Forex trading using VSA (Volume Spread Analysis)

Most traders are familiar with technical and fundamental analysis. There are several ways to use these two methods to analyze the forex market, but, in general, fundamental analysis examines the reasons that the market moves and technical analysis tries to find out when the movement will occur.

There is a third approach for analyzing stock market prices and forex prices. It combines the best of both fundamental and technical analysis to simultaneously respond to the "why" and "when" questions; this methodology is called VSA (volume spread analysis - the analysis of differences in volume).

History of Volume Spread Analysis

VSA is an improvement upon the teachings of Richard D. Wyckoff, who began stock trading in 1888 at the age of 15. In the 1910s, Wyckoff published his weekly forecasts which were read by over 200,000 subscribers. His mail-order courses are still available today. Moreover, the Wyckoff method is offered as part of the curriculum at Golden Gate University in San Francisco. Wyckoff was at odds with market analysts whose trading was based on chart formations. He believed that mechanical or mathematical analysis techniques had no chance of competing with proper training and experienced judgement.

Tom Williams, a former professional stock market trader in the 60s and 70s improved upon the work that Wyckoff started. He highlighted the importance of price differences (price spreads) in relation to volume and the closing price. Williams was in a unique situation that allowed him to develop his own methodology. His research has been available since the 1993 publication of his "Master the Markets" book.

An approach to universal analysis

VSA can be used in all markets and with different timeframes, the trader just needs a volume histogram in his price charts. In some markets like the stock market or the futures market, actual transaction volumes are available, yet in other markets - like forex which isn't centralized - actual volume numbers are not available. However, this doesn't mean that a trader can't analyze foreign exchange market volumes, he must simply analyze the volume observed on each tick.

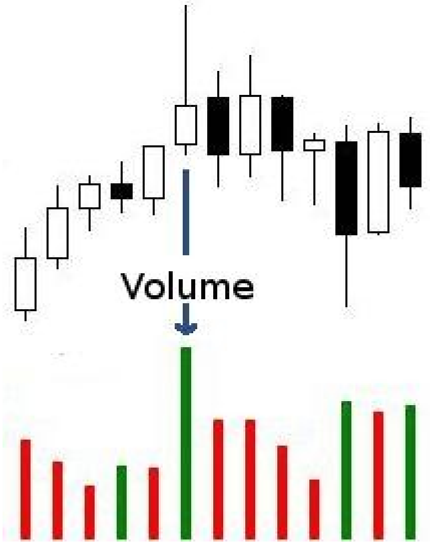
Forex volume can be represented by the amount of activity observed in each bar or candlestick. One must keep in mind that the big professional traders are heavily involved if there is a lot of activity on a candlestick. Conversely, a low level of activity means that professional traders are abstaining from the movement. Each scenario can have implications on the balance of supply and demand, thereby helping the trader identify a probable direction of the market in the short to medium term.

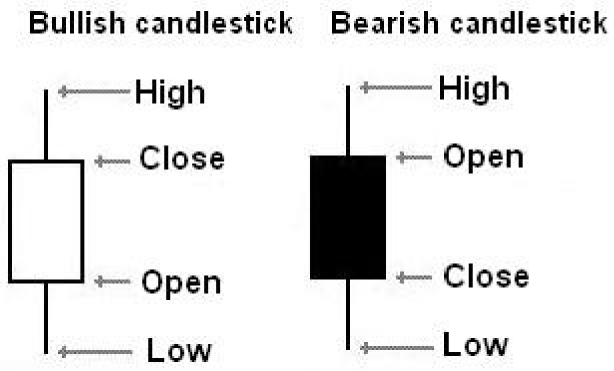
What is an analysis of volume differences?

VSA looks for differences between supply and demand that are primarily created by the major forex players: professional traders, institutions, banks and market makers. The transactions of these professional traders are plainly visible on a chart, assuming that you're a forex trader who knows how to read them.

To determine the balance between supply and demand, VSA examines the interaction between three variables on a forex chart in order to determine the balance between supply and demand, and the probable short-term market direction:

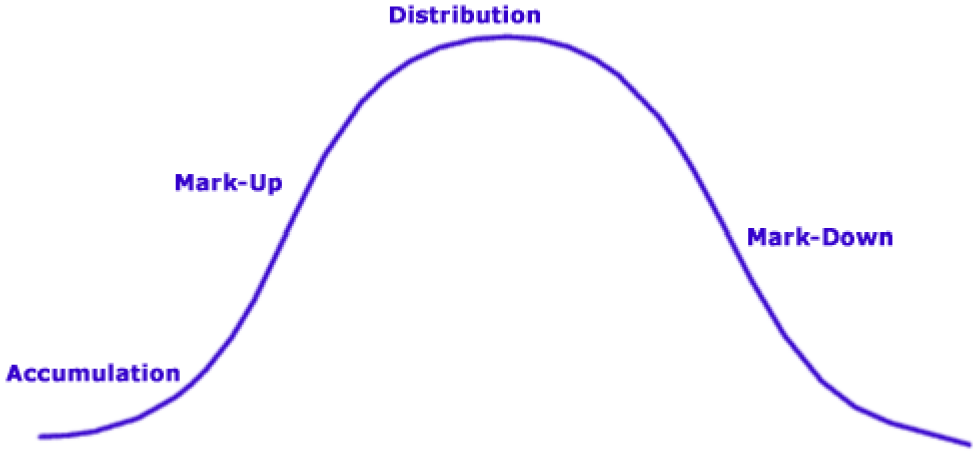
- The quantity of volume on a price bar
- Price variations, or the range (high and low)
- The closing price.





Using these three pieces of information, a qualified trader will clearly identify whether the market is in one of the four following phases:

- Accumulation (professionals buying at wholesale prices)
- Mark-up (bullish movement)
- Distribution (professionals selling at retail prices)
- Mark-down (bearish movement)



The meaning and the importance of volume seems to be poorly understood by most novice traders, yet it is a very important component when conducting technical analysis of a chart. A price chart without volume is like a car without a fuel tank. The volume gives half of the information, while the other half is found by studying the difference in prices (the range).

The volume always indicates the transaction amounts and the price range shows the movement in relation to this volume. Nevertheless, a bull market can exist with either high or low volumes, prices can move in a horizontal range or even fall with an identical volume! This suggests that there are other factors to be considered when looking at a chart.

Basic Volume Spread Analysis principles

Each market moves based on the supply and demand created by professional players. If there is more buying than selling, then the market goes up. If there is more selling than buying, the market goes down. In practice, financial markets are not so easy to read, there is also plenty of information to consider when looking at a history of prices. This important concept is often overlooked by most non-professional traders. The basic principle described above is correct, but supply and demand actually work differently in the financial markets. For a market to trend upward, there must be more buying than selling, but buy orders are not the most important factor. For a genuine uptrend to occur, there must be a lack of sell orders (distribution).

Most traders are completely unaware that substantial buying can occur at lower price levels during the accumulation phase. This buying by professional players actually appears on a chart as a bearish candlestick with a volume spike. **VSA teaches that the power of a market is shown in a bearish candlestick, and vice versa, the weakness of a market is shown in a bullish candlestick.** This is exactly the opposite of what most traders think! For a real downward trend to occur, there must be a shortage of buy orders. The only traders who can provide such a level of buying are professional and institutional investors, but they have already positioned themselves to sell at the previous high price levels on the chart during the distribution phase. Selling by professionals is represented on a chart by bullish candlesticks with high spikes in volume, weakness appears on the upper bars. Since there is very little buying, the market continues to fall until the phase of decline (mark-down) is complete. Professional traders buy during selling that is frequently the result of bad economic news announcements; such bad news encourages the masses (the herd) to sell (almost always at a loss). The buying by professionals is therefore occuring on bearish or downward candlesticks!

This kind of activity has been going on for over 100 years, yet most novice traders have not heard about it until now.

How to spot and trade Volume Spread Analysis

Let us now look at a clear example of distribution which shows the massive sale by professional traders during a rising market. The below forex chart shows the USD/CHF using 30-minute bars. **This market was in the mark-up phase until the 1 bar, which has a massive volume spike. This bullish bar closes in the middle of its range.** This is a signal that indicates that professional traders are returning to the market to sell; upon observing the bar, a trader must be aware that the activity shown on the volume histogram does not only represent buying, otherwise the close of the bar would not be in the middle of the range. Professional traders sell during bullish bars when the herd is buying! This type of bar frequently appears after an economic news announcement that seems to forbode a rising market, leading retail forex traders to initiate long positions. Professional traders take advantage of these opportunities to liquidate their long positions and initiate short positions.

A properly trained trader immediately understands that a bar that closes in the middle of its range and with large volume means that a transfer is taking place between professionals and the flock, which will soon end up on the bad side of the trade. Professional traders will sell at retail (distribution) after having initiated buy positions at wholesale prices (accumulation). The transfer to weak investors continues on bar 2. An expert trader can see that bar 3 is now closing lower, confirming that there was a large chunk of selling on the previous bar.

Don't be part of the "herd"

In the chart below, professionals have sold their positions to the mass public, the so-called "herd". The new buyers now find themselves stuck in losing long positions. Prices can no longer climb any higher if the professionals do not support higher prices. Without buyers to support the market, prices fall during the mark-down phase. For a true downtrend to occur, there must be a lack of buying. The only traders capable of buying at such prices are professionals, but they sold while prices were high, during the distribution phase.

After the market has fallen, professional traders will switch back to buying and the herd will be forced to sell - with significant losses. The cycle repeats itself over and over again. This is how the markets work! Professional traders are specialized in several markets and in different timescales, this cycle will therefore be found in all timescales: 30 minutes, 1 hour, 1 day, etc... VSA works with all financial markets such as forex, stocks and futures. VSA is a market analysis technique that is based on the transactions of the market's biggest players; it informs traders on the reasons and the time when professional traders will be positioned in the market.