Herald Sun

Letting demand and supply lead you to profitable patterns

TERMS OF TRADE

with CARL CAPOLINGUA

LAST week I discussed the broad concepts behind devising the rules for a technical analysis-based investing system.

Today we'll discuss which technical indicators I use in my own investing system.

My thesis is that markets are almost always efficient.

Therefore price moves based upon all of the available fundamental information.

This information is used by sophisticated investors to determine the risk-adjusted return of various securities against all other possible investing alternatives.

This analysis occurs in real time and the resultant actions to become a buyer or seller for a particular security, or to remain a holder of that security, are also implemented in real time.

These actions contribute to the demand-supply equilibrium. When there is an imbalance the price will move. If demand exceeds supply the price will increase, if supply exceeds demand the price will decline, and when demand and supply are in equilibrium the price will stagnate.

In terms of identifying the best securities to buy, one can infer that the strongest demand-exceeds-supply imbalance will result from the most compelling relative risk-adjusted return on offer. In such a case, the price is sure to be increasing over time.

Thus we require tools that analyse the magnitude and nature of upwards price movement to determine the most opportune investment opportunity. I attack my universe (securities I analyse each session) in three ways.

Firstly, by using broad trend filters to infer the price movement over short, medium and longer term periods. I require that the demand-exceeds-supply imbalance is prevalent over each timeframe.

To accomplish this task I use exponential moving averages or "EMAs".

The calculation of EMAs is well beyond the scope of this article, but they are available on all technical analysis platforms. I require that the 21, 63, and 125 period EMAs are each rising and the current price is above each.

They should also be in the correct order being 21 above 63, and 63 above 125.

Using scanning software, the trend filters allow me to reduce my universe of over 10,000 securities to just a few hundred in a matter of seconds. On this smaller list I move to step two, analysing price action. Price action hones in on the nature and sustainability of the trend over the short to medium term. Here, I use a number of Japanese Candlestick patterns and swing charting concepts.

For the most part, I am looking for signs that demand is pervasive in the market, and that each supply event is pounced upon quickly by those on the demand side. Frequently occurring white candles and lower shadows, and regular higher swings on the swing chart are key here.

Finally, I must determine how attractive the security is compared to other securities in the market — which shows the greatest demand-exceeds-supply imbalance?

To do this I use a concept called Relative Strength Comparison (RSC), which compares the strength of the trend of a security against the benchmark index within which it trades.

My brand of technical analysis is based upon pattern recognition. It assumes there are patterns in how price moves over time, which repeat with enough statistical expectancy that one can profit from entering and exiting when the patterns exist.

My technical indicators combine to give me a sense of the probability of success associated with any particular investing opportunity. The rest is up to the market!

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