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Stock Market Buying Tests - Part 2

How to Take a Profitable Position in the Stock Market

After an individual stock has completed a stopping action with preliminary support, a selling climax, automatic rally and secondary test, a Wyckoff stock market trader needs to see the price demonstrate relative strength. It is most desirable if the stock shows relative strength compared to other issues in the same stock market industry group and to the stock market as a whole. There are two ways that a stock can demonstrate that it is relatively strong. One way is to look at the bigger picture. On the decline that was stopped by the selling climax, how much down side progress did the stock make? This should be measured from the top of the previous advance to the bottom of the decline that has just been stopped.

The measurement should be taken in terms of a percentage not in terms of the number of points lost. The percentage decline in the individual stock being considered should be compared to that of other issues in the same group. If an industry group index is available for that industry, it would be a good idea to compare the performance of the individual issue to that on the group index.

A similar comparison should be made to a general stock market index. Those stocks that can be determined to have performed more bullishly on the previous decline relative to other issues in the group and the general market are most likely to be the best candidates for new long positions.

Relative strength also needs to be demonstrated after a previous decline has been stopped. The tendency is to assume that the preparation following a decline is going to be for an advance. This is not always the case. If the price of an individual stock does not continue to demonstrate relative strength during preparation for its next move, there is a good chance that the move being prepared will be in the same direction as the previous move. Relative strength in the trading range that prepares the price for its next move can be identified by comparing the percentages of the rallies and reactions within the range to those in other stocks in the same industry group and to the general stock market.

The Wyckoff stock market trader should also consider the character of the price and volume action on the rallies and reactions during the trading range phase. If the rallies are made quickly with wide price spreads, increased volumes and strong closes, the action is providing an indication of strength. These issues are more likely to be better long candidates than those issues that have to struggle to make their rallies. On the reactions within a trading range, relatively strong issues will struggle to make down side progress. Their price spreads will be relatively narrow compared to those during the rallies within the range and their volumes will be relatively lower. This combination of narrower spreads and lower volumes should make the action during the reactions appear more laborious.

Wyckoff traders looking for stock trading opportunities on the long side should avoid stocks and markets that make laborious rallies during the trading range and then give back the ground gained quickly. This pattern suggests that the sellers are still in control of the action. Traders should also beware of issues that make both high volume wide spread rallies and reactions within the trading range. These rapid swings in the trading range are more often an indication of distribution than accumulation.

When an stock or the market has stopped a decline and moved into a trading range, it is likely that the previously defined down trend will still be in tact. During this period, the down trend and the trading range are said to be in competition for control of the action. Wyckoff stock traders should wait until the trading range has won the competition before seriously considering an entry on the long side.

The trading range has won the competition when the supply line of the previously defined down trend has been broken. Many times, there is a particular set of steps that unfold in the action that lead to the breaking of the supply line. They begin with the price making a small and relatively insignificant penetration of the supply line. This is said to weaken the line.

On the day or days that this is accomplished, the price will likely spend part of the day above and below the supply line. The price will likely follow up on the weakening of the supply line with a move back into the heart of the down trend channel. This provides the price with an opportunity to demonstrate that the down trend is still in solid control of the action or to provide an indication that the level of control has been diminished by the weakening of the supply line.

If the degree to which the down trend is in control has been compromised, the next rally should decisively break the supply line. This is demonstrated by wide price spreads on increased volumes that result in the entire spread for a day or several days is above the supply line. The final step in breaking the supply line is when the stock's price reacts back toward the supply line on narrower spreads and lower volumes and refuses to reenter the down trend channel.

The sixth buying test is met when the stock's price demonstrates the ability to put in higher supports on rallies. This can be shown by the action within a trading range or after the price has left the trading range to the up side. Frequently, the rallies and reactions within a trading range will all be completed near the top and bottom of the range.

The Wyckoff stock market trader should not automatically consider this to be a bearish indication. It is actually normal action. Some times, the low points of the reactions within the trading range will put in gradually higher bottoms. This indicates a willingness on the part of buyers to pay a higher price suggesting that the price is getting ready to leave the trading range to the up side.

A pattern of higher supports in a trading range and the desirability of seeing the price move into the primary buying position of a spring seem to be at odds with each other since it is not possible for the price to maintain a consistent pattern of higher bottoms and still move into a spring position. The development of a spring position following a pattern of higher bottoms on reactions does not neutralize the stock's bullish indication of the higher supports. It actually confirms it by providing supply with one last opportunity to reclaim control of the action. If supply declines to take advantage of the opportunity, the stock trader can conclude that the price is ready to make an effort to leave the trading range to the up side.

The test of higher supports can also be demonstrated after the stock has left the trading range to the up side. Two of the primary buying opportunities develop when the price is passing this buying test. Both the back up to a creek and a normal correction of a previous advance require a higher support. The entire definition of and the continuation of a stock's up trend require a pattern of higher supports. The seventh buying test is a logical follow up to the sixth test. It and the last two buying tests will be considered in part three of this series.