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Directional Indicators and Timing Tools

Wyckoff traders have several tools that can help them determine the direction in which the market or an individual issue is likely to move and the likelihood of a change in that direction. These tools are the Optimism-Pessimism Index (O.P.), Technometer (Tec) and the Force. They are all derived from the volumes of the intra-day buying and selling waves.

The purpose of these tools is to confirm the indications provided by the price and volume action. They are not intended to take the place of a regular interpretation of the character of the price and volume action, the trend of that action or the position of the action in the trend.

Those who attempt to use them in this incorrect manner are embracing an mechanical approach to Wyckoff. The market may let them get away with this approach for a while. However, the Wyckoff approach is judgmental and not mechanical. Those who persist in efforts to use these tools in a mechanical manner will eventually pay a price for their laziness.

Wyckoff tells us that for a move in the market or an individual issue to continue there needs to be harmony between effort and result. The result is measured by the amount that price moves from point A to point B. The effort is measured by the O.P. The O.P. moves from point A to point B by adding the volume in the up waves and by subtracting the volume in the down waves.

As long as the price of an index or an individual issue and its O.P. are moving in the same direction at approximately the same rate making similar highs and lows relative to previous highs and lows, the price is likely to continue making progress toward an indicated objective.

Positions taken in anticipation of an objective being reached can be maintained as long as this harmony exists and new positions can be considered at appropriate points in the action. If there is a lack of harmony between effort and result, Wyckoff traders need to be more defensive with respect to existing positions because the lack of harmony suggests a change in the direction of the price movement. Although these indications can be detrimental to existing positions, they also represent opportunities to consider positions on the other side of the market.

When effort and result are not moving in the same direction at approximately the same rate, the condition is referred to as inharmonious action. Inharmonious action can be corrected without a change in the direction in which prices are trending by either effort or result accelerating to catch up with the other or hesitating to allow the other to catch up.

If harmony is not restored, there will be a change in the direction in which the trend of the action is pointed. Some inharmonious actions are obvious and some are not. However, there is one type of inharmonious action that is especially obvious. It is a divergence.

A divergence develops when the lack of harmony is so great that the price action and the action of the O.P. do not make new highs or new lows relative to previous rally tops or reaction lows at the same time. Divergences can be bullish or they can be bearish. They can result from too much effort for the result, or they can result from too much result for the effort. In each case, the development of a divergence is a warning of an impending change in the direction of the price movement.

A bullish divergence develops when the price of a market or an issue makes a lower low on a current reaction than on the low point of the previous reaction but the O.P. does not make a similar lower low. A bullish divergence also develops when the O.P. makes a lower low on a current reaction than on the previous reaction and the price does not make a similar lower low.

Either way, the lack of harmony is so great that the result is likely to be a change in the direction of the price movement away from the direction in which it was moving when the divergence developed. Although both types of bullish divergence favor an advance in the price, one has over time tended to be more reliable than the other in turning the price.

If the O.P. makes a lower low and the price does not, the situation is indicating effort without result. This is the more reliable bullish divergence. The effort has been expressed but the price has not responded. Therefore , as the effort is relaxed, the price is likely to move in the opposite direction. In the other type of bullish divergence where there has already been a result expressed by the price not supported by the effort, the effort may still enter the market and eliminate the divergence. Since the effort has this extra opportunity to correct the situation, this type of bullish divergence is somewhat less reliable in warning of a likely change in direction.

Bearish divergences are measured across the tops of rallies rather than across the bottom of reactions. As was the case with bullish divergences, there are two types of bearish divergences. One is where there is effort without result. It is the more reliable type.

There is also the type where there is a result without effort. The effort without result variety is when the O.P. on a current rally makes a higher high than on the previous rally, but the price does not. The result without effort variety is when the price makes a higher high on the current rally relative to the high on the previous rally but the O.P. does not.

Divergences should not be used as timing tools for entering or exiting positions. They provide warning of likely changes in the direction of price movement, but they do not trigger the change in direction by themselves. A divergence that develops on one day may widen over the days that follow resulting in a more extreme divergence providing a stronger warning. Therefore, a position taken on the first day that a divergent condition develops could be stopped out as the divergence becomes more extreme resulting in the trader being moved to the sidelines just where he should actually be taking a position.

The best place to act on the indication of a divergence is when it confirms a primary buying or selling opportunity. A bullish divergence in combination with a primary buying opportunity is more likely to produce a change in direction than either the divergence or the buying opportunity alone. The same is true of bearish divergences in combination with primary selling opportunities.

The development of divergences is not limited to the price action and the O.P. action. They can also develop between the price action and the Force. The Force measures the amount of volume in the intra-day buying waves relative to the volume in the intra-day selling waves over a ten day period.

The primary difference between the Force and the O.P. is that the Force looks at a limited amount of time while the O.P. does not. As the excess of volume in the up waves grows relative to the volume in down waves, the value of the Force moves higher. It may move from a more negative number to a less negative number, or from a negative number to a positive number, or from a less positive number to a more positive number.

The absolute value of the Force reading is not what matters most. What does matter is how the peaks and valleys in the Force relate to rally tops and reaction lows in the price. Divergences develop when the price and the Force do not make higher tops or lower bottoms together. When this happens, the excess or lack there of in the accumulated up side volume over the down side volume during the ten day period reaches an extreme that needs to be corrected by a turn in the direction of the price movement.

The short term excesses mentioned above are a tool that can be used in timing the entry or exiting of a position or an adjustment in how a position is managed. The Force also provides a directional indication. If the values of the Force from day to day are posted to a chart, the Wyckoff trader will note that they tend to trend. This means that there will be periods of time when there are lower peaks and lower valleys and periods of time when there are higher peaks and higher valleys. Trend lines can be drawn on a chart of a Force just as they can be drawn on a chart of the price action. When a tend in the movement in the Force is broken, the indication is that a change in the direction of the price action should be anticipated. As with the price and O.P. relationships, the price and Force relationships are most reliable when they confirm primary buying and selling opportunities.

The Tec is a timing tool only. It indicates over bought and over sold conditions. The Tec measures a ratio of the volume in the intra-day buying waves relative to the volume in the intra-day selling waves over a five day period. However, longer time periods can be used to provide longer term over bought and over sold indications. Theoretically, the Tec reading of a market or an issue can range from zero to one hundred.

However, neither of these extremes has ever been recorded or is likely to ever be recorded. A reading of zero would require five consecutive days during which there were only one intra-day wave per day and only down waves for each of the five days. A reading of one hundred would require five consecutive days during which there were only one intra-day wave per days and only up waves for each of the five days. Decades of monitoring Tec readings have revealed that readings of 50 or higher should be viewed as indicating an over bought condition and that readings of 38 or lower should be viewed as indicating over sold conditions. A reading of 44.4 indicates absolute neutrality. When an over bought condition is indicated, the price is vulnerable to down side progress. When an over sold condition is indicated, the price is vulnerable to up side progress. If an over bought or over sold condition on one day is replaced by a more over bought or more over sold condition the next day, the vulnerability of the price to a reaction or rally increases. The degree to which the market or an issue is over bought or over sold does not provide any indication as to the size of the reaction or rally that is being forecasted. These indications are provided by figure charts. Although over bought or over sold indications may develop at any time as the price action unfolds from day to day, those that develop when the price is in primary buying or selling positions are the most important.

The indications provided by the O.P., the Tec and the Force should be used to confirm the indications of the price action. They should not be used in lieu of an interpretation of the price and volume action. Anyone who does so is attempting to use these tools in a mechanical manner and that will not result in the desired results over time. This warning cannot be stressed to much.