



What expectations should you have of indicators?

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First of all let's be clear about one issue. Indicators are derived from algorithms that used past data to provide a current value. They are by definition lagging. There are some developers who claim that their indicators are leading indicators – that they provide signals for the next period. Well, there are some such as pivot levels and Fibonacci, but in the ordinary range of indicators such as momentum and derivations of momentum, moving averages and bands that are supposed to indicate support or resistance, they are all lagging.

Consider a selection of popular indicators.

RSI/Stochastics

- Is it safe to buy when the indicator is oversold or sell when it is overbought? You bet your bottom Dollar they don't.
- Do divergences always generate a reversal? Nope.
- Does a momentum indicator tell us where price is going next? No way.

Moving averages

- Do they forecasts price direction? Only 50% of the time – but then probably flipping a coin will do that just as well.
- Do they provide support or resistance on a test? Can do – but do you know when they will?
- Does a crossover of a shorter average across a longer average provide a trading signal? Well, not if you want to make a profit.
- Do they tell us where price is going next? Nope.

Bollinger Bands

- Do they provide support or resistance? Not accurately. Actually even Bollinger declared that support & resistance are not what his bands are for – they indicate relative weakness of strength.
- Can you tell when they'll work (approximately) and when they won't? Rarely.
- Do they tell us where price is going next? Nope.

Well, well, well... well what do we do? Why are there so many indicators if they provide us with so little information?

When I look at indicators, or even develop them myself, I look at how they are calculated and what information they provide.

For example, RSI does show relative overbought or oversold extremes. They can also highlight when momentum is slowing in a trend through divergence. I like to observe that type of thing but I do not use it to forecast – because it can't forecast. I use it as supplementary information to help support my forecasts.

If I have a target resistance and when we get there I see a bearish divergence I begin to take note. Would I automatically sell? Maybe – it would depend on how confident I was of the forecast. Otherwise I'll want a confirmation of reversal by noting the rising swing lows – with the break of the last swing low providing support for my forecast.

However, they then cannot help me one little bit to identify where price will then go... I will develop indicators because I want a particular situation to be highlighted. This could be the level of volatility as indicated by the extent of overlapping bars during a period of time or one I like called the Pivot Cloud that gives me a general band of prices that represent an equilibrium band. However, it doesn't forecast anything at all.

So you can see that indicators do not hold any magic that if you look at the Fibonacci retracements in RSI or consider every twist and turn in its development that it will magically tell you when to trade. Forget those ideas – they will only lose you money.

What is vital is that you understand price. You must understand what generates support or resistance, how Fibonacci works, how it applies to particular moves and how different legs of a move are related. Then you need to understand how price moves – and it does move in recognizable sequences. Without that you trading will always have an element of confusion and hits and misses. You'll not really know where to put your entry and stop loss orders.

Once you have mastered the understanding of price then indicators can then provide excellent supporting tools as long as you use them in respect of what the formula is measuring.

Good luck

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