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Focus on True Supply and Demand ...And Better Your Odds for Low-Risk Entries
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Noted economist Adam Smith suggested hundreds of years ago that when supply exceeds demand at a price level, prices will decline and vice-versa. Noted physicist Isaac Newton suggested in his three laws of motion that an object will remain in motion until it is met with an equal or greater force. These two simple, yet brilliant principles have stood the test of time and are directly responsible for the movement of price in the markets we trade today. There is no doubt in my mind that the two of them would have made excellent traders.

Getting down to business, the focus of this article is on what conventional technical analysis refers to as support (demand) and resistance (supply). We'll be digging deeper into what support and resistance really are, how we identify and quantify them on a price chart, and how we use them to make objective, profitable trading and investing decisions. The trade examples used in this piece are real trades executed by our capital management firm.

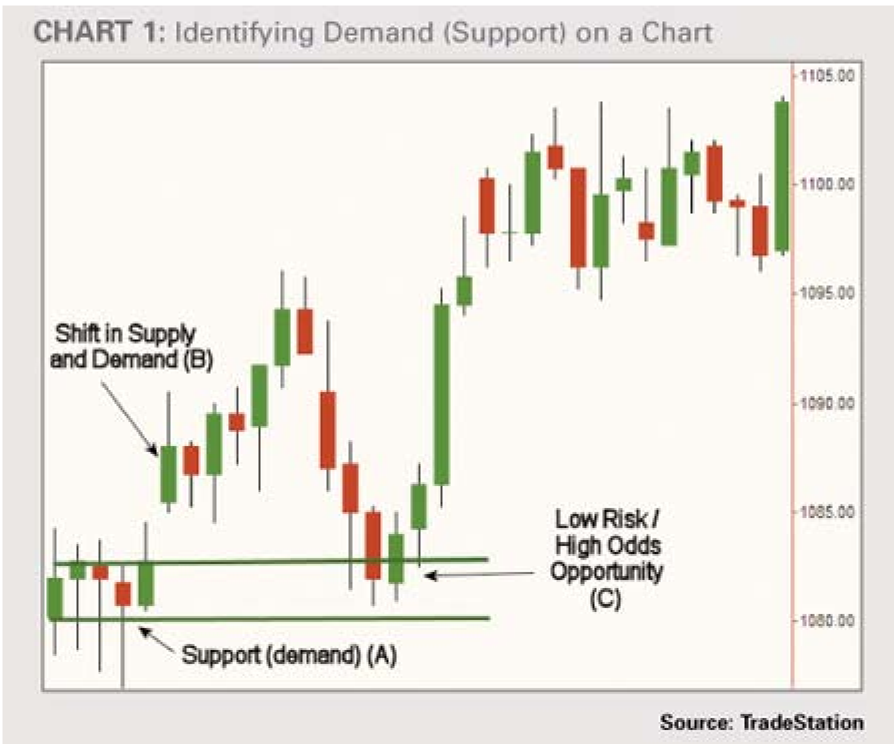
Think Corporate Profits

The way traders and investors derive profits from the markets is very similar to the way corporations profit in their marketplace. Microsoft, for example, identifies demand for a type of software, estimates the cost of production and determines what price the consumer will pay for that software. If the company's projections are reasonably accurate and they are on target with supply and demand, they can estimate their price and profit. Microsoft clearly has been very successful in this regard, enjoying large profit margins on many of their products.

As in any other marketplace, the financial markets reflect human action in response to an ongoing supply and demand relationship. Unfortunately, when the average person enters the world of trading and investing, operating in these markets becomes a kind of "art" based on subjective indicators and oscillators, news-driven perceptions and pictures of conventional price patterns that are more valuable with a frame around them on a person's wall than they are in his financial statement!

Traders need to remember that the markets are nothing more than pure supply and demand at work, with human action reacting to that ongoing supply and demand relationship. This is ultimately what determines price, and opportunity emerges when this simple and straightforward relationship is out of balance. When we simply look at the ongoing supply and demand relationship, identifying where prices are most likely to turn is really not that difficult.

Back to the Basics
Yes, this is basic, but why not begin at the start to get this right? Support (demand) is a price level where there are more willing buyers than available supply at a specific price level. Resistance (supply) is a price level where there is more supply available than there are willing buyers to purchase the supply at a specific price level. Let's take a look at Chart 1 to identify what constitutes truly objective demand and why.



Area A in Chart 1 represents a price level where supply and demand are in relative balance or equilibrium. Everyone who wishes to buy and sell at that price level is able to do so, and prices are stable. On the close of the candle (B), the supply and demand relationship in area A is no longer in balance. We now know that there is much more demand at price level A than there is available supply. How do we know this to be true?

The only thing that can cause prices to rise as they did is a shift in the supply/demand relationship. In other words, when candle B closes, we can objectively conclude that some willing buyers were left behind. Area A can now objectively be labeled demand (support). The area labeled C represents a decline in price to our objective demand level. And, this is where we would find opportunity for a low-risk/high-odds trade as price revisits an area of imbalance. We'll discuss how to take advantage of this opportunity shortly.

Now simply stand that previous example on its head for identifying supply (resistance) and quantifying it on a chart. Just apply and reverse the criteria and logic from the prior demand example to Chart 2.

CHART 2: Identifying Supply (Resistance) on a Chart

Lack of Balance Equals Opportunity

The identification of true demand (support) and supply (resistance) price levels typically is where market participants complicate trading decisions most. Specifically, where prices are likely to turn and why is what consumes most people's thoughts. The demand and supply definitions are all that needs to be considered when identifying turning points in price. Smith kept things simple, logical and real. When applying his theory to the trading markets, nothing breaks down.

Let's face it. The only truly objective information available to us is price and volume. Everything else is either subjective or a derivative of price and volume, so why not go right to the source? Most trading books and so-called market professionals will talk about moving averages, Fibonacci retracement levels, and so on, as being demand (support) and supply (resistance) areas. This could not be further from the truth. Any indicator or oscillator that someone touts as a tool for identifying support and resistance is just that, an indicator or oscillator, not demand and supply. These will appear to work only at times when they line up with true supply and demand levels on a chart. Can you imagine Microsoft directors sitting in a meeting talking about head and shoulders patterns and cup and handles? Not likely.

Don't Forget about the Human Element

Let's take Smith's theory a step further and add the element of human behavior to our supply and demand analysis. To do this, let's look at a tick chart instead of a time-based chart, as it is made up of trades and price, not time. This is the most objective way to view any market. Each candle represents a specific number of trades (human action), not a time interval. After all, the goal in analyzing any market is to determine the buying and selling activity at each price level.

The green dots on Chart 3 are a proprietary indicator we created (and use) that identifies extreme selling. Area A is a sideways trading range where supply and demand are in balance. Next, there is a shift in the supply and demand equation when prices rally out of price level A as noted on Chart 3. Now, one can objectively conclude that there are now more willing buyers at price level A than available supply. This level now, of course, becomes a demand (support) level. Traders need to refocus their thought process. The breakout of area A actually just gave the astute trader all of the objective information he needs for a potentially low-risk/high-odds trade if and when prices revisit that area. It’s faulty to think that you have just missed a breakout.

CHART 3: Tick Chart (Based on Trades, not Time)

Source: TradeStation

Again, the green dots in the demand area in Chart 3 tell us objectively that there was heavy selling during that period of sideways trading. With that much selling, one would think prices would fall, but they rose instead. This suggests there is strong demand in that price level (A).

The green dot that appears when prices revisit this demand level means that aggressive sellers have taken action (sold) after a decline in price and into an area of demand. The laws of supply and demand tell us that novice sellers have entered the market and that prices are likely to rise. Someone who sells after a period of selling and into an area of objective demand is likely to consistently lose according to the laws and principles of supply and demand. Therefore, we simply need to identify the novice seller and take the other side of that trade each and every time we see it.

Like Mass into Motion

When determining the strength of a demand or supply level, there are two important factors that need to be considered. First, we must determine the amount of trading activity in the level of demand or supply. This is no different than how the great physicist Isaac Newton incorporates mass into his three laws of motion. For traders, mass would simply equal volume. The higher the volume in a demand or supply area, the stronger that area will be if and when prices reach it. If there is a willing buyer of 100 shares of stock at a price level where there are 1,000 for sale, prices can't move higher until all 1,000 shares are bought (supply absorbed). When they all are bought, more buyers are needed for prices to rise and so on.

Second, we must determine objectively how many times prices revisit a demand or supply level. The highest-odds buying opportunity, for example, is when prices revisit an objective demand area for the first time, not the second, third or fourth. Remember what demand is – some buyers who desired to buy were not able to because prices rose. Each time prices revisit the demand level, more buyers that were left behind are now able to buy. This logically weakens the strength of the demand level in question each time it is revisited simply because there are fewer buyers. Think of chopping down a tree. Each time the tree is struck by the axe, the likelihood of the tree falling increases, as there is less mass in the trunk.

Successful Trading

Executing entries and exits and determining protective stops properly and objectively can only be accomplished by identifying true demand and supply areas and taking advantage of imbalances when they occur. If one can accomplish a trade entry into true demand and supply price levels, it solves the two most important tasks in trading. First, it allows the trader to enter a full position very close to his protective stop and to take advantage of sound money management strategies.

Second, it allows a trader to enter and be a part of the reversal in price that then invites others in to pay the trader! Price reversals that end up as pretty green candles after a number of red candles at demand areas on a chart, for example, invite the masses to buy. Smart traders consistently strive to be a part of that invitation (the first green candle) that goes out to the masses.

Knowing When It's Real

Let's now develop an objective set of rules and criteria for entering and exiting consistently profitable trades and investments. The low-risk/high-odds trade seen in Chart 4 incorporated an entry based on identifying an objective supply and demand imbalance.

CHART 4: Trade on a Supply/Demand Imbalance

Source: TradeStation

How did we know this demand area was demand? Simply, the breakout from the area of price stability objectively told us so. Prices eventually revisited that demand area, which we had flagged as an entry point for a long position because of the supply/demand imbalance. Once prices reached that level, we concluded that the sellers in that area were novice traders who consistently lose. But how does one know this? Again, the laws of supply and demand tell us that someone who sells after a period of selling and into an objective area of demand will consistently lose, and that was exactly the scenario at hand with this opportunity.

The profit zone (or profit margin in the case of Microsoft) is the distance between the demand area and the supply area, as seen on the chart. Based on this information, the trade was taken. The risk was low as the trade was taken near the demand level (very close to the protective stop). We also became a part of the reversal candle, which is the invitation to the masses to buy after we do – which is ideal. Profits were taken into the area of supply, identified prior to entry.

How Long Does It Work?

A common question among traders is how far to look back on a chart to identify demand and supply areas. The answer is always the same. Traders searching for demand and supply levels should look back as far as need be in order to find the true demand or supply level. Much of the time, a few days will suffice. Occasionally, the market being traded is at a multi-day/week high or low. In some cases, we must look back further. To limit the look-back search for true supply and demand in a given market to a specific number of days is a case of form-fitting the market to fit a convenient need; it is not real and objective. The key is to eliminate time from the equation completely.

Why Is It So Difficult?

It all seems pretty simple. But why then do so few traders and investors enter properly into demand and supply areas? The answer is simple: human emotion. The fear of a potential break of a demand level is stronger than the benefit a low-risk entry at a demand or supply area offers. But traders need to remember that opportunity always lies where the majority is afraid to go.

However, anyone can do this. The key is to have a set of rules based on the laws and principles of supply/demand and the human behavior relationship that is responsible for the movement of price. As I've suggested in prior articles, the only two books one really needs are the old Econ 101 and Psych 101 books!

As we've discussed in this article, it is the origin of the movement of price that serves as the demand (support) or supply (resistance). The origin is actually where the equation becomes out of balance, which in essence is the definition of demand (support) and supply (resistance).

Don't watch an initial advance or decline in price and get upset. It isn't actually a missed opportunity. In reality, this simply gives traders the objective information that is needed for a low-risk/high-odds opportunity. Or put in another way, breakouts and breakdowns from areas of congestion show us exactly where the shift in supply and demand has taken place.

Do true support and resistance areas always hold and produce turns? Most of the time the answer is yes when the analysis is objective. However, we actually don't always need them to produce a turn in price. After all, our trading objective is bettering the odds of success, not guaranteeing certainty. Simply identifying an area of price congestion above or below current prices is not enough. The area in question must meet the definition of true demand or supply. Trade what is real, not what you feel.

— *end*

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