In this lecture we will talk about some of the peculiarities and imperfections of price action that you should be aware of, and how these details will impact your trading on a consistent basis. It's not any news that price action contains a decent amount of noise, and sometimes, price will fall short from where it was supposed to go or it will overshoot a little bit due to this inherent background noise. This can create some problems because, as a trader, you want a decent level of objectivity in your analysis, and when this sort of things happens, you will be confused. It's better to know in advance that this sort of thing can happen.

The answer to all of these little problems is not only to observe the levels and areas where price is likely to bounce from, but most importantly, to observe how price reacts when it gets to these areas if it gets there at all. The critical thing here is understanding that sometimes in price, too close is close enough. What I mean by this is that sometimes you will be waiting for price to reverse at an inward frequency line, but price will reverse a little before reaching the inward frequency for no apparent reason, and you will end up missing the trade if you were just relying on the inward frequency line alone.

However, if you pay attention to the past and the present of price, it's more likely that you will not miss an opportunity like this. In some ways, paying attention to the present of price is slightly more important than holding your expectations on the recent past. That's the case simply because the present is more relevant than the past. On the same token, we have to consider the present in light of the recent past. I talked a little bit about this in the price action trading volume one when I mentioned the idea of the short-term memory window of the market. Price has a short-term memory window that moves together with the arrow of time where the left border of the window is placed at the oldest relevant price action, and the right border of the window is placed at the present moment. The realization here is that the left border of this short-term memory window is constantly leaving irrelevant price action behind.

When you pay attention only to the left border of the moving window, you run the risk of grounding your analysis on price action that might be obsolete. This is why the correct attitude is to look at the present in light of the recent past while remembering that the present is slightly more relevant than the recent past. With that in mind, let's analyze a situation that happened in the British Pound versus the US dollar. In this current chart the situation seems to be very clear. We have the formation of a downward bias by the detection of lower highs and lower lows in the major flow.

We have a solid major high that gained such quality after price broke down the low that precedes the solid high in question. With the exception of the beginning of the price vector down, we have a steady pattern of lower highs and lower lows in the candlestick level as well. We can see a tiny minor flow embedded in this vector, which guarantees that it's not as smooth as it could be, but we are still talking about a smooth price vector. If we look at the beginning of the price vector, we'll notice a few important details. The very extreme of the vector is composed by a fractal bar pointing down as you'll see frequently in the market.

The very next bar opened with a large gap down, so the market corrects it by creating a bullish bar that fills that gap. That's the unusual situation at the near extreme of the price vector. So, price comes back up with some inertia after quickly filling that gap, but of course is not enough to counteract the sellers that created the fractal bar down in the first place. Notice that we have the regular inward frequency breakout at the vector extreme, and we have a second frequency breakout after the gap, which is slightly lower than the first one.

The thing here is that if you were not analyzing the market extreme at this level of detail, you would miss the peculiarity. We can extrapolate this frame of analysis to any market extreme, and all of them will have peculiarities of their own. That's why it's so important to understand how to read the story behind price action. If you don't understand the narrative behind it, the price bars are nothing but meaningless noise moving in chaotic motion.

In this picture we can also see that the current price vector is reaching two different levels. A simply support line and an outward frequency line. We can clearly see that price is also creating a hybrid bar with the fractal and buying pressure qualities. Take a moment to realize that a lot of the times, events that appear to be small and insignificant like this one can produce increasingly larger events. This is analogous to the butterfly effect idea in chaos theory where slight variations in the initial position of a system will produce dramatically large and different events later on.

The bottom line here is that even a small candle like this one can spark a reversal and it's a good idea to not underestimate this fact. However, the other side of that is the outside of the correct context, small events are just small and insignificant.

IMAGE 2

In this second image we can see that price ignores the two lines and only reversed further down the road. Notice that just by talking about the possibility of a butterfly effect, you probably were already waiting for this next slide to be a confirmation of the idea, but as you can see, the idea can certainly be frustrated. This is an important lesson on how easily our biases can be influenced by whatever is holding our attention in the current moment.

We can see that price developed an upward price vector and that this upward vector touched the second inward frequency line that was identified after the peculiar situation with the gap after the formation of the solid major high. Observe that it fails to touch the standard frequency line, and we can certainly develop a rationale for that. One reasonable explanation for this is that sellers only really took control of the market at the second frequency line because buyers still had some fuel left in the tank to produce the filling of that gap. For practical purposes, the market memory recognizes the second event as the more relevant because we don't care about all the other times sellers might have taken control. We only care about the very last one that is still fresh.

You may look at this and think that I might be getting ahead of myself since price can still continue to go up and reverse at the first frequency line, and you could certainly be correct about that. In fact, if you have enough experience, you probably have seen both situations happen multiple times. The reality here for us is that it doesn't matter because if we wanted to produce a short trade in one of the frequency lines, the stop would be above the major solid market extreme.

However, I'm talking about a reversal from here for a few different reasons that have to do with the present moment of price in light of its past, not only its past. Notice how there is selling pressure at the bar that pierces the second frequency line, and how the very next bar creates a dynamic frequency breakout to the downside. All of this means sellers are assuming control here, and if you keep waiting for price to go to the first frequency line, you might wait in vain. Let's see what happens next.

IMAGE 3

In this chart we can see that price starts to go down from the second frequency line and it never comes back to test the first one. Once again, if you were looking just at the recent past, you would miss the opportunity to go short. A professional price analysis is like driving. If you only look at the rearview mirror, it's very likely that you are going to crash at some point. However, if you look forward and use the rearview mirror to guide you in specific times, it’s very likely that you will complete the journey. Once again, the present in light of the recent past.

There is also a very interesting situation regarding the counterpoint between buyers and sellers at this exact moment. Observe how price is now in a demand zone. This demand zone represents the buyers who attempted to break the last major high and failed. The situation here is pretty clear. Sellers are stronger than buyers, and yet, some traders will attempt to go long here just because they are seeing a demand zone. What these traders fail to understand is that they are going to go long directly into the mouth of hungry sellers, and that’s obviously going to fail.

As I often say to many people, you should always pay attention to both sides of the market because while you might be focusing entirely on the obvious thing, the market is giving you a quiet opportunity to the correct side. This is exactly what’s happening here. While most people will pay attention to the long trade out of the demand zone, the traders who are really paying attention will understand that this is an opportunity to go short at the inward frequency line that has just been formed in a minor flow. This is the sellers giving you a second opportunity to enter the trade you may have missed before.

This is a situation where minor sellers will win over major buyers simply because they have major sellers, who are stronger than major buyers in this case to back them up. You can see that this can be a tricky game, but in this case the situation is textbook. Let’s see what price does next.

IMAGE 4

Look how price tests the inward frequency and starts to go down from there while the long traders try to wrap their heads around what’s happening. A simple line extrapolation catches the low with a good degree of accuracy and creates an overshoot. We also have a new inward frequency line a little bit lower in this minor flow going to the downside. We also just created a major solid high and a major inward frequency along with it. The big question here is where price will reverse next. At the lowest frequency line or at the major one that is higher? As we saw in another example, this is one of the problems of financial speculation. We have to pay close attention to the clues and make educated decisions.

When we trade, we want solid rules what of to do for obvious reasons, but we cannot always get that unfortunately. That’s part of the game of trading and there is no other way around it. Of course, you can fabricate such rules and convince yourself they will work, but for the most part you will be fooling yourself by doing that. What I’m trying to get to by saying all of this is that sometimes the opportunity that doesn’t look so good ends up being the one that turns out to be amazing. In the situation we have here, we can look for the inward frequency in the minor flow, and we can look at the inward frequency in the major low.

The thing is that if price has enough barriers to nudge it in any of those points, a minor flow inward frequency might be enough to produce a good trade. We also need to assess the buying power of this market, but in this case is difficult to do that because we don’t have much information about the buyers in here. Notice that I drew a non-equidistant line extrapolation using the angle of the simple line extrapolation. The line was grounded on the minor high out of which the lowest inward frequency line comes. Observe how it seem suggestive that this non-equidistant extrapolation line crosses the minor inward frequency line in the near future of price. Let’s see what price does next.

IMAGE 5

In this image we can see that price hit the area where the two lines intersect and created another bump down, but now we have more information about the buyers of this market just by observing the shape of the last bar. Observe how it pierces the last minor low and simply refuses to close below it. Observe also how the simple line extrapolation that was drawn a while ago catches the lower extreme of the bar. Your attention should be focused on the extreme shape of this last bar because it represents new information about the buyers of this market.

Observe that it is a hybrid bar with the fractal and pressure qualities. The buying pressure on the lower wick is incredibly large and disproportional to the rest of the market. The interpretation there is simple. Once the market went lower than the last low, buyers simply refused to let the market continue to go down because sellers were getting too comfortable with the trend down. The lower wick on that bar is like buyers saying that was enough. Observe that the lower tail alone is larger than most bars on the chart. That means you should be careful trusting the last inward frequency line to the downside again because now sellers have some strong competition. This is also doesn't mean you should start buying right now. You should only observe what the market does near it edges.

As you can tell by these examples where we go a little deeper into the relationship between buyers and sellers that even though we are dealing with simple highs and lows, this is far from being an easy game to master. It's a simple game, but it is a difficult one. The reason for this is that we deal with simple highs and lows but in different degrees, and we have to decide which structure is going to win over the other based on our reading of the market, which is not an easy thing to accomplish.

Along side the identification of the narrative contained behind the price bars, the counterpoint between buyers and sellers of varying magnitudes is of paramount importance for any trader. I would argue that without being aware of these things, it's virtually impossible to become a good trader. That's the precise opposite of just trying to follow signals or setups in a price chart. Signals are supposed to give you a condensed view of whatever is going on and free you from the job and responsibility of actually analyzing the market. Needless to say, that doesn't work for very long, and with good reason because when a trader tries to oversimplify things, a lot of information is lost along the way, and that's obviously not a good thing since information is the only thing we have to make good decisions.

Often times when traders are learning how to analyze price charts, they will come to the conclusion that this is unrealistically complicated, and that there is no way a person can do this on a daily basis without being overwhelmed or burned out. The reality is that anything that is great takes time to master for a very simple reason. You have to get used to the complexity, and not try to avoid it. Imagine a person studying to be a neurosurgeon. It's an incredibly risky and complicated job with loads of liabilities. A neurosurgeon cannot simply give up and try to oversimplify the job at hand for obvious reasons. Imagine that you needed brain surgery. You would not want the lazy doctor for sure.

Trading is like that, but people desperately want to believe it's simple because they want an easy way out. The difference between being a neurosurgeon and a trader is that neurosurgeons get into that profession already knowing it's a brutally difficult enterprise. Traders on the other hand get into the profession thinking they are outsmarting everybody and that everything is going to be easy once they find the trick. This kind of attitude is counterproductive and it's very wasteful in terms of time and effort. Ironically, when you try to avoid work, you end up having to work more that you would have to if you faced the challenge in the first place.

I often say that things like trading need to get complicated before they get simple. If you are too overwhelmed by the amount of details in the analysis, it's just because you're not used to it yet, but eventually these things you become second nature to you. It’s a matter of practice and constant exposure. This is why I spent a considerable amount of time in the beginning of the price action course volume 1 trying to explain how people actually learn how to read price. I did that because I knew people would get the course and jump straight to the techniques and ignore everything else, but it’s important to understand that everything in there has its importance. Techniques are great of course, but they’re just the tip of the iceberg.