The Dow Theory in Technical Analysis

esDowisthefatherofthemoderntechnicalanalys
/est.Hedevelopedatheory,latercalledDowTheo
hexpresseshisideasonpriceactionsinthestockmar

Charles H Dow

INTRODUCTION

Today Foreign Exchange Market is one of the popular segments of the global financial market. FOREX is the largest and the most liquid financial market in the world. The daily turnover of the market reaches up to $5 trillion. That's really an enormous number! Day by day more and more people get interested in Forex and try to make money by trading. The reason why Foreign Exchange Market is so attractive is due to the following characteristic features:

- high liquidity
- variety of trading instruments
- availability of the market, that is to say the market is active 24 hours a day, except for weekends

Being that much attractive, Foreign Exchange Market is also very unpredictable, and you should be very careful while trading and use some methods of analysis and tools that will help you somehow to forecast the behavior of the market.

The two most well-known methods of analysis for predicting the market are technical analysis and fundamental analysis, which are considered to be the inseparable part of trading. In this article we are going to speak about technical analysis trying to observe its role in financial markets.

The history of technical analysis dates back hundreds of years. According to the historical sources, technical analysis seems to be first appeared in Japan, in 18th century. Homma Munehisa, a rice merchant, is considered to be the founder of

CharlesDowisthefatherofthemoderntechnicalanalysisin
theWest.Hedevelopedatheory,latercalledDowTheory
whichexpresseshisideasonpriceactionsinthestockmarket

the Japanese version of technical analysis based on the candle charts, which are very popular tools nowadays. Later on, in 19th century, technical analysis became popular in America. Charles Dow is the father of the modern technical analysis in the West. He developed a theory, later called Dow Theory, which expresses his ideas on price actions in the stock market. Charles Dow was also one of the founders of Dow Jones and Company, as well as the first editor of Wall Street Journal, where he published his ideas on the behavior of the stock market.

Dow Theory served as an initial basis for further development of technical analysis, and nowadays it still plays an important role in the financial world.

Dow never managed to publish the complete theory on the market, and due to this, after Dow's death (1902) several followers William Peter Hamilton, Robert Rhea and E. George Schaefe collectively represented his theory, based on his reviews.

The Dow Theory is made up of six tenets, and all traders who decide to use technical analysis should know these 6 principles, as they will help them to better understand how the markets work.

THE DOW THEORY IN TECHNICAL ANALYSIS

1. The Averages Discount Everything

Every single factor, information that is likely to have influence on both demand and supply is reflected in the market price. For example, presidential elections in the United States or introduction of a new product, etc.

2. The Market Has Three Trends

Dow has considered a trend to have three parts: primary, secondary and minor.

- The Primary trend (compared to the tides) is the largest trend, which lasts for more than a year. When there is a wave of rising prices, we have a rising (bull) market, when prices are declining we have a falling (bear) market. So, the Primary trend can be either rising (bullish) or falling (bearish).

- The Secondary trend (compared to the waves in the tide) is an intermediate trend. This trend represents corrections in the primary trend, which lasts from three weeks to three months, retracing from one-third to two-thirds of the previous trend movement.

- The Minor trend (compared to the ripples) is considered a short-term movement, and it usually lasts less than three weeks. This trend is associated with the movements in the secondary trend.

3. Major Trends Have Three Phases

Dow states that there are three phases to every primary (major) trend, which is the most important trend to be paid attention to.

- Accumulation phase – the first stage of informed investors to start entering the market with the belief that turning point is inevitable.
- Public participation phase – in this phase prices start rising rapidly and economic news improves becoming more optimistic.
- Distribution phase – this phase takes place when economic conditions and news reach their peaks. Many investors become more encouraged and public participation increases, as media keeps on publishing bullish stories.

4. The Averages Must Confirm Each Other

Dow stated that for having a valid change of trend, the Industrial and Rail Averages must confirm each other. Both averages must exceed the previous peak to confirm the inception or continuation of a bull market. According to Dow, the signals did not have to occur simultaneously, but he believed that a shorter length of time between the two signals provided stronger confirmation.

5. Volume Must Confirm the Trend

Dow paid much attention to price action, because he considered the main signals for buying and selling to be based on price movements. Dow recognized volume as a secondary indicator, which played an important role in confirming price signals. In other words, the volume should expand in the direction of the primary/ major trend.

6. A Trend Is Assumed to Be Continuous Until Definite Signals of Its Reversal

Dow believed that trends kept on existing regardless of the influencing factors known as "market noise." Markets might move in the direction opposite the trends for a short time, but they will soon return to prior move. According to the physical low of motion, an object in motion remains in the same direction until an external force causes it to change the direction. Dow in his turn believed that if the trend lasted longer, the probability of its change would be greater and, of course, there are reversal signals to look for.

Technical Analysis is based on the following 3 principles:

- **Price Discounts Everything**
  According to technical analysts, price reflects everything that can affect the market. Factors, affecting the market, are economic, political, psychological and fundamental. Technical analysis is mainly concerned with the price movements going up or going down, and it does not take into consideration the factors that affect the price changes.

- **Prices Move In Trends**
  In technical analysis it is accepted to say that price movements follow the trend. That is to say after the trend has been established it is more likely that the future price movement will be in the same direction as the trend.

- **History Repeats Itself**
  History tends to repeat itself mostly in terms of price movements. Technical analysis uses chart patterns for analyzing the historical data of price movements for forecasting the future movements. The repetition of the price movements is closely connected to market psychology, and the market participants are expected to react the same way to the similar events which are likely to occur in future.

The role of technical analysis is quite essential in forecasting the market; that is why it is very important to understand how to conduct an accurate analysis. The two main tools which help traders and investors to make technical analysis easy are indicators and chart patterns.

A technical indicator is considered to be the inseparable part of technical analysis. Technical indicators are tools used by traders and investors for forecasting future market movements; it is done by analyzing the moves of the price trends in the past. There is a great variety of technical indicators, like indicators by Bill Williams, Oscillators, Trend and Volume indicators, and traders are free to study and use the one which is the best for them.

A chart pattern is another important and inseparable part of technical analysis. Chart patterns are intended to predict the market trends. The proper usage of chart patterns helps traders and investors to decide when is the right time for them to enter and exit a particular trade. With the help of chart patterns it has already become possible to forecast whether the price is going to continue its direction or reverse. Accordingly, there are two types of chart patterns: Trend continuation patterns and Trend Reversal Patterns.

Trend continuation patterns are formed during a pause in the trend, and they are quite easily recognized on the charts. Continuation patterns are usually shorter in their duration than the reversal patterns, and in contrast to reversal patterns, continuation patterns indicate trend consolidations, and continuations and not trend reversals. Continuation patterns include the following formations:

1. Ascending Triangle
2. Descending Triangle
3. Symmetric Triangle
4. Bullish Rectangle
5. Rectangle (Bearish)
6. Forex Flag
7. Pennant
8. Wedge

Trend reversal patterns indicate the end of a previous trend and show that the market is ready to begin a new trend. The most well-known reversal patterns are the following:

1. Head and Shoulders
2. Inverse Head and Shoulders
3. Double Top
4. Double Bottom
5. Triple Top
6. Triple Bottom
7. Forex Diamond

CONCLUSION

The participants of the market, whether experienced or not, need a certain method or a strategy for conducting their investment and trading decisions in the market easily. One may use fundamental analysis, the other one may use technical analysis, or even the mixture of both for deciding when is the right time to buy or sell a certain financial instrument. Each method of analysis has its unique principles which will help traders and investors to make their trading decisions easily.

In this article we presented you the evaluation of technical analysis, the Dow Theory, 3 main principles on which technical analysis is based and the main tools which help to make accurate technical analysis.

Each trader and investor should keep in mind that technical analysis is one of the essential components of their trading, and they should have a better understanding on it for making right decisions and for avoiding possible loses.