

A Wyckoff Approach To Futures

by Craig F. Schroeder



The Wyckoff approach, which has been a standard for decades, is as valid for futures as it is for stocks, but even students of the technique appear to be unaware of its extended uses. Most technicians know that Wyckoff analysis stresses volume and price, and as there is always uncertainty about the level of volume on current and previous days for futures, it seems logical to conclude that Wyckoff and futures are not compatible. This may seem logical, but it's wrong. According to Schroeder, Wyckoff is not simply about price and volume; it is concerned with three laws — supply and demand, cause and effect, and effort and result — because these three laws apply to all interactions. Schroeder explains.

Many students of the Wyckoff method do not associate Wyckoff analysis with futures trading — unfortunate, but not difficult to understand how such a mistake can be made. Anyone familiar with the teachings of Richard Wyckoff knows that stocks and stock market action exclusively are used as examples of principles. The lack of examples from the futures market naturally leads to the erroneous conclusion that the principle cannot be applied to futures. Most technicians also know that Wyckoff analysis stresses the study of volume and its relation to price. As there is always uncertainty about the level of volume on both current and previous days, it is logical to conclude that Wyckoff and futures do not mix. Although these conclusions may seem logical, they are not correct.

Wyckoff analysis is not just about stocks and the stock market. It is not even just about price and volume relationships, even though they are the primary focus. Wyckoff is about three basic laws: supply and demand; cause and effect; effort vs. result. These three laws apply to everything that people buy from, sell to or exchange with others.

IF/THEN FOR ALL

In the law of supply and demand, when the pool of buyers demands more product than is immediately available, the price of that commodity will rise until demand diminishes to the level of available supply. At the same time, the pool of sellers, seeing that prices are rising, will take steps to increase the available supply of a commodity. When available supply exceeds the demand, then prices will start to fall.

The law of cause and effect is closely related to the law of supply and demand and states that every price movement is the direct result of a previous price movement or combination of movements. The price markup phase results from the accumulation phase that precedes it and is proportional to that accumulation phase. Similarly, the price markdown phase is the result of the distribution phase that precedes it and is in proportion to the distribution phase.

The law of effort vs. result states that for every effort there should be a result and that the result should be in direct relation to the effort. When this is not the case, a change in direction may be expected. Wyckoff analysis equates effort with volume and result with price.

Futures contracts have a price and a volume, and therefore, this law applies to futures just as it does to stocks. It is true that futures volume is not as readily available as it is with stocks or the stock market, but that does not alter the relationship. There is still a result (price) and an effort (volume). Price moves as a result of the effort being applied in the form of competing bids and efforts in an organized marketplace.

THE CONCEPTS REMAIN THE SAME

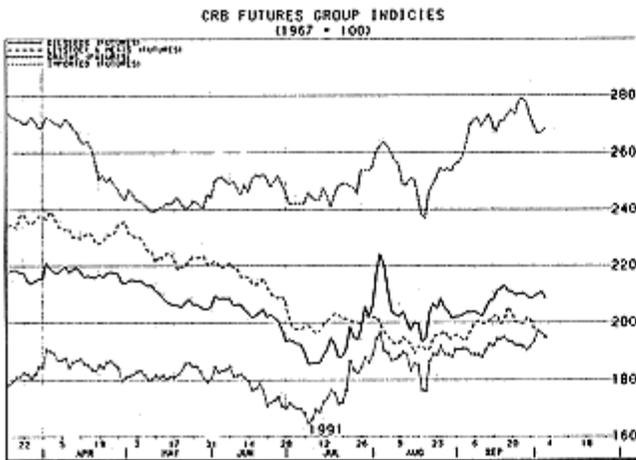
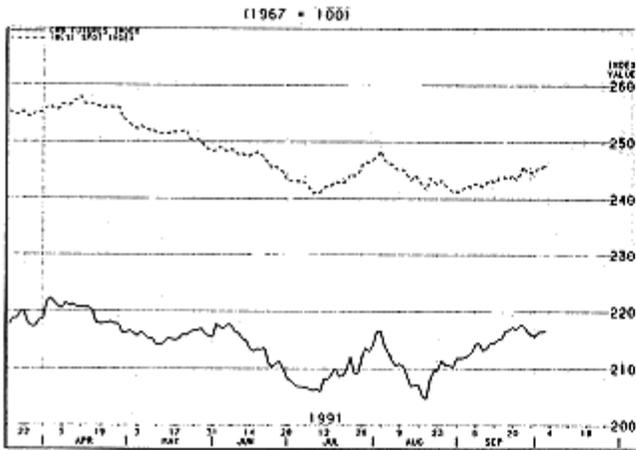
Using the Wyckoff approach is as valid in the futures market as it is in stocks. The concepts are the same. The differences that exist are the result of the highly leveraged nature of the trading vehicle and the limited availability of some key data. In futures trading, the highly leveraged nature of the vehicle can make excessive diversification a curse. Extreme leverage means that results come more quickly than with less leveraged or unleveraged vehicles. This is true whether the results are good or bad. Therefore, the windows of opportunity for both entering and exiting positions are smaller, and they open and shut more quickly.

Thus, the trader must be more alert. Diversification divides the trader's attention into smaller pieces. If the trader is trying to watch all the futures markets, his attention is fragmented into very small pieces, so countless opportunities are missed and many of those that are not are either poorly entered or poorly exited or both. Limiting diversification can help avoid this. The trader should follow no more than six markets on a regular basis and in selecting those, markets that are thinly traded — especially those that do not fit comfortably into a group of related futures — should be avoided.

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The Wyckoff method suggests that study begin with the general market, move to industry groups and end up with individual issues. With futures, this process can begin with the Commodity Research Bureau (CRB) index (Figure 1), which includes most commodities but not the currencies or interest rate futures.

COMMODITY PRICE INDICES



CRB INDEX			
Commodity price index 23 spot prices		Commodity price index 21 futures prices	
Burlap	Rubber	Cattle	Lumber
Butter	Soybean oil	Cocoa	Orange juice
Cocoa	Steel scrap	Coffee	Platinum
Copper scrap	Steers	Copper	Pork bellies
Corn	Sugar	Corn	Silver (NY)
Cotton	Tallow	Cotton	Soybeans
Hides	Tin	Crude oil	Soybean meal
Hogs	Wheat (Mpls)	Gold (NY)	Soybean oil
Lard	Wheat (KC)	Heating oil	Sugar
Lead	Wool tops	Hogs	Wheat (Chi)
Print cloth	Zinc	Oats (Chi)	
Rosin			

Grain	Oilseed	Livestock & meats	Imported
Corn	Flaxseed	Cattle	Cocoa
Oats (Chi)	Soybeans	Hogs	Sugar
Soy meal	Rapeseed	Pork bellies	Coffee
Wheat (Chi)			

FIGURE 1: The Commodity Research Bureau futures index includes 21 commodities but does not include currencies or interest rate futures.

However, some sectors of the futures market periodically tend to trade counter to other sectors. Despite this, all sectors can provide worthwhile opportunities, and this is an important difference between futures and stocks. In stocks, Wyckoff dictates that those issues that are trading against the trend of the general market be avoided.

Since individual sectors of the futures market are more independent, a distinct benefit exists in the indexing of related contracts. Five sectors of the futures market appear to be best for this approach — interest rates, currencies, precious metals, grains and livestock. Figure 2 shows an index of interest rate futures.

The contracts used in this index are bonds, 10-year notes and five-year notes. Defined thus, the index provides a view of interest rate instruments overall but is aimed more directly at intermediate- and longer-term maturities. The definition could be broadened to include the two-year note future and Treasury bill futures. These additions would redirect the primary focus of the index to a shorter maturity. Another valid approach would be to leave the definition narrow with only three components, but to use the three shortest maturities. The effect would be to retain the sensitivity that comes with a narrower definition but to direct the primary focus at the short-term maturity end of the yield curve.

Indexing of related contracts provides two important benefits. One, it gives the trader a broad overview of each sector for a minimum amount of effort. With practice, the trader can determine at a glance which sectors are worthy of a closer look. Two, indexing also provides the basis for relative strength and weakness comparisons, which is an essential part of the Wyckoff method. The best comparisons to make are index to index and between the components of an index. The trading technique is the same as it is in the stock market. Look for relative strength for buy candidates during market reactions and commodities that show relative weakness on rallies for sell candidates.

Whether or not indexing is used, the Wyckoff futures trader is still faced with the problem of volume. He needs to gather as much information as possible. Although the need for information varies depending on what the price is doing, it is a good idea to get in the habit of collecting the same set of figures on a daily basis. Doing so can help avoid some errors in judgment.

The daily publications provide volume from the trading session two days ago, plus an estimated volume figure for yesterday. While it is true that more timely presentation would be better, the actual volume for a particular session is very important even two days after the fact by providing the basis for confirming the conclusion made about that day's action. With Wyckoff analysis, the conclusions made about the action on a particular day are built on those from the prior day or days. The ability to confirm those previous conclusions will help improve the quality of current conclusions. Without this confirmation, it is possible that the analysis will stray farther from the truth, resulting in more numerous and costly trading errors.

The estimates of the previous day's volume tend to miss the actual numbers by a wide margin regularly. However, they are important in Wyckoff analysis for developing a conclusion about the character of the previous day's action. The price spread, net change and relative level of volume for a day combine to make a statement about that day's action. These statements are an essential element in determining what action, if any, needs to be taken. Increasing or decreasing volume together with widening or narrowing price spread and expanding or contracting net progress indicates whether demand or supply is in control and whether that control is increasing or decreasing. The result is either a positive or negative statement,

BOND INDEX

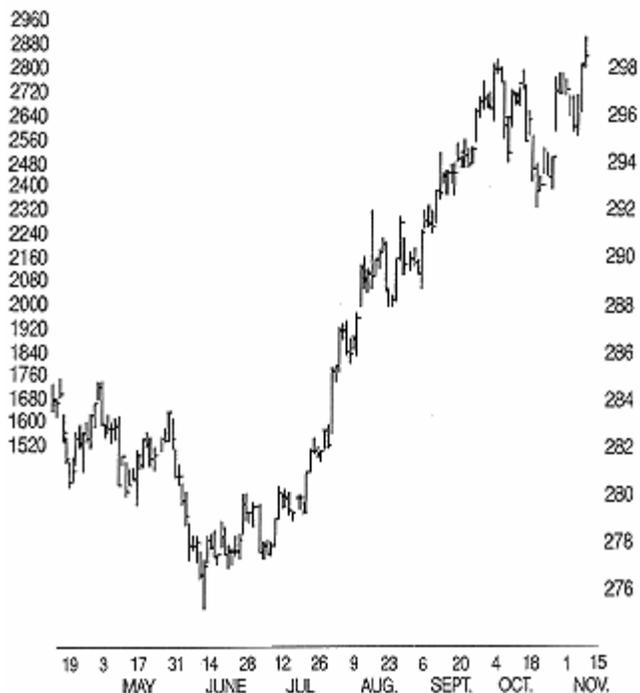


FIGURE 2: *The bond index is formed by adding together the nearby price of the Treasury bond, 10-year Treasury note and five-year T-note contract prices.*

or an unclear statement. Where each statement is made relative to previous action determines what, if any, action needs to be taken from a trading standpoint.

Many traders with access to quotation devices or market monitoring systems intraday have access to the tick volume figures. Tick volume is activity. It measures the number of trades rather than contracts in a trade. A trade may present one contract or one thousand. Therefore, any attempt to relate tick volume to actual volume must be approached cautiously.

VOLUME, VOLUME, VOLUME

From a Wyckoff standpoint, relative volume, particularly when it is combined with price spread and net change, is as important as actual volume. An increase or decrease in the level of activity (tick volume) from one day to the next will usually reflect an increase or decrease in the level of volume from one day to the next. Thus, it is possible to arrive at a conclusion about the character and significance of a day's action before acquiring the actual volume during the next session. Keep in mind that this relationship is not absolute; as always, exceptions do exist. Therefore, it is always necessary to retrieve the actual volume as it becomes available to provide additional confirmation. Also, volume characteristics tend to change over time. Comparing the tick volumes of two consecutive days will provide a more accurate comparison of the relative volume of those two days than comparing tick volumes of days that are weeks or months apart.

Although volume is absolutely essential to Wyckoff analysis, sometimes volume is not necessary for a conclusion. Narrowing price spread and decreasing net change at the top of a rally is a negative indication; this is true whether the volume is larger or smaller. Narrowing price spread and decreasing net change at the bottom of a reaction is a positive indication; this is true whether volume is increasing or decreasing. Although these conclusions do not require volume, they can be more informative if volume is added.

Narrowing price spread and decreasing net change at the top of a rally indicates whether demand is being withdrawn or supply is being met. Both are negative indications, but the meeting of supply is viewed as being more negative than the withdrawal of demand. The level of volume indicates which process is most likely taking place. Increasing volume is equated to the meeting of supply, while decreasing volume is equated to the withdrawal of demand.

At the bottom of a reaction, narrowing price spread and decreasing volume indicate either the meeting of demand or the withdrawal of supply. Here again, the determining factor is volume. It enhances the degree of bearishness or bullishness of the situation. However, it is the character of the price spread and net change at the top of the rally or bottom of a decline that in truth indicates the desirability of establishing a position. That being the case, the Wyckoff trader can feel reasonably comfortable about establishing a position without knowing the volume.

The Wyckoff trader's confidence level can be increased if the price action is compared with past action. Narrowing price spread at the top of a rally or at the bottom of a decline is especially important if it is penetrating a previous key level. Wyckoff students know these positions as variations of the broader classification of springs and upthrust; they represent attempts to break through established support and resistance that are unusually subject to failure due to a lack of demand or supply. These conclusions can be made without having solid volume information. For this reason, Wyckoff students who are futures

traders are encouraged to learn everything they possibly can about springs and upthrusts (Figure 3).

AND ALSO KEEP IN MIND

In addition to studying the price action and volume, trend and position, condition and potential (Figure 4) are important factors in judging the merits of a particular potential spring or upthrust. Since a spring is expected to produce a positive result, that it develops while the market is in an uptrend makes it more interesting to the Wyckoff trader. If the market is also positioned at the bottom of the uptrend channel when the spring develops (Figure 5), it is even more interesting to the Wyckoff trader. Trend and position are also important when an upthrust develops. The upthrust by itself is of interest to the Wyckoff trader, but the upthrust that develops in an established downtrend is more interesting and those that develop with the market positioned near the top of the downtrend channel are more interesting still.

Everyone likes a market that is in a well-defined uptrend or downtrend, especially when a position in harmony with the trend is in place. Most of the time, however, the futures trader will be looking at markets that are in trading ranges. This should not be viewed as a negative situation. As a result of the highly leveraged nature of futures trading, trading range activity can actually lead to more opportunities. Since the primary thrust of the action is horizontal, the trader can justify trading both spring and upthrust positions without having to worry about violating the Wyckoff method by being positioned counter to the trend.

During trading range activity, it is likely that only one spring or upthrust position will exist. In some cases, there will be one or both. However, repeated springs or upthrusts will be seldom seen. That being the case, how is it possible for trading ranges to produce more trading opportunities?

A trading range has three distinct parts. It begins with a stopping action that breaks the previous up- or downtrend and defines the trading range, which in turn is completed with an ending action. This provides a clue about the timing and direction of the departure from the trading range. The spring and upthrust belong in this category.

Between the stopping action and the ending action, there is the testing process, which may last for days, weeks or months. During this time, the price moves up and down within the trading range, testing the strength of the support and resistance. Each test that does not result in a penetration of the support or resistance level adds to the strength of that level and adds to the potential that will fuel the move that eventually leaves the trading range.

Each rally from the bottom of a trading range or reaction from the top of a trading range is a potential trading opportunity. The Wyckoff student selects his entry points from among these by first analyzing the character of the price action and the volume action as far as it is known — action that indicates the meeting of supply or withdrawal of demand at the top of a rally, which represents an opportunity on the short side, or action that indicates the meeting of demand or withdrawal of supply at the bottom of a reaction, which represents an opportunity on the long side. Opportunities on either side are confirmed by divergent action between price and volume and by the development of clearly overbought or oversold conditions.

IS TIMING ALL?

It is a commonly held belief, especially among futures traders, that timing is all. Wyckoff students are

SPRINGS

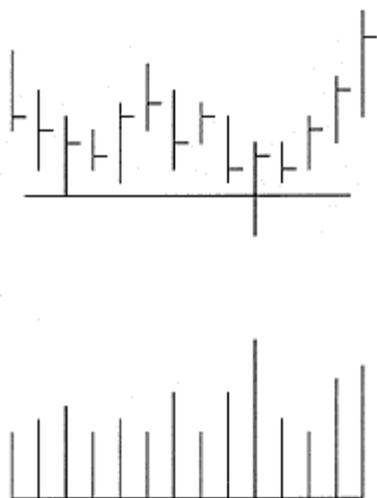


FIGURE 3a: *A SPRING OCCURS WHEN THE PRICE ACTION CARRIES THE MARKET BELOW A PREVIOUS SUPPORT POINT DURING THE DECLINE TO NEW LOWS THE WEAK HAND TRADERS ARE FORCED TO LIQUIDATE TO THE STRONG HANDS THAT BID THE PRICE BACK UP TO ABOVE THE PREVIOUS SUPPORT POINT. THE VOLUME IS VERY GOOD, INDICATING THAT LARGE TRADERS (GOOD DEMAND) HAVE ENTERED THE MARKET TO ASSUME NEW POSITIONS FROM THE WEAK HANDS.*

UPTHRUSTS

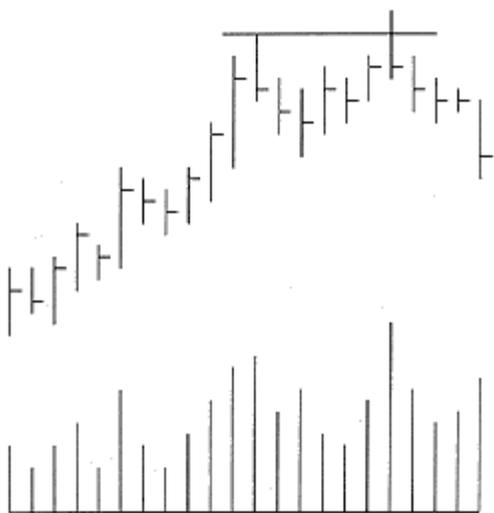


FIGURE 3b: *An upthrust occurs when the market fails to stay above a previous supply or resistance level. Typically, the news that pushes prices higher is quite favorable but viewed as an opportunity to unload positions held by large traders to the late buyers. The failed attempt to hold the new highs attracts supply, as indicated by the increased volume.*

BOND INDEX POINT & FIGURE

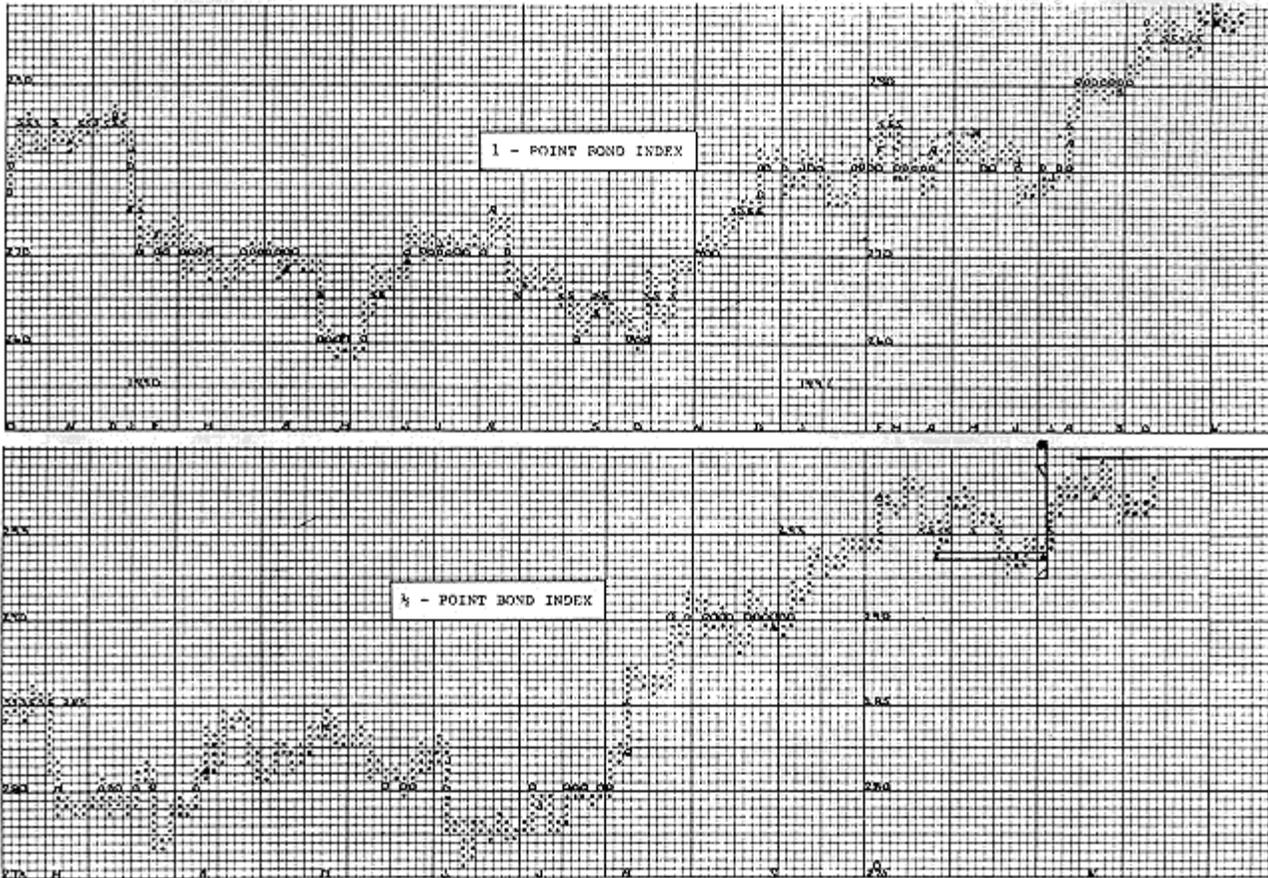


FIGURE 4: The Wyckoff method uses point & figure charts to determine potential for a move in the market. Counting sideways along a horizontal trading range produces an objective adding this count to the top or bottom of the trading range is the objective for the market once the price movement has exceeded the boundaries of the trading range.

SPRING AT SUPPORT LINE

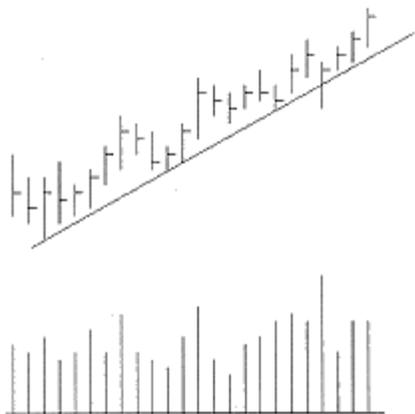


FIGURE 5: *If the price movement temporarily breaks the uptrend line, only to uncover demand at a previous support level, the uptrend can be expected to continue.*

WITHDRAWAL OF SUPPLY



FIGURE 6: *The shortening of the daily ranges along with contracting volume indicates that the lower prices are producing a withdrawal of supply, which is a bullish indication.*

taught that although timing is important in achieving success, it is not everything. Good money management is as important as good timing. These money management guidelines given from a Wyckoff perspective should aid in futures trading:

As a result of the highly leveraged nature of futures trading, trading range activity can actually lead to more opportunities.

- When establishing commitments, build winning positions. Do *not* average into losing positions.
- Always use a stop-loss order and be sure that the stop is set when the position is established. In addition to placing a stop relative to the anticipated profit, it should be placed relative to the level of capital.
- Never risk more than one third of the anticipated profit.
- Never risk more than 10% on any one trade.
- Never meet a margin call. If you get a margin call, one of two things is happening. The position held is too large for the capital, or the position itself is wrong. Either way, increasing the exposure to risk is more likely to make a bad situation worse.
- Finally close out positions when profit objectives are reached . No position has unlimited profit potential. The best estimate of potential profit is the one made just before the position is established. When it has been realized, it is time to get out.

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FOR FURTHER READING

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