CORRECT CHART ANALYSIS IS ESSENTIAL
By Daryl Guppy

Some elements of technical analysis look easy. Some experienced professionals make technical analysis look easy. Some software promoters pretend to make technical analysis look easy and this is misleading. When you get your technical analysis wrong then there are monetary consequences.

A basic knowledge of technical analysis and charting is essential for trading success. It's also essential for evaluating the information produced by others so you can distinguish between good analysis and analysis which is dangerous to your wallet.

Below is a chart that came with this analysis.

"The recent decline was halted by a combination of support factors. These are the moving average and the horizontal support at $2.34. The market has rebounded from this support level and the other indicators are showing bullish buy signals. Upside target is $2.71."

Lets examined these analysis claims one by one.

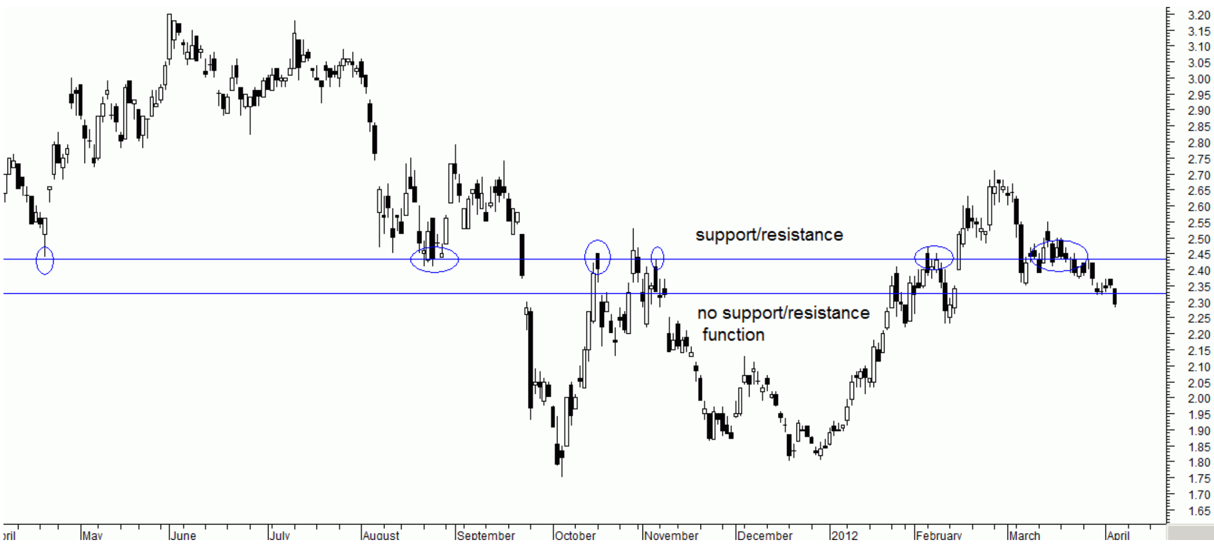
Support is provided by the moving average.

This is just plain wrong. A moving average line does not create a support or resistance level. Support and resistance features are created when the market moves away from previously established price points. You cannot adjust the calculations for the position of a support or resistance level. These levels can be seen clearly time and again on a long term chart.

A moving average is a mathematical calculation of an average price. Change the calculation period for the moving average and the position of the support level also changes. A moving average gives a variable figure and this is not a support level. The price may oscillate around the moving average, but the extremes of oscillation can be very large. We can speak of price returning to the moving average, but we cannot use the variable value of a moving average calculation as a support feature.

Horizontal support is at $2.34.

This is incorrect. A support/resistance level is created when price consistently rebounds from this value. On the chart extract there is a single rebound point at $2.34. Extend the line to the left and the line does not define any rebound or retreat points. The price activity ignores the line, moving above and below it. The placement of this line at $2.34 is just a figment of imagination.



The longer term 1 year chart shows a support/ resistance line is more accurately placed at $2.44 This has acted as a support point three times in the 12 month period. It has acted as a resistance level three times in the 12 month period. Place the support line accurately and it shows just how nonsensical the rebound analysis is.

Indicators are bullish - stochastic

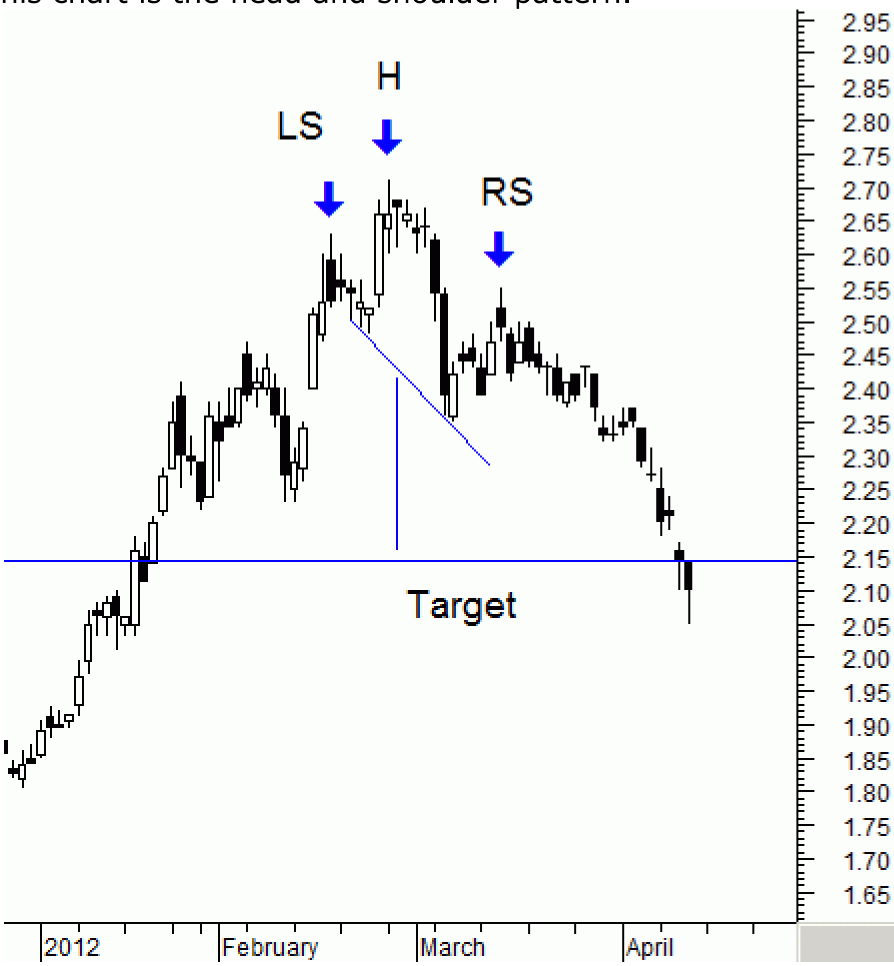
The stochastic indicator is showing a bullish crossover signal. It follows the four bullish crossover signals in the six month period shown on the chart. Of the four previous bullish signals 50% were incorrect! There is a 50% probability this bullish stochastic signal will fail. That is, the signal says buy, but the price goes down. As the most recent chart shows, this signal did fail again. The validity of an indicator signal must be assessed against its past performance and reliability on this particular stock. It fails the test.

Indicators are bullish – MACD

This appears to be using the MACD Histogram crossover as the signal. For the buy signal this indicator is correct 60% of the time in the time period shown. For the sell signal it is correct 50% of the time. Using a combination of the MACD and the MACD-H the buy signal is correct in 2 out of 3 buy signals. But there is a problem. The chart does not show a combined MACD and MACD-H buy signal. The conclusion that the MACD display is showing a bullish buy signal is not correct.

CORRECT CHART ANALYSIS

Technical analysis follows chart analysis. Technical analysis uses indicators. Chart analysis uses the activity and patterns of price behavior. The dominant pattern on this chart is the head and shoulder pattern.



The pattern was developing on the original chart extract shown above. It took several more days to confirm the right shoulder. However this was a high probability outcome because the analysis that rested on moving average and support line features was incorrect. Two days after the original chart extract the retreat developed. The neckline projection for this pattern gives a downside target near $2.15. This target has been reached and exceeded.

There is always room for interpretation and disagreement on analysis. We see the same charts, apply the same indicators, and depending on our own biases, often come up with different interpretations. This is the business of the market. For every buyer there is a seller who has the opposite opinion and reached the opposite conclusions.

The real problem comes when the analysis methods are incorrect or incorrectly applied. This is not a disagreement about interpretation. It is just an invitation to lose money. Traders who went long based on the original chart misinterpretation went on the lose money.

Trading and investment analysis should be objective. One of the strengths of charting and technical analysis is that it uses an objective set of figures – price activity – which are readily available to everybody interested in the market. How individual traders choose to apply and interpret those techniques is a matter of subjectivity.

The fundamental analysis relies on figures created by the company in annual reports and press releases. He works with figures generated by outsiders, such as auditors and accountants. He also works with figures derived by others for particular purposes. For instance, if the analyst works for a brokerage involved in an IPO launch then the figures are often a little brighter than market reality would suggest. The application of fundamental analysis is a subjective process from the very start because very few of the figures used can be independently verified. Even the balance sheet is a carefully massaged document.

A significant problem for traders and investors who rely on the research and analysis of others is the objectivity of the research, and recommendations. When a research company is being paid for a company to do the work then it is not uncommon for the report to put the best possible gloss on the situation. When a brokerage is preparing a report on a company, and it is also handling trading work for the same company, then the same constraints apply.

The result is that few sell recommendations are produced by the analysis industry.

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