Five Guiding Principles of Short-Term Trading

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I recently posted five guiding principles of trading psychology. Those are big concepts that help me understand traders. Here are five guiding principles that I draw upon in understanding the psychology of the marketplace:

1) ***Markets are moved by their largest participants*** - I believe this is the single most important principle in short-term trading. Accordingly, I track the presence of large traders by determining how much volume is in the market and how that compares to average. Because volume correlates very highly with volatility, the market's relative volume helps you determine the amount of movement likely at any given time frame--and it helps you handicap the odds of trending vs. remaining slow and range bound.

2) ***Trends are created by shifts in supply/demand generated by global/macro relationships*** - The forces that ultimately move stocks are related to intermarket changes in supply and demand that result from interest rate shifts, movements among currencies, inflation and commodity prices, and profitability among companies in various international markets. This means that the short-term trader must keep one eye on the intraday shifts in buying and selling of large traders, but the other eye on the day to day and week to week changes that impact the demand for stocks. Knowing the big picture is crucial to trading in the right direction, even when the trading is short-term and your focus is on the initial minutes of trading.

3) ***Market moves on strong momentum tend to persist in the short run; moves on weak momentum tend to reverse*** - When the vast majority of stocks are participating in a market move, those moves tend to continue as short-term trends. When markets make new highs or lows and a large proportion of stocks and sectors do not follow, those moves are more likely to be reversed. This is one reason that it is important to watch the entire market, not just the stock or instrument that you happen to be trading. Because the major market indices tend to be capitalization weighted, they can make new highs or lows simply because a few stocks happen to be strong or weak. Tracking the breadth of moves tells you if there is an overall demand or supply for stocks.

4) ***There are only three kinds of trades: breakout trades, trend-following trades, and reversal trades***. Breakouts and reversal typically occur in the context of bracketing markets. As we establish value in a relatively narrow range, the market probes the upper and lower bounds of the value range to test demand and supply. The breakout trades result when prices away from value (i.e., away from the average trading price within a range) attract fresh buying or selling interest. The reversal trades occur when prices away from value fail to attract buyers or sellers, leading to movement back toward value (the average trading price). The trend-following trade

occurs after a breakout and consists of buying pullbacks in an uptrend or selling bounces in a decline. These trades last as long as markets continue to make new highs or lows on successive moves in the trend direction--and especially as the majority of stocks participate in those new highs or lows. Knowing the status of the market--bracketing or trending--tells you the type of trade likely to set up. Following Market Profile over multiple time frames is very helpful in determining market status.

5) ***Tracking market activity at the bid and offer is useful in detecting shifts in short-term demand and supply*** - Such tracking includes contract volume at the bid vs. offer, as charted in Market Delta, but also includes the number of stocks trading at their offer vs. bid price, as in the NYSE TICK. Over time, we commonly see transitional structures in which extremes of buying or selling interest bring the market to new highs or lows, resulting in reduced buying/selling, and eventual reversal. These transitions clue us into shifts in the psychology of the marketplace and are very helpful in framing trade ideas.

I stress the above five principles because they capture how I've found successful professional traders approach the markets. I'm sure there are highly profitable pros somewhere who trade wave patterns, moving averages, chart formations, and the like. In several years of working hands on with such traders, however, I have yet to meet one who uses these methods. The pros do, on the other hand, care very much about who is in the markets and why markets are moving. The principles provide a framework for making sense of market behavior, which then can be used to filter the setups provided by charts, cycles, and the like. The really good traders understand markets; they don't just predict them.