The Pros and Cons of Technical Analysis

By Ryan Watkins, Chief Content Creator at TraderTactics.com

Technical Analysis has been around for an exceptionally long time, over 100 years. Famous traders have used it, Hedge Fund Managers use it, professional traders use Technical Analysis and of course, even novice traders learning how to trade or invest use Technical Analysis.

Let's first talk about what exactly is Technical Analysis, then show you some examples, and then let's compare the pros & cons of Technical Analysis.

What is Technical Analysis?

Technical analysis is the analysis (or study) of market movement, mainly using charts, chart patterns, volume, or other indicators to predict future price direction.

Types of Technical Analysis

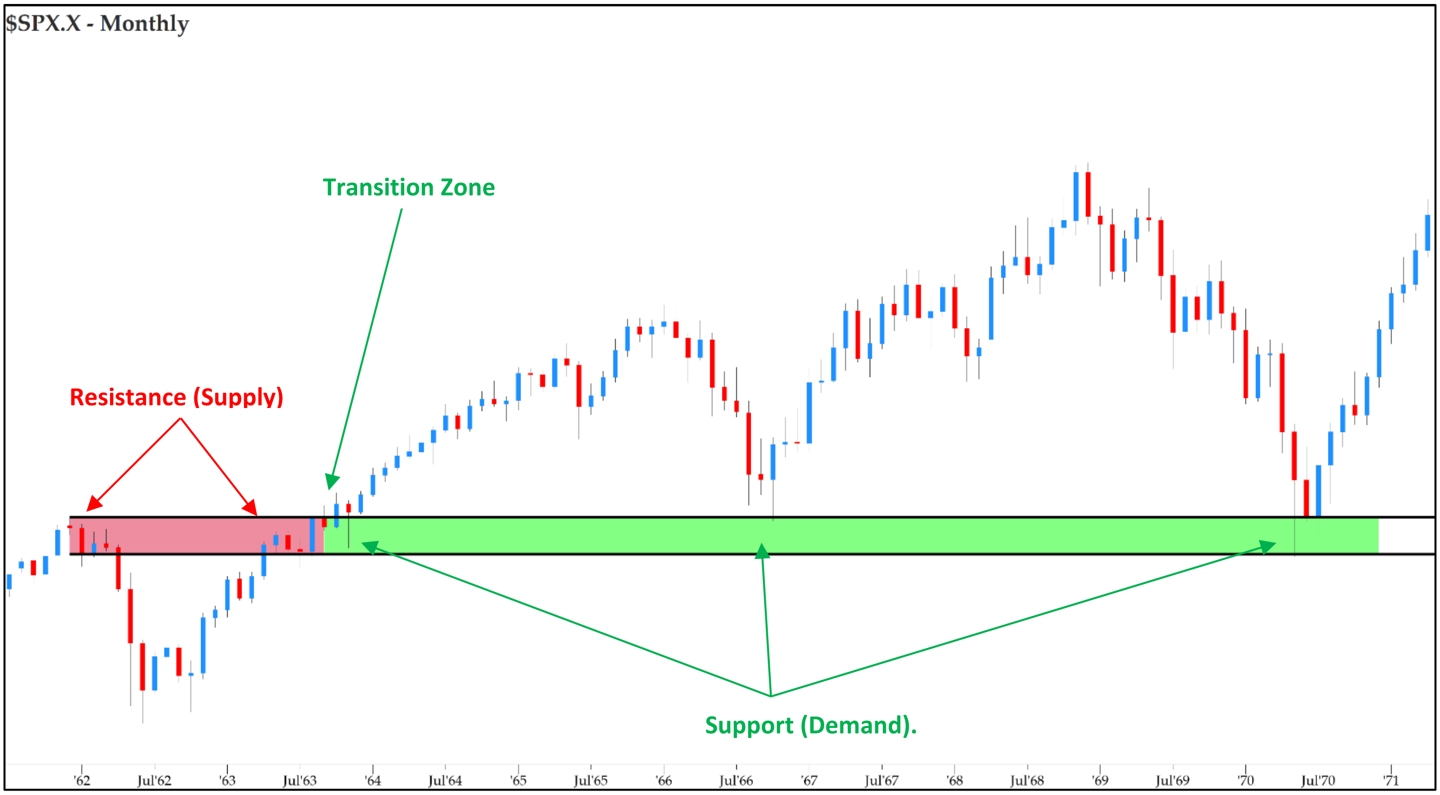
a) **Chart (Price) Patterns** such as Trend Direction, Flags, Pennants, Head & Shoulders, Double Tops, Double Bottoms, Cup & Handle, Support, Resistance, Supply Areas, Demand Areas, and much more.

b) **Indicators** such as Moving Averages, MACD, Oscillators, Momentum Indicators, Volume, Fibonacci, etc.

c) **Psychological/Theory Based** such as Dow Theory, Elliott Wave Theory, Relative Strength, and more.

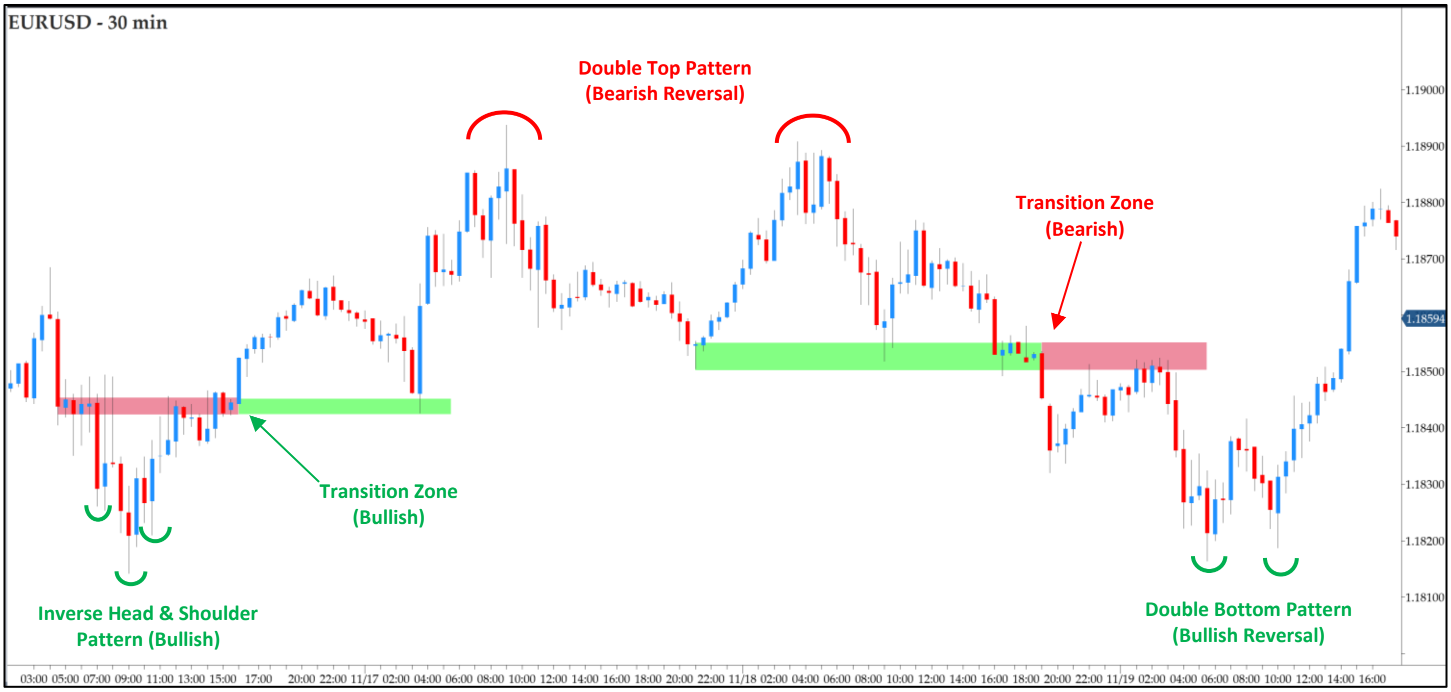
Examples of Technical Analysis from the 1960s

The S&P 500 ($SPX.X) is a major market and the largest equity market in the world. One classic Technical Analysis Chart Pattern is an "Oldie but Goodie", Old Resistance becomes New Support. We call these price areas **Transition Zones** and are used to place buy orders when either price breaks out of the Resistance Area or waits until price returns to the Support Area. In this example of $SPX.X, you can see a Transition Zone right after July of 1963.



Examples of recent Technical Analysis

In a more recent example, in November 2020, the **EURUSD** Forex Pair is displayed in a 30-minute chart. Meaning, each Blue & Red Candlestick is 30 minutes of trading data. Traders that use Technical Analysis would use chart patterns like these to trade. There are several to choose from, Head & Shoulders Reversal Pattern, Double Top Reversal Pattern, Double Bottom Reversal Pattern, and Transition Zones. Traders use Technical Analysis because these, and many more patterns show up repeatably on every market and offer consistent trading opportunities.



The Pros & Cons of Technical Analysis

Cons – The bad news first

1) It takes time to learn and there of many types of patterns, indicators & oscillators.
2) The learning curve is not easy. Many traders take months or years to get good at their trading skills.
3) Some work better than others and some work best with other patterns or time frames and some work best using multiple time frames and that can get confusing and difficult to learn.
4) A lot of trading companies disguise Technical Analysis patterns with stimulating words that work well in marketing, but ultimately are simply just another form of price pattern information. Unless you know the patterns, you may fall into that trap.
5) Even if you master a few technical patterns or indicators, you must realize, they do not work the way you want them to every time. Even the best traders in the world know they won't be right 100% of the time.

Pros

1) Chart Patterns happen very often with a predictable outcome. Traders that are seeking consistency or a criterion to trade may find Technical Analysis patterns particularly useful.
2) Many patterns can be back-tested before a trader decides to use them.

3) Technical Analysis can be used on any market and any time frame.
4) Accessible: Many books have been written, blogs, internet articles & websites about technical analysis, so it is easy to find information about it.
5) Self-Fulfilling Prophecy: Because so many people are using it, looking for specific patterns in the chart, traders buy or sell based on what they learn. Technical Analysis is immensely popular and is one of two dominant factors in trading or investing. Fundamental analysis is the other.
6) One of the most reliable pros of Technical Analysis is it was happening long before traders even knew about it. For example, in the 1800s, you can see price patterns that are the same patterns that are traded today. Why? Because humans are doing the trading and we trade based on beliefs, emotions, and thoughts, not just a price pattern. It just so happens that these beliefs, emotions, and thoughts are the same in humans today as they were since the start of trading exchanges. We, humans, are predictable with our thoughts, we can see the actual pattern shape of our buy and sell decisions in the form of a price chart. In other words, our greed, fear, and other emotions are predictable. These predictable emotions are shown in buy & sell orders on the charts. We, humans, want to trade something we feel comfortable trading, so we rely on chart patterns we are familiar with. Trading is more psychological than most people realize.

The bottom line is that trading using Technical Analysis can be very useful, but it takes time to learn it and a long time to master it. The good news is you do not have to learn it all. Only a small handful of price patterns are needed to do well in this business. Trading is about probabilities and using technical analysis correctly can help increase your trading probabilities, especially when it comes to timing a trade's entry and exit.

Author: Ryan Watkins

You may learn more about Trading & Investing at www.TraderTactics.com