Tenets of technical analysis

Keep these principles in mind while guessing the next move of indices or individual stocks

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Technical analysis is based on three tenets — the market discounts everything, price moves in trends, and history tends to repeat itself.

'The market discounts everything', ie, the price action of a particular stock factors in the company's fundamentals, besides broader economic factors and market psychology. Therefore, all relevant market information such as company fundamentals or broader economic issues is discounted or reflected in the price, but with the exception of unpredictable news such as natural disasters.

Thus, only the price movement is primarily taken for analysis.

As demand increases, the price is likely to move higher, while as supply increases, the price of a stock is expected to decline.

'Price moves in trends', ie, price movements are believed to follow trends. As demand increases, the price could move higher and establish a trend that is broadly known as an uptrend. Likewise, if there is an increase in supply and the price action charts downwards, it is called a downtrend.

When there are not much indication or clue on the demand and supply, the price could consolidate in a band — a sideways trend.

Three, 'history tends to repeat itself', predominantly in terms of price movement.

For instance, market participants tend to provide a consistent reaction to similar market stimuli over time. By observing financial markets, it is evident that there are trends, momentum and patterns that repeat over time. These may not be exactly the same, but can have similarities. That is, the overall pattern is made up of smaller versions of the same pattern, whether in stocks, commodities, currencies or bonds.

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For example, during the subprime mortgage crisis in 2007-08, during which the Dow Jones Industrial Average slumped sharply, historical price data was useful in determining the market base.

Another classic example is visible in the Nikkei 225 chart — to envisage a move beyond 25,000 levels, technical analysts need to do a backtrack of the price action that occurred in 1991.

Technical teachings

- The market discounts everything
- Price moves in trends
- History tends to repeat itself

Bellwethers

SBI (₹198.3)

The stock of SBI, which had been largely flat throughout the week, rallied sharply on Friday, ending the week at ₹198.3 versus the preceding week's close of ₹190.3. Thus, the scrip has posted a gain for two weeks in a row, indicating good positive momentum. Notably, the price has inched past both 21- and 50-day moving averages. That said, the stock, which had been on a decline since the beginning of September, seems to have made considerable progress in turning the short-term outlook in its favour. Supporting the positive view, the daily relative strength index is showing a fresh uptick. The moving average convergence divergence indicator on the daily chart, which was pointing downwards, has reversed its trajectory. Though the above factors hint at further appreciation, the stock faces a hurdle at ₹200. Hence, traders can buy the stock with a stop-loss at ₹190 if the price breaches ₹200

ITC (₹167.8)

The stock of ITC has been on a downtrend since the beginning of September, but it took support at ₹166 and attempted to rally a couple of weeks ago. The scrip was unable to rise above the resistance level of ₹175, from where the price declined last week. The 21-day moving average coincides at ₹175, making it a considerable resistance. Given that, the stock should breach this level to turn the short-term trend bullish. Notably, the recent price action shows that the likelihood of the stock depreciating from the current level is high. Substantiating the bearish outlook, the daily relative strength index remains below the midpoint level of 50. The moving average convergence divergence indicator, though stays flat, is hovering in the negative territory. On the back of this, if the stock breaches ₹166, the sell-off can intensify. Hence, traders can sell the stock with a stop-loss at ₹175 if it breaks below ₹166. Below

Infosys (₹1,106.8)

The stock has been on a strong uptrend since March. It rallied throughout last week and gained nearly 9 per cent. The scrip broke out of the prior high and registered a fresh lifetime high of ₹1,124 last Thursday. Thus, the bulls are in the driving seat and are likely to lift the stock further up. The daily relative strength index has been rising in tandem with the price, indicating considerable strength in the rally. The moving average convergence divergence indicator remains in the bullish zone and its recent movement shows that the uptrend is only gaining momentum. Considering these factors, traders can remain bullish and buy the stock on declines. Since the rally is steep, intermittent corrections, if any, can be sharp and so a dynamic stop-loss is preferred over a fixed stop-loss. That is, while the initial stop-loss can be at ₹1,060, move it upwards with a span of 1.5 times the daily average true range if the

RIL (₹2,233.4)

Even as the major trend is positive, the stock of Reliance Industries has been moving in a sideways trend for the past couple of weeks — the price has largely been oscillating in the band between ₹2,200 and ₹2,270. Immediately below ₹2,200 is the strong support of ₹2,170, where the 50-day moving average - lies. While prolonged consolidation can increase the probability of the stock slipping below the support of ₹2,200, the near-term trend will be inclined upwards as long as the price stays above ₹2,170. Since the stock is in a consolidation phase, the daily relative strength index remains flat in the neutral region. That said, even though the overall trend is positive, one can wait for evidence of fresh upward momentum being built before initiating fresh longs. Traders can buy with a stop-loss at ₹2,170 if the stock decisively breaks out of ₹2,270. A breakout of ₹2,270 can lead to the stock

Tata Steel (₹369.5)

The stock of Tata Steel, which has been on a downtrend, had found support at ₹350 and bounced during the final week of September. However, last week, the stock seems to have hit a wall, since ₹387 is now acting as a resistance. Also, the 21-day moving average lies at ₹379, which, too, is acting as a resistance. Hence, the recovery is not sustainable unless the price breaks out of ₹387. Adding to the bearish signs, the daily relative strength index is below the midpoint level of 50 and the moving average convergence divergence indicator lies in the negative territory. Moreover, the price action is showing a downward bias. But the stock tests a support at ₹368. Hence, the next leg of trend cannot be confirmed until either ₹368 or ₹387 is breached. A breakout of ₹387 can take the stock to ₹400, and if the momentum sustains, it can rise to ₹420. But if it breaches the support

Snapshot

1. SBI likely to advance
2. ITC's price action looks bearish
3. Infosys set to rally further
4. RIL in consolidation phase
5. Tata Steel tests a support