



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.

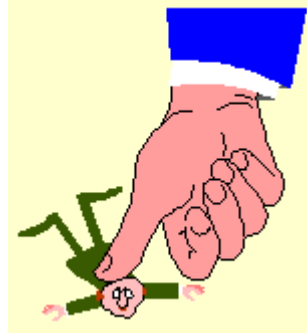
In a nutshell, **when demand is greater than supply, prices go up. When supply is greater than demand, prices go down.** Sounds simple, doesn't it? And it is simple when compared to something like gene splicing. But as simple as it may be, it nevertheless confounds many investors who are desperately 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 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