CLASSIC TECHNIQUES

Combining Price And Volume To Predict Price Movement

Price + Volume = Price Movement

Here's how you can use price and volume to determine buy and sell signals.

by Tim Ord

I use a lot of different indicators and methods, but one that has been consistently successful is the price/volume relationship at support and resistance levels. Support or resistance areas occur at previous highs and lows. Prices bounce off previous highs and lows and develop trading ranges. I will show you how price and volume react to previous highs and lows, and why price pushes through or reverses at these points.

SWINGS

Previous highs and lows in a stock or index define current support and resistance areas. A previous high or low in a stock or index is referred to as a *swing*. I draw a horizontal trendline from the previous swing high or low to determine at what price support or resistance will appear in the future. These previous swing highs and lows are points where I make decisions for placing buy or sell orders. The horizontal lines drawn from previous highs and lows indicate where the support or resistance may come in. The line graph of a stock or index in Figure 1 illustrates a swing high and low.

By studying the works of Richard Wyckoff, the master of price and volume, I have developed some rules using the price/volume relationship. Wyckoff developed techniques in the 1930s that combine price and volume of equities with price predictability. The techniques he developed stood the test of time and still work to this day. I expanded on his ideas and came up with several rules that I use daily in my trading. Let's go over these rules and look at a price history to see where buy and sell signals developed.

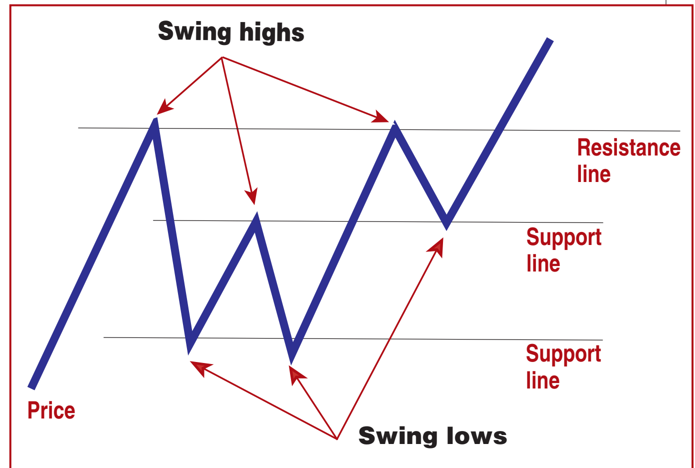

FIGURE 1: SWING HIGHS AND SWING LOWS. These are created by using the previous highs and lows as reference points.

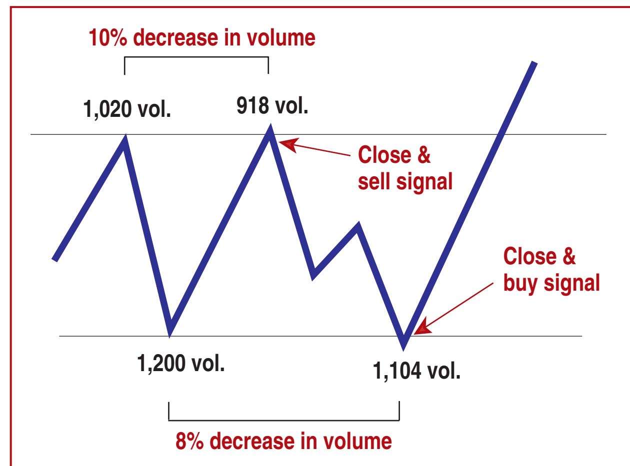

FIGURE 2: BUY SIGNAL. Markets need to break a previous high or low and then close back into the trading range on 8% or greater *decrease* in volume.

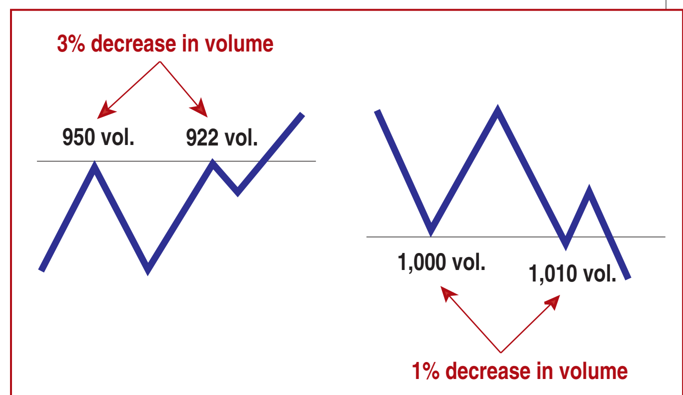

FIGURE 3: EXCEEDING PREVIOUS HIGH OR LOW. This will take place if the previous high or low is tested on a 3% or smaller decrease in volume.

TRADING RULES

Here are the rules that I follow, using price and volume to determine buy and sell signals on the Nasdaq Composite and the New York Stock Exchange (NYSE) indexes:

1. When price tests a previous high or low on an 8% or larger decrease in volume and closes back below the previous high (or above the previous low), it implies a reversal. The market needs to *break* the previous high or low, then close back into the trading range (Figure 2).

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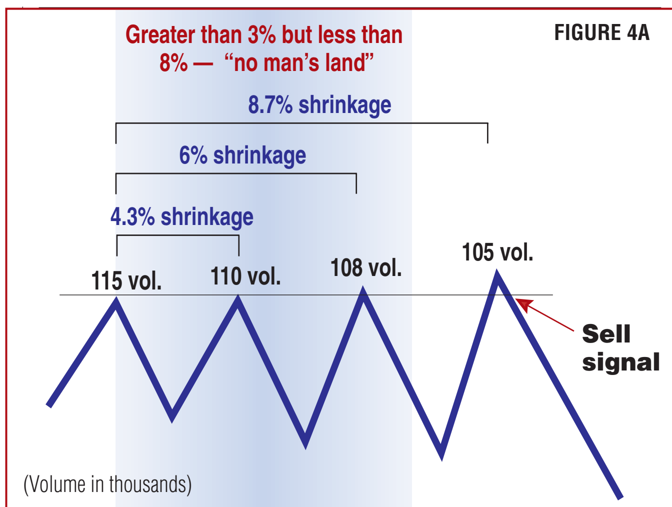

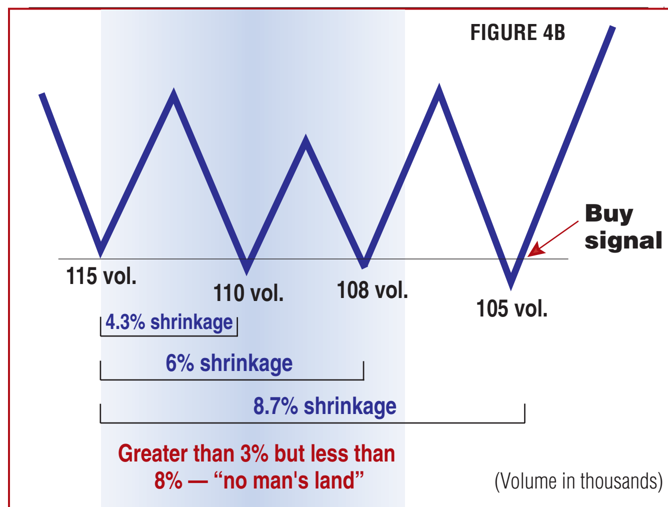

FIGURE 4: COMPARING VOLUME TO FIRST HIGH OR LOW. This should be done even on the third or fourth retest.

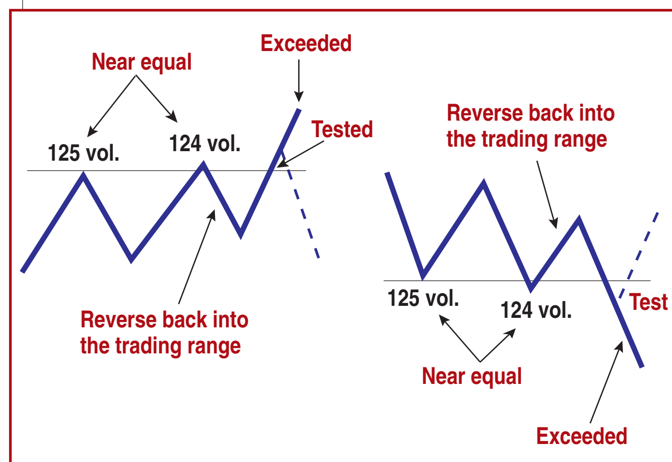

FIGURE 5: REVERSING BACK INTO TRADING RANGE

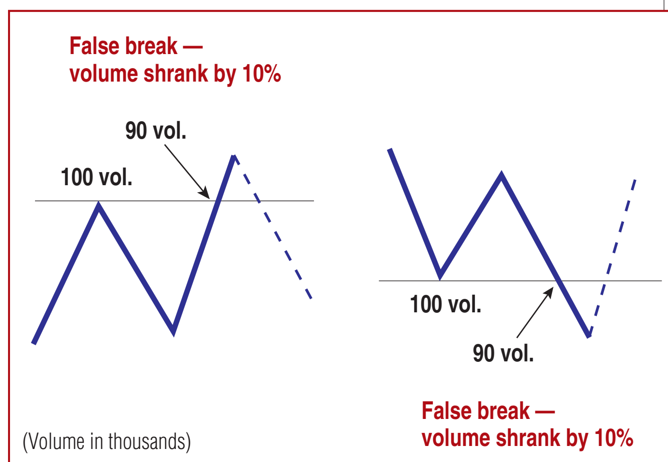

FIGURE 6: FALSE BREAKS. Keep an eye on that volume.

2 When price tests a previous high or low on a 3% or smaller decrease in volume, it implies that the high or low will be exceeded (Figure 3).

3 Always compare the volume relationship to the first high or low, even on the third and fourth retest. The buy and sell signal relationship stays the same (Figures 4A and 4B). It's not the volume figure that is important on a retest of previous highs or lows, but the *percentage* increase or decrease in volume relative to previous highs or lows. These volume relationships will signal if the market will pass through or reverse at these previous highs and lows.

4 When markets break to new highs (or lows) on near-equal or increased volume, then reverse back into the trading range, the last high (or low) will be at least tested, and possibly rally through to the next swing high or low (Figure 5). But how do you tell if the last high (or low) will be tested and then reverse or continue through? The answer lies in the volume.

- If volume is at least 8% lighter on the test of high (or low), then expect a reversal.
- If volume is within 3% on the test, then expect continuation.

5 Markets that break to new highs or lows on 8% or greater decrease in volume and close outside of the trading range imply a false break and will come back into the trading range (Figure 6).

6 Tops and bottoms of gaps act and work the same way as previous highs/lows and previous support/resistance zones. The same volume percent relationship works with the gaps as with retest of previous highs and lows (Figure 7).

Note: If the market cannot take out the previous high on near-equal or greater volume, it will reverse and try to take out the previous low of the same degree on near-equal or greater volume. The reverse applies for the lows.

HERE'S AN EXAMPLE

Let's now take these rules and apply them to the Standard & Poor's market. Remember, we are going to use previous highs, lows, and gaps as reference points to generate signals. I am using the continuous S&P 500 futures chart (Figure 8) because the futures have gaps (the S&P cash market does not). Gaps are important events, and it's good to know where

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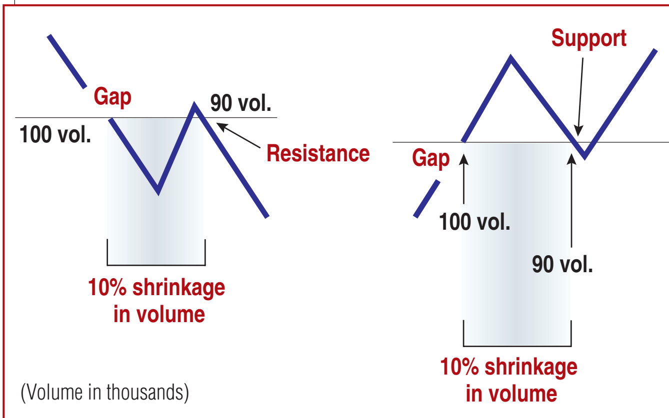

FIGURE 7: THE IMPORTANCE OF GAPS. They can be good reference points when determining highs and lows.

they are. I have used volume from the NYSE instead of the S&P volume because I have found that the higher-volume markets produce better signals. These rules work just as well on high-volume equities. Low-volume equities or indexes can be less accurate.

On Figure 8, you can see the following:

1 On February 6, 2002, the S&P closed above the low on January 30, 2002. Volume decreased from 1.95 billion to 1.64 billion, a 16% decrease. A bullish signal is generated. This meets rule 1.

2 On February 14, 2002, the gap area is tested. Volume shrinks from 1.41 billion to 1.24 billion, a 12% decrease. A bearish signal is generated. This meets rule 6.

3 On February 20 and February 22, 2002, the first important low is tested and volume decreases almost 30% (1.95 billion to 1.38 billion). The bullish signal is intact. This meets rule 3.

4 On February 26, 27, and 28, volume was higher than the previous high on February 14, 2002. This implied a break above the February 14 high.

5 On March 1, 2004, the high of February 14, 2002 was broken on increased volume. This meets rule 2.

Following the six price and volume rules I have discussed here will certainly give you an edge in your trading. Keep in mind that this system has greater accuracy in higher-volume securities.

Tim Ord is editor and president of The Ord Oracle*, 17300 Van Dorn, Walton, NE 68461, an email market letter that uses price and volume studies along with other indicators to trade indexes and equities.*

SUGGESTED READING

Hutson, Jack K., David H. Weis, and Craig F. Schroeder [1991]. *Charting The Stock Market: The Wyckoff Method*, Technical Analysis, Inc.

†See Traders' Glossary for definition

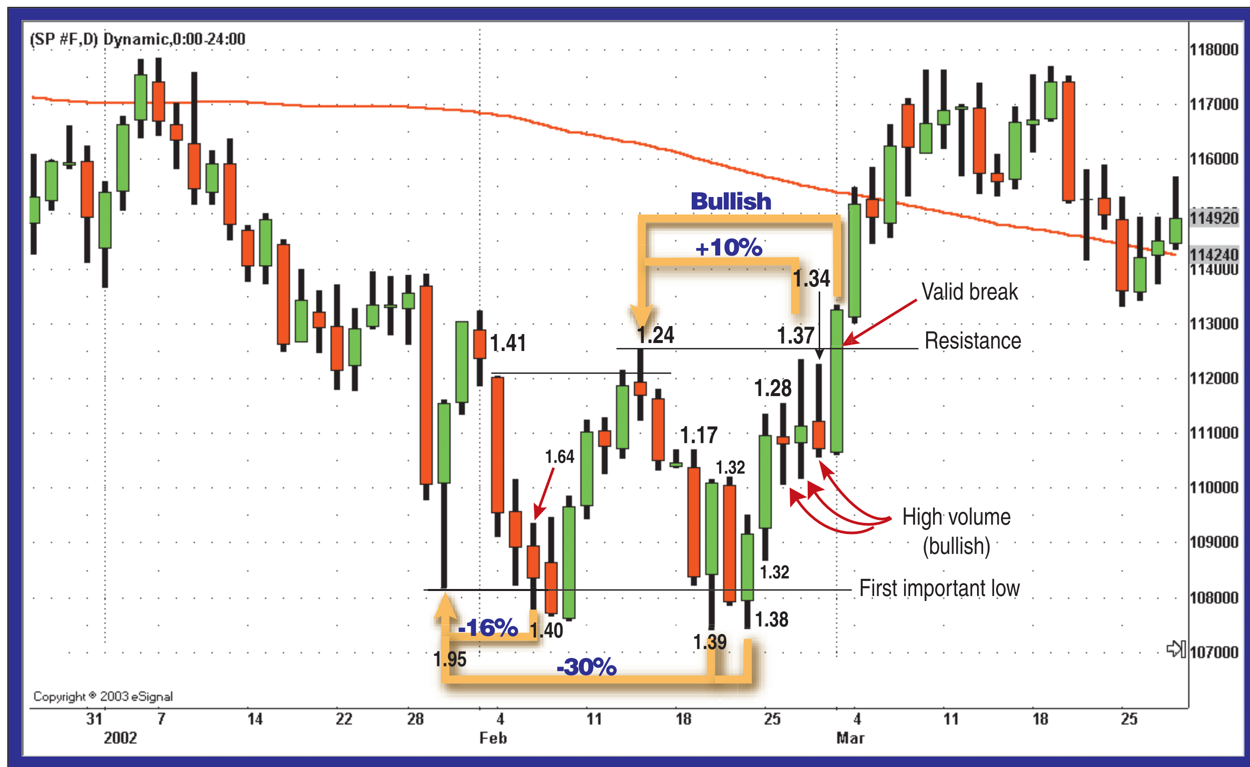

FIGURE 8: THE RULES AT WORK. You can see some of the price/volume rules at work on this chart of the S&P 500 continuous contract.

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