



THE
HUDSON SESSIONS
SESSION 2

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Tuesday 16 May 2023

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The risk of trading can be substantial and each investor and/or trader must consider whether this is a suitable investment. You should use risk capital, and not capital required for other purposes, such as retirement savings, student loans, mortgages or education. Past performance, whether actual or indicated by simulated historical tests of indicators, is not indicative of future results.

To every thing there is a season, and a time to every purpose under the heaven.

-Ecclesiastes 3:1

Tonight's Outline

Wyckoff Cycle

- What it is
- What we can do with it

Support and Resistance

The Four Trades

Discretionary Trading

Why not just quantify everything and use a computer to trade?

What advantages might a discretionary trader have?

- Adaptability
- Superior pattern recognition
- Implicit learning

“The left-brained analytic system on Wall Street has become overdeveloped. Like a tree that has grown too large for its place in the forest, it has crowded out intuition, vision, creativity, and gestalt sensing, which are the properties of the right hemisphere.

As professionals of the Street continue to try to overpower darkness, opportunities will exist for those who can sense new directions.”

-Bennet Goodspeed (1984)

Discretionary Weaknesses

Intuition can be highly misleading

Your emotional state is a key part of your process

- Same data + different “you” = different decisions

Can be very hard to be consistent

- Same data, different decisions?

The market is a wicked learning environment

- Deliberate practice is not possible
- Implicit learning is suspect

Theory of Mind

Ability to understand people by creating some “theory” of what might be going on in their heads

- Animals seem to be capable of this too!

Research shows that traders, even inexperienced traders, are good at this

Can misfire, but it’s a valuable guide

How to structure and train ToM?

Richard D. Wyckoff (1873-1934)

Stock market speculator and educator

Accumulated considerable wealth from his trading

- Was an active trader and daytrader

Became interested in protecting the public from market scams

- Wrote articles
- Created a set of courses

Key ideas:

- Find right places to trade
- Use stops to get out if you're wrong
- Match techniques to the market environment
- Understand impact of order flow on prices

The Composite Man

One of Wyckoff's goals was to reveal the "true reasons" behind the market's movements

He discovered large groups manipulating stock prices

Claimed to be able to see their operations in the patterns they left on prices

And proposed that it was useful to think of them as a "composite operator" or "composite man"

Is This True?

We don't know, so I would tend to assume not true

But it does not matter

Markets are **always manipulated**

Personifying “market forces” is a useful mental trick

- But be careful not to go too far!

I'm more likely to say “buyers” and “sellers”, but there is 1:1 overlap with Wyckoff's composite operator

The Goal of the Composite Operator

To buy inventory without alerting the public

To sell to the public while prices are going up

To be positioned correctly before the market makes
its movement

The Market Cycle

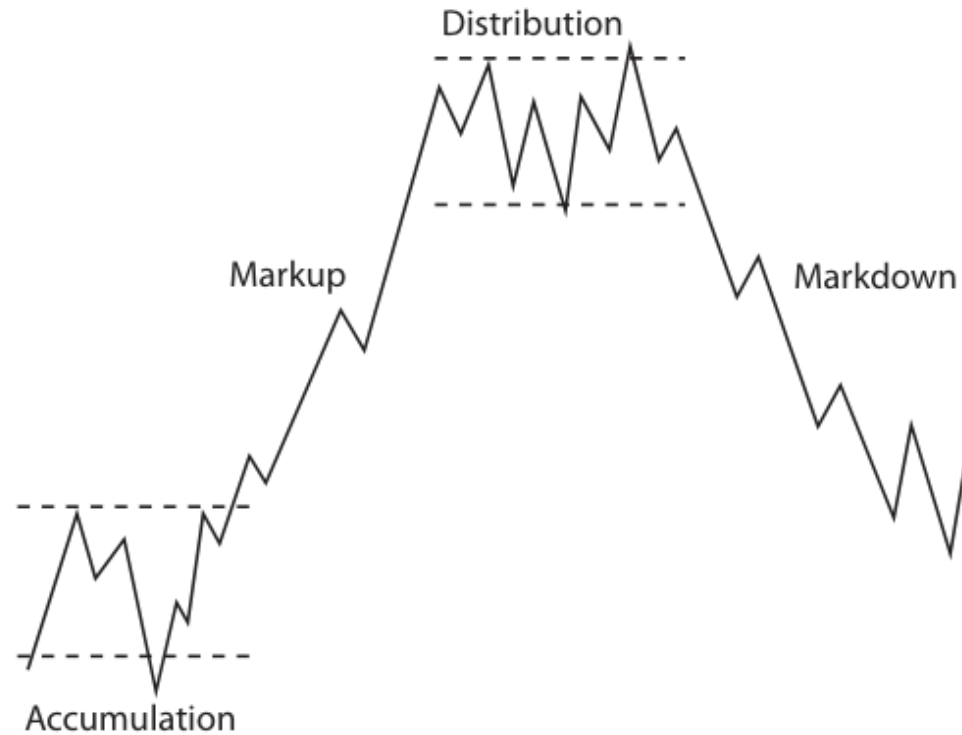
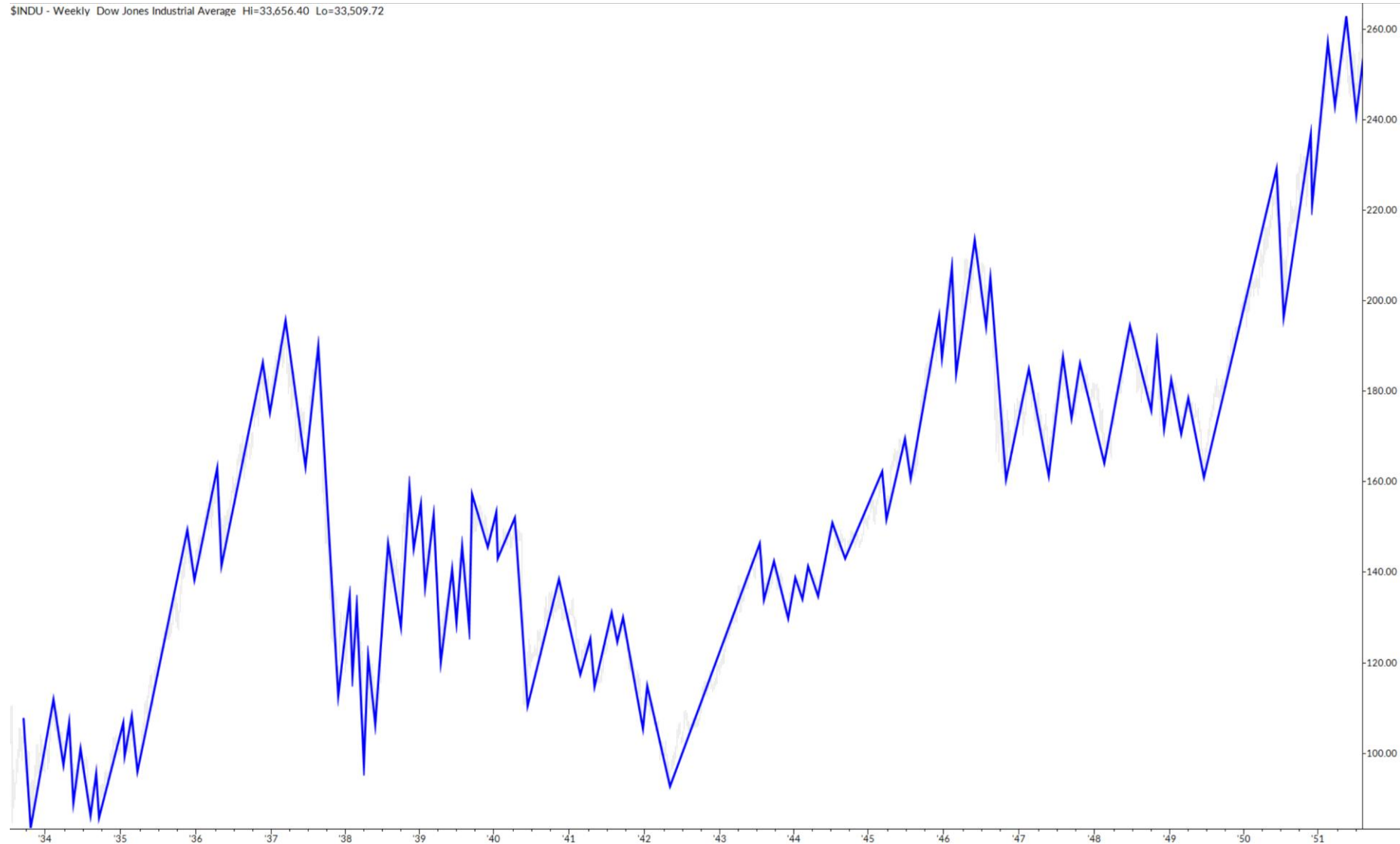
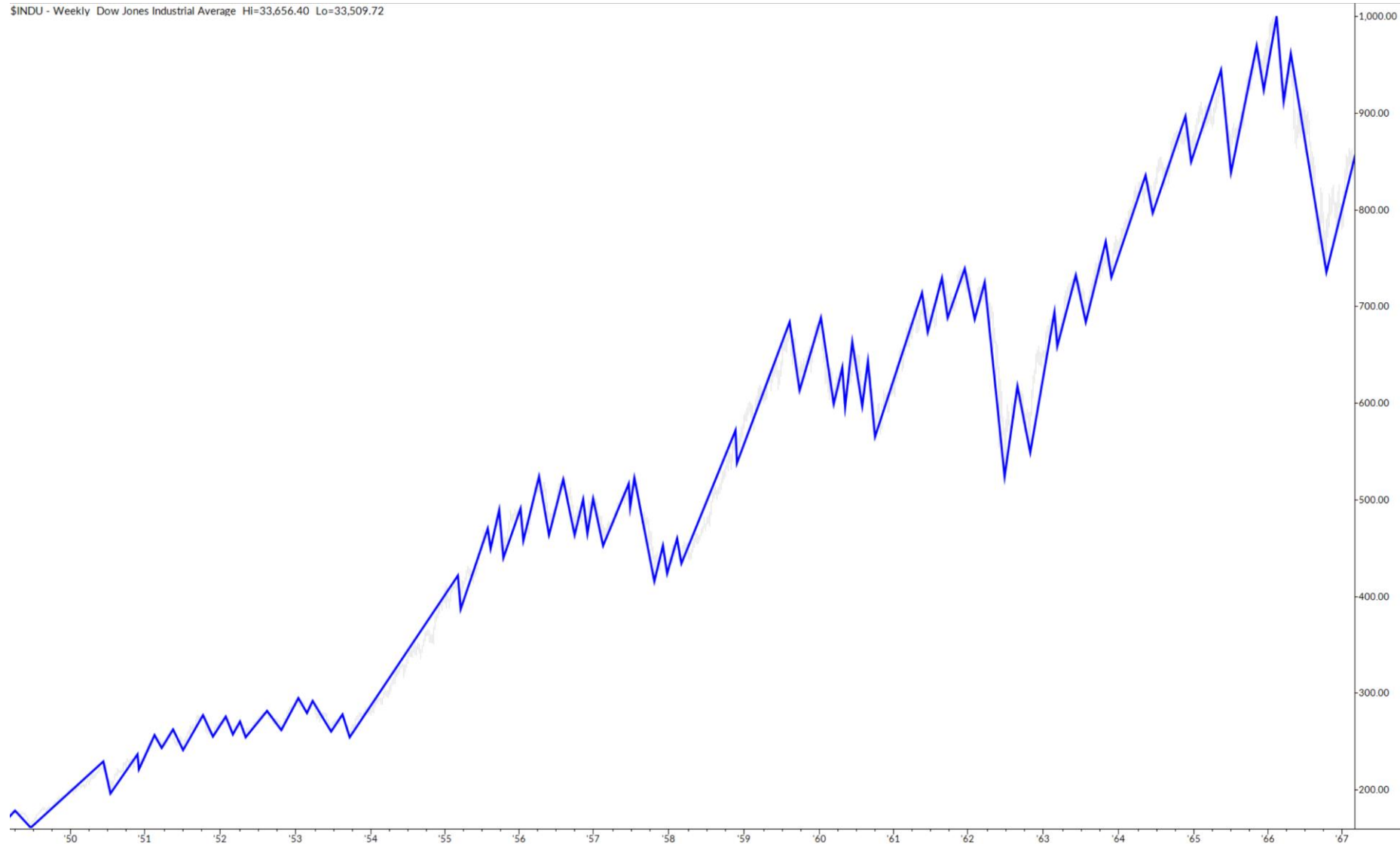


FIGURE 2.1 The Classic Wyckoff Cycle

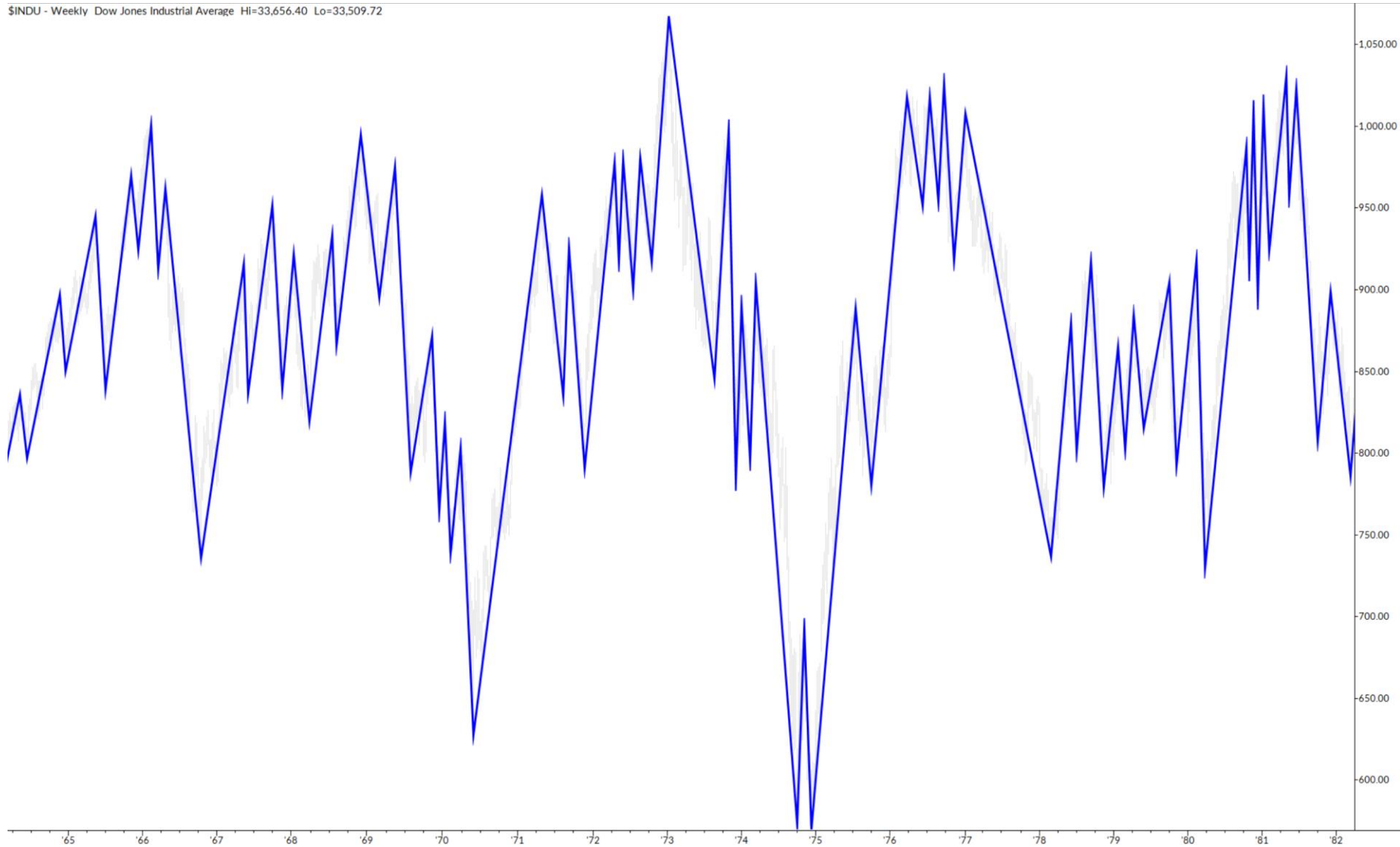
Does This Work?



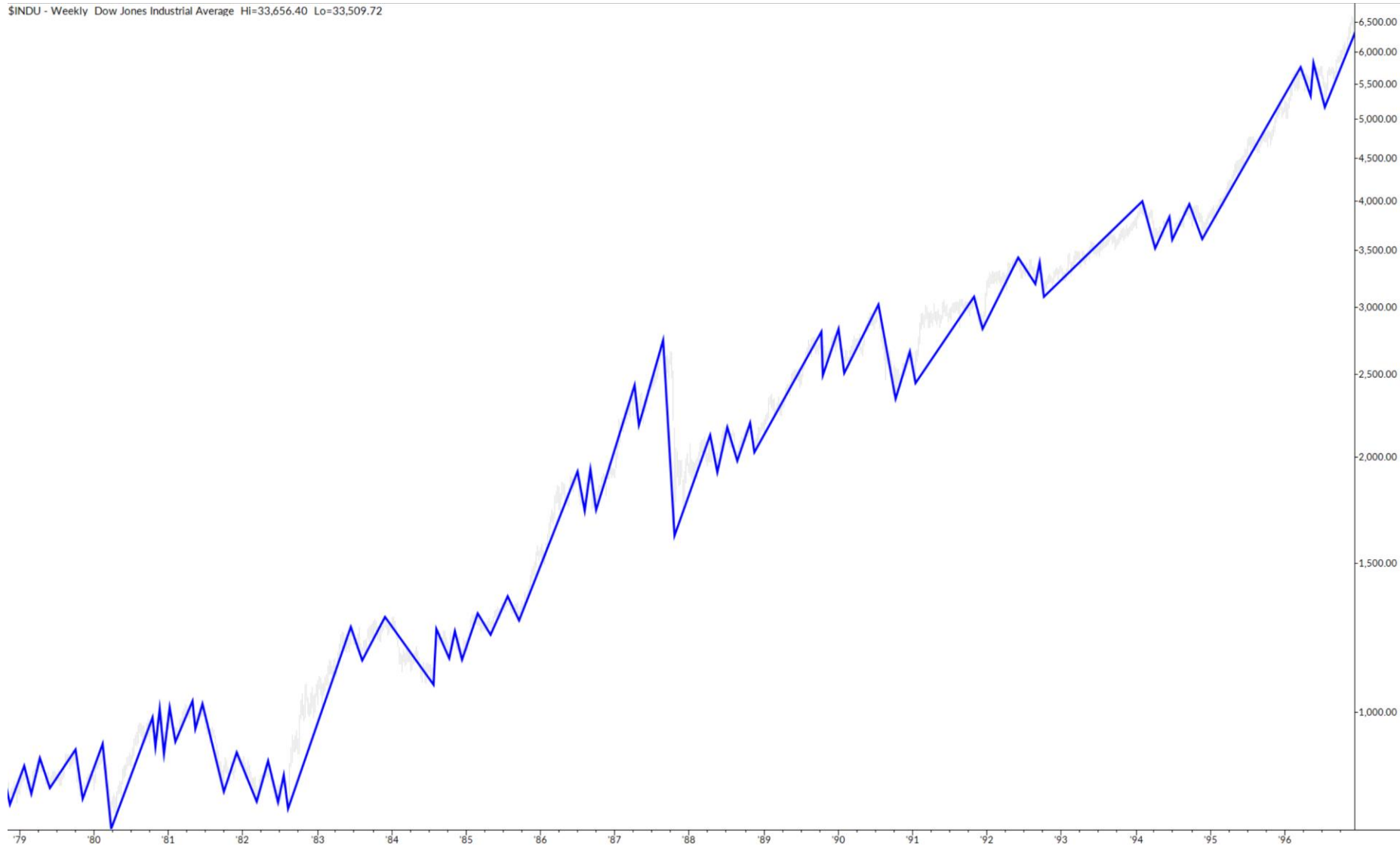
Wyckoff Cycle



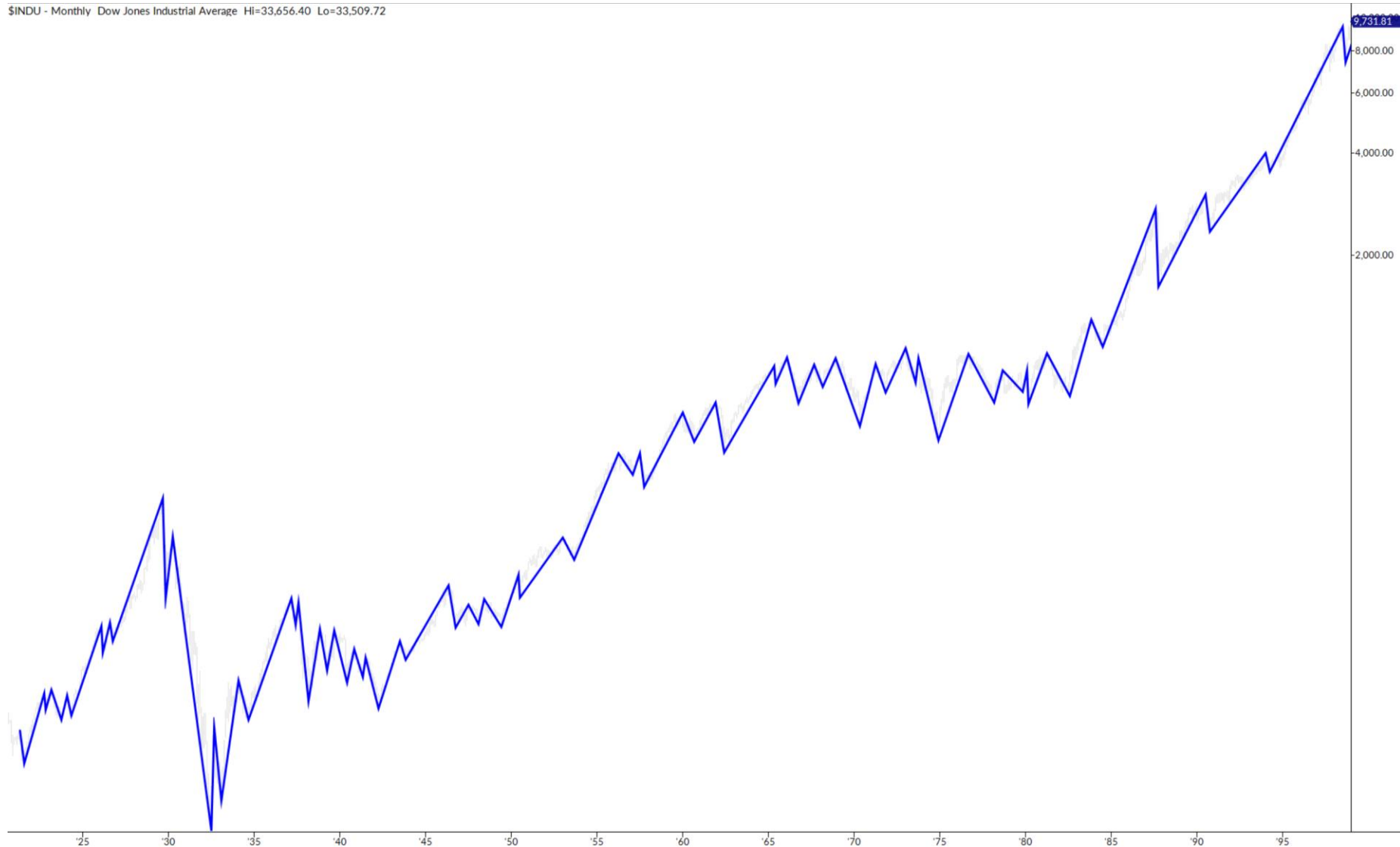
Wyckoff Cycle?



Wyckoff Cycle??



How About Bigger Picture?



So, What Do We Do With This?

Don't expect any theoretical framework to fit real data very well

In particular, don't expect the natural cycle to find predictable expression

Useful take-aways:

- Composite operator
- Hidden manipulation
- Market moving in cycle of trend and not-trend
- What does manipulation look like on a chart?

Accumulation / Distribution

The basic concept is:

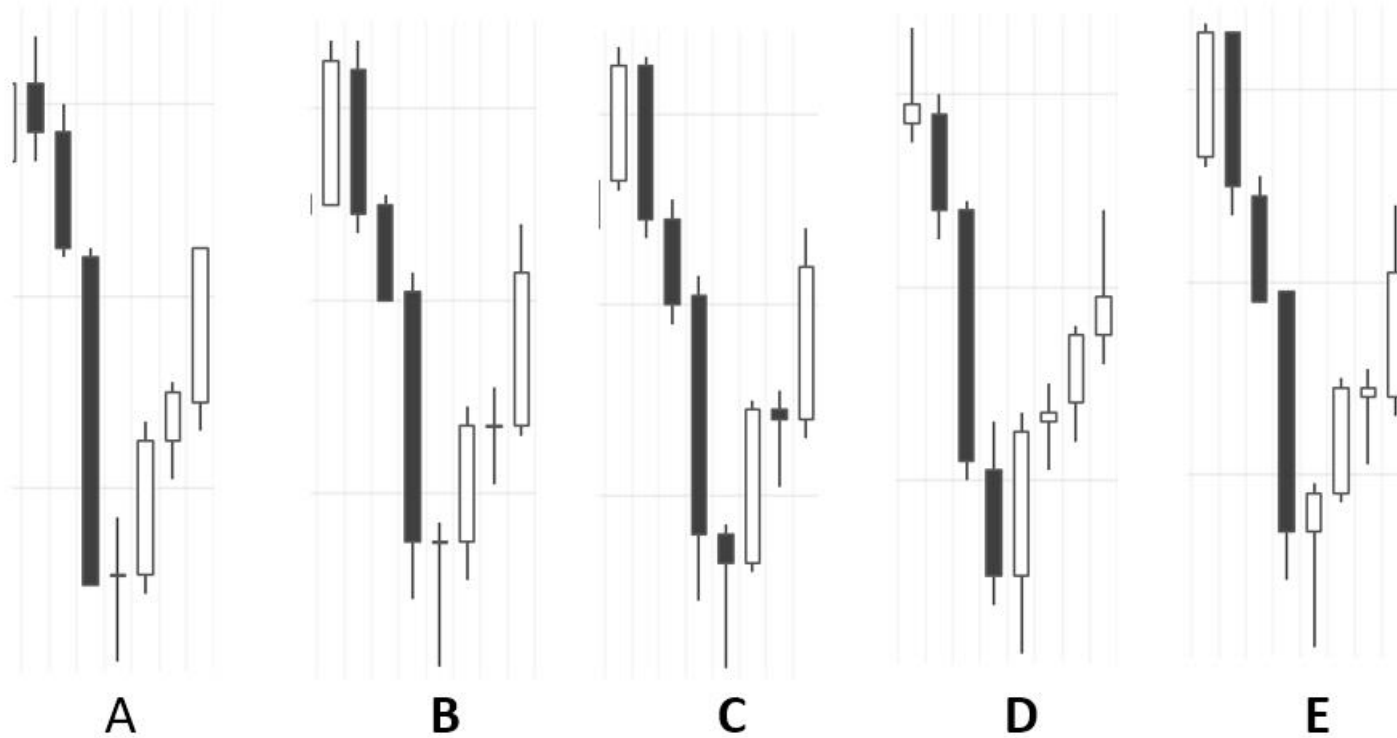
- Support will hold in accumulation
- Resistance will hold in distribution
- Small patterns may show when this is happening

Failure tests at the level are common

- Wyckoff called them
 - Springs
 - Upthrusts (potentially misleading – this is bearish)
- I would also consider “reversal complexes”

Reversal Complexes

(Remember last session's offsets!)

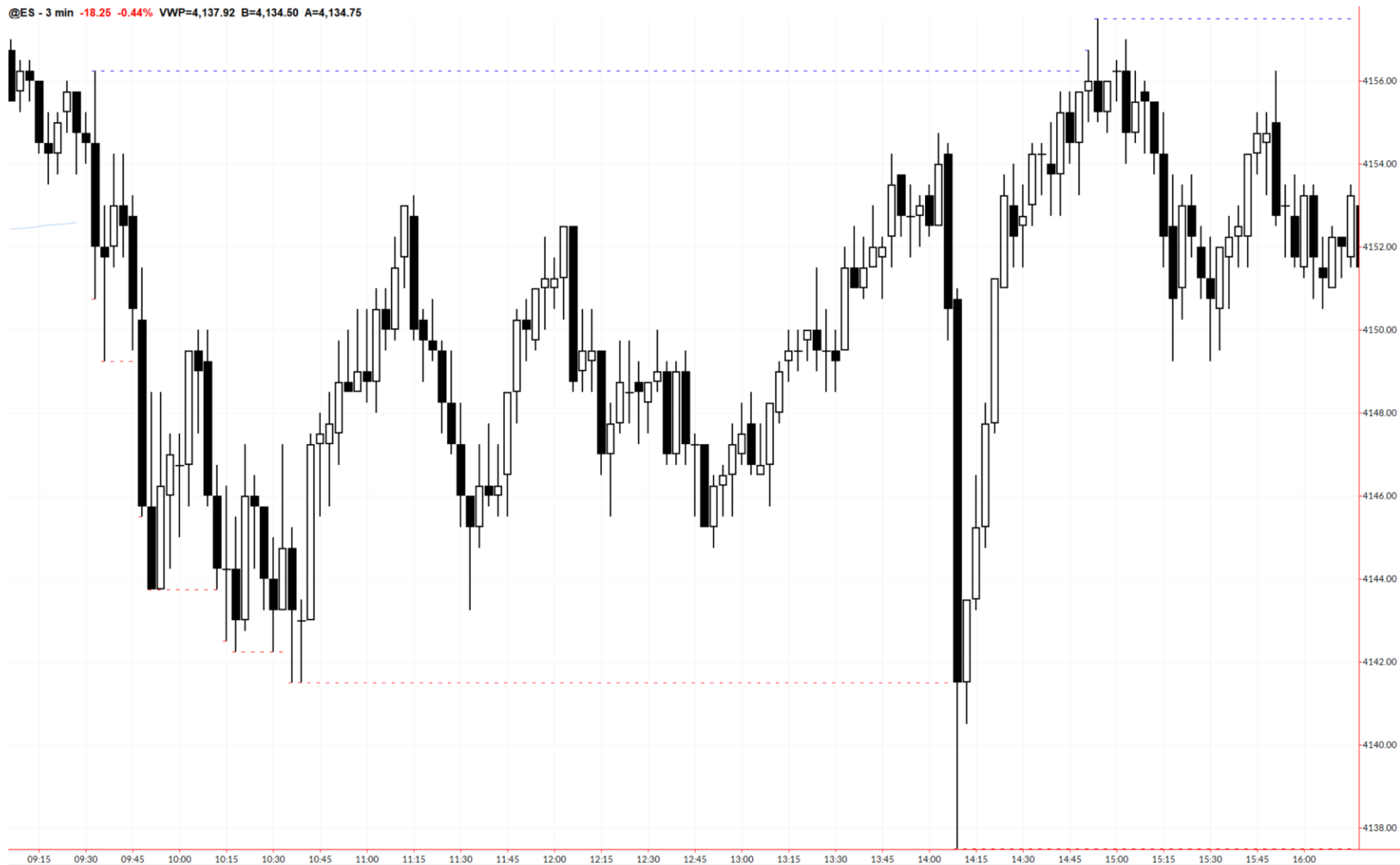


Accumulation & Distribution

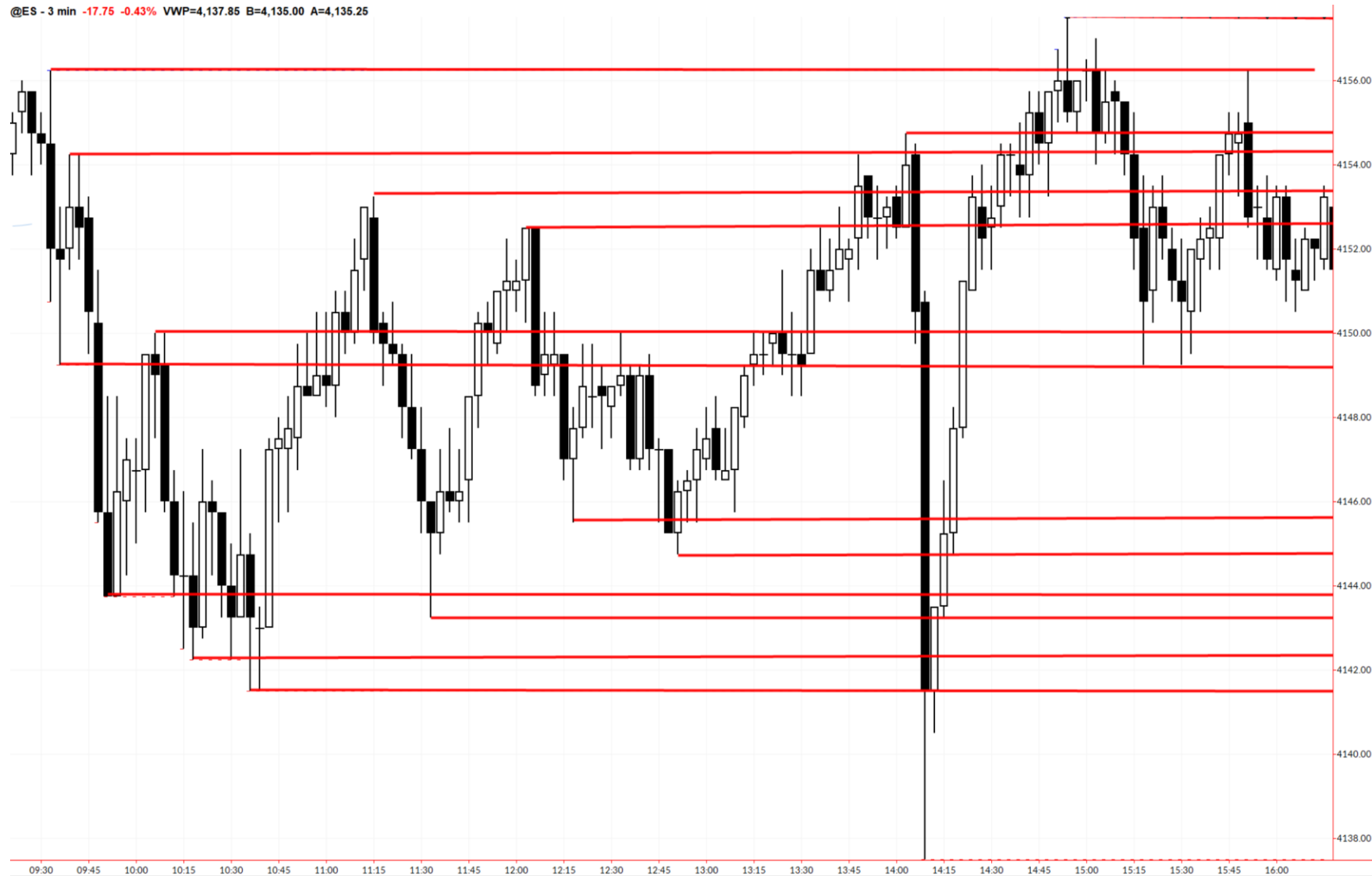


FIGURE 2.2 Accumulation in Daily Platinum Futures with a Classic Spring at A

Support/Resistance



Every Pivot? (Not really...)



Cognitive Bias: Apophenia

The human brain is a fantastic pattern-recognition and pattern-matching machine

But this machinery misfires often (and brutally)

We will happily find patterns where none exist

- And feel very confident in those patterns

The classic example is seeing faces in clouds

- But conspiracy theories are also an expression of this
 - Not just visual

Practical Lessons

- Any line you put on a chart is going to seem to be important
 - Horizontal grid lines are usually at round numbers
- Any trendline will seem to be important
- Any horizontal line from a pivot will seem to be important
- Any ratio you watch will seem to “work”
- Closes of bars (e.g., intraday) will seem to be significant
- Patterns of bars that imply lines will look really good

Maybe any or all of these are real, but
you cannot trust your perception!

But Don't Go Too Far...

The presence of a pattern in random data does not
invalidate the pattern in real data

Random Lines

In 2010, I did a public illustration of drawing random lines on a stock chart. You should watch it:

<https://adamhgrimes.com/randomsrlevels/>

Why haven't I updated it?

- The “file drawer” problem
- This was the first and only time I intended to create this

But don't take my word for it: **repeat it yourself!**

These are Random Levels!



These are Random Levels!



If This Bothers You...

Good

It's always good to think deeply

- About the tools we use
- About the simplifications we make
- About our perceptions
- About ourselves

A good discussion on this topic, started after I did the initial illustration: <https://futures.io/traders-hideout/7364-random-line-theory.html>

The Key Question in All Quant Testing

Is this any better than what I could expect from random chance?

(How different is this test from what I could expect if there were, in fact, no value in the signal?)

A Test of Levels

In 2019, we asked 1,535 traders to look at 20 panels

Each panel showed a “real” level and a “fake” level,
randomized

The task was to choose which was the real level

Levels studied were:

- Round numbers in EURUSD (apologies to Bob Volman)
- In S&P futures, PDH/PDL and GBH/GBL

Real vs. Fake Levels

We avoided all test specifications by simply asking traders which levels “looked” real

- Used pattern recognition of brain
- Traders’ training and experience were not assessed

For ES 5 minute charts: plotted levels on day session

- So, anchors were not visible from prior data
- No axis labels
- For fake levels, shifted prices +/- 20% of daily ATR

EURUSD Levels

Many traders believe round numbers are important

Understanding Price Action (Bob Volman, 2014)

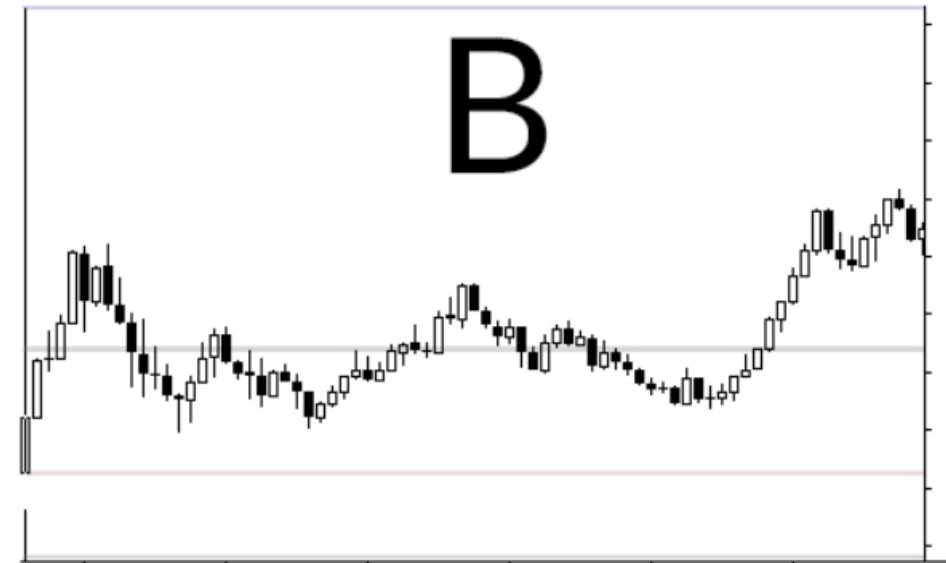
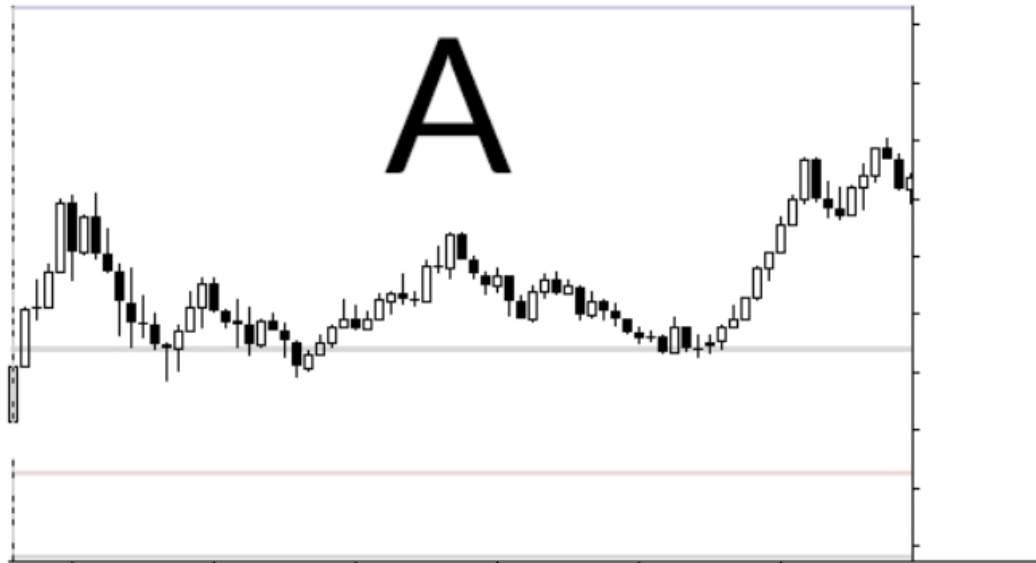
- Numbers such as 1.3300, 1.3250, 1.3200 are important
- Presents well over 400 charts, many of which focus on this

We repeated this procedure with EURUSD 5 minute charts

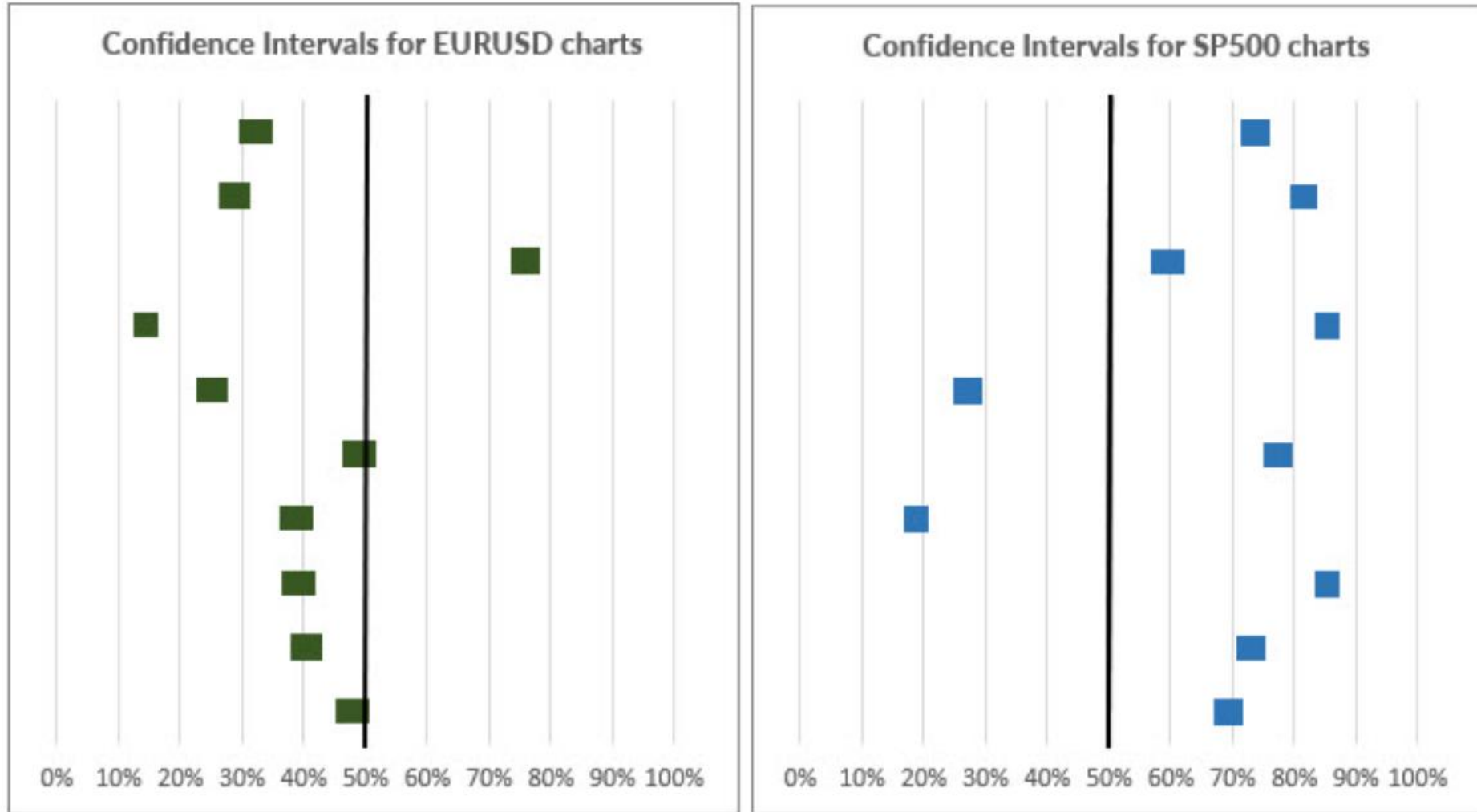
- Shift in this case was “half round number” (.0025)
- Used the time period covered in his book so presented the same data, just in case the market has changed

The shifts should have obliterated any real influence from the levels

Sample Panel



What We Learned



Results Max to Min

	EURUSD	SP500
	75.9%	85.6%
	48.9%	85.3%
	47.9%	81.4%
	40.3%	77.3%
	39.0%	74.2%
	38.8%	73.2%
	31.7%	69.0%
	28.7%	59.2%
	24.9%	26.8%
	14.3%	18.6%
Total	32.5%	65.1%

Summary

We found **no evidence** that round numbers matter in EURUSD

We found **strong confirmation** that previous day and overnight highs and lows are significant in S&P futures

These are only tendencies

We might have missed something

(But this does overlap with common sense...)

Extending the Concept

We have done conceptually similar testing on other levels

- Fibonacci levels
- Moving averages
- Other calculated levels
- Trader-supplied levels

Always looking for evidence that something is a significant departure from randomness

Our conclusions, in almost all cases, are that there's nothing there

Guiding Principle of Data Analysis

Something **cannot be both**
profoundly important
and **invisible** in the data

Practical Lessons

We can find many of the patterns we find in markets in random data

This does not necessarily invalidate the patterns

But it should be a call for humility in pattern recognition

So Let's Get Back to Practice

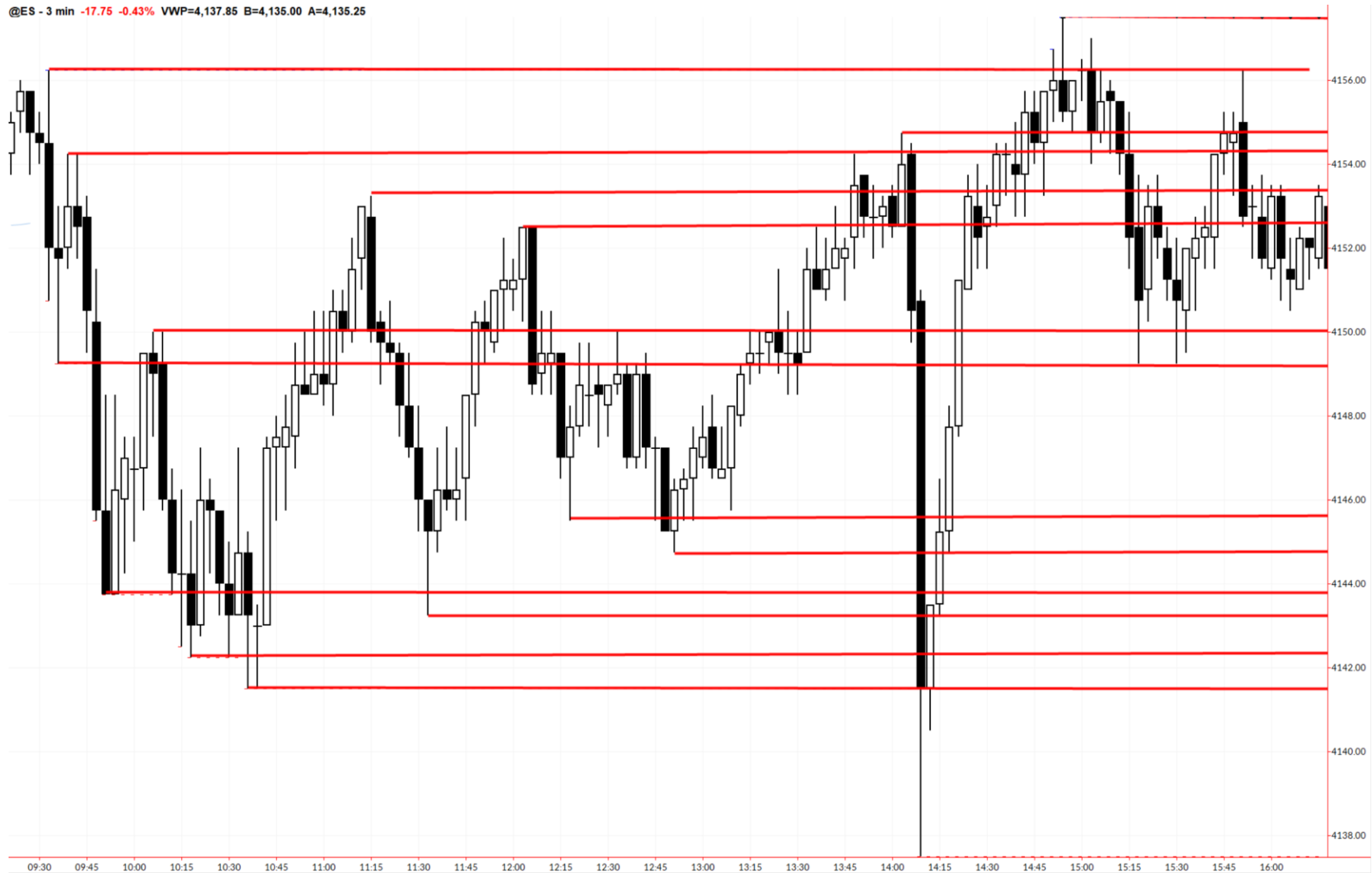
But that context and warning must always inform our thinking

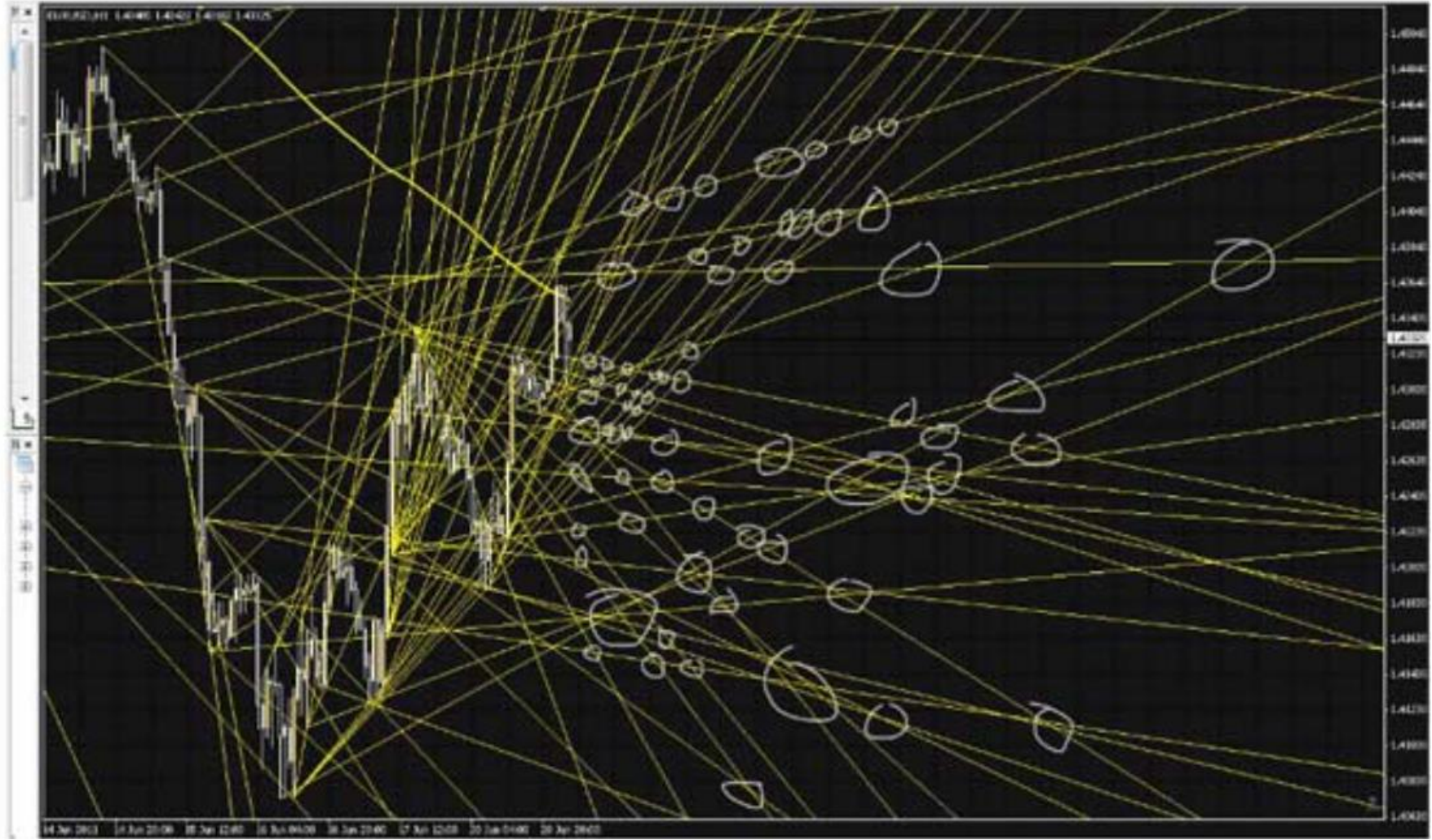
- You cannot trust your perception of any one case
- Must understand behavior over a large sample size

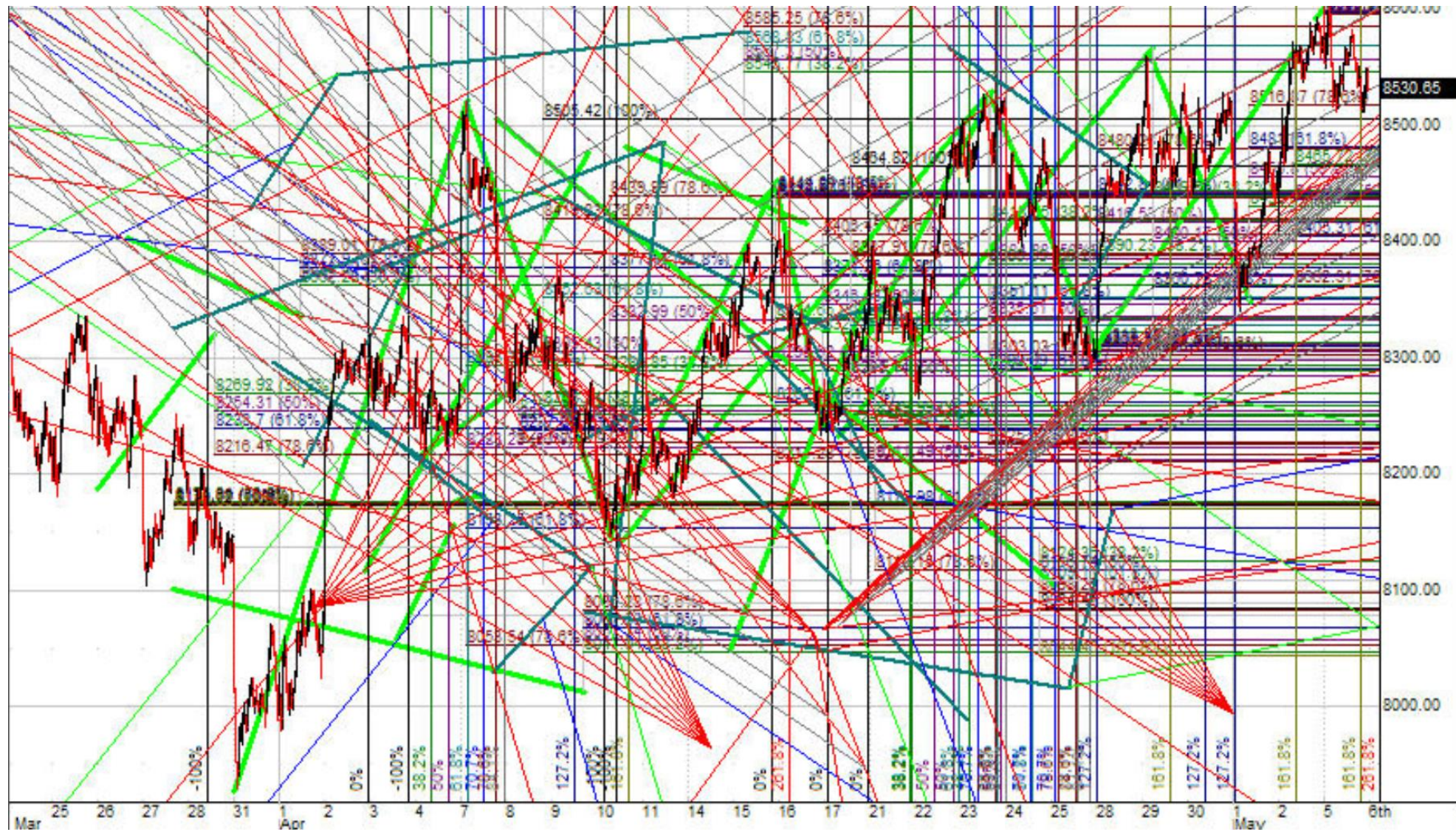
It's better to think correctly than to be misled

- But don't get paralyzed or discouraged

So, Back to Support and Resistance...







Thinking About Evolving Support/Resistance

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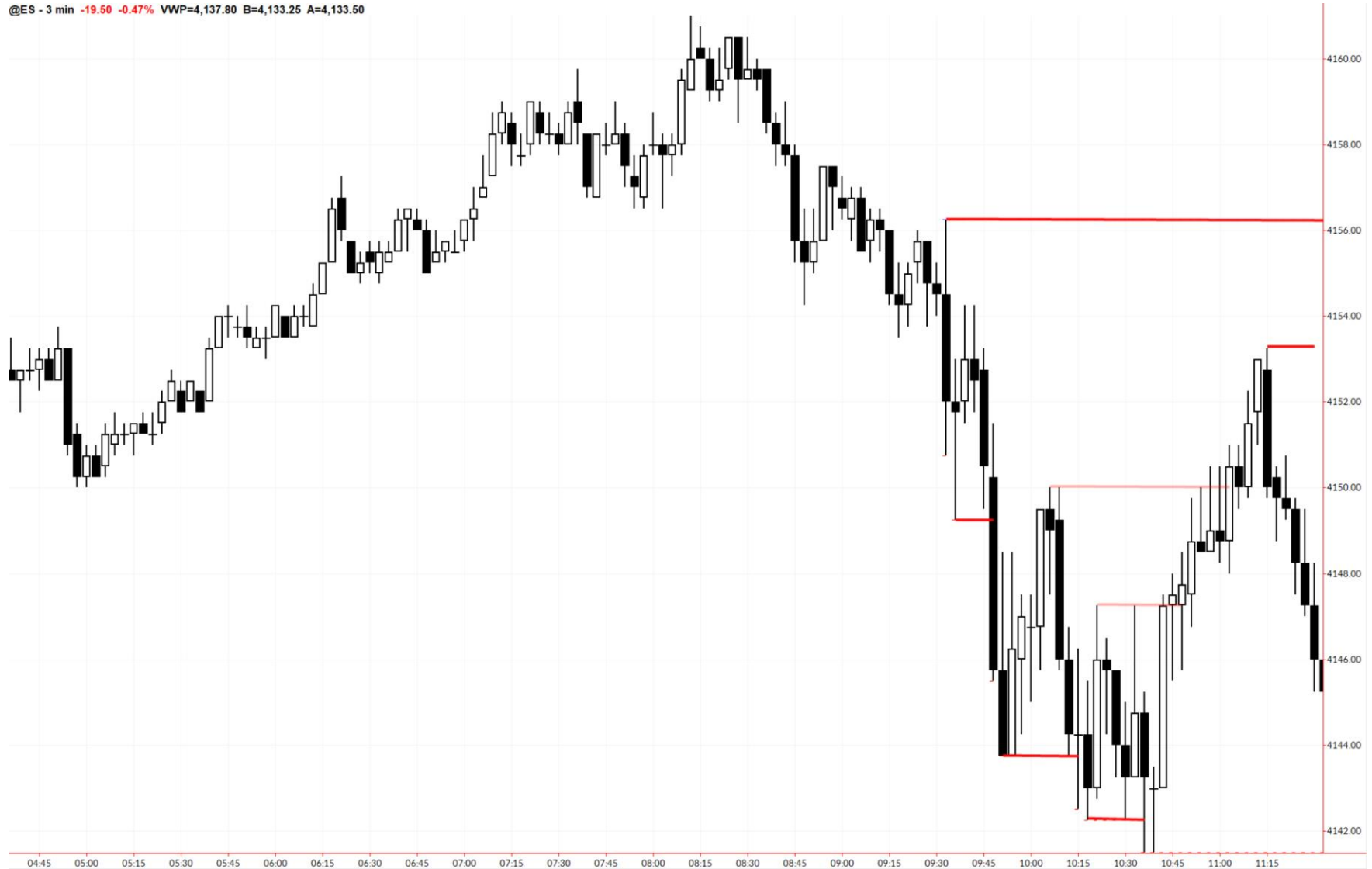
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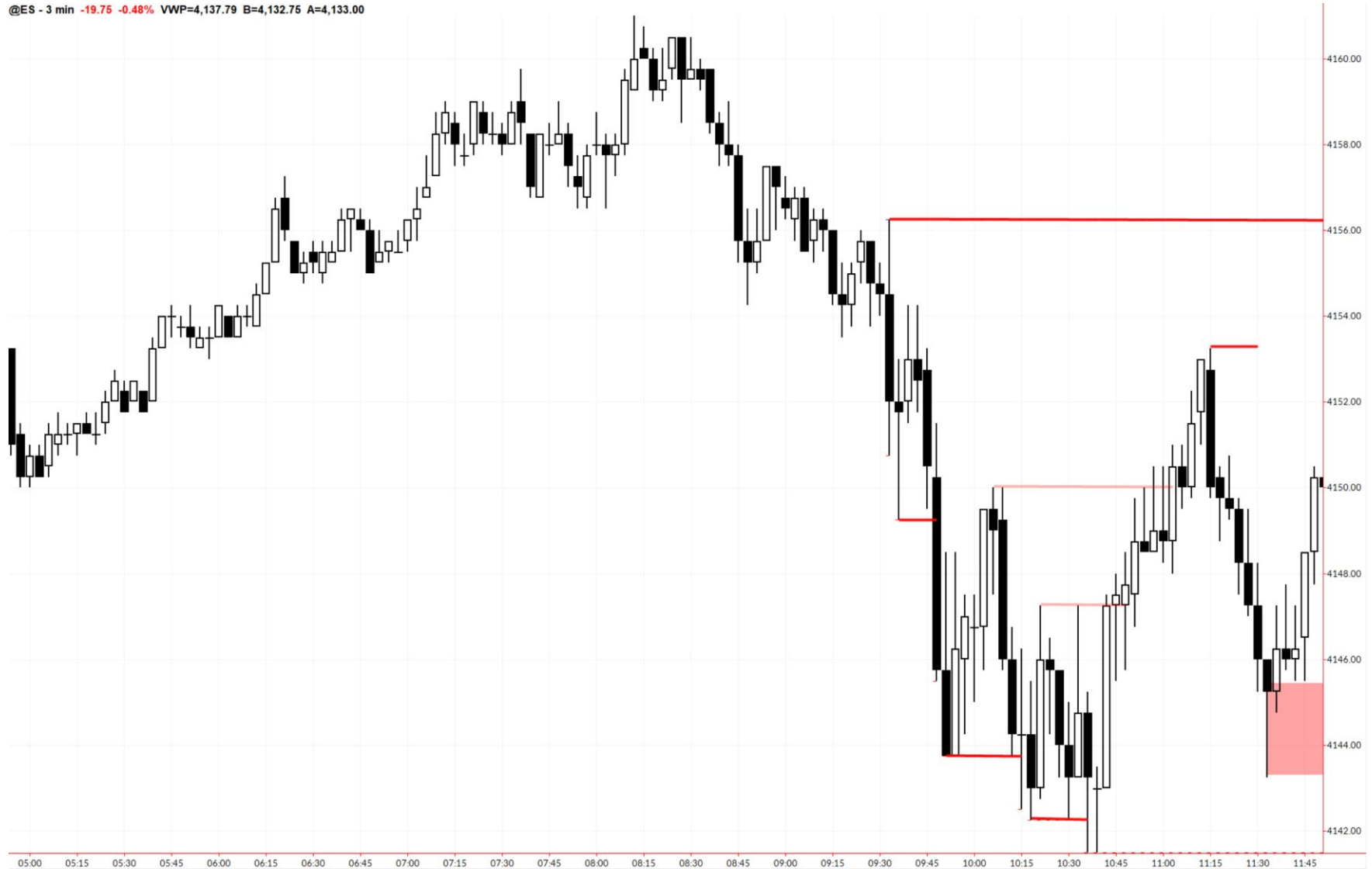
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@ES - 3 min -19.50 -0.47% VWP=4,137.80 B=4,133.25 A=4,133.50



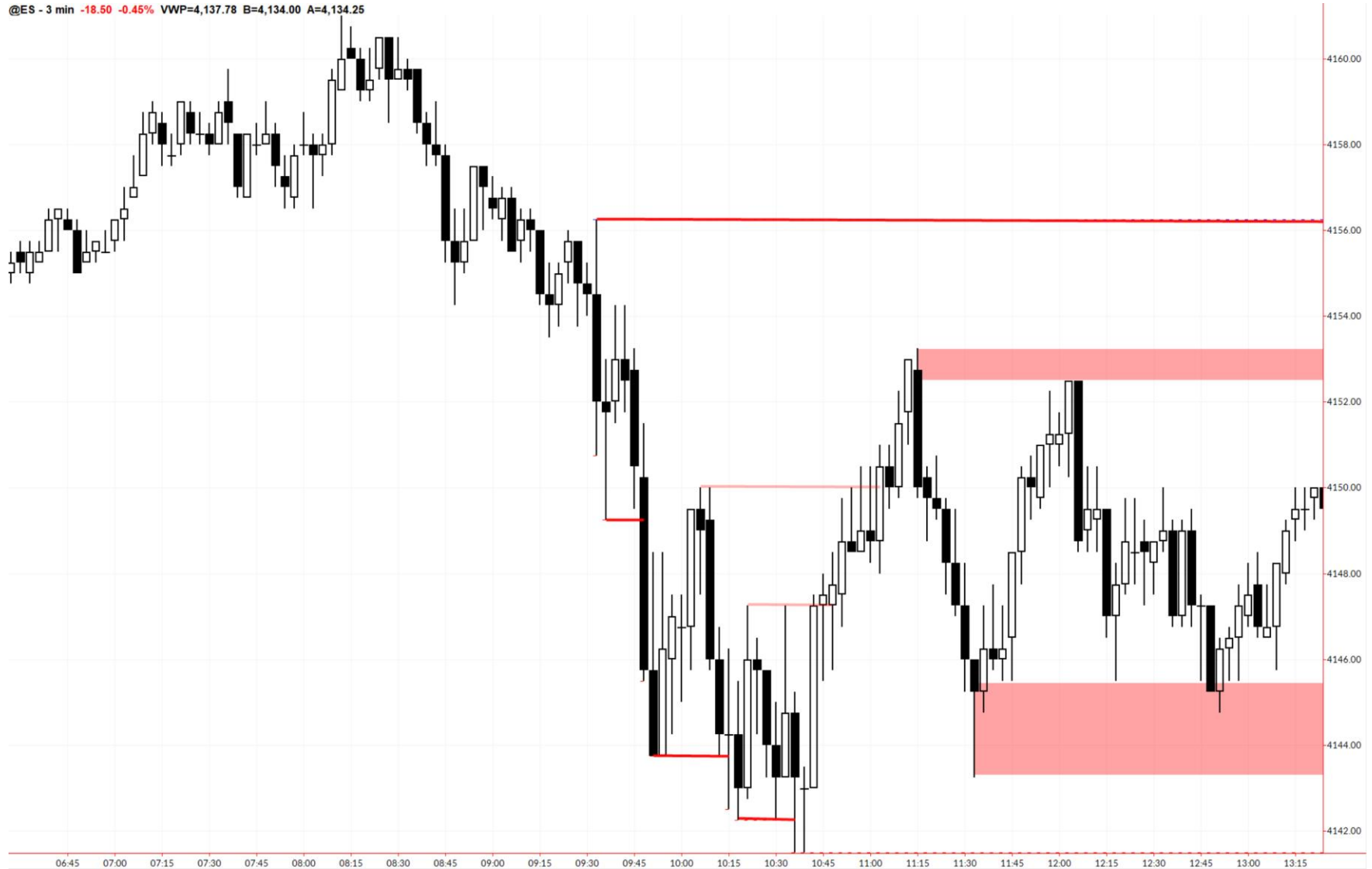
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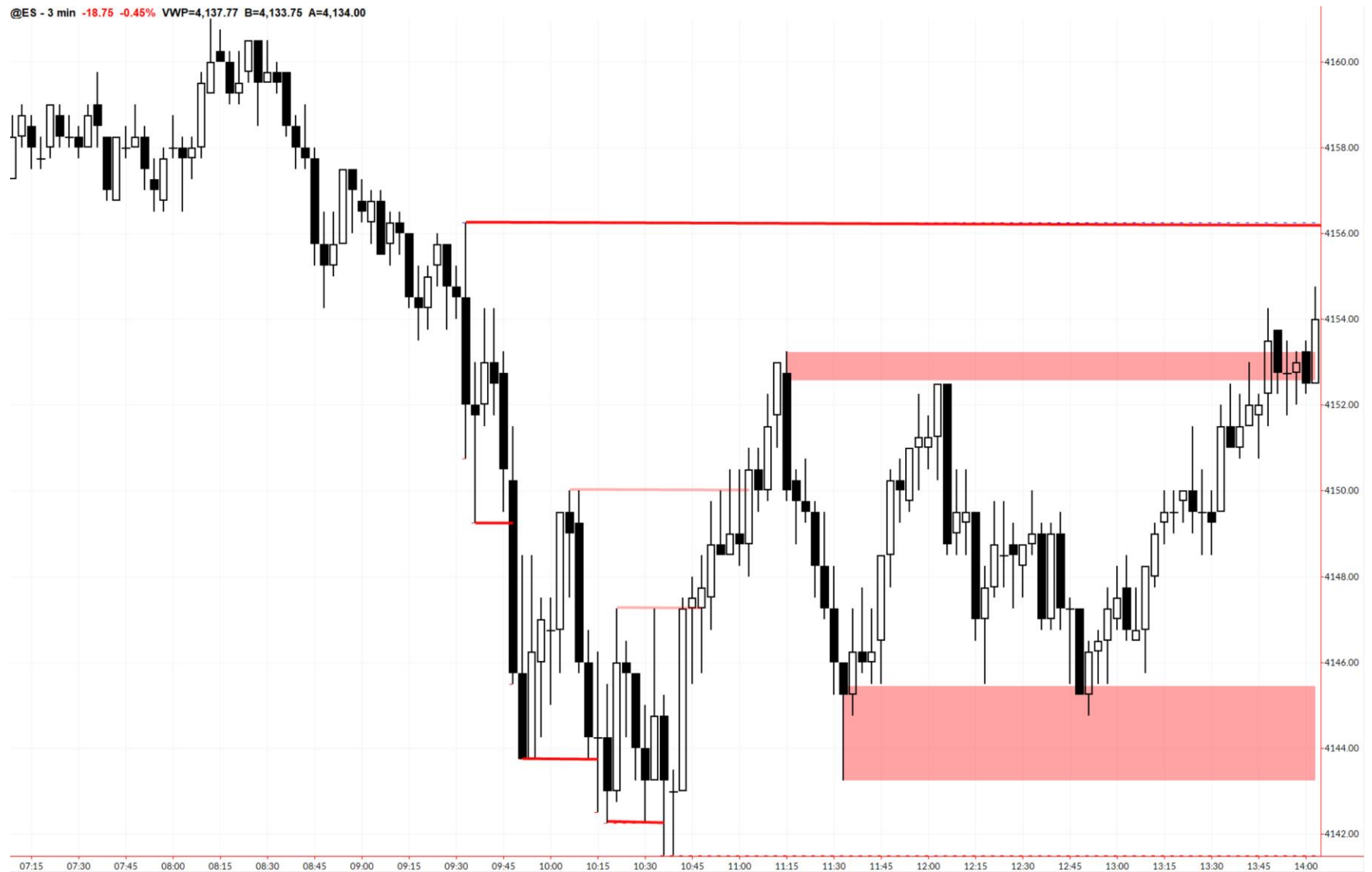
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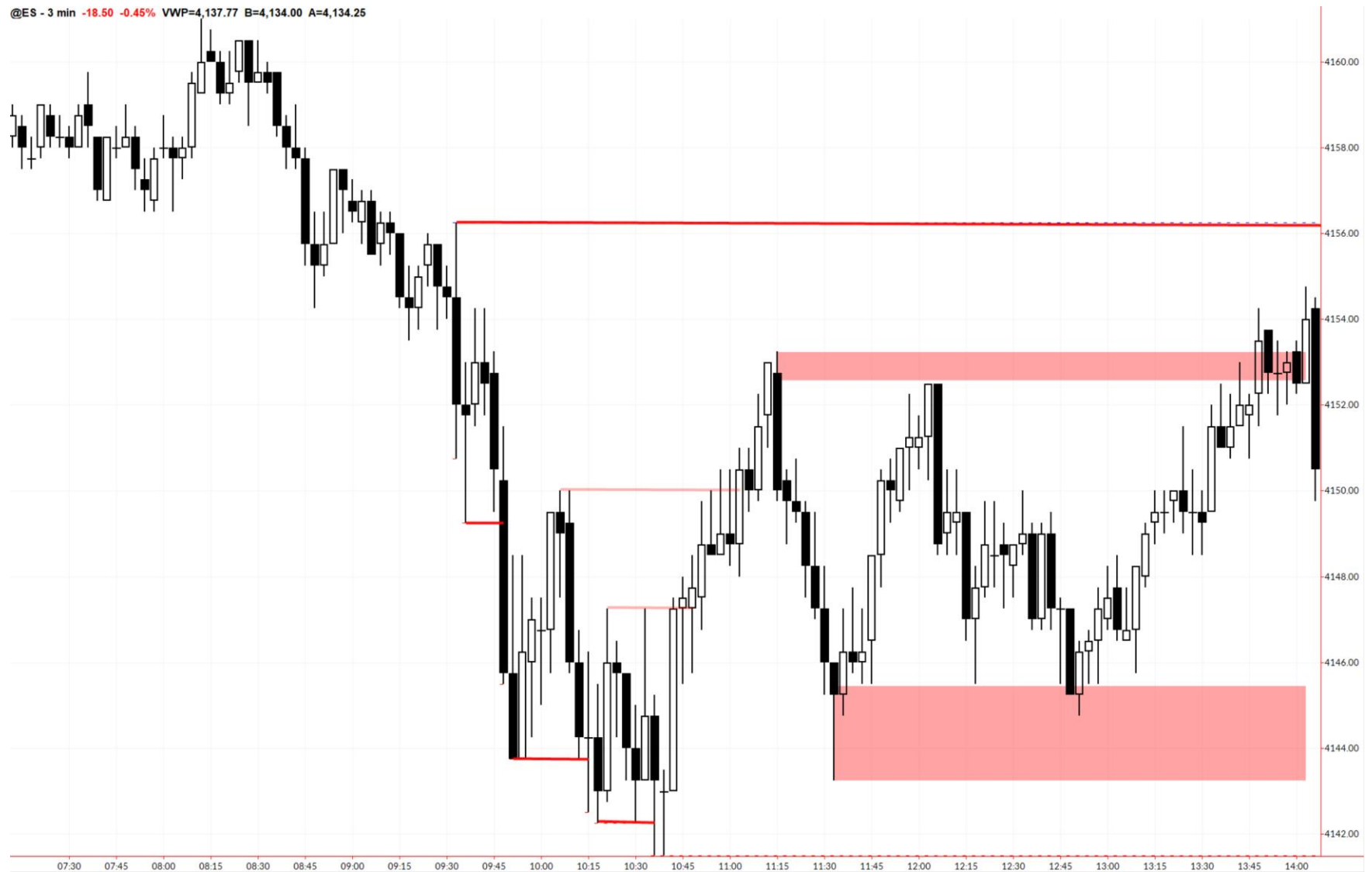
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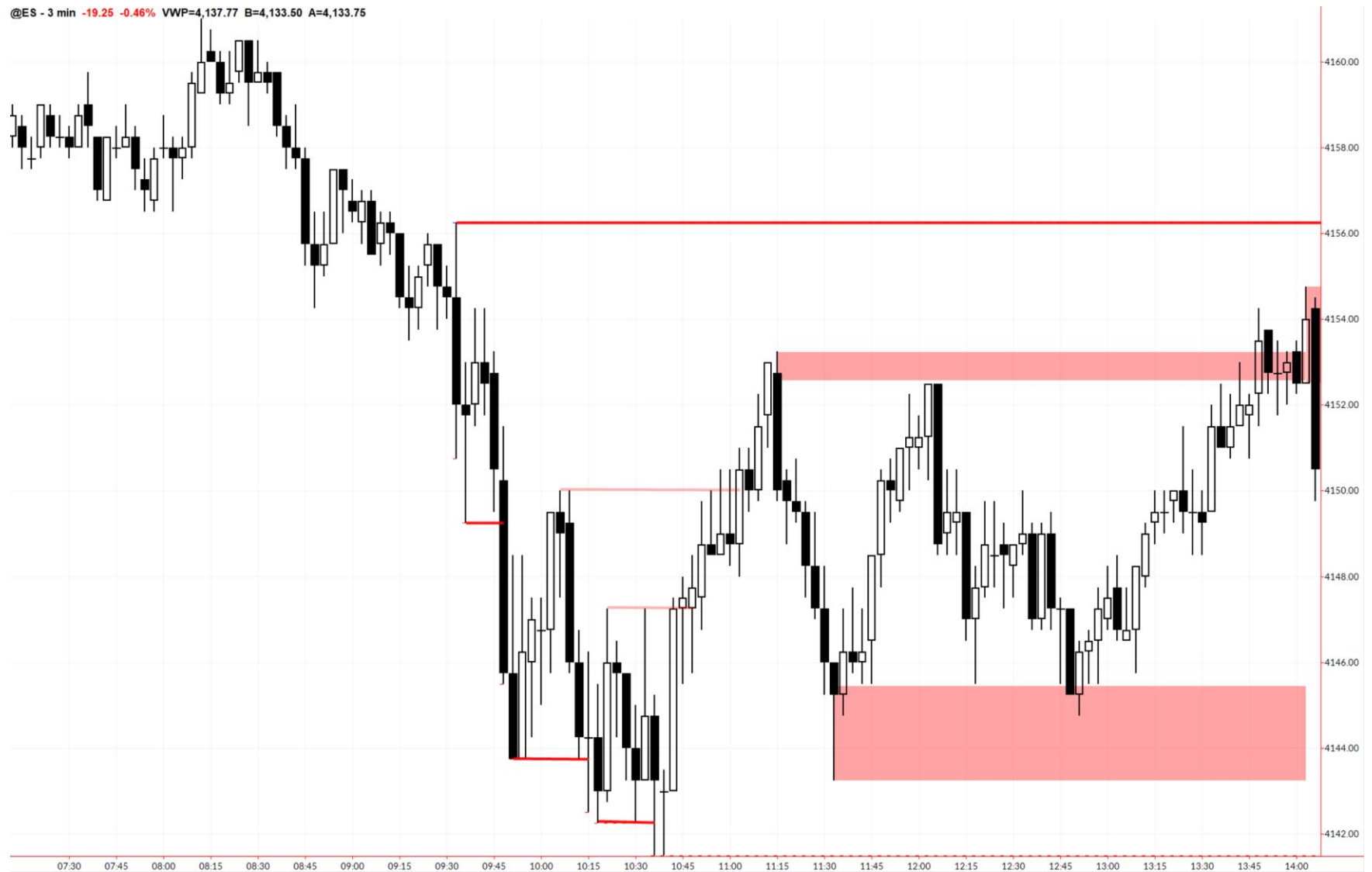
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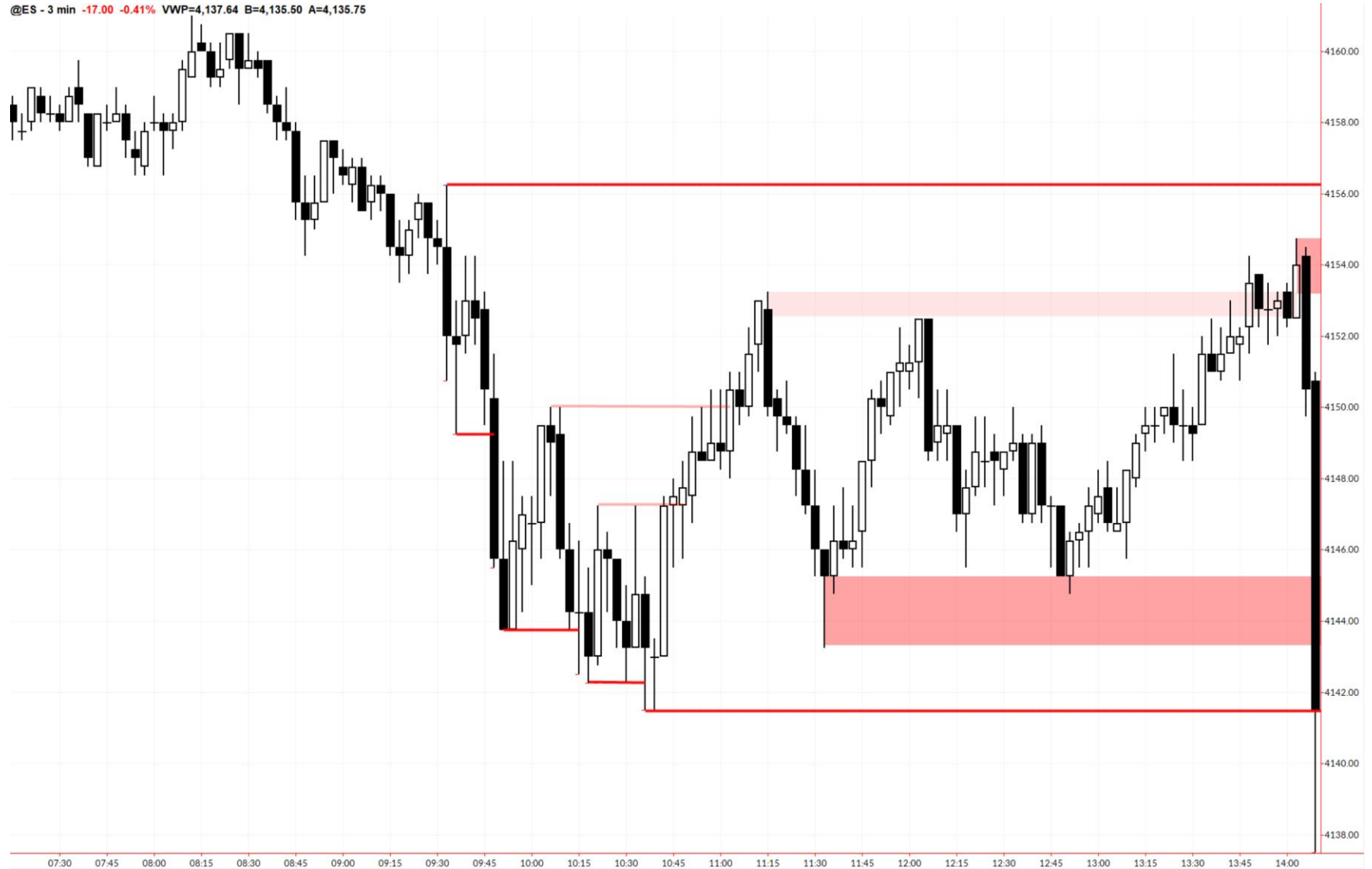
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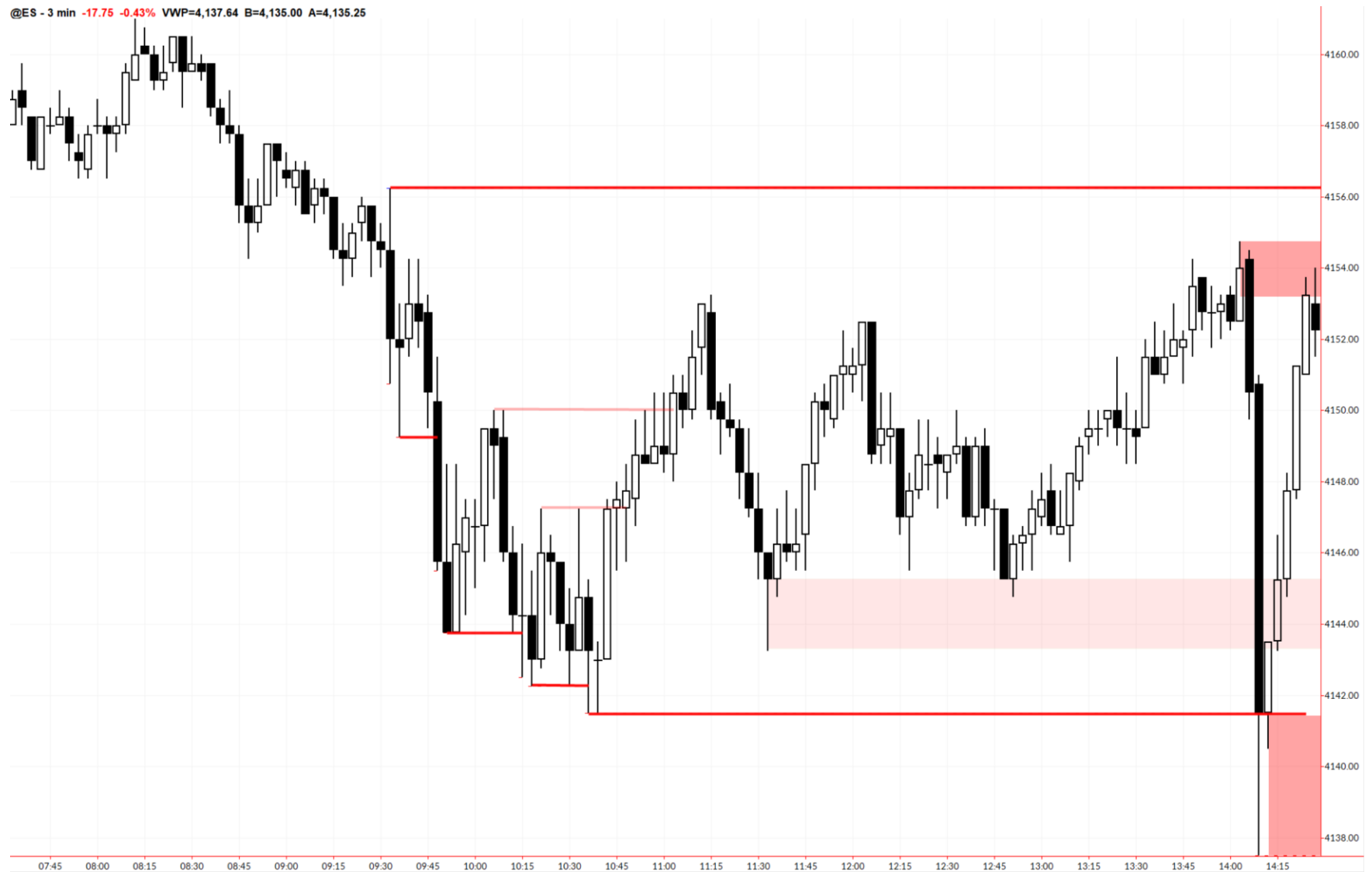
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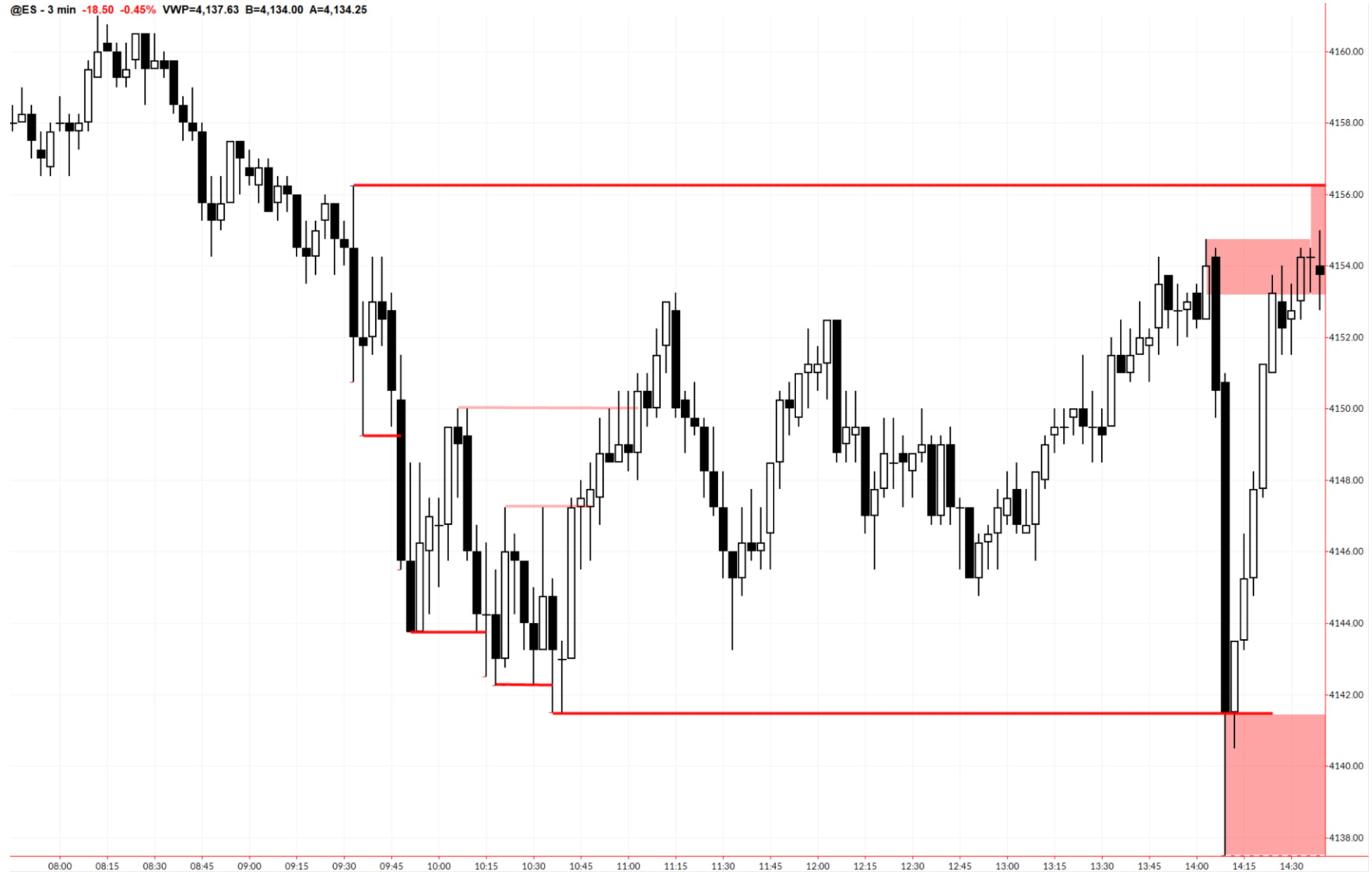
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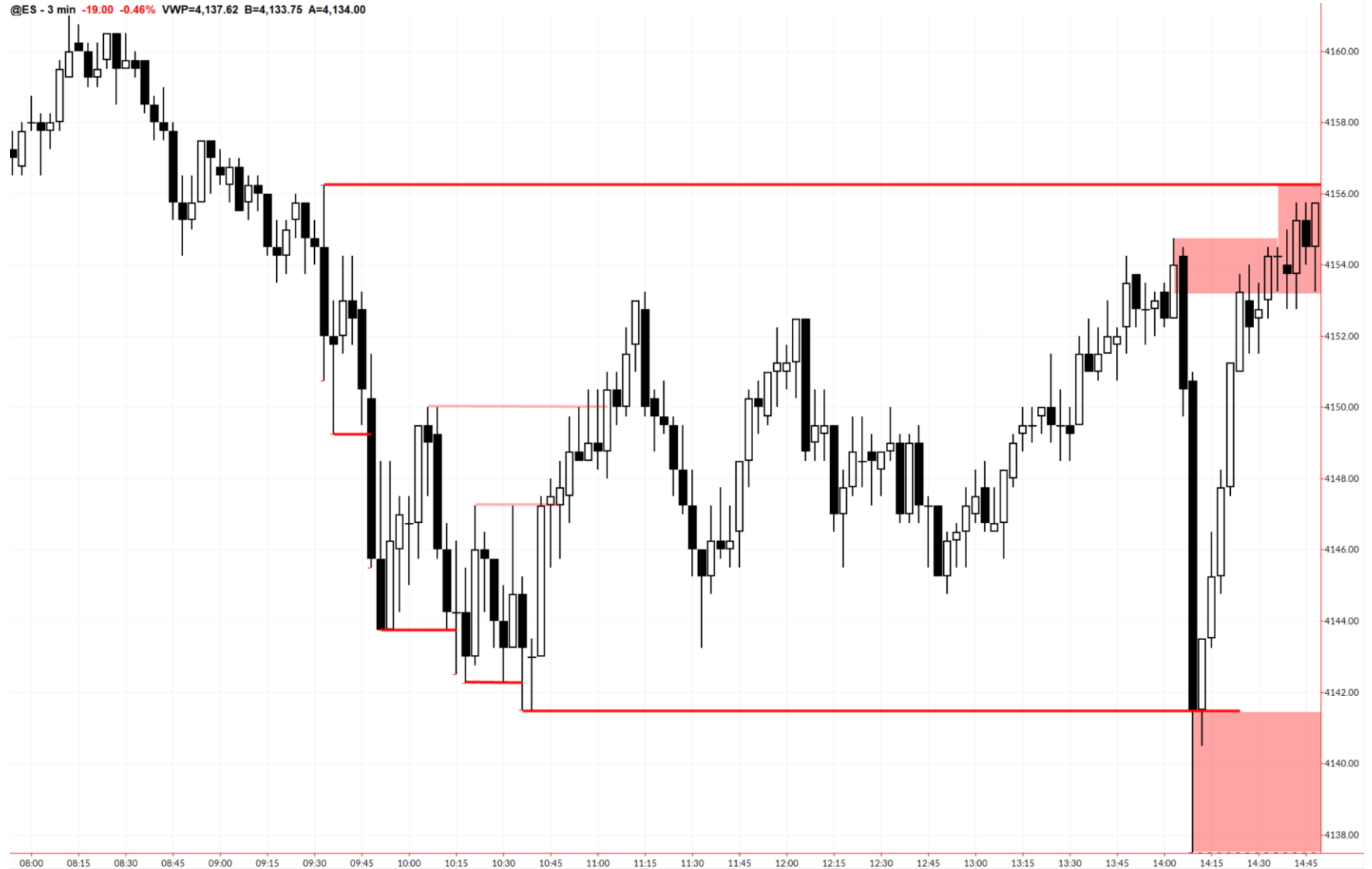
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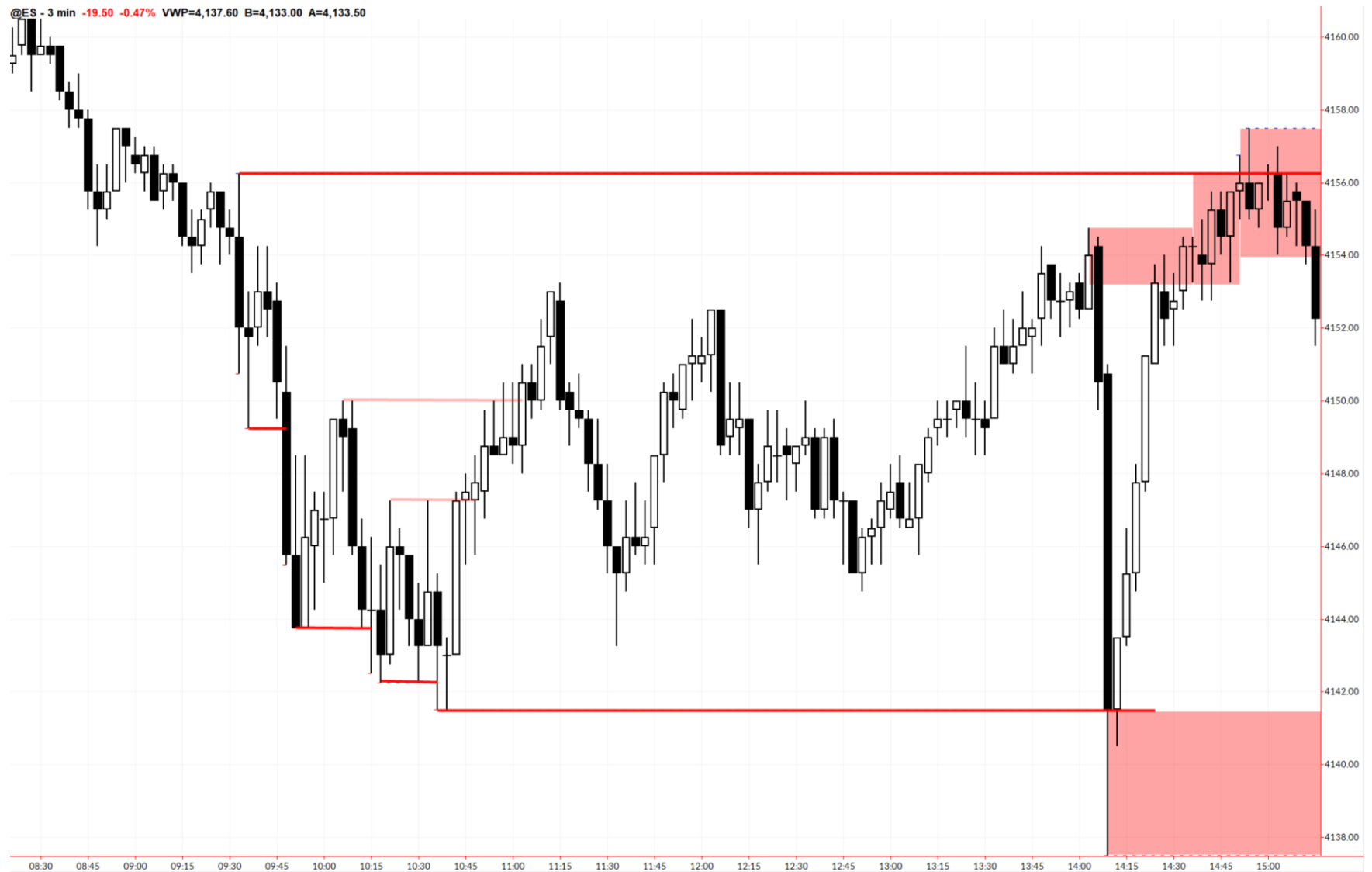


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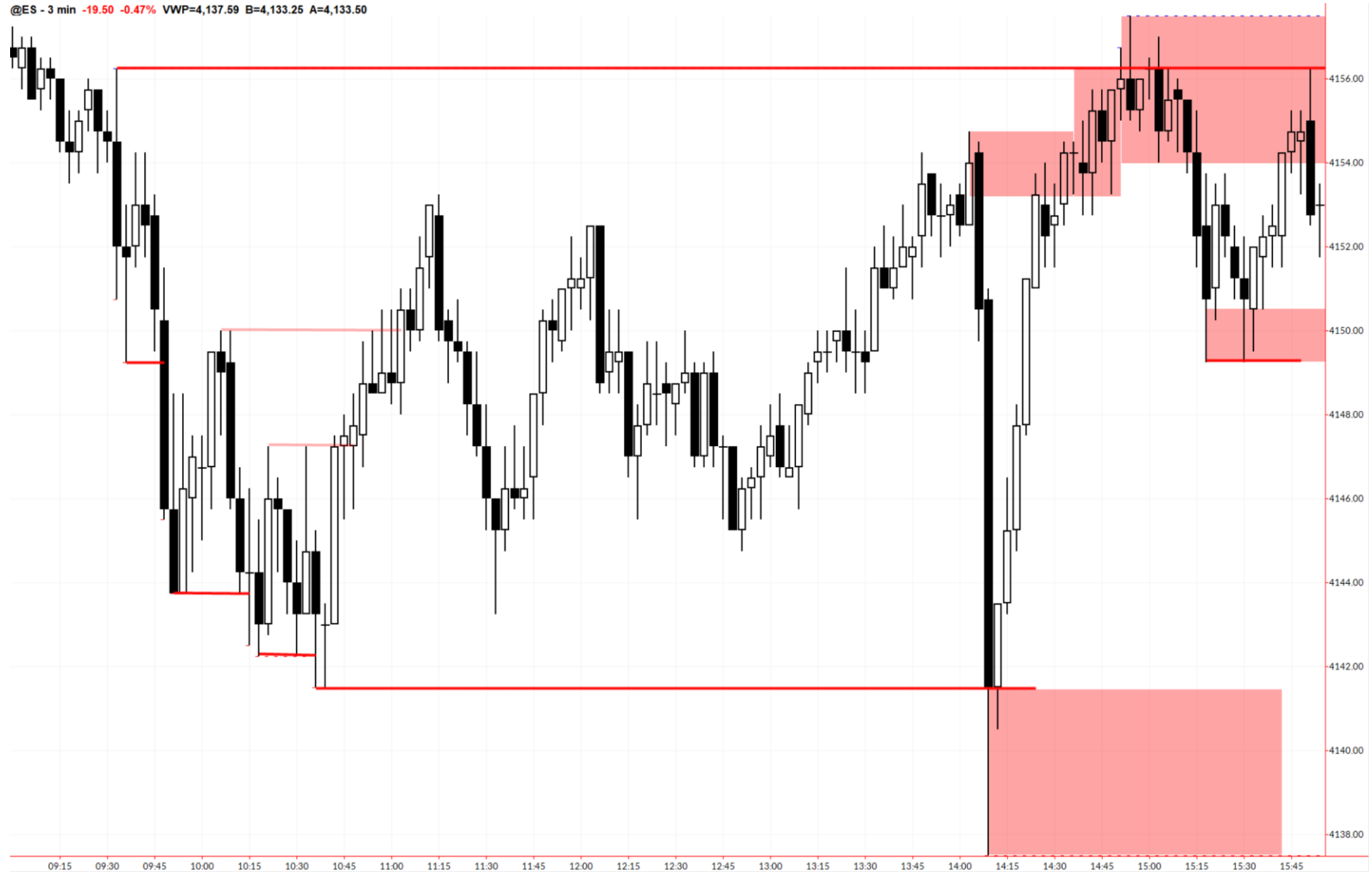




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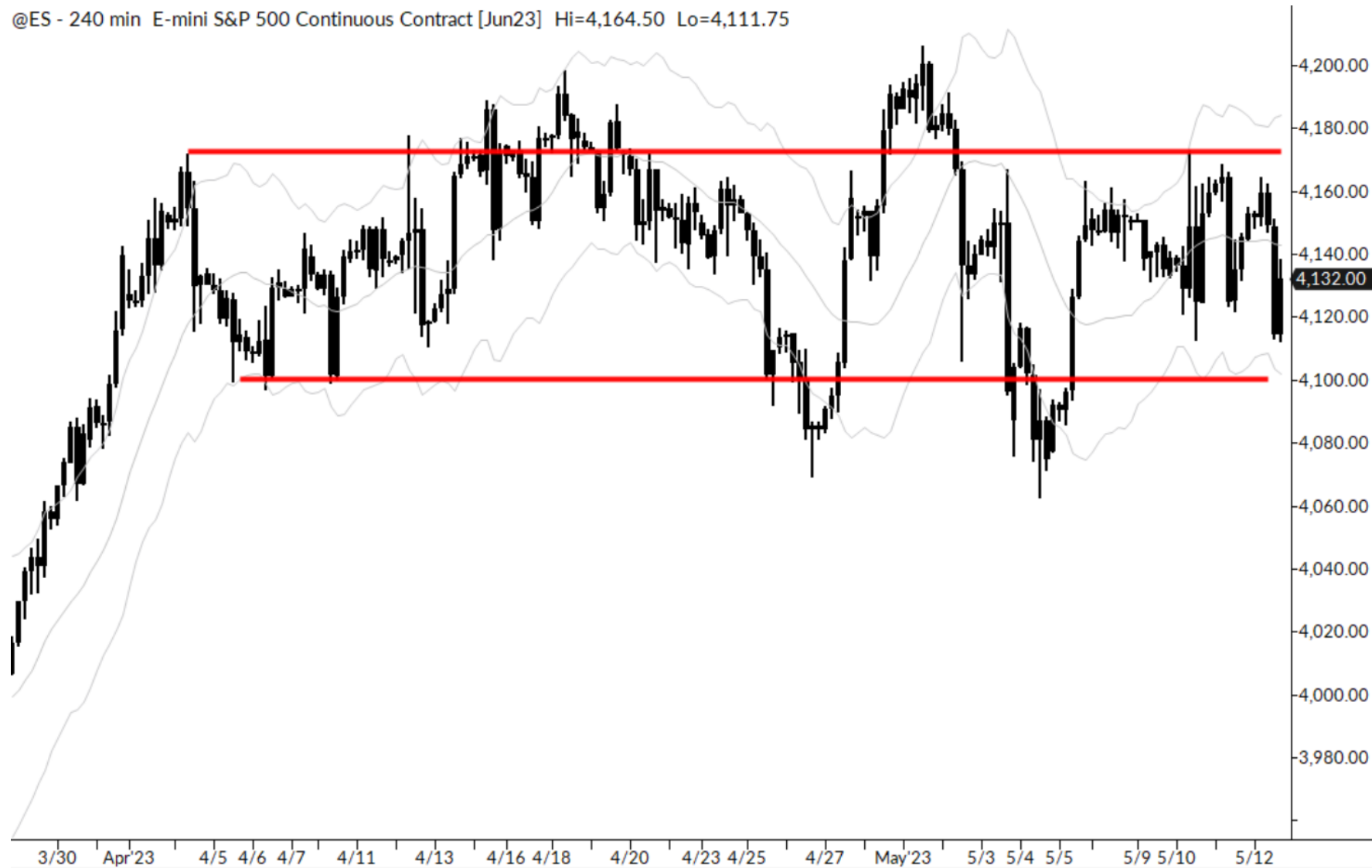


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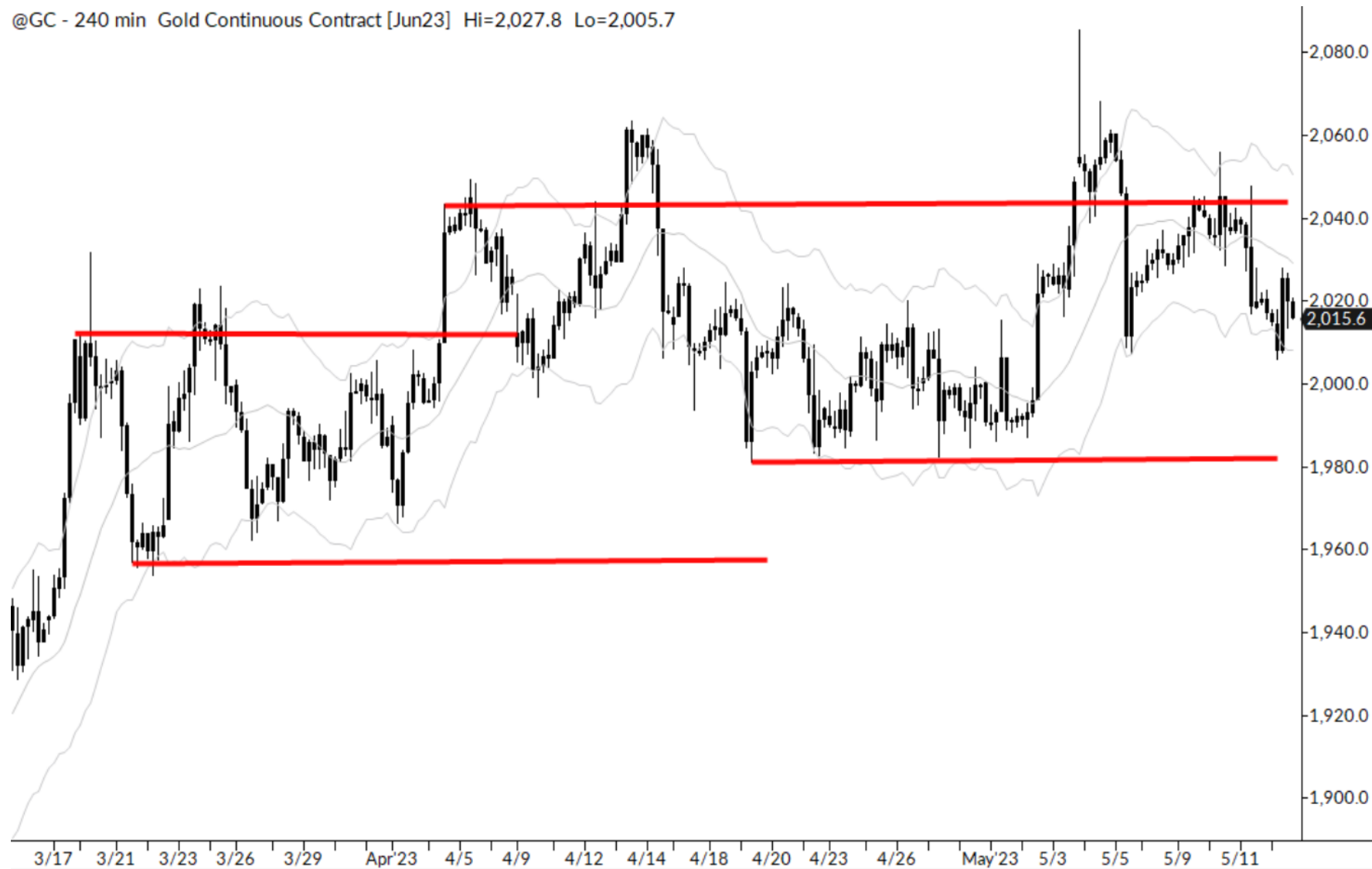
“Internal” S/R

@ES - 240 min E-mini S&P 500 Continuous Contract [Jun23] Hi=4,164.50 Lo=4,111.75

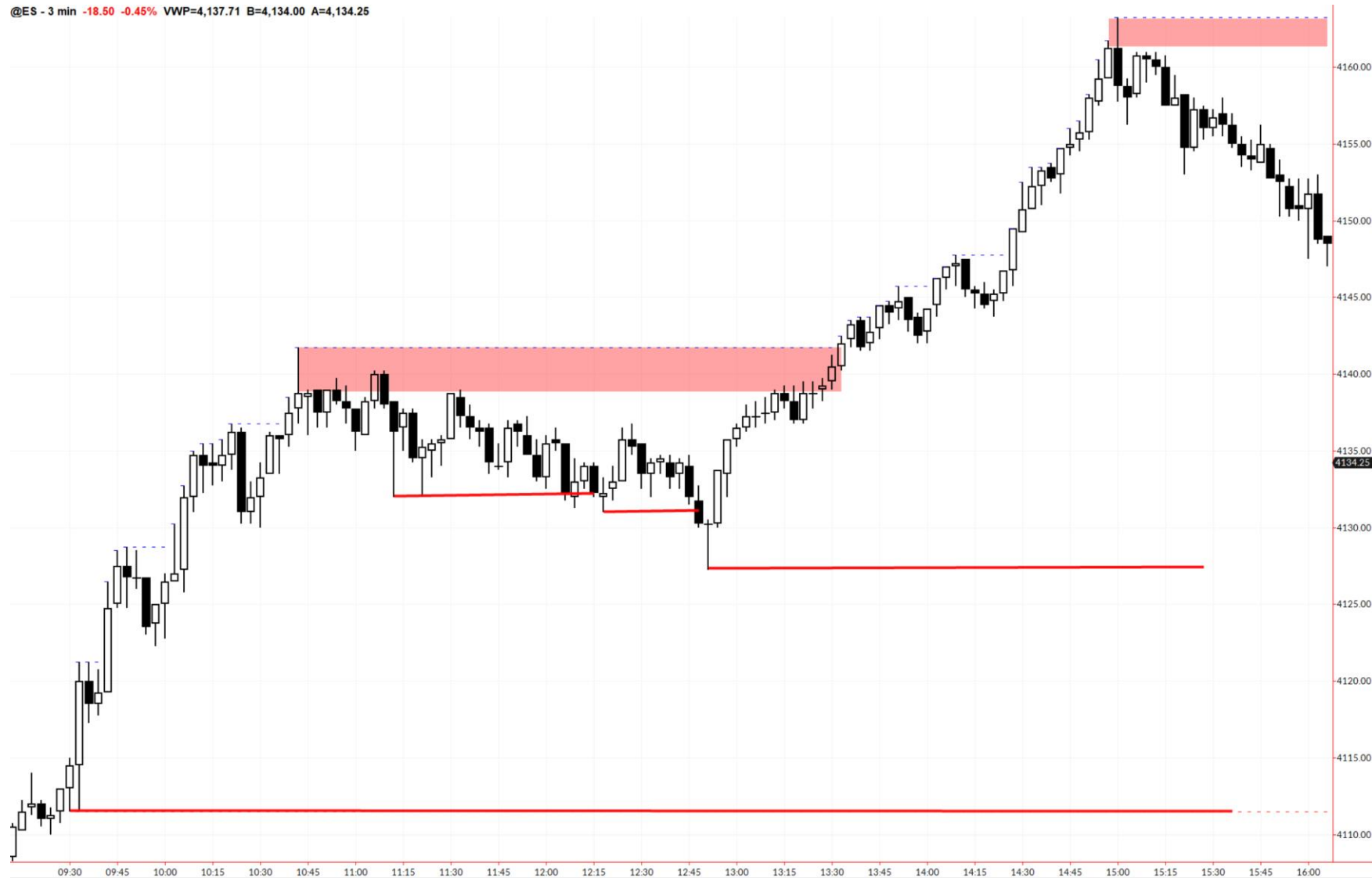


Internal S/R

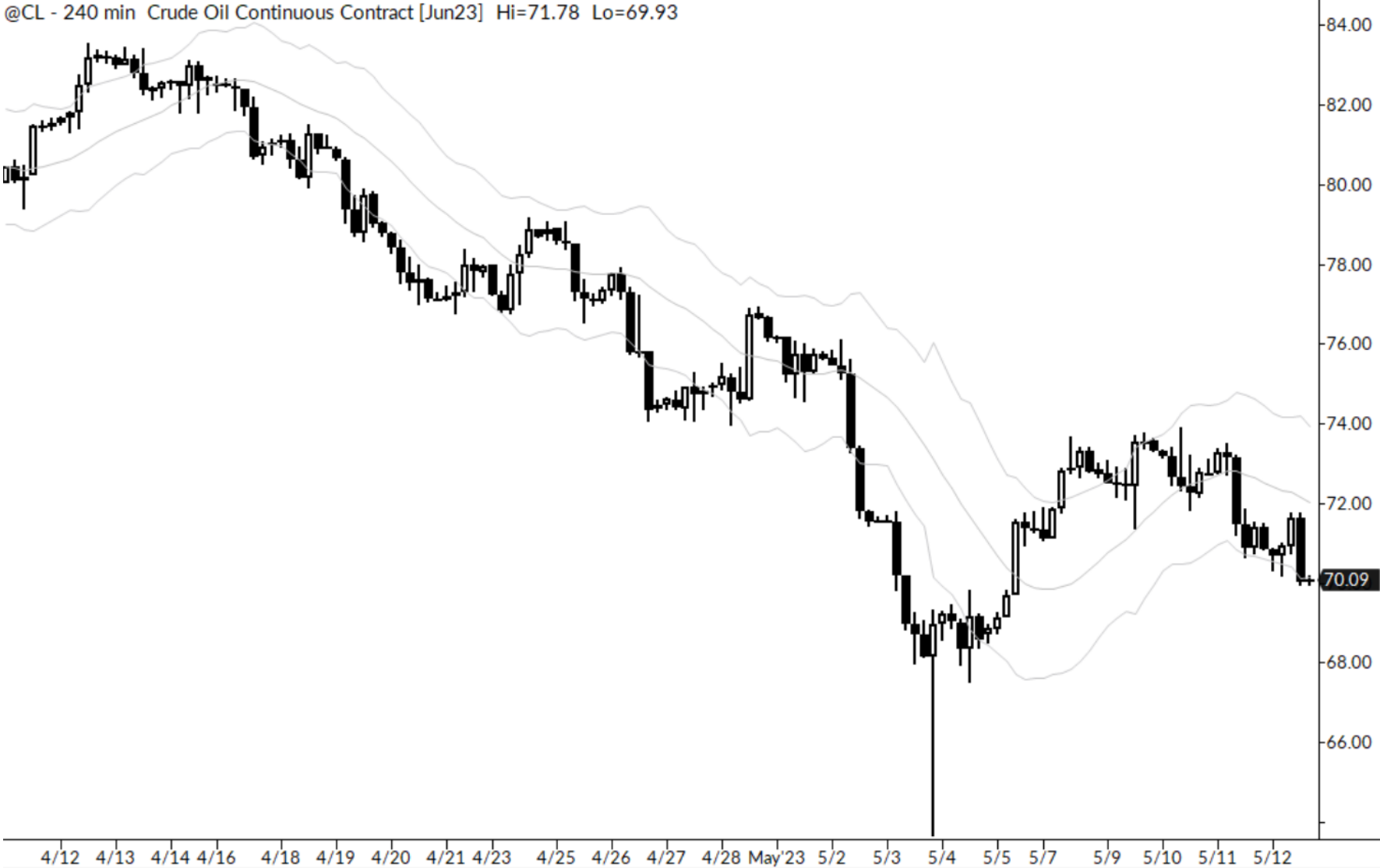
@GC - 240 min Gold Continuous Contract [Jun23] Hi=2,027.8 Lo=2,005.7



S/R in Trending Market

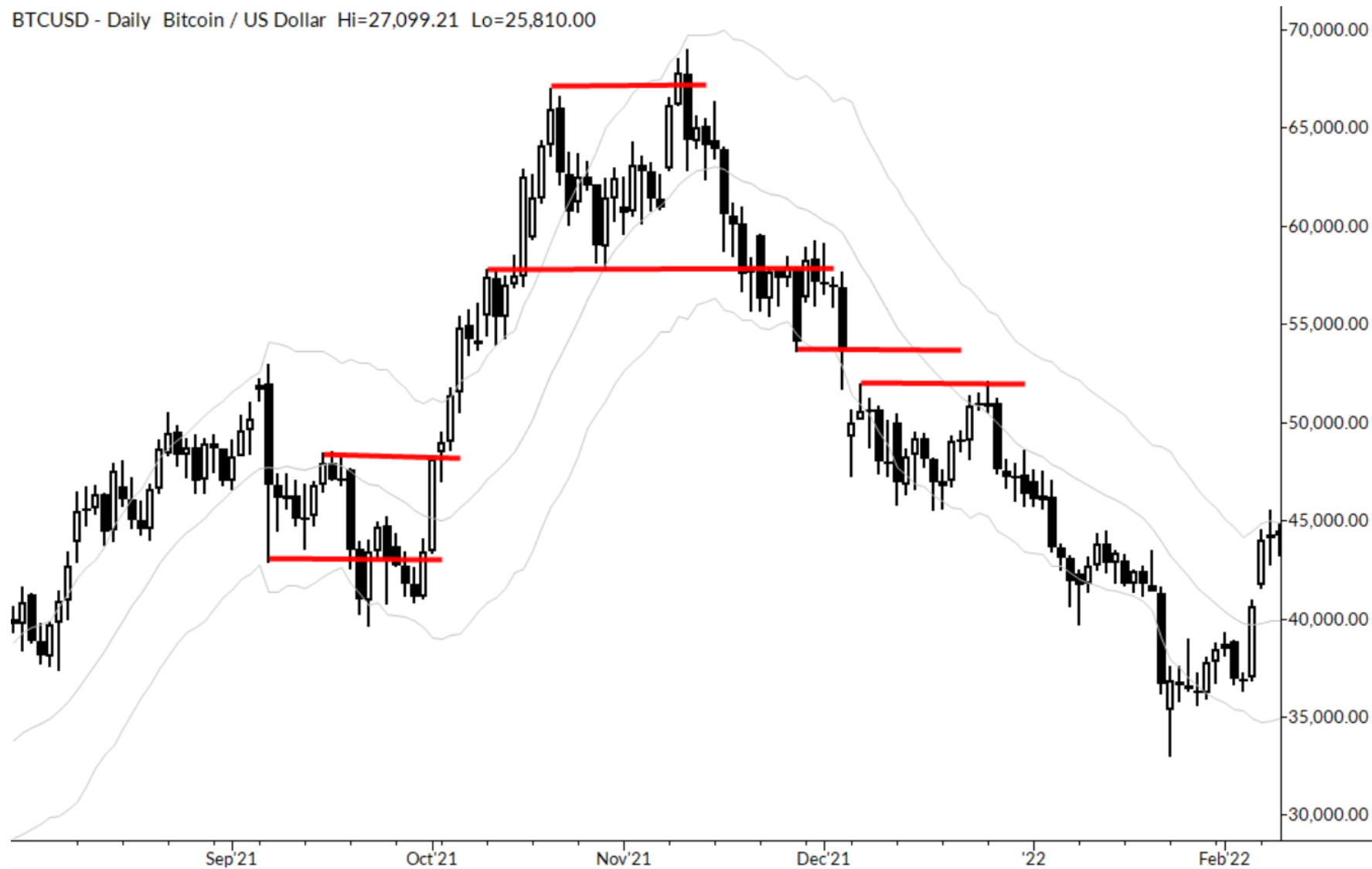


Trends Break S/R



But S/R Is Not Useless in Trends!

BTCUSD - Daily Bitcoin / US Dollar Hi=27,099.21 Lo=25,810.00



Support / Resistance Practical Advice

Best levels are obvious levels

- HTF can be useful

You want people to take action around those levels

May be different in different markets

- Understand microstructure

Support and resistance are areas where something **might** happen

- That might be the most important point in this entire presentation
- Important to monitor action around levels to see what is happening

“Potential” Support and Resistance

All developing traders should use this vocabulary

Words are a mind-trap! Be precise in how you think

You can probably relax this after you trade well for a decade or two because you will be well-aligned with what to expect around S/R

The Four Trades

There are only four possible directional trades

Trend Continuation

Trend Termination

Support/Resistance Holding

Support/Resistance Failing

Trend Continuation

Classic examples:

- Pullbacks or pauses in trends
- Breakouts that might lead to start of trend

Markets have “inertia”, so there is a natural edge to trend continuation

Every trade is a test of a hypothesis

Every trade involves uncertainty

Trend Termination

These are not “trend reversal” trades

If we successfully find the end of a trend:

- Trend reversal
- Transition into range
 - Which might become a reversal
 - Or a continuation
- Pause in the existing trend which then continues
 - At a new rate
 - At a different rate
- A test of extreme to stop you out

Important Principle of Price Behavior

The market will do whatever it can to hurt the most traders

Why?

The market's job is to find activity and to facilitate trade

- Other traders know this
- Exchanges want this
- The market is an auction

The market tests and probes levels, looking for orders

Support/Resistance Holding

Must have some reason to expect a “good” S/R level

Watch price upon approach to the level

Certain characteristics of price behavior apply

- Consider doing a study of LTF action around key levels

These trades can be taken

- Before a break of the level
- At the level
- After a penetration of the level fails

Support/Resistance Breaking

Of course, if one thing isn't happening, the other probably is...

These are trades that occur when support or resistance fail to stop prices

Markets probe beyond levels and find sufficient interest there to drive prices to new levels

Define Your Trading Timeframe

These trades often “nest”

Most confusion is avoidable by clarifying expectations

Which are most clearly related to the trading timeframe

(We’re not even touching on stops and targets yet...)

Is This All Too Complex?

At its heart, trading is simple

Traders cannot be burdened with a heavy cognitive load when they are “in process”

Some traders suggest that technical analysis can be taught in less than an hour

How do we find the right balance of depth and complexity?

Review

The Wyckoff Cycle is useful, but suspect

The “Composite Man” is useful

Support and resistance must be understood

Testing trading ideas—key concepts

The four trades framework defines every possible technical trade

Next Session

Saturday 3 June 2023 @ 13:00 EDT

Register here:

<https://attendee.gotowebinar.com/register/7980160168032814427>

Will cover chapter 3: On Trends

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