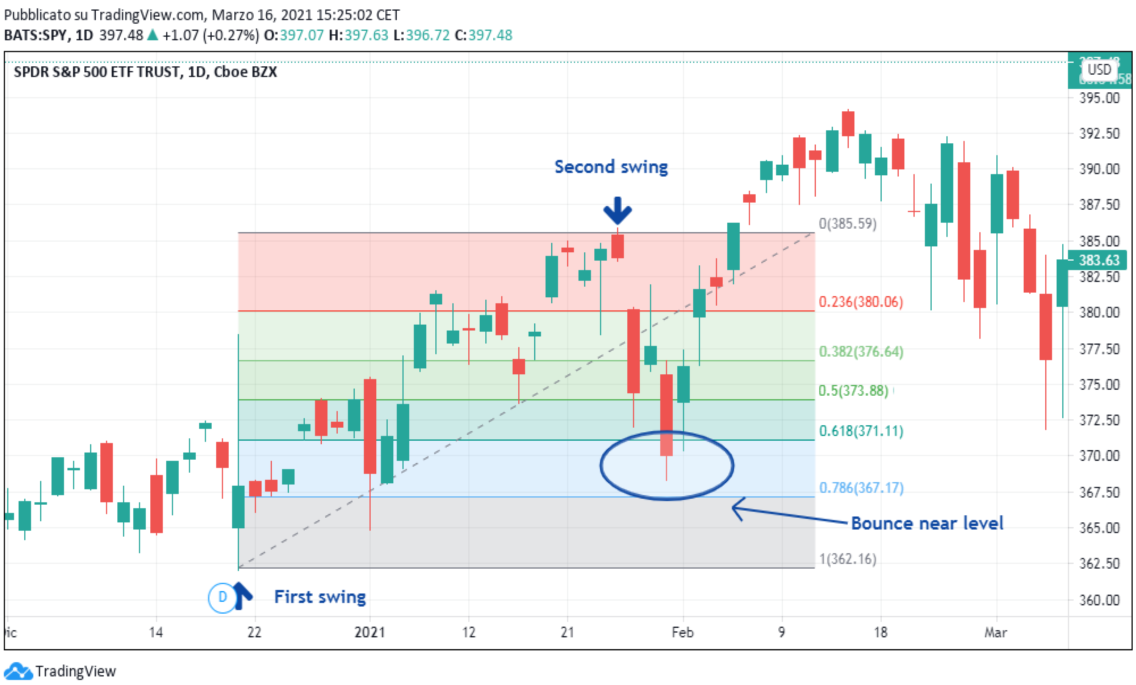
The difference between Trendline and channels (Support and resistance) is that More than one trendline can be applied to a chart. Traders often use a trendline connecting highs for a period as well as another to connect lows in order to create channels. A channel adds a visual representation of both support and resistance for the time period being analysed. Similar to a single trendline, traders are looking for a spike or a breakout to take the price action out of the channel. They may use that breach as an exit point or an entry point depending on how they are setting up their trade.

Price Patterns:

Price Patterns are some patterns which bare made up of multiple candlesticks combined together. These patterns help us to understand whether the price is looking Bullish or Bearish. Some of the most used patterns are “Double Top”, “Double Bottom”, “Triple Bottom”, “Triple Top”, “Cup and Handle”, “Inverted Cup and Handle”, “Head and shoulder”, “Inverted Head and Shoulder”, “Bullish Flag”, “Bearish flag”, “Rising Wedge”, “Falling Wedge”, “Pennant Pattern”, “Triangle Pattern” etc. All these patterns can be classified into two types which are Continuous Pattern and Reversal Pattern.



Fibonacci Theory:



Fibonacci retracement is a technical tool that consists of several retracement levels. These levels are horizontal lines that indicate where support and resistance are likely to occur. Each level is associated with a percentage. The percentage is how much of a prior move the price has retraced. The Fibonacci retracement levels are 23.6%, 38.2%, 61.8%, and 78.6%. While not officially a Fibonacci ratio, 50% is also used.

Fibonacci retracements can be used to place entry orders, determine stop-loss levels, or set price targets. For example, a trader may see a stock moving higher. After a move up, it retraces to the 61.8% level. Then, it starts to go up again. Since the bounce occurred at a Fibonacci level during an uptrend, the trader decides to buy. The trader might set a stop loss at the 61.8% level, as a return below that level could indicate that the rally has failed.

Gap Theory:

A gap is produced when on a particular day a certain stock at its lowest price is traded higher, compared to its highest price at which it was traded on a preceding day. In layman's terms, gap represents a price range at which (at the time it occurred) no shares changed hands.

Gaps occur because of underlying fundamental or technical factors. For example, if a company's earnings are much higher than expected, the company's stock may gap up the next day. This means the stock price opened higher than it closed the day before, thereby leaving a gap. Similarly, a stock breaking a new high in the current session may open higher in the next session, thus gapping up for technical reasons.

Gaps can be classified into four groups:

- **Breakaway gaps** occur at the end of a price pattern and signal the beginning of a new trend.
- **Exhaustion gaps** occur near the end of a price pattern and signal a final attempt to hit new highs or lows.
- **Common gaps** cannot be placed in a price pattern—they simply represent an area where the price has gapped.
- **Continuation gaps**, also known as runaway gaps, occur in the middle of a price pattern and signal a rush of buyers or sellers who share a common belief in the underlying stock's future direction.

Technical Indicators:

Technical indicators are heuristic or pattern-based signals produced by the price, volume, and/or open interest of a security or contract used by traders who follow technical analysis. By analysing historical data, technical analysts use indicators to predict future price movements. Examples of common technical indicators include the Relative Strength Index (RSI), Money Flow Index (MFI), stochastics, Moving Average Convergence Divergence (MACD), and Bollinger Bands. Although indicators are not necessary for proper price action trading. Depending upon trades the use of different indicators varies.

There are two basic types of technical indicators:

1. **Overlays:** Technical indicators that use the same scale as prices are plotted over the top of the prices on a stock chart. Examples include moving averages and Bollinger Bands.
2. **Oscillators:** Technical indicators that oscillate between a local minimum and maximum are plotted above or below a price chart. Examples include the Stochastic oscillator, MACD or RSI.

There are quite a number of indicators. Depending upon the person to person, different types of indicators are used by different people for chart reading purpose.

Question:

1. Why is Technical Analysis used?

- To analyse company's cash flow
- To do long term Investment
- For price action study
- None of the above

2. Are indicators necessary for technical analysis?

- Yes
- Occasionally
- No
- Varies from trader to trader