Wyckoff method of trading stocks part 8

Trendlines: Refinements in charting

by Jack K. Hutson

Like any complex activity, chart interpretation includes some aids to the process. Trendlines are one of these aids that help Richard D. Wyckoff analysts visualize what is occurring in their Vertical and Figure charts.

The rationale behind Trendlines is straightforward. When a stock is being accumulated, it is storing up the force of demand which is the power for an ensuing upward movement. The force of demand gives price a certain momentum to carry it higher until demand is diminished or a new force of supply strong enough to change its path comes into the picture. An indication that demand may be dying out on a rise or that supply is gaining the upper hand is the tendency of prices to *arch over* or flatten out.

When the growing force of supply overpowers demand, its momentum drives price downward until the force of supply is exhausted or demand is revitalized and brings price to a state of comparative equilibrium. An indication that supply may be dying out on a downswing or that demand is gaining the upper hand is the tendency of prices to *round up* or level off.

Thus, the momentum that the forces of supply and demand impart to price is as important to a stock market analyst as the momentum imparted to a moving object is to a physicist— and in both cases, momentum can be measured.

In stock analysis, momentum is measured by the angular climb or the downward pitch of the vertical bars on Vertical Line charts. This is the easiest way to visualize with Trendlines, which are simply straight lines drawn through the successive tops or bottoms of a price moving through minor, intermediate, and major swings.

Trendlines define the stride of price movement, and direct the analyst's attention to prices that may be changing pace or actually reversing their trend. Basically, any threatened violation of a trendline may be signaling that the force of demand or supply that was in effect is now weakening. The force could change its rate of progress up or down or the trend could be in danger of reversal.

Of course, like any other charting aid, Trendlines are valuable when they are used with other indicators to open up as complete a picture of the market as possible. It is self-defeating to exaggerate the importance of Trendlines and to use them in a purely mechanical way. Judgment is called for in both plotting and interpreting Trendlines.

The significance of Trendlines is not just that a line is broken, but how it is broken and the conditions under which it occurs. Interpreting the quality of buying or selling around the violation point determines if the direction of breakthrough will continue or if it is a temporary change. Violations of former tops and bottoms and old levels of support and resistance are equally important, but a trader must be able to deduce if a moving stock or average has hit a *resting spell* or trading range, and is likely to resume its movement with as much or more force than before.

Also, an analyst must be careful not to plot Trendlines indiscriminately, especially on every minor move. Plotting Trendlines without judgment results in confusion and fallacy. The danger in recklessly drawing Trendlines is that every horizontal formation is not necessarily a zone of accumulation or distribution. It may simply be a trading range, or zone of comparative equilibrium where small forces are at work and the minor rallies and reactions will tend to neutralize each other. The key is to analyze horizontal formations to make sure they do signify accumulation or distribution. As we know already, this decisive price movement occurs when forces of supply or demand have built up to such a point that when they become unbalanced their power can sustain a move.

It's always best to first locate Trendlines on Vertical charts because these charts are most sensitive to price movements and afford the most logical placement of the lines. Then, plot the more important Trendlines on the Figure charts, where the lines may show developments even more strikingly than the Vertical chart.

Plotting Trendlines need not be complicated. There are four "basic" Trendlines—support, supply, oversold position, and overbought position as shown in Figure 1.

A support line shows an advancing angle in a bull market by passing through two successive points of support (the lowest points of two successive reactions).

A supply line shows the angle of decline of a bear market by passing through two successive points of resistance (the tops of rallies).

An oversold position line is drawn parallel to the supply line and passes through the first point of support (the lowest point of a reaction) that occurs between the supply line's two successive tops.

An overbought position line is drawn parallel to the support line and passes through the first point of resistance (the top of a rally) that occurs between the support line's successive points of support.

The support and oversold position lines alert a trader to buy or cover, while supply and overbought position lines indicate it's time to sell out or go short.

You can see these Trendlines developing very clearly on a Vertical chart. Let's say our stock or group has hit one rally. As soon as the Vertical chart shows well-defined evidence of a second rally, we can draw a straight line—a supply line— through the two rally tops.

By extending this supply line out to the right, we define the limits that subsequent rallies would be expected to reach until the price develops enough sideways movement, indicating there's enough demand to punch through the supply line.

Should the stock or group break the supply line with increasing volume or a material gain in price—both of which indicate strength—then it's a fairly conclusive indication that the force of demand is being released into a worthwhile upward swing.

Such an advance then enables us to plot a support line passing through the low points of two successive reactions. The support line indicates how far future prices should drop on normal, corrective reactions. This, then, gives us an advance hint as to where new demand should kick in if the major upward movement is continuing.

The continuation of the overall upward movement may very well accelerate as large operators hurry to wind up their campaigns, and another support line at a steeper angle would be warranted. At this point, plotting the support lines of minor movements may help determine if a steep, intermediate advance can continue.

Plotting Trendlines on a Vertical chart ensures the greatest accuracy in judgment. Transferring the Trendlines to one- and three-point Figure charts will make trends more noticeable. However, because the Figure chart is a condensation of information, indications from its Trendlines can contradict those of Vertical chart lines. In these cases, the Vertical chart is the one to follow.

We can see how Vertical and Figure chart Trendlines are related in the following example. Here, we're looking back at a stock or group in decline. An initial supply line drawn through two rally tops and extended to the right shows how far a rally would have to jump to signal a trend change.

Should the rate of decline accelerate, a new and steeper supply line is warranted. A supply line pitched almost perpendicularly points to an emerging oversold position. When this steeper supply line is breached by a vigorous rally, it says demand is overcoming supply and we anticipate this selling climax will be followed by a technical rally.

If the technical rally does not break through the original supply line, it's a sign the rally is ending. The next normal event would be a secondary reaction to test support. Our one-point Figure chart, at this point, would tell us just how high a recovery could rise. A quick look at the Vertical chart tells us whether the potential rise would break the Vertical chart supply line. When the rally breaks the line, it's confirmation that the trend is changing from technical weakness to technical strength.

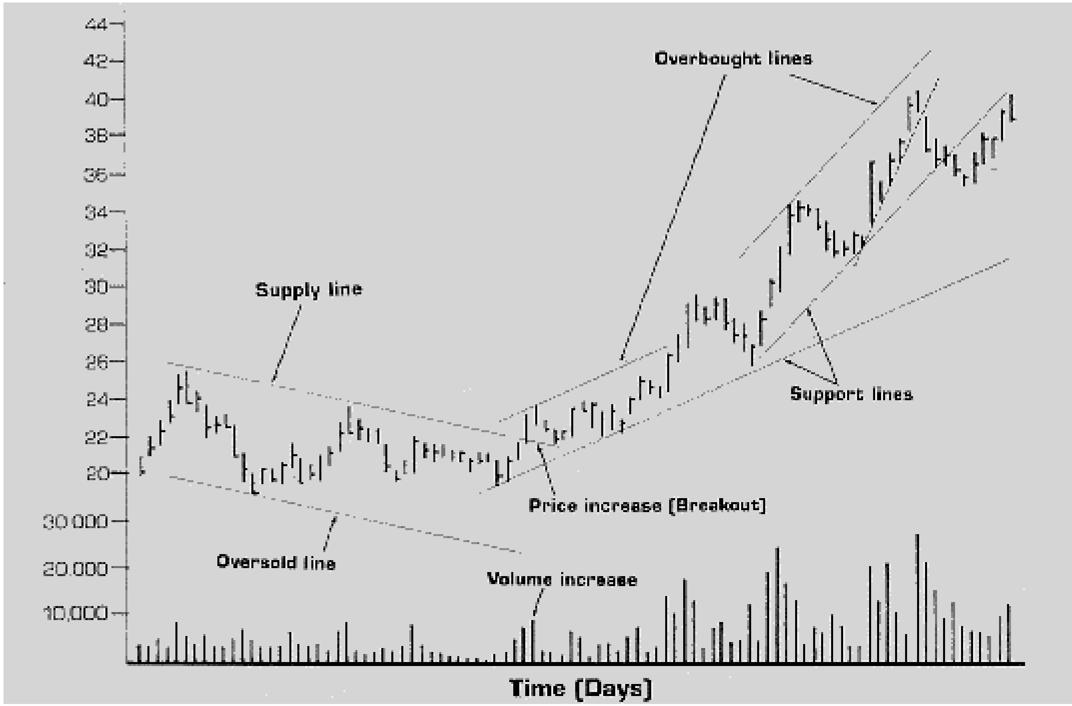
At times, Trendlines do not give clear-cut indications, making it all the more important to continue drawing on complete chart analysis. For example, when the reaction to our trend-changing rally breaks an existing support line, is it a sign of further weakness and a resumption of decline or is it a temporary and minor selling climax? Only further developments will clear up the question.

The ensuing sideways price movement marks the reaction as just another point at which to redraw the support line. As price swings to dead center, we also can draw a new supply line and notice that the new supply line and the redrawn support line cross and form an "apex." While Wyckoff analysts eschew geometric patterns, the apex is one formation that highlights how the price is working itself to a springboard, poised to release the accumulating force of demand. The apex shows up even more strikingly on the one-point Figure chart. A three-point Figure chart will condense even more history into a small space and bring the angles of Trendlines into sharper focus.

You can refine your Trendlines by adding oversold position and overbought lines to your charts, where possible. To do this, you must first have a supply or support line. Where a rally occurs between the two points of the support line, draw a line from the top of the rally parallel to the two points of the supply line, draw a line from the bottom of the reaction, parallel to the supply line.

If price tends to stop short or pull away from an oversold or overbought position line, it's a strong hint of impending change of pace or change of trend.

Of course, any Trendline on any chart must be judged in light of all other technical factors. It is best to think of Trendlines by themselves, as hints rather than positive indications.



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Overbought lines
Supply line
Support lines
Price increase (Breakout)
Oversold line
Volume increase
Time (Days)

Figure 1

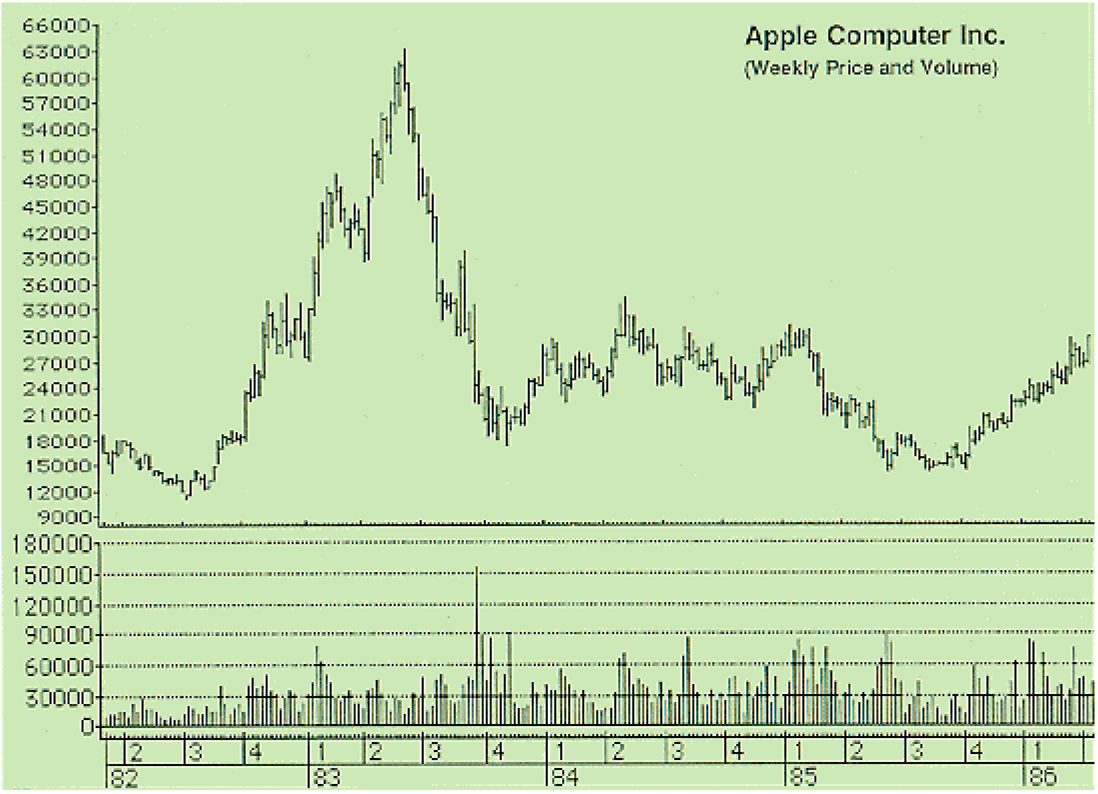

Figure 2: Apple Computer Inc. *(Weekly Price and Volume)*

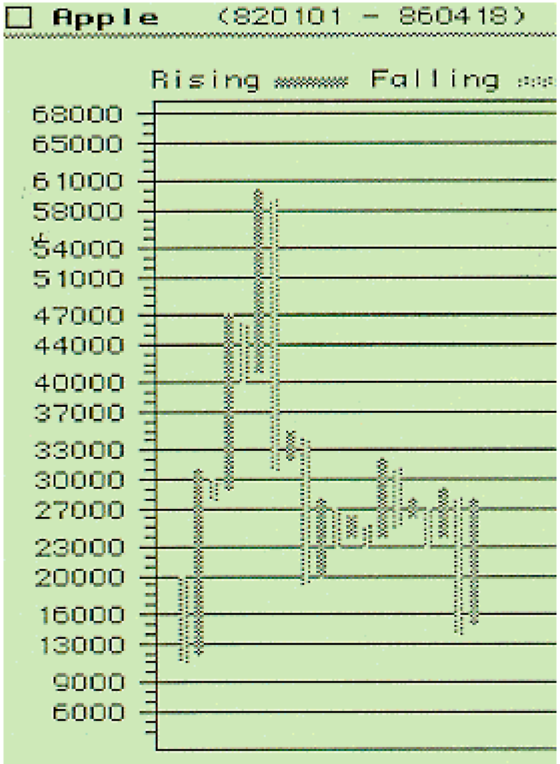

Figure 3: *Three-point Figure chart example with $1.00 box size and $3.00 box reversal for Apple Computer, Inc. weekly prices. Note that there is no time scale*.