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THE VISUAL INVESTOR

HOW
TO
SPOT
MARKET
TRENDS

SECOND EDITION

JOHN J. MURPHY

The Visual Investor

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The Visual Investor

How to Spot Market Trends

Second Edition

JOHN J. MURPHY



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To Clare and Brian

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Preface

This may come as a surprise, but I don't really think of myself as a writer. I think of myself as a market analyst who writes about things that I see on charts. Fortunately, I've achieved some success in both fields. My first book, *Technical Analysis of the Futures Markets* (New York Institute of Finance/Prentice Hall, 1986) was described by many as the bible of technical analysis and was translated into a half dozen languages. A second edition was published under the title *Technical Analysis of the Financial Markets* (Prentice Hall, 1999) and, as the newer title implies, broadened its coverage to include all financial markets. I authored *Intermarket Technical Analysis* (John Wiley & Sons, 1991) which was described as a landmark publication since it was the first book to emphasize linkages between financial markets and asset classes. A second edition of that book, *Intermarket Analysis* (John Wiley & Sons, 2004) was published 12 years later.

The first edition of *The Visual Investor* (John Wiley & Sons, 1996) was my favorite of the books written thus far—and still is. While my other two books were written primarily for market professionals, or investors with some degree of charting experience, *The Visual Investor* was for the general public with little or no charting experience. The genesis for the book came while I was the technical analyst for CNBC. I usually had three or four short segments on the air each day to discuss some aspect of the financial markets. And I used a lot of charts. Unfortunately, there wasn't a lot of time to explain how the charts were constructed and exactly how to interpret them. I received an awful lot of mail from viewers asking me to explain what all the lines on the charts meant. The first edition of *The Visual Investor* was my answer to all of those viewer requests.

We decided to call the book *The Visual Investor* for a couple of reasons. What I did on TV (and still do in my market commentary) is show pictures of markets in much the same way that meteorologists look at weather maps. It's all visual. There was no point calling it anything else. Besides, a lot of people are intimidated by the term "technical analysis." Even I still don't understand what that means. So we decided to call it what

it really was in an attempt to get more people to consider this valuable form of market analysis without all the unnecessary technical baggage and jargon.

I also started calling what I did *visual analysis* to lessen the fear factor of TV producers who seemed terrified by the subject (despite the fact that TV is a visual medium). It seems like every TV story has some chart attached to it these days. It still seems, however, that TV producers are reluctant to interview someone who actually knows how to read a chart. They'll ask economists, security analysts, and sometimes one of their own commentators what the charts mean. They seem reluctant, however, to ask a card-carrying chart analyst (yes, professional chartists now carry cards). They seem afraid that would be "too technical" for them or their audience. That's probably just as well because you don't need to watch TV to find out what markets are going up and which are going down. One of the purposes of this second edition is to convince you that you're perfectly capable of doing your own visual analysis of the various financial markets. And it's not as hard as you might think.

One of the things that happens to most market veterans over the years is that they tend to simplify their work. Part of the reason for that may simply be lack of energy as one gets older. I prefer to think of the tendency to simplify things as a sign of experience and, hopefully, some increased maturity and wisdom. When I first started my career as a chartist 40 years ago, I studied (and tried to apply) every technical tool and theory that I found. Believe me, there were a lot of them. At one time or another, I studied and used virtually every one of them. And I found some value in each one of them. As my intermarket work forced me to broaden my horizon to include all financial markets all over the world, however, there simply wasn't time to perform in-depth chart analysis on each and every one of them (especially with as many as 80 technical indicators in some charting packages). Then I found something else out. It wasn't really necessary to do so anyway. All one really needs to do is find out which markets are rising and which ones aren't. It's really as simple as that.

On an average day, I scan hundreds of financial markets. I don't necessarily look at each chart however. We now have screening tools (which I'll show you later) that help us to quickly determine which markets are rising and which ones are falling. Within the stock market, for example, we can usually tell at a glance which market sectors and industry groups are the strongest and which ones are the weakest on any given day. We can then look to see which individual stocks are driving those groups higher or lower. Only after we've uncovered the leaders (or laggards) do we actually look at the charts. We can do the same for foreign stocks and other financial markets such as bonds, commodities, and currencies. The Internet makes all of that easy to do.

One advantage of scanning so many markets is that it gives me a feeling for the big picture. Since all financial markets are linked in some fashion, it's helpful to get a sense of what the main theme is. Rising stock prices, for example, are usually associated with falling bond prices. A falling dollar usually coincides with rising commodities and stocks tied to those commodities. Strong foreign markets usually signal a higher U.S. market and vice versa. A strong stock market usually favors economically sensitive stock groups like technology and transportation. In a weaker market, defensive groups such as consumer staples and health care usually do better. No market trades in a vacuum. Traders who look at only a handful of markets miss out on valuable information. By the time you finish this book, you'll have a better grasp of how the big picture works.

The second edition of *The Visual Investor* follows the same theme as the first edition. I've tried very hard to keep it simple. I've chosen only those few indicators that I believe the most useful. If you can read a line on a chart and learn to tell up from down, you won't have any trouble grasping what visual analysis is all about. Knowing why a market is going up or down is interesting, but not crucial. The media is full of people telling you why they think a market is going up or down. It really doesn't matter. The media is also full of people telling you what the markets should be doing. All that matters is what the markets are actually doing. Visual analysis is the best way to determine that. And that's what this book is all about.

As you begin to understand the principles of visual analysis, you may notice an increase in your own sense of self-reliance. You may find that you don't really need to listen to all those analysts and economists who like to explain why the markets did what they did yesterday (which they didn't know or didn't bother tell you about the day "before" yesterday). You'll begin to realize that all those financial "experts" aren't that expert after all. Remember all those experts who didn't see the housing bubble bursting in 2007 until it was too late. Or those experts who assured us that the subprime mortgage mess wasn't all that serious in summer 2007. Even the Federal Reserve Board kept insisting during the second half of 2007 that the economy was in fine shape and inflation was well contained. While they were saying that, the stock market and the U.S. dollar were falling while bond prices and commodities were rising—a recipe for stagflation. By the middle of 2008, the Fed admitted that it was trying to battle a weakening U.S. economy and rising inflation at the same time. It took those experts several months to recognize what the markets were telling us all along. That's why we prefer looking at the markets instead of listening to the experts.

When I first started writing about intermarket principles more than a decade ago, it wasn't that easy to implement many of the strategies. Commodities, for example, were the hottest asset class over the past five years.

In the past, the only way to benefit from that was through the futures markets. The advent of exchange-traded funds have made access to commodities much simpler for the average investor. ETFs have also made sector trading much easier as well as access to foreign stocks. I'll show you how ETFs have made the life of the visual investor easier.

I started out to make this a “visual” book. I wanted to show you a lot of pictures of markets that could tell a story on their own. As a result, you're going to see a lot of charts. The charts I chose were taken from recent market data. They weren't chosen to depict perfect textbook examples, but to show real-life examples of visual principles at work in the current market environment. I hope I've chosen wisely. Please keep in mind there's only one question you have to continually ask yourself: Is the market I'm looking at going up or down? If you can answer that, you'll do okay.

—JOHN MURPHY

June 2008

Acknowledgments

In the first edition of this book, I recommended that an investor have charting software and access to an online data service to perform visual analysis. Thanks to the increasing number of Internet resources, all one needs now is a good charting website, which eliminates the need for a separate data service. In other words, all you need to do is log on and start charting. One such charting service is StockCharts.com. As the chief technical analyst (and part owner) for that award-winning site, I've had some say in its development. Needless to say, I'm very proud of the result. All of the charts (and visual tools) in this book are taken from that website. I'd like to thank Chip Anderson, president of StockCharts.com, for giving me permission to do that. I'd also like to thank Mike Kivowitz of Leafygreen.info for his help in producing the artwork. More information on StockCharts.com can be found at the end of the book. It's a good place to start your own visual analysis.

SECTION ONE

Introduction

Traders and investors have been using a visual approach to investing for over a century. Up until the past decade, the use of visual analysis as a serious method of trading and investing was pretty much limited to professionals and full-time traders. Most successful traders would never think of making a trade without first consulting the pictures on their charts. Even the Federal Reserve Board now uses price charts.

WHAT HAS CHANGED?

For the average investor, however, the world of visual trading had been largely closed. The intimidating jargon and complicated formulas were beyond the reach and, indeed, the interest of the nonprofessional investor. A couple of important factors have changed that in the past decade. The most important is the availability of inexpensive *computers* and Internet charting services. The investing public now has an impressive array of technological and visual tools that weren't available to the professional community 30 years ago.

The second development has been the dramatic expansion of the *mutual fund* industry to the point where more mutual funds exist than stocks now traded on the New York Stock Exchange. This phenomenal growth has produced both benefits and challenges for the average investor. The challenge lies in the fact that the job of choosing among mutual funds has been greatly complicated. In a very real sense, the mutual fund growth has

made the task of the individual investor more difficult. The original purpose of mutual funds was to *simplify* investing. If someone didn't have the time or expertise to pick stocks, that task could be turned over to a mutual fund manager. Besides professional management, instant diversification was provided. An investor could buy one fund and be in the market. Now, however, mutual funds are so segmented that the investor has a bewildering set of choices to make. In the past decade, the arrival of *exchange-traded funds* (ETFs) has replaced many mutual fund choices.

FUND CATEGORIES

Domestic stock funds are categorized by goal and style—*aggressive growth*, *growth*, *growth and income*, and *equity income*. Funds are also divided by the size or capitalization of the stocks included in their portfolios. *Large-cap stock funds* limit their portfolios to those stocks included in the Standard & Poor's 500 stock index. *Midsized funds* focus on stocks included in the S&P 400 Mid-Cap Index or the Wilshire Mid-Cap 750. *Small-cap funds* choose their portfolios from the Russell 2000 or the S&P 600 Small-Cap Index. Stock funds can be further identified by their specialization in various stock market sectors, such as *Technology*, *Basic Industry*, *Health Care*, *Financial Services*, *Energy*, *Precious Metals*, and *Utilities*. Stock sectors can be further subdivided into *industries* with even more specified funds. The Technology sector, for example, would include funds that emphasize *computers*, *defense and aerospace*, *communications*, *electronics*, *software*, *semiconductors*, and *telecommunications*. Fidelity Investments offers as many as 40 sector funds for the individual to choose from.

GLOBAL FUNDS

Another dimension has been the growing popularity of global investing. Investors can now trade in individual foreign countries or geographic regions by selecting the appropriate stock fund. As a result, investors are forced to keep abreast of market developments not just in the United States, but all over the world. While overseas investing carries more risk than domestic funds, the rewards are well worth it. From 2003 through the end of 2007, foreign stocks rose more than twice as much as U.S. stocks.

During these same four years, emerging markets gained four times as much as the U.S. market. Overseas investing provides diversification from the U.S. market, which is why financial advisors recommend leaving as much as a third of one's portfolio abroad to improve returns and lessen risk.

INVESTORS NEED TO BE BETTER INFORMED

For many investors, *fund* investing has replaced *individual stock* selection. However, with the degree of segmentation that has taken place in the stock fund industry, investors have little choice but to become better informed and more actively involved in the fund selection process. Investors must be aware of what different sectors of the American market are doing as well as how global markets are faring. The number of choices available to the investor is a mixed blessing.

So, too, are the technological advances of the past decade. The problem is knowing how to select and use the resources available. The technology has outpaced the public's ability to use the new data in the most efficient way. Which brings us to the purpose of this book—to help the average investor quickly acclimate to visual trading; and then show how these relatively simple principles can be applied to the problem of sector investing primarily through exchange-traded funds.

BENEFITS OF VISUAL INVESTING

The bright side of the increased specialization among funds is that the investor has never before been provided with so many vehicles to choose from. Individuals who favor a certain market sector or industry, but don't want to choose which stocks to buy, can now buy the whole group. Sector funds also provide additional ways to diversify one's core stock holdings and to pursue more aggressive growth opportunities with a portion of one's assets. That's where visual analysis comes in.

The tools explained in this text can be applied to any market or fund anywhere in the world. With the aid of a computer and easy access to price data, the task of monitoring and analyzing funds has been made immeasurably easier. The power of the PC can also be harnessed for such things as *monitoring* portfolios, *back-testing* rules for buying and selling decisions, *scanning* charts for attractive opportunities, and *ranking* funds by relative performance. While the challenges of learning how to apply new technology to fund and sector investing are there, so are the rewards. If you're in the market, you've already accepted the challenge. This book will show you how to reap the rewards.

STRUCTURE OF THE BOOK

The book is divided into four sections. Section One explains what visual analysis is and how it can be blended with more traditional forms of

investment analysis. The critically important subject of *market trend* is explained, along with some visual tools to help identify the trend. You may be surprised to discover how much value lies in some of the simplest tools that are covered in the first section. Throughout the book, a special emphasis is placed on ETFs. Exchange-traded funds have greatly simplified the asset allocation and sector rotation process.

Section Two covers some of the more popular market indicators in use today. We stress the *concepts* behind the various indicators and how they are *interpreted*. We limit our coverage to only the most useful tools. For those wishing to explore the world of indicators more fully, reference sources are given at the end of the book.

Section Three introduces the idea of *market linkages*. This is especially important in order to appreciate why stock market investors should also monitor movements in commodity prices, bond prices, and the dollar. *Intermarket analysis* is also helpful in understanding asset allocation and the process of sector rotation within the stock market. Along the way, you'll gain some insight into policy-making decisions of the Federal Reserve. You'll be able to watch many of the same things the Fed watches.

Section Four focuses on sector analysis. *Relative strength* analysis is shown to play an important role in the selection process. We also show you how to analyze the global markets.

I'll pull things together in the Conclusion with the admonition to keep things simple, along with some final thoughts. The Appendices will offer advice on getting started and where to find valuable resources to help you do so. The Appendices will also introduce some increasingly popular charting styles you might want to incorporate into your visual analysis.

What Is Visual Investing?

They say a picture is worth a thousand words. Maybe they should have said a thousand dollars. After all, we're talking here about using pictures to make money. And that's really what this book is about. It's that simple. A stock either goes up or down. If it goes up, and you own it, that's good. If it goes down, and you own it, that's bad. You can talk all you want about what a stock *should* be doing or *why* it isn't doing what it *should* be doing. You can talk about inflation, interest rates, earnings, and investor expectations. Ultimately, however, it comes down to the picture. Is the stock going up or down? Knowing the reasons behind a stock's movement is interesting, but not critical. If your stock goes up on a given day, they won't take the money away from you if you don't know why it went up. And if you can explain why it went down, they won't give you back your lost money. All that really matters is a picture, a simple line on a chart. The trick to visual investing is learning to tell the difference between what is going up and what is going down. The goal of this book is to help you tell that difference.

WHY MARKET ANALYSIS?

As the various chapters unfold, you will be provided with some relatively simple visual tools to aid you in market analysis and timing. Notice our use of the term *market analysis*. Whatever you choose to call it, the bulk of this book deals with visual analysis of the financial markets by utilizing

price and volume charts. Analysis of fundamental data, such as earnings expectations and the state of the economy, helps determine what a stock *should* be doing. Market analysis tells us what the stock actually *is* doing. The two approaches are very different. The use of earnings estimates comes under the general heading of *fundamental* analysis. The use of market analysis comes under the heading of *chart*, or *visual*, analysis. Most investors are more familiar with the fundamental approach because that is what they are taught in school and read about in the media. There's no question that the fundamentals are what ultimately move a stock or group of stocks. It's just a question of how one goes about studying those fundamentals and their effect on the stock.

THE TREND IS TO BLEND

The fact of the matter is that most successful traders and money managers use some blend of the visual and the financial. The more recent trend is toward a blending of the chart and fundamental disciplines. The use of *intermarket analysis*, the study of *market linkages* (discussed in Section Three), blurs the line between those two disciplines even further. The intention here is simply to explain how the two approaches differ and increase the reader's understanding of why the charting (or visual) approach should be a part of any investment or trading decision.

WHAT'S IN A NAME?

Visual analysis (also called *chart* or *technical analysis*) refers to the study of the market itself. Price charts can show individual stocks, industry groups, major stock averages, international markets, bond prices, commodity prices, and currencies. Visual analysis of various types of funds can also be accomplished. Many people are intimidated by the term *technical analysis*. As a result, they deprive themselves of the benefits of a very useful form of analysis. If that is the case with you, simply call it *visual analysis* because that's what it is. The dictionary defines *visual* as "capable of being seen by the eye; visible." *Technical* is defined as "abstract or theoretical." Believe me, there's nothing abstract or theoretical about this form of analysis. I'm often amazed at the number of people who are terrified by technical analysis but look at price charts all the time. They're scared more by the name than the analysis. To relieve that anxiety, we'll use the terms *visual analysis*, *market analysis*, and *chart analysis* throughout this book.

WHY STUDY THE MARKET?

Let's suppose an investor has some money to invest in the stock market. The first decision is whether or not this is a good time to put new funds into the market. If it is, which sector of the market would be most suitable? An investor has to study the market in order to make an informed decision. The question is how to accomplish that task.

An investor can read the newspapers, plow through a lot of earnings reports, call up his or her broker on the phone, or subscribe to some financial publication or web site. All of those things should probably be done as part of the process anyway. But there's a quicker and easier way: Instead of wondering what the market should be doing, why not look at what it is doing? Begin by studying the price trend of major stock averages. Then, look at the charts of the various stock sectors to see which way they're trending. Both steps can be accomplished in a matter of minutes by looking at the appropriate chart pictures.

CHARTISTS ARE CHEATERS

In a way, using chart analysis is a form of cheating. After all, why does a stock go up or down? It goes up because its fundamentals are bullish. It goes down because its fundamentals are bearish. Or, at least, that is how the market perceives a stock's fundamentals. How many times have you seen a stock fall in price in the face of a bullish piece of news? What matters isn't always the actual news, but what the market was expecting and what it thinks of that news.

Why, then, is chart analysis cheating? Because it is a shortcut form of fundamental analysis. It enables a chartist to analyze a stock or industry group without doing all of the work of the fundamental analyst. And how does it do that? Simply by telling the chartist whether the fundamentals of a stock are bullish or bearish by the direction its price is moving. If the market perceives the fundamentals as bullish, the stock will be rewarded with a higher price. A negative market evaluation of a stock's inherent fundamental value will punish the stock by pushing its price lower. All the chartist has to do is study the direction of the stock to see if it is going up or down. It almost seems like cheating, but it really isn't. It's just smart.

IT'S ALWAYS JUST SUPPLY AND DEMAND

The simplest way to understand the difference between the two approaches is to consider *supply and demand*. Simple economics tells us

that when demand increases relative to supply, prices rise. When supply exceeds demand, prices fall. The same principle applies to stocks, bonds, currencies, and commodities. However, how does one tell what those supply and demand figures are? The ability to tell which is greater is obviously the key to price forecasting. The hard way is to actually study all of the supply and demand factors, individually and collectively, to determine which is greater. The easier way is to let the price itself tell us. If the price is rising, demand is greater. If the price is falling, supply is probably greater.

CHARTS ARE JUST FASTER

An excellent example of the difference between the two approaches was provided to me early in my career as a market analyst. Our portfolio manager called me and a fundamental analyst into his office one day and gave us both the same assignment: to analyze the historic value levels for a list of stocks that he was considering purchasing for the company's investment portfolio. He wanted to know at what level each stock was overvalued and which were at more reasonable historic levels and more suitable for purchase.

I went back to my office and got out a long-term chart book showing price histories, going back several decades, for each stock. I simply noted the price levels where the stocks had peaked and troughed in the past, and which stocks were closest to those peaks and troughs. The entire project was completed the same afternoon.

However, my report wasn't submitted for another two weeks, which was how long it took my fundamental counterpart to complete his report. When both lists were submitted, the funny thing was that we both came up with essentially the same results. He had taken all of the fundamental factors, including historic price/earnings ratios and the like, into consideration to determine his numbers for historic valuations. I simply looked at the price histories of the stocks. We came up with the same numbers, but my task took two hours while his took two weeks. I learned two things from that. First, both approaches often give us the same results, demonstrating the enormous overlap between the two. Second, the chart approach is much quicker and doesn't require much knowledge of the stocks in question.

CHARTS DO LOOK AHEAD

The market is always looking ahead. It is a *discounting mechanism*. We don't always know why a market is rising or falling. When we do find out,