Technical Versus(??) Fundamental

Are Most Trend Analysts Doing About The
Same Thing from Different Perspectives?

"The market is a creature of expectations." -Anonymous

I really do not care whether a trend analyst says they are a "pure" fundamentalist or technician. The important thing is whether they have established a performance approach which effectively manages risk. All *trend* analysts are basically attempting to establish *expectations* which address the same four basic price movement questions: Which Way? When? How Far? How Fast?

The information which a performance-minded analyst of either school knows is also crucial regarding the first two questions is: "Within What Tolerance?" In other words, how do I know if my opinion is wrong? With the notable exception of a few total extremists on both sides, most fundamental and technical analysts are purposefully or subliminally borrowing some insights from the other school. More on this later, after some background on why this is.

Inflation and Foreign Exchange

Supply and demand determine the trends of the markets. Yet, the impact of inflation and deflation, along with floating foreign exchange rates, as potential distortions of the supply/demand balance since the early 1970s has encouraged the use of technical analysis as a tool for assessing trends. Widespread computer use since the late 1970s has also had a major impact by making technical indications accessible to a broad range of commercial and speculative interests.

In the stable, relatively inflation-free markets of the 1950s and 1960s it was possible to use supply and demand information alone to successfully determine the trends and objectives for price movements. This was done substantially through projecting current and anticipated supplies (including cyclical industry influences), while assessing demand elasticity during previous significant price changes. Actually, I started as a fundamentalist in 1970, successfully employing just this kind of economic analysis, and still keep an eye on the fundamental expectations driving any trend.

The attempts at economic micro-management by the central bank while the U.S. accrued major fiscal deficits to support the war in southeast Asia from the late 1960s, followed by dropping the gold standard and Bretton Woods exchange rate stabilization regime in the early 1970s, created a lack of confidence in the U.S. dollar as a reserve currency. Aside from various geopolitical triggers, this was one of the major reasons

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for the oil shocks and “stagflation” of the mid-late 1970s. We were left with a fine mess of inflationary and deflationary influences, along with foreign exchange volatility, playing a major role in the price trends of all markets.

It is no surprise that these influences, along with some occasional major production anomalies, led to our contemporary volatile trends in prices of everything from soybeans to treasury bonds. While the actual supply/demand situation for a given commodity remains a major influence, inflation, deflation, and currency realignments can significantly accelerate or mitigate a particular trend. The swings of the dollar played no small part in the over-extension and subsequent collapse of the agricultural bull market of the early 1970s. The extent of the moves in both directions was very disorienting to most classical fundamental analysts' expectations.

As such, it was appropriate for globally oriented traders to ask, "Am I trading steel or soybeans priced in dollars, or dollars priced in soybeans or steel?" With the markets so blatantly outperforming (or not responding to) classical fundamental influences, there were many who decided a different point of view would be useful. While it had been around for some time as a relatively arcane discipline, technical analysis became progressively more popular for monitoring trends, and assessing risk and reward.

Trend Analysis Overlap

It is not the purpose of this article to discuss the specific techniques of either school. Let it suffice to say that market trends develop because of supply and demand factors (i.e. fundamentals.) Yet, it is very hard to determine which fundamentals are going to dominate the price movement of a particular market over the near term future. Is the near term oversupply or the intermediate term shortage more important for the price movement today? Tomorrow? Next week? And, to what degree are inflation, deflation, and currency trends going to accelerate or mitigate the price change?

A cogent assessment of fundamental factors can lead to a plausible projection for the intermediate-to-long term trend. But, they are relatively imponderable for determining a short term tolerance projection at a specific price level as an essential part of a risk management plan (you remember, "Where am I wrong?")

Which is why most fundamentalists use a fairly recent significant high (if bearish) or low (if bullish) as their working tolerance to manage risk from the point at which they feel the prices should be trending in a given direction. (The alternative, assuming an unlimited risk, is unacceptable to all but the foolhardy.) In doing so they borrow one of the basic tenets of technical analysis: a bull market is defined by higher lows, followed by higher highs at some point in time; a bear market is defined by lower highs, followed by lower lows at some point in time.

Besides which, even if the fundamentalist gets the news right, there is no guarantee that the price will respond as predicted. For a good example of this, see illustration 1, below. In example A, the U.S. Federal Reserve cut rates in late January 1996. There was a not insubstantial group of analysts who had predicted this. They also felt a rate

cut would confirm the Fed's conviction that inflation was not a problem for the U.S. Treasury Bond market. As such, they were anticipating a further extension of the long term T-bond up trend in response to that news.

In the event, the market barely challenged its resistance in the low 120-00 area before starting a major break. Sanguine inflation expectations notwithstanding, in retrospect no one would have wanted to buy this market without a risk management plan.

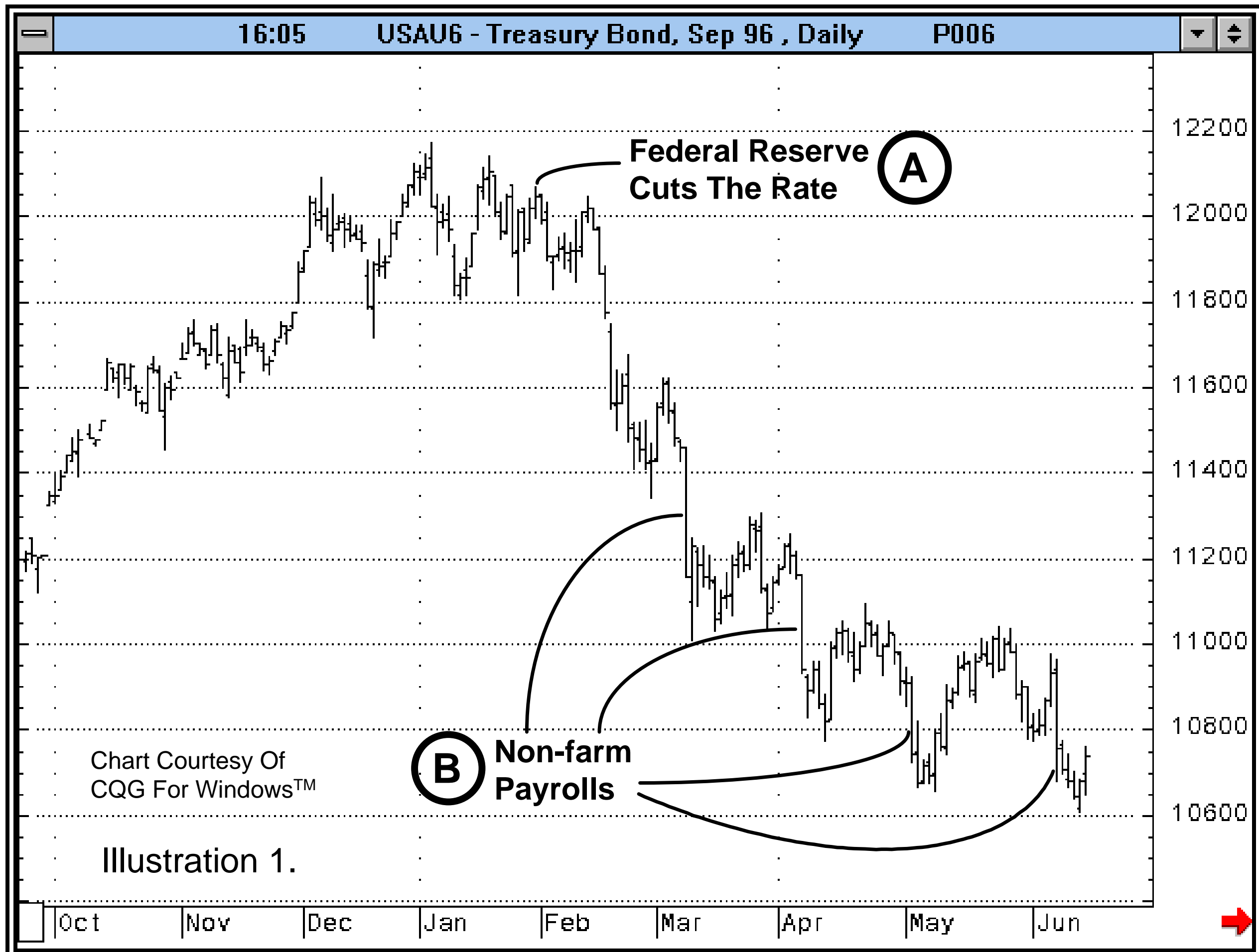

Illustration 1.

On the other hand, the most zealous technicians tend to say, "All news is incorporated in the price." Yet, except for the aforementioned extremists, you can bet most traders who primarily rely on charts and indicators are watching closely at major report release times or during influential speeches. We refer to these as fundamental "event horizons." Even though they do not use news as a primary focus of their analysis, they know from experience that news can push the prices to, or through, the next significant threshold; note the price reactions to early-mid 1996 non-farm payroll reports (B.)

Which any experienced technician can tell you is the real point: Prices tend to move through phases from critical levels at which the short-to-intermediate trend is decided, after which they fluctuate somewhat more randomly within a sustained trend to the next

critical level in either direction. These sustained trends between critical decision levels are the foundation for all technical analysis.

Expectations
Yet, as much as it seems to work very well in retrospect on the long term projections from the major signals, technical analysis can not guarantee a trend in a given direction. What it will do is to provide insight on those times and key price levels where the market is more critical than not; it is up to the analyst to assess whether prices are acting as they should from any particular technical signal. This is done by a synthesis of the "expectations" for follow through from the most salient current trend signals.

This is one of the big problems the anti-technical school has with this discipline, but we have found that whether any given trend signal succeeds or is negated, these expectations are clear enough to be useful. They make a valid point that the technical signals only work a certain percentage of the time; that is why it is so important to have well developed "expectations" as to whether the trend momentum is consistent with the current signals, and what happens next if a signal fails.

And this is where the well-rounded analyst who is primarily a technician takes a page from the fundamentalist. One of the main influences which can warn that a trend is in jeopardy (or a technical signal is false) is the failure of the prices to follow through as expected from a particular piece of news. Very much akin to technical false breakouts.

The failure of the German treasury bond (Bund) futures to sustain their late April daily chart Head & Shoulders bottom up breakout, in spite of interest rate cuts by the Bundesbank, is the most glaring recent example. Experienced technicians will not be surprised that prior to this failure the daily volumes on higher closes were not strong enough to reinforce the bull signal.

Balance
Therefore, it is not surprising that most savvy traders and trend analysts keep an eye on both sets of influences. While it is not possible to blend them evenly, the thorough analyst will proactively check the analysis from the other school, as well as assess their primary discipline for factors which might confirm or negate the relevant trend signals.

As trend analysts we are all trying to successfully project which way, when, how far, and how fast? Along the way it is essential to know which expectations from both schools are being fulfilled and which are not, regardless of our primary focus. This aids our assessment of the important risk management question, “Within what tolerance?” And that is an integral part of any well-thought approach to price trend analysis.

- Alan Rohrbach
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