TRADING AND INVESTING IN THE FOREX MARKET USING CHART TECHNIQUES

G. A. Burgess

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This edition first published 2009

Registered office
John Wiley & Sons Ltd, The Atrium, Southern Gate, Chichester, West Sussex, PO19 8SQ, United Kingdom

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Library of Congress Cataloging-in-Publication Data

Burgess, Gareth.
Trading and investing in the Forex market using chart techniques/Gareth Burgess.
p. cm.
Includes bibliographical references and index.
ISBN 978-0-470-74527-4 (cloth : alk. paper) 1. Foreign exchange market. 2. Foreign exchange futures. 3. Investment analysis. 4. Charts, diagrams, etc. I. Title.
HG3851.B866 2009
332.4′5–dc22 2009015945

ISBN 978-0-470-74527-4

A catalogue record for this book is available from the British Library.

Typeset in 10/12pt Times by Aptara Inc., New Delhi, India.
Printed in Great Britain by TJ International Ltd, Padstow, Cornwall, UK

To
Piers Leslie

"A lie gets halfway around the world
before the truth has a chance to get its pants on"
—Winston Churchill

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Preface

People lie, charts do not, so when I pull up a chart onto my screen and apply techniques that help me interpret the price action of the market I feel more confident in my own ability to understand the financial markets and the financial industry as a whole. My judgement and decision making is therefore stronger because it is based on sound reasons that are not subject to someone else's mistakes or lies. I am alone with my business, but my business is stronger because I am at the heart of the decision-making process and do not have to rely on half-hearted attempts from others.

My first experience with charting began back in 1988, I used an Amstrad PC and spreadsheet software known then as Supercalc 3, to create a type of chart. It wasn't very successful but it was my first attempt at creating a chart. I didn't follow it any further because I went off to study at university. Since that time, however, I have visited various technical analysis courses and seminars, read some very useful books and some books that are a useless waste of valuable time. Since 1999, however, I have been drawing lines on charts as a professional and over the last five years I have invested a lot of my time in researching the financial markets.

Chart analysis, to me, as a method of interpreting market price action is actually a very efficient way of finding great investment opportunities. For the technical trader it is a method of finding the optimal point at which to enter the markets. The difficult part about charting, however, is the correct interpretation of price action and with so many techniques and signal based packages available today, it only goes to make the process of price interpretation even more complicated. I have researched many markets using certain ideas or a certain criteria believing that the more complicated the analysis the greater the success at trading. The more I searched and researched the more I have come to realise that the most suitable methods, at least those methods that suit my character, are the simplest methods. That is to say, trend lines, support and resistance levels, patterns, Japanese candlesticks, moving averages and in many cases Fibonacci based signals. All of which are very straightforward and visually very well displayed on a financial chart. To me these are the essential chart techniques necessary to find trade and investment opportunities in the financial markets today. For this reason they are compiled in this book.

All of these aspects of charting have one very significant and little thought about fact, they are the aftermath of market price action, therefore they do not rely on a system but instead your own interpretation of the price action; and because trading and investing is essentially the task of finding opportunities in the financial markets, chart analysis is about finding and confirming investment opportunities. The reason I believe this is that the markets are always trending either long term, intermediate term, short term and very short term i.e., intra-day. The advantage of this phenomenon is that you find a market where change is taking place and use the opportunity to go with it. A market that has been trending upwards changes and moves sideways, then changes again and moves down. In fact, that is all the markets do, they either go up or down, it's that simple. Yet for many traders and investors making consistent profits is anything but simple!

Likewise over the years I have seen how many traders and investors are too concerned about the immediate and fundamental aspect of the markets, listening to every piece of news and reading various recommendations that might help them determine the direction of the market for the next 100 or 200 pips, even if there are sufficient technical reasons that are pointing essentially to a market top. Given enough recommendations or positive news releases, it is enough to make traders and investors abandon their initial idea and fall into the trap of becoming unseated, disconcerted and then lost, resulting in poor performance.

Even when some traders are able to find sound investment ideas and initiate a good trade they tend to be disconcerted the moment the market moves against them, and change their opinion completely. I have also seen how many traders, especially those new to the business and those who trade in their spare time, do so without a plan and with the most complicated or flawed technical set up. Even if it is a short-term trade, by creating a plan based on the daily charts the short-term trading becomes easier and has more directional bias if the context of the bigger picture is understood. Quite simply, if there is a signal on the daily chart that the market is going to retrace the short-term trade should be interpreted with that direction in mind. Traders new to the business are often more interested in the reasons than trading the actual price.

The very nature of trading and investing makes this business difficult. The uncontrollable human emotions that rotate around greed, fear and hope are the elements of the human reaction in the markets that form the same repetitive scenarios time and time again. The need for some sort of confirmation or more useful methods is always at the forefront of investing, and when I came across Japanese candlesticks they seemed, at first, to be the answer. It was, however, after many attempts at trying to decipher candles that I realised they would not be the final part of the puzzle in my investment strategy, at least not applied on their own. I do make use of Japanese candlesticks as signals but they have to be confirmed and put into context. In this book they are used on a very basic level, but are an essential aspect of interpreting market sentiment visually.

The purpose of this book is to demonstrate how to find opportunities that present themselves as trade and investment opportunities. The signals, the warnings about market sentiment, and the context and confirmation of signals that are necessary will become apparent, and you will be introduced to some of the familiar chart techniques that have stood the test of time, examples made available in such a way that it will not take long to understand how to apply these techniques to your own charts and study them for market opportunities.

The financial markets do not care who you are or what you do but you care about the markets because you don't want to be treated badly by them for not having done your chart analysis properly. Remember, opportunities don't look you in the face every day, but when they do you should exploit them to the full. Chart technical analysis will help you do this, set strategically into the financial playing field where luck is not a fact! Finally, if you have experienced bad investments and wrong trade decisions you need to identify those factors that have undermined the investment and neutralise them. You will have to take steps to strengthen your decision process and become capable of resisting other challenges that might give rise to faulty decision making. This book will help you to at least see signals that are presenting a market that has an investment opportunity. They are clear and concise and therefore should help your decision-making process. If you feel, however, the need to look for advice by listening to other people, or other recommendations, then at least try to listen only to those people who have real trading experience!

ACKNOWLEDGEMENTS

First and foremost I would like to thank Caitlin Cornish for insight and suggestions during the draft stage of the book. I would also like to express my thanks to Aimee Dibbens, Samantha Hartley, Louise Holden and Lori Boulton at John Wiley & Sons. Thanks also to my copy editor Dan Leissner. Finally I would like to thank my wife Johanna, and my three wonderful children, Robin, Piers, and John-Jamie, for their understanding and patience during the writing of this book.

1
Candlesticks = Signals

INTRODUCTION

Traders and investors have been looking at charts for well over 85 years as Edwin Lefèvre wrote (1994, p. 61), "I should say that a chart helps those who can read it or rather who can assimilate what they read". The problem today, however, arises not only from the interpretation of the chart but also how best to apply the mass of indicators and what indicators are best applied.

This book and the techniques that are discussed set out to demonstrate how to use a chart in the context of the market price action, that is, what to look for on a financial chart and then to place the signal into some form of technical context that will make it possible to gain insight very quickly into a particular currency market, thus saving many hours of fundamental research. This book demonstrates chart analysis that can give you, as a technical trader, an edge for entering a position in the financial markets, allowing the position to be monitored on a daily basis for signs of change or weakness.

The purpose of this book is not to teach you how to trade the markets, but instead how to find opportunities in the markets that present themselves as trade and investment opportunities. The signals, the warnings about market sentiment become apparent once you understand how to apply some of the familiar chart techniques that have stood the test of time, examples made available in such a way that it will not take long to understand how to apply these techniques to your own charts and find trade and investment opportunities.

Regardless of whether you are a part-time trader or full-time trader, your only concern is to find important signals that represent opportunities that will lead you to a profit. The daily market price action that appears on charts in the form of Japanese candlesticks or patterns are, for whatever reason, the result of the actions of market participants, but a technical trader is not interested in the crowd's reasons for doing what they do, but instead the result of their buying and selling.

It is, however, during the buying and selling that the emotional responses of many market participants are heightened and these emotionally loaded responses to the market occur time and time again and are categorised as FEAR, HOPE and GREED. In light of the vast amount of information that is available via the internet or news channels, these emotions are quite often heightened to such an extent that it is almost impossible to make a clear decision leading in many cases to badly executed trades. The opinion of some expert somehow gets the message across that undermines your objective thinking, and it is ultimately the recommendation that is the technical trader's worst enemy. To invest in the financial markets it is absolutely necessary to create your own plan based on your own analysis. A trade should be executed from a position of power and confidence not from uncertainty or based on feelings.

In this book the techniques are applied in a relatively straightforward manner so as to create a technical picture on which to base an investment decision that does not rely on any outside recommendations but instead on your own visual analysis of the markets. A chart should be used to identify the opportunities that are ever present in the financial markets, monitor long-term investments and help to plan an investment decisively. Charts should also be used to find the appropriate level at which to enter or exit a position.

Chart analysis is a cold hard study of the markets, it is a study of the price action and nothing more. If the closing price of the Euro continues to move higher in the week then foreign exchange traders and investors will be buying that currency, which is a fact, in spite of what the fundamental and economical reasons may be.

Interpreting a chart is about recognising and understanding the sentiment of the market. If the market was bullish, is it still bullish, if not, why not? Is the market correcting or is it a reversal?

In this book, the more obvious techniques have been taken and applied as ideas for expressing the technical picture. The techniques have been arranged in order of importance and are readily and quickly understandable and bring those searching for a method of interpreting the financial markets to their objective.

Each subject relates to the phenomenon of chart technical analysis with the issue of the investment and trading strategy being part of the plan. Six primary chapters cover the subject matter.

Chapter 1 looks at the categories and ideas behind signals produced by Japanese candlesticks with a focus on the market sentiment. The candles are reduced to eight types in order to comprehend the ideas derived from them, covering the more general standard type signal representing both extreme and normal market conditions with the more abstract representing uncertainty and imminent change.

Chapter 2 relates to the patterns that appear in the financial markets and the various relationships to market sentiment including how to find possible measured targets upon a breakout of the pattern, a pause in the market trend and a change in market sentiment. Patterns are important signals and many market participants trade them.

Chapter 3 looks at the idea of support and resistance levels focusing on trend line support and resistance and the phenomena of polarity and pivot lines that give rise to a simple price observation at levels considered as bullish or bearish, allowing the technical trader to determine market direction and monitor positions.

Chapter 4 introduces the moving averages and the momentum indicators, both of which are based on the underlying price action. The averages supply information about the conditions of the market such as trending environment and support and resistance, the momentum indicators monitor the close in relation to the highs and lows over a set period of time and reflect this as the rate of change within the market. The momentum indicator is used for confirmation of market price action, displaying over-bought and over-sold conditions and divergence.

Chapter 5 applies certain techniques to the charts for finding optimal entry levels as confirmed by the techniques in the previous chapters. The obvious consequences of finding optimal market entry, covered by such themes as volume, pivot lines and interpretation of short-term charts, are very important for the technical trader.

Chapter 6, the final chapter, draws on all the methods and techniques discussed previously in order to create a plan not only for watching the markets for signals but also for developing a strategy to be used for investing and monitoring a position.

All of the methods and ideas covered here come under a form of classification in the world of technical analysis. There will be the view that the ideas contained here must include also the ideas relating to their class. This is not necessarily the case as there has to be an element of will in trading and investing. The operations that involve placing wealth at risk involve emotions, therefore all that can be achieved technically is to arrange those technical tools in accordance with the dominant ideas behind them and convey them in such a manner that the primary task of creating a consistent yet simple technical picture of the financial markets is achieved.

In studying these techniques the reader will undoubtedly try to adopt and produce slight variations. This should be encouraged, however, these techniques, especially those indicators used for the purpose of demonstrating a change in momentum, have stood the test of time, that is, they are universally accepted as being sufficient and do not require change or modification. Applying the same parameters and back testing will prove this argument. It is with these techniques that you will master the basics necessary to understand your own charts and thus read the underlying market sentiment.

JAPANESE CANDLESTICK SIGNALS

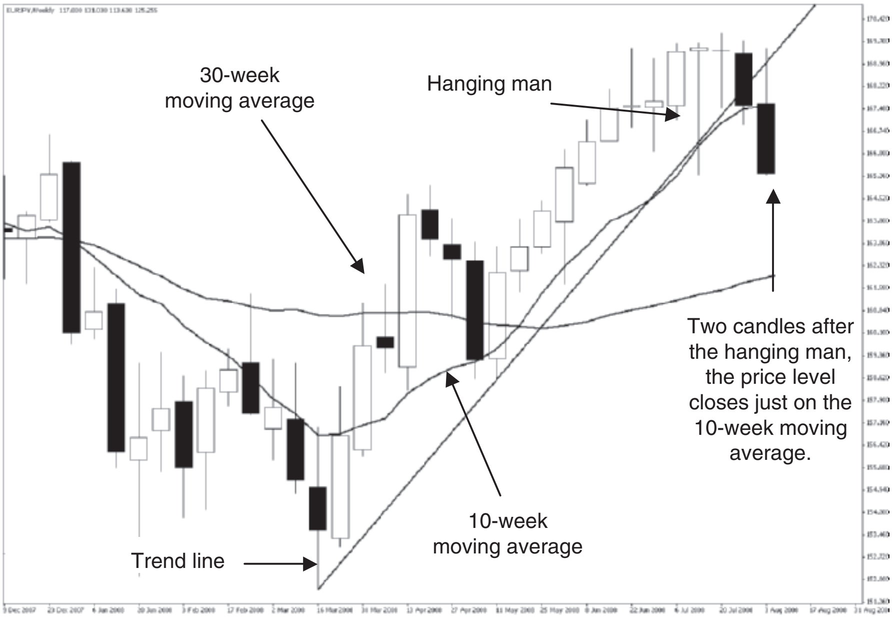
On Friday 13 July 2008, the foreign exchange cross EUR/JPY closed the week leaving a large bearish signal on the weekly candlestick chart. This signal, known as a "hanging man" in Japanese candlestick terms, is bearish if seen at certain levels on a chart especially after an advance in recent price action. It is considered by chartists and technical traders to be a warning that the market is reaching a top and may falter on attempts higher. This simple candlestick signal offered traders of the foreign exchange market (Forex or FX) a great opportunity to enter a short position in the EUR against the JPY, see Figure 1.1 overleaf.

(source MetaQuotes Software Corp)

Figure 1.1 EUR/JPY weekly chart with large hanging man candlestick.

The hanging man candlestick signal appeared on the chart because during the early part of the week the market had sold off sharply only to see buyers re-enter the market and push the price back towards the opening levels thus creating the "hanging man" with a lengthy "shadow".

At the close of that week there would have been many traders in the market, including fresh buyers, all of whom were anticipating higher levels to come and yet were nervous at the slightest decline in price action. The following week a similar candlestick appeared at the weekly close, another warning signal which left many forex traders that weekend concerned about their positions in the market. Two weeks after the first hanging man appeared, clues begin to unfold which confirmed that there is a change taking place in the market, a change which the initial bearish candlestick had signalled previously. For example, there was a close below the current trend line that week, the first since the trend began on 16 March 2008, that is 19 weeks had passed before the trend line had been violated! Another very important clue was the close of that weekly candlestick on Friday 25 July 2008, this was the first weekly close at the 10-week moving average level since the two averages crossed positive on 18 May 2008. In fact, prices dipped below the 10-week moving average before closing just above it but still below the trend line, see Figure 1.2 opposite.



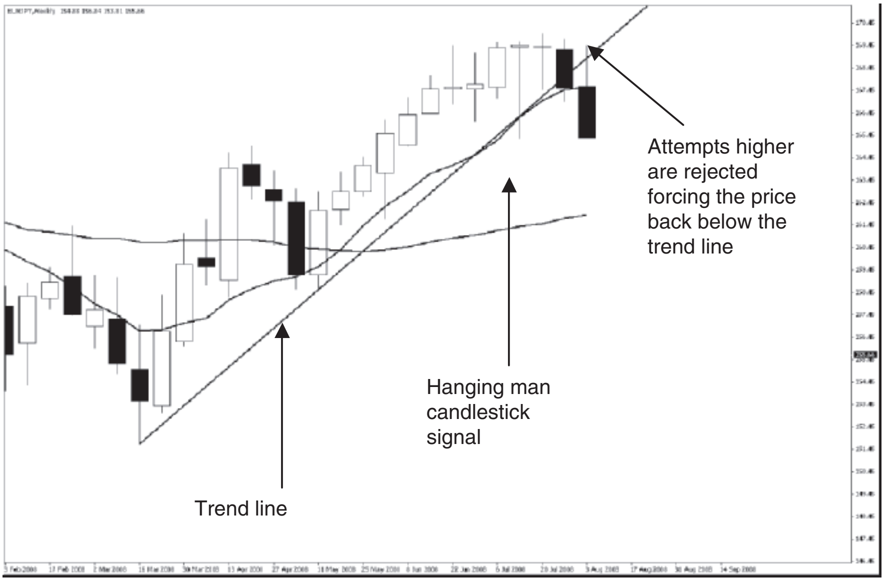
(source MetaQuotes Software Corp)

Figure 1.2 EUR/JPY weekly chart demonstrating a break of a trend line and a close below the 10-week moving average, the market sentiment is changing.

At this point those traders that had entered the market pushing the market back up would have been left holding losing positions but still hanging on in hope that the market would move off higher from the current level. Although the EUR/JPY cross did attempt to move higher from the 10-week moving average it was rejected, not only from the highs, but also from the trend line where technical traders had been waiting to sell, see Figure 1.3 overleaf.

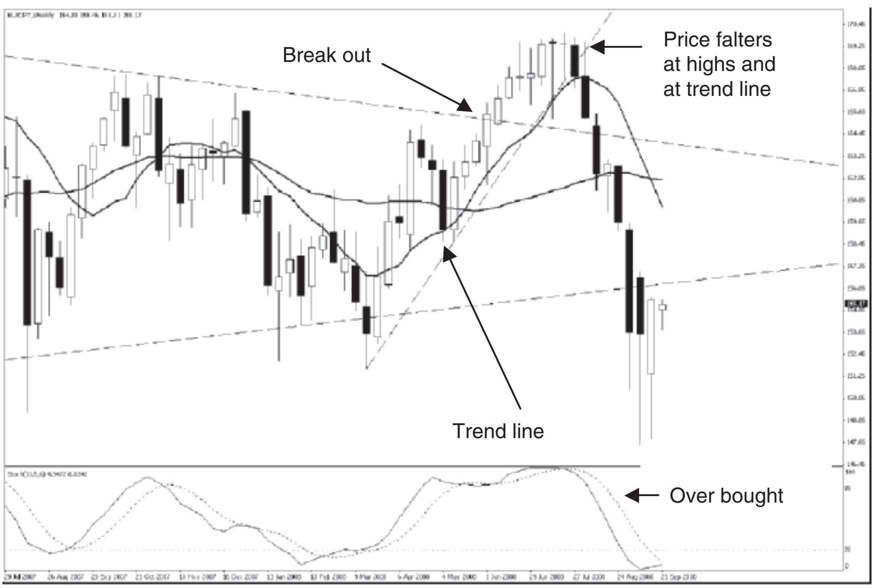
The hanging man candlestick signal now began to take effect. At some point, those traders, either working in banks or large corporate organisations that were still long began to reduce their exposure in the market by cutting the size of their positions. The result of all of this is that the EUR/JPY cross accelerates lower as traders cut their positions. As you can see from the chart in Figure 1.4 overleaf, the price pauses at the 30-week moving average before continuing much lower. Originally, all of this price action was based on a very powerful and yet very visual signal.

There were also two other very important clues that the EURO would struggle to move higher against the Japanese Yen. The stochastic indicator was in the over-bought zone and was beginning to cross negative, there was also a large triangle pattern from which the EUR/JPY had broken out too soon, suggesting that prices would falter and find their way back inside the triangle.



(source MetaQuotes Software Corp)

Figure 1.3 EUR/JPY weekly chart showing the beginning of break down in market price action.



(source MetaQuotes Software Corp)

Figure 1.4 EUR/JPY weekly chart after the break down in market price action has occurred.

(source MetaQuotes Software Corp)

Figure 1.5 USD/CAD daily chart showing buy and sell areas.

Having seen the hanging man candlestick signal, you as a technical trader of the foreign exchange market would have been prepared for a change in market sentiment. You would have expected the change to happen and would have been watching the chart for further technical evidence to confirm the signal, gathering information and creating a strategy from your chart that would enable you technically to follow the market. What is probably more important, however, is the trade which you would have seen as a low risk trade in your favour. A stop-loss order placed some points above the hanging man, at the level where you would have been wrong and wanted to protect your money, was easily positioned in the market, ensuring absolute risk/reward.

A chart should be technically easy to interpret. If the technical picture is difficult to understand then something is wrong with your analysis or some technical indicator has not been placed correctly on the chart. It is the signals together with indicators as well as support and resistance and trend lines that make up the technical picture that helps to dissect the market price action and display the market sentiment in such a way that a conclusion may be reached, see Figure 1.5. These techniques must be consistent and concise in their application. Consistency will help to avoid uncertainty in finding and confirming the opportunities as and when they appear on the chart.

THE SINGLE SIGNALS

Beginning with Japanese candlesticks, these signals originate with a Japanese rice merchant named Munehisa Homma (also known as Sokyu Honma) (1724–1803),