bar 5 (not shown) and so added nothing to a trader looking for a short. It is shown only for completeness.

Deeper Discussion of This Chart

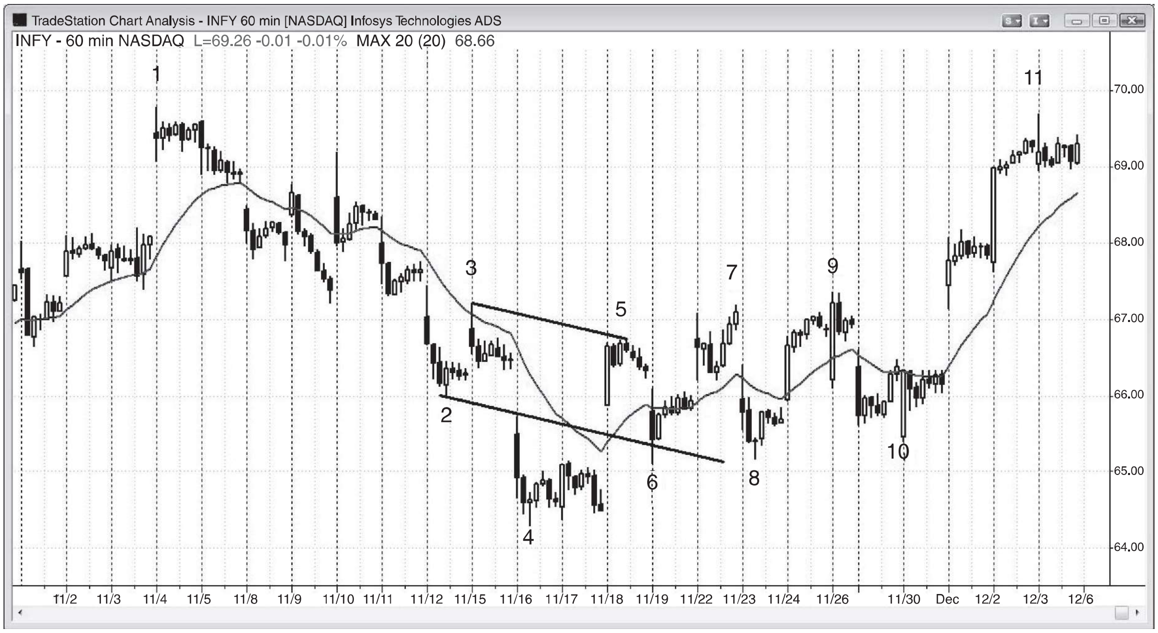
Bar 6 in Figure 13.3 was also a failed overshoot of the bars 3 and 5 trend channel line, making the bar 6 short an example of a dueling lines trade. This is where a trend channel line in a pullback or a leg of a channel intersects the channel's trend line. Here, the pullback to the trend line was in the form of a wedge bear flag created by bars 3, 5, and 6.

FIGURE 13.4 Trend Channel Line Creating a Channel

After the first couple of pushes, sometimes the trend channel line that they generate can be used to create a channel. Figure 13.4 is the daily chart of the Russian communications company Mobile Telesystems (MBT).

The push up to bar 6 was strong and there was a second strong move up to bar 8. After the wedge bottom at bar 4, the market might have been developing a trend reversal and a bull channel. Traders could have used the trend channel line from bar 6 to bar 8 to create a parallel, and then they could have dragged it to the bar 7 swing low in between them to create a channel. Traders then watched the sell-off from bar 8 to see if it was followed by a reversal up at the bottom of the channel. The bar 9 bull reversal bar was the buy setup.

Similarly, bar 10 was in the area of the bar 1 high, so traders were aware of a possible double top. The market gapped down on bar 11 and had a second leg down to the bar 12 low. Traders could have drawn a trend channel line across their lows and then they could have dragged it to the high in between them, which happened to be the top of bar 11. They would then wait for a rally off the bar 12 low to see if it found resistance at the top of this potential new bear channel. When they saw the strong bear reversal bar at bar 13, they could have shorted, expecting that the market might have been in the process of channeling down.



Created with TradeStation

FIGURE 13.5 Head and Shoulders Using Trend Channel Line

As shown in Figure 13.5, when a possible head and shoulders pattern is setting up (the area around bar 4 is the head), a trend channel line drawn across the neckline (bars 3 and 5) and dragged to the left shoulder (bar 2) sometimes gives an approximation of where the right shoulder might form (bar 6). When the market falls to that level, traders will begin to look for buy setups, like the strong bull inside bar that followed the bar 6 sell climax. This is of minor importance since the most recent bars are always much more important in deciding where to enter. This is the 60 minute chart of Infosys Technologies (INFY), one of the leading software companies in India.

FIGURE 13.6 Trend Channel Line Creating a Channel

In Figure 13.6, the dotted trend channel line that runs from the bar 3 low to just below the bar 5 low was created as a parallel of the dotted bear trend line drawn across the highs of bars 1 and 4. Although neither bar 5 nor bar 6 touched it, they were close enough and many bulls would have been satisfied that the bottom of the channel was adequately tested and therefore the market could be bought. However, many traders prefer to see a penetration of the channel before looking for a reversal up that should penetrate the top of the channel as a minimum target.

When a trend channel line is so steep that it is tested but not broken, it is wise to look for other possible ways to draw the line. Maybe the market is seeing something that you have not yet seen. Since the bear trend began in earnest with the bar 2 large bear trend bar, it is reasonable to consider that as a starting point for a trend line. If you draw a trend line from bars 1 to 4 and then create a parallel and drag it to the bar 3 low, you would discover that bar 6 was the second reversal up from an overshoot of the bottom of that channel (bar 5 was the first). The market, as expected, rallied and broke above the top of the channel. It then pulled back and ran even further up.

Deeper Discussion of This Chart

Today broke above yesterday's high with a gap up in Figure 13.6, and the breakout failed. The market trended down for four bars, creating a trend from the open bear trend. Bar 2 was the first pullback, and that is usually a reliable entry into the bear trend. It was a breakout to the downside and therefore a spike down and was followed by a bear channel that ended with three pushes down to bar 3. Since a spike and channel pattern is a type of climax, the reversal usually has two legs up and the rally usually tests the top of the channel where it often sets up a double top bear flag short, as it did here.

Bar 4 was another spike down, and there was an even larger bear spike eight bars later. It was followed by a bear channel, and the top of that channel was tested by a bull spike and channel that ended just after 12:00 p.m. PST. There was then a four-bar sell-off that tested near the bottom of that bull channel, setting up a double bottom bull flag, and it was followed by a strong rally that tested the bar 4 high. This was a potential double top bear flag setup going into the next day.

The average daily range was about 20 points, so once the market got down to about 20 points below the open, this gave traders another reason to look for a bounce.

FIGURE 13.7 Repeated Tests of a Trend Line

As shown in Figure 13.7, the dotted bear trend line was repeatedly tested about 15 times and eventually the bulls gave up. The trend line was a best fit line across the highs to illustrate all the tests of the resistance line. The bulls finally stopped trying. They sold out of their longs, adding to the selling pressure, and stopped looking to buy again until the market fell for many more bars. The market was therefore very one-sided and the bears were able to accelerate the trend downward. Usually when the market repeatedly tests a trend line and is unable to fall from it, it breaks above it. Other times, like here, it accelerates downward and ends in a climax around the bottom of a channel. The trend line drawn across the highs of bars 3 and 15 contained all of the highs and therefore was a reasonable choice for the top of the channel. A parallel was anchored to the bar A low, and both bars B and C broke through the bottom of the channel and reversed up. Once the reversal was confirmed by the two-bar reversal at bar C and the bar after, the first objective of the rally was a test above the top of the channel. There was a breakout on bar D, then a one-bar pause, which is a type of pullback. Instead of finding resistance and sellers at the bear trend line, the market found strong buying and had a strong bull breakout above the bear channel.

Deeper Discussion of This Chart

Today tested the moving average in Figure 13.7, and then broke out below yesterday's swing low. Traders could short below the first bar, since it was a low 2 short (it was a small two-legged pullback to the EMA) or below the fourth bar of the day. However, the second, third, and fourth bars were large and almost entirely overlapping, and this is a sign of uncertainty, one of the hallmarks of a trading range. This makes shorting below that fourth bar more likely to be followed by a breakout that would not go far before getting pulled back by the magnetic force of that tight trading range.

The market remained in a trading range for several hours and then broke down to a new low of the day. The two-sided forces continued to control the market and the market reversed up into the close, ending the day about where it began.

CHAPTER 14

Trend Channel Lines

In a bull or bear channel, the trend channel line is on the opposite side of the price action from the trend line and has the same general slope. In a bull trend, a trend line is below the lows and a trend channel line is above the highs, and both are rising up and to the right. A trend channel line is a useful tool for fading a trend that has gone too far, too fast. Look for an overshoot that reverses, especially if it is the second penetration that is reversing.

A trend channel can have roughly parallel lines, or the lines can be convergent or divergent. When they converge and the channel is rising or falling, the channel is a wedge and this often sets up a reversal trade. In general, any channel that is sloping up to the right can be thought of as a bear flag and it is likely that there will be a breakout through the bottom of the channel. The breakout can lead to a trend reversal or to a trading range that can break out to the upside or the downside. Sometimes the market will accelerate to the upside and break out of the top of the channel. When this happens, it is usually a climactic rally that leads to a reversal back into and often through the bottom of the channel, but sometimes it can be the start of another leg up in an even stronger bull trend.

Similarly, a channel that slopes down to the right can be thought of as a bull flag and the market will likely break out of the channel to the upside. This can be the start of a trend reversal or a trading range. If the market falls through the bottom of a falling channel, the breakout will usually fail within about five bars and lead to a reversal, but it can also be the start of a new, stronger bear leg.

A trend channel line can be created as a parallel of a trend line that is then dragged to the opposite side of the price action. It can also be drawn across spikes on the opposite side of the channel, or it can be drawn as a best fit line, like a linear regression line or by simply visually drawing a best fit line. In a bull trend, a trend line is drawn across two lows. If that trend line is used to create a parallel that will be used for a trend channel line, drag the parallel line to the opposite side of the trend. You want it to contain (be above) the highs of all of the bars located in between the two bars used to create the trend line, so drag it to the high of whatever bar will leave it touching that bar alone. Occasionally you will get a better sense of the trend if you anchor the line to a bar that is outside of the two bars. Always do whatever best highlights the trend.

Sometimes there will be a single spike up within an otherwise fairly tight channel, and when that is the case, it is usually best to ignore it and use the other bars for the location of the trend channel line. However, be aware of the possibility that the market might ultimately decide that the channel line should instead be across that spike up. If the market begins to have wider swings and they all are stopping at the top of the channel that uses that one spike as the anchor for the trend channel line, then you should use that wider channel.

A trend channel line can also be created on its own, rather than as a parallel of the trend line. In a bear swing, a trend line will be downward sloping and above the highs. The trend channel line will have a similar slope, but draw it between any two swing lows in the bear swing. It is most useful if it contains (is below) all of the other bars in the swing, so choose the bars that will give that result.

Trend channel line overshoots are closely related to wedges and should be viewed and traded as if they are one and the same. Most wedges have failed trend channel line breakouts as the trigger for a reversal trade, and most trend channel line overshoots and reversals are also wedge reversals, although the wedge may not be obvious or have a perfect wedge shape. The wedges are less obvious and less likely to be present when the trend channel line is constructed as a parallel of a trend line, but wedges are still often present.

When a channel has a wedge shape, it is due to urgency. For example, in a wedge top, the slope of the trend line is greater than the slope of the trend channel line. The trend line is where the with-trend traders enter and the countertrend traders exit, and the opposite happens at the trend channel line. So if the slope of the trend line is greater, that means that the bulls are buying on smaller pullbacks and the bears are exiting on smaller sell-offs. What first distinguishes a wedge from a channel where the lines are parallel is the second pullback. Once the second push up has begun to reverse down, traders can draw a trend channel line and then use it to create a parallel line. When they drag that parallel line to the bottom of the first pullback, they have created a trend line and a trend channel. That tells bulls and bears where support is, and bulls will look to buy there and bears will look to take profits there. However, if the bulls begin to buy above that level and the bears exit their shorts early, the market will turn back up before it reaches the trend line. Both are doing so because they feel a sense of urgency and are afraid that the market will not drop down to that support level. This means that both feel that the trend line needs to be steeper and that the trend up is stronger.

Once the market turns up, traders can redraw the trend line. Instead of using the parallel of the trend channel line, they now can draw a trend line using the bottoms of the first two pullbacks. They now see that it is steeper than the trend channel line above and they begin to believe that the market is forming a wedge, which they know is often a reversal pattern. Traders will draw a parallel of that new steeper trend line and drag it to the top of the second push up, in case the market is forming a steeper parallel channel instead of a wedge. Both the bulls and the bears will watch to see whether the original trend channel line will contain the rally or the new, steeper one will be reached. If the original one contains the rally and the market turns down, traders will think that although there was more urgency in the buying on the second pullback, that urgency did not continue on the third push up. The bulls took profits at the original, shallower trend channel line, which means that they exited earlier than they could have. The bulls were hoping that the market would rally to the steeper trend channel line but now are disappointed. The bears were so eager to short that they were afraid that the market would not reach the steeper, higher trend channel line so they began to short at the original line. Now it is the bears who have a sense of urgency and the bulls who are afraid. Traders will see the turn down from the wedge top and most will wait for at least two legs down before they look for the next major pattern to buy or sell.

Once the market makes its first leg down, it will break below the wedge. At some point, the bears will take profits and the bulls will buy again. The bulls want to cause the wedge top to fail. When the market rallies to test the wedge top, the bears will begin to sell again. If the bulls begin to take profits, they believe that they will be unable to push the market above the old high. Once their profit taking, combined with the new selling by the bears, reaches a critical mass, it will overwhelm the remaining buyers and the market will turn down for that second leg. At some point, the bulls will return and the bears will take profits, and both sides will see the two-legged pullback and wonder if the bull trend will resume. At this point, the wedge has played itself out and the market will be looking for the next pattern.

Why do so many reversals occur after a trend channel line overshoot when everyone knows that it commonly leads to a reversal? Won't early entrants prevent the line from ever being reached? Common wisdom is that novice traders on the wrong side hold their losing positions until they cannot stand any more pain, and then suddenly all of them exit at once, creating a blow-off or a parabolic climax. For example, in a bull channel, the market works its way up to some resistance level, even if it is not very apparent or impressive, and pokes through it, causing the last shorts to no longer be willing to take the pain. They suddenly give up. As soon as these last shorts cover in unison, many euphoric, inexperienced bulls see the upsurge and buy into it, adding to the sudden, sharp move that breaks above the trend channel line. This spike up causes more remaining shorts to cover, and the impressive upsurge causes more naïve bulls to initiate new longs, with the process feeding on itself. But then there are not enough shorts left who will cover and move the market higher, and those euphoric bulls who were trading on emotion rather than logic will panic when the market suddenly stops accelerating up, pauses, and starts to turn down. They suddenly realize that they bought at the high of a possible climax and will be quick to exit. With no more buyers left and with trapped new longs panicking to sell out of their positions, the market suddenly becomes one-sided and dominated by sellers so that it can only go down. That is the conventional logic and it is not important whether it is true. In fact, it is likely not a meaningful component of a reversal in a huge market like the Eminis where institutions dominate and most of the trading is probably computer generated. Smart traders won't trade countertrend until either there is a pullback from a strong trend line break or there is a reversal from a trend channel line overshoot. For example, in a bull trend, smart money will keep buying until they drive the price above the bull trend channel line and then they will take profits. There may be a couple of failed attempts to reverse, and the market may continue to rally at an accelerated pace, creating steeper trend channel lines. Incidentally, if you find yourself redrawing trend channel lines repeatedly, this is usually a sign that you are on the wrong side of the market. You are looking for a reversal but the trend keeps getting stronger. You should be trading with the trend instead of intensely looking for a reversal.

Eventually the market will agree on which trend channel line is the final one and you will see a convincing reversal. Be patient and trade only with trend until then; never trade against the trend until it has clearly reversed. At the same time as the profit takers are taking profits, many will reverse and many other traders who were already flat will initiate shorts. Other smart traders will wait for a reversal on the charts and there will be traders entering on reversals on all types of charts (1 to 5 minute, and volume charts and tick charts of any size).

Once they believe that the top is in, this smart money won't be looking to buy any longer. They are short and most of these traders will hold through a new high, despite an open loss on their current position, believing that the top is in or close to in. In fact, many will add on above the high, both to get a better average price for their shorts and to help push the market down. The big players are only thinking short and won't be scared out except by the rare occurrence of a failed second entry or a huge failure (for example, maybe three points above their entry in the Emini). There are no buyers left, so the market only has one way to go.

Although you do not need to look at volume when deciding whether to place a trade since it is so unreliable, it is often huge at key turning points, especially at bottoms. Every trade is between one or more institutions buying and one or more selling. The major buyers at a market bottom are the profit taking bears and the new longs. Why would a firm ever sell at the bottom tick of a bear market? Every firm uses strategies that they have carefully tested and found to be profitable, but all lose money on 30 to 70 percent of their trades. The firms selling at the low tick are the ones who were selling at the low tick all the way down in the bear, making profits on many of their earlier entries, and they simply continue to use those strategies until it is clear that the trend has reversed. So, yes, they lose on that short at the final low tick of the bear, but make enough from all of their earlier shorts to end up profitable. There are also HFT firms that will scalp for even a single tick right down to the low tick of the bear. Remember, the low is always at a support level, and many HFT firms will short a tick or two above support to try to capture that final tick, if their systems show that this is a profitable strategy. Other institutions sell as part of a hedge in another market (stocks, options, bonds, currencies, etc.) because they perceive that their risk/reward ratio is better if they place the hedge. The volume is not from small individual traders, because they are responsible for less than 5 percent of the volume at major turning points. The reversal at an overshoot happens because it is such an entrenched part of institutional trading psyche that it has to happen. Even if institutions do not look at charts, they will have some other criterion that tells them that the market has gone too far and it is time to exit or reverse, and this will invariably coincide with what price action traders are seeing. Remember, price action is the inescapable footprint of what is happening to price as a huge number of smart people are independently trying to make the most money they can in the market. In a big market, the price action cannot be manipulated and will always be basically the same.

One final minor observation is that the slope of the final flag of a trend often provides an approximation of the slope of the new trend. This has limited value to a trader because there will be other much more important factors involved in the decision leading up to placing a trade, but it is an interesting observation.

FIGURE 14.1 Testing a Trend Channel Line

A trend channel line points in the direction of the trend but is on the opposite side of the trend from the trend line. Extend it to the right and watch how the price acts when it penetrates the channel line. Does it reverse or does the trend accelerate, ignoring the line?

Trend channel lines are commonly drawn in one of two ways. The first way is to draw it as a parallel line (dashed lines in Figure 14.1) of a trend line (solid lines), drag it to the opposite side of the action, and place it to touch a swing point located between the two bars used to create the trend line. Choose the point that will result in all of the bars between the trend and channel lines being contained between the lines. The second type (dotted lines in Figure 14.1) of a trend channel line is drawn across swing points and is independent of any trend line. You can also simply draw a best fit, but these are usually not helpful in trading.

FIGURE 14.2 Slope of the Final Flag

The slope of the final flag of the bull trend provided direction for the subsequent bear trend in Figure 14.2. A linear regression trend line drawn between bars 1 and 2 became a rough bear trend channel line for the sell-off that extended into the next day. It is possible that it contributed to the buying at bar 7, but bar 7 was a buy simply based on the break of the trend line drawn over the first hour of trading, and the second attempt to reverse the breakout below the bar 5 low of the open. It is usually far better to place orders based on the most recent price action if it provides a justification for a trade than to look back 30 or more bars.

In hindsight, the bull trend effectively ended at bar 1, even though the market made a higher high after bar 2. The move down to bar 2 was the first leg down in the bear channel.

Deeper Discussion of This Chart

The market was in a bear channel in Figure 14.2 for the final couple of hours of yesterday, so the odds of a successful first attempt to reverse upward were not great. The breakout below the trend channel line reversed up with the first bar of the day, which was a bull trend bar, but the failed breakout went only a few bars before setting up a breakout pullback short.

FIGURE 14.3 Lengthy Trend Channel Line

In Figure 14.3, the trend line from bars 2 and 3 was used to create a parallel that was dragged to bar 1 and extended to the right. This trend channel line was not penetrated by bar 6. Also, it was anchored to bar 1, which was not in between bars 2 and 3 (the bars used to create the original trend line). However, traders should always be looking at every possibility. Had there been a penetration and reversal, the chances of a two-legged rally off the bar 5 low would have been improved.

The simple trend channel line created from the bars 1 and 5 lows was penetrated by bar 6, but this was not an ideal trend line to use as a basis for a countertrend trade since bars 1 and 5 were far apart and bars 5 and 6 were close together. Trend lines work best when they are tested by a third leg. Here, bars 5 and 6 were essentially still part of the same leg (three pushes down, bars 4, 5, and 6). The trade was still worth taking because bar 6 was small, so the risk/reward ratio was good. This was also a shrinking stair pattern down (discussed later, but it is a series of lower lows where each successive breakout is smaller than the prior one), which indicated waning bearish momentum and supported a long.

Deeper Discussion of This Chart

The large gap down in Figure 14.3 was a breakout, as all large gaps are, and the day started as a trend from the open bear day. The small opening range put the market in breakout mode, and there was a large bear breakout bar. However, an unusually large bear trend bar forming after a bear trend has gone a long way usually is a sell climax that will be followed by at least a two-legged sideways to up correction that lasts at least 10 bars. Bar 1 was a strong bull reversal bar that set up the failed breakout long. There was a two-legged sideways correction that ended with the bar 3 failed breakout of a tight trading range, and it formed an approximate double top with bar 2. Even though most of the trading was sideways, the day still opened near its high and closed near its low. This was a trending trading range day with upper and lower trading ranges.

CHAPTER 15

Channels

When trading is mostly confined to between a pair of lines, it is in a channel. The market is always in some kind of channel if you look hard enough to find one, and it usually is simultaneously in several, especially if you look at other time frames. A trend channel is a channel that is diagonal and is contained by a trend line and a trend channel line. For example, a bear channel has a descending trend line above (a bear trend line) and a descending trend channel line below (a bear trend channel line). A trading range is contained between a horizontal support line below and a resistance line above. Sometimes a trading range can be slightly rising or falling, but if so, it is better to think of it as a weak trend channel.

Triangles are also channels, since they are areas of price action contained between two lines. Since they have either higher highs or lower lows, or both in the case of an expanding triangle, they have some trending behavior in addition to their trading range behavior. An expanding triangle is contained between two diverging lines, both of which are technically trend channel lines. The line below is across lower lows, so it is below a bear trend and therefore a trend channel line, and the line above is across higher highs and therefore a bull trend channel line. A contracting triangle is contained between two trend lines, since the market is both in a small bear trend with lower highs and a bull trend with higher lows. An ascending triangle has a resistance line above and a bull trend line below, and a descending triangle has a support line below and a bear trend line above. A wedge is an ascending or descending channel where the trend line and trend channel line converge, and it is a variant of a triangle. An ABC correction in a bull trend is a small bear channel, and when it is in a bear trend it is a small bull channel.

Although the moving average often functions as support or resistance in a strong trend and many traders create curved channels and bands based on the moving average and many other factors, straight trend lines and trend channel lines consistently provide more reliable setups and profitable trades.

A bull channel can be in a trading range, a bull trend, a bear trend, or at a possible bottom of a bear trend as the market begins to reverse up. When it is in a trading range, traders can consider buying when in the lower half of the range, but the odds of success become less as the channel progresses into the upper half of the range. When a channel is in a bull trend, higher prices are more certain, and traders should look to buy near the bottom of the channel. The chance of a successful long remains good until the channel begins to have prominent selling pressure, or until it approaches significant resistance. When a channel is especially tight, meaning that the trend line and trend channel lines are close together and the pullbacks are small, it is a sign that the trend is strong, and it can be a spike on a higher time frame chart. A broader channel may follow, which might reach a measured move target, based on the height of the tight channel. A channel that is so tight that it has no pullbacks or only one or two tiny pullbacks is a micro channel, which is discussed in the next chapter.

When a bull channel forms in a bear trend, it is a bear flag, and traders should look to short near the top, or on the pullback from a downside breakout. Sometimes when a bear trend begins to reverse up, the first five to 10 bars are in a weak bull channel, with lots of overlapping bars and one or more attempts to break below the bear flag, but these fail and quickly reverse up. After a failed low 2 or low 3, the market then sometimes breaks out to the upside from the bear flag, the market suddenly becomes always-in long, and a bull reversal begins. When traders suspect that a bear flag might be the start of a bull trend, many will buy below the low 1, 2, or 3 signal bars, expecting them to fail and for the market to reverse up.

As a channel is forming, traders are uncertain if there will actually be a channel or just a two-legged move and then a reversal. In fact, you usually cannot even draw channel lines until after the market begins to reverse from the two-legged move and the reversal fails, and the third leg begins. For example, if the market just completed two legs up and has started to reverse, many traders will short the reversal if the rally is not a strong bull trend. However, if the leg down ends and is comparable in size to the first leg down (the leg after the first leg up), and then it reverses up again, traders will now begin to assume that a bull channel is underway rather than a reversal down into a bear leg. Once that second leg ends, traders will draw a trend line from the bottom of the first leg down to the bottom of this second leg and extend it to the right. They will look to buy whenever the market again comes back to the trend line. They will also create a parallel of the line and drag it to the top of the first leg up, and this is their first creation of a channel. Whenever the market rallies up to that trend channel line, traders will take profit on their longs, and look to short. Since a bull channel needs at least those first two legs down to confirm the existence of the channel and the market will usually then test above the top of the second leg up, bull channels usually have at least three pushes up. Traders will usually not look for a reversal and a downside breakout of the channel until after that third leg up forms. However, once it does, especially if there is an overshoot of the trend channel line and a strong bear reversal bar, traders will short aggressively because the odds of a successful downside breakout have increased. Because of this, many bull channels end after a third push up. Likewise, many bear channels end after a third push down.

Why does the market race toward the top and bottom of the channel? This is because of a vacuum effect. For example, if there is a bull channel and there is a leg that is approaching the trend channel line above, the traders believe that the market will likely touch that line and may even go a tick or two above it. Since they believe that the market will go at least a little higher than it is right now, they will hold back on their selling. The bulls want to sell out of their longs eventually to take profits, and the bears want to sell to initiate new shorts. The current relative absence of selling creates a buy imbalance, and whenever there is any imbalance, the market moves quickly. The result is that there is often a large bull trend bar or two that form as the market tests the top of the channel. This often attracts overly eager bulls to buy at the top of the spike since they think the market is forming a new, stronger bull leg. However, most breakout attempts fail, and this one will likely fail as well. Why? Because of the institutional traders. The strong bears want to short, but they believe that the market will touch that upper trend channel line, so they wait. Once the market is there, they short heavily and overwhelm the bulls. They like to see a strong bull trend bar because they believe that the market will go lower and there is no better price to short than at the point of maximum bullishness. The market might pause for a small bar at the top of the bull trend bar as both the bulls and the bears decide if the breakout will fail, but it will usually then quickly fall since both the institutional bulls and bears know that the odds are strongly in favor of all breakout attempts failing.

So what do those strong institutional bulls do? They stop buying and they quickly sell out of their longs, capturing a brief windfall profit. They know that this opportunity will likely be brief because the market does not stay at an extreme for long, so they exit and they won't look to buy again for at least a bar or two. The relative absence of these institutional bulls and the aggressiveness of the institutional bears force the market down quickly to the bottom of the channel, where the opposite process begins. Both the bulls and the bears expect the trend line below to be tested; the bears will keep shorting until the market gets there and then they will buy back their shorts as they take their profits, and the bulls won't buy until the market gets there. This creates a brief, sharp move down that will entice beginning traders into shorting, expecting a bear breakout, but they are doing the exact opposite of the institutions. Remember, your job is to follow what the institutions are doing. You should not be doing what you hope they will soon do, and you should never do the exact opposite of what they are doing. Each of these small pullbacks is a micro sell vacuum. Once the market gets close to the bottom of the channel, both the bulls and the bears expect the market to reach the bull trend line and they stop buying until it gets there. Once there, the bulls buy to initiate new longs and the bears take profits on their short scalps. Both expect a new channel high and a test of the top of the channel, where the process begins again. This takes place in all channels, including in trading ranges and triangles.

Even in a trend channel, there is two-sided trading taking place and this is trading range behavior. In fact, a trend channel can be thought of as a sloping trading range. When the slope is steep and the channel is tight, it behaves more like a trend, and trades should be taken only in the direction of the trend. When the slope is less steep and there are broad swings within the channel, some lasting five or even 10 bars, the market is behaving more like a trading range and can be traded in both directions. As with all trading ranges, there is a magnetic pull in the middle of the trading range that tends to keep the market in the range. Why does the market stay in a channel and not suddenly accelerate? Because there is too much uncertainty, like with all trading ranges.

For example, in a bull channel, the bulls want to buy more, but at a lower price. The weak shorts want a sell-off so they can exit with a smaller loss. Both the bulls and the weak bears are concerned that there may not be a pullback that will allow them to buy all of the shares that they want to buy (the weak shorts are buying back their losing short positions) at a better price, so they continue to buy in pieces as the market goes up, and this adds to the buying pressure. They buy even more aggressively on any small dip, like with a limit order below the low of the prior bar or at the moving average or near the trend line that forms the bottom of the channel.

In general, when a channel is beginning it is better to trade with the trend, and as it is approaching a target area and as it develops more two-sided trading, experienced traders will often to start trading countertrend. So at the start of a bull channel, it is better to buy below the lows of bars, but as the channel reaches resistance areas and starts to have more overlapping bars, bear bars, deeper pullbacks, and prominent tails, it is better to consider shorting above bars instead of buying below bars.

However, for traders just starting out, whenever they see a channel, they should trade only with the trend, if at all. Trading channels is very difficult because they are always trying to reverse, and have many pullbacks. This is confusing to beginning traders and they often take repeated losses. If there is a bull channel, they should only look to buy. The most reliable buy signal will be a high 2 with a bull signal bar at the moving average where the entry is not too close to the top of the channel. This kind of perfect setup does not occur often. If traders are just starting out, they should wait for the very best setups, even if that means missing the entire trend. More experienced traders can buy on limit orders below weak sell signals and near the moving average and near the bottom of the channel. If traders are not consistently profitable, they should avoid taking any sell signals in a bull channel, even if there is a small lower high. The market is always-in long and they should not be looking to short, even though there will be many signals that look acceptable. Wait for the market to become clearly always-in short before looking to short. That will usually require a strong bear spike that breaks below the channel and below the moving average and has follow-through, and then has a lower high with a bear signal bar. If the setup is any weaker than that, beginners should wait and only look to buy pullbacks. Do not fall into the regression toward the mean mind-set and assume that the channel looks so weak that a reversal is long overdue. The market can continue its unsustainable behavior much longer than you can sustain your account as you bet against that very weak-looking trend.

Many bulls will be scaling into their long positions as the market goes up, and they will be using every conceivable logical approach to do this. Some will buy on a pullback to the moving average, or below the low of the prior bar, or on pullbacks at fixed intervals, like every 50 cents below the most recent high in AAPL. Others will buy as the market appears to be resuming the channel up, like every 25 cents above the prior low. If you can think of an approach, so can some programmer, and if she can show that it is effective mathematically, her firm will probably try trading it.

With both the bulls and trapped bears wanting lower prices but afraid that they will not come, both continue to buy until they have nothing left to buy. This always happens at some magnet like a measured move or a higher time frame trend line or trend channel line. Since channels usually go much further than what most traders expect, the trend usually continues up beyond the first one or more obvious resistance levels until it reaches one where enough strong bulls and bears agree that the market has gone far enough and will likely not go much higher. At that point, the market runs out of buying pressure and the strong bulls take profits and sell out of their longs, and the strong bears come in and sell more aggressively. This results in a reversal into a deeper correction or into an opposite trend. The bull trend often ends with a breakout of the top of the channel as the last desperate bears buy back their shorts in despair, and the weakest bulls who have been waiting and waiting for lower prices finally just buy at the market. The strong bears expect that and will often wait for the strong breakout and then begin shorting relentlessly. They believe that this is a brief opportunity to short at a very high price and that the market won't stay here for long. The strong bulls see the spike up as a gift and they exit their longs and will now buy again only after at least a two-legged pullback lasting at least 10 bars. They often will not buy until the market gets down to the beginning of the channel, where they originally bought into a profitable trade. The strong bears know this and will look to take profits exactly where the strong bulls will be buying again; the result usually is a bounce and then often a trading range as both sides become uncertain about the direction of the next move. Uncertainty usually means that the market is in a trading range.

Or at least that is the conventional logic, but it is probably more complicated, sophisticated, and unknowable. All institutions are familiar with this pattern, and you can be certain that their programmers are constantly looking for ways to capitalize on it. One thing an institution might do is try to create a buy climax. If it has been buying all the way up and is ready to take profits but it wants to be sure that the top is in, it could suddenly buy a final big piece with the realization that it might even take a small loss on it, but with the goal of creating a climactic reversal on the charts. If the firm is successful, and it might be if several other institutions are running programs that are doing similar things, it can exit all of its longs, most with a profit, and then even reverse to short, confident that the sellers now control the market.

Does this happen with every climax? It is unknowable and irrelevant. Your goal is to follow what the institutions are doing, and you can see it on the charts. You never have to know anything about the programs behind the patterns, and the institutions themselves never know what types of programs the other institutions are running. They only know their own programs, but the market rarely goes far unless many institutions are trading in the same direction at the same time, and they have to be trading with enough size to overwhelm the other institutions that are doing the opposite. The only time that the vast majority of the institutions are on the same side is during the spike phase of a strong trend, and that occurs in fewer than 5 percent of the bars on the chart.

It is not just bulls and weak shorts who are placing trades as the channel continues up. Strong shorts are also selling as the market moves higher, scaling into their positions, believing that the upside is limited and ultimately their trade will be profitable. Their selling begins to create selling pressure in the form of more bars with bear bodies, larger bear bodies, tails on the tops of the bars, and more bars with lows below the low of the prior bar. They are looking for a downside breakout of the channel and maybe even a test to the beginning of the channel. Since they want to short at the best possible price, they are selling as the market is going up rather than waiting for the reversal. This is because the reversal might be fast and strong and then they would end up shorting much further below the top of the channel than they believe is likely to be profitable.

They have several ways to add to their short position, like selling on a limit order above the high of the prior bar or above a minor swing high in the channel, at every test of the top of the channel at the trend channel line, at measured move targets, at a fixed interval as the market goes up (like every 50 cents higher in AAPL), or on each potential top. Once the market reverses, they might hold their entire position with the expectation of a significant reversal, or they might exit at a profit target, like on a test of the trend line at the bottom of the channel or even at the entry price of their first short, which is often near the start of the channel. If they do that, their first entry will be a breakeven trade and they will have a profit on their higher entries.

If you are scaling into shorts in that bull channel, it is best to do this only in the first two-thirds of the day. You do not want to find yourself heavily short in a bull channel with your breakeven entry so far below that you don't have enough time left to get out without a loss, never mind with a large profit. In general, if you are trading a channel in the second half of the day, it is far better to only trade with the trend, like buying below the low of the prior bar, or above every bull reversal bar at the moving average.

If the market continues higher than the shorts believe is likely, they will buy back their entire position at a loss, and this is probably a significant contributor to the climactic upside breakout that sometimes comes at the end of a channel. They no longer expect a pullback any time soon that would allow them to buy at a better price, and instead buy at the market and take losses on all of their short entries. Since many are momentum traders, many will switch to long. All the momentum-trading bulls will aggressively buy as the market accelerates upward because they know that the math is on their side. The directional probability of the next tick being higher and not lower is more than 50 percent, so they have an edge. Even though the breakout might be brief and the reversal sharp, their buy programs will continue to buy as long as the logic supports doing so. However, this is like musical chairs; as soon as the momentum music stops, everyone quickly grabs a chair, which means that they exit their longs very quickly. As they are selling out of their longs, there are aggressive bears shorting as well and this can create a strong imbalance in favor of the bears. If the bears take control, the sell-off will usually last at least 10 bars and there will usually be a reversal back below the trend channel line and into the channel, and then a breakout of the downside of the channel.

The television pundits will attribute the sharp upside breakout to some news item, and there are always many to choose from, because they see the market only from the perspective of a traditional stock trader who trades on fundamentals. They don't understand that many things that happen, especially over the course of an hour or so, have nothing to do with fundamentals and are instead the result of large programs doing the same thing at once with no regard for the fundamentals. Once the market quickly reverses on the climactic blow-off, they move on to the next story. They never address the fact that they just gave a report that was foolishly naïve, and they remain completely oblivious to the powerful technical forces that drive the market in the short run. Every few years there is an exceptionally huge intraday move, and that is pretty much the only time that they will acknowledge that technical factors were at work. In fact, they invariably blame it on programs, as if the programs suddenly briefly appeared. There is nothing to blame. The vast majority of all intraday price movement is due to programs, yet the reporters don't have a clue. All they see are earnings reports, quarterly sales, and profit margins.

Since a channel is a sloping trading range, just like with other trading ranges, most attempts to break out of either the top or the bottom fail. Yes, one side is stronger, but the principle is the same as for any trading range. For example, in a bull channel, both bulls and bears are active but the bulls are stronger and that is why the channel is sloping up. Both the bulls and the bears are comfortable placing trades in the middle of the channel, but when the market gets near the top of the channel, the bulls become concerned that the upside breakout will fail; and as soon as they think that a failure is likely, they will sell out of some of their longs. Also, the bears were comfortable shorting in the middle of the channel and will short even more aggressively near the top, at a better value. When the market gets near the bottom of the range, the bears are less interested in shorting at these lower prices and the bulls, who were just buying moments ago at higher prices, will buy even more aggressively here. This leads to a bounce up off of the trend line. The market usually pokes below the channel one or more times as it is forming, and you have to redraw the trend line. The result is usually a slightly broader and flatter channel. Ultimately, the downside breakout will be strong enough to be followed by a lower high and then a lower low, and when that happens, traders will begin to draw a bear channel, even if the bull channel still exists, albeit much wider.

It is important to realize that most bull breakouts of bull channels fail. If the bulls are able to create a bull breakout and they can overwhelm the bears, they usually will be able to do so for only a few bars. At that point, the bulls will see the market as too overdone and will take profits; they won't want to buy until the market has corrected for a while. The magnetic effect of the middle of the channel will usually pull the market back into the channel and cause the breakout to fail, making the breakout a buy climax. Once back in the channel, the market usually pokes through the bottom of the channel as its minimum objective. The buy climax usually leads to a two-legged correction that lasts about 10 bars and usually breaks below the channel. Once the downside breakout happens, if the selling continues the next objective is a measured move equal to about the height of the channel. The bears also know that the buy climax will likely be followed by a correction and they will short aggressively. With the bulls selling out of their longs, there is strong selling pressure and the market corrects down and can even become a bear trend.

Sometimes an upside breakout of a bull channel is strong and does not fail within a few bars. When this is the case, the market will usually rally to a measured move target, and the breakout will become a measuring gap. For example, if the bull channel has a wedge shape, and breaks to the downside, but the downside breakout fails within a few bars, and then the market races up and breaks above the top of the wedge, the rally will usually reach a measured move up that is equal to about the height of the wedge. The trend bar or bars that break above the wedge then become a measuring gap. Gaps, measured moves, and breakouts are discussed in book 2.

If instead of an upside breakout, there is a downside breakout but without a failed upside breakout, buy climax, and bear reversal, the market usually goes sideways for a number of bars. It may form a lower high and then a second leg down, or the trading range might become a bull flag and lead to a resumption of the bull trend. Less commonly, there is a strong spike down and a strong bear reversal. The opposite of all of this is true for bear channels.

Since a trend channel is simply a sloping trading range, it usually functions like a flag. If there is a bull channel, no matter how steep or protracted, it usually will have a downside breakout at some point and therefore can be thought of as a bear flag even if there was no bear trend preceding it. At some point, the strong bulls will take profits and they will be willing to buy again only after a significant pullback. That pullback often has to go all the way to the beginning of the channel, where they began buying earlier, and this is part of the reason why channels often lead to a correction all the way to the bottom of the channel, where there is usually a bounce. The strong bears are as smart as the strong bulls, and generally just when the strong bulls stop buying, the strong bears begin to aggressively short and will not be shaken out higher. In fact, they will see higher prices as an even better value and they will short more. Where will they take profits on their shorts? Near the bottom of the channel, just where the strong bulls might try to reestablish their longs.

Because a bull channel behaves like a bear flag, it should be traded like a bear flag. Similarly, any bear channel should be viewed as a bull flag. There may or may not be a bull trend that precedes it, but that is irrelevant. Sometimes there will be a higher time frame bull trend that might not be evident on the 5 minute chart, and when that happens, the bear channel will appear as a bull flag on that chart. Although a higher time frame trend might increase the chances of a bull breakout and the chances that the breakout will be strong and go further, you will so often see huge bull breakouts from bear channels that it is not necessary to look for a higher time frame bull trend to trade the channel like a bull flag. The opposite is true of bull channels, which are functionally bear flags.

Since a bull channel is a bear flag, there is usually a bear breakout eventually. Sometimes, however, there is a bull breakout above the channel. In most cases, this breakout is climactic and unsustainable. It might last for just a bar or two, but sometimes it lasts for five or more bars before the market reverses down. Less often, the bull trend will continue in a very strong trend. If it reverses, it usually reenters the channel, and with any channel breakout that reenters the channel, it usually tests the opposite side of the channel. After a failed breakout of the top of a bull channel, since this is a type of climax, the reversal should have at least two legs down and last at least 10 bars, and it often becomes a trend reversal. The opposite is true of a downside breakout of a bear channel. It usually is a sell climax and reverses back above the channel and has at least two legs up.

All channels eventually end in a breakout, which can be violent or have very little momentum. Trend channels usually last much longer than what most traders suspect and they often trap traders into prematurely taking reversal trades. Most channels usually have at least three legs before they end. This is especially clear in triangles, and in wedges in particular. With triangles, the breakout is usually imminent but the direction is often not clear.

The steeper the slope and the closer together the lines are, the stronger the channel is and the stronger the momentum is. When a channel is steep and tight, it is a special type of channel called a tight channel. When it is horizontal, it is a tight trading range, which is discussed in book 2. When a channel is strong, it is risky to trade the first breakout against the trend, and it is likely that the entire channel will be a spike on a higher time frame chart. So if there is a steep bear channel and most of the pullbacks within the channel have been only a single bar, it is better not to buy one of those breakouts above the prior bar, even if it breaks above the bear trend line. Instead, it is better to wait to see if there is a breakout pullback, which can be a lower low or a higher low. If there is and the reversal up looks strong (for example, maybe there were two or three good-sized bull trend bars within the past several bars), then you can consider buying the breakout pullback. If there is no pullback and the market races upward, then the odds of even higher prices are good and you can wait for any pullback, which should come within five bars or so. The odds of the long being profitable are better if the rally up goes above the moving average and that first pullback stays above the moving average. This is a sign of strength. If the first pullback forms below the moving average, the bulls are weaker and the chance of a second leg up is less. If the market continues to sell off after the upside breakout, the breakout failed and the bear trend is resuming.

The strength of a channel is especially important when the market might be in the process of reversing. For example, if there is a strong bull trend and then there is a strong sell-off that breaks well below the bull trend line, traders will study the next rally carefully. They want to see whether that rally will simply be a test of the bull high or will instead break out strongly above the high and be followed by another strong leg up in the bull trend. One of the most important considerations is the momentum of that test of the bull high. If the rally is in a very tight, steep channel with no pullbacks and very little overlap between the bars, and the rally goes far above the bull high before having any pause or pullback, the momentum is strong and the odds are increased that the bull trend will resume, despite the strong sell-off and breakout below the bull trend line. Usually the first breakout of a tight, prolonged channel will fail. The trend will then resume and often break out to a new extreme and reach a measured move equal to about the height of that initial breakout.

By contrast, if the rally has many overlapping bars, several large bear trend bars, two or three clear pullbacks, maybe a wedge shape, and a slope that is noticeably less than the slope (momentum) of the original bull trend and of the sell-off, the odds are that the test of the bull high will result in either a lower high or a slightly higher high and then another attempt to sell off. The market might be reversing into a bear trend, but at a minimum a trading range is likely.

Whenever there is a breakout of any channel and then a reversal back into the channel, the market will try to test the other side of the channel, and will usually try to break out of it, at least by a little. If there is a successful breakout of the channel in either direction, the next minimum objective is a measured move equal to about the height of the channel. For example, a double top is a horizontal channel and if there is a successful breakout of the downside, the minimum target is a measured move equal to the height of the channel. However, the breakout can become a trend reversal and the move can be much greater. If instead the breakout is to the upside, the target is again a measured move up equal to the height of the double top. If AAPL is forming a double top and the top of the pattern is $5.00 above the bottom, the initial target of any breakout to the upside is $5.00 above the top. If the breakout instead is to the downside, the initial objective is $5.00 below the low of the pattern. The same is true for a wedge bottom. The first objective is a test of the top of the wedge. If the market continues up, the next target is a measured move up. If the rally continues, the market might then be in a bull trend. Even when a channel is sloping, the initial objective is a move equal to the height of the channel. In a bull channel, for example, pick any bar and look at the channel lines directly above and below. Simply measure how far apart they are to get the measured move projection. The measured move targets are only approximate, but the market often hits them exactly and then pauses, pulls back, or reverses. If the market goes much beyond the target, a new trend is likely underway.

As with all breakouts, three things can then happen: it can be successful and be followed by more trading in that direction; it can fail and become a small climactic reversal; or the market can just go sideways and the pattern can evolve into a trading range. Most breakouts have an attempt to reverse within a few bars. If the reversal bar is strong compared to the breakout bar, the odds of a failed breakout and a successful reversal are good. If the reversal bar is weak compared to the breakout, the odds are that the reversal attempt will fail and set up a breakout pullback within a bar or two, and the breakout will resume. If the breakout and the reversal are about equally strong, traders will then look at the bar after the reversal signal bar. For example, if there is a strong bull trend bar that breaks out of a bull flag, and the next bar is an equally impressive bear reversal bar, the bar that follows becomes important. If it trades below the bear reversal bar, the breakout has failed, at least for the moment. If it then has a strong bear close and is a strong bear trend bar, the chance that the reversal will continue down increases. If instead it is a strong bull reversal bar, chances are that the failed breakout will not succeed, and this bull reversal bar then becomes a signal bar for a breakout pullback buy at one tick above its high. Breakouts are discussed in book 2.

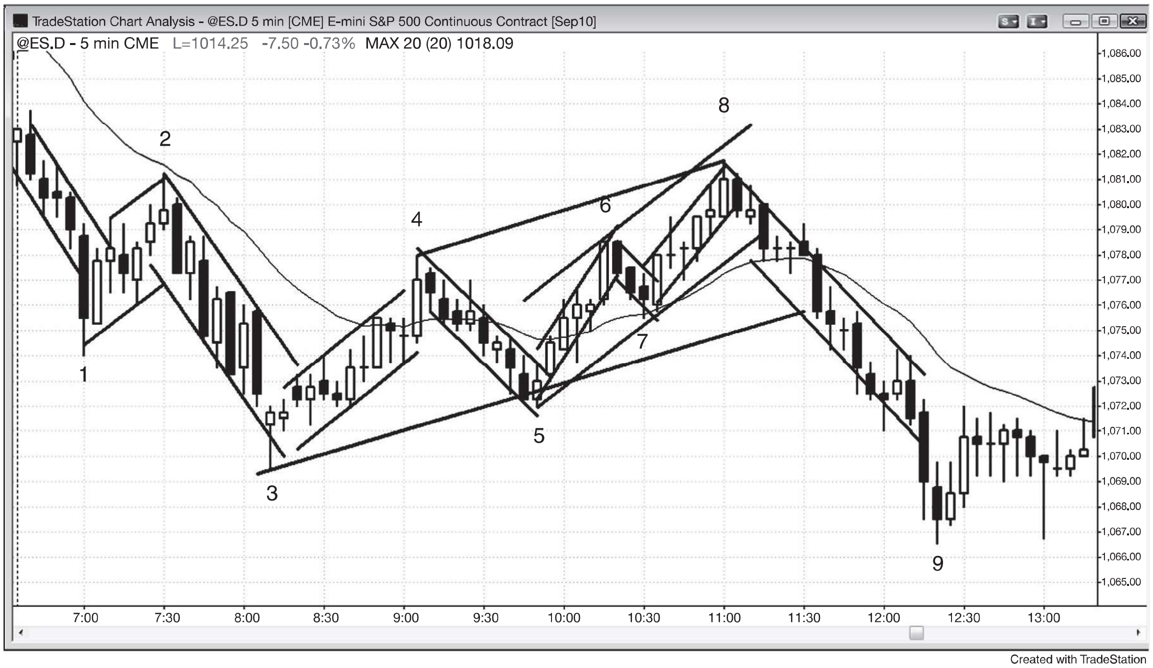


FIGURE 15.1 Nested Channels

Channels are common on all charts, and some smaller channels are nested inside of larger channels. In Figure 15.1, notice that the lines do not always have to be drawn to contain all of the highs and lows in the channel. Drawing them with best fit lines helps to make the channel behavior clearer and often makes it easier to anticipate signals. Since most trading is institutional and placed by computer programs, it is reasonable to assume that each small, tight channel is due to program trading. Since there are so many firms running programs all day long, a channel probably can develop only when several firms are running programs in the same direction and with enough volume to overwhelm the programs that are trying to make the market move in the opposite direction. For example, in the channel down from bar 4, there were enough sell programs going on to overpower any buy programs, and the market moved down. When the buy and sell programs are largely in balance, the market moves sideways in a tight trading range, which is a horizontal channel.

Bull channels are indistinguishable from bear flags, and bear channels should be thought of as bull flags. When the channel is tight like from bars 2 to 3, buyers should wait until there is a failed breakout and reversal up before looking for longs, as occurred at bar 3. They could also wait for a pullback after the breakout, like the buying above the high of the small bar that formed five bars after bar 3.

Until either of these develop, traders should only be shorting. When a channel has broader swings like the channel from bars 3 to 8, trades can be taken in both directions, since it more clearly resembles a sloping trading range and trading ranges are two-sided markets that give both buy and sell signals.

Most of the channels in the chart were tight, and since several had no pullbacks or small (only one- to three-tick) one-bar pullbacks and lasted about 10 bars or less, they were also micro channels.

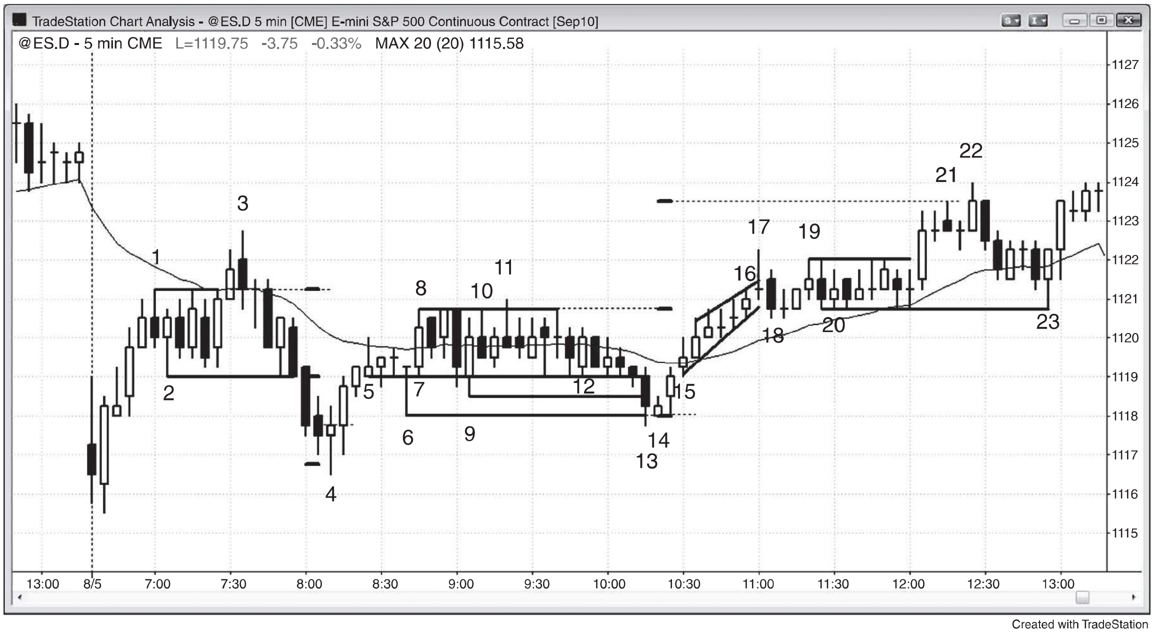


FIGURE 15.2 Failed Channel Breakouts

When there is a breakout of a channel and then a reversal back into the channel, the market usually tests the opposite side of the channel and often breaks out of the other side, at least minimally. If the breakout has follow-through, the first target is a measured move equal to the height of the channel. In Figure 15.2, bar 3 broke out of the top of a trading range and reversed back down. After breaking through the bottom of the channel, the bar 4 low was one tick below a perfect measured move.

Bar 11 broke above the top of a trading range and then the market tested the bottom of the range with bar 13. Sometimes there are several bars to choose from when drawing the lines, and it is usually worth being aware of all of the possibilities because you may not know which is best until several bars later. The widest channel is the most certain.

The bull inside bar that followed the bar 13 breakout set up a failed breakout buy. Since the market was again reversing into the channel, the first target was a test of the top of the channel. The breakout of the top was successful and the next target was a measured move up. Bar 22 went one tick above that target. Sometimes a trend will begin and carry much further.

Bar 17 broke above a bull micro channel or wedge and reversed back down on the next bar. Since the channel was so tight, the objective of testing the lower end of the channel was met on that next bar, but there was not enough room for a profitable short and no trade should be taken.

The measured move up for the breakout of the channel formed by bars 19 and 20 was at the same price as the measured move up from the trading range defined by bars 6 and 10. When multiple targets are around the same price, any reversal there has an increased chance of success. Bar 21 was a valid short setup but it failed on the bar after entry. There was a second entry below bar 22 and the market tested the bottom of the channel. There, it formed a bull reversal bar and the market then tested the top of the channel.

Deeper Discussion of This Chart

The market broke below a closing trading range with a large gap down in Figure 15.2, but the first bar was relatively large and had good-sized tails above and below. This is trading range behavior and not a good signal bar for a trend from the open buy or short. The second bar was a strong bull reversal bar and signaled a long for a failed breakout and a trend from the open bull trend. The market entered a tight trading range just below the moving average, and it became a final flag with a failed breakout and reversal down. Although traders could short as soon as bar 3 went below the low of the prior bar, it was safer to wait until the bar closed to confirm that it would have a bear body, and then short below its low.

The rally to bar 1 was in a micro channel, so the bar 2 downside breakout was likely to not go very far without a pullback. When the market moved above the high of the bar 2 breakout bar, the breakout failed. At that point, the market went sideways as traders fought for control. The bears were looking for a higher high or lower high pullback from the bar 2 breakout, and the bulls simply wanted a failed breakout and then another leg up.

The bears won and the market fell in a micro channel down to bar 4, where the process reversed. Bar 5 was the signal bar for the failed breakout, but the four-bar bull spike was strong enough for traders to believe that the market would likely test higher, which it did in the move up to bar 8.

The move from bar 14 to bar 17 was another bull micro channel, and bar 18 was the breakout. The market then went sideways before the small trend resumed in the move up to bar 22.

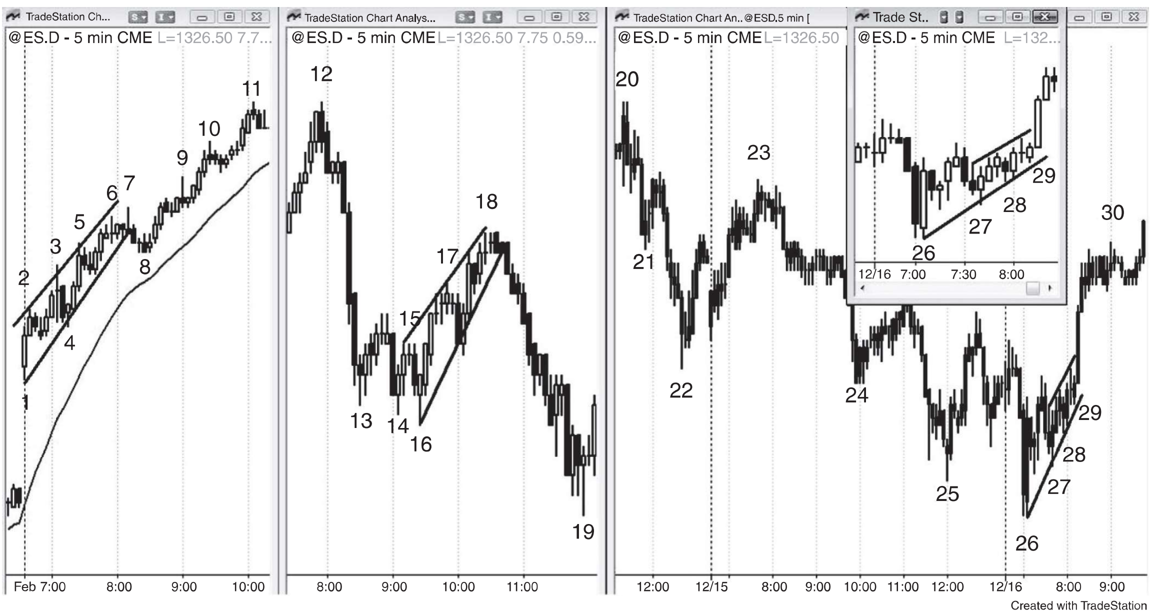
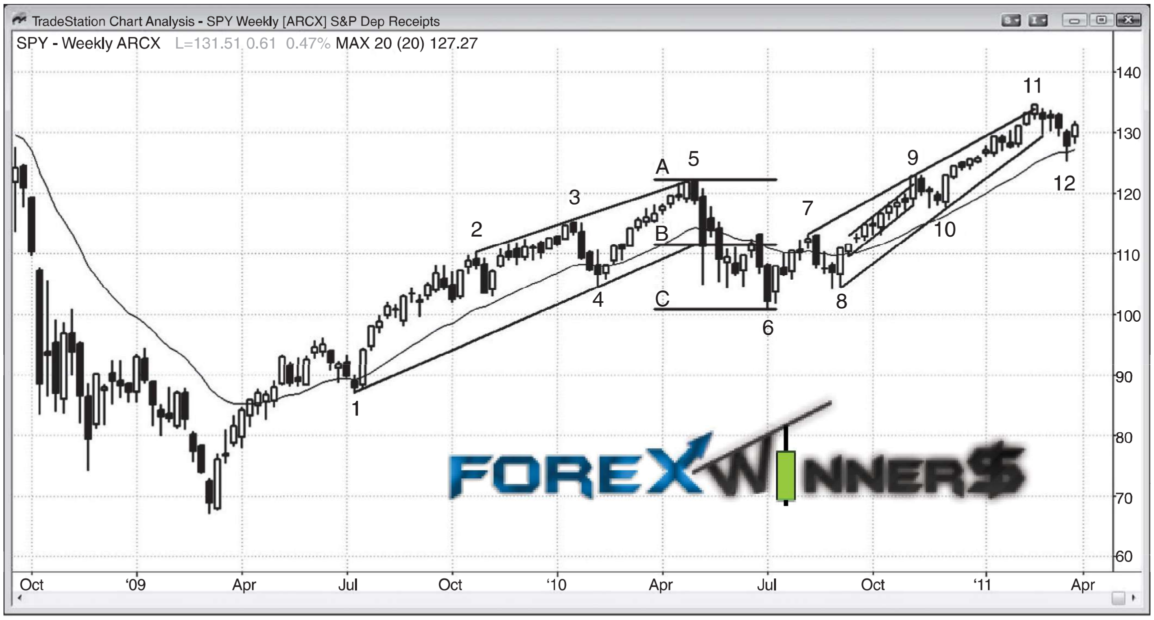


FIGURE 15.3 Bull Channels in Bull and Bear Markets

A bull channel can occur in any type of market. In Figure 15.3, the 5 minute Emini chart on the left had a bull channel in a strong bull trend, where the market gapped up and became a trend from the open bull trend day. The pullbacks were small, and the market worked higher all day. Because the day was a strong bull trend day, traders were buying small pullbacks, like at and below the low of the prior bar.

The bull channel in the middle chart was a wedge bear flag in a bear trend, and traders should not have been looking for longs. They could have shorted below the ii pattern at bar 18, or on any of the several following bars, as the market became always-in short.

The bull channel on the right was a small bear flag in an overdone bear trend. It formed after the large bear trend bar on the open, which was the third push down. Bar 26 (see insert) set up a strong two-bar reversal up from yesterday's low. Even though the channel from bar 26 to the bar before bar 29 was a bear flag, traders believed that the market was reversing up, and bought below the lows of the prior bars, expecting the low 1 and low 2 sell setups to fail. Bar 29 was a strong bull trend bar that broke out of the top of the bear flag and turned the market into a clear always-in long. Not all bear flags break out to the downside. Some become the final flag of the bear trend, break out to the upside, and lead to a bull trend, as happened here.



Created with TradeStation

FIGURE 15.4 Channel Breakout and Measured Move

When the market successfully breaks out of any channel, the first target is a measured move. In Figure 15.4, a weekly chart of the SPY, the trend line was drawn across the lows of bars 1 and 4 and the trend channel line drawn from the highs of bars 2 and 3 was touched at bar 5. This is a bull channel and the lines are slightly convergent. Horizontal line A is across the bar 5 high and line B is the bottom of the channel directly below bar 5. Line C is a measured move down from lines A to B. Bar 6 found support at the measured move and a rally followed.

A similar target would have been projected using an Andrew's Pitchfork, but since basic price action analysis gives the same result, it is all that you need. There were probably countless reasons why bears were taking profits around the bar 6 low and why aggressive bulls were buying. None of them is important since there is never any way to know how many dollars are being traded for each reason. All that you know is that the chart is the distilled result of all of those dollars being traded for countless reasons, and understanding recurring patterns puts you in a position to know when to take profits and when to consider reversal trades.

The move down to bar 1 was the first breakout below a tight, strong bull channel and was therefore likely to fail. When a first breakout fails and the trend resumes, it often extends up to a measured move that is approximately equal to the height of that initial reversal attempt. Here, the rally extended much further.

The channel that began after the bar 1 bull spike was also very tight, and the spike down to bar 4 was the first strong breakout. The reversal failed and the trend resumed. The bulls tried to extend the rally for about a measured move up. That measured move was equal to the height of bar 3 to bar 4, added to the top of bar 3, but the market did not quite reach the target.

The rally to bar 7 broke above the two-legged bull flag down to bar 6, and bar 8 was the breakout pullback. It was also the start of another bull channel, and the move down to bar 12 broke below the channel, reaching about a measured move down, based on the height of the channel and the height of the first leg down (bar 11 and the bar after it). Bars 3, 5, and 7 formed a head and shoulders top, and like most reversal patterns, became a large bull flag and not a reversal.

Deeper Discussion of This Chart

The bar before bar 6 in Figure 15.4 was a breakout pullback short setup and a low 2 short at the moving average. The bar after bar 5 had a large tail, as did several of the next bars, and that trading range below the moving average was a barbwire pattern, which often becomes a final flag, as it did here.

There was a one-bar spike up on the low of the chart, which was followed by a very tight channel. In fact, there were three or four tight channels in the rally (some traders saw the second spike from bar 1 to bar 3 as a single steep channel or spike, and others saw it as two). When a channel is tight, it often functions like a spike, and is followed by a channel. The pullback to bar 1 was followed by a two-bar spike and then another channel that again was so tight that it was likely to function as part of the initial spike. After the pullback from bar 2, the channel up had several bear bodies, which was a sign of building selling pressure. The result was a strong four-bar bear spike down to bar 4. The selling pressure was building, and bulls were likely to take profits on the test of the high. Although the channel up from bar 4 was tight and therefore possibly another spike, a spike can also function as a climax. This was the third or fourth consecutive buy climax (every spike, whether it is one bar or many bars, is a climax), and it followed a strong bear spike. Consecutive climaxes usually lead to a larger correction, as they did here.

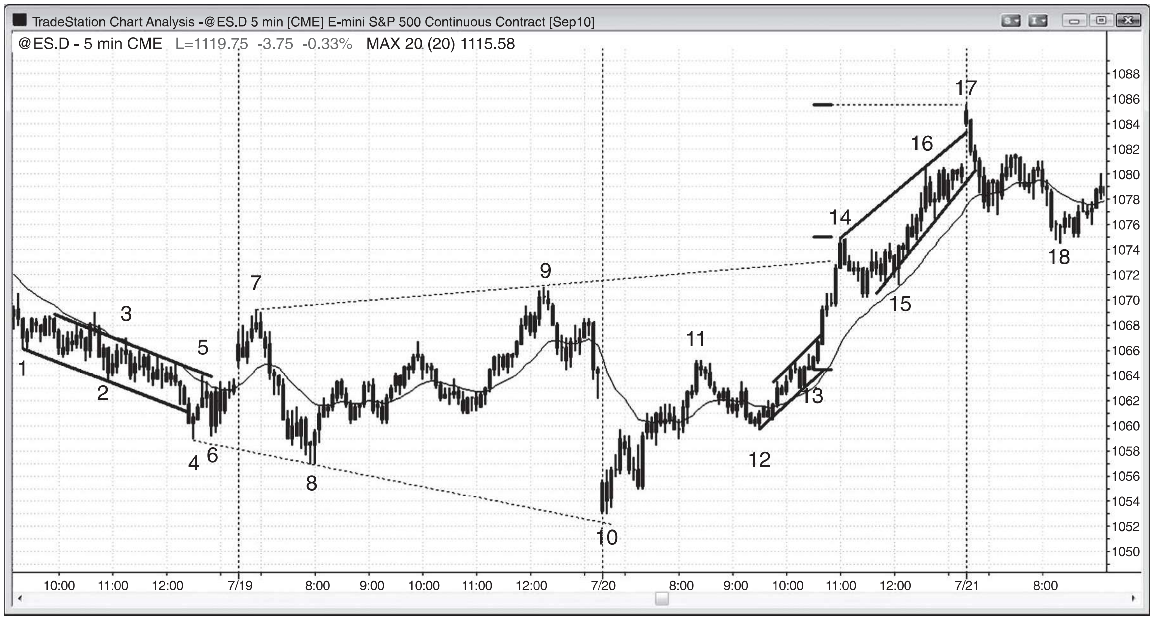


FIGURE 15.5 Climactic Bear Breakout of Bear Channel

A bear channel that breaks out of the bottom of the channel can be followed by an even stronger bear trend, but the breakout usually soon becomes a climax and is typically followed by at least two legs up, as shown in Figure 15.5. Bar 4 broke below the bear channel but became a sell climax, as expected, and was followed by a two-legged rally that ended at bar 7.

There was a bull spike up to bar 14 that was followed by a pullback to bar 15, and then a wedge-shaped channel developed. The market broke out to the upside on the gap up to bar 17, but this breakout was just a buy climax that reversed back into the bull channel and then broke out of the downside. The correction had two legs, ending at bar 18. Many channels have three pushes in them before reversing, and bars 14, 16, and 17 were three pushes up.

The small bull channel that started at bar 12 broke out to the upside, and the breakout was very strong. All breakouts are climaxes, but climaxes don't always lead to reversals. Some can become very strong breakouts, like this one. Once they finally finish correcting and the trend then resumes, it usually does so with less momentum (the slope is less) and there are usually more overlapping bars, which is a sign of increased two-sided trading.

When a bull trend is strong, traders will buy tests of the moving average, like at bars 13 and 15. The moving average therefore contains the trend, and functions like the lower line of a channel. You can write indicators to create a parallel of the trend line and place it above the highs, creating a channel, but usually curved channel lines or bands of any type do not provide as many reliable trades as do straight channel lines.

Deeper Discussion of This Chart

The strong move up from bar 13 to bar 14 in Figure 15.5 was almost vertical, and all strong bull breakouts should be thought of as spikes up and as buy climaxes. When the spike is composed of two or more large bull trend bars, it is particularly strong and more likely to have some type of measured move up before there is a significant correction. Measured moves using the open or low of the first bar of the spike and the close or high of the last bar often are good areas for the bulls to take partial or full profits and sometimes are good areas for bears to initiate shorts. Bar 13 had no tail on the bottom and closed near its high; it was the first of many bull trend bars, so it is the bottom of the spike. The height of the spike using the open of bar 13 and the high of the bar 14 top of the spike projected a measured move up to the exact high of the channel, the bar 17 high.

Bar 7 was a second-entry moving average gap bar short in a bear trend, which often leads to the final leg in the bear trend before a larger reversal develops. The rally to bar 7 broke the bear trend line and was followed by a lower low trend reversal at bar 8.

Bar 10 was another lower low in what at that point was a trading range, but it was also an expanding triangle bottom. Expanding triangles often rally to a new high and set up an expanding triangle top. The market attempted to do that at bar 14, but the momentum was so strong that anyone thinking about shorting would have to wait for a second entry, which never set up. It was far better to be looking to buy a pullback than to consider taking a short after such a strong bull breakout. The expanding triangle top failed, as expected, and the breakout of the top of the trend channel line and the bar 9 high of the prior day was followed by a two-legged sideways breakout pullback correction to the moving average at bar 15.

FIGURE 15.6 Reversals at Lines

Once the market appears to be trending, look for all possible trend lines and trend channel lines because they are areas where the market might reverse. Traders will use every technique to draw the lines, like connecting swing points, creating parallels, and using best fit lines. Figure 15.6 shows some of the more obvious lines, but there were many others. Some would have been based on related markets like the cash index, and others were based on other types of charts like volume and tick charts. The shorts can take partial profits on the tests of the bottom of the channels near the trend channel lines, and aggressive bulls can initiate long scalps there. At the top of the bear channel, bulls will take profits on their scalps and bears will initiate shorts for swings and scalps.

The line A bear trend line created by the bar 3 to bar 7 high was tested to the tick six bars after bar 7 and again at bar 10 and bar 11, and it contained all of the upside price action. This made it clear that it was important today. Because it was important, creating a parallel (line B) and anchoring it at a swing low that contained all of the sell-offs would likely create a channel that traders would feel was significant. Bar 6 was the logical choice for the anchor.

Once bar 14 broke below the bottom of the channel, traders would look at a measured move down using the height of the channel at the time of the breakout for a possible measured move projection. The move was exceeded on the open of the next day. When a bear channel breaks out of the downside instead of the top, even if the breakout is sharp as it was here, it usually goes only a few bars before reversing. Once it reversed back into the channel on bar 17, the objective was a poke above the channel, which occurred at bar 19.

The sell-off from bar 13 to bar 16 had 10 bear trend bars with little overlap and large bodies with small tails, all signs of bear strength. This was unsustainable behavior and therefore climactic; it had to be an unusually large bear trend bar on some higher time frame chart, although nothing is gained by looking for the perfect higher time frame chart. Any large bear trend bar is a spike, a breakout, and a sell climax. The strong move up to bar 19 had to create a two-bar reversal with that sell-off from bar 13 on some higher time frame chart, and even a bull reversal bar on an even higher time frame chart. Never lose sight of the big picture, and don't become frightened by an unusually strong sell-off. Yes, a huge bear spike is a strong sell climax and will often be followed by a protracted bear channel, but it can also represent exhaustion and lead to a big reversal, as it did here.

The market usually races to the top and bottom of the channel due to the vacuum effect. For example, bar 7 was a strong bull trend bar and there was another strong bull bar two bars earlier. Weak bulls saw a three-bar spike and a strong reversal up on the day and bought as bar 7 was forming and on its close and on the high 1 three bars later. Strong bulls instead exited their longs on the test of the top of the bear channel.

So why was the market vacuumed up with such force on a bear trend day when bears clearly controlled the day? It was because the bears believed that the trend line was going to get tested, so as the market got closer and closer to it, they became more confident that the price would soon reach the bear trend line. There is no incentive for them to short when they believe they can short at an even better price a few minutes later. This absence of the strongest of the bears creates an updraft that sucks the market up quickly to the trend line. The momentum traders kept buying until the momentum stopped and since there were fewer bears willing to short, the market quickly moved up to a price that represented value to the bears. Once there, the bears, who had been waiting for the test, shorted aggressively. They had been able overwhelm the bulls all day, as seen by the bear trend day, and both the bulls and bears knew that the bears were in control. There was a bear channel and the market was spending most of the day below the moving average.

Since everyone except novice traders knew that the odds strongly favored the failure of any attempt to break above the trend line, it was a great location to put on shorts. Also, shorting when the bulls were at their strongest gave the bears a great entry. They saw the market as overextended and not likely to go much higher. Since they believed that the market might not go another tick higher, they finally came back into the market and shorted heavily and relentlessly, even though they were on the sidelines for several bars. The bulls used the test as a place to take profits on their scalps. Both the bulls and the bears knew that the market would be at the top of the channel only briefly, so both acted quickly. The bulls quickly scalped out of their longs because they did not want to risk the market reversing down quickly below their average entry price, and the bears began shorting heavily and continued to short all the way down to the test of the bottom of the channel. There, some took partial profits and others continued to hold short until they saw a strong trend reversal, which did not come until the next day.

Deeper Discussion of This Chart

The market formed a wedge bear flag with bars 2, 4, and 6 in Figure 15.6, and once the market broke below the flag, it fell to a measured move down, reaching the target three bars before the close.

The day opened with a small gap down but the first bar was a doji and therefore a weak setup for a failed breakout long. By bar 3, the day was a trading range so it was acceptable to short below the bar 3 low 2, especially since the high or low of the day usually forms in the first hour and this was a possible high of the day. The market might have been forming a lower high and was failing to hold above the moving average.

Bar 5 was a test of the breakeven stops of the traders who shorted below bar 3, and set up another low 2 short at the moving average. The market was forming lower highs and lows and might have been in the early stages of a bear trend.

FIGURE 15.7 Channels Are Always Trying to Reverse

When the market is in a channel, the reversal setups often don't look quite right. That is because they are not reversal setups, but just the beginning of flag pullbacks. In Figure 15.7, the Emini completed a wedge bull flag down to bar 12, which poked a couple of ticks below an earlier low on the 60 minute chart (insert) and set up a large double bottom bull flag. Traders saw the market as flipping to always-in long on the bar after bar 12, on bar 14, or on the breakout above the bar 18 signal bar for the bull breakout of a small triangle (bars 15, 17, and 18 were the three pushes down).

A bull trend is either in a spike or in a channel. Since the market was not in a strong spike, traders assumed that it was in a bull channel, which meant that there would be pullbacks. Anything that looked like a low 1 or low 2 signal bar was then a buy signal. Instead of shorting below those bars, there would likely be more buyers at and below the lows of the signal bars. This is what happened with the low 1 short signal bar that followed bar 17. Traders bought the breakout below the bear inside bar, because they saw the market as always-in long and in a bull channel, and not in a bear leg. They wanted to buy at and below the low of the bar before bar 18, expecting the low 2 sell signal to fail. However, the bulls were so eager to get long that they placed their buy limit orders one tick above the low of the bar. They were afraid that there would not be enough bears left to push the market below the low of the sell signal bar, and they did not want to get trapped out of what they saw as the early stage of a bull trend. They saw the market as always-in long, and believed that the bears were wrong and that any sell signal would fail. They expected any sell-off, along with any opportunity to buy on a markdown in price, to be brief. They were happy to see any bear trend bar, especially a low 1 or low 2 that might trap bears, who would then be forced to buy back their losing shorts as the market reversed up. These bears would then be buyers, helping to lift the market, and they would be hesitant to short again for at least a few bars. This would make the market one-sided in favor of the buyers, giving them at least a scalper's profit, and possibly a swing profit.

Because the three pushes up to bar 16 were in a tight bull channel, many traders saw that wedge as a single spike up and were looking for a bull channel to follow after a pullback. Since the three prior pullbacks in the rally were between five and nine ticks, bulls would have placed limit orders to buy pullbacks of about that size. The pullback to bar 20 was seven ticks, the pullback to bar 22 was eight ticks, and the pullback to bar 24 was also eight ticks. Other traders just buy with limit orders at one to three ticks below the low of the prior bar in a channel, risking to below the most recent swing low. For example, they bought as bar 20 fell below the small doji before it, or below bar 19, and had their protective stops below bar 17. To a beginner, this is counterintuitive, but to experienced traders, this is an opportunity. They know that 80 percent of attempts to break below the bottom of the channel will fail, so buying as the market is making an attempt is likely to be a good trade.

Bears who saw the entire move up from bar 12 as an overdone bear rally were unhappy with how weak the short signals were at bar 13, the bar before bar 15, bar 16, the bar after bar 19, the bar before bar 21, bar 23, and the bar after bar 25. Whenever the market is working higher in a relatively tight channel, all of the sell signals tend to look bad, because they are not really sell signals—they are just the start of small bull flags. Since the strong bulls are buying below the lows of the prior bars and on limit orders that are located between maybe five and 10 ticks below the most recent swing high, it is a low-probability bet to short exactly where the strong bulls are buying. In a tight bull channel, it is rarely wise to short below the low of a bar unless there has been a strong climactic reversal after a breakout of the top of the channel, and even then it is often better not to short below a bar until after a sell-off that is then followed by a lower high. Remember, the market is always-in long and it is always better to only buy until the market flips to always-in short. It is easy to look at the channel and see it as weak, and to look at the sell-off down to bar 12 and assume that the bears will return, but you have to trade the market in front of you, not the one that just ended or the one that you think should soon begin.

When a channel has relatively small bars, bars with prominent tails, and trend bars in the opposite direction, there is significant two-sided trading taking place, even though the channel is a trend. This creates an opportunity for countertrend scalpers. The channel up from bar 18 is an example. Bears will short the closes of bull trend bars above prior swing highs, like the bar after bar 22, and the closes of small bull bars that follow, like bar 23, for scalps. Many are willing to scale in higher (scaling into trades is discussed in book 2). For example, if they shorted the close of the bull trend bar after bar 20 and one or more of the closes of the small bull bars that followed, or a point or so above their first entry, they would then take profits on their entire position at their original entry. That original entry would then be a breakeven trade and their later entries would give them a scalper's profit. These profit-taking bear scalpers bought back their shorts on the low of bar 22, since its low fell below the entry price of their first entry (the close of the bull trend bar after bar 20). That bar was also a test of the moving average, so there were also bulls who bought the test, in addition to the profit-taking bear scalpers who exited because the market reached whatever profit target they were using, such as the close of the bull trend bar after bar 20, the moving average, a breakout test of the 16 high, or five ticks below the high of the doji bar after bar 20 (as discussed in book 2, that was a weak buy signal bar, so bears would have shorted with a limit order at its high, and they would have scalped out one point lower; this meant that the market had to fall five ticks, which it did at the bar 22 low). There are always many different traders entering or exiting at every tick all day long for every conceivable reason. The more reasons that line up in the same direction, the more likely the market will trend.

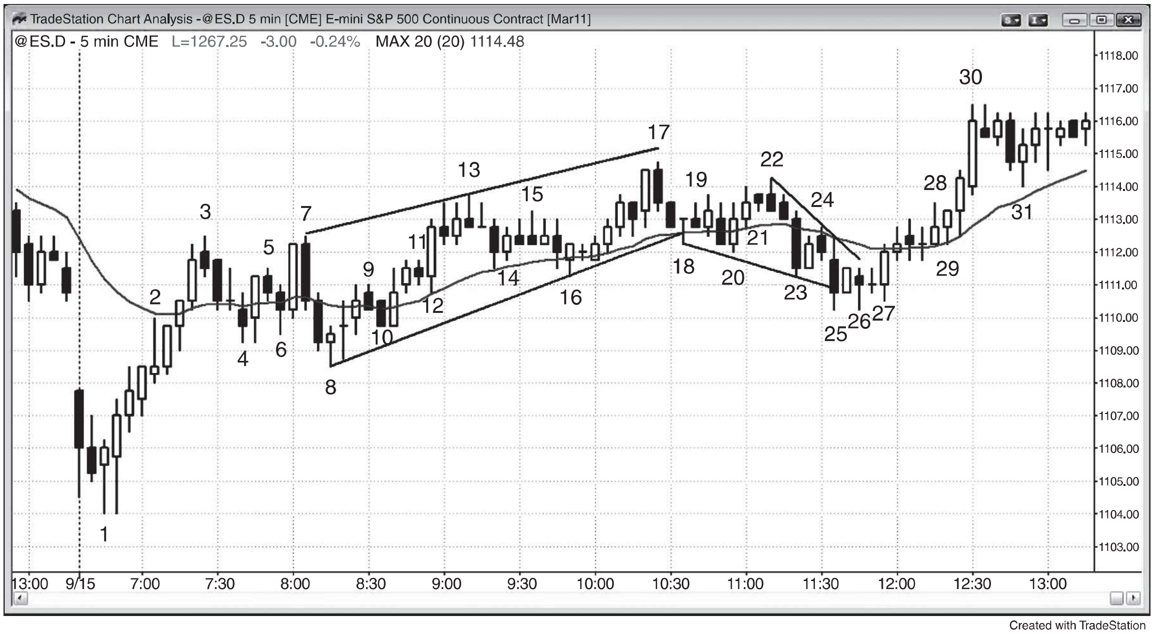


FIGURE 15.8 Entering on Limit Orders in Channels

In addition to entering on stops, entering on limit (or market) orders can be an effective approach whenever the market is in any type of channel, including triangles and trading ranges. In Figure 15.8, the market had eight consecutive bull trend bars in the strong bull spike up to bar 3, so the market was likely to have a test of the high after a pullback. Although bears shorted below the bar 3 bear reversal bar, bulls were scaling in on limit orders below the low of the bar. Some bought on a limit order at the low of bar 3, but because the next bar was a strong bear trend bar, there were far more sell orders. Other bulls bought on a limit order at one tick above the moving average, since the market might have only touched the moving average and not filled a buy limit order exactly at the moving average. Some bulls scaled in lower, maybe buying more at one-point intervals. If they did, they could have then put a limit order to exit both positions at the entry price of the first order, at or just below the low of bar 3. They would have been filled on bar 5, would have broken even on the first entry, and would have made a profit on their second. This profit taking by these bulls contributed to the bear reversal bar at bar 5.

Traders saw the doji inside bar after the bear trend bar that followed bar 3, and many thought that this was not a good short setup. Since they believed that shorting below the bar would likely not yield a profitable scalp, some traders instead bought on a limit order at or one or more ticks below its low. This buying contributed to the tail at the bottom of bar 4. Bar 4 was the fourth consecutive down bar, which is enough bearish momentum to make traders hesitant to buy above its high, even though they believed the market would test the bar 3 high. They expected the first attempt up would likely fail and they preferred to wait for a two-legged pullback to buy. Bears realized this and thought that the traders who bought above bar 4 would likely lose money. This made shorting on a limit order at or just above the high of bar 4 a reasonable scalp. They exited with a one-point profit as bar 6 fell five ticks below the high of bar 4. Why was the low of bar 6 exactly five ticks below the high of bar 4? In large part because those short scalpers became buyers as they took their profits down there, and their buying helped create the tail at the bottom of bar 6.

Since most traders still believed that the market should test the bar 3 high, they were still looking to buy. Since the market clearly became always-in long in the spike from bar 1 to bar 3 and there was not yet a clear flip to short, the always-in position was still long. Therefore, they did not believe that shorting below the low of bar 5 was a good trade. Given that they thought it would be a losing trade, many traders did the opposite and bought on a limit order at or below the low of bar 5. Their buying, in addition to the buying by the shorts who were taking profits from their scalp down from above bar 4, created the tail at the bottom of bar 6.

Bar 6 was a two-legged sideways correction down from the bar 3 high, and many traders bought above bar 6 on a stop for the test of the bar 3 high. At the same time, many of the traders who bought below bar 5 sold out for a profitable scalp on the rally.

Although the market formed a double top at bar 7, many traders did not expect a trend reversal and instead expected a trading range and then a bull channel because that is what usually happens after such a strong spike on a day where a strong case could be made that bar 1 was likely going to remain as the low of the day. Bar 7 formed a two-bar reversal with the bar before it and the better entry is below the lower of the two bars. The problem with entering below the low of the bar 7 bear bar is that the market often has a one-tick bear trap. This means that it falls one tick below the bear bar but not below the low of both bars of the two-bar reversal, and then the rally resumes. This risk is less if you enter below the low of both bars, and that is why the market reversed up six ticks later. The bears bought back their shorts on a profit-taking limit order located five ticks below the signal bar low, which usually requires the market to fall six ticks. The bar 8 low was exactly six ticks below the bottom of the two-bar reversal.

If this was a strong bear trend, traders could short on a stop below the prior swing low at bar 4. Since most traders thought that the low of the day was in and that the market would likely form a bull channel, they thought that shorting below the bar 4 low was a bad idea. This means that buying below its low might be a good long, especially if the traders could scale in lower if need be. Also, since the market was likely to form a channel that could last for hours and the market might not again come down to this level, these bulls could swing some or all of their positions.

Other bulls saw bar 8 as the second leg down from bar 3 (bar 4 was the first leg down) and they bought above the high of bar 8 on a stop. The bar after bar 8 was a doji bar, which indicates that the market is still two-sided. Bar 8 was not a strong bull reversal bar, and the two-bar spike down from bar 7 made traders wonder if the market might be reversing. Traders had to decide if they thought that bar 9 was going to be the lower high pullback that would lead to a bear channel, or if always in was still long and that the market was in the early stages of a bull channel.

The traders who thought that the bottom was in believed that bar 9 was a bad short setup and they placed limit orders to buy at and below the low of bar 9. Many of these bulls would have added on if the market fell below the bar 8 low. The bears who shorted below bar 9 bought back their shorts when the market reversed above the bar 10 entry bar. Bulls also bought, believing that this failed short was more evidence that a bull channel was forming.

Channels have lots of pullbacks along the way, and the bulls would not let themselves be stopped out by a pullback. Instead, they would buy on a limit order at or below the low of the prior bar, like below bars 9 and 11. Since channels have two-sided trading, as long as the channel is not too tight and too steep, bears will short at or above swing highs. For example, they would have shorted as bar 12 went above the bar 7 high and some would have added on one point higher. This in part was the reason that the high of bar 13 was exactly five ticks above bar 7. They would also have shorted on the move up to bar 17 as the market went above the bar 13 high. Some bears would even have shorted the sharp rally up to bar 30 as it moved above the bar 17 high and they would have added on one point higher. They could have bought back both shorts at the original entry price as the market fell to bar 31. Their original short would have broken even and their add-on would have made a one-point profit.

The bulls would have looked at the rally up to bar 29 as having trending highs, lows, and closes, and therefore would have believed that it was strong. Some would have bought more on a stop at one tick above the bar 17 high. They could have exited with a profit on bar 30. Whenever a breakout trade results in a profit, it is a sign that the trend is strong. However, it is not absolute and if the market is mostly in a trading range, as it was today, there may not be follow-through.

There was two-sided trading throughout the day and both bulls and bears were entering on limit orders and on stops. For example, once the always-in position flipped to short at the bar 17 wedge top (wedge reversals are discussed later), bears began shorting above the high of the prior bars, like above bars 18, 20, and the bar after bar 24. Bulls were buying below prior swing lows, like below bars 20 and bar 23. There were many other setups during this day, as there are on all days, but the purpose of this chart is not to show every possible trade. Instead, it is to make the point that when the market is in a bull channel, bulls are buying below the low of the prior bar and bears are selling above swing highs. In bear channels, they do the opposite—bulls buy below swing lows and bears short above the high of the prior bar.

CHAPTER 16

Micro Channels

A micro trend line is a trend line on any time frame that is drawn across from 2 to about 10 bars where most of the bars touch or are close to the trend line and the bars usually are relatively small. Typically a trend channel line can be drawn along the opposite ends of the bars as well, and the result is a very tight channel called a micro channel. Unlike a conventional channel where pullbacks are common, a micro channel progresses with no pullbacks, or rare, small pullbacks, making it an extremely tight channel.

The more bars, the stronger the bars (like bars with big trend bodies in the direction of the micro channel), and the smaller the tails, the stronger the micro channel, and the more likely that the first pullback will fail to reverse the trend. A micro channel can last for 10 or more bars, and other times it will run for about 10 bars, have a small pullback, and then resume for another 10 bars or so. It does not matter whether you view the entire channel as one big micro channel (a micro channel is a type of tight channel), two consecutive micro channels separated by a small pullback, or a large tight channel, because you will trade it the same way. The trend is very strong and traders will look at reversal attempts to fail and become pullbacks and for the trend to continue.

Ten years ago, traders saw micro channels as a sign of program trading. Now, since most trading is done by computers, it adds nothing to say that micro channels are signs of program trading, because every bar on the chart is due to program trading. A micro channel is just one particular type of program trade, and it is likely due to many firms running programs simultaneously. One or more firms will start it, but once the momentum is underway, momentum programs will detect it and begin trading in the same direction, adding to the strength of the trend. Once the trend begins breaking above resistance levels, breakout programs will start trading. Some will trade in the direction of the trend and others will begin to scale in against the trend, or scale out of longs that they bought lower.

Eventually one of the bars penetrates through the trend line or the trend channel line, creating a breakout. Bull and bear micro channels can develop in bull or bear trends, and in trading ranges. The environment in which they occur determines how to trade them. Both bull and bear channels can have breakouts to the upside or the downside. As with all breakouts, three things can then happen: it can be successful and be followed by more trading in that direction, it can fail and become a small climactic reversal, or the market can just go sideways and the pattern can evolve into a trading range.

As with any breakout, traders will trade either in the direction of the breakout, expecting follow-through, or in the opposite direction, if they expect the breakout to fail. Breakouts, failed breakouts, and breakout pullbacks are closely related and are discussed in book 2. As a guide, traders compare the strength of the breakout with that of the reversal attempt. If one is clearly stronger, the market will likely go in that direction. If they are equally strong, the trader needs to wait for more bars before deciding where the market is likely to go next.

When a bear micro channel forms in a bull trend, it is usually a bull flag, or the last leg of a bull flag, and traders will look for a signal bar and then place a buy stop above its high to enter on the breakout of the bear micro channel and of the bull flag. When a bull micro channel forms in a bear trend, it is usually a bear flag or the final leg of a bear flag and traders will short below any signal bar.

If instead of a bear micro channel forming in a bull flag, the micro channel is a rising micro channel (a bull micro channel) in a bull trend, the first downside breakout (the first pullback) will usually not go far, and it will be bought aggressively. The more bars in the bull micro channel, the more likely that the bear breakout will not reverse the bull trend. For example, if there is a five-bar bull micro channel in a bull trend, there will probably be far more buyers at and below the low of that fifth bar than sellers. If the market trades below that fifth bar, the bar creates a bear breakout of the bull channel. However, it is unlikely to lead to more than a bar or two of selling because the bulls will be eager to buy the first pullback from the strong micro channel bull trend. Remember, many traders have been watching the rally for five bars, waiting for any pullback to buy. They will be eager to buy below the fifth bar and above the high of the pullback bar, which is a failed breakout buy signal bar (a high 1 buy setup). If the market triggers the long but creates a bear reversal bar within a bar or two, this then sets up a micro double top sell signal. It can also be thought of as a pullback from the breakout below the bull micro channel, even if its high is above the highest bar in the micro channel. It would then be simply a higher high reversal, which is a micro version of a major trend reversal (reversals are discussed in book 3).

It is important to realize that traders do not have to wait for a pullback to get long. Many experienced traders understand what is happening after the second or third bar of the bull micro channel in a bull trend. They think that the market is in the early stages of a very strong buy program where momentum buy programs are also buying aggressively. These traders will try to copy what the computers are doing and will buy every bull close, and place limit orders one or two ticks below the close of every bar, and one or two ticks above the low of the prior bar. If the biggest pullback in the micro channel has been five ticks, they will place limit orders to buy any three- or four-tick pullback. They expect that the first time a bar falls below the low of the prior bar will attract even more buying, so they know that their most recent buy will likely be profitable, despite the pullback. Since they made money all the way up, they are not worried about getting out at breakeven or with a small loss on their final entry when a pullback finally does come.

As with any channel, a bull micro channel can form in a trading range, or within a bull or bear trend. When it is in a bull trend, higher prices are more certain, and traders should look to buy near the middle or bottom of the prior bar. When the micro channel is especially tight, it can be a spike on a higher time frame chart; a broader channel may follow, and it might reach a measured move target based on the height of the tight micro channel. When a bull micro channel is in a bear trend, it is a bear flag, and traders should look to short the downside breakout or the pullback from a downside breakout. When a bull micro channel forms after a possible low in a bear trend, it can become the final flag in the bear trend and break out to the upside instead of to the downside, and the breakout can be the spike that leads to a bull trend. When a bull breakout occurs, it usually follows a failed low 1, 2, or 3.

A micro channel is a sloping tight trading range, and therefore it has a strong magnetic pull that tends to prevent breakouts from going very far. It is also often tight enough to sometimes act as a spike, and it can be followed by a broader channel, creating a spike and channel trend. When there is a breakout from a micro channel, it is usually just for a bar or two and is mostly due to profit taking. For example, if there is a bull micro channel (an upwardly sloping micro channel) and a bar trades below the low of the prior bar, that is a breakout below the micro channel. This is primarily due to bulls taking profits, although there are some bears who are shorting. Within a bar or two, other buyers come in, some bears exit, and the market usually trades above the high of the prior bar. Some traders will see this as a failed breakout of the micro channel, and they will buy as the market goes above the high of the prior bar. For them, this is a high 1 buy setup. Others will assume that the trend is reversing down; they will wait for the market to form either a higher high or lower high breakout pullback over the next couple of bars, and then they will short below the low of the prior bar. The overall context can give a clue to which outcome is more likely. For example, if the market is in a strong bear trend and the bull micro channel is just a pullback, the odds favor that the breakout below the micro channel will be followed by more selling. If the market trades above the breakout bar, bears will place stop orders to short below the low of the prior bar. If instead the bull micro channel is forming as a breakout from a trading range in a bull market, the odds favor the breakout below the micro channel becoming a pullback in the bull trend, and bulls will place buy orders at one tick above the high of the prior bar.

A breakout of the trend line sets up a with-trend entry. For example, if there is a bull micro channel and the market is always-in long, and then there is a bar with a low below the micro bull trend line, then buying the high of that bar can be a reliable trade. This is a tiny but strong one-bar bull flag (a high 1 buy setup) and it is a failed breakout buy signal. It might be a two-legged correction on a smaller time frame chart; however, it is better to not look, because you will find yourself with too much information to process in a short time and you will likely mismanage or not take the trade.

If the bull micro channel is within a trading range or in a bear trend instead of in a strong bull trend, you have other things to consider before buying above the failed bear breakout. If the channel is at the top of a trading range, it is often better not to buy the failed breakout and instead to wait to see if the reversal back up stalls and becomes a higher high pullback from the breakout. If it only goes up for a bar or two and then forms a bear reversal bar, this can be a reliable short setup when it is near the top of a trading range (a micro double top, discussed in book 3). If the bull micro channel is a bear flag just below the moving average, you should only look to short, since the odds are that the shorting by the bears will overpower the bulls who bought the pullback. Wait for the breakout below the channel and then for the failure and one more push up. If that reversal back up forms a bear reversal bar at the moving average within a bar or two, this is usually a reliable breakout pullback short setup (a low 2). The market broke out of the downside of the bull micro channel and then pulled back to a small higher high. Finally, if it reversed back down, it set up a breakout below what has become a bear flag.

As with any breakout below a bull channel, there might be a pullback and then a resumption of the selling. That pullback can be a lower high or a higher high (a higher high means that the high of the bar goes above the high of the most recent swing high, which is likely the highest bar in the bull channel). Because most attempts at reversing a trend fail, the odds are in favor of the bear breakout failing and becoming just a pullback in the bull trend, followed by the bull trend resuming. Traders should place an order to go long at one tick above the high of the breakout bar, in case the bear breakout fails and the bull trend resumes.

However, they must be aware that their long might be a bull trap, trapping them into a losing long trade. Remember, although most attempts to reverse a trend fail, some succeed. Instead of the breakout to the downside failing, the market might be just briefly pulling back from the bear breakout and forming a small higher high or lower high before the selling resumes. This could be followed by a successful trend reversal into a bear leg or trend. Because of this, the trader has to be prepared to reverse to short below his long entry bar, if the overall price action makes a reversal seem appropriate. In this case, this is a breakout pullback short setup. Whenever a breakout fails, this failure sets up a trade in the direction of the original trend. If that also fails, then it becomes a breakout pullback from the original bear breakout (opposite failures create a breakout pullback) and a second attempt to reverse the trend to down.

If the breakout pullback short triggers (by the bar going one tick below the low of the prior bar, which is usually the bull breakout bar), look at the size of the bodies of the recent few bars. If the bars are bull or bear trend bars, then this second failure has high odds of being a successful second entry short. Remember, the first failure was when the bears lost on the failed downside breakout, trapping them out of their short trade. The second failure was when the bulls were trapped into their losing trade, which was set up by the failed bear breakout below the channel. If the market now turns down again, you have just had bears trapped out and bulls trapped in. In general, if both sides get trapped in or out, the odds of success of the next setup increase. If the bars have more of a doji look, then the market will likely enter a trading range, but the odds still favor a downside breakout. If you are not certain, then wait because it is likely that most traders will not be certain and a trading range will usually follow.

Although the vast majority of micro trend line breakouts are one- and two-legged pullbacks on the 1 minute chart, you should avoid trading off that chart because you will likely lose money. Most traders are unable to take all of the signals and invariably pick too many losers and not enough winners. The best trades often set up fast and trigger quickly and are therefore easy to miss. Many losing trades are often slow to set up and give traders plenty of time to enter, trapping them in the wrong direction.

That bull micro channel could instead have a breakout to the upside, above the trend channel line, in an attempt to form an even steeper bull trend. If it fails and there is a strong bear reversal bar, this buy climax is a potential short setup.

When a micro trend line extends for about 10 or more bars, the odds increase substantially that there will soon be a tradable reversal. This type of trend is unsustainable and therefore a type of climax, which is usually followed eventually by a pullback or a reversal. After such climactic behavior, be ready to take a breakout pullback entry. This is the second attempt to reverse the trend, with the original trend line breakout being the first.

A micro trend line break is important not only when the micro trend line is part of a micro channel, but also whenever there is any strong trend underway. If there is a strong bear trend with large bear trend bars and little overlap between consecutive bars and there are no pullback bars for four or five bars, you are likely eager to get short. Look for any bear micro trend line and then sell below the low of any bar that pokes above any bear micro trend line. Any poke through it is a setup for a failed breakout short entry. Enter at one tick below the bar that breaks above the bear micro trend line (a low 1 short setup).

Small, steep trend lines, even drawn using two consecutive bars, often provide setups for with-trend trades. If the trend is steep, sometimes a small pullback bar or a pause bar can penetrate a tiny micro trend line. When it does, it can become a signal bar for a with-trend entry. Some of the penetrations are smaller than one tick in the Eminis, but are still valid.

When there is a trend and then it has a pullback, it is common to see a micro trend line in the pullback. For example, in a pullback in a bull trend, if there is a bear micro trend lasting about three to 10 bars, and then there is a break above that bear micro trend line, this theoretically sets up a short on the failed breakout. Since this is occurring during a bull trend and it almost always happens above or near the moving average, you should not be shorting this pattern. You would find yourself holding a short at the bottom of a bull flag near a rising moving average in a bull trend, which is a very low-probability trade. As this short will likely fail, you should anticipate this and be ready to buy the failure, getting in exactly where the trapped shorts will get out. Your long will be a breakout pullback buy since the market broke above the bear micro trend line and then pulled back to either a small lower low or a higher low, and then the market resumed in the direction of the breakout, which is also the direction of the major trend of the day.

It is critical to remember that micro trend lines should only be used to find with-trend setups. However, once the trend has reversed, for example after a bull trend line break and then a reversal down from a higher high, you should be looking for micro trend line short setups, even if they are at or just above the moving average.

As with any chart pattern, a micro channel's appearance is different on both smaller and higher time frame charts. Even though the trend bars in a micro channel or any other type of tight channel are usually not large and there is usually a lot of overlap between adjacent bars, the trend is strong enough to be a large trend bar or a series of trend bars on a higher time frame chart. This means that it often functions as a spike, and is often followed by a broader channel, like any other spike and channel trend. Also, even though there are no pullbacks in the micro channel, there are many pullbacks if you look at a small enough time frame chart.

FIGURE 16.1 Micro Trend Lines

Small trend lines can generate many scalps during the day, especially on the 1 minute chart, which is seldom worth trading. In Figure 16.1, the chart on the left is a 1 minute Emini chart and the numbers correspond to the same bars on the 5 minute chart on the right. Both show that failed breakouts from tiny trend lines can result in profitable fades. There are other trades on the 1 minute chart that are not shown because the purpose of this figure is only to show how 5 minute micro trend lines correspond to more obvious, longer trend lines on the 1 minute chart, so if you can read the 5 minute chart, you do not have to additionally look at the 1 minute chart to place your orders. Many of these trades could have been profitable scalps on the 1 minute chart.

Note that several breaks of micro trend lines on the 5 minute chart are easy to overlook and are less than one tick in size. For example, bars 3, 5, 6, and 7 were failed micro trend line breaks on the 5 minute chart that would have been invisible to most traders, but the one at bar 5 was particularly significant and led to a good short scalp. It was the second failed attempt to break above a bear trend line (bar 3 was the first).

The failed breakout below the bull micro channel at bar 7 was a risky long and a scalp at best. Since it was a bear flag pullback to the moving average, it was better to expect the move up to stall and become a breakout pullback sell setup, which it became here.

Price action trading works even at the tiniest level. Note how bar 8 on the 1 minute chart was a higher high breakout test (it tested the high of the bar that formed the low of the bear trend) long setup and that although the market came down to test the bar 8 signal bar low two bars after entry, the protective stop below the signal bar would not have been hit. Also note that there was also an even smaller major reversal in this segment of the 1 minute chart. There was a tiny bull trend, indicated by the bull micro trend line up from the low of the chart, then a break of the trend line at bar 7, and then a higher high test of the tiny bull trend extreme. Since the pattern is so small, the trend reversal down to bar 8 was just a scalp, as expected.

On the 5 minute chart, bar 8 did not set up a long. Why? Because it was a pullback in a bear trend. You should not be buying the top of a pullback in a bear trend day. Instead, once you see the micro trend line buy trigger, get ready to short its failure, entering exactly where the trapped longs will be forced out with their losses.

FIGURE 16.2 Failed Breakouts of Micro Trend Lines

Even trend lines created using just two or three consecutive bars in a steep trend can set up with trend entries when there is a small break that immediately reverses. Each new break becomes the second point in a longer, flatter trend line until eventually trend lines in the opposite direction become more important, and at that point the trend has reversed.

In Figure 16.2, bar 1 dipped below a three-bar trend line and reversed up, creating a long entry at one tick above the prior bar.

Bar 2 dipped below a six-bar trend line. Traders would have placed buy stops above its high. When not filled, they would move their buy stops to the high of the next bar and would have been filled on bar 3. This was a high 1 buy entry, and most bear breakouts of bull micro channels in a bull trend fail and become high 1 buy setups. Since the micro channel is usually breaking above something, like a prior high, as it did here when it moved above the first bar of the day, the high 1 is usually also a breakout pullback buy setup. Incidentally, the bar before bar 2 was a possible short setup based on a failed breakout of a micro trend channel line (not shown) that is a parallel of the three-bar micro trend line leading up to bar 1. The upward momentum was too strong for a short without a second entry, but this illustrates how micro trend channel lines can set up countertrend trades.

Bar 4 was a small inside bar that extended below a two-bar trend line (the penetration is not shown). The buy is on a stop at one tick above the high of the small inside bar.

Bar 5 broke the major trend line of the day (any trend line lasting about an hour or so is more significant), so traders would be thinking that a two-legged pullback was more likely. After the break above the bear trend line on the bar following bar 5, a short would be triggered on the bar 6 lower high. When bars are small doji bars like those following bar 5, it is usually best to wait for bigger trend bars before taking more trades, but these trend line reversals still led to profitable scalps of 30 to 50 cents in Amazon (AMZN). Since bar 5 was the first breakout of a fairly tight bull channel, it is better not to short it and instead to wait for a breakout pullback to short.

Bar 6 was a reasonable lower high breakout pullback short entry for a scalp down toward the moving average. This was not a good trend reversal trade because there had yet to be a test of the moving average followed by a test of the bull trend high.

Bar 6 was a micro trend line short in a bull trend, which is a bad trade when it occurs close to the moving average. Here, however, there was plenty of room down to the moving average; in addition, it was following a wedge top and therefore would likely be part of a two-legged correction down.

Unlike a conventional channel, where pullbacks are common, in a micro channel the lack of pullbacks is one of its defining characteristics. For example, in the bull micro channel that started on the bar before bar 8, the first leg ended with the small bar 9 pullback. Some traders saw the next four bars as part of the same channel, with bar 9 as a pullback, and other traders saw bar 9 as the start of a second micro channel. It really does not matter, because the sideways move to bar 10 broke below both.

Deeper Discussion of This Chart

The market gapped up in Figure 16.2 and therefore broke out above the close of yesterday and the first bar was a bull trend bar. The body was reasonably strong and there was a tail below, both showing buying pressure. Yesterday closed with some bull bodies, again showing strength by the bulls, so this bar was not a strong signal bar for a short on the basis of a possible failed breakout setup. The second bar had a bear body and dipped below the low of the first bar and was a reasonable breakout pullback long setup for a possible trend from the open bull day. There were four bull trend bars, creating a spike up, but the final one had a large range and might indicate some exhaustion. This led to the first pullback long setup, and bar 3 was a strong entry bar. This was also a breakout pullback long from the breakout above the opening high. Since the first bar of the day was unusually large, it could and did lead to about a measured move up.

FIGURE 16.3 Micro Trend Lines in Strong Trends

Small trend lines in strong trends, even when drawn using adjacent bars, often have failed breakouts that set up good with-trend entries. Many of these are two-legged pullback setups (ABC corrections) on 1 minute charts, but you don't need to look at the 1 minute chart when you see the false breakouts on the 5 minute chart.

When trading, you do not have to actually draw the trend lines on the chart very often because most trends are visible without the help of the drawn lines.

There were many good with-trend entries in AAPL on this 5 minute chart in Figure 16.3 based on failed breakouts of micro trend lines. When the trend is steep, you should only be looking to trade with the trend and you should not be trading small reversals. For example, even though bar 3 broke above a bear micro trend line, the bear trend was actually a bull flag in a strong bull trend where the market has been above the moving average for more than 20 bars. You should only be looking to buy and not short, especially not just above the moving average.

Bar 2 was a breakout below a bull micro channel in a strong bull trend, and it should be expected to fail. This set up a reliable high 1 buy setup.

Bars 10 and 12 were first breakouts above steep, tight channels and therefore not good long entries. Although bar 12 was the second breakout to the upside on the way down, the move down from bar 10 lasted several bars and was steep; it therefore created a new small micro channel, and bar 12 was the first attempt to break out of the new channel (both bars 10 and 12 were low 1 sell signal bars).

Bar 9 was a bear reversal bar and a signal bar for the downside breakout of the small triangle. A triangle is a mostly sideways trading range with three or more pushes in one or both directions. The bar before bar 9 was the third of three small pushes down, and was the point at which the trading range became a triangle. Since the market was in such a tight bear channel from the first bar of the day, it was unreasonable to believe that the triangle would be a reliable buy setup. In fact, most traders did not see the pattern as a triangle yet, and were continuing to look for shorts. Once the bar 9 bear reversal bar formed the third push up, traders were confident that the pattern was a triangle in a bear trend, and a reliable sell setup. Even though bar 9 had a bull body, it was a small doji and therefore did not have much buying pressure. However, it was still a reversal bar since it closed below its midpoint. Bar 9 would have been a stronger signal if it had bear body.

The tight bear channel that ended three bars after bar 8 had several smaller micro channels within it. It does not matter whether a trader sees the tight channel as a large micro channel with a couple of small pullbacks, three consecutive micro channels, or as a large tight bear channel, because he would trade the market the same way. The move down is very strong and is probably a strong spike on a higher time frame chart. Smart traders were looking for any pullback to short, expecting that any pullback would simply be profit taking by the bears, and would be followed by lower prices and not a trend reversal. In a strong trend such as this, traders will short above the high of the prior bar and below the low of any pullback, like below bars 9, 10, and 12.

Many bull trends that have only small pullbacks but result in large profits have low probability short setups. For example, both bars 10 and 12 were doji bars in areas of other bars with tails, and therefore were signs of two-sided trading. When the market begins to develop signs of two-sided trading, it often is evolving into a trading range, which means shorting near its low and hoping for a breakout of the developing trading range is a low probability short. The probability of a successful swing down might be only 40 percent. However, since the reward is several times the risk, the trader's equation is still very positive. Traders who prefer to take only high probability trades would not have shorted below bars 10 or 12, and instead would have waited for high probability reversals to buy (like the bull reversal bar after a series of sell climaxes at the low of the day; reversals are discussed in book 3), or pullbacks to short (like the bar 9 triangle), or strong bear spikes to short (like the bar 11 close, since it was a breakout below a wedge bottom; the low of the bar before bar 11 and the high of bar 12 formed a measuring gap, which is discussed in book 2).

Deeper Discussion of This Chart

In Figure 16.3, yesterday closed with a strong bull trend bar breakout of a largely horizontal bull flag after a protracted bull trend. This was a final flag short setup and it triggered on the first bar of today. Traders could short below the bull trend bar or below the first bar, which had a small bear body, or below the bottom of the final flag. The entry bar was a large bear spike and was followed by a tight and therefore very strong bear channel. The day was a trend from the open bear trend day.

The first reversal attempt of micro channels is due to profit taking. For example, when the bear bar before bar 2 fell broke below the bull micro channel, it was due mostly to bulls taking profits. Other bulls were eager to get long, since this was in a bull trend, and bought using limit orders as that bear trend bar fell below the low of the prior bar, and others bought one to several ticks below. Some bought on the close of the bear bar, expecting it to become a failed breakout. Limit order entries are discussed in book 2. Traders who prefer stop entries bought above the bar 2 two-bar reversal, which was a high 1 and a breakout pullback buy setup.

FIGURE 16.4 Micro Trend Lines Are Just Trend Lines on Smaller Time Frames

What appear as micro trend line setups on a 5 minute chart are usually 3- to 10-bar pullbacks on the 1 minute chart (see Figure 16.4). The 1 minute Emini provided entries on trend line tests and trend channel overshoots and reversals all day long. Many of the penetrations were less than one tick but still meaningful. The lines shown are just some of the ones that could be drawn on this chart; there are many others. Just because it looks easy when you look back at a 1 minute chart at the end of the day does not mean that it is easy to make money trading the chart in real time. It is not. Invariably the best setups look bad but set up and trigger too fast to take them, whereas the losers give you plenty of time to get in. The result is that you end up taking too many bad trades and not enough good ones to offset your losses and you lose money on the day.

Each successive trend line in Figure 16.4 gets shallower until trend lines in the other direction dominate the price action.

A micro channel is usually a trend bar (a spike) on some higher time frame chart, and a channel with many pullbacks on a smaller time frame chart.

FIGURE 16.5 Micro Trend Lines When the Dow Is Down 700 Points

There were many micro trend line and channel trades in the Eminis on the day charted in Figure 16.5 (only four are shown), a very unusual day when the Dow was down over 700 points but rallied into the close to make back half of the loss.

Bar 5 was a micro trend channel overshoot that became the first bar of a two-bar reversal. The channel line was a parallel of the bars 1 to 4 micro trend line. You could also have drawn the channel line using the lows (the low of the bar after bar 1 and the low of bar 3). There was a great ii setup where both bars had bull closes, which is always desirable when fading a strong bear trend. The bar after bar 5 formed a two-bar reversal with bar 5.

When a micro channel starts having five to 10 bars like the channel from the open that ended at bar 5, you can just as accurately simply refer to it as a channel. The term does not matter because a micro channel is simply a channel and the only reason to distinguish it from larger channels is because micro channels often set up reliable with-trend scalps in trends.

Bars 7 and 9 were micro trend line failed breakout short scalps and both were quickly followed by buy scalps as the failures failed, creating breakout pullback buy setups (even though both were lower lows). Bar 7 was the first breakout above the micro channel and therefore not a good long setup. Instead, it became an outside down entry for a short. You could also have waited for bar 7 to close to be sure that it had a bear body and then short the breakout below the bar 7 outside down bar for a scalp.

Bar 11 was a classic trap to get you out of a strong rally. If you exited, you needed to buy again on the high 1 above the bar 11 micro trend line false breakout. Bar 9 was a breakout above the bear micro channel, and bar 10 was a lower low breakout pullback, so traders were wondering if a larger rally was likely. Bar 10 had a small bear body and the next bar was a strong bull trend bar. The following bar also had a bull body. The buying pressure was building, and that made that third bull bar a weak low 1 sell setup. Traders expected it to fail and bought at and below its low. They did not know that a bull trend would follow, but believed that the market would rally enough for at least a long scalp. Within a bar or two after bar 11, traders saw the market as always-in long, and swung the remainder of their longs, and even added to them.

Many of the bars today had a range of over 6 to 8 points. It would be prudent to reduce your position size to half or less, and increase your stop to 4 points and your profit target to 2 points. Otherwise, it was just another well-behaved price action day.

Deeper Discussion of This Chart

The day opened with a large gap down in Figure 16.5, but the first bar was a strong bull reversal bar and therefore set up a trend from the open buy signal based on the failed breakout below the close of yesterday. The third bar was a strong bear bar and therefore a spike down, but the market might just be forming a higher low before the rally resumes. Instead, the market traded above the higher low and then reversed down in an outside bar down (bar 1), triggering a breakout pullback short entry. The gap down was the breakout, and the failed breakout and attempt to rally failed and became a breakout pullback for a resumption of the bear breakout. Traders reversed to short as the bar went outside down. Other traders shorted below the low of the outside down bar, and others shorted below the low of the bull reversal bar (the first bar of the day). The day became a large trend from the open bear day as the market traded in a tight channel down to bar 5. The channel was so tight that it was effectively just a spike. The market pulled back to the moving average and then a bear channel unfolded down to the bar 10 low of the day.

Most failed micro trend line trades are low 1 entries in bear trends and high 1 entries in bull trends. Bar 9 was a low 1 sell setup. Bar 11 was a high 1 buy setup; it was the first higher low in the new bull leg, and a higher low after a possible trend reversal into a bull is a good buy setup. The low 1 signal bar before bar 11 was a doji bar and it followed two bull trend bars. The first was a strong bull trend bar that might have turned the always in direction to long (it was a two-bar reversal with the bar after bar 9, after the bar 9 one-bar final flag). Aggressive bulls would have bought with limit orders at the low of the low 1 signal bar, expecting the short to fail.

Breakout pullback trades that have higher highs or lower lows are small final flag reversals. For example, bar 9 was a breakout above a micro trend line, and the breakout failed and sold off to a lower low at bar 10. Bar 10 can be thought of as a pullback from the bar 9 breakout, and it pulled back to a lower low, which breakout pullbacks sometimes do. Since it reversed up, bar 9 became a one-bar-long final flag.

The sell-off down to bar 5 was in a tight channel, but it was so strong that it had to be a spike down on a higher time frame chart. The market then rallied to the moving average, where there was a 20 gap bars sell signal. This was followed by a long channel down to bar 10, completing the bear spike and channel pattern. The first target of the reversal was the top of the first strong buy setup, which was the bar 5 two-bar reversal. After that, the next target was the start of the bear channel, which was the moving average test at 8:30.

FIGURE 16.6 Micro Trend Lines in a Bull Trend

On a strong bull trend day, shorts should be avoided, including micro trend line shorts, especially near or above the moving average. In Figure 16.6, shorting on bars 1, 2, and 3 would have been selling against the bull trend in the area of the moving average or above the moving average. Yes, the downward-sloping micro trend line indicated that there was a small bear trend, but each occurred as part of a pullback in a very strong bull trend, and you should have been only looking to buy. These were bull flags and they were above the moving average, which is a sign of bull strength. There had been no break of a significant bull trend line followed by a reversal down from a higher high or lower high test of the bull high. The only value of bear micro trend lines on a bull trend day is to alert you to buy the breakout pullback that will form as the micro trend line short fails. In other words, don't short on bars 1, 2, and 3, and instead go long where those shorts would have covered. The failure would form a small lower low (like after the bars 2 and 3 failed micro trend line breakouts) or a small higher low (like on the bar 1 failed breakout), and would just become a pullback in the bull breakout of the bear micro trend line (a breakout pullback long setup).

With-trend micro trend line entries are high-probability trades, like the longs at bars 4 and 5.

Deeper Discussion of This Chart

The chart in Figure 16.6 shows a trend from the open bull day, so shorts should be avoided, including micro trend line shorts, especially near or above the moving average. The market broke out below the moving average but immediately reversed up in a failed breakout. The bears tried to turn the rally into a breakout pullback short at the moving average, but the rally had several strong bull bodies, which meant that traders should short only on a second entry. There was none. The sell-off was brief and became a higher low.

CHAPTER 17

Horizontal Lines: Swing Points and Other Key Price Levels

Most days are trading range days or have a lot of trading range activity. On these days you will find that horizontal lines across swing highs and lows often serve as barriers that result in failed breakouts and then reversals. Expect swing high breakouts to fail and form higher high reversal setups, and swing low breakouts to fail and form lower low reversal setups. Sometimes the failure fails, which is a breakout pullback setup, and the market makes a second more extreme higher high or lower low. A fade of a second higher high or lower low setup is even more likely to be successful, because they are second attempts to reverse the market and second signals are good setups on trading range days.

On trend days, horizontal lines should generally be used only to enter on pullbacks. For example, if there is a strong upside breakout of a trading range on a bull trend day, there might be a pullback to the area of breakout level after a few bars. If there is a bull reversal setup on the test, this is a good breakout pullback buy setup.

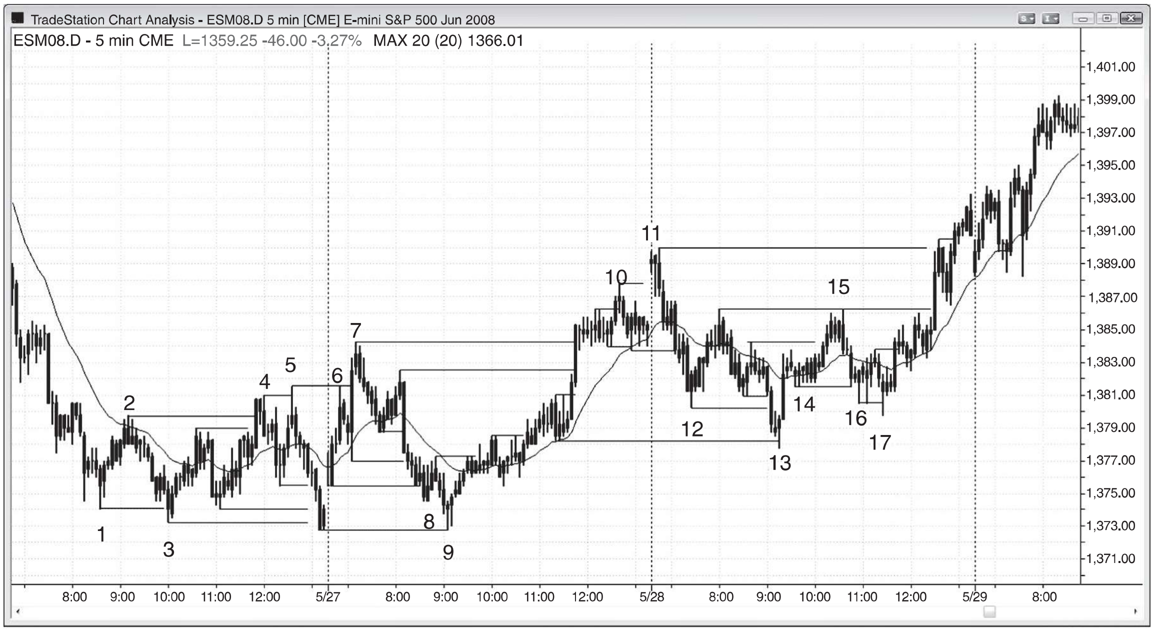


FIGURE 17.1 Breakouts Can Set Up Reversals

Most days are not strong trend days, and on these days traders should be looking at all prior swing highs and lows to see if the market creates failed breakouts, which can lead to reversal entries. Second signals are the best. A second higher high or lower low is a more extreme point on a trading range day where the middle of the day acts like a magnet, and this further extreme is therefore more likely to yield a scalper's profit. For example, in Figure 17.1, bar 5 was a second higher high over bar 2.

Bar 9 was a second attempt to reverse up after falling below the low of the open, and a double bottom with the low of the day before.

Deeper Discussion of This Chart

Bar 5 was also the third push up from the bar 3 low in Figure 17.1. Even though it did not have a wedge shape, three push patterns usually behave like wedges and can be considered to be variations of wedges.

Bar 9 was the seventh point of an expanding triangle bottom (even though it was a double bottom with yesterday's low and not a lower low, close is close enough) and bar 11 was an expanding triangle top. It was also a smaller expanding triangle where bar 10 was the second push up and it was about five bars after the first.

Bar 13 was a large double bottom pullback. There were multiple bottoms to choose from for labeling the double bottom, and bars 3 and 9 might have been the best. It was also a high 2 buy setup since it was at the bottom of two large, complex legs down. Since bars 9 to 11 formed a bull channel, which is a bear flag, bar 13 was a failed breakout of that bear flag. It was also a large wedge bull flag where the small swing low before or after bar 10 was the first push down and bar 12 was the second.

Bar 15 was a double top bear flag. It failed as a large bull breakout bar went above its high, and the market became noticeably more bullish.

Bar 17 was a second lower low below bar 14 and a lower low below bar 16. It was also a wedge bull flag with bars 14 and 16, and a breakout pullback to a higher low following the breakout above the bull flag of bars 11 to 13.

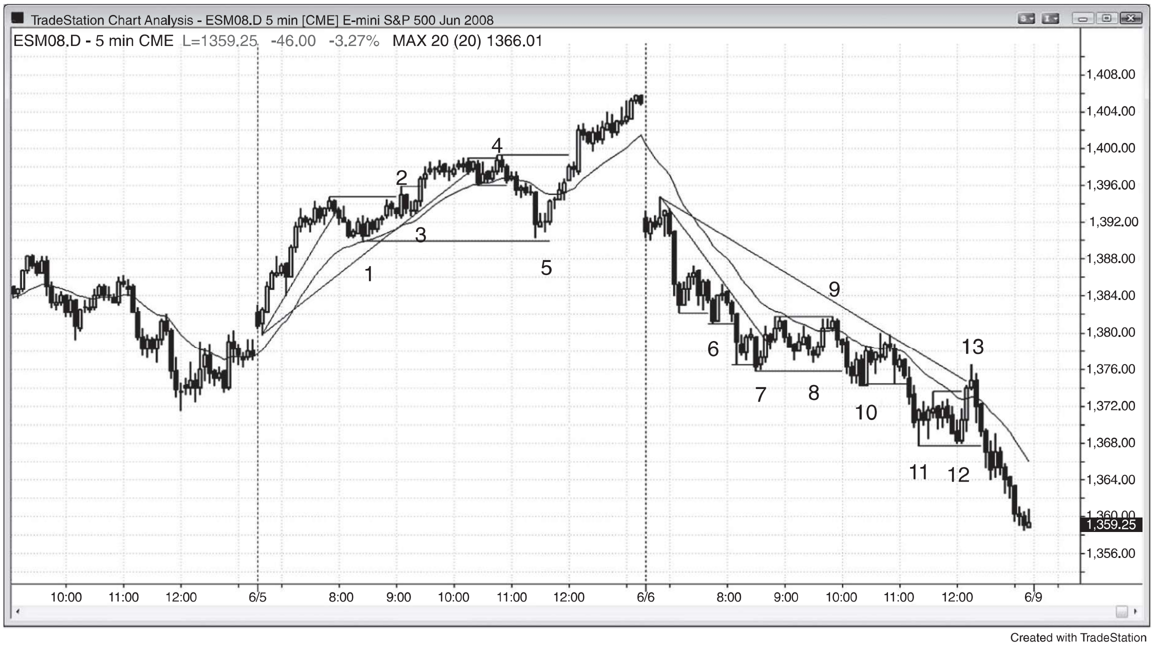


FIGURE 17.2 Don't Fade Strong Trends

On strong trend days, consider fading swing highs in bull trends and swing lows in bear trends only if there was first a good trend line break and a strong reversal bar. In Figure 17.2, both days were strong trend days with one extreme near the open and then no moving average pullback for over two hours (20 gap bar pullback setups). Bar 4 was a bear reversal bar and a reversal down from the breakout above a trading range following a small reversal up from a breakout below. Also, bar 8 was the first bar of a small two-bar reversal and there was a higher low above bar 7. However, since these are countertrend and there was only minimal countertrend momentum on the trend line breaks, these trades are not strong and should only be scalps. Do not take them if they are distracting you from the with-trend entries, where you should swing much of your position.

Deeper Discussion of This Chart

In Figure 17.2, today opened with a breakout below the bull channel of the final hour of yesterday. A bull channel should always be thought of as a bear flag. The first bar had a bear body, indicating strength by the bears on the open; but the next bar reversed up in an attempt to form a failed breakout and a trend from the open bull day. Instead, the failed breakout failed and led to a breakout pullback short below the fourth bar and again below the low of the opening range. There was a strong two-bar bear spike followed by a protracted bear channel.

Bars 1 and 5 formed a double bottom bull flag, and bar 9 was part of a double top bear flag. Bar 8 was another small double bottom bull flag. Remember, a double bottom bull flag is often just a higher low that is a double bottom.

Bar 4 was a possible top of a channel in a spike and channel bull day, and the market tested down to the bar 1 beginning of the channel. This set up a double bottom bull flag buy setup.

Both bars 5 and 13 were moving average gap bar setups. They were after 11:30 a.m., when there is often a strong countertrend move that traps traders out of the trend and into the wrong direction. This sets up a reliable with-trend trade that usually results in a new extreme and often lasts into the close.

PART III

Trends

A trend is a series of price changes that are mostly either up (a bull trend or a bull) or down (a bear trend or a bear). This is very important when it comes to trading because a trader usually should not be looking to buy unless the market is at least forming a higher low and should not be looking to short unless the market is at least forming a lower high. A trend can be as short as a single bar (remember, a trend bar is made up of a trend on a smaller time frame) or longer than all of the bars on your screen. Trends can be loosely classified into four overlapping and often interchangeable categories: trend, swing, pullback, and leg. The distinctions are just guidelines because each of the three smaller versions is a different version on different time frames. For example, a pullback in a bull trend on a 60 minute chart might be a strong bear trend on a 1 minute chart. Also, each category will contain one or more of the smaller versions. A trend might be made of 10 swings, each containing one to four pullbacks, and each pullback might have one to four legs. Every upswing and downswing of any size is commonly referred to as a leg, so the distinctions are not very important, but each term carries a subtle distinction with it.

At its simplest, a trend is present when the chart on your computer screen starts at one of the two left-hand corners and ends at the diagonally opposite corner of the screen without huge fluctuations in between. For example, if the bars on the left are near the lower left-hand corner of your monitor and the bars on the right are near the upper right-hand corner and there are not many large upswings and downswings in the middle of your screen, then this is a bull trend. Your personal radar can tell you if the market is more likely in a trend instead of in a strong leg within a trading range. If you have a sense of uncertainty, the market is more likely in a trading range. If instead you have a sense of urgency and you are hoping for a pullback, then the market is more likely in a trend.

Trends can be very steep, with a series of trend bars with large bodies, very little overlap between adjacent bars, and small tails. This is the spike phase of a trend, and it can be as brief as a single bar. It is when the market becomes clearly always-in long in the eyes of most traders if the trend is a new bull trend, or always-in short in the case of a new bear trend. The market eventually begins to have some two-sided trading in the form of pullbacks, and the trend then transitions into the channel phase, which can last far longer than most traders expect is possible. Trends can have small spikes with big or small channels, or big spikes with big or small channels. The spikes can have some overlap between the bars and look more like a tight channel, and the channels can be steep with very little overlap between adjacent bars and look more like a large spike. The key point is that most trends tend to be very strong when starting out and then lose momentum as they mature, and the market eventually has larger pullbacks and evolves into a trading range. The trading range is simply a pullback on a higher time frame chart. At some point, the market breaks out into a spike in the opposite direction, and then the market reverses into a trend in the other direction.

A chart only shows one or two trends. If more than two trends are present on a chart, it is preferable to describe the trends by using one of the other three classifications because the two-sided action creates different trading opportunities. Both swings and legs are smaller trends, and there are at least two on the chart. The term *swing* is used when there are two or more smaller trends on the chart, even though the overall chart might be sideways.

A leg is any smaller trend that is part of a larger trend; it can be a pullback (a countertrend move), a swing in a trend or in a sideways market, or a with-trend move that occurs between any two pullbacks within a trend.

A pullback is a temporary countertrend move and is part of a trend, swing, or leg. For example, a bull pullback is a sideways to downward move in a bull trend, swing, or leg that will be followed by at least a test of the prior high. Any bar or series of bars that represents any pause or loss of momentum is a pullback, even if there is no actual backward movement. This includes a single inside bar, which obviously does not extend below the low or above the high of the prior bar. When it is a single bar, the bar is a pause bar or a pullback bar. These one-bar pullbacks are made up of a series of small swings on a smaller time frame chart. However, you might have to go all the way down to a 1 minute chart or a 100 tick or smaller chart to see them. This is a waste of time for a trader, but it is helpful to be aware of the reality because it provides a rationale for considering placing a trade.

Within any trend, there are a number of smaller opposite trends, some lasting for only one or two bars. All of them should be considered as likely to fail and therefore setups for trades in the direction of the larger trend. In a bull trend, the swings should be trending upward, meaning that each pullback should be above the prior pullback and result in a new high (trending highs and lows, or trending swings). All moves with strong momentum usually have at least a test of the extreme following a pullback (all strong moves usually have at least two legs, even if the second one falls short and reverses).

All trends, no matter how small, must first break a trend line from the prior trend or a support or resistance line from a prior trading range, and then have trending swings (e.g., a series of higher highs and lows in a bull trend). Absent either of these, there is no trend. The best risk/reward ratio occurs when you enter on the first pullback after a trend line break, before there is a clearly established trend. As a possible trend day is unfolding, traders should look for signs of strength, each of which increases the odds that the trend will continue.

Why is it important to recognize the existence of a trend? Because then most of your trades should be in that direction and you must try to take every with-trend entry and rarely take countertrend entries. Depending on how you define a trend and a reversal attempt, about 80 percent of attempts to reverse a trend will fail. Markets have inertia and tend to continue what they have just been doing. Because of this inertia, it makes far more mathematical sense to wait for the reversal attempt to fail and become simply a pullback in the trend and then enter in the direction of the trend. Incidentally, market inertia also means that if a market is in a trading range, it will resist breaking into a trend and about 80 percent of breakout attempts will fail.

The earlier you see the trend, the more money you stand to make. Focusing on the countertrend setups will likely make you miss the much more profitable but often scarier with-trend entries. The with-trend entries are scary because the market always looks overdone and it's hard to imagine that selling near the low of an overdone bear or buying near the high of an overdone bull could ever be profitable. However, that is exactly why it is! For example, in a bear trend, no one is sure if there is going to be a bounce where they can sell at a better price but everyone is sure that the market will be even lower very soon. Because of this, everyone is selling at the market or on tiny pullbacks, and larger pullbacks just don't materialize. The longs need to get out at any price and the bears want to get in at any price, because both believe the market is heading lower and they don't want to risk missing it while they wait or hope for a bounce.

When a trend is especially strong, there is usually follow-through over the next one or more days. For example, if today was a huge bull trend day, especially if it was a reversal or a breakout and a possible start of a big move, the day will usually close near its high and the next day will also usually have a close above its open. This may continue for several days in a row. The opens often have sharp sell-offs that trap bulls out and bears in but usually find support at the 15 or 60 minute moving average or at some other support level (these are discussed in the section on support and resistance in book 2).

A trend is an area of relative certainty, where the odds are greater than 50–50 that the market will move X ticks further before it moves X ticks in the opposite direction. A trend is a series of spikes alternating with small trading ranges, and during each brief spike phase, the odds are better than 50–50, but in each trading range phase, uncertainty increases and the odds hover around 50–50 again. One of the difficulties in trading a trend is that the spike phases are often brief, and by the time you realize that one exists, there may not be enough ticks left with those increased odds to make a profit. Before you know it, a trading range forms and the odds are back to 50–50. One of the best ways to trade a trend is to anticipate when the next spike will begin and to enter on a stop as it is starting. That way, you can catch a spike with maybe a 60 percent probability or even higher of making X ticks before losing X ticks, and if you become proficient at this, you will be a successful trader.

Big traders don't hesitate to enter a trend during its spike phase, because they expect significant follow-through, even if there is a pullback immediately after their entry. If a pullback occurs, they increase the size of their position. For example, if there is a strong bull breakout lasting several bars, more and more institutions become convinced that the market has become always-in long with each new higher tick, and as they become convinced that the market will go higher, they start buying. This makes the spike grow very quickly. They have many ways to enter, like buying at the market, buying a one- or two-tick pullback, buying above the prior bar on a stop, or buying on a breakout above a prior swing high. It does not matter how they get in, because their focus is to get at least a small position on, and then look to buy more as the market moves higher, or if it pulls back. Because they will add on as the market goes higher, the spike can extend for many bars. A beginning trader sees the growing spike and wonders how anyone could be buying at the top of such a huge move. What they don't understand is that the institutions are so confident that the market will soon be higher that they will buy all the way up, because they don't want to miss the move while waiting for a pullback to form. The beginner is also afraid that his stop would have to be below the bottom of the spike, or at least below its midpoint, which is far away. The institutions know this, and simply adjust their position size down to a level where their dollars at risk are the same as for any other trade.

In every trend, no matter how strong, the market eventually pulls back a little. For example, if there is a strong bull breakout, or a trend from the open bull, where there is a bull spike made of four consecutive large bull trend bars with small tails, and then the fifth bar falls below the low of the prior bar, this is a pullback. If everyone is looking to buy a pullback, why would one ever develop? It is because not everyone is looking to buy. Experienced traders who bought early on look for price levels to take partial profits (they will begin to scale out of their longs), and sometimes they will sell out of their entire positions. These are not the bulls who are looking to buy a few ticks lower on the first pullback. The traders who are taking partial or full profits are afraid of a reversal, or of a deeper pullback, which would allow them to buy again many ticks lower. If they believed that the pullback was only going to last for a few ticks, and then the bull was going to resume, they never would have exited. They always take their profits at some resistance level, like a measured move target, a trend line, a trend channel line, or at the bottom of a trading range above the market. Most of the trading is done by computers, so everything has a mathematical basis, which means that the profit-taking targets are based on the prices that anyone can see on their screens. With practice, traders can learn to spot areas where the computers might take profits, and they can take their profits at the same prices, expecting a pullback to follow.

Sometimes the spike will have a bar or a pattern that will allow aggressive bears to take a small scalp, if they think that the pullback is imminent and that there is enough room for a profitable short. However, most traders who attempt this will lose, because most of the pullbacks do not fall far enough for a profit, or the trader's equation is weak (the probability of making their scalp times the size of the profit is smaller than the probability of losing times the size of their protective stop). Also, traders who take the short are hoping so much for their small profit that they invariably end up missing the much more profitable long that forms a few minutes later.

Some traders don't like to buy spikes because they don't like to risk too much. They prefer to feel like they are buying at a better price (a discount). These value bulls will only buy pullbacks and will wait for one to form. Other bulls who missed the initial buy or did not buy enough during the spike eagerly wait for the first pullback to buy or to add to their positions. They place limit orders at and below the low of the prior bar, hoping for a small dip, so that they can get long. Because of this, the first pullback usually only falls below the low of the prior bar by a few ticks. When the bulls are particularly aggressive, they will buy above the low of the prior bar, and what appeared to be a bar that would become a pullback bar might instead not fall below the low of the prior bar.

If the bulls holding profitable longs think that the bull spike is weakening and that the next bar will trade below the low of the current bar, some will sell out of their longs at the market. Others will wait for the bar to close, and if the bar is not another strong bull trend bar, they will sell at the close of the bar, realizing that they might be selling too early, but happy with being able to sell at a high price. Eventually, there will be a true pullback bar, with a low below the low of the prior bar. Once there is, other bulls will place stop orders to buy above its high, because this bar is a high 1 buy setup in a strong bull spike and therefore a high probability buy setup. Some traders prefer to buy on stops above bars and not limit orders below bars because they want the market going in their direction when they enter, so that they will have the wind at their backs instead of in their faces. They are willing to exchange some of their potential profits for a higher probability of success. Both approaches are reasonable, if the trader's equation is favorable for their trades. Bull trends on higher time frame charts tend to have rallies in the final 30 to 60 minutes of trading on the 5 minute chart. Some of the buying is from mutual funds and some is from short covering, but much of it is simply statistically based program trading where the programmers have testing that shows that buying into the close in a bull trend is a profitable strategy. The strong finish often pushes the close above the open of the day. The result is a bull trend bar on the daily chart. When the market is in a bull trend, look for buy setups in the final hour. Likewise, when the daily chart is in a bear trend, look for sell setups in the final hour, as the 5 minute chart will often sell off into the close, causing the bar on the daily chart to be a bear trend bar.

The most recent bars are at the top of your computer screen in a bull trend and at the bottom in a bear trend, and psychologically there does not appear to be any more room for the market to go further. The result is that many traders won't take a great buy signal at the top of a bull trend or sell signal at the bottom of a bear trend and will instead look for reversals. But that computer screen illusion has nothing to do with the market and if you can add space above or below the chart, there suddenly will be lots of room for the trend to run. The market draws in countertrend traders, and if you enter in the direction of the trend exactly where they exit at a loss, they will drive the market in your direction, even though the market looks so overextended.

A move above a prior swing high in a bull trend will lead to predominantly one of three outcomes: more buying, profit taking (by far the most common possibility), or shorting. When the trend is strong, strong bulls will buy the breakout above the old high (they are "pressing," or adding to, their longs) and there will be a measured move up of some kind. For example, if a bull trend forms a wedge top, but then breaks above the top of the wedge, if enough bulls are pressing their long, the market will often go up for a measured move that is equal to the height of the wedge. The bears will quickly see how strong the breakout is and will buy back their shorts. This urgent short covering adds fuel to the breakout and contributes to the size of the bull spike. The strong bears who were shorting during the wedge top will now see that their premise is wrong. They will expect about a measured move up and will quickly buy back their losing shorts and not consider shorting again for several bars and probably not until the market tests some resistance area, like the measured move target. This often leads to a strong bull breakout lasting one or more bars, with follow-through over the next several bars. If the move up is very strong, the bears might not look to sell again for dozens of bars and possibly even for the rest of the day.

Whenever the market goes up far enough above the breakout to enable a trader to make at least a profitable scalp before there is a pullback, then assume that there was mostly new buying at the high. If it goes sideways, assume that there was profit taking and that the bulls are looking to buy again a little lower. If the market reverses down hard, assume that the strong bears dominated at the new high and that the market will likely trade down for at least a couple of legs and at least 10 bars.

In the absence of some rare, dramatic news event, traders don't suddenly switch from extremely bullish to extremely bearish. There is a gradual transition. A trader becomes less bullish, then neutral, and then bearish. Once enough traders make this transition, the market reverses into a deeper correction or into a bear trend. Every firm has its own measure of excess, and at some point enough firms decide that the trend has gone too far. They believe that there is little risk of missing a great move up if they stop buying above the old high, and they will buy only on pullbacks. If the market hesitates above the old high, the market is becoming two-sided, and the strong bulls are using the new high to take profits.

Profit taking means that traders are still bullish and are looking to buy a pullback. Most new highs are followed by profit taking. Every new high is a potential top, but most reversal attempts fail and become the beginnings of bull flags, only to be followed by another new high. If a rally to test the high has several small pullbacks within the leg up, with lots of overlapping bars, several bear bodies, and big tails on the tops of the bars, and most of the bull trend bars are weak, then the market is becoming increasingly two-sided. The bulls are taking profits at the tops of the bars and buying only at the bottoms of the bars, and the bears are beginning to short at the tops of the bars. Similarly, the bulls are taking profits as the market approaches the top of the bull trend, and the bears are shorting more. If the market goes above the bull high, it is likely that the profit taking and shorting will be even stronger.

Most traders do not like to reverse, so if they are anticipating a reversal signal, they prefer to exit their longs and then wait for that signal. The loss of these bulls on the final leg up in the trend contributes to the weakness of the rally to the final high. If there is a strong reversal down after the market breaks above the prior high, the strong bears are taking control of the market, at least for the near term. Once that happens, then the bulls who were hoping to buy a small pullback believe instead that the market will fall further. They therefore wait to buy until there is a much larger pullback, and their absence of buying allows the bears to drive the market down into a deeper correction, lasting 10 or more bars and often having two or more legs.

There is one situation where the breakout in a bull trend is routinely met by aggressive shorts who will usually take over the market. A pullback is a minor trend in the opposite direction, and traders expect it to end soon and for the larger trend to resume. When there is a pullback in a strong bear trend, the market will often have two legs up in the minor bull trend. As the market goes above the high of the first leg up, it is breaking out above a prior swing high in a minor bull trend. However, since most traders will see the move up as a pullback that will end very soon, the dominant traders on the breakout will usually be aggressive sellers, instead of aggressive new buyers or profit-taking longs, and the minor bull trend will usually reverse back down into the direction of the major bear trend after breaking out above the first or second swing high in the pullback.

The same is true of new lows in a bear trend. When the bear trend is strong, strong bears will press their shorts by adding to their positions on the breakout to a new low and the market will continue to fall until it reaches some measured move target. As the trend weakens, the price action at a new low will be less clear, which means that the strong bears are using the new low as an area to take profits on their shorts rather than as an area to add to their shorts. As the bear trend further loses strength, eventually the strong bulls will see a new low as a great price to initiate longs and they will be able to create a reversal pattern and then a significant rally.

As a trend matures, it usually transitions into a trading range, but the first trading ranges that form are usually followed by a continuation of the trend. How do the strong bulls and bears act as a trend matures? In a bull trend, when the trend is strong, the pullbacks are small because the strong bulls want to buy more on a pullback. Since they suspect that there may not be a pullback until the market is much higher, they begin to buy in pieces, but relentlessly. They look for any reason to buy, and with so many big traders in the market, there will be some buying for every imaginable reason. They place limit orders to buy a few ticks down and other limit orders to buy a few ticks above the low of the prior bar, at the low of the prior bar, and below the low of the prior bar. They place stop orders to buy above the high of the prior bar and on a breakout above any prior swing high. They also buy on the close of both any bull or bear trend bar. They see the bear trend bar as a brief opportunity to buy at a better price and the bull trend bar as a sign that the market is about to move up quickly.

The strong bears are smart and they see what is going on. Since they believe, just like the strong bulls, that the market is going to be higher before long, it does not make sense for them to be shorting. They just step aside and wait until they can sell higher. How much higher? Each institution has its own measure of excess, but once the market gets to a price level where enough bear firms believe that it might not go any higher, they will begin to short. If enough of them short around the same price level, more and larger bear trend bars form and bars start to get tails on the tops. These are signs of selling pressure and they tell all traders that the bulls are becoming weaker and the bears are becoming stronger. The strong bulls eventually stop buying above the last swing high and instead begin to take profits as the market goes to a new high. They are still bullish but are becoming selective and will buy only on pullbacks. As the two-sided trading increases and the sell-offs have more bear trend bars and last for more bars, the strong bulls will want to buy only at the bottom of the developing trading range and will look to take profits at the top. The strong bears begin to short at new highs and they are now willing to scale in higher. They might take partial profits near the bottom of the developing trading range if they think that the market might reverse back up and break out to a new high, but they will keep looking to short new highs. At some point, the market becomes a 50–50 market and neither the bulls nor bears are in control; eventually the bears become dominant, a bear trend begins, and the opposite process unfolds.

A trend that has gone on for 30 or more bars will often have an unusually strong breakout, but it can be an exhaustive climax. For example, in a protracted bull trend, all strong bulls and bears love to see a large bull trend bar or two, especially if it is exceptionally large, because they expect it to be a brief, unusually great opportunity. Once the market is close to where the strong bulls and bears want to sell, like near a measured move target or a trend channel line, especially if the move is the second or third consecutive buy climax, they step aside. The absence of selling by the strongest traders results in a vacuum above the market, which creates one or two relatively large bull trend bars. This bull spike is just the sign that the strong traders have been waiting for, and once it is there, they appear as if out of nowhere and begin their selling. The bulls take profits on their longs and the bears initiate new shorts. Both sell aggressively at the close of the bar, above its high, at the close of the next bar (especially if it is a weaker bar), and at the close of the following bar, especially if the bars are starting to have bear bodies. They also sell below the low of the prior bar. When they see a strong bear trend bar, they sell at its close and below its low. Both the bulls and the bears expect a larger correction, and the bulls will not consider buying again until at least a 10-bar, two-legged correction, and even then, only if the sell-off looks weak. The bears expect the same sell-off and will not be eager to take profits too early.

Weak traders see that large bull trend bar in the opposite way. The weak bulls, who had been sitting on the sidelines hoping for an easy pullback to buy, see the market running away from them and want to make sure they catch this next leg up, especially since the bar is so strong and the day is almost over. The weak bears, who shorted early and maybe scaled in, were terrified by the rapidity with which the bar broke to a new high. They are afraid of relentless follow-through buying, so they buy back their shorts. These weak traders are trading on emotion and are competing against computers, which do not have emotion as one of the variables in their algorithms. Since the computers control the market, the emotions of the weak traders doom them to big losses on big bull trend bars at the end of an overdone bull trend.

Once a strong bull begins to have pullbacks that are relatively large, the pullbacks, which are always small trading ranges, behave more like trading ranges than bull flags. The direction of the breakout becomes less certain and traders begin to think that a downside breakout is about as likely as an upside breakout. A new high is now a breakout attempt above a trading range, and the odds are that it will fail. Likewise, once a strong bear trend begins to have relatively large pullbacks, those pullbacks behave more like trading ranges than bear flags, and therefore a new low is an attempt to break below a trading range and the odds are that it will fail.

Every trading range is within either a bull trend or a bear trend. Once the two-sided trading is strong enough to create the trading range, the trend is no longer strong, at least while the trading range is in effect. There will always be a breakout from the range eventually, and if it is to the upside and it is very strong, the market is in a strong bull trend. If it is to the downside and strong, the market is in a strong bear trend.

Once the bears are strong enough to push a pullback well below the bull trend line and the moving average, they are confident enough that the market will likely not go much higher and they will aggressively short above the old high. At this point, the bulls will have decided that they should buy only a deep pullback. A new mind-set is now dominant at the new high. It is no longer a place to buy, because it no longer represents much strength. Yes, there is profit taking by the bulls, but most big traders now look at the new high as a great opportunity to initiate shorts. The market has reached the tipping point and most traders have stopped looking to buy small pullbacks and instead are looking to sell rallies. The bears are dominant and the strong selling will likely lead to a large correction or even a trend reversal. After the next strong push down, the bears will look for a lower high to sell again or to add to their short positions, and the bulls who bought the pullback will become concerned that the trend might have reversed or at least that there will be a much larger pullback. Instead of hoping for a new bull high to take profits on their longs, they will now take profits at a lower high and not look to buy again until after a larger correction.

There will still be bulls who bought much lower and want to give the bull trend every possible chance to resume. Traders know that most reversal attempts fail, and many who rode the trend up will not exit their longs until after the bears have demonstrated the ability to push the market down hard. Many longs bought puts to protect themselves in case of a severe reversal. The puts allow them to hold on to give the bull trend every possible chance to resume. They know that the puts limit their losses, no matter how far the market might fall, but once they see this impressive selling pressure, they will then look for a rally to finally exit their longs, and as that rally begins, they will take profits on their puts. Also, most of their puts expire within a few months, and once expired, the traders no longer have downside protection. This means that they cannot continue to hold on to their positions unless they keep buying more and more puts. If they believe that the market will likely fall further and not rally again for many months, it does not make sense to continue to pay for ongoing put protection. Instead, they will look to sell out of their positions. Their supply will limit the rally, and their selling, added to the shorting by aggressive bears and the profit taking by bulls who saw the sell-off as a buying opportunity, will create a second leg down.

These persistent bulls will each have a price level on the downside that, if reached, will make them want to exit on the next rally. As the market keeps working lower, more and more of these bulls will decide that the bull trend will not resume anytime soon and that the trend might have reversed into a bear trend. These remaining die-hard longs will wait patiently for a pullback in the bear swing to exit their longs, and their positions represent a supply that is overhanging the market. They sell below the most recent swing high because they doubt that the market will be able to get above a prior swing high, and are happy to get out at any price above the most recent low. Bears will also look for a pullback from each new low to add to their shorts and place new shorts. The result is a series of lower highs and lows, which is the definition of a bear trend.

If the market enters a bear trend, the process will reverse. When the bear trend is strong, traders will short below prior lows. As the trend weakens, the bears will take profits at new lows and the market will likely enter a trading range. After a strong rally above the bull trend line and the moving average, the bears will take profits at a new low and strong bulls will aggressively buy and try to take control of the market. The result will be a larger bear rally or possibly a reversal into a bull trend.

A similar situation occurs when there is a pullback that is large enough to make traders wonder if the trend has reversed. For example, if there is a deep, sharp pullback in a bull trend, traders will begin to look at moves below prior swing lows, but this is in the context of a pullback in a bull trend instead of as part of a bear trend. They will watch what happens as the market falls below a prior swing low. Will the market fall far enough for bears, who entered on a sell stop below that swing low, to make a profit? Did the new low find more sellers than buyers? If it did, that is a sign that the bears are strong and that the pullback will probably go further. The trend might even have reversed to down.

Another possibility on the breakout to a new low is that the market enters a trading range, which is evidence that the shorts took profits and that there was unimpressive buying by the bulls. The final alternative is that the market reverses up after the breakout to a new low. This means that there were strong bulls below that swing low just waiting for the market to test there. This is a sign that the sell-off is more likely just a big pullback in an ongoing bull trend. The shorts from higher up took profits on the breakout to the new low because they believed that the trend was still upward. The strong bulls bought aggressively because they believed that the market would not fall further and that it would rally to test the bull high.

Whenever there is any breakout below a swing low, traders will watch carefully for evidence that the bulls have returned or that the bears have taken control. They need to decide what influence is greatest at the new low, and they use the market's behavior to make that decision. If there is a strong breakout, then new selling is dominant. If the market's movement is uncertain, then profit taking by the shorts and weak buying by the bulls is taking place, and the market will likely enter a trading range. If there is a strong reversal up, then aggressive buying by the longs is the most important factor.

This part of the book describes many common trend patterns that you should look for every day. Although a trend can begin with any bar during the day, the majority of trend days begin within the first hour or so. If you see a trend pattern setting up within the first hour or two of the day, there will likely be several high-probability with-trend trades that you can then make. You need to decide many times every day if the day resembles any of the types of trends described later in this chapter, and if it does, force yourself to take the with-trend trades.

However, if none of these patterns is present, the day is a trading range day and you need to look for opportunities to fade new extremes. Also, if the market makes a run for a couple of hours and the day appears to be a trading range day, be aware that the opposite extreme might get taken out over the course of the next couple of hours, so do not be too eager to take profits on the swing portion of your reversal trade. The odds are very high that the reversal will at least test the midpoint of the day's range.

After a substantial decline in a bear market on the daily chart, people begin to become very concerned about the money that they've lost and they do not want to lose any more money. This makes them sell, regardless of the fundamentals. There was an added problem in the bear market of 2008. Baby boomers were on the verge of retiring and were shocked by what they saw as comfortable nest eggs quickly falling 40 percent in value. So what will they do? They will continue to sell every rally as they try to preserve what they have left. Also, all that money that they are taking out of the market will never return to lift prices again. They will take their money at all the "Thank you, God" points along the way. This will be just below the prior swing high, where they exit and promise God that they will never buy again in return for Him letting them recoup some of their losses. This creates a series of lower highs and lows until the last bear has sold. Once that happens, the market will then be able to rally above the prior swing highs.

The result of people selling regardless of fundamentals is that the market often falls in huge bear trend days, dropping much further than what the fundamentals warrant, and often there is a huge plunge in the final 30 minutes as funds are forced to sell because of redemption orders. There will be vicious rallies along the way as people become convinced that the bottom is in and they panic to get back long. Also, because the trend is so clearly down, there will be many who are short. They may cover aggressively on any reversal, resulting in huge bull trend bars on the daily chart, even though it is still a bear market. The end result is a collection of very large range days once the bear trend is well underway. The huge ranges offer great price action day trading opportunities but you might have to increase your stop size and therefore reduce your position size. While many people following the daily charts are selling at the low and buying at the high of each trap (every strong short covering rally), trading off emotion more than reason, a good price action trader can do very well just looking for standard price action setups.

This kind of mentality is not restricted to unsophisticated investors. In the fall of 2008, most hedge funds were down on the year and their sophisticated investors aggressively pulled their money out as the market continued to sell off. The hedge funds had to continue to liquidate on every small rally to meet redemptions and anticipated redemptions. This continued to drive the market down, independent of fundamentals, and just like with less sophisticated investors, the selling will continue until all that's left are positions that investors will hold until they fall to zero.

Also, for many hedge fund managers a big part of their income is incentive based. For example, every quarter that the fund closes at a new high, they might take 20 percent of that profit above the old equity high. If the fund instead is down 30 percent on the year, it will need to earn about 50 percent to get up to that incentive level again. Rather than working for free for several years, it might make more sense to close the fund and start over with a new fund. However, when they close the fund, they have to liquidate and since there is no incentive for them, they can liquidate at any price, no matter how low. This adds to selling that is independent of the intrinsic value of stocks. If they had a $1 billion fund, their new fund is starting from scratch and it will take a few years before they have enough equity and own as much stock as they did in the old fund, so buying by the new funds doesn't immediately lift the market.

When the volatility reaches an extremely high level, the end of the bear trend is often near as traders give up responding to the whipsaws and decide that there is nothing left that they will sell at any price. When there are no more sellers and the market is overdone on the basis of fundamentals, a good rally should follow. And just how far can a big-name stock fall in a bear market? Much farther than you might think, even for the bluest of the blue chips. Cisco (CSCO) lost 90 percent of its value in three years after the tech wreck of 2000, and Apple (AAPL) lost 95 percent of its value during the six years starting in 1991. General Motors (GM) lost 90 percent in the seven years after 2001. So don't be eager to buy just because a stock is down a Fibonacci 38 percent, 50 percent, or even 62 percent. Wait until there is a price action setup, and it must include a prior break of the bear trend line.

CHAPTER 18

Example of How to Trade a Trend

When the market is in a trend, traders should look for any reason to enter. The simple existence of a trend is reason enough to enter at least a small position at the market. Here are some other reasonable approaches that use stop entry orders:

- Buying a high 2 pullback to the moving average in a bull trend.
- Selling a low 2 pullback to the moving average in a bear trend.
- Buying a wedge bull flag pullback in a bull trend.
- Selling a wedge bear flag pullback in a bear trend.
- Buying a breakout pullback after a breakout from a bull flag in a bull trend.
- Selling a breakout pullback after a breakout from a bear flag in a bear trend.
- Buying a high 1 pullback in a strong bull spike in a bull trend, but not after a buy climax.
- Selling a low 1 pullback in a strong bear spike in a bear trend, but not after a sell climax.
- When a bull trend is very strong, buying on a stop above a prior swing high.
- When a bear trend is very strong, selling on a stop below a prior swing low.

Entering using a limit order requires more experience reading charts, because the trader is entering in a market that is going in the opposite direction to the trade. However, experienced traders can reliably use limit or market orders with these potential setups:

- Buying a bull spike in a strong bull breakout at the market, at the close of every bull trend bar in the spike, or on a limit order at or below the low of the prior bar (entering in spikes requires a wider stop and the spike happens quickly, so this combination is difficult for many traders).

- Selling a bear spike in a strong bear breakout at the market, at the close of every bear trend bar in the spike, or on a limit order at or above the high of the prior bar (entering in spikes is difficult for many traders).
- Buying the close of the first bear bar in a bull spike.
- Selling the close of the first bull bar in a bear spike.
- In a bull trend, buying at a bull trend line or at a prior swing low (a potential double bottom bull flag).
- In a bear trend, selling at a bear trend line or at a prior swing high (a potential double top bear flag).
- Buying at or below a low 1 or 2 weak signal bar on a limit order in a possible new bull trend after a strong reversal up or at the bottom of a trading range.
- Shorting at or above a high 1 or 2 weak signal bar on a limit order in a possible new bear trend after a strong reversal down or at the top of a trading range.
- Buying at or below the prior bar on a limit order in a quiet bull flag at the moving average.
- Shorting at or above the prior bar on a limit order in a quiet bear flag at the moving average.
- Buying below a bull bar that breaks above a bull flag, anticipating a breakout pullback.
- Selling above a bear bar that breaks below a bear flag, anticipating a breakout pullback.
- When trying for a swing in a bull trend, buy or buy more on a breakout test, which is an attempt to run breakeven stops from an earlier long entry.
- When trying for a swing in a bear trend, sell or sell more on a breakout test, which is an attempt to hit breakeven stops from an earlier short entry.
- Buying at a fixed number of ticks down from the high in a bull trend. For example, buying a two-, three-, or four-point pullback in a bull trend in the Emini when the average daily range has been about 12 points. Also, if the biggest pullback in the first couple of hours was 10 ticks, buying about an eight- to 12-tick pullback.
- Selling at a fixed number ticks up from the low in a bear trend. For example, selling a 50 cent bear rally in GS when the average daily range has been about $2.00. If the largest pullback in the first couple of hours was 60 cents, selling about a 50 to 70 cent pullback.
- Scaling into the direction of the trend as the market moves against you. If you scale in, plan out in advance what size each order has to be to keep your total risk the same as with a typical trade. It is easy to find yourself with too large a position and a protective stop that is too far away, so be very careful.

- In a bull trend that has not pulled back to the moving average in 20 or more bars, buy at the moving average on a limit order, and scale in lower. For example, if there is a strong bull trend in the Emini where the market has been above the moving average for 20 or more bars, buy with a limit order at one tick above the moving average. Buy more one, two, and maybe three points lower. If scaling in, consider exiting the entire position at the first entry price, but if the bull trend is strong, look to exit on a test of the high.
- In a bear trend that has not pulled back to the moving average in 20 or more bars, sell at the moving average on a limit order and scale in higher. For example, if there is a strong bear trend in the Emini where the market has been below the moving average for 20 or more bars, sell with a limit order at one tick below the moving average. Sell more one, two, and maybe three points higher. If scaling in, consider exiting the entire position at the first entry price, but if the bear trend is strong, look to exit on a test of the low.
- In a strong bull trend, buy on the close of the first bear trend bar that has a close below the moving average.
- In a strong bear trend, sell on the close of the first bull trend bar that has a close above the moving average.
- In a strong bull trend, a pullback is a small bear trend. The bulls will expect that a breakout below a prior swing low in this small bear trend will fail, and they will buy there with a limit order.
- In a strong bear trend, a pullback is a small bull trend. The bears will expect that a breakout above a prior swing high in this small bull trend will fail, and they will short there with a limit order.
- A trader can always be long, short, or flat. At any moment during a trend, only two of those choices are compatible with being a successful trader. If the market is in a bull trend, successful traders are only long or flat. If it is in a bear trend, they are either short or flat. A tiny fraction of traders have the ability to consistently make money by trading against a trend, and you should assume that you are not part of that group. Unfortunately, most traders starting out go for years believing that they are, and they consistently lose money month after month and wonder why. You now know the answer.

Every type of market does something to make trading difficult. The market is filled with very smart people who are trying as hard to take money from your account as you are trying to take money from theirs, so nothing is ever easy. This includes making profits in a strong trend. When the market is trending strongly with large trend bars, the risk is great because the stop often belongs beyond the start of the spike. Also, the spike grows quickly, and many traders are so shocked by the size and speed of the breakout that they are unable to quickly reduce their position size and increase their stop size, and instead watch the trend move rapidly as they hope for a pullback. Once the trend enters its channel phase, it always looks like it is reversing. For example, in a bull trend, there will be many reversal attempts, but almost all quickly evolve into bull flags. Most bull channels will have weak buy signal bars and the signals will force bulls to buy at the top of the weak channel. This is a low probability long trade, even though the market is continuing up. Swing traders who are comfortable taking low probability buy setups near the top of weak bull channels love this kind of price action, because they can make many times what they are risking, and this more than makes up for the relatively low probability of success. However, it is difficult for most traders to buy low probability setups near the top of a weak bull channel. Traders who only want to take high probability trades often sit back and watch the trend grind higher for many bars, because there may not be a high probability entry for 20 or more bars. The result is that they see the market going up and want to be long, but miss the entire trend. They only want a high probability trade, like a high 2 pullback to the moving average. If they do not get an acceptable pullback, they will continue to wait and miss the trend. This is acceptable because traders should always stay in their comfort one. If they are only comfortable taking high probability stop entries, then they are correct in waiting. The channel will not last forever, and they will soon find acceptable setups. Experienced traders buy on limit orders around and below the lows of prior bars, and they will sometimes take some short scalps during the bull channel. Both can be high probability trades, including the shorts, if there is a strong bear reversal bar at a resistance level, and some reason to think that a pullback is imminent.

With so many great ways to make money, why do most traders lose? It is because there are even more ways to make mistakes. One of the most common is that a trader begins with one plan and, once in the trade, manages it based on a different plan. For example, if a trader just lost on his past two long swing trades and now buys a third, he might be so afraid of losing again that he scalps out, only to watch the trade turn into a huge trend. Swing traders need these big wins to make up for the losses, since swing trading often is less than 50 percent successful. If traders do not hold on for the swing, they will not be getting the big wins that they need, and they will lose money. Something opposite to this can happen to scalpers. They might have taken a profitable scalp, but became sad when the trade turned into a huge trend and they watched from the sidelines. When they see another scalp, they take it, but once it reaches their profit target, they decide that the trade could turn into a swing trade, just like last time, and they do not exit. A few minutes later, the market comes back, hits their stop, and they take a loss. This is because most scalps are high-probability trades, and when the edge is large and obvious, the move is usually small and brief, and not the start of a big swing. The best way to make money is to have a sound strategy, and then stick to the plan. For most beginning traders, the plan should be some kind of swing trade, because the winning percentage needed to be a successful scalper is much higher than most traders can maintain for the long term.

Once traders take a position, they then have to decide how to manage it. The most important decision that they have to make is whether they are looking for a scalp or for a swing, both of which are discussed in detail in the second book, as is trade management. Only the most experienced traders should consider scalping, because the risk is sometimes greater than the potential reward. This means that they have to win about 70 percent of the time, which is impossible for anyone except an extremely good trader. You should assume that you will never be that good, because that is the reality. However, you can still be a very profitable trader. If traders are trading the Eminis at a time when the average daily range is about 10 to 15 points, they generally have to risk about two points. For example, if they are buying in a bull trend, their protective stop should be about two points below their entry price. Alternatively, their stop can be one tick below the low of the signal bar, which usually is still about two points. Some traders will risk five points or more on a swing trade if they feel confident that the trend will eventually resume. This can be a profitable approach for traders who understand the trader's equation: trade only when the chance of success times the potential reward is significantly greater than the chance of failure times the risk.

If a trader is scalping, then he is trying to make between one and three points on the trade. However, some scalpers think that two- and three-point trades are small swings, and consider a scalp to be a one-point trade. Although there are many trades every day where a trader can risk two points to make one point and have an 80 percent chance of success, there are many other setups that look similar but have only a 50 percent chance of success. The problem that most traders have is distinguishing between the two, and even a couple of mistakes a day can mean the difference between making money and losing money. Most traders simply cannot draw the distinction in real time, and end up losing money if they scalp. A trader who scalps only the two or three best setups a day and trades enough volume might be able to make a living as a scalper, but he might also find it difficult to watch the market for hours and be ready to quickly place a trade when one of the rare, brief setups unfolds.

The better way for beginning traders to make money is to swing their trades. They can enter all at once, or can press their trades by scaling in as the market continues in their direction. This means that they are adding to their positions as their earlier entries have growing profits. They can either exit all at once, or scale out as the trade goes their way. For example, if they buy early in a bull trend, their initial stop is two points, and they are confident that the trade will work, they should assume that the probability of success is at least 60 percent. Because of that, they should not take any profits until the trade has gone at least two points. The mathematics of trading are discussed in the second book. A trader should exit a trade only when the chance of success (here, 60 percent or higher) times the potential reward is significantly greater than the chance of failure (here, 40 percent or less) times the risk. Since the protective stop is two points below the entry price, the risk is two points. This means that the trader's equation begins to become favorable only when the reward is two points or more. Therefore, if traders take a smaller profit, they will lose money over time, unless they believe that their probability of success is about 80 percent, which is rarely the case. When it is, an experienced trader can scalp part out at a one-point profit and still make money while using a two-point stop. Most traders should never risk more than their reward.

So, how should traders swing their trades in that bull trend? This is addressed more in the second book. Swing trading is much more difficult than it appears when a trader looks at a chart at the end of the day. Swing setups tend to be either unclear or clear but scary. After a trader sees a reasonable setup, he has to take the trade. These setups almost always appear less certain than scalp setups, and the lower probability tends to make traders wait. A trend begins with a breakout either from a trading range or after a reversal of the current trend. When there is a potential reversal and it has a strong signal bar, it usually comes when the old trend is moving fast in a strong, final, climactic spike. Beginning traders invariably believe that the old trend is still in effect, and they probably lost on several earlier countertrend trades today and don't want to lose any more money. Their denial causes them to miss the early entry on the trend reversal. Entering as the breakout bar is forming, or after it closes, is difficult to do because the breakout spike is often large, and traders have to quickly decide to risk much more than they usually do. As a result, they often end up choosing to wait for a pullback. Even if they reduce their position size so that the dollar risk is the same as with any other trade, the thought of risking two or three times as many ticks frightens them. Entering on a pullback is difficult because every pullback begins with a minor reversal, and they are concerned that the pullback might be the start of a deep correction, their stop will be hit, and they will lose money. They end up waiting until the day is almost over. When they finally decide that the trend is clear, there is no longer any time left to place a trade. Trends do everything that they can to keep traders out, which is the only way they can keep traders chasing the market all day. When a setup is easy and clear, meaning it has a high probability of success, the move is usually a small, fast scalp. If the move is going to go a long way, it has to be unclear and difficult to take, to keep traders on the sidelines and force them to chase the trend.

Since a bull trend has trending highs and lows, then every time the market reaches a new high, traders should raise their protective stop to one tick below the most recent low. This is called trailing their stop. Also, if their profit is large enough, they should consider taking partial profits as the market goes above the most recent high. Lots of traders do this and that is why trends often pull back after reaching a new high. The pullback very often goes below the original entry price, and inexperienced swing traders will have tightened their stops to the breakeven price and will get stopped out of a great trend trade. Once the market tests the original entry price and then goes to a new high, most traders would then raise their stops to at least their entry price because they would not want the market to come back to test it a second time after reaching a new high following the first test. Others would put it below the low of the pullback that just tested their original entry.

Some traders will allow pullbacks below the signal bar as long as they believe that their premise of a bull trend is still valid. For example, assume that the average range in the Emini has been about 10 to 15 points lately, and they bought a high 2 pullback in a bull trend on the 5 minute chart. If the signal bar was two points tall, they might be willing to hold on to their position even if the market falls below the low of the signal bar, thinking that the pullback might evolve into a high 3, which is a wedge bull flag buy setup. Other traders would exit if the market falls below the signal bar and then buy again if a strong high 3 buy signal sets up. Some might even buy a position that is twice as large as their first, because they see the strong second signal as more reliable. Many of these traders would have bought just a half-size position on the high 2 buy signal if they thought that the signal did not look quite right. They were allowing for the possibility of the high 2 failing and then evolving into a wedge bull flag, which might even look stronger. If it turned out to be, they would then feel comfortable trading their usual full size.

Other traders trade half size when they see questionable signals, exit if their protective stop is hit, and then take the second signal with a full size if the signal is strong. Traders who scale in as a trade goes against them obviously do not use the signal bar extreme for their initial protective stop, and many look to scale in exactly where other traders are taking losses on their protective stops. Some simply use a wide stop. For example, when the average daily range in the Emini is less than about 15 points, a pullback in a trend is rarely more than seven points. Some traders will consider that the trend is still in effect unless the market falls more than between 50 to 75 percent of the average daily range. As long as a pullback is within their tolerance, they will hold their position and assume that their premise is correct. If they bought a pullback in a bull trend and their entry was three points below the high of the day, then they might risk five points. Since they believe that the trend is still in effect, they believe that they have a 60 percent or better chance of an equidistant move. This means that they are at least 60 percent certain that the market will go up at least five points before falling five points to their protective stop, which creates a profitable trader’s equation. If their initial buy signal in the bull pullback came at five points below the high, then they might risk just three points, and they would look to exit their long on a test of the high. Since the pullback was relatively large, the trend might be a little weak, and this might make them take profits below the trend high. They would try to get at least as much as they had to risk, but they might be willing to get out just below the old high if they were concerned that the market might be transitioning into a trading range, or possibly even reversing into a bear trend.

At some point, selling pressure will be strong enough to convert the trend into a trading range, which means that a pullback might fall below the most recent low. Experienced traders have a good sense of when the market is transitioning from a trend into a trading range, and many will exit the remainder of their positions when they believe that it is about to happen. They might then trade the trading range using a trading range approach, which means looking for smaller profits. This is discussed in the second book. They might instead hold on to part of their long positions until either the close or when the market flips into always-in short. If it does, they would then either exit their longs or reverse to short. Very few traders can reverse consistently, and most prefer to exit their longs and then reassess the market, and maybe take a break before looking to go short.

FIGURE 18.1 Strong Trend Day in GS

There are countless ways to trade any day, but when there is a trend like the bull trend in GS shown in Figure 18.1, traders should try to swing at least part of their trade. I had extensive discussions years back with a trader who excelled on days like this. He bought early and then determined his initial risk (how far his protective stop was from his entry price). He then took half of his position off once the market reached twice his initial risk and held the other half until there was a clear reversal. If there never was a strong reversal, he exited in the minutes before the close. After every new high, he tightened his stop to below the most recent higher low, since as long as the trend kept making higher highs and lows, it was still strong. If it stopped making higher lows, it was beginning to weaken.

There is one sure way to consistently lose money on a day like this, and all traders know it. Successful traders avoid it, but beginners are irresistibly drawn to it. They see the market as constantly overdone. The most recent bar is always at the top of the computer screen and there surely can't be enough room up there to go higher, and there clearly is a lot of room below. Also, they know trends have pullbacks, so why not short every reversal for a scalp, and then go long on the pullback? Even if the trade is a loser, the loss is not big. They don't buy the pullback when it finally comes, because the market might be reversing into a bear trend, and the buy setup does not look strong enough. Also, since they were short and the market did not quite reach their scalper's profit target, they were rooting for the market to go down just a little bit more, and therefore were not expecting, and actually not wanting, the pullback to end just yet. They saw bars 7, 10, 18, 20, 21, and 24 as reversals that were likely to fall far enough to offer at least a scalper's profit and as potential highs of the day. However, experienced traders know that 80 percent of reversal attempts fail and become bull flags, and they held long, took some profits on their earlier longs, or bought more as the pullback progressed. The beginners don't accept this premise and they take small losses all day, and by the end of the day are shocked that they have lost so much. They have been successful all their lives in other careers and are very smart. They see trading gurus on television who look more like clowns and used car salesmen than like formidable adversaries, so they are confident that they can trade at least as well as those so-called experts. They are right in their assessment of the abilities of those pundits, but wrong in their assumption that those people are successful traders. They are entertainers, and the networks hire them to create an audience that will result in advertising dollars. The networks are companies, and like all companies, their goal is to make money, not to help the viewer in any way. Beginners do not stop losing until they are able to stop themselves from looking for shorts in bull trends (or bottoms in bear trends). They can start winning only when they accept that each top is the start of a bull flag.

Some of the material that follows will be covered later in books 2 and 3, and is included here because it is important in trend trading.

Great swings usually begin with weak setups, like the two-bar reversal that began at bar 3. Both bars were small dojis, and they followed a large two-bar reversal top. The setup that leads to the breakout is usually weak enough to trap traders out. Traders wait for a higher-probability setup after the breakout occurs, and miss the initial breakout. Entering either on the low-probability setup or on the higher-probability ones after the breakout are both mathematically sound approaches.

Most traders would have decided that the always-in direction was up by either bar 2 or bar 4. That means that they believed that the market was in a bull trend and they therefore would look for sensible reasons to buy, and there were many. They could have bought as bar 4 broke above bar 2, on the close of bar 4, or at one tick above its high. They could have placed a limit order to buy at or below the low of the next bar and the lows of the next several bars. They would have been filled below bar 5. Some would have placed orders to buy a small pullback to the midpoint of the prior bar, maybe 20 cents down. They also would have looked to buy a bear close because they believed that attempts to reverse should fail. The move from bar 4 to bar 5 was a tight channel, so an attempt to break to the downside was likely to fail. They could have bought below bar 5, on the close of the small bear trend bar that followed, or above it as a failed breakout below a bull micro channel. Bar 7 was a breakout pullback short but traders expected it to just lead to a pullback. The market broke below the bull micro channel on the move below bar 5, and the rally to bar 7 was a breakout pullback higher high. Traders expected the reversal to fail and some had limit orders maybe 50 cents down and in the area of the bar 6 low, expecting a double bottom bull flag. Some traders had their protective stops below bar 6 since it was a strong bull trend bar, and a strong bull trend usually would not fall below such a bar. Therefore, buying just above its low was a low-risk, high-reward trade with at least a 50 percent chance of success. They also could have bought above the bull reversal bar that followed bar 8 since it was a double bottom bull flag setup and a high 2 long (bar 6 was the high 1).

Bar 9 was another break below a bull micro channel, and traders expected it to fail. Some would have had limit orders to buy at the low of the prior bar as the micro channel was growing, and they would have been filled on bar 9. Other traders bought above the bar 9 high as a failed breakout below the bull micro channel.

Bar 11 was another high 2 buy setup, but the market had been mostly sideways for over 10 bars, and the bars were getting small. Although this was also a double bottom buy signal, the tight trading range could have continued, so many traders would have waited to see if there was a third push down and then looked to buy above the wedge bull flag, which some traders would have seen as a triangle, since it would have been sideways instead of down. These traders got long on bar 12 and above bar 12. After the breakout from this bull flag, the market went sideways for several bars and created a breakout pullback buy entry above bar 13 and again on the bar 14 outside up strong bull trend bar. This was a high 2 entry bar since bar 13 was a high 1 entry and the pullback below the next bar was a second leg down in this four-bar-long tight trading range.

Some traders bought as the market broke above bar 10, which they saw as a breakout of a trading range in a bull trend. Traders also bought the close of bar 14 and above its high. The next bar had good follow-through, which was a sign of strength, and traders therefore bought its close and above its high. There was a two-bar pause, creating a small breakout pullback bull flag, and traders bought the breakout above the bar after bar 15.

Bar 16 was a doji top but there was no prior bear strength and no significant selling pressure, and the bar was small and weak compared to the bar 14 bull spike. Traders expected the reversal attempt to fail and therefore placed limit orders to buy at and below its low. Bar 17 was a failed top buy signal, and bar 19 was a small second push down and therefore a high 2 buy setup. Traders bought as the market went above its high and above the high of the bull bar that followed it, which was a two-bar reversal buy setup.

The move up to bar 20 was another strong bull spike. Traders would have bought at and below the low of the prior bar, on the close of the bull trend bars, and on the close of the first bear trend bar, like the bar after bar 20. Since bar 20 was an especially large bull trend bar in a mature trend, it was enough of a buy climax to warrant a larger correction, one that might go sideways or down to the moving average. There was less urgency for the bulls, who were expecting a high 2 or a triangle.

Bar 21 was a one-bar final flag reversal attempt but the up momentum was strong. Traders expected another bull flag and not a reversal. Some bought below its low while others waited to see if there would be a high 2, a wedge bull flag, or a triangle. Bar 22 was another double bottom and therefore a high 2 buy setup. Traders placed stop orders to go long above its high and above the high of the inside bar that followed it. Some saw bar 23 as a high 2 buy setup with the bar after bar 20 as the signal for the high 1. Others saw it as a wedge bull flag with the first push down as the bear bar after bar 20. It was also a breakout pullback buy setup for the breakout above the bull flag that occurred on the prior bar.

Bar 24 was a very important bar. It was the third push up and third consecutive buy climax after the spike up from bar 14 (the top of the spike was the first push). The channel in a spike and channel bull often ends on a third push up and is then followed by a correction. Also, bar 24 was a particularly strong bull trend bar in a protracted bull trend. This is just the bar that strong bulls and bears were waiting for. Both saw it as a possible temporary end of the trend, and they expected it to be a brief opportunity to sell before a larger pullback developed. Both expected a correction to have at least two legs and 10 bars and to penetrate the moving average. The bulls were selling to take profits and the bears were selling to initiate shorts. Both sold at the close of bar 24, above its high, at the close of the next bar, and below its low.

The bulls thought that the market might be transitioning into a trading range, and that there was a reasonable chance that they could buy again lower. Bar 28 was a two-legged correction to the moving average and therefore a high 2 buy setup. It was also the first touch of the moving average all day, and therefore a 20 gap bar buy setup, and was likely to be followed by a test of the bull high. The bears took profits on their shorts here and the bulls bought for another leg up.

The biggest prior pullback of the day since the rally began at bar 3 was 75 cents on the pullback to bar 8. Some traders expected the largest pullback of the day to come after 11:00 a.m. or so and therefore had limit orders to go long at 75 cents below the most recent swing high. They might have scaled in at 75 cents below that and maybe risked up to a little more than twice the size of that first pullback, or about $1.60. Throughout the day, traders would have expected pullbacks to remain less than the first and they would have had limit orders to buy any pullback that was about half as big, or maybe 40 to 50 cents. The pullback to bar 11 was 40 cents, which meant that traders tried to buy a 50 cent pullback and when they did not get filled on the second attempt on the bar before bar 12, they decided to chase the market up and bought above the high of bar 12. Some traders saw the bars 9 and 11 double bottom and would have placed limit orders to buy just above its low, maybe 30 cents down from the high. Traders would then have to determine where a worst-case protective stop would be. They should pick a level where they would no longer want to be long. An obvious location would have been below the bar 8 low, since a bull trend has a series of higher highs and lows, and after each new high, the bulls expect the next pullback to stay above the most recent higher low. Since they were planning to get long at $161.05, 30 cents down from the high, and they would need to risk to around $160.35 or 70 cents lower, they had to determine the position size. If they normally risk $500 or less on a trade, they could have bought 600 shares of GS. Since they were risking 70 cents and they always should have a reward that is at least as large as their risk, their profit target should have been at least 70 cents above their entry. This was clearly a strong trend day at this point and the probability of success was therefore at least 60 percent, and maybe higher.

On a strong trend day like this, it was far better to use a generous profit target. Traders should not have tried to take any profit until the market went to at least twice their risk, or $1.40 above their entry price. They would have placed a limit order to sell half of their position at $162.45. After the bar 12 strong bull trend bar broke above the triangle (some thought of it as a wedge bull flag), they could have tightened their protective stop to just below its low at $161.05, reducing their risk to less than 20 cents. After the bar 14 strong bull trend bar breakout, they could have tightened their stop to just below its low, reducing their risk to a penny. Their limit order to take profits on 300 shares would have been filled on bar 20, giving them $420. At that point, they could have tightened their protective stop to below the bar 19 start of that most recent bull spike. If the stop was hit, they would have made about 80 cents on their remaining 300 shares. At this point, they would have held their position until there was a clear reversal down or until the close. When you have a large profit, it is usually wise to exit in the final hour or so on any setup that could lead to a larger pullback and then maybe look to get long again once that two-legged pullback is complete. The bear reversal bar at bar 24 was a third push up and was followed a buy climax bar, so the market could finally have been getting ready to pull back to the moving average. If traders exited below its low, they would have made $2.00, or $600, on their remaining 300 shares. If they held until the close, they would have made $375 on those shares. The market never even clearly became always-in short.

Many traders would have bought on a limit order at one tick above the moving average as bar 27 tested the moving average, since it was a 20 gap bar buy setup, and held for a test of the high. Some traders would have bought on the close of bar 27 because it was the first bear trend bar with a close below the moving average. Although it was the second bar of a two-bar bear spike and a breakout below bar 25, the bears needed follow-through before believing that the market had flipped to always-in short, and instead got a bull inside bar for the next bar. This was the bottom of a developing trading range and the test of the beginning of the channel up from the bar 22 pullback from the four-bar bull spike up to bar 20. The bull bar that followed bar 27 also closed above the moving average. Some bulls would have bought on the close of that bull bar, while others would have bought at one tick above its high. Their entry would have been three bars later. Traders would also have bought above the high of the inside bar that followed bar 28, since it was a high 2 buy signal, ending two legs down from the high of the day. It was also a small wedge bull flag where bar 25 was the first push down and bar 27 was the second.

A pullback is a minor trend in the opposite direction, and traders expect it to end soon and for the major trend to resume. When GS began its second leg down from the bar 24 high, it formed a lower high at bar 26 and the bears needed it to form a series of lower highs and lows to be able to convince the market that the trend had reversed to down. Some therefore shorted as the market broke out below the bar 25 swing low, hoping for a series of large bear trend bars. Instead, bar 25 was a small bear trend bar and there was no follow-through. In fact, the rally up showed that most traders instead bought the breakout below bar 25 because they believed that the sell-off was only a pullback and doomed to be a failed attempt at reversing the major trend into a bear trend. Since most reversal attempts fail, the first pullback in a strong bull trend that has a second leg down usually is bought aggressively as it breaks below the prior swing low, and many bulls bought this one, even though it took several bars before they could turn the market up again. This was a sign that they were not as aggressive as they could have been. This told traders that the pullback might evolve into a larger trading range, which it ultimately did.

Many traders use trend lines for entering and exiting. Some would have taken partial profits near the high of bar 7 as it moved above the trend channel line. They also would have bought as bar 9 fell below the bull trend line and above the bar 9 high, since they saw bar 9 as a failed channel breakout. Bar 12 broke above a small bear trend line, and traders bought as the bar moved above the line since they saw that as the end of the pullback and the resumption of the bull trend. Bar 24 was the third push up in the channel that followed the two-bar bull spike that began at bar 14, and some traders would take profits on their longs above that line, even on the strong bull close of bar 24. The bar was an especially large bull trend bar and the third consecutive bull climax since bar 14, and the market was likely to have a more complex correction. What better place to take profits than on a buy vacuum test of a trend channel line on the third consecutive buy climax? The move down to bar 28 broke below the bull trend line and held below it for many bars, so traders wondered if a larger correction might be starting. This made many quicker to take profits. When the move up from bar 28 could not produce any strong bull trend bars, traders thought that the market might be in a trading range and therefore took profits on the bar 29 test of the bar 26 lower high. This was a potential double top bear flag and lower high trend reversal. The next bar was a bear trend bar, which indicated that the bulls were becoming less aggressive and the bears were becoming stronger.

When a bull trend is very strong, traders can buy for any reason if they use a wide enough stop, and many traders like to buy on breakouts above prior swing highs. However, buying pullbacks before the breakout generally offers more reward, smaller risk, and a higher probability of success. The breakout traders will place buy stops at one tick above the old high and will be swept into their longs as the market breaks above the old high. The most common reason for traders failing to buy a pullback is that they were hoping for a larger or better-looking pullback. Many pullbacks have bear signal bars or follow two or three bar bear spikes, making traders believe that the bull trend needs to correct more before resuming. However, it is important to get long when there is a strong bull trend, and a trader should place a buy stop above the prior swing high when the trend is very strong, in case the pullback is brief and the trend quickly resumes. Reasonable entries included the bar 4 breakout above the bar 2 high and the breakouts up to bar 10 as it moved above bar 7, the bar 14 spike as it went above bar 10, and the bar 20 spike as it moved above bar 16. These old highs are often the highs of higher time frame bars, like on the 15 or 60 minute charts, so the entry is usually a breakout above the high of a prior bull trend bar on these higher time frame charts. Since higher time frame charts have larger bars and the protective stop is initially below the signal bar, the risk is greater and traders should trade smaller size, unless they are only looking for a quick, small scalp. After the trend has gone on for a while, the pullbacks become deeper and last for more bars. Once the two-sided trading becomes apparent, the strong bulls begin to take profits above swing highs rather than buying new positions, and the strong bears begin to scale into shorts as the market goes above the old highs. For example, the bear bar after bar 20 and the bar 22 bear bar were signs of selling pressure, so most traders would have used the move above the bar 21 high to take profits rather than to buy more. At some point, most traders will see new highs as shorting opportunities and not simply as areas to take profits. Although many traders shorted below the bear bar after bar 24, most traders still believed that the trend was up and that there would be a test of the bull high after a pullback. Until there has been a strong bear move that breaks well below the bull trend line, the strong bears usually will not dominate the market.

Since this was a trend day, a trader would ideally swing part, take profits along the way, and then go back to a full position size on every pullback. However, most traders cannot continue to hold part of their trade for a swing and also repeatedly scalp the other part. Traders instead should try to put on a full position early and not take additional signals, and instead scale out of their profits as the market works higher. There are many ways to do this. For example, if they bought early on and had to risk about $1.00 (probably less), they might have taken a quarter off after a $1.00 profit and another quarter off at $2.00, and maybe a third quarter at $3.00, and held onto the final quarter until either a strong sell signal formed or until the end of the day. It was better if they instead waited until the market rallied $2.00, or twice their initial risk, before taking their initial profit, because they had to sure that they were adequately compensated for taking that initial $1.00 risk. It does not matter how they did it, but it was important to have taken some profit along the way in case the market reversed down. However, since traders subjected themselves to risk, they must resist the temptation to exit with too small a reward. As long as the trend is good, it is always best to try to resist taking profits until the market has gone at least twice as far as your initial risk. If traders are out of half of their position but then see another strong buy signal, they might put part or all of the other half back on, at least for a scalp; but most traders should simply stick to their original plan and enjoy their growing profit.

With all of these buy signals, traders could have accumulated an uncomfortably large long position if they kept adding new longs, which they should not have done. Instead, they should have simply held their position until a possible end of the trend, like at bar 24, or they could have scalped out part after each new high as soon as a bar had a weak close, like at bars 16, 21, or 24. Then they could have put the scalp portion back on when they saw another buy signal. They would have continued to hold their swing portion until the end of the trend.

When did traders see this day as a trend day? Aggressive bulls thought that the gap up and strong bull trend bar had a reasonable chance of leading to a trend from the open bull trend day, and they might have bought on the close of bar 1 or one tick above its high. Their initial protective stops were one tick below the bar 1 low, and they planned on holding part or all of the position until the close or until a clear short signal formed.

Other traders always look for double bottoms on gap up days, and they would have bought above the two-bar reversal that began at bar 3, which formed an approximate double bottom with bar 1 or with the low of doji bar that followed it.

Bar 4 was a strong bull trend bar that broke above the opening range and closed above the bar 2 high. Some traders bought at one tick above the bar 2 high, and others bought on the close of bar 4 or one tick above its high. This breakout bar was a statement by the bulls that they owned the market, and most traders at this point believed that the market was always-in long. For the time being, the best place for a protective stop was one tick below its low, but since that was almost a dollar lower, traders had to choose a small enough position size so that they were trading within their comfort zone.

Most traders saw the day as a bull trend day by bars 5 or 7, and probably as soon as bar 4 closed. Once traders believe the day is a trend day, if they are flat, they should buy a small position either at the market or on any small pullback. Traders could have placed limit orders to buy below the low of the prior bar and to buy at a certain number of cents down, like maybe 20, 30, or 50 cents. Others would have looked to buy above a high 2 on a stop or on a moving average pullback. Buying above the bar 8 two-bar reversal was a reasonable long, as was the wedge bull flag (some saw it as a triangle) that ended in a two-bar reversal at bar 12. The protective stop would still have been below the bar 4 low or maybe below its midpoint. Traders need to trade small enough so that their risk is within their normal risk tolerance. Other traders had their stops below the bars 6 and 8 double bottom, and if they got stopped out but the market then formed another buy signal and they believed that the bull trend was still intact, they would have bought again.

The most important thing that traders must force themselves to do, and it is usually difficult, is as soon as they believe that the day is in a trend, they must take at least a small position. They must decide where a worst-case protective stop would be, which is usually relatively far away, and use that as their stop. Because the stop will be large, their initial position should be small if they are entering late. Once the market moves in their direction and they can tighten their stop, they can look to add to their position, but they should never exceed their normal risk level. When everyone wants a pullback, it usually will not come for a long time. This is because everyone believes that the market will soon be higher, but they do not necessarily believe that it will be lower anytime soon. Smart traders know this and therefore they start buying in pieces. Since they have to risk to the bottom of the spike, they buy small. If their risk is three times normal, they will buy only one-third of their usual size to keep their total dollar risk within their normal range. When the strong bulls keep buying in small pieces, this is buying pressure, and it works against the formation of a pullback. The strong bears see the trend, and they too believe that the market will soon be higher. Since they think it will be higher soon, they will stop looking to short. It does not make sense for them to short if they think that they can short at a better price after a few more bars. So the strong bears are not shorting and the strong bulls are buying in small pieces, in case there is no pullback for a long time. What is the result? The market keeps working higher. Since you need to be doing what the smart traders are doing, you need to buy at least a small amount at the market or on a one- or two-tick pullback or a 10 or 20 cent pullback, and risk to the bottom of the spike (the low of bar 4 for most traders, but some would have put their stops below the low of bar 3). Even if the pullback begins on the next tick, the odds are that it won't fall far before smart bulls see it as value and buy aggressively. Remember, everyone is waiting to buy a pullback, so when it finally comes it will only be small and not last long. All of those traders who have been waiting to buy will see this as the opportunity that they wanted. The result is that your position will once again be profitable very soon. Once the market goes high enough, you can look to take partial profits or you can look to buy more on a pullback, which will probably be at a price above your original entry. The important point is that as soon as you decide that buying a pullback is a great idea, you should do exactly what the strong bulls are doing, and buy at least a small position at the market.

After the market moved above the bar 7 high, many traders trailed their protective stops below the most recent swing low, which was at bar 8. As long as the market holds above the most recent swing low, the trend is likely still very strong. If it starts to make lower lows, the market could be transitioning into a trading range or even a bear trend. In either case, traders would then trade it differently from how they would trade a one-sided market (a trend).

Bulls would continue to buy pullbacks all day long, and after the market went to another new swing high, they would move their protective stop to below the most recent swing low. For example, once the market moved above the bar 16 high, traders tightened their protective stops to below the bar 19 low. Many traders moved their stops to breakeven once there was a pullback that tested their entry price and then the market reached a new high. They did not want the market to come back down to their entry price a second time, and if it did, they would have believed that the trend was not strong.

Bar 24 was the third push up from the spike up to bar 15 (bar 21 was the second push up), so the market was likely to correct for a couple of legs sideways to down. The bar after it was a bear inside bar so the market might have reversed down at this point, especially since this would have been a failed breakout above the trend channel line. The market made a couple of attempts to pull back to the moving average earlier in the day, so it was reasonable to assume that it might succeed this time. This was a good place to take profits on the swing longs. Aggressive traders might have gone short for a scalp, but most traders would have waited to see if a 20 gap bar buy signal formed at the moving average.

Should traders try to take most of these entries? Absolutely not. However, if they are watching on the sidelines, wondering how to get in, all of these setups are reasonable. If they take just one to three of these swing entries, they are doing all that they need to do and should not worry about all of the others.

CHAPTER 19

Signs of Strength in a Trend

There are many characteristics of strong trends. The most obvious one is that they run from one corner of your chart to the diagonally opposite corner with only small pullbacks. However, in the early stages of a trend, there are signs that indicate that the move is strong and likely to last. The more of these signs that are present, the more you should focus on with-trend entries. You should start to look at countertrend setups only as great with-trend setups, with you entering on a stop exactly where those countertrend traders will be forced to exit with a loss.

One interesting phenomenon in trend days is that on many of the days, the best reversal bars and the biggest trend bars tend to be countertrend, trapping traders into the wrong direction. Also, the lack of great with-trend signal bars makes traders question their entries, forcing them to chase the market and enter late.

Finally, once you realize that the market is in a strong trend, you don't need a setup to enter. You can enter anytime all day long at the market if you wish with a relatively small stop. The only purpose of a setup is to minimize the risk.

Here are some characteristics that are commonly found in strong trends:

- There is a big gap opening on the day.
- There are trending highs and lows (swings).
- Most of the bars are trend bars in the direction of the trend.
- There is very little overlap of the bodies of consecutive bars. For example, in a bull spike, many bars have lows that are at or just one tick below the closes of the prior bar. Some bars have lows that are at and not below the close of the prior bar, so traders trying to buy on a limit order at the close of the prior bar do not get their orders filled and they have to buy higher.

- There are bars with no tails or small tails in either direction, indicating urgency. For example, in a bull trend, if a bull trend bar opens on its low tick and trends up, traders were eager to buy it as soon as the prior bar closed. If it closes on or near its high tick, traders continued their strong buying in anticipation of new buyers entering right after the bar closes. They were willing to buy going into the close because they were afraid that if they waited for the bar to close, they might have to buy a tick or two higher.
- Occasionally, there are gaps between the bodies (for example, the open of a bar might be above the close of the prior bar in a bull trend).
- A breakout gap appears in the form of a strong trend bar at the start of the trend (a trend bar is a type of gap, as discussed in book 2).
- Measuring gaps occur where the breakout test does not overlap the breakout point. For example, the pullback from a bull breakout does not drop below the high of the bar where the breakout occurred.
- Micro measuring gaps appear where there is a strong trend bar and a gap between the bar before it and the bar after it. For example, if the low of the bar after a strong bull trend bar in a bull trend is at or above the high of the bar before the trend bar, this is a gap and a breakout test and a sign of strength.
- No big climaxes appear.
- Not many large bars appear (not even large trend bars). Often, the largest trend bars are countertrend, trapping traders into looking for countertrend trades and missing with-trend trades. The countertrend setups almost always look better than the with-trend setups.
- No significant trend channel line overshoots occur, and the minor ones result in only sideways corrections.
- The corrections after trend line breaks go sideways instead of countertrend.
- Failed wedges and other failed reversals occur.
- There is a sequence of 20 moving average gap bars (20 or more consecutive bars that do not touch the moving average, discussed in book 2).
- Few if any profitable countertrend trades are found.
- There are small, infrequent, and mostly sideways pullbacks. For example, if the Emini's average range is 12 points, the pullbacks will all likely be less than three or four points, and the market will often go for five or more bars without a pullback.
- There is a sense of urgency. You find yourself waiting through countless bars for a good with-trend pullback and one never comes, yet the market slowly continues to trend.
- The pullbacks have strong setups. For example, the high 1 and high 2 pullbacks in a bull trend have strong bull reversal bars for signal bars.
- In the strongest trends, the pullbacks usually have weak signal bars, making many traders not take them, and forcing traders to chase the market. For

example, in a bear trend the signal bars for a low 2 short are often small bull bars in two or three bar bull spikes, and some of the entry bars are outside down bars. It has trending "anything": closes, highs, lows, or bodies.

- Repeated two-legged pullbacks are setting up with trend entries.
- No two consecutive trend bar closes occur on the opposite side of the moving average.
- The trend goes very far and breaks several resistance levels, like the moving average, prior swing highs, and trend lines, and each by many ticks.
- Reversal attempts in the form of spikes against the trend have no follow-through, fail, and become flags in the direction of the trend.

When a trend is in runaway mode, there will likely be no pullbacks for many bars and the bars will be good-sized trend bars with mostly small tails. Since you want to keep scalping more as the trend continues while still holding on to the swing portion of your position, you might consider looking at the 3 minute chart for additional with-trend setups. It often has more pause bars (countertrend inside bars and one-bar pullbacks) that allow for with-trend entries. The 1 minute chart also has with-trend entries but in addition it has some countertrend setups, which can be confusing when you are trying to trade only with trend. This, along with the speed of the reading required, can create too much stress during a runaway trend and can interfere with your ability to trade effectively. Since you need to be making sure that you catch every with-trend entry, it is best to trade only off the 5 minute chart in a runaway trend. Once you become experienced and successful, you might consider also looking at the 3 minute chart.

Over time, the trend weakens; more signs of two-sided trading develop and the signs of strength begin to disappear. For example, in a bull trend traders begin to take profits above the highs of the prior bars and above swing highs, and aggressive bears begin to short above the highs of bars and above swing highs and will scale in higher. The strong bulls will eventually only buy pullbacks. The initial bull spike is replaced by a bull channel, and it eventually evolves into a trading range.

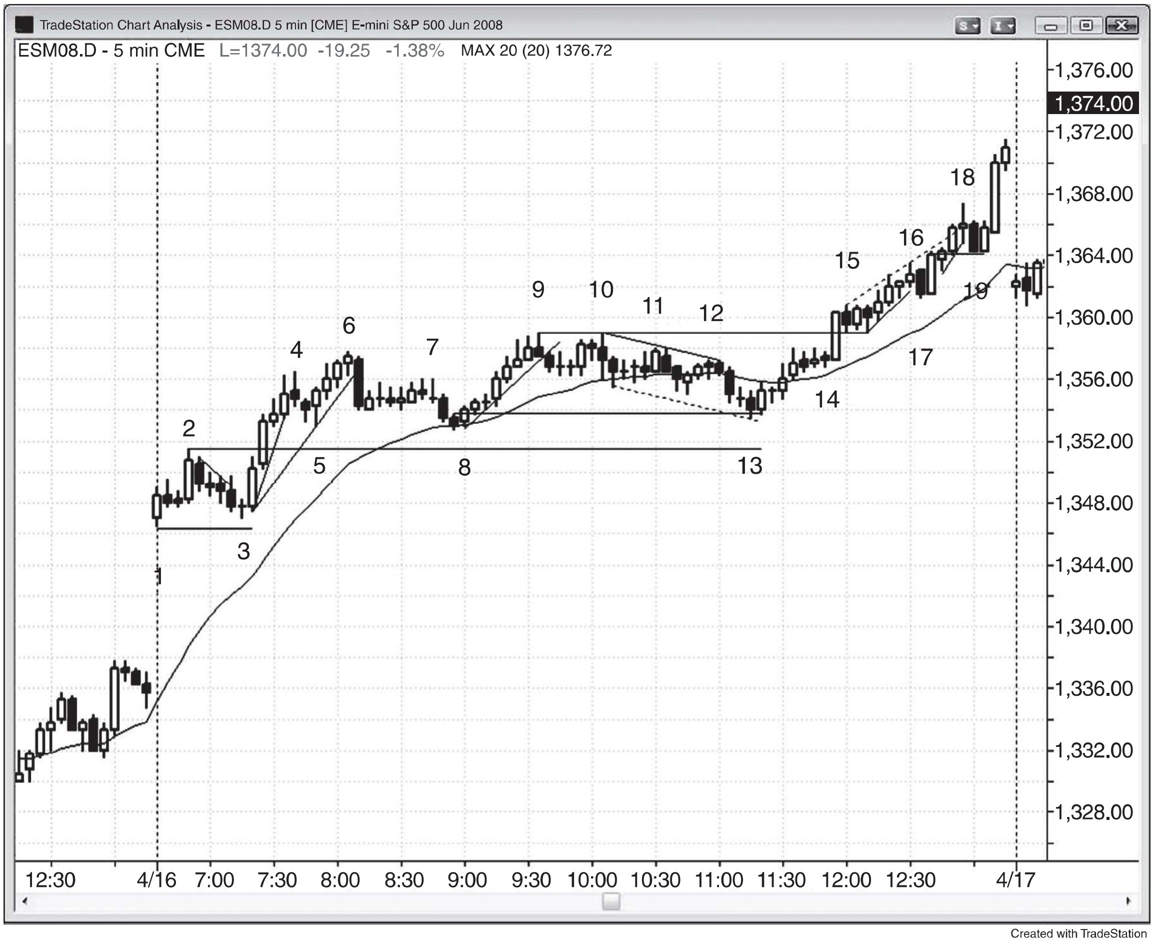


FIGURE 19.1 Big Gap Up on Bull Day

Large gaps that don't reverse early usually mark the start of a strong trend for the day and the day often closes at or near the high (or low, in a bear). As shown in Figure 19.1, the 5 minute Emini gapped up 11 points, which is huge, and the first bar was a bull trend bar. Also, the market did not test the moving average for over two hours, another sign of strength. Notice how there was not much emotional behavior (big bars, climaxes, big swings). Quiet markets with lots of small bars, many of which are dojis, often lead to the biggest trends.

On days like this, the institutions have a huge amount to buy and they want lower prices, but when the lower prices don't come, they have to fill their orders in pieces all day long, at increasingly higher prices. Even though they see the trend day unfolding and expect that they will likely have to be buying at higher prices throughout the day, they don't dump all of their buy orders onto the market at once, because this could cause a climactic spike up and then possibly a reversal down below their average entry price. They are content filling their orders in manageable pieces all day long, understanding that they are buying higher and higher, but knowing that the market will likely go higher still. Also, strong days like this usually have higher prices over the next one to several days.

Deeper Discussion of This Chart

The market broke out above yesterday's high in Figure 19.1, but the breakout became a failed breakout when the market turned down below the bear inside bar that followed the bar 2 strong bull spike. Big gap up days often test the low of the open and form a small double bottom bull flag. When the opening range is small like this, that market is in breakout mode and traders will enter in the direction of the breakout. On a big gap up day, the odds favor an upside breakout. Aggressive bulls could enter above bar 3, based on the double bottom, but many bulls entered on a stop above the bar 2 high of the opening range. The day was a trend from the open bull trend day and a trend resumption bull day.

The market had a small two-legged move down to bar 3. A bear trend bar and two dojis composed the first leg. The second leg was made up of a bear trend bar with a large bear tail on top (the tail was the pullback that ended the first leg down) followed by a doji. This variant of a two-legged move would certainly have two clear legs down on a smaller time frame chart, setting up an ABC buy signal. A trader could buy at one tick above bar 3. It was also a test of the gap, forming a double bottom with the low of bar 1. Since this was a possible trend day and as such could extend much further than most traders would ever suspect, smart traders would swing part or all of their positions. Note how the open of the day was very close to the low of the day, which is a sign of strength, and trend from the open days that open within a few ticks of the low of the day often close within a few ticks of the high of the day, and there is often a trend into the close.

Bar 5 was a high 1 breakout pullback after a strong move up (four bull trend bars), and a high 1 is always a good buy in the spike phase of a strong bull trend. The bar 4 low 1 break below the trend line and reversal from the new high was not a short, even for a scalp. In fact, it is incorrect to use the term low 1 here because a low 1 sets up trades in trading ranges and bear trends, not strong bull trends. After such a strong up move, smart traders would only be looking to buy and would consider a short only if there was a second entry.

Bar 6 was a low 2, which was a second entry short and a possible top of a trading range within a bull trend. However, in the face of the strong bull trend, shorts would only scalp this trade. They would swing it only if there was first a prior strong down move that broke a substantial trend line (maybe 20 or more bars). If they shorted, they would be quick to exit and then they would look for a long setup for a swing trade. With-trend entries in a strong trend should be mostly swung, with only a small potion taken off as a scalp. If you find that you missed a with-trend entry, stop looking for countertrend scalps and start trading only with-trend setups. During a trend day, you must try to catch every with-trend signal, because that is the source of the most consistent money.

Since the bar 6 entry bar was a strong bear trend bar, it is a breakout and therefore a spike. Spikes are usually followed by channels with at least two more pushes; but when they occur against a strong trend, they often just have one more push and become a two-legged bull flag. In any case, after a spike down, there was a good chance for at least one more leg down.

Bar 7 was an entry bar for a low 2 short into the second leg down, but after a six-bar tight trading range, any breakout in either direction would likely fail after not going very far.

Bar 8 was a two-legged pullback and the first to the moving average in a strong bull trend, which is a great buy. Whenever the market stays away from the moving average for 20 bars or more (a 20 gap bar buy setup), the trend is very strong and the odds are high that there will be buyers at the moving average.

Bar 9 was a reversal at a new swing high, but there were no bear trend bars among the prior seven bars so no short could be taken unless a second entry forms.

Bar 10 was a second entry, but in a tight trading range in a bull trend, any short is a scalp at best and it is probably best to pass on this trade. Sideways price action in a bull trend is usually a bull flag and will usually break out in the direction of the trend that was in effect before it formed. Outside bars are less reliable, but you could consider taking the short for a scalp since second entries are so reliable. Three small dojis developed at the moving average. This was a small tight trading range and therefore had a magnetic effect. The odds were high that there would be a trend bar breakout in either direction and it would fail. Traders held short and risked maybe four ticks. The bar 11 bull trend bar breakout failed, as expected, allowing traders to take a four-tick scalp profit on the next bar.

Bar 13 was a breakout test that extended one tick below the high of the signal bar that generated the strong move up from the bar 8 long. The move down from bars 9 to 13 was very weak and appeared essentially sideways. The market struggled to get down to test the breakout, meaning the bears lacked conviction. Bar 13 also set up a high 4 entry just below the moving average, and it followed the first moving average gap bar of the day (a bar with a high below the exponential moving average). This was a moving average gap bar setup in a strong trend and should be expected to test the high of the bull trend with either a lower high or a higher high. A moving average gap bar in a strong trend often leads to the final leg of the trend before a deeper, longer-lasting pullback develops, and the pullback can grow and become a trend reversal. This might have happened on the following day. Bar 13 formed a higher low (higher than bar 8) following a higher high at bar 9, and is part of trending bull swings. It is essentially a double bottom bull flag with bar 8.

Bar 14 was a high 2 breakout signal bar, and the high 1 was the prior bar.

Bar 15 was a signal bar for a final flag short but the market never triggered the entry because it did not trade below the signal bar low. However, as a bear bar, it was a small leg down. The next bar was a bull trend bar and then there was another bear trend bar. This second bear trend bar was a small second leg down and therefore was a high 2 buy setup.

Bar 17 was the first breakout of a bull micro channel on a strong bull day, and therefore it was a setup for a buy at one tick above its high. The channel had a wedge shape and, although traders would not short here, the theoretical protective buy stop for shorts is one tick above the high of the wedge. There was a large bull trend bar that ran through those buy stops, showing a strong rejection of the bear case. The bar was so strong because there were bulls who expected the bar 17 short to fail and therefore placed buy stops above its high to get long, and there were the bears who got stopped out at one tick above the bar 16 top of the wedge.

Bar 18 broke above a bull trend channel line and gave a low 2 short signal. However, on a strong trend day, smart traders will short only if there is first a strong bear leg that broke a trend line. Otherwise, they would view all short setups as buy setups, and place orders to go long exactly where the weak shorts would have to cover (like one tick above the highs of bars 17 and 19).

Bar 19 was a one-bar trend line break that failed, and therefore a buy setup. There was a two-bar bull reversal that became the signal for the long.

FIGURE 19.2 Most Reversals Fail on Trend Days

As shown in Figure 19.2, one peculiarity of trend days is that often the best-looking reversal bars and trend bars are countertrend, trapping traders into losing trades in the wrong direction (bars 1 through 8). Notice how there was not a single great bear reversal signal bar all day, yet this was a huge bear trend. Just look at the moving average—the market could not put two consecutive closes above it until the gap bar at the top of the rally that began with bar 8. This was a bear trend, and every buy should be viewed as a short entry setup. Just place your entry order exactly where the longs would have their protective stops and let them drive the market down as they liquidate.

The weak sell signals are a key reason why the trend is so relentless. Bears keep waiting for a strong signal bar, so that they can short their full position. Trapped bulls keep waiting for strong evidence that the trend is strong and that they need to exit immediately. The signs never come, and both the bulls and the bears keep waiting. They look at the trend and see lots of bull bars and two- or three-bar bull spikes, so assume and hope that this buying pressure will soon create a larger rally. Even if they see that the market cannot get above the moving average and that all of the pullbacks are very small, they deny these signs of a strong trend and keep hoping for the bulls to lift the market to a level where they feel more comfortable shorting. It never happens, and both the bears and the trapped longs continue to sell in pieces all day long, just in case the rally that they want never comes. Their relentless selling, along with the aggressive, relentless shorting by the strong bears who see this as the very strongest of bear trends, makes the market work lower and lower all day without any big pullback.

FIGURE 19.3 No Pullbacks Means the Trend Is Strong

When traders cannot get filled on a limit order to buy at the close of the prior bar, the trend is strong. In Figure 19.3, as soon as bar 1 closed on its high, some traders would immediately place a limit order to buy at the price where that bar closed, hoping to get filled during the opening seconds of the next bar, bar 2. But since the low of bar 2 never dipped below the close of bar 1, the limit order would likely not get filled. Instead, the buyer would keep trying to buy higher. Bars 3, 4, and 5 were also very strong, although as soon as bar 3 closed, a trader who placed a limit order to buy at the level of that close would have been filled during the first few seconds of bar 4 because the low of bar 4 dipped one tick below the close of bar 3. Usually when there is a series of strong bars like that, they create a spike and the market typically then develops a bull channel.

However, that is not always the case. The next day, bars 6 through 9 were also strong but they led to a lower high. Yesterday was a spike and channel bull trend day, so the start of the channel should get tested today. That was a downside magnet in the market, and when the market opened below yesterday's bull trend line, the lower high following the bars 6 to 9 spike led to a trend reversal down.

Stock traders would describe this bull channel up to yesterday's high as a crowded trade. Everyone who wanted to buy had already bought and there was no one left to buy. As the market started to fall, all of the buyers in the channel were quickly holding losing positions and then everyone rushed to the exits to minimize their losses and protect some of their profits. The result was that the market fell quickly.

Deeper Discussion of This Chart

The open broke out below the bull channel of yesterday's spike and channel in Figure 19.3, and bar 6 was a bull trend bar that set up a failed breakout long. The failed breakout became a lower high and breakout pullback short with a second entry below the bull bar that followed the 7:05 a.m. PST bear spike.

CHAPTER 20

Two Legs

The market regularly tries to do something twice, and this is why all moves tend to subdivide into two smaller moves. This is true of both with-trend and countertrend moves. If it fails in its two attempts, it will usually try to do the opposite. If it succeeds, it will often then extend the trend.

Everyone is familiar with an ABC pullback in a trend that unfolds in three steps. There is a countertrend move, a small with-trend move that usually does not go beyond the trend's extreme, and then a second countertrend move that usually extends deeper than the first. Trends themselves also tend to subdivide into two smaller legs as well. Elliott Wave followers look at a trend move and see three with-trend waves. However, it is better to look at the first strong with-trend leg as the start of the momentum (the Elliott Wave 3), even if there was a prior with-trend move or wave (Elliott Wave 1). That strong with-trend move often subdivides into two smaller with-trend moves, and, after a pullback, the trend will often make two more pushes to test the extreme of the trend (these two pushes create Elliott Wave 5). This two-legged view of markets makes more sense to a trader since it offers sound logic and abundant trading opportunities, unlike Elliott Wave Theory, which is essentially useless to the vast majority of traders who are trying to make money.

A break of a trend line is the start of a new leg in the opposite direction. Any time there is a new trend or any capitulation of one side, there will usually be at least a two-legged move. This can occur in a pullback in a trend, a breakout, a major reversal, or any time that enough traders believe that the move has sufficient strength to warrant a second attempt to test whether or not a protracted trend will develop. Both the bulls and the bears will be in agreement that the momentum is strong enough that a test will be needed before they develop a strong conviction one way or the other. For example, in a two-legged rally in a bear trend, bulls will take profits above the first leg, new bears will short, and other bears who shorted the first up leg will add to their shorts as soon as the second leg up goes above the high of the first leg. If all of these shorts overwhelm the traders who bought the breakout above the first leg up, the market will go down and enter either a trading range or a new bear phase.

Some complex two-legged moves take place over dozens of bars and, if viewed on a higher time frame chart, would appear clear and simple. However, any time traders divert their attention away from their trading charts, they increase the chances that they will miss important trades. To be checking the higher time frame charts for the one signal a day that they might provide simply is not a sound financial decision.

Two legs is the ideal but there is some overlap with three-push patterns. When there is a clear double top or double bottom, the second push is the test of the prior price where the market reversed earlier, and if it fails again at that price, a reversal or pullback is likely. But when the first move is not clearly the possible end of a trend, the market will often then make a two-legged test of that extreme. Sometimes both legs are beyond the prior extreme, creating a clear three-push pattern. At other times only the second leg exceeds the prior extreme, creating a possible two-legged higher high at the end of a bull trend or a two-legged lower low at the end of a bear trend.

Sometimes one or both of the legs of a two-push move are composed of two smaller legs so that the overall move actually has three legs. This is the case in many three-push patterns where often two of the pushes really are just part of a single leg. However, if you look carefully at the leg that has the two small legs and think about what is going on, that leg with its two small legs is comparable in strength or duration or overall shape to the other leg that has just a single move. This is difficult and frustrating for traders who want perfect patterns; but when you trade, you are always in a gray fog and nothing is perfectly clear. However, whenever you are not confident about your read, do not take the trade—there will always be another trade before too long that will be much clearer to you. One of your most important goals is to avoid any confusing setups, because losses are hard to overcome. You do not want to spend the rest of the day struggling to get back to breakeven, so be patient and take only trades where you are comfortable with your read.

FIGURE 20.1 Every Leg Is Made of Smaller Legs

Every trend line break and every pullback is a leg, and each larger leg is made of smaller legs (see Figure 20.1). The term *leg* is very general and simply means that the direction of movement has changed, using any criterion that you choose to determine that the change exists.

PART IV

Common Trend Patterns

Trends days can be classified into specific types, and if you become familiar with the characteristics of each type, you will be prepared to spot specific trading opportunities as they are setting up. The names are meaningless because all that a trader needs to know is how to read the price action, which is the same for any pattern. On most trend days, features of more than one type of trend will be present, but don't look at that with confusion or disappointment. Instead, it is an opportunity because there will be more tradable setups once you become familiar with how each tends to develop.

With all trend patterns, the only reason to apply names to them is because they are commonly recurring patterns; if you recognize one as it is unfolding, you should be focusing on trading in the with-trend direction only and be more confident about swinging a larger part of your trade. The setups will be the same as during trading range days, but you should be trying to take every with-trend entry, no matter how weak the setup looks, and you should take countertrend entries only after a trend line break, only if there is a good reversal bar, and only if you are still able to take every with-trend signal. If you find that you are missing any with-trend entries, stop trading countertrend and focus only on with-trend setups. On the countertrend trades, you should scalp your entire position. Also, you should not find more than two or three countertrend trades in the day; if you do, you are spending too much time looking in the wrong direction and likely missing great with-trend swings. The stronger the trend, the more you need to be swinging with the trend and not scalping countertrend. In a very strong trend, all trades should be with-trend swings (scalping out part) and no trades should be countertrend scalps, as tempting as they are.

The opening range usually provides clues to how the day will unfold, and these are discussed in detail in the section on opening patterns and reversals in the third book. In general, if the opening range is small, it will be followed by a breakout. If the opening range is about half of the range of the recent days, the breakout will often lead to a measured move and a trending trading range day. If the opening range is large, there is usually a spike and the day will likely become a spike and channel trend day.

Once you are familiar with these patterns, you will find that you can see them potentially setting up in the first 30 to 60 minutes. If you do, make sure to take every with-trend trade and swing part of your position. Sometimes you will get stopped out of the swing portion a couple of times, but keep swinging a part because if the day becomes a trend day, a single swing can be as profitable as 10 scalps.

As a corollary, if you cannot see one of these patterns setting up, then assume that the day is a trading range day and look for entries in both directions. Also, a trend day can turn into a trading range day or a trend in the opposite direction at any time. When it happens, don't question it or be upset by it. Just accept it and trade it.

CHAPTER 21

Spike and Channel Trend

Primary characteristics of spike and channel trend days:

- There is a spike that is made up of one or more trend bars, and it signals that the market is breaking into a clear always-in situation. During the spike, there is a sense of urgency and traders add to their position as they press the trade. The spike is effectively a breakaway gap (discussed in book 2).
- The spike usually forms in the first hour and often within the first few bars of the day.
- The stronger the breakout, the more likely there will be follow-through in the form of a channel, and the more likely the channel will go far (see the sections on the strength of trends in Chapter 19, and the strength of breakouts in Chapter 2 of book 2).
- When the breakout is strong, it is often the basis for a measured move where the channel may end and you can ultimately take partial or complete profits.
- Immediately after the spike, there is a pullback that can be as short as a single bar or as long as a couple of dozen bars.
- The trend resumes in the form of a channel. During the channel, there is a sense of worry and uncertainty, due to the two-sided trading.
- When the market is channeling, it is better to trade it like a trending trading range (for example, in a bull channel, it is better to buy below the low of the prior bar and hold part of the trade for a swing, and if you take any shorts, sell above swing highs or the highs of prior bars and primarily scalp).
- The channel will rarely break out in the with-trend direction, but when it does, the breakout usually fails within five bars and then the market reverses.

- The channel ends at some measured move target, and often on a third push.
- If the channel breaks out against the trend, as it usually ultimately does, don't enter on the breakout and instead wait for the pullback (for example, if there is a bull spike and channel and the market breaks below the channel, look to short a lower high).
- The market usually corrects to the start of the channel, which is a test of the gap (the spike, like all spikes, is a gap).
- The market then reverses back at least 25 percent in the direction of the trend as it attempts to form a trading range. In a bull spike and channel, the pullback often forms a double bottom bull flag with the bottom of the channel, which is the bottom of the pullback that followed the spike up.
- When it is weaker, it is probably more likely a trending trading range day (discussed in the next chapter).

The spike and channel trend is the most common type of trend and is present in some form almost every day and in every trend. There are countless variations and there are often many smaller ones nested inside larger ones. Because it often is the controlling force over so much price action, it is imperative that traders understand it. It is a pattern with two components. Every trend has both a spike phase and a channel phase, and every trend is in either of those two modes at all times. First, there is a spike of one or more bars where the market is moving quickly. There is a sense of urgency and everyone believes that the market has further to go. The spike is a breakaway gap where the market quickly moves from one price level to another. Next, there is a pullback, which can be as short as a single bar or can last dozens of bars and even retrace beyond the start of the spike. For example, if there is a bull spike, occasionally the pullback will fall below the bottom of the spike, and then the channel begins. After the pullback, the trend converts into a channel, where there is less urgency and more a sense of worry and uncertainty. This is the wall of worry that you sometimes hear pundits mention on TV. Everyone sees two-sided trading taking place and the trend constantly looks like it is about to end, yet it keeps extending. Traders are quick to take profits, but as the trend continues, they keep reentering or adding to their positions because they are not certain when the trend will end and they want to make sure to participate. Rarely, there will be a second spike phase and then another channel, but usually the second spike becomes a failed breakout and is followed by a correction. For example, if there is a bull spike and then a lower-momentum bull channel, the market can break out of the top of the channel with another bull spike. Rarely, it will be followed by another bull channel, but more often the spike becomes a failed breakout and the market then corrects down.

When the market has a series of bars that cover a lot of points with little or no pulling back, this strong trend is a spike. The spike can be one trend bar, a series of trend bars with little overlap, or sometimes even a very tight channel. In fact, a spike on a given time frame is a steep, tight channel on a smaller time frame. Likewise, steep, tight channels are spikes on higher time frames. The spike ends at the first pause or pullback, but if it resumes within a bar or two, it becomes either a second spike or a spike on a larger time frame. The spike can be as small as a single moderate-sized trend bar or it can last for 10 or more bars. Spikes, climaxes, and breakouts should be thought of as being the same, and they are discussed more in the chapter on breakouts in book 2. In a spike up, everyone is in agreement that this is not an area of value for the bears and therefore the market needs to go up further to find prices where both the bulls and bears are willing to trade. The market will continue to quickly move higher until the bulls are willing to take some profits and are less willing to buy new positions, and the bears are beginning to short. This causes a pause or a pullback, and it is the first sign of significant two-sided trading. The opposite is true for a spike down.

Almost all trends begin with a spike, even if it is a single trend bar and not recognizable as the start of the trend until many bars later. Therefore, almost all trends are variations of a spike and channel trend. However, when the trend has more characteristics of one of the other types of trends discussed in this chapter, you should trade it as that other type to maximize your chances of success.

By definition, the spike ends immediately before the first pause bar or pullback because it is the pause that signifies the end of the spike. The market can then go on to do any of the obvious three things: the trend can resume, the market can enter a trading range, or the trend can reverse. The first possibility is the most common. The market pulls back for a couple of bars, or maybe a dozen bars, and then the trend resumes. This pullback is a gap test (remember, the spike is a gap) and the start of the channel. When the trend resumes, it is usually less strong as indicated by more overlapping bars, a flatter slope, some pullbacks, and some trend bars in the opposite direction. This is a channel, and the pattern then becomes a spike and channel trend.

The second possibility occurs if the pullback extends for more than 10 bars. It will then have grown into a trading range, which can break out in either direction. In general, the odds always favor the trading range breakout to be in the same direction as the original trend. If the trading range lasts for a long time, it is simply a flag on a higher time frame chart (for example, a three-day-long trading range on the 5 minute chart that follows a bull spike will usually be just a bull flag on the 60 minute chart, and the odds favor an upside breakout). This is a trend resumption situation and is discussed later in this chapter. Although the trend usually resumes before the end of the day and the day becomes a trend resumption trend day, the breakout from the trading range can sometimes fail or reverse within a few bars (final flag reversals are discussed in book 3 in the chapter on reversals). Rarely, the trading range lasts for several hours or even several days and has very small swings (this is a tight trading range and is discussed in book 2 on trading ranges). As with any trading range, the breakout can be in either direction but is slightly more likely to be in the direction of the trend.

The third possibility is that the market reverses. As long as the pullback from the spike is not strong enough to flip the always-in trade to the opposite direction, the market will likely continue the trend, and the continuation will almost always be in the form of a channel. Less often, the market will reverse and form a spike in the opposite direction. When this happens, the market will then usually enter a trading range as the bulls and bears fight for follow-through. The bulls will keep buying as they try to create a bull channel to follow their bull spike, and the bears will keep selling as they try to create a bear channel to follow their bear spike. Although the trading range can last for the rest of the day, one side usually wins and the market breaks out. At that point, either it forms a channel and the day becomes a spike and channel trend day or the breakout is soon followed by another trading range and the market forms a trending trading range day, which is discussed in the next chapter.

Besides reversing with a spike in the opposite direction, the market can also reverse if a trading range forms after the spike. For example, if there is a bull spike and then a trading range, in about a third of cases the market will break out of the bottom of the trading range instead of the top. The breakout can be by a sharp, large bear spike, but more often it is by an unremarkable bear trend bar that is followed by a bear channel.

If it forms a channel, it is better to trade it only in the direction of the trend. Sometimes there are large swings in the channel, which can provide countertrend scalping opportunities as the channel progresses. Be aware that channels can last much longer than you might imagine and they are always looking like they are reversing. There are many pullbacks along the way, trapping traders into the wrong direction. There are usually many bars with tails, many trend bars in the opposite direction, and lots of overlapping bars, but it is still a trend and it is very costly to trade countertrend prematurely.

Some days have an early strong momentum move (a spike) and then the trend continues in a less steep channel for the rest of the day. However, the channel sometimes accelerates and follows a parabolic curve instead of a linear path. At other times, it loses momentum and forms a flatter curve. Regardless, the start of the channel is usually tested later in the day or in the next day or two, and the test can then be followed by a trading range or a trend in either direction. The important thing to realize is that if the channel is fairly tight, it is tradable only in the with-trend direction because the pullbacks will not go far enough for a countertrend trade to be profitable. Much less often, the channel has broad swings and is tradable in both directions.

You should be prepared to look for entries in the countertrend direction after there is a breakout from the channel against the trend, since there is a good chance that the countertrend move will extend all the way back to test the start of the channel and attempt to form a trading range. Remember that a channel, no matter how steep, is a flag in the opposite direction. A bull channel is a bear flag and a bear channel is a bull flag. Also, even though a channel is a sloping trading range, it is also the first leg of a larger trading range, and the reversal is usually to the area around the start of the channel. For example, if there is a spike up, then a pullback, and then a bull channel, the bull channel is usually the first leg of a trading range that has yet to unfold. The market will usually correct down to the bottom of the channel, where it will try to form a double bottom bull flag with the bottom of the channel. This usually leads to a bounce, which is the third leg of the developing trading range. After the bounce, traders should begin to look for other patterns because the predictability of the spike and channel pattern at this point has ended. A spike is a breakout, which means that there will be a gap between the breakout point and the first pullback, which is the start of the channel. The test to the bottom of the channel is a test of the gap and is a breakout test.

Stock traders often describe the end of a bull channel as a crowded trade because they believe that anyone interested in the stock has gone long and there is no one left to buy. They then expect a fast sell-off down to the start of the channel as all of the channel buyers exit. As the stock quickly falls, they think of the bear leg as being caused by all of the late-entering bulls with open losses quickly exiting to minimize those losses. That rush to the exits by the crowd of bulls leads to the rapidity and depth of the sell-off. There are obviously many factors that influence every move, but this is likely an important component when there is a sharp correction down to the start of the channel.

Since the second part of the pattern is a channel, the behavior during the channel phase is like that of any other channel. Almost all spike and channel bull patterns end with a breakout through the bottom of the channel and a test to around the bottom of the channel. The easiest reversal setup to spot is a three-push pattern in a channel with a wedge shape, where the third push overshoots the trend channel line and reverses with a strong reversal bar, especially if there is a second entry. However, most of the time the reversal is not so clear and it is better to wait for a breakout pullback setup. For example, if there is a breakout below a bull channel, wait for a pullback to a higher high or lower high, and if there is a good bear setup, go short. If the sell-off reaches the bottom of the channel and sets up a buy, then look to go long for the double bottom bull flag bounce.

If there is a strong spike and any pullback, even a single bar, and then the trend resumes, the odds favor a spike and channel trend. For example, if there is a strong spike up that broke out of a trading range and then an inside bar, and then a bar that falls below the inside bar but reverses up into a bull reversal bar, traders will buy above that bar in anticipation of a bull channel. As soon as the market goes above that bull reversal bar, a channel is in effect. It can have a single push up lasting from one to several bars (a final flag reversal, which is discussed in book 3) and then reverse into a bear leg, or it can have two or more legs and then reverse. If the channel up is developing in an area where a reversal seems probable, like near the top of a trading range, it may reverse after a couple of legs up, before clear channel lines can be drawn. If it is forming in an area where a bull trend is probable, like in a reversal up from a strong bottom pattern, it will usually have at least three pushes, but it could have many more.

Just how far can a channel go? In a strong trend, it usually goes much farther than what most traders believe is likely. However, if the spike is large, one measured move target is from the open or low of the first bar of the spike to the close or high of the last bar of the spike, and then you project that same number of points up. Another measured move target is a leg 1 = leg 2 move where the spike is leg 1 and the channel is leg 2. Look to see if a reversal is setting up once the channel is at the measured move target.

You will usually see other measured move projections and trend line and trend channel line targets as well, but most of these targets will fail, especially if the trend is very strong. However, it is important to look for them because when a reversal finally does set up, it will usually be at one of these resistance areas, and that will give you more confidence to take the reversal trade. In general, it is far better to look at measured move targets as areas to take profits than as locations to take reversal trades. Traders should take a reversal trade only when the setup is strong, and reversal trading is discussed in book 3. Experienced traders will often scalp against the trend at measured move targets, sometimes scaling in if the market goes against them (scaling in is discussed in book 2), but very few traders can consistently do this profitably and most will lose money if they try.

A strong spike is a sign that the market is quickly moving to a new price level where both the bulls and bears feel that there is value in placing trades. The market usually overshoots the value area and then pulls back into what will become a trading range. Because both the bulls and the bears are satisfied with the prices in this new area, the directional probability of an equidistant move is about 50 percent in the middle of the trading range. That means that there is about an equal chance that the market will move up X ticks before it moves down X ticks. This uncertainty is the hallmark of a trading range. It does not matter why the market is trending. All that matters is that it is moving quickly. You can view the move as a breakout and a move away from some prior price or as a move toward some magnet. That magnet can be a key price level like a prior spike, a measured move, or a trend line. Or you can think of the breakout as a move toward neutrality where the directional probability is once again about 50 percent. This always occurs in a trading range, so once the directional probability has fallen to 50 percent, a trading range will become evident. A trend is simply a move from one trading range to another, and while in the new trading range, both the bulls and the bears are placing trades in an attempt to be positioned for what they believe will be the next breakout. This is discussed more in the section on the mathematics of trading in book 2.

As an example, if the market is in a bull channel, the directional probability of an equidistant move starts to fall, and at some unknown point it hits 50 percent. This will ultimately be the middle of the trading range, but no one yet knows where that is and the market usually has to overshoot to the upside and downside as it searches for neutrality. As the market is going up in the channel, traders will assume that the directional probability of higher prices is still better than 50 percent until it is clearly less than 50 percent. That clarity occurs at some magnet, and at that point everyone sees that the market has gone too far. This will be the general area of the top of the trading range, and the directional probability at the top of a trading range favors the bears. The result is that the market will trade down in search of neutrality, but it will usually overshoot it again because neutrality is never clear but excess is. Once the market gets to some magnet (discussed in book 2), traders will see that it has gone down too far and it will reverse up. Eventually, the range will become tighter as traders home in on neutrality, which is a price level where both the bulls and the bears feel there is value in placing trades. They are in balance and the market is then in breakout mode. Before long, perceived value will change and the market will have to break out again to find the new value area.

Once you recognize that a spike and channel trend is in effect, do not take countertrend trades in the hope that an ABC pullback will extend far enough for a scalper's profit. This is because invariably there will not have been any prior trend line break, and the tightness of the channel makes countertrend trading a losing strategy. The failures of these countertrend scalps are great with-trend setups. Just enter on a stop where the countertrend traders are exiting with their protective stops.

Aggressive traders will enter channels using limit orders, trading with trend until two-sided trading becomes prominent, and which point they will start trading countertrend. For example, if there is a bear spike and then a channel, bears will enter with limit orders at or above the highs of the prior bars. As the channel approaches support levels, they will watch to see if the bars are overlapping more, if there are more and stronger bull trend bars, if there are more dojis, and if there are bigger pullbacks. The more of these signs of two-sided trading that are present, the more willing the bulls will be to buy with limit orders at and below the lows of prior bars and swing lows, and the less willing bears will be to short above or below bars. Bears will scale out of their profitable trades after the trend has gone on for a while and is in the area of measured move targets or other types of support. Bulls will begin to scale into longs in the same areas. The increased buying and reduced selling ultimately lead to a breakout above the bear trend line.

Institutions and traders who have large enough accounts can scale into a countertrend position, expecting the market to test the start of the channel, but most traders should trade only with trend until there is a clear sign of a reversal. Also, it is risky to scale into a countertrend position in a channel in the second half of the day, because you will often run out of time. You will find yourself holding an ever-larger losing position and you will be forced to buy it back with a large loss by the close. When the bears are scaling in, some will look for a large bull trend bar that breaks above a prior swing high. They will see it as a possible exhaustive top of the trading range that should soon form. They will place limit orders to short the close of the bar and above its high, because they see the channel as the first leg of a trading range, and shorting bull spikes in the area of the top of a trading range is a standard trading range technique (discussed in book 2 on trading ranges). After the trading range has formed, traders will look back and see that the bull channel was the start of the range, and very experienced traders can begin to use trading range trading techniques as the channel is forming, if they believe that the market is in the area of the top of the soon-to-be trading range.

The spike that forms before the channel is a thin area on the chart (there is very little overlap of adjacent bars, and is a type of breakout or measuring gap, as discussed in the second book) where there is agreement between the bulls and the bears that the market is mispriced, and therefore the market moves through it quickly. Both are contributing to the rapid move away from the prices in the spike as they search for the equilibrium that can be inferred to exist once the channel starts to form. Yes, the market is still trending because one side is still dominant, but there is finally some two-sided trading. The channel itself usually has lots of overlapping bars and pullbacks and is essentially a steeply sloped tight trading range. Since this type of price action represents two-sided trading, it is reasonable to expect the start of the pattern to be tested before too long, despite how strong the trend has been. For example, in a spike and channel bear trend, all of those early bulls who bought at the very start of the bear channel, thinking that the spike would become a failed breakout, are finally back to breakeven on the pullback to that area, and this will make the pullback function like a double top. These bulls will exit around breakeven on those early longs and may not want to buy unless the market falls back again. This is likely an important component of the reason why there is usually at least some downward movement after the top of the channel is tested. Any channel is usually the first leg of a trading range and is most often followed by a countertrend move that tests the start of the channel and reveals the trading range. At that point, the trading range usually expands in duration and has at least a partial move in the direction of the original channel. From there, the market behaves like a trading range and is in breakout mode (traders are looking for a breakout) and the breakout into a new trend can come in either direction.

Sometimes the channel is so vertical that it accelerates and becomes parabolic. Although there is so little overlap between consecutive bars that it does not look like a typical channel, this parabolic move functions like the channel phase and is therefore a variant of a spike and channel trend. This parabolic move will often contain a large trend bar. For example, if there is a bear spike, which is one or more large bear trend bars, then a pause, and then another bear spike, then you have consecutive sell climaxes. Every large trend bar should be thought of as a spike, a breakout, a gap, and a climax. When there are consecutive climaxes (separated by a pause or a small pullback), they are usually followed by a two-legged correction that tests the pause that followed the first climax. The second climax should be thought of as the channel phase of the spike and channel pattern, even though it is another spike and not a low-momentum channel. However, since what usually follows is the same as with a conventional spike and channel pattern, consecutive climaxes form a variant of a spike and channel trend. Rarely, there will even be a third consecutive climax before a more complex correction ensues.

Why does the market tend to have a larger correction after consecutive sell climaxes? When there is a sell climax, there is panic selling. Weak bulls feel that they have to get out of their longs at any price. Also, weak bears see the strong momentum and are afraid they are missing a great move so they are shorting at the market to make sure they get in. If the market pauses and then has another large bear bar, that second sell climax again represents urgent sellers who don't want to wait for a pullback that may never come. Once these weak longs are out and the weak bears are in, there is no one left to short at these low prices and this creates an imbalance to the buy side. There aren't enough bears left to take the opposite side of the trade, so the market has to go up to find enough traders willing to short to fill the buy orders. The opposite is true with consecutive buy climaxes. They represent urgency. Traders feel compelled to buy at the market as it is rising quickly because they are afraid that there will not be a pullback that will let them sell at a better price. Once these emotional weak bears and bulls (the late bulls are weak) have bought all that they want to buy at these high prices, there is no one left to buy and the market has to come down to attract more buyers. The result is a correction that usually has two legs and lasts at least 10 bars or so.

Another type of a strong channel occurs in a spike and climax trend. Here, after the pause from the spike, the market creates another spike. All spikes are climaxes and when the market forms consecutive climaxes, it usually will form a larger correction, often to the beginning of the second spike. But this is exactly how a spike and channel behaves and it is therefore a variant, where there is a second spike instead of a channel. Sometimes the climax is a spike and the spike is more of a channel. For example, there might be a bull channel that then has a large one-bar bull spike. This can become a spike and climax reversal. Even though there was a channel and then a spike, it behaves like a traditional spike and channel pattern.

Since any strong vertical move can function as a spike, a gap opening qualifies. If you look at the Standard & Poor's (S&P) cash index on a day when the Emini has a large gap up opening, you will see that the first bar of the cash index is not a gap.

Instead, it is a large bull trend bar with its open around the close of yesterday and its close around the close of the first bar of the Emini. If there is then a pause or pullback and then a channel, this is a gap spike and channel trend.

When the channel is very steep, the spike and channel often together form just a spike on a higher time frame chart, and that spike will usually be followed by a channel on that higher time frame. At other times there will be a spike that lasts several bars but there is no channel. Usually the final bars of the spike have some overlap and there actually is a channel on a smaller time frame chart.

There will sometimes be a large bull trend bar, which is a spike up, and then a large bear trend bar, which is a spike down. When this happens in a bull trend that has gone on for a while, the market usually enters a trading range, with the bulls trying to generate a bull channel and the bears trying for a bear channel. Eventually one side wins and either the trend resumes or the market forms a spike and channel bear trend. The opposite happens in bear trends, where there is then a large bear trend bar. If there is a bull spike bar soon afterward, the market usually goes sideways as the two sides fight over the direction of the channel. If the bears win, the bear trend will resume, and if the bulls win, there will be a reversal. Sometimes one side appears to win in the form of a second spike, but it fails within a bar or two and leads to a channel in the opposite direction.

A spike and channel pattern is composed of two parts, and they are best traded differently. A spike is a breakout and is traded like all breakouts, which are discussed in book 2. In general, if the breakout appears to be very strong and in the context where it is likely to be successful, you can enter at the market or on small pullbacks as the spike is forming. Since a spike is also a climax, there will be a pullback at some point and this provides other opportunities to enter with the trend. Finally, the channel is no different from any other channel. If it is a tight bull channel, you can enter in the direction of the trend on pullbacks, such as those to the trend line or the moving average, or on a limit order below the low of the prior bar, or every 10 cents lower in Intel (INTC) when it is trading at $20. If the channel has broader swings, it has stronger two-sided trading and you can take trades in both directions. Since a channel is a flag in the opposite direction, once it starts to reverse you can take the reversal trade. It usually corrects to around the beginning of the channel where you can enter on a test of the start of the channel, which will be a double bottom bull flag in a spike and channel bull pullback, and a double top bear flag in a spike and channel bear pullback.

If the channel has lots of overlap between adjacent bars and many trend bars in the opposite direction and several pullbacks that last several bars, it is a weak channel. The weaker the channel, the more aggressive the institutional counter trend traders will be. For example, if there is a weak bear channel after a bear spike, strong bulls will scale in as the market moves lower. There will be firms buying with every conceivable reason, like buying below the low of every bar or every prior swing low, or buying every $1.00 lower in Google (GOOG) when it is trading at $500, or on every test of the trend channel line, or on every reversal bar on a small time frame chart, or on every $1.00 bounce up off the low in GOOG, in case the reversal up has begun. If, instead of breaking out of the top of the channel, the market breaks strongly out of the bottom and creates a strong bear spike that lasts several bars, these bulls will have to cover by exiting their longs. As they sell out of their longs, they add to the strength of the bear breakout, and they might even reverse to short for a momentum trade down. However, in most cases the downside breakout will not go very far, and once the last desperate bulls have sold out of their positions, there is no one left who is willing to short at these low prices. The market will usually rally for at least two legs and at least 10 bars as it searches for a higher price where bears might be willing to short once again.

When the market is trending strongly and then develops a spike in the opposite direction, the spike will usually lead to just a pullback (a flag) and then the trend will resume. However, it is a statement that the traders who believe that the market might reverse are now willing to begin taking positions. If the market begins to form one or two more spikes over the next 10 to 20 bars, the countertrend force of those spikes is cumulative and the market is transitioning to more two-sided trading. This can develop into a trading range, a deeper correction, or even a trend reversal. For example, if there is a very strong bull trend of any type, not simply a spike and channel bull, and the market has been above the moving average for 20 or more bars and it is at its high, then the bull trend is very strong. If there is suddenly a moderately sized bear trend bar that opens near its high and closes near its low, this is a bear spike. The bar can be a bear reversal bar, an entry bar below a bear reversal bar, or even an inside bar, and it does not matter. This first spike down will almost always just lead to a bull flag. After the bull trend resumes, watch for another bear spike. Eventually one will be followed by a pullback to the moving average. This first pullback to the moving average will usually be followed by a test of the high of the bull trend. The test can be in the form of a higher high, a double top, or a lower high. However, the pullback to the moving average is usually enough to break at least some bull trend line and then the rally that follows might be the final rally before a significant pullback or even a reversal takes place.

If there is a third and larger bear spike at the new high, the odds of at least a two-legged correction increase, and the move down after the spike down will usually be in some type of channel. Is the market ignoring those prior two bear spikes? The market never ignores anything. Although this latest bear spike might be the one everyone considers to be the seminal event, there is a cumulative effect from the other bear spikes as well. In fact, if the second bear spike was particularly strong and then the market rallied to a new high, and the next bear spike was modest but it led to a correction, you have to consider a different interpretation of what just took place. It is possible that the second bear spike was actually the more important one, and was the actual start of the down move, and that the rally to the new high after the spike was simply a pullback from that spike. It is important to understand that any breakout pullback can test the old extreme with either a lower high, a double top, or a higher high, and that test can often be the start of the bear channel. Although it may appear that the small spike down began the bear trend and that the channel that followed it was the first bear channel, sometimes the earlier spike is more influential. Its channel can begin at the high of the bull trend, and it can begin with that smaller spike down from the high. The channel that follows that small bear spike is then inside the larger channel that began at the bull high, just before that small bear spike formed.

When the market is in a trading range, it often has both a bull spike and a bear spike. The bulls and bears then fight to create a channel. Eventually one side will dominate and will be able to form a trend channel. It often begins with a breakout, which is then a second spike. Both spikes contribute to the formation of the channel.

A bull channel is a bear flag and a bear channel is a bull flag, and like all flags they are continuation patterns that usually break out in the direction of the trend. However, sometimes they break out in the opposite direction, leading to a trend reversal. The breakout is a spike, so instead of a spike and channel trend, the market forms a channel and spike trend that is unrelated to a spike and channel pattern. But usually the spike is followed by a channel. For example, if there is a bear trend and it has a pullback, the pullback is a rising channel and therefore a bear flag. Sometimes the channel will break out to the upside. A breakout is a bull trend bar and a spike, and if the breakout is successful, the follow-through will be a channel. The bull trend began with the spike, and that spike and the channel that follows form a spike and channel bull trend. The original channel was the final flag of the bear trend and it broke to the upside, but it is not related to the spike and channel bull trend that followed. The spike changed the market and it is the start of the new perspective for traders, who will then ignore the bear flag that preceded it.

A similar situation happens when a wedge reversal fails. For example, a wedge top is a rising bull channel, and therefore a bear flag, and it usually breaks to the downside. If instead it breaks to the upside, the breakout is a spike and it may be followed by a channel and a measured move up. The breakout always resets the mind-set and should be thought of as the start of a new trend. In this case, the trend is still a bull trend, like the trend before the wedge, but now it is an even stronger bull trend. Usually, upside breakouts do not go more than five to 10 bars before reversing into either a protracted, two-legged pullback or a trend in the opposite direction. They represent exceptionally climactic and therefore overdone buying. This is at the tails of the bell curve of behavior, and institutions will have all sorts of indicators telling them that the bull trend is overdone and should correct. Each institution will rely on its own measure of excess, but enough institutions usually will see the rally as excessive and their bets that the market will fall will soon overwhelm the bulls, and the reversal will ensue.

Spike and channel behavior is one of the most common and therefore most important things that you will see on every chart. There are countless variations and many interpretations of every pattern. Sometimes the spike will be one bar, but then, after a pause, there will be an even better-looking spike. The channel can be so vertical that it functions as part of the spike, and the spike and channel might be simply a spike on a higher time frame. That channel can be very small or very large relative to the spike. When there is a strong trend, there will usually be several spikes within the channel, and the channel can subdivide into smaller spike and channel patterns. Be open to all possibilities because they all have the potential to offer profitable trading opportunities.

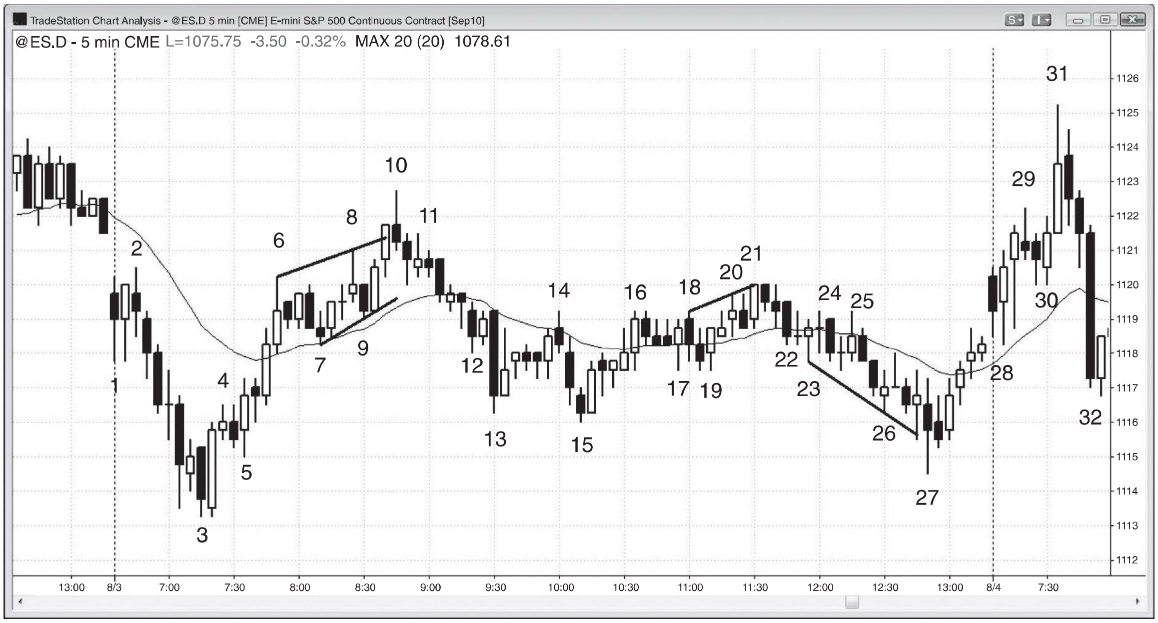


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FIGURE 21.1 Three Pushes in a Spike and Channel

Sometimes a bull spike and channel can end with three pushes up, a trend channel line overshoot, and a strong bear reversal bar, but most reversals are not so straightforward. In Figure 21.1, bar 6 was part of a two-bar spike up but the move up from the bar 5 low was so steep that you can also consider bar 5 as the start of the spike. It does not matter because any strong reversal up on the open is likely to have follow-through buying, and there will be buy programs based on each. Here, it was in the form of a channel that had three pushes up and a wedge shape. Channels often pull back after a third push up. Bar 10 overshot the trend channel line and reversed down into a bear reversal bar, which set up a short trade. A bull wedge usually corrects in two legs down to around the bottom of the wedge, and a channel in a spike and channel bull usually corrects down in two legs to the start of the channel, which is also the bar 7 low.

Spikes can be cumulative. The bar before bar 7 was a bear spike but it simply led to a test of the moving average. Bar 9 was a second bear spike. These two spikes indicate that the bears were trying to seize control over the market and that the market was becoming two-sided. Bar 10 was the first bar of a two-bar bear spike, and bar 11 was followed by another bear spike. Just because that final spike broke below the wedge and clearly led to the bear leg does not mean that it turned the market all by itself. Those earlier spikes were also part of the transition and should not be overlooked. As they were forming, you should understand that the market was telling you that it was in transition and you should begin to look for trades in both directions and not just buy setups.

Bar 16 was a one-bar spike but the spike up also can be considered to have begun with bar 15. There was a pullback to bar 17 and then three small pushes up to bar 21, where the market reversed.

The bar after 15 is a one-bar spike, and the four bars that followed formed a small channel, ending at bar 16; the entire move up to 16 was also a spike.

Bar 22 was a spike down and it corrected sideways to bar 25, where a channel began down to bar 27, which was the third push down after the spike (bars 23 and 26 were the first two), and bar 27 overshot the trend channel line and closed in its middle. That was not a strong signal bar and neither was the bear inside bar that followed, but the market reversed up into the close.

Deeper Discussion of This Chart

In Figure 21.1, the market broke below the moving average and the trading range at the close of yesterday. Since there were many bear trend bars in that trading range and the first bar of today had a strong bear body, it is reasonable not to buy the failed breakout long that was set up by the second bar of today and instead to wait for a second signal before going long. Even though the second bar was a strong bull reversal bar, there was nothing to reverse since it totally overlapped the prior bar. This was a small trading range, not a good reversal. All down gaps are bear spikes and can be followed by bear channels. Bar 2 trapped bulls and became a breakout pullback short setup for a bear spike and channel trend to bar 3. Bar 3 was a breakout below a one-bar final flag and became the first bar of a strong two-bar reversal that became the low of the day. Arguably, this bull reversal can be described as a failed breakout but it more accurately is a reversal up at the end of a bear channel.

The bull trend bar before bar 6 is when traders gave up on the possibility that the rally from bar 3 was just a bear flag. That bar was a breakout from the notion that the market was in a bear trend to the idea that it had flipped into a bull trend. This idea was confirmed on bar 6, when most traders finally believed that the market became always-in long. Many believed that the market had reversed to up by the close of the bar before bar 6, and that bull trend bar was also a spike, a breakout bar, and a gap. The low of the bar that followed it (bar 6, in this case) formed the bottom of the gap, and the high of the breakout point formed the top of the gap. Here it was both bar 5 and the small bear inside bar that followed it. Since the bar before bar 6 was a gap, that gap was a magnet and had a good chance of being tested over the next 10 bars or so. Bar 7 was the test, and it became the bottom of the channel that followed the spike up. Some saw the spike beginning on the trend bar before bar 6, and others saw it as beginning at bar 5 or the bull bar after bar 3. Bar 12 was the correction down from the channel high, and, as expected in a spike and channel pattern, the pullback again tested the gap and tried to form a double bottom with the bar 7 bottom of the channel up to bar 10. In this case, it failed.

Bar 12 was the test of the bar 7 bottom of the bull channel that ended at bar 10, but the move down to bar 12 was in a tight channel so it was likely just the first of two legs down. Because of this, a double bottom bull flag long never triggered above the bull inside bar after bar 12. Instead, bar 13 was a large bear trend bar. Since it was occurring at the end of a relatively long bear leg, it was more likely to be an exhaustive climax that should lead to at least a 10-bar, two-legged sideways to up correction. I use the phrase "10-bar, two-legged" often, and my intention is to say that the correction will last longer and be more complex than a small pullback. That usually requires at least 10 bars and two legs.

The move up to bar 14 was the first leg, and then it pulled back to a lower low at bar 15, and this was followed by a second leg up to bar 21. Bar 15 might have been the second leg down from the bar 10 high but it turns out that the correction became more complex and the second leg ended at bar 27, which formed a double bottom bull flag with bar 5 and again with bar 15. It does not matter which you consider, because the implication is the same. There will be some programs that use one and other programs will use the other, but both types of programs will be buying for a measured move up. They were looking for a second leg up from the bar 3 low in the form of leg 1 = leg 2 where leg 1 was bar 3 to bar 10, and leg 2 was the bar 27 low up to the bar 31 high. On a higher time frame chart, bar 27 was a simple high 2 buy setup, since it was two legs down from the rally to bar 10. It was a two-legged higher low after a strong move up, and became the pullback that led to the measured move up to bar 31. The rally to bar 31 overshot the measured move by a few ticks but it was close enough to satisfy the bulls who took profits there. The market then sold off to the bar 32 low.

The move down to bar 15 was a wedge bull flag where the first two pushes ended at bars 7 and 13. It does not matter that bar 10 was a higher high test of bar 6 instead of a lower high because this is common in wedge flags.

Bar 21 was a wedge bear flag, which is common when the breakout above a double top fails. Bars 16 and 18 formed a double top but instead of breaking out to the downside, the market broke out above. The market had two small legs up to bar 21, where the market reversed and the breakout failed. Bars 16, 18, and 21 are the three pushes up in the wedge bear flag.

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FIGURE 21.2 Spike and Channels Occur Every Day

Some form of a spike and channel trend is present every day. In Figure 21.2, the first day, March 28, was a bear spike and channel day that began with a spike up but reversed into a three-bar spike down from bar 2 and then again from bar 3. There, it attempted to form a double bottom with the swing low at the end of the prior day. Either of the two large bear trend bars between bars 2 and 4 could also be considered the initial spike of the bear trend. Bar 8 formed a double top with the top of the small bear flag that followed bar 6, and then the market drifted down in a tight channel all day, with several good short entries near the moving average.

The market broke above the channel on the next day with the spike up to bar 17. Since the start of the channel usually gets tested, traders could now start to look for long setups for a test of the bar 5 area. The bar 5 start of the bear channel was tested by bar 23 and exceeded by the bar 27 gap up on the following day.

The channel down to bar 15 became slightly parabolic (it broke below the bear trend channel line from bar 9 to bar 11, indicating that the slope of the decline increased), which is climactic behavior and therefore not sustainable long-term. Traders could have also created the trend channel line by taking a parallel of the bar 5 to bar 8 trend line, and then anchoring it to the bar 6 or 7 low. Bars 13 and 15 would have overshot that line as well.

During the sell-off, the bears scale into shorts and scalp for every conceivable reason. For example, they might sell on every two-point bounce or above the high of the previous bar, like above bar 9 and above the high of each of the five bars that followed bar 9 and had a high above the high of the prior bar. They would short at the moving average and at the trend line, like at bar 10. They would short on every tiny break above the trend line, like at bar 11. They would also short below the low of every pullback bar, like below the low of bar 10. Other bears will short on a fixed amount below every test of the top of the channel, like one or two points down after the test, betting that the downward momentum will have follow-through. Since this bear trend will be evident on every other small time frame and every other type of chart, traders will be shorting based on those charts as well, and on higher time frame charts.

Aggressive bulls would be buying in that same bear channel. Some will be buying for scalps, like maybe at every test of the trend channel line, like at the bar 13 and bar 15 lows. Others will be scaling in, believing that the market should test the bar 8 or bar 10 top of the channel either today or tomorrow. They might buy every test of the trend channel line and every new swing low. For example, they might have limit orders to buy as the market fell below the bar 11 low during the spike down to bar 13. They might buy at the low, a few ticks lower, or a couple of points lower. Others will buy at the first sign that the sell climax down to bar 13 is stalling. They would see the smaller bear body and the large tail as a sign of exhaustion and therefore likely to be followed by a tradable rally. Some traders will scale in with larger positions, like two to three times the size of the prior position. Some will buy on a stop two points above the low, seeing a bounce of that size as a sign that the reversal in underway. Others will be trading off smaller and larger time frame charts or charts based on ticks or volume. The sell-off might be a pullback to the 60 minute or daily moving average, or to a strong bull trend line on a higher time frame chart. There are traders both buying and selling for every conceivable reason and scaling in and out using every imaginable approach. They can all make money if they know what they are doing. For most traders, however, it is risky to scale into longs in a bear channel in the final couple of hours of the day. They will too often find themselves holding a large losing position that they will be forced to exit before the close with a loss. Traders are more likely to make a profit in a bear channel if they look for short setups rather than trying to scale into longs, especially in the final couple of hours of the day.

The spike up to bar 17 was followed by a wedge-shaped channel up to bar 23, and then a pullback, and then a large gap up on the next day. That gap up move might still be part of the channel up. Any gap is also a spike, and it can then be followed by another channel.

The move down from bar 8 to bar 9 was also a spike, and the bear channel from bar 10 to bar 15 was retraced by the rally to bar 21. The move down from the double top bear flag created by bars 10 and 21 ended at bar 22, which was also a test of the moving average. A strong bear move should not be expected since there has been a trend reversal into a bull trend and the move up to bar 21 was strong. Seven of the prior eight bars had bull bodies and trending highs, lows, and closes.

Deeper Discussion of This Chart

Bar 4 in Figure 21.2 was a wedge bull flag buy setup and the rally ended in a double top bear flag (bars 3 and 5).

The bear channel tested the bear trend line five times, yet was never able to accelerate to the downside very far. Whenever the market repeatedly tests a line and does not fall far from it, the market usually breaks above it.

The bottom was formed by the three pushes down at bars 13, 15, and 16. Even though the pattern did not have a wedge shape, the implication is identical.

The spike up to bar 17 broke above the bear trend line. Bar 17 was a moving average gap bar, which often begins the final leg of the trend before a larger reversal takes place.

The sell-off from the moving average gap bar tested the bear low in the form of a higher low at bar 18, which formed a double bottom bull flag with bar 19, and a double bottom pullback with the bar 15 and 16 double bottom. A double bottom bull flag is just a higher low that has two tests down.

Channels often pull back after the third push up, and since the rally to bar 23 was below the top of yesterday's bear trend, many traders saw it as a bear rally and were looking to short it. The wedge bear flag and the bar 23 bear reversal bar formed a good sell setup for at least a two-legged move down. Traders expected it to last about 10 or more bars and maybe test the bar 22 or bar 19 lows. The move down to bar 24 had two legs but was steep enough to make traders wonder if it was actually just a complex first leg. This resulted in the sell-off to bar 26 at the close. Bar 26 tested near the bottom of the bull channel, where it formed a double bottom bull flag with bar 18 (or 19).

The bar 17 gap up opening was almost a measured move up above the wedge, which is common when the market breaks above the top of a wedge.

There was a small wedge bear flag from bar 24 to bar 25.

The rally from bar 4 to bar 5 was also a wedge bear flag.

There was a large wedge bull flag using bars 22, 24, and 26, even though the rally to bar 25 eliminated the wedge shape. Most three-push patterns function exactly like wedges and they should all be considered to be variants.

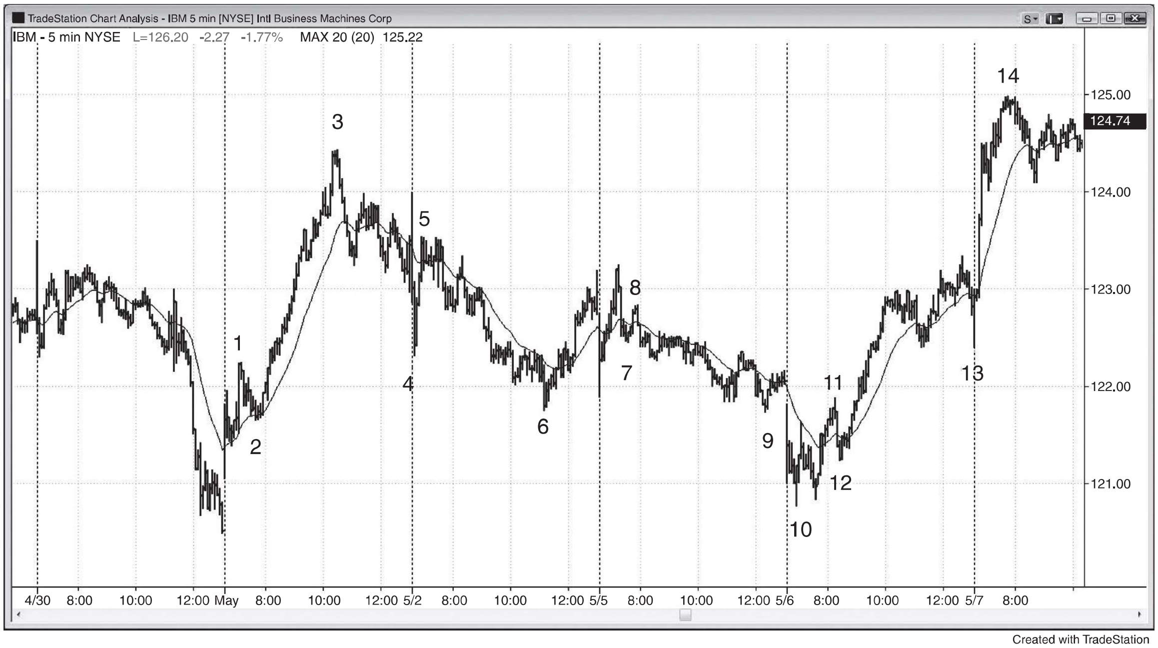

FIGURE 21.3 Spike and Channel Trends Are Common

IBM had several spike and channel days on the 5 minute chart in Figure 21.3, and some were nested, with larger ones subdividing into smaller ones, which is common. Since the start of the channel often gets tested within a day or two, make sure to consider countertrend setups even on the next day. Each of the channel beginnings (bars 2, 5, and 8) was tested except the last one (bar 12). Bar 13 tried to begin the sell-off to test bar 12, but it instead it quickly failed and reversed up strongly.

The spike up to bar 1 was followed by a nearly vertical and slightly parabolic move up to bar 3 instead of a typical channel. This is a variant of a spike and channel trend. This also happened with the spike up to bar 11 and the channel up from bar 12. When channels are this steep, they usually are spikes on higher time frame charts.

The rally to bar 3, from either bar 2 or the low of the chart, was so steep that it was a large spike. In fact, it formed a four-bar bull spike on the 60 minute chart, and was followed by a large, two-legged pullback that ended at bar 10 (bar 6 was the end of the first leg). The market rallied for the next two weeks to almost an exact measured move up (at $128.83, which was equal to about the height of the low of the chart to the top of bar 3, added to the high of bar 3).

Although the spike down to bar 7 appears to be the obvious choice for the start of the bear leg, there was another interpretation and both probably influenced the market. Notice the large spike down on the open of May 5. Although the market rallied to a nominal higher high, this bear spike was very important and can be considered the spike that led to the channel down. The higher high might have been simply a higher high pullback from the bear spike and can be viewed as the start of the bear channel.

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FIGURE 21.4 Steep, Parabolic Micro Channel

Figure 21.4 is a close-up of the prior chart that illustrates the parabolic nature of the channel. The move from bars 8 to 9 was in a steep micro channel but the market broke above the channel and formed an even steeper bull channel from bars 10 to 11. This increase in the slope creates a parabolic shape, which is unsustainable and therefore a type of climax. However, a climax can last longer than you can sustain your account, so never look to short such a strong bull trend, even though you know it cannot last indefinitely.

Although it did not seem likely, the market tested below the low of the beginning of the channel at bar 3 on the following day.

Whenever a market starts to develop about 10 or more strongly trending bars with little overlap and small tails, it is in a very strong trend and traders are buying it at the market. Why are they not waiting for a pullback? Because they are so certain that prices will be higher very soon and they are not certain that there will a pullback soon, so they don't wait for a pullback that might not come. Even if there is a pullback, they are confident that it will be shallow and last only a few bars before there is a new high.

The move from bar 1 to bar 2 is a spike and climax trend. Bar 1 is the spike, but instead of a channel, the market created a second spike at bar 2. Consecutive climaxes are usually followed by a deeper pullback, often to the bottom of the second climax, as it did here. Since this is exactly what spike and channels do, a spike and climax should be thought of as another type of spike and channel trend.

Although the move from bar 7 to bar 11 was a micro channel, it was tight enough so that traders expected it to be a spike on a higher time frame chart. The entire move from bar 3 to bar 15 was tight enough to be a spike as well. In fact, the market pulled back to near the bottom of the spike over the next three days. This was followed by a seven-day bull channel that reached a measured move up, based on the height of the spike.

The move up from bar 12 to bar 14 was in a channel, and it was followed by a spike breakout consisting of two bull trend bars to the bar 15 high. Here, there is a spike following a channel, which is sometimes the case in a spike and climax variant of a spike and channel pattern. The spike is the channel up to bar 14 and the channel is the spike up to bar 15, and the combination behaves like a traditional spike and channel pattern.

As strong as the three-bar bull spike up to bar 21 was, on a small enough time frame—for example, a 10 tick chart—it was almost certainly a tight channel, as are most spikes.

Deeper Discussion of This Chart

In Figure 21.4, bar 1 was a strong bull breakout bar that broke above the bear channel of yesterday's close and above the moving average. It opened almost on its low tick and was a bull spike that was likely to be followed by a bull channel. There was a second bull spike at bar 2, and these back-to-back buy climaxes were followed by an eight-bar pullback to the moving average, where bar 3 tested the low of the pullback after bar 1 and set up a double bottom bull flag long.

The four bull trend bars ending at bar 9 were fairly uniform in size, not too large so not climactic, and contained in a micro channel. This kind of strength would almost certainly be followed by higher prices and traders could have traded it like a bull spike, which it probably was on a higher time frame chart. They could simply buy on the close of any of the bars and put a protective stop below the bottom of the spike, which was the bull bar that formed two bars after bar 8. Whenever the market is trending strongly and has not yet had a climax, experienced traders are buying small positions all of the way up. Since their protective stop is relatively far away, their risk is greater so their position size is smaller, but they keep adding to their position as the market rises. Bar 12 was the first attempt to reverse the channel and was likely to fail, but the bulls started taking profits on the bear bars that followed, like the bar after bar 13 and again on bar 14. They took their remaining profits on the two-bar buy climax up to bar 15, on the small bear inside bars that followed, and on the strong bear trend bar after that, which was probably going to lead to at least a two-legged correction after the buy climax.

Bar 15 was a large bull trend bar at the end of a protracted trend. Although it might have been a breakout and the start of another leg up, it was more likely a buy vacuum. The strong bulls and bears were waiting for a bar like this to sell around its close. It always forms just below one or more resistance levels, and as the market approaches the area, the bears and many bulls step aside. The bulls who like to buy strongly rising markets were unopposed and quickly pushed it up to the target. The strong bulls took profits and the strong bears shorted. Both expected the buy climax to be followed by a deeper, more complex correction, where they would then both buy. The bears would take profits on their shorts and the bulls would reestablish their longs.

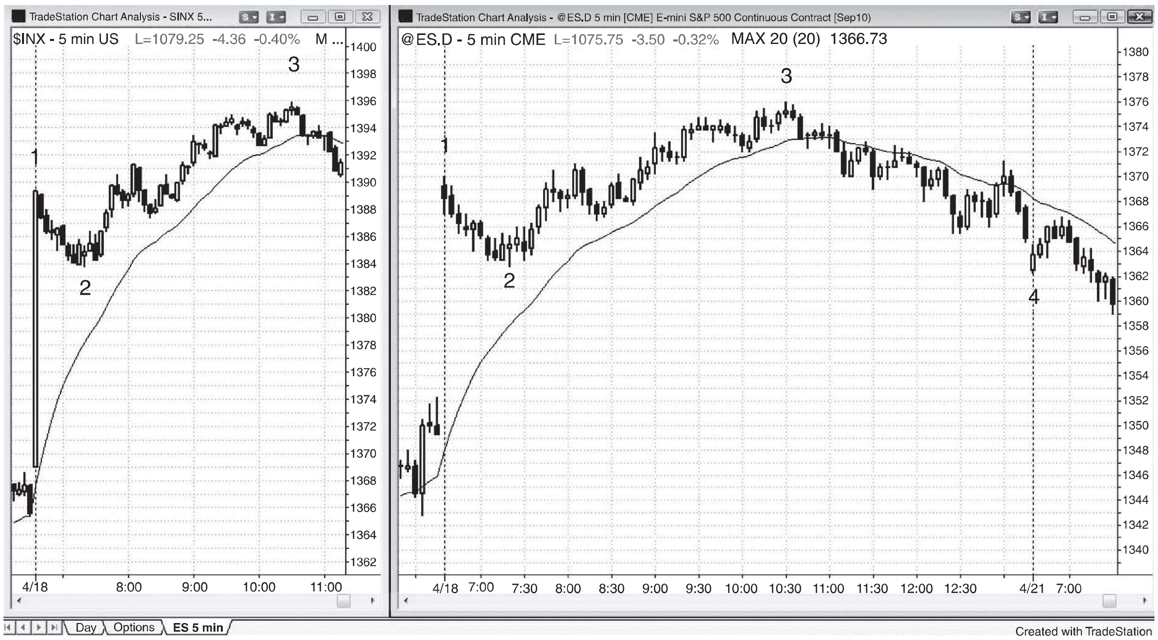

FIGURE 21.5 A Gap Spike and Channel Day

Sometimes a gap can be the spike, forming a gap spike and channel day (see Figure 21.5). The chart on the left is the S&P cash index, and you can see that the gap up on the Emini chart on the right was just a large bull trend bar and therefore a spike up on the cash index. Therefore, it makes sense to consider a gap on the Emini as just a large trend bar.

The bar 2 start of the channel was tested on the next day (bar 4). The channel up to bar 3 was losing momentum and began to curve downward as it rounded over at the top.

Deeper Discussion of This Chart

The bull flag from bars 1 to 2 that led to the channel in Figure 21.5 also functioned like a final flag, but the breakout before the reversal down from bar 3 was protracted. It might have been a final flag on a higher time frame.

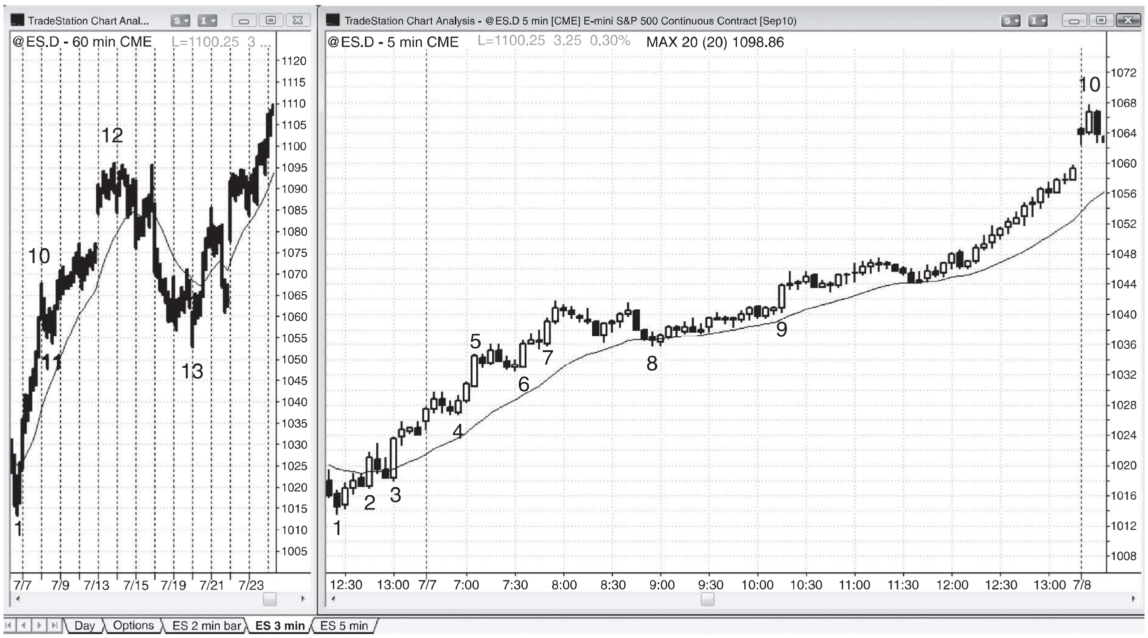

FIGURE 21.6 Steep Channels Are Spikes

Sometimes the market just keeps forming a series of spikes, and the channels are so steep that they become spikes on a higher time frame chart (see Figure 21.6). The 5 minute Emini chart on the right had many spikes up, and the channel from bars 8 to 10 was so steep that there was no pullback that tested the beginning of the channel. Instead, the entire spike and channel pattern up to bar 10 was just a spike on the 60 minute chart on the left. Bar 10 on the 60 minute chart corresponds to bar 10 on the 5 minute chart. The 60 minute chart then formed a channel up to bar 12 and the market corrected back to the bottom of the 60 minute channel by bar 13.

Although the three-bar spike from bar 4 to bar 5 formed the clearest spike of the day on the 5 minute chart, there were several other spikes, like bars 2, 3, 6, 7, and 9, and all had the possibility of being followed by a channel up. The three-bar move down to bar 8 was a spike down, and it could have led to a channel down to test the start of either of the channels up from bars 4 or 6, but the bull trend was so strong that it was simply a 20 gap bar buy signal leading to a protracted channel up.

Deeper Discussion of This Chart

Yesterday closed in a small bull trend in Figure 21.6, and today's open broke above a two-bar bull flag from yesterday's close. Bar 4 was a breakout pullback long entry in this trend from the open bull trend day.

FIGURE 21.7 A Channel Can Follow Long after the Spike

As shown in Figure 21.7, strong spikes don't always *appear* to lead to channels, like the spike down to bar 2 or the spike up to bar 9. However, trends almost always begin with some spike, even though it might be easy to overlook. Sometimes, spikes and channels look very different on higher and lower time frame charts, but you do not need to look at them if you can infer what they show from what you can see on the 5 minute chart. What at first glance appears to be a big spike might in fact, on a smaller time frame, be a spike and channel that is so steep that it is easy to miss the channel. Conversely, what appears to be a steep spike and channel might be simply a spike on a higher time frame chart.

The move down from bar 1 to bar 2 looks like a spike but the market instead saw bar 1 as a spike and the next four bars down to bar 2 as a channel, which was probably much easier to see on a smaller time frame chart. The entire move down to bar 2 can also be viewed as a spike down that was followed by a pullback to a higher high at bar 9, and then the channel down began. Sometimes the pullback from the spike goes beyond the start of the spike before the channel begins.

The first part of that channel down was a spike from bar 9 to bar 11, which was followed by a channel down from bar 14 to bar 18. Also, the gap before bar 10 together with bar 10 itself formed a spike down, and then the move down to bar 11 was a channel.

Once you understand how to see the subtleties of spike and channel patterns, you will adjust your assessment of probabilities of your potential trades, and you will also find many more trading opportunities.

FIGURE 21.8 Consecutive Climaxes

Consecutive climaxes create a variant of a spike and channel trend pattern. Every large trend bar should be thought of as a breakout, a spike, and a climax. In Figure 21.8, bar 3 was a large bear trend bar in a bear trend, and it was a sell climax. However, a climax does not mean that the market will reverse. It simply means that it went too far, too fast, and it might pause for one or more bars. The trend can then resume, or the market could go sideways or even reverse.

This climax was corrected by a one-bar pause, which was a bear inside bar, and was then followed by bar 4, another sell climax. Bar 4 was followed by a three-bar correction and then a third consecutive sell climax that marked the low of the bear trend. This final sell climax was the two-bar move down to the bar 5 low. It does not matter that the bars are strong bear bars with large bodies, small tails, and little overlap. A climax usually leads to a correction. These traders were desperate to sell and could not take the chance of waiting for a bounce that would allow them to sell at a better price. Once these weak traders have sold, there is no one left who wants to sell and this leaves the buyers in control, lifting the market. There was a one-bar correction after the bar 3 climax, a three-bar correction after the bar 4 climax, and a major reversal after the bar 5 climax. Usually when there are two consecutive climaxes, there is at least a two-legged correction. When there are three, the reversal is generally even larger, as it was here.

Since consecutive climaxes are a variant of spike and channel trends, you can think of bar 3 as a spike and bar 4 as a channel, even though there is no series of small overlapping bars with tails as you would see in a typical channel. Then bar 4 became a spike for the channel down to bar 5.

Bar 6 was a bull spike that ended with the bar 8 channel. The move up to bar 8 was so steep that bars 6 to 8 could have been considered a spike, and they probably formed a spike on a higher time frame chart. Bars 7 to 10 formed a channel after the bar 6 spike. At this point, the breakout gap created by the bar 6 spike had two breakout points, the top of the small rally after bar 4 and the high of the bar before bar 6. Different traders have put more emphasis on one over the other, but both were important. Bar 11 was a test of the bottom of the channel and therefore a test of the gap. This made bar 11 a breakout test, and as usual it formed a double bottom bull flag with the bar 7 or bar 9 start of the bull channel. Once the market started moving up again, the bulls would not have wanted it to test back down. If it did, they would have seen that as a sign of weakness and the chance of a strong move up would have been greatly reduced.

Bar 10 was at the end of a four-bar parabolic move up. If you connect the highs of the consecutive bars from bar 9 through bar 10, the line created would have a parabolic shape. Its slope increased two bars after bar 9 and decreased between the final two bars. The channel from bar 7 to bar 10 was so steep that the move from bar 6 to bar 10 was probably a spike on a higher time frame chart.

Bar 12 ended a two-bar spike and bar 15 ended a parabolic channel.

Bars 7 through 15 created a larger channel with three pushes.

Bar 17 was a three-bar spike, and it was followed by a parabolic channel up to bar 18.

The three-bar spike down to bar 19 was followed by a small channel down to bar 22. Bars 21 and 22 formed a small spike and a second sell climax (the move to bar 19 was the first) and were therefore likely to lead to a correction up.

Deeper Discussion of This Chart

When beginning traders looked at the chart in Figure 21.8 at the end of the day, they immediately would see a trading range that began around bars 7, 9, or 11. As the bull channel from bar 7 to bar 15 was forming, they were probably not aware that a bull channel in a spike and channel day is usually the start of a trading range. However, experienced traders knew this, and they began to short above every prior swing high, and many scaled in higher. They exited their shorts around the bar 22 double bottom test of the bar 9 or bar 11 bottom of the bull channel. Bar 22 also appeared to be a possible final flag reversal, as well as a second entry long setup at the bottom of the developing trading range. Finally, it was a lower low pullback from the bar 20 breakout above the bear micro channel down to bar 19.

The wedge up to bar 15 was also a shrinking stairs bull channel since the second peak was eight ticks above the first and the third was only three ticks above the second. This indicates waning momentum.

A wedge usually has a two-legged correction, but when the wedge is large, the legs often subdivide. The move down to bar 16 was contained in a fairly tight bear channel and therefore was likely to be just the first leg down, even though it subdivided into two legs. It had too few bars to adequately correct a wedge of this size. The low-momentum move to bar 18 was the pullback that led to the second leg down, which ended at bar 22. Bar 18 was an exact double top with the bar 15 top of the wedge, and when the market reverses down at a double top test of a wedge high, traders become more confident that the top is in for the near term. The sell-off is usually strong and has at least two legs. Bar 22 tested the bars 9 and 11 bottom of the channel and formed a double bottom bull flag with them. Since bar 20 broke above the micro channel down to bar 19, bar 22 was a two-legged lower low pullback from that channel breakout. The two-bar reversal that began with bar 22 was therefore a reasonable buy setup for at least a small swing up.

The move from bar 6 to bar 15 was so strong that the trading range to bar 22 that followed would likely have an upside breakout and maybe lead to a leg 1 = leg 2 measured move up (leg 1 was from bars 6 to 15 and leg 2 began at bar 22 and its end had not yet formed).

Most breakouts of trading ranges fail, so traders were expecting the move down to bar 19 to have little follow-through, since it was near the bottom of the trading range. If they shorted the low 2 at bar 21, they were expecting a final flag (bars 19 through 21) and a reversal up from the bottom of the trading range.

Since bar 6 was a large bull spike, traders should look to take profits at possible measured move targets based on the spike. You should look at the open or low and measure to the close or high of the bar. In this case, the top of the spike was the bar 7 doji, which is not an obvious choice to consider, but it is best to look at every possibility. The bar 15 high of the wedge was a measured move to the tick from the low of bar 6 to the high of bar 7, projecting that number of points up from the bar 7 high.

FIGURE 21.9 A Gap Up and Double Bottom

A large gap up on the open often has a two-legged sideways or down move before the trend up begins. Whenever the opening range (the first five to 10 bars or so) is under 30 percent of an average daily range, the day is in breakout mode and traders will buy a breakout above and short a breakout below. If this small range occurs when there is a large gap up, the odds of a trend day up or down are high.

In Figure 21.9, the rally from bar 5 to the bar before bar 6 was a strong bull spike. The market corrected sideways to bar 9 and then had a buy climax rally up to bar 10, completing the spike and climax type of spike and channel bull trend.

Bar 6 was the first bear spike in a strong bull trend, and it led to a bull flag (an iii pattern) as expected.

Once traders saw the strong bar 11 bear spike, they wondered if there might be a trend reversal because it was a reversal down from a higher high after the final bull flag to bar 9 broke the steep bull trend line. It followed a strong spike up after bar 9. When the market has two strong spikes in opposite directions within a few bars of each other, it then usually goes sideways as the two sides fight over the creation of the channel. The bulls want the channel to go up and the bears want it to go down. The market went sideways here but ultimately the bear spike won.

As the market went sideways, it formed a lower high in the form of a small double top at bar 12 and then a pullback to bar 13. Bar 13 was a bull trend bar that trapped bulls into a long position, and was the first bar of a two-bar reversal that led to a large sell-off.

There will often be a spike down and a spike up within a trading range, and this usually puts the market in breakout mode. The bulls are hoping for follow-through in the form of a bull channel, whereas the bears want a bear channel. Bar 9 led to a two-bar bull spike, and the pullback that could lead to a bull channel began with the bar 11 bear spike. At this point, the bears were looking for a bear channel. The market entered a tight trading range and the bulls attempted to begin their channel with the bar 13 bull trend bar, but the bears overwhelmed them and were able to turn the market down into a bear channel.

Deeper Discussion of This Chart

The market gapped up strongly in Figure 21.9, breaking out above yesterday's high, but the first bar was a bear reversal bar and it set up a failed breakout short. The market went sideways and formed a double bottom at the bar 4 outside up bar. Some traders would have reversed to long as bar 4 went above the high of the prior bar, because many large gap up days have small double bottoms and then huge bull trends. Other traders bought above the bar 5 breakout pullback setup (an inside bar is a pause and, therefore, a type of pullback), and still others waited to buy until there was a breakout above the opening range, above bar 2.

Bar 5 was a breakout pullback buy setup for the breakout above the bars 3 and 4 double bottom or high 2. Bars 3, 4, and 5 also formed a triangle after a large gap up. The large gap up was a spike and the triangle was likely to be a bull flag, since most trading ranges in bull trends break out to the upside.

Bars 6, 8, and 9 created a triangle (it could also be called a wedge bull flag), and any trading range in a bull trend is a bull flag. Bar 9 was also a one-bar pullback from the breakout on the bar before it from the bars 6 and 8 double bottom.

Although the bars 6, 8, and 9 triangle became a large final flag, the four bars down from bar 12 and the double bottom bull flag created by bar 11 and the third bar after bar 12 were also a final bull flag. The bull breakout to the bar 13 high was brief and could not even go above the bar 12 lower high, but it was still a final flag. It was a bull flag and the final attempt by the bulls to resume the trend, but it immediately reversed down after just a one-bar bull breakout.

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FIGURE 21.10 Spike and Climax

A spike and climax variant of a spike and channel pattern often has the spike and channel reversed. In Figure 21.10, there was a channel from bar 2 to bar 3, and it was followed by a large bull trend bar. The channel functions as the spike up and that one-bar spike functions like the channel.

Deeper Discussion of This Chart

The reversal down from the bar 5 high of the day in Figure 21.10 was also a final flag reversal where bar 4 was a one-bar final flag. After a climax, especially after a final flag reversal, the market usually has a two-legged correction, which means that a high 1 and maybe a high 2 would fail. If you shorted below bar 5, you then have to expect pullbacks and keep your protective stop above the bar 5 high until after the market has begun its second leg.

Once the market broke to the downside on the move down to bar 11, traders believed that there was going to be more selling, which meant that the breakout turned the market into always-in short. The breakout bar was therefore likely to lead to a measured move down and there could be a measuring gap. The gap between the bar 8 breakout point and the bar 11 pullback became that gap.

Since the spike up was sharp and therefore climactic, the high 1 above bar 6 was likely to fail. Aggressive traders would place limit orders to short at or above the bar 6 high 1 signal bar high and above the bar 7 high 2 signal bar high.

Bar 8 was a wedge bull flag (a high 3) and a reasonable scalp, but only if you were emotionally prepared to reverse to short as you took profits on your long, since a second leg down was likely. Since the move down to bar 8 was a channel, it was probably just the first leg.

The opening range was about half of the size of an average daily range, and therefore the day could become a trending trading range day, which it did. The upper range was from the bar 2 low to the high of the day, and the lower range was from around bar 12 to bar 22. The market then broke again to the downside and formed a channel from the bar 24 tight trading range, final flag area to the bar 26 low of the day, although there was very little two-sided trading and the market quickly reversed back into the middle range by the close.

It also became a spike and channel bear trend day where the move from bar 5 to bar 12 was the spike and the three pushes down to bars 12, 18, and 26 created a parabolic, climactic channel.

Once the market reversed up from the breakout below the channel at the bar 26 low, the next objective was a poke above the top of the channel, which it accomplished on the close.

CHAPTER 22

Trending Trading Range Days

Primary characteristics of trending trading range days:

- The opening range is about a third to half the size of the range of recent days.
- There is a breakout after an hour or two and then the market forms another trading range.
- Because there are trading ranges, there are usually opportunities to take trades in both directions.
- There sometimes are multiple breakouts and trading ranges, but when this happens, it is usually better to consider the day as a stronger type of trend day and trade only with trend.
- After the second trading range begins to form, there is usually a pullback that tests the earlier trading range.
- The test often breaks back into the earlier range. When it comes close to but does not penetrate the prior range, the trend is a little stronger.
- Sometimes the market goes all the way through the earlier range and the day becomes a reversal day.
- Most reversal days begin as trending trading range days.
- When the breakout is very strong, the day is more likely to become a weak spike and channel trend.

Since every trend has pullbacks and they are small trading ranges, some form of a trending trading range day is present during every trend day, and the trending trading ranges are the dominant features at least a couple of times each week. If the opening range is about a third to half of the size of the recent average daily range, then look for a breakout and an approximate doubling of the range of the day. These trend days are made of a series of usually two, or occasionally more, trading ranges separated by brief breakouts, and the formations are sometimes not readily seen as trading ranges. However, on the daily chart, the day is clearly a trend day, opening near one end of the bar and closing near the other. Whenever the market is creating trending swings but the day does not look like a clear trend day, it is probably a trending trading range day. Also, if the day's range in the first hour or two is only about a third to half of the average range of recent days, watch for a breakout and an approximate measured move, and then a second trading range forming over the rest of the day. This type of trend is present in some form several days each week but is often better classified as another type of trend or even a large trading range.

Many days can be classified as either spike and channel trend days or trending trading range days, depending on their strength. The stronger the trend, the more the day will behave like a spike and channel trend day. The reason to try to distinguish between them is that they should be traded differently. When a day is more of a spike and channel trend day, it is a strong trend, and traders should focus on with-trend trades and swing trades. They should avoid countertrend trades unless there is a clear transition into a trading range or an opposite trend. When the day is more of a trending trading range day, traders can usually take trades in both directions and look for more scalps. As a day is forming, there are clues that tell traders if the breakout is more likely to lead to a strong trend day, like a spike and channel trend day (or even a small pullback trend day), or to a trending trading range day. Trading ranges are more common than strong trends, and trending trading range days, in particular, are about twice as common as spike and channel trend days, although every day has at least one spike and channel swing. The spike in a spike and channel trend day is most likely to begin early in the day, often from the first bar or with a large gap up or down. Also, it usually either breaks well beyond bars from yesterday or strongly reverses from a breakout, like a sharp rally from the first bar on a large gap down day. The spike in a trending trading range day is a breakout from a trading range, but it is usually still within the range of the prior day.

The opening trading range often lasts one to three hours and can be about half of the size of an average day's range. This lack of urgency is a sign that the day is less likely to become a strong trend day. Also, the initial trading range has a magnetic pull, as does any trading range, and that works against the breakout going too far before pulling back and forming another trading range. The breakout on a spike and channel trend day is often large and fast. The spike can have three or more large bull trend bars with small tails and very little overlap. On a trending trading range day, the spike is usually just one to three bars, and they tend to be smaller and have larger tails and more overlap. If the pullback is just a single bar and the breakout from the pullback is another spike, even if it is smaller and only a single bar, the day is more likely to be a spike and channel trend day. If the pullback goes sideways for five to 10 bars, or if the breakout from the pullback is a weak channel with overlapping bars and trend bars in the opposite direction, the day is more likely to be a trending trading range day. If the pullback after the spike is strong enough to make traders uncertain of the always-in direction, a trading range is more likely than a trend channel, so look for scalps instead of swings.

Entering on the breakout of any trading range is a low-probability trade, except in special circumstances, which are discussed in book 2 on trading ranges. It is usually much better to enter on a breakout pullback or on some earlier reversal from the opposite side of the range, but if a trader is confident that the day might be evolving into a trending trading range day and the breakout is strong, the trader can consider entering as the breakout bar is forming, or around the close of the breakout bar or on the close of the next bar, if it is also strong. The breakout spike is usually followed by a channel, but it will often stop around the measured move area, and then the market will begin to form a trading range. The market breaks out of one range and then forms another. Rarely, three or four small trading ranges will develop in a day, but when that happens, the day should probably be thought of and traded as a stronger type of trend day, like a spike and channel or a small pullback trend day. Traders should focus much more if not exclusively on with-trend setups. If the market later pulls back into a prior range, it will often retrace all the way to the other side of that range. The implication is that the market consolidates in a range after the breakout. This means that there will be two-sided trading that tests both the top and bottom of the new range and possibly breaks out in either direction at some point. Once the market reaches the measured move area, it is likely to transition into a second trading range. Traders should then transition with it from trend style trading to trading range trading. For example, if the day is a bull trending trading range day, traders should take profits in the area that is approximately a measured move up, if the trend is weakening, based on the height of the lower trading range. This is because the market will then usually test down into the breakout area and then form a trading range.

Traders should not trail their protective stops below a swing low once they think that the market is in a trending trading range, because those stops will usually get hit. It makes more sense to look to exit on strength when the market is forming an upper range, than to exit on weakness. Remember, in a trading range, traders should buy low, sell high. Aggressive traders will fade big trend bars in the area of the measured move target. For example, in a bull trending trading range day, once the market gets close to the measured move target, bears will look for a large bull trend bar. If one forms, they will often short its close or just above its high, and then scale into more shorts if the market goes higher. They expect that the large bull trend bar is an exhaustive buy climax, and that it will be followed by an eventual test down into the gap (the two or three bull trend bars forming a breakout from the lower trading range), and possibly to the top of the lower range. Since they are expecting an upper trading range to develop, shorting at the top of a bull spike in the area where the market is likely to form the top of the upper trading range gives them an excellent entry price. This is discussed more in the second book in the section on trading range trading. Even if the market goes higher, the odds are very strong that the market will come back below their entry price. If they scaled in higher, they could exit their first entry at breakeven, and then move the stop on their higher entry to breakeven, and hold for a test into the gap.

Since there is two-sided trading throughout the day, it is common for the day to reverse through at least one of the trading ranges in the final hour or two of the day. Since each trading range has two-sided trading, it is a comfort zone for bulls and bears, who both see the area as value. This creates a magnetic pull and tends to draw breakouts back into the range.

The importance of recognizing this type of trend day is that this reversal is a reliable countertrend trade, since the market will usually form a breakout test. Because of this, once the breakout reaches the approximate measured move target where trend traders will take profits, traders will watch for a trade in the opposite direction, looking to exit on the breakout test. Experienced traders will fade strong trend bars around the measured move area, looking for the pullback to test the breakout gap. For example, when the average daily range in the Emini is about 10 points, if there is a trading range for a couple of hours and then an upside breakout, strong bears will begin to scale into shorts at about four to six points above the lower range. They are looking for a pullback into the breakout area and maybe all the way back to the top of the lower trading range. If the market reverses back into the prior range, it will likely test the countertrend signal bars in the prior range. For example, if a bear trend reverses up, it will attempt to reach the high of prior failed bull signal bars. If the rally extends to the top or above the upper trading range and the day closes up there, the day will be a reversal day on the daily chart. The day sold off and then reversed up and closed near its high. Most reversal days begin as trending trading range days (the section on reversal days in the third book has examples), so whenever traders recognize that the day is a trending trading range day, they should always be prepared for a possible late reversal swing trade, which might become a large intraday trend trade that can cover the entire day's range.

Trending trading range days often give a subtle clue that a breakout should be expected. If you see a trading range day forming, but each swing high is a little higher than the prior one and each swing low is higher than the prior one, the market may already be trending even though it is still in a trading range. Once enough participants recognize this, the market breaks out and quickly moves to a higher level, where it once again will become two-sided and form another trading range.

When the initial breakout occurs, do not assume that a measured move is assured as the market tries to grow to an average daily range. In about a third of cases, the market will break out of one side and extend the range a little, and then reverse and break out of the opposite side and extend the range a little more, resulting in a quiet trading range day.

Sometimes there is a trading range with a height that is about half of the recent average daily range and the range stays small until the final hour. For example, if the day's range in the Emini has been just five points as the market enters the final hour and the average recent range has been 12 points, and only two days in the past 12 months ended up with a range of five points or less, be prepared for a breakout at the end of the day. Every day has a range of five points at some point, if only for the first minute. Most trending trading range days with an initial range of only five points have a breakout within the first two or three hours, but several times a year the day will stay small until the final hour or two. When that happens, most of the time there will be a breakout that will increase the range, but usually not all the way up to the recent daily average. Don't give up on the day and assume that it will end up as only a five-point range day, because in 90 percent of the cases the range will increase before the close and you can often profitably trade the brief breakout. Because the breakout occurs so late, there is often not enough time left to form much of a trading range, but because the day appeared likely all day long to be a trending trading range day, it is appropriate to discuss it here.

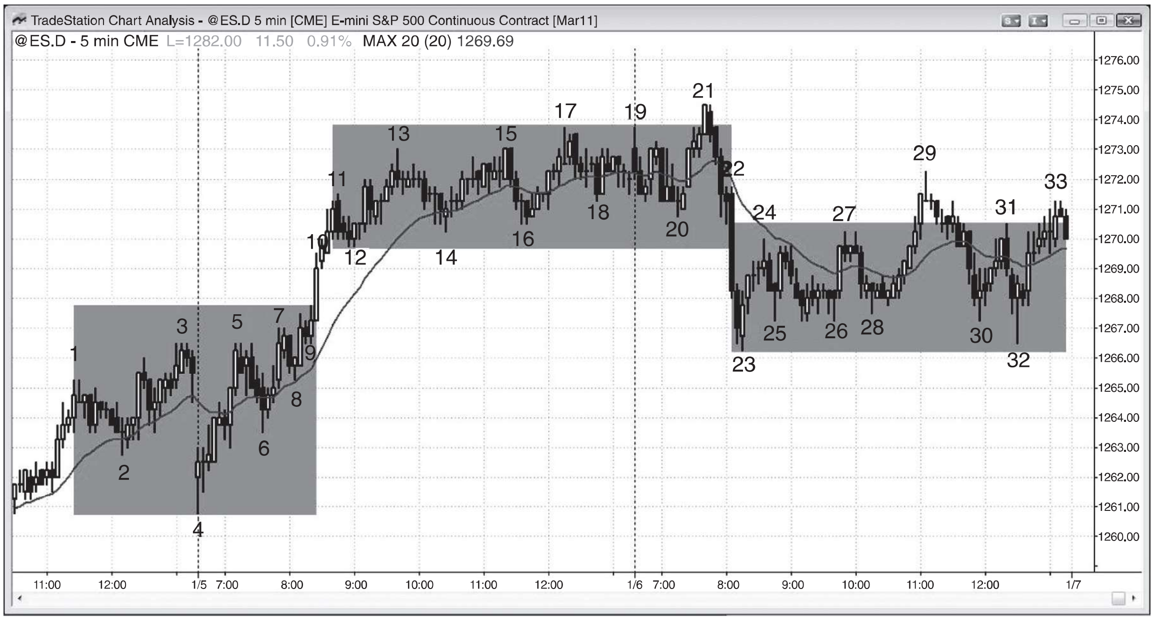

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FIGURE 22.1 Trending Trading Range Days

Trending trading range days often have a single large trend bar in between the ranges. In Figure 22.1, the market was in a trading range for the final couple of hours of yesterday from bar 1 to bar 3, and the trading range continued through the first couple of hours of today. Bar 10 was a large bull trend bar that broke out of the trading range and above the wedge top formed by bars 5, 7, and 9. The next bar was a bull trend bar, and it confirmed the breakout (it significantly increased the chance of higher prices and some kind of measured move up). The market immediately entered a small trading range for the rest of the day.

That range continued into the third day. Any trading range has a magnetic pull on the market, and this makes most breakout attempts fail. The trading range from bar 11 to bar 19 was the final bull flag in the rally, and the breakout to bar 21 failed. The market then broke below this upper trading range with the large bar 22 bear trend bar. The sell-off tested the top of the range from the prior day and formed another trading range. Bar 29 was a failed breakout of the top of the lower range and a third push up, and the pull of the lower range was greater than that of the upper range. The market traded back through the lower range, tested the bottom at bar 32, and then closed near the top of the lower trading range.

The bull spike from bar 8 to bar 13 was large but the follow-through channel from bar 12 to bar 17 was disproportionally small. The breakout gap in between the bar 9 top of the lower trading range and the bar 12 bottom of the upper trading range was large compared to the height of the upper range. This increased the chances that the market would come back into the gap to test its strength. The trading range from bar 23 to bar 33 was mostly within that breakout gap between bar 9 and bar 12, which often happens.

The initial range from bar 4 to bar 9 was about half the size of an average day. So traders expected the range to approximately double. When there is a trading range that is about half of the size of an average daily range, the most common way that the range increases is by a breakout and the formation of a trending trading range day.

The third day's opening range from bar 19 to bar 21 was about a third of the size of an average day, and traders expected a breakout. Since they also expected a test into the gap of the prior day, a downside breakout was likely, and it followed the failed attempt to break out of the top of the range. The spike down to bar 23 was strong and it was possible that the day could have become a spike and channel bear trend day, but bar 23 tested the support provided by yesterday's trading range (the highs of bars 3, 5, and 7). It was about a measured move down, and it also tested a three-day trend line (not shown). This means that the sell-off might have simply been a sell vacuum created by strong bulls and bears stepping aside until the market fell down to the support zone, at which point they bought aggressively. The bull spikes up from bars 23, 25, and 26; the double bottom bull flag created by the spikes in between bars 25 and 26; and the double bottom pullback at bar 28 all represented increasing buying pressure, and the market even flipped to always-in up on the spike up to bar 29. This is not what typically happens in the pullback after a spike in a spike and channel bear trend day, and this made a trending trading range more likely. If this was to become a spike and channel bear trend day, the pullback from the bar 23 spike would not typically have much buying pressure compared to the strength of the bear spike. The uncertainty created by the buying pressure increased the chances of a trading range instead of a brief pullback and then a protracted bear channel. Uncertainty is the hallmark of trading ranges and not of bear flags (a pullback leading to a bear channel).

The distinction between a spike and channel trend day and a trending trading range day is not always clear and sometimes not important. Although the trading range that began at bar 12 made the day a trending trading range day, it also had higher lows and highs and therefore was a weak bull channel. Remember, a channel is just a sloped trading range and both are areas of two-sided trading. The less sloped it is, the more it behaves like a trading range and the more safely traders can trade in both directions.

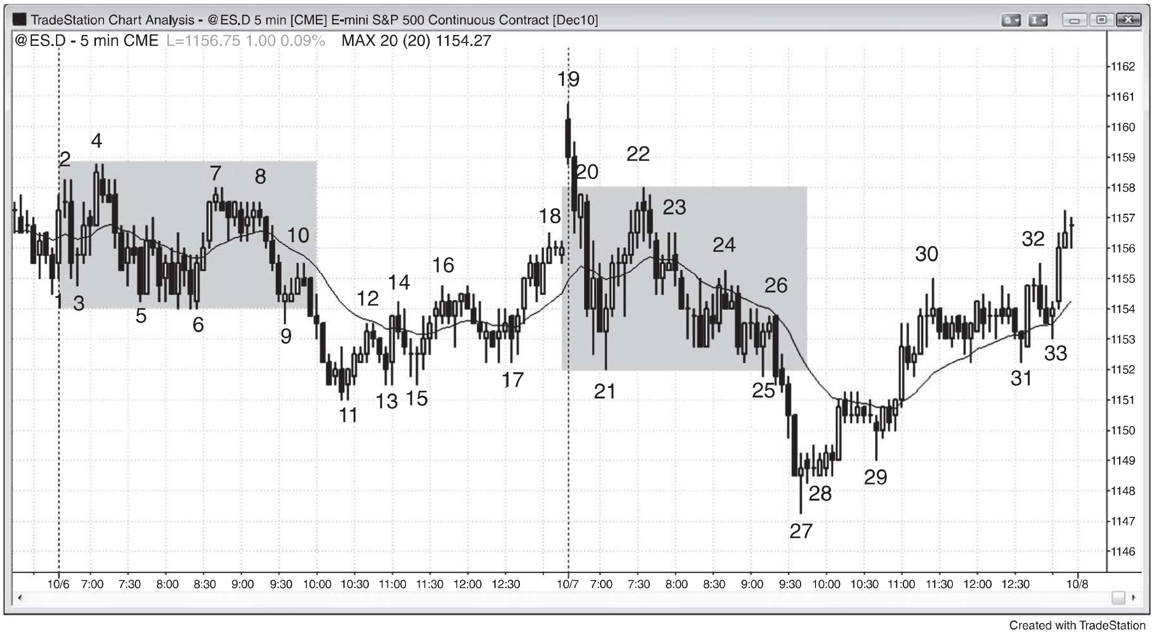

FIGURE 22.2 Initial Trading Range Is About Half of the Average Daily Range

As shown in Figure 22.2, for the first couple of hours of both days, the range was about half that of the recent days. This alerted traders to a possible breakout in either direction. When the breakout starts later in the day like this, without a clear direction in the opening range, and the initial range is about half that of an average day, the breakout usually does not result in a strong, relentless trend, like a spike and channel trend. Instead, it usually has a pullback and then the market forms a lower trading range. The lower range may or may not break back into the upper range, and may sometimes break out again to the downside and form a third or fourth trading range. Since a lower trading range is more likely than a strong bear trend, the trading should be two-sided and the market usually works its way back to the breakout area. Once the breakout extends below the breakout point for about a third of an average range, traders will start looking to buy for a swing up to the bottom of the upper range. They would have bought the second attempt to reverse up above bar 11 and above bar 28. They also would have bought the double bottom at bar 5 and the higher low at bar 29.

Once the market breaks back into the upper range and holds up there, it often tests up near the top of the upper range, as it did on the second day. If the day closes near the top or above the upper range, the day becomes a reversal day. Aggressive bulls would have bought the close of the large bear trend bar before bar 27, expecting it to be an exhaustive sell climax that would lead to a test up to the bottom of the upper trading range. Some would have bought on limit orders at a measured move down from the height of the upper trading range. They would have counted the number of points between the top of bar 22 down to the bottom of bars 21 or 25, and then subtracted that number from the low of bars 21 or 25. They would have then begun to scale in around that price level, maybe starting a point or two above to a few points below. Others would have bought at the first sign of two-sided trading, like the close of bar 27, or as bar 27 was reversing off its low. Assuming that the average daily range was about 10 points, some bulls would have scaled in at four to six points below the bar 25 bottom of the upper range, looking to make three to six points on the pullback into the breakout gap (the bear trend bars below bar 25).

Although the sell-off from bar 19 to bar 21 was sharp, so was the rally up to bar 22. This led to enough uncertainty about the direction in the opening range to reduce the chances of a spike and channel trend day and increase the chances of a trending trading range day.

FIGURE 22.3 Trending Trading Ranges Create a Trend

Sometimes a day can spend most of its time in trading ranges but still be a trend day. As shown in Figure 22.3, today may not look like a trend day, but it is, as can be seen in the thumbnail of the daily chart (today is bar 1), and it is made up of a series of trending small trading ranges. These days frequently reverse in the final couple of hours and retrace at least the final trading range.

Deeper Discussion of This Chart

Some days do not have reliable setups for an hour or more. In Figure 22.3, today opened at a flat moving average within the range of the final bar of yesterday, which had been in a small trading range, and that range continued for the first two bars of today's open. The first two bars of today were large compared to the height of the trading range, and this makes them risky signal bars. Although shorting below the second bar was acceptable since it was a two-bar reversal short setup and a wedge bear flag below the moving average, the entry would be near the low of the trading range. It was safer to wait for the breakout and then short a breakout pullback, if there was one. One developed a few bars later but it was in a small, tight trading range and the bars had big tails, making it a less reliable trade. A better entry was below the 8:00 a.m. PST two-bar reversal and pullback to the moving average, which was a low 2 short.

There was a moving average gap bar short at 11:45 and the test of the bear low was in the form of a higher low. It is also appropriate to call it a double bottom bull flag.

This was a trending trading range day, so once it started to base around the $185 level, traders could have bought in that area for a test of the bottom of the upper range just above $186. The market made a two-legged sell-off down to the $185 level and the second leg was an approximate measured move. The middle of the morning trading range was about $2.00 below the high of the day and the large two-bar reversal at 10:15 a.m. was about $2.00 lower, so traders would start buying. The bears were buying back some of their shorts and the bulls were buying for a test of the bottom of the upper trading range. The market entered a tight trading range and there were three small pushes down that ended with a large bear trend bar at 11:05. This was followed by a higher low at 11:30, and the signal bar had a bull body. This higher low was also a high 2 since the bar before it and the bar two bars before that had bear bodies. This is microscopic analysis and most traders would not trust this in real time, but experienced traders are always looking for signs that the market might turn, and these subtle hints would help give them confidence to take the long. If they bought above the 11:30 low, they could risk about 50 cents to below that low with the goal of making about a dollar on the test of the upper trading range.

Although you never know the directional probability of an equidistant move with certainty, whenever you feel that there is an imbalance, you should assume that it is at least 60 percent. Here, it was reasonable to assume that if you bought around $185, there was at least a 60 percent chance that the test of $186 would happen before your protective stop was hit if you placed that stop equidistantly below your entry (there is a 60 percent chance that you would make a dollar before you lost a dollar). You could have taken a partial profit on the doji inside bar after the bull spike up at 11:40 and exited the rest at breakeven as the breakout failed. Once the market double bottomed at 12:25, you could try the same long again and you would have succeeded. There was a chance of a measured move up to a $2.00 profit from the double bottom, but with so little time left in the day, this was unlikely.

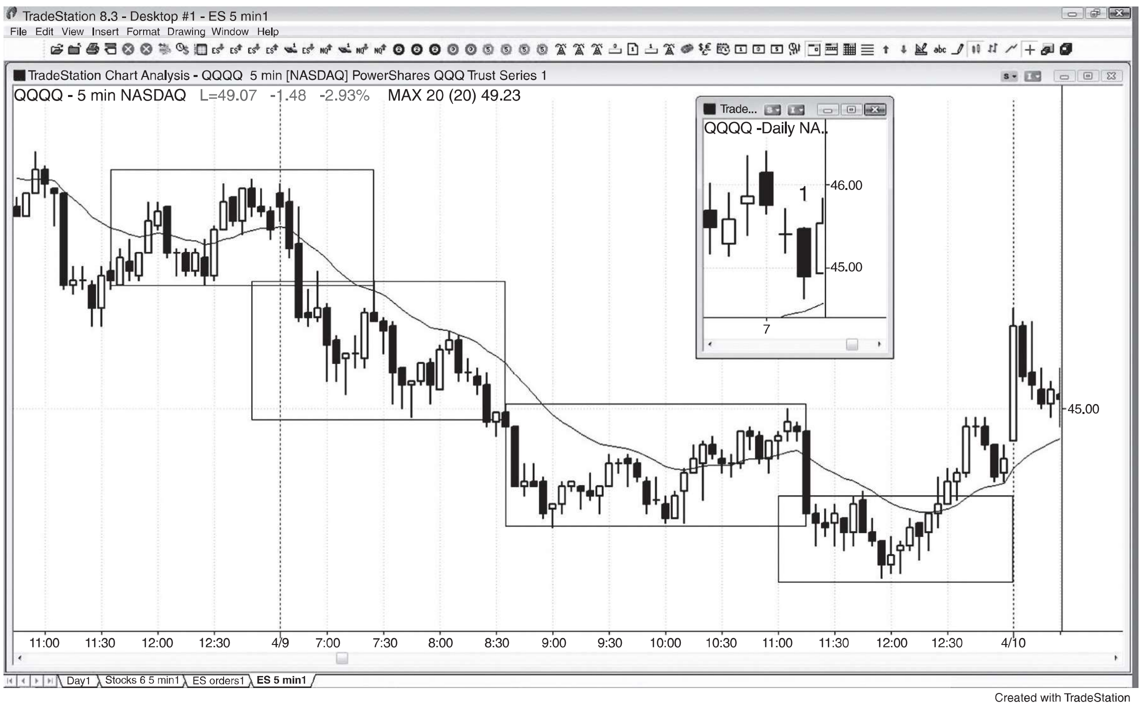

FIGURE 22.4 The First Trading Range Can Form Yesterday

As shown in Figure 22.4, this was another trending trading range day with the first trading range beginning yesterday. The thumbnail of the daily chart shows it was a bear trend day (bar 1).

The final trading range reversed up and the market tested near the top of the higher trading range just before it. This often happens, since the two-sided trading means that the trending forces are not as strong as they are during other trend days. When a day is less strong, it is less likely to close on its low. Traders know this and look for a reversal trade going into the close.

Deeper Discussion of This Chart

In Figure 22.4, today again opened essentially unchanged and near a flat moving average. However, the three-bar bear spike made a bear trend day likely. The spike broke below the trading range that formed in the final hour of yesterday. That trading range was also a two-legged rally and therefore a bear flag, so the breakout can be thought of as a breakout below the bull trend line along the bottom of the bear flag. Traders could short below the first pullback and then again below the moving average test, which was also a two-legged sideways correction to the moving average and an approximate double top bear flag setup.

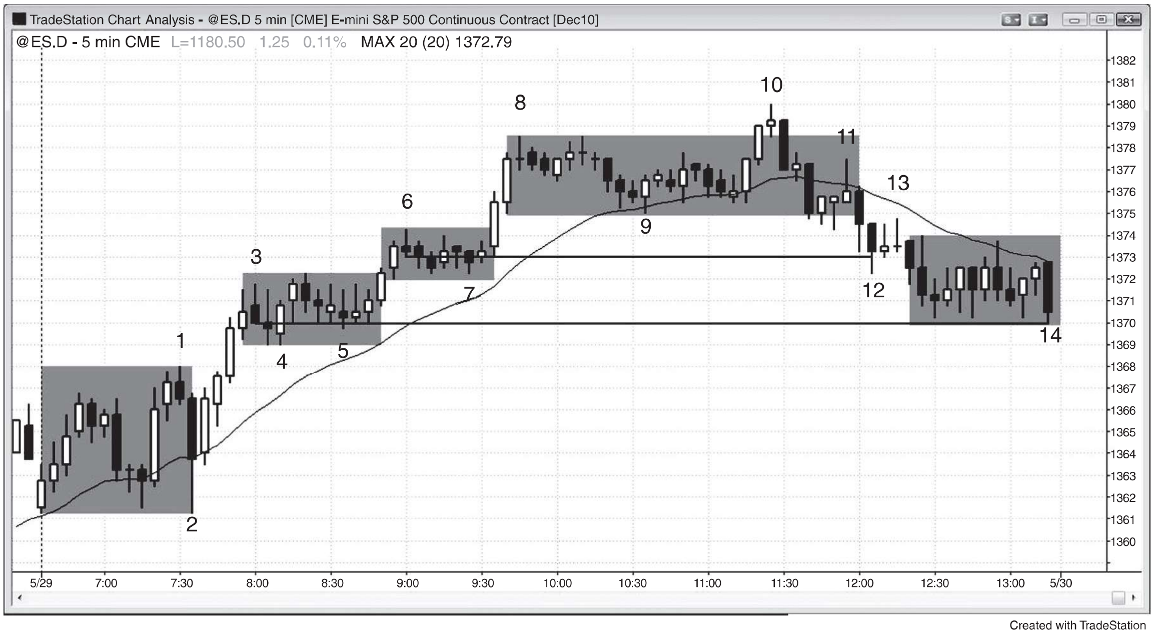

FIGURE 22.5 Trading Ranges Separated by Breakouts

As shown in Figure 22.5, the first hour was contained in a seven-point range but the average range lately had been about 20 points, so traders expected the range to approximately double. Whenever a trend begins after an hour into the day, the day often becomes a trending trading range day, in part because by definition that first hour obviously was a trading range. The day often reverses back into and sometimes through one or more of the lower trading ranges late in the day, as it did here.

Deeper Discussion of This Chart

When the day is forming multiple trending trading ranges as in Figure 22.5, traders should concentrate on taking with-trend trades. Traders should have looked to buy only from the two-bar reversal at bar 2 to the 20 gap bar high 2 at bar 9. They should have considered shorting only at the bar 10 final flag reversal setup.

Many bulls would have taken profits on their longs, and aggressive bears would have shorted on the close and above the high of the bull trend bar before bar 10. The market had a spike up to bar 3 and then a channel or a series of small trading ranges, but the one that began at bar 8 was relatively tight and horizontal. This was an area of strong two-sided trading, and therefore a magnet that would tend to draw the market back in after a breakout. The market also often retraces into the prior trading range later in the day, and since 11:30 a.m. PST is a common time for reversals, the odds of a failed breakout and final flag reversal were high. The pullback could have tested the bar 4 start of the bull channel, so bears were happy shorting at the high of a large bull trend bar breakout above a swing high and potential final flag. Many would have scaled into more shorts higher, believing that the market had a 70 percent chance or better of at least testing their first short entry price before the close. This would have enabled them to exit their original shorts at breakeven and decide whether to exit their shorts from above with a profit or to move the protective stops to breakeven and swing the trade down.

Bar 2 was the first bar of a two-bar reversal up from a possible failed low 2 from a double or triple bottom, and the start of a bull trend. Traders were aware that the market could break out and run. Once the market broke out, it formed a higher range from bars 4 to 6, and that range contained two small tight trading ranges. The high 2 long above bar 5 was a reasonable breakout pullback entry, despite the barbwire. The breakout was both from the small bull flag from bar 3 to bar 4, and from the entire bar 3 to bar 5 trading range, which was a two-legged sideways pullback from the breakout above bar 1.

The market broke out to a third range, from bars 8 to 9. When it broke out again, it failed at bar 10 (a final flag reversal) and retraced through the bottom of the third range and ultimately to the bottom of the second range. There was a breakout pullback short below bar 11 after the bear spike, but the barbwire made it more risky. After the two bear bars forming a spike that ended at bar 12, there was a second breakout pullback short below bar 13.

The implication in the word *range* is that the market will test the low of the range at some point, although it could continue trading up. When a market retraces a strong move, the first target is always the earlier countertrend entry points. Here, the closest bear entry point after the market broke out of the top range was the low of the closest bear signal bar, bar 6. The market broke out of the top range, and then broke into the next lower range and took out that bear signal bar low on bar 13.

By the close, the market had tested the low of the bar 3 lowest bear signal bar in the second range.

FIGURE 22.6 Two-Sided Trading in a Trend Day

Although today (see Figure 22.6) opened on its high and closed on its low, and was a trend from the open bear trend day, there was too much sideways action during the first two hours for this to trade like one. A trend from the open trend day usually doesn't have many significant tradable countertrend swings, but a trending trading range does, and is a weaker, less predictable type of trend day. The initial trading range broke down into a lower range on bar 4, creating a trending trading range day.

Until bar 3, the day's range was only about half that of recent days, so traders were aware of the possibility of a lower trading range forming.

Bar 6 was a breakout pullback to the moving average and a breakout test of the bar 2 bottom of the upper range, offering a reasonable short entry.

Bar 9 was a breakout test of the upper range and failed breakout of the top of this lower range, setting up another short.

Bar 12 broke down into a third range, but there was not enough time left in the day for a test up to the bar 13 top of the range.

Deeper Discussion of This Chart

In Figure 22.6, yesterday closed below the moving average and today's open was a bull breakout above the close and moving average. The first bar of the day was a doji and therefore not a reliable short signal bar. The bar 1 strong bear trend bar was a reasonable signal bar for a short one tick below its low for a test of the moving average and maybe the close of yesterday. Since large gap openings often lead to trends and this bear bar was a sign of urgency on the part of the bears, today could become a bear trend day and traders should short early and swing part until there is a strong bull reversal or until the close of the day.

After the two-bar bear spike, traders were expecting a bear channel and began to short pullbacks. The first pullback short was the low 2 that was triggered by the outside down bar just after 7:00 a.m. PST, and the next short was below the bar 3 bear reversal bar. It was a dueling lines short setup, forming both a double top with the earlier pullback and a wedge bear flag (the first push up was two bars before bar 2).

Bar 14 was a bull reversal bar, but it overlapped the prior two bars too much for it to be reliable. Also, it was within a relatively tight channel after the bar 12 bear spike, so it would be better to wait for a breakout pullback higher low before going long in a bear trend. Since it was a weak buy setup in a bull trend, its failure would likely be a good short setup. Bar 15 was failed high 2, and a low 2 with a bear reversal bar near the moving average in a bear trend is a very high-probability short setup because the bulls who bought the high 1 and the high 2 trend reversal attempts usually exit on a low 2. The market just made two attempts to reverse the new low of the day, and this second one failed on the bar after the bar 15 long. When the market fails twice at trying to do something, it usually then goes in the opposite direction.

FIGURE 22.7 A Trend Starting after the First Hour Is Often Weak

Whenever a market begins a trend after the first hour, assume that it will lead to a trending trading range day or that it will behave like one, and look for scalps in both directions. Although there was a bull trend from the open in Figure 22.7, it ended with a spike and climax at bar 5 and then reversed down into a trending trading range bear trend. It also can be viewed as a spike and channel bear trend, with the move from bar 5 to bar 6 being the bear spike, and the moves down from bar 7 to bar 8 and then the three-bar breakout to bar 10 as additional spikes. The channel down was broad enough and the pullbacks after the two breakouts overlapped the prior swing lows so that it was also a bear stair pattern.

Deeper Discussion of This Chart

The market gapped down to a higher low and formed a possible bull trend from the open in Figure 22.7. It was a test of the moving average after a strong spike into the close and a failed breakout below that strong bull channel.

A two-legged move up ended in a final flag short at bar 5. This was followed by a four-bar bear spike, which became part of a larger spike that ended at bar 6. This move broke below the bull trend line of the rally from the open, so a lower high could lead to a trend reversal down.

A two-legged lower high ended at bar 7, alerting traders to a possible continued move down. Bar 7 was a dueling lines pattern. It formed a double top with the top of the wedge bear channel down to bar 6 (the channel began with the small lower high that formed after the four-bar bear spike below bar 5), and it was a wedge bear flag (the first push up ended with the bar before bar 6, and bar 7 was the third push up).

The market behaved like a trending trading range bear for the rest of the day. The strong bull momentum up to bar 1 and again up to bar 5 were spikes up and could be followed by a bull channel at some point over the next day or two. Bars 6, 8, and 10 created a large wedge bull flag, and a test of the bar 5 high was possible. Bar 4 can also be considered part of that bear channel. The next day (not shown) in fact gapped up near the high of bar 7 and became a strong bull trend from the open day.

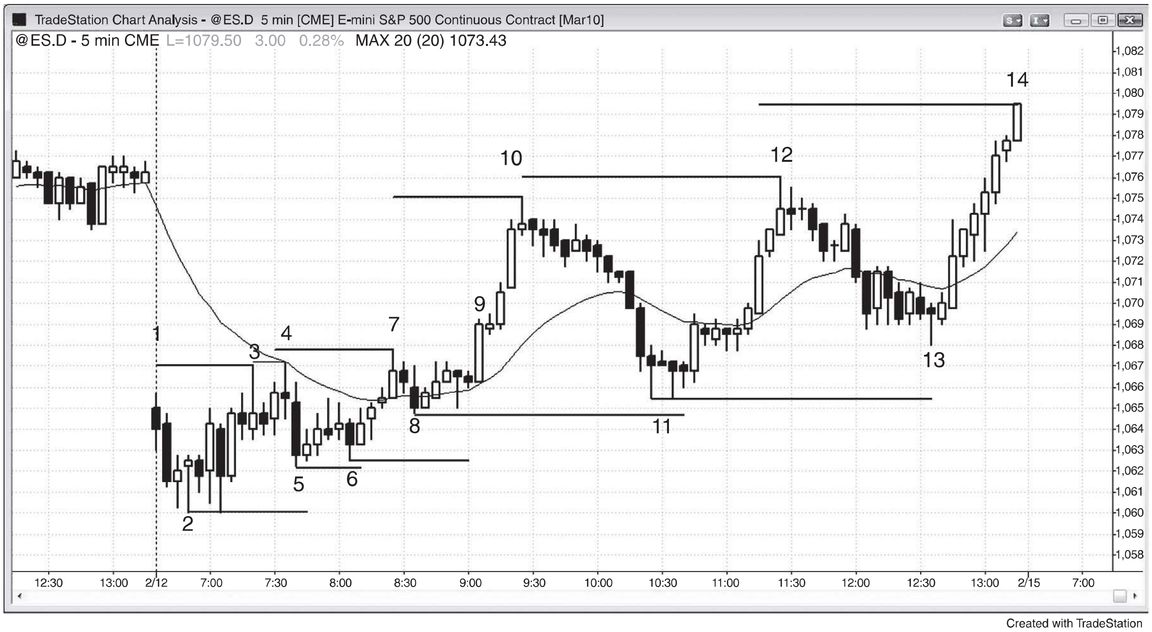

FIGURE 22.8 Initial Trading Range Often Presages Another Trading Range

In Figure 22.8, the range for the first couple of hours was about half of an average daily range and this alerted traders to a possible breakout and the formation of a higher or lower trading range and the creation of a trending trading range day. The bull trend was already apparent before the bar 9 breakout. Notice how the bar 5 swing low was above the bar 2 low, the bar 6 low was above the bar 5 low, and the bar 8 low was above the bar 6 low. The same thing was happening with the swing highs at bars 3, 4, and 7. Even though the market was in a trading range for the first two and a half hours, both the swing highs and the swing lows were trending upward, indicating that there was already a bull trend going on within the trading range. This alerted traders to watch for a breakout, which occurred at bar 9. This higher trading range lasted until the breakout that followed the reversal up at bar 13. Both bars 11 and 13 were breakout tests. The double bottom at bar 11 dropped into the lower trading range, but the bar 13 low tested the bar 7 top of the lower trading range to the tick. When a pullback cannot drop below the breakout point, it is a sign of strength by the bulls.

Deeper Discussion of This Chart

The market broke out below yesterday's close in Figure 22.8, and the first bar had a bear body, so the day could become a trend from the open bear trend day. However, there were tails above and below bar 1, and this increased the chances of an initial trading range. Traders should wait. Bar 2 was a micro double bottom, but both bars were dojis so this was not a setup for a strong trend. Even the bar 4 wedge bear flag at the moving average was a weak setup because it was part of a six-bar tight trading range and all of the bars had tails. This means that there is uncertainty, and that is the hallmark of a trading range. Traders could have bought above the bull inside bar that followed bar 5, but after that bar 4 wedge bear flag the market should have a second test down. This occurred at bar 6 and formed a double bottom with bar 5 and a double bottom pullback for the double bottom at the low of the day (bar 2 and the bar three bars later). It would be safer to wait to buy until after more evidence of bull strength, like the four-bar bull spike up to bar 7, but there were a couple of strong bull trend bars just after bar 2, and this is a good enough sign of strength to start taking long trades on pullbacks. Those large bull trend bars are a sign of buying pressure, which is cumulative. Once there is a critical mass of buying, the bulls take control and the market goes up.

After that bull spike to bar 7, there was a breakout pullback buy setup above the bull inside bar that followed bar 8, and that was also a failed low 2 buy signal. There was a high 2 long setup four bars later that led to the bar 9 strong bull breakout.

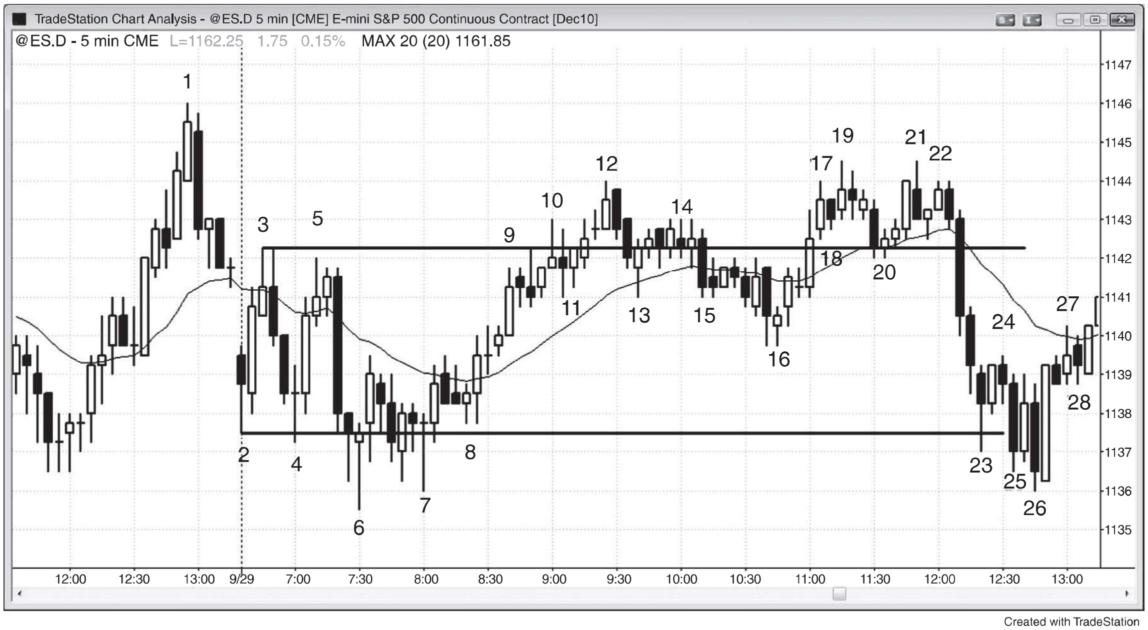

FIGURE 22.9 An Initial Trading Range Can Be Followed by a Trading Range Day

Just because the range of the first couple of hours is about half that of an average day does not mean there will be a breakout into a trending trading range day. In about a third of cases, the range increases by a breakout of both the high and low of the day, as it did in Figure 22.9. The market reversed up from new lows of the day at bars 4 and 6, and down from new highs of the day at bars 3, 10, 12, 19, and 21. The opening range probably ended with the reversal down from bar 5, and at that point the range of the day was about half that of recent days. This alerted traders to the possibility of a breakout either up or down and then a measured move that would approximately double the day's range. However, simply entering on the breakout of a trading range is a losing strategy since the market always has inertia and most attempts to change from a trading range to a trend, or from a trend to a trading range, fail. No good short developed after the bar 6 breakout to a new low of the day, and in fact the bar 7 higher low after the three pushes down (bars 2, 4, and 6) and the bar 8 breakout pullback were reasonable buy signals for a test of the high of the day.

Bar 10 reversed down after breaking to a new high of the day, but the market was in a tight bull channel and therefore this was not a good short setup. The momentum up was not particularly strong so buying the bar 11 breakout pullback was a scalp trade at best. The market turned down again with a two-bar reversal at bar 12. Second-entry reversals on trading range days are usually reliable for at least a scalp.

The market had a run to a new high of the day after the bar 16 wedge bull flag and the market again failed at bars 19 and 21. Once it was clear that the upside breakout would not succeed, the market once again tried for a breakout of the opposite end of the day. As is often the case on trading range days, the market closed in the middle of the range.

When there are several possibilities for the top and bottom of the opening range, it usually does not matter which you choose because there is no agreement. When looking for a measured move target where you can take profits, initially use the smallest possibility for the opening range, like bar 2 to bar 3. If the market does not pause in that area, then look at the next larger possibility, like bar 3 to bar 4, or bar 3 to bar 6. Since today ended as a trading range day and not a trending trading range day, the obvious measured move targets were not reached. However, every reversal is due to computer algorithms based on some measurement, and there is almost always some type of measured move in the equation, even if it is not obvious.

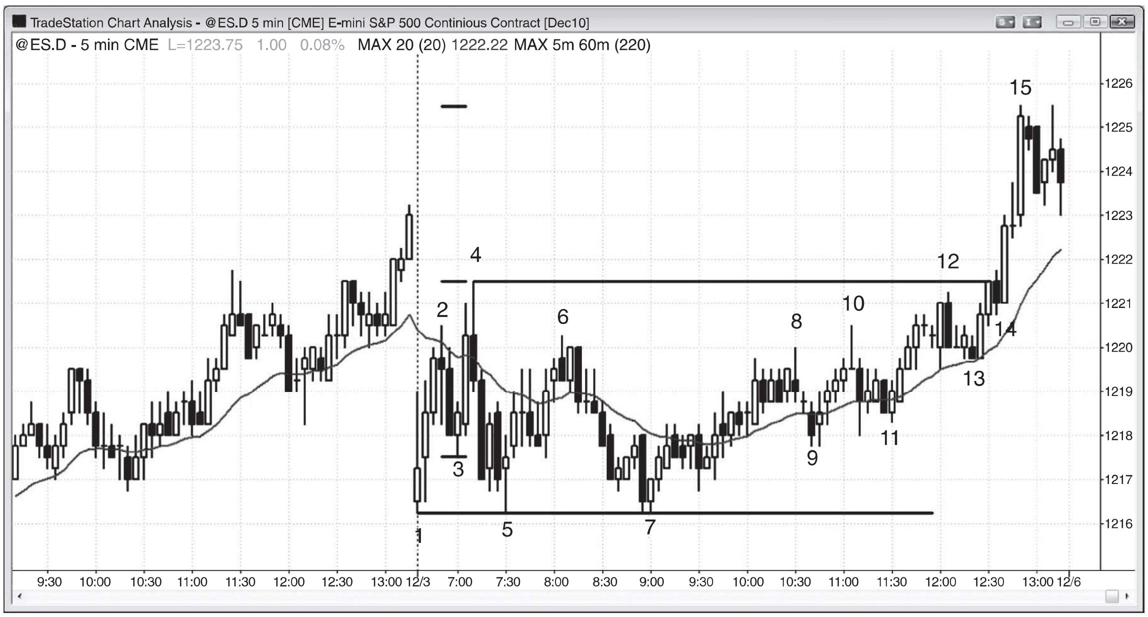

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FIGURE 22.10 Late Breakout

Sometimes the initial trading range is about half of the size of an average daily range and the breakout does not come until the final hour. In Figure 22.10, although there was not enough time left to form much of an upper range, the day was a setup for a breakout into a trending trading range day all day long. The range prior to the breakout was only 5.25 points and there were only two days in the past 11 months that ended with a range of 5.25 points or less. This meant that other days this year that may have had a 5.25 range for most of the day had a bigger range by the close, and that made it likely for today to have a late breakout up or down as well. Since the market had been trending up since the bar 7 triple bottom and triangle, and the number of bars between bars 9 and 12 with bull bodies was high, buying pressure was present and an upside breakout was likely. Traders would have bought on the bar 14 breakout above the bar 4 high of the day and on the close of the strong bar 14 breakout bar and again above its high.

The initial bear spike from bar 3 to bar 4 generated a measured move to the high of the day. Traders never know which of the possible measured move targets will be the level where the bulls will take profits, but it is good to be aware of the possibilities so you, too, can take profits as the market is racing up rather than a couple of points lower on the sell-off. The market might have also topped out at a measured move based on the bar 1 low to the bar 2 high or from the bar 5 low to the bar 4, 6, 10, or 12 high.

CHAPTER 23

Trend from the Open and Small Pullback Trends

Primary characteristics of trend from the open days:

- The low of a bull trend day or the high of a bear trend day is formed within the first few bars of the day.
- If the opening range of the day is less than 25 percent of the average daily range of recent days, there may be a double bottom on a bull trend day or a double top on a bear trend day (if the opening range is about 50 percent of the average daily range, a breakout is more likely to lead to a trending trading range day).
- The day may begin with a strong spike lasting many bars or it may have a small opening range.
- If the market trends from the first bar or so and the initial spike lasts three or more bars, entering on the first pullback is usually good for at least a scalp.
- If there is a strong spike on the open that lasts many bars and covers many points, the day will usually become a spike and channel trend day.
- A large gap opening often leads to a trend from the open day, and the trend can go in either direction. When there is a large gap up and a trend from the open day forms, the day will be a bull trend day about 60 percent of the time and a bear trend day 40 percent of the time. The opposite is true for gap down openings. The larger the gap, the more likely the day will be a trend day and the more likely the trend will be in the direction of the gap.
- Trend from the open days have urgency and conviction from the outset and are usually the strongest trends and have the smallest pullbacks.
- Twenty gap bar and moving average gap bar setups come late in the trend.

- The strongest type of a trend from the open day and the strongest type of trend is one where the opening range is small, and then the day trends relentlessly with small pullbacks all day long. This is a small pullback trend day. For example, the pullbacks in the Emini might be just 10 to 12 ticks (10 to 30 percent of the average daily range). When that is the case, there is usually a pullback in the final couple of hours that is about 150 to 200 percent of the size of the earlier pullbacks, followed by a resumption of the trend into the close.
- To an experienced trader, the swing setups are 70 percent or more likely to work, even though to they never look that certain to a beginner. Many of the signal bars look bad, as is the case for all strong trends. Most setups *appear* to have 50 percent or less probability of success. This makes traders not take the trades and forces them to chase the market, or miss the trend completely.
- There are often many trend bars in the opposite direction, which is a sign of countertrend pressure, and it keeps beginning traders looking for reversals instead of with-trend trades. For example, in a bull trend, there will be many bear trend bars and many two-bar and three-bar bear spikes. Beginners repeatedly short them and lose. The spikes evolve into bull flags that look weak, which discourages beginners from buying them. They just got out of a losing short and are not ready emotionally to risk losing again, especially on a setup that does not look strong. Each bad-looking bull flag is successful, and is followed by another good-looking short setup that fails.
- The trend is often in a relatively tight channel, and pullbacks often come back and hit breakeven stops, trapping traders out. Traders need to trail their stops below swing lows in a bull trend or above swing highs in a bear trend. If they are too eager to move their stops to breakeven, they will get trapped out.

Since almost all small pullback days are trend from the open days, they should be considered to be a strong variant. A trend from the open day is usually the strongest form of trend pattern, but it develops in only about 20 percent of days. That means that buying above the first bar or shorting below it, expecting it to be the start of a strong trend, is a low-probability trade. Reversals are far more common in the first hour, as is discussed in book 3. The chance of the first bar being the high or low of the day on a day when there is a large gap opening can be 50 percent or more, if the bar is a strong trend bar in either direction. The high or low of the day forms within the first five bars or so in about 50 percent of days. However, it forms within the opening range, which can last a couple of hours, in about 90 percent of days. Any type of trend day can trend from the open. In a trend from the open day, the market forms one extreme in the first bar or first few bars and then trends all day, and often closes at or near the opposite extreme. There may be a small trading range for the first 30 minutes or so and then a breakout, but the open of the day will usually be very close to one extreme of the day (the low in a bull trend or the high in a bear trend). These days often open with large gaps and then the market continues as a trend in either direction. In other words, a large gap down can lead to either a bull or a bear trend from the open day. The setup is more reliable if it forms at a strong magnet like a trend channel line (for example, forming a wedge reversal setup) or if it is part of a reversal pattern, like a reversal from a final flag at yesterday's close.

This type of trend can be so strong that there can be follow-through in the first hour or two of the next day, so traders should be looking to enter with trend on pullbacks after the open of the next day. The pullback often is strong enough to make traders wonder if the market is reversing, but it is usually just a higher time frame, two-legged correction, like a pullback to the 15 minute moving average. However, most traders would find it easier to simply read only one chart when trading and there is always a 5 minute setup at the end of the pullback.

As a trend from the open day is evolving, the pullbacks are often very small all day long. When this happens, this is a small pullback trend day. This is the strongest type of trend day and it forms only once or twice a month. About two-thirds of these days have a larger pullback after 11:00 a.m. PST. That pullback is often about twice the size of the biggest pullback since the trend began in the first hour. It is often heralded by a relatively large, strong trend bar or two in the direction of the trend, but representing climactic exhaustion. Take the example of a small pullback bull trend day when the biggest pullback has been nine ticks and the market has been channeling up all day. If sometime between 11:00 a.m. PST and noon the market has two relatively large consecutive bull trend bars breaking out to a new high, the move is more likely an exhaustive buy climax than the start of a new leg. Climaxes are discussed more in the third book, but when a trend has gone on for a long time and then has unusual further strength, it usually signals the end of the move for the time being and the start of a two-legged pullback that will last about 10 bars or so. Experienced traders are expecting a three- to five-point pullback and they will exit their longs. Some will even short the close of that second bull trend bar, or maybe a tick or two above its high, expecting the pullback. They might wait for the next bar to close, and if it has a close around the middle, they might short the close. If it is a bear reversal bar, they might short below its low. If they entered below a bear reversal bar, their protective stop would be above its high, but if they entered at the market at the close of the bull spike, they might use a three- or four-point stop and scale in a point or two higher. Even if they are wrong and the market does not sell off for a few points, it will likely enter a trading range and they should be able to get out with a small profit within the final hour.

There might have been a slightly larger pullback in the first hour just before the trend began, but only the pullbacks after the trend began are important. Look at their size and if they are all very small and each subsequent one stays around the same size or smaller than the first, the day is a strong trend day. For example, in a bull trend in the Emini where the average daily range has been about 12 points, the pullbacks might all be just two or three points. The bulls want a bigger pullback where they can get long, hoping for less risk. After waiting and not getting what they want, they start taking small positions at the market and on small pullbacks. This small buying all day long keeps lifting the market. The bears never see a great short and they decide instead to short smaller positions and weaker setups. There is no follow-through and they are forced to cover, and this buying adds to the slow rise in the market. Momentum traders see the trend and they, too, buy all day long. The trend usually continues all day with only small pullbacks, but because the bulls have been buying small positions all day long, they never have to chase the market up in a panic. Also, because the bears are never heavily short, there is not strong short covering. The result is that even though the day is a trend day, it often does not cover too many points and the bulls do not make a windfall profit, even though they were on the right side of a strong trend.

A report at 7:00 a.m. PST can often lead to a reversal bar, a breakout bar, or a large outside bar that becomes the start of a strong trend, which can last all day. However, computers have a huge edge on reports. They receive the data instantly in a format that they can process to make decisions that lead to orders. All of this happens within a second, and it gives them a significant advantage over traders. When the computers have a big edge, traders are at a disadvantage and therefore should rarely enter at the moment a report is released. The computers will usually show what the always-in trade is within a bar or two, or they will set up a strong reversal. Traders will then have probability on their side, and can look to enter in the appropriate direction. The strong bar that leads to the start of the trend does not always come on a report and can form several bars before or after the report. It happens on the report often enough for traders to be ready for it and then to enter as soon as the always-in position becomes clear.

Sometimes, after about 30 minutes of a small range, there is a test of the open that occurs around 7:00 a.m. PST, usually coinciding with a report. Although this results in a small trading range, the trend that breaks out is much stronger than that seen on a trending trading range day; it is identical to a trend from the open day and should be considered a variant.

Even the best patterns still fail to do what you expect about 40 percent of the time. If the market does not pause by the third or fourth bar, it might have gone too far too fast, and this increases the chances that the market will reverse instead of trend.

Every day begins as a trend from the open day within the first few bars of the day. As soon as a bar moves above the high of the prior bar, the day is a trend from the open bull trend day, at least for that moment. If instead it trades below the low of the first bar, it is a trend from the open bear trend day. On most days, the move does not have much follow-through and there is a reversal, and the day evolves into some other type of day. However, when the breakout of the prior bar grows into a larger spike, the odds of a strong trend from the open trend day increase considerably, and traders should begin to trade the day as a strong trend day.

If the market trends for four or more bars without a pullback, or even two large trend bars, the move should be considered to be a strong spike. The spike is an area where both bulls and bears agree that very little trading should take place, and the market therefore needs to quickly move to another price level. When the spike begins during the first few bars, the day is a trend from the open day. It may remain so for the rest of the day, but sometimes the market soon reverses and breaks out in the other direction. This can result in a trend in the opposite direction, like a spike and channel trend or a trending trading range day, or simply a trading range day. As with any strong spike, the bulls who bought early on will take partial profits at some point, creating a small pullback (as discussed earlier in the section on trends). Other bulls who missed the move will aggressively buy the pullback, as will bulls who want a larger position. The bulls will buy with limit orders at and below the low of the prior bar, hoping that the current bar will fall below the prior bar and allow them to buy a little lower. Other bulls will buy with stop orders above the high of the pullback bar (a high 1 buy signal).

A spike is usually followed by one of three things. First, the market might have gone too far too fast and be experiencing exhaustive climactic behavior. For example, if there is then a pause or pullback like an inside bar or a small wedge flag, this could become a final flag and lead to a reversal after a small breakout, and the reversal could last for several hours. Alternatively, the market might go sideways in a tight trading range for several hours, followed by the trend resuming into the close, resulting in a trend resumption day. This small, sideways movement is very common following a relentless five- to 10-bar spike. The third and most common outcome, when the spike is not so large as to be exhaustive, is the formation of a trend channel, and the day then becomes a spike and channel trend day.

Entering on the first pullback after a strong first leg is simply capitalizing on the propensity for strong moves to test the extreme. Most strong moves have at least two legs, so entering on the first pullback has a very good chance of leading to a profitable trade. This entry is especially important on trend from the open days if you missed the original entry. In strong trends, what constitutes the first pullback is not always clear because trends frequently have two or three sideways bars that don't break a meaningful trend line and therefore really aren't significant enough to constitute a pull "back." However, even if there is no retracement and no real pulling back in price, a pause is a sideways correction and is a variant of a pullback.

The single most difficult part of trading these very strong trend days is that the trends do not look particularly strong as they are forming. There are usually no impressive spikes or easy, high-probability pullbacks to the moving average. Instead, the market has pullbacks after every few bars and lots of trend bars in the opposite direction. It often is in a weak-looking channel. What beginners fail to see is that the pullbacks are all small, the market never seems to get back to the moving average, and the price keeps moving slowly away from the open. Experienced traders see all of these things as signs that the bull trend is very strong, and this gives them the confidence to take swing trades. They correctly know that, although the bars look like they are part of a weak channel and therefore should create low-probability setups, when they occur in a small pullback bull trend day, they form high-probability swing setups. All pullbacks in trend from the open days are great with trend entries, even though they almost always look weak. A trader can continue to have confidence entering with trend even after a pullback finally breaks a meaningful trend line. In a strong bull trend, look to buy at the low of the prior bar, or one or two ticks below its low, or on a stop at one tick above high 1 and high 2 setups. Look at the size of the pullbacks since the trend began. For example, in a small pullback bull trend, if the largest pullback in the past couple of hours has been only eight ticks, buy with a limit order at five to seven ticks below the high of the day. In strong bear trends, traders will do the opposite and short at the high of the prior bar or one or two ticks above it, on a stop at one tick below low 1 and low 2 signal bars, and on any bounce that is about the size of an average bar.

The market has inertia and the first attempt to end the trend usually fails. Once a trend line has been broken and there has been a significant pullback, then the first leg of the trend has likely ended. Even then, the first break of the trend line has high odds of setting up a with-trend entry that will lead to a second trend leg and a new extreme in the trend.

The pullbacks often have weak signal bars, and there are many countertrend trend bars. For example, in a strong bull trend, most of the buy signal bars might be small bear trend bars or doji bars, and several of the entry bars might be outside up bars with small bodies. They often follow two or three consecutive bear trend bars or bear micro channels. This constant selling pressure makes many traders look for sell signals, trapping them out of the bull trend. The sell signals never look quite strong enough, but the traders sell anyway because they look better than the buy signals, and they want to trade. They see that there was a pullback after just about every buy signal that comes back and hits a breakeven stop and think that this is a sign of a weak bull trend. They see that it is a bull trend and want to get long, but can't figure out how to do so, because they think every buy signal looks bad. The pullbacks are too small and the setups are too weak. Also, since these days happen only a couple of times a month, they are conditioned to the other days, when selling pressure usually leads to a tradable short, so they continue to short sell setups that don't quite look right. They don't look right because they are the start of bull flags, not reversals. However, when experienced traders see a bull trend with small pullbacks and an inability to fall below the moving average, along with many bear trend bars and weak buy signals, they understand what is going on. They see traders being trapped out of longs and being fooled into constantly looking for tops, and know that this bull trend is especially strong. The experienced trader knows that too many traders will be doing the opposite of what they should be doing, and will be forced to exit their losing shorts and chase the market up. This creates a relentless tension on the upside where many traders want to buy but don't, and experienced traders buy relentlessly and have a very profitable day.

These days are usually in relatively tight channels, and if traders are looking to swing their trades, they should not be overly eager to move their stops to breakeven. When a trend is in a tight channel, it will usually come back to the entry price before reaching a new trend extreme, and inexperienced, fearful traders will mistakenly let themselves get trapped out of a strong trend. For example, if there is a strong bull trend, the market will often come back to the entry price at the signal bar high in five to 10 bars, and will often dip a tick or two below it. This can make beginning traders nervous. They had enough profit for a scalp, but since the day was a trend day, they wanted to swing the trade for a larger profit. Now, after an hour, the market is back to the entry price. They worried for an hour because the market was not going much above the entry price, and they are now afraid that their winner will turn into a loser. They cannot take the pain anymore and exit with a small profit or loss. A few bars later, they are upset because the market is now at a new high and they are on the sidelines, trapped out of a great trade, waiting to buy the next pullback. They should trail their protective stops below the most recent swing low only after the market pulls back to the area of the signal bar high and then rallies to a new high. Trends tend to have trending highs and lows, so once a bull trend makes a new high, traders will raise their protective stops to just below the most recent swing low. Since they expect trending lows, they want the next pullback to stay above the last. If the market begins to enter a trading range, pullbacks will fall below prior higher lows, and they will then adjust to a trading range style of trading (discussed in book 2).

If there is a gap open that is more than just a few ticks and the first bar is a strong trend bar (small tail, good-sized bar), trading its breakout in either direction is usually a good trade. The first bar of every day is a signal bar for a trend from the open bull day and a trend from the open bear day, depending on the direction of the breakout of the bar. If you enter and your protective stop is hit on the next bar, consider reversing for a swing trade because the market will usually move more than the number of ticks that you lost on the first entry, and there is always the possibility that it could develop into a trend from the open day.

Even if there is not a gap open, a trend bar for the first bar is a good setup for a trade; but the chance for success is higher if there is a gap, since the market is more overdone and any move will tend to be stronger.

FIGURE 23.1 Buy the First Pullback in Strong Trend

The market formed a bull trend from the open in Figure 23.1, and the bar 2 break below the trend line was the first pullback. Traders bought on a stop at one tick above its high, even though it was a weak signal bar (bear close, but at least the close was above the midpoint). Aggressive bulls bought on a limit order at the low of the bar before bar 2, anticipating a failed micro channel breakout and higher prices.

It was reasonable but aggressive to short below the first bar of the day because it was a bear trend bar and there was a gap up, and there was room to the moving average and to yesterday's close. However, yesterday ended with several strong bull trend bars in the final hour, which is a sign of buying pressure. When there is any doubt, especially on the open, it is better to wait for more information or until one side is trapped. The problem with this initial short is that most traders would not have been able to change their mind-set quickly enough to reverse to long above bar 2. They would have been trapped out; most would have waited to buy above the first pullback, and that later entry would have cost them several points of profit.

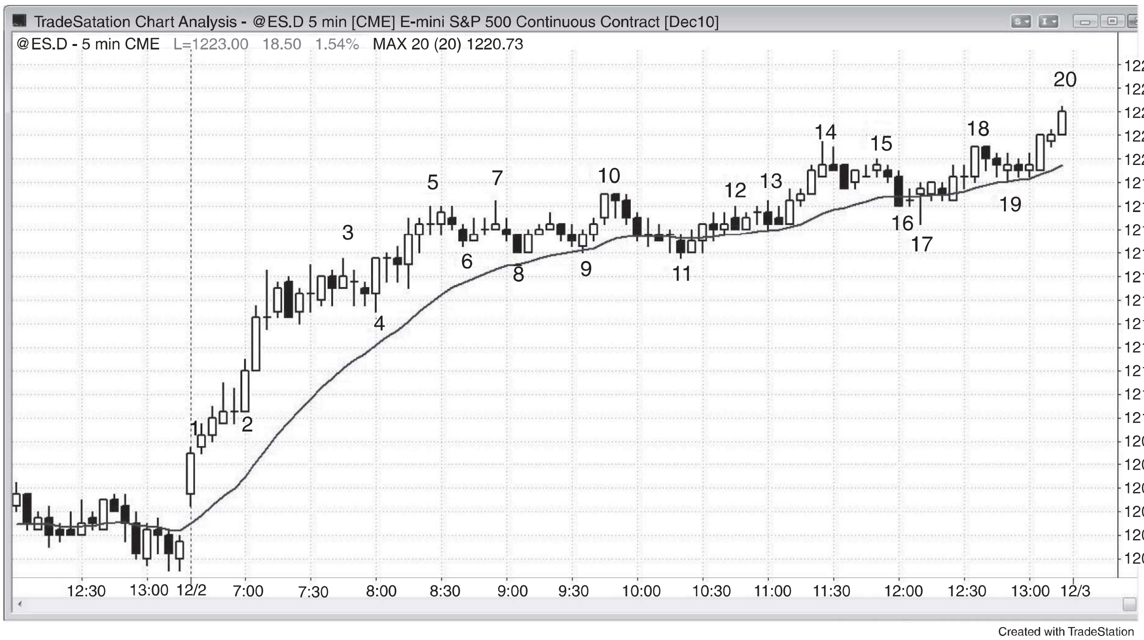

FIGURE 23.2 Small Pullback Bull Trend Day

A trend from the open day is the strongest type of trend day, and a small pullback day is the strongest type of trend from the open day. Trend from the open days occur about once or twice a week, but small pullback days (seen in Figure 23.2) form only once or twice a month. The average daily range in the Eminis had been about 12 points, and by bar 9 the biggest pullback of the day was only nine ticks. The pullback to bar 11 was only 11 ticks. Smart bulls saw this and therefore placed limit orders to buy maybe from six to 10 ticks down from the most recent high. Their initial stops might have been a couple of points. The market tried to create a larger pullback in the move down to bar 17 but could not drive the market down more than 14 ticks. Bulls saw the large bull trend bar before bar 14 as a possible buy climax, and many exited longs. A sudden surge that was likely to be followed by a pullback is a great opportunity to exit at a very good price that was likely to be brief. Other experienced traders shorted the close of the bar and the close of bar 14 and the next bar, since they had tails on the top, which is a sign of selling pressure. These traders expected a two-legged pullback lasting about 10 bars, and almost certainly a test of the moving average, since the market already tested it at bars 9 and 11. On a small pullback trend day, the market usually has a pullback sometime after 11:00 a.m. PST that is about twice the size of the largest pullback of the day.

There was a 20 gap bar long above bar 9 and the bulls bought the moving average tests at bars 8, 9, 11, 13, 17, and 19. There was not a strong sell signal all day, but aggressive bears could have scalped below the inside bar after bar 14. However, most traders instead would have looked to buy pullbacks instead of shorting new highs since this was such a strong bull trend day.

The market had a strong bull spike up from bar 2 and then the rest of the day was a bull channel. Traders became always-in long on bar 2 or on the strong bull trend bar that followed. Most of the channel was a slightly upward-sloping tight trading range with very little price gain, which is often the case on small pullback days. The high of the day was only four points above the bar 5 high at 8:25 a.m.

As is the case with all strong trends, most of the buy signal bars looked bad. This kept bulls from buying, trapping them out, and they ended up having to chase the market higher. It also kept shorts from exiting, and they were trapped into larger and larger losses. There were also many bear trend bars and bear spikes. This selling pressure made beginning traders look for reversal setups and not take buy signals. Experienced, unemotional traders understand that bad buy signal bars and bear trend bars in a trend day with very small pullbacks are signs of a very strong bull trend. They made sure to buy despite the weak setups. They bought on bar 2 as it broke above the doji high 1 signal bar. They bought again as bar 4 reversed up into an outside bar after forming a double bottom with the bull reversal bar from seven bars earlier. They bought the high 2 above bar 8 and above the bull bar that followed it, which created a two-bar reversal.

Bar 9 was a triangle (bars 6 and 8 were the first two pushes down) in a bull trend day and therefore a bull flag buy setup. They bought above the bar 11 bear trend bar that closed below the moving average, because it was a failed one-tick breakout below the bars 8 and 9 double bottom. It was also a pullback from the breakout to bar 10 of the triangle. At this point, the market was in a trading range, so most bulls would not have exited on a breakout below. They know that most breakout attempts fail and that most trading ranges in bull trends are bull flags and will ultimately break out of the top of the range. Most bulls either would have exited their longs below the bear bars after bar 10 or would have used the bottom of the most recent bull spike for their protective stops. For example, they might have had their stops at one tick below bar 4 or below the outside up bar that formed three bars later.

Usually, when there is a bear micro channel, like the one from bar 10 to bar 11, it is better to buy a pullback from the breakout, but there is a sense of urgency when the trend is strong, and smart traders are unwilling to wait for perfection because they don't want to risk missing the move. They also bought above the bear bar after bar 13, even though it had a bear body. It was a high 2 buy setup (the high 1 was the bull bar after bar 12) and a second-entry breakout pullback buy setup from the breakout above the bear micro channel down from bar 10 (the high 1 was the first setup). They bought again as bar 17 became an outside up bar, even though it followed a small doji bar and a big bear trend bar. The moving average was continuing to contain all sell-offs. They bought above the bar 17 bull doji, and above the bull bar that followed it. They bought above the bear bar after bar 19 because it was another small high 2 at the moving average. It was a bear bar, and the first leg down was made of the two bear bars after bar 18. Others bought on a stop above bar 19 because it was a bull bar in a pullback to the moving average in a strong bull trend.

The market spent most the day trying to reverse down, running stops on the bulls and trapping beginners into losing shorts, but relentlessly forming higher highs and lows, opening near the low of the day and closing near the high of the day. The buy setups all looked like they were low probability, and this trapped inexperienced bulls out. However, experienced traders knew what was going on and bought every sharp sell-off all day. They realized that, as bad as the long setups looked, the trend was so strong that the probability of success was much higher than it appeared.

FIGURE 23.3 A Small Pullback Day Is the Strongest Type of Trend

When there is a trend from the open and all of the pullbacks are less than 20 to 30 percent of the recent average daily range, the day is a small pullback day, which is the strongest type of trend day. There is usually a pullback later in the day that is about 150 to 200 percent larger than the size of the earlier pullbacks, and that was the case here in the OIH (see Figure 23.3). Any sideways movement was a pause and a type of pullback and was a buy setup. The ii breakout at bar 1 was a good entry, and the bar 3 breakout of the two-legged sideways correction was another. Finally, there was the tight trading range breakout at bar 4. All of these entries should be considered to be part of the first up leg and not a first pullback, which comes after the first leg and sets up the second leg. Rarely, days just don't seem to pull back and traders are forced to enter on breakouts from even brief sideways pauses. The reality is that on strong days like this you can just buy at the market at any point, trusting that even if there is a reversal, the odds are overwhelming that the market will make another high before the pullback retraces very far. Many traders buy the closes of bull and bear trend bars and at or below the low of the prior bar.

FIGURE 23.4 The First Trend Line Break Usually Fails

In a strong trend, determining which pullback is the first significant pullback is often difficult to do. When that is the case, the odds are very high that your trade will be profitable because an unclear pullback means the countertrend traders are very weak. In Figure 23.4, bars 2 and 3 were tiny pullbacks that did not break a meaningful trend line. The first pullback to break a trend line was bar 4. The first trend line break has a very good chance of being followed by another trend leg and is therefore a great entry (like shorting below the bar 4 bear trend bar). Today was a small pullback type of trend from the open bear trend day.

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FIGURE 23.5 Strong First Bar Can Trap Traders in the Wrong Direction

Sometimes the first bar of the day can trap traders into entering in the wrong direction, and the day can then become a strong trend day in the opposite direction. In Figure 23.5, the market gapped below yesterday's low and broke out of a large trading range formed over the second half of yesterday (a head and shoulders top bear flag). The first bar today, bar 9, was a bull trend bar, which usually would lead to a partial gap closure or even a bull trend. Many went long on a stop at one tick above its high. However, the market trapped those longs two bars later when it traded below its low. That bull trend bar trapped bulls in and bears out because traders assumed that its strength was a sign that the market was going to try to close the gap and maybe become a bull trend day. It tried to reverse up from the breakout below yesterday's trading range and from breaking below the trend channel line. You have to be very flexible on the open and assume that the exact opposite of what you believed a minute ago can happen. You want to be able to see what is happening as early as it is happening so that you can enter as early as possible. The market tried to reverse back up above the trend channel line and failed, and this two-bar breakout pullback could lead to some kind of measured move down. If the day becomes a trend day and you miss the earliest entry, there will be chances to enter all day long.

Bar 10 provided a great opportunity to go short at one tick below the low of the bar 9 bull trend bar because this is where most of those trapped longs would get out, driving the market down. Also, any potential buyers would be waiting for more price action, so there were only sellers in the market, making for a high-probability short. Shorts added on at the bear flags along that way that trapped other early longs into believing that the market was bottoming.

Traders became confident that the market was always-in short by the close of bar 11, which confirmed the downside breakout. Many traders were confident of the always-in trade at the close of the bear breakout bar, just before bar 11.

Despite all of the reversal attempts, the market closed on its low. This is a good example of why it is important to try to swing at least part of your trade when you see a strong trend from the open day. If you do take long trades, you have to force yourself to get back on the short side as you exit your longs because you don't want to miss out on a huge short just to catch a small long.

Deeper Discussion of This Chart

Bar 12 was a strong bull reversal bar in Figure 23.5, but it largely overlapped the prior two bars and therefore it was part of a small trading range and was not functioning as a reversal bar, despite its appearance. Reversal bars always have to be judged in context, and when they overlap the prior bars by too much they are part of a small trading range, and buying above a trading range in a bear trend is a losing strategy. Smart traders are doing just the opposite. They have limit orders to go short at and above the high of the prior bar, even if the bar has a strong bull body.

Bar 13 was a low 2 short setup but the signal bar was a small doji. A doji is a weak signal bar, and weak setups often mean that the market is not yet ready to break out. However, in a strong bear trend like this, you can short for any reason and just use a wider stop. You could also go short below the bar 12 or bar 11 lows. In a strong bear trend, you can sell below the lows of bars and below swing lows and expect to make a profit.

Bar 14 was an attempt to reverse up after the failed low 2 and was therefore the third push up. The doji after bar 11 was the first push and bar 12 was the second. A third push up in a bear flag creates a wedge bear flag, so it is reasonable to short below its low.

This bar 14 failed low 2 buy setup illustrates one of the worst things that a trader can do, which is buying above a weak bar in a bear flag in search of a scalper's profit. You will not only lose on the scalp, but your mind-set will be that of a buyer. You will not be mentally prepared to short the breakout of the bear flag, which has a much higher chance of success and is more likely to result in a swing trade and not just a scalp.

The bar 15 breakout bar was a strong bear trend bar and a statement that the bears controlled the market. When there is a strong bear breakout like this, there will usually be at least two more legs down in the form of a bear channel, and those two additional legs often create a wedge bear flag. This usually leads to a two-legged correction, as it did here in the rally to the moving average at bar 22.

Bar 22 was a bear reversal bar at the moving average and a low 2 short. It was also a 20 gap bar short and a wedge bear flag where the push up to bar 19 was the first leg up in the wedge.

The market sold off to a new bear low at the two-bar reversal at bar 25. It was also a reversal up from a one-bar final flag and a high 2 buy signal at the bottom of a developing trading range.

Bar 27 was a strong bull trend bar and an attempt to form an upside breakout, but it formed a double top bear flag with bar 22.

The bar 28 ii pattern became a final flag as the market reversed down from the small bar 29 lower high and moving average gap bar short setup.

Bar 30 was a two-legged higher low test of the bear low.

The bear rally ended with a wedge bear flag at bar 35, where bars 27 and 33 were the first two pushes up. The higher highs trapped bulls in and bears out, but alert traders were prepared for the bear day to resume, and they noticed how bar 35 missed the breakeven stops on the shorts below bar 11. This means that the strongest bears were reasserting themselves. They took over the market on the strong bar 15 bear spike; they were sitting on the sidelines, waiting for a test, and then they appeared out of nowhere and drove the market down into the close.

Created with TradeStation

FIGURE 23.6 Gaps Can Lead to Trends Up or Down

Here, in Figure 23.6, are three consecutive gap openings but with different results, even though the first bar on each day was a bear trend bar. Bars 1 and 9 were also gap openings on the daily chart.

Bar 1 had no tail at the top and a small tail on the bottom and was a large bear trend bar, which is a good short setup on a day with a large gap up open. It was followed by a strong bear entry bar. If the first bar of the day is a strong trend bar (see thumbnail), there will usually be follow-through, and when the first two bars are strong, an attempted reversal up usually becomes a lower high, as it did here. A large gap up with strong selling usually becomes a trend from the open bear trend day. There was a sharp rally to bar 3 that tested the open, but this failed opening reversal resulted in a lower high or a double top, and then a lengthy down move.

Bar 2 was an attempt to form a breakout pullback from the breakout above yesterday's high, but the bears were too strong and the rally failed at bar 3.

Two bars after bar 6 was a strong bull reversal bar, and an opening reversal after a bear trend bar on the open broke below the bull channel of the final two hours of the day before. A bull channel is a bear flag, and the bull reversal bar that formed two bars after bar 6 was an attempt to have the breakout of the bear flag fail. Shorting below the first bar of the day was risky here, even though it was a bear trend bar, because the bar was at the level of a trading range at the end of yesterday and shorting at the bottom of a trading range is usually a losing strategy, especially in a market where there is no clear direction (a trading range).

The sharp rally up to bar 7 tested the close of the prior day and formed a lower high or a double top. The bear signal bar made this a good short. Pullbacks happen when bulls take profits. Why do traders ever take profits when a trend is strong? Because no matter how strong a trend is, it can have a deep pullback that would allow traders to enter again at a much better price, and sometimes the trend can reverse. If they did not take at least partial profits, they would then watch their big profit disappear and even turn into a loss.

Bar 9 gapped below the low of the prior day and formed a bear trend bar, but it had big tails, indicating that traders bought into the close of the bar. The second bar was a bear trend bar with a close on its low, indicating that the bears were strong, but it was followed by a strong bull trend bar, forming a reversal. Although the long did not trigger, this was again evidence that the bears lacked urgency. When the gap is this large, everyone knows that the behavior is extreme and if there is no immediate follow-through, the market will reverse quickly to undo this extreme situation.

Bar 10 was a large bear trend bar and therefore a sell climax. The next bar was an inside bar and this created a breakout mode situation. If there was no immediate follow-through selling, the bears would aggressively begin to buy back their shorts and look to sell higher, and bulls would buy, hoping for a low of the day. The market had been in a large bear channel for a couple of days and it was at the bottom of the channel, so there was a good chance that it would reverse up and a smaller chance that it would break through the bottom of the bear channel and form an even steeper bear trend. The channel lines are not shown, but the bear trend line is above the bar 1 and bar 7 highs and the bear trend channel line is a best fit line that could be drawn along the bar 4 and bar 8 lows. Bulls also bought above bull trend bars, like above the bull trend bar before bar 10 and the bull trend bar that formed two bars after bar 10. They would also buy above the small inside bar after bar 12, since that would be a failed low 2. Since this is a possible reversal up from the low of the day and the bottom of a two-day bull flag (a bear channel is a bull flag), it is a good buy setup.

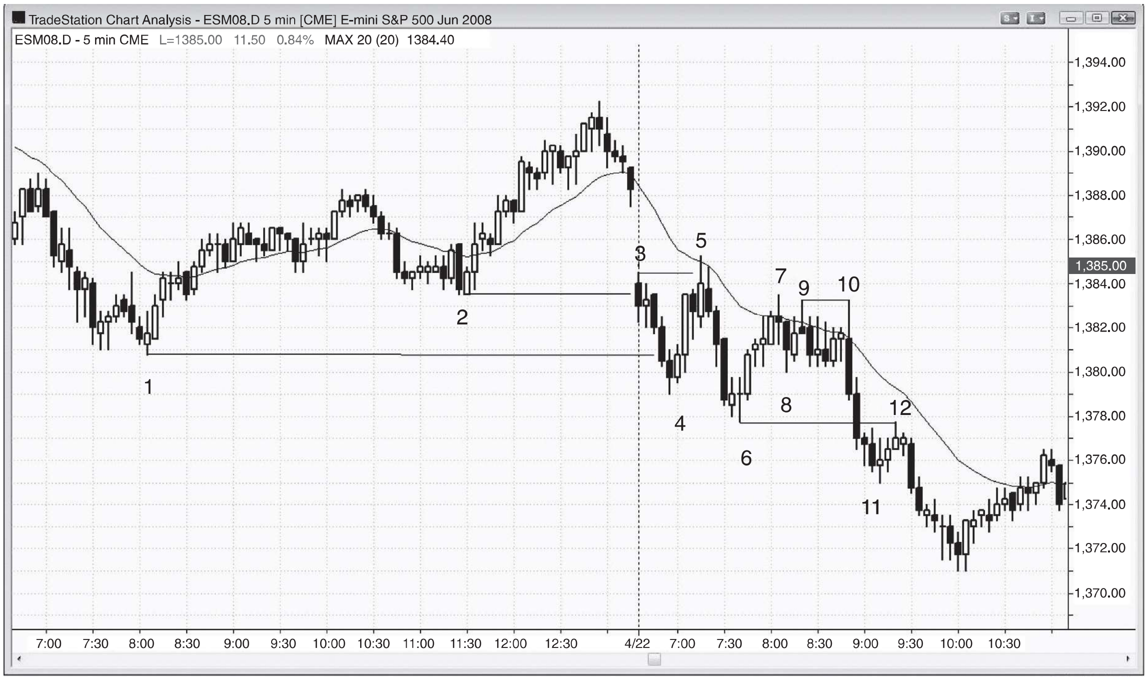

FIGURE 23.7 First Bar on Gap Day Often Points to Trend's Direction

The market in Figure 23.7 opened with a moderate gap down, which can be near the high or low of the day. Bar 3 was the first bar and it was a bear trend bar and a possible start of a bear trend from the open. The market failed to reverse the bar 2 swing low from yesterday so it would likely test the next level of support from yesterday, which was its low at bar 1. A trader would place an order to go short at one tick below the low of bar 3. Once the market fell below yesterday's low, it was likely to try to reverse up again, at least briefly, so a trader would place an order to go long on a stop at one tick above the first good signal bar. Although some traders would buy above bar 4, it was a bear trend bar with a close below its middle. It would be safer to wait until the next bar closed to see if a better setup would develop. The bar had a good-sized bull body and it formed a two-bar reversal with bar 4. The entry is above its high. In general, it is always better to buy above bull trend bars, especially when trading countertrend.

If the buy order wasn't filled and the next bar had a lower low, traders would try to buy above its high since they would be looking for a failed breakout below yesterday's low to form an opening reversal. However, if the market fell much further without a good buy setup, traders should only trade shorts until after a rally breaks a trend line.

The market made a small two-legged rally to the moving average and above the high of the day, where it set up a double top bear flag at the moving average. The large bull trend bar that broke above the bar 4 reversal was followed by a bear bar, which is bad follow-through and a signal that the market might be forming a trading range instead of a bull trend. The market continued in a trading range until midday. Up to that point, the range was about half the size of an average daily range. This alerted traders to the possibility of a breakout, an approximate doubling of the range, and the formation of a trending trading range day. The breakout began with the strong spike down from bar 10. Although not shown, the day ended with a strong reversal, as is often the case on trending trading range days, and it closed back in the tight trading range that began at bar 7. Tight trading ranges are magnets and tend to pull breakouts back into them.

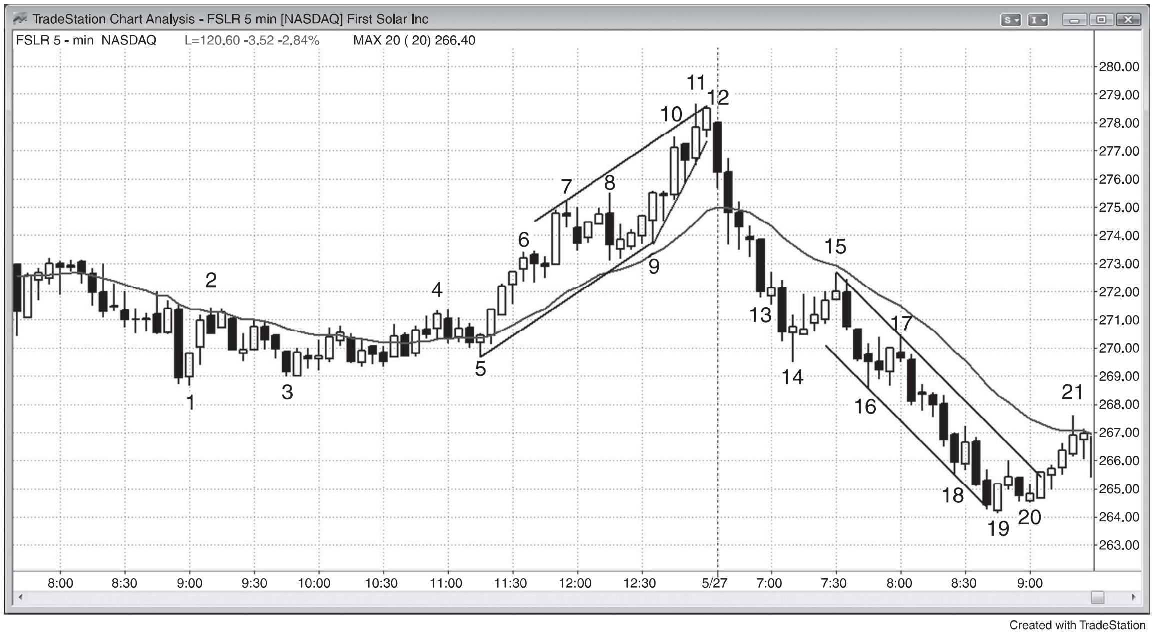

FIGURE 23.8 Open on High Tick of the Day

Sometimes, a trend from the open day opens on the highest tick of the day. In Figure 23.8, bar 12 was the first bar of the day and it opened on its high tick and broke out below the wedge from yesterday's close. Most traders would not be nimble enough to sell below the inside bar at the end of yesterday, but it would be reasonable to sell a small position on the close of the first bar. If you missed the first entry, you could look at a 1 minute chart for a small pullback (there were many) to short or simply wait for a 5 minute setup. When there is a trend from the open, selling the first pullback is a high-probability trade, even though it is hard to take since you are selling near the low of a big move down in this case. Bar 15 was the signal bar for that first pullback short, and it was also a pullback that reversed down just below the moving average. The shorts were so eager to get in that they were selling below the moving average without waiting for the market to actually touch the moving average. Some traders would be afraid to short after five bars with bull bodies, but the bodies were small and this was the first pullback after a strong bear spike and therefore a reliable low 1 short setup. It was also a moving average test and a double top bear flag with the bar 13 high.

The day became a spike and channel bear with the bear channel beginning at bar 15 and also at bar 17 and ending at bar 19. The market rallied into the close and did not close on the low.

Deeper Discussion of This Chart

There was other spike and channel behavior in Figure 23.8, as is the case on most days. Bar 12 and the bar after it formed a spike, as did bar 13 and the bar before bar 14, and the entire move down to bar 14 was a spike. The two bars after bar 15 formed another spike, which was followed by the channel that began with the bar 17 low 2 and ended at bar 19.

Bar 16 was also a breakout pullback from the breakout below bar 14 and bar 1. It was also close enough to a breakout below yesterday's low to behave like a pullback from an actual breakout (close is close enough). The eagerness of the bears to short prevented that first pullback from reaching the moving average. They were afraid that it might not get there and therefore shorted so heavily on the approach that it never reached the moving average target. When the pullback turns back down just below the moving average, the bears are very aggressive and have a sense of urgency. They are very eager to short, even at relatively low prices, so lower prices are likely to follow.

Bar 19 was a spike up, and a channel up began with the bar 20 higher low. The bar after bar 20 was also a spike that ended with a three-bar channel at bar 21, the final bar on the chart.

Yesterday also had spike and channel activity, such as the spike up to bar 2 and the channel that began with either bar 3 or bar 5. The move from bar 5 to bar 6 was another spike, as was the bar before bar 7. The channel for both began with the bar 8 low. The entire move up from bar 5 to bar 7 was probably a spike on a higher time frame chart.

Yesterday's bull channel into the close poked above the trend channel line, which was drawn as a parallel of the bull trend line from bar 5 to bar 9. Once the market reversed back into the channel on the bar 12 first bar of the day, it was likely to poke through the bottom of the channel at a minimum. The next target is a measured move down using the vertical height of the channel, and the target after that is the bottom of the channel from yesterday, which was the bar 8 low. Since the move up to bar 11 had a wedge shape and the market tested below the start of the wedge, the next downside target is a measured move down. Use the height of the wedge (the bar 11 high minus the bar 8 low) and subtract that from the bar 8 bottom of the wedge. This target was exceeded during the sell-off below bar 17.

Bar 19 was a reversal up from a second break below a bear trend channel line (drawn parallel to the bar 15 to bar 17 trend line), so two legs up were likely. Bar 18 tried to reverse up from a tiny poke below the trend channel line, but the market never went above the high of the two-bar reversal so there was no long entry.

It is important to realize that although yesterday ended with a wedge top, there was still a strong bull trend into the close. This made beginning traders look for an additional rally on today's open, and deny the unfolding reversal. Always be ready for the opposite of what might appear likely, because it will happen in about 40 percent of the time.

FIGURE 23.9 Reversal after Trend from the Open

Not all days that begin as trend from the open days result in strong trend days in the direction of the initial trend. In Figure 23.9, the day started as a bear trend from the open. It gapped below yesterday's low but then pulled back and almost closed the gap, and bar 1 became a breakout pullback short setup. The market sold off for five bars and set up a first pullback short below bar 3, but it then entered a tight trading range instead of immediately triggering a short. Although a scalp was possible, the market reversed up in a higher low at bar 4.

Deeper Discussion of This Chart

In Figure 23.9, bar 1 was a breakout pullback short following the breakout below yesterday's closing trading range. The initial sell-off down to bar 2 was around 12 points, which was about the average daily range recently. Once the market reversed back above the high of the open and broke to the upside, a measured move up was likely. Sometimes the market will make a measured move up equal to the open of the day to the low of the day and then close back down near the open, creating a doji day on the daily chart. Other times the measured move up is equal to about the height of the entire initial leg down. The bar 17 high of the day was three ticks below that measured move target. That reversal up above the opening range created a large bottom tail on the daily chart. When the market turns down from about a measured move up from a large opening range, it often comes back down and the day closes somewhere in the middle of the range, as it did here.

The spike up from bar 4 to bar 5 was also a good basis for a measured move, but it did not happen here. Instead, the market went one tick higher than a leg 1 = leg 2 move where leg 1 was from bar 4 to bar 5 and leg 2 was from the bar 6 low to the bar 17 high of the day. The sell-off into the close was also a test of the bar 6 bottom of the bull channel that followed the spike up.

The two-bar spike down from bar 15 was followed by a pullback to a higher high at bar 17, which was the start of the bear channel. Sometimes the pullback after the spike down can be a higher high, but when it is, there is usually another spike down after the pullback. Here, the large bear inside bar after bar 17 was a spike down, and the move down from bar 18 formed another spike down, with the large bear trend bars being the most influential. The three-bar move down to bar 13 was also a bear spike and therefore probably had some influence on the sell-off that eventually followed. When the market starts to form many bear trend bars, it is accumulating selling pressure, and it often is able to overwhelm the bulls eventually, as it did here.

FIGURE 23.10 Strong Trends Have Weak Setups

Figure 23.10 shows a trend from the open bull trend day, but why are the best trends so difficult to trade? Because most of the with-trend entries look weak and there are many small pullbacks that trap traders out of the market. None of these pullbacks would have hit a two-point money stop, which is usually the best stop to use in a strong trend. With so many small, sideways bars, price-action stops below the lows of prior bars get hit too often and it makes more sense to rely on the original two-point stop. When the trend is strong, you need to do whatever you can do to stay long. Strong, relentless trends are often made of small bars with tails and lots of overlap but very small pullbacks that are mostly sideways pauses.

With a large gap up on the open, the odds favored a trend day up or down, and a larger gap like this makes a bull trend more likely. Because there was no significant selling in the first several bars, there was a possibility of a bull trend from the open, so traders had to be looking long. The market moved up quietly all day because institutions had buy orders to fill, and they filled them in pieces during the day because they were afraid that a pullback might not come and they needed to buy. Their constant buying prevented a significant pullback from forming. They don't buy all at once because they might create an exhaustive buy climax and a significant reversal to well below their purchase price. Also, as the market is going up, they are receiving additional buy orders throughout the day as investors become more confident.

Deeper Discussion of This Chart

In a strong trend such as that shown in Figure 23.10, you can buy for any reason and at any time. Buying above pullback bars is reliable, but you can also place limit orders to buy at or below the low of the prior bar. Shorting below bars is a loser's strategy. If you were to look for shorts, you should short only above the highs of bars or at the close of strong bull trend bars. When a day is this strong, most traders should not short, because shorting would probably be a distraction and result in missing buy setups, which are swing trades in a strong trend and therefore more profitable than scalps.

Bar 3 was the first bar of a two-bar spike up, and the market corrected sideways in a tight trading range before the channel up began. The very strongest trends tend to create reversal patterns all day long, but they somehow don't look just right. However, they constantly trap early bears into shorting, thinking that the small bars mean small risk, but after four or five small losses, they are so far behind that they will never catch up. You cannot take a trade simply because the risk is small. You need to consider the probability of success and the size of the profit target as well.

Bears saw bars 5, 7, and 9 as a three-push pattern and therefore a wedge variant, and they then saw bars 7, 9, and 10 as another wedge. When the correction from a wedge is sideways instead of down, you should conclude that the trend is very strong; stop looking for reversals and only trade with trend.

Bar 14 coincided with a Federal Open Market Committee (FOMC) report, and the market sold off sharply but immediately reversed up after missing the bar 5 high by one tick.

Going into the close, there were several two-bar bull spikes (bars 16, 17, and 21 were the first of the two bars in each spike).

A strong trend like this sets up reversals all day long, but the setups are never quite right and they almost always fail. The wedge that ended at bar 9 was in a tight bull channel composed almost entirely of bull trend bars. The market had not hit the moving average in over two hours. The odds were high that there would be buyers there, so there was little to be gained by shorting. Bar 10 broke above the trend channel line but it had a bull body. Again, the channel was very tight with no prior bear strength. You could only short a second signal and only if there was some prior bear strength, like a five- to 10-bar pullback to the moving average. In the absence of that, any short is a bet that the market would do something that it had not done all day. The biggest pullback all day was only nine ticks. If you short below a bar, your entry is about five ticks down and you need the market to go another five ticks down for you to make a one-point scalp. Since the market has tried to pull back repeatedly and could not fall more than nine ticks, betting that your short would now succeed is a very low-probability trade. You can scalp for one point and risk six or seven ticks only if the probability of success is 60 percent or higher, so you cannot short this market. You could argue that the move to bar 12 broke the bull trend line and therefore it was acceptable to short the bar 13 higher high, but the market still had not yet pulled back to the moving average, which is just six ticks below, and there would certainly be buyers there. Also, bar 13 was the fifth consecutive bull body and that represents too much strength to be shorting.

On most strong trend days, there is usually a sharp, brief reversal between 11:00 a.m. and noon PST that shakes out weak longs and traps overly eager bears who are hoping to recoup their earlier losses. It is always attributed to some news event, but that is irrelevant. What is important is that it usually sets up a buying opportunity for those who do not get frightened by the spike down.

Today, there was an FOMC report at 11:15 a.m. When the report came out, bar 14 was briefly a bear trend bar with a large bear body. If you shorted before the bar closed, believing that the market was going to sell off hard on the report, you were ignoring a very important rule: you should wait for the bar to close, because what appears as a large bear trend bar at four minutes into the bar can become a doji bar or even a bull reversal bar by the time the bar closes.

Bar 16 was a higher low after the rally from the bottom of bar 14 to the top of bar 15, and it was followed by the bar 17 breakout pullback long entry. All spikes should be thought of as spikes, climaxes, and breakouts, so the two-bar spike that began with bar 16 was a breakout and bar 17 was the entry from the pullback.

Bar 19 was a double top bear flag, but there was no prior strong spike down so the market was more likely just going sideways after the bar 17 spike up.

Bar 20 was a bull reversal bar and a high 2 long, and bar 21, the bar after the entry bar, traded below the entry bar and trapped longs out. However, since the move up from bar 20 had gone only one tick, the protective stop was below the bar 20 signal bar and you should not tighten it too soon. Strong trend days constantly trick traders into exiting longs early and into taking shorts. The bears have to buy back their shorts, which adds to the buying pressure and removes the bears from additionally shorting for at least a bar or two. They just lost and will need to recover before they look to short again. Also, the bulls who were just trapped out will chase the market as it goes up, adding to the buying.

FIGURE 23.11 Double Top in a Strong Bear Day

A trend from the open can have a double top or bottom before the strong trend begins. In Figure 23.11, bar 7 tried to set up a bear trend from the open but the high was tested on a 7:00 a.m. report, which commonly happens. Even though the market formed a small trading range up to bar 9, you always have to consider the possibility that the market was just waiting for the report before it unleashed its strength.

The opening range was less than a third of the size of the range of recent days, and this put the market in breakout mode. Once there was a spike down and a spike up after the first bar (a reversal down and then a reversal up), some traders would enter on a breakout, expecting the range to increase severalfold. After the market fell below the bar 7 two-bar reversal, the bar 7 reversal down became a swing high. After the market moved above bar 8, bar 8 became a swing low and a reversal up. These traders placed a buy stop at one tick above the bar 7 spike top and a sell stop at one tick below the bar 8 spike bottom. Once the buy order got filled as bar 9 moved above the high of bar 7, they doubled the size of the sell stop below bar 8. As that second order got filled, as it did in the move below bar 8, they got stopped out of their longs and they reversed into shorts. This is the traditional approach to this setup, but it is generally better to be more aggressive. A better approach would have been for traders to short below the bar 7 two-bar reversal and scalp out part, and then tighten their protective stops. Next, they could reverse to long on the bar 8 high 2 at the moving average. They could scalp out part and tighten their stops. They could reverse to short below the bar 9 outside down bear bar, since there were trapped bull breakout traders and the market was forming a double top bear flag with bar 7. They could scalp out part, tighten their stops, and swing the balance until there was a clear buy signal; if there was none, they could hold short into the close. If they did buy at maybe the bar 15, 18, or 21 lows, they had to reverse to short as they took profits. If they were unable to do that, they should either continue to hold short or exit on those minor buy signals and look to short rallies.

Even though the day began with a small trading range and some traders might call this a trending trading range day or a bear trend resumption day, when the pullbacks are this small, you are dealing with a very strong bear trend. When that is the case, it is better to make sure that you are short for most or all of the day. Thinking of this as a trending trading range day will make you take longs and often miss shorts. The pullback that began at bar 15 was about twice the size of the earlier pullbacks since the trend began at bar 9. The day was not a classic small pullback trend day because those days usually don't have a larger pullback until later in the day, like after 11:00 a.m. PST, but today was still a strong bear trend day.

Deeper Discussion of This Chart

Bars 11, 13, and 15 formed a wedge in Figure 23.11, but since the market had not touched the moving average in about 20 bars and the bear channel was tight, this would likely lead to a test of the moving average where bears would short aggressively. The bulls were able to generate two legs up to bar 17, which was a moving average gap bar. The first moving average gap bar in a bear trend often leads to the final leg down before there is a larger correction up.

Since the leg up to the moving average gap bar almost always breaks a significant bear trend line, the higher low or lower low test of the bear low usually leads to a protracted correction up or even a reversal. The market tried to reverse up at bar 18 and again at the small wedge that ended at bar 21. The market created a strong two-bar bull spike up to bar 22, trapping bulls in and bears out, but experienced traders know that the market often has a strong countertrend move after 11 a.m. PST on a trend day and they would be ready to short the failure, like the small double top at bar 24. There was a bear inside bar for the signal bar and the bar 22 and 24 double top formed a larger double top bear flag with bar 17. The spike down to bar 25 was followed by a couple of strong bull trend bars, which set up the bar 26 breakout pullback short for the sell-off into the close. That reversal attempt at bar 25 was the signal bar for an expanding triangle bottom, where bars 18, 21, and 25 were the three lows. Instead, the bottom failed and bar 26 became the breakout pullback short entry bar. A failed wedge often leads to a measured move down, and the sell-off into the close came close to the target.

This turned the day into a trend resumption bear, where there was an initial bear trend down to bar 13, then a trading range that lasted a couple of hours to bar 24, and then another bear leg into the close.

CHAPTER 24

Reversal Day

Primary characteristics of reversal days:

- The day trends in one direction and then it trends in the opposite direction into the close.
- Most start as trending trading range days.
- If the reversal starts in the last couple of hours and is strong, it will usually have follow-through on the next day and often the next several days.

Some of the strongest trends begin in the middle or end of the day. Sometimes they originate as trading range breakouts or climactic trend reversals, usually attributed to some news item, but this is unimportant. In either case, the market can enter a runaway trend mode where it trends relentlessly with only minor pullbacks. There are large trend bars with little overlap and mostly small tails. This is a breakout and a clear always-in flip. You must enter quickly, even if the new trend looks climactic and overdone (and it is, but it will likely continue to get much more so!), and swing most of your position. You should trade these breakout spikes aggressively and make sure that you have at least a small position because the move can go very far. Trading strong spikes is described in detail in the section on breakouts in book 2, and reversals are discussed in detail in book 3.

At other times, the market is trending and then begins a pullback, but the pullback just grows endlessly and becomes a trend channel in the opposite direction. There is almost always at least one countertrend spike before the channel begins, so whenever you see a pullback that has a strong countertrend spike, be aware that the trend might be reversing. For example, if the market has a strong sell-off for the first hour or two and you think there might be a two-legged rally to the moving average, but that pullback begins with a fairly strong bull trend bar, make sure to consider the possibility that the bar could be a bull spike that could be followed by a relentless bull channel instead of a small bear flag. By the end of the day, the pullback can grow larger than the bear trend that preceded it, and the day could become a bull reversal bar on the daily chart. If you recognize this behavior early, you should restrict your trading to buying only, because you will lose money on shorts as you desperately hope that the bear trend from the first hour resumes. Many of these days can be classified as other types of trend days, and they are commonly trending trading range days. In fact, most reversal days begin as trending trading range days. The opposite is true for bear trends on the open that reverse into relentless bear channels.

FIGURE 24.1 Strong Trend Can Fail

A strong trend can start at any time during the day, even if the day initially had a strong trend in the opposite direction. As shown in Figure 24.1, there was a sharp two-legged move up in the first hour, followed by a tight channel pullback to test the moving average. The market then went sideways for over two hours and finally broke down at bar 9 into a lower range. The last profitable long entry was at 8:50 a.m. PST at bar 5. If you continued to take long scalps, you would eventually realize that you were losing on every trade, which is a sure sign that the market is trending in the wrong direction and either you didn't see it or you didn't believe it.

Pullbacks happen when bulls take profits. Why do traders ever take profits when a trend is strong? Because no matter how strong a trend is, it can have a deep pullback that would allow traders to enter again at a much better price, and sometimes the trend can reverse. If they did not take at least partial profits, they would then watch their big profit disappear and even turn into a loss.

Deeper Discussion of This Chart

The market in Figure 24.1 broke out above the trading range of the final hour of yesterday. The large tail on top of the first bar indicates that sellers were reasonably strong and therefore buying above it was risky. The market rallied for six bars and reversed down hard during bar 2, presumably on a 7:00 a.m. report. After the bull momentum leading up to the report and no sign of a top or a buy climax, it was not good to short below the top bar of this rally. This was the first pullback in a trend from the open bull trend and is a buy setup. However, the strength of the bar 2 bear spike was unusual if the day was to become a bull trend day.

The bar 3 low (the bottom of bar 2) formed a possible double bottom with the bar 1 low. It is common for a gap up day to have a pullback that tests the low of the open and then to become a bull trend day. Since the opening range was greater than about 30 percent of the average range of recent days, the opening range was not a good breakout mode setup. The likelihood of a strong, relentless trend after a bull breakout was less. If the market was to become a bull trend day, it would more likely be a weaker version, perhaps like a trending trading range day. The bull ii setup after bar 3 was a good signal for a long, but since a strong bull trend was unlikely, bulls should take at least half off after about two to four points' profit. It is also possible that the bar 3 strong bear spike could be followed by a bear channel after a pullback. Here, the pullback was to a higher high at bar 4, which followed buy climax bars on the bar before and two bars before that. Consecutive buy climaxes usually lead to at least a two-legged correction lasting about 10 bars. Since this was not a clear bull trend day and it had strong selling at bar 3, this bear reversal bar was an acceptable low 2 short setup.

The pullback to bar 5 broke the bull trend line, and the bar 6 lower high set the stage for a bear trend day into the close. Bar 6 was the first bar of a two-bar bear spike, which alerted traders to the possibility that a channel down might follow. The bar before bar 5 was a bear spike, as was the very large bar 3 bear trend bar. There were other bear spikes as the bear channel progressed, and the market could not close above the moving average after the bar before bar 8.

As with most strong trend channels, you would make more by swinging than by scalping because there are frequent pullbacks that would run stops on even the with-trend scalps (like the shorts from bars 8 and 10), resulting in losses. It is better to trail your stop above the prior swing high.

The bar 9 spike down that broke below the upper trading range was followed by a perfect measured move into the close. Bar 9 was a breakaway gap, the gap being between the bottom of the upper range and the bar 10 breakout pullback. The middle of that gap was the middle of the move down from bar 4 to the low just before the close of the day.

On the daily chart, this would be a doji bar with a small body and a large tail at the top, and if it is in the area on the chart where a bear reversal is likely, it can be a good signal bar for a short trade on the daily chart.

Notice that the market was forming lower highs and lows between bars 5 and 9, hinting that a bear trend might be underway.

FIGURE 24.2 Most Reversals Begin as Trending Trading Range Days

Most reversal days begin as trending trading range days as shown in Figure 24.2, and this day was also a spike and channel bear trend day and a trend from the open bear day. It reversed up after three pushes down (bars 8, 15, and 17) into a bull reversal day that trended up into the close. This is a common occurrence in trending trading range days.

Deeper Discussion of This Chart

A large gap opening often is followed by a trend in either direction, and since the first bar of the day in Figure 24.2 was a strong bear trend bar, the odds of a bear trend were greater. This is a failed breakout setup, and traders would short below its low for a possible trend from the open bear day.

Bars 4 and 5 were large bear trend bars and therefore bear spikes and sell climaxes. A pair of consecutive climaxes is usually followed by at least a several-bar pause or pullback, as happened here (a pullback to the bar 7 high). Bar 7 was then a third sell climax, and a third consecutive sell climax is usually followed by an even larger correction. The move down to bar 8 was a spike and climax type of bear trend, and it was followed by a rally to bar 10 that tested the bar 7 start of the channel down to bar 8. This formed a double top bear flag, and ultimately an approximate measured move down to the low of the day. The entire move down to bar 8 was in a tight channel and was therefore a larger spike.

After a large wedge bottom, the market usually has at least a two-legged rally that tests the top of the wedge (here, the bar 10 high), and the number of bars in the correction is usually at least a third or so of the number of bars in the wedge. This large wedge was also the bear channel that followed the bear spike from bar 4 to bar 8, and that was also a reason for the test of the bar 10 high (the beginning of a channel usually gets tested). The test may break above that high but more often forms a double top bear flag, as it did here.

When there is a wedge reversal, it is usually safer to buy after a higher low like at bar 19 or above the bar 22 failed low 2. You can see the large bull spike entry bar there, and it was a sign that traders believed that the rally was no longer just a bear flag and the market could have a measured move up and trade into the upper trading range. This was a complex day, and the wedge reversal could also be thought of as the bottom of a lower trading range on a trending trading range day. If enough traders believed that was the case, buying the first entry above the inside bar after bar 17 was reasonable, with the expectation of a test of the bottom of the upper trading range.

Bars 11, 13, and 14 formed a wedge bull flag, but the market broke to the downside instead of reversing up. When that happens, the market usually falls to about a measured move down from the top to the bottom of the wedge. Bar 10 was the top of the wedge, and the move down to bar 15 exceeded the measured move objective. When that happens, there is usually another leg down after a pullback, as was the case here.

Although the move up to bar 18 had two legs, this rally had too few bars to adequately correct that large wedge bottom. Also, it was in a tight channel and was therefore likely just the first of two or more legs up. There was a second leg up to bar 20, but the problem was the same. The move from bar 17 up to bar 20 had too few bars to correct such a large wedge and it was still in a relatively tight channel. This creates uncertainty and increases the odds that the market will need a larger second leg up to convince traders that the wedge was adequately corrected.

The move from bar 21 to bar 25 might be good enough to satisfy traders that an adequate two-legged correction was complete, but the market then broke out to the upside in a three-bar bull spike up to bar 27. Since the bears could not generate much of a downside breakout in the channel from bar 17 to bar 25, no clear two-legged move ever developed. This absence of any clear pullback after a first leg up was a sign of strength by the bulls.

FIGURE 24.3 Strong Trend Entries on Smaller Time Frames

In a runaway bull trend, there are more chances to buy on the 3 minute chart than on the 5 minute chart (see Figure 24.3). Bars 1 and 2 were small countertrend inside bars on the 3 minute chart on the left, setting up high 1 longs, but they were not clear signals on the 5 minute chart. The bar 3 long was present on both charts (on the 5 minute chart, it was a high 1 long in a strong bull spike, even though it had a bear body).

CHAPTER 25

Trend Resumption Day

Primary characteristics of trend resumption days:

- The day has a strong trend in the first hour or so and then enters a trading range.
- The trading range lasts for hours and often lulls traders into thinking that the day will be quiet into the close.
- The trend resumes in the final hour or two.
- The second leg often is about the same size as the first leg.
- The protracted trading range is often a very tight trading range.
- There is often a breakout from the trading range late in the day that tries to reverse the trend, but it is usually a trap. The market then reverses and breaks out in the opposite direction into the close. A trap is more likely when the trading range is unusually tight.
- There is often a breakout pullback entry for traders who did not enter earlier or on the breakout.

Sometimes there will be a strong trend for the first hour or so and then the market goes sideways for several hours. Whenever this happens and especially if the sideways action is in a very tight trading range, the day is likely becoming a trend resumption day. Don't give up on the boring midday trading range, because there might be a strong trend in the final hour or so. The breakout is usually in the direction of the earlier trend, but sometimes it can be in the opposite direction and turn the day into a reversal day. For example, if the trend from the open was a bear trend, there is usually a late downside breakout from the trading range, and the day often opens near its high and closes near its low. There is frequently a brief one- or two-bar strong reversal breakout that fails between 11 a.m. and noon PST, trapping traders into the wrong (long) direction, and it is usually followed by a breakout in the other direction. This happens quickly, but if you are expecting it, you have a chance of catching a big bear move into the close. Less often, the reversal breakout succeeds and the trend in the final hour, if there is one, can retrace all or part of the opening bear trend.

The midday sideways action does not have to be a tight trading range, and it often has tradable legs in both directions. Sometimes there are three countertrend lazy pushes, creating a wedge flag. At other times the third leg fails to surpass the second, and this forms a head and shoulders flag (most head and shoulders reversal patterns fail and become continuation patterns). Because the pattern often has three pushes instead of two, it traps traders out of their positions from the open, thinking that this countertrend action might in fact be a new, opposite trend. However, don't let yourself get trapped out, and be ready to enter when you see a good setup that will get you into the market in the same direction as the morning trend. Traders are scaling into positions in both directions and, at some point, many reach their maximum size. Once there is a breakout, the losing side cannot scale in anymore, and their only choices are hope and getting stopped out. For example, if there is a strong morning bear trend and then the market goes sideways, both the bulls and the bears will continue to add to their positions during the trading range over the next several hours, and many will reach the maximum size that they are willing to hold. Once the market begins to break to the downside, the bulls can no longer continue to buy. With a lot of bulls no longer able to buy, the bears are unopposed. As the market falls, it will often accelerate as more and more bulls give up and sell out of their losing longs, adding to the collapse into the close. The difficult part of this type of day is that the quiet midday sideways movement often leads traders to give up on the day when in fact they should view this as an opportunity. Just be ready to enter. The best forms of this pattern occur only a couple of times a month.

Instead of a midday trading range, the market will sometimes form a weakly trending countertrend move for a couple of hours, leaving traders wondering if the day is a reversal day instead of a trend resumption day. What might be developing is a weak trend resumption day, one that feels more like a trading range day but ends up opening on one extreme and closing on the other. Watch for the trend of the open to resume in the final hour, and be prepared to enter. For example, if there was a strong sell-off on the open, and then a lower-momentum rally with three pushes up that retraces some or even all of the initial sell-off, be prepared for a break below that bull channel and a resumption of the bear trend into the close. If there is a breakout of the top of the bull channel that reverses back down, this can be a good swing short entry for the trend into the close. Instead, there might be a setup that looks like a good low-risk short on the breakout below the channel. Otherwise, you can wait for the bear trend to resume and then look to enter on a breakout pullback or a pullback near the moving average. Even though the 5 minute chart might look like a trading range, maybe like an ABC on a higher time frame chart, if the market closes near the low, the day will create a bear trend bar on the daily chart.

Trend resumption patterns often take place over two or more days. Although the 5 minute chart might look like it has huge swings during those days, they may create a simple ABC on the 60 minute chart. For example, if yesterday had a strong bull spike for a couple of hours and then entered a trading range and that trading range continued for a couple of hours today, yesterday's trend might resume at any point. If you are aware of this, you will be more likely to be willing to swing a larger part of your position for what could be a big move.

FIGURE 25.1 Gap Test after a Gap Up

On big gap days, the market often tests the open before the trend begins. In Figure 25.1, the market opened with a large gap up and then had a double bottom test of the low followed by a big rally up to bar 3. From there, it traded in a tight range for more than three hours, lulling traders into thinking that the good trading was done. Bar 6 reversed up from a poke below a bear trend channel line and it also dipped one tick below the bar 4 signal bar high. This trapped some bears into a short and many bulls out of their longs. The signal bar for the rally into the close was the first moving average gap bar of the day.

There were several other chances to get long, like the reversal up from the failed breakouts below micro trend lines at bars 7, 9, and 10.

Deeper Discussion of This Chart

In Figure 25.1, bar 7 was a high 2 entry and a reversal up from a one-tick break of a small bull trend line. Bar 1 was the high 1 entry.

Bar 8 was a high 2 variant (bear-bull-bear bars: the bar after bar 7 had a bear body and therefore the first push down, the next bar had a bull body and therefore traded up, and then the following bar had a bear body again, for a second push down).

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FIGURE 25.2 Tight Trading Range and Then a Reversal

Sometimes a tight trading range that follows a strong trend can lead to a reversal instead of trend resumption. In Figure 25.2, today had a strong sell-off from bar 3 and then entered a tight trading range for a few hours. This often leads to a bear trend resumption into the close with the final sell-off often being as large as the initial one. There is frequently a failed breakout of the top of the range before the final bear leg begins. Bar 12 was a perfect setup for a swing short because it was a bear reversal bar that broke out of the top of the tight trading range late in the day. However, instead of the next bar being an entry bar for a large bear move, it was a small bull inside bar, and therefore a breakout pullback long setup. Bar 12 broke out and this inside bar was a pause, which is a type of pullback.

Deeper Discussion of This Chart

In Figure 25.2, the day opened with a large gap down and a strong bull reversal bar, setting up a failed breakout long and a possible trend from the open bull day.

Bars 13 and 14 were large bull trend bars that formed a two-bar breakout. Any breakout often is followed by a measured move based on the spike. It is usually based on the height from the open or low of the first bar of the spike to the close or high of the final bar. The closing high of the day was at a measured move from the open of bar 13 to the high of bar 14.

Most trend resumption bear days do not have a large rally on the open, and that large rally is an indication that the bulls were willing to buy aggressively today. Even though the middle of the day was setting up perfectly for a big sell-off into the close, you can never be certain and there is always about a 40 percent chance that the exact opposite can happen. Another clue that the market might rally to test the open of the day was that the low of the day was almost a perfect measured move down from the open of the day to the top of the initial rally. That means that the open of the day was in the middle of the day's range. If the market could get back up there, the day could be close to a doji day, which is fairly common. Notice how the market repeatedly tested the support line at the bar 7 low to the tick and continued to find buyers. There were double bottom pullback long setups at the inside bar after bar 8, the inside bar after bar 9, and the higher lows at bars 9 and 11.

The support line was one tick below the initial bar 5 entry bar for the expected pullback from the sell climax. Bar 5 was the entry bar above the two-bar reversal setup at the low of the day. The market ran the stops below that entry bar by one tick, but, despite many attempts, it could not go any further down. This is a sign of strong bulls at work. Both buy and sell programs continued throughout the tight trading range, but eventually the buy programs overwhelmed the sell programs. All of those shorts had to be bought back, and this added to the buying pressure. Also, many sell programs reversed to buy programs, adding to the buying. The bars 14 and 15 spike up was followed by a channel into the close.

Created with TradeStation

FIGURE 25.3 Trend Resumption

Even though the initial rally may only have a couple of strong trend bars and appear to be leading to a trading range day, the trend resumption can still be strong. In Figure 25.3, the market started as a trend from the open bull trend when it rallied from an expanding triangle bottom and a failed breakout of yesterday's low. It then ran for two bars, but it stalled in the middle of yesterday's trading range. A rally from any three-push pattern usually results in at least two legs up, which ultimately developed here. Bar 2 was a breakout pullback that led to another small rally, but then the market lost momentum. It continued to weakly trend above the moving average until bar 3. At this point, it was clear that something was not right. A trend from the open bull trend is one of the strongest forms of trends but this was clearly not trending strongly. That meant that traders would soon decide that the day was not what they thought and they would exit and wait. They would then be looking for a trading range day and a possible new low for the day. It was possible for the bar 2 low to be followed by a double bottom bull flag, but, in the absence of strong early bulls, bears would aggressively push for a new low of the day and the bar 2 low would likely fail. Bar 4 was a second small push below bar 2 and it was followed by a trend into the close, creating a trend resumption bull day, albeit a weak one, and giving the expected second leg up from the expanding triangle bottom. Bar 4 was an exact breakout test of the trend from the open signal bar high.

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FIGURE 25.4 Trend Resumption after Several Days

Trend resumption can take place over the course of several days. In Figure 25.4, the market had a strong move down to bar 2 and then entered a trading range that lasted two and a half days. Trading ranges can last a long time, but usually break out in the direction of the trend. The bear trend resumed and had a second leg down from bar 5 to bar 14, five days after the first move down.

The bear leg down from bar 5 to bar 6 was followed by a trading range, and the second leg down ended on the open of the next day at bar 9.

The sell-off from bar 7 to bar 9 was followed by a trading range to bar 13, and the bear trend resumption occurred with the move down to bar 14. This was a three-day trend resumption pattern.

CHAPTER 26

Stairs: Broad Channel Trend

Primary characteristics of stairs days:

- A stairs day is a variant of a trending trading range day where there are at least three trading ranges.
- The day has broad swings, but trending highs and lows.
- Because the swings are large, traders can usually place trades in both directions, but they should try to swing part or all of their with-trend trades.
- Almost every breakout is followed by a pullback (a breakout test) beyond the breakout point, so that there is some overlap between consecutive swings. For example, in a broad bear channel, every breakout to a new low is followed by a rally that goes back above the breakout point but stays below the most recent swing high. However, there is sometimes a swing or two that will extend above the prior swing high by a little. This will make some traders wonder if the market is reversing, but the trend will usually soon resume.
- If each breakout gets a little smaller than the prior one, then this is a shrinking stairs pattern and a sign of waning momentum, which can lead to a larger correction.

When a market has a series of three or more trending swings that resemble a mildly sloping trading range or channel, both the bulls and the bears are active but one side is exerting somewhat more control. Each pullback retraces beyond its breakout point, creating overlap between each breakout spike and the following pullback. Two-way trading is taking place within the broad channel, so traders can look for entries in both directions. If the breakouts get smaller and smaller, then this is a shrinking stairs pattern and indicates waning momentum. It often leads to a two-legged reversal and a trend line break. Many three-push reversals qualify as stairs or shrinking stairs trends that failed and reversed. Stairs are often just pullbacks or flags in higher time frame trends, and it is common to see stairs over the final hour or two of the day and then a breakout of the flag on the open of the next day. For example, a broad bull channel today might just be a large bear flag, and the bear trend could break out tomorrow.

Alternatively, one stair might suddenly accelerate and break out of the trend channel in the with-trend direction. If it then reverses, this overshoot and reversal will likely result in at least a two-legged move. If it does not, the breakout will probably continue for at least two more legs or at least the approximate height of the channel in an imprecise measured move (the distance beyond the channel should be about the same as the distance within the channel).

Traders pay attention to how many ticks breakouts run past the most recent swing point, and then use that number to fade subsequent breakouts, expecting a breakout test. For example, if the last swing low fell 14 ticks below the swing low before it, traders will look to scale into longs beginning around 10 ticks below the most recent swing low, which will usually be around the trend channel line. If the pullback from the most recent breakout was about 15 ticks, they will look to take profits around 10 to 15 ticks up from the low, which will usually be around the trend line (the top of the bear channel).

FIGURE 26.1 Bear Stairs

A bear stairs pattern is a downwardly sloping channel where each breakout to a new low is followed by a pullback that goes back above the breakout point. For example, in Figure 26.1 the breakout leg below bar 6 down to bar 9 was followed by a pullback that went back above the bar 7 low, and the rally after the leg that broke below bar 9 down to bar 13 was followed by a pullback that went above the bar 9 breakout point, overlapping the prior range.

Some traders buy near the trend channel line and short near the trend line. Other traders pay attention to how far a breakout goes before there is a pullback. For example, the low of bar 5 was about four points below the low of bar 3. Aggressive bulls placed limit orders to buy at about three to four points below the low of bar 5. They were not filled on the sell-off to bar 7. However, as the market fell below bar 7, they again placed limit orders to buy three to four points lower, and were filled on the move down to bar 9, which had a low that was four points below the low of bar 7. Since prior rallies were about four points, they took profits at around three points above their entries. They did the same on the sell-offs to bars 11 and 16. They tried on the sell-off to bar 13, but the market did not fall far enough for their orders to get filled. Bears did the opposite. They saw that past rallies were about four to six points, so they scaled into shorts around three to five points above the most recent swing low, which was in the area of the bear trend line. This style of trading is only for experienced traders. Beginners should restrict themselves to stop entries, so that the market is already going their way (this is discussed in the second book).

Bar 7 was the third push down and a shrinking stair (it extended less below bar 5 than bar 5 extended below bar 3). The channel lines are drawn as best fit lines to highlight that the market is trending down and in a channel. There is clearly two-sided trading and traders should be buying the lows and selling the highs when they see appropriate setups.

Deeper Discussion of This Chart

The market opened near the bottom of the bear channel that started yesterday in Figure 26.1 and broke out below the channel. The breakout failed with a two-bar reversal that led to a four-bar bull spike. After a double top that tested the bear trend line (drawn as a parallel of the best fit trend channel line), the market had a spike down to bar 13. With both bull and bear spikes, the two sides were fighting over the direction of the expected channel. The bulls started a channel but it failed at the trend line and reversed down in a bear channel. The market reversed up from a test of the trend channel line where the bar 16 low could not reach the line. This is a sign of aggressive buying. The bar 16 two-bar reversal was also a final flag long setup from the bar 15 four-bar final flag.

Three pushes down does not guarantee a trend reversal. The move down to bar 7 had very little buying pressure. There were no large bull trend bars and no strong climactic reversals. The move up from bar 7 was also not particularly strong. This was not how strong reversals typically look, and because of that, it did not attract enough strong bulls to reverse the market. Instead, the market formed a wedge bear flag (bar 6 and then the two small pushes up from bar 7 were the three pushes) and a lower high (although the rally was above bar 6 and therefore a sign of some strength, it was still below bar 4), and the bear trend resumed.

FIGURE 26.2 Stairs Accelerating into a Strong Trend

A stairs pattern can accelerate into a stronger trend (see Figure 26.2). By bar 7, the EUR/USD forex chart had three higher highs and lows in a channel and therefore formed a stair type of bull trend.

Bar 8 was a bull trend bar that broke out of the top of the channel, and it was followed by a bear reversal bar that never triggered a short. The breakout should extend to about a measured move up to a parallel line that is about the same distance from the middle line as the middle line is from the bottom line (an Andrew's Pitchfork move), which it did. The acceleration upward is typical when a wedge top fails. There were three pushes up that ended at bar 6, but you could also view the small swing high just before bar 8 as the third push up if you restarted your count with the strong bull spike up to bar 4. The failed wedge was followed by about a measured move up equal to about the height of the wedge (the bar 6 high to the bar 3 or maybe bar 1 low).

FIGURE 26.3 Shrinking Stairs

When each breakout is smaller than the previous one, the trend's momentum is waning and a deeper pullback or a reversal might soon follow. Figure 26.3 shows a bull trend stairs pattern with three or more trending higher highs and lows contained in a roughly drawn channel. Bars 4, 6, and 8 formed shrinking stairs, representing loss of bullish momentum and presaging the reversal. The channel functioned like a large bear flag and the bear breakout occurred at bar 9.

After the bar 9 breakout, there was a lower high breakout pullback to bar 10 that resulted in a stairs bear trend. Bar 10 was a rough double top bear flag with the high of the first pullback in the move down to bar 9.

Bar 11 overshot the bear channel to the downside and led to a small two-legged reversal up and the expected penetration of the top of the channel.

Once the market begins to form stairs down, you can usually fade the close of every strong trend bar breakout for a scalp. Buy every bear trend bar that closes below a prior bear stair for a scalp. Likewise, in bull stairs, you can scalp a short on the close of any trend bar that exceeds the high of the prior stair. In general, though, it is safer to enter on a stop as the market reverses (for example, if the market reverses up from the bottom of the channel, enter on a stop above the prior bar).

About the Author

Al Brooks is a technical analysis contributor to *Futures* magazine and an independent day trader. Called the trader's trader, he has a devoted following, and provides live market commentary and daily chart analysis updates on his website at www.brookspriceaction.com. After changing careers from ophthalmology to trading 25 years ago, he discovered consistent trading success once he developed his unique approach to reading price charts bar by bar. He graduated from the University of Chicago Pritzker School of Medicine and received his BS in mathematics from Trinity College.

About the Website

This book includes a companion website, which can be found at:

www.wiley.com/go/tradingtrends

All of the charts provided in the book are included on the website for your convenience. The password to enter this site is: Brooks1.

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