FINANCE

technical analysis of the financial markets by john murphy

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Quick Takeaways

- Technical analysis is the study of market action, primarily through the use of charts, for the purpose of forecasting future price trends.
- John J. Murphy's work is considered the "Bible" of technical analysis, providing a comprehensive framework for understanding price behavior.
- The three pillars of technical analysis are: market action discounts everything, prices move in trends, and history repeats itself.
- Effective trading requires a blend of chart patterns, technical indicators, and volume analysis to confirm price movements.
- Intermarket analysis, a concept championed by Murphy, highlights the crucial relationships between stocks, bonds, currencies, and commodities.

Introduction: The Legacy of John J. Murphy

In the world of finance, few books hold as much weight as Technical Analysis of the Financial Markets by John J. Murphy. Often referred to as the "Bible" of the industry, this seminal work has served as the foundational text for generations of traders, analysts, and investors. Murphy, a former technical analyst for CNBC and a veteran of the financial markets, distilled decades of wisdom into a cohesive manual that covers everything from basic charting to advanced intermarket relationships. To understand technical analysis is to understand Murphy's teachings.

Technical analysis is not merely about drawing lines on a screen; it is a psychological and mathematical approach to understanding the collective behavior of market participants. While fundamental analysis looks at the "why" (earnings, economic data, geopolitical events), technical analysis focuses on the "what" (the actual price movement). Murphy argues that because all fundamental factors are eventually reflected in the price, studying the price itself is the most efficient way to navigate the markets.

The Three Philosophical Pillars of Technical Analysis

Before diving into specific patterns or indicators, one must internalize the three basic premises that underpin Murphy's entire philosophy. Without accepting these tenets, technical analysis becomes a futile exercise.

1. Market Action Discounts Everything

This is perhaps the most important concept in technical analysis. The technician believes that anything that can possibly affect the price—fundamental, political, psychological, or otherwise—is already reflected in the price of that market. Consequently, a study of price action is all that is required. When prices rise, it is because demand exceeds supply; when they fall, supply exceeds demand. While the fundamentalist might seek to understand the reason behind the shift in supply and demand, the technician is content to observe the result and trade accordingly.

2. Prices Move in Trends

The concept of trend is absolutely essential to the technical approach. The whole purpose of charting the price action of a market is to identify trends in early stages of development for the purpose of trading in the direction of those trends. A trend in motion is more likely to continue than to reverse—a principle adapted from Newton's first

law of motion. Technical analysis is, in essence, the art of trend-following.

3. History Repeats Itself

Much of the body of technical analysis and the study of market action has to do with the study of human psychology. Chart patterns, for example, which have been identified and categorized over the past century, reflect certain pictures that appear on price charts. These pictures reveal the bullish or bearish psychology of the market. Since these patterns have worked well in the past, it is assumed that they will continue to work well in the future because they are based on human psychology, which tends not to change.

The Foundation: Dow Theory

John Murphy begins his masterclass by rooting his teachings in Dow Theory, the oldest and most famous strategy for analyzing market trends. Developed by Charles Dow at the turn of the 20th century, these principles remain the bedrock of modern technical analysis.

- The Averages Discount Everything: Similar to Murphy's first pillar, Dow believed that the market price reflects all known information.
- The Market Has Three Trends: Dow identified the primary trend (tides), the secondary trend (waves), and the minor trend (ripples). Murphy emphasizes focusing on the primary trend for long-term success.
- Major Trends Have Three Phases: These are the accumulation phase (informed buying), the public participation phase (the largest move), and the distribution phase (informed selling).
- Averages Must Confirm Each Other: In Dow's time, the Industrials and the Rails had to move in the same direction to signal a valid trend. In modern terms, this means different sectors or indices should confirm each other.
- Volume Must Confirm the Trend: Volume should expand in the direction of the primary trend. In an uptrend, volume should increase as prices move higher and decrease during corrections.
- A Trend Is Assumed to Exist Until Definitive Signals of a Reversal: This encourages traders to stay with a trend as long as possible and not try to "pick tops or bottoms" prematurely.

Chart Construction and Essential Elements

To apply Murphy's principles, one must first master the tools of the trade. While modern software handles the heavy lifting, understanding the construction of charts is vital for interpretation.

Types of Charts

1. Line Charts: The simplest form, connecting closing prices over time. Murphy notes that many technicians believe the closing price is the most important data point of the day.
2. Bar Charts: These show the high, low, and closing prices (and often the opening price). Bar charts provide a more detailed view of the volatility within a specific timeframe.
3. Candlestick Charts: Originating in Japan, these charts use "bodies" and "wicks" to illustrate the relationship between the open and close. They are visually superior for spotting immediate shifts in sentiment.

Support and Resistance

Support is a level or area on the chart under the market where buying interest is sufficiently strong to overcome selling pressure. As a result, a decline is halted and prices turn back up again. Resistance is the opposite; it represents a price level or area over the market where selling pressure overcomes buying pressure and a price advance is turned back.

Murphy introduces the critical concept of **role reversal**: once a support level is decisively broken, it often becomes a resistance level in the future, and vice versa. This occurs because traders who bought at support and saw the

price drop are now eager to sell and break even when the price returns to that level.

Comprehensive Comparison: Technical vs. Fundamental Analysis

To better understand the niche that John Murphy's methodology fills, it is helpful to compare it directly with fundamental analysis.

Feature	Technical Analysis (Murphy)	Fundamental Analysis
Data Source	Price, Volume, Open Interest	Financial Statements, Economic Indicators
Primary Focus	Market Psychology and Trends	Intrinsic Value and Earnings
Time Horizon	Short to Long Term (Scalping to Years)	Usually Long Term (Quarters to Years)
Goal	Timing Entry and Exit Points	Identifying Over/Under-valued Assets
Core Philosophy	Market Action Discounts Everything	Value Will Eventually Drive Price

Advanced Chart Patterns: Reversal vs. Continuation

One of the most exhaustive sections in Murphy"s book covers chart patterns. He divides them into two main categories: reversal patterns and continuation patterns.

Reversal Patterns

These patterns signal that a significant change in trend is taking place. The most famous is the **Head and Shoulders**pattern. It consists of three peaks, with the middle peak (the head) being the highest and the two outside peaks (shoulders) being lower and roughly equal in height. The "neckline" is drawn connecting the lows. A break below the neckline on heavy volume completes the reversal.

- Double Tops and Bottoms: These resemble the letters "M" (top) or "W" (bottom) and indicate that the market has failed twice to break a significant level.
- Triple Tops and Bottoms: Similar to double patterns but with a third test of the level, indicating even stronger exhaustion.
- Spike Reversals (V-Tops): These occur when a trend moves too far, too fast, and suddenly reverses without forming a complex pattern.

Continuation Patterns

These patterns indicate that the market is merely pausing for a brief period before resuming the existing trend. They are generally shorter-term in nature.

- Triangles: Murphy identifies three types: Symmetrical (neutral), Ascending (bullish), and Descending (bearish).
- Flags and Pennants: These represent brief pauses in a dynamic market move. They are usually preceded by a sharp price advance or decline on heavy volume.
- Rectangles: Also known as a trading range, this represents a period of consolidation where the price moves sideways between two parallel lines.

The Role of Volume and Open Interest

Murphy emphasizes that price action should never be viewed in a vacuum. Volume is a secondary but vital indicator. It represents the total amount of trading activity in a particular stock or commodity for a given period. The general rule is that volume should go with the trend.

In futures markets, Murphy also uses **Open Interest**, which is the total number of outstanding contracts. Rising open interest during an uptrend is a bullish sign, suggesting that new money is flowing into the market to support

the move. If open interest begins to flatten or decline during a price advance, it may signal that the trend is nearing its end.

Technical Indicators: Oscillators and Moving Averages

Beyond the price bars themselves, Murphy provides a deep dive into mathematical indicators that help quantify momentum and trend strength.

Moving Averages (MA)

A moving average is a way to smooth out price action by constantly updating an average price. The two most common are the Simple Moving Average (SMA) and the Exponential Moving Average (EMA). Murphy suggests using the 50-day and 200-day moving averages for long-term trend identification. A "Golden Cross" (50-day crossing above the 200-day) is a major bullish signal, while a "Death Cross" (50-day crossing below the 200-day) is bearish.

Oscillators

Oscillators are used to identify overbought or oversold conditions. They are most effective in non-trending, sideways markets. Key indicators include:

- Relative Strength Index (RSI): Measured on a scale of 0 to 100. Readings above 70 are typically overbought, while readings below 30 are oversold.
- Stochastic Oscillator: Compares a closing price to its price range over a certain period. It is excellent for spotting divergences where the price makes a new high but the indicator does not.
- MACD (Moving Average Convergence Divergence): Developed by Gerald Appel, this indicator uses the difference between two exponential moving averages to signal changes in momentum and trend direction.

Intermarket Analysis: The Murphy Specialization

While most books focus on a single asset class, John Murphy's unique contribution is his mastery of intermarket analysis. He posits that all markets are interrelated and that no market moves in isolation. This is a critical skill for the modern macro trader.

The Four Key Sectors

Murphy focuses on the relationships between Currencies, Commodities, Bonds, and Stocks. A classic example is the relationship between the US Dollar and Gold. Typically, a stronger Dollar leads to lower Commodity prices. Another crucial link is between Bonds and Stocks. Since interest rates (which move inversely to bond prices) are a cost of doing business, falling bond prices (rising rates) are often a precursor to a decline in the stock market.

When the US Dollar strengthens, it puts downward pressure on Gold and Oil. Because Oil is a major component of inflation, falling oil prices can lead to higher Bond prices (lower yields). Higher bond prices generally provide a tailwind for the Stock market, provided the economic growth remains stable.

Step-by-Step Methodology for Analyzing a Market

Based on Murphy's teachings, here is a blueprint for conducting a professional technical analysis of any financial asset:

1. Determine the Overall Market Trend: Start with the broad indices (S&P 500, Dow Jones). Is the tide rising or falling?

2. Analyze the Sector: Use relative strength analysis to see if the specific industry group is outperforming or underperforming the broad market.

3. Examine the Long-term Chart: Look at a weekly or monthly chart to identify major support and resistance levels and the primary trend.

4. Identify Chart Patterns: On the daily chart, look for reversal or continuation patterns. Are there any Head and Shoulders or Triangles forming?

5. Check Moving Averages: Is the price above or below its 50-day and 200-day averages? Are the averages sloping up or down?

6. Verify with Volume: Does volume expand on rallies and contract on pullbacks?

7. Use Oscillators for Timing: Check the RSI or MACD for overbought/oversold conditions or potential divergences.

8. Perform Intermarket Check: Is the currency or bond environment supportive of this trade?

Common Pitfalls and Troubleshooting

Even with Murphy's guide, many traders fail. Here are common mistakes and how to fix them:

- Ignoring the Trend: Many traders try to pick tops or bottoms. Solution: Always trade in the direction of the trend revealed on the higher timeframe.
- Over-Complicating the Chart: Adding too many indicators can lead to "analysis paralysis." Solution: Limit yourself to 2-3 indicators that complement each other (e.g., one trend-following and one oscillator).
- Neglecting Risk Management: Technical analysis tells you where to enter, but it must also tell you where to exit if you are wrong. Solution: Always place a stop-loss order at a level where the chart pattern would be invalidated.
- Failing to Adapt: Markets change from trending to sideways. Solution: Recognize the market regime. Use trend-following tools (MAs) in trending markets and oscillators (RSI) in ranging markets.

Frequently Asked Questions (FAQ)

John Murphy's Technical Analysis of the Financial Markets is more than just a book; it is a comprehensive system for navigating the complexities of global finance. By focusing on price action, respecting the trend, and understanding the interconnectedness of different asset classes, traders can move away from guesswork and toward a disciplined, evidence-based approach. Whether you are a novice or a seasoned professional, returning to these foundational principles is the surest way to maintain a competitive edge in the markets.

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