MOMENTUM TRADING

Enter Or Run For The Hills

Where Price Action Meets Momentum Trading

Often, traders blindly place trades based on expected price moves derived from specific price patterns. But we know too well that price patterns can fail. How do you know when a price pattern will respect the price action rules? Find out here.

For the last 15 of my 34-year career working within the European financial markets arena, I have been passionately interested in and actively trading the forex markets using price action techniques. This has been a wonderful journey and experience for me, and I would like to share with you some of the best discoveries I have made about price along what I call the *price action road*.

Over the years, I have met and talked to traders from all over the world and we have exchanged ideas, techniques, and trading methods. However, being known as a price action specialist, I have often been confronted by perplexed yet knowledgeable students and market technicians who ask me why a particular price pattern did not respect the rules of price action on a given occasion. My normal reply to this question is, "In trading as in life, there are no *rules*."

If you want to become an expert in price action trading, you need to first understand the possible price patterns that can potentially appear on your trading screen. Then you need to combine those patterns with the concepts of momentum trading.

In doing so, you will get as close as possible to creating something nearing what could be called a price action trading rule. This, in turn, will offer you a trade with an edge and an above-average chance of being a winner. Let me step back a little and explain what I mean.

THE KING OF PRICE

It is a commonly held belief within the technical trading community that Richard D. Wyckoff was not only one of the very early pioneers of technical analysis but also "king of price."

It is undoubtedly true that Wyckoff was a frontrunner in understanding that price could be traded as a standalone entity, without the need to apply additional traditional analysis techniques, be they fundamental or otherwise.

Wyckoff's publications, still considered majestic reference works on the subject of technical price pattern analysis and price action trading, are the first port of call for many aspiring price action traders, and quite rightly so.

Wyckoff, via his in-depth and clear understanding of the markets, was one of the first market operators to discover that it is human emotion that drives price and furthermore, that such emotion can be clearly seen on the charts, appearing in the form of simple and complex price patterns. Such patterns are recognizable as they repeat over and over, irrespective of the instrument being traded or the time frame in which they occur.

How is it, then, that most traders seem unable to mimic Wyckoff, who only had the tape and hand-drawn charts at his disposal yet managed to be hugely successful? Today's technicians have much more analysis material at their disposal including powerful computers, charting packages, and technical indicators. But why is it that they are not generally profitable? After years of my own price action research, I think I may now have the answer.

ROY WIEMANN

by Paul Langham

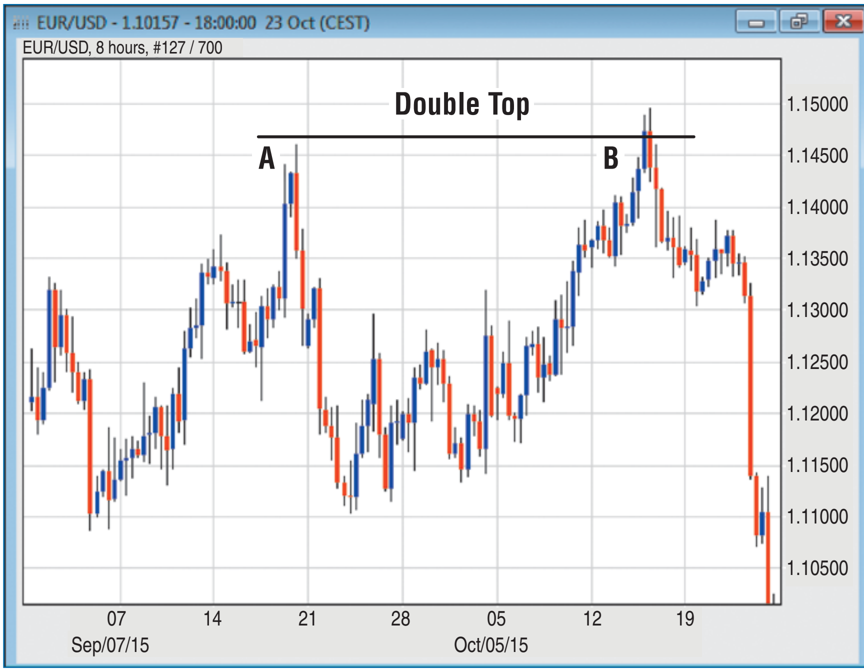

FIGURE 1: DOUBLE TOP IN THE EUR/USD. Once the double top is confirmed, price moves swiftly away to the downside. Typically, you would place a short trade close to or level with the earlier high.

PRICE ACTION AND MOMENTUM

It is clear to me that Wyckoff understood technical price action patterns and price momentum. It is my belief that he combined the two to make his trading decisions. Perhaps the latter was intuitive on his part, but the coupling of the two was fundamental to his success.

Before I go any further, I want to remind you of what I mean by *price action* in relation to the concepts of technical analysis. Let me offer the following definition:

> *Price action*—The reaction that price makes at predetermined price points or levels, with such reaction having the potential to form a decision point in relation to the future direction of price.

This definition might sound like a complex and somewhat confusing definition, but I will explain what I mean.

For the purposes of this example, take a look at the well-known technical pattern of a double top. It is one of the most discussed, widely understood technical setups on the planet. The pattern occurs in all time frames, can be seen across all instrument types, and during all sorts of market conditions.

In Figure 1, you'll see an easy-to-spot double top in the EUR/USD that successfully confirms the previous high that was made on September 19, 2015. Once confirmed, in textbook fashion, price duly moves swiftly away to the downside.

Typically, such a move can be traded by anticipating the double top price pattern and placing a short trade, close to or level with the earlier high, the idea and premise being that price will move away from the short entry point and confirm the double top price pattern.

Points A and B denote the original high and the confirming double top. Once in profit, the trader would then look to take profit and close his trade using any one of a variety of take-profit methods. It could be based on price target, reward-to-risk ratio, or number of pips.

In Figure 2 you see a similar move in the EUR/USD except that this time, the price pattern does not confirm. As you can see, price does not react the way the trader would have expected or wanted it to and the trade, if taken, would have ultimately been a losing one.

FIGURE 2: FAILING DOUBLE TOP. Here, price continued moving up, so if a short trade had been taken on the expectation that price would have moved down, it would have ultimately been a losing trade.

Many traders do not understand price action trading or its merit as a valid trading method. This is because they jump into the market based on a price pattern they have spotted and simply hope that the pattern will develop as seen in the examples found in the myriad of books on technical analysis.

The result of simply hoping that a price pattern will confirm without taking into account any other factors leads to, in most cases, failure and trading losses.

I will now look at the difference in price action between the two moves I mentioned earlier and try to understand why one move was successful and the other was a failure.

MOMENTUM PRICE CONTROL

When trading price action, there is one missing factor that traders do not seem to take on board, which, for me, is the missing link between success and failure. It's a concept I call *momentum price control*.

What I mean by momentum price control

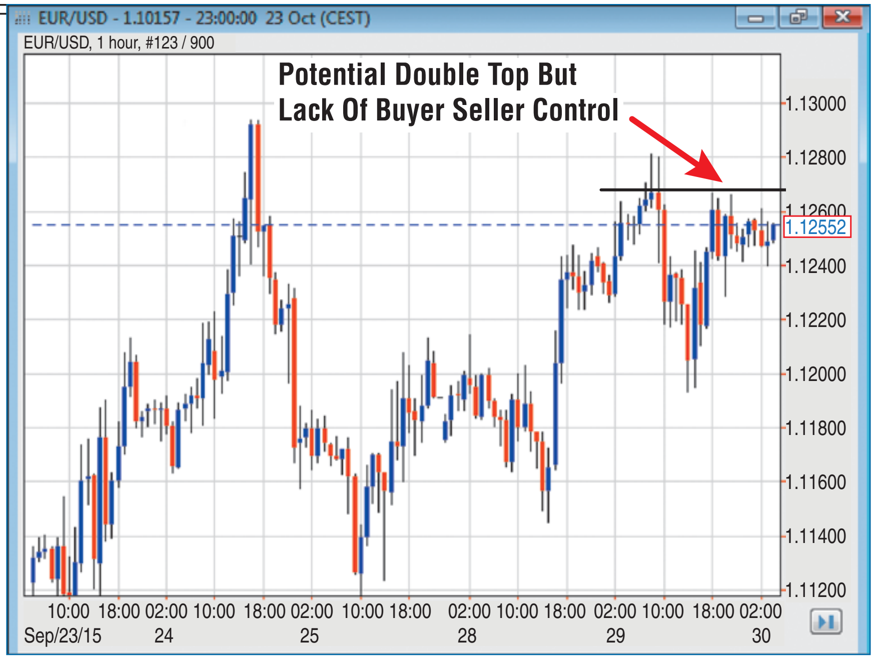

FIGURE 3: MOMENTUM PRICE CONTROL. Although it appears as if a double top is forming, there is lack of buyer or seller control. Which way should you trade?

is the idea of establishing—prior to entering a trade—who has control of price. Is it the buyers or is it the sellers? When you place a trade and you don't know who has control of price, irrespective of any potential technical price pattern you are looking to exploit, then you need to be asking yourself the question, "What is the point of entering such a trade?"

Entering a trade when you don't understand who has control of price is akin to gambling, as opposed to investing with a proven edge and an above-average probability of a successful outcome.

In Figure 3 it is clear that a potential double top is forming, but based on the price momentum shown, understanding who is currently in control of price is not clear. No one group has the upper hand, prices are drifting sideways, and there is indecision as to the direction of the next major move in price. Neither the buyers nor the sellers have really shown their hand yet.

While it should be obvious, it is worth reminding yourself that when price moves to the area of the double top, you should see if there is buyer control. This can be confirmed by looking at the strength of the bullish candles that got price to such levels.

What traders don't seem to take on board when making their trading decisions is that confirming the double top pattern should also include a step to confirm the price action momentum control. In this scenario, the control is on the part of the sellers. If you trade a potential double top that shows no visible selling pressure, you are just hoping for success and not guaranteeing it.

In Figure 4 you can clearly see the difference in the price action or momentum price control compared to Figure 3. The sellers have taken control and price is moving away from the double top. If you closely inspect the *ensemble* of the red bearish candles, you can see that the momentum within those candles is similar in size and form to the candles that took price higher to form the original high. The result of the price action and price control is indeed to move price lower. When it is clear that the momentum price control is with the sellers, then it is safe to enter the market to join the momentum move and profit from it.

Based on the price action in Figure 4 and following a short entry into the market, there are typically three things that could happen:

- Price can continue to move away from the double top and momentum price control is confirmed
- Price meets with some resistance and buyers intervene to take price back up to the double top or close to it. As long as the sellers truly have control when a short trade was entered, then the price should be met with additional sellers who will overpower the buyers. This will result in price moving further to the downside
- The original analysis of sellers having control was incorrect. The selling was probably just profit-taking from the upside move. In this case, if the buyers come back with any conviction and take control, the double top will be challenged and price will potentially break to the upside.

FIGURE 4: THE SELLER TAKES CONTROL. Here it is evident that sellers have taken control and price is moving away from the double top. In such a scenario, it's safe to enter a position that moves in the direction of the momentum.

FIGURE 5: TRADE OUTCOME. Here you see a double top with a successful outcome

In Figure 5 you see the final outcome of that trade.

Another example of a successful double top price pattern can be seen in Figure 6. Note again how at point B sellers have taken control. The size and momentum of the candles that have moved price away from the top are similar in shape, form, and momentum to the bullish candles that took price to the top in the first place. Points A and B show the details of this.

Trade entry and management

For the trader who uses momentum price control to gauge entries, it means entering a trade a little later than some price action traders would normally do. Allowing price to make its move or show its hand before entering a trade allows you to increase your overall winning percentage and does not take anything away in terms of profit potential. Because of the increased likelihood of the trade being a winner, it builds trader confidence and reduces the potential problems of hesitating to pull the trigger.

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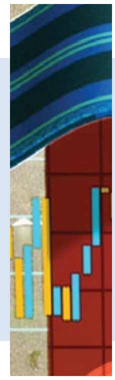

Typically, a stop placed sufficiently far enough beyond the high of the double top can be trailed once the trade is a certain number of pips in profit. This avoids being whipsawed out of the trade if price does meet some resistance and the buyers take control again.

Dig deep

I urge you to revisit your own charts and take a look at the many examples of the most popular price patterns that occur in all instrument types and time frames. Once you start comparing the winners with the losers, I am sure you will notice how the momentum price control is the ultimate piece of the jigsaw puzzle. It allows you to understand whether a price pattern has confirmed and will become a successful trade.

FIGURE 6: DOUBLE TOP WITH STRONG PRICE MOMENTUM CONTROL. At point B, sellers have taken control. The size and momentum of the candles that have moved price away from the top are similar in shape, form, and momentum with the bullish candles that took price to the first top.

Paul Langham lives in Brussels, Belgium, and has been trading the financial markets for 34 years. He runs his own trading website at www.exacttrading.com and currently works for a major European bank. He can be contacted at paul@exacttrading.com.

Further reading

Hutson, Jack K., ed. [1991]. *Charting The Stock Market: The Wyckoff Method*, Technical Analysis, Inc.

Wyckoff, Richard D. [1931]. *The Richard D. Wyckoff Method of Trading and Investing in Stocks*, Wyckoff Associates, Park Ridge, IL.

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‡See Editorial Resource Index