A Stock & Options
Market Newsletter by
TheMarketMessenger.com

Purely Technical

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The Four-headed Monster, Called 'Technical Analysis'

Dear Purely Technical subscriber,

In the latter part of August – yes, merely a couple of weeks ago – there was a cacophony of market calls for an impending collapse in the stock markets.

The growing consensus was that the economy was at a high risk of falling into a "double-dip recession" and the stock markets were primed to go along for the ride.

In fact, many market gurus who normally wouldn't touch the intricate art of technical analysis with a ten-foot pole, were pointing to the development of what they believed was a 'head and shoulders top' on a number of major market indices and using the same as added proof that another market meltdown was in the works.

While the 'head and shoulders top' meme was rapidly making its way through the investment world, a small number of astute technical analysts – this author included – noticed the development of a handful of signals on the charts that pointed to the likelihood that the 'head and shoulders top' scenario envisioned by many was, in fact, misguided and instead a bullish reversal was on the cards...

Over the past two weeks, the view of this small group of chart readers has been proven correct, with the leading market indices having gained as much as 10%, since that critical juncture in late-August.

A climb of 7-10%, over such a short span of time, is an exceptional rate of progress by any measure. But, it might just be the beginning. If another set of confirmatory signals can be dealt with successfully over the coming week, a further rise of a similar or greater magnitude would be on the cards over the subsequent four to six weeks.

Certainly, by now you're keen on getting some insight into the particular methods that the astute technical analysts amongst us used, in order to arrive at the conclusion that the falling markets were more likely to reverse course than to continue their downward trend, in the early part of September.

Over the course of the rest of this article, we'll introduce you to a few of these concepts including how we noticed that the 'head and shoulders top' alleged to have been taking shape on the charts was actually a "false" pattern and, in fact, contained an 'inverted head and shoulders' or 'head and shoulders bottom' formation that called for a sharp rebound!

The Head & Shoulders Top That Wasn't (The Pitfalls of a Myopic View of Technical Analysis)

Now, in order to get a better understanding of where the proponents of the bearish head and shoulders scenario went wrong, we need to take a look at the price action that lead into the now-failed pattern and try and decipher what lead the aforementioned market watchers to (mis-) identify the pattern as a 'head and shoulders top.'

This is not an exercise in finger pointing, mind you, but rather an attempt to identify common mistakes made when market watchers have a myopic view of technical analysis – drawing only from one or two areas – as opposed to a broader view of the arena.

The accompanying chart in Illustration 1, shows the action on the S&P-500 index (SPX), as of the end of August. Now, traders who've read about the head and shoulders pattern in the past will notice that the price action between November of 2009 and August of 2010 looks rather similar to the textbook form of a H&S top.

A potential 'left shoulder' formed between Nov. '09 and Feb. '10. A potential 'head' took shape between Feb. and May/Jul. (depending on where you draw the second intervening trough). Finally, a purported 'right shoulder' developed between May/Jul and Aug... The height of the shoulders was within the realm

of acceptability and so was the duration of formation of each of the shoulders. Furthermore, the ratio of the height of the head to that of the shoulders was also close to the textbook case.

Illustration 1: S&P-500 Index (SPX), as of Aug 31, 2010, highlighting purported 'Head & Shoulders' Top.

So, aside from the fact that traders who actually followed the advice of the misguided analysts probably unfortunately ended up losing money or at least losing the opportunity to profit from the impending bullish reversal, one can almost bring oneself to forgive the well-meaning analysts for having raised the alarm as a result of their interpretation of the formation.

On the other hand, the astute technical analyst who has made the effort to study the intricacies of the art will have gathered, even from this basic chart, that there were a couple of inconsistencies between this potential case and the ideal case…

Rather than get sidetracked by a phantom pattern, he/she would have been able to garner a more holistic view of the chart, which would have painted a picture of a developing bullish reversal (rather than a bearish continuation), and would have been prepared to take advantage of the same.

In a moment, you'll be shown how other areas of technical analysis (including 'moving averages,' 'price envelopes' and 'momentum indicators') would have unearthed even more warning signs that would have put this potential pattern into serious doubt, but for now let's focus on what can be seen on the basic chart, which consists solely of price action (top pane) and volume action (lower pane), in *Illustration 1*.

<u>Duration of pattern:</u> The typical head & shoulders topping pattern takes 3-6 months to form. At 10 months in duration, the purported H&S pattern being studied would have been considered a little long in the tooth and this fact alone would have been enough to doubt the validity of the formation.

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Breach of neckline: The neckline of a head and shoulders pattern is, generally speaking, sacrosanct. Now, in order for the formation above to have been considered as a legitimate pattern, the neckline would have to be drawn at the 1045-level (because, as you can see, there are several minor lows, at that level). However, in doing so, the trader encounters a small but not negligible issue…

Notice the action that took place in late-June/early-July. The index broke through support (1045) and traded as low as 1010. While minor excursions through the neckline are permissible during the formation of a H&S pattern, such moves should, preferably, take place only on an intraday basis and not on a daily closing basis.

However, it is clearly visible that the index closed below the neckline on 3 or 4 trading sessions, during the aforementioned period. This occurrence along would have hoisted a warning flag, as far as the skilled technical analyst is concerned.

Volume trend: The accompanying volume often confirms or casts doubt on a given move in the markets. In the case of a textbook H&S top pattern, the volume that is seen during the formation of the head is lighter than that seen during the formation of the left shoulder. You'll notice that this was not the case this time around; trading volume during the formation of head was in fact higher than that seen during the formation of the left shoulder.

Additionally, in the textbook case, volumes generally rise during the descent from the peak of the right shoulder. As you can see, in this case, trading volumes did not rise – if anything, they seem to have fallen slightly – during the completion of the purported right shoulder.

While a trader who had a proper understanding of the theory of 'Chart Patterns' would have found any one of the inconsistencies, described above, to have been something that could have been ignored if it were to have occurred in isolation, he/she would definitely have had serious reservations upon having noticed all of them taken together.

Four Indispensable Areas of Technical Analysis

So far, our discussion of the price action leading into late-August has been relegated to the area of 'Chart Patterns.' Now, make no mistake about it, the area of chart patterns is important the well-rounded technical analyst but, as far as this author is concerned, it is merely one head of the four-headed monster that is 'Technical Analysis.'

When a chart is analyzed thoroughly, the following four areas from the discipline of technical analysis are utilized:

- Trend Analysis
- Chart Patterns
- Moving Averages & Price Envelopes
- Momentum Oscillators

Certain specialists and niche players will tell you that there are a handful of other narrow areas within the realm of technical analysis ('Elliot Wave Theory' and 'Fibonacci Analysis,' for example), as well. That fact is true, but by and large, these other areas derive data from and/or build upon the four leading areas mentioned above and, as such, it is crucial for a trader to study these four areas and have a good working knowledge of the same.

So, you might now be wondering, did the other leading areas of technical analysis provide any clues regarding the likelihood of a further decline in late-August?

Yes, they did! And astute technical analysts who were awake to this fact, were able to position themselves for the impending bullish move and to profit from the same, when it arrived almost on cue…

Trend Analysis

One of the primary pillars of technical analysis is 'trend analysis.'

Without going into the details of how various durations of trend are deciphered, suffice it to say that the 'intermediate trend' was neutral, during this phase, and the 'minor trend' was bearish. The

contention of the proponents of the head and shoulders top was that the intermediate trend was set to change from neutral to bearish and the minor trend was going to experience a 'bearish continuation.'

(For reasons that will be elucidated later, skilled technical analysts were preparing for the minor trend to actually reverse to bullish and for the intermediate trend to remain neutral.)

Now, aside from duration of trend, there are several other considerations in the area of trend analysis. We're going to focus, for a moment, on one aspect from within this area: Support.

'Support' is a level on the chart under which buying pressure is intense enough to overcome selling pressure. A support level typically shows up as a lateral level on a chart, at which a security that is falling tends to reverse course and rally. In other words, it is a level at which several "reaction lows," as they are called, have formed and, as such, might be seen as a level at which traders would want to consider closing bearish positions and/or initiating bullish positions.

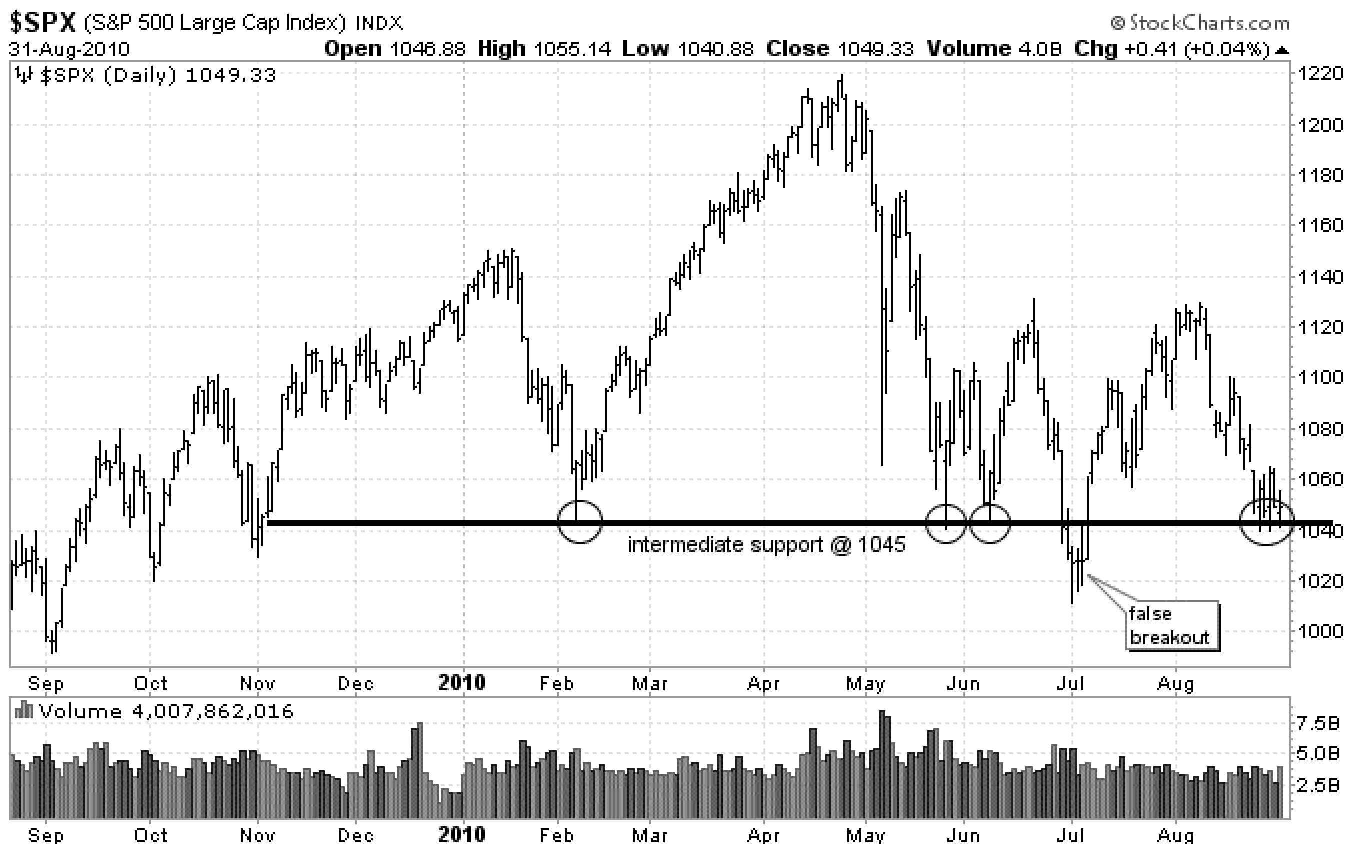

Illustration 2: S&P-500 Index (SPX), as of Aug 31, 2010, highlighting intermediate support level.

Now, needless to say, support levels have a shelf life. Sooner or later, the bears muster enough strength to push prices through the level and render it defunct. However, one of the tenets of technical analysis is that traders should not try and anticipate a breaking of support; rather wait for price action to confirm a bearish breakout (for prices to fall through support), before actually initiating a short position - or a bearish options position - on the security.

As such, analysts who were taking a bearish stance prior to the actual breaking of support in the case of the purported head & shoulders pattern on the S&P-500, were misusing the respective tools of technical analysis and, thereby, doomed to end up paying the price.

As illustration 2 shows, the S&P-500 found support at around the 1045-mark in Feb and then again in late-May and early-June. On each occasion, a rally of over 50 points took place on the index and not once was the level breached, over that period. Clearly, the 1045-level was acting as a source of 'support' to the index.

As such, when prices tested the support level in late-June, no one would have faulted a trader for looking to buy stocks, in the hope of a rebound. As it turned out, support was breached on this occasion and unless he had set a wide stop, it is quite possible that the trader's stop loss would have

triggered and he'd have taken a small loss on the trade. That's okay; losses are a part of trading and, as long as one is entering and exiting positions based on properly laid-out rules, the law of averages should end up working out in one's favor, over time.

But look at what happened within a week of the breach of support (late-June)… The index ended up finding support near the 1010-level and quickly bounced back above the old support level at 1045, on its way to a peak at 1125 (which has since shown up as a significant "resistance" level).

Short-lived breakouts such as the one that took place in late-June are known as "false breakouts" or "fake-outs." Fake-outs are relatively common on the charts of stocks, stock indices and other securities. For this reason, the seasoned technical analyst not only waits for a breakout to actually take place before taking on a position (rather than pre-empting a breakout, just because a potential pattern has developed) but also utilizes tools from other areas of technical analysis to either confirm the breakout or raise the possibility that it may be a false move.

Coming back to *illustration 2*, we see that after rallying to 1128 and finding resistance at that level, the index started to fall back towards the lows, once again. Once the index started to approach 1045 in the latter part of August, several market watchers started to raise the alarm that a potential head and shoulders pattern was showing up on the charts.

As we'd mentioned earlier, the form of the pattern that had showed up between Nov '09 and Aug '10, was close enough to the textbook form of the H&S top, to leave room for the possibility that the pattern was legitimate. However, an essential element was still missing…

Now, the cardinal rule of chart patterns is that a breakout must take place, in order for the pattern to be considered complete and for a position to be taken, thereafter. In the case of a head and shoulders top, there has to be a breaking of the neckline, in order for the pattern to be considered complete and for a bearish position to be taken.

In other words, a breaking of the support level that is identified as the neckline is required. Now, if you were to glance at illustration 2 in search of a neckline for the potential H&S top, you would arrive at two potential candidates – 1045 and 1010. The big question would be: Which level should be chosen?

It's simple, really. The 1045-level had held up to scrutiny a good handful of times and, on nearly every occasion, it provided a decent bounce to the index. On the single occasion that the index fell through 1045 (when it fell to 1010 in early-July), the situation reversed itself relatively quickly and the move proved to have been a false break. As such, the support level at 1045 should have been deemed to be the neckline of the pattern.

Coming full circle, it would have taken a break of support at 1045 on the S&P-500, in order for the head and shoulders pattern to be seen as complete and, as a result, for the 'intermediate trend' to have been seen as having changed from neutral to bearish.

As of the end of August, support had in fact not been broken, despite the fact that the index had been sitting promptly at or just above 1045, for a week or so, and, as such, the analysts who were taking on a strongly bearish stance, at that point, were being premature.

Momentum Oscillators

So far, we've illustrated how a study of the S&P-500, as of the end of August, may have painted a picture of ambiguity for a trader who only used 'trend analysis' and 'chart patterns,' as a basis for his/her investment decisions. Now let's add another layer to the mix and take a look at what a couple of momentum indicators were saying about the state of the markets, at that point in time.

'Momentum oscillators' are a group of technical indicators that are used to measure the momentum of a trend. They are extremely useful in non-trending market phases, when prices are trading within a narrow range.

As it turned out, the S&P-500 was trading in a range (mostly between 1045 and 1125) for just over three months, leading into the end of August. As such, the momentum indicators were generally well suited for use, during this period.

Illustration 3 provides a close look at price action and the corresponding developments on two leading momentum indicators – 'Relative Strength Index (RSI)' and 'Moving Average Convergence-Divergence (MACD)' – in the several months preceding August.

Illustration 3: S&P-500 Index (SPX), as of Aug 31, 2010, highlighting momentum indicators.

There are a good number of interpretations that can be derived from momentum indicators. For example, you can see a 'positive divergence' on MACD (third pane from the top) in early June, which gave risen to a rally of 90 points from low to high over the ensuing two weeks.

Additionally, you'll notice that each time RSI (second pane from top) reached 'oversold' territory between May and July, a tradable bounce took place on the index. In fact, those developments provided the alert technical analyst with further evidence that perhaps the index was not likely to fall much further and instead might even rally, when RSI got very close to oversold levels in late-August (SPX was testing the 1045-level, at this point, as well)…

Furthermore, MACD provided the well-rounded technical analyst with another potential signal that perhaps support was going to be found: Now, while there are other more "sexy," if you will, interpretations of RSI and MACD, one of the basic interpretations is the relevance of trendlines, drawn on the indicator itself…

Notice that if you drew a line joining the three lows that formed on MACD in late-May, early-June and early-July, respectively, and extended that line to the right, you'd find that MACD ended up "testing" the trendline in late-August (once again, at the time SPX itself was testing support at 1045).

The technical analyst would have noticed the possibility that support might not only be found on the index, but on the indicator itself, and that was another sign that confirmed the potential for an imminent bullish reversal!

Moving Averages & Price Envelopes

A moving average is a price overlay that depicts the average value of a security, over a specific period of time. Moving averages can be of varying lengths and periodicities. One of the most common moving averages used by swing traders, is the 20-day Moving Average ('20-dMA', for short). As you can imagine, the 20-dMA depicts the average price of a security, over the preceding 20 trading days.

Now, moving averages have several uses in their own right but perhaps the foremost use of the 20-dMA by avid technical analysts is in a 'price envelope' technique, known as the 'Bollinger Bands' technique.

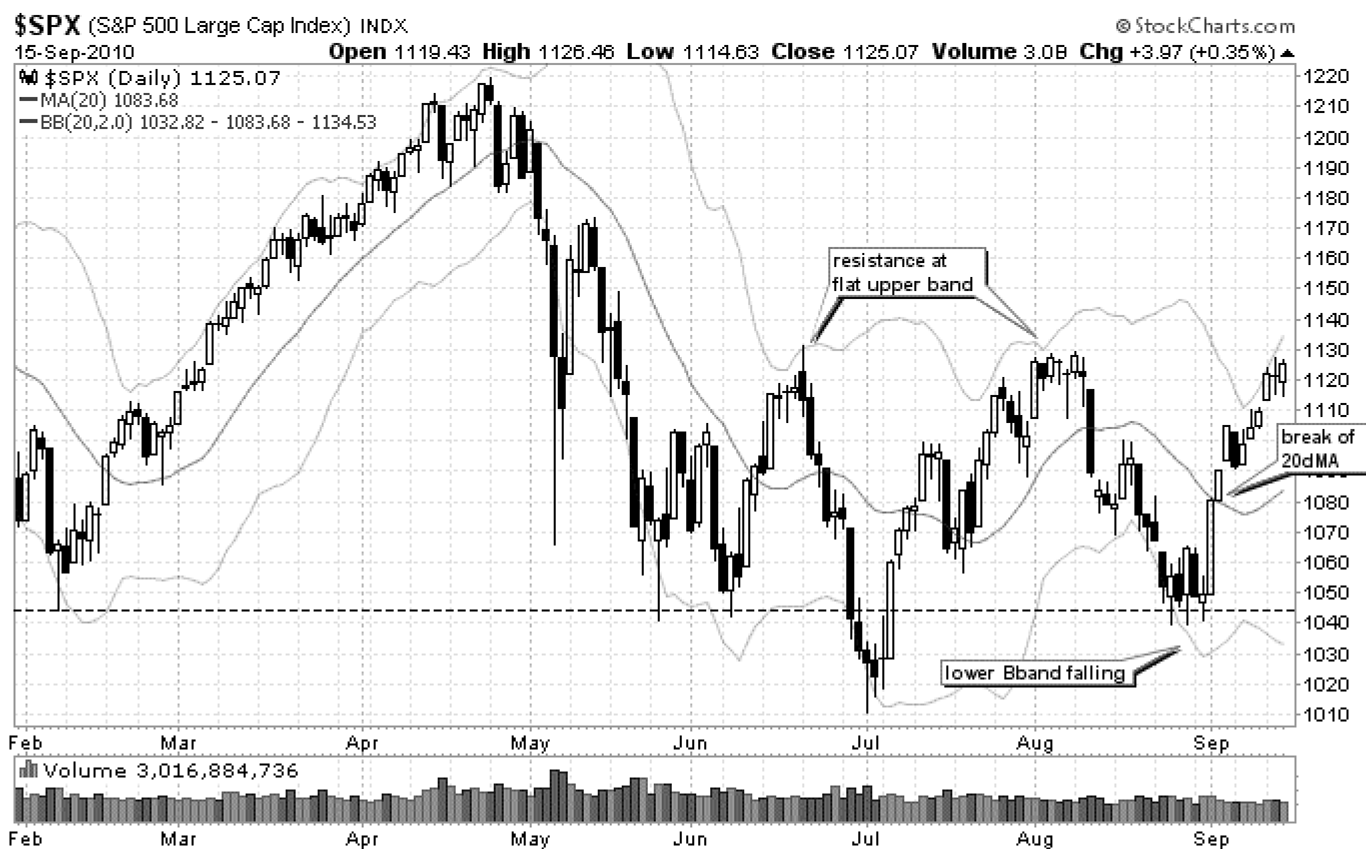

Illustration 4: S&P-500 Index (SPX), as of Sep 15, 2010, highlighting 20-dMA and Bollinger Bands.

Bollinger Bands are a graphical depiction of volatility and relative price level, over a given timeframe. This price envelope technique blends the statistical concept of standard deviation with the technical analysis concept of the price envelope. The Bollinger Bands are constructed by plotting an upper band two standard deviations above the 20-dMA and a lower band two standard deviations below the 20-dMA.

The usefulness of the Bollinger Bands technique is manifold. The trader studies the movement of the bands both in absolute terms and in relation to one another and comes up with an interpretation of the current market action, based on Bollinger Band theory.

Illustration 4 depicts the price action in this case study (plus the action that followed over the ensuing two weeks), overlaid with the 20-dMA and the Bollinger Bands.

Now, while the 20-dMA and Bollinger Bands provided several buy, sell, buy confirmation and sell confirmation signals, over the course of the action seen on the chart (in the interest of time and space, we won't delve into each of these signals, but notice that the mid-June and early-August peaks were formed when the index found resistance from the upper Bollinger band, which was flat in each of those instances), it must be mentioned that the 20-dMA and the Bollinger Bands were not necessarily calling for a bullish reversal at the end of August.

You'll notice that each of the Bollinger bands and the 20-dMA were falling at the end of August, at a time when SPX was testing support at 1045. As such, these techniques were not necessarily challenging the contention that support was going to be broken, in the manner that the momentum indicators were.

On first blush, it might seem like this development is a contradiction of the bullish case; in fact, it is not unequivocally so. By their nature, moving averages and price envelopes generally tend to lag price action by a short span of time and, as such, they are often useful as sources of confirmation of a reversal that has taken place on the markets, instead of as predictors of an impending reversal.

On the first trading day of September, SPX found support at 1045 and sprung to 1080 in one leap. The index was sitting precisely at its 20-dMA, at the end of that session. The next day, the index broke through its 20-dMA. Such a move is considered a bullish confirmation signal. It provided those traders who had taken bullish positions when SPX was trading at 1045, a sense of confirmation that they had made the right choice.

Additionally, note that the lower Bollinger Band started to curve inwards, at the same time. This was another sign that the downtrend (on the minor level of trend) was over and, given that the 20-dMA had been broken, perhaps a move to the upper Bollinger Band was on the cards. If you look at the action that followed, prices did in fact end up rallying to the upper Bollinger Band, merely a week or so later...

The Importance Of A Holistic Approach To Technical Analysis

In the case study presented to you herein, we've shown you how technical analysis consists of a series of building blocks. Without each of these building blocks, the foundation of any chart reading exercise would be weak and the results of any trading strategy built upon this foundation would be potentially disastrous.

In fact, in this author's opinion, it is precisely because dabblers in technical analysis draw conclusions from only a portion of the entire picture – and end up consequently deriving sub-par trading results therefrom – that the art of technical analysis has a bad rap in certain circles.

As an experienced researcher in the field of technical analysis, this author, who by the way has completed the equivalent of two graduate degrees in finance (most of which dealt with 'fundamental analysis,' which is the antithesis of technical analysis), can attest to the fact that there is no more effective set of tools for the short-, medium- or long-term trader, than the body of technical analysis.

When used properly, this set of tools is indispensable to the trader, because it allows him/her to remove emotion from the equation and provide him/her with the skills needed to identify potentially attractive trading opportunities for entry into, those that help identify when a profitable setup has run its course and needs to be exited from, as well as those that help identify when a setup has failed to live up to expectations and should be let go of.

As a seasoned trader who uses a "Purely Technical" approach, I'll be the first to admit that technical analysis is not 100% foolproof. There is no trading approach that will produce a winning trade every time. But, when conventional technical analysis is used properly, with no shortcuts and with adherence to the rules, a trader's rate of success can increase dramatically.

As such, a thorough grounding in technical analysis is a must-have, for every trader worth his salt...

An Analysis Of Current Market Action

Two weeks have passed, since the formation that was misidentified by many as a 'head & shoulders top' has failed, and has instead made way for a sharp rally. Let's now utilize the tools that have been briefly studied above, and wrap up this piece with a look at current market action.

As you can see, in *Illustration 5*, the S&P-500 (SPX) actually ended up finding support at the 1045-level at the end of August and rallying to resistance at 1128, over the ensuing two weeks.

That amounts to a rally of over 80 points or 7.7%, which is a pretty impressive rate of return for anyone who had bought into the rally at the bottom (not so much so, for anyone who shorted the markets or implemented bearish options strategies, at that point)!

Illustration 5: A complete analysis of the S&P-500 Index (SPX), as of Sep 15, 2010.

But where are the markets headed over the next several weeks? Is the rally over? Or does it have legs?

The recent rally has taken the markets back to the level at which resistance was found back in June and then again in August. You'll remember that we'd earlier mentioned the fact that support or resistance is to be given due respect until or unless it is actually broken. So, for traders to add to bullish positions right now would be premature, but if the index can break through the 1128-level (and, importantly, stay above that level), not only will an important resistance level be taken out and the intermediate trend (not just the minor trend) arguably be seen as 'bullish,' instead of just 'neutral,' but amazingly an apparent 'inverted head and shoulders' pattern will be complete.

Think about that for a moment… Certain market watchers were calling for a significant head and shoulders top, a couple of weeks ago, but in a short span of time that pattern has proven false and a smaller 'inverted head and shoulders' or 'head and shoulders bottom' has potentially cropped up on the charts, instead!

If the pattern proves true, it will bring about a move to the 1220-1240 range (this projection is based on the 'height method' of price projection). In other words, if the pattern proves legitimate, we should see a further rally of 100+ points on the index, over the coming month or two…

Now, are we going to jump with both feet at this potentially lucrative opportunity? Not so fast. The form of the pattern is great – as you can see, the left shoulder and the right shoulder are rather similar in duration and are perfectly similar in depth and, moreover, the depth of the head is in a good proportion to that of the shoulders – but what about the other aspects of the chart?

One of the leading factors that need to be paid attention to when assessing the chances of a potential H&S is the volume trend, of course. In the case of the head and shoulders bottom, the textbook case calls for a decrease in trading interest coincidental to each successive trough (left shoulder, head and right shoulder) in the sequence. If you focus your attention on volume action (bottommost pane) in illustration 5, you'll notice that this requirement has been fulfilled, in the case of this H&S pattern. In other words, the volume trend confirms this potential head and shoulders pattern.

So, can we now jump headfirst into bullish positions? "No, not as yet," an astute technical analyst would say…

Remember it takes an actual breaking of the neckline, which in this case lies at 1128, in order for the pattern to be seen as complete and for the trader to consider entering a trading position in anticipation of a move towards the pattern's target. So, at the very least, the trader will have to wait for a closing price above 1128, before taking a position. Ideally, there should be a massive rise in trading activity, coincidental to this breakout, or else the trader will need to be wary of a potential fake-out in the making and will need to ensure that an effective stop loss strategy has been put in place.

What about other facets of the chart? Do they support the potential for a breakout and for a sustainable rally thereafter?

As far as this daily chart is concerned, the following are aspects of the chart that an astute technical analyst would notice:

Chart Patterns: In addition to the potential H&S bottom that has already been identified, there is another potential pattern on the charts. A close look at the minor trend shows that a potential 'bull pennant' or 'bull flag' has taken shape on the chart, over the past three sessions. It will take a breaking above the upper pennant (or flag) line, which lies at approximately 1125, in order for the pattern to be complete and, if such a breakout can take place and be sustained, a move towards the 1155-1160 area should be on the cards. If instead there is a close below the lower pennant line (~1115), the pattern will have failed.

Moving Average: The 20-dMA currently lies at 1083 and it is rising. As long as the 20-dMA continues to rise and the S&P-500 is trading above it, the minor trend will continue to be seen as bullish. If the index falls below the 20-dMA, the minor trend will no longer be seen as bullish and instead might shift to neutral or even bearish.

Bollinger Bands: The bands seem to be expanding, at present. This is a sign that volatility is expanding and that a strong new trend is underway. Furthermore, the upper band is rising and moving out of the way of the rising trend. If the upper band were to start to flatten out or to reverse course, a bearish reversal might be on the cards.

Relative Strength Index: RSI is showing a positive centerline crossover, which is a bullish confirmation signal. As long as RSI sits above its 50-line, the minor trend will continue to be seen as bullish. If RSI turns around and makes a negative centerline crossover, however, the move will be seen as a big warning sign and the bullish minor trend will be in serious doubt. Also note that RSI is currently still a good distance from levels that would be considered "overbought." So, what that means is that there is still a good amount of room to the upside, before traders have to worry about the fact that this indicator points to a high probability of a corrective move.

Moving Average Convergence-Divergence: MACD has moved into positive territory, over the past week. This is ordinarily a strong bullish confirmation signal. Moreover, as with RSI, there is lots of room to the upside before this indicator reaches overbought levels. As long as MACD is above its 0-line, the bulls will be sitting firmly in the driver's seat. Any move back below the 0-line, however, would raise the alarm.

So, to summarize, virtually every aspect of the chart shows that there is the potential for a continuation of the rally, but only if the index can break out above 1128 and stay above that level. If so, a move towards 1220-1240 will be on the cards.

So what will the astute technical analyst, who would have bought stocks at the lows, a couple of weeks ago, be doing at this point?

Remember that everything hinges on the resolution to the testing of resistance (and neckline of the potential H&S bottom) at 1128. If the index closes above that level, the persnickety - that's a good thing in this business - technical analyst will then go all out and add to bullish positions. But even then, he will not let his guard down. There is always the potential for a false break, and in order to protect his trading positions, he will place suitable stop loss orders at a reasonable distance below the broken resistance level and allow price action to run its course.

If, on the other hand, the index is not able to break resistance at 1128 within the next few session, he will be trimming his winning bullish positions and waiting for the charts to show him the next big potential trading opportunity...

Conclusion

I hope that you have found this report to have been an eye opener and to have provided you with an insight into the art of technical analysis done the right way.

In the coming week or two, I shall be writing a shorter follow-up piece that will provide you with an update on what has happened on the markets, in the interim. The upcoming phase should be an interesting one, because just like the juncture at the end of August, the markets are now at a cusp...

Will resistance at 1128 hold? Or will it be taken out? In the answer to that question lies the prospects of the markets for the next several weeks and, perhaps, for the rest of 2010!

I wish you the very best with your trading and hope that you find success in all your endeavors.

Sincerely,

Asher Pinto

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