



Straight Line Approach, The 1



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Straight Line Approach, The

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 has been a particularly interesting week (ending 020714), one of the reasons why I decided to put this together now, since I am able to show you just about everything you need to know to trade price profitably, without relying too much on hindsight. Any sort of review at all is of course by definition "hindsight", and this hindsight begins 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 extraneous 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

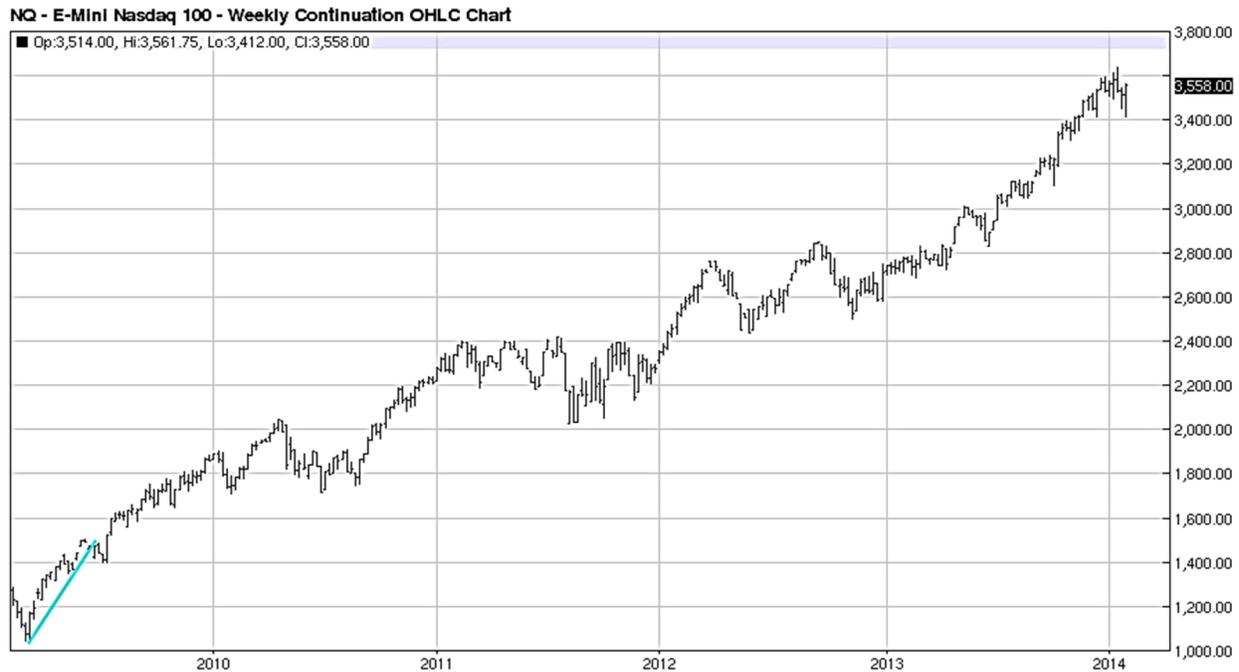
The Trendline

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.

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 trendline would have looked like this at the time (note that this is a daily chart while our master is weekly, thus the slight shift in the line):



The Weekly Chart So, the first line is drawn under the first two swing lows. That's your trend/demand line *at the time* (see above):



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 (see next page).

NQ - E-Mini Nasdaq 100 - Weekly Continuation OHLC Chart



And ditto here:

NQ - E-Mini Nasdaq 100 - Weekly Continuation OHLC Chart



And ditto here:

NQ - E-Mini Nasdaq 100 - Weekly Continuation OHLC Chart



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 "V" or "\/" reversal). This particular "softening" took almost three years:

NQ - E-Mini Nasdaq 100 - Weekly Continuation OHLC Chart



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.



Traders then, having rested for over a year, began to depart from the lower limit of the trend channel. Or at least they appeared to do so. And here is where the difference between a demand line and a trendline may be made a bit clearer. Here you have what appears to be a departure from the trendline but you really won't know until price exits through the upper limit and fails to make the return trip to the lower limit. So, you leave the trend channel in place and draw a tentative demand line underneath what is/was at the time the upslope of price.

NQ - E-Mini Nasdaq 100 - Weekly Continuation OHLC Chart



Still with me?

When price then works its way through the mean and you've got two new swing lows, you can draw a new demand line. If price falls through this and seeks the lower limit of the long-term trendline again, fine. That's unknowable. In the meantime, you can keep track of demand so that you're not surprised by something unforeseen.

NQ - E-Mini Nasdaq 100 - Weekly Continuation OHLC Chart



When price then works its way through the upper limit of the trend channel, it's time to draw a parallel supply line, though this could also have been done against any of the demand lines on the way to this point, one little trend channel after another.

NQ - E-Mini Nasdaq 100 - Weekly Continuation OHLC Chart



We see now that the angle of ascent has not only become more severe but that the NQ has exited, temporarily, the upper limit of the trend channel. What this means in terms of whatever entry one needs to make at the opening bell will be addressed later. For now it's enough to know the context of all that's going on in the daily charts. And that you need update the weekly maybe once a month or even less. It's not something you have to do every day.

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:



The upper limit of the trend channel was tested many times over three months, so there's no way to time the big plunge. Assuming we'd never seen this before, we know now that it did plunge and that it rode the mean for a week. After that, it dropped to and tested the lower limit of the trend channel.

Now what?

This is the chart we're looking at while we prepare for the next trading session. We may have studied it the night before, which is likely, or we may have waited until the morning thereof. In either case, we can see what happened in more detail with regard to the interplay between buyers and sellers as price worked its way down toward the lower limit of the trend channel. We can also see how the bounce unfolded.

The Continuity of Price

And now 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 illustrate 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.

On Your Mark, Get Set . . .

And now back to the morning of the 6th. We already know that price bounced off the lower limit of the trend channel, either because we saw the above chart or because we were there. Either way, we want to know **how** price hit and bounced off that limit. We can see that there was a hell of a plunge on Monday, but before the market opens the next day, we can find the midpoint of that plunge, which turns out to be around 3470. When price reverses there, we can begin thinking that maybe we have a little trend channel shaping up here, and when we get that climactic drop the next day which not only tests the Monday low but snaps back above the long-term trend channel (the dashed lines), our tentative trend channel is confirmed and we can draw it in, along with a mean.



(A Word About This Trend Channel. Some of you will note that this trend channel is completely illegal. The lower limit does not begin with the swing low, at 3480, between the first two swing highs. Instead it's drawn below a much later swing low, on the 3rd. But the clever will realize that there are or had been other trend channels preceding this one, such as the one immediately preceding, with the first swing high at 3545. But to get into that would mean at least three more charts and the accompanying explanations and they really aren't relevant at this point and I'm sure everyone would like to get on with it. So . . .)

We can also see, 3½ hrs before the NY open (these charts are MtnTime; sorry), that price has worked its up and through the upper limit of this little channel, and while ordinarily this would call for a reversal and a short, price just bounced off the lower limit of a **four-year trend channel**. Though one has to be prepared for anything, the circumstances surrounding this bounce shift the probabilities to a move further upward, perhaps to the mean of that four-year channel (see Auction Market Theory, later, p. 30). If we check in a couple of hours later, we find this (next page):



Buyers clearly have a tiger in their tank, and while it's always possible that they will have a major fail, the probabilities, for all the reasons previously stated, favor the upside, and if one turns out to be wrong in his analysis, the demand/supply lines he draws will keep him on the right side of whatever direction price takes.

As it turns out, price did in fact make it all the way to that midpoint plus a little more, reaching 3560 before shutting down for the weekend.

So much for context and for zooming in out of the monthly to the weekly to the daily to the hourly to the moment of truth, when one has to look for an entry into this. Now it becomes a matter of knowing what to look for and waiting until one sees it. Which is where the lines come in. Unfortunately, I can't go much further with this because I don't know how it will turn out. I suspect that price will go all the way to the previous high, but whether it will reach the top of the trend channel or not is another matter because the high was outside the channel to begin with. Are there enough buyers to propel price not only to the last swing high but to a higher high and the upper limit of the long-term trend channel? Stay tuned.

. . . Go!

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.
2. When price takes off in one direction or the other, wait for a retracement.
3. Enter on that retracement, a few ticks above the trough of a \vee retracement or a few ticks below the crest of a \wedge retracement, and stay in until your line is broken. And by "broken" I don't mean that price 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 13 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, whereas the beginner who may be a touch more fearless may find himself a bit more in tune with price than with fear and will 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.

I've annotated hindsight charts which don't accomplish much because one glance tells you how it all came out and how hard is that? Yes, one can learn what to look for that way, but it's not the same thing. So I have also done series of charts in real time to show what to look for and what to do when one doesn't know what's going to happen next. Unfortunately, the winrate is so high (around 80%) and the profit:loss ratio is so high (never mind) that nobody buys it. The thing is, though, that if one knows the plan and one knows the rules, he can recreate the trading sequences himself. And people have. And they've come extremely close to the same entries and exits that I took. It's not like there's a whole lot of wiggle room.

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). You can figure out the profit:loss ratio yourself.

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



It looks like the sky's the limit, but if one completes the trend channel for that last 3-month segment, he can detect weakness by the departure from the long-term supply line (next).

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



Here we see from the departure from the upper limit of the long-term channel that this rocket may be running out of fuel. Yes, it may rally and even hit the upper limit again. If so, price will have broken that tentative supply line on what may or may not be a new trend channel and we go long. But we don't have to concern ourselves with that now. 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 days, price is in fact weak, and we ought to be looking for a short. We get one in that first retracement, but I'm not showing it here because I wanted this series to begin the new year, on Jan 1. So I fudged. Shoot me. One can see, though, that a short would have been 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 bias 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 fail to breach it. 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 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, keeping in mind that even if he had exited, there's always 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 below the halfway point of the immediately preceding downdraft.

After the market opens on the 6th, price spends the day forming a hinge, or coil:



The coil – or hinge – represents – or can – an energy compression. The difference between what sellers are seeking as value and what buyers are seeking as value gets narrower and narrower. If this doesn't go on too long, this compression will result in a substantial and sometimes explosive move out of this coil ("coil" implies a readying to spring).

As you can see, buyers have been able to push price up to the upper limit of the coil. Sellers can be expected to push it down toward the lower limit (this is all part of the exploration process to "feel each other out").

If price has not broken out to one side or the other by the time the coil is nearly complete, it is more likely to do little more than dribble out the end and move sideways until somebody gives somebody a hot foot and price takes off again into parts unknown. This listlessness occurs because traders have given up their efforts to make something happen, for whatever reason, and are focusing instead on their Danish. Why they've given up is less important than the fact of it, and that can be determined by the price movement. Or lack of it. This goes on here for six hours before buyers move to test that supply line.



And they not only test it, they break it, so we go long on the first retracement thereafter. The fact that price can rally to and through and hold above the halfway point is encouraging.



Self-explanatory, I hope.



These lines may need some explanation. Once price goes as far as it can, rolls over, and breaks the demand line, a short is taken at the first retracement. Price then rallies, breaking the new supply line as well as the last swing high – which happens to be at the same level as the top of that brief trading range where the arrow line is begun – and the halfway point, not drawn, but which is on the same level as those arrows. So there's really no wiggle room here. You have to exit. The first retracement thereafter provides the long, or, if you prefer, re-entry.



This one is a trick chart. But before we get to that, I want to point out the "retracement" that is noted by the arrow. Some traders have all sorts of bar intervals plotted on their screens, but unless you're watching a tick chart, you can see what price is doing, if you're actually watching the screen, by following the righthand tick on each bar. Here, after price reached what would become the high of the bar, it retraced, as you can see. So if you happen to be there at the right time, it's perfectly okay to consider that a "retracement" for a long entry. It is, after all. All one has to do is look at a smaller bar interval to see it. Point is, you don't have to take up extra real estate in your display to accommodate another chart.

As for the trick. Everything is cool here, done just like it's supposed to be done, but there is also a caution. If you'll look at the two swing highs and the two swing lows, you may see what looks like a very-short-term trend channel. That puts that last short just above the mean of it, which suggests a move upward. However, if one is following the rules, one has to take this. As Douglas says, "anything can happen" but "you don't have to know what's going to happen next in order to make money". If you happen to notice that undrawn trend channel, you can be prepared for an event other than a drop.



Here's the same chart without all the extraneous lines but with the trend channel drawn in along with the short just taken. Notice that price does rally, just as can be expected – though not guaranteed – by holding above that mean. But if one is alert and sees that channel, he can enter the reversal which one can expect during a test of the limit of a trend channel. Unfortunately, if he isn't alert, he'll lose about 6 pts on that short and won't find an opportunity to participate in what was one hell of a dramatic fall.



The recoil is easier to play because of the SLA setup: first retracement after a break of the supply line. The blue dot here is where I exited, not because the demand line was broken but because it rose all the way back to that upper-limit trendline. And it did it fast. And it was late in the day. So I took it. Shoot me.

Price obviously continues to rise and eventually breaks an undrawn demand line (surely one can see that price is rising), providing a short op at the first retracement. This doesn't result in much, maybe even a small loss. After that is a retracement which provides an op for a long, undrawn. That's stopped out quickly (for an hourly chart), and the short off the first retracement after the break of the supply line, also undrawn, is also stopped out pretty quickly. This tells you you're in chop, and you need to back off until you get out of it. By this time, you can draw the upper and lower limits of the trading range you may not have noticed.

The next opportunity, though, does better. An interesting facet of coils/hinges is that they nearly always provide a clean entry if one pays attention to the midpoint or apex of them. They very often make fake moves out one side before returning to the hinge – usually the apex – and then making their real move out the other side (some would think that this is some sort of conspiracy, running stops and so forth, but all it means is an effort to find buyers or sellers out one side and, failing to find them, fishing for them out the other side). If they don't make a move in the opposite direction, an entry off the retracement to that apex is perfectly okay. If price takes off in the opposite direction, the entrystop generally

isn't triggered, so the risk is minimal to non-existent. If this in fact occurs, one can then enter a retracement off the move out the opposite side. This is a lot easier in real time than it sounds in the explanation, but if one doesn't want to futz with any of this, he can just wait until everybody decides just what it is they want to do and then enter the first retracement thereafter.



This short works out pretty well, providing 8pts by the time the supply line is broken, and the long entry is very clean. In fact, one could have drawn a tighter supply line and gone long at 3585 after the double bottom at 3578. Trader's choice.



All this should be self-explanatory except for that NT, which means "not triggered", i.e., the short that would ordinarily have been taken there wasn't triggered, so no entry, no loss. Instead, price reaches the last swing high and retraces a bit before continuing upward. The same scenario could have unfolded here, i.e., a failure to continue the move upward would have resulted in an untriggered entristop and, again, no loss.

And, finally, the last:



The long is stopped out after the demand line is broken at 3620, and the short is taken off the first retracement thereafter.

This was one hell of a three-week arc, but you just never know. That's what's challenging but also fun about real-time trading: to paraphrase Douglas, you never really know what's going to happen. But you can determine the probabilities.

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, trend, 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 fundamentals 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's 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 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). 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.

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 \wedge and \vee 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.*

***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.

At this point, you have three options: a **reversal**, a **breakout**, or a **retacement**. 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. 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.

The Trend Channel

Applying AMT to trend channels is tricky. Yes, trend channels are ranges. If they weren't, they wouldn't be channels. However, they aren't the result of just taking a lateral trading range or "box" and tilting it. For one thing, the volume dynamic is different. The greatest amount of volume in a lateral trading range is in the middle. That's how the "middle" is defined. If the greatest amount of volume were someplace else, so would be the middle. One could argue, in fact, that the characteristic box is defined not by its limits but (a) by its middle and (b) by how far price travels from one side of it to the other. In any case, as price moves back and forth from one extreme of the range to the other, the transactions in the middle pile up because that's where price spends the most time. If one then has a lot to buy or to unload, he looks toward the middle, as explained in the first part of this piece, since that's where the bulk of trading is taking place (and if anyone has noticed a potential Chicken Or The Egg Conundrum at this point, no, I don't want to get into it here; in practice, it doesn't matter anyway).

If one thinks instead of the middle of the trading range as the mean, many of the difficulties one might have in wrapping his mind around the whole idea of applying AMT to trading ranges may evaporate, or at least lift, since trend channels also have means. Even the sloppy ones. And price tends to revert to the mean, along with the traders it's saddled with. This is called "mean reversion", and there are sound behavioral reasons for it which I have no intention of getting into here since this is not a monograph. Suffice it to say that even in – or particularly in – a rising market, at least some people will say to themselves that they've made an awful lot of money in whatever and maybe it's time to act like a grown-up and sell some of it while others, for whatever reasons, think prices are just too damn high and stop buying. Prices will then fall, at least to the mean, or "home". Sometimes they'll go past that, particularly if the advance has been a bit too "exuberant". If the downdraft gets out of hand, price may travel all the way to the other extreme of the channel at which point traders will think Hey!, this is a pretty attractive price here; let's buy some of this. And price rises. It does not usually, however, rise all the way to the opposite extreme that it just left in one fell swoop. More often it stops off at the mean, gets out of the car, uses the restroom, has a Coke, walks the dog. The same dynamic applies to a falling market, which is why it eventually stops falling.

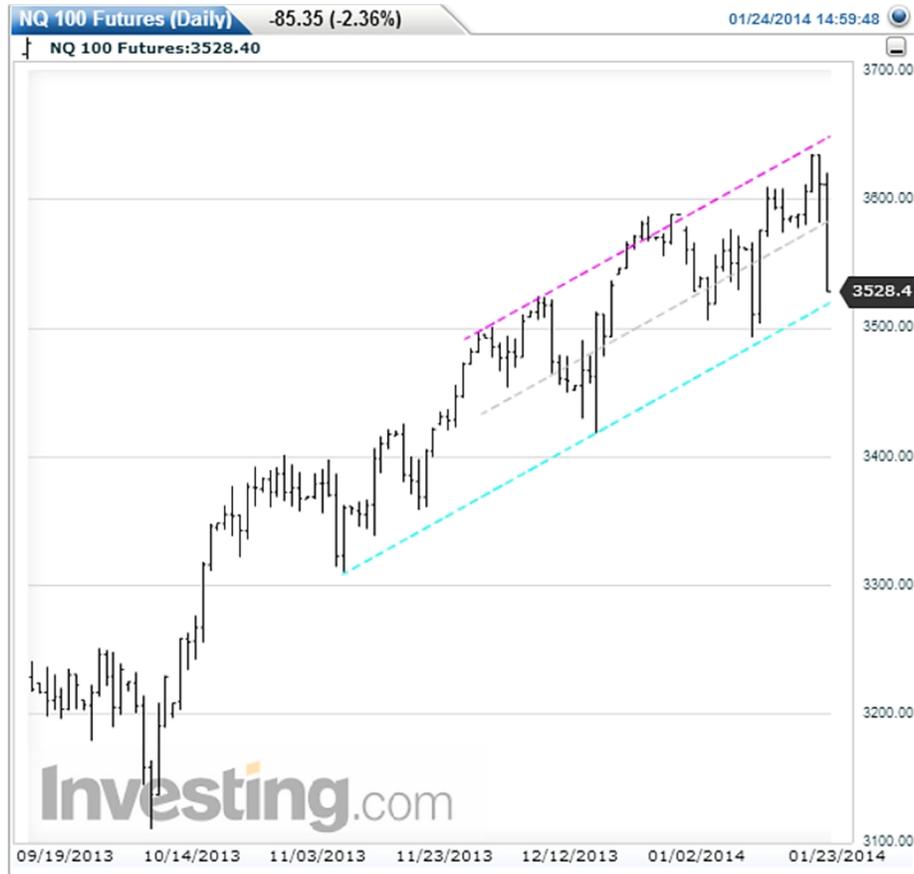
The attentive reader may have noticed by now that one's ability to make use of this information depends largely – or entirely – on his ability to draw a trend channel. Many cannot do this. However, if one can at least tell whether price is going up or down and enclose this movement in something resembling a PVC conduit, then he is at least on the right track. If he continues to have difficulty and he has or has access to a child under the age of 10, let him do it. He should have no difficulty in doing so, particularly if he has some experience with Chutes And Ladders. If the trader then draws a line down the middle of this channel, a line that is equidistant from the two sides, he will have his mean and can then begin making prognostications about price movements and Amaze His Friends (depending on how easily his friends are amazed).

On the next pages are examples of some recent trend channels, or at least recent as of 01/24/14. They may be helpful. Or not. But at least they're free.



When initiating your trend line, begin with the first two swing lows, here the first point, then "1". As the trend runs its course, "fan" your line down to include new swing lows ("2") if and when price makes higher swing highs. Otherwise, your line will begin to cut through the price course and become useless (if price does not make higher highs and your line does cut through price's course, then you have a signal of a potential change in that course; a more complete discussion is provided on p. 6). The next fanning takes place when swing low "3" is made.

Note that if your trendline isn't within a country mile of the price course, then you're doing it wrong. The whole point of a trendline is to track the trend. If it isn't doing that, it serves no purpose.



Once you have your lower line, draw a parallel line beginning with the first swing high between the first and second swing lows used by your trendline. Draw a mean equidistant between these two lines.



And, finally, an example of how price can react to a mean.

It might be instructive at this point to look at how we got to this day from the beginning of the trend five years ago.

As explained earlier, one begins with the swing lows and plots his trendlines and, if it all works out that way, his trend channel with the information that he has available to him at the time. Once he's plotted these lines, he will most likely find that price escapes them either to the upside or downside from time to time. This in itself is not cause for concern.

However, when price penetrates one trendline or the other, in this case the upper trendline, and doesn't come anywhere near returning to the lower, one must be alert to the possibility that traders are seeking new value and a new value area, again as explained earlier.

Note here, for example, how price lifts off the lower trendline in August '11 (B) and never looks back. And though it doesn't actually leave the channel until June '13 (D), it never even drops below the mean during this period.



One need not wait for these breakthroughs, however, in order to track the course of price and be alert to changes that may affect either current or future trades and investments. Here, for example, we can begin at "B" to anticipate the future course of price by adding an upper trendline and a mean to the lower trendline which we plotted in the chart above (the letters in these charts all correspond to the same price/time points throughout):



(And a note here about the seeming ill-fit of this trend channel. Those who aren't familiar with the function and purpose of trendlines and trend channels will alter them – either by changing their angles or raising or lower them – in order to force them to more closely conform to price, in the manner of the Prince trying to fit the glass slipper onto the wicked stepsister's foot.

But that's not what trendlines/channels are for. By drawing them in this manner, unusual price activity alerts the trader – if he's paying attention – to possible important changes in the course of price. Here, price becomes "overbought" in March, which means that buyers are paying a price that is too high – too far away from the mean – even to them. They therefore lighten up, and price falls. That price does so again just six months later is a testament to the short-term memory of traders, though the break above the trendline is less severe this time. After that, it behaves, at least until "E", which comes as no surprise since traders have twice driven price outside the channel. This time however, there hasn't been a return visit to the lower trendline for months. Not even the mean. All of this signals a potential search for new value and a change in the course of price.)

Here we skip ahead to save time and plot a complete trend channel off "D":



The very end of this chart, just after "E", may be found in daily form on p. 36 (4p back). For trading purposes at that time, it was decided to "zoom in" to the activity taking place between the mean and the upper trendline since there was nothing taking place below. The mean in the chart above therefore became the lower trendline for the trend channel posted on p. 3, and a new mean was drawn for the new channel.

Where price will go from here is anybody's guess. It may continue to fall to the lower trendline illustrated above, or it may bounce here and make a return trip to the upper limit. The trader who is prepared for both will profit.

When Worlds Collide

Occasionally one will come across a situation in which the world of the box and the world of the channel merge, and while trading these can seem like rubbing one's stomach and patting one's head at the same, monitoring both will provide more trading opportunities – sometimes dramatic opportunities – than choosing one over the other.

Here, for example, one can see that price has been in an uptrend. It's been in no rush and appears to be in the midst of a trend change. Whether it is or not, it is making lengthy

sideways movements to the extent that trading ranges are formed, with clearly delineated upper and lower limits. Keeping both the diagonal and the lateral in one's sights may require more attention, but the rewards are numerous (not all opportunities are annotated):



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 risk¹. 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".

Continuity of Price: 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.

"Setups": 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.

¹Risk 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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Appendix A: The Hinge

A **hinge** is a trading range that's tired of screwing around. While price in a trading range will bounce up and down in search of **equilibrium** with no particular timetable in mind, price in a hinge conducts that search more seriously, giving itself a deadline, i.e., that point – the apex – where the diagonal lines meet. Hinges are created by **successive lower highs and higher lows** and represent a **tightening and compression**. If interest is sufficient, this compression will eventually lead to a worthwhile move (if it isn't, price may simply dribble off into nothing worth bothering with). As Schabacker wrote, these hinges or coils should be "**filled with price**", that is, there is no aimless drift but a struggle between those who want to move price ahead and those who don't. Therefore, price should bounce in an ever-tightening range which culminates in a release of **pent-up energy** and a tradeable move. This tightening and compression leading, typically, to this release is why many people call this a "coil". A particularly attractive feature of the hinge is that it's so easy to recognize in real time: as soon as you note a higher low and a lower high (or vice-versa), be on the lookout. A hinge may be on the horizon.

Genuine hinges – those which form as the result of successive negotiations between buyers and sellers to find equilibrium – share common characteristics and can therefore be traded in much the same way. If shorting what appears in real time to be a downside breakout through the demand line, keep a tight stop. If it doesn't go, you're out at breakeven. If price returns to the midpoint, one can place a sellstop below this activity so that one can be stopped in on a second attempt at a decline. If none of that goes, one can sell a break of the supply line, again with a tight stop. If he is again stopped out but the return to the midpoint turns out to be a test, he can place a buystop above this test and be stopped in on a second attempt at an advance.

For example:



The dynamics of this endgame are not difficult to understand. The hinge, after all, is created because of differences of opinion. That this testing should continue once one side or the other pushes price out of the hinge should not come as a surprise. But clearly one has to be quick on one's feet to avoid getting trampled.

Many beginning traders – and many not-so-beginning traders – have trouble trading this because they think that the market, or the "big" money, or the "smart" money, is out to get them, to trick them. It never occurs to them that neither the market nor the big/smart money could care less about them. Therefore they are forever looking out for the trick, the trap, the gotcha, and are thus guarding themselves against a threat that doesn't exist, making all the wrong decisions at the wrong times.

It's really just a matter of looking for trades, which is after all the business of trading. If traders can find trades out of the bottom of a trading range, great. If there are none, traders will search for trades out of the top of the range. This doesn't mean that anybody "tricked" anybody into selling the breakdown. It means only that there was no business there. This is also why first exits from hinges are so often in the opposite direction from the ultimate move. Knowing this gives the trader the confidence to reverse his position. And, yes, sometimes there are no trades out of the opposite side, either. Then everybody returns to their corners and futzes around inside the range for a while, and the "price action" trader is standing aside, waiting for everybody to decide what they want to do. Quite often what they want to do is go to lunch.

There are, of course, many hinges without drama. They more closely resemble rest stops than combat zones. In these cases, everyone decides after discussion and negotiation that they want to go up:



Then there are those which require very little discussion and even less negotiation. Long before the hinge completes itself, most decide they want to go down. Buyers may give it the old college try after exiting the hinge, but they have too much trouble pushing their way back inside the hinge and beat a reluctant retreat. After all, it's Friday afternoon and everyone wants to go home:



Price moves because traders are trading, and bots notwithstanding, traders are people, and people behave in expected ways. The hinge is a sign of this, which is why looking at it as nothing more than a pattern won't help the trader much in terms of making a trading decision. The hinge exists because traders are looking for -- and in the process, determining -- a new value level. If they weren't, the hinge would never form. The hinge therefore is a kind of reset, and whatever came before is not necessarily pertinent to what happens after due to the task that traders are performing. In short, all bets are off.

Playing a pattern usually entails following a relatively rigid set of rules: flags, pennants, head-and-shoulders, wedges, 2Bs, 123s, N4s, N7s, hooks, springs, and on and on. Playing the behavior involves understanding what it is that traders are doing that prompts the "pattern" to form in the first place, where they're doing it, what buyers and sellers are trying to accomplish. If one understands this, he is more likely to trade it profitably than be yanked around by other traders into a state of immobilized frustration.

Therefore, one must abandon whatever biases he may have or have had and let the market tell him what to do. If he doesn't understand what the market is telling him, then he should back off and just listen until the sense of it becomes clear. If one is the corporate sort, he might think of the hinge as a closed meeting. Once the meeting is over, the rank-and-file finds out what conclusions were reached in the meeting by what the participants then do. The participants exit and go about their business according to those conclusions, and in this case, those conclusions were to head downward. Whether these decisions make sense to the trader or upset his plans in any way is entirely beside the point.

Appendix B: The Dog That Didn't Bark

A Sherlock Holmes short story, "Silver Blaze", has to do with the disappearance of a race horse and the murder of its trainer. Holmes suspects that Scotland Yard Inspector Gregory has the wrong man because of what he terms a "curious incident":

Gregory: "Is there any other point to which you would wish to draw my attention?"

Holmes: "To the curious incident of the dog in the night-time."

Gregory: "The dog did nothing in the night-time."

Holmes: "That was the curious incident."

The fact that the dog did nothing, didn't bark, suggests to Holmes that the dog knew the perpetrator, that he was not a stranger but rather a friend of the family or even a member of the family itself.

The dog did not do what one would expect it to do under normal circumstances. When price doesn't do what one expects it to do under normal circumstances, one should at least begin to suspect that "something is afoot". Yes, it's silly. But it provides the trader with a mental hook on which to hang his thoughts and examine them.



When price first drops out of that narrow range (1), one expects it to continue its move downward. But it doesn't. When it drops out of the range a second time (2), it still doesn't, even though it makes a lower low. If price does not do what's expected, it will more likely do the opposite. If price won't fall, either buyers are supporting it or sellers aren't very motivated to sell. Either way, pressing for a short entry will not likely be productive. Price isn't doing what's expected. The dog isn't barking.

All goes well until price tries to make a higher high at (3). The trend is up, there is a series of higher highs and higher lows, but then price doesn't do what it's expected to do, i.e., make a higher high. The dog doesn't bark. So price reverses and begins a downtrend, lower highs, lower lows until price reaches (4). Price doesn't do the expected thing. It doesn't make a lower low. The dog doesn't bark. Price reverses and begins a new uptrend.

Reversals v. Retracements

This particular way of looking at price behavior also aids in resolving that common bugaboo regarding retracements and reversals: when and how does one become the other?



Here we have a demand line. According to the rules, when it's broken the trader looks for the first retracement in what he expects to be a reversal and enters a short. This short is triggered, but price doesn't confirm it by making a lower low, i.e., dropping below the swing low. The trader is left hanging. Price isn't doing what's expected. The rules have been followed so far, but the dog ain't barking. Instead, price takes off in the opposite direction, suggesting a reversal of the "downmove" that was supposed to be and a continuation of the preceding upmove. If one is REAL fast, he might be able to get out of his short and go long.*

But wait. Price once again gets sly and doesn't do what's expected, i.e., make a higher high. So even though the long may be triggered, there's no confirmation. The dog doesn't bark. The eventual result? A lower high and a higher low, and the stage is set for a hinge. Betcha didn't see that coming, unless you were aware of that curiously silent dog.

**Reversals can be simple and not-so-simple. The reversals above illustrate price movement that goes in one direction and is expected, under the conditions noted, to reverse and go in the opposite direction. But when those conditions aren't met, it then reverses the "reversal" and becomes a continuation.*

On the other hand are the "V" or "\/" reversals which take place at the ends of parabolic moves, up or down. These do not often give one the opportunity to enter the opposite side via a retracement because there isn't one, or else it's so far into the opposite movement that it's almost guaranteed to recoil to such an extent that the trader is thrown out. Entering this sort of reversal is a much more testicular trade, requiring as it does the willingness to step right out there on the basis on one's own judgement and press that Transmit button. AMT can help with this

decision – a demand or supply line is largely irrelevant – in that price that's creating a parabola at or near the limit of a trading range or trend channel is more likely to provide a successful reversal trade than one that's being created in thin air.

Needless to say, one should spend a considerable amount of time observing parabolic moves before trying to trade them.

Appendix C: The Law of Supply and Demand

(underlinings from the original)

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.

. . . 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. . . . The trend [is] simply the line of least resistance. When a stock [meets] 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 [is] encountered to halt the decline, it [will] turn upward. The critical moments in all these various phases of the market [are] these minor and major turning points, or else the points where the price [breaks].

. . .

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 struggle is continuous. The tape shows all this in detail. The charts enable you to pick the market apart and study whatever portion or phase of it you choose.

. . .

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.

. . . prepare your mind for [this] 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 need never read anything on the financial page of your newspaper except the table of stock prices and volumes.

You need pay no attention to the news, earnings, dividend rates or statements of corporations.

You need never study the financial or the business situation.

You need not understand railroad or industrial statistics, the money market, the crop situation, the bank statements, foreign trade or the political situation.

You can absolutely ignore all the thousands of tips, rumors, reports and especially the so-called inside information that flood Wall Street.

You can discard all of these completely and finally.

UNLESS YOU DO THIS YOU WILL BE UNABLE TO GET THE BEST RESULTS FROM YOUR MARKET OPERATIONS.

--Richard Wycoff, 1931

Appendix D: Anatomy of a Top

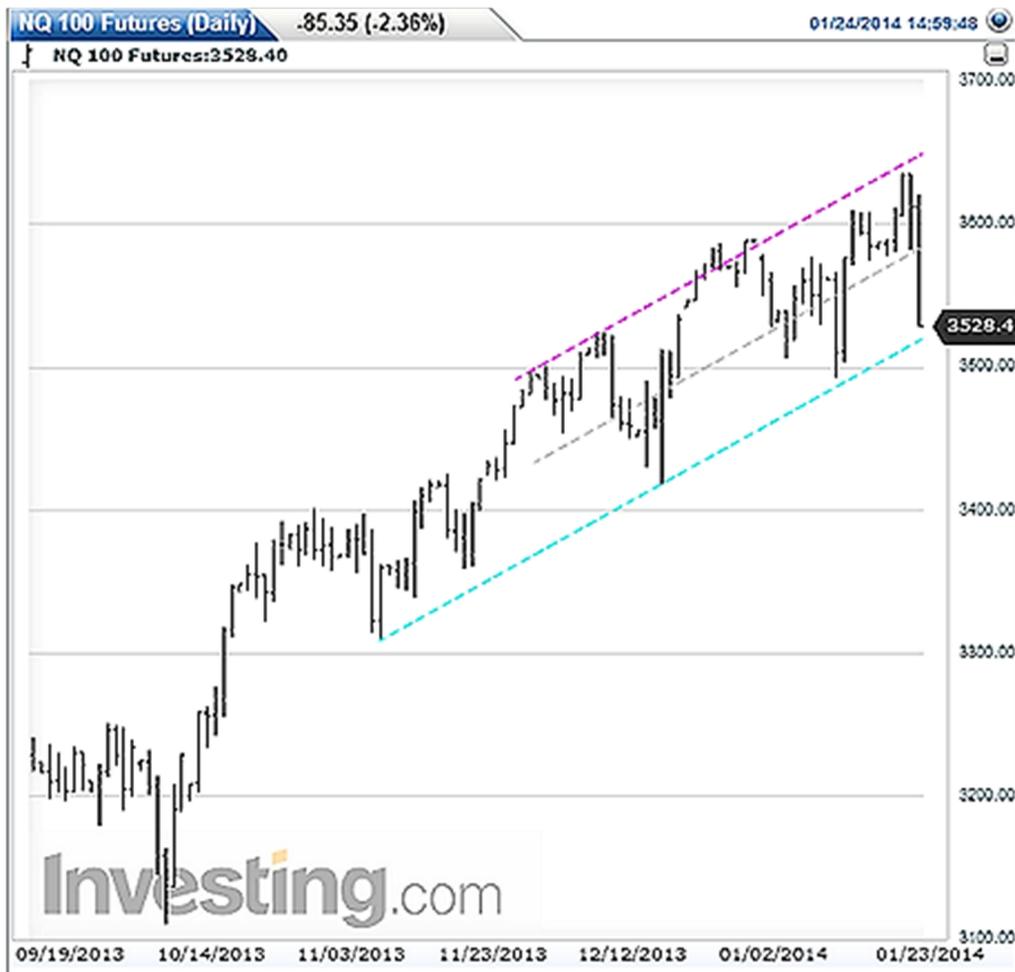
(maybe)

We left our valiant NQ at the end of January, at 3528, perched on a precipice. Would it find wings and fly to new highs? Or would it stall and plummet to earth? Who knew? For that matter, who knows?

For the fact of the matter is, no one really knows whether or not a top is in place until long after the fact. If you've been following this drama on your own, you know that we seem to have turned a corner. But we could also rally from here into all-time highs. It's happened. And it could happen again. You never know in real time whether you are trading a top. So you just go on about your business as usual and, later, look back at what you did. Hopefully you followed the rules and profited from them instead of guessing at what comes/came next.

That's why the "maybe" in the title.

The following is a copy of the chart posted on p. 36:



And this chart is from 10 weeks later:



The channel noted in the previous chart is shown here framed by dashed lines. As you can see, two days later, price dropped below that trend channel and fell all the way to the longer-term channel beginning the previous June. It then rallied to the top of the now-wider channel. It then hugged the upper limit of that larger channel for the next 3+ weeks. It then began its return trip to the lower limit of the trend channel where it bounced around for a little over a week, finally plunging below it.

So what now?

The following is a view going back to the next-longer channel beginning in November '12.



You can see here that the lower limit of the June channel jibes with the upper limit of the November '12 channel. If price can pull back into the June channel, then one can expect it to rally to the upper limit of that channel. The probability of this is, fortunately, not up to me to determine. Consider, though, that 3Q earnings are right around the corner and that the NQ has been "overbought" for nearly six months.

If, on the other hand, price just doesn't have what it takes to rally, AMT suggests that it will fall to the lower limit of the November channel at what is currently 3300 (this will of course be higher as the days roll by since the line is pitched upward). If that doesn't hold, there is a "falling down the stairs" character to the manner in which price may/will follow the lower

trendline down all the way back to the beginning in '09, at 1000. Now wouldn't that be a buying opportunity?

If someone retrieves this from a time capsule in 2064, he will know for sure.

Appendix E: Characterizing a Market

To "characterize" a market means to determine the characteristics or behaviors of the traders engaged in that market. Since a price is the result of a transaction between a buyer and seller, it is more productive to attempt to understand the unique buying and selling behaviors of these participants than to engage in gurbabble about "price behavior" (yes, I know, I'm guilty of this myself due to the shorthand made possible by what appear to be little cheats but which are more mnemonics, much like a chef will instruct the student to "prepare a mirepoix"* rather than go through detailed instructions every time he gives the order). After 50 pages, I know that you know that I know that price behaves as it does because of what traders do. And now you know that I know that you know that I know.

While nearly all hobbyists resort to mathematical TinkerToys like indicators and formulas and others look for "fanciful shapes", professionals focus on traders and their behavior. When, for example, they see a "double top", they don't think "Ah, a double top" but rather "Hmm, sellers ran out of buyers". **The first and probably most important step is therefore to think in terms of trader behavior** for it is that, not TinkerToys, that moves price.

In 1936, British economist John Maynard Keynes gave the best description of the stock market I've ever heard. He said stock market investors are like judges in a beauty contest. But the idea of this beauty contest is not to pick the prettiest girl, but rather to pick the girl that all other judges will think is the prettiest.

This simple metaphor is profound because it reveals the truth: For all of our study of the economy and companies, it is subjective perception -- not objective reality -- that sets stock prices.

And it's perplexing because, as Keynes pointed out, all of the judges are fully aware of the true nature of the contest and act accordingly. Each judge knows that he's a player in an fabulously complex game of psych and double-psych, an infinite regress of figuring out what the other guy is thinking you're thinking he's thinking you're thinking he's thinking, and so on and so on ...

Don Luskin

The second step is to begin the characterization process, part of which is cut-and-dried and part of which requires a certain sensitivity to behavioral dynamics, particularly the dynamics of fear (fear of making the wrong decision, fear of losing money, fear of missing out, fear of holding too long, fear of not holding long enough, fear of being tricked, fear of being trapped, fear of being blind-sided, etc, etc, etc). But regardless of which aspect may appear to be more important at any given time or interval, **it is absolutely essential that meticulous records be kept**. Without that, you may as well save yourself the time and effort. Trading for a living is not for you.

If you're prepared to create and maintain these records, **the next step is to observe your market during whatever timeframe is of interest.** If beginning with a day, how does your market behave **overnight**? Is it flat and listless? Or does it provide clues as to where buyers and sellers may be found? If there is a pre-market report coming up, do traders anticipate the results or do they lie in wait? Are certain levels tested repeatedly? Broken? Reset? Are prices trending upward or downward? What are the extents and durations of the waves? Does the pace change at any point? In what way? What effect does the change have on price movement? Are any nearby previous levels of supply or demand probed and tested? How? What is the result?

At the open, does price spike or plunge, providing no opportunity for entry other than a market order? Is there an opportunity to enter before the "open"? How high or low do these moves go? How long do they last? What are the qualitative and quantitative differences between the first 10 minutes and the second 10 minutes? The third 10 minutes? How "emotional" is all of this? When does trading settle down? What is the breadth of the opening range? If there is an economic report due out at 1000, how does price behave in anticipation of it? Do traders appear to wait for it? Is there a line beyond which they will not go? How does it behave after the report is released? How does it react to earnings reports? How does it react to unanticipated news events?

How long is trading active? An hour? Ninety minutes? Two hours? At what point does activity begin to trail off? At what time does it begin to pick up again? 1300? 1400? 1430? How does it behave at the "close"? How does it behave as it drifts into the evening and the overnight? Does foreign trading become active? Or does the market go to sleep?

Looking back on the day, does the market trend with any sort of pattern or is it seemingly chaotic? If it trends, is it mean-reverting? Does it spend more time trending or ranging? If and when it trends, how deep are the retracements? Do the bars overlap a great deal or are the trending moves "clean"? Are the ranges wide enough to permit a retracement tactic or must one trade reversals at the limits? Are the limits easily definable? Are the trend channels stable enough and long-lasting enough to be tradeable? Do they provide easily definable limits or must one make his decisions according to how far price travels from the mean? At what levels do sellers run out of buyers? At what levels are buyers able to force sellers to meet their price? At what levels are most contracts traded (incorporating a T&S display or plotting Volume At Price will help here). How does price react to those limit levels suggested by AMT?

What are the cost-benefit implications of all these trending/ranging movements for scaling in or scaling out? What are the relative risks attending to one or the other? How can one orchestrate scaling-in or scaling-out tactics to obtain the best cost-benefit ratio while minimizing risk?¹

IF you can maintain meticulous records and **IF** you are diligent in reviewing these records every day, **THEN** you can **BEGIN** to cobble together a set of strategies and tactics that you hypothesize will exploit the behaviors that you found during your observations. Much of these have been done for you through the SLA and AMT. However, the SLA and AMT do not relieve you of the responsibility for pouring over your day's records every evening and

preparing a plan of action for the following day. If you do not do this every day, you may as well not trade at all on those days when you just didn't feel like doing the work. You'll not only be throwing away your money but you'll be setting yourself back. **Never forget that professionals are doing all this work.** If you're not, and you can't properly characterize your market and anticipate the most probable moves (see AMT again), then you're not prepared. If on the other hand you are able and willing to maintain these records and review your trades after each and every trading session, there is every possibility – given how few people go through this procedure – that you will find something that nobody else sees and take advantage of it while everybody else is standing around wondering what just happened.

With regard to prediction vs expectation vs anticipation, hobbyists who don't understand trader behavior, much less how to characterize their markets, call these debates "semantics". They see no difference between prediction and anticipation. Those who have gone through the characterization process, however, understand the difference quite well. They understand that AMT, for example, provides the expectation that price will reverse at the upper limit of a trend channel and one can anticipate, based on his work, that price will do so. Can he predict that price will reach a specific price at that upper limit? No. Can he observe the behavior of other traders to see what they do as price approaches that level and act accordingly even though price begins to stall just ahead of it or overshoots it a bit? Of course. Can he then postulate the level to which price will fall based on the principles of AMT? Yes. And when price reaches that level, will onlookers be amazed, convinced that he is a wizard, a genius, a seer? Depends on how easily the onlookers are amazed.

But none of this has anything to do with precognitive abilities or tea leaves or crystal balls. It's simply a matter of doing the prep. Those who don't do it will understandably be impressed, just as those in the audience who know nothing about magic tricks will be amazed and delighted when Presto pulls a rabbit out of his hat.

**a finely-diced mix of carrots, onions, and celery, used as the seasoning base for a meat dish or sauce.*



¹One possible scenario for scaling out 5 contracts, or multiples of 5 contracts:



Many thanks to Steve46. If he hadn't got me thinking about this several years ago, I probably wouldn't have given it as much deliberate thought.

The average man does not like uncertainties. He is not trained to cope with them. He will try to "sweep them under the rug." He will use any device that will make it possible for him to feel "more sure," for he is not willing to accept a "maybe" or an "I don't know" as an answer.

And so he will resort to averages, to market indicators, to complicated charts of intersecting lines designed to prove that "it" is either a Bull Market or a Bear Market. He will accept almost any kind of nonsense if it is stated with enough assurance. He will buy horoscopes to determine the trend of the market by the position of the planets. If all else fails, he will look for some authority who will relieve him of using his own intelligence, by making the either/or decisions for him. But he must have a straight, simple answer; otherwise it means nothing to him.

Do you see how this way of looking at things is out of line with the facts? Do you see how it leads, inevitably, to frustration, anxiety, and demoralization? It is asking too much of reality. It is setting up a make-believe world, and then crying if the world isn't exactly like the make-believe.

We know, for instance, that trees "in general" are round. But you have seen tree trunks distorted by a cramped location, or by the trunks of adjacent trees, that are not round at all. It is useful to know that "tree trunks are round," only so long as we understand that this is an abstraction, and the reality in any particular case has to be looked at, and if it is not round, that is that; the territory is the final answer, not our "map."

John Magee

Mapping that territory is what characterization is all about. The more distant the trader is from it, the more likely he is to make errors, to miscalculate, to remain out of touch. But when he begins to slow down, to observe, to wonder, to postulate, to test and verify, he begins to understand all the many-varied features of the territory, not someone's map of it. At this level, he is prepared to whup some posterior.



The following is just one example of what can be discovered during the characterization process.

Notice the similarities and difference in how the NQ and ES moved on Friday, April 4, 2014. They both fell, as one might expect, even though the ES represents the S&P 500, with its five hundred stocks, while the NQ represents the NDX with its one hundred. But look at **how** they fell.



By 1130 (the arrowed bars), the NQ had fallen 78pts. The ES had fallen 12pts (30 equivalent NQ points)

By the end of the session, the NQ had fallen 133pts. The ES had fallen 36 (90 equivalent NQ points).

All else being equal, which would you have preferred to have traded that day?

Now how did AMT fit into all this? How could a knowledge of it have helped the trader prepare for this dramatic one-day plunge?

(next page)



The left chart represents part of the prep done the day before. It shows the upper limit of the trend channel, the mean of the channel, and the lower limit of the channel.

As you can see, after the market opened, price came within 2pts of the upper limit of the trend channel, then plunged all the way down to the lower limit and beyond, overshooting the lower limit by 15pts.

In addition, the five most heavily-weighted stocks in the NDX – AAPL, MSFT, GOOGL, AMZN, and INTC – were charted and annotated. AAPL, GOOGL, and AMZN were and had been already weak. MSFT and INTC were vulnerable to reversal under the right conditions. AMT provided the right conditions.

This is only one day, of course, but it serves as an example of the kind of thing one looks for during the characterization process. One also looks at the swings, the overlaps, when and where and how much price retraces once an entry has been triggered, which symbol requires the fewest trades to capture price movement going up or down and so on.

Is this a case of cherry-picking? Of choosing an exceptional or even unique example in order to "prove" the auction market theory? Arguably. AMT is after all only a theory, not a law like the Law of Supply and Demand. However, by going through the characterization process, especially with AMT in mind, one can determine the probabilities himself for likely moves, their locations, and their extents, then anticipate and exploit those moves. If he figures the probabilities correctly, he will be in a better position to profit than his peers who have done none of this.

Here's another example (next page) from two weeks earlier:



As you can see, this plunge took two days instead of one and wasn't quite so dramatic. But, again, AMT provided the upper and lower limits for the (same) trend channel. In this case, price had already reversed off the upper limit on Friday, so the only question was whether it would bounce off the mean and rally back to that upper limit or drop through the mean and fall to the lower limit. Two choices (other than the possibility that it would just sit there buffing its nails all day long).

If you can draw a straight line . . .

Wall Street is a tough teacher but also a good teacher. If you have any weakness – arrogance, laziness, stinginess, cowardice, procrastination – the market will zero in on that weakness and make you pay dearly.

Richard Russell