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Technical Analysis Applied

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There are two major types of analysis normally used to predict the performance of commodity futures: fundamental and technical. Fundamental analysis examines the supply and demand factors that influence price, while technical analysis is the study of price and price behavior. The world of technical analysis is complex, but with a working knowledge can be applied to virtually any market. There are literally hundreds of different patterns and indicators that traders have in their trading toolbox, but you will find early on what works for you. In this article, I'll introduce you to ten important rules of technical trading and how to apply them for your trading purposes.

What is Technical Analysis?

Applying technical analysis to charts allows commodity traders to identify tops, bottoms, patterns, trends as well as other factors that affect price movement; which they then use to aid in buy and sell decisions. Technical analysis includes such principles as the trending of prices, current prices discounting all-known information, moving averages, volume effecting changes in price, and even the identification of support and resistance levels in small and large periods from minutes to months.

The price of a commodity represents an agreement between buyers and sellers for all the information about that commodity at any given point in time. It is the price at which one person agrees to buy and another agrees to sell. This price at which a trader is willing to buy or sell depends primarily on his/her expectations about the future. Technical analysis is a method of evaluating commodities by analyzing statistics generated by market activity, past prices, indicators, and volume. Technical analysts do not attempt to measure a commodity's intrinsic value; instead they look for patterns and indicators on the charts that will determine the future performance.

Technical analysis reflects on historical prices in an effort to determine probable future prices. This is done by comparing current price action with comparable historical price action in order to predict a logical result. The premise with technical analysis is that history repeats itself in price behavior because human behavior repeats itself. Although, market dynamics are constantly changing the behavior of the investor, namely fear and greed and how they play into the psyche of traders has not changed over time.

Anyone that has ever looked at technical analysis has heard of John J Murphy; a former technical analyst for CNBC that has over 35 years of market experience that I feel we can all learn from. "Technical Analysis of the Financial Markets" should be in every trader's

library, I also often use it as a reference. I wanted to expand upon the 10 Important Rules of Technical Trading of John J. Murphy.

His rules are designed to help explain the whole idea of technical trading for the beginner and to streamline the trading methodology for the more experienced practitioner. These rules should present an outline and by applying technical analysis it ought to assist a trader with their buying and selling decisions. Which way is the market moving? How far up or down will it go? And when will it go the other way? These are the basic concerns of the technical analyst and I will try to make light of these mysteries.

The following are John J. Murphy's Ten Most Important Rules of Technical Trading:

1. Map the Trends

Study long-term charts. Begin a chart analysis with monthly and weekly charts spanning several years. A larger scale "map of the market" provides more visibility and a better long-term perspective on a market. Once the long-term has been established, then consult daily and intra-day charts. A short-term market view alone can often be deceptive. Even if you only trade the very short term, you will do better if you're trading in the same direction as the intermediate and longer term trends.

When establishing a position trade look at the monthly, weekly, and then daily chart in that order. My best trades have said the same thing on all three time frames; buy or sell.

2. Spot the Trend and Go With It

Determine the trend and follow it. Market trends come in many sizes - long-term, intermediate-term and short-term. First, determine which one you're going to trade and use the appropriate chart. Make sure you trade in the direction of that trend. Buy dips if the trend is up. Sell rallies if the trend is down. If you're trading the intermediate trend, use daily and weekly charts. If you're day trading, use daily and intra-day charts. But in each case, let the longer range chart determine the trend, and then use the shorter term chart for timing.

You've heard "the trend is your friend" now apply it.

3. Find the Low and High of It

Find support and resistance levels. The best place to buy a market is near support levels. That support is usually a previous reaction low. The best place to sell a market is near resistance levels. Resistance is usually a previous peak. After a resistance peak has been broken, it will usually provide support on subsequent pullbacks. In other words, the old "high" becomes the new "low." In the same way, when a support level has been broken, it will usually produce selling on subsequent rallies -- the old "low" can become the new "high."

This helps a lot with stop placement and buying or selling breakouts.

4. Know How Far to Backtrack

Measure percentage retracements. Market corrections up or down usually retrace a significant portion of the previous trend. You can measure the corrections in an existing trend in simple percentages. A fifty percent retracement of a prior trend is most common. A minimum retracement is usually one-third of the prior trend. The maximum retracement is usually two-thirds. Fibonacci retracements of 38% and 62% are also worth

watching. During a pullback in an uptrend, therefore, initial buy points are in the 33-38% retracement area.

If you already do not incorporate Fibonacci retracements in your trading, start. In fact go back and look at past trades and insert Fibonacci levels and see how much easier the trade could have been.

5. Draw the Line

Draw trend lines. Trend lines are one of the simplest and most effective charting tools. All you need is a straight edge and two points on the chart. Up trend lines are drawn along two successive lows. Down trend lines are drawn along two successive peaks. Prices will often pull back to trend lines before resuming their trend. The breaking of trend lines usually signals a change in trend. A valid trend line should be touched at least three times. The longer a trend line has been in effect, and the more times it has been tested, the more important it becomes.

Recognizing if you are above or below support and or resistance will help with stop placement.

6. Follow that Average

Follow moving averages. Moving averages provide objective buy and sell signals. They tell you if the existing trend is still in motion and help confirm a trend change. Moving averages do not tell you in advance, however, that a trend change is imminent. A combination chart of two moving averages is the most popular way of finding trading signals. Some popular futures combinations are 4- and 9-day moving averages, 9- and 18-day, 5- and 20-day. Signals are given when the shorter average line crosses the longer. Price crossings above and below a 40-day moving average also provide good trading signals. Since moving average chart lines are trend-following indicators, they work best in a trending market.

Some averages work better depending on the market and time frame but for position trades the 40, 100, and 200 day moving averages are critical as those are usually what the "big boys" follow.

7. Learn the Turns

Track oscillators. Oscillators help identify overbought and oversold markets. While moving averages offer confirmation of a market trend change, oscillators often help warn us in advance that a market has rallied or fallen too far and will soon turn. Two of the most popular are the Relative Strength Index (RSI) and Stochastics. They both work on a scale of 0 to 100. With the RSI, readings over 70 are overbought while readings below 30 are oversold. The overbought and oversold values for Stochastics are 80 and 20. Most traders use 14-days or weeks for stochastics and either 9 or 14 days or weeks for RSI. Oscillator divergences often warn of market turns. These tools work best in a trading market range. Weekly signals can be used as filters on daily signals. Daily signals can be used as filters for intra-day charts.

Many a time RSI and stochastics have kept me from taking on a position and in addition aided in a timely exit. Knowing when markets are either overbought or oversold is important because it is generally an early warning sign of a trend reversal.

8. Know the Warning Signs

Trade MACD. The Moving Average Convergence Divergence (MACD) indicator combines a moving average crossover system with the overbought/oversold elements of an oscillator. A buy signal occurs when the faster line crosses above the slower and both lines are below zero. A sell signal takes place when the faster line crosses below the slower from above the zero line. Weekly signals take precedence over daily signals. An

MACD histogram plots the difference between the two lines and gives even earlier warnings of trend changes. It's called a "histogram" because vertical bars are used to show the difference between the two lines on the chart.

MACD helps to identify when a trend reversal is likely and I like to use MACD on longer term charts but have not found it to be too effective on shorter time frames.

9. Trend or Not a Trend

Use ADX. The Average Directional Movement Index (ADX) line helps determine whether a market is in a trending or a trading phase. It measures the degree of trend or direction in the market. A rising ADX line suggests the presence of a strong trend. A falling ADX line suggests the presence of a trading market and the absence of a trend. A rising ADX line favors moving averages; a falling ADX favors oscillators. By plotting the direction of the ADX line, the trader is able to determine which trading style and which set of indicators are most suitable for the current market environment.

Obviously when looking at a price chart a trader can realize if the trend is up or down but the ADX allows you to further quantify the strength of the trend and if the trend appears likely to continue.

10. Know the Confirming Signs

Include volume and open interest. Volume and open interest are important confirming indicators in futures markets. Volume precedes price. It's important to ensure that heavier volume is taking place in the direction of the prevailing trend. In an uptrend, heavier volume should be seen on up days. Rising open interest confirms that new money is supporting the prevailing trend. Declining open interest is often a warning that the trend is near completion. A solid price uptrend should be accompanied by rising volume and rising open interest.

Generally speaking, when you see a significant increase in volume that coincides with other technical indicators, you will see highs and lows typically made followed by trend reversals.

“Technical analysis is a skill that improves with experience and study. Always be a student and keep learning.” John J. Murphy

Technical Analysis is a vital part of my trading and assists in the decision on almost every transaction but I do not make light of the situation that a trader must not ignore the fundamentals. I simply hold more regard for technicals.

Risk Disclosure: The risk of loss in trading commodity futures and options can be substantial. Before trading MB Wealth recommends that you should carefully consider your financial position to determine if commodity trading is appropriate for you. All funds committed should be purely risk capital. Past performance is no guarantee of future trading results. There are no guarantees of market outcome stated, everything stated above are our opinions. Calculations of profit and loss have not factored in commissions and fees.