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Selling Tests - Part 2

Wyckoff teaches that an individual issue should only be considered as a potential short candidate if it has demonstrated that it is weaker than the market. There are two ways in which an issue provides this indication. One is based on price action and the other is based on volume. The Wyckoff trader is looking for those issues that under perform relative to the market on rallies and out perform the market on reactions.
A trader may wish to make these comparisons by calculating the percentage moves of the market and the issues being considered. This will eliminate the judgment factor from making the determination as to which issues are weaker than the market. However, the process of determining and comparing percentages will be time consuming and will likely limit the number of issues that can be considered. An alternate approach is to look for those situations where the individual issue is obviously weaker than the market. If the market rallies to a higher top on a rally verses the previous rally and an individual issues rallies to a lower top, the individual issue is weaker than the market. If the market reacts to a higher bottom verses the previous reaction and an individual reacts to a lower bottom , the individual issue is weaker than the market. An issue can have the same pattern of lower tops and lower bottoms and still be weaker than the market. This can be determined by locating the halfway points of the rallies and reactions for both the market and the individual issues. Even if both the market and an individual issue make a lower top on a rally or a lower bottom on a reaction, it is likely that one of them will fail to reach its halfway point or will over run the halfway point by a smaller margin. If the one that performs in this manner is the individual issue, it is weaker than the market.

The volume factor in determining relative weakness will help to confirm the indication provided by the price action. If an issue makes a lower top or a lower bottom on a rally or reaction than does the market, it is providing an indication of relative weakness. If the volume on the rally to the lower top is relatively lower than that of the market, the indication is of a lack of demand and that tends to confirm the indication of relative weakness. If the price of an issue is putting in a lower top on relatively higher volume than the market, the indication is that supply is being met and that also tends to confirm relative weakness. The level of volume on lower bottoms can also confirm relative weakness. If the individual issue makes a lower low than the market on reduced volume relative to that of the market, the indication is of a lack of demand. If the volume is relatively higher than that of the market, the indication is that supply has been entering the market.

It is possible for an individual issue to be demonstrating relative weakness when compared to the market and for the issue to be in an up trend. Wyckoff traders want to avoid these issues. The trend represents the line of least resistance. It is the most important thing that any trader can know about an issue. Trading against the trend greatly reduces the odds of realizing a profit. Wyckoff traders want to be certain that a previously defined up trend has been broken before considering an entry on the short side. The breaking of an up trend will frequently have four distinct steps. The first step is an initial weakening of the demand line. This can be observed as a day or several days where the price action spends part of the time but not all of the time below the demand line of the up trend. The second step is an effort to rally back into the up trend. This action can be used to make a further judgment as to the relative weakness of an issue. Those that rally to a lower position in the previously established up trend are demonstrating a higher degree of relative weakness. The third step in the process of breaking an up trend is for the price action to decisively break the demand line. This is indicated by several days where all of the price action is below the demand line. Those issues that make the most decisive breaks are the most attractive potential short candidates and among those, the ones with the highest volumes are even more attractive. The final step in the process is when the price rallies and is unable to reenter the up trend channel. This confirms that the trend has been broken.

Lower tops on rallies is a necessary test for a potential short candidate to pass before a position should be considered. They were a factor in determining relative weakness and they were a factor in breaking a previously established up trend. The Wyckoff trader should also watch for a pattern of lower tops in trading ranges as the price prepares for its next move. If the price is making lower tops in a trading range, the indication is that demand is being withdrawn or that supply is being met at progressively lower levels. This increases the odds that the price will fall through the support level of the trading range and begin a mark down phase. There is one place in the development of a trading range where a higher top can be a negative development. That place is on an up thrust. If the price has been making lower tops on rallies within a trading range and then rallies above all those previous tops an makes a small penetration of the resistance level of the range, the action is a potential up thrust. It has likely caused many of those who have already taken short positions to run for cover. An up thrust leaves the price unusually vulnerable to down side progress and is a good spot to enter a short position even though it represents a high top.

When examining the action of an issue to see if it has passed the three selling tests presented here, it is important that the Wyckoff trader look for indications that are consistent with the time frame of his or her market operation. Using longer term indications to justify short term trades or using shorter term indications to justify longer term investments usually will produce disappointing results. If both shorter term and longer term indications are consistent with the trade under consideration, the results are likely to be the most satisfying.