Technical Analysis for Forex Beginners

Understanding Charts and Trends

About ActionForex.com

ActionForex.com was set up back in 2004 with the aim to provide insightful analysis to forex traders, serving the trading community over a decade. We started providing only a daily and a mid-day report, now known as Action Insights. Gradually, we added a lot more in-house contents to the site. Techinical Outlook section was expanded to cover more pairs. Central Bank Views, China Watch and Special Topics are added to cover fundmental developments that affect the markets. In addition to that, Top Movers, Heat Map, Pivot Point Charts and Pivot Meters, Action Bias and Volatility Charts, are tools used by traders from all over the world.

"Empowering the individual traders" was, is, and will always be our motto going forward.

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I: Introduction

There are two major approaches to analyzing the currency markets, fundamental analysis and technical analysis. Fundamental analysis focuses on the underlying causes of price movements, such as the economic, social, and political forces that drive supply and demand. Technical analysis focuses on the studies of the price movements themselves. Technical analysts use historical data to forecast the direction of future prices.

The premise of technical analysis is that all current market information is already reflected in the price movement. By studying historical price movements, investors can make informed trading decisions. The following articles aim to give a thorough presentation of technical analysis tools and theories.

The primary tools of technical analysis are the charts. This ebook firstly introduces common types of charts available on charting softwares. Charts are used to identify trending and ranging markets. The ebook then continues to explain how to identify support and resistance levels, trend lines and price channels. Next, it presents simple trading strategies in trending and ranging markets.

II: What are Charts?

A chart is the most important tool for understanding what is going on in the market. Almost all traders today, particularly those who trade actively, use their favourite types of charts to analyze the markets. In the end, a chart is a visualized representation of the price movements, a reflection of the psychology of the market and a visualization of the interactions between buyers and sellers in the market. Because it is a reflection of all the activity that has taken place for a particular traded instrument, a chart also shows how the market values a particular asset based on all the information available. And because a chart has the potential to offer such insights and to accurately reflect the entire perspective of the market, it is an indispensable tool in the arsenal of any trader.

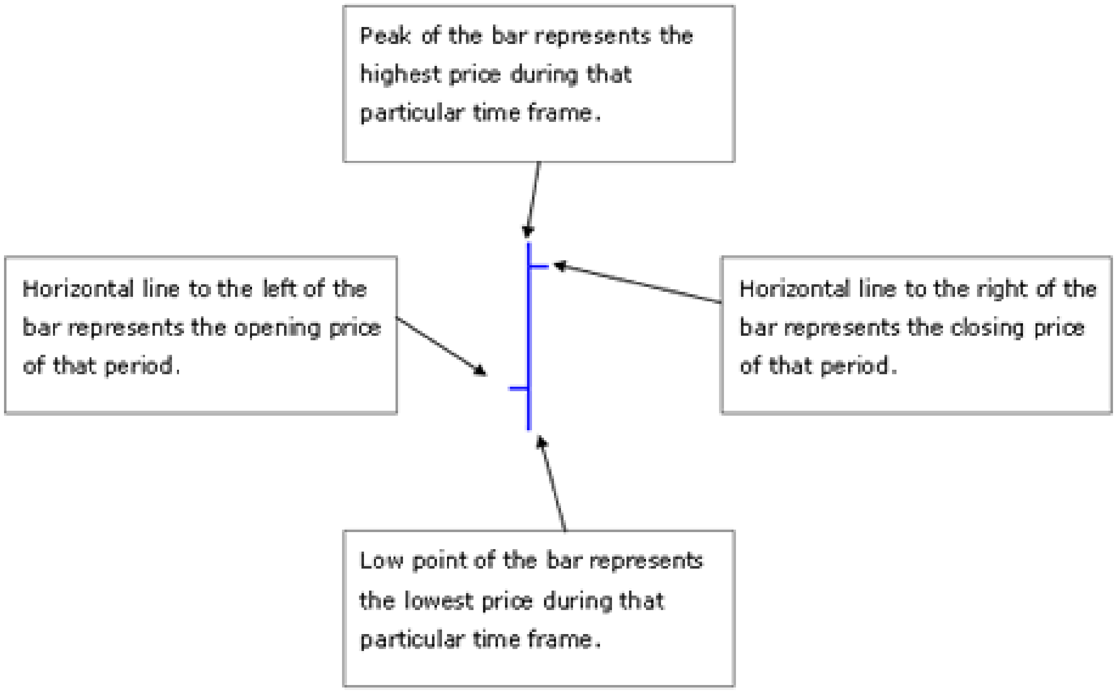
There are three major kinds of charts: bar charts, candlestick charts, and line charts. These charts are described below. Within the articles, we will use primarily candlestick charts, because they are the most commonly used charts amongst active traders.

Three major types of charts

1. Bar Charts

Bar charts provide traders with four key pieces of information for a given time frame: the opening price during that time frame; the closing price; the highest price; and the lowest price. Bar charts can be applied to all time frames, and hence a single bar can summarize price activity over the past minute or over the past month. Different traders use time frames in various manners, although a good rule of thumb is that the longer the time frame, the more significant it is as it will account for more data -- and hence will be a better reflection of the market's psychology.

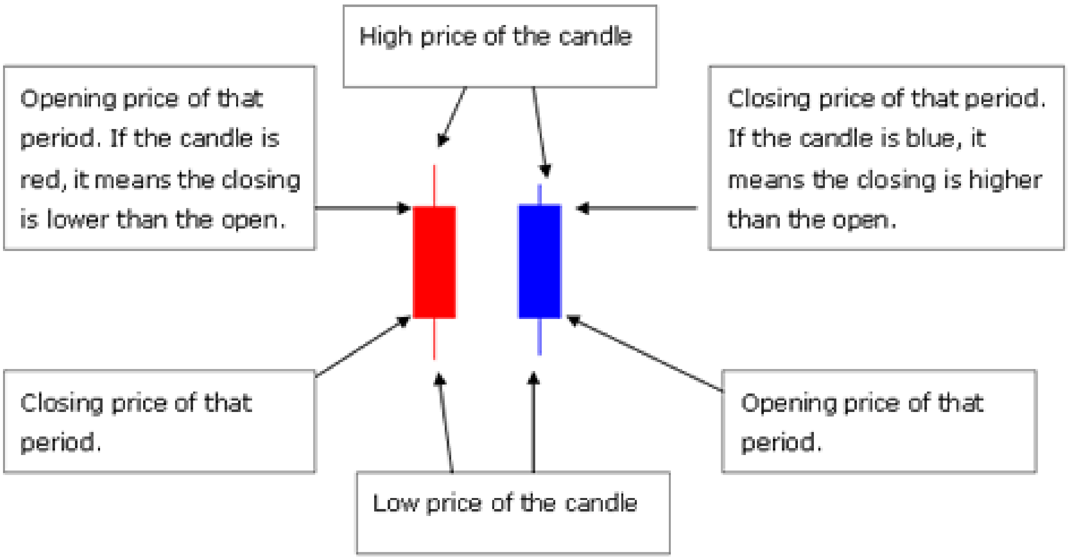
Below shows how a bar chart conveys information.



2. Candlestick Charts

The candlestick charts were invented by the Japanese in the 1700s. Just like a bar chart, a candlestick contains the market's open, closing, low and high price of a specific time frame. The main difference is the candlestick's body part, which represents the range between the opening price and the closing price of that particular time frame. When the body part is filled with red (or black), it means the closing is lower than the opening. When the body part is filled with blue (or white), it means the closing is higher than the opening. While the bar charts put more emphasis on the progression of closing price from the last bar to the next, while the candlestick charts put more emphasis on the relationship between the opening and the closing price within the same time frame. Above and below the candlestick's body are the 'wicks', while the wick on the top is the highest price and the wick at the bottom is the lowest price of that period. Candlestick charts are more popular than the bar charts and the line charts, because they tend to be more visually appealing.

Below shows a candlestick chart and its components.



3. Line Charts

Unlike bar and candlestick charts, line charts present much less information; they only show the closing price for a series of periods. As a result, line charts serve best to measure the overall direction of long-term trends, and hence are of limited used for most traders.

Below is an example of a line chart. Note how it clearly and simply shows the direction of the trend.

III: Support and Resistance

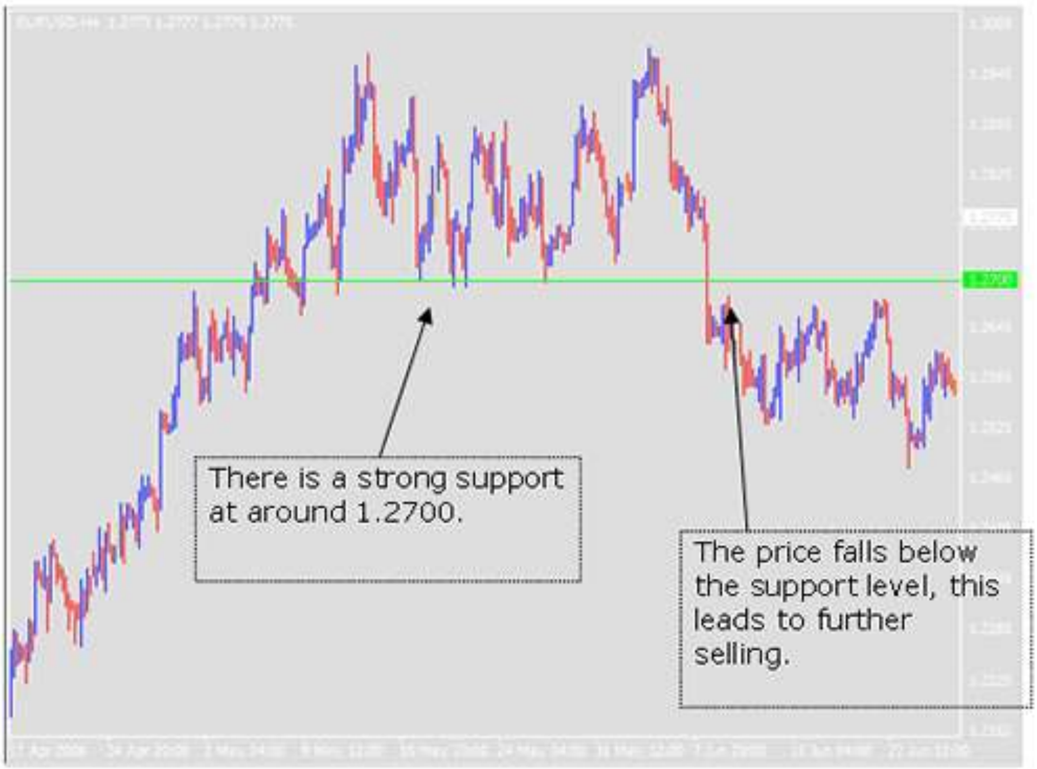
What are support and resistance?

Support levels are prices where buyers have shown or are likely to show strength. Resistance levels are prices where sellers are likely to be strong.

Support

Support levels essentially give the market a 'floor', since they are areas where buyers tend to be strong. If the price falls to a strong support level, traders should expect buyers to step in and drive the price up, or at least keep it from moving any lower.

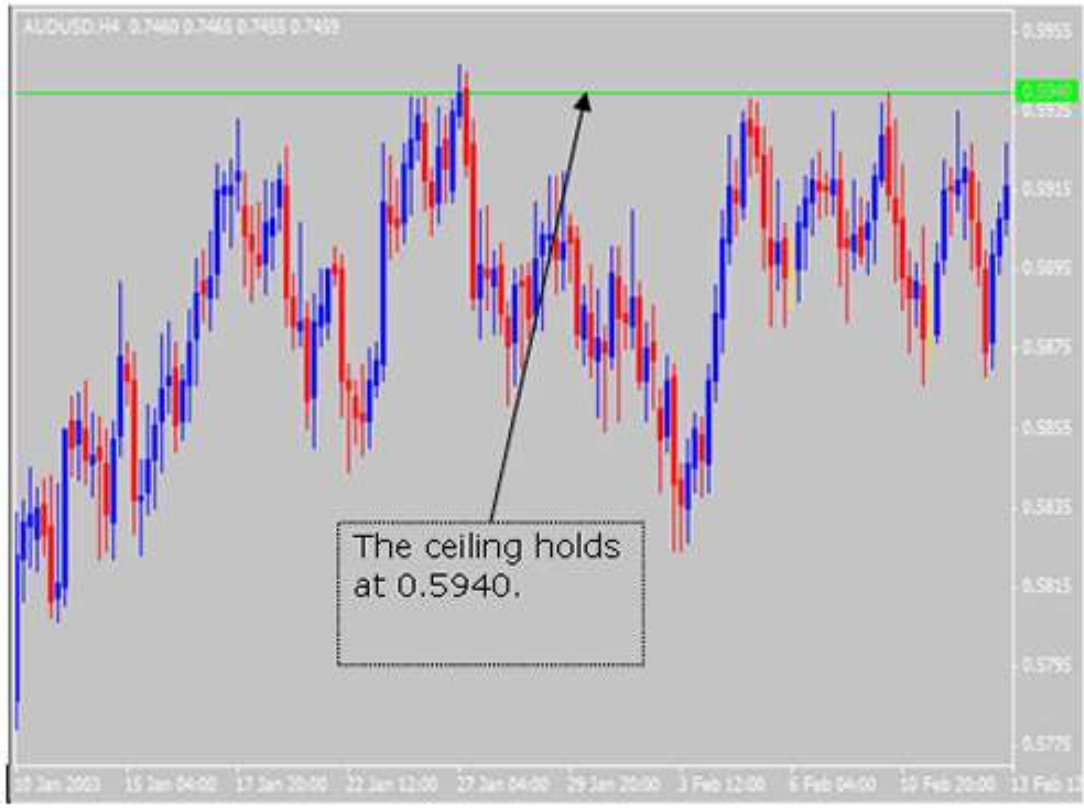
Because support levels are prices where buyings are supposed to be strong, if the price falls below a support level, this is an important signal of weakness. It shows that there is more selling pressure (or less buying) pressure than previously thought, and it often leads more traders to exit long positions and take short positions.



Resistance

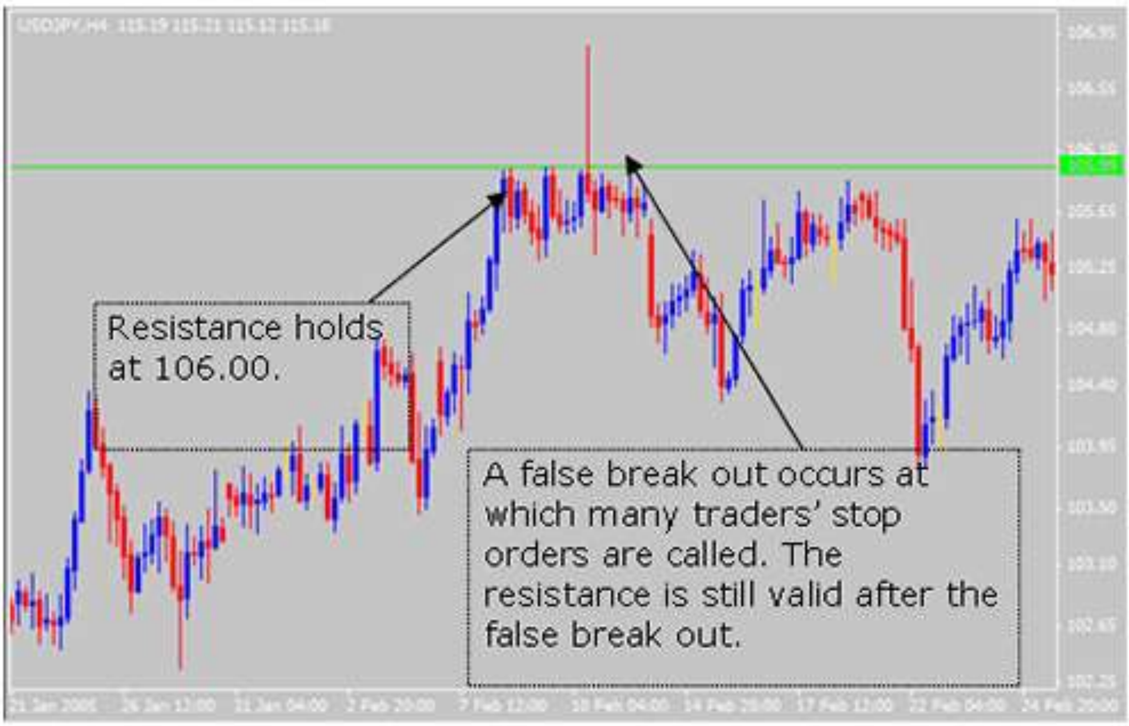
Resistance levels perform the opposite functions of support levels, which provide a 'ceiling' to the markets. If the price rises to a strong resistance level, short sellers should be expected to enter the market and traders in long positions may cover their positions to take profits. This combination of selling pressure will often drive the price lower.

Resistance functions in the same manner as a safety net for short positions and an entry point for traders looking to buy on a breakout.



When price breaks through a resistant level, it often triggers a large number of stop orders and makes for even greater buying power. Often the stronger the resistant level, greater the number of stops that are triggered and the larger the move above resistance.

Unfortunately, not every breakout is valid. Because they know that many traders place stops to sell just above resistant levels, some large institutional traders attempt to drive the price higher in the short term just to trigger these stops. Without any sustainable force behind the move higher, the price can fall back to below the resistance. The same risks of false breakouts apply to support levels as well.



IV: Identify the Market Trend

Three Phases of Major Trends

A trend represents a general direction of the market. Dow Theory asserts that major trends have three distinct phases: accumulation, public participation and distribution. The accumulation phase represents the first part of the trend in which those who are well-informed buy or sell. In other words, if the well-informed recognize that the recent downtrend is soon coming to an end, they would buy, and vice versa.

The public participation phase involves the masses following the major trend. This occurs as prices begin to accelerate rapidly and there is news supporting the trend.

The final distribution phase occurs as the news highly favors the current trend and speculative volume and public participation increase even further. At this point, the well-informed investors who accumulated when the market was at its peak (trough) begin to sell (buy) before other investors begin to follow suit.

A Trend Is Assumed to Be in Effect Until It Gives Definite Signals That It Has Reversed

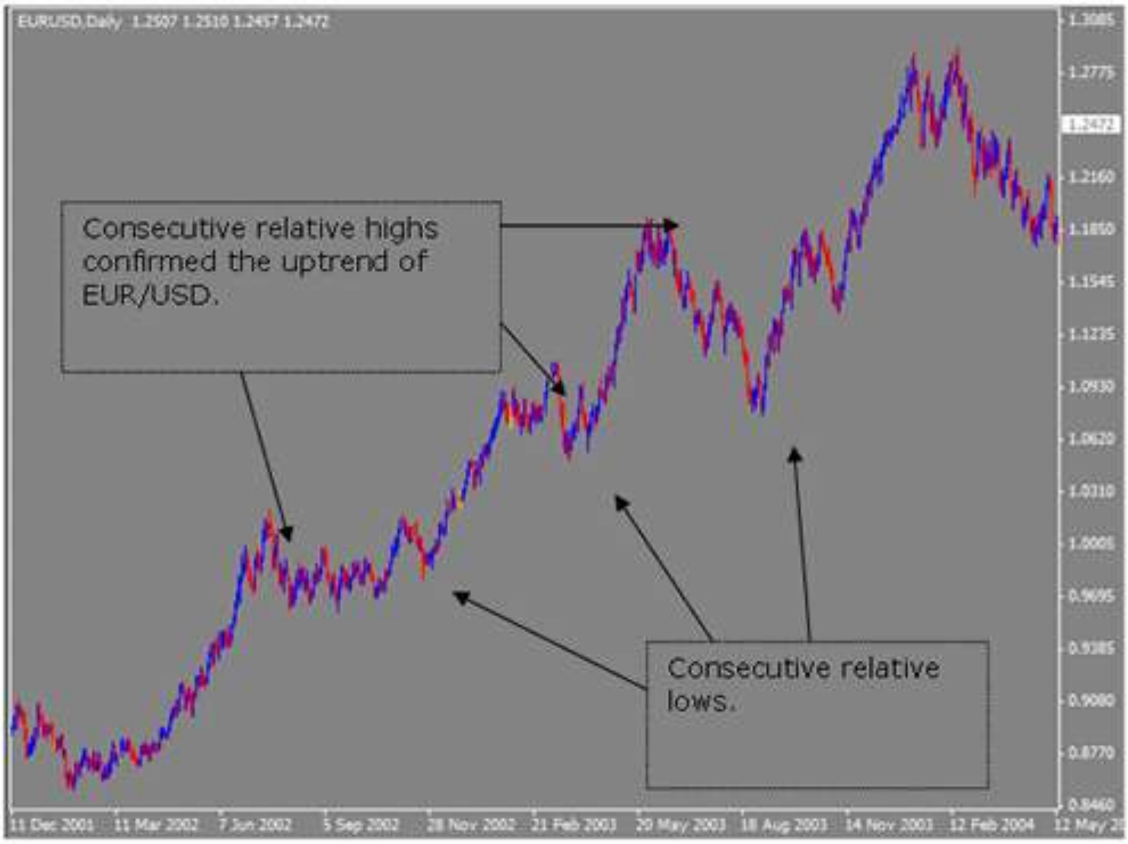
This is a major theory that essentially mirrors the physical law stating that an object in motion tends to continue in motion until some external force causes it to change direction. Relating that principle to price trends, a strong trend will tend to continue in its current direction unless there is a price reversal indication, as per technical or even fundamental analysis. The later sections will focus on learning to spot reversals in the market and how traders can place orders to take advantage of such reversals.

V: Trending and Ranging Markets

In Trending Markets

The existence of a trend in any market depends on a series of relative highs and lows. Two consecutive relative highs, each above the previous relative high, and two relative lows above the previous low would be constitute a tentative up-trend. A third relative high would confirm the trend.

The chart below illustrates a up-trend of EUR/USD:



The continuation of a trend depends on the successive rallies reaching a higher price than the previous ones. Traders can buy at relative lows and profit from the rest of the trend. Or traders can speculate the reversal of the trend and sell at relative highs. If an up-trend establishes a relative high and the subsequent rally fails to break through to a higher price, then the up-trend is in doubt. A series of decreasing relative lows would be necessary to determine that the market trend had reversed to a downtrend. More likely, the market will be range bound for a period.

In Range Bound Markets

Markets do not always move in trends. They spend a lot of time in ranges, fluctuating between established highs and lows. Often a range bound market is considered to have a sideways trend, since it is neither moving upwards to new highs or down to new lows. If the short-term trend is that of a sideways market, it is sometimes called a consolidation range. The price during a consolidation period is simply building up support for a continued move in the original direction. See the following chart:

VI: Trend Lines

What are Trend lines?

Trend lines are lines drawn on the historical price levels that depict general direction of where the marking is heading, and provide indications of support or resistance.

Drawing trend lines is a highly subjective matter. The best test of whether a trend line is a valid one is usually whether it looks like a good line. In an up trend, a trend line should connect the relative low points on the chart. A line connecting the lows in a longer-term rally will be a support line that can provide a floor for partial retracements. The down trend line that connects the relative highs on the chart will similarly act as resistance to shorter moves back higher.

Any two relative highs or lows will be on the same line, so it is possible to draw a tentative trend line between any two points. Traders can use tentative trend lines as an indication of where support or resistance might be, but until a tentative line holds as support or resistance, it is not yet confirmed as valid.

Of course, the more times a trend line holds, the stronger it will be in the future. If a single line can connect 4 or 5 relative lows, then the chances of the next pullback bouncing off the line are high.

The best trend line?

It is an unusual situation where three points on a chart will exactly coincide with a straight line connecting them. More often, prices will be close to a line, and a best-fit line will have to suffice. This is where trend lines become more art than science. Different traders may draw different trend lines given the same chart or even connecting the same series of relative low points.

Sometimes a trend line will have to be revised as new relative highs or lows appear. Even if the trend line is a very close fit between three or more points, it is important to be flexible and redraw trend lines when necessary.

Using High/Low or Close/Open

Often the differences in drawing trend lines depend on whether the high and low prices are used or whether the closing and opening prices are used to determine the line. On a candlestick chart, the question becomes using the wicks of the candlesticks instead of the solid bodies of the candles only.

Generally closing prices are more significant points than the intra-day prices on a chart, and if a trend line can be drawn using the body rather than the wick of a candle, the body should be used. Similarly, when drawing a trend line, an intra-day spike through a line should not automatically invalidate it. If there is a candle that closed below the trend line, though, it would be a much more serious breach of the line.

VII: Trading the Trend Lines

Only one of two things can happen when a price approaches support or resistance: the price can break through it, or it can bounce off and reverse direction. The same is of course true for trend lines.

1. Trading on a Pullback

If a chart is trending in a clear direction, and a trend line can be drawn connecting a series of relative highs or relative lows, trading opportunities exist when the price approaches the trend line. If the price bounces off the trend line and resumes the trend in the original direction, this can be an excellent opportunity to enter the market in the direction of the dominant trend. This is often referred to as buying on a pullback in an up trend or selling into strength in a downtrend.

Buying on a bounce off such a support line can be done through a limit order just above the support.

2. Trading a Break of the Trend

The second possible trade is the break of the trend line, which can be traded just as any other broken support or resistance line. If a candle closes through a trend line to the downside, as in the example below, the proper entry point would be to sell once the price moves below the low of the breakthrough candle.

This ensures that the short term force is in the direction of the break lower. The opposite would be true for a break above a resistance line.

VIII: Price Channels

A trending market can move between parallel support and resistance levels. A price channel between two parallel lines can often be drawn in a trending market. The key to a price channel is that the lines be parallel to each other. The value of the price channel in predicting the ongoing speed of a trend depends on the lines being parallel.

Unlike trend lines, which can be drawn on any chart with two relative lows or highs, price channels should not be forced on a chart where they are not quickly apparent. Once a trend line is established, create a duplicate parallel line on the chart. Then move it up to the relative highs above or down to the relative lows below the trend line. If two or more fit with the line, there may be a valid price channel. Otherwise, the market may simply be too volatile - even in the midst of a strong trend - to plot a channel.

In the above example the (support) trend line itself is valid, but creating a parallel line on the opposite side of the prices does not add any value to the chart and is not warranted by the data. Placing a support or resistance line where it does not belong will simply provide you with false signals to buy or sell.

IX: Conclusions

Technical analysis is one of the two major methods used in analyzing the forex markets, or any other financial markets. It's important for all forex traders to grasp the basics of technical analysis. And the basics start with knowing how to read charts, understanding the concepts of trends, and identifying trends.

We hope that the ebook serves well as an introductory guide to technical analysis for forex beginners. It's just a start. When you're ready, let's move on to other ebooks of the series for building your skill as a successful trader.

Trading is a journey, not a destination.