JUDGING THE MARKET BY ITS OWN ACTION

(--from *The Richard D. Wyckoff Method of Trading and Investing in Stocks*, c 1931)
(edited)

THE BASIC LAW OF SUPPLY AND DEMAND (Sect. 2M)

The Law of Supply and Demand operates in all markets in every part of the world. When demand exceeds supply, prices rise, and when supply is greater than demand, prices decline. This is true not only of stocks; it is constantly being demonstrated in markets for wheat, corn, cotton, sugar and every other commodity that is bought and sold; also, it is reflected in other markets such as real estate, labor, etc.

I demonstrated this further in a series of articles entitled: "Studies in Tape Reading" which attracted wide attention as the first of their kind ever published anywhere, as far as I knew.

My basic idea in this series was that the stock market, by its own action, continually indicates the probable direction of its immediate and future trend, and anyone able to determine this with accuracy should attain success in trading and investing.

Coming events, I claimed, were foreshadowed on the tape because large interests there disclosed their anticipation of advances or declines by their purchases or sales. So, too, with the large speculator who was endeavoring to raise or depress prices. If one were to become sufficiently expert, he could judge by the action of stocks what was in the minds of these large interests and follow them.

The trend was simply the line of least resistance. When a stock met opposition in its rise, it must either be strong enough to overcome this resistance (selling) or it must inevitably turn downward, and when, in its downward course, sufficient buying was encountered to halt the decline, it would turn upward. The critical moments in all these various phases of the market were these minor and major turning points, or else the points where the price broke through the opposition into a new field.

Further development of this method of judging the market from its own action resulted in my using it as a basis for predicting the probable course of the market, and this eventually led to my issuing weekly, "The Trend Letter" (first published in 1911) which had a most successful career for many years. In fact, the forecasts
contained in this Letter were so accurate that a large following was developed. As a result of a series of successful campaigns we were not only overwhelmed with business but brokerage houses throughout the country passed along these recommendations to their clients. So many followers were gained that an undue effect was had on the quotations for the stocks in which they traded, and in certain cases the effect on the market was important.

My reason for mentioning these facts is to show that this method of judging the market by its own action was highly successful from the standpoint of profits realized for subscribers who followed my advices, as well as for many thousands of people who were not subscribers but who bought and sold when we did.

From the above you may judge how vital it is in the stock market, as in every field, to operate with the proper principles.

JUDGING THE MARKET BY ITS OWN ACTION (Sect. 3M)

No one can deny that in Wall Street the big fish eat the little ones. Large operators could not operate successfully without the large number of people making up the public; that is, if there were only ten big interests in the market and no public, these ten could only make a profit by dealing with each other. It would be difficult for one crowd to deceive any of the nine others. But when the public enters the stock market, the large operator's game becomes easier for him.

Tape Reading and Chart Reading enable one to detect and profit by these inside operations or manipulation; to judge the future course of stocks, by weighing the relation of supply and demand. This sometimes can be done from price movement alone, but if you consider also the volume of transactions you gain an additional and vitally important helpful factor.

Whenever you study the tape or a chart, consider what you see there as an expression of the forces that lift and depress prices. Study your charts not with an eye to comparing the shapes of the formations, but from the viewpoint of the behavior of the stock; the motives of those who are dominant in it; and the successes and failures of the buyers and sellers as they struggle for mastery on every move.

The tape is like a moving picture film. Every minute of the day it is demonstrating whether supply or demand is the greater. Prices are constantly showing strength or weakness: strength when buyers predominate and weakness when the offerings overpower the buyers. All the various phases from dullness to activity; from strength to weakness; from depression to boom, and from the top of the market down to the bottom – all these are faithfully recorded on the tape. All these movements, small or great, demonstrate the workings of the Law of Supply and Demand. By transferring to the charts portions of what appears on the tape, for study and forecasting purposes, one is more readily enabled to make deductions with accuracy.

And now that you are undertaking to learn this Method, it is best that you prepare your mind for it by discarding most of the factors that you have heretofore employed in forming your judgment and making your decisions, such as: tips, rumors, news items, newspaper and magazine articles, analyses, reports, dividend rates, politics and fundamental statistics; and especially the half-baked trading theories which are expounded in boardrooms and popular books on the stock market.

It is not necessary for you to consider any of these factors because the effect of all of them is boiled down for you on the tape. Thus the tape does for you what you are unable to do for yourself; it concentrates all these elements (that other people use as a basis for their stock market actions) into the combined effect of their buying and selling.

You draw from the tape or from your charts the comparatively few facts which you require for your purpose. These facts are: (1) price movement, (2) volume, or the intensity of the trading, (3) the relationships between price movement and volume and (4) the time required for all the movements to run their respective courses. You are thus far better equipped than the man who is supplied all the financial news, statistics, etc., from the whole world.

BUYING AND SELLING WAVES (Sect. 5M)

Every upward or downward swing in the market, whether it amounts to many points, only a few points, or fractions of a point, consists of numerous buying and selling waves. These have a certain duration; they run just so long as they can attract a following. When this following is exhausted for the time being, that wave comes to an end and a contrary wave sets in. The latter may attract more of a following than the former. By studying the relationships between these upward and downward waves, their duration, speed and extent, and comparing them with each other, we are able to judge the relative strength of the bulls and the bears as the price movement progresses.

All stock market movements, however large or small, are made up of buying and selling waves. The market does not rise and fall like the water in a tank which is being filled or emptied. It moves to a higher or lower level by a series of surges - a good deal like an incoming or outgoing tide, with successive waves higher or lower than those preceding.

The small buying and selling waves which occur during every stock market session run so many minutes. They are caused largely by the restlessness of active professional traders, much like the ripples produced by the wind upon the ocean. Traders must have activity; they make their livelihood by trading on fluctuations. Therefore, they engage in a ceaseless tug of war, trying to put prices up whenever the condition of the market is favorable, or drive them down when they find that the bulls are weak or have over-extended themselves. The degree of success or failure attending their efforts enables us to determine whether the market is growing stronger or weaker.

These small waves are part of the larger waves which run several days, and eventually make up movements of 3 to about 5 points [Note: this was the average daily range of the index at that time; today the average daily range is more than 200 points; adjust accordingly]. The 10 and 20 point moves are made up of 3 to 5 point waves, and the bull and bear markets are composed of many swings of 10 to 20 points or more.

You can easily confirm the above by examining any chart. It is important that you do this so as to impress upon your mind these numerous waves of various sizes, inasmuch as this will help you to understand the market. You will thereafter think in waves.

When you are looking for an opportunity to buy, watch for the <u>down</u> waves in the market and in your stock. After you have bought, you sit through a number of small, medium and good-sized waves, until finally you observe that it is about flood tide in that stock. Then watch for an especially strong up-wave and give your broker an order to sell your stock at the market.

The waves of the market furnish a clear insight into changes in supply and demand. By learning to judge all sizes of market waves, you will gradually learn to spot the time when a rising market or a rally, and the time when a declining market or a reaction, has halted and is about to reverse. <u>These are the turning points</u>***.***

To be able to say when these turning points are occurring - at the bottom of a bear market, or at any important rallying point on the way down to the bottom, or at the top of a bull market, or at any important reactionary point on the way up - is a mark of ability in an investor as well as a trader.