WHAT'S UP FOR STOCKS FOR THE REST OF 2005? p.75 HOW TO USE CONTRARIAN HEADLINE ANALYSIS p.79

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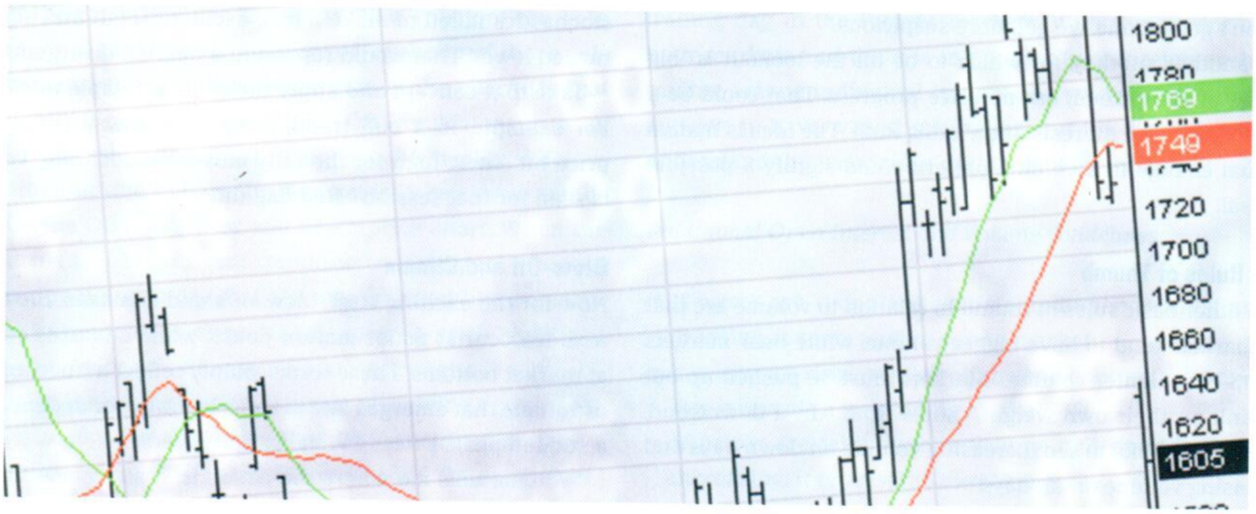

By Kira McCaffrey Brecht

Many technical traders will tell you that price is king. Everything comes down to price, and price is the most important indicator in and of itself. Experienced traders know that many technical indicators are simply price massaged, oiled and spit out into a fancy blue or red line at the bottom of one's chart. But volume is a completely different animal. While you'd have to travel far and wide before you'd chance upon a trader who would say that volume readings are more important than price, they are useful and significant raw data readings that measure the amount of action and psychology of the market players.

Volume, of course, simply is the measure of the number of shares of Intel or Qualcomm or any stock traded during a day. In the futures arena, volume measures how many corn contracts or S&P E-minis changed hands that session. For those who are trading on an intraday basis, 5-minute volume bars can be found, or for traders more comfortable with a longer-term view, weekly or monthly volume data can be called up just as easily.

Newton's Law

Remember back to high school physics. Newton's first law of motion reflects the concept underlying volume analysis in the financial markets. This law says that an object in motion will stay in motion unless acted upon by an unbalanced force.

Thus, many technical traders call volume the fuel behind a market move. Is the gas tank full and providing powerful momentum for that Porsche speeding down the Autobahn? Or is the gas tank nearing empty, which means the engine is likely sputtering, and the driving machine is slowing and limping toward the shoulder of the road? For a trader who is looking to put on a stock trade from the long side, knowing how much gas is likely left in the tank is an important variable. After all, how many smart drivers set off for a long trip with only a gallon of gas left in the tank?

Joe Granville, editor of the ***Granville Market Letter*** and developer of the popular volume tool called on balance volume (OBV) [we'll get to this later...], puts it another way and says that volume "is the steam in the boiler that makes the Choo Choo go down the tracks."

Use It to Confirm

"Generally speaking, volume has to confirm price," explains John Murphy, author and chief technician at Stockcharts.com. "When price breaks out to the upside [or downside], we normally like to see a nice pickup in volume to confirm that."

One of the basic rules of thumb for traditional volume analysis is that a healthy uptrend would see expanding volume on up days and contracting volume on down days. Just the opposite would be true for a downtrend. "When you get an exception to that, it can be a sign that trend is changing," says Phil Roth, chief technical analyst at Miller Tabak & Co. Daily volume data is easy to find and can even be tracked via the ***Wall Street Journal***, and most charting software packages offer an option for volume bars across the bottom of the chart.

"A market rallying on light volume is a sign there isn't as much bullishness. It is a hesitant market," says Murphy. "When we don't get volume, we get more suspicious."

Or another subtlety for which to be on the lookout is "big volume in an uptrend, but no price progress. That could be a signal that you've hit resistance," adds Roth. The idea is that an unusual change in a volume pattern could signify a possible reversal.

More Rules of Thumb

Some other basic rules of thumb in relation to volume are that bull markets tend to have bigger volume, while bear markets tend to have lighter volume. "Markets must be pushed up but can sink on their own weight," notes Roth. In a downtrend, traders would like to see increasing volume on down days and decreasing volume on up days.

Brian Shannon, director of research at Marketwise uses volume in his trading and analysis. He says "volume is second only to price. Price is what pays, and volume lets us know about the emotional condition of the buyers and sellers."

Shannon highlights a couple of his favorite reflections on volume:

- Big volume without further upside equals distribution;
- Big volume without further downside equals accumulation;
- Volume tends to peak at turning points;
- Volume often precedes price movement;
- Volume is a relative study.

Shannon outlines an example for a stock that is rallying. "You'd like to see that stock advancing on increasing volume each day, say 600,000 the first day, a million the second day and a million-five the third day. Price pullbacks should see successively lower volume, such as 900,000, 600,000 then 450,000" to reflect a healthy advance.

One of the old market adages says that once a trend is established, it is more likely to continue than to reverse. "That is even more likely to be true if pullbacks are on declining volume," says Shannon. For traders who may have missed an entry opportunity on a breakout, if a stock posts a retreat on declining volume, that may offer a second entry opportunity for a trend move.

Divergence

Themes that come up over and over again in the field of technical analysis are the concepts of confirmation and divergence. Divergence often is used in the world of oscillator readings with such tools as stochastics or the relative strength index. Simply, the idea with those tools is that with a bullish trend, one should see rising oscillator readings. When that doesn't occur, a divergence occurs, and that is an important "red flag" warning signal that trend could be about to change. Example? – if a price made a new high in an uptrend, but stochastics failed to make a new oscillator high and actually turned lower. That would represent a bearish divergence.

Take that concept and apply the same principle to volume. For example, in a bull trend, does a stock or a commodity price hit a new high for the rally move, but declining volume is seen for that session? Red flag time.

Blow-Off and Climax

Now for the exciting stuff: blow-offs and climaxes. Blow-offs tend to occur at major market peaks, while climaxes emerge at market bottoms. These terms simply reflect a huge amount of volume that emerges late in a market rally (or decline) with a sudden peak. Prices then abruptly reverse.

"Volume tells me where the action is. It shows me the collective psychology of the participants if they are fearful or overly optimistic," says Shannon. However, "it's tough to say what a climax or blow-off is until after it is over."

Confirm Pattern Breakouts

Another use of volume analysis is to incorporate volume readings along with pattern breakouts. For those schooled in traditional pattern analysis, volume can be a helpful confirming indicator for double bottom or top, flag, triangle or any type of pattern breakout. How does it work? Jordan Kotick, global head of technical analysis at Barclay's Capital says that for him, "Volume shows conviction. Is there conviction in a move?"

Combining a price breakout with a volume confirmation simply helps a trader to see if there is conviction behind that price breakout. Let's say that corn futures have been in a downtrend. But because markets don't ever simply go straight up or down, the bear trend takes a pause, prices consolidate for several weeks, and a continuation triangle develops on the daily chart. Then one day, traders wake up and corn breaks out to the downside of that triangle, blasting below the lower triangle line at the final bell. On that day, traders could look for a high-volume day, a large and long volume bar, relative to the recent sessions. A high-volume day would be viewed as "confirmation" to the downside breakout of that pattern.

Drill a Little Deeper

For those wanting to take volume analysis to the next step, traders could study what is called upside volume, versus downside volume, when analyzing the major U.S. stock averages. Just as it sounds, the upside/downside ratio simply reveals the relationship between the total volume of advancing shares, versus the total volume of declining issues.

On Balance Volume

There are a variety of tools and ratios based on volume, but one of the early volume indicators, developed by Joe Granville in the early 1960s, is known as OBV. This tool can help traders avoid the subjective nature of "eyeballing" those volume bars streaming across the bottom of the chart. (Is that one slightly bigger or smaller?) The OBV indicator turns the volume data into a line graph, which can be displayed across the bottom of one's chart. Traders actually can draw trendlines on the OBV indicator just like a price chart. When the OBV turns and breaks that trendline, it can signal a potential turning point in price. It also can be used like an oscillator to help pinpoint divergences between price highs and volume peaks or price lows and volume troughs.

"If price is moving up, OBV should be moving up, too," explains Murphy. He also notes that OBV could actually be a leading indicator. "OBV can break out before the stock does," Murphy says.

The calculation behind the OBV is extremely easy to understand even for those who are as math-challenged as this author. The total volume for a session is given a plus or minus value depending on whether prices closed higher or lower that day. A higher close would result in the volume to be counted as a "plus," while a lower close would result in a "minus" value. Thus, a running total is achieved by simply adding or subtracting volume depending on direction of the market close.

For those who are just beginning to use volume as part of their analysis and trading, Granville advises students to "pick a stock, preferably a well-known stock. Follow it every day in the newspaper. Keep a running total of volume. If it closes up, add all the volume of the stock traded that day. If it closes down, subtract the volume of that day from the previous figure. You'll see a running commentary on the action of the stock. You'll see the evidence that volume precedes the price trend."

Equivolume Charts

Volume analysis has spawned a range of indicators and even a new type of charting technique, called equivolume bars. This type of chart actually combines price and volume into one bar or box. For those familiar with Japanese candlestick charts, the concept is somewhat similar. Basically, the top of the equivolume box represents the day's price high, while the low is seen at the bottom of the box. The width of the box represents the day's volume. The wider the box, the heavier the volume during that session. "By just glancing at the bars, you can tell which days have heavier volume," explains Murphy.

Add Open Interest to the Mix

Traditionally, some technical analysts have combined volume with the study of open interest, which simply refers to the number of outstanding contracts still open at the end of the trading day in the futures markets. With the advent of 24-hour markets and the rise in popularity of foreign exchange trading among individual traders, the study of open interest appears to have waned somewhat. But for those wanting to understand the basic rules of thumb, they still apply.

Traditional Open Interest and Volume Guidelines:

- If prices are rising and volume and open interest are increasing, it represents a strong market;
- If prices are rising while volume and open interest are falling, it reveals a weakening market;
- If prices are falling while volume and open interest are increasing, it represents a weak market;
- If prices are falling while volume and open interest are falling, it represents a strong market.

Don't Make This Mistake

According to Marketwise's Shannon, one of the biggest misuses of volume is an interpretation when a stock is declining. Let's say a trader is long a stock and price begins to pull back. "People convince themselves to hold on because it [the pullback] is on light volume," Shannon says. But that may not be the best way to manage a trade. "Would you rather lose ten percent of your money on light volume or big volume?" asks Shannon. He instead advises traders to exit a position "based on price action."

Another common mistake is that many traders could point to a heavy volume day and be convinced that it is a climax or blow-off day. "Most people end up misreading big volume," says Shannon. "Just because it is the biggest volume in three days, doesn't mean the move is over. Volume could be even bigger the next day."

Timing Is Everything

Typically, trading in the stock market (and the futures on the major stock indexes) sees the heaviest volume during the first hour-and-a-half of the day and then the last hour-and-a-half of the day. Traders can use this generality to help them in their intraday trading. "The midday doldrums occur because institutional traders are waiting you out," warns Shannon. Often times, major institutional players will execute large portions of orders in the morning, and then wait for heavy volume and renewed trending action late in the day to finish orders.

This can be helpful information for those who are trading very short term on an intraday basis. "If you are a hyperactive trader and have to take your profits, take them during the first move in the morning," says Shannon. There may be another opportunity during the second late-day wave of action. Otherwise a trader who bought, say, the S&P E-mini early in the day and saw some profits in that trade, may slowly watch that profit erode during the lunchtime doldrums, as prices simply tick slowly lower. For those who get spooked on pullbacks or don't have the patience to wait for the afternoon move, it may be wise to simply book the profits early on.

Closing Thoughts

Here are a few more tidbits on incorporating volume into your trading and analysis.

Use volume simply as a screening tool. For those who are scanning thousands of stocks looking for a good trading opportunity, volume can help distinguish between those that are in an uptrend or downtrend (depending on whether one is looking for long or short trades). How? Those stocks with the best volume profile or pattern can help weed out the stocks most likely to continue with that trend.

Barclay's Kotick closes with another tip for beginning volume followers. "It's not the level of volume that is key, it is the trend of volume. Look at it over a range of time." One day of volume can't be viewed in a vacuum. Volume analysis is most useful when compared to previous sessions. Some like to say volume is simply a reflection of supply and demand. A high-volume day simply reflects more demand in the marketplace. But overall, traders and analysts note that volume should be used as a confirming indicator. Most still agree that price remains the most important factor to consider while trading. Volume may offer up warning signals, red flags or generate trading ideas. But use it as a supplementary tool.

If you've haven't incorporated volume readings or analysis into your trading, it may be worth exploring. "Volume is very useful and important. You can't do good technical analysis without looking at volume," concludes Murphy. SFO

*Kira McCaffrey Brecht is senior editor of **SFO** magazine.*

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