

# Long-Term Secrets to Short-Term Trading

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# Long-Term Secrets to Short-Term Trading

Larry Williams



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Published simultaneously in Canada.

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***Library of Congress Cataloging-in-Publication Data:***

Williams, Larry R.

Long-term secrets to short-term trading / Larry Williams.

p. cm. — (Wiley trading advantage)

ISBN 0-471-29722-4 (cloth: alk. paper)

1. Commodity futures. 2. Speculation. I. Title. II. Series.

HG6046.W539 1999

332.63'28—dc21

98-44949

Printed in the United States of America.

10 9 8 7 6 5 4 3 2 1

# Acknowledgments

This book is not the product of research—it is the culmination of a career that has included a great deal of research, personal introspection, and, along the way, some personal growth.

My career, and accordingly this book, would not have been the same without the help, support, and sharing of knowledge with others over the years. Prominent among these people are Don Sarno, who was the first one to invite me to speak for *Commodities Magazine*, and Bill Meehan and Tom DeMark—both brilliant analysts, yet poles apart—who were most instrumental to my understanding of the markets. Both these guys were always willing to swap ideas. I also owe a large debt of gratitude to Ken Hornbrook, who was always willing to help me program yet “one more” idea.

I want to thank Mike Stock for his programming and idea exchange; Jake Bernstien for his friendship for over a quarter of a century; the brokers, including Al and Greg Alesandra, who have put up with my constant questions and phone calls; Joel Robbins for his support and fine staff including Larry Herst and my daily contacts, the dynamic duo of “Rick and Gene.” Thanks to Andy Daniels as well, and most of all to Ed Walter for taking my phone calls from all over the world and giving me quotes every day of the year for more years than we can remember.

So many fellow analysts have urged me on in one way or another, from Bob Prechter, probably the nicest person in the advisory business, to Bruce Babcock, my personal devil’s advocate. Frank Taucher and Bob Prechter have been the only other big names to stand up for—and pay the lawyer bills of—newsletters trying to establish their first amendment right to publish without being registered with the U.S. government’s Commodity Futures Trading Commission (CFTC). Marty Zweig and Ned Davis taught all of us what research should be about. And thanks to the many friends I have developed within the business: Joe DiNapoli; Welles Wilder; R. E. McMaster; Nick Van Nice (Joe and Willie’s son, who is a real rising star and also battler against the CFTC); Linda Bradford-Raschke; George Angell; Brian Schad; Mark Benjamin; Sheldon Knight; Miles Dunbar; Glen Larsen, at Genesis Data; Stan and Gretchen Marzalk; John Hill; Bo Thunman, founder of “Club 3000”; Kim Henrie, and the entire staff at British American for their tremendous support and backup. I have been blessed to know all of you and am certain I have left others off this list who should be here.

vi Acknowledgments

My secretary and office manager, the very efficient Jennifer Wells, deserves special attention for her work, efforts, and support of my somewhat different lifestyle. Jennifer is a real gem.

My career and this book would never have been possible without people from all over the world subscribing to my newsletter, *Commodity Timing*. My subscribers, seminar attendees, and readers of my other books deserve personal thanks for being with me through the good times as well as some I would like to forget! You are a great group of people I have come to know and deeply appreciate.

Finally, thanks to my wife, Carla, and five unique and wonderful children—Kelley, Jason, Sara, Michelle, and Paige.

LARRY WILLIAMS  
*Rancho Santa Fe, California*

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# Long-Term Secrets to Short-Term Trading



# Chapter

# 1

## Making Order Out of Short-Term Chaos

*There are two primary ways we make money trading; catching a big price move with a small position or having a large position and catching a small move.*

—Bill Meehan

If what I have written so far has meshed with your speculative goals, it is time to learn how markets operate. Speculation—stock and commodity trading—is not for everybody; it may not be for you. I have even wondered at times if it is for me!

### How I Learned about the Market

My career as a trader began in Portland, Oregon, where I had met a Merrill Lynch broker who thought we could make some money together. He was half right, we got lucky immediately. He made good money on his commissions and I lost money. Worse yet, the money wasn't mine; a fellow I had never met had asked me to invest it. In hindsight, the initial beating I took was more than fortunate, it was life changing.

That event hardened my desire to learn the business; after all, if it was that easy to lose, it had to be pretty easy to win, right? My broker was as new

to the game as I was and really had very little advice or suggestions. His market insight was to buy good stocks and hold on (a brilliant insight), but my aptitude or desire was to make money from catching short-term market swings. Thus began my education as a short-term trader.

I had no teacher and knew no other traders, so I naturally turned to books to help solve my problems, just as you have in buying this book. The authors all made it sound so easy. I read Joe Granville's classic work on technical analysis and began keeping daily open, high, low, and closing prices on stocks as well as indicators Joe said we should follow. Before I knew it, I was not only totally consumed by the markets but spending 5 to 6 hours a night and all my weekends on trying to beat Wall Street, gaining a fortune, and beginning to lose a marriage.

My first wife, Alice Fetridge, had become a "chartist's widow" yet still supported my habit. We eventually left Portland and moved to Monterey, California. We both had jobs, and I was also working on my law degree. I even sat for and passed the "Baby Bar Exam" (the test given to night school and correspondence students). By then, however, I had pretty much given up on becoming a lawyer, especially after working for one. I had thought being a lawyer meant being in court, saving people's lives; the reality was that it dealt with collecting money from judgments, finding deadbeats, and representing bums and outright criminals. It was not like trading.

Fortunately in Monterey, I met two brokers who, like me, kept charts. Joe Miller and Don Southard were soon swapping war stories with me, teaching what they knew about the markets. We were all big followers of Granville's On Balance Volume (OBV) work and kept OBV charts on the 30 to 50 stocks we followed. I also started to keep moving averages, another tool espoused in all the books back then, just as they are today.

My stock trading met with some success, but what accelerated my career was a book by Gil Haller, unabashedly called the *Haller Theory*. I learned a lot about stocks and speculation from the book, then got to know Gil and to this day appreciate the support and encouragement he provided. Gil's concept was to buy stocks that had already moved up a lot. This is now a methodology used by the funds to buy what they call "momentum stocks." Haller was doing it way back in 1964 and making a living. But, he didn't live the way I wanted to! His desk was an old door atop cinder blocks, stationery was the back of a letter someone else had written him. Gil was not cheap, just a frugal spender who precisely counted and saved every extra penny.

Eventually, I began to envision a theory of how markets work: In the short term, markets spurt in rallies and declines, moving above and below a balance point I could call the "average" price. My object was to determine when price was low and should move back to the average. That meant I needed to identify an overextension of price and then have something that would tell me when this move was over and the spring back to the average had

begun. Because it all seemed so easy, I was sure there must be some master theory or code to how all this was done. There must be some basic undeniable way the market—all markets—moved from point A to point B, I reasoned.

What I eventually found out is that this original thesis is true: there is a way markets move. The good news is that there is a structure in how prices move from point A to point B. The bad news is that the structure is imprecise. Nevertheless, there is a semblance of order to price action, and like a foreign language, it can be learned. It has taken most of my life to figure out the basics of this language that the market speaks, and I am more than happy to help you learn to use my magic decoding ring.

## Charting the Market

If you have begun your study of the markets, you already know it is a visual world, where charts prevail. As shown in Figure 1.1, the common charts represent each day's opening price with a horizontal slash mark to the left side of each bar and the closing price with a horizontal slash on the right side of the bar. The topmost point of the bar reflects the highest price reached by the stock or commodity during the day while the bottom of the bar represents just the opposite, the lowest price the commodity traded at on that day.

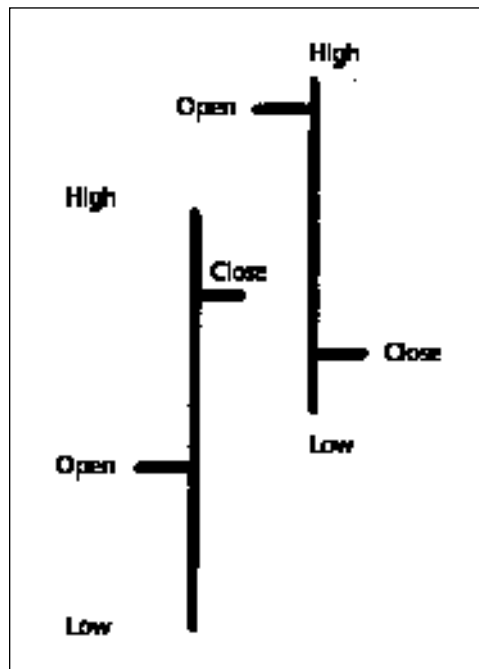


Figure 1.1 Typical Chart showing openings, closings, highs, and lows.

The opening price, as you will see later on, is the most important price of the day. I developed this notion with Joe Miller, Don Southard, and Curt Hooper, a naval postgraduate student who—in 1966—was the first person I ever worked with using a computer for answers. While we were impressed with OBV, we wanted a more reliable formula; and once we learned that the original OBV work came from two guys from San Francisco, Woods and Vignolia, we thought we too could create a better approach.

Our chart reading problem begins and gives birth to chaos, when we start combining these daily bars of price action on a chart. These graphic representations of price action were “read” for years by folks calling themselves “chartists.” By and large, chartists were about as welcome as your unemployed brother-in-law until the early 1980s.

This crowd gleaned over chart formations, found patterns, and gave them names like wedges, head and shoulders, pennants, flags, triangles, W bottoms and M tops, and 1-2-3 formations. These patterns were supposed to represent the battle of supply and demand. Some patterns indicated selling, others professional accumulation. Fascinating stuff, but wrong-headed. These same precise patterns can be found in charts of things that do not have a supply/demand factor.

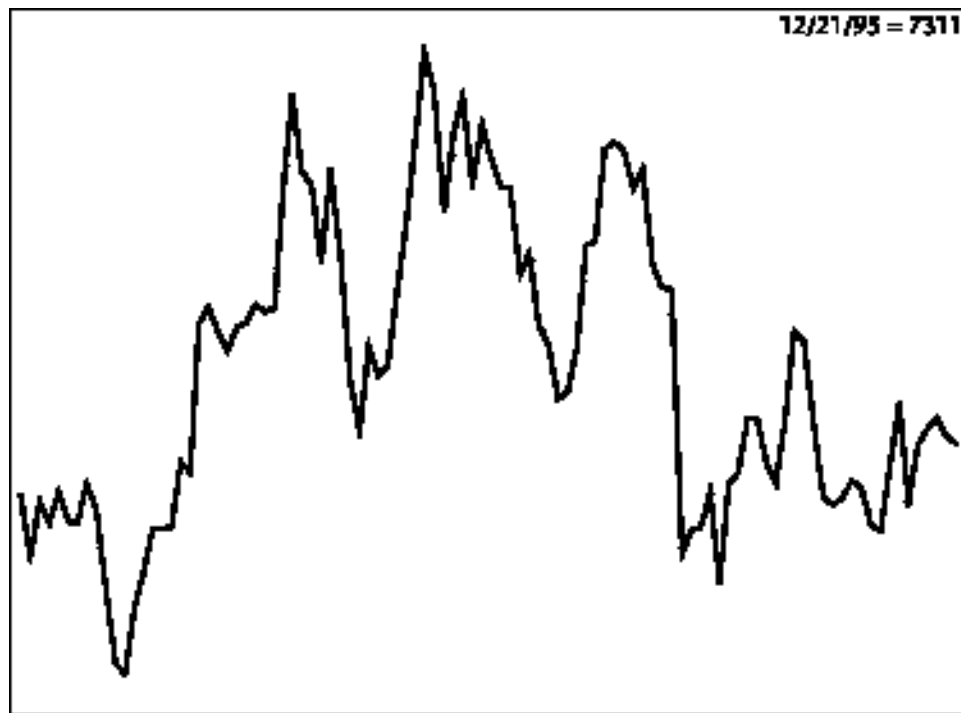


Figure 1.2 A flip of the coin heads and tails on accumulative basis.





Figure 1.3 A stock? No, daily temperature; high for the day; low for the day; last reading.

Figure 1.2 shows a chart of the 150 flips of an old silver dollar that graphs out to look much like a chart of Pork Bellies. Next, Figure 1.3 is a chart or graph of temperature extremes, or is it Soybeans? Who knows? What we do know is that plotted data of nonmarket or economically driven information charts out just like data for stocks and commodities, producing the same patterns that are supposed to reflect buyers and sellers. I caution you against confusing chart forms with intelligence.

Chartists became “technical analysts,” severing their ties from Ouija boards and charts in favor of computers. Computers made chartists look and sound more respectable, like scientists. In fact, many books came out with titles like *The New Science of . . .* or *Scientific Approaches to . . .* Is there science to this madness?

By and large, I think not.

Prices do not dance to the beat of some mystical, magical drum that hides deep in the recesses of a plush room in New York City, and has a rhythm only a few insiders recognize. Prices jump all over the place, and our charts become erratic because human emotions are influenced by news and brokers’ hot tips of immediate boom or gloom.

## The Nonrandom Market

For the most part, commodity prices are like a drunken sailor, wandering down the street without any knowledge of where he is going, or where he has been. Mathematicians would say there is *no correlation* between past price activity and future trends.

About that, they would be wrong: there is *some correlation*. Although that drunken sailor does swagger, stagger, and seemingly move in a nonrandom fashion, there is method to his madness. He is trying to go someplace, and we can usually find out where.

While price action involves a large degree of randomness, it is far from a totally random game. If I cannot prove that point, right now, early on in this book, the remaining chapters should be devoted to learning how to throw darts. In a random game, the dart thrower will outperform the experts.

Start with a given—if we flip a coin 100 times, it will come up heads 50 times and tails 50 times. Each time it comes up heads, on the next flip we will have 50 percent heads and 50 percent tails. If heads has now appeared two times in a row and we flip again, the results continue to be 50/50 that a head will appear on the next flip. As you have probably heard, the coin, dice, or roulette wheel has no memory. The odds are fixed, as this is a random game.

If that were true of the market and prices close higher 50 percent of the time, then after each up close we would expect to see another up close 50 percent of the time, and following that up close again 50 percent odds of another up close. The same thing should apply to a down close: 50 percent of the time following one down close, we should see a repeat; and again 50 percent of the time following two in a row, a third down close should appear. In our real world of trading, it does not turn out that way, which can only mean *price action is not totally random!*

**Table 1.1**  
Commodity Percent Time Close > Open

Commodity	% Time Close > Open
Bellies	51
Cotton	53
Beans	51
Wheat	52
British Pound	56
Gold	52
Nekii	55
Eurodollar	57
U.S. Bonds	52
Standard & Poor's 500	53
Average % Higher	53.2

Table 1.2  
Commodity Number of Times after One-Down Close Percent;  
Number of Times after Two-Down Close Percent

Commodity	Number of Times after One Down Close Percent	% Up Next Day	Number of Times after Two Down Closes Percent	% Up Next Day
Bellies	3,411	55	1,676	55
Cotton	1,414	53	666	55
Beans	3,619	56	1,612	56
Wheat	3,643	53	1,797	55
British Pound	2,672	57	1,254	56
Gold	2,903	58	1,315	55
Nekii	920	56	424	60
Eurodollar	1,598	59	708	56
Bonds	961	54	446	52
Standard & Poor's 500	1,829	55	785	53
Average + Close		55.8		55.2

Table 1.1 shows the percentage of time that prices closed higher in a wide variety of markets. There were no criteria; the computer just bought on the open each day and exited on the close. Instead of having a 50/50 result we have a slight skewing in that 53.2 percent of the time price closed higher than the opening. This shouldn't be.

Well, if this "shouldn't be," how about buying on the opening following a down close? In theory, we should see the same percent of up closes shown in Table 1.1. The problem is (for college professors and other academics who are long on theory and short on market knowledge) that it does not turn out this way. Table 1.2 shows the number of times price closed higher following a number of down closes.

This is not earth-shaking news to a trader; we know market declines set up rallies. The exact percentages were not known in the past, and I would never use these tables to take or stay in a trade. That is not the point: the point is we should have seen an average up close of 53.2 percent following the one minus close as well as two consecutive minus closes. The fact we did not suggests the market is not random; patterns do "predict" and now we can proceed, sans darts.

## Understanding Market Structure

Whereas chartists have strange names for most every market wiggle and waggle, they have seemingly missed the major point of the market, which is that price (as represented by daily bars, where the top of the bar is the highest

point prices traded on that day and the bottom of the bar the lowest price traded) move in a well-defined and amazingly mechanical fashion. It is similar to learning to read a new alphabet—once you understand the characters, you can read the words, and once you know the words you can read the story.

The first letter to master tells you what market activity causes the formation of a short-term high or low. If you learn this basic point, the meaning of all market structure will begin to fall into place.

I can define a short-term market low with this simple formula: any time there is a daily low with higher lows on both sides of it, that low will be a short-term low. We know this because a study of market action will show that prices descended in the low day, then failed to make a new low, thus turned up, marking that ultimate low as a short-term point.

A short-term market high is just the opposite. Here we will see a high with lower highs on both sides of it. What this says is that prices rallied up to the zenith of that middle day, then began to move back down, and in the process formed a short-term high.

I initially called these short-term changes “ringed” highs and lows in deference to the work done in the 1930s by Henry Wheeler Chase. In the days before computers, we kept notebooks of prices, and to identify such termination of a move, we simply circled or “ringed” these points in our workbooks so we could see them more easily.

Figure 1.4 shows several short-term highs and lows. Take a minute now to see what this pattern is all about.

If you understand this concept, we can begin the building process of putting these elements together. You may have already figured out the sequence; the market swings from short-term highs to short-term lows. This is exciting; we can actually measure market movement in a mechanical and automatic way. There is no need for complex chartist talk, nor will we be as inclined to fall into the illusory world of the chartist or technician.

Two specific types of trading days can cause confusion with our basic definition. First, there is what we call an inside day. It is so named because all the trading on this day took place inside the previous day’s range. These days are identified by having a lower daily high and a higher daily low. In a study of nine major commodities covering 50,692 trading sessions, I noted 3,892 inside days, suggesting we will see these days appear about 7.6 percent of the time.

For our purposes in identifying short-term swing points, we will simply ignore inside days and the possible short-term points they produce. An inside day means the market has entered congestion, the current swing did not go further, but then again it did not reverse, thus until this condition is resolved, we must wait and not use the inside day in our identification process.

Next we have outside days. These days are easy to spot because they have both a higher high than the prior day and a lower low! When these days

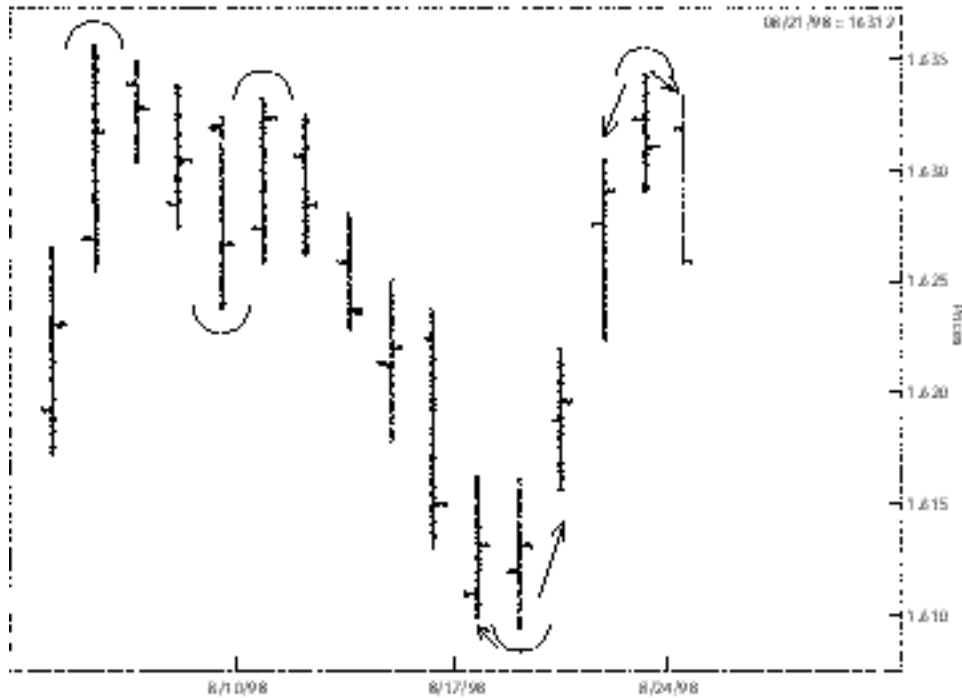


Figure 1.4 British Pound (daily bars). Graphed by the "Navigator"  
(Genesis Financial Data Services: 800-808-3282).

occur (and they do so about 3 percent of the time), we will have to study the flow of prices during that day by looking at the way price moved from the opening of the day to the close of that same day. In that study of 50,692 trading sessions cited earlier, there were 3,487 outside days, suggesting they are not as frequent as inside days, yet account for almost 7 percent of all days.

With the preceding information in mind, turn your attention to Figure 1.5, which illustrates these inside and outside days. Remember, what we are out to do is identify the short-term swings as traders move price from one terminus to another.

By now you should understand the basic concept, and be able to see how prices move in swings. On Figure 1.6 I have marked off these terminal points and connected a straight line from point to point to show the swing patterns.

## Defining Intermediate Highs and Lows

Now the fun begins! Consider this, if we can identify a short-term high as any day with lower highs (not counting inside days) on both sides, we can take a gigantic step forward and identify an intermediate term high as *any short-term high with lower short-term highs on both sides* of it. Hold on to your seat belts because we can take yet another step and say any *intermediate-*

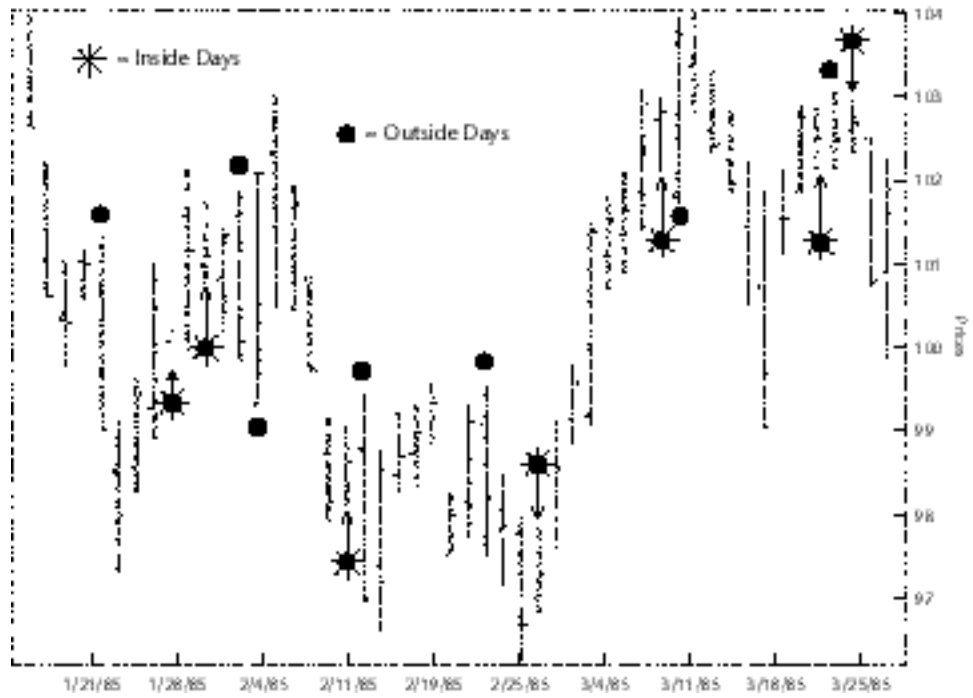


Figure 1.5 Pork Bellies (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

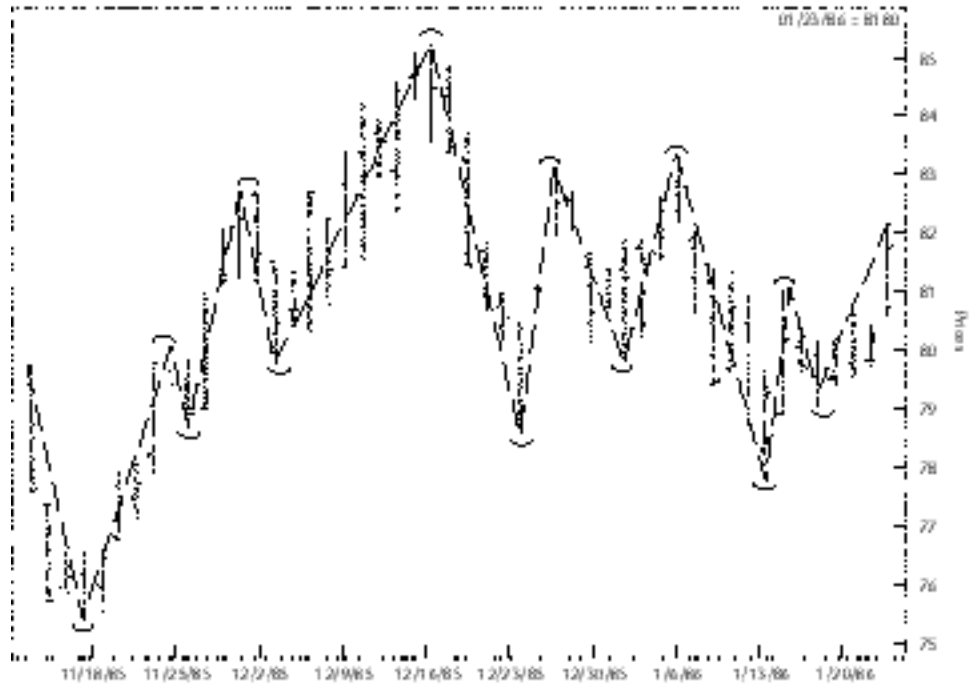


Figure 1.6 Pork Bellies (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

*term high with lower intermediate-term highs on both sides is—you've got it—a long-term high.*

In just one paragraph, we have been able to define the three dominant swings in a market, going from short term to intermediate to long. The identification of market lows is done in just the same fashion: first find a day with higher lows on both sides; that is a short-term low. Then find a short-term low with higher short-term lows on both sides and you have an intermediate-term low. Locating a long-term low is simple: it is any intermediate-term low with higher intermediate-term lows on both sides.

It is time for a picture of what this all looks like. In Figure 1.7, I have marked off all short-term swings, then located the intermediate-term points, and finally gone to the next level and marked off the longer term points. This chart tells all; it is really all there in a simple format. If you look at it now, you will understand market structure and will see that we can create order out of much of the chaos.

With the preceding in mind, I have moved from a sample chart to a real one of the Swiss Franc and Coffee (see Figures 1.8 and 1.9). My first step was to circle or ring all short-term swings; then I began the overlaying pattern of higher/lower short-term points. After that, I identified the next layer of higher/lower intermediate-term points to arrive at the long-term points. While words are great, until you study these charts, it will be difficult for you to get the picture. Go study.

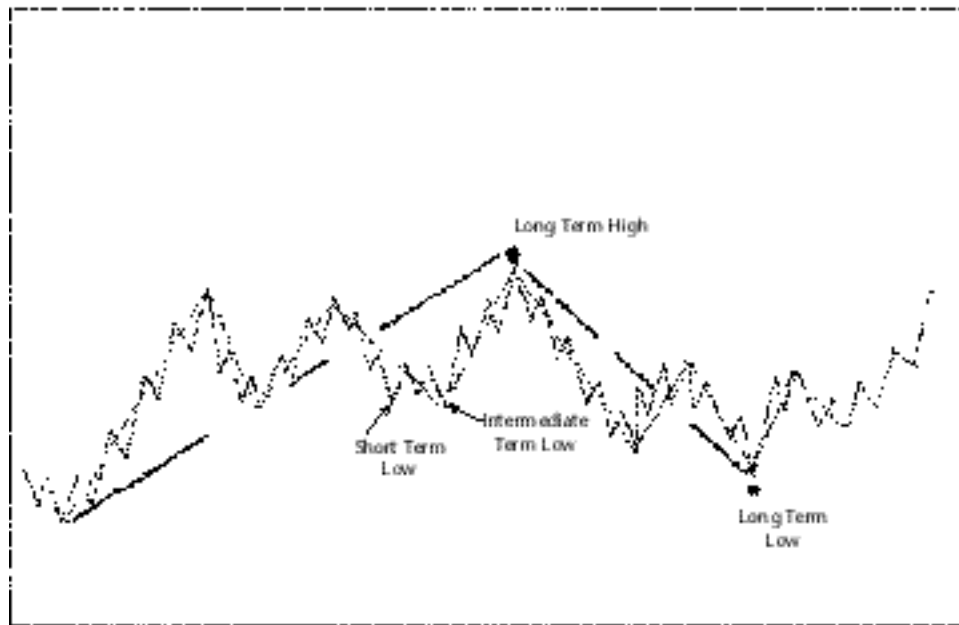


Figure 1.7 Charting creates order out of chaos.

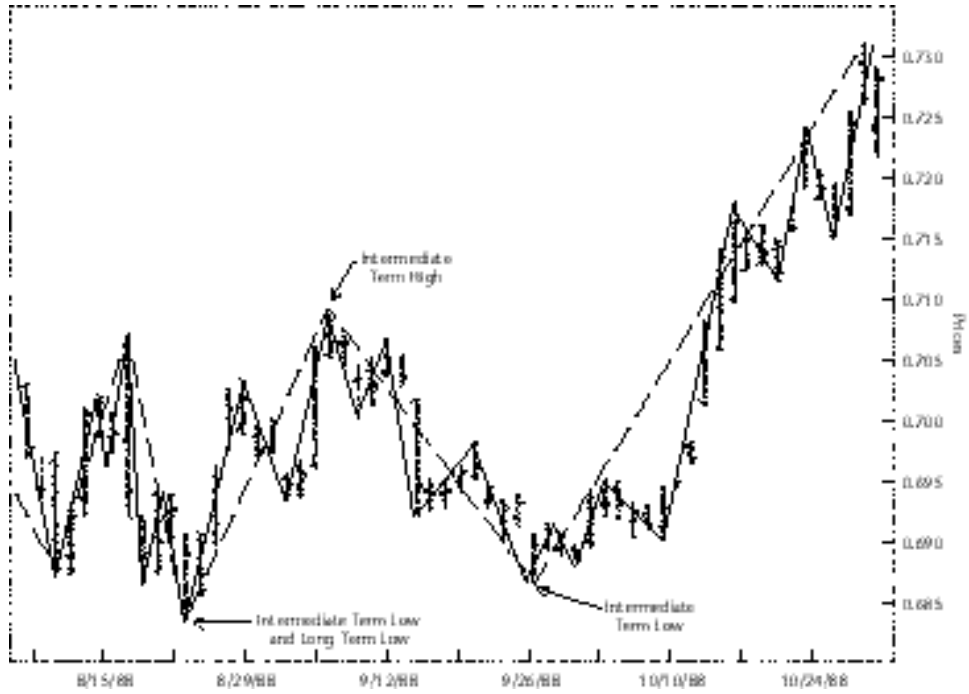


Figure 1.8 Swiss Franc (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

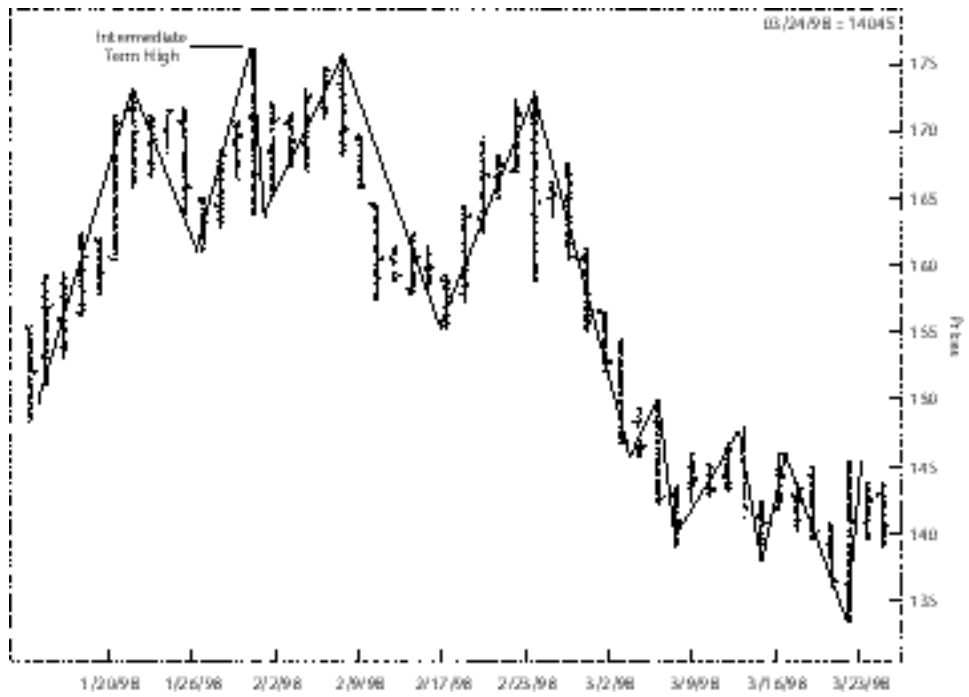


Figure 1.9 Coffee (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).



### Why This Is Important

Once you have this basic understanding of market structure you can identify, very early on, these market turns. You will always know that a short-term low has been made when you rally above the high of a day with a lower low than the prior day. By the very nature of this penetration, we know the short-term down swing has terminated. By the same token, whenever price declines below the low of a day with a higher high than the prior day, a short-term high has been formed. This means we can know, during the trading session, when these points are established.

As short-term traders, we also can tell when intermediate-term highs and lows are made. How? Simple, if the formation of a short-term high will confirm an intermediate-term high, which in turn confirms a long-term high, we can get in at some optimal turning points.

Figure 1.10 shows how this can all be combined. By going above the high of the day marked at (A), we have formed a short-term low that is in turn higher than the prior short-term low. This means the low at (B) is a long-term low and we can be buying at the start of an up leg in what is some type of long-term move.



Figure 1.10 Pork Bellies (daily bars). Graphed by the "Navigator" (Genesis Financial Data Services).

## 22 Making Order Out of Short-Term Chaos

It is really all about nesting swings together, fitting the pieces of the puzzle into their proper place, to give us an understanding of the structure of market activity. The beauty is you can now identify, at all times and for all markets, whether the trend (based on price structure) is up or down and pick your points to get in and out.

For years, I made a pretty good living using just the formation of these points as buy and sell entries. These points are the only valid support and resistance levels I have ever found. They are highly significant and the violation of these price points provides important information of trend and trend change. Thus I can use them for my stop-loss protection and entry techniques.