Teach Yourself Technical Analysis

Common Indicators

in the Meta Trader

SAMPLE

8. Bollinger Bands (BB)

This famous indicator was developed by John Bollinger and is used to measure the significance of the volatility in a market. It is a charting tool plotted two standard deviations away from a Simple Moving Average. Because standard deviation is a measure of volatility, the BB can tell you when the market is rangebound and when it is trending significantly. The bands are narrow in a rangebound market, whereas they are wide in a significantly trending market.

Computation:

Middle Band = SMA(20)
Upper Band = SMA(20) + (20-day standard deviation of price x 2)
Lower Band = SMA(20) – (20-day standard deviation of price x 2)

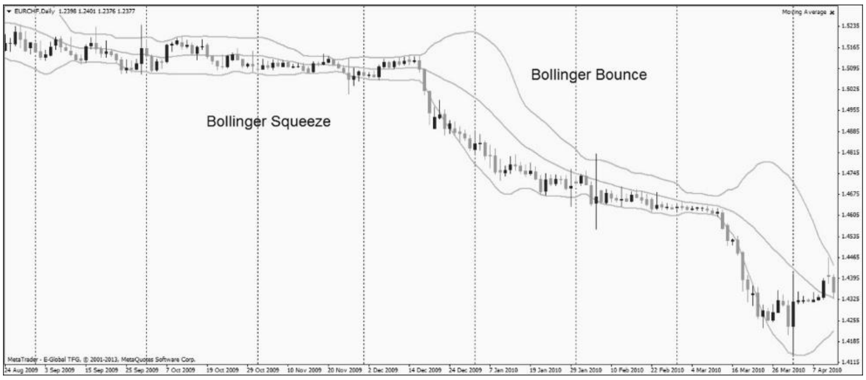
The computation could be modified a little to blend with the intrinsic nature of some trading instruments or approaches. The creator of the BB, John Bollinger, advises some tweaking to the standard deviation calculation. When the SMA period is also modified, it reflects on the amount of candles or bars considered when computing the standard deviation.

Lack of space does not enable us to go into more detail here. For more information on that go to www.bollingerbands.com.

The BB Bounce and the BB Squeeze

See figure 10: since the BB has the Upper Band, the Middle Band, and the Lower Band, it is no surprise that the price is prone to returning to the Middle Band. When the price is pushing the Upper Band upwards, it may pull back. When it is pushing the Lower Band downwards, it may experience a rally. Thus, the more the price pushes against the Upper Band, the more overextended the bull market; the more the price pushes against the Lower Band, the more overextended the bear market. It can be said that the price is going up when it is above the Middle Band and that the price is going down when it is below the Middle Band. The higher the time frame on which the BB is used, the more important are these points, including supply and demand zones in the market (for the indicator also acts as supply and demand zones, of sorts).

Fig 10. When the BB Bounces and Squeezes



This is a daily chart of the EURCHF. The Bollinger Bands period 20 are shown in magenta. You can see how it behaves during a sideways market and during a trending market (the BB Bounce and the BB Squeeze).

The BB Bounce occurs when the market is trending up strongly. You would see the price pushing against the Upper Band, which means it would soon go back towards the Middle Bands. The reverse is the case when the price is trending down strongly and pushing against the Lower Band.

The BB Squeeze occurs during a quiet phase in the market. The Bands would become tightened – a condition which chartists like to take as an early signal that the market will soon become highly volatile. As the market consolidates, the BB becomes narrow – hence the Squeeze. It is known that a breakout will eventually follow a consolidation phase, no matter how long it may hold out. When the price breaks upwards from the BB Squeeze, it is probable that it will continue trending upwards. This pushes the price further northward as it shrugs off any bearish threats to it: the marsh would stay aloof, if it had no relationship with the river. When the price breaks downwards from the BB Squeeze, it is probable that it will continue trending downwards.

Bear in mind that the BB can also be used in conjunction with other indicators, and it can be used for many types of strategies and in many ways, in addition to those mentioned here.

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