



Demand/Supply



Wandering through NetLand recently, I heard the plaintive cries of a fellow traveler, wailing that his indicators had once again betrayed him. "How could the stock have gone up?" he sobbed. "MACD was *negative!* The 12-day ROC said *Sell!* **The borogroves were mimsy!**" You hear this stuff a lot. Another investor moans "How can the market be making new highs? We're in a 3C Wave!" It sort of reminds me of those people who try to understand brain function by feeling the bumps on somebody's head. Seems to me that if you want to understand how the brain functions, you study the brain and what makes it twitch and shudder. If you want to understand how the market functions, you study the market, not market indicators.



Technical indicators are the high-tech equivalent of feeling the bumps on the market's head. Since these indicators are often vague and muddy at best, anyone who claims to have any but the most superficial understanding of them can gain great prestige and status. He can cloak himself in a robe embroidered with the Doji Star, the Black Crow and the White Soldier and invoke the Detrended Price Oscillator (shipping and handling extra). But just as tossing the virgin maiden into the volcano had only tangential relevance

to the return of spring, the behavior of technical indicators--useful though they may be under certain circumstances--bears only a tangential relationship to the behavior of the market or of an individual stock. To see the relationship, in fact, you have to look out of the corner of one eye.

All technical indicators are based on price and/or volume behavior, usually both. One might surmise, therefore, that to get at the root of all this, one should study the relationship of price and volume in addition to the proper use of technical indicators. Maybe *instead of* technical indicators. But you wouldn't be going far enough. Price and volume behavior are further dependent on the relationship between supply and demand. Therefore, **in order to make consistently profitable trades/investments over the long haul** (perhaps even the short haul), **it is absolutely essential that you understand how the relationship between supply and demand affects what happens to your stock.** Using technical indicators as a shortcut through this landscape is like trying to drive a car without first understanding the functions of the steering wheel, the brake pedal, and the accelerator.

In a nutshell, **when demand is greater than supply, prices go up. When supply is greater than demand, prices go down.** Sounds simple, doesn't it? And it is simple when compared to something like gene splicing. But as simple as it may be, it nevertheless confounds many investors who are desperately trying to determine if their stock is going to go up, when it's going to go up, and by how much it's going to go up (if it goes up at all), and whether they should buy more and if so when, or take their profits (if any) and head for the exits. Let's turn on a few lights, then, by going back to the beginning and walking through the process of determining supply and creating demand step by step.

Accumulation

As with the price of red bell peppers in January, **if a lot of people want something and there isn't much of it, it's going to cost more than if there's a lot of it lying around and nobody cares much.** If there are very few shares available for trade and a lot of people want them and are willing to pay through the nose for them, the shares are going to cost more than if there are gazillions of shares to be had and everybody can have as much as they want and then some. Many investors, novice and otherwise, interpret this to mean that they should and must focus on companies with a low "float" (shares issued by the company and not owned by insiders, therefore available for trade) in order to increase the odds that their stock's price will rise.

In a sense, they are right. Given the requisite demand, the fewer the shares, the higher the premium they'll bring. **A low float, however, is not always the key in and of itself to rapid price appreciation and investment success.** Momentum investors, particularly daytraders, can and often do drive the prices of low-float or "illiquid" stocks up rather quickly and dramatically. But as seen during the current Internet phenomenon, small floats can turn over several times in a day as a result of daytrader activity, and prices can plummet just as quickly and just as dramatically as they rose, so quickly in fact that one's stop may not be triggered until the price is well below the intended stop level, and those extraordinary gains can evaporate like a Popsicle in July.

Even so, this situation is perceived by many to be a more attractive situation than that in which institutions own a large percentage of the stock, whether the stock originally came from a large float or a small one. The fear is that institutional dumping can drive the price of a stock downward so quickly that one doesn't have time to react. And institutional dumping can drive down prices faster than you can imagine. But if your stock is plummeting, your brokerage account doesn't care whether it's bleeding because of institutional dumping or daytrader dumping. Dumping is dumping. Bleeding is bleeding.



Nonetheless, these cautionary statements do not alter the fact that a small number of shares is preferable to a large number of shares if you want the biggest bang for your buck in the shortest amount of time. A low float, however, can be the result not only of the shares never having been issued in the first place, but also of the process of **accumulation** (call it a *practical* low float, as the end result -- reducing the number of shares available for purchase -- is the same).



Accumulation is the process whereby a quantity of stock is acquired at the lowest possible price. It is not throwing money at a rocket or even a breakout. It is a subtle, sophisticated, and sly effort to amass a stake that is large enough to not only make the next phase (the "markup" phase) worthwhile, but also possible. The markup phase becomes possible because the number of shares available for trade has been quietly reduced, and when the demand for those shares increases, the prices charged for them can be increased as well. In other words, as with diamonds, there may be a lot of them, but they're released into the marketplace in controlled amounts in order to keep the price artificially inflated (stocks, like diamonds, are worth only what people are willing to pay for them).

The accumulation process takes place in what is called a "**congestion area**", a sideways movement of the stock in which price shows no inclination to take off either up or down and is accompanied by consistently low volume (see **Bases**). The low volume part is important, as **low volume levels are characteristic of indecision** (if people were confident in a decision to buy or sell, they'd do so, and in big lots too; when volume is high, everybody's being decisive--they just don't necessarily agree on whether the stock should be propelled higher or driven lower). Low volume can occur in congestion areas that are part of uptrends or it can occur in congestion areas that are part of downtrends. In either case, **the determining characteristic of the pattern as it relates to accumulation or distribution is the indecision within the pattern itself as to direction, not necessarily the prior direction**, for one can never be really sure in which direction the stock is going to break out except in hindsight.

So how do you know whether the stock (or whatever) is being accumulated or being gradually and surreptitiously dumped? Remember first of all that **when a stock is being accumulated, it is storing up the force of demand that will be the power behind a subsequent upward movement.** This accumulation takes time, and that doesn't mean one or two weeks, much less one or two days (daytrading is a somewhat different ball of wax since the price targets are so much less, but the principle's the same: you want results, you've got to build up the force to get them). And not every horizontal formation, no matter how long it is, represents a zone of accumulation. In addition to a base that is long enough to allow accumulation to take place, you must also satisfy yourself that somebody actually wants this stock, and you know that by the context in which this base or zone or congestion area is placed. Investors who like to think that they are "value" players often miss the boat on this point, believing that since the stock is cheap, it is a "good buy". But **if no one wants the stock, it is not a good buy no matter how cheap it is.**

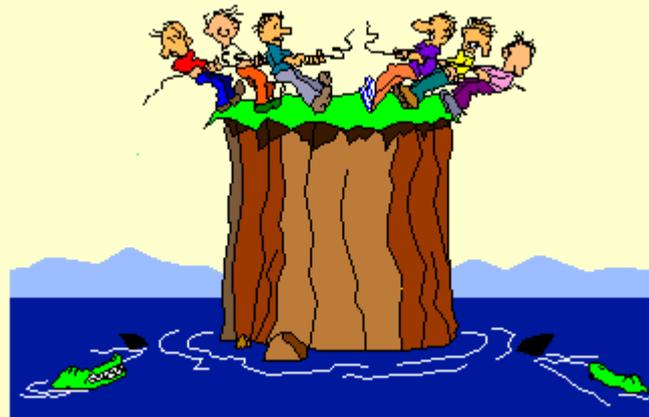


Determine, then, that this is a stock that interests someone.

Where was the stock prior to this base you're studying? Has there ever been any interest in this stock at all at any time? Is it resting, is it asleep, or is it dead? What is its strength in relation to its group? In relation to the market? If it is a "famous" stock, it is clearly in demand by someone, but it need not be famous in order for accumulation to take place. Was there increasing volume and higher prices before it reached its current plateau (a well-defined uptrend is always a big plus)? Has the stock ever gone through a sustained advance at any time, even if it was followed by a sustained decline? If so, and particularly if you have reason to believe that a new cycle of demand followed by higher prices is in the cards, **you must then evaluate the character of the base.**

In order to properly evaluate the supply/demand relationship, you need a bar (or candle) chart of prices showing the open, high, low, and close for each day (OHLC), and you need a bar chart of volume which shows how many shares of the stock are traded each day. If you have color-coded volume, get rid of it. This coding shows you what the volume was like on days the stock closed "up" (usually green) and what the volume was like on days the stock closed "down" (usually red). However, it is not at all unusual for price to, for example, close lower than it opened, yet close higher than the close of the previous bar. This makes the volume bar "green" even though the price bar may not be bullish at all within the context of the bars before it. Leave the volume bars black so that you can approach them without bias. If you use candles, their graphic clarity should be enough to give you a general idea of where prices are closing. As for "indicators", you need nothing else, not even moving averages. Just a plain ol' nekkid price and volume chart.

First, volume should be relatively quiet. It should reflect indecision, not an ongoing tug-of-war for dominance between bulls and bears. To the contrary, there should be general agreement between fans and detractors that the stock is pretty much worth whatever it's going for. There should be no massive flows of volume on either up days or down days. In fact, the "up" days and "down" days should be within a fairly narrow range of each other.



Second, even if volume is quiet there should not be a generally wide range between highs and lows each day. If there is a wide range between the highs and lows (indicated by long bars), there is still considerable disagreement intraday and day-to-day as to the value of the stock.

Third, when prices hit the low end of the trading range in the base (the "support" or "demand" line), **volume should remain low.** Coincidentally, when prices reach the upper end of the trading range (the "resistance" or "supply" line), volume should be higher. Color-coded volume, if you just can't live without it, should show generally higher green bars than red bars, though, again, even a high red bar should be analyzed carefully. As mentioned earlier, if the stock falls toward the support line and shows a strong recovery during the day, closing near its high for the day but a hair below the previous day's close, it will show as red. However, you have been sent a message that there is strong support at whatever level the stock reached before rebounding and that there was enough demand on that day to propel it back into the court. Make sure that you're home to receive this message.

Fourth, is the low end of the trading range less than halfway to the support line? For example, if the highest high is 24 and the lowest low is 20, are most of the price bar bottoms at 22 or higher?

Fifth, if the base is several weeks (or months) old, have there been any shakeouts, i.e., short, sharp spikes to the downside generally accompanied by relatively high volume but which last for only a day or so and which have no lasting effect on the day-to-day progress of the stock?

If the answers to the above questions are mostly if not all yes, then your stock is probably under accumulation. But first, a few more words about shakeouts, as they can be very unsettling to those who don't know what they are or how to recognize them.

Shakeouts

A shakeout is designed to frighten, and it does a pretty damn good job of it. **The general idea is for an elephant who's been accumulating a stock to throw a sizeable portion of it onto the market and temporarily drown demand, thereby temporarily driving the price down.** This rattles the unwary and prods them to sell their shares, making those shares available for purchase by the elephants. Those who have grown weary of waiting for the stock to do something other than drift along in this interminable base may also decide to throw in the towel and let somebody else babysit. And, of course, those who have placed hard stops just below the support line will be stopped out in a flash.

The shakeout is not always easy to spot at the time as one's first reaction is that something has gone horribly wrong and the stock is in deep trouble. But if the stock has been basing for a while, if the base has been relatively contained (it hasn't shot out of the trading range so far), if volume has subsided, and if there has been evidence of accumulation up to that point, one can at least suspect that a shakeout is taking place.

The acid test is the next day or so. If the stock bounces back into its trading range and makes its merry way as if nothing had happened, then you have probably witnessed a shakeout. On the other hand, if volume picks up and efforts to push the stock back up are defeated by too much supply and/or too little demand (except on the sell side), then the stock may actually be in trouble, and if you can't find out what's going on, you may want to get out and watch from the sidelines until the situation becomes clearer.

Markup

Toward the end of the accumulation campaign, we get ready for the second act of our little drama, the "markup" phase. This can get its motor running in several ways, and the road ahead may be rocky and full of potholes, but **the general idea is to propel the stock upwards so that the elephant(s) who went through all this accumulation hassle can make some money.** You'll begin to notice the **lows are gradually millimetering their way higher** and that **volume is increasing** -- perhaps ever so slightly -- along the way (volume need not be terribly heavy, however, as there is now much less supply than there was at the beginning of the base; therefore, it takes less demand to move the price upward). You may notice also that **price ranges from low to high are getting wider**, indicating that those who want the stock are willing to pay higher prices for it and aren't as content to "wait" for their price. The **closes are getting nearer and nearer the daily highs.** And there is **an increasing amount of net upside progress from day to day.** If there are rallies, they may stop short of resistance, but reactions must stop well short of support.



At some point, however, one must inevitably face the supply or resistance line. One can get there gradually as just described, or the stock may "pop" on strong volume and "break out" of the constraining base. **What happens at this point will tell the investor a great deal about the presence of demand and the quality of whatever demand there may be.** If the price breaks through resistance with increased volume, there is likely sufficient demand to sustain an upward move. The larger and swifter the increase in volume, the more likely you're looking at a turning point.

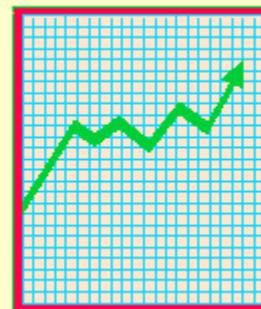
This initial move upward, however, is only the beginning. Does the stock close more than halfway up from the low to the high for the day? Is it breaking through interim resistance or is it making a new high? Is the volume strong, i.e., at least 150% of the ADV (Average Daily Volume)? Is the volume *too* strong?

Too strong? What do you mean "*too* strong"? Well, oddly enough, volume can be too strong on a breakout. Remember that volume is entirely a function of supply. **No matter what the demand, if there's no supply to meet it, the volume is going to remain low.** The price may rise because those who want the stock are willing to pay a premium for it, but the volume will remain low due to the fact that there aren't many shares available for trade.

But so what? All that matters is that the price go up, right? Well, no. Demand will drive up the price in the face of meager supply, but what happens when those few who really want that stock have all that they want or need or can afford? Who's going to take over the reins and continue to move the price? If you happen to have taken the momentum train (either by design or by mistake), perhaps daytraders will begin to churn the stock and turn over whatever shares are available over and over again at higher and higher prices, calculatingly selling to the "greater fool". In this case, **a long volume bar will reflect this churning** (check the float against the number of shares being traded), **not genuine demand for the stock** by people who really want it and want to hold onto it for at least the intermediate-term. If this is what you want and you know what you're doing, great. If it's not what you want and you don't know what you're doing, you better know how to recognize what's going on. Otherwise, the greater fool who winds up holding the bag and an empty wallet will be you.

Therefore, **you want to see strong volume on the breakout (or break"through") because it shows strong demand, with enough supply to feed that demand but not so much that it drowns demand.** But you don't want to see it so strong that it becomes more indicative of rapid turnover, even some distribution, ending in a move that collapses back into the base, than it is of a stock that is on its way higher. If the stock breaks out on decent volume which is nothing to write home about, that doesn't mean the breakout is faulty. If everything else is in order, consider buying the breakout anyway. However, if increased volume doesn't kick in within a day or two, you may be in trouble. If supply is being withheld, or the float is thin, you may be being manipulated.

The move upward, if it is healthy and legitimate (not the result of short-covering or daytrader manipulation), will usually take place in several stages, what are sometimes called "two steps forward and one step back" or some variant. The first step may actually be a return to the base, if it hasn't moved too far away from the base in the first place. This is generally the result of "fading", or a short-lived short-term bout of profit-taking done by those who played the breakout for only a few points, or even less. Volume should be lower on a fade. If it is, this U-turn represents a "second chance" to buy into the stock (see [Rectangles](#)). It is also usually a much safer spot to enter since the very-short-term players are now mostly out of it.



Stocks don't always return to the base, however, and the "second chance" may not arrive until the stock is considerably higher. If it looks particularly strong, even short-termers may stick with it for the ride. Therefore, no fade. **Your first opportunity to buy, if you hadn't already done so, or to pyramid your position if you had done so, will probably be during the first bout of more serious profit-taking.** Here again, volume should be relatively low and the stock shouldn't break its trendline or fall below its last reaction low (much of this will be done by the elephants who were accumulating the stock in the first place and is the first phase of distribution on their part). **The point at which this "reaction" stops will become important, as it is this point which must not be violated after the stock begins its next leg up.** If it is, there may not be another leg up.

These drives upward should all be accompanied by good volume--not necessarily great volume, but enough volume to keep the price moving. Consider that once you've got your car moving, you don't need to give it much gas to keep it moving, but you do have to



goose it from a standing position to get it going, or from a cruising status to pass somebody who presents an obstacle to you (a level of resistance?). **Any bouts of profit-taking or near-term shyness about busting through a resistance level should be accompanied by lower volume.** If volume increases, you may have a problem. If it increases dramatically, we're not talking typical profit-taking here. Act accordingly.

The pattern of these moves may resemble arrow-heads--move up a lot, pull back a little, move up a lot, etc. However, they may also look like a series of ascents interrupted by plateaus (like a Mayan pyramid). **These plateaus, or bases, or congestion areas, require just as much attention as the profit-taking pullbacks, for one of these plateaus is likely to be the final resting place before the rocket makes its return trip to earth** (you may want to look at [Rectangles](#) again), or at least alters its course to an earthward direction. How accurate you are in determining which of those plateaus is going to be the last stop will depend on how well you can spot **distribution.**

Before getting into distribution, however, there is one other stunt which the stock may pull on its way up and which may cause you grief. At some point during the markup phase, the stock will swoop upward in a ski-lift-turned-on-its-end sort of **climax run** in which volume explodes, the price soars skyward, short-sellers scramble to cover, "over-extension" acquires a whole new meaning, and green newbies everywhere are rubbing their hands with glee when they ought to be sweating bullets (this particular phenomenon is linked to all sorts of sexual metaphors that we won't get into here; you can probably guess what they are). If you're ever lucky enough (or unlucky enough, depending on how it all turns out) to be caught up in one of these rocket rides, keep in mind what happens to rockets when they run out of fuel.

It's not pretty.

Remember that volume is a two-edged sword. As stated earlier, you can have too much of a good thing at breakouts. Likewise, **if it seems as though you're getting too much of a good thing after your stock has run for a while, start thinking "top"**. Even if your stock doesn't launch itself into a climax run, take the market's temperature. If there seems to be a general consensus that your stock's price can only go higher, locate the exit door even if you're not quite ready to lunge for it.

Distribution

At some point, demand will not only diminish, but dry up. As the Street puts it, trees can't grow to the sky. Buyers have run out of greater fools, and no one is willing to pay a higher price for the stock, at least for now. On the other hand, there aren't a great many people who want to sell, either. They like the stock, want to hold onto it, think it's worth what's being asked for it, and are willing to wait for a new wave of demand, spurred perhaps by news or rumor or earnings. Some may want to sell, and there may be buyers who are willing to pay the ask, but there aren't very many, if any, who are willing to pay anything higher.

So there it sits, and if its angle of ascent was 45 degrees or less, it may sit for quite a while. **Your task is to determine whether the stock is just resting, or whether it's sharpening its machete in preparation for cutting you off at the knees.** The angle of ascent, as just mentioned, has a lot to do with danger level (the steeper it is, the more vulnerable the stock becomes to the withdrawal of experienced buyers). So does a careful analysis of the relationship between price and volume. **It is here and on the way up to here that distribution (a process whereby the accumulated store of stock is sold at the highest possible price) takes place, not on the way down,** and unless you enjoy wedgies, learn to recognize the signs.

As an upward move deteriorates, price spreads narrow and less price progress is made from day to day. **Determining whether or not this is a result of the stock's meeting supply will help you decide whether an ensuing reaction is profit-taking or a mad dash for the exits.** If volume remains strong, the stock is most likely meeting supply (distribution), and whatever shares are offered to the market as a result of profit-taking will be absorbed by this demand (as long as nobody gets spooked) and the stock will resume its advance (but watch that trendline). If, however, volume diminishes as spreads narrow and progress is less and less, or if volume was strong and is now diminishing, it is more likely that demand is diminishing as well, and trouble may be coming 'round the corner PDQ.



It is extremely important at this point to focus on the price-volume relationship, unless you enjoy holding the bag (it is also extremely important at this point that you not take any vacations). Watch where the stock begins to hesitate. Does volume begin to pick up when the stock closes closer to its lows? Is each successive low lower than the one previous? If and when the stock rallies, is volume higher or lower? Are rally attempts stopped (met by further supply) at the same place each time? Does each attempt end lower than the one previous? If volume promptly decreases when the stock begins to roll over, it's unlikely that the market is ready to kick it down the stairs, but **it's important to note the quality and character of rally attempts.** If each one is coincident with stronger volume, but is stopped at or near the same place each time, then a considerable amount of supply needs to be worked through. Again, this is part of the distributive process, and it may be taking place at some older level of resistance, but **distribution is not necessarily a death sentence for a stock.** It simply refers to the process whereby elephants unload sizeable portions of their accumulated store. As long as demand is sufficient, they can exit entirely and the stock will go on its merry way building a Stairway To Paradise.



On the other hand, **if volume picks up on the downside, you've got a problem.** Some investors will hold the stock and wait to see where the reaction stops. If it stops at an important support level, wonderful. If it blows through that support level, they sell. In a volatile and nervous market, this strategy can have its drawbacks, since the stock may not be taking its leisurely time to telegraph all this information. It may, in fact, sink like a stone without giving any warning whatsoever. Which is why **smart money learns how to recognize distribution and to sell at the same time the rest of the smart money does.**

On the third hand, there is always the possibility that your worries are for naught, and that the stock is merely basing again. Evaluate this base just as you did the last one when the stock was being accumulated, though this base may be considerably shorter. Ask yourself the same questions and note the same phenomena. If volume declines and continues to fade away during reactions, not much stock is available for sale, even at the lower prices asked at the bottom of these reactions. If the price ranges widen, the closes move higher toward the highs, and volume gradually increases, you should most likely get back on the bus for the next leg up. Beware, however, of the red-spotted **thrust.**

Thrusts

Thrusts are a particularly ugly feature of bases in which distribution is taking place. **They are designed to sucker amateurs into thinking that the stock is getting ready to advance again** when, in reality, the elephants are merely harvesting the wallets of the unwary so that they (the elephants) can unload whatever they have left before they catch that plane for Barbados.



Thrusts are pretty much the same as shakeouts, only in the opposite direction--a spike in volume, a rapid move upward, perhaps even a close near the high. But, like the shakeout, there's no follow-through. The novice, thinking he's "missing the move", jumps in all innocent and dewy-eyed, at which point the floor collapses beneath him and he drops down the rabbit-hole. The price drops back into the base or below and, before you know it, we're on a sleigh-ride to perdition.

How do you detect a thrust? It's unlikely, though possible, that demand sufficient for a genuine breakout will just appear out of nowhere without any warning whatsoever. Any such move should be viewed with suspicion. If you can't get in within 5% of the buypoint, pass. Even if you can, don't take any magazines into the bathroom. Stay in front of your computer and watch to see that the bottom doesn't fall out of the "advance". If you're using daily charts, you may want to consult an intraday chart (if you're already using intraday charts, check a shorter bar interval). If any of this activity looks the least bit suspicious, start exercising your trigger finger to place that "sell" order if necessary. **Do not hang onto the stock if it closes at or near the low for the day, much less below your purchase price.**

Markdown

At the end of a base or congestion area which has been used for distribution, the price either continues to advance on the wings of new demand, or we enter the markdown phase. The markdown phase is the most depressing and often terrifying part of the entire cycle, unless you specialize in short sales. It is here that hopes are dashed, doubt turns to fear and fear to panic, and Tiny Tim gets trampled in the rush to the exits. The elephants are done, investors who bought in during the just-completed base and have no profit whatsoever will be (if they're smart) the first to get the hell out, and absolutely no one is supporting the price anymore, except perhaps for green newbies and a few truly clueless individuals who seize this "opportunity" to average down. **Supply is thrown onto the market, as evidenced by widening price spreads, increasing volume, and increasing downside deterioration.**



There will be rallies during this phase, just as there are reactions during the markup phase. At certain points, supply will be withdrawn or demand will overpower what's available, perhaps due to elephants trying to shore up prices. For whichever reason, the bleeding will be stanchd and the stock (and the investor who's watching his life savings go down the toilet) will be given a break. **As with all rallies and reactions, watch the relationship between price and volume.** Does the volume suddenly disappear during the rally? If and when the first rally attempt fails and the next reacton follows, does it exceed the previous low? If there's another rally attempt, does it exceed the previous rally high or fall short? Is volume stronger on the downsides or the upsides? **If rallies consistently stop short of supply, and up volume is consistently weaker than down volume, don't be shocked when your stock re-accelerates to the downside.**



As with the journey up, the road will not be a smooth one. In fact, it'll be downright nauseating. What makes this particular road tricky is the perennially bullish outlook of the average investor (if he weren't bullish, he wouldn't be in the market in the first place). Whereas fear will generally keep him from jumping into overextended stocks (though an overabundance of hope may cause him to do just that), hope will induce him to try to buy in at the bottom (buy low, sell high, right?), even to the point of trying "catch a falling knife". When the rally attempt fails and the stock continues to fall, he panics, dumps his shares and adds fuel to the downside slide (this is referred to as "**capitulation**"), assuming he's not one of the truly clueless mentioned earlier who will continue to buy all the way down to what eventually does become the bottom (this is referred to as "ignorance" the first time it happens, "stupidity" thereafter).

Most stocks do not hit the bottom with a thud. **Even if there is a "selling climax" with a precipitous drop on high volume, the true bottom may not be reached until days or even weeks later.** If a bottom (though perhaps not *the* bottom) is reached quickly, there will usually be at least one rally off of it, given the colorful name of "**dead cat bounce**", meaning that it will go nowhere except, eventually, south. This is referred to as a "**technical rally**", as opposed to a legitimate rally attempt, because of the reasons for its occurrence, and it is not to be trusted. This sort of rally occurs not because there's a mad rush of people who are desperate to own this stock and who plan to bequeath it to their children, but because elephants are instituting buy programs to stop the decline, short-sellers are covering their positions, amateurs are attempting to catch the bottom, shareholders are averaging down, and/or daytraders are anticipating (thus helping to create) the rally and want to play whatever points it turns out to be worth. Professionals expect these rallies. They are, after all, helping to create them. And they don't pay much attention to them. They may, in fact, use them as further opportunities to sell, just in case they still have some accumulated stock left over in the fridge. **The volume clues mentioned above will help you to determine if this is what's going on.** If the "rally" does fail, you may find yourself looking at the world-famous double bottom, or **W pattern**.

Under the right conditions, however, such as those of October '98, stocks will do what's least expected, shatter all fondly-held notions of "how markets (and stocks) behave" and make what is called a "**V bottom**". In highly volatile markets such as those we've seen this summer and fall (1998, that is), stocks may rebound off these V bottoms without pause, and recover much of their losses before reaching equilibrium and forming the kinds of bases or handles in which at least some accumulation can take place. Conventional wisdom says that **one shouldn't buy if the stock has regained 50% of the loss because it may retrace 50% of the just-achieved gain** (you'll often see this in a W formation in which the low of the second leg doesn't exceed the low of the first). This is why one wants to see a base or handle of at least minimal length to indicate that some agreement has been reached between bulls and bears as to the value of the stock, at least at that time (if the stock bases long enough to reach its trendline, so much the better). Without that, the stock is just as likely to collapse as it is to take off again, taking into consideration all the factors of price and volume, demand and supply, accumulation and distribution that I've delved into here.

There are signs to look for if one is irremediably aggressive and wants to try to buy these bottoms. If you have a cast-iron stomach, a will of iron, and are willing and able to remain glued to your monitor, you may want to try buying these bottoms as well. Otherwise, wait for at least some confirmation of strong demand before writing any checks.

The first, most-rewarding, and far riskiest opportunity to enter or re-enter a position in a stock that's being marked down is immediately after the selling climax. Making assumptions is never a good idea. Far better to let the chart tell you what's happening rather than some preconception, talking head, or message board post. But in this case, break the rule and **assume that whatever rally ensues will be a technical one leading to a double bottom.** Prepare to use what you've learned about price and volume clues and demand and supply to get out fast if this rally *does* turn out to be technical and *does* collapse just as it's supposed to. If the "technical" rally defies all expectations, turns out to be a legitimate rally after all, and results in a V pattern, you may not be in the clear but you will be able to see light ahead. Never lose sight of the fact, however, that **the many V bottoms that were evident this fall were the result of market activity, not news or anything fundamental pertaining to a particular stock.** Typically, buying V bottoms is a recipe for disaster, is only for the most risk-tolerant, and should never be attempted by those who are new to the markets and to investing.



If the rally does turn out to be technical after all, **watch to see if the ensuing reaction falls below the level of the first reaction or holds above it.** Also carefully watch volume throughout. **If the previous low cannot hold, and particularly if volume picks up,** expect a resumption of the decline as those who bought during the rally or were holding *before* the rally began now throw their shares onto the market. If the amount of this supply is large enough, and whatever demand there may be is not sufficient to absorb it, prices will fall. On the bright side, however, if volume is substantial, there may be less supply to slog through if and when the stock resumes its advance. **If volume subsides and the previous low does hold,** you will be given your **second chance to buy,** though it's best to wait until the advance actually resumes. You may also choose to wait for the market's "follow-through day"* if the market as a whole is also going through one of these cycles. **If volume subsides and the previous low does not hold,** this will indicate that those who are holding are mostly still holding. They may be waiting for the stock to rally to the midpoint of the W, in which case they'll get the hell out, or they may consider the stock to be a hold and have no intention of selling at all (or they may all be on the same cruise ship). Anticipate the behavior of both.

*(for those who haven't read O'Neil, the follow-through day is characterized by [1] a minimum 2% increase in whatever major market average you're following concurrent with [2] volume which is greater than the volume the day before and which [3] falls within a window of 3 to 10 days after what seems to be the bottom has been reached).

Your third opportunity to buy is the point at which the stock exceeds the high of the first rally attempt, the "midpoint" of the W, though there is always the possibility that a "handle" may form here. This does not necessarily mean that you should wait for one, but be prepared for the possibility that one may form (this midpoint is important resistance as it represents all those suckers who bought the first rally attempt; therefore, getting past it is an important achievement). If a handle does form and you don't want to wait for the breakout, you have the option of moving on to something else. If you choose to stay, monitor price and volume rigorously, as there is always the possibility of a further retest and a triple bottom. Just as the midpoint signifies important resistance, the low of the first leg down represents important support. If it's broken, pay very close attention to volume. Or get out altogether until volume and price show that buyers are clearly in charge once again.

V and W bottoms, however, are not the most common resolutions of the markdown phase. Typically, **volume will subside as selling pressure lets up, spreads will narrow, a line of support will be found, and price will begin to bob up on relatively light volume,** indicating that supply is becoming more scarce, the waters are subsiding, the sun is emerging from behind the clouds, the birds are singing, and a new accumulation phase has begun. It may take a while. There are a lot of burned-out and battle-weary investors out there, many of whom still don't quite understand what just happened. But these are exactly the conditions under which the elephants are most likely to begin buying up all those cheap shares.

And how do you know that your stock is being accumulated? Accumulation takes place in what is called a congestion area . . .



It's the Circle of Life, Simba.



I'm sure it has occurred to at least some readers that if the accumulation-distribution pattern I've described here were dependable in all circumstances under all conditions, then all stocks would have a pattern of up, across, down, across, up, across, ad infinitum. This is clearly not the case. **The markets are not represented by a straight and narrow highway.** A far better metaphor would be a roiling sea of rallies, reactions, markups, markdowns, shakeouts, thrusts, buying and selling climaxes, turning points, all happening all at once in timeframes varying from minutes to years and with all the accompanying eddies, currents, inversions, and undertows. This is the primary reason why I haven't provided graphic examples here of the concepts I've presented. **The point is not to find some stock somewhere that typifies accumulation or a shakeout and use it as a template for all future investigations of manifestations of changes in demand and supply, but to understand at a deeper level how the threads of demand and supply, accumulation and distribution, and the relationship between price and volume all intertwine.** What I've provided here is only the beginning of an exploration, not an exhaustive treatment of the subject.

Each chart you look at, instead of being "typical", will instead be unique. **Each movement of price and volume in a chart has meaning only within the context of what has gone before in that particular chart.** Therefore, solving the puzzle of the dynamics of demand and supply will be a new challenge with each chart. Achieving mastery of this skill will take time, if mastery is ever achieved at all. But applying even the most basic of the principles outlined above will result in an almost immediate payback, if not in money gained, then in money saved.

