Frozen In Analysis Paralysis?

Use Volume To Break Through The Ice

By *Todd Krueger.*

It's not about quantity, it's about quality. Using more than one indicator may not always be the best solution...

As traders, we have a plethora of choices regarding our individual approach to trading the markets.

There are dozens of variables that go into trading, including, but not limited to, the style of trading that we adopt (day trading, swing trading, position trading, options trading), the markets that we trade (stocks, futures or Forex), the time frames to trade in (1-minute, 5-minute, 60-minute, daily, weekly, etc.) and the tools we use to make our trading decisions (fundamental analysis, technical analysis and/or volume spread analysis).

Feeling Overwhelmed?

With all of these choices to make, it can be very difficult to figure out what is truly important to achieve the goal of successful trading. It is very common for inexperienced traders to feel overwhelmed and succumb to the detrimental "analysis paralysis" syndrome in which they tend to overcomplicate the entire trading process by rationalizing that if one indicator is good, then two must be better and if two are better, then four must be even more accurate in predicting what the market will do next. Unfortunately, this line of thinking leads many traders down a long, frustrating and most often a losing path in their trading careers because they are focused on the wrong areas of the trading spectrum.

I believe that to be a successful trader in today's environment, one needs to master three specific areas: trading psychology, money management and chart reading ability. This article focuses on how to read a chart properly. We will be using a method called volume spread analysis to determine where there is supply or demand from professional money, and we will look at how multiple time frame analysis confirms their activity on the price chart.

Multiple Time Frame Analysis

In my years as a trading educator I have found that most losing traders have a critical glaring weakness in their approach to analyzing a market. The majority of their focus is placed on mathematical technical analysis tools such as moving average convergence divergence (MACD), the relative strength index (RSI) and/or stochastic studies (among many others). All of these types of tools are derivatives of price movement and are lagging indicators. To make matters worse, many of these traders attempt to use these tools in isolation and they completely lose focus on reality; indicators don't move price, price movement moves indicators! Then the nail in the coffin occurs when the trader uses this approach on only one or two time frames (i.e. a 1- and 3-minute chart or a 5- and 15- minute chart).

The problem with this approach is the trader is not focused on why the price is moving in the first place. Price moves occur because there is an imbalance of supply/demand in the marketplace and this imbalance is created from the activity of professional traders. These professionals are very cagey when it comes to disguising their true intentions and hiding their positions from the uninformed retail trader. The average retail trader doesn't understand how to read a chart in order to determine the underlying strength or weakness in the market. Even for a trained VSA expert, it is nearly impossible to accurately forecast the near-term direction of a market by analyzing a single time frame; there just isn't enough corroborating evidence if we only look at one or two time frames. Think of each singular time frame as a musical note, when we combine multiple time frame's together we go from the market blaring out one note noises, to the market singing us a melody and revealing the message that is so often hidden to the trader who can't read a chart; that message is where the professional traders are positioned. Before we move to our chart examples we must understand the following rules of multiple time frame analysis:

1) Each time frame can and will look structurally different from another.

2) The smaller time frame will lead the larger time frame.

3) The combination of activity on the smaller time frames summed together creates the structure of the larger time frames.

4) The larger the time frame showing strength/weakness the larger the impending move.

5) We use the larger time frame to confirm the smaller time frame's message; if there is no corroboration we have no confirmation.

Putting It Into Action

Let's take a look at an example. We will be analyzing the E-mini S&P with the following time frames: 5-minute, 10-minute, 15-minute and 30-minute charts. It is important to note that the individual trader must determine the selection of time frames to be used based on his or her own style of trading; there is no magic formula for the best time frames. A scalper would use a shorter combination of time frames while a swing trader would possibly use higher time frames in their analysis. Another important point is that because of the limit to the number of charts that can be used in this article, the daily chart is not shown, but in reality it must be included in your analysis no matter what other time frames you trade with.

We will start our analysis with the 5-minute chart (see Figure 1). We can see the big six-point, gap-up open of the day session, September 2006 contract (labeled bar 1). The day we are looking at is August 4th, 2006; this was a non-farm payroll report day that came out with lower job growth numbers than expected. The retail trader (general public) read this as being bullish for the market since this lessened the probability that the Federal Reserve would hike interest rates with the upcoming FOMC meeting on August 8th. The media also helped out with this perception as the talking heads were on TV espousing how this should be bullish for the stock market. This is a classic example where the news drives the retail trader into the market and creates a short window of opportunity for the professional money to distribute their long positions to the mass public (the herd).

FIGURE 1: E-mini S&P 5-minute Chart

Source: TradeGuider Systems, LLC

Volume Can Reveal Who's Buying and Selling

Remember the previous statement that weakness appears on up bars; it has to work like this because professional money trades with very large size, and they must sell their positions into an up move in order to unload those positions without the pressure of their own selling driving prices down against them. Notice the first 5- minute bar (labeled bar 1), it's a gap-up bar with massive volume, but the closing price is in the middle of the bar; this indicates that there is supply coming from professional traders. The reason that we know this is that there is no other way to explain how that big up move could close in the middle of the bar if no selling were occurring. The retail trader is buying on the bullish news, and the only traders out there with enough size to sell into this up move and cause the price to close back into the middle of the bar are professional traders.

On the smaller time frames it is common to see several up bars in the distribution process before the market rolls over; this allows the professionals the opportunity to transfer all of their remaining positions to the herd (and establish their new short positions). On the third bar of the session on this 5-minute chart (labeled bar 2) we see another up bar with even higher volume with the very next bar sharply down, closing near the low, this now effectively locks the new long (weak holder) into their losing position. These retail traders that have bought at the top of the market will soon have to cover by selling their positions and adding fuel to the down move, creating more profits for the smart money and creating substantial losses for the weak holder. So on the 5-minute chart we know by 8:50 a.m., CST that there has been a mass transfer of ownership to the weak holder. We must now look at our longer time frame charts to confirm that this is serious weakness; this will provide proof that we have a very high-probability turning point that can be traded.

We will now focus our attention on the 10-minute chart (see Figure 2). The first thing to notice on this chart is that we can see the weakness coming in, which further confirms the weakness on the 5-minute chart. It only takes three bars on this longer time frame to see the distribution process turn the market over; the telltale sign of weakness occurs on the second bar of the session (labeled bar 1) with the very next bar (labeled bar 2) closing down near the low with an increase in the price spread; again this price action locks the new long into a poor position. On the 10-minute chart we have confirmed the weakness that occurred on the 5-minute chart and it has happened by 9:00 a.m., CST. As stated earlier, we now have two notes of a possible melody developing, but we still need to confirm this on the next higher time frame.

FIGURE 2: E-mini S&P 10-minute Chart

Source: TradeGuider Systems, LLC

On the 15-minute chart (see Figure 3) the weakness is also confirmed as we see the first bar of the day (labeled bar 1) gap-up to close on the high with a high volume spike. The next bar (labeled bar 2) closes down near the low, with an even wider price spread and slightly more volume. Bar 1 on this chart is a good example of one of the rules that traders learn when they study volume spread analysis; high volume up bars (or greater), with a wide price spread (or greater) is an area where the professional trader can be invisibly dumping huge supply onto the market. Since we have already seen the proof of this on our smaller time frames, the musical notes are starting to string together to form a melody.

FIGURE 3: E-mini S&P 15-minute Chart

Source: TradeGuider Systems, LLC

Finally, let's look at the 30-minute chart (see Figure 4) to see what the summation of these smaller time frames together looks like on one 30-minute bar. It should now be very easy to see the extreme weakness on the opening bar of this chart (labeled bar 1), this is what VSA refers to as an up thrust; these are designed to mislead as many traders as possible into the wrong position and we can now see, with the benefit of multiple time frame analysis, how this happens on the charts! With all of the supply that has hit the market from the smart money in the first 30 minutes of trading, we have all of the ingredients necessary to establish a high-probability short position in the market. This is a classic example of a news-driven event that triggers the herd into long positions, and then we confirm the smart money is selling into this up move with multiple time frame analysis and chart reading skills.

FIGURE 4: E-mini S&P 30-minute Chart

Source: TradeGuider Systems, LLC

Chart Reading Skills Are A Must

By taking the reader through the analysis of multiple time frames and employing the chart reading skills that one can master by studying volume spread analysis, it is my hope that you have gained at least a rudimentary understanding of how the professional trader operates in the market and how it can be identified by the trained eye. For successful trading results, there is no substitute for the ability to read charts using multiple time frames. The chart can talk to you if you let it, but it is a learned skill which is far more accurate than simply relying on mathematical technical analysis indicators which never reveal why a market is at a turning point and very often confuse the trader that there even is a high-probability turning point to trade.

SIDEBAR

A Primer on Volume Spread Analysis

Volume spread analysis (VSA) is the improvement upon the original teaching of Richard D. Wyckoff by Tom Williams, a former syndicate trader for 15 years in the 1960s-1970s (professional operator in the stock market). Williams enhanced the work started by Wyckoff by further developing the importance of the price spread and its relationship to both the volume and the close. In 1993, Williams made his work available to the public when he and TradeGuider published his methodology, Master the Markets. VSA seeks to establish the cause of price movements. The “cause” is quite simply the imbalance between supply and demand in the market, which is created by the activity of professional operators (smart money).

The activity of these professional operators, and more importantly their true intentions, are clearly shown on a price chart if the trader knows how to read them. VSA looks at the interrelationship between three variables on the chart in order to determine the balance of supply and demand, as well as the probable near term direction of the market. These variables are the amount of volume on a given price bar, the price spread, or range of that bar (do not confuse this with the bid/ask spread) and the closing price on the spread of that bar (refer to Figure 1 on the lower left side of the chart). It is important to understand that weakness (supply) in a market appears on up bars and strength (demand) appears on down bars; this is exactly opposite to what most non-professional traders believe to be true. This explains why many retail traders buy at market tops and sell at market bottoms; they simply don’t know any better. [More information on the background of VSA can be found in the June 2006 SFO article entitled: Rediscover the Lost Art of Chart Reading, by Todd Krueger.]

It is also important to note, in closing, that the VSA methodology works in all time frames and markets; we could have analyzed a stock or commodity from a swing or position-trading standpoint just as effectively as the example that we used. It may also help some traders to understand the methodology more clearly if we substitute the term spread in volume spread analysis with the term range, volume range analysis. It is possible for some traders to confuse spread to mean the analysis of the bid/ask spread, which has no significance in VSA.