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Stock Market Analysis Tools & Strategies

Analyzing the Wyckoff Wave, O. P. Index and Trend Barometer

Since the Wyckoff Wave put in its all time high back in July of 2007, its action has been dominated by down trends. Three of the down trends are of special interest because they have or may have an impact on current and future action of the Wave. The most important down trend was defined off the July high (Column 2).

The second rally top used to define this trend was the October high (Column 9). The parallel over sold line for this trend was constructed through the August low (Column 4). Since it was defined, the supply line of this longer term down trend has never been weakened or even seriously challenged and it is unlikely that it will be in the near future due to the fact that the current action of the Wyckoff Wave is more than 5000 points below the supply line. The action of the Wave has had encounters with the over sold line of the down trend.

The action of the Wyckoff Wave first encountered the over sold line of the longer term down trend in November (Column 12). The resulting penetration of the over sold line produced an over sold position that needed to be corrected. The correction of an over sold position can unfold as a period of horizontal action that over time allows the Wave to move back into the down trend channel.

However, the correction normally unfolds as a rally, which is what happened in this case as the Wave rallied back to near the middle of the down trend channel (Column 13). With the Wave solidly back in the middle of the down trend channel, it was free to resume down trend activity. During January (Column 15), the Wave again encountered the over sold line of the down trend and entered an over sold position.

This time, the ability of the Wave to correct the over sold line with a normal corrective rally was less impressive. Instead of moving back to the middle of the down trend channel, the Wave has moved in more of a horizontal direction clinging to the over sold line. The inability of the Wave to make the normal corrective rally to the middle of the down trend channel indicates continuing weakness. It suggests that the bears are content with their short positions and see no reason to be panicked into a short covering rally. It also suggests that the bulls that have been worn out or shaken out of the market are reluctant to return. If this thinking among the bears and the bulls continues, the Wave may continue to move horizontally until a position near the middle of the down trend channel is reestablished. Other possibilities include a gradual drift lower as the over sold line moves lower. If the bulls and the bears change their assessment of the action, a normal corrective rally is another possibility.

In addition to serving as the second point for defining the supply line of the longer term down trend, the October high (Column 9) also was a factor in defining the intermediate down trend. The second point used to define this trend was the December high (Column 13). The over sold line was constructed parallel to the supply line from the November low (Column12). During January (Column 16), the action of the Wyckoff Wave approached but did not reach the over sold line of the intermediate down trend. Normal down trend action would have penetrated or reached the over sold line of the down trend. The failure to reach the over sold line indicated that the intermediate down trend was in trouble and vulnerable to being broken. It was also a warning to bears whose positions were based on the existence of this trend to become more defensive in the management of their positions. As the action of the Wave moved from January into February (Column 17), the supply line was penetrated. This action weakened the intermediate down trend. Frequently, down trends are ended with a four step process that begins with the weakening of the supply line. The second step is for the price to reenter the down trend, but not make a lower low than the low that occurred before the supply line was weakened. In this case, step two was completed during February (column 18). Step three is for the supply line to be decisively broken by a rally that takes out the high recorded when the supply line was weakened. The final step is for the price to confirm the breaking of the down trend with a reaction that is unable to reenter the down trend channel. As of the last day posted, the action was working on step three, but the outcome was inconclusive resulting in a conclusion that the intermediate down trend was still having an impact on the action.

The third significant down trend since the July high was defined off the highs that were recorded during December (Columns 13 & 14). The over sold line that completed the definition of this shorter term down trend was constructed through the low point of the reaction that separated the two rally tops used to define the supply line. The over sold line of this trend was penetrated twice during January (Columns 15 & 16). The response to the first over sold position was a normal corrective rally. The response to the second over sold position was more impressive. After slightly weakening the supply line and briefly reentering the shorter term down trend, the supply line was decisively broken (Column 16 & 17). The Wyckoff Wave could have clearly ended the shorter term down trend by failing to reenter the short term down trend channel, but it did not. During February (Column 17) the action of the Wave slipped back into the down trend channel, but did not make a lower low. On the one hand, this action seemed to confirm the breaking of the short term down trend by failing to make a lower low. However on the other hand, the action seemed not to confirm the breaking of the down trend by reentering the down trend channel. Conflicting signals such as these encourage traders to be more defensive. Since the action of the Wave reentered the down trend, it has been horizontal in nature and has lifted the Wave out of the down trend channel. As horizontal action continues and the gap between current action and the supply line widens, it may be concluded that the breaking of the shorter term down trend has been confirmed even though there was the reentry into the trend after the supply line was decisively broken.

The three down trends mentioned above are the ones that are having an impact on current action. However, there have been others that deserve to be noted. After the July high (Column 2), there was a rally to a lower top during August (Column 3) that allowed a shorter term down trend to be defined. An over sold position relative to this down trend developed at the August low (Column 4). The correction of the over sold position began the process than lead to the end of the down trend being confirmed during September (Column 6). Another shorter term down trend was defined near the end of October (Column 9) when the Wyckoff Wave rallied to a lower top relative to the high that had been recorded earlier in October. The Wave has moved out of this down trend. However, it should be noted that the stopping action was not the more classic type mentioned earlier.

Although the action since July 2007 has been dominated by down trends, there have been up trends as well. There have to be up trends for down trends to be defined. The up trends that have unfolded have all been short term in nature. They have been characterized by being relatively narrow compared to the down trends discussed earlier and they have been steep. Trends that are steeply inclined and narrow are difficult for the action to sustain. In this case with the action dominated by down trends, the short, steep and narrow up trends likely were the result of bears rotating out of some short positions and bulls rushing back into the market to avoid missing the next advance and in the process setting themselves up to being shaken out or worn out later. The up trends that stand out most clearly were defined off the August low (Column 4), the November low (Column 12) and the January low (Column 16).

Earlier it was noted that in order to have down trends there must be up trends. However, in order for there to be trends in either direction, there must be trading ranges that provide the potential that the fuel the advances and declines that lead to up trends and down trends. The trading ranges that have developed since the all time high of the Wyckoff Wave will be the subject of the second part in this series.