

Refining chart analysis

Wyckoff method of trading stocks part 10

by Jack K. Hutson

At this point in our examination of Richard D. Wyckoff's methodology for stock market analysis, we have explored all of the major tenets of this classic technique—from basic charting to the more esoteric consideration of trendlines, position sheets and chart interaction.

Now, we are ready to pursue the technical refinements which distinguish slapdash amateurs from proficient and effective traders and investors. If this is your beginning foray into technical analysis, you may be feeling a bit overwhelmed by all that we've introduced about the Wyckoff Method. At this point, too, experienced technical traders may have the natural reaction to pick and choose pieces of Wyckoff's design and try to meld them with other, more familiar systems.

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To both the new student and the proficient analyst I would caution against "any inclination to grow fainthearted," as Wyckoff would have put it, and to take shortcuts with his method. This is a complete system combining mental attitude with interconnected technical details. Separating facets of this method from the rest is like drawing random pieces from a puzzle box—you've got the parts, but no picture.

If the Wyckoff Method at this point in your study seems unduly complex, rest assured that with practice it will all boil down to a matter of routine reasoning. Steps that may seem detailed at first become second nature. Principles that appear numerous and confounding soon become instinct.

I have summarized Wyckoff's most important tests for buying and selling in Figure 1. The indications are applicable to market and group averages, as well as individual stocks. Notice, too, that these telltale tests rely on both Figure and Vertical charts, the two charts from which all refinements are created and the two charts that are always used in conjunction with one another to portray the most accurate picture of market activity.

Before we look for these indications on sample Figure and Vertical charts, the Wyckoff student should incorporate a few more market phenomena into his or her body of knowledge. These can occur at various times and, unless understood, can lead to erroneous conclusions from the Vertical and Figure charts.

The first of these phenomena is the shakeout—either ordinary or terminal. An ordinary shakeout is a sharp downward movement such as an exaggerated selling climax. A terminal shakeout is even more pronounced. It is a rapid downward movement occurring at or near the end of extensive preparation for an advance.

Buying and Selling Tests

Buying Tests

(Applied to an average or a stock after a decline)

Indication:	Determined From:
1) Downside objective accomplished	Figure Chart
2) Activity bullish (volume increases on rallies and decreases on reactions)	Vertical Chart
3) Preliminary support	Vertical and Figure
4) Average or stock stronger than market (i.e., more responsive on rallies and more resistant to reactions)	Vertical Chart
5) Downward stride broken (i.e., supply line penetrated)	Vertical or Figure
6) Higher supports (daily low prices rising)	Vertical or Figure
7) Higher tops (daily high prices rising)	Vertical or Figure
8) Base forming (horizontal price line)	Figure Chart
9) Estimated profit is at least three times the indicated risk	Figure Chart for profit objective; Vertical Chart for stop order placement

SELLING TESTS

(Applied to an average or a stock after an advance)

Indication:	Determined From:
1) Upside objective accomplished	Figure Chart
2) Activity bearish (volume decreases on rallies and increases on reactions)	Vertical Chart
3) Preliminary support	Vertical and Figure
4) Average or stock weaker than market (i.e.: more responsive on reactions and sluggish on rallies)	Vertical Chart
5) Upward stride broken (i.e.: support line penetrated)	Vertical or Figure
6) Lower tops (daily high prices falling)	Vertical or Figure
7) Lower supports (daily low prices falling)	Vertical or Figure
8) Crown forming (lateral movement)	Figure Chart
9) Estimated profit is at least three times the indicated risk	Figure Chart for profit objective; Vertical Chart for stop order placement

FIGURE 1

Viewing it through the eyes of a market "manipulator," the plunge of a terminal shakeout is intended to scare a stock's persistent hangers-on into selling out, to catch stop orders placed below earlier support prices, or even induce the unwary public into short selling. The manipulator buys

up the stock offered by sellers frightened or caught by the terminal shakeout, and the ensuing scarcity of the stock on the market sends the price rapidly or gradually higher.

A thrust is the reverse of a shakeout. It may also be known as an upthrust or a terminal markup. Whatever the name, it is a sharp run up and out of an area of distribution, or a temporary bulge through the top of a trading range. The inability to hold these thrusts or quick bulges indicates weakness.

At times, the trader may also be caught unawares by another phenomenon—a sharp rally out of a plunging oversold condition that is not heralded by the customary evidence of accumulation. In such a case, a declining stock's Figure Chart may not show the usual long, compact horizontal trading range that forecasts a major recovery. Instead, the horizontal trading range indicates a small upward movement. The attuned Wyckoff analyst, however, notices that this small upward movement would break the diagonal trendline formed by the previous decline. With such a possibility, the entire downward movement could be re-evaluated as a probable zone of support and previous horizontal formations reviewed for the potential price objective of a major upswing.

Of course, a Figure Chart's horizontal formations alone cannot be taken as evidence of an impending rally. A "chart fiend," as Wyckoff calls them, might easily mistake a Figure Chart's long horizontal formation as the basis for a tremendous rise when, in fact, the Vertical Chart would plainly show it to be an extended trading range where small changes in supply and demand neutralized each other for a considerable time.

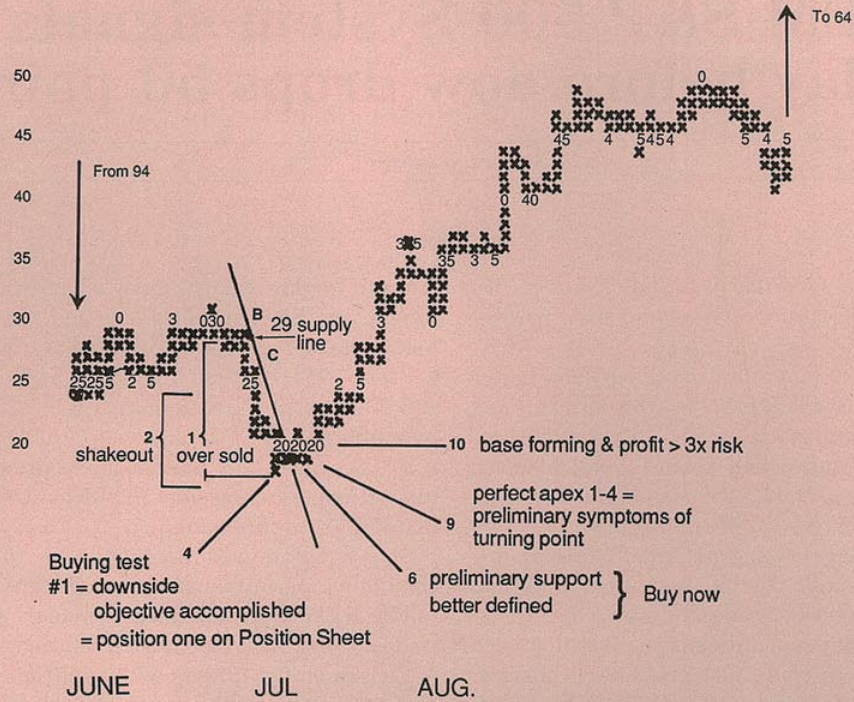
As a quick review, we'll examine the Vertical and Figure Charts of a hypothetical stock (Figure 2) for buying tests and other phenomena. The following numbered comments correspond to the charts which depict the stock of Hypothetical, Inc. recovering from an oversold position.

- 1)**The speed and severity of the decline from 31-1/2 to 17-7/8 occurs without corrective rallies and creates an oversold condition.
 - 2)**During the decline, the sudden breaking of previous supports around 24-25 appears to be a shakeout and is confirmed with the rapid recovery revealed by the 3-point Figure Chart .
 - 3)**An abnormal volume expansion indicates the movement's climax and the development of preliminary support (Buying Test No. 3).
 - 4)**The line of 29s in the 1-point Figure Chart indicates a downside objective, which is accomplished when the stock reaches 18(Buying Test No. 1).
- Steps 1 through 4 are the preliminary symptoms of a turning point. Here, the stock would be placed tentatively on the Position Sheet in Position 1 and a purchase somewhere around the low point, say 19 with a stop at 16 5/8, could be ventured.
- 5)**A quick rally to 20-3/8 with light volume indicates a scarcity of offerings, and breaking the supply line B-C confirms the change from weakness to strength (Buying Test No. 5).

Also, the stock should rally easily compared to the general market (not shown). Its low points lift while the average responds sluggishly (Buying Test No. 4).

Hypothetical, Inc.

1-point Figure chart



Vertical (Bar) chart

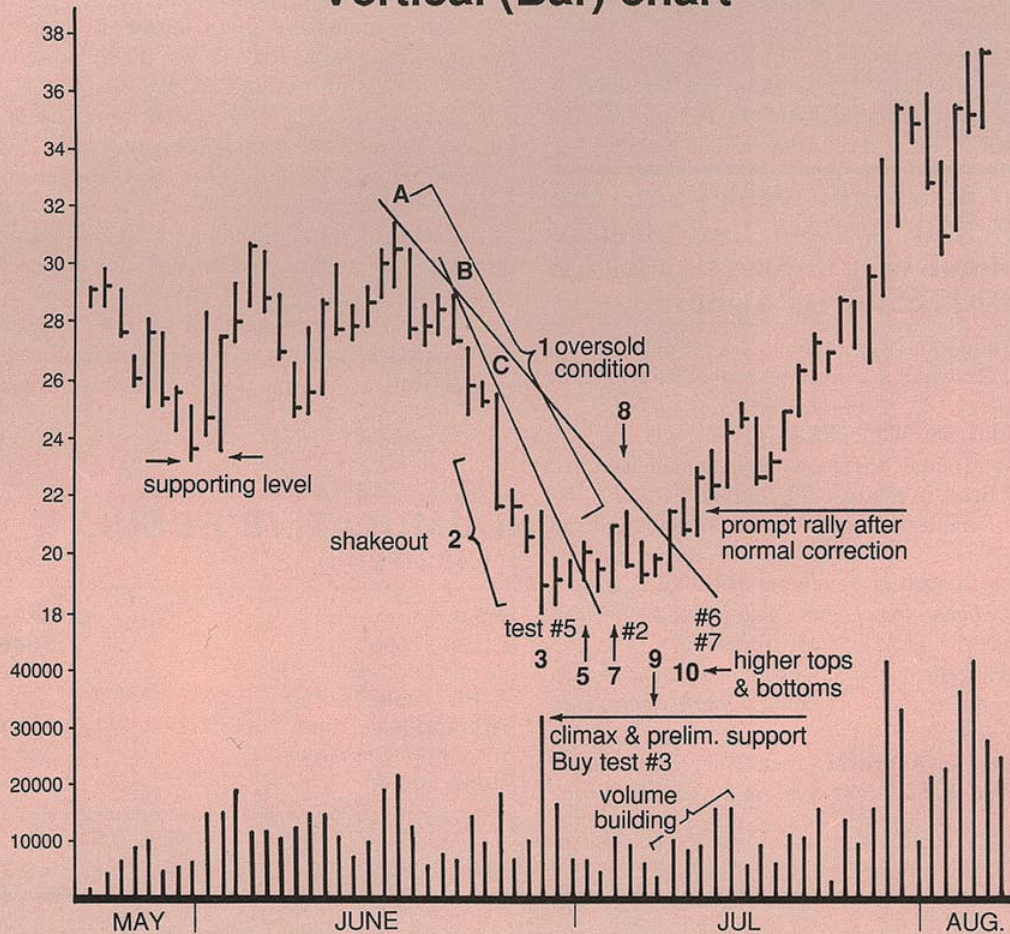


FIGURE 2

6) The 1-point Figure Chart more clearly defines the preliminary support. When the price reacts from 20-3/8 to 18-5/8 on light volume it is definitely in Position 1 on the Position Sheet and it is time to buy another lot or make the first purchase if the earlier opportunity was missed.

7) A fast rally on increasing, but still light, volume adds to the accumulating evidence of strength (Buying Test No. 2), and the stock is clearly stronger than the market that is hitting new lows.

8) The rally is checked by general market weakness and the supply line A-B. Cancel Position 1 in anticipation of a setback and wait for another buying opportunity if it reacts towards the 18 supports on diminishing volume.

When the stock reacts, volume tapers off, and the price holds at higher supports, it is back in Position 1. On the Figure Chart, support at 19 has stretched to a count of five and the line of 20s is at six.

9) Price and volume have narrowed to an extreme, developing a perfect apex or hinge. A rally now would easily penetrate the supply line A-B and put the stock on the springboard at 21—another buying opportunity.

10) Price penetrates the supply line A-B on light volume (a bullish sign) and responds to an upturn in the general market. With higher supports and higher tops, it fulfills Buying Tests No. 6 and 7. The stock is now in Position 2 and the Figure Chart adds one more point to the objective, fulfilling Buying Tests No. 8 and 9.

With this example and the consolidated lists of Buying and Selling Tests, take the time to review past chart illustrations in this series and other historical charts. When you can recognize Buying and Selling Tests with an entire chart in front of you, test yourself by covering the righthand of an unfamiliar chart and revealing the action day by day as if you were watching it unfold in real time. With practice, the principles of Wyckoff analysis will become second nature.

Glossary:

Terminal shakeout—a rapid downward price movement occurring at or near the end of extensive preparation for an advance.

Thrust—a sharp price run up and out of an area of distribution, or a temporary bulge through the top of a trading range that does not hold and indicates weakness.