



Mike Swanson's

StockMarket  
Mastery

WallStreet Window

Magic Indicators - Five Indicators You Must Use to Analyze any Stock

There are literally hundreds of technical indicators that you can plot out on a stock chart. If you have your own stock software you undoubtedly have seen many of them. But if you are like most investors you may be overwhelmed by the number of indicators available to you. Many of them are similar to other indicators so there is a lot of duplication. Over the years I have found about a half dozen indicators that work best for me.

You should already have learned about the life cycle of a stock and how a stock can go from being in a bull market and into a bear market in module two titled Bullish Beginnings - How to Identify Any Market, ETF, or Sector Just Starting a New Bull Market with One Simple Indicator. In this module I showed you how you can use the moving average indicator to determine what stage a stock, sector, or market is in.

There are several other indicators that I use to detect when a change in trend is occurring. In the next report I will show you how I use them to do this and to even make entry and exit points, but first I need to explain these indicators to you so that you will know how they are calculated and how they work. You should use this report as a reference point when you see these indicators come up again in future lessons and the WSW Power Investor service. The first report and this one will give you the basic building blocks of knowledge that you will need to begin to understand how to adapt to any market environment by employing several different basic trading strategies.

First you must realize that there is no need to put dozens of indicators on a chart. All of the indicators use only three variables - price, volume, and time. Most of them are only different versions of the same things. In fact there are

hundreds of these indicators and you can even make your own if you want to. Don't overanalyze things. You are best off to just use a few simple indicators and get a good feel for them. Understand what makes them move and then you'll be able to better understand what is going on with your stocks.

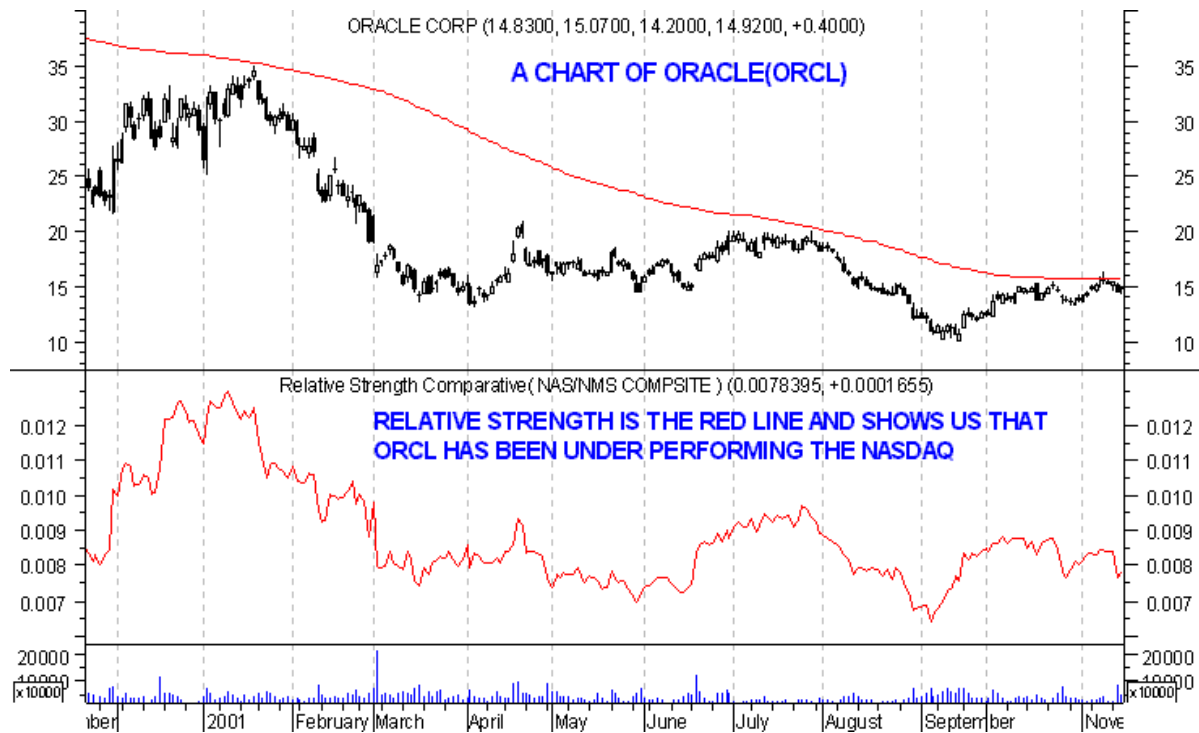
The indicators themselves cannot tell you what to do. But they can be extremely useful to someone who knows what they mean and has a basic knowledge of stock market chart patterns. They can provide the trained eye information that is not easily available by just looking at a chart.

In using technical indicators though, it is best to keep things simple. Some people will show you a chart and put dozens of indicators on them and use them to fool you. They try to confuse you so that you'll just assume that they know what they are talking about.

Indicators are not magic bullets. You make money in the market by understanding how markets work and analyzing market trends. Indicators can help you with the latter, but they do so in a complimentary fashion. There are indicators that work better in one stage of a market trend than in others so in the end you have to understand market stages in order to correctly apply them.

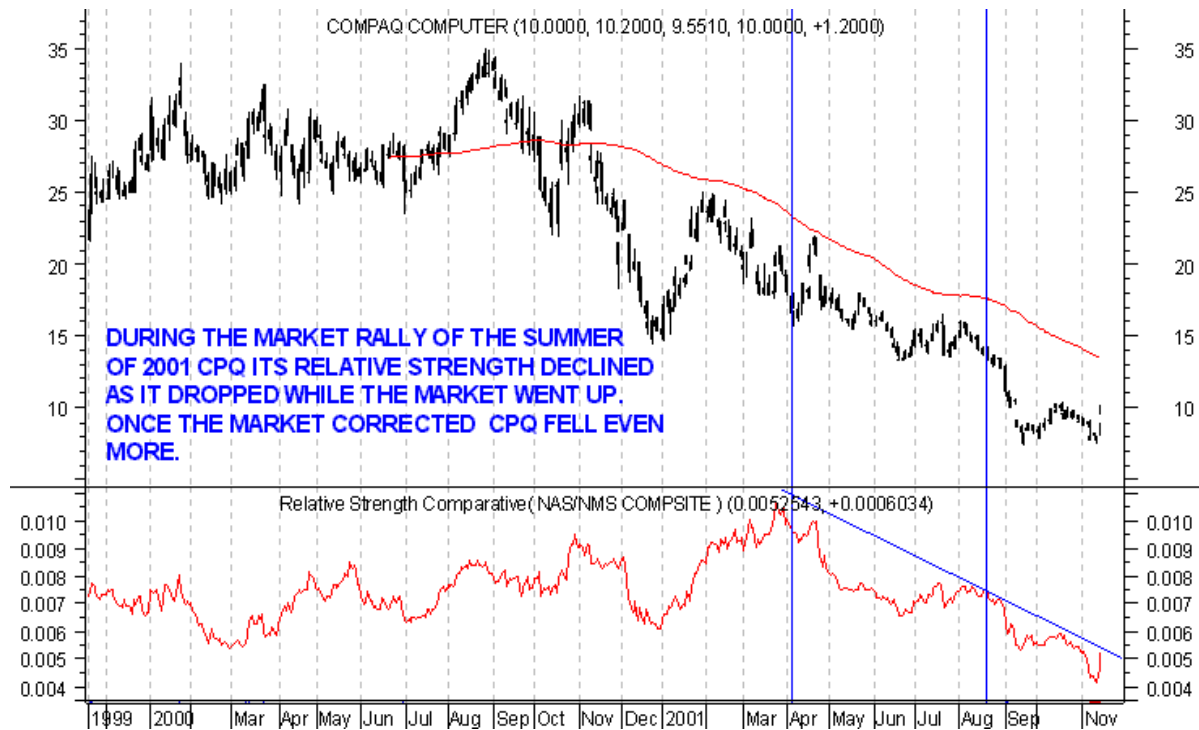
I already discussed moving averages. In this report I will now show you the indicators that I've found the most useful in my own investing and analysis: relative strength, on balance volume, bollinger bands, stochastics, and simple trendlines.

Relative strength:



A relative strength line compares the price action of the stock or market that you are charting with another one. It is a simple ratio of X divided by Y. For example, the relative strength line may compare the price action of a stock with the Nasdaq or with the S&P 500 to see if it is outperforming the market or underperforming the market. Or you may want to compare two markets against one another, such as the Dow Jones Industrial Average and the gold market to see which one is stronger. Or you may wish to compare one sector with the broader market. Such as the semiconductor sox index with the Nasdaq index. Relative strength takes two items and tells you which is the stronger.

Dividing the price of one item by another creates the relative strength line (for example price of a stock divided by price of the Nasdaq market average). Relative strength is then plotted as a line underneath the price of the item that you are charting. If the line is going up then your stock or market is outperforming the item that you are comparing it to.



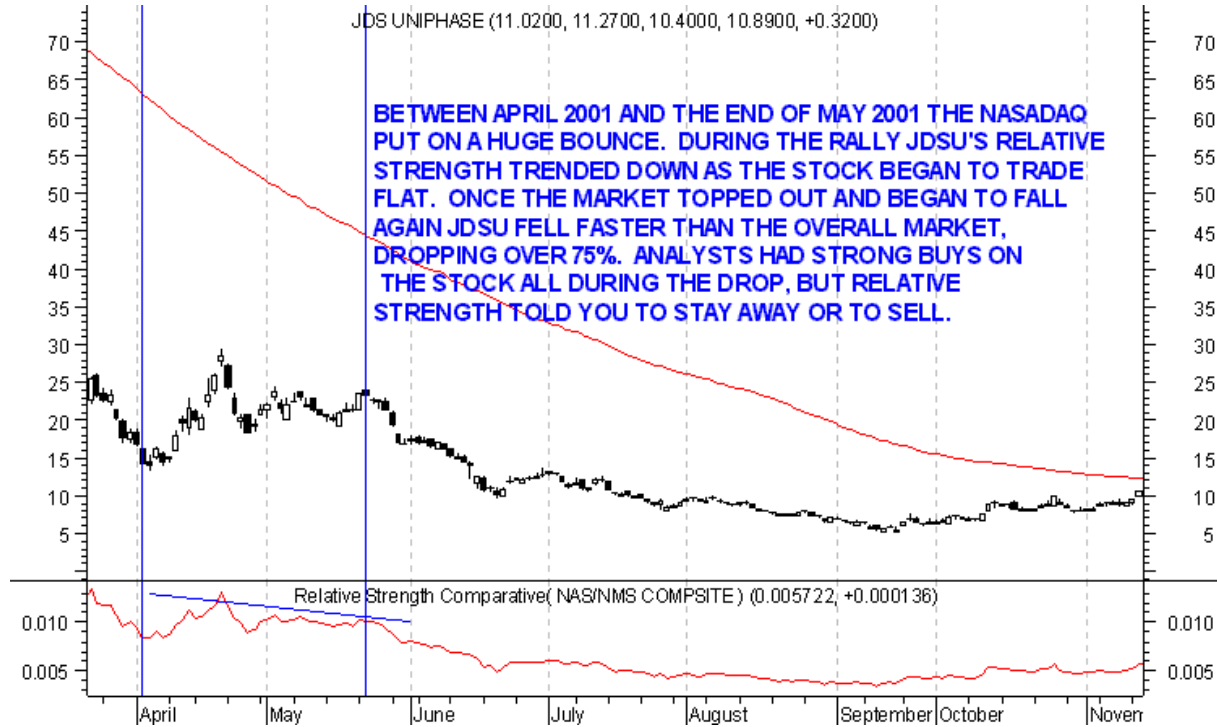
I most commonly use relative strength to compare a stock's price action to the activity of one of the broad market averages. If the relative strength line is rising then the stock is outperforming the Nasdaq and the broader market. This is important. When the market rallies stocks stronger than the market will tend to rally more than the market. When the market drops they will drop less, not at all, and may even continue go up. The opposite is also true. If the market rallies a stock may go up, but if it has weak relative strength it will tend to drop more than the rest of the market when the market has a correction. You do not want to be long stocks with poor relative strength. Changes in relative strength can be a warning sign that you should sell a stock.



What I really use relative strength for is to narrow down a list of potential buy candidates. If I am interested in going long a stock and it has poor relative strength then I won't buy it. Instead I'll look for a stock with strong relative strength. I also use relative strength to help me make a decision on whether or not to short a stock, which is a way to profit when a stock declines in value. If a stock's relative strength line is rising then I won't short it. Shorting is a subject we will go into depth in a future lesson together.

I want to be long stocks that are stronger than the market and short stocks, which are weaker than the market. And I want to stay that way. That means I also use the relative strength line as a warning signal for all of my positions. If I have been long a stock, which has been rising and doing well for me, but the relative strength line begins to move down then I will consider that a big warning flag. Usually relative strength peaks out and changes its trend before a stock begins to decline. What happens is that, during a market rally, the stock price will often go up, but not as quickly as the rest of the market. The stock lags the rally. Once the market pulls back such stocks will tend to lead the decline.

Relative strength cannot tell us when to buy or sell a stock by itself. But it can help us to make a decision on whether or not to enter a position and more importantly whether or not to keep it.



Are you long a lot of stocks now? Chart them out and look at their relative strength lines. If they have been declining while the market has been rallying you may want to consider selling them, or at least making sure that you have stops on them to protect yourself. If the market corrects - which it eventually will - you are in danger of having these positions put big dents in your portfolio. And you don't need that. Stick with the strong stocks, they are your friends, and eliminate the weak before they eat your capital.

If the market is in a correction then you can use relative strength to find strong stocks, which will lead the next market rally. Stocks that hold up well while the rest of the market drops tend to go up a lot when the market comes back. The relative strength line can help you find these gems.

## On Balance Volume:

Like relative strength, on balance volume is plotted as a single line on a stock chart. However, unlike relative strength, which is concerned solely with price activity, on balance volume looks at both the price and the volume action of a stock. On balance volume is a running total of the volume on days when a stock rises minus the volume on days when the stock drops. The total volume for each day is assigned a positive or negative value depending on whether prices closed higher or lower that day. Adding or subtracting each day's volume based on the direction of the close keeps a running total. As long as the stock has more volume on up days than down days then the on balance volume line will move up. If a stock has more volume when it drops than it does when it goes up then the on balance volume will trend down.

The formula for on balance volume is simple:

If Today's Close > Yesterday's Close THEN OBV = Yesterday's OBV + Today's Volume

If Today's Close < Yesterday's Close THEN OBV = Yesterday's OBV - Today's Volume

If Today's Close = Yesterday's Close THEN OBV = Yesterday's OBV

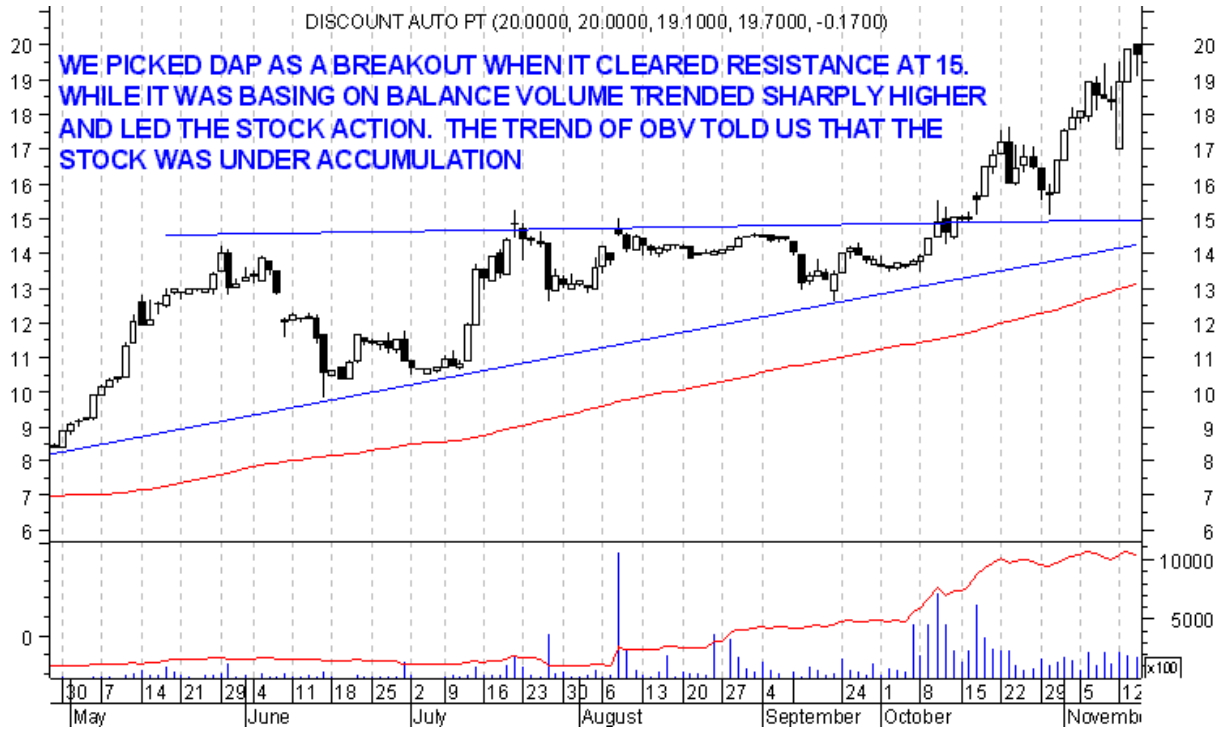
On balance volume is used to tell us whether there is more volume going into a stock or out of a stock. It is used for two things: to confirm a stock's trend or to alert us to a possible change in trend.



If a stock is in a stage two price advance then on balance volume should trend up along with price. If a stock is advancing then volume on up days should be greater than the volume on down days for the advance to be considered healthy. If not then the price advance is questionable. The reverse is true of price declines. On balance volume should drop along with price if the decline is going to be sustainable.

Some examples follow:





On balance volume, though, is more useful when it alerts us to a change in trend. Movements in on balance volume often lead movements in stock price. If on balance volume rises, while the stock consolidates in a base, a strong breakout usually follows. In this type of situation the rising on balance volume tells us that there is more volume on up days than on down days. If this happens while the stock is in a base then it is likely that the stock is under heavy accumulation.

The reverse is also true. If a stock makes a lengthy run and then forms a base watch the on balance volume carefully. If it drops while the stock bounces in a narrow range then the next likely move is down. What you are seeing is money flowing out of the stock. Once the buyers run out the stock usually drops.

Just like relative strength lines, on balance volume cannot tell us when to get in and out of a stock by itself. But on balance volume can be used as a strong confirmation of your own stage analysis of a stock. If you think a stock is about to break out of a stage one base and on balance volume is dropping then you may want to question your analysis. If it confirms your analysis then get ready to put in a buy order.

## Bollinger bands

Plotted above and below the price of a stock, Bollinger bands appear as two moving lines that sandwich the price of a stock. What they do is tell you whether or not prices are high or low based on a relative history of how the stock has traded. Is the stock price high in its range or low? Bollinger bands can tell you.

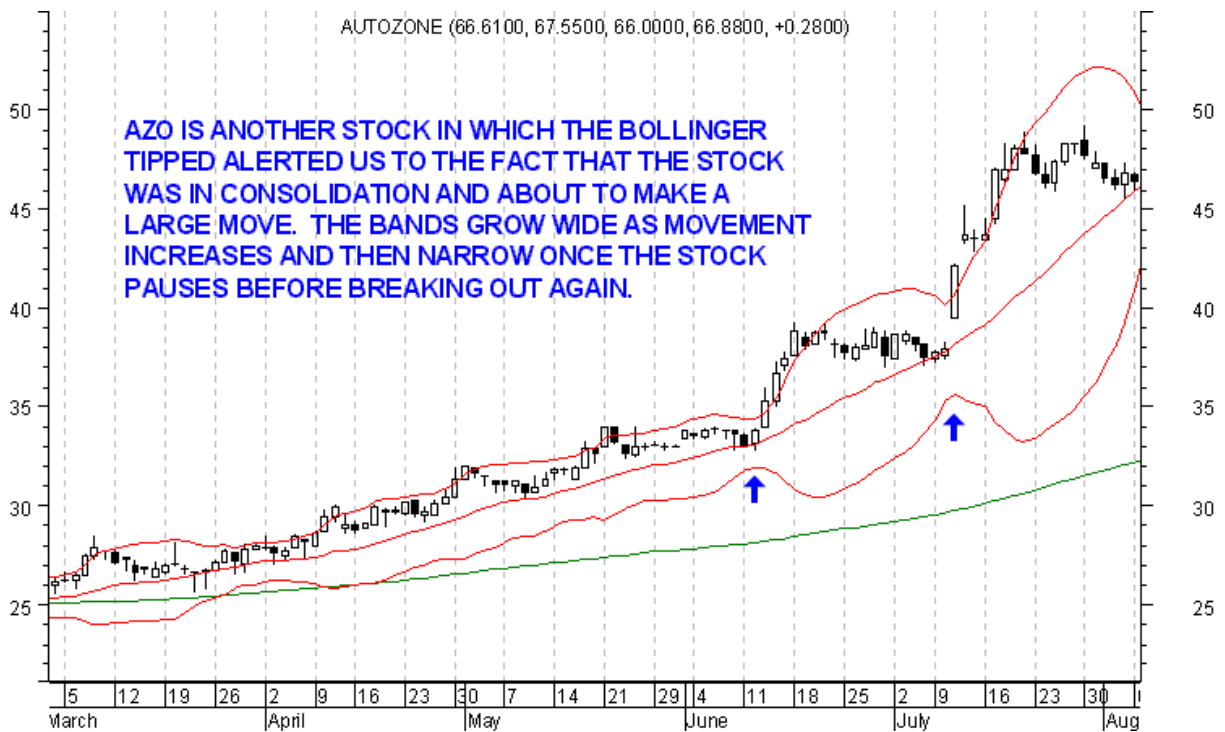


Some people construct parallel lines to a moving average in order to create a trading envelope. These lines are drawn at an identical proportional distance to the moving average. When a stock is at the top of the envelope they take that as a sign that it may be overbought and vice versa.

Bollinger Bands are a little different. Bollinger Bands are two lines that are plotted as two standard deviations above and below the 20 day moving average. A standard deviation is a statistical measure of volatility.

Unlike regular trading envelopes, which remain at a fixed distance from the moving average, Bollinger Bands will widen as a stock becomes more volatile and narrow as its trading range shrinks.

Most people use Bollinger Bands to pick out tops and bottoms. If a stock moves below the lower band than they consider it oversold and if it moves above the upper band than it is overbought.



I mainly use Bollinger Bands to measure the volatility of a stock. When a stock becomes less volatile and begins to trade in a smaller and smaller range usually a big move soon happens, because as volatility shrinks, the buying and selling pressure on a stock becomes more equal.

As the sellers and buyers put more and more pressure on each other the stock's trading range narrows. After one side is defeated the stock breaks out and makes a big move. Think of it like a spring. It takes a lot of force to push a spring together and make it smaller. If you do that and then let go it will leap out in one direction.

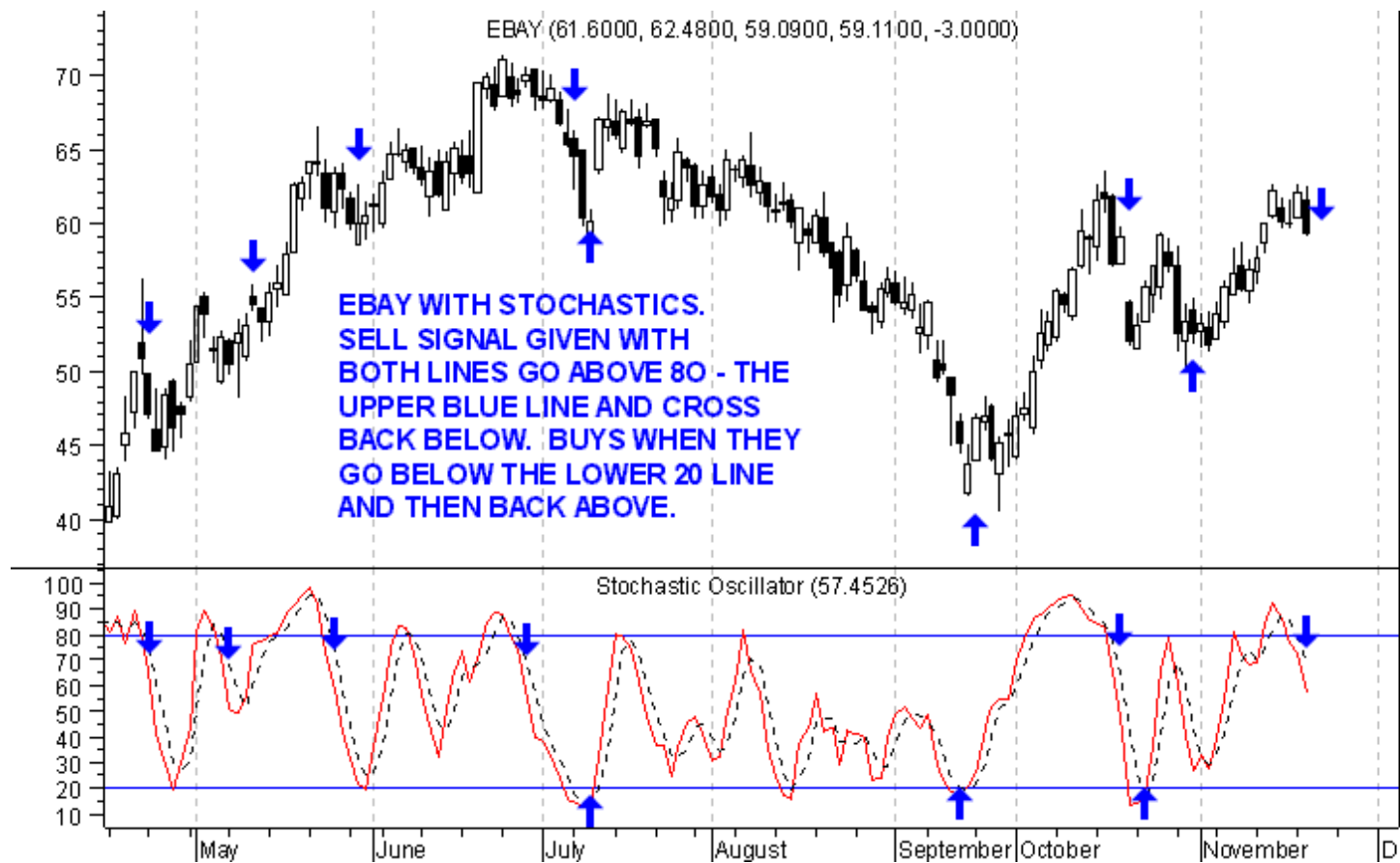
One of the laws of physics is that for every action there is an equal and opposite reaction. The stock market is not much different. However, while physicists use gravity and motion as their two main variables stock market technical analysts use price and volume in order to understand how the forces of supply and demand are affecting a stock.

I use Bollinger Bands to alert me when a stock's volatility is dropping. The stock price usually makes a large swing soon after the two Bollinger Bands come closer together.

## **Stochastics**

The stochastics indicator, developed by George Lane, compares a stock price level to its price range over a period of time. Lane theorized that in an upward trend stock prices tend to close near their highs and during a downtrend stock prices tend to close near their lows. Stochastics attempt to identify a change in trend by identifying when an upward moving stock's prices begin to close further away from their high and vice versa. I use stochastics to determine when a stock may be overbought or oversold.

The stochastics indicator is plotted as two line, the %D Line and the %K Line. Both lines are plotted on a chart with values ranging from 0 to 100. Readings above 80 indicate a stock price closing near its high and below 20 indicate a stock closing near its lows.



The stochastic lines are calculated as follows:

$$\%K = 100[(C - L5\text{close}) / (H5 - L5)]$$

$$\%D = 100 \times (H3/L3)$$

Whereas C = recent close, L5 = lowest low for last five trading periods, H5 = highest high of last five trading periods, etc.

Once the stochastics go above 80 and then cross back below it a change in trend is indicated. Likewise if the stochastics fall below 20 and then cross back above 20 they indicate a potential price bottom.

I have found that stochastics do not reliably indicate a change in trend by themselves. In an uptrend stocks will tend to remain overbought and when they are in a phase three decline stochastics will give many false indications of a bottom.

However, I have found stochastics to be useful for picking tops during declines and bottoms during advances. During the 2000-2003 bear market, for instance, I used stochastics to identify

short term Nasdaq tops when it was in an extended price decline with the use of a 60 minute intraday chart and during stage two uptrends I use stochastics to make entry points on pullbacks. My usage of these indicators will become clearer to you in the next lesson as we begin to bring these things together.

### **Trendlines and Simple Trend Detection**

One of the most basic principles of charting is simple trend detection. The simplest way to detect a stock's trend is to look at the stock's price action on a line chart. Is the stock making new highs or new lows?



A line chart turns the stock price action into peaks and valleys. If each peak is higher than the last one and the valleys are higher than the previous valleys then the stock is in an uptrend. The trend changes if this pattern changes. If an uptrending chart takes out the lower valley then its uptrend ends and the stock enters a downtrend. If a stock has been making higher peaks and then fails to make a higher peak then the price movement becomes a warning sign that the trend may end.



Trendlines are a way to display the stock's trend on a chart. If a stock is in an uptrend then the trendline is drawn by drawing a line that connects the valleys of a stock. If the stock is in a downtrend then trendline is drawn connecting the stock's valleys.

Trendlines are also used to alert you when a stock's trend changes. If a stock is in an uptrend then the trendline will act as support. The stock remains in an uptrend as long as it does not close below the trendline. The opposite is true when a stock is in a downtrend. As long as a downtrending stock continues to close below its resistance trendline then its trend remains in place.





People use line charts and trendlines to make entry points in stocks and to set stops. They can be used in any time frame so anyone from daytraders to long term buy and hold investors can find them useful.

I use trendlines all of the time in my charts and want you to understand how I draw them and the theory behind them. I do not usually use them by themselves to make buy or sell decisions - although some people do that with individual stocks, especially daytraders. I use them to define where a stock's resistance area is and use them to give me an idea of where to place a sell stop. If I expect to hold a stock for several months then I'll often give it more leeway, but even then I take a close below the trendline seriously and take it into consideration when I ask myself whether I should keep holding a position.

We will go over using these indicators for entry points in the next report. The chart examples in this report are several years old. To see these concepts put into use in real time take a 30-day risk free subscription to WSW Power Investor. Just click here:

<http://www.wallstreetwindow.com/wswpowerinvestorservice.htm>