Time to Buy?

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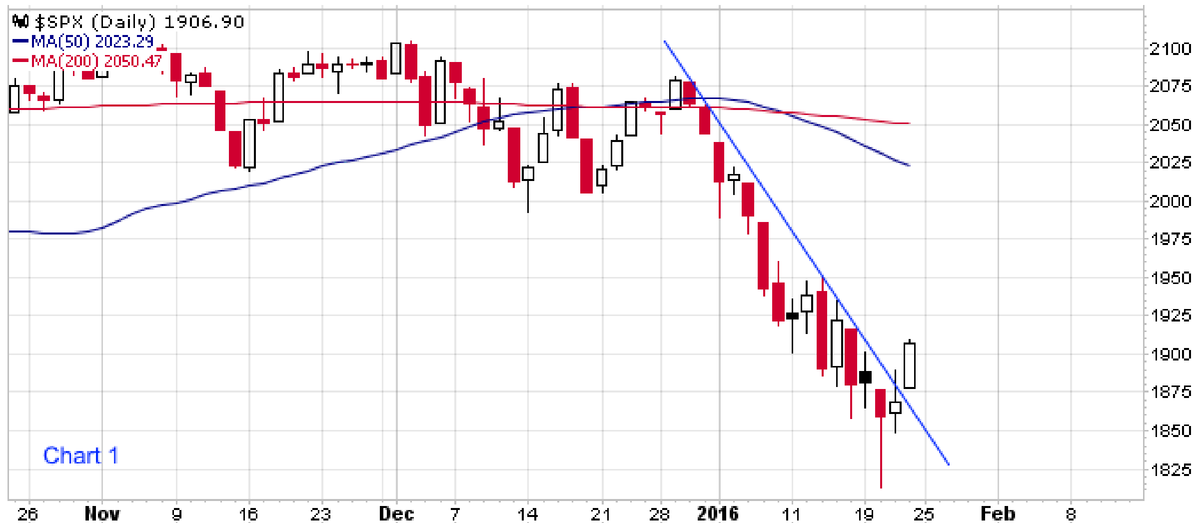
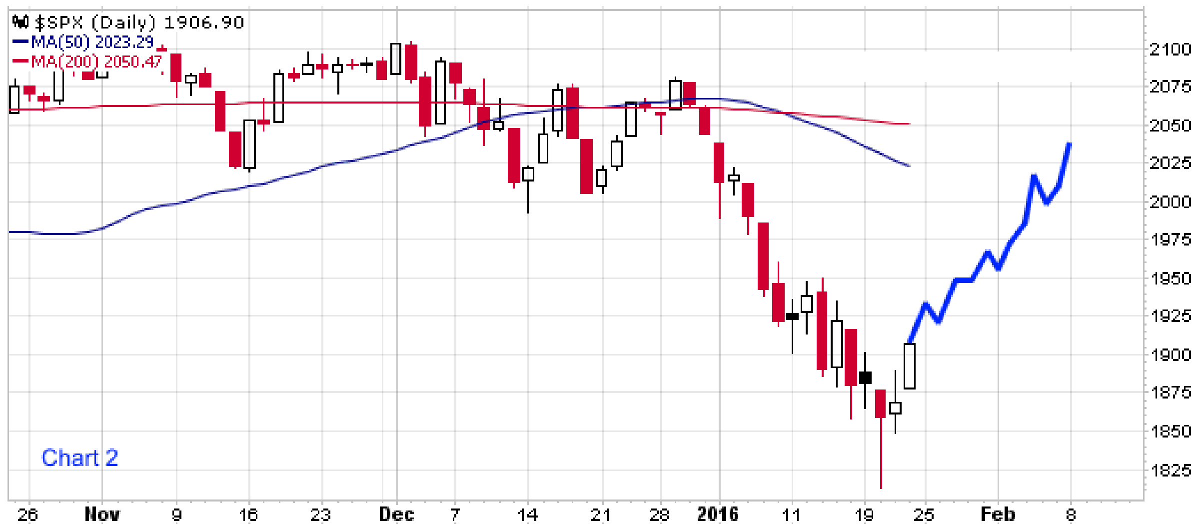
This brief article looks at the question "Is it time to buy?" by examining a specific example from the past…

It's Friday, January 22, 2016. After a bone rattling decline for a couple of weeks, price has shot up 2.5% in 2 days. Some people may draw in a short trendline and think, "Wow, Friday broke right through the declining trendline. The decline is over. I'm going to go long Monday morning."

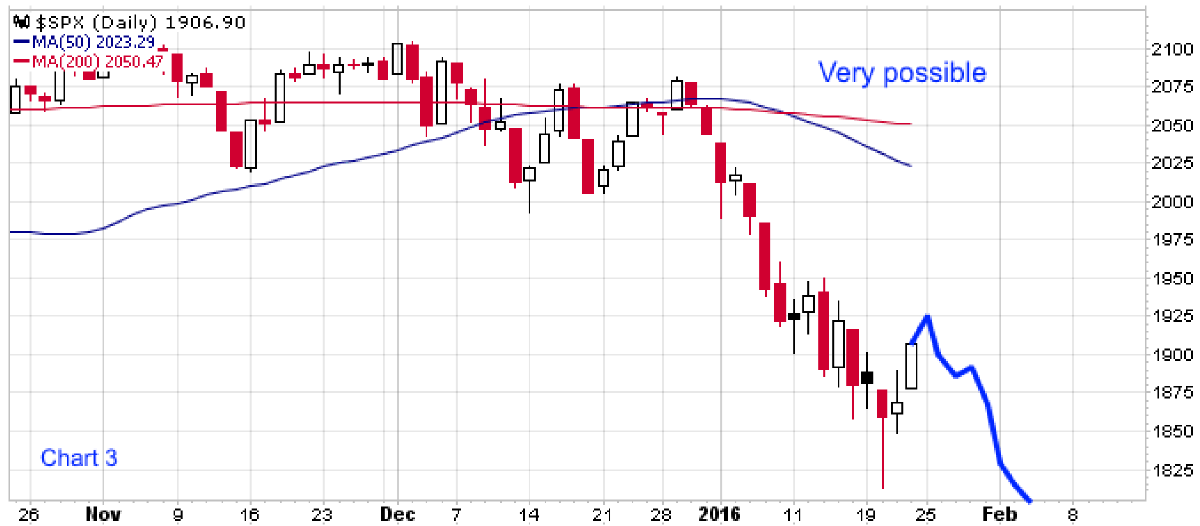


Unfortunately, this trendline is too steep and too short to be believable.

Chart 2 is what most people expect to happen. (Or they hope it will happen and hope quietly becomes expectation, which biases their judgment.) The action depicted in chart 2 is entirely possible but, in fact, it is not very likely. Price almost never falls in a hole and then climbs right back up the other side.

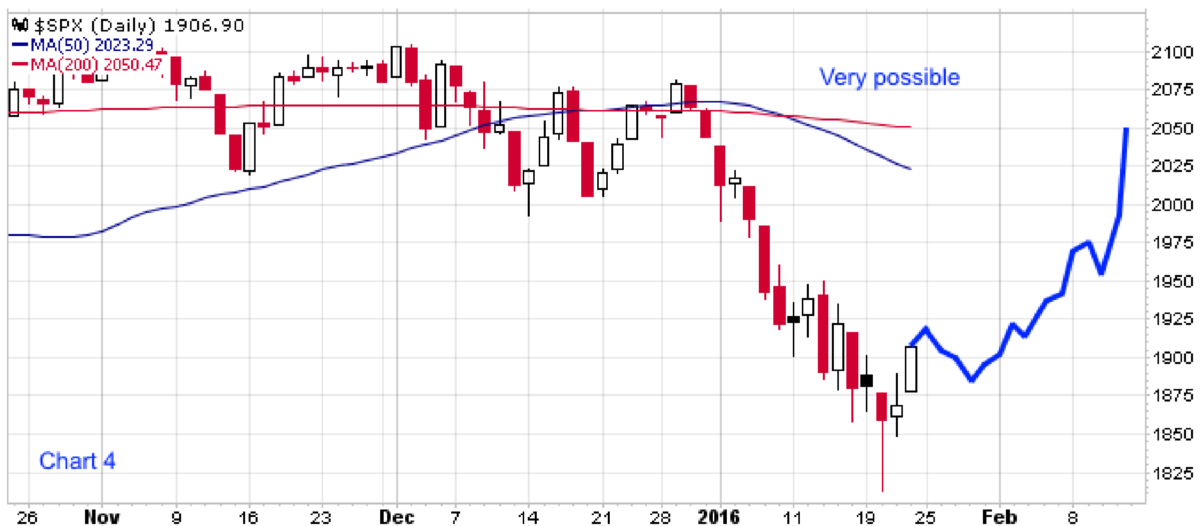


The next scenario is more likely: after another day or two of rallying, price will resume its downward course and people who go long Monday morning will watch their hopes evaporate. (Worse, they won't sell when price drops below $1850 because they won't believe what they are seeing.)



If you are already long on a major index like SPX and the downward slide resumes, you should close your position as soon as price drops below the close of January 20th (or $1850 at the very latest). There are good reasons not to wait to see how far down the market can go.

In chart 4 we see another outcome that is just as likely as chart 3. That is, it will go up for another day or two, then price will drop for a few days before heading further upward.



If this occurs, we can look for a local peak on the rising side and draw a trendline that crosses the valley. Second, we verify that price has turned up by waiting for an ABC setup, as shown in the next chart.

The trendline going down through the tops in the decline on Chart 1 was too short and too steep to be very credible. This trendline isn't much longer, but it has an anchor on both sides of the low point that occurred on the 20th of January. Further, we have an ABC setup with C being higher than A. Once price breaks above point B, this is a high-probability entry and we can buy with much more confidence. We have taken every reasonable precaution and done everything we can to verify that the turn is for real.

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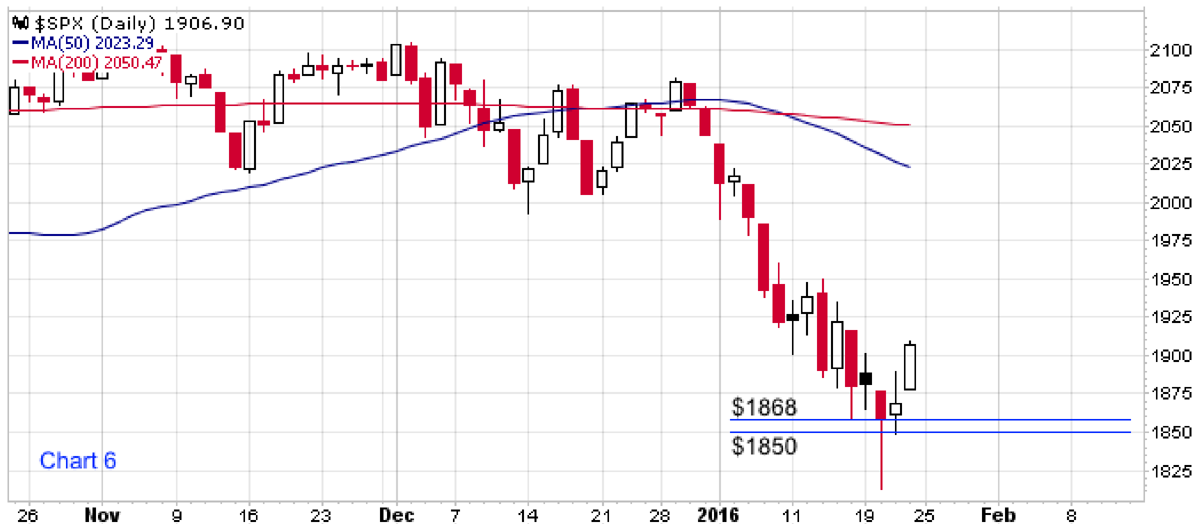
Once you decide to open the trade, you also need—at the very least— to decide on a loss-control exit level. In other words, where you're going to get out if the market moves against you. There are two reasonable choices. One choice is $1868, the closing price on January 20th. The other is $1850. $1850 is a psychological impedance level and it's also very close to the low on January 21st.



Remember, since you can't know what the market is going to do, you need to know what you are going to do. Where/when will you get out if the market moves in your favor. Where/when will you get out if the market moves against you. Make these decisions before you open the position. Then you're prepared for whatever the market throws at you.