Straight Line Approach, The

Keep Your Hands And Feet Inside The Stochastic Until Your Oscillator Comes To A Complete Stop

Charts are among the most mysterious aspects of the financial markets that the beginning trader will face. For many people, charts look like a child's experimentations with a Spirograph. But charts are really nothing more than stories, using symbols rather than words, like algebra uses symbols instead of numerals (yes, I know that words and numerals are technically symbols, but you know what I mean). They are a bit like the storyboards used in producing movies and cartoons, except we use dots and lines rather than drawings or photographs. Understanding the stories these charts are trying to tell can make you money. Or, at the very least, save you what could become a great deal of money.

Many technicians and technical analysts sabotage their own case by making the subject of charts and charting so elaborately complex as to be ludicrous. More than a few beginners have visions of wizened old crones with palsied hands, stroking – in a vaguely obscene way – ancient leather pouches filled with dessicated chicken bones which they scatter onto pitted and scarred tables while muttering invocations to Chaikin, Bostian, Donchian.

These technicians then explain the results of their analyses much as Lewis Carroll might, by pointing out how brillig the pattern is, and how the slithy toves are gimbleing in the wabe, while over here (they point), the borogroves are mimsy, which indicates a possible outgrabe by the mome raths, unless of course the Bandersnatch whiffles, in which case . . .

It's just not that hard.

A chart is a visual representation of transactions. The results of these transactions are depicted by either a line which will look like a map of the Pacific Coast Highway, or by a bar which represents the opening price (the little notch on the left side of the bar), the low for the day (the bottom of the bar), the high for the day (the top of the bar) and the closing price (the little notch on the right of the bar). At the bottom of the graph you'll usually also find volume bars which will tell you how many transactions were completed that day.

But beyond all this, a chart is a visual representation of buying and selling behavior on the part of investors, not just a tally, and this behavior creates patterns, like ranges, or "boxes". Thus if you approach this from the viewpoint of psychology and sociology rather than cut-and-dried mathematical models, you'll have a leg up. These patterns do not exist in nature. They are created by the buying and selling dynamic.

Law of Supply and Demand, the

Much nonsense has been circulated about trading over the past seventy years or so, the bulk of it since the internet made possible discount brokers, affordable charting software, real-time streaming data, chat rooms, trading rooms, trading websites, blogs, and so forth, all of which offered fertile ground to a literally endless assortment of books, DVDs, courses, seminars, "alert" services, mentors, counselors, trading software, indicators and so on, all designed to separate the beginner or struggling trader or otherwise low-hanging fruit from his money.

There is, however, only one essential, one lynchpin, one fundament when it comes to understanding the auction market: supply and demand and the Law thereof. Everything else – support, resistance, trend, price movement, volume – stems from the balances and imbalances between supply and demand, selling pressure and buying pressure, sellers and buyers, yet struggling traders are generally incapable of accurately assessing the state of these imbalances, i.e., determining who's in charge at any given moment or interval (some are capable but can't implement what they know, but that's another subject).

Trading price hinges on the ability to assess the state of these imbalances not only in the abstract but in every moment of the trading session. If one does not thoroughly understand just what it is that he's looking at, he will be lost. When trading price, the trader knows at all times who's in charge, who's dominant, who's holding the good cards. If he doesn't know this, he's just guessing, and that's not the route to consistent profits, no matter what you read on message boards.

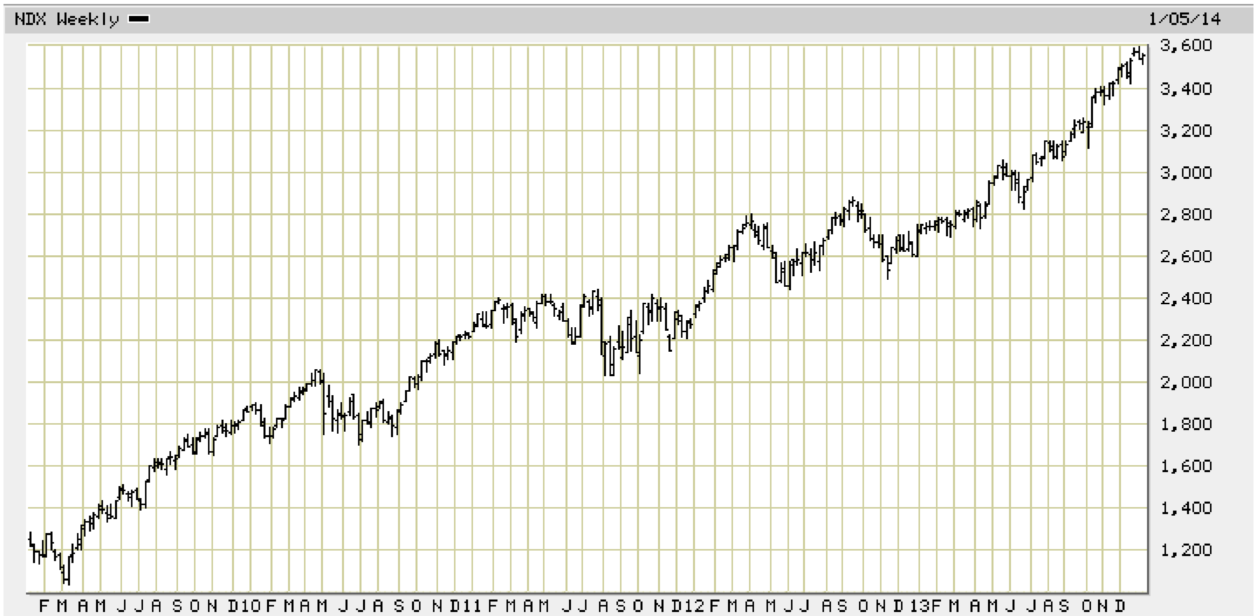
Why bother? Because once you learn how to trade price, your edge* will never fail. You will understand trend and how to play it under all circumstances, including its endings and reversals. You will also learn how to distinguish between trending and ranging, the latter including "chop" which is a collection of micro-trends which generate tons of commissions and very little if any profit.

**the knowledge you gain through your research and testing that a particular market behavior offers a level of predictability that provides a consistently profitable outcome over time (from Douglas)*

The Importance of Context

Trading price begins with determining the context, i.e., what is the market doing outside the intraday world, daily, weekly, monthly, even yearly? By studying the illustration of activity that is a chart, one can (1) assess whether buyers (demand) or sellers (supply) are in charge (price is going up or down) at any given interval, (2) determine how active they are (**volume**), how quickly price reaches its destination (**pace**), how far each buying or selling wave goes (**extent**), how long each of these lasts (**duration**), where and how and for how long traders come to rest (**equilibrium**). Daytraders often consider this to be a waste of time since the trading that begins at the opening bell so often seems to have little to nothing to do with what price was doing overnight or where it was going. But this sort of analysis will at least provide one with a sense of the "tone" of the day, even if that amounts to no more than his first trade. After that, one must follow price, wherever it leads, though price has a tendency to halt at points and levels that were important at previous intervals and even take off in the opposite direction. If one has not even scanned these points and levels, price is likely to take off without him. leaving him wondering what just happened. He may even find himself taking the wrong side of the trade, an all-too-common occurrence.

Determining the Context This began a little over five years ago:



The purpose of the Straight Line Approach (SLA) is to enable both the beginning and the damaged trader to focus on what is most likely to affect his ability to enter and manage profitable trades. Both will find this simple. That's the point of it. But those who are just starting will likely find it far easier (there's a difference between simple and easy) than those who have been struggling for years, largely because of all the nonsense the latter have been carrying in their heads. All that must be got rid of, and not everyone can do it. Many cling to their MACDs and RSIs as if they were rosaries. The SLA, however, ***demands*** that the trader focus, pay attention, keep his mind on business and ignore all the extranea like indicators and Fibonacci and Pivot Points and envelopes and bands and clouds and candles and what CNBC said and whatever the hell else and perform the simple task of drawing straight lines to track the course of demand and supply and the balance between them. If he can do this simple thing, his profits will be consistent and his losses will be minimal. Why? Because the SLA forces him to be in synch with the market, and if he can keep his ego out of it and stop trying to outsmart it, he will be in and stay in the right side of the market.

> *I've said it before, and I'm going to say it again, because it cannot be overemphasized: the most important change in my trading career occurred when I learned to* ***divorce my ego from the trade****. Trading is a psychological game. Most people think that they're playing against the market, but the market doesn't care. You're really playing against yourself. You have to stop trying to will things to happen in order to prove that you're right. Listen only to what the market is telling you now. Forget what you thought it was telling you five minutes ago. The sole objective of trading is not to prove you're right, but to hear the cash register ring.*
>
> *–Marty Schwartz*

The Trendline

> *You can talk all you want about what a stock* should *be doing or* why *it isn't doing what it* should *be doing. You can talk about inflation, interest rates, earnings, and investor expectations. Ultimately, however, it comes down to the picture. Is the stock going up or down? Knowing the reasons behind a stock's movement is interesting, but not critical. If your stock goes up on a given day, they won't take the money away from you if you don't know why it went up. And if you can explain why it went down, they won't give you back your lost money. All that really matters is a picture, a simple line on a chart. The trick to visual investing is learning to tell the difference between what is going up and what is going down.*
>
> *–John Murphy*

To bring order out of what may appear to be chaos, the first straight line one must learn to draw is a trendline, specifically, in this case, for now, a trendline that tracks demand. A demand line. These lines can be drawn just about anywhere, and many traders do just that. But if they are to do their job, track the trend, they have to be drawn a particular way.

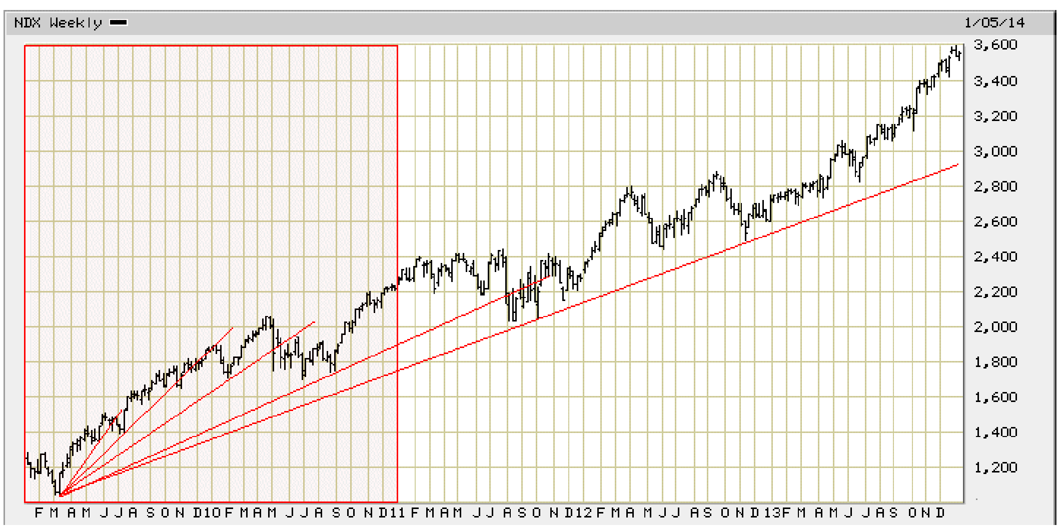
Looking at a chart on which no trendlines of any sort have been drawn is sort of like the burglary movies where the guy is trying to steal the big diamond that's sitting on a pedestal in the middle of the room. He knows that there is an alarm which is triggered by the interruption of one or more of a series of laser beams which criss-cross the room. Unfortunately, he doesn't know where those laser beams are because they're invisible to the naked eye. So what does he do? He blows smoke into the room so that the beams become visible. Knowing where they are enables him to miss them and avoid setting off the alarm. Similarly, there are a variety of trendlines on your chart, even though you may not be able to see them. Blowing smoke on your chart will be of no help, however, so you'll have to be satisfied with a less-dramatic straightedge and pencil.

A chart, again, is a visual representation of stock transactions, or the buying and selling behavior of traders. The price points which represent those transactions can be plotted as a line (like on a heart monitor) or as a series of vertical bars (which show the high, low, closing, and usually the opening prices). The purpose of trendlines is to help the trader find order in all these price points and tell him whether price is going up or down (he could also ask a five-year-old to look at the chart and tell him whether price is going up or down as small children have an uncanny ability to do this, but five-year-olds aren't always available).

Even though the upcoming chart is presented *in toto* and the lines are drawn in hindsight, you will probably be able to ignore everything but the left edge and work your way forward. If you can't, just cover most of it with a sheet of paper. Why do this? Because tomorrow you're going to start plotting trendlines on your own charts in preparation for your own upcoming session, and as they "ripen" over the coming days and weeks and months, you'll need to know how to make the necessary adjustments that will enable them to continue doing their job, which is, again, to track the trend. If you had been tracking this trend four years ago, for example, your first trendlines would have looked like this at the time:

The first is drawn from the first swing low to the next. When the line is broken, it's "fanned" clockwise to the next higher swing low when a higher high is made (asterisk; if no higher high is reached, then price moves sideways and there is no trend, but that's another subject). When the fanned line is broken, we wait to see if there will be another higher high. If so, we fan the line again and use the next higher swing low to anchor it. And so on with the next break, the next higher high, and the next higher swing low.

<u>The Weekly Chart</u> So, the first line is drawn under the first two swing lows. That's your trend/demand line *at the time* (the shaded area is that which is illustrated in the above daily chart):



And that's it. As long as price remains in this trend, its moves will more or less conform to the trendline you've drawn, not because it's aware of your trendline but because this is one of the characteristics of price movement. You're following price; price is not following you. Price doesn't even know you. When traders decide they want to do something else, your lines will warn you of their plans and you can make the necessary adjustments, i.e, when the line is broken, you "fan" the line down to the next swing low once price has indicated that it's finished falling by making a higher high, as stated above.

This process will continue until the advance has cooled down enough and reduced its angle enough to segue into a sustainable advance (severe angles are unsustainable because sellers run out of buyers too fast; if the angle isn't softened, price collapses into a "\/" or "/\" reversal;a gently-sloping price gives more buyers a chance to take positions; the more holders at a given price or zone of prices, the more "support under the market"). This particular "softening" took almost three years

Once things have settled down, you can copy your trendline and plot the copy against the highest swing high between the two swing lows used for the lower limit of your trendline, in parallel. This is your supply line and provides you in most cases with a trend "channel".

Then plot another copy down the middle of this channel. This is your "mean" and it will be important to you. But that can wait for now.

The Daily Chart Now we look at the daily chart leading up to the day for which we're preparing. This is the tail end of the weekly chart posted above:

Unfortunately, there's a problem. The lines I've drawn don't conform to the price movement, and, as we know, it's the task of the trendline/channel to follow price, not the other way around. Clearly there is an issue with the upper limit as price spends so much time above it. It is therefore not as useful as it should be.

So we look at that one bar the second week of October that drops down to about 3120. Is that bar an outlier? Is that really where the "true" trend lies? Rather than draw the line across the first two swing lows and draw the upper limit in parallel using the highest swing high, let's reverse it and draw the upper limit first:

Now price is contained, as it should be, and if and when price exits the upper limit, we can say with greater confidence that it is indeed "overbought" as a result of overexuberance and not a poorly-drawn trendline. Excessive rigidity – particularly when it comes to rules – is not a virtue.

The upper limit of the trend channel was tested several times over three months, each time providing a short opportunity which, while it didn't take the trader all the way to the lower limit, took price toward and sometimes all the way to the median. Nothing to sneeze at. How to take advantage of these opportunities? Assuming that the trader would rather not take on the wide stops necessary when trading daily bars, we look to the hourly (and in case you're wondering why I'm using freely-available charts, it's to demonstrate that one can play with all this and even develop a trading plan without having to spend truckloads of money on charting programs, data feeds, trading platforms, etc. In fact, one can do it all without spending so much as a dime).

The Continuity of Price

But first we have to take a timeout to talk about price, and bars, and candles, and the meaning of it all.

In order to trade price effectively, one must first accept the continuous nature of the market, the continuity of price, the continuity of transactions, the continuity of the trading activity that results in those transactions. The market exists independently of you and of whatever you're using to impose a conceptual structure. It exists independently of your charts and your indicators and your bars. It couldn't care less if you use candles or bars or plot this or that line or select a 5m bar interval or 8 or 23 or weekly or monthly or even use charts at all. And while you may attach great importance to where and how a particular bar – or candle – closes, there is in fact no "close" during the market day, not until everybody turns out the lights and goes home, which doesn't happen until the end of the week with the NQ, ES, *et al*.

Therefore, **trading by price**, or at least doing it well, **requires getting past all that and perceiving price movement and the balance between buying pressure and selling pressure independently of the medium used to illlustrate or reveal the activity**.

Once the continuous nature of these movements is understood, the idea of wondering – much less worrying – about what a particular bar – or candle – "means" is clearly ludicrous (including where it "opens" and "closes" and what it's high is and so forth), and eventually the trader may come to the realization that all those people who've been insisting that these bars have some cosmic meaning have been trying to sell him something, i.e., DVDs and courses and software and seminars (box lunch included) and so forth that explain what these meanings allegedly are.

If the continuous nature of these movements is not understood, then the trader spends and wastes a great deal of time over "okay so this bar is higher than that bar but lower than this other bar, and price is going up (or down or nowhere), so . . .".

Price is a movie, not a slideshow

Now it's time to get down to the actual business of trading.

The SLA is as simple as I can make it:

1. Track the balances between supply and demand with straight lines. Don't hug price like Spandex. Otherwise your line is guaranteed to be broken for what may be nothing more than a stumble. If price is ranging (moving sideways), so much the better.

2. When price breaks a line and takes off in the opposite direction (a reversal), or when it breaks out of a range (a breakout), wait for a pullback (a retracement).

3. Enter on that retracement, a few ticks above the trough of a \/ retracement or a few ticks below the crest of a /\ retracement, and stay in until your line is broken. And by "broken" I don't mean that price just pokes the line. As long as buyers are in charge, stay long. If sellers are in charge, stay short.

4. When the line is broken, exit and wait for a retracement in the opposite direction.

5. Continue until you enter chop (two consecutive trades that don't go anywhere and are accompanied by a higher low and a lower high, i.e., not trending.

6. Wait patiently. Quit when you get tired and start to lose focus.

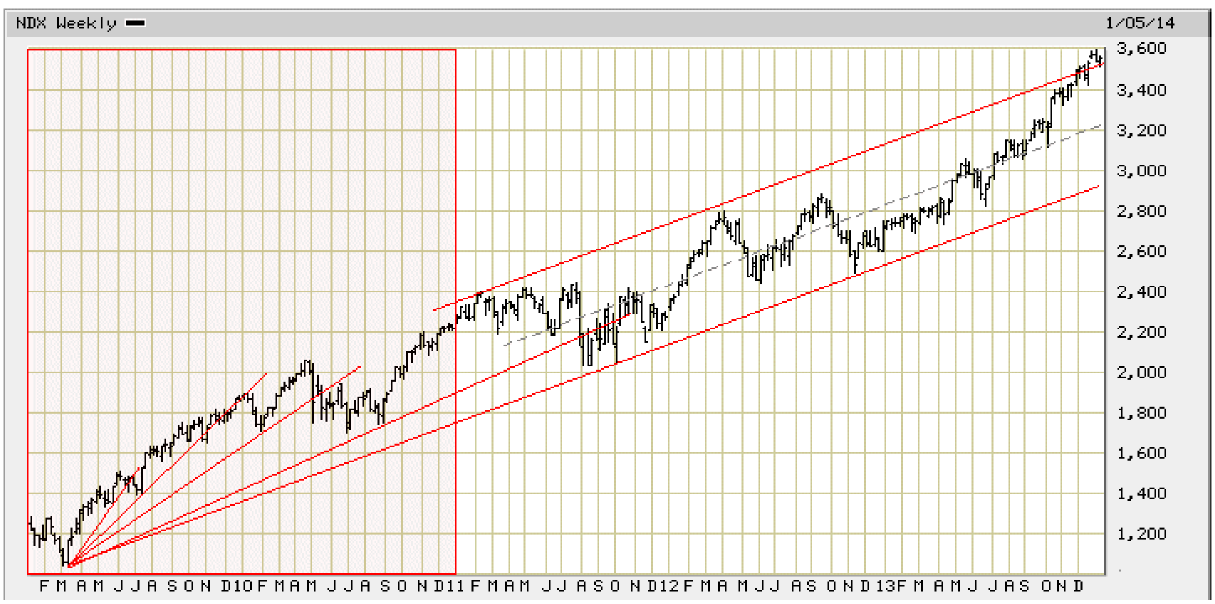
And that, at its most basic, after 8 pages of build-up, is it. Yes, judgement is often called for, and if one has been batted around by the market and has the bruises to show for it, he will be far more likely to exit at those breaks, and if he wants to grab five points and pat himself on the back, who's to say he shouldn't, whereas the beginner who may be a touch more fearless may find himself a bit more in tune with price than with fear and be willing to give price a little more room to pull back a little before continuing on its original course. If there is a pullback and continuation, he may have to "fan" his line a bit to cozy up to the line that's on the chart rather than the one that's in his head. But, yeah, that's pretty much it.

So what follows is a series of charts that are by now hindsight. But they will at least illustrate the lines and the retracements and the entries (the exits are always taken at a break of the line unless otherwise noted; you can't, after all, take the opposite side until you've exited whatever side you're in).

I chose hourly for this series because I encourage traders to use an interval they can follow in real time. It doesn't do much good to use a 1m bar interval if one is working or in class. An hourly isn't exactly a tick chart, but as long as one has reached an understanding of the continuity of price movement, it serves as an example. And one can cover more territory, time-wise. The process and the rules are identical regardless of bar interval.

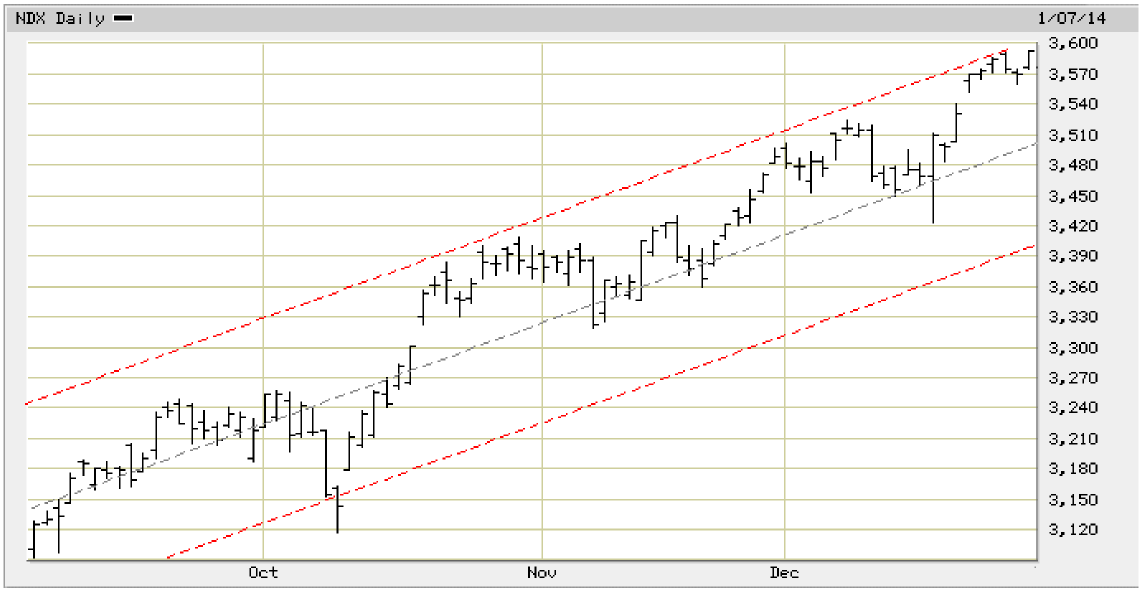
The first step is to determine the current trend of the market (Wyckoff)

The hourlies following are from December/January, so we'll use the same long-term chart we used earlier and cut closer to the chase:



The second step is to determine one's place in the current trend

If we zoom in on the last leg, from June '13, we see that price is having issues with 3600:



Yes, it may bust through the upper limit of the channel and begin an even more severe uptrend. But according to Auction Market Theory (later), it is more likely to visit at least the median of the channel, again, and perhaps even make it to the lower limit of the channel. But we don't have to concern ourselves with making a choice. All we have to do is draw lines and track the demand/supply imbalances.

The third step is to determine the proper timing of one's entry into whatever it is he's trading.

Next we zoom in to the very last of December, before the weekend. This chart represents in an hourly interval the last 12 days of the daily chart above:

Yes, the bigger picture implies weakness. But we don't have to make judgements. The demand lines are broken, which tells us that in this timeframe, 11 trading days, price is in fact weak, and we ought to be looking for a short. We get one in that first retracement. The short was exited on the 30th, due to a break in that fanned supply line, for a small gain. The job then is to wait for a retracement thereafter, regardless of whatever expectation we might have or have had toward weakness. That retracement takes place overnight, and a long is entered.

The fourth step is to manage the trade by monitoring the balance between buying pressure and selling pressure, exiting when the balance is no longer in your favor.

This is a zoom-in of the chart on the previous page with two extra days added. The same long is still there, but it's easier to see its particular context. Doubts about taking this long are easily understood since we're looking at the task of breaching that last swing high before our entry. But the requirements for a long are met, so we take it. When the trading session opens in NY, we head hellbent for leather to that last swing high and breach it, but fail to breach the next higher one. And we could exit there if we were to have drawn an extremely tight demand line. But we also have the option of finding the halfway point of that rally, which is where the dashed blue line has been drawn. If price can hold there, that rebound suggests strength. But when it then fails a second time to make a higher high, we are entirely justified in exiting the long. The market is not just telling us what to do; it's screaming at us. Even so, we can hold for a break of the demand line just like we're supposed to and exit for 5 or 6 points. Not a fortune. BUT NOT A LOSS. We then short the first retracement thereafter and ride that down. When the supply line is broken, we can exit, or we can see just how much strength the buyers have. As it turns out, not much. They can't even rally half of the downdraft (the dashed blue line again), so we stay in and see if we can make a lower low. We can, so we fan our supply line out to include that next swing high.

Price then breaks our new supply line and again we have to make a choice: exit the break and take the money or wait to see how strong the rally might be, not unlike "Let's Make A Deal" ("Do you want to take the car or Door #2?"). Here, though, we have three choices: exit at the break of the supply line, exit at a breach of the last swing high, or exit at a breach of the halfway point. For our purposes here, we'll assume that the trader relaxed and stayed in due to Auction Market Theory (again, later), which suggested that the line of least resistance was down, keeping in mind that even if he had exited, he'd've always had the option of getting back in.

On that next attempt, price just barely breaches the halfway point and immediately retreats. Nonetheless, one could have exited and then re-entered off that failure, which itself is a retracement. When price makes a lower low, the supply line can be fanned again, and when price retraces, the swing high holds well below the halfway point of the immediately-preceding downdraft.

In Conclusion

The straight line approach enables the trader to act confidently and decisively when price flashes a big red sign in his face that it's going to travel in a particular direction. If the trade turns out not to be worth much, this same approach gets him out of a potentially losing trade rather than let him hang. He may even wind up with a point or two. More importantly, HE WILL NOT SUFFER A LOSS, at least nothing of the magnitude that he's used to or that he fears. A few ticks. A couple of points. Bupkus.

The three-legged stool here, as I've said, is constructed of a thorough understanding of supply and demand, trending and ranging, and support and resistance. A surprisingly large number of people are absolutely convinced that they possess this understanding when in fact they haven't the least idea what support and resistance and trend and so forth are all about. But even if one has no idea what these three fundaments are, much less how to apply them, he can still turn a profit if he knows how to draw a straight line. Unfortunately, quite a few people can't do that either. These people ought to find some other way to trade. Or quit. Otherwise they will find themselves trading congestion, day after day, and getting chopped up in the process with no understanding of what wrong and blame the method ("another method that's all baloney, another scam, more snake oil").

Traders trade not the market but their perceptions of it. Drawing a straight line can help prevent the trader from wandering into that particular field of weeds. But, like the werewolf tied to the chair, eventually, if he wants to sabotage himself badly enough, he will find a way to do so. This may be beyond even the power of a straight line to cure.

A final note: those who are fearful will scatter like cockroaches at the flip of the lightswitch when price makes the slightest move against them. Even a tick. But the money is made by staying in the trade for as long as it generates a profit. Therefore, the trader should look for every excuse to stay in a trade, not to get out of it. This doesn't mean sitting there like a post when the trade is clearly going against you. But neither does it mean setting "targets" and exiting as soon as they're reached, nor freaking out for no other reason than price has tripped over its own feet and fallen to just the other side of a line.

This approach is by no means mechanical. It requires instead that the trader be continuously sensitive to the changing imbalances between supply and demand – or selling pressure and buying pressure – and act accordingly. Therefore, any break or countermove should not be cause for panic but for reassessment. Those who follow this approach will find it difficult to lose if they just pay attention and refuse to allow their egos and biases to prevent them from doing what's required.

Wyckoff and Auction Market Theory

The Box

Traders who have a lot to buy or a lot to unload will avoid trying to catch the tops and bottoms and focus on "the middle", since "the middle" is by definition where most of the trading is going on. However, since "the middle" is by definition largely non-directional, there is also a lot of whipsawing there, and that generates a lot of losing trades. One can sometimes avoid this by widening the stops, but, since the market always teaches us to do what will lose the most money, this will turn out to be an unproductive tactic.

The safest and generally most profitable trades are found at the extremes. Therefore, you wait for the extremes. Wyckoff used a combination of events to tell him when a wave was reaching its natural crest or trough: the selling/buying climaxes, the tests, higher lows/lower highs, and so on, all confirmed by what the volume (trading activity) was doing and by the effect this activity had on price. As a result of this work and of his exploration of trading ranges, he developed the concepts of support and resistance along with their practical application. **Auction Market Theory** (AMT) takes these investigations into support and resistance further, an "organic" definition of support and resistance like Wyckoff's, that is determined by traders' behavior, not by a calculation originating from one's head or from a website somewhere. Determine whether you are trending or "balancing" (ranging, consolidating, seeking equilibrium, etc.), determine the limits of the range (support and resistance), and you're in business.

The notion of support and resistance has been and is the missing piece for many market practitioners, the ignorance of it being the chief reason why the "2b", "1-2-3", "Ross Hook" and other "borrowed-from-Wyckoff" ideas so often fail. One can try to hit what appear at the time to be the important swings again and again and be stopped out again and again, like Dunnigan, hoping all the while that once one hits the true turning point, all the effort will turn out to have been worthwhile and the P&L will change from red to black. But by waiting for the extremes, one avoids most or all of those losing trades, and, even more important, avoids trading counter-trend. The "Darvas Box", which illustrates Wyckoff's notions of range, at least provides a graphic means of locating those extremes. What I've found most useful about them is that they are encapsulated by time, i.e., the price and volume ranges have a beginning and an end. This enables me to see at a glance where the important S&R are, or at least are likely to be. Without them, one ends up with line after line after line until the S/R plots become a parody of themselves.

All of this can be very confusing to someone who's learned to view the market in a different way, perhaps less so to someone who's just starting since he has so much less to unlearn. But backing up to the basic tenets of AMT, as well as to the concepts developed by – and in some cases originated by – Wyckoff, one can perhaps find a solid footing and proceed from there.

To begin with, in the market, price is often not the same as "value". In fact, one could say that since the process of "price discovery" is a search for value, they match only by coincidence, and then perhaps for only an instant. Blink and you missed it. Add to this the fact that for all intents and purposes there is no such thing as "value" but rather the perception of value. After all, what is the "value" of, say, Microsoft or GE or that little stock your stylist told you about? This state of affairs may seem like a recipe for chaos, but it is in fact the basis for making a market, that is, reconciling the differences – sometimes extraordinarily wide differences – in perceptions of value.

As Wyckoff put it, if a stock (or whatever) is thought to be below "value" and a trader or group of traders see a large potential for profit ahead, he/they will buy all they can at or near the current level, preferably on "reactions" (or pullbacks or retracements), so they don't overpay. If the stock is above what they perceive to be value, they'll sell it (or short it), supporting the price on those pullbacks and unloading the stock on rallies until they are out (or as much out as they can be before the thing begins its downward slide). "This", he writes, "is why these supporting levels and the levels of resistance (a phrase originated by me [Wyckoff] many years ago), are so important for you to watch." When price then begins to lose momentum and move in a generally sideways direction, you've found "value" (if value hasn't been found, then price won't stop advancing or declining until it has). Value, then, becomes that area where most of the trades have been or are taking place, where most traders agree on price. Price shifts from a state of trending to a state of balancing (or consolidation or ranging), the only two states available to it.

The trading opportunities come (a) when price is away from value and (b) when price decides to shed its skin and move on to some other value level (that is, there's a change in demand, either more of it or less). This is also where it gets tricky, partly because demand is ever-changing, partly because you've got multiple levels of support and resistance to deal with and partly because we trade in so many different intervals, from monthly to one-tick. If we all used daily charts exclusively, it would all be much simpler, though not necessarily easier. But that's not the case, so we must remember always that a trend in one interval, say hourly, may be a consolidation in another, such as daily. The hourly may be balancing, but there are trends galore in the 5m chart. Or the 5s chart. Or the tick chart. Regardless of how one chooses to display these intervals – line, bar, dot, candle, histogram, etc – there are multiple trends and consolidations going on simultaneously in all possible intervals, even if they're in the same timeframe, even if that timeframe is only one day (to describe this ebb and flow, Wyckoff used an ocean analogy: currents, waves, eddies, flows, tides). If the trader becomes confused by all this to the extent that he is well into the weeds, he should keep in mind that all charts, at bottom, are tick charts, i.e., price moves in ticks, not bars or candles or whatever. What most traders choose to do is view summaries of ticks, whether in 1m bars or 5m or 7m or 26m or 48m ad infinitum. None of this changes the fact that price moves in ticks, and charts are displays of one sort or another of ticks. What is of more practical importance to the trader is an awareness that as price moves up and down, he will be trading with different "classes" of traders. When price makes a new daily high, for example, those traders who trade daily bars will be aware of it and will act according to their own lights, whereas they may pay no attention whatsoever to what price is doing in the 15m bar realm. This is why breaks through the previous day's or week's high or low can be so forceful: not only are different groups entering the fray, but there are more of them. The trick is to hitch your wagon to one of their stars.

To sum up where we are so far, and keeping in mind that there is no universally-agreed-upon auction market theory, the following elements are, to me, basic, and are consistent with what I've learned from Wyckoff et al:

1) An auction market's structure is continuously evolving, being revalued; future price levels are not predictable.

2) An auction market is in one of two conditions: balancing or trending.

3) Traders seek value; value is price over time; price is arrived at by

negotiation between buyers and sellers.

4) Change in demand drives change in price.

5) One can expect to find support where the most substantial buying has occurred in the past and resistance* where the most substantial selling has occurred. This does not mean that anyone who bought at a particular price at some point in the past still holds what he bought. In fact, no one who is viewing this past activity may have been part of it at all. But anyone who looks at it in whatever form will see the obvious level of interest overall as well as those price levels where interest was most intense. Whether or not this intense interest will reoccur is unknowable, but the preconditions for unusual activity are there.

I'm sure everyone has noticed that swing highs and lows and the previous days' highs and lows and other /\ and \/ formations can serve as turning points and appear to act as resistance. However, this type of resistance stems from an inability to find a trade and is accompanied by low volume. Price then reverts to an area where the trader finds it easier to close that trade. "Resistance" in this sense, then, refers to resistance to a continuation of the move, whether up or down, because there's nobody there to trade with.*

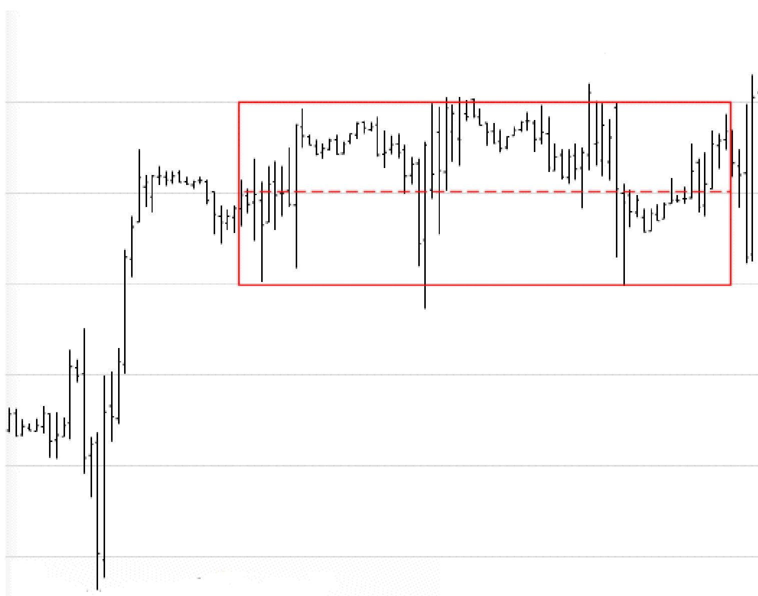
***Volume may look "big" at the highs and lows, but the price points are vertical, not horizontal (as they would be in a consolidation), so the volume – or trading activity – at each price point is less than it would be if the same price were hit repeatedly, as it would be in a consolidation.*

So how does one trade all this?

First, find a range, preferably one with an easily determinable upper and lower limit.

Second, determine where price is within that range.

Third, locate the extremes. If you have a range that is wide enough for you to trade (that is, there are enough points from top to bottom to make a trade worthwhile) and price is at the bottom of that range, there is a good possibility for a long. If price is at the top of the range, there is a good possibility for a short (note that a trend channel is also a range, with a mean/median; it just happens to be diagonal).



At this point, you have three options: a **reversal**, a **breakout**, or a **retracement**. If, for example, price bounces off or launches itself off the bottom of the range (support), trade the reversal and go long. If instead it falls through support, short the breakout (or breakdown, if you prefer). If you don't catch the breakout, or you prefer to wait in order to determine whether or not the breakout was "real", prepare yourself to short whatever retracement there may be to what had been support and may now be resistance.

A more boring alternative is that price is nowhere near the top or bottom of any range that you can find but rather drifting up and down, aimlessly. No change is occurring; therefore, there is no trade, or at least no compelling trade. Finding the midpoint of the range – where the largest number of trades are occurring – may be useful since price sometimes ricochets off the midpoint, or launches itself off the midpoint if it has settled there. Such actions represent change since price may be looking for a different value level. It may come to a screeching halt and reverse when it gets to one side or the other of the range and return to the midpoint, or it may launch itself through in breakout form and extend itself into the next range, if there is one, or create a new range above or below the previous range (in determining which, zoom out in order to determine whether or not price is in a wider range that is outside your view, i.e., back away from the tree a bit and take a look at the forest). Or it may reverse off one side, break through the other, and begin trending. When all is said and done, however, the most profitable alternative, boring or not, may well be to do nothing, i.e., just stand aside attentively until one extreme or the other is approached and a more attractive trading opportunity presents itself. If one is patient, the market will eventually show its hand and tell the trader what to do.

Crib Notes

1. Determine the current **trend** of the market (Wyckoff), weekly then daily.
2. Determine your place in the current trend.
3. Determine the proper timing of your entry into whatever you're trading.
   a. Find a **range**, preferably one with an easily determinable upper and lower limit.
   b. Determine where price is within that range.
   c. Locate the extremes (support and resistance).
   d. Short **reversals** off the upper limit; buy reversals off the lower limit.
   e. When breaks out of the range, either trade the **breakout** or wait for and trade the **retracement**.
   f. Track the balances between supply and demand.
   g. When the trend or "stride" is broken, exit and wait for a retracement in the opposite direction.
   h. Continue until you enter **chop** (two consecutive buy/sell or sell/buy trades that don't go anywhere and are accompanied by a higher low and a lower high, i.e., not trending).
   i. When price exits the chop (which may become a range), resume trading the trend.

GLOSSARY

Breakout: BO. A breakout is not just a matter of a price exceeding a previous price level. Price must break *out of* something, most often a trading range. There are three strategies: breakouts, reversals, and retracements.

Climax: A major buying or selling panic that occurs at the end of a steep increase or decline in prices

Demand: Buying power, buying pressure.

Demand Line: DL. That line which passes through two successive swing lows.

Last Swing High/Low: LSH/LSL. A swing high or low represents a point at which traders are no longer able to find trades. Whether that point represents important support or resistance will be seen the next time traders push price in that direction. But everyone knows this point, even if they aren't following a chart. It exists independently of the trader and his lines and charts and indicators and displays. It is the point beyond which price could not go. Hence its importance, both to those who want to see price move higher (or lower) and those who don't.

Price movement (price action, price behavior): PA. The continuous tick-by-tick (transaction-by-transaction) movement of price as shown on the tape (or on a corresponding chart).

Resistance: An area where selling pressure overwhelms buying pressure. More specifically, resistance is the zone or level at which those who have enough money to make a difference attempt to retard, halt, and reverse a rise by selling.

Retracement: RET. The first pullback after a break through support or resistance or a V reversal and the second opportunity (the first being the break or reversal itself) to enter the trade. If price does not resume its course, the "retracement" becomes a failed breakout or a retracement after a reversal that never was.

Reversal: REV. A bounce off of or rejection of the upper or lower limit of a trading range. Also the result of a buying or selling climax.

Scratch: To exit a trade if the market does something that proves your initial decision to enter the trade was wrong.

Supply: Selling power, selling pressure.

Supply Line: SL. That line which passes through two successive swing highs.

Support: An area where buying pressure overwhelms selling pressure. More specifically, support is the zone or level at which those who have enough money to make a difference are willing to show their support by retarding, halting, and reversing the decline by buying.

Tape: A thin strip of paper on which is printed a series of stock symbols, each print representing a transaction in that stock and consisting of the price at which the transaction took place and the volume of shares changing hands. Modern day equivalents are the "time-and-sales window" and the one-tick chart.

Tape Reading: The art of determining the immediate course or trend of prices from the action of the market as it appears on the tape.

Trading Range: TR. A period of balance between buyers and sellers. Prices move within a range where the bottom represents demand and the top represents supply.

Trend: The line of least resistance (LOLR).

Trendlines: TL. Straight lines drawn through the tops or bottoms of the price path established during an upward climb or downward pitch. They "serve to define the stride of the price movement, thereby frequently directing our attention either to possibilities of an approaching change of trend or to an actual reversal." (Wyckoff*)

Volume: Number of units changing hands in each transaction.

**Richard Wyckoff (1873-1934) was a pioneer of technical analysis. While Dow contributed the theory that price moves in a series of trends and reactions, and Schabacker classified those movements into chart patterns, developed gap theory, and stressed the role of trader behavior in the development of patterns and support/resistance, Wyckoff contributed the study of the relationship between volume and price movement to detect imbalances between supply and demand, which in turn provided clues to direction and potential turning points. By also studying the dynamics of consolidations or horizontal movements, he was able to offer a complete market cycle of accumulation, mark-up, distribution, and mark-down, which was in large part the result of shifts in ownership between retail traders and professional money.*

Wyckoff sought to develop a comprehensive trading system which (a) focused on those markets and stocks that were "on the springboard" for significant moves, (b) initiated entries at those points which offered the highest probability of success, and (c) exited the positions at the most advantageous time, all with the least possible degree of risk[1]. His favorite metaphor for the markets and market action was water: waves, currents, eddies, rapids, ebb and flow. He did not view the market as a battlefield nor traders as combatants. He counseled the trader to analyze the waves, determine the current, "go with the flow", much like a sailor. He thus encouraged the trader to find his entry using smaller "waves", then, as the current picked him up, ride the current through the larger waves to the natural culmination of the move, even to the extent of pressing one's advantage, or "pyramiding", as opposed to cutting profits short, or "scalping".

<u>Continuity of Price</u>*: Wyckoff began as a tape reader. By the time he incorporated daily charts into his trading, the continuity of price movement via the tape, tick by tick, had become so ingrained that he could see price no other way. Even though he might be looking at a series of daily bars on an end-of-day chart, he saw price as continuous. Thus the bar itself was irrelevant to him, and he was just as comfortable using line charts as bar charts. The line chart, in fact, more closely conforms to this continuity.*

<u>"Setups"</u>*: There are no "setups" in Wyckoff, at least insofar as we commonly use the term. He did not say that if price does this, you buy and if price does that, you short. Rather he stressed that the trader must be sensitive to imbalances in buying pressure and selling pressure, particular at levels where these imbalances might most likely result in profit opportunities, e.g., reversals. Therefore, the "trading signal" is not, for example, a "double bottom" or a "higher low" or a "climax bottom"; the trading signal is provided by the imbalances between buying pressure and selling pressure, and if one does not view price as a continuous movement and is not sensitive to these continuous shifts in balance/imbalance, he will not understand what it is that he's supposed to do.*

[1]Risk is minimized by (1) focusing on liquid markets, (2) monitoring the imbalances between buying pressure and selling pressure at those levels of "support" or "resistance" where price is most likely to reverse its trend, (3)

entering on reversals (or, if necessary, retracements) rather than breakouts, and (4) getting out when the market tells you to.

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