Technical Indicators In Forex Trading - Understanding Their Limitations

Forex traders often look at indicators such as Bollinger Bands, Pivot Points, MACD, Moving Averages and the such to help them determine where to enter or exit trades. Using technical indicators is fine, however many traders overemphasize their importance or just plain misunderstand them.

Many forex traders think that they can simply download an indicator and then mechanically apply it into their trading and do so profitably. This is just a plain illusion. Successful traders realize that there is a lot more to using indicators than just asking them to generate buy/sell signals or pin-point exact entry points. Technical indicators for them represent just one part of their trading strategy.

Let¡¯s take a look at some of the reasons why you should not put all your faith into those sometimes confusing little indicators.

Take Moving Averages (MA¡¯s) for example. They are "supposed" to show the direction of the trend. The most common and often used are the simple 200day MA, 100day MA, 50day MA, 35day MA and the 21day MA but they are only valid on daily graphs. Some forex day traders say that a good signal is when the 50day MA is crossed by the 13day MA and that when this occurs you should trade in the direction of the cross.

The problem with this (apart from the fact that it only works on daily graphs) is that these types of ¡°crosses¡± do not occur often enough for traders to exploit them. This can often lead to a situation where traders are seeing what they thought was a cross now reverse and uncross. Even worse, it can lead to a situation where day traders are "chasing" and trying to anticipate a cross. If you are doing this, you are distancing yourself from the market which you are trying to trade. Not only are you trying to guess what the price is going to do next but you are guessing what the indicator, based on the prices, is going to do next.

Other problems with technical indicators involve issues with the quotes and prices given to you by your broker. Forex brokers are market makers and as such different brokers will give you different quotes and prices at a specific point in time. Naturally, a different price could lead to a situation where different traders, trading the same market have the same indicators giving them different responses. That¡¯s how arbitrary technical indicators can be.

Finally, a lot of these technical indicators were developed by people trading the stock market. With the growth of computers and software packages that incorporate these indicators, technical analysis has become very popular and spread to other markets such as the forex market. What currency traders should be aware of however, is that as these indicators were developed in a time where real time information did not exist. As such, the limitations of technical analysis becomes even more exaggerated in forex trading ¨C not only is technical analysis an interpretation of historical events but it becomes even more so in the forex market, a market moved by real time events.

Conclusion:

Successful forex traders understand the limitations of technical indicators and realize that technical analysis should incorporate just one part of their trading strategy. In a recent international Forex market event visited by the major banks and institutions - the main players that influence the foreign currency market ¨C a survey was done to better understand what analysis they use. The results might be surprising to some tarders. The survey showed that a mere 26% use technical analysis and indicators compared to 41% who said they use fundamental analysis.

About the Author

Jovan Vucetic is the Editor of Margin Strategies, an educational forex website, which reviews forex trading systems. Learn about different types of forex trading strategies including a purely mechanical trading system which does not require interpretation of the usual Technical Indicators.