



*Stock Market Institute*

*Judging  
the  
Market*



## Table of Contents

Fundamental Concepts and Basic Tools . . . . .	1
What are the SMI Indexes . . . . .	2-4
The Wyckoff Wave . . . . .	2
The Optimism-Pessimism Index . . . . .	3
The Trend Barometer . . . . .	3
Individual Group Indexes . . . . .	4
Using the SMI Indexes for Market Analysis . . . . .	4-14
Determining and Analyzing Trends . . . . .	4
Relating the Wyckoff Wave and the O.P. . . . .	7
Analyzing the Level of Market Volume . . . . .	8
Analyzing the Trend Barometer . . . . .	8
Analyzing the Intraday Data . . . . .	10
Analyzing the Market with Figure Charts . . . . .	12
Analyzing the Market with Group Indexes . . . . .	13
Using the Daily Stock Report . . . . .	14
Tips on Trading . . . . .	14-16
Final Thoughts . . . . .	16-17
Consultation Forms	

## **Judging the Market**

A "how to" manual on determining the present position and probable future trend of the market based on it's own action as charted by the SMI Indexes.

### **I.**

#### **Fundamental Concepts and Basic Tools**

To the inexperienced or untrained trader much of the market's action probably seems like a disorganized jumble of activity. It is important to begin this study with an understanding that this is not really the case. All market fluctuations and movements in the individual stocks are reflections of the law of supply and demand at work. This truth states that when the level of demand exceeds the level of supply, individual stock prices rise and the general market advances. When it is the supply that is in excess, the prices of stocks fall and the general market declines. On any given day, the victory of the forces of demand over supply or supply over demand can be seen in the closing Dow Jones Industrials average.

Trying to use the Dow Jones average even if in conjunction with the day's total volume to judge the markets present position and probable future course is like trying to breath at the top of a very high mountain. It is possible, but very difficult. The problem is that this figure does not reflect anything about how the market acted. Indeed, in many instances, it is not even a true barometer of what happened. In addition, it says nothing about how a particular day fits into the longer term picture nor does it provide any clear indication of what is in store for the future.

Judging the market in terms of the law of supply and demand, or from its own action, is called technical analysis. To achieve success in this type of study requires tools that facilitate a detailed and reliable examination of the two conflicting forces at work in the market place. The SMI Indexes as presented at the close of each trading session in The Pulse of the Market provide a kit of tools to help the serious investor with his or her studies.

Every market move or individual trading session is comprised of a series of smaller moves and results from the development of important price and volume relationships. Sound technical analysis requires a detailed picture of all important aspects of every market session. No single part of the media fills this need. The SMI Indexes, however, do provide a comprehensive package of the raw materials needed to make sound judgements on what the market has been doing and is likely to do in the future. SMI's experience provides the training to effectively analyze the data.



## II.

### What are the SMI Indexes

The market's action can be measured in terms of price movement or volume. No single index, average, or indicator can fully reveal the meaning of both types of action nor the important relationships that exist between the two. Therefore, the SMI Indexes have been developed into a series of tools, which do cover all that is important. Price movements are reflected in the Wyckoff Wave and individual group indexes. Volume action is monitored by way of the Optimism-Pessimism Index. The important relationships between price and volume are contained in the Technometer, Force and Momentum. Taken as a group, they can lead to better understanding of the market.

#### **The Wyckoff Wave**

In order to determine the current trend, the present position, and probable future trend of the market it is necessary to have a means of charting the market's action, that will reveal the general trend. The general trend of the market is created by the interaction of the forces of supply and demand. These are reflected in the selling and buying pressures that cause stock prices to fluctuate. The total price movement is the general trend. The ideal approach to observing and measuring this movement is with a common stock price index, which is what the Wyckoff Wave is.

The SMI Wyckoff Wave is not simply an average of stock prices. It is an index, which serves as a miniature version of the market, faithfully bringing to light its movements. The Wave is comprised of the weighted movement of eight individual stocks. Currently, these eight issues and their individual multipliers are as follows:

Exxon (XON) 8	Merrill Lynch (MER) 5
General Electric (GE) 8	UAL, Inc. (UAL) 6
General Motors (GM) 4	Union Carbide (UK) 6
I.B.M. (IBM) 8	U.S. Steel (X) 8

These stocks are all market leaders. By that it is meant that they are all widely held and actively traded, and tend to participate in most important market moves.

Most of the generally accepted market indexes are computed based on invalid assumptions. These indexes generally assume that all the high prices of their components and all the low prices happen at the same time, and reflect this assumption in the quotation of their daily highs and lows. A similar assumption is made in computing the closing price for each day. In this case, however, the assumption is valid, since the end of trading for all stocks is fixed by the closing of the market. The end result of these suspect methods of calculation can be, and often is, a lack of sensitivity. This is a particularly important liability at turning points in the market, which are the best times for initiating and closing out positions.

The calculation of the Wyckoff Wave is much more representative of the market's actual action. This is because the Wave is not just calculated, but also monitored. During every market session, every price change in each of the eight component stocks is recorded and charted as it occurs. This provides a



minute by minute picture of what the market is doing. Throughout each day, the important intraday moves that develop are summarized using the prices in effect at that time. Then, at the end of the day, the high and low are picked from the intraday moves. The day's close is based on the prices at the close of trading at the New York Stock Exchange.

#### **The Optimism-Pessimism Index (O.P.)**

The Wyckoff Wave is based on price action. As such, it reflects what the market is doing. Of equal importance, is how the market is doing what it is doing. These indications come from the characteristics of the volume, which are reflected in the O.P.-Index. This index is extremely important because knowing the what without knowing the how can lead to costly mistakes.

To understand how the O.P. is computed, it is necessary to first know what it is. This index is a numerical representation of net up volume minus net down volume where one point equals one million shares.

This concept can be utilized in one of two ways. One is the SMI way and the other is the conventional approach. The conventional wisdom would be to wait until the final up and down volume figures are in for a particular day, and then to subtract the one from the other. In a very general sort of way, this would work and could be used. Unfortunately, this method is not very sensitive. It does not reflect the relative importance of the various intraday moves, which are after all where the more important moves get their starts.

At SMI, we allocate the volume based on the intraday price action. The volume that is traded while the Wyckoff Wave is advancing is considered up volume. Conversely, the volume that is traded while the Wyckoff Wave is declining is considered down volume. By adding all of the up volumes and all of the down volumes separately and then subtracting the downside total from the upside total, the result gives an indication of whether the day had net upside or downside volume and how much. This method also permits the making of assessments on the relative strengths and weaknesses of each intraday move.

#### **The Trend Barometer**

The Trend Barometer is not a single index, but rather a set of three. Their names are Technometer, Force, and Momentum. Used singly and in combination, these indicators monitor three important market factors.

One is the degree to which a particular market move has become overbought or oversold. This information comes from the Technometer. Just because prices have been moving a particular direction, there is no guarantee that they will continue to move in that direction. In fact, the more overbought or oversold the situation becomes the greater is the likelihood that the market will reverse itself. Another important indication, which is provided by the Force Index is the amount of pressure being exerted in a given direction. If the market is trying to move one way but the pressure being applied is in the other direction, the result is likely to be little progress. On the other hand, if the pressure on the market is in step with the direction of the price movement, the likelihood of a more substantial move is increased. Finally, Momentum provides a measure of the speculative interest in a particular move. The speculative interest is like a catalyst. It helps to get the action going and keep it going once started. If a move lacks a good measure of this important



ingredient, it probably will not go very far. If it is well endowed, though, the move will probably go a long way. Together, these three indications are extremely valuable in the timing of trades.

#### **Individual Group Indexes**

The market is not a single entity. It is a diverse mixture of numerous individual issues. Stocks that are in a particular industry group tend to move together. Therefore, by monitoring indexes composed of representative samples from the various groups, it is possible to isolate where the best opportunities are likely to be found at a given time. If the general market seems vulnerable to upside action, then potential trade candidates should be sought among those groups that appear stronger than the market. When the market seems vulnerable to downside action, the best opportunities are likely to be found in groups that appear to be relatively weaker.

### **III.**

#### **Using the SMI Indexes for Market Analysis**

The SMI Indexes are presented daily in The Pulse of the Market. This four page report includes all the data needed to make intelligent market decisions. It is designed to lead the subscriber through an orderly investigation of the day's activity. This begins with a longer term overview of the general market, which then focuses down on the shorter term picture. From here, the emphasis is switched to individual sectors of the market, and then finally to the individual stocks. The result is that in a relatively short period of time, the trader can arrive at concrete conclusions regarding the market's present position, it's probable future trend, and any actions that seem warranted at the time.

#### **Determining and Analyzing Trends**

The first page of The Pulse of the Market provides a graphic representation of the market's action for approximately the last six months as reflected by the five SMI Indexes and the total volume. The first step in analyzing this picture should be to determine the trend of the market. To do this, it must first be understood what a trend is. Stated as simply as possible, the trend is the path of least resistance. It may be up, down, or horizontal.

An uptrend is defined by two successive reaction lows, such as the ones in column one and column three on the sample. By connecting these two points, a support line is constructed. Inbetween these two points, there is a rally (column 2). By constructing a line parallel to the support line and passing through the highest point of the rally, an overbought line is formed. The upward sloping channel that results between the two lines is an uptrend.

A down trend is the opposite of an uptrend. It is formed by the construction of a supply line and an oversold line. A supply line is based on two successive rally tops as in columns 16 and 20. The oversold line is formed parallel to the supply line passing through the lowest point of the reaction between the two rallies. (The day separating columns 18 and 19). These two lines result in a downward sloping channel, which is the down trend.

The third possible trend is the horizontal trend. Another name for this is a trading range. The basis for defining a trading range is a support level and a resistance level. The support level serves as a floor for the trading range. It is



constructed by drawing a horizontal line through the low point of a reaction as in column 22. After the market completes a reaction, it generally rallies. The top of that rally provides the point for defining the resistance level, which acts as a ceiling for the trading range. This line is also horizontal and is parallel to the support level as in column 23. In this example, the market had been moving lower at the time the trading range was formed. Consequently, the support level was put in place first. It is equally possible for the market to form a trading range after a period of sustained upward action. In this case, the resistance level is established first. An example of this can be seen in columns fifteen and sixteen.

In addition to varying in direction, trends also cover different time frames. Some may be of a short to intermediate nature while others are of a longer term nature. There are no firm rules to establish where a short term trend becomes intermediate, or where an intermediate trend becomes long term. These designations are all relative, and can be influenced by such things as the period of time being studied or the type of trading being done. Those trends that have been drawn with the heavier lines are relatively speaking the longer term trends while those drawn with lighter lines are shorter term.

The O.P. Index also forms trends. These may be up, down or horizontal as with the Wyckoff Wave, and also may vary from short to long term. The trends identified in the O.P. are defined in the same manner as with the Wave. The only real difference is that the trends in the Wave are trends of price action and the trends in the O.P. are trends in volume action.

Once the trends have been determined, the next step is to investigate their effect on market action. As an example of how this is done, consider the trend in effect from column fifteen through column twenty-five. This is a down trend whose supply line is based on the rally tops in columns fifteen and twenty. The parallel oversold line passes through the reaction low between columns eighteen and nineteen.

As long as the market's action is contained within the defined channel, the trend, in this case intermediate in nature, is down. Therefore, maintaining or perhaps adding to short positions would be in order. If this were an uptrend, the same would be true of long positions. It is generally unwise to trade against the trend of the market. If a trader's activities are restricted to the intermediate term and the trend is down, his positions should be short sales. If a trader is able to trade both the short and intermediate term trends at the same time, he may have both short and long positions at the same time. This is because it is very possible for a short term trend to develop within an intermediate trend, and for the shorter term trend to be pointing in the opposite direction. Trading opposing trends at the same time requires a good measure of sophistication and an even greater measure of discipline. Intermediate trades are based on intermediate considerations, and short term trades are based on short term considerations. The difficulty is in trying to keep the two totally separated in ones mind and actions.

While the action of the market is confined to a particular trend, a trader's course of action remains quite clear. What happens, though, when the movement of the market penetrates either limit of a trend? These occasions are especially important because they indicate or at least warn of an impending change in direction.



In columns twenty-one and twenty-two, the oversold line of the down trend was penetrated. When this happens, the market is said to be oversold. It has gone to excess on the downside and is in need of some type of corrective action, which usually comes in the form of a rally. A similar condition can develop with an uptrend. In this case, the penetration is on the upside and is of the overbought line. In these instances the market is said to be overbought. Corrective action is again in order, but in this case it is usually a reaction. The correction made to either an overbought or oversold condition does not have to be a clear cut rally or reaction. It may also be a period of substantially horizontal action with relatively little price movement.

The other possibilities for penetrating the boundaries of a trend involve the supply line and the support line. If a trend becomes overbought or oversold, it is only an indication of over enthusiasm warranting no more than a correction. However, if a supply line or a support line is penetrated, it usually indicates a breaking of a trend or at least provides a warning that such a break may happen soon. Obviously, these are especially critical points because they are where turns in the market are accomplished or begin, and turns in the market require important changes in positions.

Inbetween an uptrend and a down trend, or inbetween two similar trends, there is usually a horizontal trend. These trading ranges provide time for the preparation of the next move. A trading range quite often forms following a selling climax (if the market has been moving down) or a buying climax (if the market has been moving up). Both climaxes bring a sharp and accelerated movement in price or a substantial increase in volume or both. They often accompany the establishment of an overbought or oversold condition, but this is not an absolute requirement. They do, however, represent excesses on either the upside or the downside, which do need to be corrected.

The corrections that follow buying and selling climaxes are called automatic reactions and rallies. These are like muscle spasms that occur involuntarily. They may be slight or substantial and may last from a few days to a few weeks depending on the type of action that is being corrected. When these have been completed, the trading range has been defined. The market then spends anywhere from a few days to many months moving up and down within the range. This action is the testing process. During this period, the market alternately tries to break down the support level or the resistance level. While this is going on, the potential that will fuel the next move is being built.

Most of the testing and building process should be accomplished within the bounds of the trading range. This does not mean that neither level will not be penetrated. When this occurs, it is potentially very important because it provides an indication that the market may be ready to begin its move.

One possible penetration is a dip below the support level. This is referred to as a spring action. Ideally the break below the support level will be very minor, and will be accompanied by relatively low volume. In this case, one can imagine the market to be a piece of elastic that is being stretched almost to the breaking point. It has to spring back, and when it does the market usually makes a substantial move up. The ideal situation does not develop all that often. Although there is absolutely nothing wrong in waiting for these situations to take long positions, there are other similar opportunities that may also be used as signals to trade. In these instances, the penetration below the



support level is more significant, though no more than moderate, and the level of volume is not as greatly reduced. These are also potential spring situations, but the immediate response is generally not as prompt or significant as in the ideal case. These lesser spring situations, usually require a test. After the immediate upward response has ended, the market will make an effort to return to the level established by the spring. If resistance to the decline is met and the volume is reduced, the test will likely hold and be followed by a period of more significant upside action.

A second possible penetration of the trading range is of the resistance level, which is referred to as an upthrust action. An upthrust is the reverse of a spring. The same sequence of events occurs except that the penetrations are on the upside. It is often helpful to think of an upthrust as nothing more than an inverted spring. There is, however, one basic and very substantial difference. The action that follows an upthrust is in a downward direction.

The spring and upthrust generally come near the beginning of important up and down moves. There are two other types of penetration that come somewhat later, but usually just before the most important part of the moves. These are referred to as a jump across the creek and a back up to the ice.

Imagine that there is a creek winding its way across the tops of the rallies within the trading range. Now, imagine that the market is a little boy who wants to get to the other side of the creek, but does not want to get wet in the process. He keeps walking up to the edge of the creek to see if it looks narrow enough to jump across. At some point, he gets up the courage, and jumps across to the other side. This corresponds to the market making a substantial break above the support level. After the little boy makes the jump, he is rather proud of himself, so he walks back to the edge of the creek to survey his accomplishment. He must be careful doing this though, because there is the danger that he might slip and fall in. This corresponds to the market backing up toward the resistance level. If it does so gradually and on reduced volume, it probably will not fall in and likely will be followed by a renewed burst of upside progress. On the other hand, if the volume remains high, the market probably will fall back into the creek. In this case, the whole testing process may have to be renewed.

Now, imagine that it is the beginning of December, and you see someone out skating on newly frozen ice. New ice generally has thin spots where one can easily fall through. When this happens, the person seldom comes back up where he fell through, but rather comes up and hits his head on the ice. The falling through corresponds to the market making a substantial break below the resistance level. The head hitting corresponds to the market returning to the resistance level on low volume and not being able to break through. This is generally fatal and followed by a substantial decline.

#### **Relating the Wyckoff Wave and the O.P.**

The primary value of the O.P. comes from the relationship of its action to that of the Wave. These two indexes will either be moving in harmony or out of harmony. When they are engaged in harmonious action (In other words moving in the same direction) it is very likely that the market will continue to move in the direction indicated by the Wyckoff Wave for a while longer. Sometimes, the O.P. will start to lead the Wave. This means that relatively



speaking the O.P. is making a larger move than the Wave. If both indexes are moving down, this will increase the downward pressure on the market. If they are both moving up, it will increase the upward pull.

The opposite of harmonious action is inharmonious action. This is particularly important because it suggests a change in direction. The nature and the importance of the change depends on the nature of the disharmony.

An important example of inharmonious action can be seen by comparing the high between column 6 and 7 and the high in column 15. In this instance, the Wyckoff Wave made a new high on the second advance but the O.P. did not. The O.P. represents effort, and the Wave represents result. That means that in this case the market was trying to move up, but without the necessary support of the effort from the O.P. This leaves the market especially vulnerable to a decline. Since this particular example was formed over many weeks, it had longer term significance and suggested a relatively important decline.

The above example could have been reversed. In this case the O.P. would have made a new high and the Wave would not. The indicated result, however, would have been the same. This reversed situation would have been indicating an upside effort to which the market was not responding. Clearly, this also would have left the market vulnerable to downside activity.

Relating the inharmonious action of the Wave and O.P. can also signal a vulnerability to upside activity. To observe this, note the lows experienced by the Wyckoff Wave in columns 11 and 22. It is very apparent that on the second low the Wave did not make a new low but the O.P. did. This tells us that there was a heavy downside effort to which the market failed to respond. It also tells us that the market had become very vulnerable to a rally. This example could also be reversed with the Wave making a new low and the O.P. not. In this situation, the market would be trying to make a decline, but without the necessary effort to sustain it. Again, the result would be a market very susceptible to a rally.

#### **Analyzing the Level of Market Volume**

The O.P. helps us to break down the market's volume into up volume and down volume. Another important aspect of the volume is the total level. What is important here is not the exact number of shares, but rather the relative number. Generally, moves that bring out an increased level of volume have more interest behind them. This means that they are likely to make better progress and last longer. Action that is accompanied by reduced volume generally has less interest behind it, and probably will not make as much progress nor last very long.

#### **Analyzing the Trend Barometer**

Located at the top of the first page of *The Pulse of the Market* is the Trend Barometer. It is comprised of the Momentum, Force, and Technometer. These three indexes are charted as vertical lines extending up or down from a zero line. Over the years, many traders have found these indexes to be the most important tool in determining which side of the market to trade, and when is the best time to be making those trades.

The Technometer is designed to measure the degree to which the market is overbought or oversold, and is represented as a vertical line drawn from the fifty level. Generally, a reading of 50 is considered to be very overbought and



readings above 50 reflect a dangerously overbought level. On the oversold side, a reading of 38 is generally considered to be very oversold, and readings below 38 reflect a dangerously oversold condition. Overbought and oversold readings, and the degree to which the market becomes overextended in either direction, reflect a vulnerability to reversal. The more overbought the market becomes on an advance, the less likely it is to continue its advance, and the more likely it is to have a reaction. Conversely, an oversold condition that develops during a decline tends to work against the continuation of that decline, and increases the likelihood of a rally.

In addition to analyzing the actual values of the Technometer, the index can also be used in comparison with the Wyckoff Wave. If the bottom of a market reaction is accompanied by an oversold reading that is more oversold than the last such reading but the market holds above its previous reaction low, the result is a positive indication. The same is true if on a reaction the Technometer fails to record a more oversold reading than on the previous reaction, but the Wave makes a lower low. The first of these two conditions can be seen between columns twenty-one and twenty-four. An example of the second condition can be seen between columns eight and eleven.

Negative indications can also be found by comparing the action of the Technometer to that of the Wyckoff Wave. When the market rallies into an overbought condition on the Technometer and then subsequently rallies into another overbought condition, it is especially important what level is achieved by the Wave on the second rally. If the Wave becomes overbought at a lower level on the second rally the indication for the future is negative.

The Force Index is designed to measure the amount of pressure on the market. It is represented as a vertical line drawn up or down from the zero level. In most cases it is a negative number. If the Force is at a very negative level, -48 or below, the usual effect on an indicated rally is that it will be diminished over what it would otherwise be. If a rally is already in progress when the Force Index starts to record especially low levels, the likely result is that the rally will be stopped. On the other hand, a low reading has a positive effect on market reactions. Since these readings indicate heavy downside pressure, they suggest that an indicated or in progress reaction at these times will make better progress on the downside than would be experienced if the Force was positive or only slightly negative.

If the Force is recording positive readings or only mildly negative readings, -32 or above, the downside pressure on the market is reduced. This will tend to diminish an indicated reaction over what it might otherwise achieve, and will also tend to work as a break on reactions that are already in progress. If the market is in a rally or presenting indications of an impending rally, a relatively positive level in the Force Index will tend to enhance the upside progress of the market during those rallies.

The value of the Force Index becomes clearer when it is used in conjunction with the Technometer. The most important readings of the Technometer are those that indicate an extremely overbought or extremely oversold condition. It is at these points that the market is most vulnerable to a move in the direction opposite of which it has been moving. How successful the market is likely to be in making progress in that opposite direction can be judged by the level of the Force. If the Technometer is very oversold but the Force is not terribly



negative, the indicated rally has a good possibility of making significant upward progress. On the other hand, if the Force Index is at a very low level at the same time that the Technometer is very oversold, the indicated rally is not likely to be very impressive. Similar situations can exist when the Technometer is at an overbought level. If this happens with a positive or only mildly negative Force, the indicated reaction is not likely to make much progress. If the Technometer becomes overbought and the Force is very negative, the reaction that is suggested has a very good possibility of being substantial.

It can also be helpful to relate the action of the Force Index to that of the Wyckoff Wave. If the market completes a reaction on which the Force moves to a very low level and then subsequently goes into another reaction that brings out an even more negative reading the indication can be positive if the Wave is able to hold at or above the low experienced on the first reaction. This is the type of action that developed in columns 22 and 24. A negative indication exists if the top of one market rally brings out less upside Force, while the market moves to a higher level. An example of this relationship can be seen in columns 5 and 6. It is also potentially negative if a market rally brings out a less negative or more positive Force reading than the previous rally top, but the market does not make a new high. Finally, it is potentially positive if the bottom of one market reaction records a less negative Force reading than the previous reaction even though the Wyckoff Wave moves to a lower level on the second reaction.

The last of the three Trend Barometer indexes is the Momentum. It is designed to reflect the speculative interest in the market, and is represented as a vertical line drawn up or down from the zero level. Speculative interest is especially important because it often is the catalyst that gets a move going. The sample report shows that the Momentum has a definite tendency to form trends through a series of higher tops and higher bottoms. Generally, an upward trend reflects continued interest in the upside while a downward trend indicates a continuing interest in the downside.

As was the case with the Technometer, and Force, the action of the Momentum can also be related to that of the Wyckoff Wave to derive added information. If the market moves to a higher level on a rally than it did on the previous rally but the Momentum fails to make a new high, the indication is negative. An example of this can be seen in columns 5 and 6. If the market moves to a lower level on a reaction than on the previous reaction, but the Momentum holds at a higher level, the indication for the future is positive.

#### **Analyzing the Intraday Data**

The next step in the analysis process is to make a more detailed study of the current day's action. This is done by using the Intraday Wave Chart located at the top of the second page of the Pulse of the Market, and the Intraday Wave Data located at the top of page three.

The Intraday Wave Chart is designed to graphically portray the action of the past seven market days in greater detail than is possible on the charts presented on the first page. It is comprised of three parts. Across the top of the chart is printed the O.P. The Wyckoff Wave is presented across the middle of the page, and the activity appears at the bottom. Each posting up or down represents the action of one intraday wave. The postings reflect the direction, size and duration of each move.



Of the three indexes that appear on the Intraday, only the activity has not been mentioned as yet. This index is a reflection of the number of trades during a particular period or wave. As the postings move farther above or below the center line, the level of activity is increasing. When the postings approach the line, the activity is decreasing. Generally the activity is greatest at the beginning and the end of the day, and is usually at its lightest just after the mid point of the session. This index is of greatest importance when it varies from the normal pattern. Unusually high or low activities tend to indicate that something important is happening. These moves should be given extra consideration.

The relationships between the Wyckoff Wave and the O.P. are the same on an intraday basis as they are on the longer term charts. The only differences are in the manner of presentation and the much shorter time frame being covered. We look for instances of harmonious and inharmonious action as well as relative degrees of effort and result. As examples of these relationships, we will consider points A through E. From A to B, the O.P. moved lower, being at a lower level at point B than at point A. During the same period, the Wave moved to a higher level. This represented downside effort without result, which tends to suggest a significant effort on the upside. In this case, that effort began the next day and started to build momentum during the following day.

As the market progressed from point B to C, the Wave and O.P. moved in harmony. These are generally the periods of greatest progress, which was true in this case. From point C to point D, there was again inharmonious action. The Wave moved to a higher level at D than C while the O.P. did not. This meant that the market was attempting to continue its move after the effort had been removed. Generally such an effort is not very fruitful. In this case, there was one final push up, and then a turn to the downside.

The final move that we will consider is the one from point D to E. This is a variation of the earlier example of an effort without a result. In this case, there was a result to go with the effort. The problem, however was that the result was not proportional to the effort. Although the O.P. made a substantial push above its previous high, the Wyckoff Wave just barely made new progress. This type of action suggests that the move in progress has just about run its course and probably will be reversed soon.

It is generally possible to make valid conclusions from a study of the Intraday Wave Chart. Sometimes, though, it is helpful to investigate the actual raw data. This provides the trader with the opportunity to quantify the relationships that appear on the Intraday, which can be of help in confirming conclusions drawn from the chart. The data that is used to update the charts on page two is presented in the Intraday Wave Data section at the top of page three.

Located on the left side of this section is the break down of the intraday waves for the current day. This information is organized into nine columns. The first two identify each move by number and by the time it ended. Column three reports the amount of time that elapsed during each wave. Columns four and five pertain to the price action of the Wyckoff Wave during each move. Under the column labeled PRICE, the level of the Wyckoff Wave at the end of each intraday swing is posted. Directly to the left of this are the net changes for



each intraday wave. In the next column under the heading VOL is the volume for each move quoted in thousands. Next to this is the O.P. These figures indicate where the O.P. Index stood at the end of each intraday wave. The last column is where the activities are listed.

Inbetween the O.P. readings and the activities are the Time Index figures. The Time Index presents yet another way of monitoring the market's action. Unlike the Wyckoff Wave which is based on price action, or the O.P. which is based on upside and downside volume, the Time Index is based on upside and downside time. Each five minute period is given a value of .05. For each five minute period that the Wave spends advancing, .05 is added to the value of the index. A similar value is subtracted from the index for each five minute period that the Wyckoff Wave spends declining.

The analysis of the Intraday Wave Chart and Data is an absolute necessity for the short term trader and the option trader. Since these trades are often measured in hours or a few days, the daily basis charts by themselves are generally not sensitive enough to adequately guide the short term trader. This does not mean, however, that intraday analysis is of no value to the intermediate or longer term trader. Every important market move has to begin somewhere. These beginnings are generally a series of short moves that build into a larger one. The trader who is able to pick out the building of an important move from the short term perspective will likely be able to enhance his return over what it would otherwise be if he devoted all of his attention to the longer term picture.

#### **Analyzing the Market with Figure Charts**

On the third page of The Pulse of the Market to the right of the Intraday Wave data is a section entitled Wyckoff Wave Figure Changes. These figures represent the last postings to the figure charts that are printed at the bottom of page two.

Figure charts are an important part of technical analysis. They will not tell much about the direction of an impending move or when that move is likely to begin. When the market or a stock gets moving, however, they generally give a rather reliable indication of how far the move is likely to carry. This is done by taking a count. When the market is in a trading range, the result on the figure chart is a relatively narrow horizontal formation. On the figure chart labeled 25-Point Modified Wyckoff Wave, one of these areas is marked off with the letter A. This zone represents a period of preparation. In this case, the eventual move was on the upside, so the preparation was accumulation. If the move had been on the downside, it would have been preceded by distribution.

Within the area of accumulation or distribution, there is the actual count level. Where this is depends on the action of the market. If the breakout from the trading range is on the upside, the count is taken at the lowest level reached on the last effort to decline. This has been done on the example. If the breakout comes on the downside, the count is taken at the highest level reached on the last effort to rally. In both cases, the count can be extended back to the beginning of the preparation phase.

The next step is to determine what the count means. This depends on the type of figure chart being used. Those that are used on the Pulse of the Market are modified figure charts. What this means can best be explained by examples. The 25-Point Modified Wyckoff Wave is posted every time the



Wyckoff Wave crosses a level evenly divisible by twenty-five providing that figure is different from the last posting. A similar procedure is used for the posting of the other figure charts. The only differences are in the number of points required to yield a posting. These are indicated by the name of the chart.

Determining the extent of a move indicated by the count requires knowing two things. They are the type of figure chart being used and the number of postings in the count. In example A, the chart is a twenty-five point modified, and the number of postings involved is fourteen. The number fourteen was arrived at by counting the actual postings, eleven, and the number of empty spaces between the postings and within the count, three. The indicated objective of this count is derived by multiplying the type of chart by the number of postings. In this case, the result of that is  $25 \times 14 = 350$ . This means that the eventual objective of the move indicated by area A is three hundred fifty points higher than the count level of 2250, which would be 2600. This figure is the maximum objective. There is also a more conservative objective that should be considered. In this case, the potential is still three hundred fifty points, but it is added to the lowest level during the accumulation phase. This objective is  $2150 + 350 = 2500$ . We would, therefore, expect an eventual move to the 2500 to 2600 area.

Which figure charts a trader should use depends on the type of trading being done. A twenty-five point modified chart is less sensitive than a ten point and a ten point chart is less sensitive than a five point. Traders who are making shorter term trades need to use the more sensitive charts. This is because the less sensitive charts will often not adequately show the preparation phases of the moves being traded by the short term trader. A long term trader, however, should use the less sensitive charts. These people are mainly interested in the markets major moves. Using a very sensitive figure chart here can lead to confusion.

There is a tendency for students of the market to rely too heavily on figure charts. They are important to technical analysis, but they are only a part of the process. The indicated objective of a count is an indication only, not an absolute fact. Whether or not the market has the ability to reach its indicated goal depends on vertical line analysis. Together, both types of analysis lead to better understanding of the market. Neither is complete by itself, and the vertical line analysis is the most important of the two.

#### **Analyzing the Market with Group Indexes**

The process of analyzing the market covered thus far has dealt with the market as a whole. This consideration is vital because it is the momentum created by the entire body of stocks that helps to move individual segments along. Obviously, though, no one can trade the entire market. Therefore, the next step is to isolate those areas that are likely to perform best based on our conclusions for the general market's future.

A good way to do this is with group indexes. The final two sections of page three deal with these indexes. First comes the data for the current day. The first three columns in this section contain the high, low, and closing price for each of the groups being followed. In the fourth column, the volume is printed. These figures are quoted in thousands. The final column contains the twenty-



five point figure changes for each of the groups. Below the day's figures, a chart of one of the indexes is published. These are printed on a rotating basis. Consequently, each chart appears once every three weeks.

Group indexes can be used in several different ways. One of the most important is in determining which groups have been relatively stronger or weaker than the market. The sample shows the Conglomerate Group. By comparing the group index to the Wyckoff Wave, it is clear that the conglomerate stocks have been stronger than the general market. This comes from the fact that the index has made a more substantial gain, and has been better able to hold that gain. If an up move in the market is anticipated, the groups that are relatively stronger should do the best. This assumes that there is a significant amount of potential available to fuel the move. The figure chart printed with the vertical line shows that there is indeed a significant amount of preparation in the 2500 to 2600 area.

#### IV.

##### Using the Daily Stock Report

After conclusions have been drawn about the general market and after the most promising groups have been isolated, there is one important last step. That is the selection of individual trade candidates. The Daily Stock Report does not do this for you, but it can be a convenient tool to assist in this process. The report contains the daily high, low, close, volume, and one point figure changes for two hundred selected stocks. These issues cover a wide variety of industry groups and price ranges. Although two hundred is only about ten percent of the listed stocks, the great variety of issues insures that the group will always contain at least a few good candidates. The stocks listed on the Daily Stock Report are also published in the SMI Charting Service, so there is no need to build a personal back history.

It is not recommended that anyone follow all two hundred stocks. Generally, the regular posting of twenty-five to fifty vertical line charts is all most traders have time to do. It is desirable, however, to keep up the figure charts of all the stocks. These charts are easy to post, and keeping them up to date will show build ups of potential and changes in character, which usually come prior to an important move.

#### V.

##### Tips on Trading

It is possible to be very skillful at analyzing the stock market and selecting good trade candidates, and still never make very much in the way of profits. The problem in most of these cases is that skillful analyzing does not necessarily imply skillful trading. To realize profits, the trader must know when to trade, how to trade, and when to close out trades. These three factors form a strong chain. If any one of the links is weakened, the chain usually breaks down.

Not every market session is a good trading day. In fact, conditions are usually favorable for the taking of positions on only a small percentage of the total trading days in a year. One characteristic of these days is that they are when the market is either oversold for taking long positions, or overbought for going short. This guideline will eliminate many days from consideration. Even



though the remaining number is relatively small, the actual number of good trading days is still smaller.

For the days that survive the initial overbought or oversold test, there are several positions that could suggest a buy or a sell short. Of these, four seem to be the most reliable at providing worthwhile results. A long position that is taken on a spring or its test or on the back up following a breakout from a trading range on the upside, will usually produce a profit. A short sale on an upthrust or a back up to the ice level following a downside breakout from a trading range will often have positive results on the other side of the market. These guidelines plus the overbought/oversold test should reduce the number of trading opportunities to a relative handful, thus making the traders job considerably easier.

Once a trading opportunity has been found and after a small group of individual stocks has been selected as possible trade candidates, the next step is deciding how to allocate the available funds. Experience has shown that the use of a device called the 1/3-1/3-1/3 rule is a very sound method of dividing funds. By putting one-third of his capital in three different issues, the trader protects himself against being badly hurt by one trade that goes sharply against him. On the other hand, restricting the number of issues to three at any one time prevents the trader from getting into so many issues that he becomes unable to effectively monitor the progress of each.

Another way in which the trader can protect himself is with the use of stop orders. These are designed and should be used to automatically eliminate a trade that turns sour. Every time a position is taken it should be protected with a stop order.

There are two ways to select a level at which to place a stop order. The first is to select a percentage above or below the purchase or short sale price, and place the stop in accordance with that percentage. Generally, a figure of 5% is the most often considered. That means that a stock bought at \$50 a share would have a two and one half point stop for a price of \$48½. This figure is an even eighth, which are often more vulnerable than odd eighths. Consequently, placing the stop order in this case at 48¾ would have been a sounder decision.

The second method of placing stops involves more judgement on the part of the trader, but is preferred over the 5% method. If a stock is in an uptrend moving from point A to point B, it probably will not make the move in a straight line. Instead, the objective will be reached through a series of rallies and reactions with each coming at a higher level. If the stock is bought at the bottom of a reaction, the stop would be placed a little below the bottom of the previous reaction. By doing this, the position could be maintained as long as the upward trend continues. The stop order would be triggered only if the trend was broken. A reverse approach can be used for short sales. This method of placing stops allows the trader to let his profits run while cutting his losses short. This is a fundamental point in good trading.

Whichever method of placing stops is used the ratio of profit to risk should be kept in mind. If the anticipated move in a particular issue is nine points, a three point stop would yield a profit to risk ratio of 3 to 1. That means that the trader is willing to risk one point for every three he anticipates making. Generally, a ratio of three to one is the minimum acceptable. If the stop on a potential trade candidate cannot be placed using one of the two methods



mentioned and maintain a profit risk ratio of at least 3:1, the stock is probably not worth trading.

Even if all the steps mentioned thus far are followed faithfully, it is still possible for a trader to end up with a loss or with less of a profit than might otherwise have been realized. This can happen by not closing out a position in time. The reasons that this happens seem to be of two varieties. One comes from an unwillingness to admit a mistake. If a position goes against the trader, there is a tendency to believe that the situation will get better. Usually it does not and the loss gets bigger instead. Fortunately, the use of stop orders can keep us from being too badly hurt by this failing. The other factor that tends to keep traders in positions too long is greed. Once a trade is going as anticipated, there is a natural desire to get as much profit out of it as possible. This is as it should be, but sometimes things go wrong. Once a stock has reached its indicated objective, all the desire in the world is not going to help increase that profit. The trader who lets himself be blinded by greed will not see these obvious signals, and will continue to hold the position until it is finally stopped out usually well below the best level of profit.

There are several signals that it is time to close out a position. We will cover three. The first of these involves the fulfilling of objectives. When a stock begins a move its figure chart provides an indication of how far that move will go. Once that objective has been reached, there is no immediate need to stay with the position. There may eventually be a continuation of the move, but likely not before a new period of preparation is built. This will take time that probably can best be used to make trades in other stocks. When the new preparation has been completed, a new position can be established.

Another signal that suggests it is time to close out a position can come from the climaxing process. If a stock that has been moving up for a while starts to encounter very high volume, it is probably experiencing a buying climax. This should mark the end of the move. If the move is over, it is obviously time to close out the position. Almost always, a climax will receive a secondary test. It is often desirable to hold a position until the secondary test because some additional progress can be made on these tests. Even if none is experienced, the amount of wasted time should be minimal.

A final indication that it is time to get out can be found in the breaking of a trend. Trends represent the paths of least resistance. As long as a stock remains in a trend it makes sense to go with it. When the trend is broken, it means that the path of least resistance has changed. Therefore, by staying with a position based on a trend that has been broken, the trader is fighting the market, this usually is not profitable.

## VI.

### Final Thoughts

Two factors contribute to the making of a successful trader. He must be a skillful analyst and a careful trader. Fortunately, both of these can be learned through study and practice. Our goal here has been to show how the analytical process can be carried out using the SMI Pulse of the Market and Daily Stock Report. We have also tried to show some of the ways that this analysis can be put to work through following a few guidelines for good trading.

Every market session is unique. It has never happened before, nor will it



happen again. Even so, there are certain similarities that have allowed us to write this booklet. The remaining pages of this book are designed to help the reader further help himself. They are consultation forms. If any questions remain unanswered or if there is some other market situation that is of interest, the reader is invited to submit these questions to SMI for answers or comment, which will be given gladly without any further cost or obligation.



## Judging the Market

## Consultation Form

You are invited to submit any questions you may have on the material contained in Judging the Market or on the Stock Market in general. We ask that you please limit yourself to one question per form.

This image shows a single sheet of white paper with horizontal blue or grey ruling lines. The lines are evenly spaced and run across the width of the page. There is no handwriting or other markings on the paper.



## Judging the Market

## Consultation Form

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