Tape Reading
by Linda Bradford Raschke

Sometimes it is nice to reexamine a simple concept when there appears to be overwhelming volatility in the markets. Mechanical systems and patterns are helpful and even necessary for the structure they impose in organizing data, but even Richard Dennis in his original course discussed ways to "anticipate" entry signals, exit trades early, and filter out "bad" trades.

Learn to follow the market's price action and read the signals it gives. This can become a strict discipline in itself and the result will be greater confidence that a trade is or is not working.

Tape Reading

"Trading technique is simply the ability, through study, observation, and experience, to recognize the signals in each of the several phases of market movement."
- George Douglas Taylor

Tape reading long ago referred to the practice of studying an old-fashioned ticker tape and monitoring prices, volume, and fluctuations in order to predict the immediate trend. (It does not mean you have to have the ability to read the prices scrolling across the bottom of the screen on CNBC!) Tape reading is nothing more than monitoring the current price action and asking: Is the price going up or down right now? It has nothing to do with technical analysis and everything to do with keeping an open mind.

Even the most novice observer has the ability to see that prices are moving higher or lower at any particular moment or, for that matter, when prices seem to be going nowhere or sideways. (Markets do not always have to be going somewhere!) It is also fairly easy to watch a price go up and then tell when it stops going up - even if it turns out to be only a momentary pause.

I've known hundreds of professional traders throughout my career. I don't want to disappoint you, but I know of only two who where able to make a steady living for themselves with a mechanical system. (I am not counting the well-capitalized CTA's who are running a money-management program with "OPM" - other people's money.) All those other traders used some type of discretion that invariably involved watching the price action at some moment - even if just to move a stop up or down.

If you can learn to follow the price action, you will be two steps ahead of the game because price is faster than any derivative. You may have heard the saying, "The only truth is the current PRICE." Your job as a trader will become ten times easier once you accept this. This means ignoring news, opinions, and personal biases.

Watching price action can actually be very confusing if you go about it like a ship without her sails up in an ocean squall. You will get tossed back and forth with no sense of direction and no sense of purpose. There are two main tricks to monitoring price action. The first is to watch the price relative to another "reference point." This is why many traders use a "pivot point" - and it works! It is the easiest way to tell if the market is moving closer to or further away from a particular point. This is also why it is often easier to get a "feel" for the market once you put a position on - your "reference" point tends to be your entry price.

Some reference points, such as a swing high or the day's opening price, will have much more significance than those points involving some type of calculation. (Some numbers might have special meaning for those who calculate them, and who am I to argue if they work.) I like to concentrate on pivot points that the whole market can see. To sum up so far, when watching price, we want to know the following: how fast, how far, and in which direction. It takes two points to measure these things. One will always be the current price, the other a pivot point.

* Do not watch price for the sake of watching price. Watch price with the intent to do something or to anticipate a certain response!

Responses

"The study of responses ... is an almost unerring guide to the technical position of the market."
- Rollo Tape (Richard Wyckoff), 1910

The second main trick to monitoring price action is to watch for the market's response to a particular condition ... in other words, anticipating a particular behavior. For example, if the market has been at a very low volatility point and just begins breaking out of it's particular trading range, one might anticipate that the price would begin to accelerate in an impulsive manner and not run into immediate resistance. Or, on a directional play, if the price is moving in an impulsive manner in a trending market and then pauses to catch its breath on a mild reaction, one would expect it then to continue on in the direction of the trend. When there is a particular behavior to anticipate, it is easier to watch the price to see if it acts according to one's expectations.

Is the market failing to break on bad news? Is it finding support after a series of advances? Does it run into an invisible overhead wall and sharply back off, implying strong resistance? These are market responses to certain conditions. Tape reading is like playing a tennis game and watching to see how your opponent hits the ball back.

Part of studying price behavior and gaining experience as a trader is gradually learning what actions to anticipate. Then you must learn what the market's most probable response or outcome should be. It will always be easier to anticipate an event or response which happens 70% of the time than to be looking for that which happens only 30% of the time.

However, it can also be a profitable strategy to recognize when a given signal or expected response is failing. Sometimes a failed signal can be more profitable than the normal expected response. For example, a classic failed response might be a scenario wherein price was consolidating in a pattern of higher lows and lower highs - a classic triangle pattern. One would expect a breakout from a chart formation to have some follow-through. However, if price only penetrates the lows by a small amount and then turns upward, picking up volume and momentum as it goes, and comes out the upside, a very significant reversal has probably occurred and there may be much more price advance to unfold.

One last trick to watching price action is to learn to think in terms of "handles," or levels. Think of the S&P's as reaching for the "1110" handle, or the "low 1060's" as a level. Each ten points is a defined level. Use big round numbers as reference points for levels. It doesn't mean that you are placing orders at those numbers. It is just a simple way of organizing data that professional traders practice subconsciously.

Pivot Points

An astute trader will always have the previous day's close in his head. He also knows the previous day's high and low (prices he would have liked to have bought and sold but probably didn't). He also knows the opening price, for that tells if the buyers or sellers are in control for the day.

The previous day's high and low and today's open have very strong psychological implications and are the most important "pivot points" to recognize. By concentrating on price action near these points, we can eliminate much of the hard work in tape reading. Many times the market will let us know right away if this is going to be an area of support or resistance.

The previous day's high and low tend to overlap in congestion areas. Look to exit profitable trades immediately at these points in sideways markets. In trending markets, the price will run through these points a bit before pausing. When the market is strongly trending, the opening price becomes the most important.

If we are watching a high, low, or opening price as a pivot point, we are watching to see whether there is any impulsive price action as the market approaches the point or moves further away from it. What is "impulsive action?" I like to call it a "whoosh." The market moves rapidly as if just coming to life for the first time. It is usually a series of ticks in one direction without a tick in the opposite direction. The market is tipping its hand. A sequence like this tends to consolidate or pause a bit before being followed by more impulsive action. This is quite easy to see in a market like the S&P's if you look on a short-term time frame. If we quantify these "whooshes," which we can do in several ways, we will see that the market tends to have continuation moves at least 2/3's of the time. Not bad for arriving at a "positive expectation" simply by following price action.

In conclusion, tape reading is not watching every trade that passes by (a monotonous task) but rather keeping an eye out for unusual impulsive action, unusual volume, or just observing the way the price trades at significant levels. Each price swing has forecasting value as to what the next most immediate move should be. We then follow the price action to see if that move plays out.

Tape reading is at the heart of swing trading. When looking for short-term moves, price-based derivative indicators will be too late to be of value. Ultimately, traders should feel a great sense of freedom when they can rely on simple charts to formulate a game plan or a conceptual roadmap in their heads - and the movement on the tape to tell them their game plan is correct.
