

The Path Of Least Resistance

The Newsletter Of High Probability Power Law Trading

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Trading:

The old street saying is the open belongs to the rubes and the close belongs to the pro's. My working theory is we are banging out a bottom around here. I would have loved to have seen either a close below 1,060 (and know we're wrong) on the S&P today or a close above 1,075 (and know we're right). We got no signal either way. I did spend many years reading the tape and today's was interesting. It did look like there was some market on close orders at the end of the day that kept the market from closing at the lows.

We have just a few days before fund buying and we could expect a push if we get going up from here.

UNG will have numbers tomorrow morning about an hour after the open. We are expecting the heat of summer to put a draw down on reserves and start UNG back up into the trading range. We should be right or wrong quickly.

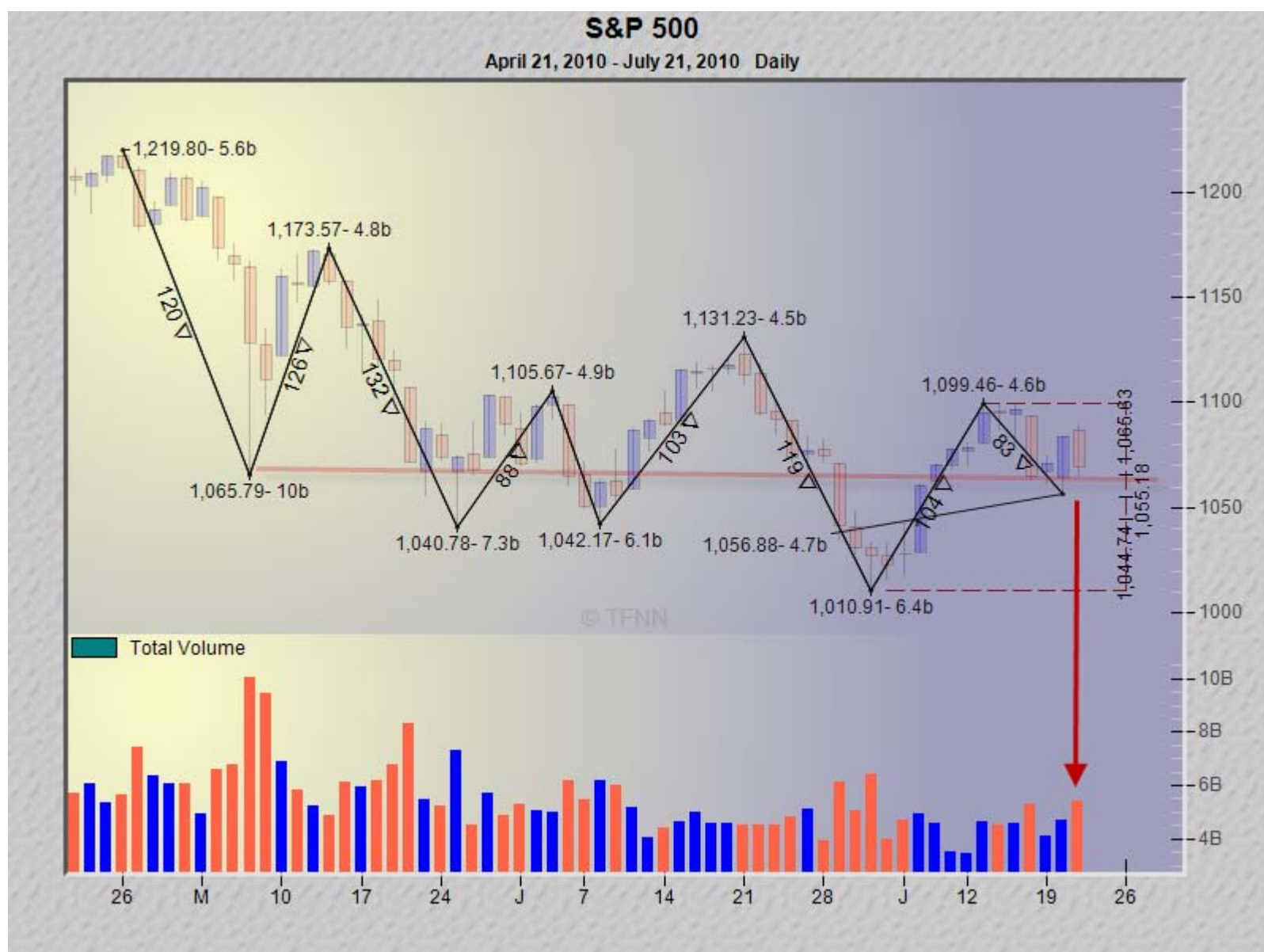
Regards,

David White

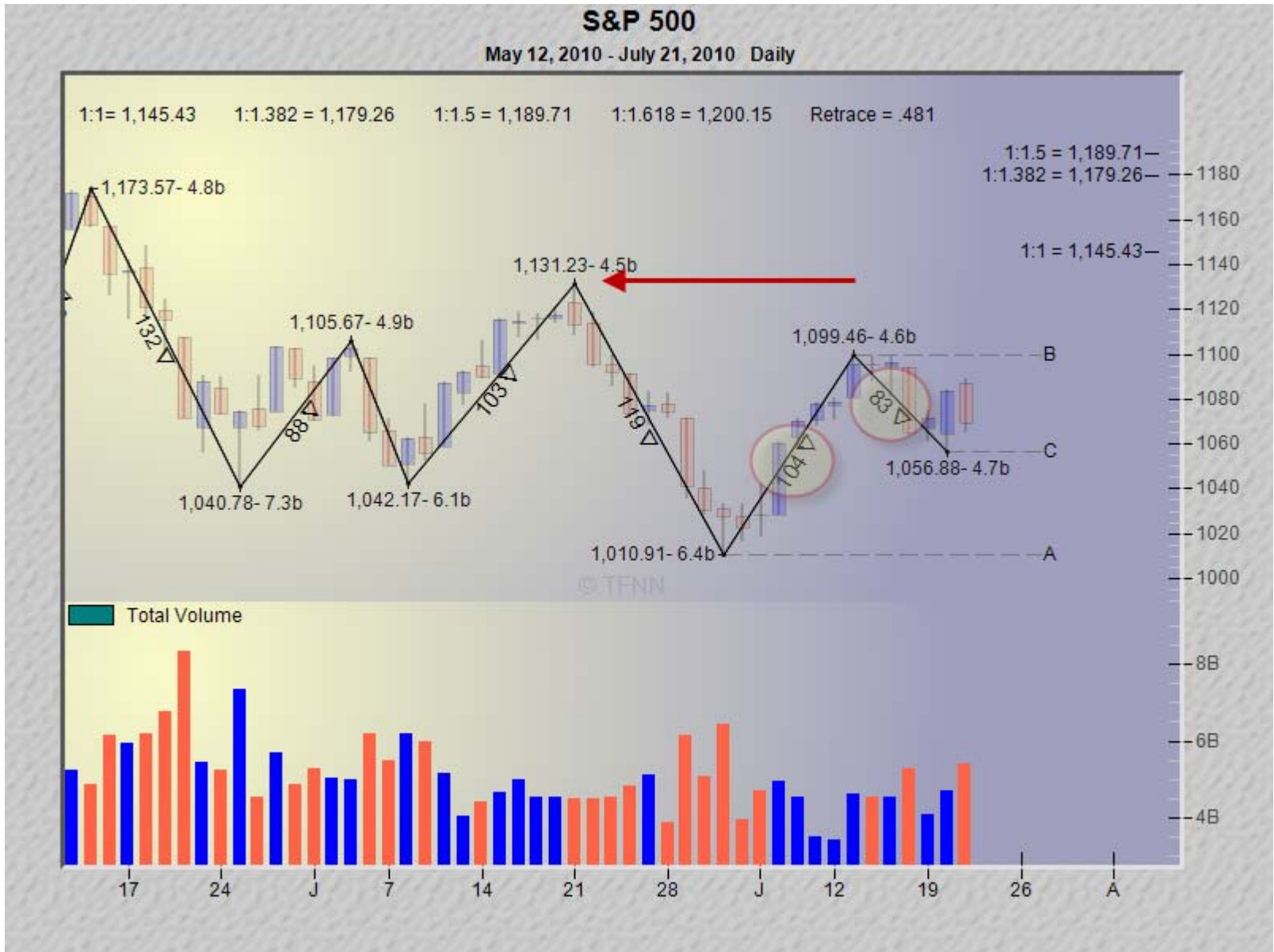
Positions:

- Long SEED at 7.10 or better on July 6, 2010. Stop at a close below 7.40. First target is 9.50.
- Long GMO at 3.00 or better on July 19, 2010. Stop at a close below 2.90. First target is 3.74.
- Long FEED at 3.00 or better on July 20, 2010. Stop at a close below 2.80. First target is 3.55.
- Long UNG at 7.74 or better on July 20, 2010. Stop at a close below 7.40. First target is 8.84.

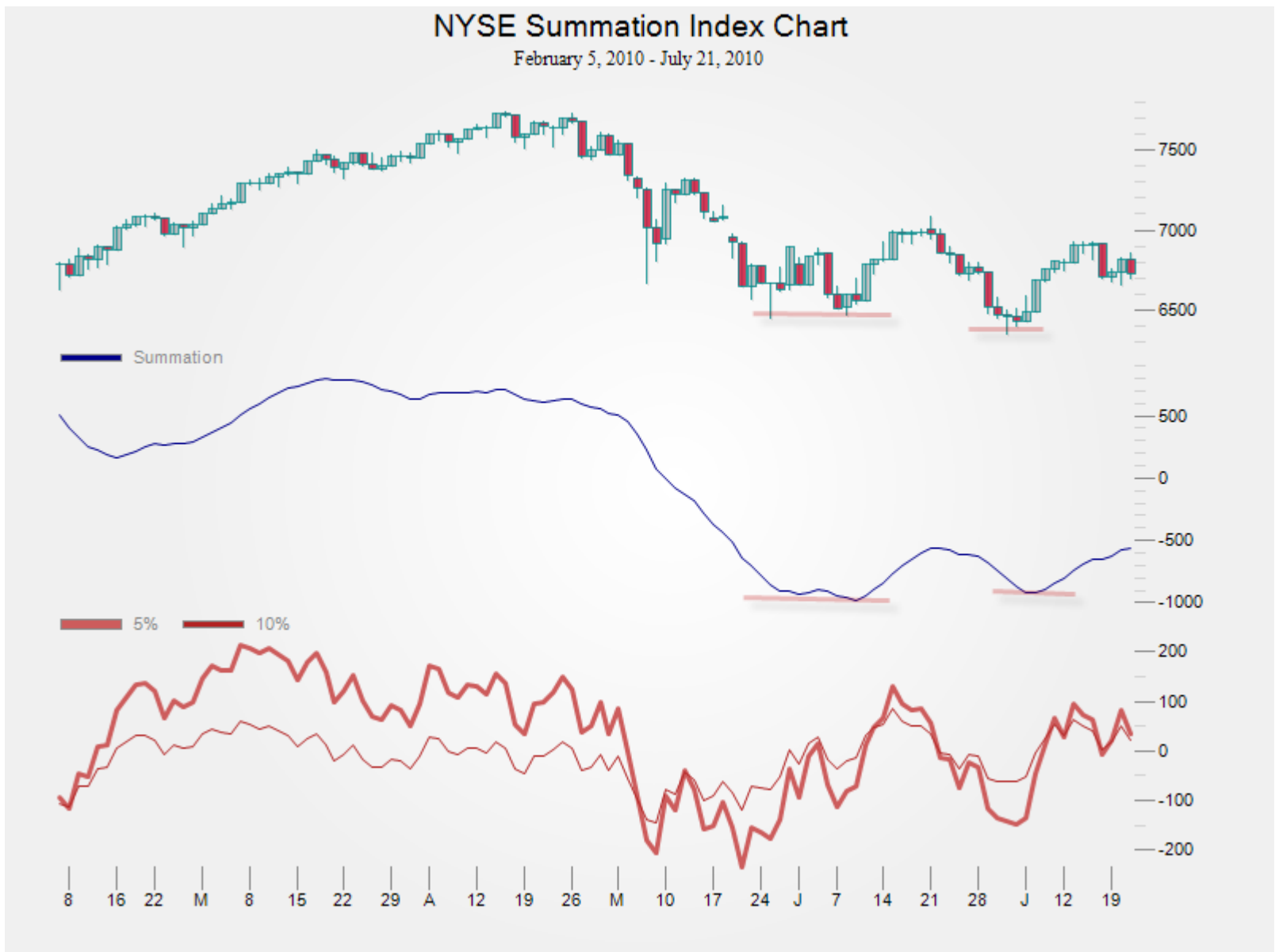
Charts:



What I'm looking for is some volume increase at the 1,065 level. We tested that yet again today and closed above it with a bit more volume than yesterday. It still has a great deal lower volume than the first low. To read the charts you always use the highest volume to the left. So far we are still looking at a bottoming pattern. To change our mind we would have to see a jumping of the support level. With the end of the summer and no huge acceleration of volume, we continue to think that a slow light volume rally is still the most likely scenario.



So far the energy down on this last leg suggests and ABC up. In the summer I could see a test of the 1131 high to drive the perma bears nuts.



Another reason we are long is that we had a lower low in the NYSE but not a lower low in the summation. That suggests that the low is in. We would look for a lower high on the summation before we think a high is in. We would look short only after we see a turn down in the summation index. The summation is good for keeping you out of the chop of a market like this. It's easy to die the death of a thousand cuts if you over trade the light volume at the end of the summer.

Methodology:

We have programmed a new mathematical tool to scan over 5000 stocks in the US markets each day to find the stocks with the best and brightest signals. While it is easy to look at the volume difference at swing points, it is much harder to look at the relative strength between the swings.

Power Law is a special kind of mathematical relationship between two quantities. Power laws describe relationships, such as the metabolic rate of a species and its body mass, and the size of a city and the number of patents it produces. What this relationship means is that there is no typical size in the conventional sense. Our formula combines volume, price, and time to give us a number that represents the energy in each move.

We can now compare the strength of the up and down moves between swing points. One place where this is easy to see is a test of a high where the stock went down 5 days and took 10 days to retest the high. Looking at volume alone skews the actual power in that move because they are not symmetrical. Using Power Law, we can correct and test for big changes in strength with statistical physics. Statistical physics is the field of physics that deals with the average behaviors of particles in given situations.

In short, we have a system for comparing time, price, and volume into one easy to understand number. We look for where that number changes drastically. Each day we look for the strongest and weakest stocks that are giving clear unambiguous signals.

The *Path of Least Resistance* describes the physical or metaphorical pathway that provides the least resistance to motion by a given object or entity, among a set of alternative paths.

Using Power Law Charts:

Fifty percent of getting a stock trade right is getting market direction correct. For testing and advising purposes, we use the advance and decline line to see if there are more or less stocks moving in concert with the major indexes. Trades should be placed in the direction of the majority of advance and decliners. This is known as the [summation index](#). We have created our own summation chart for NYSE and NASDAQ and will include it in some issues.

25 percent of getting a stock trade right is the sector. There is also a listing of sectors and how their summation index's are ranked. You can find that list as ETFs [here](#). Short the weak and go long the strong. Another good resource is to look for contradiction in the advancers and decliners versus the straight [sector rankings](#).

In picking stocks to play we want a strong move and then an extremely weak counter move with a swing test of 40% or less volume. The energy in the leg should also show a 40% change. If it's an ETF we look for 25% changes and 20% in broad indexes.

Beliefs:

- In trading stocks a formula that can mean anything means nothing. If it can't be tested I can't use it.
- The larger the volume and energy differential (PLVI) past a 40% change, the better the odds are logarithmically.
- Volume with price is the most predictive indicator by an order of magnitude.
- I do not trade for a daily wage and will wait for the odds to favor my play.
- Surprises happen in the direction of the summation index direction.

Recommending Reading:

[Fooled by Randomness](#)
[Reminiscences of a Stock Operator](#)
[Trading in the Zone](#)

I recommend the books above but don't completely agree with all their conclusions. For the most part they will help you learn how to think like a trader and question your beliefs. The first book is for understanding probability, the second for history, and the last for psychology. I am going to assume you have already read [Timing the Trade](#) and have a basic understanding of how to trade using volumes.

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