



INTRODUCTION TO PRICE ACTION TRADING

Learning to Trade Forex from Price Charts

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What is Price Action Trading?

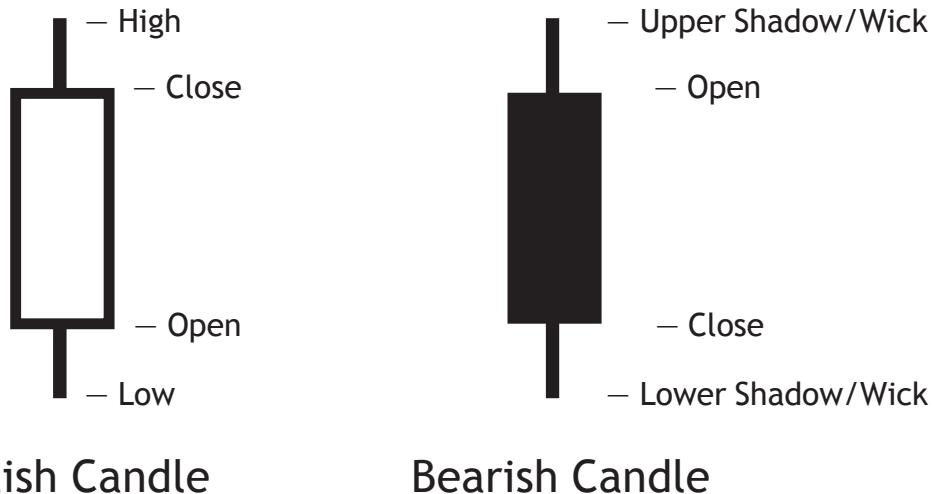
The “Price Action” method of trading refers to the practice of buying and selling securities based on the fluctuations, or “action,” of their prices; typically the data of these price changes is represented in easily-readable candlestick or bar charts, which are the bread and butter of the price action trader. Traditionally, price action traders rely on a “naked” chart - they reject the inclusion of indicators with the conviction that, since all supplemental indicators are necessarily lagging interpretations of the basic data available on the price chart, the action of price is itself the most reliable and accurate indicator. The patterns of price movements reveal in real time the balance between the supply for sale and the buying demand of any given security or currency pair. Any price change implies a shift in the relationship between buyers and sellers; an increase in supply will push price down, whereas an increase in buying demand will send price higher.

The price action trader bases their trades on predictions of whether buying demand is greater than the supply of sellers - and therefore price is poised to head higher - or vice versa. In the Forex market, this means that a trader will endeavor to buy (or “go long on”) a currency pair when the base currency, the one quoted first, is likely to appreciate against the counter currency, the one listed second; conversely, they will sell (or “go short on”) a currency pair wherein they expect the counter currency to appreciate relative to the base currency. In order to make these predictions, price action traders interpret the confluence of many factors, particularly trends, candlestick patterns, and price levels known as “support and resistance.” This guide is intended to provide an introduction to these interpretive factors, to the risk management practices essential to profitable trading, and lastly, some examples of real trades that demonstrate these ideas in action.

As such, we’ll start with a review of candlesticks and how they are plotted on charts, as this information is the fundamental building block of the science of price action trading.



The chart at left is a typical “naked” price chart - it contains no information other than the movements of price. As indicated in the top left corner, this is a daily chart of the USDCHF currency pair. Charts can be made on any time scale; on a daily chart, each candlestick - the black and white bars placed on the grid - corresponds to price’s behavior in the span of one day. Likewise, on a 5-minute chart, each candlestick represents 5 minutes of price change.



The Candlestick

Whatever the time scale, each period corresponds to one “candle.” The candlestick contains four important price levels: the open, close, high, and low. The thick body of the candle indicates the range between the period’s opening price and closing price. On a bullish candle (indicating a price increase over the time period), the open is indicated by the bottom of the body, the close by the top - the opposite is true for a bearish candle (indicating a price decrease). The wicks or shadows indicate the range of price’s movements during the period. Whenever prices are reached beyond the range bounded by the open and the close, wicks will be visible to indicate the extent of these highs and lows.

Trendlines

The most general way of describing the behavior of price over time is the “trend.” A trend is simply the primary direction of price movement in the pertinent window of time. In the daily GBPUSD chart below, price has an obvious uptrend in the 5 month span of the chart. However, this general uptrend contains a number of “legs,” smaller-scale price trends that necessarily alternate between uptrends and downtrends - bullish and bearish legs, respectively. When price remains closely within a diagonal range bounded by two parallel lines, this small price range is often delimited with “trend channels,” indicating the upper and lower boundaries of the trend. When price moves within a horizontal range without moving in a clear directional trend, the price’s action is said to be in the “trading range.”



There are a few basic rules to bear in mind when drawing trendlines:

1. **Tentative trendline** - A diagonal line the market bounces off of twice. This trendline is indicative of a potential trend, but is not confirmed and actionable just yet.
2. **Confirmed trendline** - The market has bounced off this trendline three times. Conventional analysis regards this as a sign that the trendline is real, and that the market will react around it.



It is easiest to trade from a trend when its highs or lows hew closely to a recognizable diagonal line, since this line may be used to predict future highs or lows. Opinions vary on whether trendlines should be drawn from the highs and lows of candles or from the body of the candle, the open and close prices; successful traders can be found employing either approach.



Support and Resistance

The price action trader pays particular attention to pivotal price levels, often “drawing” these lines horizontally as Support and Resistance levels. The theory behind employing these lines is that the market has a sort of memory: price behaves with respect to certain levels that have previously been significant turning points in the historical narrative of the price’s action, and other market participants are likely

to also be trading with consideration for these levels. When the levels are below the current price, they constitute “Support,” a potential buffer against bearish movement; when the levels are above the current price, they appear as “Resistance,” a potential barrier to bullish movement. As price comes close to these levels, traders often wait until the levels have been tested and either broken or defended before they are confident enough in the direction of price’s movement to enter into a trade.



The chart above is an expanded version of the previous daily GBPUSD chart with Support and Resistance levels drawn in red. As price moves through one of these levels, they convert into the opposite role - when pierced by an uptrend, a Resistance level becomes a Support level, indicating a significant level at which buyers successfully drove price up beyond a level previously guarded by sellers. Although “swing” traders trade longer-term fluctuations in price, much of Forex price action trading is concerned with

riding internal legs within larger general trends to achieve smaller-scale, more reliable profits.

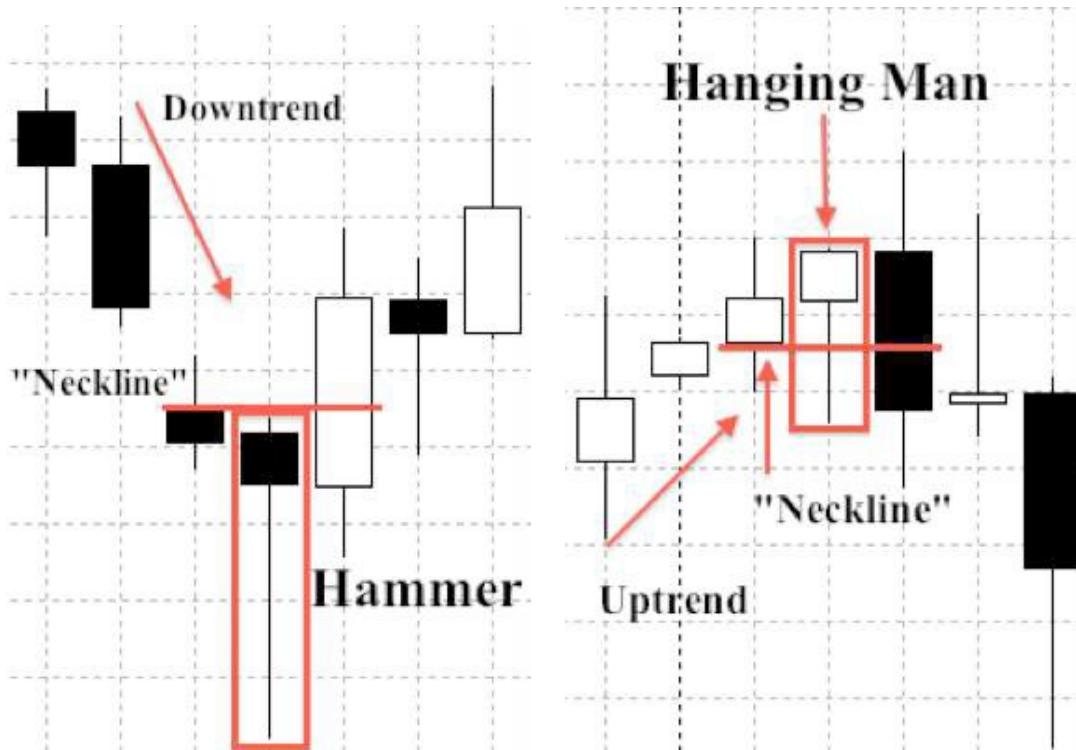
In general, price action traders buy at Support and sell at Resistance, relying on these previously-tested levels to make safer bets on the future behavior of price. The most significant Support and Resistance levels are those closest to the current price level, as they are the most likely to be taken into consideration in the immediate developments of price movement - for this reason, some traders will only draw in the nearest reliable level of Support and Resistance to simplify their charts.

Key Candlestick Patterns: The Timeliest Indicator

Since candlesticks are the basic visual unit of the price action chart, recognizing their implications within the greater narrative of price is crucial to the price action trader's ability to enter and exit positions at the most advantageous times. The relationships between the four price levels that make up each candle - open, close, low, and high - have strong implications about the future direction of price. Candlestick patterns can often be the most timely indicator of the balance between buying and selling demand.

Long Wick Patterns

Long wicks indicate areas where price can be pushed quickly in a short amount of time and potential reversals in the direction of price. We can deduce from a long wick that price made a big move after the open, but it was pushed back before the candle closed; for example, a long wick underneath a candle implies that sellers were able to push price down considerably, but the pressure from buyers pushed price back up before the close of the time period. If this power struggle between bears and bulls is conclusive, it may anticipate or initiate a reversal in the direction of price by the triumphant side; reversals can be the most desirable times to enter or exit trades. If a long wick can also be found intersecting a major support or resistance level, it may confirm that traders are ready to defend/challenge that level.

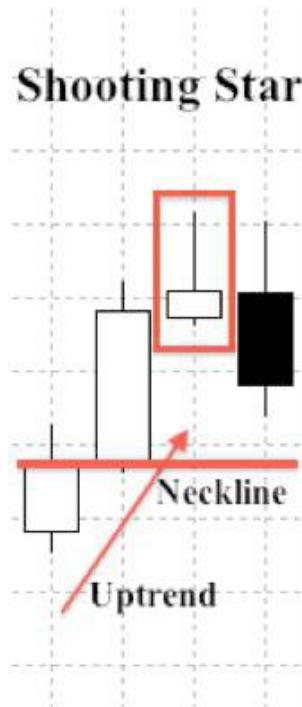


Hammer/Hanging Man

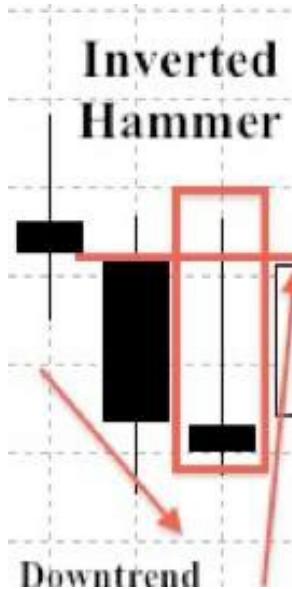
A “hammer” is a candlestick with a small body (a small range from open to close), a long wick protruding below the body, and little to no wick above. Occurring at the bottom of a downtrend, it’s long wick implies an unsuccessful effort by bears to push price down; since the bullish movement back up before the close represents a loss of dominance by the bears, this candlestick suggests the possibility of a bullish reversal. The “neckline,” often determined by the high of the previous bar, is the level that price must hit on the next candlestick in order to confirm the hammer’s reversal signal.

The “hanging man” has the same characteristics as the hammer, except it occurs at the peak of a trend rather than the bottom. In this case, the wick implies the appearance of selling pressure that contradicts the current trend, and warns of a possible reversal of the uptrend.

Shooting Star



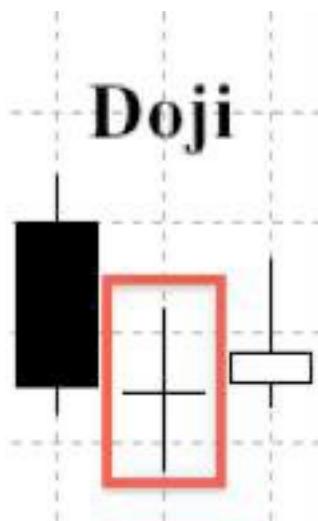
Inverted Hammer



Shooting Star/Inverted Hammer

This pair of candlesticks are the inversions of the previous two; both have a small body and a long wick protruding above it, with little to no wick below. The “shooting star” occurs at the height of an uptrend; its long wick implies that resistance to further bullish movement has been encountered above the close, and a bearish reversal may be imminent. In this case, a strong black candle or a price at the level of the previous bar’s open can act as confirmation or an entry point. Often, shooting stars are further characterized by a gap between the previous bar’s close and the relatively higher open of the shooting star.

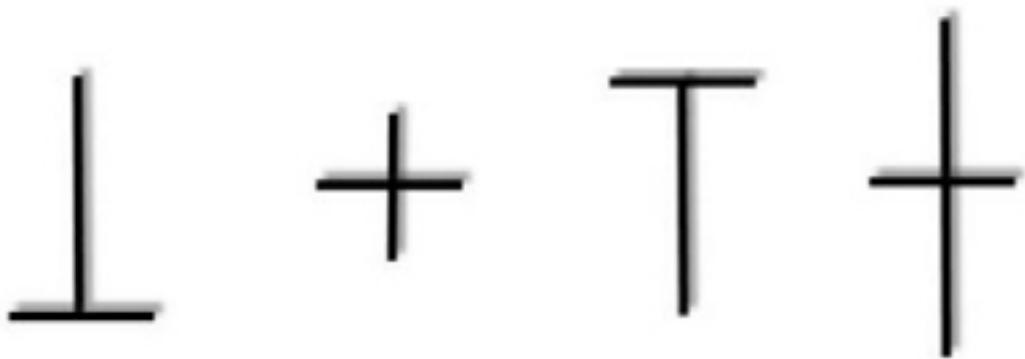
The “inverted hammer” occurs at the bottom of a downtrend, where it implies an encounter with bullish support; the appearance of this bullish force in a bearish leg implies the possibility of a bullish reversal.



Doji

This candle has zero or almost zero range between its open and close. Rather than implying potential reversal or the clear dominance of either bears or bulls, these candles suggest indecision or balance between the two forces. Neither buyers nor sellers are fully in control. A doji that occurs in the context of a strong trend implies the weakening of the dominant force that resulted in that trend.

A “long-legged doji” has long wicks in both directions, implying strong, balanced pressure from both buyers and sellers.



Gravestone

Traditional

Dragonfly

Long-legged

The “dragonfly” and “gravestone” doji imply, respectively, that sellers and buyers controlled the market for most of the trading period, but then the opposite group managed to push price back to the open before the close. They constitute a warning of the potential influence of the market participants that have pushed the wick so far from the candle’s body.

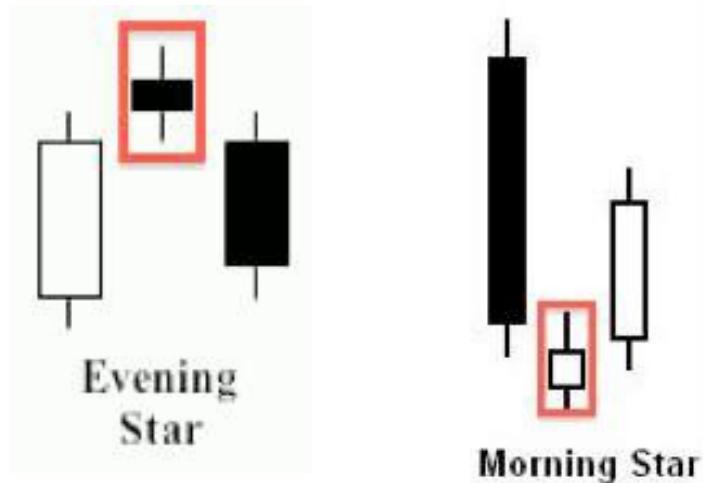
3-Candle Reversal Patterns

Rather than anticipating a reversal, the following candlestick patterns imply that a reversal has begun; in each case, a small “star” candle marks the turning point in a trend where the market pressures that have driven a trend peter out, forming an ostensible top or bottom.

Morning Star

This bullish reversal pattern plays out over the space of three candles:

1. A long black (bearish) candle
2. A small-bodied candle or doji that closes below the first candle
3. A white (bullish) candle that opens above the previous candle and closes near the center of the first candle.



Evening Star

This bearish reversal pattern also plays out over the space of three candles:

1. A long white candle
2. A small-bodied candle or doji that closes above the first candle
3. A black candle that opens above the previous candle and closes near the center of the first candle.

Checkmate Patterns

Checkmates occur when price becomes locked in a narrow trading range preceding a reversal in direction. In a typical bearish checkmate, an uptrend meets a resistance level that is tested and then rejected due to consequent pressure from holding the level. In these cases, the checkmate begins as the first candle in the range reaches a high point that the market is unable to break. Price remains deadlocked in a tight trading range before the range is broken with a long bearish candlestick, indicating that the reversal has begun. In a bullish checkmate, the opposite occurs, typically at a support rather than resistance level.

Examples of bullish and bearish checkmates can be found below.



Risk Management in Price Action Trading

Risk management in price action trading is much like risk management in any other style of trading; the same basic rules apply:

1. Know your maximum risk tolerance, i.e. the loss you are willing to take on each trade, before you place the trade. A common rule is that traders will not put more than 2% of their funds in the market at a time.
2. Understand correlation between assets, and to what extent you would like to be diversified.
3. Know when you will exit before you enter.
4. Know your reward/risk ratio.
5. Identify what you expect to happen and why, and what price point negates that expectation.

This is the price point at which you should put your stop.

Of course, with risk management, techniques are important, but, ultimately, it is up to the trader to ensure they are psychologically prepared for all that is involved. Even if a trader is using a fully automated system, he/she must still have confidence in the system, and must know when any losing streak experienced is just a temporary losing streak versus a more fundamental problem suggesting the system is no longer valid.

In terms of actual techniques, there are a few concepts traders can bear in mind:

1. Enter at support/resistance levels, or levels that suggest turning points in the market
2. Put your stop loss between such levels, or at points where there is no real signs of a force that will cause a change of direction in the market.

Basically, traders want to enter at turning points. Levels between turning points, “empty zones,” of sorts, are where stops can be put as they are where ideas are often disproved. For example, if you entered a trade at a support level expecting price to rally, you could place your stop at a level sufficiently below the support level you entered at, provided it was not a support level as well.

In this case, if the stop was hit, it would suggest your initial thesis behind the trade was not valid.

In the Trade Examples section of this trading guide, traders can find examples of placing stop loss levels between support/resistance zones.

Confluence

Trading is a science rooted in probabilities - not certainties. In other words, the theories of price action trading, like the theories of all other aspects of trading, are not meant to be seen as guaranteed forecasts of what is to occur; rather, they are meant to signal what is likely to occur. One can increase the odds of the forecasted situation of occurring if numerous signs are saying the same thing.

For instance, if we see price rally to a resistance point, and we also see a long wick pattern and a bearish checkmate forming at this resistance level, we now have multiple signs suggesting the uptrend is exhausted and price is ready to decline. The more signs we can find that confirm this viewpoint, the more valid the concept is - and thus, the more justified we may be in placing a trade based on this viewpoint.

Trade Examples

This section provides two examples of real Forex trades that exemplify price action strategies.

The order below was made on March 13, 2014, and was filled the next day; the stop buy is set at the black line, 1.21426 (meaning the order will be filled when the value of a Swiss franc is valued at that amount of Euros), the stop loss is the red line, set at 1.20890, and the take profit is set at the green line, 1.23989. The day's candlestick is an inverted hammer, implying the possibility of a bullish reversal; the signal now requires a strong bullish bar to confirm the reversal, so the entry level is set at the neckline of the preceding bar's open, which is hit the next day. Yet, there is crucial confluence occurring to reinforce the candlesticks: the 1.21 level has figured in an important resistance level in early 2013 beyond the scope of the chart, which, after being broken in February, was converted to a key support level in March and May. The bearish trend of 2014 has brought price back to this level, which is likely to be considered as a relevant support level by traders at the time of the order.

Lastly, the stop loss is set carefully between the two support levels at 1.21 and 1.206, where the formation of an important pivot point or reversal is unlikely.

Example #1



In the chart below of the GBPUSD currency pair, we see that price pulls back to a previously established support level, where it forms three consecutive hammer candlesticks. This suggests the possibility that selling supply may be temporarily exhausted, while buying demand is gathering strength. We can place our stop loss level between the

support level that the hammers are forming around - and a potential entry point - and a support level beneath it. We can set our target profit at the previously established high. As the chart illustrates, this trade would have worked well for traders who placed it.

