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# MASTERING TECHNICAL ANALYSIS

Using the Tools of  
Technical Analysis for  
PROFITABLE TRADING

John C. Brooks

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**JOHN C. BROOKS**

**McGraw-Hill**

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## Chapter 1

# Technical Analysis from My Perspective

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I began my career as a technical analyst on Wall Street in October of 1964 working for the brokerage house F.I. Dupont & Co. The job itself was as a posting clerk in the technical Research Department, and my duties included updating a 4000 Point and Figure chart library every morning before the opening bell. Every chart was to be ready before the opening and done neatly in pencil. It was about as far down on the Wall Street food chain as you could go in those days, but at least it got me into the game. Make no mistake about it, being given that opportunity by my friend and mentor, John D. Greeley, has made me very grateful to this day. I was able to land a job in lower Manhattan simply because the daily trading volume on the New York Stock Exchange had expanded all the way up to the breakneck level of 5 million shares a day. The Street was having a hard time keeping up with the increase in activity, so hiring new blood was the order of the day. It was an era of new trends in business and in our social lives. Innovation in technology was touching every single area.

This atmosphere was a result of a very healthy economy, low interest rates, low inflation, and a recent military success, a la the Cuban missile crisis. It was hard to argue with success, for the United States was running on all cylinders. The rate of unemployment would drop in the 1960s from 7 percent in 1959

to as low 3 percent by 1970. Leading economic indicators were strong, especially in the first half of the decade. Money supply was plentiful, which helped finance a rising stock market as well as a hot IPO (Initial Public Offering) arena.

I listen today about stories of the Internet and how it will change my life forever and that the world will never see another period like this again. Perhaps this will turn out to be a true statement, but I can assure you that I've seen it before. I have to shrug my shoulders and laugh a little sometimes. I can't help but remember one night when my mother came home from work where she was employed as a secretary. She told us about the excitement in the office that day because a new machine had arrived, and it seemed that it could make copies of documents and memos simply by touching a button. Up until that time, if management wanted a few extra copies of a report for distribution, those copies would have to be made by a secretary simply by repeating the task over and over again. Sometimes they could use carbon paper if they were lucky to have a boss who didn't mind a little ink stain on the reports. It seemed, however, now with this new-age gadget, no more carbon paper for that woman. It was the 1960s and they were getting their new machine. She could not remember the name of the company that made this awesome machine, but she thought its name started with a letter X.

In those days it seemed like there were an abundance of new opportunities opening up every week. They were going to change our lives and in fact they did alter almost every facet you can imagine. New "everything" was the order of the day. There were concepts from fast food stores to color TVs, calculators, supermarkets, and even computers were being introduced to the public. Up to then, these superbrains were only known to us via badly made sci fi movies. I don't believe that many people realized how much this tool called a computer was about to alter the landscape. It seemed like the sky was the limit and all you needed was a concept and Wall Street was there to finance your dreams and help you go public with a new offering.

In 1961 and 1962 they reached a level of approximately 70 IPOs a month, and in 1968 and 1969 that level was increased to more than 100 IPOs a month. This level was the record



until the start of the next great bull market in 1983. Even with that, the 1968 level was only exceeded three times over the next 30-plus years. Given the fact that the capitalization of the total market in the 1960s was a lot smaller than today, I'd have to say those were very impressive numbers indeed. Of course, with all these new deals hitting the market on a daily basis, the average trading volume exploded. The explosion of volume was Wall Street's way of expressing its acceptance for any new idea. Between 1960 and 1970, daily trading volume on the New York Stock Exchange increased from approximately 2 million shares a day to over 15 million shares a day.

From my vantage point there were a number of events that occurred on the Street within a fairly short period of time that helped to shape modern technical analysis. For one thing, with the sharp increase in daily volume, Wall Street brokerage firms were pressured to answer more requests for stock ideas from the customers, who were getting more aggressive as the market rallied. The public wanted to enter into the stock market, and technical analysis was there to fill in the gaps. This also was the time when analytical computers first appeared on the scene that would prove to be the launching pad for many new technical indicators. Finally, the advent of a major long-term bear market in the second half of the 1960s moved technical analysis into the spotlight and propelled the art to center stage of the financial world. You see, a technician's function is to interrupt charts based on the "price" facts. To a good technical analysis, a sell opinion is the natural progression in a stock's life. A stock will rise in price, then flatten out, and then start its decline. At the time not only were sell ideas a no-no on Wall Street, but many fundamental analysts feared for their jobs if they did tell accounts to sell. It just wasn't done, for the simple reason that technicians were better suited to sell stocks on breakdowns of chart patterns that made us more popular during bear markets.

Despite the bear markets from 1966 to 1974, most of the technical analysts I knew did fine in those days as long as we kept to our knitting. I recall once that I tried to stray off the path and did not recommend a sale of a stock that had broken a support level because it was a "good company." Also, I believed that it was a "solid value" and perhaps a small violation of a

support could be overlooked. My friends reminded me that I was a paper trader, meaning I was dealing with stock certificates and I was not asked to give my dissertation on some company's long-term prospects. That fine company stock eventually sold off 75 percent.

The stock market was in a full retreat, and fundamental analysis was getting a black eye almost on an hourly basis. Unlike the scandals in our recent history, the analysts back then were folks, I believe, that were trying their best. The only scandal was that most had never seen a long-term bear market and as a result could not fathom how deep a sell off could go. Wall Street is noted for its "gallows humor" and I will say that by the time the bottom in 1974 appeared, the quality of the jokes about the business was the best vintage that I have ever seen. I remember going out to lunch one day during the 1973–74 bear market and running into a friend that had just been promoted to research director at one of the firms (life expectancy was about 1 year). He said he felt like he was promoted to first mate on the Titanic.

## A MISSED OPPORTUNITY

I must say that as technicians, we knew from firsthand experience that certain price patterns had implications that were totally rational. A stock breaking down from a top pattern on expanding volume was not only a clear sign showing the sellers overpowering the buyers, but also an early warning that some negative corporate news was about to be announced. We didn't know "when" and we didn't know "what," but we knew if the stock was falling away and breaking supports levels that any upcoming news wasn't going to be good. This response to upcoming developments was reflected in the increase in daily volume and the price movement on the chart.

Indicators carry the same predicative qualities. It is not strange to me that an increase in volume accompanied by a positive increase in price in the housing market index might have a secondary implication generated about lumber prices or perhaps the health of the market in general. I remember an analyst came out with a recommendation on the auto industry one

year after the stocks had already rallied for more than 6 months. My response was to recommend the tire and oil sectors, mainly because the charts looked better, but also the Street hadn't gotten around to those groups yet. The last time I looked you can't run a car without four tires and a tank of gas, therefore the tire and oil stocks had to benefit from a boom in auto sales.

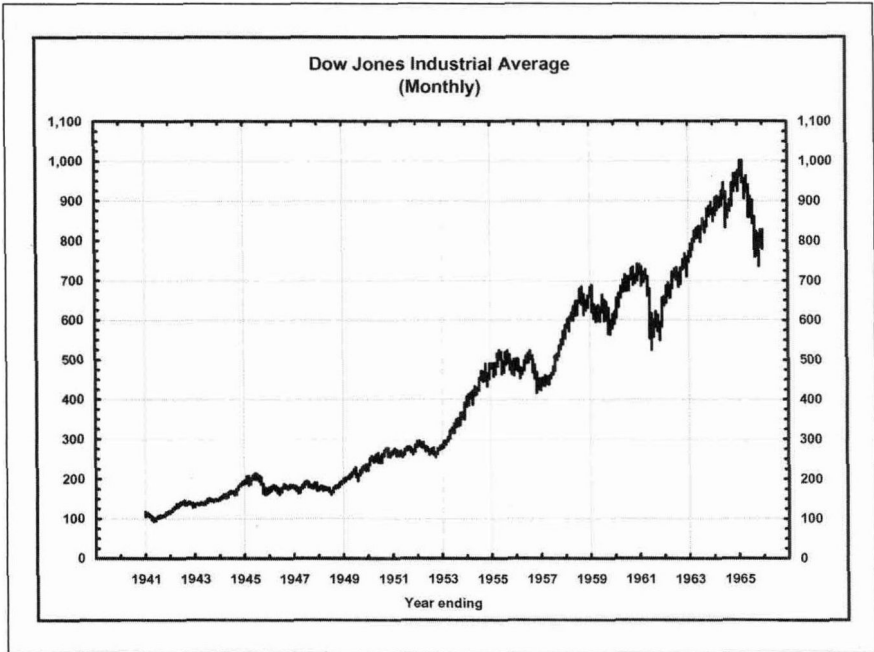
This kind of thinking was second nature to most of us. It was the fault of the technical community, and I include myself, that we never took the time to back test many of our theories or indicators and tools, but rather relied on street knowledge to get us through the day. Had we devoted more time to back testing and proving our work, we would have had a much easier time in many board meetings during the next 20 years. One major problem at the time was that we had limited access to price history. The vast majority of technical analysts had all their data and their notes in old dusty books. It was impossible to go to any university with that type of data and expect to be given an audience.

Besides, the campuses at that time were more concerned about demonstrators against Vietnam rather than any indicators that my colleagues and I could dream up. Wall Street was in trouble, as a great bear market had taken up residence in lower Manhattan.

In the 1973-74 period the Dow Jones Industrials Averages would drop from a high of 1047 in Dec. 1972 to as low as 577 in Oct. 1974, a 55 percent decline. There have been enough books written about that time, but as perverse as it might sound, technical analysts thrived during that period. After all, this was our type of market, a market of multidimensional movers. Technical analysts, on the whole, helped many a firm avoid some very nasty pitfalls during those times. Most of the people that worked in the finance community had only seen stocks move up for most of their careers. Brokerage houses that never had an official TA department up until then found it to be a good idea to have someone in the research department that actually watched the stock market. Many of the senior people in the firms felt that having their own technical department was an irrational move. They felt that the stock market would bail you out of any bad positions over time. Keep in mind that from Pearl Harbor to 3

**FIGURE 1-1**

Chart of the Dow from 1942 to 1966. Drawn by The Chartstore.com.



years after the Cuban Missile Crisis, the stock market was nothing but up, up, and away. The idea of a declining stock market, for any meaningful period, was not really a viable opinion for many of the old timers. Like the man said, "In a bull market, who needs *any* analysts' help." The typical thinking of the times was, "If prices always went up, why worry about the market?" Over time that expression was changed to, "In a bull market, who needs *any* analysts, and in a bear market, who can afford one?" (See Figure 1-1.)

The bear market of the late 1960s to the mid 1970s showed the world that attention must be given to the overall markets and thus focused attention on technical analysis. New indicators were beginning to appear in the marketplace. Negative volume, MACD, Stochastic, and the Arms Index were all offshoots during this period.

The growth in technical analysis that I spoke of came with the growth of financial markets in general. By the late 1970s, daily volume had expanded to more than 30 million shares a day, and public interest in the stock market was once again on the increase. The start of the 401k programs was a great driving force in this increased interest.

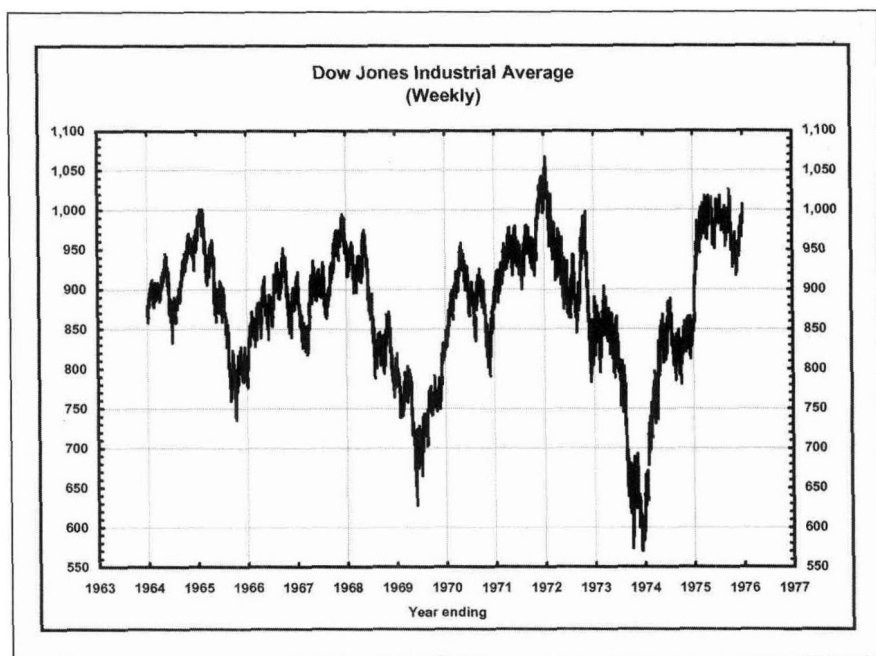
It gave the public a vested interest in stocks, and along with that interest came the demand for more information. It had been a long time since stock tips were a source of conversation at cocktail parties, but here we were again. This time, however, the information was much more meaningful in nature. Investors weren't looking for the next "hot idea" as much as they were looking to understand what the investment process was all about. The demand for information exploded on the financial front. The investor of the 1980s wanted to know the reasoning for purchases and sales. They wanted to know about all the terminology that sounded like so much double talk from the brokerage houses, the fundamentalists, the technicians, and the economists. They were willing to invest, but they wanted to know the whys and wherefores of their investments. (See Figure 1-2.)

After the shellacking we took in the 1966–1974 bear markets, the market came back slowly. The damage that was done to the big indexes such as the Dow Jones and the S&P 500 was obvious. The declines for these major averages were on the nightly news shows and on the front pages of morning papers. The worst damage, however, was felt in the smaller companies, where losses of 70 percent to 90 percent were registered during that same period. These issues that were not well known suffered from being overlooked by investors because of the general fear of the market and the lack of liquidity that smaller stocks generally carried. They had gone down much deeper than their nationally known counterparts. If Chase Manhattan Bank could fall from the mid \$62 down to \$21, a percentage drop of 65 percent, what chance did much smaller, regional banks have in attracting buyers?

However, in time these overlooked and washed-out stocks did attract buyers as investors began to recognize two facts: First that the general market had bottomed, which meant that

**FIGURE 1 - 2**

Chart of 1966–1974. Drawn by The Chartstore.com.



it might be safe to go back into the market. Second, that in making the bottom, many of these underowned issues were drastically oversold and offered a better bargain. This shift in thinking first showed up on the charts in 1975–1976.

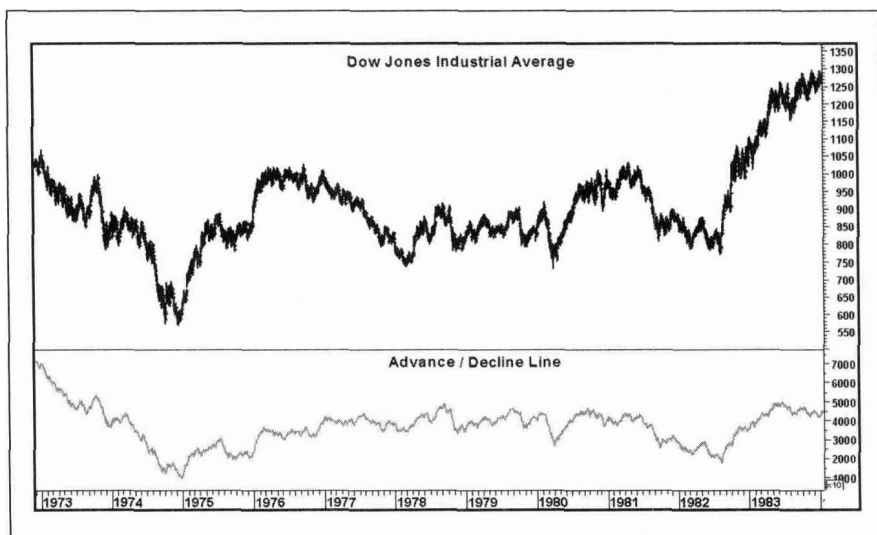
Conclusions that had never been attainable before were now showing up every day. The breadth index is the net difference between stocks that are advancing minus the stocks that are declining over a given time. It is one of the best indications of the overall health of a market. It gave us a view of a sum of all the issues in the marketplace. For 8 long years the advance/decline line had fallen, which reflected the bear market and the faltering economy. But once that A/D line began to reverse and move up, technicians had a more constructive outlook on the market. It was showing that for the first time since the top of

the Dow Jones in 1966, more stocks were advancing rather than declining. There is only one way to make that indicator turn up, and that is to have the buyers overpower the sellers. We all started thinking maybe that light at the end of the tunnel wasn't a 900-pound gorilla with a flashlight coming at us to give us another beating. Again, here was a typical example of bare bones indicators that was lost on many people on Wall Street. The one unshakable truth about the financial markets is that the forces of supply and demand are the ultimate keys to understanding the market. Without a doubt there are other forces to contend with, but they all come in second place compared to supply and demand. (See Figure 1-3.)

Overall, money was flowing into stocks, and demand for these overlooked issues had absorbed the supply of stock for sale. This time money was going to value issues rather than the very narrow group of favorite brokerage stocks that were called the "Nifty Fifty." These were issues whose earning and growth rates were never questioned. These growth stocks were

**FIGURE 1 - 3**

**ADV/DEC.** Courtesy of MetaStock.



publicized as simply one-decision stocks; you always buy them. Wrong again. The day of the one-decision stock was over. The markets once again were growing, and so was technical analysis about ready to have another growth spurt.

One of the causes of this growth was the availability of data and the computer. Some of the new tools that we were using helped us in spotting shifts in investor's psychology. These were created by men like Gerald Appel on the development of MACD, George Lane on Stochastics, and Wells Wilder on RSI. These were all part of the new landscape. By no means is this a complete list of innovators.

Investors were getting smarter and realized that many of the smaller capitalized companies that had been hurt in the bear market would be one of the first beneficiaries when the economy began its resurgence. So a reaccumulation of secondary issues became the new mantra for the market. For most of this century, the New York and American Stock Exchanges were the two key marketplaces. In the mid 1970s plans were underway to move trading for non-NYSE issues upstairs off the floors and into the trading rooms, which nearly spelled the death knell for the American Stock Exchange. To this day the Amex, which once was a powerful force in the business, is hardly even remembered.

## THE NASD

The start of the NASD in the 1970s and the technological advancement in the market in general caused nothing less than an explosion in interest for over-the-counter issues. For the next 7 years, the large capitalization issues, as measured by the Dow Jones Industrial Averages, traded in a tight trading range while these smaller names advanced like a rocket. In fact, the NASDAQ was up more than 450 percent before the major indexes started their major advance in August of 1982.

It was an unsure time with many concerns about the country:

- A. Watergate
- B. President Nixon's resignation
- C. President Ford bailing out New York, via arranging for special loans



#### **D. Iran and the Ayatollah Khomeini**

#### **E. The Three Mile Island nuclear accident**

But through it all, the technical indicators were improving despite the disconcerting news.

### **NEW INDICATORS**

The new work that was appearing on the scene showed new ways of looking at the same old data, and the personal computer was the reason we were able to go to the next level of analysis.

At the time, economists were interested in a totally difference set of numbers like the Gross National Product, earnings growth projections, and signs of economic improvement. Many of those types of numbers didn't even begin to turn strong until the 1980s. There was not a lot of interest in something called the A/D line. The fundamentalists were looking at falling earnings and the traders were just hoping their telephones wouldn't ring. If they picked up a phone it might be an account wanting to sell stock to them, and the traders wanted no part in building up their inventories. So studying technical indicators was not popular at the time.

Between the bottom of 1974 and the explosive breakout in 1982, the Dow Jones Industrial Average was stuck in a trading range of approximately 500 points. It did nothing but rally and fall and rally and fall. But under the surface, stock prices generally were increasing. The NASD from the end of 1974 to the summer of 1982 rallied nearly 400 percent by the time the Dow finally began its upward move. In August of 1982, the Dow Jones exploded on the upside with more than 100 million shares of volume, and the race was on. Not only was the stock market back, but also it was back with a vengeance. And the appetite for equities and knowledge about the markets was insatiable. The daily volume in the first half of 1982 swelled to more than 60 million shares on a daily basis, and once again new indicators and techniques were created.

This hunger for information was not going to be held back. The street needed a new way of communicating with the public because the demand was too great to be handled in the same old-fashioned way of one company research report at a time.