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# Price Action Trading

Before we delve into price action trading features, have you ever pondered the meaning of price?

Market prices are more than just numbers and trajectories formed by their change.

Those flickering digits on the screen actually carry an enormous weight of information!

According to the renowned economist and Nobel laureate Milton Friedman, prices communicate with society in three ways.

Prices transmit information, incentivize resource users to be guided by the price data, and encourage the resource owners to follow such information.

Pretty complex, isn't it?

The point is there's a depth of insight into why the prices are where they are.

Notice that we mentioned resource users and owners – these smell like fundamentals.

You can't really argue that price analysis is one thing and assessment of the real economy is another!

Although, it's people who form prices, and we're not so precise sometimes.

Considering all of the above, think about what price action trading really is.

Investors look at the "cold data," place their bets, and form prices.

Then others look at how those bets impacted the price – its "action."

By interpreting the price action, we can find quality trading opportunities.

So, let's learn to interpret right!

### Does price action trading really work?

The financial markets are always uncertain.

We're talking about millions of participants with their countless individual market perceptions.

What can we control in such an environment?

A few things, with the risk laying right at the center.

The main strength of the price action is helping to limit the risks.

As the example below shows.



Yes, the price action analysis can project where the market is very likely to be in the future.

Yes, price action can show the key market reversals (it'd be cool to dodge the market crash, wouldn't it?).

However, we can only be more or less certain of how much we stand to lose if we're wrong.

By methodically balancing out taking losses and profits, there's a chance to make money consistently.

So yeah, the price action trading does really "work" – by reducing the randomness factor.

The "random" attitude may apply to profits, but absolutely absurd considering potential losses.

## Is price action better than indicators?

Indicators are mathematical formulas that use price dynamics as the main input.

The value of such tools is in generalizing price data, making it easier to quantify the market environment.

What do we mean by that?

Here's an example of RSI.



The 30 and 70 levels, when used in the right context, minimize ambiguity of what the market is doing.

If RSI shows 30, most sellers on the current timeframe should've sold already.

Thus, we should consider going long.

However, experienced traders can see an "oversold" move with bear eyes while instantly recognizing if the context is right.

Naked price action provides **timelier signals** as we analyze what actually is happening, not the derived lagging calculations.

With the **objective state of mind** of a trader, price action trading can be **profitable without any indicators**.

The challenge is maintaining the right judgment consistently, and indicators are good **complimentary** tools to stay objective.

On the other hand, always relying solely on indicators is a recipe for disaster.

## **Do pro traders use indicators?**

Professionals do use indicators, but these only aid decision-making, not define it.

A common trait among the top traders in their toolkits is simplicity.

Most legendary traders and hedge funds build their strategies around Moving Averages – Simple and Exponential in particular.

Ever heard of Turtle traders, led by Richard Dennis?

His strategy was based on Moving Averages.

How about the creator of Bollinger Bands?

Obviously, John Bollinger has been using his invention, which is also based on Moving Average, by the way.

## **Which trading strategy is the best?**

Many beginners spend a great deal of their time in search of a "holy grail," close to 100% winning rate trading strategy.

The truth is, it doesn't exist.

The markets are just too complex and dynamic to design once fit for all static sets of rules.

That would mean one is trying to crack the minds of millions of traders!

Traders can act differently, depending on their worldview, resources, feelings at the moment, and countless other factors.

Keep that in mind.

Now, is there a strategy that can correctly guess what traders would do every single time?

Of course not!

Heck, some individuals place a trade on a whim or simply mix up buttons!

What perfect strategy are we talking about?!

Just common sense!

Instead, the "best strategy" would be the one that's in sync with you the most.

You need to know what market concept you like, how patient and risk-averse you are, etc.

The answers will determine the kind of strategy that works for you best.

## **Why does price "act"?**

There's a reason why the prices move the way they move.

It doesn't mean the randomness factor is absent, but generally, we can explain the possible reasons why the market moves.

In price action trading, we focus on the buyers and sellers and what they are doing at the moment.

Their actions should be your main reasons for trade entries or exits, disregarding the motivations behind those actions.



Next, we'll deconstruct the price action into the essential elements, so you'll be able to connect the dots clearly.

Let's start with the kinds of traders and their main sentiments.

#### Market players

The first camp of market participants is those entering or exiting trades with market orders.

These are guys who actually "draw" the charts we see on the screen.

Every time somebody wants their trade to be executed immediately, they "print" into a bid or ask.

The price of the last shown transaction is considered a reference price for that market.

Below is the Time & Sales window of Bitcoin.

| Price(USDT) | Amount(BTC) | Time     |
|-------------|-------------|----------|
| 29,689.97   | 0.00205     | 14:00:22 |
| 29,689.97   | 0.00060     | 14:00:22 |
| 29,690.03   | 0.00035     | 14:00:22 |
| 29,690.04   | 0.00096     | 14:00:22 |
| 29,690.04   | 0.02951     | 14:00:22 |
| 29,690.06   | 0.02951     | 14:00:22 |
| 29,690.05   | 0.00550     | 14:00:22 |
| 29,691.05   | 0.00550     | 14:00:22 |
| 29,691.45   | 0.00036     | 14:00:22 |
| 29,691.46   | 0.01324     | 14:00:22 |
| 29,691.57   | 0.27479     | 14:00:22 |
| 29,691.58   | 0.00656     | 14:00:22 |
| 29,692.05   | 0.00550     | 14:00:22 |
| 29,692.05   | 0.00080     | 14:00:22 |
| 29,692.06   | 0.00037     | 14:00:22 |

You can see the price, volume (amount), and the time when the trade was conducted.

The green price means somebody hit the asks (bought), while the red one tells that someone dumped BTC into bids.

Why does it all matter?

If the players, who use market orders, stand still, the prices will not move.

Somebody needs "to eat through" those bids and asks.

For instance, every time the market moves up nicely, people are printing green, with decent volume, fast.

Feel it!

If the prints barely happen, the price action signals are not reliable.

You may encounter such an environment in illiquid assets or during quiet times, so beware!

### Limit players

Here are guys who actually make the market possible.

They provide liquidity by standing there and waiting for a fill until somebody prints into their orders.

Below is the Bitcoin depth of the market (DOM), where limit orders are aggregated with a price step of \$50.

| Price(USDT)      | Amount(BTC)        | Total        |
|------------------|--------------------|--------------|
| 30800            | 0.08900            | 2,739.4      |
| 30700            | 0.01882            | 577.0        |
| 30550            | 10.67466           | 326,039.8    |
| 30500            | 55.49945           | 1,692,733.2  |
| 30450            | 0.24906            | 7,577.7      |
| 30400            | 12.36949           | 376,032.5    |
| 30300            | 11.19366           | 339,167.9    |
| 30200            | 9.25869            | 279,610.8    |
| 30150            | 5.62357            | 169,550.3    |
| 30100            | 10.48523           | 315,421.0    |
| 30050            | 41.75165           | 1,252,694.4  |
| 30000            | 31.23673           | 936,997.6    |
| 29950            | 38.24034           | 1,144,309.4  |
| 29900            | 32.63789           | 975,153.9    |
| 29850            | 47.19927           | 1,408,460.5  |
| 29800            | 32.52744           | 968,491.5    |
| 29750            | 84.15153           | 2,501,328.8  |
| 29700            | 57.22876           | 1,699,264.4  |
| <b>29,689.97</b> | <b>\$29,689.97</b> |              |
| 29650            | 63.30658           | 1,878,207.3  |
| 29600            | 25.63054           | 759,352.9    |
| 29550            | 20.77856           | 614,497.3    |
| 29500            | 2,094.16480        | 61,778,448.5 |
| 29450            | 17.24616           | 508,383.2    |
| 29400            | 279.12002          | 8,208,132.0  |
| 29350            | 44.19637           | 1,298,359.9  |
| 29300            | 28.07951           | 822,738.8    |
| 29250            | 7.48007            | 219,103.1    |
| 29200            | 35.66118           | 1,041,442.8  |
| 29150            | 0.27205            | 7,935.7      |
| 29100            | 60.63200           | 1,764,391.2  |
| 29050            | 0.00083            | 24.2         |
| 29000            | 197.90229          | 5,739,166.5  |
| 28950            | 2.21440            | 64,173.3     |
| 28850            | 0.18377            | 5,303.6      |

In the upper half of the window are the sell limits (asks), while in the down half are buy limits (bids).

You can see a black price in the middle – the last transaction.

Notice the price 29500; there is a density of bids, highlighting the price with a green background.

The low of the chart below coincides with that density – there was not enough volume to push deeper.



On the seller's side, 29750 seems to hold prices from moving higher.

You can see the actual orders in the DOM and what it caused on the chart.

If you understand the mechanics of price moves, the price action trading principles will make more sense.

## Price action – building blocks

All price formations can be categorized on a candle-by-candle basis and by the structures of numerous candles.

Let's define each "block" of a price action setup, so you can build a thoughtful building!

### Contraction and expansion candles

If you look at candles, some of them have big bodies, and even more have small bodies, often with long shadows.

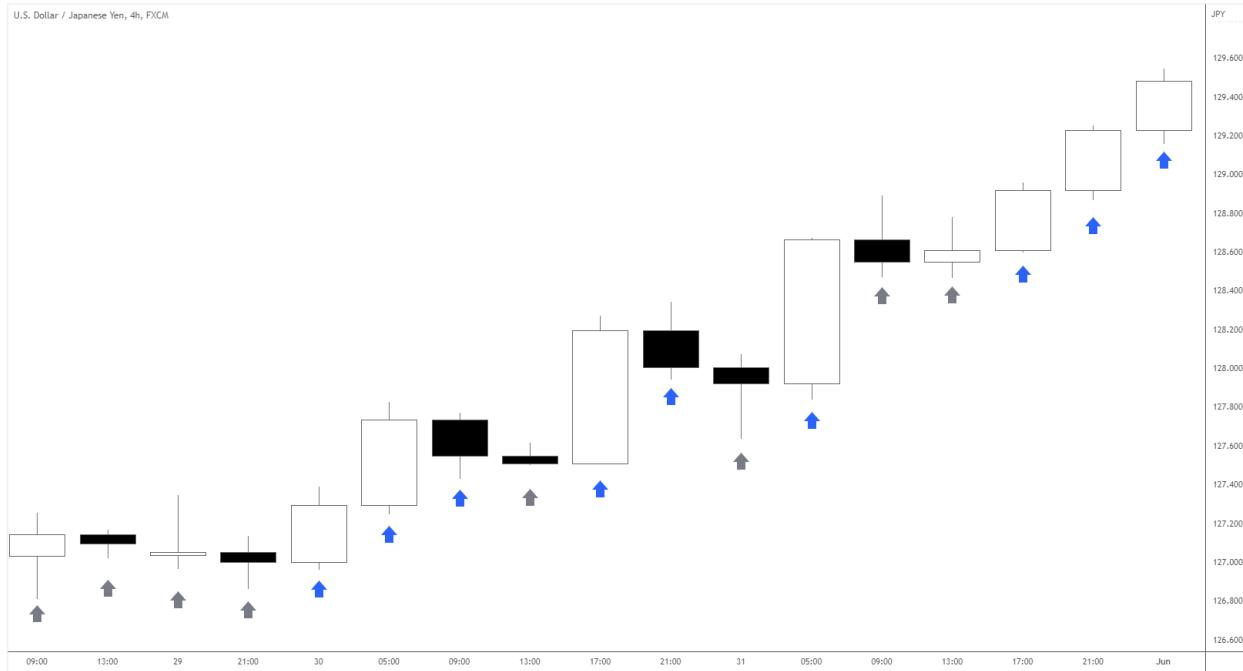
You can see small body candles as mini ranges – the **contraction** stage.

During this time, people aren't sure where the market will go next, so bulls and bears balance each other in a way.

As uncertainty continues, the stop market orders are accumulating not far beyond the range boundaries – the shadows' extremums.

When bulls or bears overpower each other, the market can shift into a momentum stage, drawing an **expansion** candle.

Here's an example.



The USDJPY chart above shows contraction candles with grey arrows and expansion candles with blue ones.

The length of the shadow matters.

For example, a candle with two equal shadows is an uncertain one indeed.

However, the one with the long down shadow suggests more likelihood of surge.

Usually, if you enter at the close of a contraction candle, the RR is higher.

### Supply and demand zones aka resistance and support

When we look at a series of candles and what shapes they form, we can figure out a broader market context.

How?

Say, if, throughout 50 candles, three candles' highs end up at the same price, never going above it.

What does it mean?

Recall our previous Bitcoin DOM example; what happens at the spot where the price clearly reverses?

There is a big order!

Or maybe even many big orders!

What matters is a certain price, or a price zone is particularly interesting for market participants, for whatever reason.

These "zones" may also be called support and resistance.

Indeed, it's better to see the support and resistance as zones, not some exact digits.

Although, sometimes those can still be exact ones, especially if they are round prices.

### **Horizontal**

Here's the classic price level type that every price action trader should primarily focus on.

We aren't being dogmatic.

The reason for such a significance lies in minimal subjectivity compared to other technical tools.

Now we're talking!

There isn't much room for interpretation when a trader decides to place an order around an important horizontal price level.

Most see the major horizontal boundaries as more or less the same, and it's easy to plot them to match others' plots.

Here's an example.



In the daily USDJPY chart above, we call those key price areas "supply zone" (resistance) and "demand zone" (support).

The sellers "supply" the asset to the market, while the buyers-demanders want to get it as cheap as possible (ACAP :D).

Thus, the market tends to stall, approaching those zones, often completely reversing the trajectory.

Notice that the zones tend to form around round prices.

In the example above, the supply is around 131.0, while the demand is near 127.0.

## How to plot?

Try to draw the zones on a higher timeframe than your main one – you'll eliminate much noise.

For instance, if you trade on a 4-hour timeframe, look for price levels daily.

At first, you'll tend to place the levels wherever the price seems to jump off somehow.

However, with practice, you'll start recognizing which ones matter the most (yeah, screen time – you got it!)

The general suggestion is to go for the most obvious ones: where does the price reverse radically?

Focus on the prices that the market will most likely interact with in the observable future.

You want to see that market feedback asap to learn faster.

Ideally, before live trading, hone your level plotting skills on price history.

## Diagonal

Such an inclining price area, a trendline, is the trickiest – there are many ways to draw it.

In addition to the up-down variations (like with the horizontal levels), we'll need to deal with the angle.

Each trader will likely use slightly different price swings to draw the trendline.

For example, some might use the EURUSD price data from February to draw the line.

Look at the EURUSD chart below.



What if some like drawing it, including September?



And for those analyzing only the last four months, the trend is already reversing!



As you see, you should be particularly careful dealing with diagonal levels.

What you see is not necessarily what the public and guys with deep pockets perceive.

### How to plot?

Your best shot would be trying to draw the line through as many swings' extremums as possible.

In this way, you can get the "average" of other traders' perceptions.

Often, to match several swings, the trendline wouldn't touch the tip of the shadow, and it's normal.



The AUDUSD example above shows that the trendline crosses some swings' shadows in the middle, others at the tips.

Some swings approach the line but do not touch it.

Get used to it – working with charts is more of an art than an exact science.

### *Dynamic*

A Moving Average (MA) serves as dynamic support or resistance, with the prices trying to bounce off the line.



On the one hand, it's also a pretty subjective tool.

Traders can use numerous variations of MA periods applied to different timeframes.

On the other hand, we know that many investors use 50, 100, and 200-day MAs.

Every charting software can show the MA and its kinds with a click of a button.

### Two camps of setups

All price action techniques can be divided into breakouts and rebounds.

#### *Rebounds*

In rebounds, we're trying to get in front of big limit players and hide the stop loss "behind" them.

Here's what it's like.



The green circles show potential buy spots around 1.2660 – in front of the bull limit players.

We'd put the stop loss right below the shadows' lows.

The target would be the resistance area between 1.2780 and 1.2800.

The idea is the density of pending buy orders is so big that they absorb most of the incoming sell market ones.

If the limit buyers are fulfilled, we don't have a reason to be long anymore.

Why?

We won't have that thick wall of liquidity standing ("behind") below our entry.

The path of least resistance becomes not clear anymore.

So, dump it!

### Trading tactics

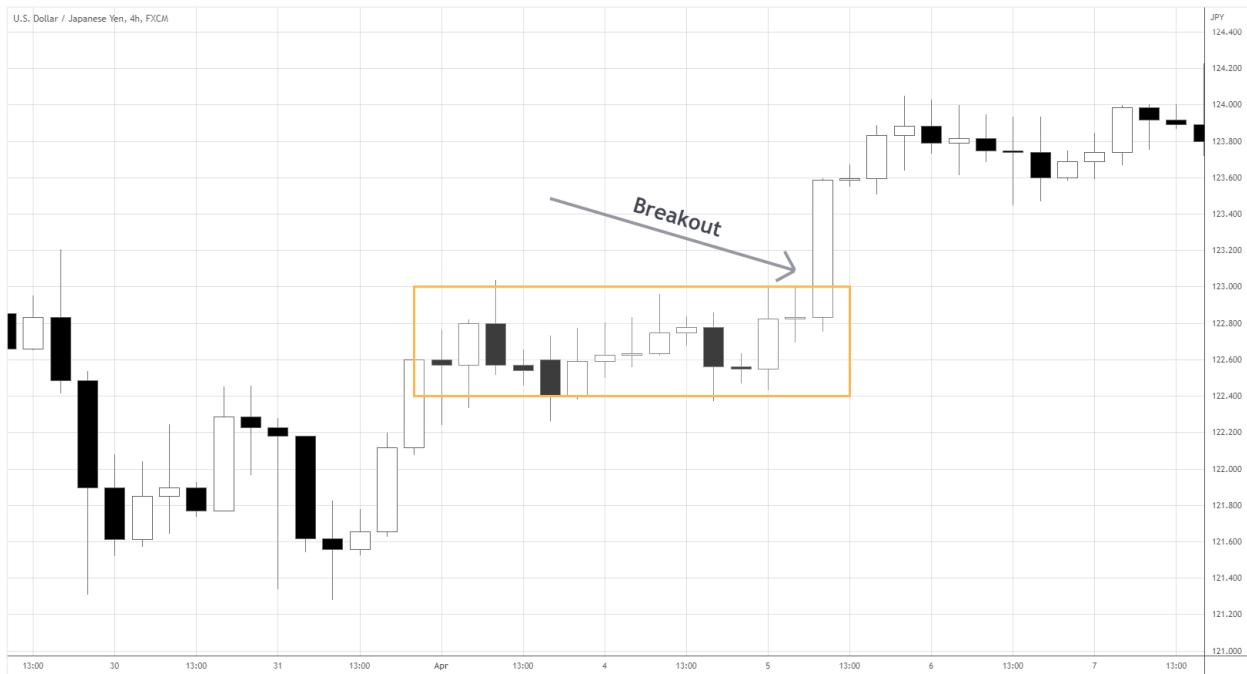
Below are two ways to trade the bullish rebound; the principle is opposite for the bearish one.

- **Reactive:** we wait for a *contraction* candle, preferably with a long down-shadow, and buy shortly after the candle's close.  
The stop loss should be below the contraction candle's low.
  
- **Predictive:** we set a pending buy order near the support, hoping to get in somewhere during the decline.  
The stop loss is not as exact but should be well below the demand zone's low.

## *Breakouts*

When the wall of limit orders is broken, the breakout occurs.

Below, the 122.4-123.0 range broke out to the upside.



In case of a real bullish breakout, the buy limit players step up, pushing the public to buy off the resistance.

The buy limit players have big orders and have been initially interested in prices at the supply zone.

So, they buy what they can over there and just wait until more fills when the market comes back after the breakout.

That's why they say the resistance turns into support.

Those limit-buyers are still waiting and picking up all suckers-sellers that don't believe in an uptrend.

The opposite happens when the bearish breakout occurs.

## **Trading tactics**

You can enter the breakout once the price gets above the high of the supply zone (in a bullish breakout).

A more conservative way is to wait until the breakout candle closes above the zone and buy at the close.

An aggressive stop loss would be right below the broken boundary level.

The conservative one should be under the breakout candle's low.

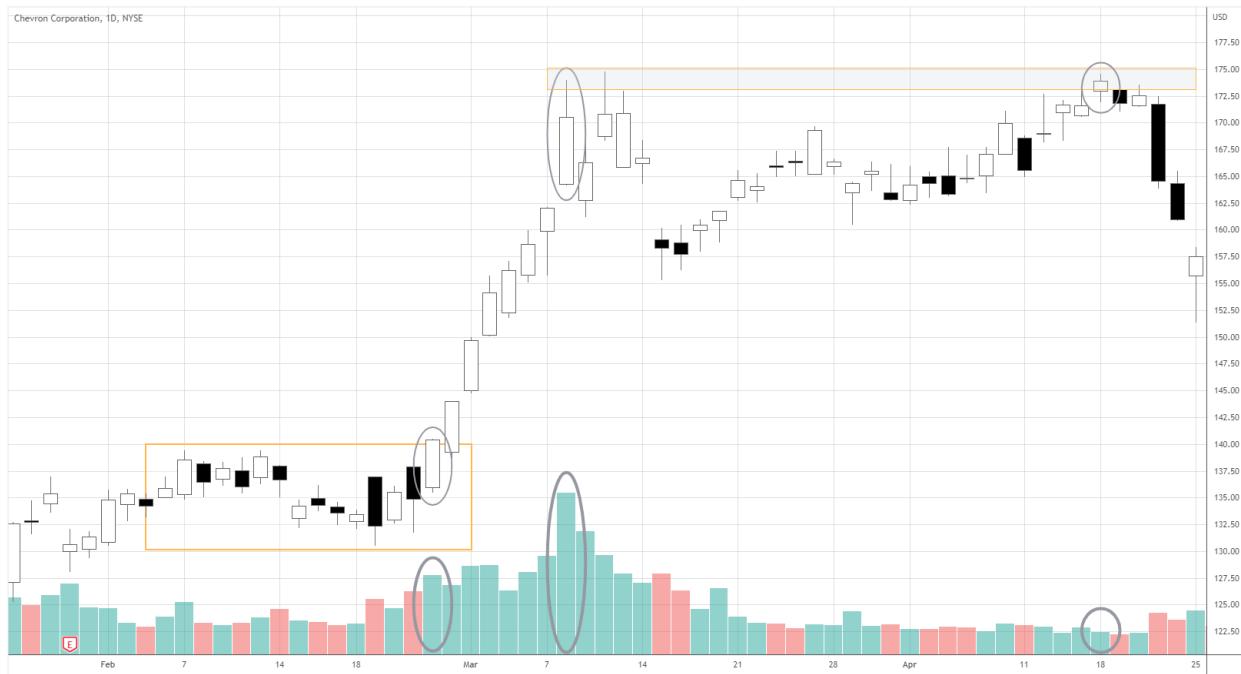
The logic is the opposite in a bearish breakout.

### Pro tip: volume confirmation

In markets that reveal real trading volume, we have the luxury to confirm more vividly the castling described above.

The genuine breakouts should have more volume than usual.

Like in the Chevron below.



Look at the increased volume when the stock broke 140.0.

After a week of market rallying afterward, how about the new supply zone formed around 172.5-175.0?

Look at that insane volume (green bar in the oval) after the first week of March!

Most of the demand must've been satisfied during the second week of March.

Because when the market tried to test the area again in the middle of April, the buyers were far from enough.

The minuscule volume on April 18<sup>th</sup> confirms that.

### Multi timeframe analysis

Analyzing different timeframes can improve the risk-to-reward (RR) and the winning rate of setups.

Let's start with RR.

Suppose you want to trade the bearish rebound, selling at the close of the first bearish candle near the supply zone.

This tactic would yield about 2.5R in the 4-hour DAX chart below.



What if we go down to 1-hour timeframe?



There's a similar entry, but much earlier.

That sneaky short shows a whopping 10R!

Of course, the probability is supposed to be lower as the stop loss is closer.

But often, such a wide stop isn't needed to prove the idea's validity.

How about improving the odds?

Consider the below's bullish breakout.



Would you buy it?

How about zooming out and seeing a bigger picture?



Although the local supply zone around 1.0450 was reliably broken (daily candle closed above it), the long-term trend is still down.

What a paradigm shift just by looking at the bigger picture!

The odds are higher if we open a trade in the direction of the long-term trend.

### Final words

Price action trading is an elegant and logical way to analyze the market.

If you want to be consistently profitable, devise a strategy that's in tune with your personality the most.

There are countless price action strategies, but all of them employ the elements described above in one way or another.

And remember, the prices move because they have no other choice!

The path of least resistance.

Think about it!

