

**W**ELCOME to lesson one of *Trend Dynamics*. ¶ Our object is to deliver an enlightening series of lessons on the rather strange world of professional trading. ¶ These twenty-three lessons contain the distillation of my twenty year's experience as an off-floor futures trader. You'll learn explicit trading strategies & tactics for trading in the stock and futures markets and you'll learn how to build a successful trading business. ¶ One consequence of the recent explosion in programming, technical software, and mechanical systems is a loss of perspective. Markets today are seldom seen with the clarity, the wholeness and integration, that a theory or framework of market understanding provides. Instead, all too many traders comprehend markets only through a smoked lens—the bottom-line results of a hypothetical computer run. ¶ Mechanical systems provide at best a relatively narrow slice of some facet of market principles. In this regard, they do have value; but because no unifying theme links these disparate systems, the trader who relies upon them makes little progress in acquiring *for himself* a broad-based and realistic understanding of the causes and effects of price movement. In spite of amassing a library of software and systems to ease his progress, the bewildered trader continues to struggle, and trudges on to the next system.

[ FRAMING YOUR TRADING SUCCESS ]

*A common trait among great traders—traders who survive & prosper over time—is some underlying framework of how markets function.* Typically this framework, whether intuitive or logical, is built upon the successful trader's fascination with the inner workings of markets and price movements. ¶ George Soros writes at length about his personal framework for market understanding in *The Alchemy of Finance*. Peter Steidlmayer's framework is the now-well-known Market Profile method. And more recently Linda Bradford Raschke, one of the subjects of Jack Schwager's book *New Market Wizards*, identified her framework as based on the obscure Taylor Book Method, developed by George Douglas Taylor in the late 1940s. Without the stabilizing effect of a core set of market beliefs, trading-plan development and trade execution remain too volatile. ¶ My purpose here is to help you build a foundation within which you can make consistently good decisions over a long period of time. Because we need to build this foundation early on, this first lesson begins by reviewing some basic core principles of price action. ¶ Let's begin . . . [1]

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## · SECTION I ·

*Theory & Principles of Trend Dynamics:*  
Modeling Price Movement

## I · PRICE ACTION IS POWER, FORCE, &amp; ENERGY

THE TWO DRIVING ELEMENTS that move prices are speculative *power* and speculative *force*. These two elements are transformed by decision/action (buy and sell orders) into the energy we see represented on our charts and screens as price movement. (See Fig. 1.1, opposite)

## [ SPECULATIVE POWER &amp; SPECULATIVE FORCE ]

Speculative *power* is the **amount of capital or credit** available to buy or sell a given contract at any point in time. Speculative *force* is the **desire** (thought) to buy or sell at any point in time. These two elements are often not commensurate.

As a trader you might have a tremendous amount of capital or credit (*buying or selling power*) with little desire to act and deploy it; or you might have a high degree of emotional urge to act (*speculative force*) with little actual capital or credit (*speculative power*) to buy or sell.

## [ THE BALANCE OF POWER MOVES PRICES ]

While these two elements are in a constant flux, it is the **balance of speculative power** at any point in time that causes tension, change, and a given market's eruptions in price.

As a market marches upward, that is, as it becomes dominated by speculative power expressed as demand, minor shifts in speculative power lead to reactions or trading ranges. If the balance of underlying speculative power is still upward, the speculative force resumes its directional tendency, expanding to new highs. Then, finally, some psychological change in the speculative force leads to a decided change in the balance of power, and the market reverses into a downtrend.

The internal dynamic of this interaction is extremely complex, for it perpetually ingests a steady stream of internal and external stimuli that constantly refuel the tug-of-war.

Those closest to this balance of power, such as scalpers and floor

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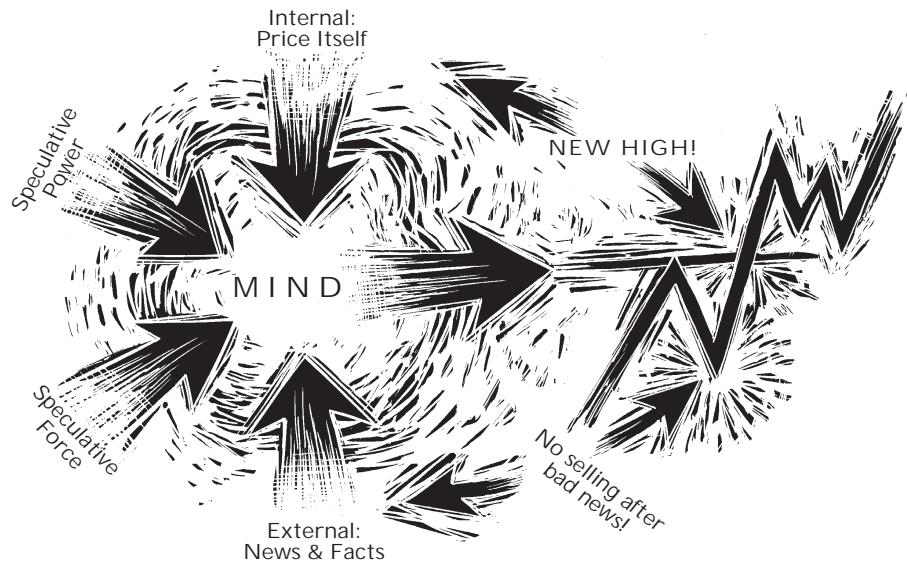


Figure 1.1  
A model of power, force,  
& price energies.

traders, often find it difficult to describe the phenomenon except in such vague terms as “gut feel,” “instinct,” “I just know,” and “seventh sense”. At a more quantifiable level, we can see the shadow this balance of power casts by following such fairly sensitive intra-day indicators as net ticks, advancing *v.* declining stocks, advancing *v.* declining volume, and put *v.* call volume. (This applies primarily to stock index futures.) The balance may also be seen, although with less sensitivity, in extreme readings of such relatively coarse tools as daily put/call ratios, margin buying, trader commitment, and bullish consensus reports.

[ INTERNAL & EXTERNAL ACTION & REACTION ]

Traders in position to act on decisions that affect the balance of speculative power constantly receive both external and internal stimuli urging them to take action, stand aside, or flee.

External stimuli to price movement are events that feed into the process as a constant flow of news and facts. But to the constant befuddlement of the layman, it is neither the actual facts nor even the news itself that affect the markets. Rather, what affects the market is, first, traders’ *interpretation* of the news; and, second, their *presumptions and expectations* of how the news will affect other traders. For example, failure of a strong market to rally on good news is a sign of exhaustion, and is a short-term negative; similarly, a weak market’s failure to sell off on bad news is the signature of a sold-out market, and is a short-term positive. (Accordingly, by the way, breakouts on positive news should be looked at with greater suspicion than breakouts on no news.)

The chief internal stimulus to price that feeds into the price/energy process is price action itself. New highs and lows, breakouts, false breakouts, increased volatility—all this is “news” to the technical trader,

news that constantly changes the balance of speculative power.

[ THE RIVER OF PRICE ENERGY ]

Like a great river, speculative power and force flow through specific exchanges, specific pits, and specific contracts fed by thousands of highly dispersed tributaries.

All over the globe, in thousands of offices, high rises, and homes, legions of traders sit in front of computer screens or chart books. Every one of them is but a quick button's push away from feeding this great river. There is something fascinating, supremely democratic, even magical in this. Unfettered price grinds the grist of supply and demand.

Because (1.) the dynamics of speculative power and force are ever-changing, and (2.) the sources of speculative power and force are globally dispersed, the *original cause* of any given price movement is difficult to quantify at its source at any particular time. Still, because of the condensing functions of the exchanges, the effect we see is definitive—pure price action.

[ THE FLOOR TRADER'S & THE SCALPER'S EDGE ]

The floor trader and scalper (as Fig. 1.2, opposite, shows) is physically in an advantageous position to access these constant changes in the balance of speculative power and to employ lightning-quick analysis and intuition in acting as soon as information condenses onto the floor. This is his edge.

As information flows into the pits, the floor trader is constantly assessing bids and offers, the flow of paper, the players, the noise, the energy—even, sometimes, the smell of panic. He has real-time auditory and visual access to information that reflects the balance of raw speculative power—information to which we off-floor speculators have muted access at best. The floor trader's actions further transform the character and balance of this power to affect prices before we can act.

[ THE OFF-FLOOR TRADER'S EDGE ]

Because the off-floor trader's access to the balance of power is relatively more distant, and since the balance itself is continually transformed by floor traders' buying and selling, our ability to feel the pulse of this raw energy is necessarily diminished.

But what might appear to be a disadvantage to us is in a sense an asset. Our distance from the hot center of things allows us the perspective of the larger timeframes that overhang or support a market. These are etched out by the relationships of prices—constantly adjusting bid/ask levels that float through time to form what we call price bars on our

§ "As off-floor traders, our ability to understand the dynamics of price movement as revealed in space (price) & time relationships, is one measure of our market savvy."

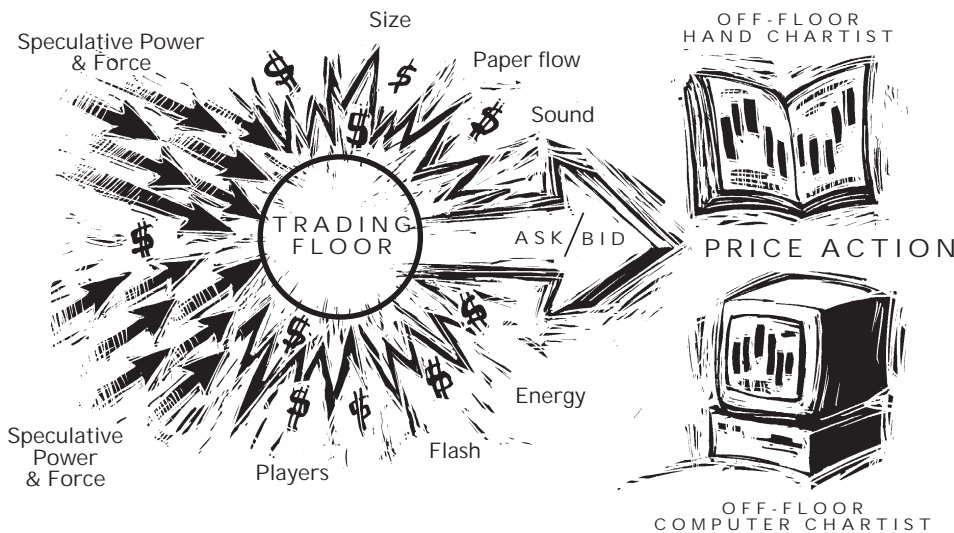


Figure 1.2  
Speculative power & force condense into price action through the trading floor acting as a centralized processing unit.

charts and screens.

As off-floor traders, our ability to understand the dynamics of price movement, as revealed in space (price) and time relationships, is one measure of our market savvy.

II · THE NATURE OF PRICE MOVEMENT

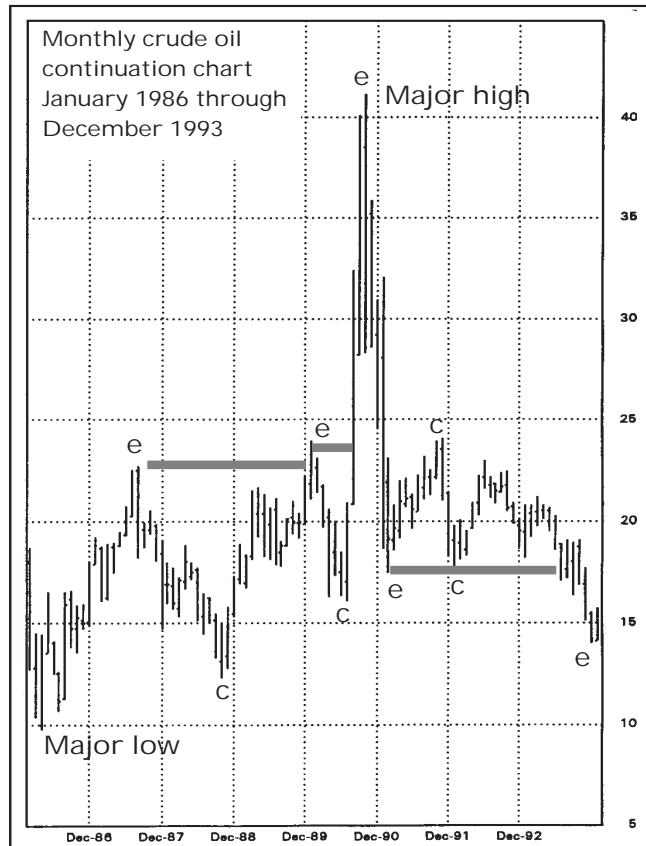
BECAUSE even the slightest change in the balance of power reflects itself immediately in price action, we can assess its presence as cause and effect. If the speculative balance of power is equal to the energy of price.

then we can track it accurately through price action. In short, if as off-floor traders we can become expert in understanding the nature of price movement (and specifically how price relationships evolve), and then employ our larger-timeframe advantage, we will have a distinct competitive edge.

[ THE PHYSICS OF PRICE ACTION ]

Price breathes in a rhythm of constant contraction and expansion, stability and instability; episodes of violence are interspersed with interludes of quiescence. Price action may be understood as a reflection of energy that is in continual transition from a state of instability (*trend*) to a state of stability (*congestion* or *trading range*)

Chart 1.1  
Major expansions & contractions in crude oil (e = expansion, c = contraction)



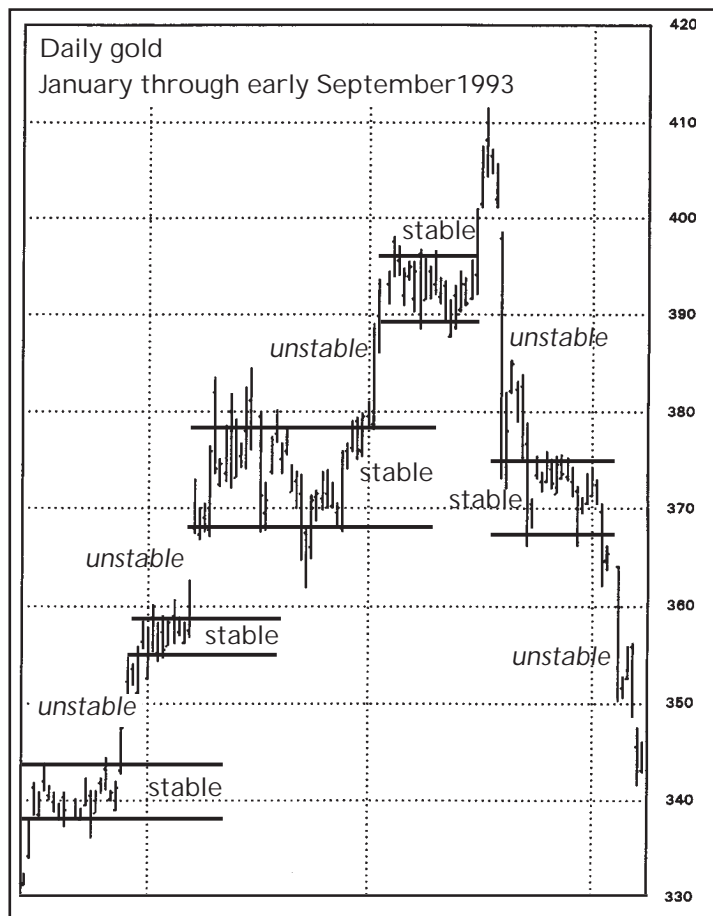


Chart 1.2  
Daily gold alternating  
between stable &  
unstable states

stability, and instability as *trend*. (See Chart 1.2, left.)

As external stimuli (news and facts) and internal stimuli (price action) change the balance of speculative power, swings and trends erupt, and are rapidly priced to the level where demand and supply reach equilibrium. Then stability (congestion or trading range) is reestablished.

In a memorable discussion I had years ago with Ed Seykota, a keen observer of markets, he described this homeostatic character of markets well. He said,

There's an inherent ecology in which people who play trend-following systems support the motion to go fast. Part of the breakout process is people going with the trend; it's not a spurious overlay where you are looking for some distant purpose. [The fact] that price goes faster speeds up the process of getting the price to the right place, and that is a stabilizing effect.

Again, what is fundamental is a price model that reveals price action to be a reflection of energy in continual transition from states of instability (*trend*) to stability (*congestion* or *trading range*).

### III · PRICE RELATIONSHIP & TIME

I HAVE DESCRIBED price movement as the energy effects of speculative power and force. And I have argued that this energy is in continual

and back again.

In Chart 1.1, at right, note the major expansions (e) in price from the major low near \$10. in 1986 up to the major high during the Gulf War in late 1989. Then a new period of expansion begins down to the early 1991 low. It is followed by contractions (c) during 1991-92, then re-expansion down into the late 1993 lows.

### [ PRICE ACTION & HOMEOSTATIC SYSTEMS ]

Price action behaves as if it were a homeostatic system. (Homeostasis is the tendency of a system to maintain or seek internal stability owing to coordinated responses of its parts to a disruptive external stimulus.) In the markets, we can view trading ranges or congestion as

#### DEFINITION

#### PRICE ACTION

¶ Price action is a continuum of sequential price transactions moving forward in time.

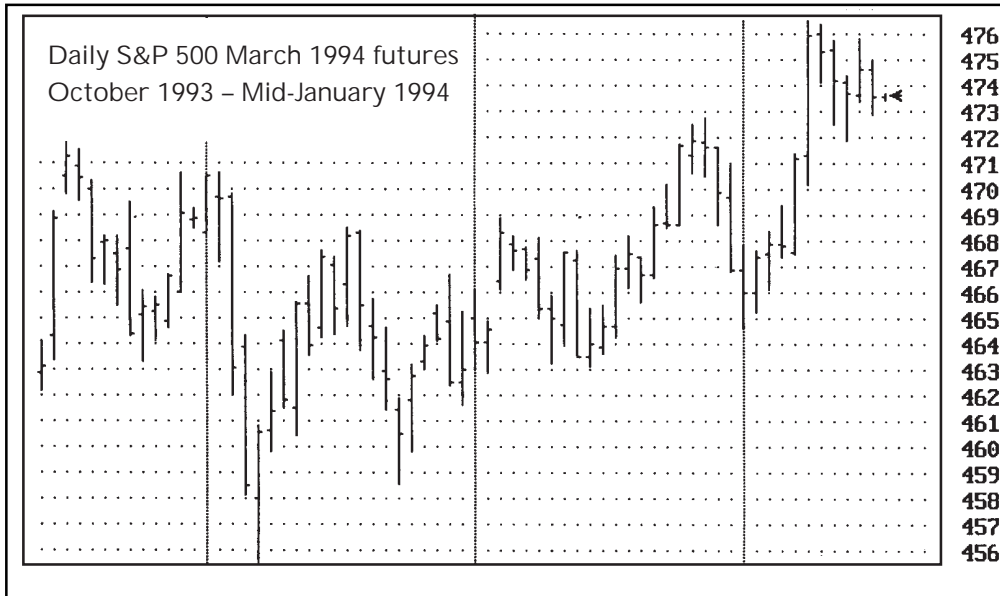


Chart 1.3  
Three months of price activity conditioned by daily timeframes

transition from states of instability (trend) to stability (congestion and trading range). Here I'd like to explore how *time*, which is fundamentally linked to the process of quantifying this energy, breaks price down in such a way that we can begin to uncover such key relationships as cause and effect, supply and demand, effort and results.

We can define price action as *a continuum of sequential price transactions moving forward in time*. Because it may be plotted in space vertically (to represent a range of motion over specific price levels), we can quantify this energy.

[ TIME CREATES PRICE RELATIONSHIPS ]

Represented horizontally, it is time that delineates a succession of instants we can use to make relative comparisons of the four key range variables—open, high, low, and close. Of course we never really trade time, we trade price. But without time we should have no qualifier with which to construct price bars. *The variables of technical analysis are dependent on time.*

For example, if from any chart we remove the horizontal axis representing time, we are left with a continuum of price transactions in but one dimension. Chart 1.3, above, is a daily March 94 S&P futures chart showing the period November 93 through mid-January 94. Chart 1.3A, right, is the same chart with the time axis removed. The only difference between the two charts is that one has been broken up into time units—in this case, daily—so we can analyze relative price ranges.

**All profitable trading is based on the study of price relationships that have predictive probability value.** Trend models, strategies, and

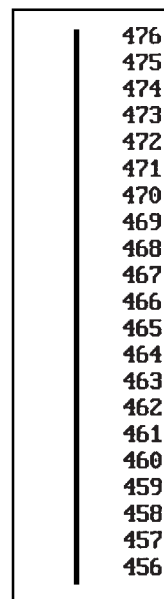


Chart 1.3A  
The same chart, but with the time axis removed

§ *“All profitable trading is based on the study of price relationships that have predictive probability value.”*