

Lesson 2: Market Structure

The foundation of reading price action is going to be able to understand the market structure.

This lesson and the following ones will be **VIGOROUS** on the details until you understand what constitutes a bullish market structure, a bearish market structure, and the ugly chop, that we as traders, **want to avoid!**

Imbalances

An imbalance occurs when the appetite for price suddenly increases or decreases - this is known as **displacement**. You usually see these types of explosive moves near breakouts, reversal breakouts, or during trends. So recall from the first lesson, these moves occur during **the EXPANSION phase** of price. The more technical definition is “it is the change of state in delivery of price, and is usually coupled with order blocks (more on this later).”

When you see these types of moves, you will want to look for where they occur, when they occur, and the significance of the order blocks around them. The reason being is that the algo has created an incomplete auction of price - buyers or sellers have been left behind before their orders could be completed. Price will then do one of two things, continue with the trend, or retrace and complete the auction allowing traders to get in before price continues again with the trend.

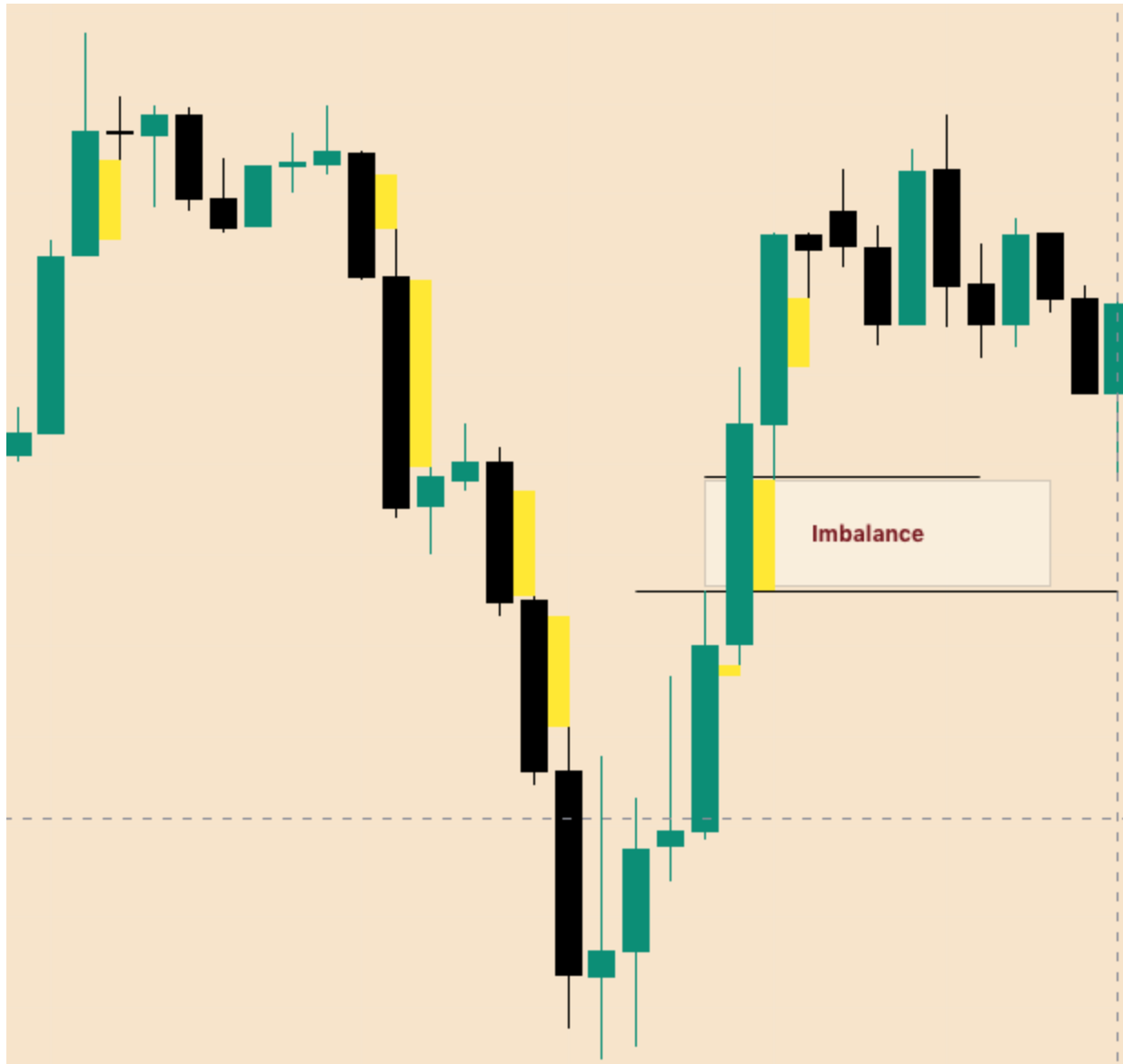
Why are these imbalances important? This is where you may want to add positions to join the trend the algos are setting. We can't get the exact bottom or top of trends, but we sure can capture a big bulk of them before they make the big move. Knowing how to recognize these imbalances and which ones to play are the next step.

Key Features

When looking for imbalances, you are looking for price action that creates a 'candle gap'

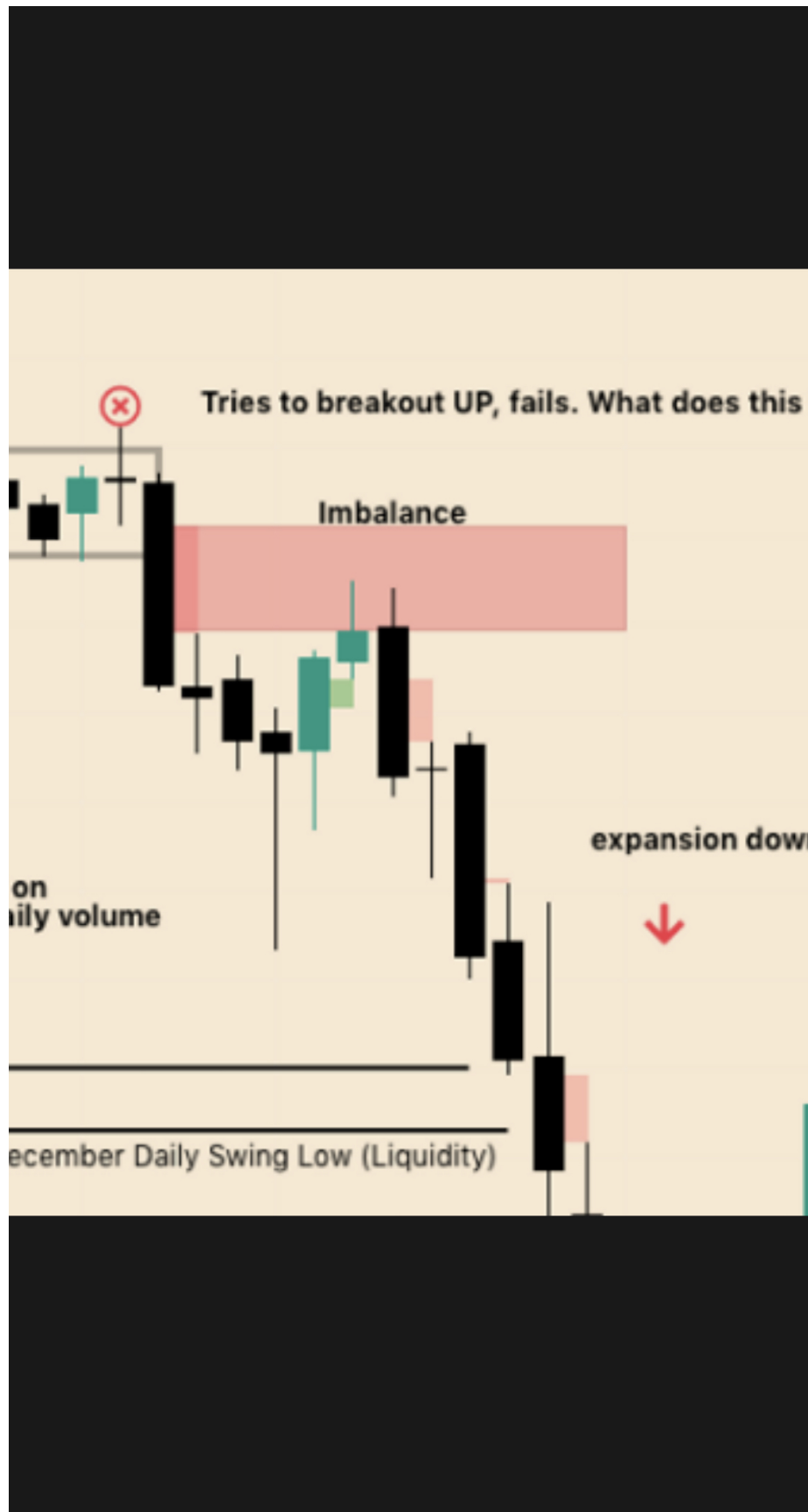
(on any timeframe). This candle gap, is created when the middle candle of a set of 3 candles, creates a gap from the high of the preceding candle to the low of the ensuing candle (bullish) OR, the low of the preceding candle and the high of the ensuing candle (bearish).

This bullish imbalance is shown below:



The two horizontal black lines define the high of the preceding candle and the low of the ensuing candle. The white box highlights the imbalance created by the middle candle. This imbalance is referred to as **displacement**.

The bearish imbalance is shown below:



The bearish imbalance is drawn by using the low of the previous candle to the high of the ensuing candle. The middle candle creates the imbalance - also referred to as displacement.

Now how do you know which imbalance is the one you should focus on for trading? This is where displacement meets market structure.

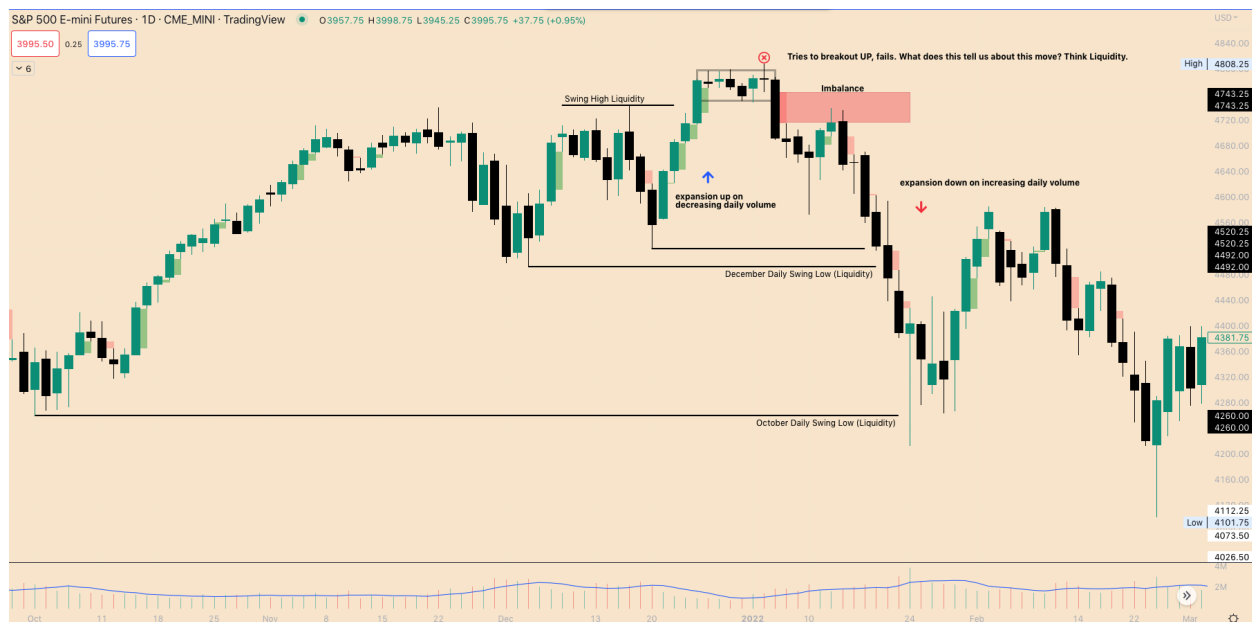
Market Structure

We have briefly covered imbalances. Let's dive deeper into how they work and what do they leave behind.

Let's use our framework of how price works. We know price likes to move from one area of consolidation to the next. It does this through expansion. Once it hits the target liquidity, it can consolidate and continue further, or consolidate and reverse. When price expands away from consolidation, an energetic move should occur and create an imbalance. These are the imbalances that we want to look for to enter the trend that is forming.

2022 January

- Mark the swing high
- Draw out the consolidation area (box)
- Mark Liquidity (Last week of December and first week of January)
- Mark the swing lows from the last 3 months
- Where does expansion occur? Does it create an imbalance (displacement)?



January 2022 - The beginning of a yearly reversal DOWN

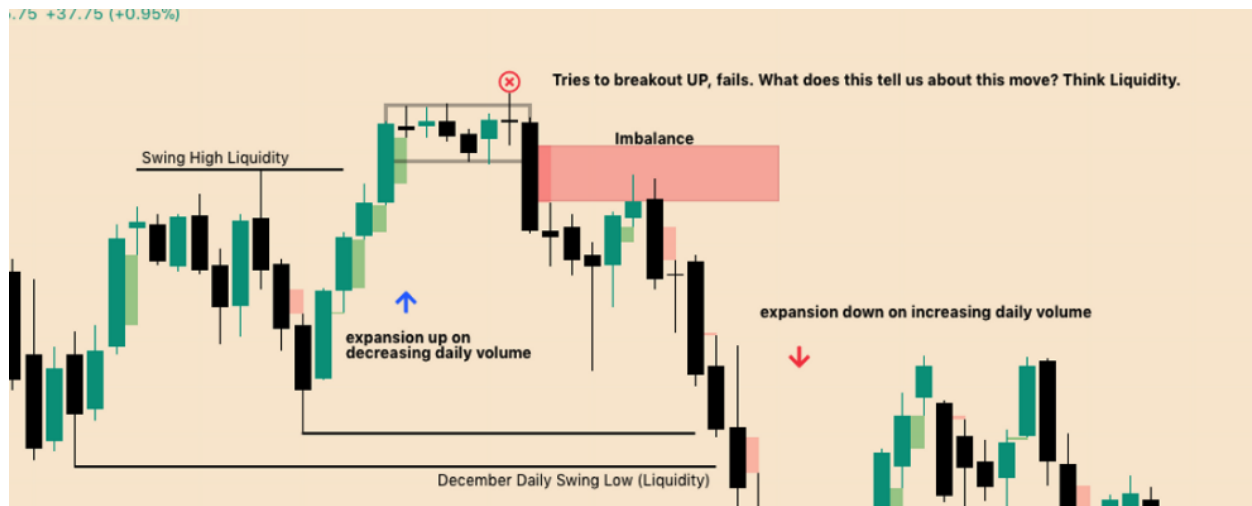
Lets start off with how price moved up to the highs from December to January.

There is a swing high liquidity on the left → this is known as **buyside liquidity** (think where are the **shorts** positioned and **where are their stops**).

We then see price move up on **LOW VOLUME** (your first red flag for VPA traders) and take out the swing high on the left. This move up is **expansion** but it takes multiple days to take out the swing high - an ideal move would be to see this move happen in 1-2 days with spikes in volume!

Price then consolidates 6-8 days. There is an attempt to continue the trend UP but it fails (red x). Price falls back into the consolidation and then the move begins...so what just happened there? The failure to break out was a move to stop out eager shorts → smart money sees this liquidity and uses the short's stops to their advantage. They then go short here for the ensuing move. **But how do we know this?**

[Consolidation → Expansion] The one down day is the equivalent of the 2 up days leading to the consolidation. This is an energetic move down (aka displacement). Now we want this displacement to form the **Imbalance** we talked about above. If an imbalance forms, then this confirms that the consolidation phase has smart money positioned short (more on this later).



What we see happen is the daily imbalance forms, and price continues to trend downwards until it hits the old area of 'support' where the expansion move up occurred earlier. You then get this daily hammer candle forming from this area. This is when and where we should be getting excited. We know there is a daily imbalance left behind, and we want to join the potential trend down. So we now look for **price to retrace back to the daily bearish imbalance.**

[Recall the imbalance is an area where there is an incomplete auction of buyers and sellers - that is, there are orders that need to be filled in that area]

Let's piece together what we have so far. We ran short stops leading into January. We consolidate, have a failed breakout up and then reverse down with displacement. Price then retraces back to the daily imbalance. This is where we look to go short. **Why? This is where market structure begins to form and take shape.**

Introducing Order Blocks

What is an order block (OB)? It is a clue that is left behind by displacement to indicate where and how smart money is positioned.

First...

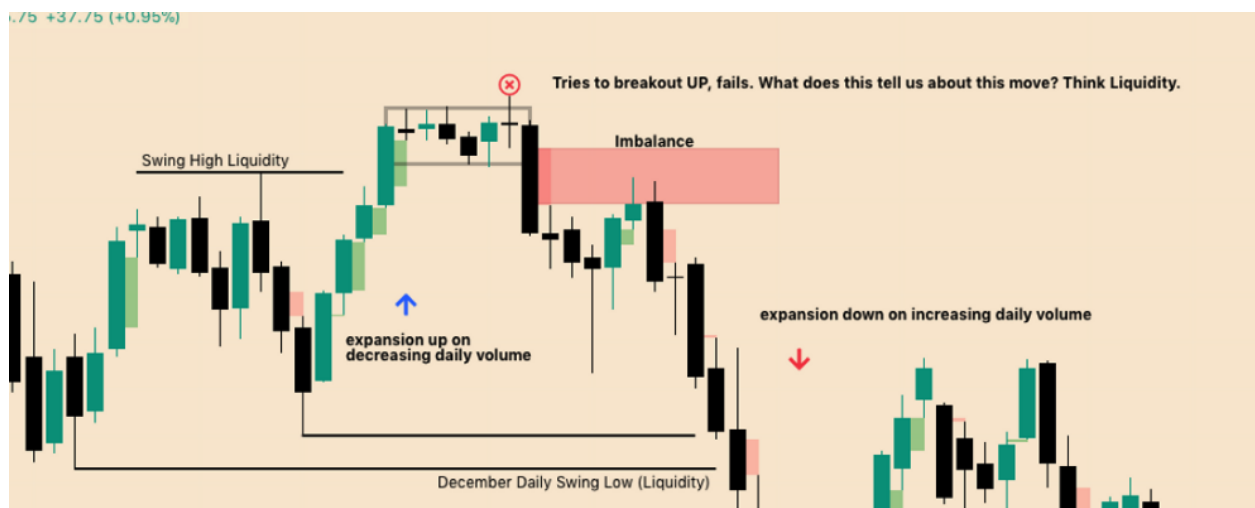
What we need to understand is how displacement gives us these hints by looking at how candles are positioned.

Up-closed Candles

These are your green candles. When combined with displacement down (on any time frame), these are known as bearish order blocks **OR** supply zones for S/D traders (resistance).

You can have a series of green candles before you see your displacement down, or you may only have one green candle before the displacement down. It doesn't matter. The point is, when you see displacement, find these green candles just before the move down. Then mark them off with a box.

Can you spot them below? (Hint: look for displacement down from the consolidation. Any up-closed candle left behind is your order block)

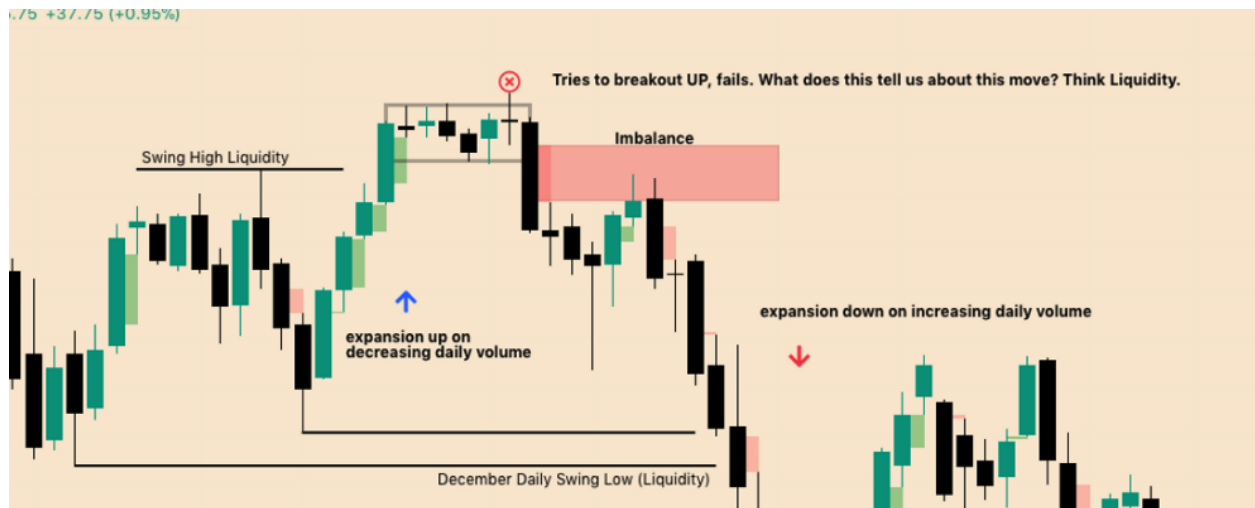


Down-closed Candles

The same concept applies for your red candles. When you see a series of them before a displacement up, mark them off with a box. This is going to be your area of “support”.

In technical terms these are your bullish order blocks (demand zone for S/D traders).

Can you spot them below? (Hint: look for displacement up on the left of the chart. Then look at the displacement down from the consolidation. Where does price form the large wick up? At our bullish order block zone)



So what do these order blocks do? They showcase where sellers are going short (green candles before displacement DOWN) and where buyers are going long (red candles before displacement UP).

So for the general purpose:

- RED candles before displacement UP are BULLISH order blocks.
- GREEN candles before displacement DOWN are BEARISH order blocks.

Want to keep it more simple? The direction of displacement tells you whether it's bullish or bearish.

[A more detailed lesson on OB's is coming later. for now, we just need to recognize a large displacement that forms an imbalance leaves behind order blocks.]

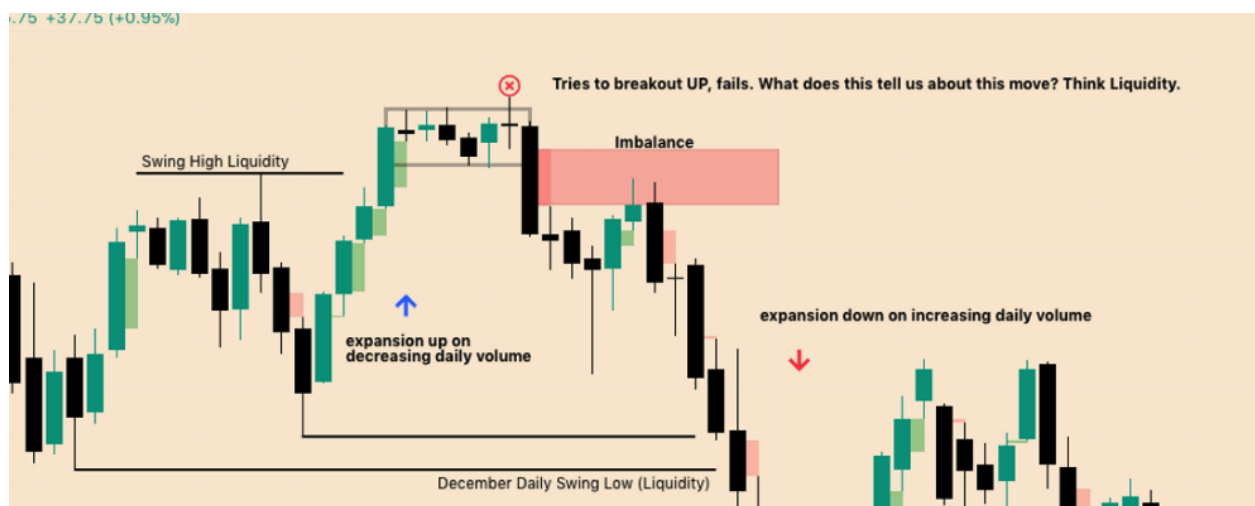
Combining it all together

Our checklist:

- Liquidity (needs to be taken first)
- Displacement (or lack of displacement)
- FIND your Order Blocks and Imbalances
- Watch for price to enter your Point of Interest
- Know your targets

You may be asking, "What is my Point of Interest?"

It's the area where you want to go long or short based on the direction of the displacement and which liquidity price is targeting next.



Let's use this picture (again) to put all of this together. Let's start at the (x) and use our checklist:

Liquidity

Price FAILS to displace up → we TAKE liquidity and return to our consolidation.

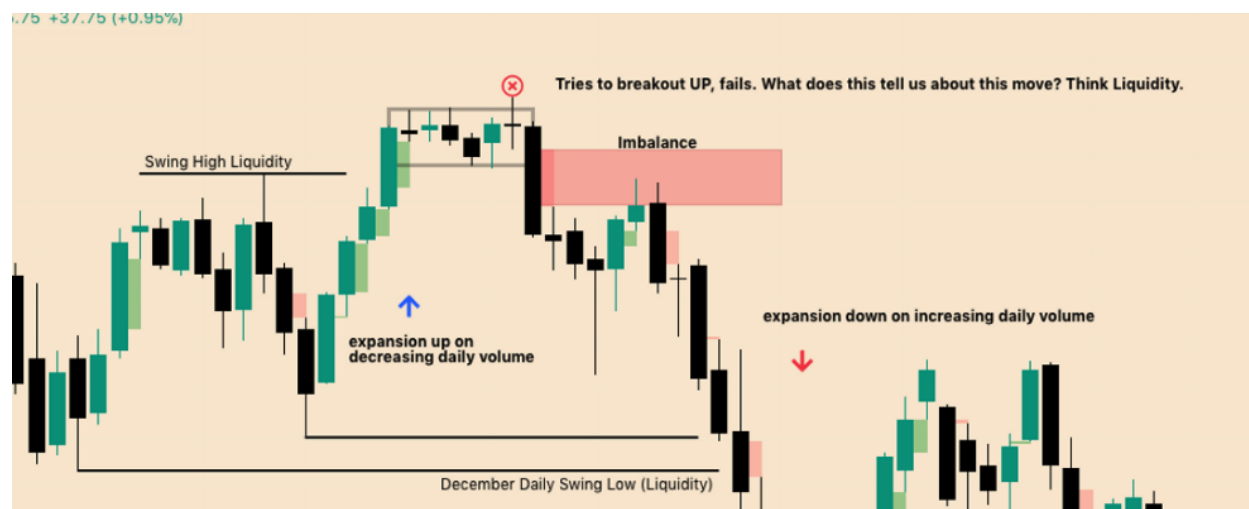
If we fail to displace up AND take buy-side liquidity, then by default, price may be seeking to take out the sell-side liquidity BELOW.

Displacement

Move is DOWN → price expands out of consolidation (it is trying to reverse here and start a downtrend). What are our target(s)?

Our target (🎯) is the swing low. Does it hit? NO. So now we watch for price to possibly return to an area where we can short and join the trend to take out our 🎯.

FIND your Order Blocks and Imbalances



The order block here will be the green up close candles we see before the displacement down (back inside the consolidation). The imbalance is shown with the RED box.

Point of Interest

We want price to return to this imbalance, enter, and then move away from it with energy. This is our PoI. Displacement down is ideal from this imbalance as it confirms our idea of the short and new trend down.

You're probably wondering "where is my stop?" Our stops go at the most recent swing high for our scenario. This happens to be just where our order block (supply zone for S/D traders) is (the red x).

Coincidence? (No!) Why? If the direction is not short, then the order blocks left behind will be taken out quickly with displacement up! But we don't get that now do we?

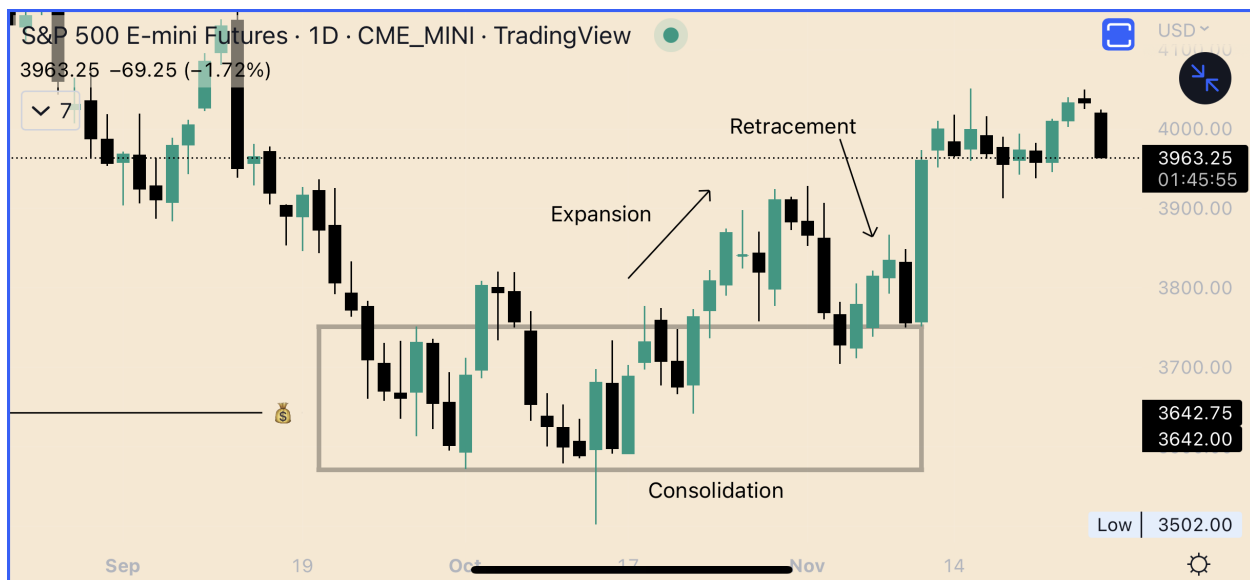
Know your targets

So if price has taken buy-side liquidity, and it now is displacing down, what could it possibly be trying to take out? The swing lows below (from the left side of the chart) which are all taken out.

Another Example (Bullish)

Our checklist:

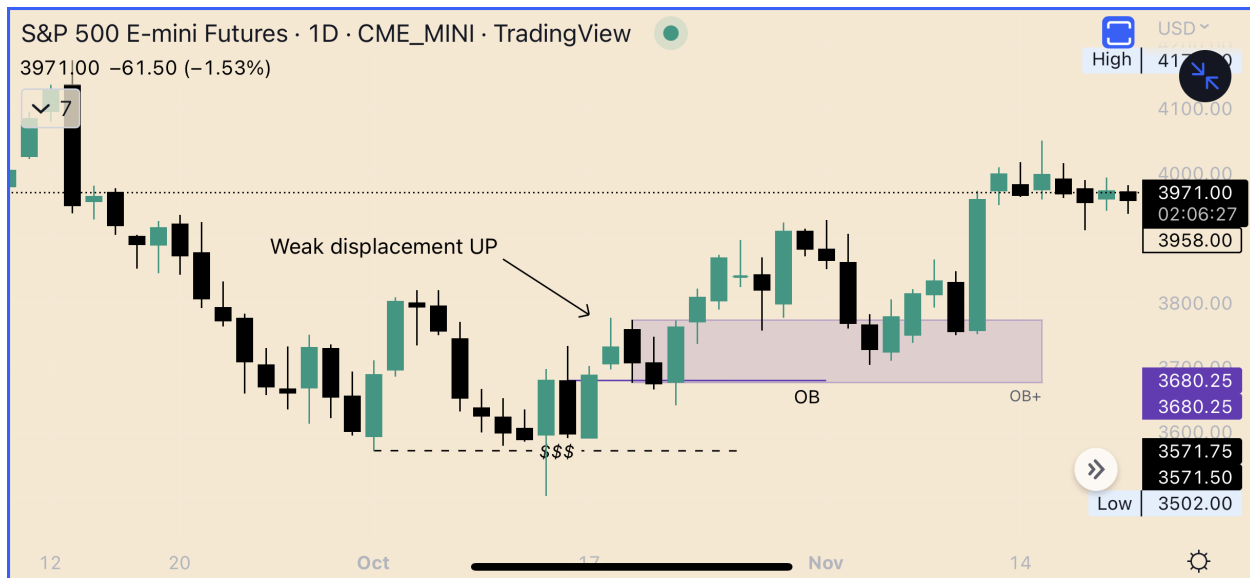
- Liquidity (needs to be taken first)
- Displacement (or lack of displacement)
- FIND your Order Blocks and Imbalances
- Watch for price to enter your Point of Interest
- Know your targets



Recall how price likes to move. It goes for a target (💰). Then it will either consolidate and continue the trend OR try to reverse. This is an example of a bullish reversal.

Liquidity

\$ES hits new yearly lows. A significant liquidity target. It then shows that it does not want to displace down from the consolidation (hint: price failing to displace in one direction is indicating it might want to go in the other direction).

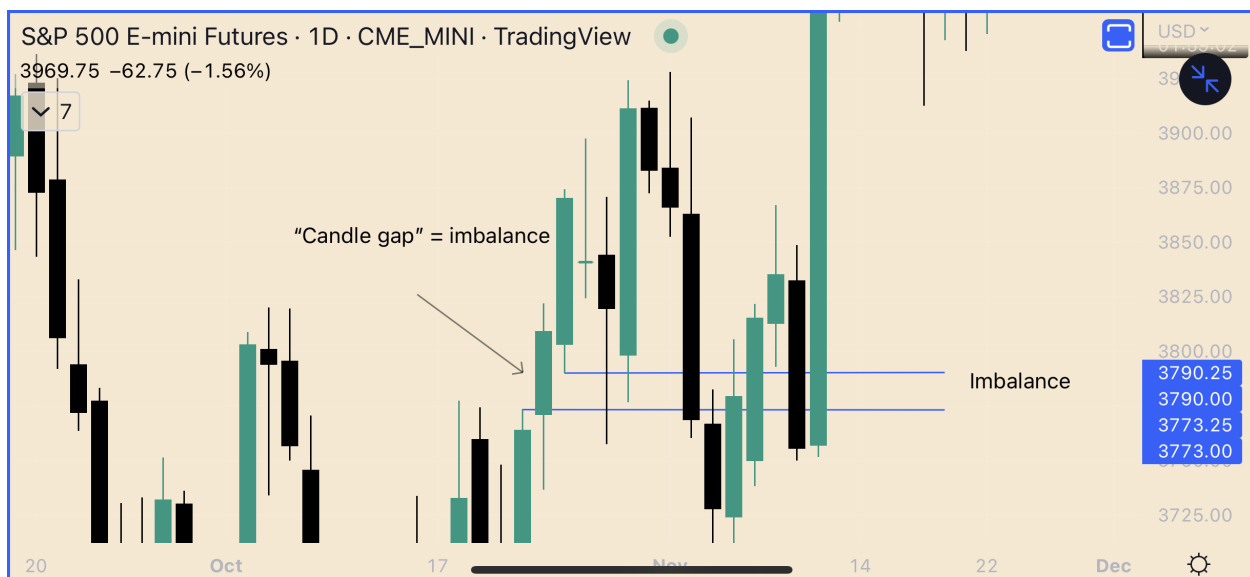
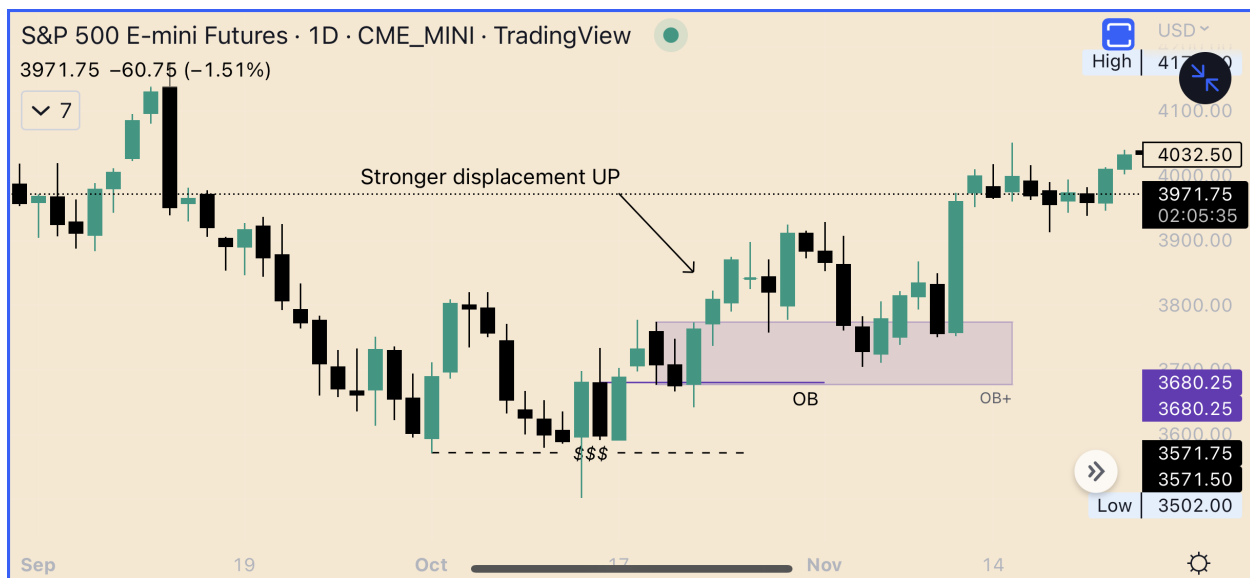


Here's what that looks like. Notice how price went below the \$\$\$ line and immediately comes back up. Then we get a weak move up shown above. This week move UP leaves behind an order block - the down closed candle before the move up (albeit not a strong one).

Why is it weak ? We're looking for energetic moves away from consolidation that leaves behind an imbalance and an order block. There is no imbalance left behind here.

Displacement

Price does find support at the order block left behind (purple line). From there, we get out energetic displacement UP! Now we look for our imbalance and order block(s)



FIND your Order Blocks and Imbalances

The stronger displacement up creates an imbalance marked above. The two down closed candles **before** the move up are our order blocks. We want to see price retrace back into our imbalance and order blocks (purple box) and then move away from this area back UP.

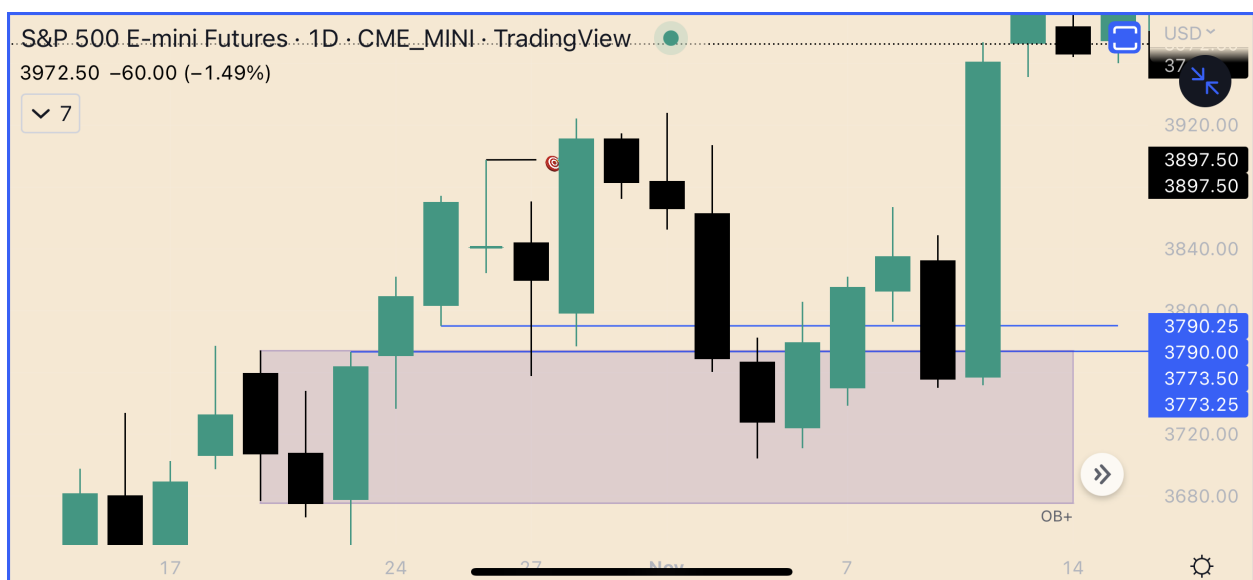
[recall our definition for imbalance]

Point of Interest (POI)

Price retraces to our imbalance and order block zone and begins to move away from it! This is our POI to add long with developing up-trend. From here, we would like price to seek recent highs and create more displacement UP to confirm our up-trend!

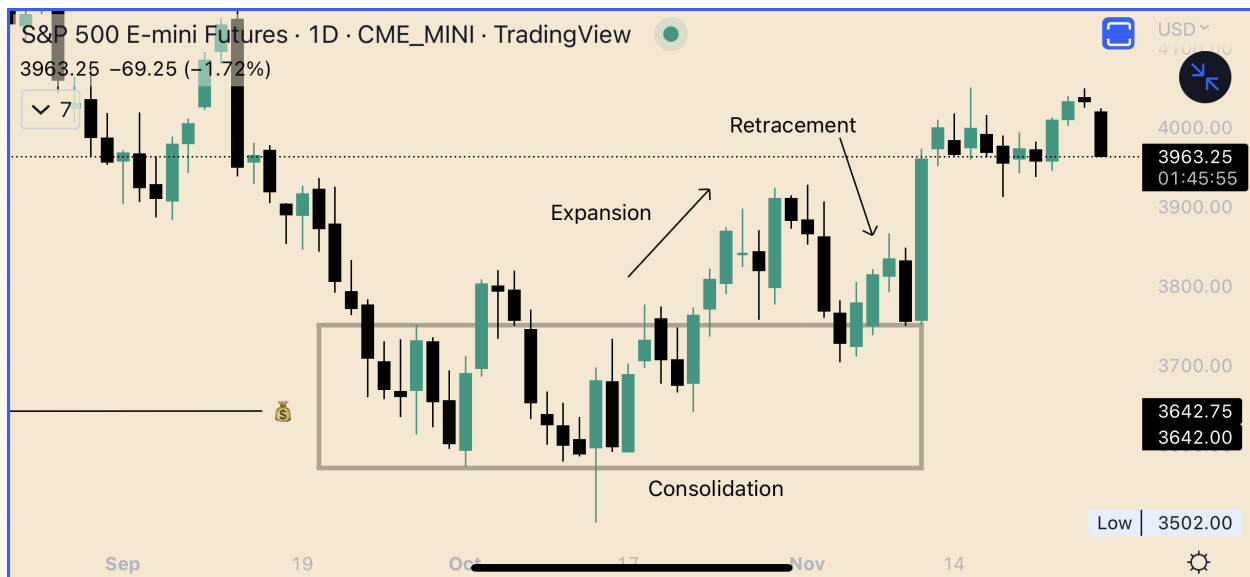
Know your targets

Our target then is our recent swing high that we just left behind. Why? If we have failed to displace lower, we are now seeking buy-side liquidity, and we want to position ourselves long with the trend!



Our stops go at the Order Block swing low (just under the purple box). We can move these up as price begins to move up and away from our adds (more on this later).

Another way of thinking about this is the failure to displace lower and take out more sell-side liquidity → price will look to take out buy-side liquidity the other way (shown below again).



So price goes → SELLSIDE liquidity target hit (💰) → consolidate → run stops to the downside (the wick on the green candle) → EXPANSION UP → RETRACEMENT → EXPANSION UP and hit our short-term and longer-term targets for BUYSIDE liquidity.

Now that we're adding structure to how price moves, we can begin to see what we are looking for long or short.

Why is market structure important?

Market structure allows us to see where smart money is positioned long or short. It allows us to join the trend with a defined R for our trades. We can visualize the potential move and have definitive targets for our trades and stop losses. Most importantly, you can avoid trading against the trend or trading in chop (consolidation phase of price) by combining liquidity with market structure!

So what comes next? We need to define when price is becoming bullish or bearish. And when to avoid trading the chop. How do we do that? You'll have to read the next lesson so don't miss out!