TECHNICAL ANALYSIS WELL SUITED FOR ALL OCCASIONS

By Brian Dolan

News about the forex arena has been hitting the headlines in recent months, amid talk of impending doom for the U.S. dollar and rampant speculation regarding the appropriate value of the Chinese currency, the yuan. Traders from a variety of markets have flocked to the forex arena to try to their hand in the world of global currency trading.

Experienced currency traders have long recognized the value of technical analysis for spotting emerging trends and short-term trading opportunities alike. For traders coming from other markets where a technical approach may not have been as appropriate, it may help to understand the reasons why technical analysis is so well suited to forex trading. A better appreciation of how and why technical analysis is used with currencies can also help technical traders new to forex understand the strengths and limitations of using a technical approach.

MARKET SIZE AND STRUCTURE

The starting point for understanding why technical analysis lends itself so well to forex is the sheer size and basic structure of the global currency market. Tens of thousands of traders around the world are active in the currency market at any given time. This stands in contrast to other markets, such as individual equities or commodities, where there may only be a few dozen significant participants. Smaller, less liquid markets are more prone to manipulation or distorted price action, which can make them far more difficult to trade from a technical approach. A large market sell order in a small ca p stock, for instance, can temporarily overwhelm a support level, generating a false break and creating a whipsaw for unlucky breakout traders. In a deeper, more liquid market such as forex, that level might have held.

When technical levels do break in forex, the massive amount and broad diffusion of market interest means that the break holds greater legitimacy and is a more actionable trading signal. The popularity of forex, and hence the number of traders and the depth of the market, has only grown since the advent of online forex trading a few years ago, and this further increases the depth of the market.

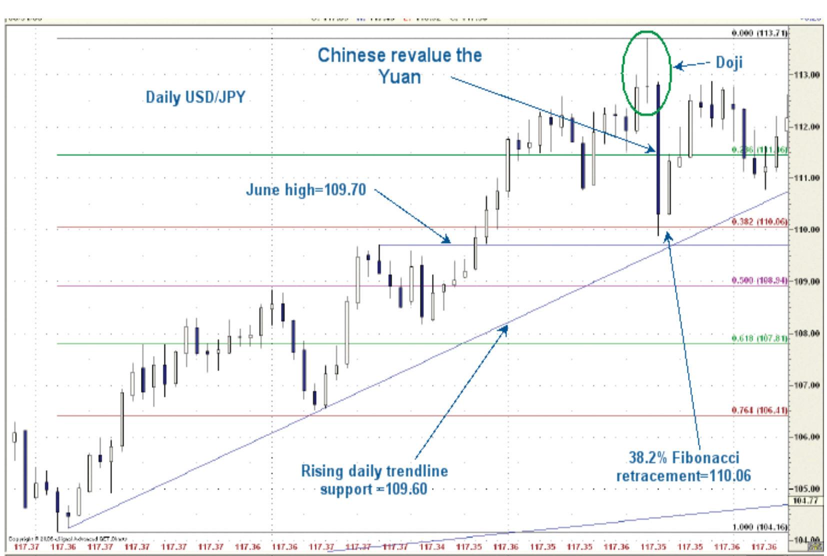
ROUND THE CLOCK

Another structural element unique to forex is that the market operates on a continuous, round-the-clock basis, from Sunday to Friday afternoon New York time. There are no closes or opens, just seamless price discovery all week long. Anyone who employs technicals realizes that price discovery is the essential building block of technical analysis. Since forex markets operate continuously, price discovery is constant and that means more price points to be incorporated by technical studies, increasing their validity. Continuous trading also eliminates the close-to-open price gaps that frequently plague exchange-based markets.

When news comes out after hours, equities and commodities markets cannot factor in the new information until the next trading session, typically resulting in a gap between the prior close and the new open. Forex markets are able to process new information as it becomes available and prices adjust in a more orderly fashion over time as the information disperses and traders act on it. To be sure, there are price gaps in forex, as anyone who has traded a U.S. employment report knows. But these gaps are mostly data-related and thus easily anticipated, and are more the exception than the rule.

Far more often in forex the case unfolds where unexpected news comes out (think of hawkish comments from the Fed chairman when he was expected to be dovish), provoking an initial price response as front-line traders react to the news. As word of the comments spreads to other market participants, who may be slumbering in time zones half a world away, fresh interest enters the market and adjusts prices further. The key factor to note here is that this process takes time, however brief—usually meaning only a few minutes or hours. Alert technical traders are more likely to benefit in this environment because they will already have analyzed the market and highlighted the major break points and price projections.

FIGURE 1: Aftermath of the Yuan Revaluation



A daily candlestick chart shows USD/JPY on the day China revalued the yuan. The confluence of rising trendline support, prior daily highs and 38.2 percent Fibonacci retracement level highlighted a significant support level amid a market meltdown.

Source: Forex charts by eSignal

FILTERING OUT THE NOISE

Currency trading is driven by macro-economic data reports, interest rate policies, and major geo-political developments. Even if you focus only on the major currency pairs, that's still at least eight major countries to keep an eye on, with each issuing its own economic reports and setting individual monetary policies. In addition, any number of government or central bank officials is likely to make public pronouncements that may or may not affect the local currency. The result can be an overwhelming amount of information, or market noise, which can obscure underlying price trends. Forex traders use technical analysis to help them cut through the fog of all the competing information and distill the essence of what is really happening.

FOREX OPTIONS

One major component of the forex market that is frequently overlooked in its effect on price action is the prevalence of forex option interest. The OTC currency option market is the largest option market in the world in terms of notional size of outstanding options. This largesse translates into a massive amount of delta and gamma-based trading in the spot market on a continuous basis. Currency option traders rely heavily on technical analysis to identify appropriate levels for hedging, reinforcing the significance of chart points and trendlines.

Option volatilities can respond significantly when major technical levels are breached. Prolonged range trading sends volatility lower, but when the range is broken, volatilities spike higher on the basis that the price is adjusting to a new level. Technical analysis can be used to identify both the range in which volatility drifted lower and the price break that triggers the spike in volatility. Option traders also rely on technical analysis to project the extent of the breakout and to adjust hedging strategies accordingly. The strike prices of exotic options, such as barriers, knock-ins and double-notouches, are frequently chosen based on chart analysis. The subsequent hedging/defensive trading that results then reinforces and highlights those same technical levels.

THE RISE OF THE MODELS

Forex markets have always been a favorite of hedge funds even before the current explosion in the ranks of the hedge fund industry. Among currency-only funds, systematic or quantitative model-based funds have risen sharply in proportion to discretionary funds over the last few years, as investors seek more predictable risk/return ratios. Technical studies of momentum and stochastics form the basis of many of these black box model funds, while others rely on methods as simple as moving averages and range analysis. For systematic traders new to forex trading, many online platforms offer API (automated program interface) links that enable individualized model-based trading, as well as back-testing features to assist in model development.

ORDER AMIDST MARKET CHAOS

Forex markets are no stranger to explosive volatility. Whether it's a terrorist attack or a disappointing employment report, currencies can react swiftly and violently to unexpected news. Many fundamental traders dismiss technical analysis as unable to cope in such environments, and even many technical traders are tempted to throw their charts out the window when it really hits the fan. No doubt, some technical methods are inappropriate. Momentum studies, for example, are ill-equipped to respond to sudden news events given their lagging nature and should probably be discounted in fast moving markets. But to suggest that technical analysis as a whole is ill suited to extreme volatility ignores the powerful tools in the technical bag.

A good example can be found in the mayhem that followed the Chinese revaluation of the yuan in July 2005. Markets had been anticipating a revaluation for most of the year and were repeatedly disappointed. When the announcement came out, markets were initially caught off guard and then reacted in an explosion of Japanese yen (JPY) buying and dollar/yen (USD/JPY) selling. (The market bought the yen based on the notion that the Japanese currency would have to appreciate in a competitive revaluation to match the Chinese currency.) USD/JPY plunged nearly 300 points in a matter of a few hours, from 112.90-109.90, a loss of about 2.5 percent. At the time, it was unclear when the move would stop, but some basic technical analysis revealed an important support level that eventually held, even in that chaotic environment.

Figure 1 shows a daily candlestick chart of USD/JPY leading up to and including the day of the Chinese revaluation. The most obvious feature is rising trendline support from daily lows dating back to the beginning of May, which came in at 109.60 on the day of the revaluation. Additional technical support was evident from the June highs at the 109.70/75 level, indicated by the horizontal line. Finally, a basic Fibonacci retracement from the May lows to the July highs revealed the 38.2 percent pullback level was located at 110.06. Taken together, trendline analysis and Fibonacci retracements suggested a significant zone of support between 109.60-110.06. Even in the chaos of a surprise Chinese revaluation, technical analysis proved its worth by highlighting an important support zone. Fundamental traders who sold based on the event would have been well served by drawing basic trendlines and calculating retracements to determine where to take profit.

Candlestick analysis might also have identified the downmove before it happened, or at least warned of the possibility. The candle of the day before is a "doji" with a long upper tail (green circle). Doji reflect market indecision and are generally considered neutral until confirmed by subsequent candles. However, doji can also give an early warning sign of an impending price reversal if they appear after a series of rising or falling candles. In this case, prices had been rising prior to the doji, suggesting potential for a reversal lower. The long tail above indicated a rejection of buyers after a new high for the upmove was reached, reinforcing the potential for a downside reversal.

TAKE A LOOK AT THE CHARTS

Forex markets are ideal trading grounds for practitioners of technical analysis. The depth and breadth of the forex market favors technical analysis to identify important price moves and filter out conflicting fundamental signals. Technical analysis is relied on by a variety of currency market participants—option traders, black box models and short-term spot traders alike—reinforcing its utility for trading forex. Technical traders would do well to consider forex trading, while fundamental currency traders would do well to consider utilizing technical analysis to improve results. ■

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