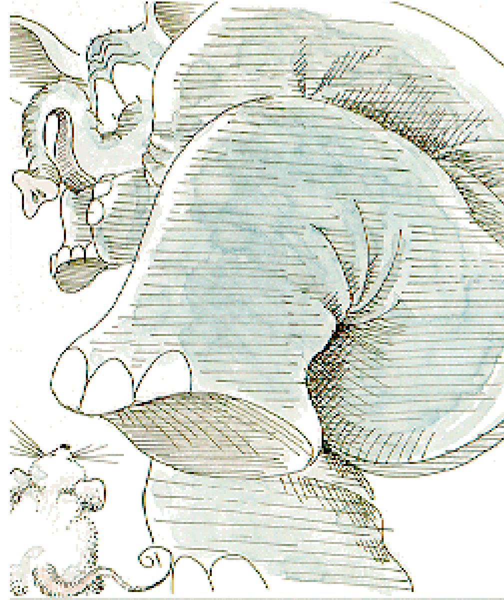
Wyckoff: Relative Strength And Weakness

by Craig Schroeder



In his course in stock market science and technique, Richard D. Wyckoff stated the basics of his method in five steps:

***Step 1*:** Determine the present position and probable future trend of the market. Then decide how you are going to play the game: long, short or neutral.

***Step 2*:** In a bull market, select from those stocks in harmony with the market the ones that are stronger than the market. In a bear market, select those that are weaker than the market.

***Step 3*:** Using point and figure charts, select those stocks that have built up a potential count for a move in keeping with your goals.

***Step 4*:** Determine each stock's readiness to move. Analyze the vertical and figure charts of the candidates with the help of the buying and selling tests.

***Step 5*:** Time your commitments with a turn in the market.

The five steps of the Wyckoff method can be divided into three groups that ask and help answer three important questions. Step 1 stands alone and asks the question *what*. Steps 2 through 4 can be grouped together and ask the question *who*. Step 5 stands alone and asks the question *when*. Therefore, by employing all five steps, the investor or speculator can determine what type of market operation to undertake, which individual stocks or bonds represent the best candidate(s) and when the best time is to make a commitment.

Last month I discussed step 1, identifying the trend. If the analysis completed in step 1 indicates that the best course of action is a neutral position, then there is no need to continue to step 2. However, if step 1's

Copyright (c) Technical Analysis Inc.

analysis indicates there is a trend, step 2 of the Wyckoff method may help identify the best individual issue(s) in which to establish a position.

SIMPLE BUT OVERLOOKED

The concept that is addressed in step 2 is relative strength and weakness. Relative strength and weakness is an amazingly simple idea that is frequently overlooked by investors and speculators. A stock that is relatively strong to the market is likely to remain relatively strong unless or until there is enough of a change in the forces of supply and demand to alter the character of the action.

The concept of relative strength and weakness is useful in all three types of trends. In an uptrend, the relatively strong stocks represent the best candidates for long positions while the relatively weak stocks represent the worst candidates. This is where many investors and speculators frequently make a potentially fatal error — the conclusion that the relatively weak stocks during an uptrend in the general market represent the biggest bargains and, therefore, the best opportunities on the long side. This is generally not true. Stocks that are relatively weak during an uptrend in the general market are in that position for a reason. You cannot assume that the stocks have been overlooked by the large interests in the market.

It is much more likely that the reason involves poor fundamentals, which may or may not be public knowledge. If the uptrend in the general market is strong enough or lasts long enough, the process of rotation suggests that some of the relatively weak stocks will make meaningful upside progress. However, the odds do not favor these stocks catching up with or surpassing the relatively strong issues, which are the ones most responsible for defining and fueling the uptrend.

When the general market is in a downtrend, the relatively strong stocks represent the worst candidates for short positions while the relatively weak stocks represent the best candidates. A stock's lack of participation in the direction of the trend should not be looked at as an indication of excessive value. When the general market moves into a trading range, both the relatively weak stocks and the relatively strong stocks represent potential trading opportunities. The position of the market within the trading range determines whether the relatively strong stocks or the relatively weak stocks represent the best opportunities.

As the market approaches the resistance level at the top of the trading range, the stocks that are relatively weak represent the best opportunities on the short side in anticipation of a move back to the bottom of the trading range. These stocks do not have to be in trading ranges themselves. They are more likely to be in downtrends as a result of the relative weakness.

As the market approaches the bottom of the trading range, the relatively strong stocks represent the best opportunities on the long side in anticipation of a move back toward the top of the trading range. These stocks do not have to be in trading ranges; relative strength is likely to have them in uptrends.

MEASURING RELATIVE STRENGTH AND WEAKNESS

Relative strength and weakness is not a subjective concept. It can be measured in absolute terms. The easiest method involves identifying a series of important rally tops and reaction bottoms in the general market. In Figure 1, a series of tops and bottoms have been marked by a through g. After these points are identified, the percentage move from one point to the next is calculated. Between point a and point b, the

Copyright (c) Technical Analysis Inc.

SHORTER-TERM DOWNTREND

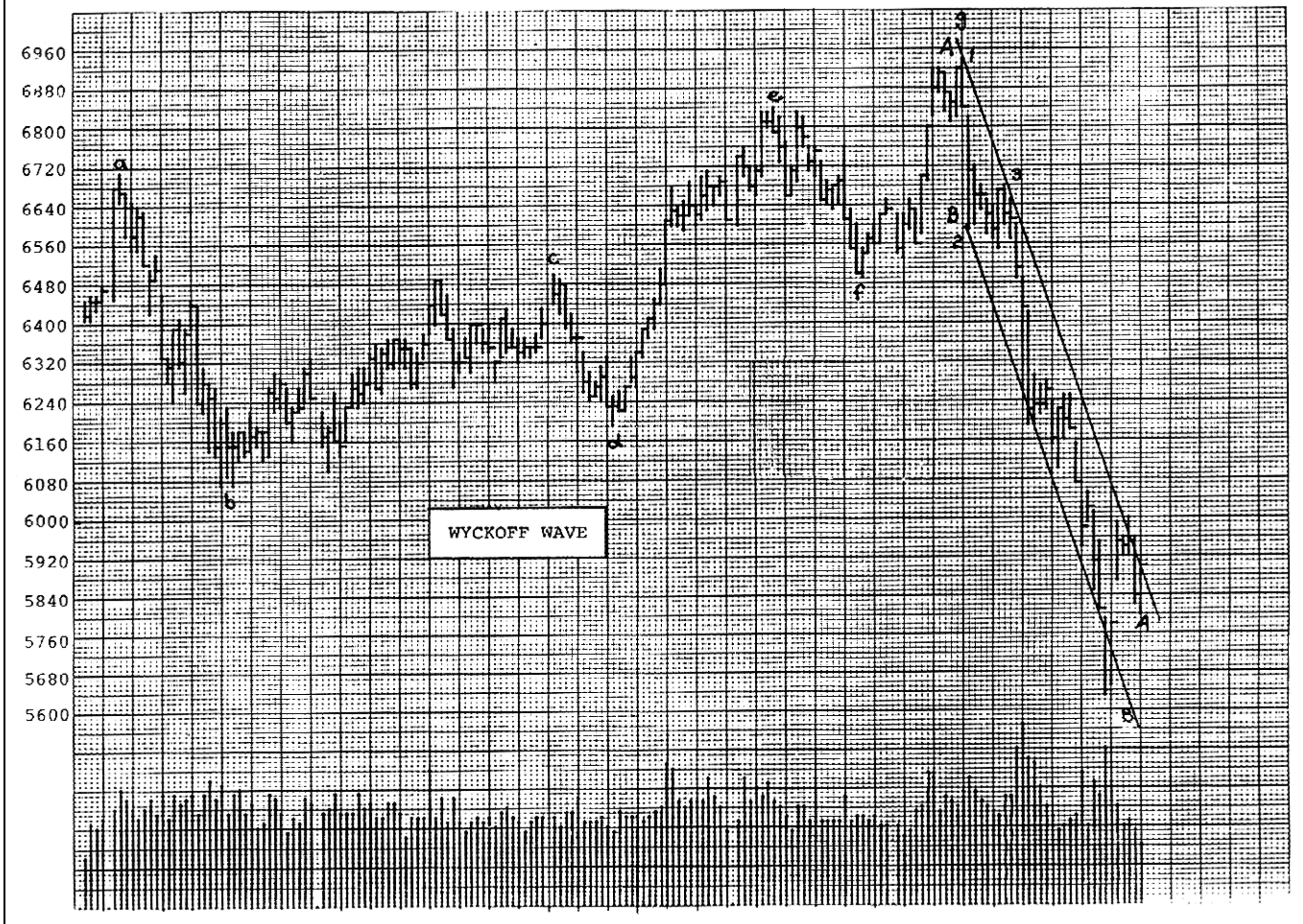


FIGURE 1: Relative strength and weakness can be measured by identifying a series of important rally tops and reaction bottoms in the general market, marked a through g, and then calculating the percentage move from one point to the next. Between points a and b, the Wyckoff wave declined 9.538%. Between points b and c it rallied 7.084%. Compare the percentage movement for individual stocks to determine their relative strength.

Copyright (c) Technical Analysis Inc.

Wyckoff wave declined 9.538%. Between points b and c it rallied 7.084%. The remaining measurements are as follows: c to d = -4.769%, d to e = +10.501%, e to f = -5.117% and f to g = +6.994%.

Stocks that are relatively weak during an uptrend in the general market are in that position for a reason.

Similar measurements should be taken on all stocks that are being monitored on a regular basis. This can be a time-consuming process. If you are following a large number of stocks, you may wish to consider computerizing the process. If that is not feasible, consideration should be limited to the issues that make up the index that is being used to follow the course of the general market. An investor or speculator who uses the Wyckoff wave can limit his universe to eight stocks. An individual who follows the Dow Jones Industrial Average (DJIA) should consider the performance of all 30 of its components. You do not have to follow hundreds of stocks to realize an above-average return.

The individual who is playing the shorter-term moves in the market is most interested in the move that immediately follows point g. Therefore, the relative performances on the moves from e to f and f to g are illuminating. Forecasting a reaction following point g, stocks that are weaker than the market on the move from e to f and from f to g represent the best candidates for short positions.

As the trading perspective of the individual expands, the number of reactions and rallies that are considered should be increased. This helps avoid being influenced by a short-term move that is not consistent with the action overall. An intermediate investor should consider adding the action from c to d and d to e to determine which stocks are the strongest and weakest. The longer-term investor should consider adding the moves from a to b and b to c as well. The stocks that most consistently outperform the general market in a manner consistent with the type of position that is anticipated represent the best opportunities.

If no stock outperforms the market on every move, the ones that outperform the market on the greatest number of moves represent the best opportunities. In these cases, the most recent rallies and reactions should be given more weight.

In Figure 1, the longer-term perspective indicated by the action from point a to point g suggests that the market is in a trading range due to very little upside progress being made during the period. An investor trading the market from this perspective and viewing the trend of the market as being a trading range can justify action on the short side at point g in anticipation of a move back toward the bottom of the range. However, an intermediate investor viewing the market from c to g sees it as being in an uptrend. A reaction may still be anticipated, but attempting to participate in it is difficult to justify because the anticipated move is contrary to the direction of the trend. The shorter-term speculator viewing the market from point e to point g and seeing virtually no upside progress may conclude that the market has moved into a trading range. A move back toward the bottom of the range may be anticipated and selecting a stock to short should be considered.

Figure 1 clearly indicates that the move to the downside following point g was substantial. Therefore, the longer-term and shorter-term players in the market who participated in the anticipated reaction realized a substantial reward. The intermediate-term player, however, is left out.

The Wyckoff method is not magic. It does not guarantee the investor or speculator that he will be correct

 Copyright (c) Technical Analysis Inc.

100% of the time. It should be noted, however, that in this case an error in judgment resulted in a lost opportunity, but the dollar cost was zero. Other errors may result in actual losses, but other aspects of the Wyckoff method address techniques for limiting losses.

After applying the first two steps of the Wyckoff method to a particular market situation, the investor or speculator knows which side of the market to consider playing. Ranking stocks by relative performance compared to an index produces a list of candidates for trading. However, it is likely that the screening provided by the second step in the Wyckoff method will leave more potential candidates than the available funds can accommodate. Steps 3 and 4 of the Wyckoff method continue and complete the stock selection process, looking at how far potential candidates are likely to move and how soon.

Those two additional criteria, when combined with relative strength and weakness considerations, should result in a manageable group of candidates with an above-average likelihood of producing a worthwhile return.

Craig Schroeder is educational director at Stock Market Institute, Inc., and a student of the Wyckoff method for 21 years. He writes daily commentary from a Wyckoff point of view and has served as a technical advisor to several regional brokerage firms.

FURTHER READING

Hutson, Jack K. [1986-87]. Wyckoff series, *Technical Analysis of Stocks & Commodities*, Volumes 4-5.

Schroeder, Craig [1990]. "A Wyckoff Guide for Investors and Speculators," STOCKS & COMMODITIES, December.

Wyckoff, Richard D. [1984]. "Corner the Market," excerpt from August 1911, *The Ticker Magazine*, reprinted *in Technical Analysis of Stocks & Commodities*, Volume 2: July/August.

 Copyright (c) Technical Analysis Inc.

THE WYCKOFF WAVE

To determine the current trend, the present position and probable future trend of the market, a means of charting the market's action to reveal the general direction of the trend is necessary. The general trend of the market is created by the interaction of the forces of supply and demand, which 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. The Wyckoff Wave is such an index.

The Wyckoff Wave is not simply an average of stock prices; it is an index that serves as a miniature version of the entire market. The wave is composed of the intraday movement of eight individual stocks. Currently, these eight issures are:

Bristol Myers (BMY)	General Motors (GM)
Dow Chemical (DOW)	IBM (IBM)
Exxon (XON)	Merrill Lynch (MER)
General Electric (GE)	Union Pacific (UNP)

These stocks are all market leaders and are widely held, actively traded and participate in most market moves.

 Copyright (c) Technical Analysis Inc.