

Contents

About the Author *xxiii*

About the Contributors *xxv*

Introduction *xxvii*

Acknowledgments *xxxi*

1 Philosophy of Technical Analysis *1*

Introduction *1*

Philosophy or Rationale *2*

Technical versus Fundamental Forecasting *5*

Analysis versus Timing *6*

Flexibility and Adaptability of Technical Analysis	7
Technical Analysis Applied to Different Trading Mediums	8
Technical Analysis Applied to Different Time Dimensions	9
Economic Forecasting	10
Technician or Chartist?	10
A Brief Comparison of Technical Analysis in Stocks and Futures	12
Less Reliance on Market Averages and Indicators	14
Some Criticisms of the Technical Approach	15
Random Walk Theory	19
Universal Principles	21

2		
Dow Theory		23
Introduction	23	
Basic Tenets	24	
The Use of Closing Prices and the Presence of Lines	30	
Some Criticisms of Dow Theory	31	
Stocks as Economic Indicators	32	
Dow Theory Applied to Futures Trading	32	
Conclusion	33	

3	Chart Construction	35
	Introduction	35
	Types of Charts Available	36
	Candlesticks	37
	Arithmetic versus Logarithmic Scale	39
	Construction of the Daily Bar Chart	40
	Volume	41
	Futures Open Interest	42
	Weekly and Monthly Bar Charts	45
	Conclusion	46
4	Basic Concepts of Trend	49
	Definition of Trend	49
	Trend Has Three Directions	51
	Trend Has Three Classifications	52
	Support and Resistance	55
	Trendlines	65
	The Fan Principle	74
	The Importance of the Number Three	76
	The Relative Steepness of the Trendline	76
	The Channel Line	80
	Percentage Retracements	85

Speed Resistance Lines	87
Gann and Fibonacci Fan Lines	90
Internal Trendlines	90
Reversal Days	90
Price Gaps	94
Conclusion	98

5 Major Reversal Patterns 99

Introduction	99
Price Patterns	100
Two Types of Patterns: Reversal and Continuation	100
The Head and Shoulders Reversal Pattern	103
The Importance of Volume	107
Finding a Price Objective	108
The Inverse Head and Shoulders	110
Complex Head and Shoulders	113
Triple Tops and Bottoms	115
Double Tops and Bottoms	117
Variations from the Ideal Pattern	121
Saucers and Spikes	125
Conclusion	128

6 Continuation Patterns 129

- Introduction 129
- Triangles 130
- The Symmetrical Triangle 132
- The Ascending Triangle 136
- The Descending Triangle 138
- The Broadening Formation 140
- Flags and Pennants 141
- The Wedge Formation 146
- The Rectangle Formation 147
- The Measured Move 151
- The Continuation Head and Shoulders Pattern 153
- Confirmation and Divergence 155
- Conclusion 156

7 Volume and Open Interest 157

- Introduction 157
- Volume and Open Interest as Secondary Indicators 158
- Interpretation of Volume for All Markets 162
- Interpretation of Open Interest in Futures 169

Summary of Volume and Open Interest Rules	174
Blowoffs and Selling Climaxes	175
Commitments of Traders Report	175
Watch the Commercials	176
Net Trader Positions	177
Open Interest In Options	177
Put/Call Ratios	178
Combine Option Sentiment With Technicals	179
Conclusion	179
8	
Long Term Charts	181
Introduction	181
The Importance of Longer Range Perspective	182
Construction of Continuation Charts for Futures	182
The Perpetual Contract™	184
Long Term Trends Dispute Randomness	184
Patterns on Charts: Weekly and Monthly Reversals	185
Long Term to Short Term Charts	185
Why Should Long Range Charts Be Adjusted for Inflation?	186
Long Term Charts Not Intended for Trading Purposes	188
Examples of Long Term Charts	188

9 Moving Averages 195

- Introduction 195
- The Moving Average: A Smoothing Device with a Time Lag 197
- Moving Average Envelopes 207
- Bollinger Bands 209
- Using Bollinger Bands as Targets 210
- Band Width Measures Volatility 211
- Moving Averages Tied to Cycles 212
- Fibonacci Numbers Used as Moving Averages 212
- Moving Averages Applied to Long Term Charts 213
- The Weekly Rule 215
- To Optimize or Not 220
- Summary 221
- The Adaptive Moving Average 222
- Alternatives to the Moving Average 223

10 Oscillators and Contrary Opinion 225

- Introduction 225
- Oscillator Usage in Conjunction with Trend 226
- Measuring Momentum 228

Measuring Rate of Change (ROC)	234
Constructing an Oscillator Using Two Moving Averages	234
Commodity Channel Index	237
The Relative Strength Index (RSI)	239
Using the 70 and 30 Lines to Generate Signals	245
Stochastics (K%D)	246
Larry Williams %R	249
The Importance of Trend	251
When Oscillators are Most Useful	251
Moving Average Convergence/Divergence (MACD)	252
MACD Histogram	255
Combine Weeklies and Dailies	256
The Principle of Contrary Opinion in Futures	257
Investor Sentiment Readings	261
Investors Intelligence Numbers	262

11 Point and Figure Charting 265

Introduction	266
The Point and Figure Versus the Bar Chart	270
Construction of the Intraday Point and Figure Chart	270
The Horizontal Count	274
Price Patterns	275

3 Box Reversal Point and Figure Charting	277
Construction of the 3 Point Reversal Chart	278
The Drawing of Trendlines	282
Measuring Techniques	286
Trading Tactics	286
Advantages of Point and Figure Charts	288
P&F Technical Indicators	292
Computerized P&F Charting	292
P&F Moving Averages	294
Conclusion	296
12 Japanese Candlesticks	297
Introduction	297
Candlestick Charting	297
Basic Candlesticks	299
Candle Pattern Analysis	301
Filtered Candle Patterns	306
Conclusion	308
Candle Patterns	309
13 Elliott Wave Theory	319
Historical Background	319
The Basic Tenets of the Elliott Wave Principle	320

Connection Between Elliott Wave and Dow Theory	324
Corrective Waves	324
The Rule of Alternation	331
Channeling	332
Wave 4 as a Support Area	334
Fibonacci Numbers as the Basis of the Wave Principle	334
Fibonacci Ratios and Retracements	335
Fibonacci Time Targets	338
Combining All Three Aspects of Wave Theory	338
Elliott Wave Applied to Stocks Versus Commodities	340
Summary and Conclusions	341
Reference Material	342

14 **Time Cycles** 343

Introduction	343
Cycles	344
How Cyclic Concepts Help Explain Charting Techniques	355
Dominant Cycles	358
Combining Cycle Lengths	361
The Importance of Trend	361
Left and Right Translation	362
How to Isolate Cycles	363

Seasonal Cycles 369

Stock Market Cycles 373

The January Barometer 373

The Presidential Cycle 373

Combining Cycles with Other Technical Tools 374

Maximum Entropy Spectral Analysis 374

Cycle Reading and Software 375

15
Computers and Trading Systems 377

Introduction 377

Some Computer Needs 379

Grouping Tools and Indicators 380

Using the Tools and Indicators 380

Welles Wilder's Parabolic and Directional Movement Systems 381

Pros and Cons of System Trading 387

Need Expert Help? 389

Test Systems or Create Your Own 390

Conclusion 390

16
Money Management and Trading Tactics 393

Introduction 393

The Three Elements of Successful Trading 393

Money Management	394
Reward to Risk Ratios	397
Trading Multiple Positions: Trending versus Trading Units	398
What to Do After Periods of Success and Adversity	399
Trading Tactics	400
Combining Technical Factors and Money Management	403
Types of Trading Orders	403
From Daily Charts to Intraday Price Charts	405
The Use of Intraday Pivot Points	407
Summary of Money Management and Trading Guidelines	408
Application to Stocks	409
Asset Allocation	409
Managed Accounts and Mutual Funds	410
Market Profile	411
17	
The Link Between Stocks and Futures: Intermarket Analysis	413
Intermarket Analysis	414
Program Trading: The Ultimate Link	415
The Link Between Bonds and Stocks	416
The Link Between Bonds and Commodities	418
The Link Between Commodities and the Dollar	419

Stock Sectors and Industry Groups	420
The Dollar and Large Caps	422
Intermarket Analysis and Mutual Funds	422
Relative Strength Analysis	423
Relative Strength and Sectors	424
Relative Strength and Individual Stocks	426
Top-Down Market Approach	427
Deflation Scenario	427
Intermarket Correlation	428
Intermarket Neural Network Software	429
Conclusion	430

18 Stock Market Indicators 433

Measuring Market Breadth	433
Sample Data	434
Comparing Market Averages	435
The Advance-Decline Line	436
AD Divergence	437
Daily Versus Weekly AD Lines	437
Variations in AD Line	437
McClellan Oscillator	438
McClellan Summation Index	439
New Highs Versus New Lows	440
New High-New Low Index	441

Upside Versus Downside Volume	443
The Arms Index	444
TRIN Versus TICK	444
Smoothing the Arms Index	445
Open Arms	446
Equivolume Charting	447
Candlepower	448
Comparing Market Averages	449
Conclusion	452

19 Pulling It All Together—A Checklist 453

Technical Checklist	454
How to Coordinate Technical and Fundamental Analysis	455
Chartered Market Technician (CMT)	456
Market Technicians Association (MTA)	457
The Global Reach of Technical Analysis	458
Technical Analysis by Any Name	458
Federal Reserve Finally Approves	459
Conclusion	460

A Advanced Technical Indicators 463

Demand Index (DI)	463
Herrick Payoff Index (HPI)	466

Starc Bands and Keltner Channels 469

Formula for Demand Index 473

B **Market Profile** 475

Introduction 475

Market Profile Graphic 478

Market Structure 479

Market Profile Organizing Principles 480

Range Development and Profile Patterns 484

Tracking Longer Term Market Activity 486

Conclusion 490

C **The Essentials of Building a Trading System** 493

5-Step Plan 494

Step 1: Start with a Concept (an Idea) 495

Step 2: Turn Your Idea into a Set of Objective Rules 497

Step 3: Visually Check It Out on the Charts 497

Step 4: Formally Test It with a Computer 497

Step 5: Evaluate Results 500

Money Management 501

Conclusion 501

D		
Continuous Futures Contracts		505
Nearest Contract	506	
Next Contract	506	
Gann Contract	507	
Continuous Contracts	507	
Constant Forward Continuous Contracts	508	
Glossary	511	
Selected Bibliography	523	
Selected Resources	527	
Index	531	