Trade the Price Action

Strategy Introduction

I have been trading currencies with decent success so far and I decided to present to you my complete detailed trading system. This strategy addresses people that have yet to succeed in the currency market, the people that have been trying hard to construct a winning strategy that will allow them to make some profits in the forex market. I know this process is very frustrating but you have come to the right place. I've put together this powerful strategy for myself after about one and a half years of frustration when everything I tried did not seem to work for me at all. After all that screen time, studying the charts endlessly, reading countless books, articles, forums, I have come to the conclusion that the most powerful things, the things that work best in the foreign exchange market are the following: trend, support and resistance zones (both horizontal and diagonal), Fibonacci ratios and candlestick patterns/price patterns. Consequently, I came up with this price action strategy that incorporates all of the above, and since then, things have been working out great for me

No indicators

As this is a strategy based on price action, it doesn't use technical indicators. As far as I am concerned all indicators are lagging behind the price because of the simple fact that they are constructed with past price information. This makes them useless in predicting future price movements. The price action itself is the best indicator that you can have to help you make a lot of winning trades in the foreign exchange market. You just need to learn how to read it and this is exactly what you will find out with this strategy. The only indicator that I find useful is the 200 period exponential moving average or 200EMA applied on the daily chart, but not because it has the ability to predict future price movements, after all, it is just like any other indicator based on past price action, but for the fact that a large majority of the traders out there seem to be keeping an eye on it to the point that it becomes self-fulfilling. If you look at a daily chart with the 200 EMA on it, you will see that price very often reacts at or near this moving average which means that there are a lot of traders that take into account this 200EMA and base some of their trading decisions on it. The exact same story is valid for the candlestick patterns. The strategy I made includes the 200 EMA inserted on the daily chart, but only for confirmation that it is in line with our price action reading, we do not base trading decisions on the moving average.

Timeframe

The 4hours timeframe zoomed out to the maximum is the best timeframe to trade if you want to make money. A smaller timeframe than the zoomed out 4h is intraday trading and it won't make a very successful trader out of you in the long term because of the many random price moves on the lower timeframes generated by the never ending economic news. The zoomed out 4h chart gives you an overview of what is going on in the market, it tells you which is the dominant trend and how you can profit from it. Trading on smaller timeframes is very risky and I do not recommend it. In this strategy I use the 4h timeframe, as it is a conservative strategy, it is designed to make you money in the long run, and you will find that it is extremely reliable. This is not a get rich quick type of forex strategy, you will not be making trades all day long, every day of the week. Substantial profits are made with just a few trades per month. Also, your live account platform from your broker has to have the New York closing time for their charts, if they don't, use a demo account from a broker that has this like Fxdd or Fxlite, do all the preparation work on that demo account and use the live account only to enter the trades into the market. Now, I will walk through the components of the strategy I mentioned earlier and discuss them in detail.

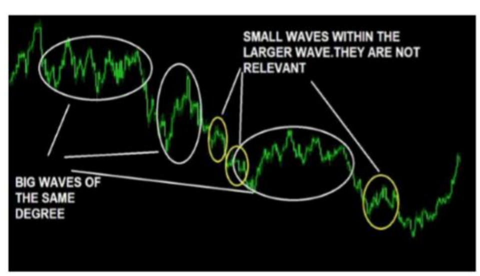
Trend

This is the most important part of the strategy. I will explain how to identify the trend by looking at price action, which is the most reliable way to do it. As you probably know, you have a trend in place as the price starts to make higher highs (HH) and higher lows (HL) or lower highs (LH) and lower lows (LL). Here is an example of a downtrend:

Now let's see an uptrend:

As you can see, when a trend is in place, price goes strong in one direction, then it corrects itself going in the opposite direction or just stalling/ranging for a period of time and after that, another impulsive move in the initial direction, another correction and so on. This is what constitutes a trend. The important thing when identifying highs and lows is paying attention to see if they are of the same amplitude, like in the picture above for example. Here is what I mean:

In the same example after the third HH price made a very small move in the direction of the trend followed by a very small correctional move (circled in the picture above). That is not a HH as it is not of the same size or amplitude like the previous HH's. That is a small wave within the bigger wave. One more example to illustrate this:



In this example you have the same situation where there are small waves contained by the bigger wave. This bigger wave is the one that has significance for the overall price action on this timeframe, those three minor waves are of a smaller degree and they should not be taken into account when deciding how to label your trend on this timeframe. Okay, now that you have an idea about how to identify a trend, let's see how a trend changes its direction and identify that exact moment from a technical point of view.

In the chart above you can see we have not one but two changes of trend. Starting from the left we see a clear downtrend with the price making LH and LL. In order for the trend to change we have to see a breach of the last LH, right at that horizontal line. Until that happens the trend is still down. You can see that eventually the price broke the last LH, made a small correction and then continued upwards changing the trend from a downtrend to an uptrend. So, the trend changed when price stopped making LH, broke the last LH and made a distinct point in the market situated higher than the last lower high. This point on the above chart is the first HH that price makes after breaching the last LH of the downtrend. After this we can see another change in trend from uptrend to downtrend. The price continues up and makes three HH's, but it cannot make a third HL as price, like in the first change of trend, breaches the last HL at the second horizontal line in this chart to make a new low at a price level which is lower than where the last HL of the uptrend is situated. It then makes a correction move and goes straight down confirming that a LL has been formed and a change in trend has taken place. Remember, a change in trend only takes place after the last LH or HL is breached, price makes a correction and shoots through the newly formed HH or LL confirming the validity of that new HH or LL. Only at this time you know that the trend has changed. Here is another example to understand the importance of this:

In the example above we have a clear long term uptrend on AUD/USD. Now, in order for this uptrend to be broken, price had to breach the last HL, retrace or correct and then go down past that point to confirm that the new LL has been formed and a change in trend has taken place. As you can see, it did not do that, it only spiked bellow the last HL and then sharply retraced back up and never came down again to confirm the LL and the trend change. So the trend on the AUD/USD is still up. OK, there is one more important thing that you have to know when you study the chart to see what is the trend. I told you already that a new high or new low has to be confirmed by price consistently going above or below it. Let's take the same chart as the one above to explain better:

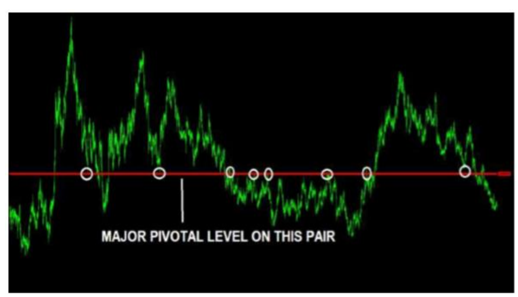
You can see that after the second HH, price made a consistent move above it, practically validating that it is indeed a HH. When price gets right at the top to that circled potential HH, it retraced and tried to move above past it to continue the uptrend and confirm the HH. It only managed to go 50 pips above it and then retraced sharply. This was not at all a strong move above that level so the HH circled in the above chart was not confirmed.

The same applies to that new potential HL that could have been valid only if price would have gone strongly up. After this failure to confirm a potential HH and HL, the HH that remains valid is the one labelled „NEW HH" and the last low is still the second HL in the chart above. All right, now you know how to spot a trend, with a little practice on your charts you will have no problem in identifying the correct trend and then try to profit from it. Let's move on now to the other components of this strategy.

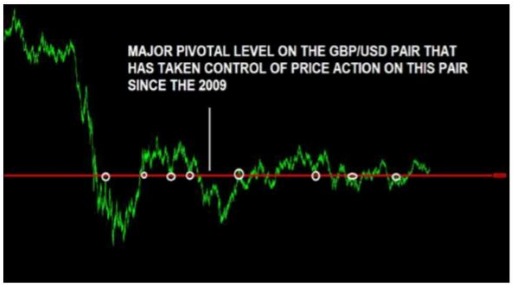
<u>Support and Resistance</u>

You probably already know that support and resistance are zones where price has reversed direction in the past. For example, all the highs and lows in the above charts are minor support and resistance zones. Major support and resistance are those areas where price has repeatedly reversed direction. The more times price touches a level of price and then reverses, the stronger that support or resistance is. There is also diagonal support-resistance or trend lines which work the same way as horizontal support-resistance. The important thing to remember about support and resistance is that when you have a trend in place, a broken resistance turns into support and a broken support turns into resistance. I will show some charts for better understanding:

We have here a downtrend, all those lines are in fact lower lows that price broke to make new lower lows so they were minor support and after they have been broken they turned into minor resistance as you can see by the fact that after each of that zone was breached price came back up to retest it and every time it bounced back down.

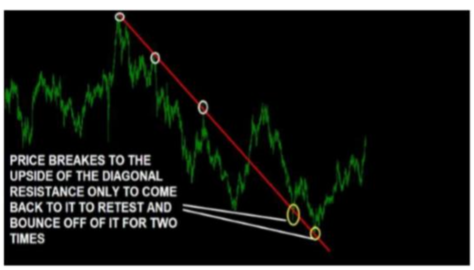


Here we have a major pivotal support turned resistance and then support again where price has reversed multiple times coming from both sides of it. Here is another example of such a level.



The important thing for you to remember about these powerful pivotal levels in the market is that they tend to attract price action. The stronger the level is, the greater the chances are that price will revisit the level sooner rather than later. Think of these levels as fair price or fair value for a forex pair. When buyers or sellers feel that they do not have sufficient grounds to push the price strongly in one direction or another meaning that there isn't a strong trend, price will always go to revisit these strong pivotal zones in the market. They are like a magnet for price action.

Here we have a diagonal support or a trend line as it is more commonly known. These diagonal levels are just as important as the horizontal ones but they do get broken faster. In this example you can see a trend line that was touched three times by price action. In the majority of situations, when price comes back to the trend line for the fourth time it will break it and cross below it. Like horizontal support and resistance levels these too act as pivotal levels in the market as you can see in the illustration below.



Okay, I think it is pretty clear now what support and resistance are. Let's move on.

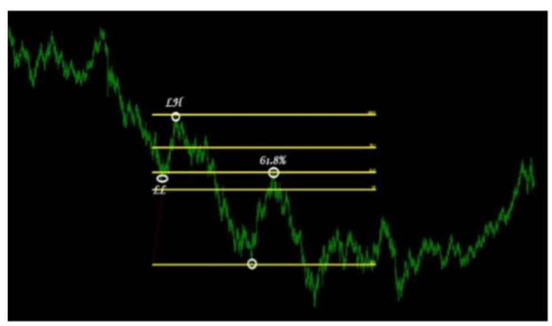
Fibonacci Retracements

This is a tool that works great in the forex market. The vast majority of traders use it to find areas where to enter their trades. In fact, the Fibonacci retracements are just another form of support and resistance. Let's see some examples to find out how well they work:

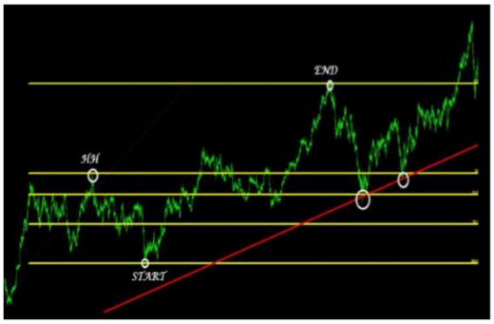
You can see, trend had just changed from down to up, price corrects itself exactly to the 78.2% retracement level and then rallies.

Downtrend, correction to the 50% retracement and then all the way down.

Uptrend, correction to the 61.8% retracement level and then rally. From my experience, the 50% retracement is by far the most reliable, followed by the 61.8% and the 78.2% in this order. There is also the 38.2% retracement level but I don't use it because I don't think it is a complete correction, the price has to correct to 50% or more. There is of course the possibility that price retraces 100% of the previous move and it should be taken into account but the strongest level is by far the 50%. Also, an important aspect when plotting the Fibonacci retracements on the chart is to see if there is confluence between a Fibonacci level and a previous support/resistance zone like below:



You can see in the chart above that the 61.8% retracement where the price reverses and resumes the downtrend coincides with minor resistance represented by the last lower low. This is a stronger signal that the trend down will resume at this point because price has reached the 61.8% retracement level and at the same time that level coincides with a resistance zone. If we have confluence of Fibonacci retracement level with a trendline it is an even stronger indication. If we have confluence of all three at the same level that is the strongest possible, signal that the trend will resume.



Look at the chart above, we are in a very strong uptrend, we have a trendline in place, price comes back down and makes a correction to the 61.8% retracement level which coincides with the trendline. This is a strong signal. Furthermore, after that it comes back to the 50% retracement level which is also right at the trendline again and is also minor support represented by the last higher high. This is a very strong signal. In conclusion, the more confluence of events at a specific price zone, the stronger the indication that the trend will resume from that point on. Ok, we now know in detail how to correctly identify a trend, we know about support/resistance zones and all about the Fibonacci retracement levels and how powerful they are in conjunction with other support/resistance zones. Let's move on to the last component of this strategy.

<u>Candlestick patterns</u>

As you probably know, candlestick patterns are used best as a confirmation when to enter a trade if a price action setup has been spotted. I will give examples of candlestick patterns that from my experience are the most powerful.

<u>Hammer:</u>

This is the most powerful of them all. When this happens at an extreme like in the chart above, chances are price is going to reverse for a while. And it did, even though the second hammer was a bullish one it still pushed the price up for more than 150 pips which is remarkable considering the trend was down at that time.

<u>Engulfing pattern:</u>

Very strong pattern. It means that a change in market sentiment has occurred. As you can see it is at a price extreme which is what we will be looking for in this strategy when it comes to candlestick patterns. When it forms at a price extreme the signal it gives is very powerful.

<u>Morning star/Evening star:</u>

Very strong pattern as well as you can see at price extremes. Strong candle in one direction, followed by one or more indecisive small candles and then a strong candle in the opposite direction that closes at least at the half of the first candle.

<u>Dark cloud/ Piercing pattern:</u>

Consists of a strong candle in one direction followed by a second candle that goes past the high or low of the first but can't continue further in that direction and closes way back in the other direction. Other patterns that work just as well when found at a price extreme:

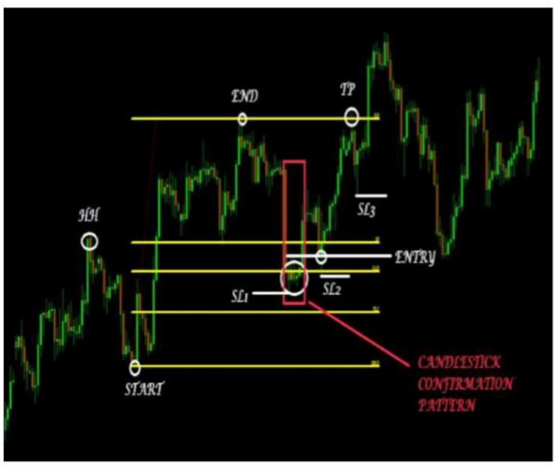
The first on the left has a first candle in a direction, the second tests within 12 pips the high or low of the first candle and then closes way above/below the first candle. The second pattern on the right of the chart above consists of three candles. The candle in the middle always has the highest high, the first and third close way below the middle candle's low.

When two consecutive candles with roughly the same size occur at a price extreme it is a clear indication of a change in price direction. Ok, now we know all about the components of this powerful price action strategy, let's put them together and define clear entry/exit rules, clear stop loss and take profit levels so we can make some money.

Strategy step by step

Move your charts to the 4hours timeframe zoomed out and insert the 200EMA on them. Remove everything else on the charts. Identify the trend on the 4hours chart as we discussed earlier. If there is a trend in place, go to the daily chart and see if the daily 200EMA confirms your identified trend, meaning that if you spotted an upward trend the price on the daily chart must be above the daily 200EMA. If you have a downtrend, then price must be below the 200EMA on the daily chart. If things on the daily chart look the way they are supposed to and they confirm your new found trend, then go back to the 4h chart and wait for a price correction move opposite to the trend direction. When the correction move starts to unfold plot your Fibonacci retracement levels on the chart and wait for price to get to the 50% level. If one of the candlestick patterns previously discussed forms at this level, we enter a trade in the direction of the trend. If no pattern occurs, we sit back and wait for price to go further to the 61.8% level and form a pattern. Same goes with the 78.2% level.

Chart examples to show entry / stop loss / take profit levels.



In the example above we have a clear uptrend, the daily chart confirms it. We lay Fibonacci retracements on the chart. Price comes to the 61.8% retracement level and makes a perfect morning star pattern. After the pattern is completed we know that there is a strong chance that the trend will resume upwards and we enter a pending buy limit order as pointed in the chart. Notice that we find a logical place to enter the trade which is that small support that the candlestick pattern has formed. The stop loss will always be at the end of the pattern and the take profit level will always be at that peak that price made before it started the correction move. All the trades with this system will look just like this one with very low risk and high reward. On this trade notice that risk is 30 pips and reward is more than 100 pips. Important money management advice: if you ever find a trade setup where the risk will be greater than the reward do not trade it, no matter how good the price action setup looks like. Also, the stop loss can be manually trailed bellow the minor higher lows price makes on his way back up to the top like shown in the above chart. Things work just the same with all the other patterns as well.

Another example, downtrend confirmed by daily chart, retracement back to 50% level, hammer pattern at that level. We enter after the hammer closes, stop loss above the hammer, taka profit way down to where the retracement started. You can see here that the 50% retracement also coincides with minor resistance formed at the last lower low. As you can see we have a 75 pip risk and a 265 pips reward.

Here we have the EUR/USD pair in a downtrend, price is below the 200 EMA on the daily chart, the pair goes down strong and then retraces back up to the 61.8 retracement level where price makes a very powerful candlestick reversal pattern.

A bullish strong candle followed by an even stronger bearish candle. We can see that we have confluence of signals because that level is also where the last resistance represented by the LL is. We enter the trade and put the stop loss in place like shown on the chart and let's see what happened next:

We see that price got eventually to where our take profit was situated, but it did not go straight down to it. You remember we talked about trailing the stop loss only to logical places, which in this case would have been lower highs made by price on its way down to our take profit level. Price did not make a lower high, it just traded in a range for some time before going strong down to the take profit. That level circled on the chart is not a valid LH because it was not confirmed by subsequent price action. Remember what we talked about earlier when we learned how to correctly identify a trend, any high or low has to be confirmed by price action. In this case, after that potential circled LH, price did not go down with conviction past that minor support where the red line is, it was not an impulsive move to confirm the lower high. Price just traded there in a range and after that it went up past that level and made a real lower low this time because it was later confirmed by price action going sharply all the way down to the take profit. In conclusion, the stop loss should have stayed at its initial level and the reward was very big as you can see: 440 pips. The risk was only 90 pips.

In this example, the same pair EUR/USD, strong downtrend confirmed by the daily chart, price retraces back to the 50% level which is also the last resistance made by that LL so we have strong confluence at this level. Price makes there a strong reversal pattern, we enter, set the stop loss and the take profit level and just sit back. Reward 420 pips / Risk 110 pips.

EUR/CHF pair, strong downtrend, retracement to the 50% level, price makes reversal pattern, we enter, trail manually the stop loss to that minor lower high(SL2) and we take 365 pips from this trade with a risk of 130 pips. Compared to the other trades above, the risk/reward ratio on this is lower but it is still very good.

This example on GBP/JPY is very interesting. It shows you how important it is to respect the rules of this system, to wait for a candlestick pattern to form before you enter the trade. Trend was up at that moment; price retraces back to the 50% level but it goes sharply below it. There is no pattern here so we do not enter any trade, we wait. Price then goes to the 61.8% retracement level but no patterns is formed here either. No trade here. We sit back and wait. After a brief bounce, price comes back down again at the 61.8% level and finally, it makes the reversal patterns we have been waiting for. We enter the trade, trail the stop loss below that minor higher low(SL2) and we get 1400 pips with a 150 pips risk. But, to win those 1400 pips you have to be patient and wait for the price to get to the take profit, do not place the stop loss in random places closer to the current price thinking that it will not get hit, do not close the trade at half way thinking that 700 pips or so is enough, respect the rules. This is how money are made, by holding on to winning trades not closing them at half way. Now, about the take profit levels, the safest thing is to take your profits and close the trade as shown above in all the diagrams, when price reaches the start of the correction move. Usually this level will get hit the vast majority of times therefore you will have no problem winning the amount of pips that you expected to win at the start of the trade. Another less conservative way that has the potential to bring you more pips per every trade but also can make you win a little less than what you would normally win by using the conservative method is to draw a trend line that connects the start of the correction move with the previous HH if in an uptrend or with the previous LL if in a downtrend. After you draw this trend line, you extend it further down in a downtrend or further up in an uptrend. You can then consider your take profit level, the point where future price action will touch your trendline. Let me show you a chart:

In this example above there is no trade because there isn't any candlestick confirmation pattern. But if there were one, you would enter the trade and set your conservative TP at the start of the correction. If you draw that red trend line like in the example you see that you can find a pretty accurate and more favorable for you take profit level because that line acts as a support for price. Usually when there is a strong trend price goes beyond the start of the correction and touches that trend line but there are cases when the trend ends just at the start of the correction/conservative TP level or just passes that point for a moment and shortly after the trend ends and price reverses direction never touching the trend line. This is entirely up to you, if you are more risk inclined go for the trend line option, you will not lose much if price doesn't get to touch it.

Patience is the key

If you decide to use this strategy you will quickly find out that it is extremely powerful and profitable you just need to follow the rules strictly and have patience. You will not have trade setups every day you have to wait paciently for them to occur. Do not chase trades, do not enter a trade if the requirements of this system are not fulfilled. Wait for the patterns to completely form before you enter a trade. Respect this system to the letter and you will make a lot of money trading forex as time passes.

Reference

Damir, L. (2012). *Trade the Price Action – Forex Trading System*. Amazon Digital Services.