cornertrader

CHAPTER 1.3

Technical Analysis:
Trends, Support and Resistance

TECHNICAL ANALYSIS: TRENDS, SUPPORT AND RESISTANCE

Stocks are rising. Stocks are falling. If you watch or read financial news reports, you have seen or read people talking about stocks moving up and down. Of course, it is not the stocks themselves that are moving up and down but rather the prices of those stocks that are moving up and down. Stock prices change daily. Your job as a stock or CFD trader is to learn to identify where the price is going to go next.

Stock and CFD traders keep track of where stock prices have been in the past using stock price charts. By keeping track of where stock prices have gone, stock and CFD traders are able to more accurately project where stock prices are going to go in the future. This process of analysing past stock prices to determine future stock price movement is called technical analysis.

Technical analysis, or chart reading, is the next natural step you can take after you have conducted your fundamental analysis. Fundamental analysis helps you determine whether you should buy or sell a particular stock or CFD. Technical analysis helps you determine when you should buy or sell that stock or CFD.

Technical analysis is considered by most traders to be somewhat of an art form that takes time and practice to master. You should start out today on the path to becoming an accomplished technical analyst by learning the following foundational concepts of technical analysis:

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TRADING WITH THE TREND

Identifying the trend and trading with it is vital to your success as a stock or CFD trader. The stock market can be an emotionally charged place and, when traders start pushing the price of a stock in one direction or another, other traders typically start to follow suit and push the price of the stock in the same direction. When you see increasing momentum building behind a moving stock, the chances are good that the stock will continue moving in that direction. At that point you increase your odds of making money by trading with the trend. Fighting the trend generally turns out to be a losing proposition.

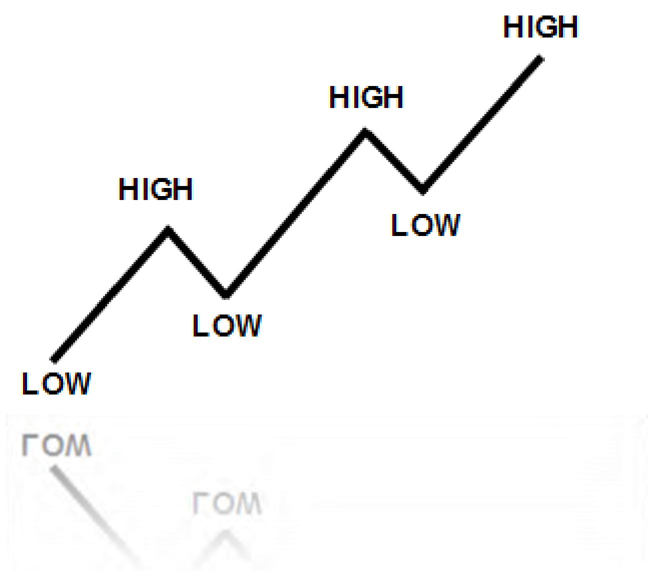
Trends tell you where prices will most likely be going in the future. If traders are pushing the stock price higher you ought to buy the stock or CFD to make money. If traders are pushing the stock price lower, you ought to sell the stock or CFD to make money. If traders in disagreement over where the stock price should go and are pushing the stock price sideways, you oughteither to alternate between buying and selling the stock or CFD or wait until the trend is clearly up or down to make money.

Trends do not move straight up or straight down. Different traders have different outlooks on where they believe the stock price is going to move in the future and they make their investments accordingly. These investments cause the stock price to move up and down within the same trend.

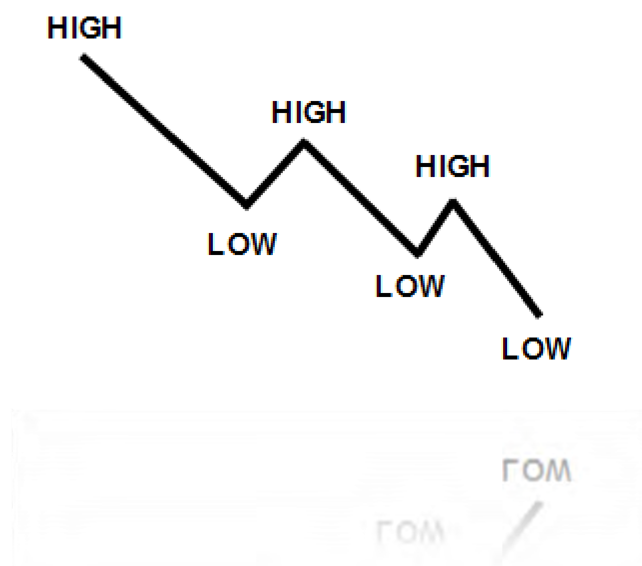
When a majority of traders believes the stock price is going to move in one direction they can overpower the minority of traders who disagree with them. When this happens, the stock price begins to follow a trend and will usually move in one direction for a while until the majority loses confidence in further movement and the price movement subsequently loses momentum. As the majority loses confidence the minority can momentarily exert its influence and push the stock price in the opposite direction to retrace part of the previous movement. However, once the majority catches its breath and decides to resume building momentum, it will turn the stock price back around and continue in the previous direction.

Every time a stock or CFD turns around and begins moving in the opposite direction it forms a new high or a new low. New highs form when a stock or CFD moves higher and then turns around and moves lower. New lows form when a stock or CFD moves lower and then turns around and moves higher. Identifying these highs and lows allows you to identify whether a stock or CFD is in an upward trend, a downward trend or a sideways trend.

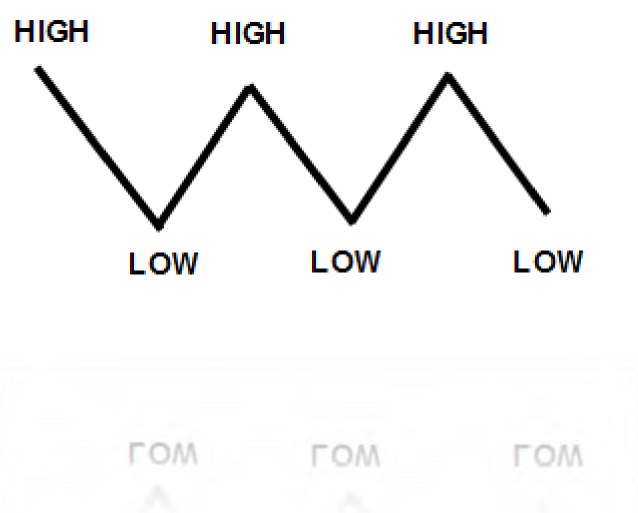
Upward trends—stocks or CFDs that are trending upward form a series of higher highs and higher lows.



Downward trends—stocks or CFDs that are trending downward form a series of lower highs and lower lows.



Sideways trends—stocks or CFDs that are trending sideways form a series of highs that are at approximately the same price level and a series of lows that are at approximately the same price level.



Trends - whether they are upward trends, downward trends or sideways trends - can form over various time periods. Identifying the following trends over each time-frame and being able to align them in your analysis is crucial to your success as a stock or CFD trader:

-	Long-term trends
-	Intermediate trends
-	Short-term trends
-	Aligning trend time-frames

Long-Term Trend

Fundamental factors are the major drivers of a stock's long-term trend. As companies perform well fundamentally their stock prices typically move higher. As companies perform poorly their stock prices typically move lower. Whilst the fundamental outlook for a company can literally change overnight, the trends established by a company's fundamental outlook tend to last for a while.

Long-term trends, sometimes called major trends, are those trends that have dominated a stock or CFD for the longest period. Looking at this weekly chart of McDonalds (MCD:xnys), you can see that the stock price has been rising in an upward trend from left to right—notice the series of higher highs and higher lows as time progressed.

When you see a strong upward trend like the one you see on the chart for McDonalds, you know that traders are eager to buy this stock and you should consider doing the same if you want to make money from this price movement. If the trend on the chart for McDonalds had been pointing downward, you would consider selling the stock or CFD to take advantage of the price movement.

Next you need to look at the intermediate trend to see if it is trending in the same direction as the long-term trend.

Intermediate Trend

Intermediate trends, sometimes called minor trends, move more rapidly than long-term trends because they cover a shorter period of time. These trends are also affected by a company's fundamental factors. Looking at this daily chart of McDonalds you can see that the stock price has not moved straight up as it has followed its long-term upward trend. It has had periods when the price has moved sideways. It has also had periods when the price has fallen.

Notice that, whilst there have been periods when the intermediate trend was moving both sideways and downward, the long-term trend was still moving upward. Trends tend to move in a stepped or zig-zag fashion. Rarely do they move straight up or straight down.

Seeing this price action should confirm your bias toward buying McDonalds. However, it should also tell you that whilst your bias is bullish (you think the stock price is going to move higher) you may want to wait to buy the stock or CFD until you see the intermediate trend move upward and in line with the long-term trend.

Next you need to look at the short-term trend to see if it is trending in the same direction as the long-term trend and the intermediate trend.

Short-Term Trend

Short-term trends, sometimes called micro trends, are more volatile than both long-term trends and intermediate trends because they cover the shortest period of time and they are predominantly affected by the news of the day. It is not uncommon to see these short-term trends change direction extremely rapidly. Looking at this hourly chart of McDonalds you can see that the stock price was in a short-term downward trend at the beginning of the chart. Notice the series of lower highs and lower lows as time progressed.


McDonalds Corp (56.0000, 56.2000, 55.6800, 55.7000, -0.29000)
61.0
60.5
60.0
59.5
59.0
58.5
58.0
57.5
57.0
56.5
55.7000
55.0
54.5
54.0
53.5
53.0
52.5
52.0
51.5
51.0
50.5
50.0
49.5
49.0
48.5
24
31
7
14
22
28
4
2008
February

Notice too that, whilst the short-term trend was moving downward, the intermediate trend and the long-term trend were still moving upward. It is therefore possible to have different trend time-frames moving in different directions at the same time.

Seeing this downward trend on the hourly chart would probably have deterred you from making a bullish investment in McDonalds at that time, even though the intermediate and long-term trends were bullish. However, since it is the only the short-term trend, you should not abandon your bullish confidence in McDonalds just yet.

In fact if you look at the end of the hourly chart for McDonalds you can see the short-term trend changing direction, which may bring all three trends into alignment.

Aligning Trend Time-frames

Your most profitable trading opportunities will come when the long-term, intermediate and short-term trends all line up in the same direction. Just as it is easier to swim downstream instead of upstream against the current, it is easier to trade with a trend than against it. When the long-term, intermediate and short-term trends are all moving higher it is an excellent time to buy a stock or CFD. When the long-term, intermediate and short-term trends are all moving lower it is an excellent time to sell a stock or CFD.

You can see in the chart of McDonalds that the trend for each time-frame has been moving higher for the past few months, and that the price of McDonalds has shot up. Had you purchased this stock or CFD, and then held it throughout this most recent surge, you would have made a large profit.

Understanding trends is only half of what basic technical analysis is about. To get the full picture you also have to understand the concepts of support and resistance.


McDonalds Corp (54.2300, 56.4100, 52.8800, 55.7600, +1.54000)
65
60
55.7600
50
45
40
35
30
25
20
15
10
2003
2004
2005
2006
2007
2008

PAYING ATTENTION TO SUPPORT AND RESISTANCE

Support and resistance levels are like the ends of an Olympic swimming pool. Just as the ends of the pool tell swimmers when it is time to turn around and start swimming in the opposite direction, support and resistance levels tell you if the price of a stock or CFD is likely to stop, to turn around, and to start moving in the opposite direction in the future. Knowing where a stock or CFD may stop and turn around helps you to enter and exit your investments at the most profitable times.

Support is a price level at which a currency pair tends to stop moving down, then turns around and starts climbing.

Support levels illustrate important psychological levels in the stock market. Support levels usually form because of the following:

-	Stock and CFD traders who missed an earlier buying opportunity decide it is a good time to get into the trade
-	Stock and CFD traders who bought the stock or CFD decide it is a good time to add to their positions
-	Stock and CFD traders who sold the stock or CFD decide it is a good time to take profits

Resistance is a price level at which a currency pair tends to stop moving up, then turns around and starts falling.

Resistance levels illustrate important psychological levels in the market. Resistance levels form because of the following:

-	Stock and CFD traders who missed an earlier selling opportunity decide it is a good time to get into the trade
-	Stock and CFD traders who sold the stock or CFD decide it is a good time to add to their positions
-	Stock and CFD traders who bought the stock or CFD decide it is a good time to take profits

Support and resistance levels are not precise. Instead they are general price ranges. When you are identifying your support and resistance levels, picture yourself drawing them in with a large marker instead of a fine-tipped pen. For example you are only going to frustrate yourself if you try to pinpoint a price level of 1410 on the S&P 500 as support. You will be much better off if you identify a price range of 1400 to 1420 or 1390 to

1430 as support. Give your support and resistance levels some room to be flexible.

You will find that support and resistance levels come in many shapes and sizes. To become a successful stock and CFD investor you will need to learn to recognise the following:

-	Horizontal support and resistance
-	Diagonal support and resistance

Horizontal Support and Resistance

Horizontal support and resistance levels form as stock prices rise or fall to the same levels time and time again. You can see these support and resistance levels take shape on charts of the stocks and CFDs you are interested in trading as the stock price moves back and forth.

Looking at the Caterpillar (CAT:xnys) chart, for instance, you can see that certain price levels (indicated by bold black lines) acted as strong levels of support and resistance. From June 2007 to the early part of August 2007 the $77.50 price level served as support for the stock price. This same price level, once the stock price broke down through it in mid-August, served as resistance for the stock price throughout the rest of August and into September.


Caterpillar Inc (70.0000, 70.3400, 69.1800, 69.9500, -0.49001)
85
80
75
69.9500
65
60
ay
June
July
August
September
November
2008
February

Imagine you had bought the stock or CFD for Caterpillar in early September at $72.50 as it was bouncing from support and it was now approaching $82.50. Knowing that this level has been a significant resistance level, you may consider exiting your Caterpillar investment so that you can realize your profits before the stock price turns around and begins moving lower.

Once you feel comfortable identifying horizontal levels of support and resistance, you can move on to diagonal levels of support and resistance.

Diagonal Support and Resistance

Diagonal support and resistance levels, you will find, can be a trader's best friend. Whilst these levels can be more difficult to identify when you are just getting started, they are invaluable when you are analyzing a stock or CFD that is on a trend. Remember, you want to identifystocks or CFD trends early because it is much easier to make profitable trades when a stock or CFD is on a trend.

As you look at the charts of the stocks and CFDs you are interested in trading, you will begin to notice that they will often form higher highs and higher lows, or lower highs and lower lows, as they increase or decrease in value. The lines that connect these highs and lows are your diagonal support and resistance levels.

Looking at the same Caterpillar (CAT:xnys) chart as we were looking at previously, for instance, you can see that the stock price was creating a series of lower highs and lower lows towards the end of 2007. If you connect all of the highs with a diagonal line and all of the lows with another diagonal line (indicated by bold black lines) you will be able to see the diagonal levels of support and resistance that were affecting the price of Caterpillar. You can also see that the downward trending level running between the support and resistance levels served as both support and resistance during that same period of time.


Caterpillar Inc (70,0000, 70,3400, 69,1800, 69,9500, -0,49001)
85
80
75
69,9500
65
60
ay
June
July
August
September
November
2008
February

If you were watching Caterpillar you would wait until you saw the stock price rise up to the downward-trending resistance level before you sold the stock or CFD. Once you had invested you could then watch for Caterpillar to fall down to the down-trending support level before you exited the investment and took your profits.

The real trick in effectively investing using support and resistance levels is to combine both horizontal and diagonal levels in your analysis. Just as you've seen in these illustrations of Caterpillar's price chart, horizontal and diagonal support and resistance levels co-exist. Your stock and CFD charts have a wealth of information locked within them, and they are waiting for you to unlock that information with simple-but-effective technical analysis techniques.

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