Technical Analysis

Technical Analysis (TA) is a bit of misnomer since it's really not that technical. A better name for the use of charts to make investment decisions might be risk/reward analysis or even market psychology.

What is TA? TA is the study of data generated from the market & from the actions of people in the market. Such data includes price level that have served as turning points in the past, the amounts of stocks being bought & sold each day (Volume), and the rate of change of price movements (momentum) over a span of time. TA also attempts to measure the collective investor psyche, calling heavily on the psychology of crowds & the cycle of greed & fear. If everyone thinks one way, the odds that the market thinks the other are usually high. Very important to understand is that the inputs of TA- the price of share & volume never change after it has happened. Charts are never revised later. Figures on which Fundamental Analysis are made can be revised.

3 Premises of Technical Analysis

There are three premises on which the technical approach is based:

1. Market action discounts everything.
2. Prices move in trends.
3. History repeats itself.

Market Action Discounts Everything: The statement "market action discounts everything" forms what is probably the cornerstone of technical analysis. Unless the full significance of this first premise is fully understood and accepted, nothing else that follows makes much sense. The technician believes that anything that can possible affect the price-fundamentally, politically, psychologically, or otherwise-is actually reflected in the price of that market. It follows, therefore, that a study of price action is all that is required.

The technician is claiming that price action should reflect shifts in supply & demand. If demand exceeds supply, prices should rise. If supply exceeds demand, prices should fall. This action is the basis of all economic & fundamental forecasting. The technician then turns this statement around to arrive at the conclusion that if prices are rising, for whatever specific reasons, demand must exceed supply & the fundamentals must be bullish. If prices fall, the fundamentals must be bearish.

Prices Move in Trends: The concept of trend is absolutely essential to the technical approach. The whole purpose of charting the price action of a market is to identify trends in early stages of their development for the purpose of trading in the direction of those trends. In fact, most of the techniques used in this approach are trend-following in nature, meaning, that their intent is to identify and follow existing trends.

There is a corollary to the premise that prices move in trends-a trend motion is more likely to continue than to reverse. This corollary is, of course, an adaption of Newton's first law of motion. Another way to state this corollary is that a trend in motion will continue in the same direction until it reverses. The entire trend-following approach is predicated on riding existing trend until it shows signs of reversing.

History Repeats Itself: Much of the body of TA & the study of market action have to do with the study of human psychology. Chart patterns, for example, which have been identified & categorized over the past 100 hundred years, reflect certain pictures that appear on price charts. These pictures reveal the bullish or bearish psychology of the market. Since these patterns have worked well in the past, it is assumed that they will continue to work well in the future. They are based on the study of human psychology, which tends not to change. Another way of saying this last premise-that history repeats itself-is that the key to understanding the future lies in a study of the past, or that the future is just a repetition of the past.

Technical vs. Fundamental Forecasting

While TA concentrates on the study of market action, fundamental analysis focuses on the economic forces of supply and demand that cause prices to move higher, lower, or stay the same.

Both of these approaches to forecasting attempt to solve the same problem, that is, to determine the direction prices are likely to move. They just approach the problem from different directions. The fundamentalist studies the cause of market movement, while the TA studies the effect. The technician, of course, believes that the effect is all that he or she wants or needs to know & that the reasons, or the causes, are unnecessary. The fundamentalist always has to know why.

Source: Murphy, John. Technical Analysis of the Financial Markets.

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