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Why does technical analysis work?

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Technical analysis describes different ways of predicting the future of the stock/futures market based on its history. Unfortunately, technical analysis is not an exact science. Many prominent scientists label it as "voodoo science". They claim that due to market efficiency, if you use TA to find your entry positions, you're no better off than someone who chooses those positions randomly. Market efficiency means that all the available information is already calculated in the stock prices, and that you can only guess how the price will behave in the future.

The "voodoo science" theory would make sense if it wasn't for the fact that there is a significant number of traders who are able to consistently make profits in the stock/futures market. These traders use technical analysis as their main tool. Since any trader has or can have access to the same TA tools we have to ask how can a small group of traders consistently win and the other larger group, more or less consistently lose in the stock market game. What is it that winning traders know about technical analysis that gives them the upper hand?

The answer is simple: Technical Analysis works but not necessarily for the reason most people believe. Many successful traders don't want to share this secret. TA works because many people use it, and successful traders are able to predict how other people will react on the different TA indicators and signals. In other words, while the losing traders are using TA to determine their trades, the winning traders are winning because they know how the losers are going to react based on this data. For example, when a price goes below one of the key moving averages, (MA's) many investors sell that instrument to protect themselves against additional losses. By doing so, they will drive the price of that instrument lower and that will prompt some traders to start short selling that instrument in anticipation of further decline. Prices continue the downward trend, forcing traders who were long on that stock to sell their positions because it is going below their stop limits. This creates a domino effect as the price continues to decline. However, at this point, successful traders realize that most of the current price action was created artificially. They start to enter positions on the buy side and more often than not price starts to reverse. The losing traders have already sold their contracts based on the TA tools. The winning traders buy the contract because they understand that the fluctuation was temporary, and they seize the opportunity based on the losing trader's reactions.

No TA tool by itself will give you reliable buy or sell signals. There is no Holy Grail or magic black box that will give you the perfect, accurate signal. However, the combining of the right group of TA indicators with discipline and adequate trading capital has been the road to fortune for many traders. There is no reason why you cannot emulate their success. Let's take a look at an example.

Understanding Pivot Points

Pivot Points are those price levels that are most likely to act as levels of support and resistance on any given trading day. As we already know, Technical Analysis works because many people use it. For the same reason, the most influential pivot points are those that are used by majority of traders. The most widely used formula for calculating pivot points is as follows:

H = previous day's high
L = previous day's low
C = previous day's close

Pivot Point = (H + L + C)/3
Resistance = 2*PP - L
Support = 2*PP - H
Previous day's last two hour high = L2HrHigh
Previous day's last two hour low = L2HrLow

When the price moves through the known pivot point on increased volume it is most likely to continue current trend, and if the price hits the known pivot point but is unable to move through it is most likely to reverse the current trend.

Figure above is a 5-minute candlestick chart for S&P 500 E-mini contract and you can observe how the Pivot Point was acting as a major support line throughout the trading day. When the advancing/declining price is not able to move through the known pivot point after two or more tries there is a good probability that it will start to decline/advance. Trading method in which a trader is waiting for a price to reverse after hitting S/R level is called swing trading. On the other hand if the advancing/declining price has easily moved through known S/R level there is a good probability that it will continue to advance/decline. Trading method in which a trader is looking for a price to continue to move in the same direction after moving through S/R level is called breakout trading. To read more about Zoran Kolundzic course Go Here

Good Trading

Best Regards
Mark McRae