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3 phases of dow theory

The Dow theory, developed by Charles Dow in the late 19th century, remains a widely respected framework for financial technical analysis. Its principles were refined by William Hamilton and Robert Rhea, and despite its age, it continues to hold value today. The theory's core tenets include the idea that averages discount all information that could impact securities demand and supply, except for natural calamities. The Dow theory recognizes three distinct trends: primary, secondary, and minor. A primary trend represents the overall market direction, lasting one to several years, characterized by consecutive highs and lows not crossing each other. Secondary trends are corrections to primary trends, occurring within a shorter timeframe, retracing part of the preceding wave. Minor trends represent daily fluctuations. The theory's application extends beyond the original Dow Jones Industrial Average (DJIA) and Transportation Average (DJTA), as its principles can be applied to various indices. The idea is that trends in these averages provide insight into the overall health of the US economy, with confirmation of primary uptrends indicating a broader market trend in the same direction. The Dow theory proposes a framework for understanding market trends, recognizing that primary and secondary trends have different implications for investors. While minor trends can be manipulated, primary and secondary trends cannot be controlled. The chart illustrates the cycle of a bull market, with phases of accumulation, public participation, and euphoria giving way to distribution. Conversely, in a bear market, the reverse sequence occurs. A key principle is that both averages must confirm each other, as unconfirmed movements can lead to misleading signals. Industrial stocks moving upwards without corresponding increase in transportation stocks can be a sign of manufacturing exceeding transportation capacity, suggesting a potential trend reversal. Average lows must be confirmed by matching lows in other averages to avoid misinterpreting market trends. When averages diverge, it may indicate an impending change in the ongoing trend direction. The chart illustration highlights the importance of average confirmation in identifying bull and bear markets. A bull market exists when both averages are trending upwards, but a divergence between them can be a warning sign that the trend is weakening. Divergence between averages can also occur due to changes in market conditions, such as increased manufacturing without corresponding transportation capacity. However, if one average fails to confirm the direction of the other, it may indicate that the overall market trend is intact but on fragile ground. Confirmation of a bear market in transportation requires matching movements in industrial stocks. Volume plays a crucial role in determining the health of a trend. In a bull market, volume should increase during rallies and decrease during secondary corrections, while in a bear market, volume should rise during declines and fall during secondary recoveries. The Dow theory assumes that averages reflect all available information affecting demand and supply for securities, with trends consisting of primary, secondary, and minor components. Market phases include accumulation, public participation, distribution (euphoria in bull markets and panic in bear markets). Movement between averages must be synchronized to accurately assess market direction. Volume's alignment with the trend is also essential in identifying market conditions. Technical analysts use various charts and tools to analyze market trends, applying theories like the Dow Theory to trade effectively across different market conditions and phases. The foundation of technical analysis lies with the Dow Theory, developed by Charles Dow, the founder of Dow-Jones Financial News Service. This approach was initially presented through a series of editorials and articles published between 1900-1902. Following Dow's death in 1902, William Peter Hamilton continued his work, compiling these articles into a cohesive theory. The Dow Theory posits that the stock market serves as a reliable indicator of the overall business environment within an economy. By analyzing the market's trends, investors can gauge the health of business conditions. A key aspect of the Dow Theory is its emphasis on market trends, which are believed to move in a predictable manner. According to this theory, if one average rises above a previous significant high and is followed by a similar rise in the other averages, it signals an upward trend. The Dow Theory also assumes that the market discounts all information consistent with the efficient markets hypothesis, meaning that any news or data relevant to the stock price or market is already accounted for. The theory is built upon six core principles, known as the Tenets, which were developed by Charles Dow based on his observations of market trends over the years. These tenets include: 1. Market discounts everything - This principle posits that all information or news known or unknown to the public is already priced into the indices or reflected in stock prices. 2. There are three market trends - The Dow Theory was the first to propose that markets move in distinct trends, including primary, secondary, and minor trends. Primary trend indicates long-term market direction, secondary trend represents a correction to the primary trend, and minor trends refer to daily fluctuations. 3. Primary trends have three phases - According to this theory, primary trends undergo three phases: accumulation phase, public participation phase, and excess phase. In a bull market, these phases are called distribution phase, public participation phase, and panic (or despair) phase. By understanding the Dow Theory's core principles, investors can gain insight into the overall direction of the market and make informed decisions about their investments. 1. Accumulation (or distribution) phase: Characterized by increased investor participation, this phase follows a bear market and marks the beginning of public sentiment in favor of buying or selling. 2. Public participation phase: As more investors enter the market, their collective sentiment influences stock prices, leading to a prevailing trend that continues until a reversal occurs. 3. Excess or panic phase: Marked by intense buying or selling, this final stage often precedes a significant trend reversal. 4. Indices confirmation: Multiple indices must confirm each other to establish a trend, as a single index cannot accurately represent the overall market direction. 5. Volume confirmation: Increased trading volumes support an uptrend, while decreased volumes indicate weakness in the trend. 6. Trend continuation: Despite short-term fluctuations, primary trends persist until a clear reversal is confirmed, at which point the market adjusts its trajectory. Dow Theory Explained The Dow theory is a technical analysis approach that views market trends as existing despite noise in the market. It assumes that the market discounts everything, consistent with the efficient market hypothesis. There are three main trends: primary, secondary, and minor, each going through three stages: accumulation, public participation, and distribution. Market averages must verify one another, and volume supports the trend. A trend is assumed to continue until a clear reversal signal is issued. The theory was developed by Charles H. Dow and is widely used to identify market trends and potential changes in direction. It involves analyzing market behavior and using tools like Fibonacci to mark key levels. The Dow theory is also known as the "Dow Jones Industrial Average theory", representing its founders Charles H. Dow and Edward Jones. Dow Theory: A Fundamental Concept in Technical Analysis Dow died in 1902, and his successor, William P. Hamilton, further developed the theory in his book "The Stock Market Barometer" in 1922. Robert Rhea expanded on Dow's ideas in 1932 with "The Dow Theory", while E. George Schaefer included a section on Dow theory in his 1960 book "How I Helped More Than 10,000 Investors to Profit in Stocks". Richard Russell's 1961 book "The Dow theory Today" provides a modern interpretation of Dow's ideas. According to Dow theory, the market moves in three ways: primary trend, secondary trend, and short swing. The primary trend is the main direction of the market, lasting several months to even a year. The secondary trend runs counter to the primary trend and can result in losses up to 66% of its value. The third phase is considered noise with little value. The theory also explains the relationship between Dow Jones Industrial Average (DJIA) and Dow Jones Transportation Average (DJT) index, which represent manufacturing and transportation industries. When these indices move apart, it's a sign of market reversal. Volume must confirm the trend, and trends will continue until there are definitive signals that prove otherwise. Combining the five concepts of Dow theory helps traders predict the stock markets and organise their exit and entries. Market sentiment is an important aspect to consider when using this theory. The Dow Theory is an investment tool that gauges market sentiment by monitoring investor attitudes towards stocks. A surge in stock prices typically indicates a positive market outlook, whereas a decline suggests bearish sentiment. Volume plays a crucial role as it signifies the number of transactions within a given period. Higher volumes often signal robust market participation and increased liquidity, which are viewed as favorable signs by Dow theory proponents. However, investors must be cautious as volume indicators can become unreliable when large players' trades remain undisclosed. The Dow Theory comprises six fundamental principles that help guide investment decisions. These principles emphasize the importance of averages undervaluing market movements, the presence of three distinct trends (primary, secondary, and tertiary), and the need for averages to verify one another. The notion that averages understate market value is a cornerstone of the Dow Theory. This suggests that stock market indices like the Dow Jones Industrial Average may not accurately reflect individual stock or overall market performance due to their weighted nature. The theory also posits that markets consist of three trends: primary, secondary, and tertiary. The primary trend is the most significant and can last for an extended period, indicating the broader market direction. The Dow Theory proposes that a rising market average must be accompanied by a corresponding rise in another index to confirm an upward trend. This approach relies on the concept that markets reflect all available information, consistent with the efficient market hypothesis. Until trends reverse, different indices must corroborate each other through price action and volume patterns. Several authors have built upon editorials to expand on Dow Theory. Notable contributions include Hamilton's "The Stock Market Barometer" (1922), Rhea's "The Dow Theory" (1932), Schaefer's "How I Helped More Than 10,000 Investors to Profit in Stocks" (1960), and Russell's "The Dow Theory Today" (1961). Charles Dow believed that the overall market is a reliable indicator of business conditions, allowing investors to gauge trends and identify market directions. The theory has evolved over time, with its emphasis on railroads and transportation sector no longer as prominent. However, Dow's approach remains fundamental to modern technical analysis. The six core components of the Dow Theory include... (No translation) The Dow Theory suggests that railroads' profits from moving freight would lead to a rise in the DJTA, mirroring a potential increase in the DJIA. Typically, trading volume surges when prices move with the main trend and declines when they oppose it, indicating weakness. In bull markets, increased buying volume during pullbacks implies traders still trust the primary trend. A crucial aspect of Dow Theory is distinguishing between primary and secondary trends, as reversals can be tricky to identify. To confirm a possible reversal, indexes should be compared, exercising caution until clear signs emerge. Charles Dow focused on closing prices rather than intraday movements. Dow Theory also emphasizes line ranges or trading ranges, periods of sideways price movement that signify consolidation. Traders should wait for a break in the trend line before making a conclusion about market direction. For instance, moving above the line often indicates an upward trend. One of the most challenging aspects of implementing Dow Theory is accurately identifying trend reversals, which are crucial to following the overall market direction. A key technique used by Dow Theory followers is peak-and-trough analysis, which identifies upward and downward trends based on successive peaks and troughs. The sixth tenet of Dow Theory states that a trend remains in effect until there's clear evidence it has reversed. The primary direction of the market will continue until significant forces, such as changes in business conditions, alter its course. A reversal is signaled when the market can no longer create successive peaks and troughs in line with the primary trend. During an uptrend, a reversal occurs if the index fails to reach higher highs and lower lows over time, instead moving in lower highs followed by lower lows. Conversely, during a downtrend, consecutively higher highs and higher lows indicate a possible reversal to an upward trend. The Dow Theory suggests that market trends can take months to materialize, with changes in price direction over short periods potentially just a correction rather than a full-fledged shift. The theory identifies three main trends: primary, secondary, and minor. Primary trends represent the long-term trend, while secondary trends are smaller fluctuations, such as corrections, and minor trends encompass day-to-day price movements. The goal of the Dow Theory is to determine the market's primary trend through evidence and verification.