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The foundations of technical analysis

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The foundations of technical analysis

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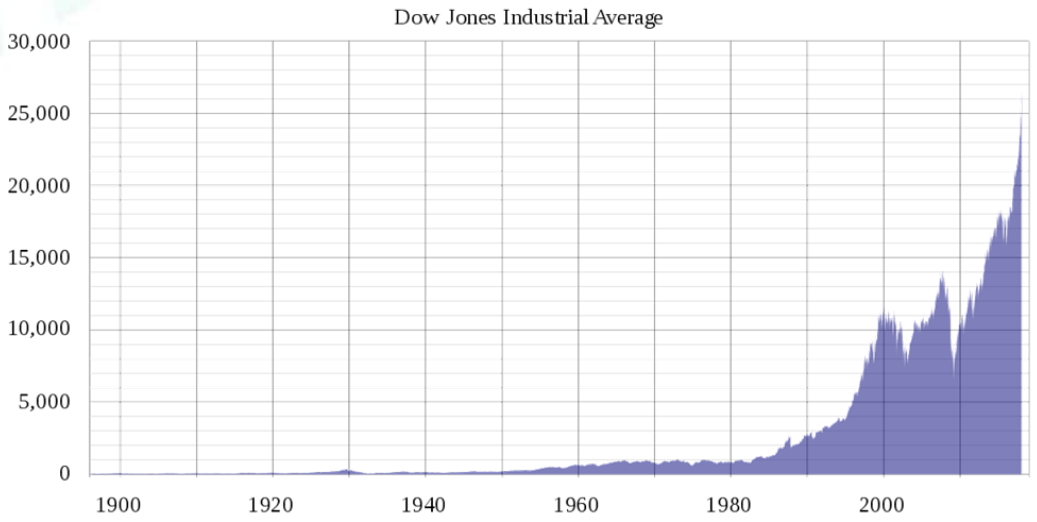
Dow Theory

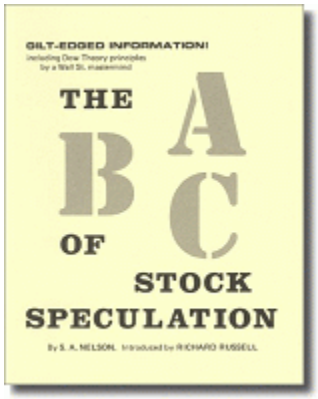
Charles Dow and his partner, Edward Jones, have established the **Dow Jones & Company** in 1882. Most technical analysts agree that Charles Dow has established the foundations of technical analysis more than hundred years ago. Dow has published his theories in **The Wall Street Journal** between 1900 and 1902. The **Dow Theory** is the basis of today's sophisticated computer trading systems. On the 3rd of July, 1984, Dow has summed the closing prices of 11 shares into one index. 9 out of the 11 shares were railway companies and the other 2 were manufacturing companies. Dow has believed that these 11 companies can give a realistic picture about the economic state of the country.

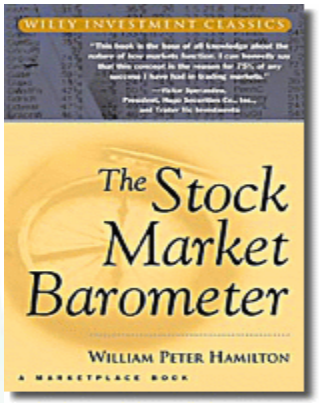
He has further developed the compression of shares into indexes, and applies two indexes in 1987. He thought they represent the market mood more accurately. He developed an *industrial index* from 11 shares, and another *transportation index* from 20 shares of railway companies. By 1928, the industrial index has consisted of 30 securities. Today it is called the **Dow Jones Industrial Average**. The editors of The Wall Street Journal have updated the list several times in the following years. In 1929, the index was completed with securities of small-scale companies.

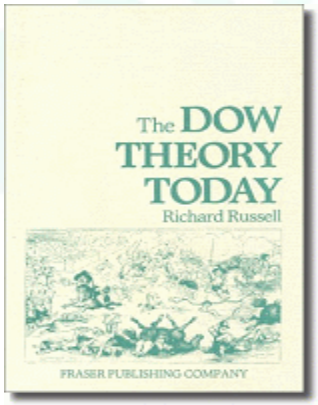


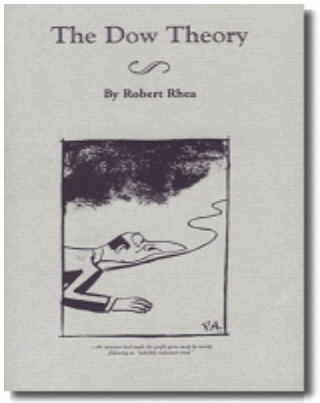
Dow Theory

Unfortunately, Dow has never summarised his theories in a book, his work was only published in *The Wall Street Journal*. In 1903 (one year after Dow's death), *S.A Nelson* has organised the publications and published a book called **The ABC of Stock Speculation**. Richard Russel - who wrote the prologue of the edition of 1978 - has compared Dow's theories with Freud's dissertations. In 1992, *William Peter Hamilton* has categorised and published Dow's aspects in the book called **The Stock Market Barometer**.





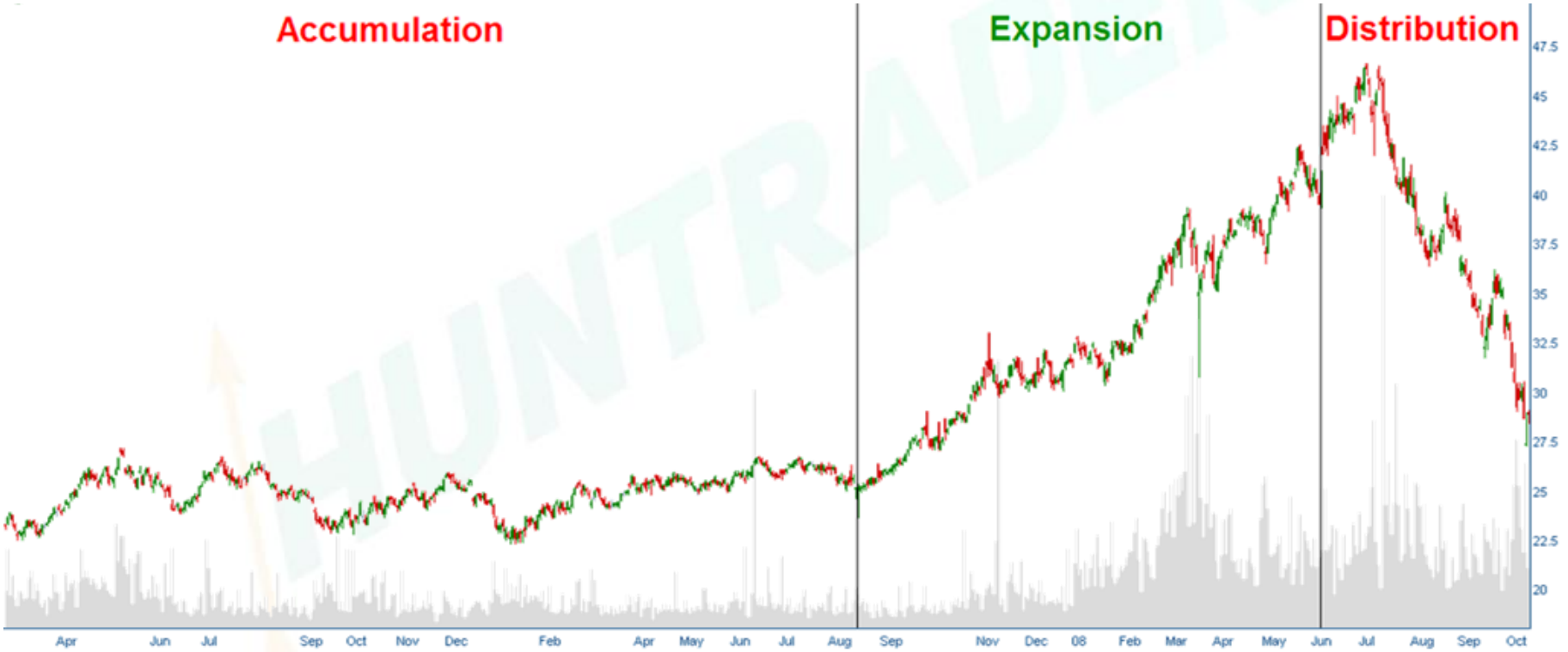




Dow has applied his theories on his industrial and railway indices, but his assumptions can be applied on any other index. In the next section, the six principles of Dow is going to be assessed and shown how it can be applied today in the technical analysis.

The primary trend consists of three phases

Example for the three phases: price of the DB Commodity Index.



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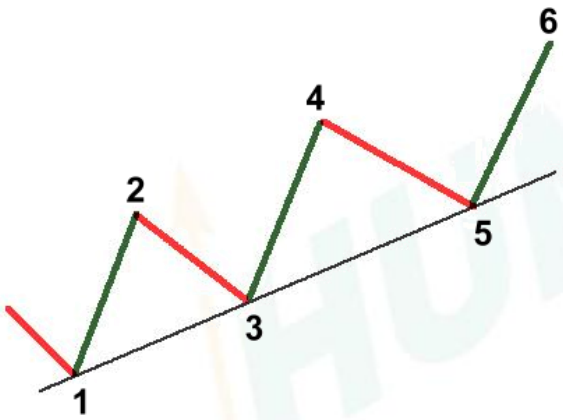
Trendline

Trendline is the simplest and most important tool of a technical analyst.

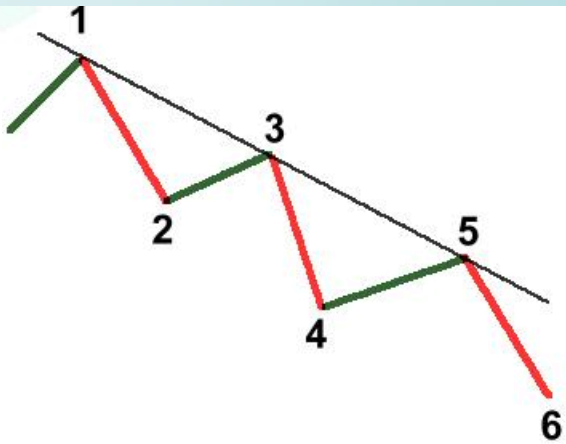
An ascending trendline is a linear line connecting local minimum points. An inclining trendline is also a linear line but it connects the local maximum points.

Ascending trendline



Ascending trendline is drawn by connecting local troughs (1, 3, 5). The experimental trendline is the line connecting the first two troughs (1, 3). However, another trough (5) is needed to get a valid trendline.

Descending trendline



Descending trendline is drawn by connecting local peaks (1, 3, 5). The experimental trendline is the line connecting the first two peaks (1, 3). However, another peak (5) is needed to get a valid trendline.

Trendline

Drawing trendlines

Drawing a trendline depends on the analyst's **skills and visualisation** - apart from some important rules. The valid trendline must be chosen from the several experimental lines.

A trend must be present on the market to draw a trendline. This means that one needs at least two increasing local troughs to draw an ascending trendline. Naturally, two points are enough to connect to draw a line, but a trendline is widely accepted when a third local trough does not break it.

Some chartists believe that on the trendlines drawn in the previous example, the share prices must exceed the 2 points to actually talk about a trend. Others may settle with the 50% consolidation of 2-3 waves.

Which points to connect?

Trendlines are drawn above or below the daily trading ranges. Some chartists draw trendlines by connecting only closing prices, but this is not the standardised method. Although closing prices are important elements of the daily price changes, but they don't tell anything about the movements during the day.

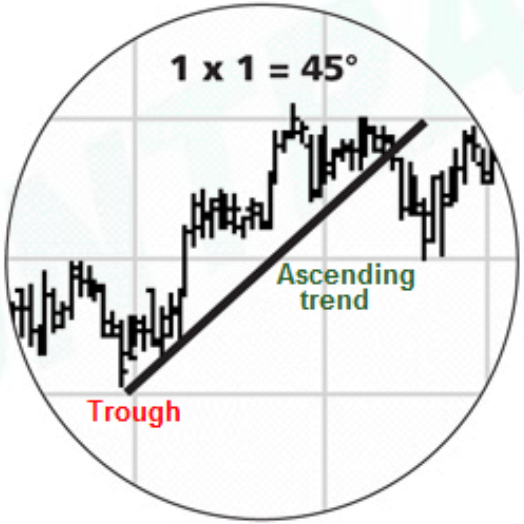
Drawing a correct trendline is by connecting the daily maximum and minimum points.

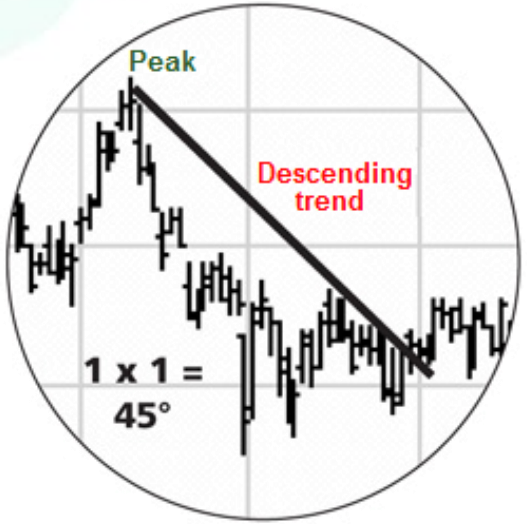
Relative steepness of trendlines

The **relative steepness of trendlines** is an important factor as well. The average steepness of the most significant ascending trendlines is 45 degrees. Some chartists draw a trendline with 45 degree steepness from local minimum and maximum points before the trend develops and use it as a trendline.

W. D. Gann was the first who applied a 45 degrees steep trendline. Gann has defined further trendlines with different steepness.

1 x 8 = 82.5 degrees
1 x 4 = 75 degrees
1 x 3 = 71.25 degrees
1 x 2 = 63.75 degrees
1 x 1 = 45 degrees
2 x 1 = 26.25 degrees
3 x 1 = 18.75 degrees
4 x 1 = 15 degrees
8 x 1 = 7.5 degrees

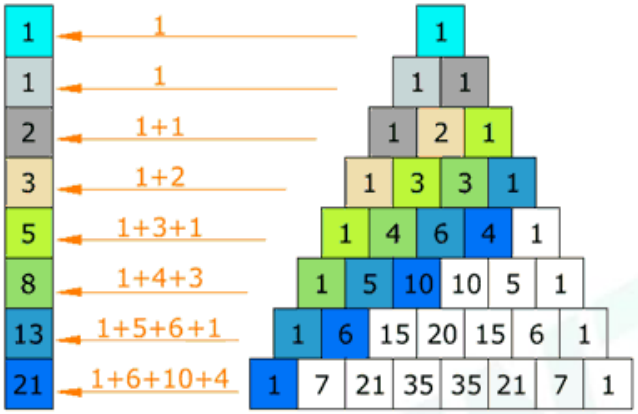




As the steepness of a trend line increases, the validity of the support or resistance level decreases.

Fibonacci Correction

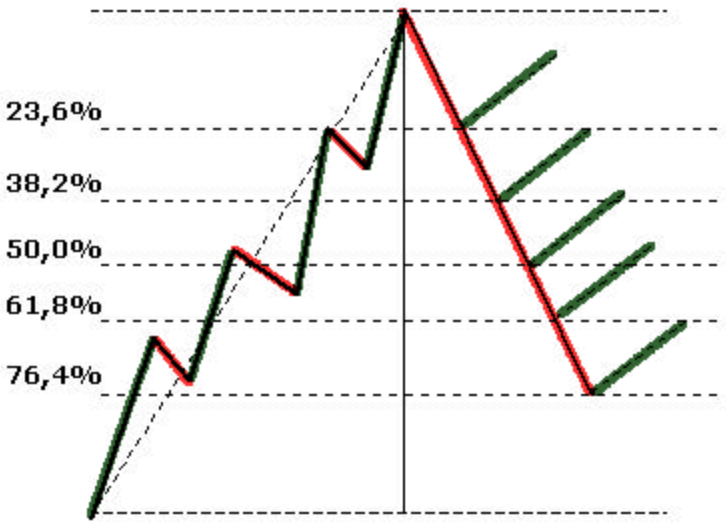
Leonardo Fibonacci was an Italian mathematician in the 12th century. He invented the "Fibonacci sequence", which is a series of numbers where every number is the sum of the previous two numbers.



This method is easily illustrated on *Pascal's triangle.* The numbers are related to each other, because every number is the multiplication of the other number by 1.618.

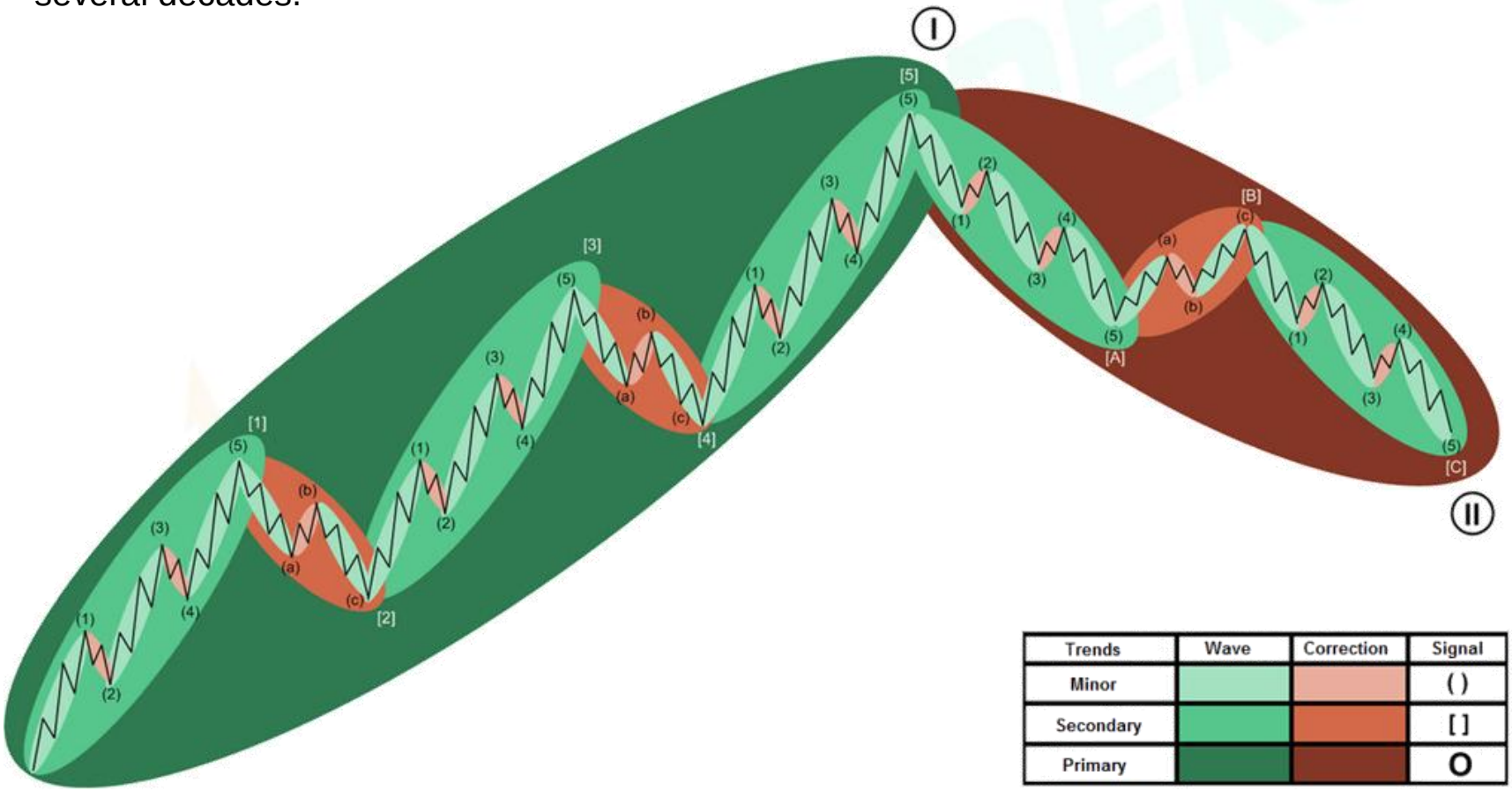
In case of a Fibonacci retracement, the levels are determined by dividing one member of the series by itself and then by the following number and then by the one following that number, and so on.

23.6%, 38.2%, (50%), 61.8%, (78.6%), and 100%
Although the 50% and the 78.6% are not Fibonacci sequence, many traders use them as support and resistance levels.



Elliott Fractals

Elliott has pointed out that **main trends can be dissected into medium waves**, which are built up by minor waves (also known from Dow's theory). These trends can be analysed in wide time horizon, because one can see cycles lasting from minutes to several decades.



Trends	Wave	Correction	Signal
Minor			( )
Secondary			[ ]
Primary			O

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