Market trends in composite averages

Wyckoff method of trading stocks part 3

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Now that you have an overview of the history and philosophy behind the Wyckoff Method and an outline of the procedures, let's start digging deeper into the actual techniques. Although we'll be concentrating on the stock market, these techniques are equally valid in the commodities, currencies, bond, and precious metals markets.

Before you can master the Wyckoff Method, however, you must remember that judgment is the most important technique. You must use your mind and your experience because there are no fixed and firm rules about market behavior—only general guidelines.

Keep two rules firmly in your mind, and you'll greatly increase your likelihood of success with the Wyckoff Method. The first rule is this: Don't expect the market to behave exactly the same way twice. The market is an artist, not a computer. It has a repertoire of basic behavior patterns that it subtly modifies, combines, and springs unexpectedly on its audience. A trading market is an entity with a mind of its own.

The second maxim is this: Today's market behavior is significant only when it's compared to what the market did yesterday, last week, last month, even last year. There are no predetermined, never-fail levels where the market always changes. Everything the market does today must be compared to what it did before.

When we study the market, our ultimate quest is to determine when the current trend will change—either briefly or for the long-term. Knowing a change is imminent tells us whether we should be trading on temporary declines and rallies or whether we should be investing for the long haul.

Every Wyckoff stock market analysis starts with a Vertical Line chart recording daily changes in a selected composite average. Almost any popular average printed each day in your local newspaper will work. I would recommend using the Standard & Poor's Composite Index 500 Stocks in the *Wall Street Journal*. The Vertical Line chart of averages shows daily high and low prices connected by a vertical line, and the closing price as a dash across the high-low line. Volume is another vertical line sprouting from the bottom of the chart.

All these elements of price plus volume are necessary to gauge the market's behavior. One alone doesn't tell the whole story. As David Weis, an expert in the Wyckoff Method, says in his *Elliott Wave Commodity Letter.* "For me, studying a chart that does not include volume is like reading a road map without highway numbers." You need price and volume to determine if buyers' demand is more powerful than sellers' supply to know if the market can move upward and vice versa.

What can you learn from a composite average chart? You learn where the market is taking your groups of stocks and individual picks. You learn to recognize the first inklings of change and to look closely at your group and individual charts for complementary or conflicting signals.

No market moves smoothly upward or downward. Experienced operators are constantly testing the waters, and the market is a rolling sea of rallies, reactions, hesitations, mark-ups, shakeouts, climaxes, and turning points.

Let's look at the averages' fundamental behavior patterns and how buyer-seller psychology brings them about. Then we'll see what they look like on an actual S&P 500 chart.

Bear market correction

We'll start with a market ready to end its decline. A declining market will always catch some investor/traders with high-priced stocks in their portfolios. Maybe they refused to sell because they thought the downturn would be short and temporary, or they bought during the decline in the hopes of a fast, profitable rally. Eventually, there comes a time when their hopes are dashed and they just want to unload their increasing losses.

This sets the stage for a Selling Climax, customarily followed by a Technical Rally (Automatic Rally or Rebound) and Secondary Reaction (or Test), and several opportunities to buy on the long side.

Selling climax bottoms

A Selling Climax is the finale to a panicky unloading of stocks, which are snapped up by more savvy operators. On a Vertical Line chart of a composite average, a Selling Climax is foretold by a sudden, abnormally large volume—sellers frantically unloading their losses. The price range usually drops and widens, the closing price hits nearer and nearer to the days' lows. Professionals rush in and the selling climaxes on a day showing a high volume and a closing price near the high (see Figure 1).

> **Diminishing volume on declining prices is a bullish sign that sellers are not pressuring the market.**

A Technical Rally follows, often caused by short covering. Volume dips and the price range jumps higher on the rally. To the uninitiated, the market seems to have instantly turned bullish. But, in actuality, the ensuing Secondary Reaction will show where the market is really headed because it will reveal what buyers were trying to accomplish during the Selling Climax.

If buyers during the climax did not intend to hold onto their purchases—perhaps they were large interests simply trying to shore up prices—then those stocks will be thrown back on the market at the first chance, normally the Technical Rally. If this new supply is too large for buyers to absorb, the market reacts with prices dropping lower than the extreme low recorded on Selling Climax day and a new decline is in the offing.

But if the market reacts to the rally with shrinking volume and prices that hold at or above the Selling Climax's low, it's an indication the selling spree has stabilized, that buying power is again coming into the market, and an upturn may be on the way.

This pattern of Selling Climax, Technical Rebound and Secondary Reaction occurs often, in the large trend and in day-to-day movements. It can be a major event or minor glitch in the market's overall direction. But one Selling Climax invariably differs from the next. The heralding volume surge may last one day or several. It may hit on the day prices reach their lowest point or some days ahead of it. Again,

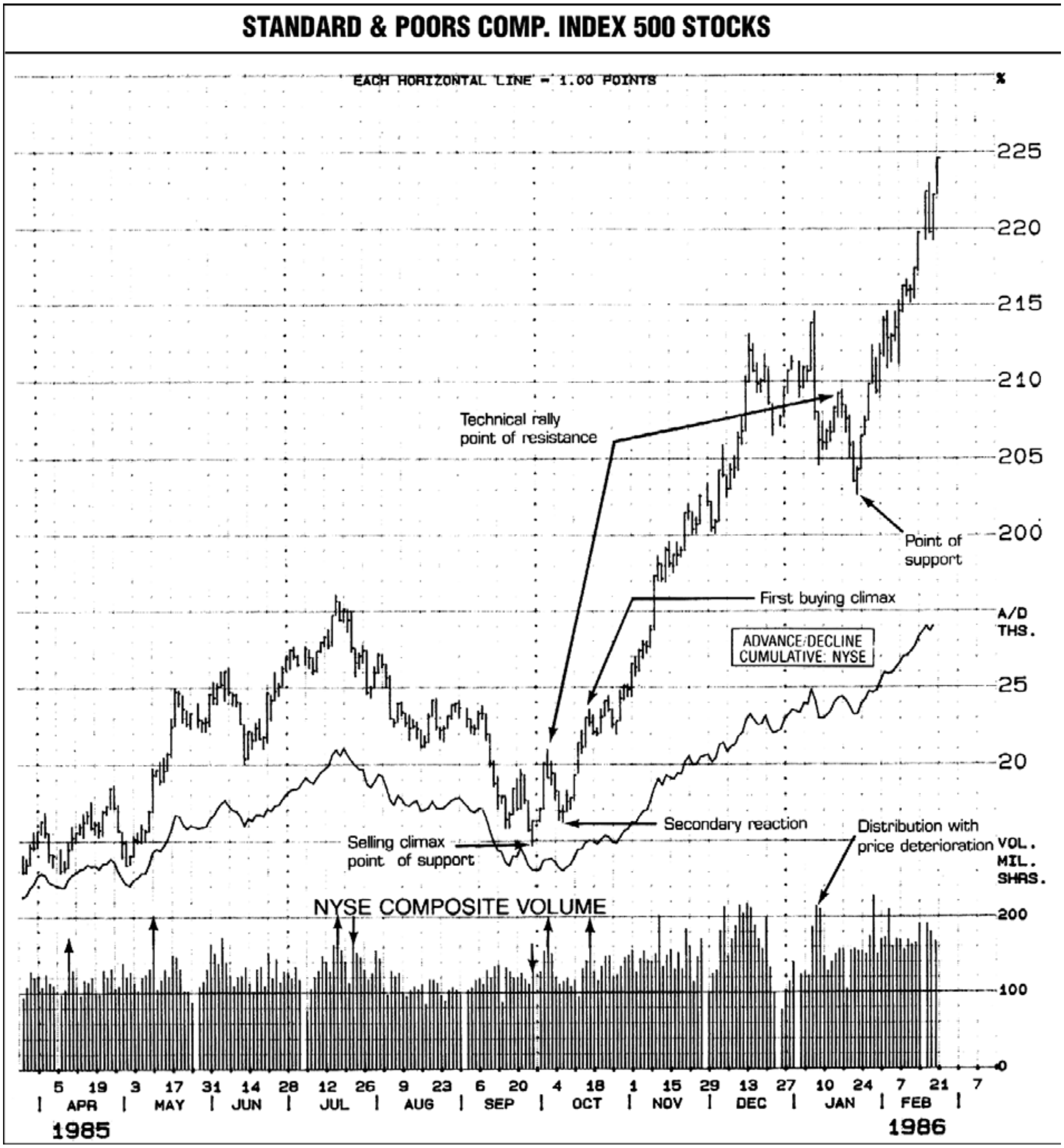
STANDARD & POORS COMP. INDEX 500 STOCKS
EACH HORIZONTAL LINE = 1.00 POINTS
Technical rally
point of resistance
Point of
support
First buying climax
ADVANCE/DECLINE
CUMULATIVE: NYSE
A/D
THS.
Secondary reaction
Selling climax
point of support
Distribution with
price deterioration
VOL.
MIL.
SHRS.
NYSE COMPOSITE VOLUME
225
220
215
210
205
200
25
20
200
100
0
APR
MAY
JUN
JUL
AUG
SEP
OCT
NOV
DEC
JAN
FEB
1985
1986

FIGURE 1

the rules of judgment and comparison must be put into practice.

An experienced Wyckoff analyst who sees the Selling Climax's combination of excessive volume and extremely low price, followed by rallying prices and low volume, would look to the secondary reaction as the basis for the next forecast. If reaction prices held above the climax's low it would indicate the decline had bottomed, and final confirmation of an important reversal would be prices rising above the Technical Rally's extreme high.

The rally's highest price is an important reference point, called a "point of resistance," because it is the most recent ceiling on price increases. Its counterpart is the "point of support ' the market's most recent, lowest price, the spot where prices stopped dropping lower. Breaching either the high, point of resistance or the low, point of support—especially when volume is increasing—is a significant market achievement. Comparing current prices to these points is an important analytical tool and placing stop orders near these points is a vital safety measure.

The bull market

Three opportunities to buy long usually occur during the Selling Climax - Technical Rally - Secondary Reaction chain of events. The first is immediately after the Climax, with a stop loss order placed two or three points under the purchase price and one to two points (about ¾ to 1½ percent of price) under the low of the climax day. The second chance to buy long is after a Secondary Reaction showing buyers are gaining the upper hand—characterized by retreating volume and prices hovering above the climax low. This type of reaction is said to have broadened the "zone of support" and the average is on the "springboard" ready to advance. The third, but least favorable, chance to buy is if the average tops the Technical Rally's highest price, the point of resistance. Purchases are now on an upwave rather than a turning point and risk is materially increased. Stop loss sell orders must still be maintained below both the recent Selling Climax point of support and Secondary Reaction low point. These low points may be tested several times before a bull market begins. The longer this period of testing, sideways or dullness persists, the more likely the resulting price move will be significant.

A market just starting an upward climb is ripe for a Buying Climax and a corrective downswing. Clues that a buying climax and downswing are surfacing: Daily highs that barely move higher and indicate buyers are reluctant to follow prices up; closing prices that barely fluctuate from one day to the next; and volume that tapers off and indicates lessening demand. Like a Selling Climax, a Buying Climax is characterized by a sudden increase in volume. When the high-volume day sets a new high yet closes near the low, a correction is in the offing.

When the price range begins to drop, analysts watch for signs that the market will be able to pull out of the corrective decline. Diminishing volume on declining prices is a bullish sign that sellers are not pressuring the market. When a session during the correction closes near its high, it's both a sign the correction is nearly over and a new buying opportunity. True bullish behavior resumes when the price ranges and closing prices move higher and are accompanied by gradually increasing volume.

Our ultimate quest is to determine when the current trend will change.

As the rising closing prices climb nearer and nearer the last point of resistance, the market's natural reaction is to hesitate. the average fluctuates within a narrow range because it is absorbing the offerings of over-anxious buyers who got hooked near the last high point and are eager to get out even.

This absorption or accumulation process can be distinguished from its opposite, the distribution process, by several factors: When prices hit the low end of the narrow trading range, volume remains low; the low end of the trading range is less than halfway to the market's last point of support; and as the lows again start to move upward, volume consistently increases—typical behavior at the end of an accumulation period prior to a mark-up.

During a mark-up phase, the average quickly gains a large number of points and volume likewise rockets. After this steep rise, the average may hesitate in a narrow range. Again, watch the lows, the supporting zone, of this hesitation and volume's reaction for a clue to coming events. If volume promptly decreases when the low dips, it says the market isn't ready to turn downward, and another advance is coming.

A lasting advance will send prices higher with proportional volume increases. If price makes smaller advances on increasing volume, then the market is warning of a distribution period. The advance has lured the public into buying and large operators can profitably unload, or distribute their holdings. The climactic signal for the distribution period is, again, a sharp volume increase and price upthrust which warns that stops should be moved closer to recent lows in preparation for a reaction.

Bull market correction

The reaction—a drop in trading range and closing price while volume stays high—says the large operators are still unloading and their supply is overcoming demand. If the market had advanced significantly before distribution set in, the reaction may be severe and even constitute a turning point. Comparing the behavior of this volume to that of previous reactions puts the magnitude of supply into perspective. Whether or not an impending, significant reaction looks like a turning point, it is time to close out all long trading positions and go short to profit from the downturn.

Wyckoff also advocates liquidating investments and standing aside while the market works out such a serious downswing. Even though the reaction may be temporary, he argues, its severity could significantly depreciate investment capital and some of the investments might not recover in an ensuing advance. With buying power intact, investment positions can be re-established when the market gives warning that it is bullish again.

Like an advancing market that tests previous highs, a declining market generally will test previous lows and a sharp decline toward the support level almost assures an attempt at a rally since some buyers will feel stocks are cheap again and bearish traders will buy out of their short positions.

The question in a case like this is how high can the rally go? Is it lasting or temporary? Large operators aren't likely to let the average immediately go back to the former highs where they unloaded large volumes. They'd just as soon let buyers at the former highs get tired of holding on to losses and then let prices run—if they felt prices could go substantially above the former level. They would need a substantial run-up to ensure themselves a profit on the stocks they would have to buy back from those who bought at the former highs.

More likely, they'd attempt just enough of a rally to keep the buyers of their original large volume sales locked in and to discourage amateur shorts from selling, while they unload even more stock on the new, lower rally. This kind of move is apparent if the average rises halfway to its previous high, but volume isn't increasing the way it did during the previous advance. This says buyers are filled up and large operators are attempting to bid up prices; the rally is purely technical, supply is outdistancing demand, and it is time to take short positions.

Attempts at rallying may persist, but after more than one period of distribution, the average is most likely in a critical position. Unless unseen buyer demand is waiting in the wings, a decline proportional to the distribution periods is in the offing.

Bear market

A test of buying power comes as the average heads downward toward a supporting point. On steadily expanding volume, it's very unlikely the supporting point will hold. Too much is being offered to buyers who have bought all they can afford.

Although declining prices accompanied by a persistent increase in volume is characteristic of a liquidating market, it may be pockmarked by occasional, sharp rallies on markedly decreased volume. These rallies are quickly lost because their driving power is short covering, not solid demand. Rather than pointing to possible upturns, these brief rallies with their immediate drop in volume simply affirm the weak buying power.

When looking only at an average, its rate of decline is a key to its future. A slowing of the decline may be the average's only warning of a turning point. A slowing of the decline accompanied by comparatively heavy volume warns that a minor turning point could be ahead and could be the precursor of an important change. If the rally is quick and violent, however, experience says it is not the stuff of lasting trend reversals, but may set a new supporting point and open a chance for long trading with very close stops. The question is whether large operators will dump a new supply on the rally's buying power and drown it.

After prices have begun to rally, a Buying climax or shortened upthrusts on declining demand are bearish signs. Yet prices may still be bid up to a new high to catch shorts and make room for large and experienced operators to sell on the impending decline. At this point, sideways movement of the average on declining volume would show lessening demand at the top of the rise and further sideways motion would definitely break the rally's stride. Narrowing price ranges, lower closings, and less volume indicate the market is saturated with offerings and buying power has lessened. This is known as the last point of supply from which the market begins its markdown. At this point, distribution is complete, and going short would carry the least risk.

When a market is heading for a serious decline, the public also can be lulled into indifference and misinterpretation by volumes that are relatively smaller than volumes in advancing markets. The reason is psychological. Most buyers are attuned to advancing markets and understand how profits can be taken when prices are increasing. Because they fear to sell short, they don't participate in the declining markets. This makes volume relatively lighter and trading a professional affair.

A market, however, will seldom run continuously in one direction without some sort of reversal. Each time the average nears former supporting points, it signals where it is headed. Either it rebounds and establishes a new support point or breaks through to new or earlier support levels. A long decline without serious interruption puts the market in an oversold condition and a sharp rebound would be expected. But again, a rally that is too effervescent is not likely to last—it is merely shorts covering at once, and liquidation is likely to resume.

A long decline in the average may give only subtle signals of impending change. An accelerated decline after a significant drop in the average is a warning to be wary. If followed by what looks to be a selling climax—a sharp increase in volume and higher closing—it may prove to be a shake-out. A trader should not jump to the conclusion that a violent recovery is on the way, but it would be time to cover shorts and closely monitor the average for rally and reaction—especially the ability to hold at former support points or steady at a new price range.

A trader will look for opportunities to go long at the end of the reaction. This end is signaled by a higher low, higher closing, and decreased volume. An upward climb will test previous resistance points and the reaction will give important insight into the possibility of a new support level or a resumption of the bear market.

The average's ability to bounce off former support points will indicate buying power is coming back into the market. But it still would be logical to hold off on investments until a period of shortened price ranges, a so-called period of 'dullness,' says a real bull market is being prepared.

Glossary

Zone of support—*A time period where market price and volume are indicating that the prevailing downward price motion has met substantial buying interest and may be preparing for a reversal.*

Zone of resistance—*Opposite of zone of support.*

Markup—*A day-by-day price range increase.*

Markdown—*A day-by-day price range decrease.*

Shake-out—*A period of increased volume after a price move attributed to weak, unsure hands unloading their holdings.*

Overbought/oversold—*Period of time in which general expressed opinion is that the price of the market has overreached itself, thus requiring a sideways movement, price retracement, or consolidation.*

Springboard—*An observed phenomenon when prices break above or bellow a support or resistance and immediately reverse themselves with a strong move in the opposite direction, thus indicating an in-place, real price barrier.*