4

Reading Momentum

Markets are moved by imbalance. If all bids were equal and all offers were equal, the market would never move. Thankfully, for various reasons, the markets are almost always dynamic.

If you are going to predict market momentum, it helps to understand one simple fact. Markets go down when sellers outnumber buyers, and they go up when buyers outnumber sellers. Yes, we know that already, but the concept is often overlooked.

Another concept we can't afford to ignore is that, upon market entry, buyers become sellers and sellers become buyers because at some point they will need to exit. Take note: I said, "Upon market entry."

As more buyers enter the market, the number of potential sellers continues to grow, and you can assume that the number of available buyers will continue to decrease. In that circumstance we could expect the number of buyers to dwindle as the market moves up and the number of traders interested in selling to increase until the two groups become equal in size.

This is where the market stops moving, but it won't stop for long!

The growing number of potential sellers includes the same people who just recently were the eager buyers.

THOSE WHO BUY WILL WANT TO SELL!

The simple truth is, those who buy eventually will want to sell, but the dynamics will have changed. The price is now higher, and those who still

want to buy have become more cautious. Those who bought earlier are hoping to protect the profits they have gained. In order to take those profits, they must sell. In addition, there usually is a group of traders who want to go short (sell high first and buy back later at a lower price). They tend to become more aggressive as the market rises. Suddenly, an overload of selling can appear, created by those who want to go short combined with those who want to take profit. The few cautious buyers are outnumbered and immediately devoured.

THE HIGHER A MARKET GOES, THE MORE POTENTIAL SELLERS IT ACCUMULATES AND THE MORE DANGEROUS IT BECOMES.

Since the market is actually an open auction, the sellers begin to ask for bids in an attempt to find others to buy the product or stock that they own. This is the main reason markets go down faster than they go up.

SUCCESSFUL TRADERS UNDERSTAND AND RESPECT MOMENTUM.

The single most important factor in market interpretation is to understand momentum. Anyone who is willing to study momentum will see his or her level of success increase exponentially with his or her understanding of it. There will be lessons in this book on how to measure markets for targets or goals, but without a clear understanding of momentum, they will not be as effective.

Momentum is a critical ingredient. The short-term trader can use it by following even the smallest incremental market movements while a long-term trader might study monthly or even annual charts to analyze momentum.

My preference is to use thirty-minute charts for my short-term trading, daily charts for intermediate, and weekly charts for longer-term trading.

Studying “moving averages” is probably the most often used tool for tracking momentum. The basic idea is that an average of, usually, closing prices for a series of bars (a line drawn on a chart or graph that represents a particular quantity of time) will be a more reliable commentary on the market’s health than any individual bar closing price would be.

For the record, trading in the same direction as these moving averages is considered to be the most productive plan.