

LANCE BEGGS

yTC
Price Action Trader



Intraday Swing
Trading for the
Forex, FX Futures
and Emini
Futures Markets

www.YourTradingCoach.com

Volume Two – Markets and Market Analysis

YTC Price Action Trader
by Lance Beggs

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About the Author



Lance Beggs is a full time day-trader with a current preference for forex, FX futures and emini-futures markets. His style of trading is discretionary, operating in the direction of short-term sentiment within a framework of support and resistance.

As an ex-military helicopter pilot and aviation safety specialist, Lance has an interest in applying the lessons and philosophy of aviation safety to the trading environment, through study in human factors, risk management and crew resource management.

He is the founder and chief contributor to <http://www.YourTradingCoach.com>, which aims to provide quality trading education and resources with an emphasis on the 'less sexy' but more important aspects of trading – business management, risk management, money management and trading psychology.

Lance can be contacted via support@YourTradingCoach.com

**“Since we cannot change reality,
let us change the eyes which see reality.”**

...Nikos Kazantzakis

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VOLUME TWO

MARKETS AND MARKET ANALYSIS

Chapter Two – Principles of Markets

2.1 – Principles of Markets

One of the key reasons most traders fail to achieve consistent success is that they do NOT understand the game they are playing.

- They fail to understand the true nature of the markets
- They fail to understand the true nature of the game of trading

In this chapter we aim to correct these errors.

Some of the discussion may appear extremely obvious; but stick with it. It sets a foundation that builds to give you a more enlightened view of the environment within which we operate and how that view of the markets allows us to profit.

Most trading books and courses focus on price movement and the resultant patterns and indicator based signals. They're missing a key fundamental concept that underlies this price movement.

At the end of this chapter, you'll have a clear understanding of:

- The true nature of the markets
- The true nature of the trading game.

You'll finally understand why all those systems you tried were ineffective.

You'll no longer be interested in systems.

You'll be free of the search for the Holy Grail trading strategy.

And the foundation will be set for correct analysis and correct trading of the markets, via the YTC Price Action Trader strategy, or in fact any other reality based strategy you may wish to develop yourself.

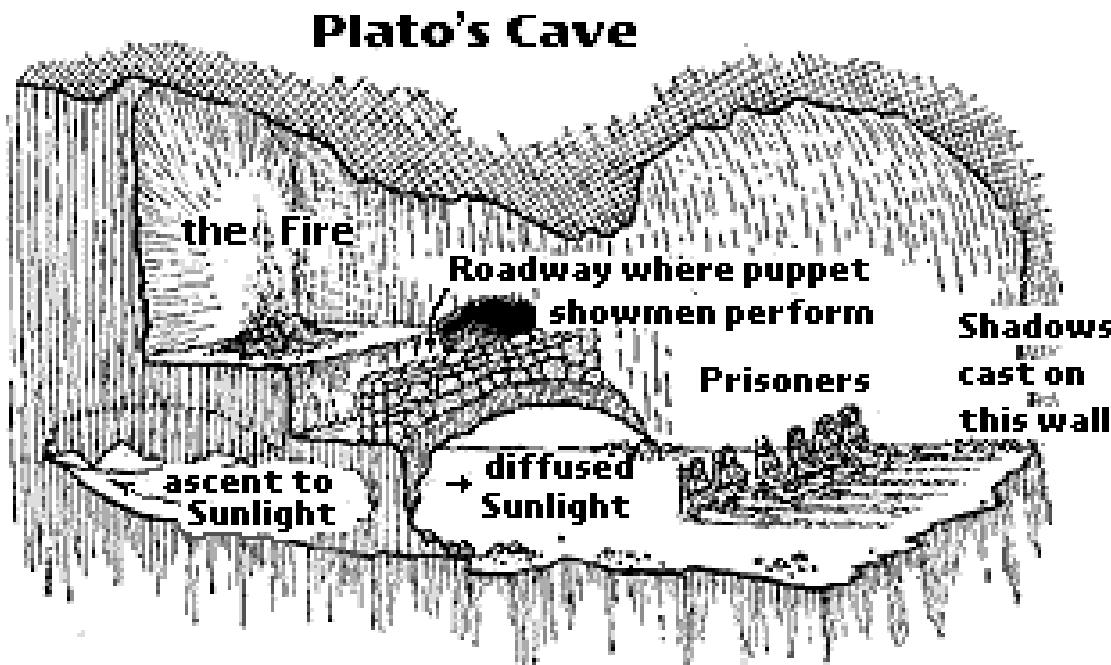
2.2 - The Reality of the Markets

2.2.1 Trading the Shadows

What did Plato know about Trading?

Probably nothing! But he has a great analogy which I'm going to share in order to demonstrate some key concepts:

- Our reality is based upon that which we perceive.
- Often there is an underlying reality which we have just not seen.



- From *Great Dialogues of Plato: Complete Texts of the Republic, Apology, Crito Phaido, Ion, and Meno, Vol. 1.* (Warmington and Rouse, eds.) New York, Signet Classics: 1999. p. 316.

Figure 2.1 – Plato's Allegory of the Cave

In describing the scenario, I'll share a short passage from [Wikipedia](#), as it discusses Plato's Allegory of the Cave...

"...imagine a cave inhabited by prisoners who have been chained and held immobile since childhood: not only are their arms and legs held in place, but their heads are also fixed, compelled to gaze at a wall in front of them. Behind the prisoners is an enormous fire, and between the fire and the prisoners is a raised walkway, along which people walk carrying things on their heads "including figures of men and animals made of wood, stone and other materials". The prisoners can only watch the shadows cast by the men, not knowing they are shadows. There are also echoes off the wall from the noise produced from the walkway.

Is it not reasonable that the prisoners would take the shadows to be real things and the echoes to be real sounds, not just reflections of reality, since they are all they had ever seen or heard?"

In other words...

What we perceive as reality is not necessarily so. Often there is a deeper reality which we have just not seen.

Or...

That, which is perceived to be reality, is actually an illusion.

The same applies to trading.

My belief is that most people do not understand what a market is.

They see a chart and perceive price movement and its resultant technical analysis patterns and indicator based signals.

And they assume this is reality. It's all they know. And it's all that's taught in the majority of books, websites and courses.

Unfortunately, these traders are like the prisoners in the allegory of the cave. Chained to their viewpoint, they falsely believe in their version of reality, which is in fact an illusion. They fail to perceive the fact that there is a much deeper truth to the markets.

A reality that I believe makes ALL the difference in trading.

Most traders are *Trading the Shadows*^{*}, usually with no understanding at all of the reality behind those shadows.

The reality of the markets (which we'll discover shortly) is projected as price chart patterns or their derivative indicators. These are the shadows, or the illusion. Most people perceive the shadows as the game. They think it's all about the price, or the patterns or the indicators, so they try to trade them. It's not about that – the game is about something else entirely.

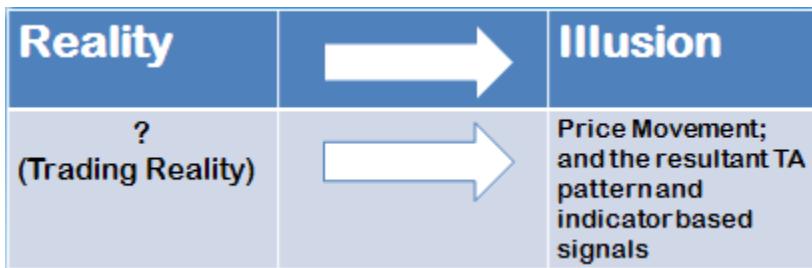


Figure 2.2 – Reality vs Illusion

Finding no success with their setups, or indicators, traders go on the search for new indicators, new setups, new parameters. But they'll never find the truth, because they're trading the shadows. They don't perceive the reality.

Successful trading requires seeing the reality that forms the shadows. That is, the reality that produces the price movement, then indicators and the patterns.

The reality is not just 'price'.

It exists at an even deeper level of understanding – that which creates price and price movement.

* Thanks to one of my newsletter readers, Stuart, who came up with the term, *Trading the Shadows*.

2.2.2 Cause and Effect

Just quickly, we'll look at this in one other way, which some of you may find more useful.

Let's look at price movement through a different lens – that of Cause and Effect.

Price movement and any resultant indicator and pattern based signals are the EFFECT. Most traders focus here. That's all they see and that's what they try to trade.

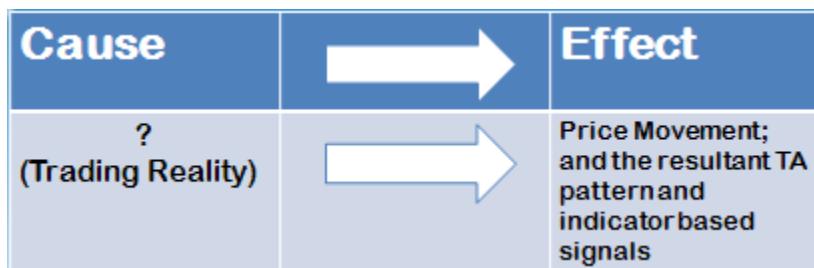


Figure 2.3 – Cause vs Effect

Instead, to truly understand the markets, we need to focus on the CAUSE.

What causes price to move? That's where we focus, because:

- Only then can we understand the reality of the markets.
- And only then can we understand how to identify when a move is likely to start, when it's likely to continue and when it's likely to end.

In analyzing the chart of figure 2.4 on the following page, most people focus solely on price. They observe the bearish breakout as price broke below a period of sideways consolidation, or a short-term head and shoulders patterns (marked by labels S-H-S).

If they're pattern based traders they'd be looking to enter short either at the break of the head and shoulders neckline (point B), or on the first confirmed close below the neckline (point C).

Indicator based traders would also likely enter in the vicinity of C as their signals are typically based on a lagging derivative of price, which won't trigger entry until significant movement has occurred in the new direction.



Figure 2.4 – Chart Based Cause and Effect

The problem for these traders is they're focusing on price.

The price move is the EFFECT.

These traders are simply responding to the effect, entering in the HOPE that the momentum of this move continues in the bearish direction, long enough for them to attain a profit.

Hope is not good enough for me.

A better way to trade is to understand the CAUSE of price movement.

Although you don't see it yet, identifying the CAUSE in this example would have allowed you an entry in the vicinity of A, with an expectation that if price broke the area of B and the slightly lower support, movement would be clear until possible target areas in the vicinity of D and E. Had the move failed at B, sufficient opportunity would be available to scratch the trade for either a small profit or a breakeven result.

Understanding CAUSE allows you to identify potential moves before or as they occur.

Understanding CAUSE allows you to enter a price move earlier.

Understanding CAUSE allows you to understand why a price move is occurring.

Understanding CAUSE allows you to assess when a move is likely to continue and when it's likely to end.

Understanding EFFECT only, means that all you can do is react to what has already occurred, usually well after it has already occurred, and then simply hope that sufficient profit potential is still available in the move.

So, if the market is not price movement, patterns and indicators, then what is it?

What is the reality?

To understand the true nature of the markets we need to take a journey through a few steps.

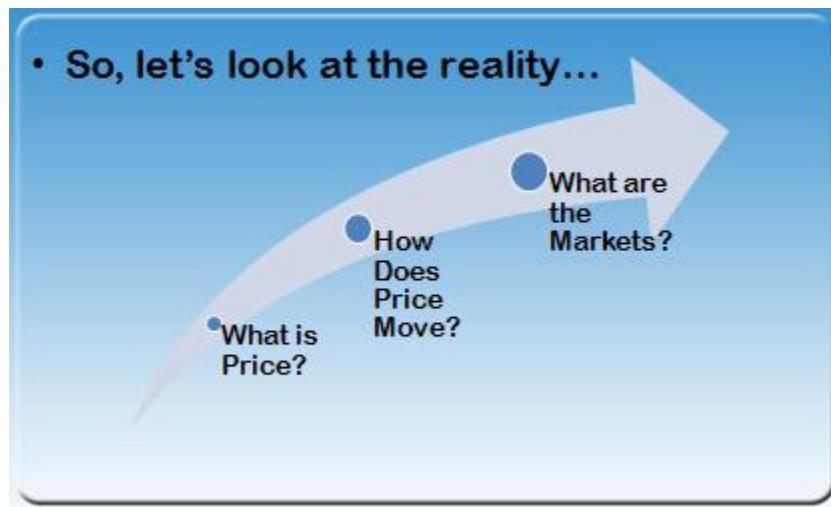


Figure 2.5 – Discovering the Reality of the Markets

We need to start at some very basics – what is price and why does it move? That will lead us to a new understanding of the nature of the markets.

The nature of markets is not price. It's something else entirely different.

2.2.3 - What is Price?

Regardless of whether we're talking stocks, futures, foreign exchange, or any other product at all, price is the amount a buyer pays to acquire a product from a seller.

Any one transaction involves a product, and two parties – the buyer and the seller. The seller holds the product. The buyer wants to purchase it.

Price is the amount that they agree upon for the transfer of the product from the seller to the buyer.

The key word in this sentence is...

... agree... The buyer wants to buy at this price. . The seller wants to sell at this same price. They come together. There's a transaction.

So, what is price?

Yes, it is the dollar amount, or points value, that they agree to transact.

But that's not how I want you to view it.

Instead, view price as two parties making a buy and sell decision.

From a trading perspective...

Price is two traders making a buy and sell decision.

It's a subtle difference, but it's important.

Now, markets don't transact all at one price... they move. Thankfully, otherwise there wouldn't be profit opportunity.

As we mentioned before, most people are happy to just accept that markets are price movement.

I'm going to take us deeper. Now that we view price as not just the dollar or point value of each transaction, but of **traders making buy and sell decisions**, we're going to look at how those decisions make price move.

This will lead us to our deeper, and superior, understanding of the nature of the markets.

2.2.4 - How Does Price Move?

Price movement is a function of supply and demand.

In fact, as we'll see it's deeper than that, again. We'll soon be discussing what drives supply and demand. But for now, I need to discuss supply and demand; to be sure you understand this basic concept.

Let's define the concept and the terms in simple (non-textbook) language:

Supply is the amount of a product which sellers want to sell at a particular price.

Demand is the amount of a product which buyers want to buy at a particular price.

Price will move with changes in supply and/or demand.

Let's look at some examples...

First we'll look at an example that most people will be familiar with - a housing auction. In this scenario, we have a fixed supply – one house for sale. And we have a variable amount of demand, depending on the public perception of value. For a very nice house in a great location during times of strong economic growth, there might be a large crowd of potential buyers, all competing for the property. For an overpriced house, in a down-turning market, there may be only a small number of potential buyers, or possibly even none.

For this example, we'll assume we have a large crowd of buyers, all desperate to take ownership of the property, all willing to buy at varying prices between say \$650,000 and \$750,000. The realtor opens the auction at \$550,000. What happens next is that the bidders will compete with each other at ever increasing prices, hoping to be the last one standing at the end of the process. Initially price will increase rapidly, \$575,000 - \$600,000 - \$620,000 - \$640,000 - \$650,000 - \$660,000. As each bidder's maximum price is exceeded they'll drop out of the race. The rate of price increases may slow and bidders will typically take more time to consider their next move. If enough emotion is involved in the purchase, bidders may even exceed their pre-planned maximum price, desperate to ensure no-one else gets *their* property. \$750,000 - \$752,000 - \$752,500 - \$753,500. Eventually there will be no bidders left who are willing to pay a higher price, and the property is sold to the highest bidder.

In this example, demand consisted of multiple buyers all wanting to buy and willing to pay higher prices to do so. Supply consisted of a single seller, willing to allow price to increase until there are no more buyers.

Demand has overwhelmed supply, leading to price rallying. Price continued to rally until there were no more buyers willing to pay a higher price.

Now let's consider a hypothetical example where there are two desperate sellers, offering for sale two essentially identical properties. Let's say two apartments side by side, with similar quality fittings and fixtures and similar view; essentially identical value. And let's assume there is only one buyer interested in purchasing a property. The process would now work in the reverse of the previous example.

The buyer can afford to hold out, while the two sellers would be required to compete. The sellers would take turns lowering their asking price, until it reached a point at which one was not willing to go lower. Assuming the price was then acceptable to the buyer, a transaction could occur.

Supply has overwhelmed demand. Price has fallen until there is no-one willing to sell at a lower price.

Important point... it's not just the number of participants that is most important, but the desperation, or urgency, with which they are seeking a transaction.

Consider the original housing auction where buyers were once again willing to pay differing amounts up to a maximum of \$750,000, but this time the owner was asking too much for the property. The auctioneer opened the bidding at \$850,000. In this case there will be no bidding. No transaction will occur, despite multiple potential buyers and one seller. The only way for a transaction to occur is if either one or more of the buyers decide they absolutely must have the property, and are willing to pay a higher price by increasing their bid above their pre-planned maximum, or if the seller is willing to drop the opening ask price in an attempt to find buyers.

Let's assume the seller is desperate to offload the property. The auctioneer will be instructed to lower the asking price in increments, until a buyer can be found and a sale can occur.

In this case, despite only one seller, the desperation of that seller has been greater than the desperation of the buyers, resulting in price falling.

Supply has overcome demand and price has fallen.

Ok, let's consider the financial markets.

We now have what is known as a dual-auction process.

Multiple buyers competing to buy into the market, and multiple sellers competing to sell into the market; all at the same time.

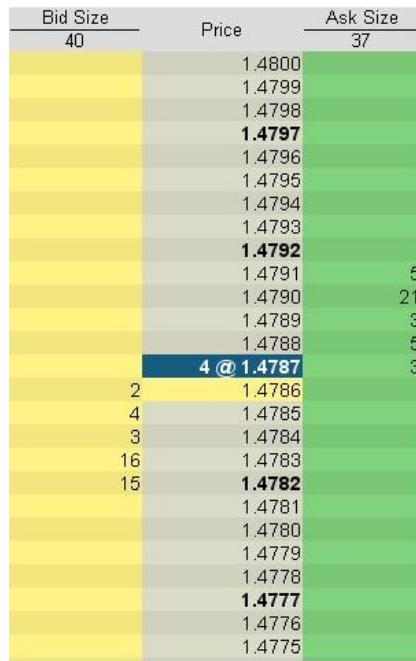


Figure 2.6 – The Dual-Auction Process

Figure 2.6 displays a depth of market (DOM) screen from Interactive Brokers TWS platform.

The centre column displays the price of the tradable item, in this case the market is 6B, the British Pound currency futures (equivalent to spot forex GBP/USD). The last sale price is the one in the centre, highlighted by the dark blue colour, currently 1.4787. The left column displays the Bid and the right column displays the Ask (sometimes referred to as the Offer).

So, looking firstly at the bid column, we can see that we have 2 contracts wanting to be bought at 1.4786, 4 contracts wanting to be bought at 1.4785, 3 contracts wanting to be bought at 1.4784, and so on, down to 15 contracts at 1.4782. It goes further, but the DOM screen here only shows 5 layers of depth. Please note that each of these bid quantities is not necessarily just one trader. The 15 contracts bid at 1.4782 could be from one trader, but are equally as likely to be from multiple traders, for example, 5 traders bidding 1 contract each and 2 traders bidding 5 contracts each, totaling 15 contracts being bid at this price.

On the Ask side, we have 3 contracts offered for sale at 1.4787, 5 at 1.4788, and so on, all the way up to 5 contracts offered at 1.4791.

So, the Bid column on the left shows the current demand, or what I sometimes refer to as Bullish Pressure.

And the Ask column on the right shows the current supply, or what I sometimes refer to as Bearish Pressure.

At the moment, the highest someone is willing to pay in order to buy a contract is 1.4786, the highest bid price being represented by the top of this column of buyers.

And the lowest price at which someone is willing to sell a contract is 1.4787, the lowest ask price being represented by the lower end of this column of sellers.

So, someone wants to buy at 1.4786, but someone else wants to sell at 1.4787.

Can a transaction occur? No. The only way for a transaction to occur is for one of the buyers to be willing to raise their price and accept the current ask price, or for one of the sellers to lower their price and accept the current bid.

Or alternatively some other trader not currently waiting in these queues decides they want to get in or out of the market at whatever price they can, and so uses a market order, which will automatically buy at the current ask price or sell at the current bid price.

Let's assume that buyers are more desperate than sellers, so they're willing to pay higher prices.

Buyers are desperate to get into this market, so they'll raise their bid and accept the asking price. The last sale price remains at 1.4787 until all three contracts at that level are bought. At this point, with no contracts remaining at 1.4787, buyers will have to buy at 1.4788. The last-sale price rises to 1.4788. Other buyers, seeing price rise, will also raise their bid in desperation or simply buy via a market order accepting whatever ask price they can get. They feel they have to get into this market. Once the 5 contracts at 1.4788 have been bought, buyers will then have to be willing to pay 1.4789, which then becomes the new last-sale price. Supply at each level will be absorbed and buyers will be forced to bid even higher and higher prices in order to get their transaction filled. The last sale price continues to rally. Some sellers will observe this rally in price and pull their sell order from the market, replacing it at a higher price. Price will continue to rally while there are more buyers willing to buy at a higher price.

At some point, the buying demand will finish. Price will have rallied to a point at which the buyers are no longer willing to pay higher prices, or until the higher prices attract more sellers, adding to the quantities available in the Ask column, in sufficient number to absorb all the bullish pressure. The rally will stop. Some of the traders who have previously bought may now offer their contracts for sale in order to take profits and close out their transaction, effectively adding to the supply, or bearish pressure.

In the absence of further buying though, sellers will be forced to lower price in order to make a transaction. They'll reduce their ask price so that it matches a bid price. The last sale price will now fall. Seeing the last transaction price fall, other sellers will follow suit and lower their price, or simply sell via a market order accepting whatever bid price they can get. Desperation will have moved from the buying side to the selling. Bids will be absorbed at each price level and so sellers will then be forced to drop price further. Some of the potential buyers will see this falling price, and will withdraw their bid and replace it at an even lower price.

Price will continue to fall until we run out of supply. Either potential sellers will be no longer willing to sell for such low prices, or sufficient new buyers will be attracted to the market by the lower prices, in order to absorb all supply. The price fall will stop.

And then the process starts all over again.

That's how the market works from a supply/demand perspective. It's a dual-auction process, with price auctioning both up and down depending on which force is dominant at the time – demand or supply.

- **Price rises while demand is greater than supply, and while those buyers are willing to pay higher prices.**
- **Price rises until we run out of buyers, or until supply increases sufficiently to absorb all the demand.**
- **Price falls while supply is greater than demand, and while those sellers are willing to sell at lower prices.**
- **Price falls until we run out of sellers, or until demand increases to the point it absorbs all the supply.**

Price movement is a function of supply and demand.

Or more correctly...price movement is a result of supply/demand imbalance. And the supply/demand imbalance is created by trader's sense of urgency to transact.

Let's look at how this dual auction process displays on a price chart, as demonstrated via figure 2.7 below.



Figure 2.7 – Dual-Auction Process Displayed on a Chart

Individual price bars are the result of the dual auction process operating within the timeframe of that price bar.

Each price swing is the result of the dual auction process operating for the duration of that price swing. Over a period of time, when the demand is consistently greater than supply price will rise as it did in swings 1 and 3. When the supply is consistently greater than demand price will fall as it did in swing 2.

Additional info: Note the gap at the start of the candle marked A. This is also a result of the auction market process. This occurred at the release of two GBP-related news events, the Claimant Count Change and the Average Earnings Index. The bullish reaction to the news means that all supply was withdrawn from the market, so those bulls wanting to participate in the market were required to seek higher prices to find a

seller. The first price someone was willing to sell becomes the open of the first post-news candle, leaving a gap on the chart of approximately 10 pips.

Individual trader sentiment at any one time may be either bullish or bearish. The net effect though, when considering all traders operating within the market, will be either a net bullish, bearish or neutral sentiment.

Bullish sentiment leads to bullish orderflow resulting in price rising, as in swings 1 and 3.

Bearish sentiment leads to bearish orderflow resulting in price falling, as in swing 2.

Neutral sentiment leads to narrow range sideways price action.

Note that price within these swings is not moving in a straight line – it fluctuates constantly. The market is comprised of buyers and sellers all competing through different analysis styles, on different timeframes, with different reasons for wanting to enter or exit. We don't know their individual reasons. It's the collective sentiment that matters. And price moves with whichever crowd most desperately needs to act.

It comes down to sentiment of the market participants.

As individual traders become increasingly bullish, they add to the bullish sentiment of the collective group of buyers. If enough of them do this, the overall sentiment of the whole market becomes bullish, demand overcomes supply, and price rises.

As individual traders become increasingly bearish, they add to the bearish sentiment of the collective group of sellers. If enough of them do this, the overall sentiment of the whole market becomes bearish, supply overcomes demand, and price falls.

- **Price moves with changes in the forces of supply and demand.**
- **Supply and demand change as the sentiment of the crowd changes.**
- **And the sentiment of the crowd changes with changes in the bullish or bearish sentiment of the market participants.**

So, here's the key point...

Just as we discovered that price is two individuals making buy and sell decision, we have now established that price moves also as a result of the net effect of all market participants making individual trade decisions.

Some people use fundamentals to make trading or investing decisions. Others use technicals. Others may even use lunar cycles. It doesn't matter. At the core level, **it's all just people making decisions.**

Price doesn't move up or down because of fundamentals or technicals. Individuals form an opinion about market direction. Some of them will act on their opinion – they'll make a decision to buy or sell.

The sum of all the buy or sell decisions forms the collective sentiment of the crowd, which may be bullish or bearish. And this collective sentiment of all market participants, leads to a net bullish or bearish order flow, which moves price.

The most 'fundamentally' bullish stock will still fall if the sentiment of the crowd is bearish, and they don't want to own it.

The most technically perfect breaking of a neckline of a head and shoulder pattern (which is supposedly bearish) will fail to reach its projected target, if the sentiment of the crowd at this point changes to bullish, and they all want to buy this stock.

It's not about the fundamentals or technicals.

It's about people... and the decisions they make about market direction.

Price changes as supply and demand change... supply and demand change based on the beliefs of market participants, or more correctly on the decisions of market participants to act on their beliefs.

Let's summarise this section – How does price move?

- Price movement results from a supply/demand imbalance
- Changes in supply and demand occur as sentiment changes within the market participants.
- Price therefore depends on the bullish or bearish sentiment of market participants.
- The net sum of all individual trader decisions and actions, form the Net Order Flow.

- When Net Order Flow is bullish (demand greater than supply), price will rise.
- Price continues to rise until we run out of buyers at higher prices, or until the higher prices attract sellers in sufficient quantity to overcome demand.
- When Net Order Flow is bearish (supply greater than demand), price will fall.
- Price continues to fall until we run out of sellers at lower prices, or until the lower prices attract buyers in sufficient quantity to overcome supply.

Or more simply:

- **Price moves as a collective result of all traders' bullish or bearish sentiment and their decisions to act in the market (buy or sell).**

Note: Some common terms which you'll hear me use from time to time, in particular when conducting price chart analysis, are:

Bullish Pressure – sum of all demand in the market (forces attempting to push price up)

Bearish Pressure – sum of all supply in the market (forces attempting to push price down)

Net Order Flow – the resultant of bullish and bearish pressure. Net order flow (NOF) is bullish if price is going up, bearish if price is going down.

2.2.5 - What Are Markets?

Most traders simply see markets as price movement. They look at a chart and they filter all the price action into what they consider to be significant movement, usually represented by either charting patterns or indicator based setups.

To return to Plato's Allegory of the Cave, these traders are trading the shadows; the illusion.

They're not considering the reality underlying the price movement.

Or if you prefer to use the cause/effect analogy, these traders are trading the effect.

They're not considering the cause of price movement – the underlying reality, or the nature of the market, which is...

Traders making trading decisions.

Traders make trading decisions; which leads to a net order flow; which leads to the effect – price movement.

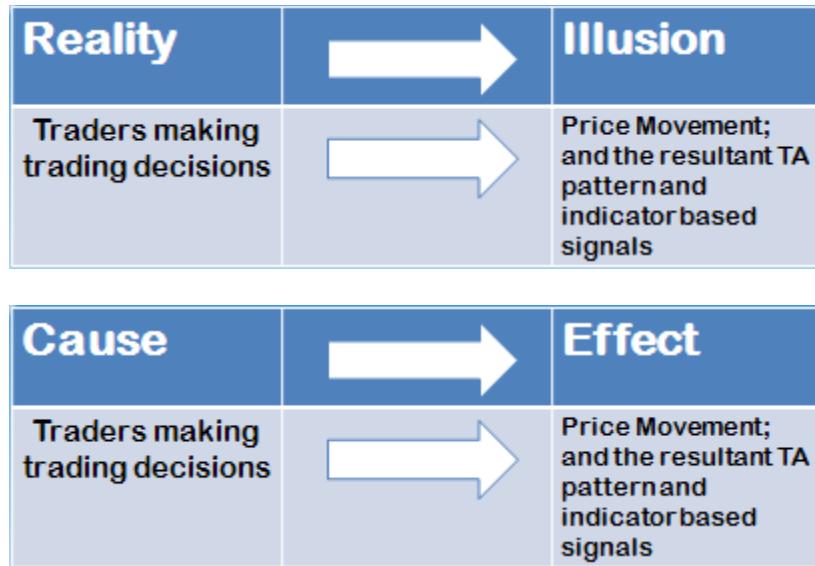


Figure 2.8 – The Underlying Reality of the Markets

We see markets as a collective group of traders all making trading decisions and taking action based upon their bullish or bearish sentiment. This leads to a net bullish or bearish orderflow, which leads to the effect – price movement.

You may think this is irrelevant. You'd be wrong.

It's a subtle difference, but it's essential. Until you get the significance of this, you'll be stuck in the indicator and pattern-based TA treadmill, simply observing past price movement and trying to predict future price movement.

Markets are traders making trading decisions. Markets are not the resultant price movement.

When we look at a chart, don't see it as price movement. See it as traders making decisions whether to buy or sell or stand aside.

You need to see when they're in pain. You need to see when they're feeling greed.

Only then will you be operating in the real market, profiting from the traders who are operating under false assumptions and a lack of understanding of the game.

Let's look at some examples.

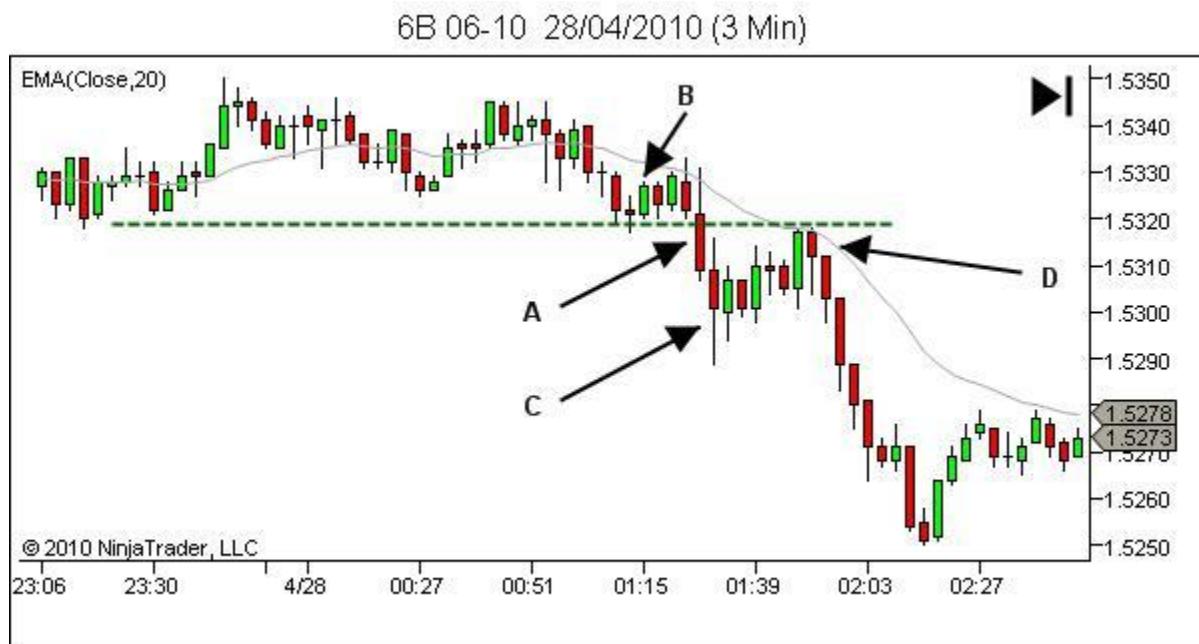


Figure 2.9 – Breakout Pullback – From the Perspective of Other Traders

Don't look at figure 2.9 and just see a breakout below support at point A.

Learn to view all price movement from the perspective of other traders, and how the price movement influences their decision making.

See the bears entering at point A with anticipation and greed, with their sell orders, expecting lower prices to follow the breakout.

See the bulls who bought at point B expecting support to hold. These people are panicking – they're in drawdown – the market is moving fast against them. Those bulls who aren't frozen will be activating their stops, adding to the bearish pressure, forcing price even lower.

Traders, making trading decisions.

When price stalls at point C, don't just see a swing low. See the shorter-term traders who caught the breakout, covering their position to take profits. This adds to bullish pressure and slows the breakout move. See also some new bulls deciding to enter long, in the hope of catching a breakout failure. These trader decisions, and their resultant buy orders, were enough to tip the supply / demand equation to the bullish side, causing a retracement.

Don't just see a breakout pullback at point D.

See the traders who missed the original breakout, enthusiastically selling as price gives them a second opportunity to enter short, or perhaps those who did catch the original move deciding to add to their position. Both scenarios adding to the bearish pressure.

See the traders who were long from point B, having suffered through the drawdown to point C, enthusiastically selling as the pullback offers them an opportunity to get out at close to their entry point for a reduced loss. Once again, adding to the bearish pressure.

See the more astute short-term traders who entered long at C in anticipation of a scalp back to the breakout point taking their profits via a sell order, further adding to the bearish pressure.

Then as this bearish pressure causes price to move down again from point D, see those longs who bought at C in expectation of a breakout failure and longer term reversal back to new highs, having to sell in panic as they realise that the breakout failure did not occur and they're stuck in a losing position.

All these trading decisions lead to a bearish sentiment, bearish pressure, bearish net order flow, and therefore a price fall.

One more example...

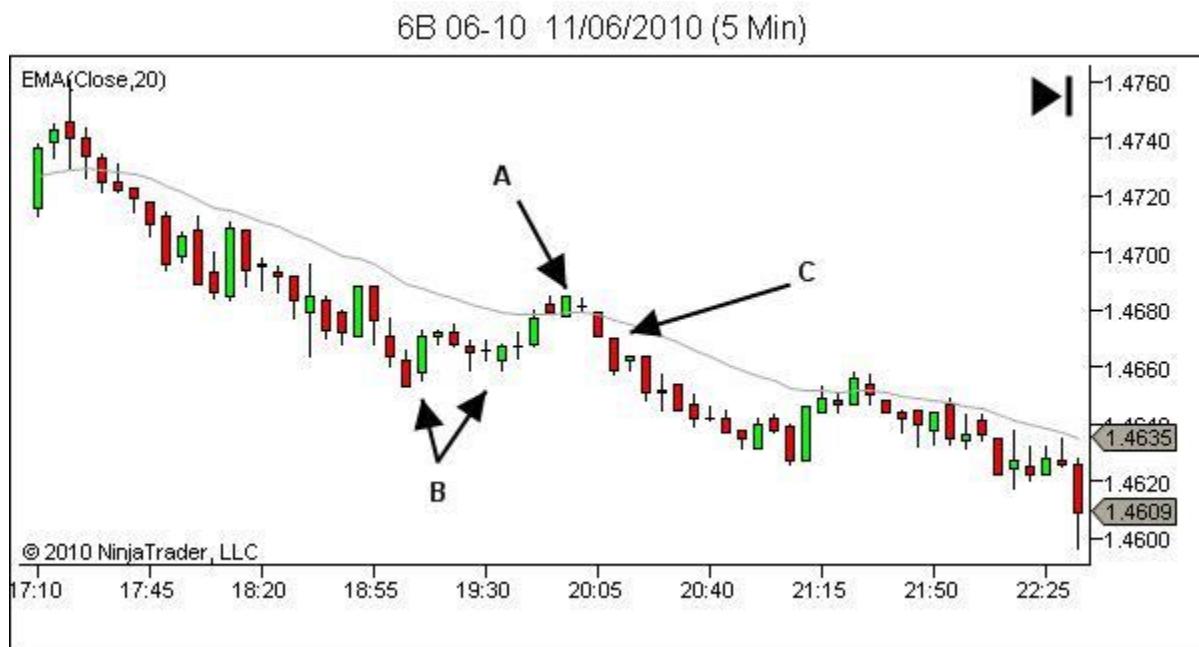


Figure 2.10 – Trend Pullback – From the Perspective of Other Traders

Don't look at figure 2.10 and see a pullback within a trending market at point A.

Learn to view all price movement from the perspective of other traders, and how the price movement influences their decision making.

Large numbers of traders have a natural tendency to try to fight a trend. These people will be looking for any opportunity to enter long, in the hope of catching the reversal.

See these hopeful bulls entering in the vicinity of B with anticipation and greed, with their buy orders, expecting higher prices and an opportunity to brag to their friends about how they caught the reversal. Their bullish orderflow, added to the pressure of those shorts who take profits at new lows (also a buy order), being sufficient to overcome the downward price movement and commence a pullback.

As price gets to the area of point A, see the fear levels rise within the longs who bought at B, as price stalls for three candles.

See the more astute traders trading with the trend and taking the pullback to point A as an opportunity to enter short, creating bearish pressure which opposes the short-term pullback.

Then see the panic set in at point C as the market thrusts back downwards, and the longs from B bail out of their positions, some smarter ones at breakeven, but most at a loss as they watch in disbelief as the market takes out their stops and their reversal is proven to be just a pullback within the trend.

2.2.6 - Summary – The Reality of the Markets



Figure 2.11 – Markets are Traders Making Trading Decisions

The reality of the market is traders making trading decisions.

It's all about people, not price.

Individual traders make trading decisions based on their perception of the market.

The net effect of all traders operating within the market will result in a net bullish, bearish or neutral sentiment, which leads to bullish, bearish or neutral orderflow and its corresponding price movement.

Learn to view all price movement from the perspective of other traders, and how the price movement influences their decision making.

When we look at a chart, don't see it as price movement. See it as traders operating through a foundation of fear and greed and all of the perceptual limitations and heuristics and biases which influence their decisions and subsequent actions.

You may feel this slight change of perspective is minor, and perhaps irrelevant. You'd be wrong. It's vitally important to defining the way we trade, and has great relevancy to the next section, where we learn what the game of trading is really all about.

2.3 - The Reality of the Trading Game

2.3.1 - How Do We Profit?

First an apology... like the previous section, this is going to appear ridiculously basic to anyone who has been around markets for a while. Please don't skip it. There's a good likelihood, especially if you're not consistently profitable, that you've missed some key concept. In order to understand the reasons WHY my strategy works, you need to get the foundation right.

Let's assume our objective with trading is to profit from the markets.

For the majority of us (with the exception of some options traders) profit comes from capturing price movement. In figure 2.12, this may be via buying at A on the trend pullback and selling at the overextended highs of B. Or it may be via selling short at the downtrend pullback C and covering at the stall at point D.

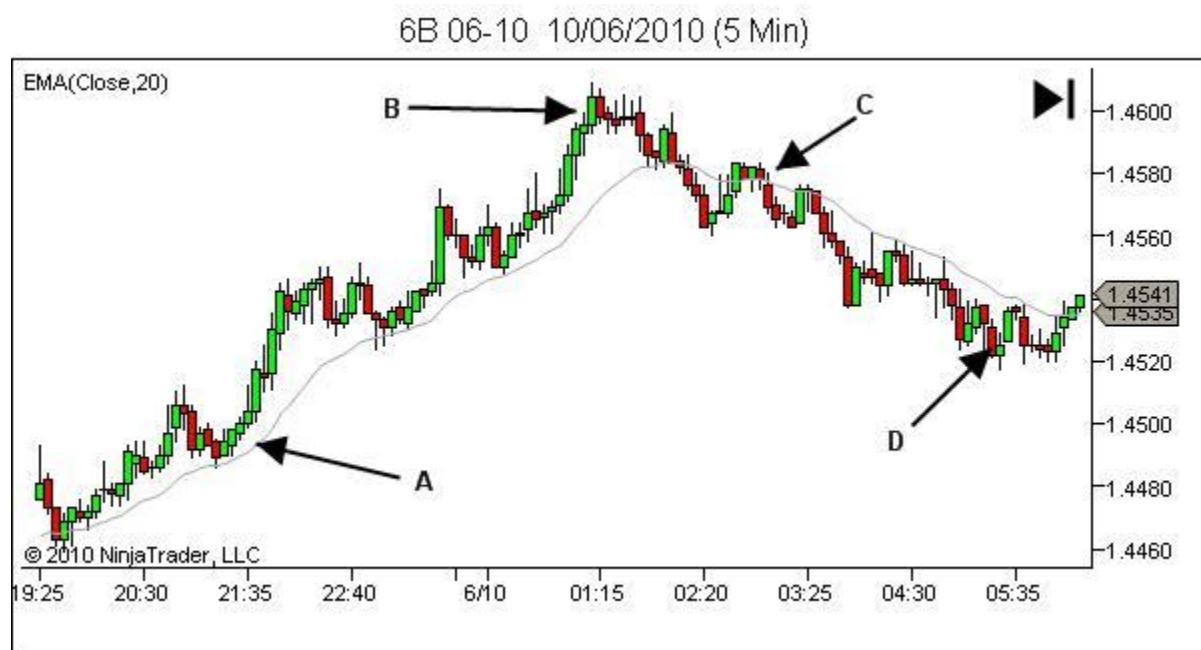


Figure 2.12 – Opportunity for Profit Requires Price Movement

Profit comes from movement of price and your ability to buy lower and sell higher, or sell higher and buy lower.

Here's an important point though. Profit requires movement of price AFTER your point of entry.

Let's consider this from the perspective of other traders and our new understanding of the nature of the markets and price movement.

Consider a long position. For it to profit, you must have bullish price movement after your entry point. Bullish price movement comes from bullish orderflow which comes from net bullish sentiment – traders making buying decisions. So to profit, other traders must be making their buying decisions at the same time as, and after, you make your buying decision.

The concept is the same for a short position. For it to profit, you must have bearish price movement after your entry point. Bearish price movement comes from bearish orderflow which comes from net bearish sentiment – traders making selling decisions. So to profit, other traders must be making their selling decisions at the same time as, and after, you make your selling decision.

Without that continuing orderflow supporting your decision, and coming after your decision, price cannot move in your favour and you will not profit.

2.3.2 - Analysis for Profit

The True Basis For Profit

The aim of your analysis then MUST be the following:

- **To buy at areas where you KNOW others will buy after you, because their buying will create the net orderflow or bullish pressure to drive prices higher, allowing you opportunity to profit, or**
- **To sell at areas where you KNOW others will sell after you, because their selling will create the net orderflow or bearish pressure to drive prices lower, allowing you opportunity to profit.**

Or more simply; buy at areas where others will buy after you, and sell at areas where others will sell after you.

To do that, your analysis must focus on areas of trader decisions.

What are other traders thinking? Where will they be making their trading decisions?

Identify areas at which others will be making buying decisions, and you can profit.

Identify areas at which others will be making selling decisions, and you can profit.

The most effective analysis is not analysis of price, but rather analysis of trader decisions.

If you haven't read it before, please review the following article on my website:

- Rock Paper Scissors – A Trading Analogy
- <http://www.yourtradingcoach.com/Articles-Strategy/Rock-Paper-Scissors-A-Trading-Analogy.html>

This is by far one of my favourite articles on the site. It examines another game which is commonly believed to be random. However the reality is far different. An edge can be gained in Rock Paper Scissors through analysis of your opponents thought processes and likely actions.

If you know what your opponent is thinking, you can beat them.

Trading is the same. If you know what the other traders are thinking, you can profit from their actions.

But Can We Know What Other Traders Are Thinking?

Individual trader decisions and actions cannot be known. We all trade for different reasons. We all make our trading decisions for different reasons.

There are so many different external influences on our decision making at any particular time... fundamentals, technicals, intermarket themes, general market sentiment (risk appetite / aversion), comments by media, economists, company CEOs, monetary officials, and so on.

Combine that with the internal factors which impact on our decision making... memory limitations, information processing limitations, perceptual errors, decision making heuristics & cognitive biases, our emotional state, values and belief systems, our susceptibility to distraction, and even our susceptibility to crowd psychology influences such as group think, and it's just not possible to know how any one person will think or act.

Price is not a true representation of fundamental value, but is a representation of the sentiment of the crowd, which is based upon flawed analysis of market information and irrational decisions.

Price movement is therefore based on psychology. It is emotional, rather than mathematical. It cannot be forecast or predicted with current mathematics or physics, and I expect it never will be.

Individual trader decisions are unknown.

And we can conclude from that statement that the collective sentiment at any one time should also be unknown.

However, our cause is not lost.

While that generally is true, remember that an imbalance of supply and demand doesn't actually mean greater numbers on one side, but rather an imbalance in desperation, or urgency.

We can, through our analysis, identify areas where significant groups of traders will be under extreme stress, and therefore feel forced to act in a reasonably predictable manner.

In times of stress, human decision making and actions become a lot more predictable, and are typically carried out with greater desperation and urgency. Exactly the qualities we're seeking.

This is not guaranteed, but generally quite reliable.

Consider human nature, in particular crowd behavior, at other times of stress. Imagine a shopping centre. Movement of any individual within that shopping centre will be largely unpredictable. And collectively, movement of all shoppers will appear essentially random.

Contrast this with their movement upon activation of a fire alarm. Their movement will now be somewhat more predictable, as all shoppers move (hopefully in an orderly manner) in the direction of the nearest exit.

We apply this same concept to our market analysis.

When are traders most under stress?

- When a position has moved against them and they're in drawdown. At some point they're going to reach maximum stress at which time they'll finally accept they're wrong and exit their position.
- When a position in profit starts to move against them. At some point they're going to reach maximum stress at which time they'll accept their trade is no longer right, and exit their position before the market can take the remainder of their profits.

In other words, at the point where they perceive they're wrong and are forced to act (in order to either minimise losses or minimise further reduction of profits).

We aim to enter before or at the point of maximum stress, where traders are coming to accept they're wrong.

Their decision to exit is a means of relieving themselves of stress. This creates orderflow that takes our position to profit (provided of course you manage the trade well).

The Real Trading Game

The real trading game is one of analysing other trader decisions.

Aim to understand all price action from the context of other traders' decisions and actions.

Aim to determine where large numbers of traders are going to be wrong in their decision making. The theory being that the point where they know they're wrong will contain an increase in orderflow as their stops are executed. I aim to profit from this orderflow by entering at exactly this point, or earlier.

To put it simply, I try to find the losers on the chart.

It's a mercenary game – I profit from their loss. But that's the nature of this game and I accept that.

It's so basic, but most traders just do not get the significance of this. Trading is all about people, and the decisions they make.

2.4 – Effective vs Ineffective Trading Strategies and Systems

Chapters 3 and 4 will present you with a method of conducting market analysis, setup identification, and trade entry and management which are based upon the principles that we have discussed so far.

This is an effective trading strategy as it's based on the true nature of the markets and the trading game.

An effective trading strategy is one based upon the analysis of the forces of supply and demand within the market, and assessment of how that will influence other traders' decision making.

Knowing how and why price moves allows us to identify areas on charts where, if price should go there, significant numbers of traders will be trapped in stressful situations and be forced to act. The resultant orderflow will create price movement.

Effective analysis allows us to identify areas of potential higher probability setups, which provide lower risk if wrong and higher reward if right.

Effective analysis allows us to actively manage our trades – holding them when price action confirms the other traders response is in accordance with our expectations, or allowing us to exit prior to our stops when price action does not act as expected.

Effective analysis allows us to manage our price targets, through identifying areas on the chart where opposing orderflow will come into the market to limit any further profit opportunity.

Figure 2.13 shows effective analysis. On price bar A, price broke below support level B. Breakout traders, and those operating off indicator based continuation signals, will likely enter on the move down, however effective analysis identifies the fact that this move occurs into an area of support in the vicinity of C and within the context of larger timeframe upwards trend (not shown). The lower prices into support are likely to bring bullish orderflow, opposing the breakout. We assess that, should the breakout fail these breakout traders will be forced to exit, creating a surge of bullish orderflow. Our entry triggers at D, with a stop below A and initial partial target at E where we expect some of the longs to take profit and therefore slow or halt the rate of climb. Partial profits will be taken here, with the remainder targeting the next level F.

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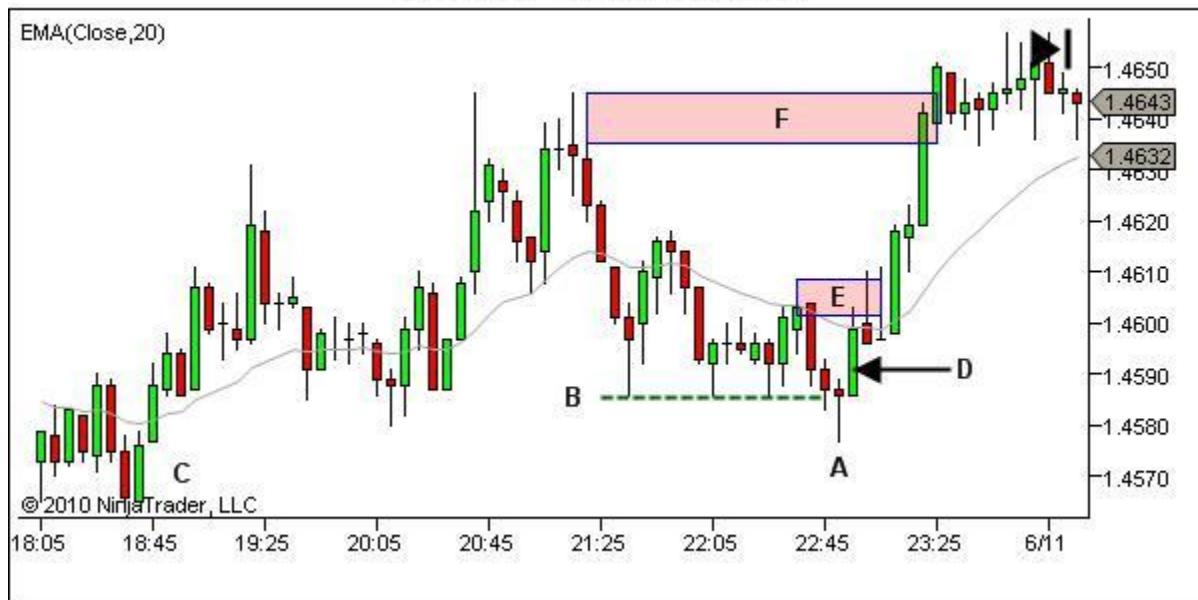


Figure 2.13 – Effective Analysis

This is not the way the masses trade. Typically, their decision making is based on the common teachings of technical analysis, involving little or no analysis of the forces of supply and demand, and absolutely no thought as to how this is influencing the decisions and actions of other traders.

Common application of technical analysis involves overlaying charts with numerous indicators, and then trading indicator based signals.

Think about how your favorite indicator based setups work. What are they actually indicating?

A trend following indicator such as a moving average cross (or any variation of this no matter how complex) is simply identifying the fact that price has already moved a certain distance, that distance being dependent on the formula and parameters defining the indicators.



Figure 2.14 – A Moving Average Cross Identifies Price Movement in a Certain Direction

This is demonstrated in figure 2.14, where the EMA 10/20 cross enters long at price level A, after price has moved sufficient distance in the long direction (AB) in order to trigger the cross. The EMA 10/20 cross enters short at price level C, after price has moved sufficient distance in the short direction (CD) in order to trigger the cross.

For most traders, entry is usually taken on these signals, or after further confirmation such as the breakout of the crossing candles.

The more confirmation required, the greater the trade risk; as the entry point is further from the point of initiation of the move (and ideal stop location). And the lower the profit potential, as the entry point is closer to the end of the move.

Price movement a certain distance from its turn point is not a guarantee of further price movement. In some cases that movement will continue. In other cases it won't. Novice traders enter these trades simply because the setup triggered, in hope that the price movement continues. They convince themselves that this is acceptable, simply because it's a probabilities game and they need to therefore take all signals. They fail to even consider the fact that more effective analysis techniques are available, which not only identify higher probability, lower risk entries, but also provide information about the potential opportunity available in the move.

There is no thought put into context. Where did this signal occur within *higher timeframe* structure? Is there any area which is likely to create opposing orderflow, limiting the extent of any move and therefore limiting the profit potential? What profit potential is available, and does this offer an acceptable reward:risk ratio.



Figure 2.15 – Moving Average Cross – Failure to Consider Context

Failure to consider context is shown in figure 2.15, the same price action as displayed in figure 2.14. We see here that the cross long at point A has occurred right into area B resistance, and the cross short at C has brought us straight into area D support.

Of course, your strategy may be more involved than just a simple moving average cross.

The point is the same though. All indicators are lagging. They're derivatives of price movement and have no future predictive ability at all. It's mathematically impossible.

They simply identify the fact that price has moved a certain distance, and entry is then taken simply in the hope that further price movement occurs, based solely on the fact that it occurred enough times in the past to prove profitable in that historical sample. As the disclaimers correctly state though – past performance is no guarantee of future performance. The fact is that the

probabilities will change across different samples of data, so future samples are unlikely to match your historical samples.

Oscillator based entries are not much better. Rather than identifying price movement, they signal changes in momentum. The way that is calculated varies from oscillator to oscillator, but essentially they are designed to identify changes in the *rate of change of price* (ie. price slowing or speeding up).

In one common application, entries are taken on an oscillator cross, or movement out of an *overbought* or *oversold* area. The oscillator pattern has signaled a slowing of price movement. The trade is taken in the expectation that this change of momentum will continue and result in a reversal of direction. Unfortunately though, price slowing in one direction is not necessarily an indicator of a reversal.

Like with the trend following indicator, you may actually use a setup and trigger that's a bit more advanced than a simple oscillator signal, but the principle is the same. Recognition of a change in indicatory-based momentum is not necessarily an indicator of change in price direction.

Once again, these setups fail to consider context. Where did this signal occur within *higher timeframe* structure? Is there any area which is likely to create opposing orderflow, limiting the extent of any move and therefore limiting the profit potential? What profit potential is available, and does this offer an acceptable risk:reward ratio.

The simplest example of failure to consider context is where an oscillator signal tries to fight a clearly strong trend, as demonstrated in figure 2.16 below.

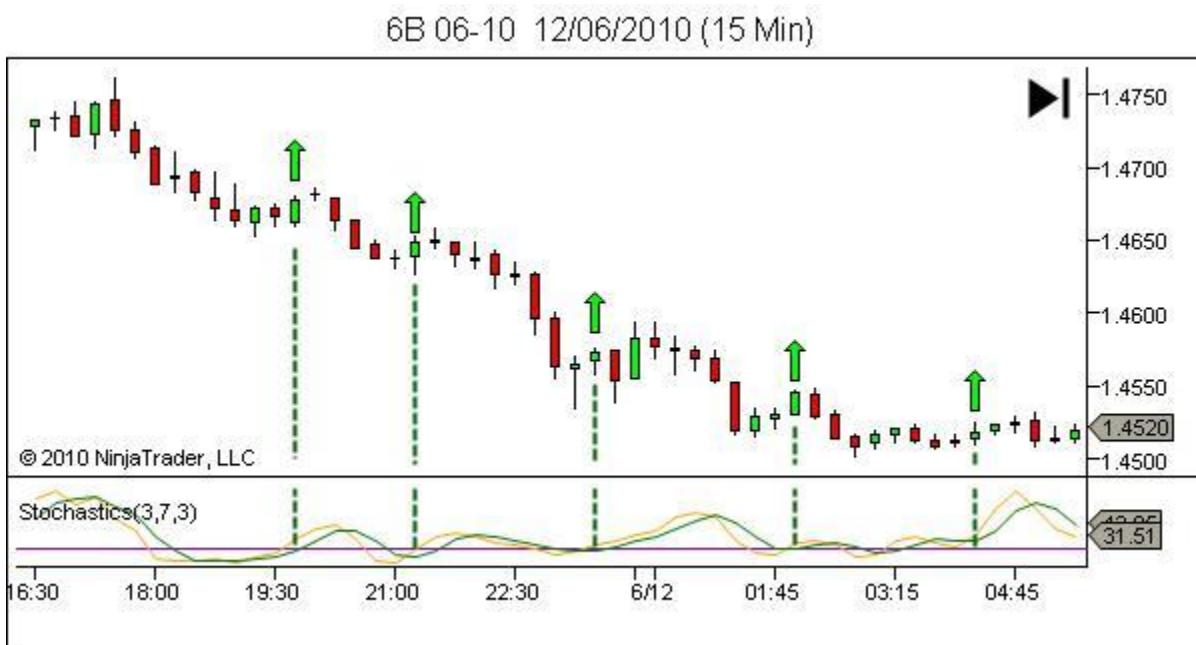


Figure 2.16 – Oscillator – Failure to Consider Context

Human beings are pattern recognition creatures. A natural human tendency is to see the patterns that worked and the huge profit potential they created, and filter out the patterns which fail.

Price movement sufficient to trigger a trend-type signal (such as MA cross) is a feature of all large market moves. However it's not a predictor of such a move.

Said another way... all large market moves have an MA cross, but not all MA crosses lead to a large market move.

Likewise, all reversals come from a slowing of momentum, but all slowing of momentum does not lead to a reversal.

Be careful if you wish to trade blindly off indicators. Quite likely, I'll be on the other side of your trade.

Pattern based signals are typically better, in my opinion, as they usually involve breakouts of clearly identifiable patterns, which should coincide with at least some orderflow in the breakout direction. However the reality is that a large percentage of these signals fail. False breakouts are a common occurrence in the markets. Blindly taking pattern breakouts leaves you susceptible to these false breakouts. Effective analysis of the forces of supply and demand, and what that

means for trader decisions, will allow you to more readily identify and react to potential breakout failure.

This is not to say that all indicator or pattern based signals will fail – obviously they work on a probabilities basis – typically though, when they work is simply because the trade area just happened to align with an area in which trader decisions were such that significant orderflow would occur within that area. Some are better than others. Oscillator signals or trend-type signals which happen to be taken in the direction of the trend, will provide higher probabilities simply due to the fact that they align with a pullback within a trend, an occurrence which will attract some new with-trend orderflow. Other signals may also prove reasonably effective, but the problem is still a lack of context or real consideration of the true nature of markets and price movement.

Is it not better then to conduct your analysis with thought as to the forces of supply and demand, and how that affects trader decisions?

In assessing the validity of any other trading strategy, or in developing your own strategies, be sure to consider the following:

- Has any explanation been provided as to why the strategy should work?
- Does it identify areas at which other traders are likely to make trading decisions?
- Does it consider the context within which this entry setup is occurring? In particular, does the *higher timeframe* structure and trend support the trade, or is it likely to create opposing orderflow and therefore limit the extent of any move and limit any profit potential?

There are some good strategies and good educators, available in the marketplace. They are based upon these principles, although they may not talk about it in the way I have presented it. My website resources page (<http://www.yourtradingcoach.com/Trading-Resources.html>) will share links to other quality strategies, or sources of education, as I come across them.

But in my experience it is a rarity. I'd suggest most strategies are ineffective, failing to consider these factors at all.

Certainly the never-ending supply of trading systems presented in the popular forums are clearly ineffective, having no consideration at all to the reality of this game – we need to be trading at areas where others will trade, after we do.

Effective trading strategies do not simply recognise price movement, entering after it occurs, and hoping it continues.

Instead, knowing that price movement is the effect of trader decisions, they work to identify the areas on the chart at which traders will be making decisions that are likely to be net bullish or bearish.

Most other traders aim to find the effect of price movement. We seek the cause, and enter before them, allowing their order flow to add to ours to move our position into profit.

We aim to enter with the professional traders, well before the retail public.

And we aim to hold the position while the premise that led to this move still exists, until price reaches an area on a chart where we know traders will be making the opposite decision, creating an opposing force that could limit further price movement.

2.4.1 – Principles of my Effective Strategy

Let's review the key principles or beliefs upon which my whole strategy, an effective trading strategy, is based:

- Profits on a single trade come from identifying potential directional price movement before it occurs, and acting on that belief. Profits therefore require price movement.
- Price movement represents changes in supply and demand. Whenever demand exceeds supply, price will rise. Whenever supply exceeds demand, price will fall.
- Changes in supply and demand occur as sentiment changes within the market participants.
- Price movement therefore depends on the bullish or bearish sentiment of the market participants.
- Price action is determined by human decision making. While individual trader decisions are generally unpredictable, as we cannot know the factors and limitations that apply to that individual's decision making potential, this is not necessarily the case when under extreme stress.
- Human action in times of stress is somewhat predictable (on a probabilities basis, not a certainty), in particular those times when our analysis is proven inaccurate and we're in a losing trade. At some point, we're going to have to exit to minimise the pain.
- Therefore, by identifying times at which a large enough segment of the trader population will be experiencing stress, we can identify areas of potentially higher probability setups.

- Because you will not win 100% of trades, success has to come from a series of trades, which result in a profit after subtracting the losses and expenses from the wins.
- Consistent profits over a series of trades can only occur if the strategy contains an edge, such that:
 - Analysis is skilled enough to identify these areas at which traders are under stress, therefore presenting higher probability setups.
 - Trader focus, discipline, confidence and psychology are sufficiently developed to identify the lower risk entries within these setup areas and take appropriate action to enter the trade.
 - Position sizing and risk management are clearly planned in order to minimise damage to the equity balance in the event that this trade is one of the many which will lose (whether due to our analysis being wrong, or the sentiment changing within the market).
 - The trader has sufficient experience to manage the trade in such a way as to minimise loss and maximise any gain.
- It is possible to develop a strategy that identifies higher probability setups. We'll discuss that in future chapters.
- It is possible to learn appropriate position sizing and risk management.
- It is possible to gain experience in the markets, improving our efficiency with trade management and exits, although due to the uncertainty within the market this area will never be mastered.
- It is possible to master our trading psychology, such that fear provides minimal disruption to our ability to follow our planned processes and routines.
- As a result, it is possible to profit from the markets.

2.5 - Conclusion

This chapter has provided you with a new way of viewing the markets, and the way to profit within this environment.

Markets are not price movement. They are traders making trading decisions.

The way to profit on a consistent basis is through finding those opportunities where there is a higher probability of a sufficient number of traders making trading decisions, which will lead to net order flow in a particular direction, and then acting to trade with this orderflow.

We've seen that individual trader decisions are usually unpredictable, leading to no or minimal edge in the markets. However at times of stress they become much more predictable.

Our trading approach therefore needs to be based on this fundamental understanding of how to profit from the markets:

- We identify areas at which traders will be experiencing stress, and will make trading decisions to relieve them of that stress, and then act before or with them in order to profit from the resultant orderflow.

That is the basis behind the strategy we'll cover in the next few chapters.

Or if you prefer to develop your own trading strategy rather than use mine, this should be the principle upon which it is based as well. Anything else, in my humble opinion, is vastly inferior.

Find the areas on a chart where other traders will make trading decisions and you've got yourself an edge.

Enter at or before the change of net order flow, and you've got a great opportunity to profit (provided you manage the trade well).

Chapter Three – Market Analysis

3.1- Introduction to Market Analysis

3.1.1 - The Aim of Our Market Analysis

This chapter is where we learn about market analysis. Do not think about trading yet. This chapter has NOTHING to do with trade setups, entry or exit.

What we're doing through our market analysis is developing situational awareness and maintaining focus.

Understanding where price has been, assessing the strength or weakness of the current price movement, and developing a feel for where that is likely to lead future price.

Or just simply:

- Where has price been?
- Where is price likely to go?



Figure 3.1 – The Aim of our Analysis

In order to answer these questions we'll be covering the following:

- How to structure the market in order to conduct your analysis. You'll learn how I analyse price action within a framework of support and resistance.
- How to analyse the direction of the trend, as price moves within our market structure.
- How to develop a feel for strength and weakness within the market, and project that forward to identify the likely future price trend.
- And finally, how to update your bias as new market data appears bar by bar.

3.1.2 – Subjectivity vs Objectivity in Market Analysis

The market is an emotional creature.

Trader decisions cannot be defined by fixed rules, and so price movement cannot be defined by fixed rules.

Attempting to define a market by fixed and objective rules will result in an approximation that will fail to represent reality at critical times.

The human mind excels in subconscious pattern recognition, and will develop its own feel for supply/demand interaction and likely future price direction.

The end result of trying to overlay objective rules upon market movement is mental conflict, as your subconscious analysis differs from that of your objective model.

Conflict in thought and emotion results in poor trade execution, poor trade management and sub-optimal results.

The answer is not in having a better and more objective model. You need to get comfortable with subjectivity. You need to trust your intuition.

You will most likely resist this idea. If so, take some time to consider why.

What are you afraid of? Why do you demand objectivity in rules, when you know these rules do NOT define the market price action?

You may accept that objective rules cannot define market price action, but argue that they're close enough; that all you need are rules for the exceptions. That sounds reasonable, until you discover that the exceptions themselves change.

It's better to embrace subjectivity and learn to operate within the uncertainty that is the market.

Of course, danger occurs when subjectivity is not based upon an open read of the market, but instead is based upon some preconceived bias. Success requires being in sync with the market flow. If you're biased towards a particular direction, and it opposes the actual market flow, your results for that session will likely be a dismal failure.

I guarantee, if you approach your market analysis with a preconceived and unchangeable bias, you'll find numerous trade opportunities and signals that support your bias, all of which look great at the time, but continually fail. Upon reflection post-session you'll clearly see that you were fighting the market the whole way.

If your results are not in accordance with expectations mid-session, it pays to exit the market and print a chart and determine whether your trades were taken in accordance with the flow, or whether you were actually fighting the dominant trend.

You need to embrace subjectivity and *feel* the market.

Let the market action tell you where it's going. Don't try to tell it where to go.

Our market analysis is a subjective process. The following sections will involve subjectivity in many areas, in particular in the definition of our framework and of our trend. More discussion will be provided in the appropriate sections on how that subjectivity is applied.

3.2 – Past Market Analysis

3.2.1 – Support and Resistance

Support & Resistance Principles

In order to conduct our market analysis, it's essential to understand and to be able to identify support and resistance (S/R).

S/R are areas on the price chart which form barriers to price movement. Support acts as a floor, limiting further downward movement. Resistance acts as a ceiling, limiting further upward movement.



Figure 3.2 – Support and Resistance

S/R are formed through the actions of traders in the market.

You will recall from our discussion of the nature of markets that price movement is a function of supply and demand.

- Price rises due to net bullish sentiment and continues rising until we run out of buyers, or until supply increases sufficiently to absorb all the demand.
- Price falls due to net bearish sentiment and continues falling until we run out of sellers, or until demand increases to the point it absorbs all the supply.

In figure 3.2, note the multiple price rallies towards the upper resistance area, around 1.4600. Price rising implies bullish sentiment and bullish orderflow. However on multiple occasions the rally was halted at that level and price fell. The only way the price could fall from this level was if either one of both of the following occurred:

- 1) Traders were not interested in buying at higher prices. Demand had dried up and there was no longer any urgency to get long into this market.
- 2) The higher prices were attractive to those selling the market. Longs took profits on their position. New shorts entered the market. The increase of supply (selling) has absorbed any remaining demand.

The end result of these two causes is that the bullish pressure which caused the price rally is no longer able to overcome the bearish pressure. Price will fall, creating a new swing high at resistance.

In figure 3.2, note the multiple occurrences of price falling towards the lower support area, around 1.4420-25. Price falling implies bearish sentiment and bearish orderflow. However on multiple occasions the fall was halted at or just above that level and price rallied. The only way the price could rally from this level was if either one of both of the following occurred:

- 1) Traders were not interested in selling at lower prices. Supply had dried up and there was no longer any urgency to short this market.
- 2) The lower prices were attractive to those buying the market. Shorts took profits on their position. New longs entered the market. The increase of demand (buying) has absorbed any remaining supply.

The end result of these two causes is that the bearish pressure which caused the price fall is no longer able to overcome the bullish pressure. Price will rise, creating a new swing low at support.

But what causes these swing highs and lows to occur at the same levels, or at least in the same area? And what causes the change of polarity, where old areas of support become new areas of resistance, once broken, or old areas of resistance become new areas of support?

Not surprisingly, it's traders making trading decisions.

It's a function of how we're wired as human beings; of how we assess *value* with regards price, and how we make buy and sell decisions.



Figure 3.3 – Creating S/R through Trader Decision Making

Let's work through an example using the price action of figure 3.3, which reproduces the figure 3.2 data but also shows a little of the prior action. Price had been in a slow grinding uptrend for two days (not shown), prior to accelerating up to swing high A. Swing low B took price back to the point where acceleration commenced up to A, affording those who missed the initial move a second opportunity to enter long.

For the purposes of our discussion, consider initially the thoughts and fears of those traders who established a long position prior to the initial move to A.

Some will be concerned at the strength of the fall from A to B. Note how the rally to A took three price swings, while the fall back to B was one swift move, even breaking below the previous swing low marked via a horizontal line. This is quite a bearish swing. Profit taking at A, combined with the possible introduction of new shorts, has driven price back quite strongly.

Seeing such a strong bearish move, traders in a long position will naturally experience some regret that they didn't take profits at A, when price was much greater than it is now. Then they

could have bought again as B held (the point of initiation of the accelerating swing up to A) for a second opportunity to profit.

Regretting this missed opportunity to sell at A, the trader will resolve to not miss that same opportunity if it should once again present itself. If only price can get back to A, they'll be ready with their sell orders.

This creates the pause in the rally at point C, as profit taking again places a cap on upwards movement, even if just temporarily.

However, you'll note that swing from B to C was also quite bullish. Some traders who had initially decided to take profits at C will change their mind and hold, with renewed (albeit cautious) confidence.

New longs, who took the second chance entry at B will likewise hold with confidence.

However this confidence is seriously dented as point D fails to push any significant distance above A. Inability to push higher implies either a lack of new buying at these higher prices and/or the introduction of new selling as the bears position themselves short expecting a reversal. The market sentiment is clearly not bullish at these levels, otherwise the break above A would have led to another strong leg upwards.

Additional longs will take profit at the pause at D, adding to selling pressure and further capping prices.

Consider now the *late* longs, who entered at the top of the move right into swing high D, as price broke above swing high A. These traders are quite frustrated; having missed the great profit opportunity up to A, and between B & C, they now find themselves in a painful, extended drawdown as price grinds sideways through area E.

These traders will be looking for any opportunity to salvage the situation, swearing that if price can just get back to their entry point, they'll take the opportunity to get out at breakeven.

The market affords them that opportunity at points F, G and H.

This selling adds to any bearish orderflow from new bears, creating what appears on the chart as resistance within this one common area.

The resistance has been created due to the traders within the market perceiving prices around 1.4600 as being high, and therefore a selling opportunity.

Let's reproduce figure 3.3 (now 3.4) below, to discuss the support.

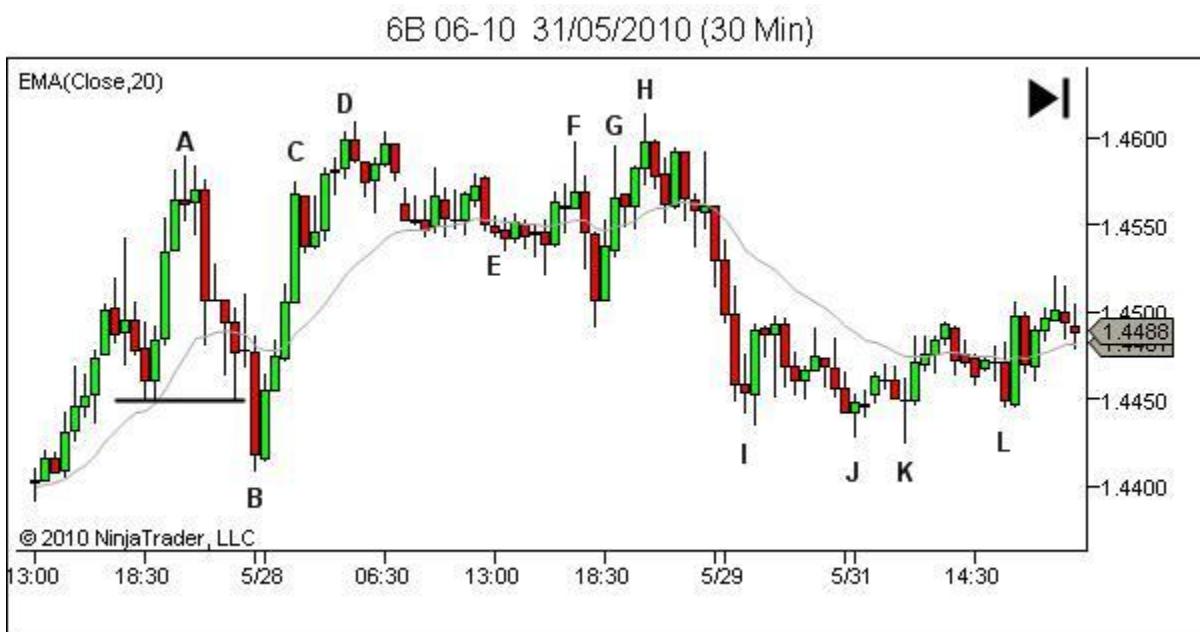


Figure 3.4 – Creating S/R through Trader Decision Making - 2

Consider the move downwards from point H, and in particular the mindset and thought processes of those holding a short position.

Where are they expecting buying to again come into the market, which might limit any further downside movement? They'll observe swing low B and note the rapid rate at which price last rejected that level and exploded back up to C. Expectations are that if traders previously perceived great buying opportunity at point B (vicinity 1.4400/20), then they may do so again.

Shorts will be looking to take profits, or at least cover part of their position, as price approaches abeam B. This bullish demand (buy orders to cover the short) will add to any other buy orders from new longs on the retest of B, to halt the downward move.

Trader expectation of support abeam B has produced support at areas I, J, K and L.

Let's look at an example of a change of polarity (figure 3.5), in this case support becoming resistance. In doing so, we'll once again consider the thought processes and emotions of traders and how that influences their decision making.

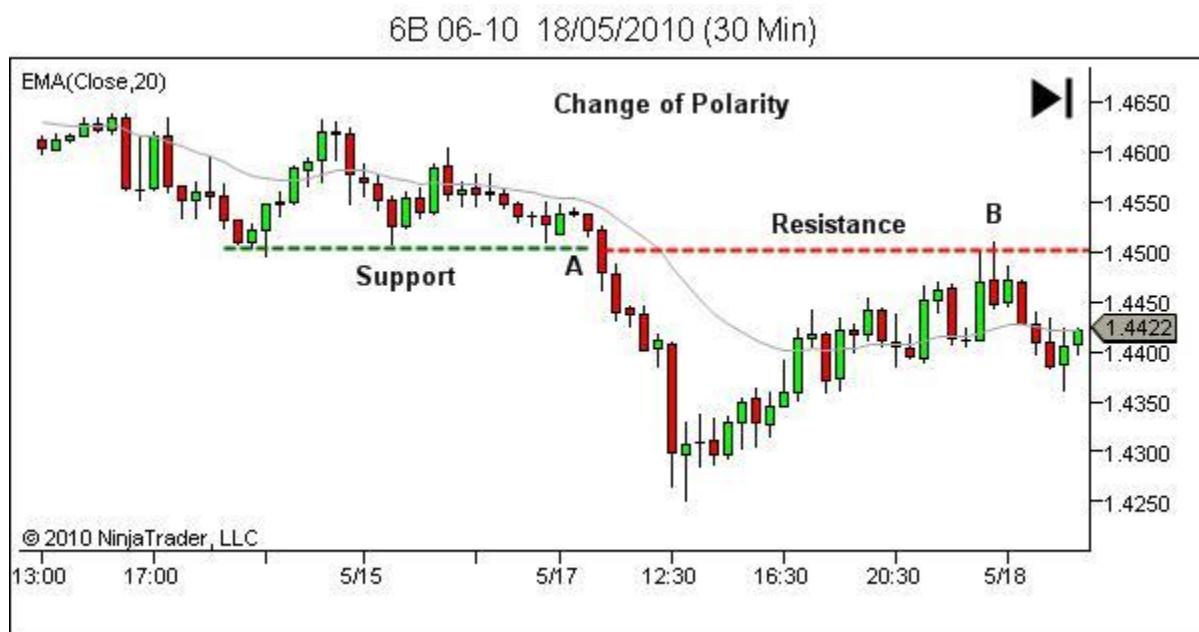


Figure 3.5 – Creating a Change of Polarity through Trader Decision Making

It's all once again trader fear, hope and regret.

Prior to point A we had an established area of support, marked by the green line. Bullish demand was entering the market here, limiting downside movement. Stops were placed below the area to exit the long positions (for those smarter traders who use stops). Entry orders were also placed below the support area where the breakout traders hoped to enter short.

The break below support at A experienced a surge of bearish pressure, as all these sell orders were executed, pushing price down to new swing lows.

Consider the different parties involved at this point.

Firstly, consider the longs from prior to A, who were not so smart and held onto their position. Right now they're in extreme drawdown and much stress, praying for any opportunity to get out at breakeven or at least as close as they can. If price gets back to the point of breakout, they promise to sell their position, just as they should have done at A.

Now consider the shorts who missed the move down from A, cursing their incredibly bad luck at missing yet another good breakout. They will be praying for price to retest the point of breakout again, so that they can have a second chance at entering short. They promise themselves that if they get this opportunity, this time they'll sell for sure.

Now consider the smarter breakout traders who caught the initial move. They'll plan to take some profits at the stall at the swing lows, and look for an opportunity to reestablish their position at higher prices again, the absolute best opportunity being the point of initial breakout.

All these decisions lead to the upper tails at point B, where bearish orderflow quickly rejects any higher prices abeam point A.

Trader decisions have led to previous support now acting as resistance.

The reverse process applies to previous resistance now becoming support, following a breakout upwards through that resistance. I encourage you to find an example on a chart and work through the same thought processes.

Support and resistance are created by the decision making of market participants, as they operate within an environment of uncertainty.

Decisions to buy or sell are made through referencing current price against previous areas which caused significant emotional response, in particular those areas which led to regret of missing out on opportunity, or those areas which trapped traders in losing positions.

There are other factors involved, not least of which is the simple self-fulfilling prophecy.

Assume a chart displays a solid area of resistance. If price ever moves back to that area, traders will be expecting resistance to again hold. Buying will dry up and selling will increase. Bearish pressure will overcome bullish pressure leading to price falling. The expectation of resistance leads to orderflow which restricts further upward movement, thus creating resistance.

The same applies to clearly recognisable areas of support. If price moves back to that support area, traders will again expect support to hold. Selling will dry up. Buying will increase. Bullish pressure will overcome bearish pressure leading to a price rally. The expectation of support leads to orderflow which restricts further downward movement, thus creating support.

Support is an area in which demand overcomes supply, limiting downward price movement.

Resistance is an area in which supply overcomes demand, limiting upward price movement.

Identifying Support and Resistance

S/R are areas which have provided a barrier to further price movement. In most cases, this will display as turning points in the market (swing highs and lows).

Let's look at how I define these swing high and low areas.

Swing Highs and Lows

A swing high is simply any turning point where rising price changes to falling price. I define a swing high (SH) as a price bar high, preceded by two lower highs (LH) and followed by two lower highs (LH), as per the following diagram:



Figure 3.6 – Swing High

Referring to figure 3.6, the Swing High is candle C. All other candles reference this one.

- Candle A has a high which is LOWER THAN candle C's high.
- Candle B has a high which is LOWER THAN candle C's high.
- Candle D has a high which is LOWER THAN candle C's high.
- Candle E has a high which is LOWER THAN candle C's high.

Note that candle A's high does not have to be lower than B. All highs only reference the high of C, as per the examples below in figure 3.7.

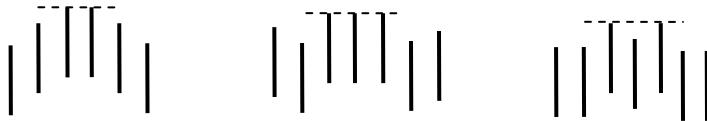


Valid Swing High Pattern Examples

Any combination in which the swing high is preceded by two lower highs and followed by two lower highs.

Figure 3.7 – Example of Swing High Variation

In the event of multiple candles forming equal highs, this will still be defined as a swing high, provided that there are two candles with lower highs both preceding and following the multiple candle formation, as shown in figure 3.8 below.



Valid Swing High Pattern Examples

Any combination in which the multiple candle swing high is preceded by two lower highs and followed by two lower highs.

Figure 3.8 – Example of Swing High Variation – Multiple Candle SH

Likewise for the swing low.

A swing low is simply any turning point where falling price changes to rising price. I define a swing low (SL) as a price bar low, preceded by two higher lows (HL) and followed by two higher lows (HL), as per the following diagram:

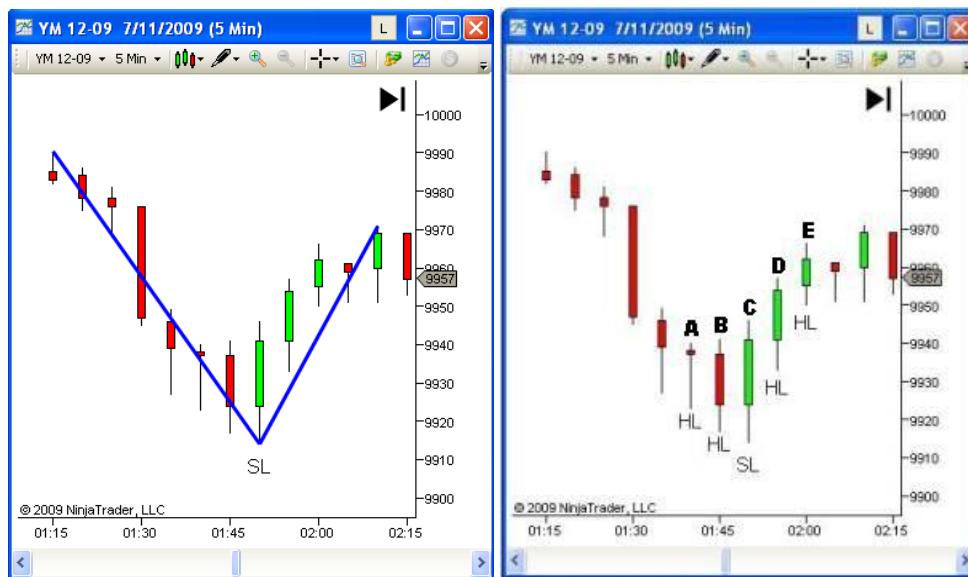
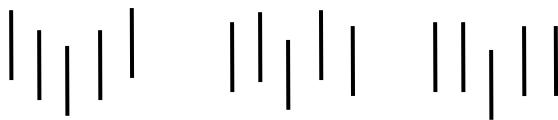


Figure 3.9 – Swing Low

The Swing Low in figure 3.9 is candle C. All other candles reference this one.

- Candle A has a low which is HIGHER THAN candle C's low.
- Candle B has a low which is HIGHER THAN candle C's low.
- Candle D has a low which is HIGHER THAN candle C's low.
- Candle E has a low which is HIGHER THAN candle C's low.

Again note that candle A's low does not have to be higher than B. All lows only reference the low of C, as per the examples below in figure 3.10.

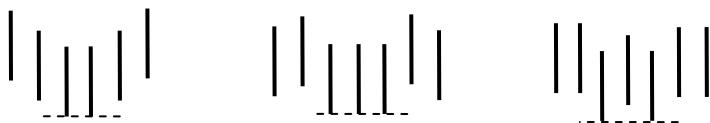


Valid Swing Low Pattern Examples

Any combination in which the swing low is preceded by two higher lows and followed by two higher lows

Figure 3.10 – Example of Swing Low Variation

In the event of multiple candles forming equal lows, this will still be defined as a swing low, provided that there are two candles with higher lows both preceding and following the multiple candle formation, as shown in figure 3.11 below.



Valid Swing Low Pattern Examples

Any combination in which the multiple candle swing low is preceded by two higher lows and followed by two higher lows.

Figure 3.11 – Example of Swing Low Variation – Multiple Candle SL

Additional Areas of S/R

The vast majority of my S/R are defined by swing highs and lows, as described. However there are additional means of identifying S/R which you may wish to consider if they're prevalent in your chosen market.

As an example, your market may produce gaps which also define S/R areas. These are not so prevalent in forex or FX currency futures, so let's look at an example from the emini-Dow futures, YM.



Figure 3.12 – Gap Support

Drawing S/R - Areas NOT Lines

When I display my S/R areas on a chart, it will usually be done via a straight line.

You'll note however that when price returns to this line it does not always stop at the exact price defining this S/R line. S/R is an AREA in which traders make decisions. Different traders will make their decision at different prices, and will act on that decision at different times within that area.

As such, during the conduct of your analysis it is imperative that you remain aware of the whole area, even though your chart may show S/R represented by a single line. Be aware that price may turn before the line; and that a break of that line does NOT necessarily constitute a break of the S/R level.

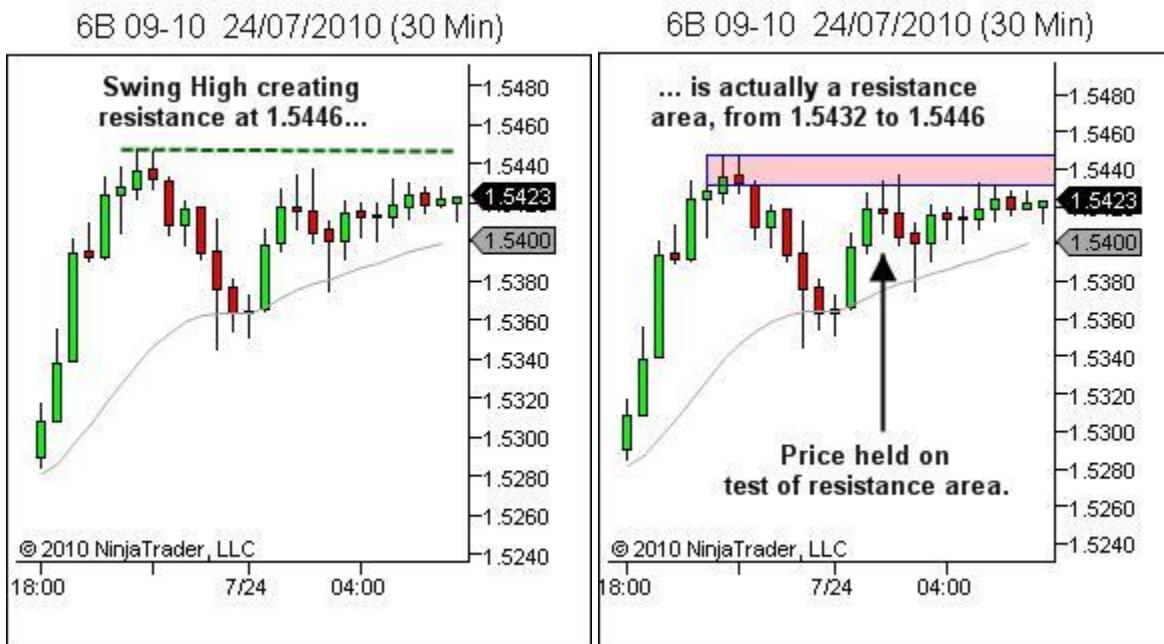


Figure 3.13 - S/R as an Area

S/R lines are usually drawn at the high/low of the swing H/L candle, as shown on the left hand side of figure 3.13. However it may be drawn in other locations, with tails protruding above/below the line, if that location better defines the area of S/R.

An example of this variation would be when the swing H/L has penetrated a significant round number level by a couple of pips; I'll usually place the S/R line at that round number level rather than a few pips above or below.

You may prefer to display your S/R as a box, rather than line, during the learning process.

Typically I'll be visualising the area as if it included the upper or lower tails and body of the swing high/low candle. This is demonstrated in the right hand side of figure 3.13 above, where the area encompasses the upper tail and body of the red swing high candle.

For small candles at swing high/low points, I may include the whole candle range as the area of S/R.

Or if the candle has too large a range, then I'll look at either market structure or a lower timeframe, in order to find an appropriate region.

That being said, even this is an approximation of the area boundaries. Fixed rules don't apply here. An S/R area is not like a brick wall. It's a price region which has some emotional attachment to traders, as a result of a previous supply/demand imbalance, which is expected to possibly be an area of future trader decision making. The boundaries of the *area of emotional influence* cannot be exactly defined.

The key is not to get too concerned about exactness and don't be afraid of subjectivity. It's an area.

Later when we discuss trading, you'll note that we don't just assume these areas will hold. They become areas of interest where we'll be looking for opportunity –sometimes expecting the area to hold, other times expecting a break.

So if you're out by a few pips or points, it doesn't really matter.

Enjoy the subjectivity. It takes a little practice, but you'll get comfortable with it in time.

Let's review a couple of examples, in which we discuss the *area* that I'd typically expect to find support or resistance orderflow...

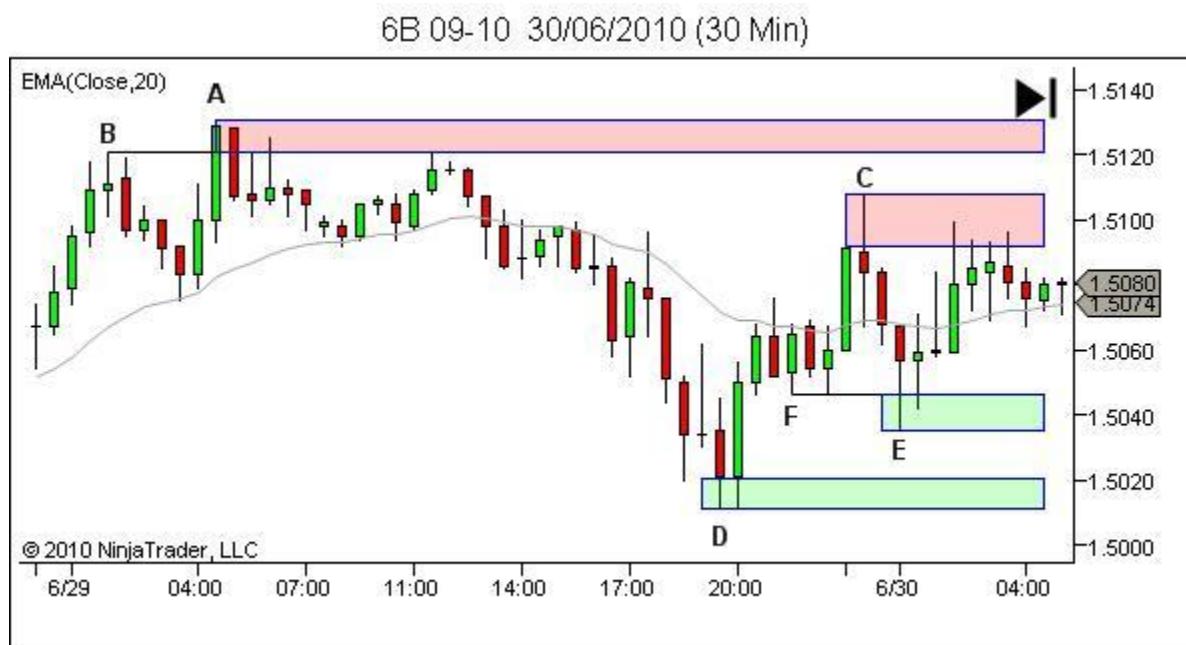


Figure 3.14 – Which Part of the Candle Forms the S/R Area – Example 1

The candles at swing high A, in figure 3.14, are too large to completely define a resistance level. In this case I would use the area from the top of swing high A to the point of breakout above swing high B.

Resistance at C is defined by the upper tails.

Support at D is defined by the lower tails.

Swing low E has quite large tails. Rather than encompassing this whole area, I'd mark the support area as being the portion of the tails which broke the low side of the area of congestion at F.



Figure 3.15 – Which Part of the Candle Forms the S/R Area – Example 2

In figure 3.15, an area of resistance is defined by swing high A, and the top of a subsequent area of sideways congestion. I would mark this area simply as the upper tails.

Support is defined by swing low B. I'd draw the support area enclosing the whole range of the narrow-range candle at swing low B.

3.2.2 – Multiple Timeframe Analysis

Markets operate in the now – the current transaction. The concept of multiple timeframes exists only through the way we choose to view past and present market action.

The higher the chosen timeframe; the greater the *bigger-picture* available to the trader.

The lower the chosen timeframe; the more *detail* available to the trader.

The challenge for us is that the market is composed of numerous market participants all operating via different timeframes. So, which timeframes should we choose for our analysis?

I've seen traders attempt to operate with half a dozen timeframes on their screen at once; everything from weekly down to one minute. Their attempt to gain a complete picture is impressive, but for me it's just too much data for one person to absorb during their development phase; at least until they've learnt what to filter out.

Likewise, I've seen traders attempt to operate on only one timeframe in an attempt to limit the information. I think this is preferable to too many timeframes. I can certainly trade this way, mostly because I can *see* the higher timeframes within the lower timeframe data.

My preference though, and certainly what I recommend for all traders while learning to trade, is to operate with three timeframes.

I may be aware of others; certainly I'll glance at the daily chart during my pre-session preparation; but the focus during my market analysis is on three timeframes only.

These are the *Trading Timeframe* and then one timeframe higher (*Higher Timeframe*) and one lower (*Lower Timeframe*).

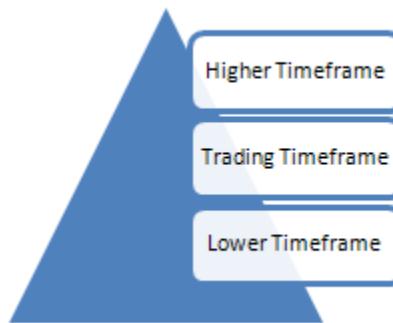


Figure 3.16 – Three Timeframes

A common error with newer traders who attempt multiple timeframe analysis is to try to find alignment of trend on all timeframes. That is, they try to identify an uptrend on all three timeframes (or a downtrend on all three timeframes) and then trade only in the direction of that trend. This seriously limits opportunity, while still being rather ineffective.

In reality, these traders are quite likely the same ones who've entered based on a lagging, indicator-based signal in the direction of the trend, simply hoping that the trend continues long enough to profit. Recognising that trends don't go on forever, they've simply filtered their trades to only take those which exist within multiple trends in multiple timeframes, in the hope that this greater force will push their trade to profit.

There is no consideration as to what **barriers** might be in place to stop the existing trend, thereby limiting their opportunity. There is also no consideration of the fact that markets spend a lot of time moving sideways.

We aim to operate differently. Figure 3.17 defines our three timeframes.

Higher Timeframe	To provide structure to our market, by identifying a framework of support and resistance, which act as barriers to <i>trading timeframe</i> price movement.	Primary: 30 min Alternate: 60 min
Trading Timeframe	To analyse the market trend and determine the likely path of future price action, as it moves within the <i>higher timeframe</i> market structure framework.	Primary: 3 min Alternate: 5 min
Lower Timeframe	To fine-tune the <i>trading timeframe</i> analysis; and to time trade entry and exit.	Primary: 1 min

Figure 3.17 – Trading Timeframes

The *higher timeframe* places a structure or framework over the market. Through identification of areas of support and resistance, we identify areas in the market which will form barriers to the *trading timeframe* trend. We've defined our battlefield.

The *trading timeframe* is the one we trade, hence the name. Our aim is to trade the swings within this *trading timeframe*, regardless of whether the market is trending or ranging sideways. We do this through understanding past price movement, assessing the strength or weakness within that price movement, and determining the likely path for future price action.

The *lower timeframe* provides us with finer detail in order to fine-tune our *trading timeframe* analysis, allowing us to *zoom in* to see the internal forces of supply and demand; plus in allowing us to time our entry and exit (more on entry & exit in Chapter 4).

We trade the *trading timeframe*. But we do so by placing this price action within the context of *higher timeframe* structure.

A trend within our *trading timeframe* may simply be a price swing within a *higher timeframe* sideways market. Multiple timeframe analysis allows us to be alert for a potential trend reversal at the area of *higher timeframe* barriers.

A breakout through resistance on our *trading timeframe* may simply push us deeper into a *higher timeframe* resistance area. So we'll be watching the shifting bullish and bearish sentiment for signs of breakout failure.

Multiple timeframe analysis is all about placing *trading timeframe* market action within the context of the bigger picture, *higher timeframe* action.

The timeframes we will use for the majority of examples throughout this book are:

- **Higher Timeframe: 30 min**
- **Trading Timeframe: 3 min**
- **Lower Timeframe: 1 min**

This is what I use as standard YTC Swing Trader timings for my trading of 6B or YM.

Although, it is flexible! Sometimes if I don't feel like I'm in sync with the market on these timeframes I'll find a better *feel* for price action using alternate *higher* and *trading timeframes* of 60 min and 5 min respectively. Spot forex pair GBP/USD, for example, is always more comfortable on these slightly higher timeframes.

We'll talk more about alternate timeframes and markets in a later chapter.

Let's work through an example using our three timeframes. We haven't yet covered analysis of trends, nor the creation of our *higher timeframe* S/R structure, so just accept this analysis for now.

The key at this point is just seeing how the timeframes interact. In particular, how the *trading timeframe* price action is placed into the context of the *higher timeframe* support or resistance.

While with-trend trades are always preferable when possible, I'll give a counter-trend example here, simply so that you can see how it works without requiring all timeframes in trend alignment.



Figure 3.18 – Multiple Timeframe Example – 30 min

Figure 3.18 displays a *higher timeframe* (30 min) chart. Resistance areas are displayed via the red lines. Support areas are displayed via the green lines. Note the area which changes from green to red. Previous support has become potential resistance once price dramatically broke through the support at point A. The area we're interested in for the purpose of this example is marked as point B, where price returns to test the area of resistance.

Figure 3.19 (below) shows the *trading timeframe* (3 min), where we analyse price action and seek trading opportunity. Ignore earlier opportunities (because we haven't yet learnt analysis or strategy) and focus solely on the retest at point B.

Our analysis of the *trading timeframe* (3 min) shows an uptrending market pushing into the area of resistance, and in fact slightly breaching the level. We'll be watching for one of two primary opportunities here – highest probability being a break of the level which quickly fails, second likely being a breakout which holds then continues in the breakout direction.

Again, just accept the analysis for now.



Figure 3.19 – Multiple Timeframe Example – 3 min

The *lower timeframe* (1 min) of figure 3.20 displays finer detail, allowing us to see a clear slowing of momentum on breaching the previous swing high, the 1.4500 level and the resistance area.



Figure 3.20 – Multiple Timeframe Example – 1 min

Consider the traders who have bought on a break above these areas. With price reaching 1.4510, their stops will likely be somewhere just below the zero's level. That's where we want to enter short, aiming to trade the overextended 3-min chart back downwards. Noting that it's counter-trend, we'll be looking for an initial target just above the prior swing low, in the vicinity of 1.4470.

Entry occurs on failure at the resistance area and price easily moves to our target over the next 6 to 7 minutes.

Key points from the example – The *trading timeframe* (3 min) was traded within the context of *higher timeframe* (30 min) structure, with the *higher timeframe* resistance providing a barrier to our *trading timeframe* trend. The *lower timeframe* (1 min) was used to fine-tune analysis as well as timing our entry and exit decisions.

Multiple Timeframe Support and Resistance

In discussing and trading my strategy, I will refer to two primary types of S/R, as follows:

- S/R identified on the *higher timeframe* chart is referred to as **Support or Resistance**.
- S/R identified on the *trading timeframe* chart is simply referred to as **Swing High or Low**.

Note that the *higher timeframe* S/R will also be evident on the *trading timeframe* chart, while *trading timeframe* swing highs and lows will often be insignificant on a *higher timeframe* chart.

Numerous chart examples will follow in the remainder of this chapter, displaying both S/R and swing highs and lows.

NOTE:

In viewing my earlier videos and reading the articles on my website, you may have seen me refer to S/R as either *Major S/R* or *Minor S/R*. These were the names I used for several years, simply because that's what I was taught.

My use of these terms was simply based upon timeframe. S/R identified on the *higher timeframe* chart was referred to as Major S/R. S/R identified on the *trading timeframe* chart was referred to as Minor S/R.

In preparing this book and discussing this issue with other traders, I have decided to change the names I use for these S/R levels. I will (from now on) be referring to my S/R levels via the simpler names, S/R and Swing H/L.

The reason for this change is simple. Firstly, Major S/R and Minor S/R are quite common names used by many traders; however there is no standard definition and you will find many different interpretations and definitions. The new names are simpler and will hopefully result in less confusion when reading other educators material. Secondly, Major and Minor tend to give the false impression that Major S/R are stronger than Minor S/R. Although sometimes the case, it's not necessarily true.

Common Abbreviations Used on Charts:

- S/R – Support and Resistance (any type)
- Spt – Higher Timeframe Support
- Res – Higher Timeframe Resistance
- Swing H/L – Trading Timeframe turn points
- SL – Trading Timeframe Support
- SH – Trading Timeframe Resistance

3.2.3 – Market Structure

Market Structure Principles

Our Market Structure operates in accordance with two principles:

- Principle 1 – Price moves within a structural framework of support and resistance.
- Principle 2 – A breakout of the structural framework support or resistance will lead to price movement in the next area of the framework.

Through identification of areas of support and resistance, we identify areas in the market which will form barriers to the *trading timeframe* trend. We've defined our battlefield.

Price then moves within the framework defined by these levels, back and forth between levels of support and resistance, based on the decision making of traders.

These S/R barriers are not impenetrable. They are *decision areas* for price, which will then either reverse or breach the barrier, depending on sentiment.

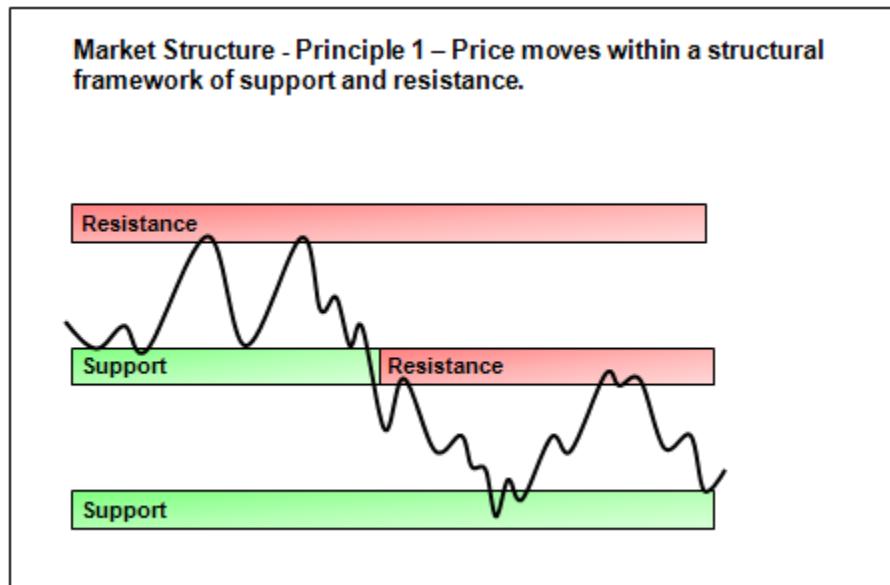


Figure 3.21 – Market Structure – Principle 1

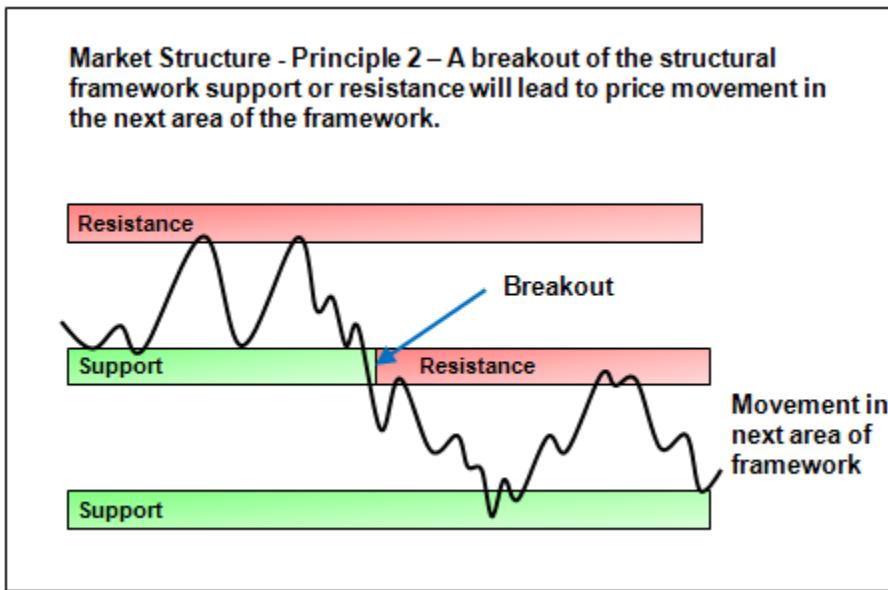


Figure 3.22 – Market Structure – Principle 2

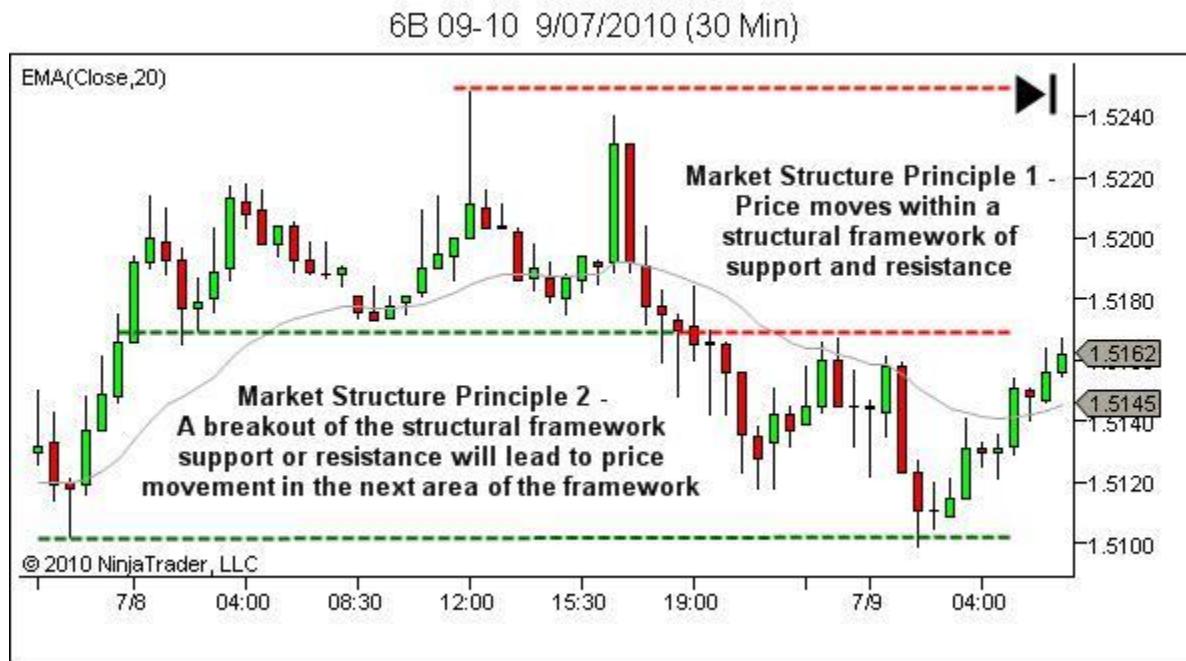


Figure 3.23 – Market Structure Principle 1&2 – Chart Example

Creating the Structure

The process for creating our *higher timeframe* structure is simple.

- Open your *higher timeframe* chart
- Identify and mark areas of S/R

Subjectivity

While the rules for identifying S/R are quite objective, not all S/R levels will be marked on charts.

If price is flowing in a smooth and orderly manner as identified below in figure 3.24, then all identified S/R may be marked on the chart.



Figure 3.24 – Smooth Flow

Swing high A clearly defines an area of resistance, which temporarily halted price at area C. Swing low B clearly defines an area of support.

Swing high D forms a new area of resistance, which holds price for the remainder of the displayed chart. Swing low E forms a new area of support, which once again holds price for the remainder of this chart's price action.

However, more often than not, price action is choppy with much overlap between candles. Strictly following our definitions for swing high/low would leave us with a market structure that is just unworkable.



Figure 3.25 – Choppy Action - Unworkable

This is demonstrated in figure 3.25, where strict adherence to the definitions of swing highs and lows provides a chart with support and resistance lines showing every 10-20 pips.

In these cases, we're required to *mentally* zoom out and select only those most relevant levels.

Our intent is simply to identify those key turning points which stand out on the chart as the most obvious levels, and therefore offer potential barriers to future price action.

Figure 3.26 below demonstrates how I would mark up the choppy price action of figure 3.25.

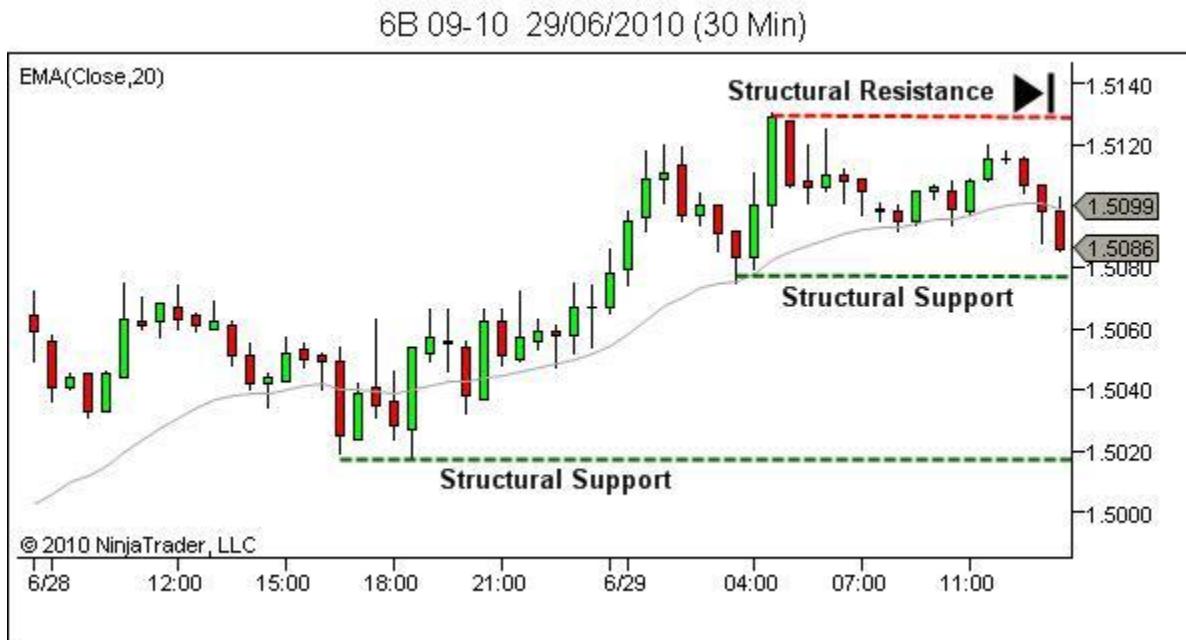


Figure 3.26 – Choppy Action – Selecting Key Levels Only

Don't try to make this too complicated. It really is as easy as, "*If it looks like a relevant S/R level, then it probably is*".

The Best S/R

The absolute best S/R, which should NOT be missed in your creation of market structure, are those levels which displayed the greatest supply/demand imbalance when price last left the area.

That is, those times when the difference in urgency between the bulls and bears is greatest, leading to RAPID price movement.

This will be evident at swing highs and lows which show a rapid reversal of price; and at areas of congestion which lead to a sudden and strong breakout with good follow-through.

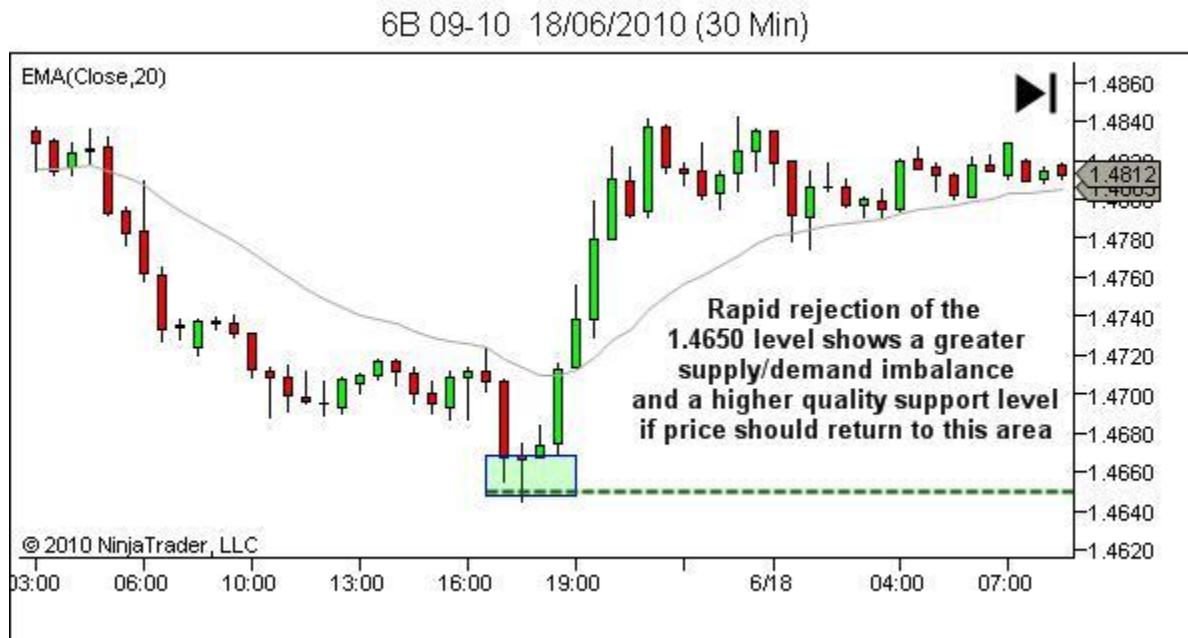


Figure 3.27 – Rapid rejection provides a higher quality S/R level

Be sure to include all such areas when defining your market structure.

Market Structure Examples

Let's finish up our discussion of Market Structure with a couple of examples, in which we define our support and resistance framework and then see how future price action reacts to those levels.



Figure 3.28 – Higher Timeframe (30 min) Structure Example 1

Figure 3.28 shows the market prior to the open of the UK forex session on 25 June 2010.

Resistance R1 exists above the market at swing highs between 1.5000 and 1.5015, which capped the upside of the 24 June UK and US sessions.

Support S1 exists below the current price action in the area of 1.4920-30, based upon the early Asian session congestion and breakout.

Support S2 exists at 1.4850-70 based upon the 23 June US session swing low tails.

Support S3 exists at 1.4800 based upon the 23 June Asian session swing low and congestion (just off the left of the chart). Note that the area of potential support in this case would extend right up to 1.4840 where the momentum really exploded to the upside

Let's look at how the UK session progressed over the next six hours...



Figure 3.29 – Followup to Higher Timeframe (30 min) Structure Example 1

Figure 3.29 shows further *higher timeframe* (30 min) price action.

Candle A marks the open of the UK session. Note the lower tail on this candle (marked B) showing some support being provided by our 1.4900-20 support area. Once price broke that area, where does it go next? Straight to our next support area S2, identified by the lower tail of candle C.

The intent of our *higher timeframe* structure is to define the framework within which price moves. If we do this accurately, subsequent price action will move between your areas of *higher timeframe* support and resistance.

Another example...



Figure 3.30 –Higher Timeframe (30 min) Structure Example 2

Figure 3.30 shows the market structure prior to the UK session of 17 June 2010.

Resistance R1 appears above price in areas 1.4840-60, based on the tails at the top of the previous US session. Resistance R2 exists at 1.4825-35, based on the swing high prior to the breakout downwards. Resistance R3 and R4 define one resistance area of 1.4720-40 based upon the late US session congestion, the lower level of which capped price during the followup Asian session).

Support S1 exists at 1.4685-95, based upon swing lows of both recent and prior price action. Support S2 exists at 1.4645-65 based upon previous swing low and congestion to the left.

Let's now look at the price action over the next few hours...

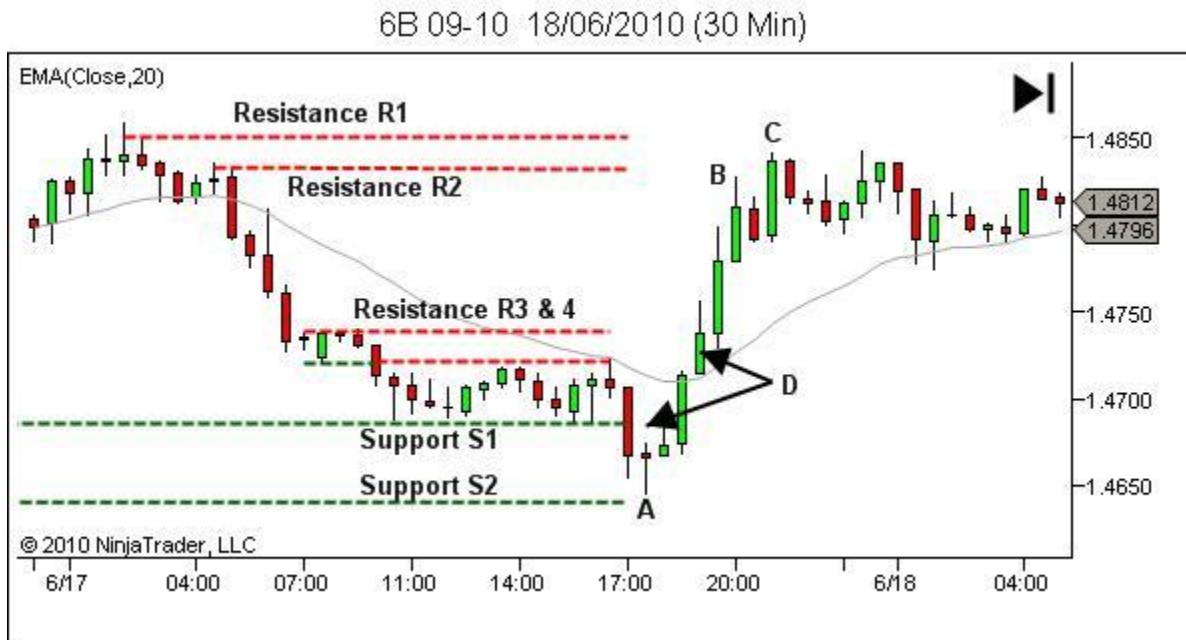


Figure 3.31 – Followup to Higher Timeframe (30 min) Structure Example 2

On the open of the UK session on 17 June, price blew straight through support S1 which defined the lower edge of Asian session range, to halt at the next support area, S2. On the 30 min chart this shows a failed breakout, as it then reversed and travelled back through the Asian session range to the upside.

Resistance R2 slowed price initially at B, before the next higher resistance area at R1 provided a final barrier to higher prices at C, defining the highs for the remainder of the UK and US sessions.

Points D show a great example of why we do not automatically place buy orders at support and sell orders at resistance. These are just areas at which we watch the *trading* (3 min) *and lower timeframe* (1 min) price action with interest. How price reacts there will define our bias for future price action and our actions with respect to trade opportunity.

This is particularly so for areas such as those at D which define the upper and lower edges of the Asian session range. These S/R areas are commonly watched in the forex world, with many traders aiming to play any breakout from this range. Once again, we don't automatically trade a breakout. We watch these areas for opportunity, which may eventuate as a successful test of the area, a breakout or a breakout failure (more to follow later when we learn to trade – at the moment we're just defining the structure).

Market Structure Practice

Take a break from reading, open your platform and display a chart using your selected *higher timeframe*. If you're not sure which market you'll be trading, or which timeframes, just practice on the 6B or GBP/USD 30 minute chart.

Scroll back through your historical chart data to the earliest date available and position the start of a trading session on the right hand side of your screen. For 6B or GBP/USD this will be the start of the UK forex session (0800 GMT)

Identify and mark the areas of S/R, using the data to the left.

Step forward through the data bar by bar, updating the S/R as new areas come into play and old areas lose relevance.

Repeat until you're comfortable with this process.

Common Question:

How far back in time should we go to find S/R?

As far back as necessary!

Realise though, the further back you have to go, the more time has elapsed since price was last there. As S/R is a result of trader decisions and actions, more elapsed time usually means it will have less influence.

Of course, significant levels on daily charts will be visible to these higher timeframe traders for many months and may still have some influence.

And areas which have historical significance may remain relevant for years, such as the 2003 Dow and S&P lows.

Summary

Higher timeframe structure is created by marking support and resistance levels on the higher timeframe chart.

This support and resistance structure forms the framework within which our trading timeframe price action will move.

A breakout of the structural framework support or resistance will lead to price movement in the next area of the framework.

3.2.4 – Trends

Having defined our *higher timeframe* structure, let's now see how price moves within that structure. We'll start with the objective, rule-based method with which I define a trend. And we'll then follow that up with a talk about applying subjectivity over top of our objective definition.

Trend Definition

Trend Support and Resistance – Swing Highs & Lows

The principles governing price movement are the same on all timeframes. Price moves as a function of supply and demand. It moves between areas of previous supply/demand imbalance, which are defined as support or resistance.

On our *higher timeframe* (30 min) we defined a structure based upon *higher timeframe* support and resistance.

Within that structure, price still moves between areas of shorter timeframe support and resistance. On the *trading timeframe* (3 min) I simply refer to them as swing highs (SH) and swing lows (SL), as demonstrated in figure 3.32 below.



Figure 3.32 – Trend– Swing Highs & Lows

It's important to remember that these swing highs and lows form *trading timeframe* S/R, and could potentially impact future price action, as demonstrated below. Swing H/L are areas of previous supply/demand imbalance which will be referenced by other traders when they make their trading decisions.



Figure 3.33 – Trend– Swing Highs & Lows as S/R

Although I've marked the swing H/L with labels and lines, in the chart above, this is for demonstration purposes only. Typically my charts will not display the labels or lines, as these swing H/L areas are usually visible to the eye. The only time I may mark a swing H/L line on a chart while trading is when the line extends from price action off the left hand side of the chart.

While learning to trade, you may choose to initially mark the swing H/L and corresponding line on your chart, until experience is gained in seeing these areas without the extra visual cue.

As with *higher timeframe* S/R, in a choppy market with much candle overlap you may need to mentally step back from the noise and select only those most obvious levels. Don't be afraid of a little subjectivity. Like S/R on the *higher timeframe*, if it looks like a significant swing high or low, it probably is.

Trend Direction

Price movement between these swing H/L will form into trends; either as an uptrend, downtrend or a sideways trend (trading range).

Uptrend - Definition

An uptrend comprises a repeating sequence of:

- 1) An upward extension
- 2) A swing high
- 3) A downward pullback
- 4) A swing low

This is demonstrated below in figure 3.34, where you'll also notice a few other key observations:

- The price extensions are longer than the pullbacks.
- Extensions will break above previous swing high, reaching new price highs for that trend.
- Pullbacks will not break below previous swing lows.

This results in a series of higher swing highs and higher swing lows.

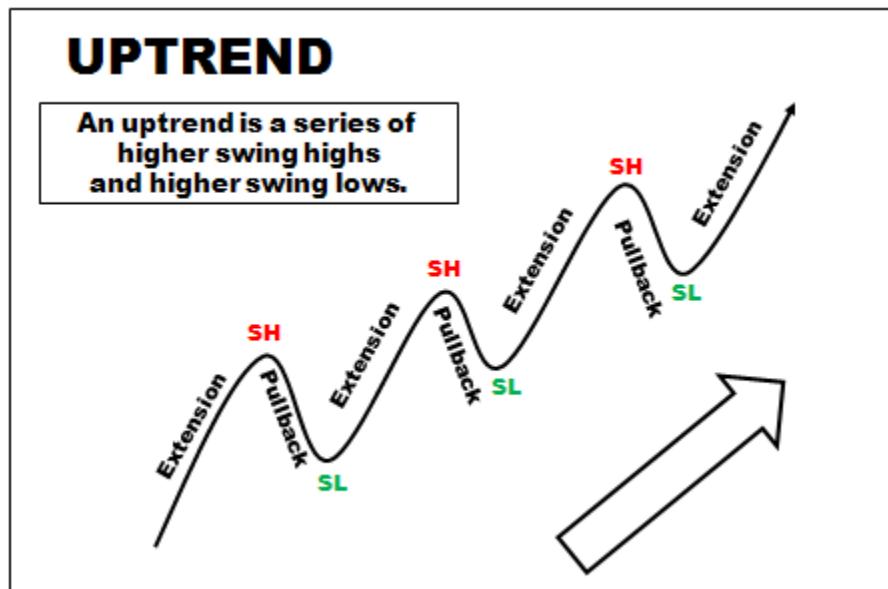


Figure 3.34 – Uptrend – Diagram

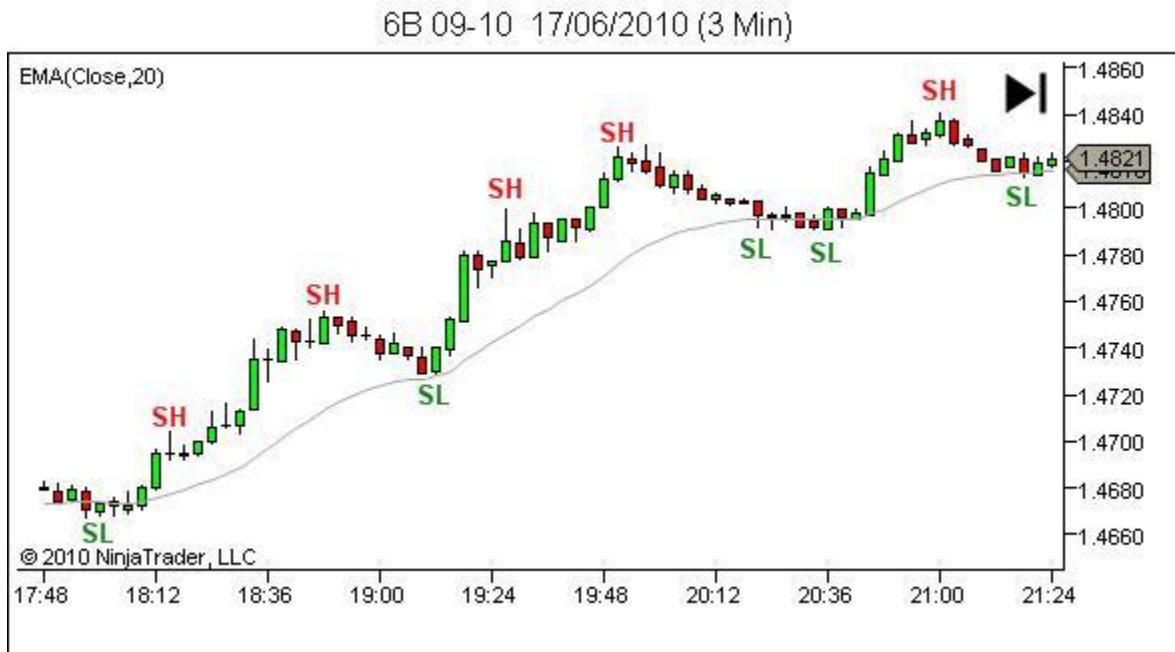


Figure 3.35 – Uptrend - Chart

An uptrend ends when price breaks the swing low which leads to the highest swing high of the trend. We'll demonstrate that in figure 3.36 below.

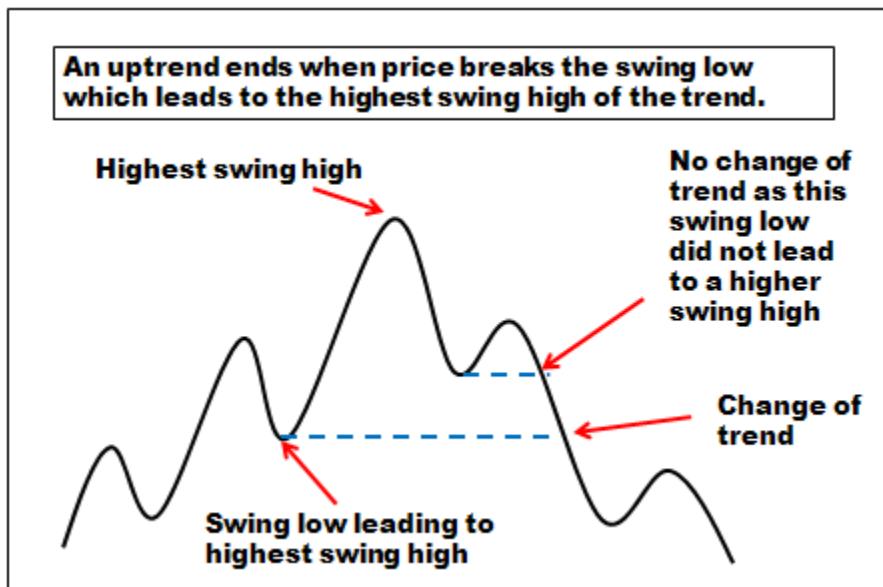


Figure 3.36 –Uptrend End

Failure to break the swing low that leads to the highest high, could simply indicate a complex pullback rather than a reversal, as demonstrated below in figure 3.37.

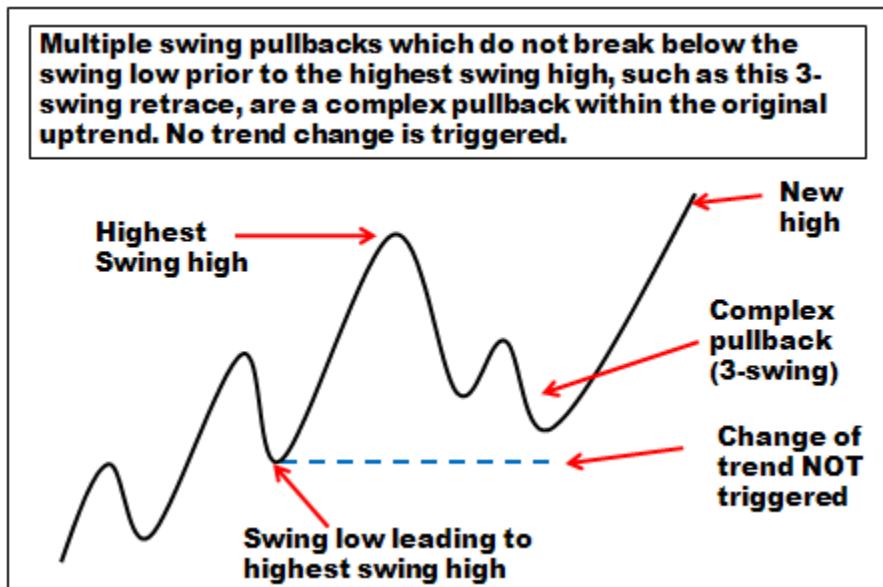


Figure 3.37 – Complex Pullback Leading to Uptrend Continuation

Uptrend – From the Perspective of Supply & Demand and Trader Decisions

An area of support has formed as traders, for whatever reason, have determined that the swing low is good value. New long positions are established and bullish sentiment results in rising prices.

An upwards extension develops due to bullish pressure overcoming bearish pressure. Traders continue making buying decisions and are willing to continue buying at higher prices in order to get into this market, pushing price to new highs.

At some point, short-term longs will take profits and new shorts will be attracted to the market by higher prices. This increase in bearish pressure will overcome the bullish pressure and form a topping pattern; an area of trend resistance forming as a swing high.

The fall below the swing high attracts more bearish orderflow, as more longs will take profits (having recognized the swing high resistance) and more shorts are attracted to the market.

The price pullback involves bearish pressure temporarily overcoming the bullish pressure to drive price downwards. Traders are making selling decisions and are willing to continue selling at lower prices in order to get their order filled.

This is not necessarily an indication of a trend reversal. The lower prices that occur as a result of the bearish sentiment are unable to attract sufficient bearish orderflow to break the previous swing low and result in a trend reversal. Rather, these lower prices attract more buying, sufficient to match the bearish orderflow and halt the pullback. Sentiment changes again to bullish as more buying is attracted and as shorts cover their position, recognizing that the downwards price swing is simply a pullback and not a reversal. A new area of trend support forms as a higher swing low.

Bullish sentiment again leads to a rally from this swing low area and the process repeats.

Interestingly, the bullish pressure within an uptrend is not just from new buying decisions. Remember, each transaction involves both a buy and a sell. Price movement is a result of the net trading decisions of all traders, and the urgency with which one side is more desperate to transact than the other side. Much of the bullish pressure within an uptrend comes from shorts (who tried to pick the reversal) exiting out of their losing positions.

Consider the psychology and thought processes of the majority of traders (those who consistently lose). Having failed to catch the uptrend and now seeing rising prices, these traders are consumed by negative thoughts and emotions – regret, anger and ultimately revenge. Knowing a price swing can't go on forever they enter short at the first sign of potential stall or resistance, hoping to gain an early entry into the trend reversal. Usually they're wrong. Even if they're right and have managed to time an entry at or near a swing high, it's usually only temporary as the down swing proves to be a pullback within the continuing uptrend rather than a trend reversal. Our emotionally influenced trader is then forced to cover their short position (buy order) as their stops are hit; contributing once again to their net loss situation through another poorly managed losing trade.

A significant portion of the bullish pressure within an uptrend is the losing short exiting their position (via a buy order). In many respects, the uptrend is fueled by the losers on the bearish side.

Downtrend - Definition

A downtrend comprises a repeating sequence of:

- 1) A downward extension
- 2) A swing low
- 3) An upward pullback
- 4) A swing high

This is demonstrated below in figure 3.38, where you'll also notice a few other key observations:

- The price extensions are longer than the pullbacks.
- Extensions will break below previous swing lows, reaching new price lows for that trend.
- Pullbacks will not break above previous swing highs.

This results in a series of lower swing lows and lower swing highs.

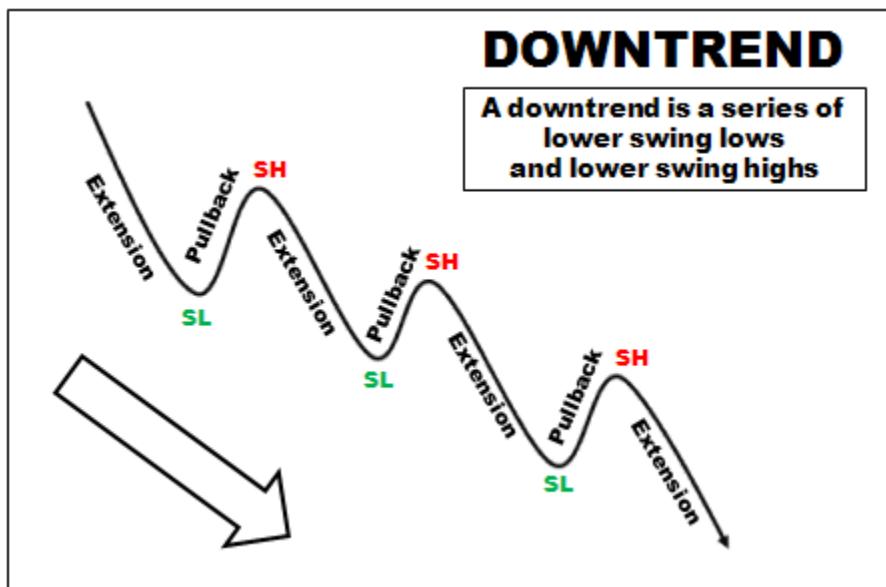


Figure 3.38 – Downtrend – Diagram

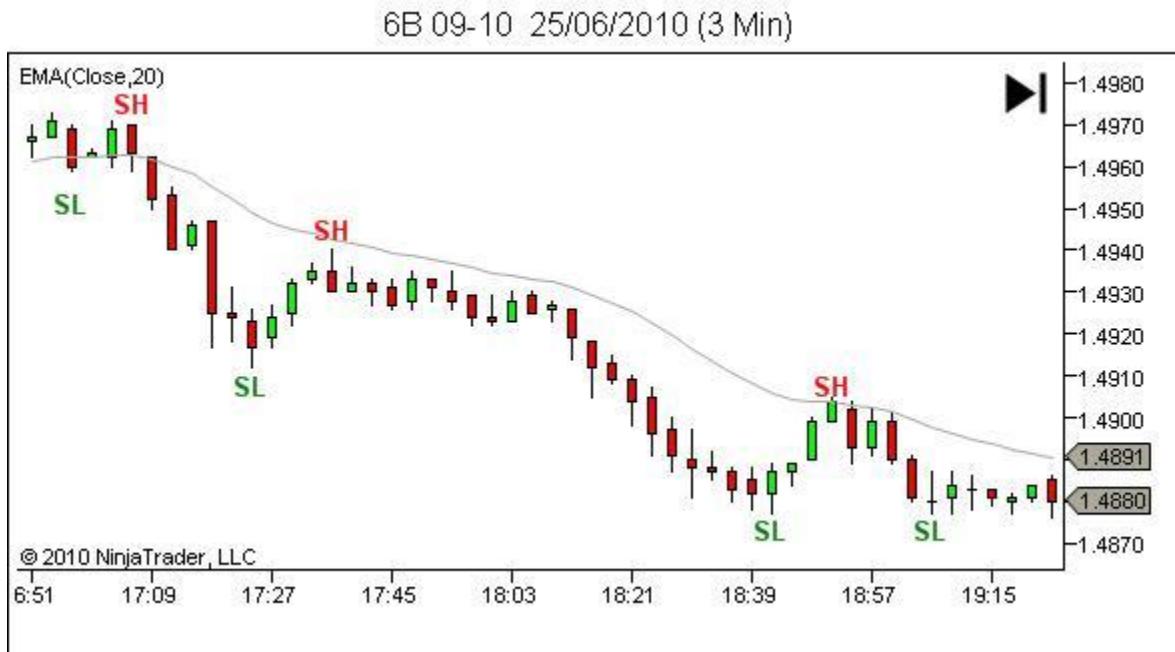


Figure 3.39 – Downtrend - Chart

A downtrend ends when price breaks the swing high which leads to the lowest swing low of the trend. Let's demonstrate that below, in figure 3.40.

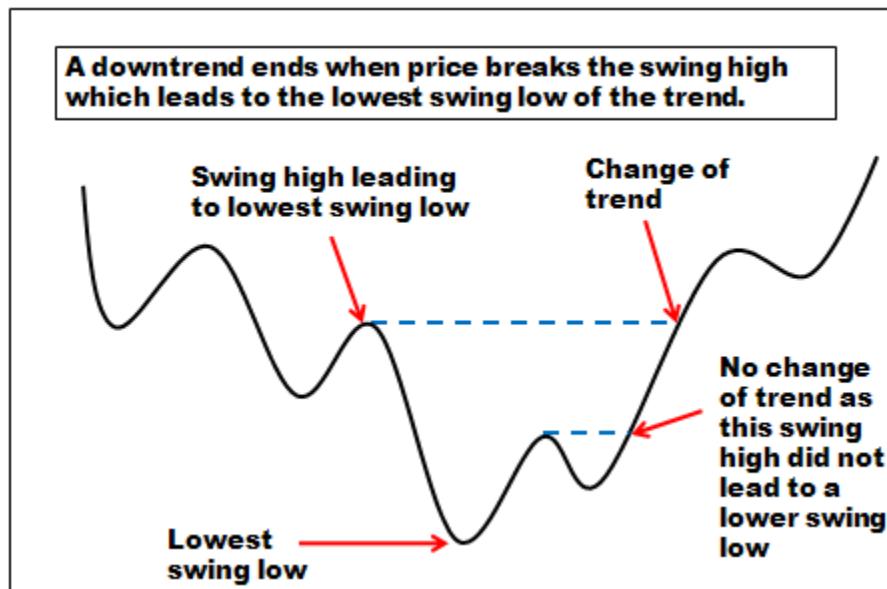


Figure 3.40 – Downtrend End

Failure to break the swing high that leads to the lowest swing low, could simply indicate a complex pullback rather than a reversal, as demonstrated below in figure 3.41.

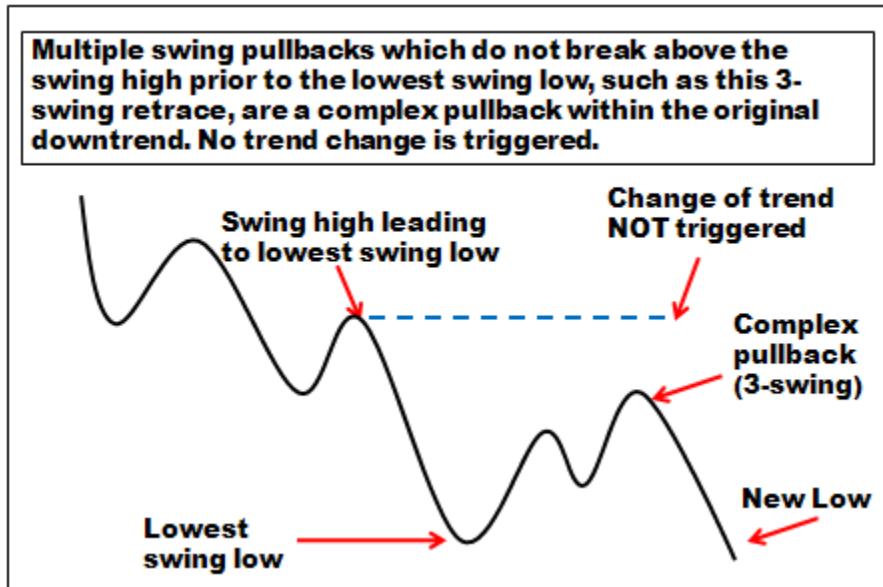


Figure 3.41 – Complex Pullback Leading to Downtrend Continuation

Downtrend – From the Perspective of Supply & Demand and Trader Decisions

An area of trend resistance has formed as traders, for whatever reason, have determined that the swing high is overvalued. New short positions are established and bearish sentiment results in falling prices.

A downwards extension develops due to bearish pressure overcoming bullish pressure. Traders continue making selling decisions and are willing to continue selling at lower prices in order to get into this market, pushing price to new lows.

At some point, short-term shorts will take profits and new longs will be attracted to the market by lower prices. This increase in bullish pressure will overcome the bearish pressure and form a bottoming pattern; an area of trend support forming as a swing low.

The rally from the swing low attracts more bullish orderflow, as more shorts will take profits (having recognized the swing low support) and more longs are attracted to the market.

The price pullback involves bullish pressure temporarily overcoming the bearish pressure to drive price upwards. Traders are making buying decisions and are willing to continue buying at higher prices in order to get their order filled.

This is not necessarily an indication of a trend reversal. The higher prices that occur as a result of the bullish sentiment are unable to attract sufficient bullish orderflow to break the previous swing high and result in a trend reversal. Rather, these higher prices attract more selling, sufficient to match the bullish orderflow and halt the pullback. Sentiment changes again to bearish as more selling is attracted and as longs cover their position, recognizing that the upwards price swing is simply a pullback and not a reversal. A new area of trend resistance forms, as a lower swing high.

Bearish sentiment again leads to price falling below this swing high and the process repeats.

Interestingly, the bearish pressure within a downtrend is not just from new selling decisions. Remember, each transaction involves both a buy and a sell. Price movement is a result of the net trading decisions of all traders, and the urgency with which one side is more desperate to transact than the other side. Much of the bearish pressure within a downtrend comes from longs (who tried to pick the reversal) exiting out of their losing positions.

Consider the psychology and thought processes of the majority of traders (those who consistently lose). Having failed to catch the downtrend and now seeing falling prices, these traders are consumed by negative thoughts and emotions – regret, anger and ultimately revenge. Knowing a price swing can't go on forever they enter long at the first sign of stall or potential support, hoping to gain an early entry into the trend reversal. Usually they're wrong. Even if they're right and have managed to time an entry at or near a swing low, it's usually only temporary as the upswing proves to be a pullback within the continuing downtrend rather than a trend reversal. Our emotionally influenced trader is then forced to exit their long position (sell order) as their stops are hit; contributing once again to their net loss situation through another poorly managed losing trade.

A significant portion of the bearish pressure within a downtrend is the losing long exiting their position (via a sell order). In many respects, the downtrend is fueled by the losers on the bullish side.

Sideways Trend - Definition

A sideways trend comprises a series of price swings existing within the range of a significant upper resistance area and a significant lower support area. The range support and resistance boundaries (range lower and upper boundaries) may be formed from either *higher timeframe* S/R and/or significant *trading timeframe* swing highs or lows.

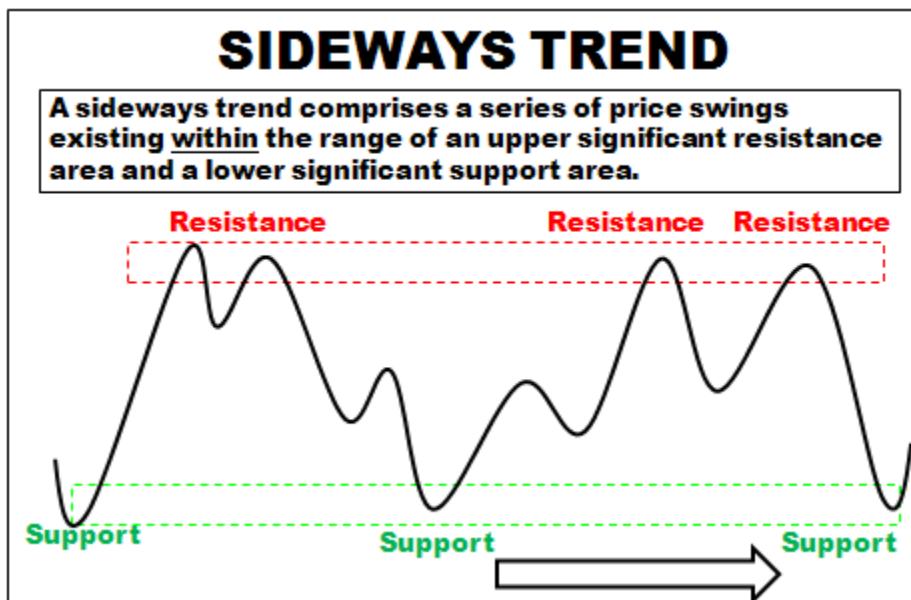


Figure 3.42 – Sideways Trend – Diagram



Figure 3.43 – Sideways Trend - Chart

I define the official start of a sideways trend as follows:

A sideways trend starts when four trend turning points (SH and SL) develop within the range of a previous price swing.

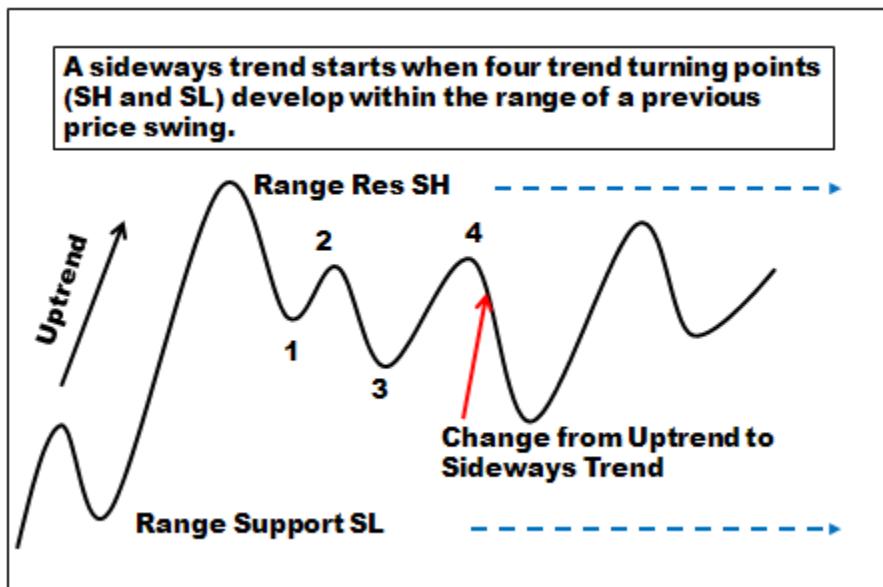


Figure 3.44 – Sideways Trend Start

Less than four turning points may simply be a complex (three swing) pullback rather than a change of trend. Four turn points are required to indicate a change to a sideways trend.

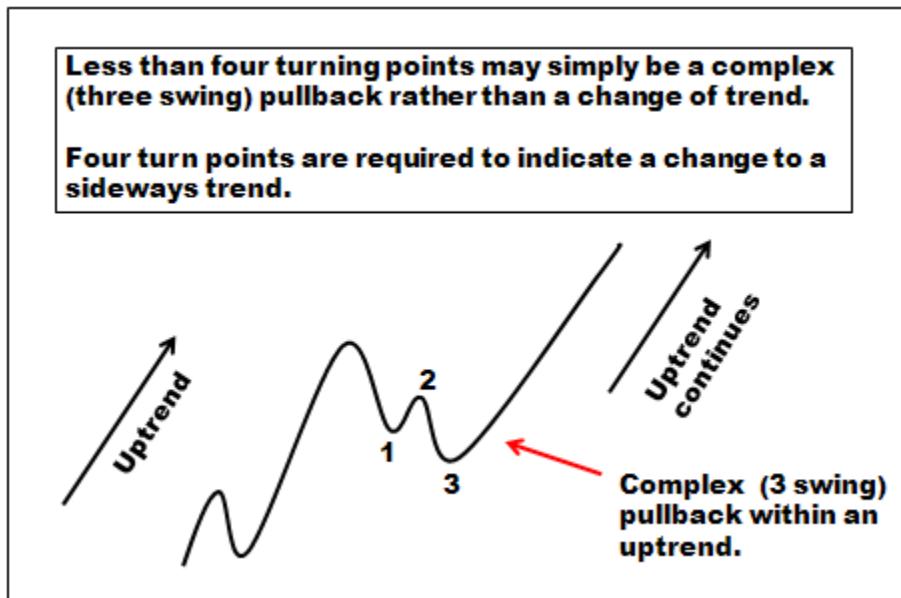


Figure 3.45 – Complex Pullback Vs Sideways Trend

I define the official end of a sideways trend as price breaking either the high or low which define the sideways trend.

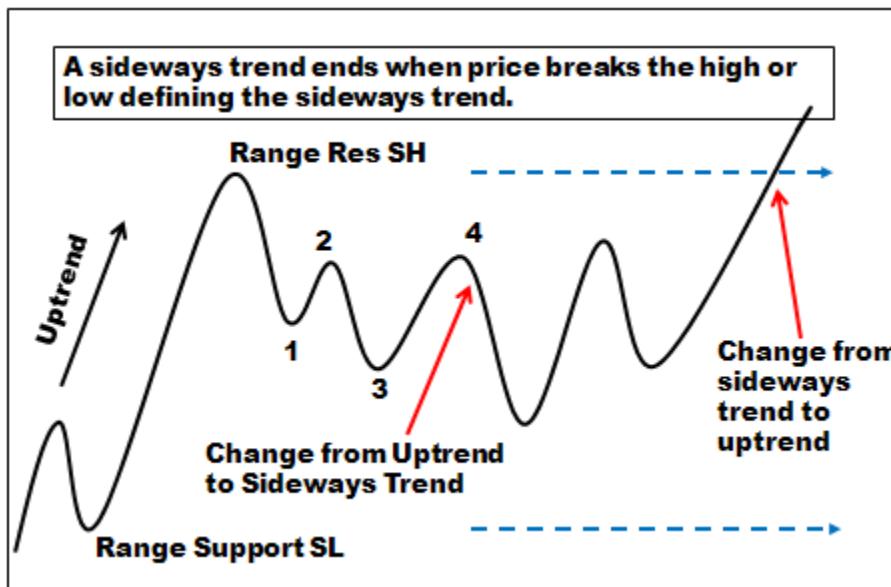


Figure 3.46 – Sideways Trend End

Sideways Trend – From the Perspective of Supply & Demand and Trader Decisions

The defining price swing has established a lower price area (support) at which traders perceive a good buying opportunity. Until sentiment changes within the market, price movement towards this area will result in new longs entering the market, and shorts taking profits after having profited from the move down. This bullish orderflow will overcome any bearish orderflow and price will rally to remain within the defined range.

The opposite occurs at the upper price area (resistance) which traders perceive as a good selling opportunity. Until sentiment changes within the market, price movement towards this area will result in new shorts entering the market, and longs taking profits after having profited from the move up. This bearish orderflow will overcome any bullish orderflow and price will fall to remain within the defined range.

Trend Definition – Alternates

People looking at my charts often see either an EMA(20) or an EMA(9/18) cross, and assume I use those as a trend definition. Not so.

Trend direction depends on the supply/demand imbalance. And this is dependent on traders' decision making. And traders' decision making is influenced largely by areas of previous supply/demand imbalance.

The areas on the chart which are important for defining trend change or continuation are the areas of previous supply/demand imbalance – the swing lows and highs which define the trend. It's not some line overlaying the chart.

Otherwise, which moving average should we use? Why the EMA(20) or EMA(9/18)? Why not the EMA(19) or EMA(8/21)? Why not an SMA? Why not a WMA?

Price causing an EMA cross simply indicates that price has moved sufficiently in that direction in order to cause the average lines to cross. Where that does define a trend change, it will be because the market has also crossed a critical S/R area (or swing H/L) and found acceptance of price in that new area.

The crossing of critical areas of previous supply/demand imbalance, and acceptance of price in that area, is the indicator of trend change. Nothing else.

So, why are these EMAs displayed on my charts?

Firstly, they are not essential to the strategy – hence you'll usually see them as faint grey lines on my charts – sort of background information.

Secondly, they are (partly) a hangover from previous trading approaches.

Thirdly, they act as a quick reference visual guide to my trend analysis – an *easy-to-see approximation* of trend. The majority of time the EMA will define the trend quite accurately.

The EMA on my charts are a guide only. A support tool! Use it if you wish. Or leave it off if you prefer. Either way it won't impact the strategy.

An EMA system won't tell you when the trend has changed. An EMA system won't tell you when the market is ranging sideways. However an EMA cross system does provide a good *approximate* trend indicator, when it is trending.

If you do use an EMA on your chart, be sure to use it as a guide only – not as your actual trend definition.

Trend Definition - Applying Subjectivity

As we discovered earlier, the market cannot be defined by fixed rules or mathematical models. It's an emotional beast.

Every attempt to objectively define a trend will break down at some point in time. Regardless of how you define the trend, at some point in time it will produce a pullback that goes just far enough to trigger an *objective trend definition change*, before reversing to continue in the original trend direction.

Subjective definitions are superior, although difficult for newer traders to accept.

A pullback against a trend that triggers an *objective trend definition change*, but then fails, may not change the subjective trend definition.

Let's look at an example...

We have here what is visually easy to identify as a downtrend. Following the strict definition of swing highs and lows, and trend change, we find that the trend changed from a downtrend to an uptrend by one tick (at point 3), before reversing and continuing downwards again.

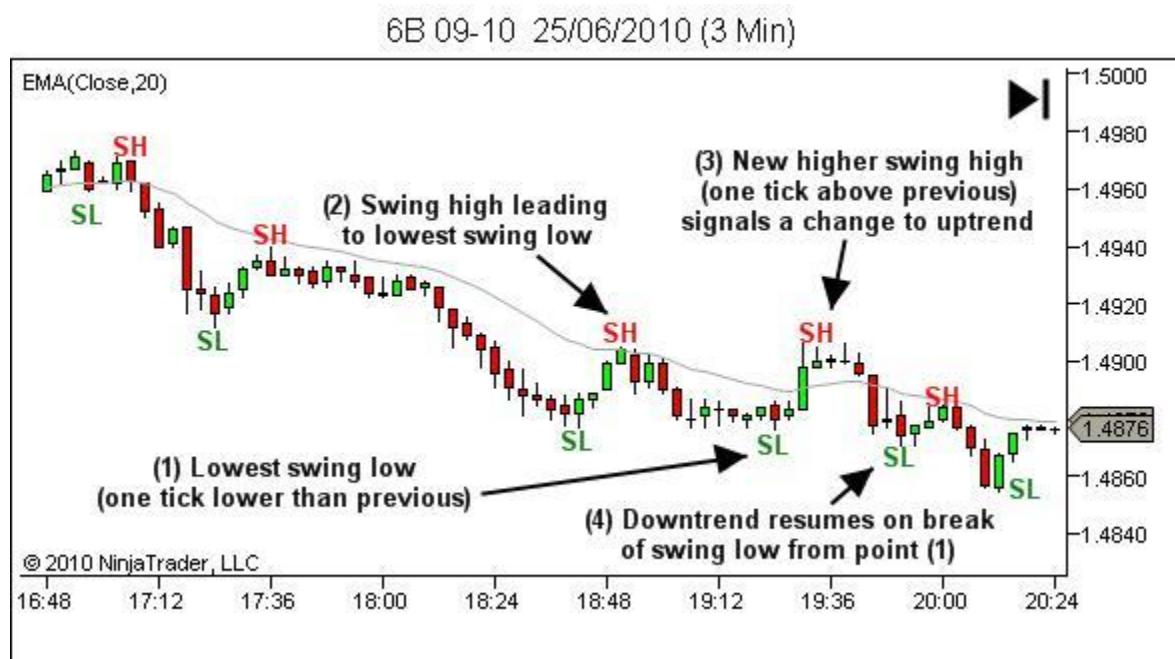


Figure 3.47 - Trend Definition Failure – Swing H/L

EMA definitions of trend fail even more often – resulting in whipsaw price action and poor trading results. This is demonstrated in figure 3.48 which defines the trend by the slope of the EMA(20); and demonstrates an inability for that trend definition to cope with the back-and-fill sideways price action at the bottom of a downtrend.

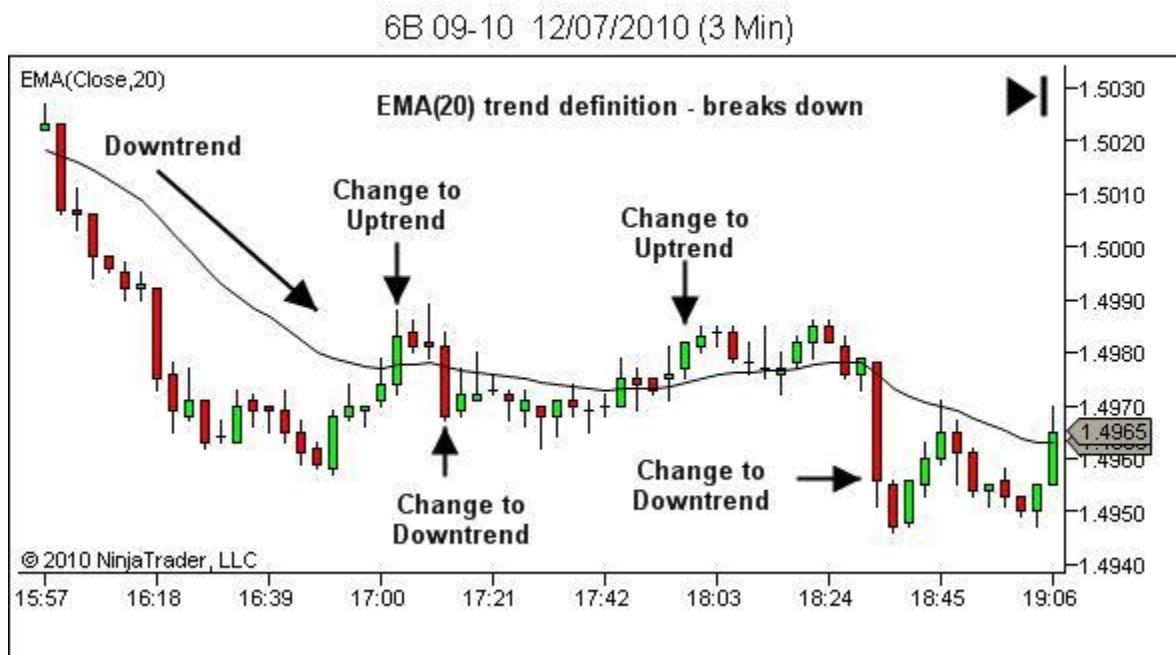


Figure 3.48 EMA trend definition failure

The inability for an EMA system to adequately define a sideways trend is one of its major problems. The swing H/L trend definition is vastly superior (in my opinion). But let's see if we can improve it...

Every objective trend definition breaks down at some point.

The problem is in relying on fixed objective rules in an environment that does not work in that manner.

The solution is in allowing some subjectivity, which allows for breaks of the objective definition. We allow price to test the levels of potential trend change. We even allow price to exceed these levels. Trend change, though, is not triggered by the break. Rather it's a result of price acceptance in this new area.

Upon making the break, does price quickly reject this new area and return back to the original trend definition, or does price hold the break and then continue?

Let's reproduce the price action from figure 3.47, now 3.49.



Figure 3.49 - Defining Trend Change through Subjective Assessment of Acceptance or Rejection

In this case, the downtrend now remains intact, as we see no evidence of acceptance of breakout prices. The trend will not be considered to have changed, until we see confirmed evidence of a behavioral change.

Subjectivity allows for breaks of definition – relying on these breaks to show the way forward, through how price reacts at these key times.

Will it hold beyond that level (price acceptance) or fail (price rejection)?

Tests of the areas of *objective trend change* are great sources of information about the *future trend*.

When you think about it, we can take this even further. A subjective assessment of price acceptance after the break of trend definition, really means that the trend is simply whatever it appears to be visually.

This doesn't mean we're totally guessing the trend. We are aware of our swing high/low trend definition, but then apply some subjectivity over top of that.

Essentially, if it looks like an uptrend (price appears to be moving from the lower left to the upper right) it is an uptrend. If it looks like a downtrend (price appears to be moving from the upper left to the lower right) it is a downtrend. Anything else is a sideways trend.

All other rules are secondary to this.

Through practice you will become comfortable with a subjective assessment of trend direction, and also a subjective assessment of which swing highs and lows you consider significant. Our discussion (coming shortly) on assessing the strength or weakness of the trend will assist greatly in your ability to subjectively assess the trend direction at the points of objective trend break.

Don't make this more complex than it needs to be.

A trend is a general tendency for price movement in one direction. Your mind is much more capable of identifying this trend, than any objective definition.

And if you get it wrong – price behavior will very quickly alert you to this fact.

Trend Examples

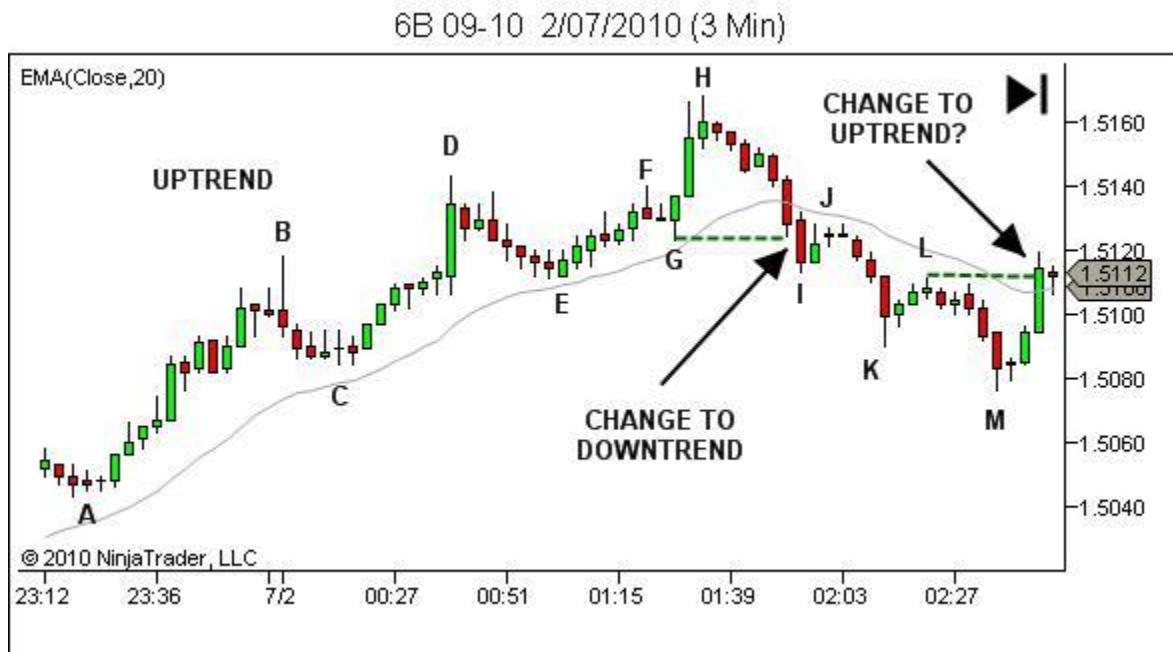


Figure 3.50 – Uptrend – Downtrend - Uptrend

In this first example, we have an uptrend defined by swing low A, swing high B, swing low C, swing high D, swing low E, swing high F, swing low G and swing high H.

I marked F and G due to the significance of G. As a candle which initially moved downwards continuing the move lower after F's retest of D, it then reversed quickly to rally back upwards. The speed of this move will have trapped some shorts in losing positions. It's a significant area and therefore suitable for selection as a swing low. Should price break below this level it indicates a change in the supply/demand dynamics of this market.

Swing low G is therefore the last swing low before the highest swing high H. The change of *objective trend definition* from uptrend to downtrend therefore occurs on the break of the lows of swing low G, as marked.

Applying some subjectivity though, we want to see evidence of price accepting this change. The first close below the trend change level was strongly bearish, and it was followed by three weak bullish candles, indicating a lack of demand (if there was significant demand, price would have rejected the breakout and rallied back up through the level). Continuation lower confirms our trend change.

Also, applying our “if it looks down, then it is down” rule, the acceleration down to I followed by the weak pullback to J, just makes this look like downward strength to me.

The downtrend continues from swing high H to swing low I, congestion J, swing low K, swing high L, swing low M.

Swing high L was the last swing high before swing low M. Price breaking above L indicates a change back to uptrend, in accordance with our objective trend definition.

The next candle shows a pause. Subjectively, a trend change looks a possibility given the rapid move up into the area of L, but more information will be needed in the next candle or two, to accept a change to an uptrend, or reject this and continue down.

In this next example, figure 3.51 below, we have an uptrend defined by swing low A, swing high B, swing low C, swing high D, swing low E and swing high F. Note that swing low E does NOT lead price up to new highs, as swing high F does NOT exceed the highs at D. This means that price breaking below E does NOT trigger a change of trend, but rather a complex pullback. Price would need to break below C in order to trigger a change to downtrend, which of course did not occur in this example.

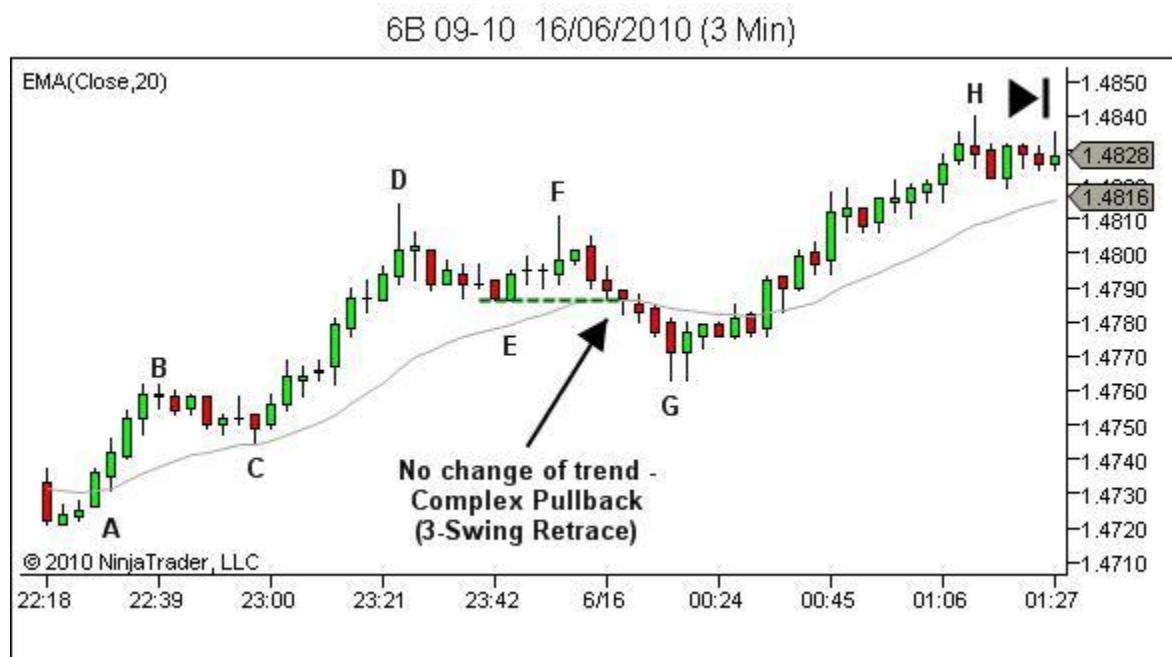


Figure 3.51 – Uptrend with Complex Pullback

The 3-swing retrace through E, F and G was followed by a continuation of the uptrend through to new highs at H.

You'll often find a 3-swing retrace or other form of complex pullback following a larger extension such as occurred from C to D (note the distance with which price pulled above its average line indicating possible over-extension – another visual advantage of having an EMA overlaying the price action as a support tool).

In figure 3.52 below, a downtrend exists at the start of the UK forex session, through previous price action, leading into swing high A, swing low B and swing high C. Swing low D is a higher swing low. The trend does not change on confirmation of the higher swing low, nor on the break of swing high C, as it did not push prices down to new lows. The trend change occurs when price breaks swing high A, as indicated on the chart, as swing high A was the swing high which preceded the lowest swing low B.

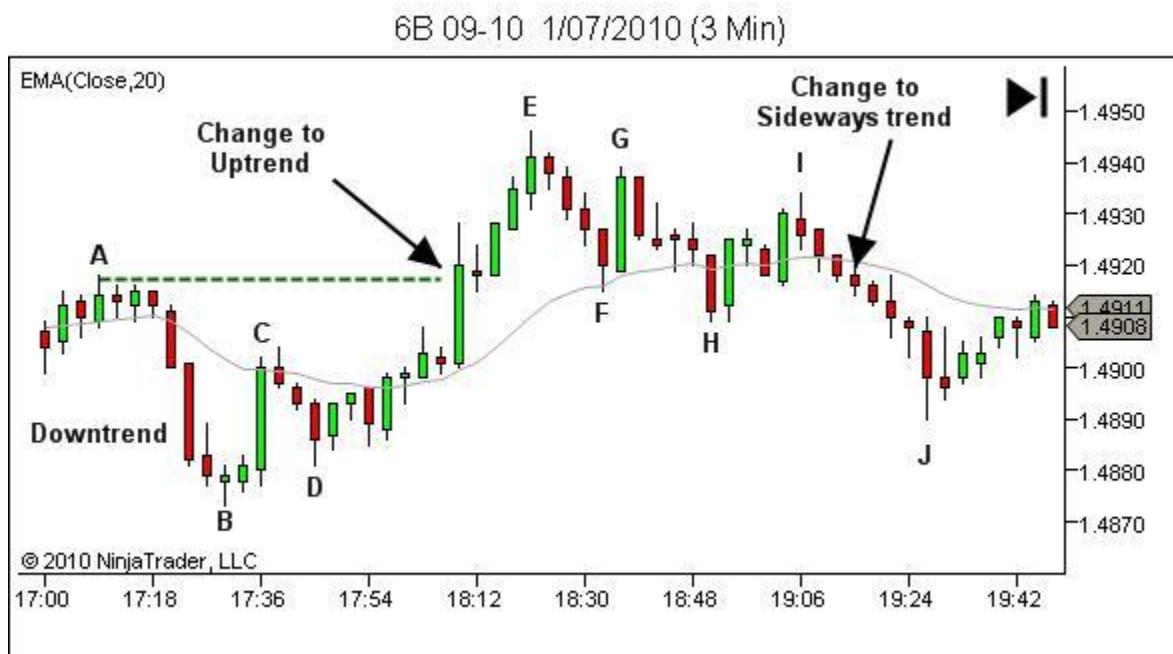


Figure 3.52 – Downtrend – Uptrend – Sideway Trend

Price accepts the breakout and change of definition. The uptrend then moves on to swing high E and swing low F. Swing low G provides a lower high, followed by a lower low H. At this point, the trend has not changed, as move F-G-H could simply be a complex pullback within the continuing uptrend. This would be proven on continuation back above E.

In this case, price was not able to exceed E, creating another swing high at I. At this point we now have four swings or turning points (from E to F, G, H and I), confirming a change from an uptrend to a sideways trend. The upper resistance area defining the sideways trend or trading range will be the swing high at E. The lower support area defining the sideways trend would be swing low D, according to the definition, however given the proximity of swing low B, and the fact that it also defines the lowest prices of the UK forex session, I'd personally define swing low B as the range support area which needs to be broken to trigger a downtrend. This is an example of the subjectivity that you should apply to your analysis.

From a subjective visual perspective, I'm also happy to define this as a sideways trend. Earlier demand has clearly been exhausted, and price is not rallying to new highs. Similarly, there is no great strength on the downside either. Until I see a change in behavior in which one side starts to dominate, it's likely that the early UK session range (B to E) will define the upper and lower boundaries of the remainder of the session.

In figure 3.53, A and B mark the lower support and upper resistance following the 2 July 2010 Non-Farm Payroll (NFP) economic release. Price established itself clearly within a sideways trading range following the short period of post-NFP volatility. The sideways trend is in force until either price breaks below A, or above B.

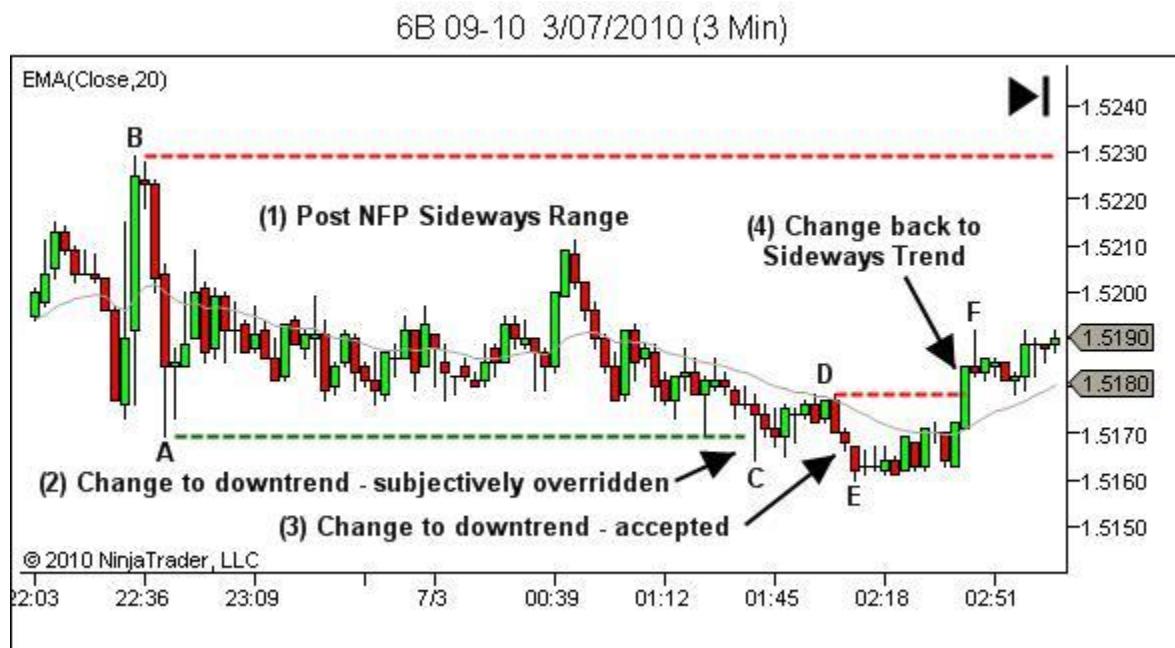


Figure 3.53 – Sideways Trend – Downtrend – Sideways Trend

At point C, price broke the lower support on two occasions, however was not able to accept and hold these breakout prices. The objective change of trend was overridden and the trend assessed as remaining sideways (not entirely unexpected either, in the leadup to the 4th July long weekend).

The initial break swung back within the trading range to form swing high D. Note though that the move to D was very weak, unable to produce a higher swing high. Price collapsing back below the level of A was enough for me to subjectively change the trend to a downtrend.

A new swing low E was established, followed by some grinding sideways action which shows neither side really dominant. Continuation below this congestion would be required to continue the downtrend. A break back above the level of D would indicate further rejection of the levels below A and a return to the sideways trend environment.

The second scenario proved to be correct, from both a subjective and objective perspective.

Swing high D was the last swing high before the lowest lows. The strong move from E up to F breaks through swing high D, invalidating the downtrend. The sideways trend is reestablished, as the break of swing high D takes price back within the bounds of the original sideways trend.

The upper sideways trend resistance would remain at point B. The lower support would be defined as the swing low which led to price returning to the sideways trend, in this case swing low E.

Trend Practice

Take a break from reading, open your platform and display a chart using your selected *trading timeframe*. If you're not sure of which market you'll be trading, or which timeframes, just practice on the 6B 3 minute chart or GBP/USD 5 minute chart.

Scroll back through your past chart data to the earliest date available and position the start of a trading session on the right hand side of your screen. For 6B or GBP/USD this will be the start of the UK forex session (0800 GMT).

Identify the pre-session trend, if applicable for your market.

Step forward through the data bar by bar identifying the trend, noting new areas of swing highs and lows, and the points of trend change.

Repeat until you're comfortable with this process.

3.3 Future Trend

3.3.1 - Strength and Weakness

We established earlier that the aim of our analysis was to develop a feel for the strength and weakness within a trend, and a feel for where that is likely to lead future price action.

Or just simply:

- Where has price been?
- Where is price likely to go?

Defining our market structure and conducting trend analysis allows us to identify where price has been.

We now work to identify where price is likely to go.



Figure 3.54 – The Future Trend – Where is Price Likely to Go?

I call this the *future trend*.

The concept in determining *future trend* is as follows:

- 1) Price action leaves clues as to the strength or weakness of the two opposing forces (bullish and bearish pressure); allowing us to see which side is winning control of the price flow.
- 2) Future price action is likely to be in the direction of whichever force is showing greater strength, or opposite to whichever force is showing weakness.

That is, we're feeling the strength or weakness of the market as both bullish and bearish pressures compete, and projecting that forward to identify possible future price action.

The market moves in the direction of strength, and against the direction of weakness.

A quick example follows. We haven't yet discussed the process for identifying strength and weakness. So, as we work through this example you'll need to accept the analysis. The point of this example is in seeing how future movement is in the direction of strength and against weakness.



Figure 3.55 - The Market Moves in the Direction of Strength;
 and Against the Direction of Weakness

Figure 3.55 shows strength in downtrend swing (a) and weakness in pullback (b). The downtrend continues in the direction of previous strength (a) and against weakness (b).

Continuation occurs with a strong extension (c) and a weaker pullback (d). Strength is still to the bearish side.

Extension (e) shows continued bearish strength, while pullback (f) is again weaker. The downwards move once again continues as strength remains in the bearish direction.

Extension (g) initially shows strength, but then weakens considerably through (h). Bearish pressure shows signs of having weakened considerably, through extension (g/h) – certainly weaker than the previous extension (e) and weaker now than the last pullback (f).

The next move is in the direction of last strength (f) and against weakness (h). Price swing (i) rallies quite strongly.

It's not always as easy as this example makes it appear. Often clear signals are not available. Many times the bullish and bearish price swings will show similar strength.

However sudden changes in the strength or weakness in any direction are almost always evident on the chart, as occurred here when the momentum of swing (g) flattened out through (h). Changes in the strength or weakness are often easy to identify. And these sudden changes provide great clues as to the way forward.

So, how do we identify strength and weakness?

3.3.2 - Identifying Strength and Weakness

We identify strength and weakness within a trend through analysis of various properties of price movement, in particular through analysis of **momentum** and **projection & depth**.

This analysis is primarily conducted on our *trading timeframe* (3 min), but fine-tuned as necessary through the *lower timeframe* (1 min). Examples will follow.

Momentum

What is Momentum?

- *Mechanics.* A quantity expressing the motion of a body or system, equal to the product of the mass of a body and its velocity, and for a system equal to the vector sum of the products of mass and velocity of each particle in the system.

Ok, forget that!

What is Momentum, as far as we're concerned?

- **Observing price action in order to note changes to speed and acceleration; and assessing the meaning of this change with respect to potential future orderflow and potential future trend direction.**



Momentum is a poor name, in my opinion. I've used it simply because it's the name most commonly used for this property of price movement.

Momentum should really be two separate properties, called Speed (rate of change of price) and Acceleration (rate of change of speed).

Please note that we are not talking about any of the common momentum indicators (or oscillators) such as Stochastics, MACD, RSI, ROC, Williams%R or even the one called Momentum.

Momentum is not an indicator, but a property of the price movement.

We are simply observing price action in order to compare the current speed and acceleration of price movement with historical speed and acceleration.

Momentum is visible on a chart through observing the slope (angle) of price movement.

Figure 3.56 below demonstrates a graph which displays price on the vertical axis and time on the horizontal axis (just like a price chart does). The graphs on the left and right of this diagram both represent upwards price swings.

The slope of a straight line represents the speed of price – the rate of change of price per unit time.

A more shallow line (in blue) represents less price increase for the same period of time as the steeper line (in red). The blue line therefore represents less speed than red. The blue line shows less bullish momentum than the red line. The blue line shows bullish weakness when compared with the red line. The red line shows bullish strength when compared with the blue line.

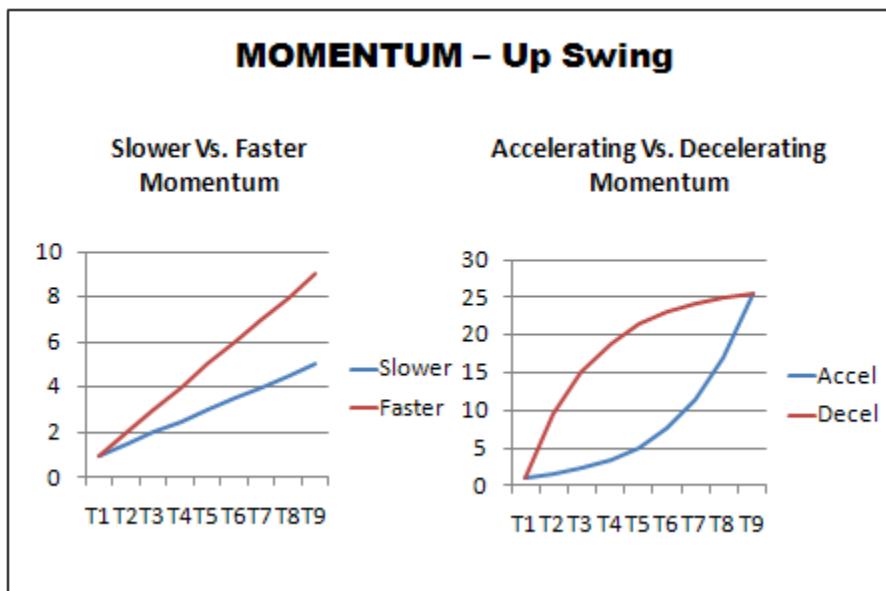


Figure 3.56 - Graphical Representation of Momentum Changes – Up Swing

The slope of a curved line represents acceleration or deceleration – the rate of change of speed.

Increasing slope (the blue line) shows increasing speed. Momentum within this price swing is increasing, showing increasing bullish strength.

Decreasing slope (the red line) shows decreasing speed. Momentum within this price swing is decreasing, showing weakness developing in the price swing.

Figure 3.57, below, shows the same concept for a downwards price swing.

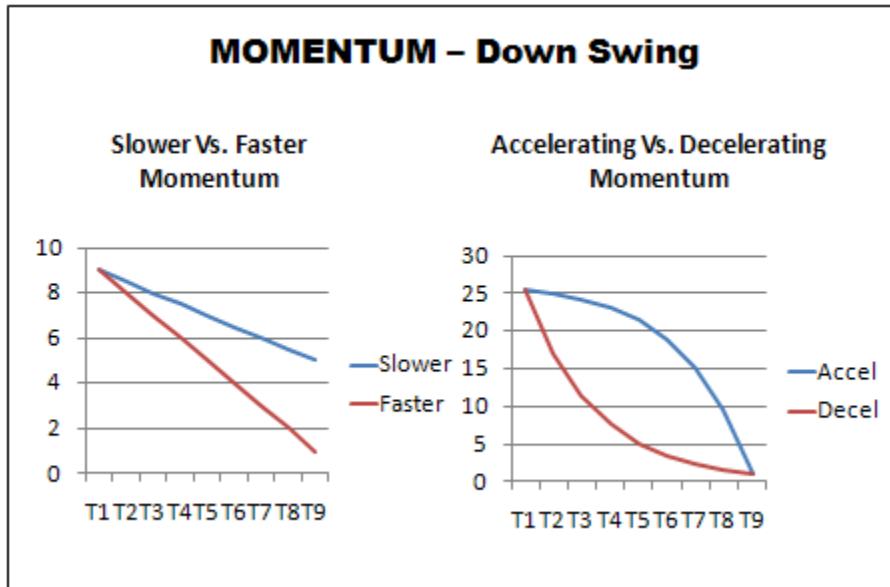


Figure 3.57 - Graphical Representation of Momentum Changes –Down Swing

Look first at the straight lines on the left hand side of the diagram.

A more shallow line (in blue) represents less price decrease for the same period of time as the steeper line (in red). The blue line therefore represents less speed than red. The blue line shows less bearish momentum than the red line. The blue line shows bearish weakness when compared with the red line. The red line shows bearish strength when compared with the blue line.

The right hand side of the diagram represents bearish acceleration and deceleration.

Increasing slope (the blue line) shows increasing speed. Momentum within this price swing is increasing, showing increasing bearish strength.

Decreasing slope (the red line) shows decreasing speed. Momentum within this price swing is decreasing, showing a weakness developing in the price swing.

The same concept applies to price action on charts. Changes in momentum are observed through changes in the slope (angle) of the price action, as we'll demonstrate through some diagrams and chart examples below.

As we look through these diagrams and examples, please take note of the following important point...

Analysis of momentum is not about measuring any absolute value of momentum, but in making a comparison of current price action momentum with prior price action momentum.

- Compare the momentum of the current price swing with the momentum of the previous price swing in the same direction? Is price faster or slower than before? What does that mean?
- Compare the momentum of the current price swing with the momentum of the previous price swing in the opposite direction? Is price faster or slower than before? What does that mean?
- Is the current price accelerating or decelerating? What does that mean?

Let's quickly examine each...

1) Compare the momentum of the current price swing with the momentum of the previous price swing in the same direction? Is price faster or slower than before? What does that mean?

Refer to the left hand side of figure 3.58, where we see a downtrend weakening and reversing direction to become an uptrend.

Compare the slope of down-swings (a), (c) and (e). Note the decreased speed on each of these legs, indicating a reduction in bearish momentum. Weakness is appearing on the bearish side.

Compare the slope of upswings (b) and (d). Note the increasing speed on each of these legs, indicating an increase in bullish momentum. Bullish price swings are showing signs of strength.

Price movement is more likely to continue in the direction of strength and against the direction of weakness. The market reverses as strengthening bullish momentum overcomes the weakening bearish momentum.

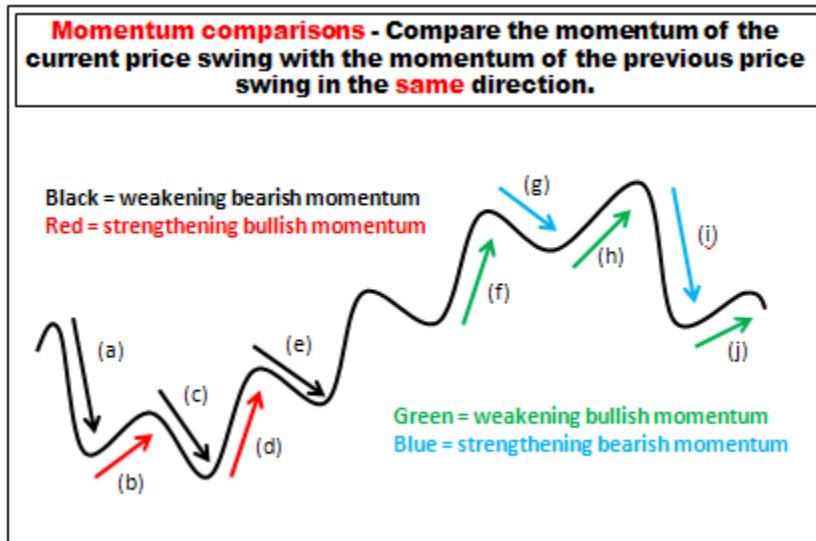


Figure 3.58 - Momentum Comparison – Same Direction Swings – 1 of 2

Refer now to the right hand side, where we see the uptrend weakening and reversing to a downtrend.

Compare upswings (f), (h) and (j). Note the decreasing speed on each of these legs, indicating a reduction in bullish momentum. Bullish price swings are showing signs of weakness.

Compare the downswings (g) and (i). Note the increasing speed on each of these legs, indicating an increase in bearish momentum. Strength is showing on the bearish side.

Future price direction is more likely to continue in the bearish direction, with the bearish strength and against the bullish weakness.

Of course, not every price swing provides clear signals such as described by the ‘perfect’ trend of these diagrams.

Often there is no significant difference between the speed of price swings, indicating no change to the current strength or weakness of the price movement.

Referring to figure 3.59 below, you’ll see that a comparison of the speed of price swings (a), (c) and (e) show comparable momentum. No change is noted in bullish strength.

Likewise, no change is observed in bearish momentum through downswings (b), (d) and (f).

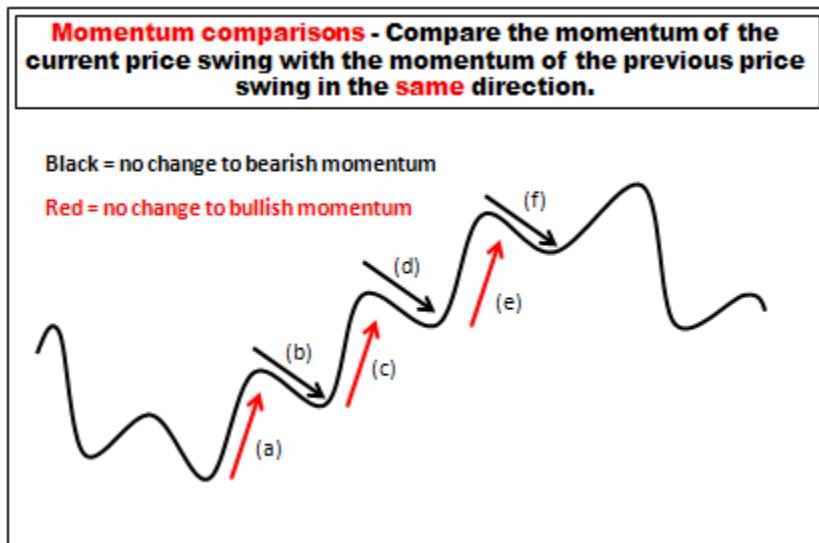


Figure 3.59 - Momentum Comparison – Same Direction Swings – 2 of 2

In the absence of any observable changes in momentum, we expect a trend to continue in its current state.

This will continue until the price action shows evidence of changing momentum; ie. strength or weakness.

2) Compare the momentum of the current price swing with the momentum of the previous price swing in the opposite direction? Is price faster or slower than before? What does that mean?

Another means of identifying strength or weakness comes through comparing the strength of a price swing with the previous swing in the opposite direction.

That is, comparing the current bullish swing with the previous bearish swing; or comparing the current bearish swing with the previous bullish swing.

Refer to figure 3.60 below. Note the slope of (a) is quite steep (almost vertical) compared with the slope of (b) which is at more of a 45% angle. The latest upswing (b) has shown weakness compared with the previous downswing (a). Strength is still in the bearish direction.

Downswing (c) shows downwards speed comparable to the speed of the previous upswing (b); if anything perhaps slightly stronger on the downside. While strength is still to the bearish side,

there's not a great deal of difference between the bearish and bullish sides. More information is required to identify any change in sentiment.

Bullish upswing (d) shows very slight increase in speed compared with the last downswing (c). While the strength is now to the bullish side, it's once again a very small difference.

Bearish swing (e) however shows greatly reduced momentum, compared with bullish upswing (d). Note the shallow angle of (e) compared with the steep rise of (d). Strength is now clearly on the bullish side.

Price movement is expected in the direction of strength and against the direction of weakness. The trend has changed to upwards; and further price movement is expected in this new trend direction.

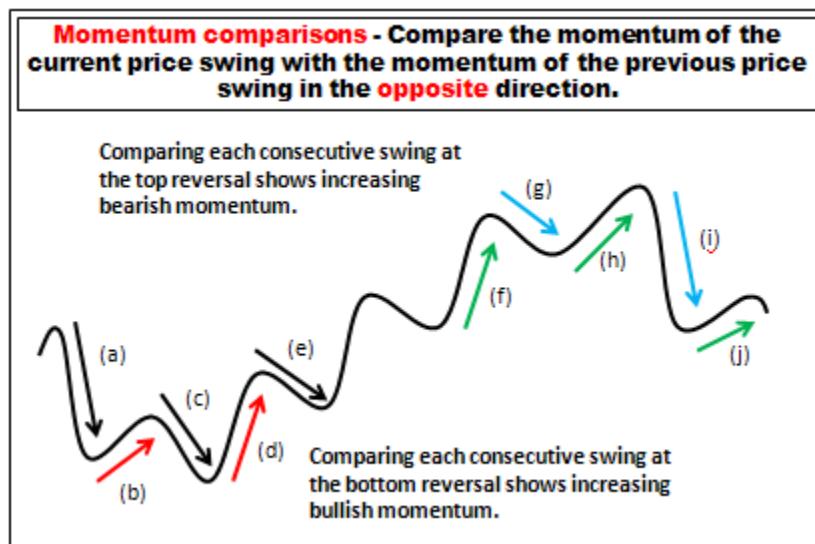


Figure 3.60 - Momentum Comparisons – Opposite Direction Swings – 1 of 2

The same analysis techniques can be applied at the top reversal.

Comparing (f) and (g) show greater upswing momentum than downswing momentum. Strength is still in the direction of the trend.

Swings (g) and (h) show comparable momentum. Further information is required.

Swings (h) and (i) show a change of state. Momentum has strengthened to the bearish side.

This is now confirmed when comparing the momentum of (i) and (j). The momentum of upswing (j) is quite weak when compared to the momentum of downswing (i). Further price movement would be expected in the direction of the new downtrend.

Figure 3.61 below demonstrates why a comparison with the opposite-direction swing can sometimes provide information that is not available through a comparison with the previous same-direction swing.

When comparing the speed of downswings (b), (d) and (f) we note no change to bearish momentum. There is no evidence of weakening or strengthening in the bearish direction. Similarly when comparing the speed of upswings (a), (c) and (e) we note no change to bullish momentum. There is no evidence of weakening or strengthening in the bullish direction.

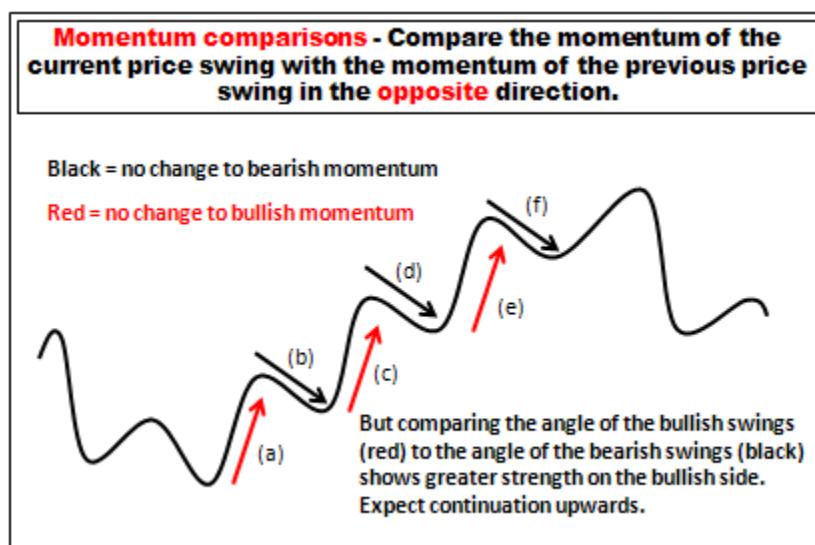


Figure 3.61 - Momentum Comparisons – Opposite Direction Swings – 2 of 2

However, comparing swings in opposite directions does provide us with useful information.

Comparing (a) and (b) we see a steeper bullish swing than bearish swing. Strength is on the bullish side.

The same is evident with all other pairs (b/c, c/d, d/e, e/f) which also show strength to the upside.

3) Is the current price accelerating or decelerating? What does that mean?

Figure 3.62(a), shows price deceleration on an upswing. Momentum is weakening. Note that this does not necessarily indicate a coming reversal. It's simply an indication that the current price swing is weakening and a downside correction is likely. Whether or not that develops into a full trend reversal will depend on subsequent price action.

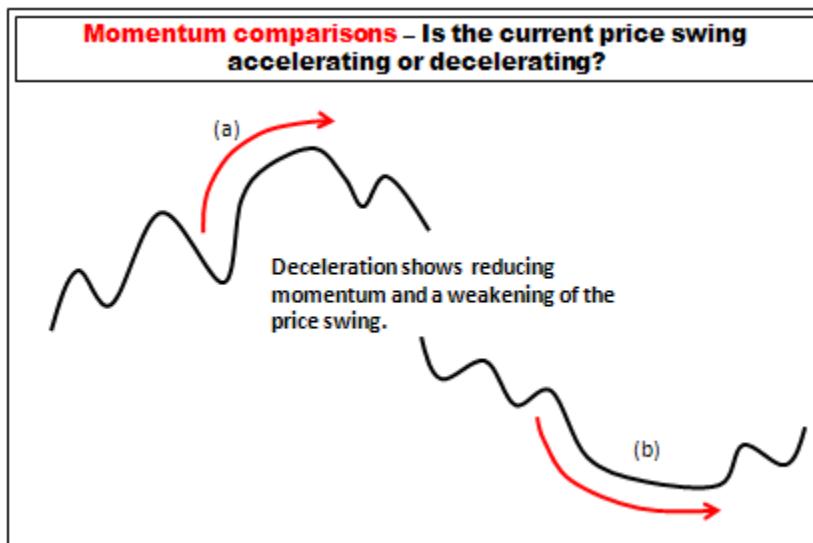


Figure 3.62 - Momentum Comparisons – Deceleration

Similarly, price swing (b) shows a deceleration of the downmove. Momentum is again weakening in the direction of the trend. The next move is likely to be a correction upwards.

Acceleration on the other hand can be much more difficult to analyse.

As demonstrated in figure 3.63 it may indicate a strengthening of the momentum in the current price swing direction, and a greater likelihood of price continuation in that direction.

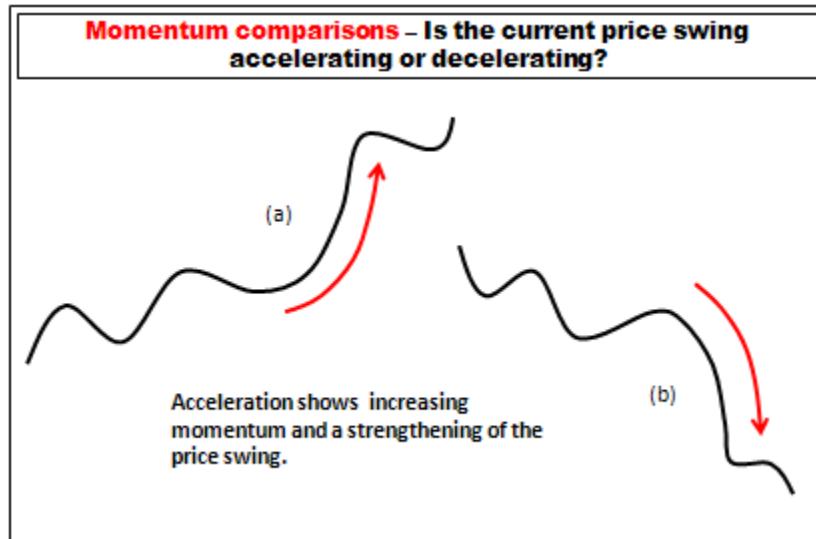


Figure 3.63 - Momentum Comparisons – Acceleration

However, extreme levels of acceleration can indicate weakness from the point of exhaustion of the acceleration, as shown below in figure 3.64. These climactic moves often end violently, forming (at the very least) a strong area of support or resistance, and occasionally a rapid reversal.

These price swings are usually associated with greatly increased price bar range, extension well above or below any average lines, and extremely high volume when compared to prior action.

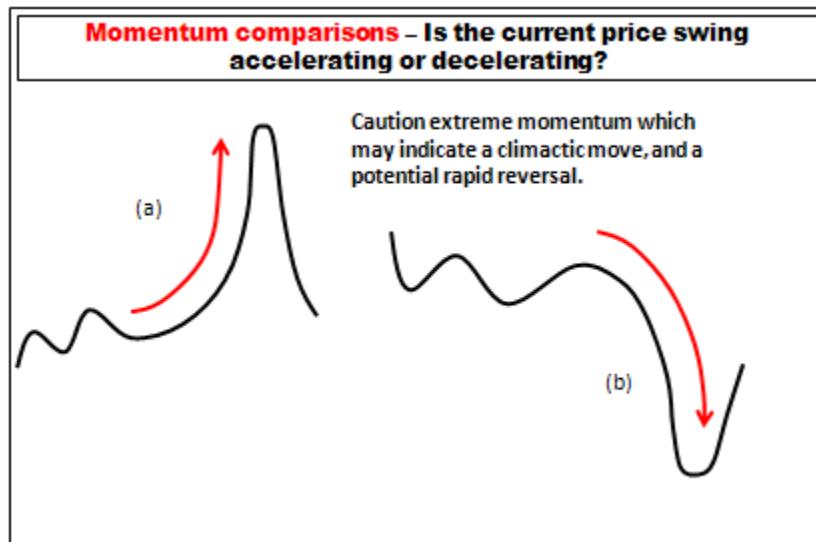


Figure 3.64 - Momentum Comparisons – Climactic Move

Climactic moves such as the bullish price swing (a) represent the last of the emotionally-influenced public, desperate to buy into the market at whatever price they can, chasing price higher and higher. When there are no buyers left and the price rally halts, selling into the market reverses price, trapping all the late longs. The reversal can be quite rapid, as these longs are stopped out of their position (sell order) and more shorts are attracted to the market.

Climactic move (b) represents the same process to the downside. Late shorts desperately chasing price lower and lower in panic, along with previous longs in an extreme drawdown exiting at the point where they just can't take the pain any longer. Once the selling is exhausted, the professionals will be buying, driving prices higher and trapping the late shorts into a losing position. Any reversal may again be quite rapid, as the trapped shorts are stopped out of their positions (buy order) and more longs are attracted to the market.

So, price acceleration does indicate strength. But excessive acceleration is unsustainable, and likely to end in climactic exhaustion and potential reversal. Placing the degree of acceleration into the context of background market action will usually identify which of these scenarios is playing out.

Let's examine some charts...



Figure 3.65 - Changing Momentum

Figure 3.65 above demonstrates changing momentum on consecutive price swings of the same direction.

Compare both the extensions, swing A and swing C. Note the slope of swing C is shallower than swing A, indicating reducing upwards momentum. The speed of the price extensions has slowed from swing A to swing C. Bullish momentum is weakening.

Compare both the pullbacks, swing B and swing D. Note the slope of swing D is steeper than swing B, indicating increased downwards momentum. Bearish momentum is strengthening.

Both observations show evidence of a weakening of our trend.

Note the trend has not yet changed. A downtrend would not be triggered unless the price swing continued down and broke swing low E (previous swing high resistance and breakout point, now support).

The trend is still upwards. However momentum analysis says it has weakened considerably.

The *future trend* will be determined via the processes to be discussed shortly. For now, we have identified weakness in the uptrend; and given the potential for support at E there is a good likelihood of sideways action from this point on.

Let's review the example from a *trader's decision making* perspective.

The rapid extension of price swing A will lead to a lot of traders jumping on this uptrending bandwagon, quite excited about the potential for higher prices. Pullback B would be a little deeper than they'd like to see, at approximately 50% of the previous extension, but that's not entirely unexpected given the speed of the extension. The pullback also affords other bulls the opportunity to enter long, had they missed the original move.

However, the majority of the novice traders are usually late to these parties, entering towards the end of any move. Many would have bought late into extension A at the area which subsequently formed the swing high. These traders would be under extreme stress during the extended pullback and likely looking for any opportunity to get out at breakeven or close to it. Given the slower rate of climb in C, it's unlikely the original enthusiasm would be restored, and these traders would likely add to bearish orderflow as they take their exit towards the highs of C (if they're lucky), or more likely as it accelerates down through the second pullback D.

Likewise anyone who missed the original move in extension A and entered into extension C after the pullback, will likely bail out at breakeven or have their stops hit as price falls in D, further adding to the bearish pressure and weakening the likelihood of future bullish orderflow.

This has led to where price is now. From here, we expect more bearish pressure in the next candle, as price continues its break of the B-C swing low and even more stops are hit.

However any bearish move is expected to be short lived. Shorts will be taking profits approaching E. Longs will be entering at this area, which last time showed extreme bullish pressure (they won't want to miss this opportunity again). Bullish orderflow should overwhelm bearish orderflow, creating support.

Another example...



Figure 3.66 - Reducing Momentum

Referring to figure 3.66, note the reducing momentum on each down swing extension, as price forms this rounded bottom formation and creates new support at the 1.4510 level.

As the third swing (C) moves down towards the prior swing low, the reduced momentum should have alerted you to a changing bias. Supply was no longer overwhelming demand to the degree displayed by the initial two drops. Either there was a lack of selling, or it was being absorbed by an increase in buying.

Either way, the balance of power has shifted and the bears are no longer the dominant force they once were.

The downtrend has weakened. Further price movement is more likely against the direction of the weakness (ie. in the long direction).

As stated before, the important point is not any absolute value of momentum, but the comparison of one price swing with another. In this case, reducing speed on each price swing is evidence of a weakening of the downtrend.



Figure 3.67 - Decelerating Price Swing into an Area of Support

Figure 3.67 demonstrates deceleration. Note how the price falls quite rapidly at the beginning, but the rate of fall slows towards the end.

This is an example of initially strong bearish pressure – supply overcoming demand as traders exit their longs and shorts enter on break of the high candle (shooting star). This initial bearish pressure was not able to be sustained. The further price falls, the less other traders become interested in shorting. And the more price approaches the area of support, the more traders are interested in searching for an entry long. After all, last time price left this area (17:12) it did so quite quickly.

Rapid price movement from an area of S/R makes it a higher quality area if tested again. We expect it to hold.

Traders who enter short late into this move downwards are taking a very low odds trade.

The end result is that the price action in this case (deceleration) confirms weakness in the downwards price swing; and increases the likelihood of the area of support holding.

Figure 3.68 below demonstrates the same concept, although this time involving deceleration of an upwards price swing into an area of resistance.



Figure 3.68 - Decelerating Price Swing into an Area of Resistance

Deceleration in this example is evidence of bullish momentum gradually weakening as bearish pressure overcomes any bullish pressure.

Traders who buy late into this move are once again taking a very low odds trade. The smarter trader will have identified the weakness at resistance and so will look for an opportunity to enter short, in order to profit from the losers orderflow.

Of course, we're not considering trades yet – just identifying signs of strength or weakness.

In these last two examples, we've demonstrated the concept that decelerating price into an area of support or resistance indicates weakness; with the level quite likely to hold price.



Figure 3.69 - Accelerating Price Swing

Figure 3.69 shows acceleration on swing D; a sign of strength. But first let's look at the prior price action.

Comparing swings A to C we see weakening bearish momentum due to the reducing slope.

Swing D initially shows comparable momentum to swing B, but then accelerates just prior to breaking swing high E.

This price acceleration shows strength in the bullish direction.

The next pullback F shows weakness, in comparison to the accelerating bullish swing D.

Strength is clearly in the bullish direction; weakness is clearly in the bearish direction. Future price action is likely in the direction of strength and against the direction of weakness.

But what about extreme climactic acceleration?



Figure 3.70 - Extreme Acceleration (Climactic)

An accelerating price swing, as shown in figure 3.70 represents extremes of emotion. Bullish pressure vastly exceeds bearish pressure as everyone chases price higher and higher, desperate to get into this market before they miss out on what they perceive to be guaranteed profits.

This type of move is often associated with increasing price bar ranges and a much greater than average volume.

While this clearly shows strength during the period of acceleration, the nature of this type of move is such that it accelerates until a point of exhaustion, at which there is no-one else desperate to get long and willing to pay higher prices.

The swing high then forms an area of resistance. If no-one is willing to pay higher prices, then price cannot rally. The path of least resistance is down. The market will display weakness beyond the point of exhaustion.

Sometimes, these climactic moves will result in a very rapid reversal. Price falling will trigger trailing stops; leading to further price falls which trigger more stops; and on and on.

Other times, a retest of the point of exhaustion will precede the reversal (creating a great trade opportunity in the process).

At the very least though, price should be expected to form S/R which will hold price at least for the foreseeable future, as occurred in this example.

One final example; including a look at the *lower timeframe* chart to confirm and fine-tune our analysis...

The *lower timeframe* chart is made from exactly the same data as the *trading timeframe* chart. However it allows you to zoom in on the price action to get a closer look. Kind of like a microscope for the *trading timeframe* action.

The *lower timeframe* chart will be monitored throughout your analysis, but there are some key times when extra focus will be placed on this chart. Such as:

- 1) When clear signals are not available through the *trading timeframe* (3 min), such as within areas of sideways congestion.
- 2) When price is at a critical decision point – such as the break of a swing high/low.
- 3) When price is in a trade setup area.

Figure 3.71 shows our *trading timeframe* (3 min) chart, as the market has decelerated into an area of sideways price action (shown by the blue box). Is this sideways action an indication of potential reversal? Or simply a pause before continuation?



Figure 3.71 - Trading Timeframe Deceleration into Sideways Action

Zooming in to the *lower timeframe* (1 min) allows us to more clearly see the changes in momentum within the price swings.

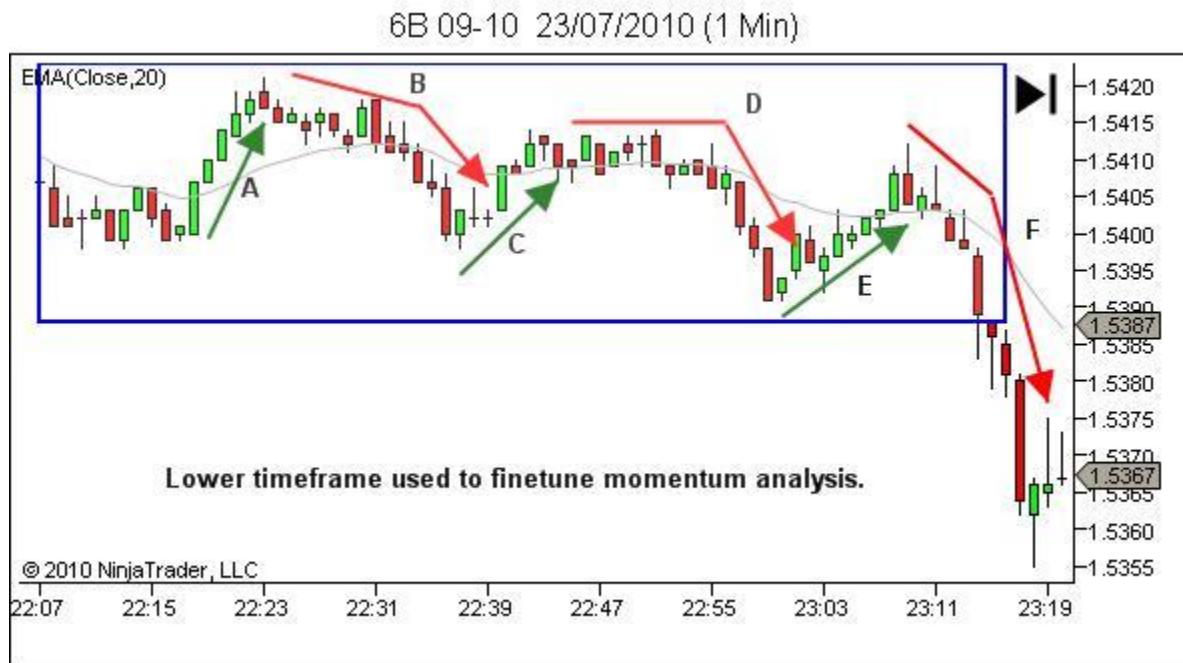


Figure 3.72 - Lower Timeframe Deceleration into Sideways Action

On the *lower timeframe* (1 min) we can clearly see that bullish momentum is weakening within each upswing, evidenced by the decreasing slope from swings A to C to E.

We also see downswings B and D, accelerating to lows, with D showing more bearish strength than B. Bearish momentum is increasing from one swing to the next.

Although the data does not show one side dominating the other, the balance of power is slowly shifting from the bulls to the bears, as the bullish momentum weakens and the bearish momentum strengthens.

Swing F resumes the *trading timeframe* (3 min) downtrend as the bears finally overwhelm any remaining bullish pressure.

From the perspective of supply and demand, each price swing is showing reduced demand and encountering greater supply. In the absence of any external factor introducing new demand, the likelihood is for supply to exhaust any demand and force price lower.

From the perspective of traders and their decision making processes...

This market deceleration has offered some tempting entries long, which will attract many traders who are hoping to capture an early entry to a reversal. There are numerous entry opportunities, but for the sake of simplicity let's consider just one group – those who missed the rally at A, suffered great frustration at the fact that they missed such an obvious entry, then were overjoyed to see the second entry opportunity at C. This time they didn't miss out. Entering at C, they become frustrated as price stalls sideways for a good 10 minutes or so, before accelerating downwards. Some will stop out on swing D, as it breaks the swing C lows. Others will hold, overwhelmed by fear initially, but then with relief as swing E takes them back into profits (possibly also with a slight feeling of satisfaction, knowing how smart they are for holding during the drawdown).

These traders do not perceive the signs of weakness that are evident through simple momentum analysis.

As the bearish strength overwhelms the weaker bullish pressure, the market collapses, triggering the stops of these very frustrated and angry longs.

As YTC Price Action Traders, we aim to profit from these losing traders. Recognising the strength shifting to the bearish side, gave us an opportunity to work an entry short, in the direction of strength, allowing us to profit from the orderflow of the losers who tried to trade in the direction of weakness.

Let's wrap up momentum...

Not every price swing will provide useful information through analysis of momentum. However we monitor momentum as price moves in order to note any significant changes. These may display via a change in speed from one swing to another (changing slope), or a change in speed within one price swing (acceleration or deceleration).

- Compare the momentum of the current price swing with the momentum of the previous price swing in the same direction? Is price faster or slower than before? What does that mean?
- Compare the momentum of the current price swing with the momentum of the previous price swing in the opposite direction? Is price faster or slower than before? What does that mean?
- Is the current price accelerating or decelerating? What does that mean?

Noting these changes, we consider the meaning from the perspective of supply & demand, and from the perspective of traders making trading decisions.

Momentum analysis allows us to sense changes in strength or weakness of the price swings within a trend; thus allowing us to assess the strength or weakness of the trend itself.

Price movement will most likely continue in the direction of strength and oppose the direction of any weakness.

This ability to assess the strengthening or weakening of a trend gives us an edge over those traders who fail to see this information, despite it being openly presented right in front of them.

Projection & Depth

Strengthening or weakening of a trend may also be observed through analysis of **Projection** and **Depth**.

Projection refers to the distance with which a price extension projects past the previous swing high (in an uptrend) or swing low (in a downtrend).

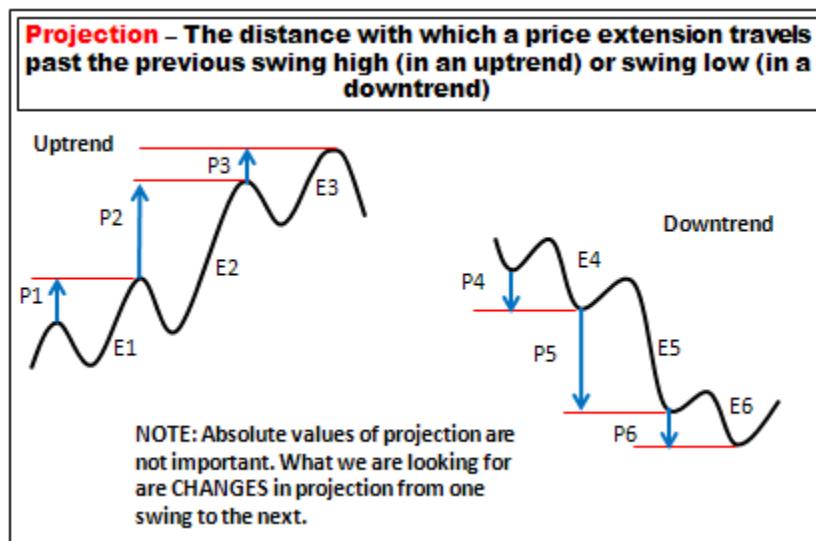


Figure 3.73 - Projection

Referring to the uptrend within figure 3.73, we see the price action shows three price extensions E1, E2 and E3. The projection of each is displayed as P1, P2 and P3. P1 is the distance with which E1 projects (or travels) beyond the previous swing high. P2 is the distance with which E2 projects beyond the previous swing high. And P3 is the distance with which E3 projects beyond its previous swing high.

The important information is not so much the distance, but changes when comparing one projection with the next.

Note the increased projection of E2 (P2) when compared with E1 (P1). Extension E2 projects much further than E1 did, indicating greater strength within the trend.

P3 is then much shorter than P2, indicating weakness developing with the trend.

The downtrend shows similar information. Projection P4 is the distance with which Extension E4 travels past its previous swing low. And so on for P5 and P6.

P5 shows greater distance than P4, indicating increased downtrend strength. P6 shows a decrease in projection compared to P5, indicating possible downtrend weakness.

Increased projection is a sign of potential trend strength. Decreased projection is a sign of potential trend weakness.

Let's see a chart example:

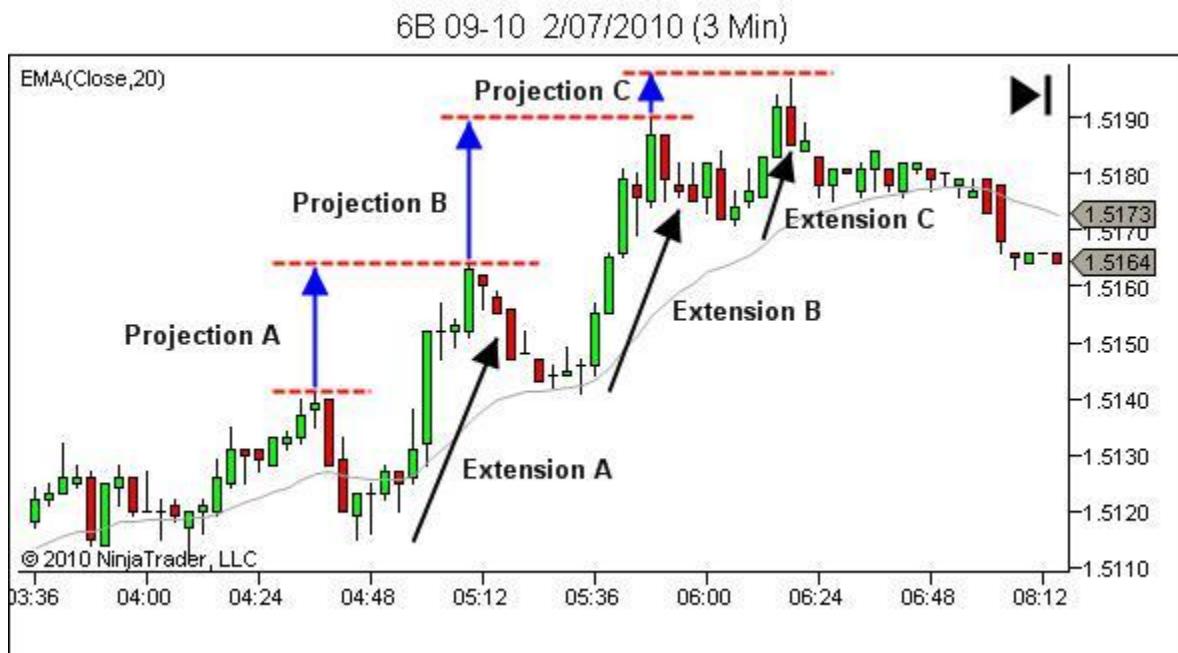


Figure 3.74 - Projection on a Chart

Projection A is the distance with which Extension A carries past the previous swing high. In this case the projection is equivalent to 45% of the whole Extension A range.

Projection B is the distance with which Extension B carries past the previous swing high. In this case the projection is equivalent to 52% of the Extension B range.

Projection C is the distance with which Extension C carries past the previous swing high. In this case the projection is equivalent to only 25% of the Extension C range.

In conducting analysis you do NOT have to work out percentages. We are not concerned with absolute values of projection, but simply looking for changes which are visually obvious.

In this example, Extensions A and B are easily able to break and move to new highs. Extension C though is unable to project to the same distance. Something has shifted in the balance of supply and demand. If there was no change from previous sentiment, then the extension should have carried through approximately the same distance as previously occurred. The fact that the market was unable to do so indicates either a decrease in bullish pressure and/or an increase in bearish pressure.

The uptrend is showing signs of weakening.

Depth refers to the distance with which a pullback retraces the previous extension.

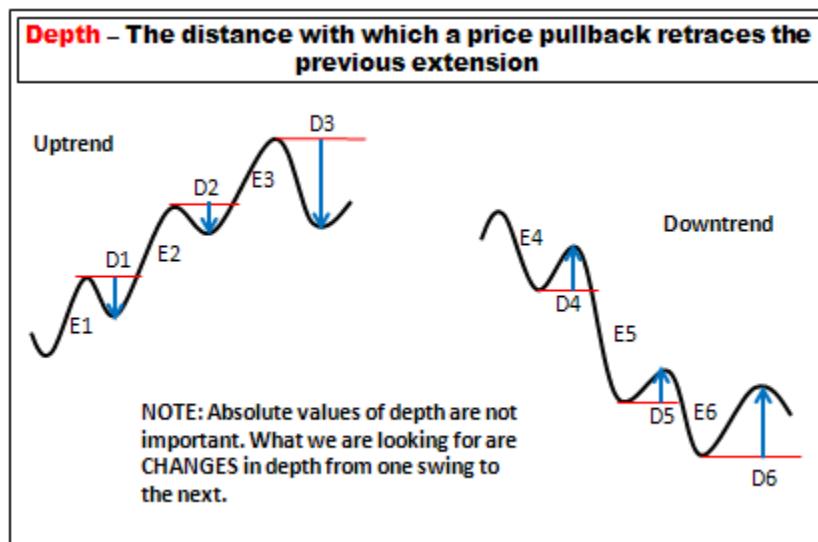


Figure 3.75 - Depth

Looking at the uptrend in figure 3.75, we see three extensions E1, E2 and E3.

Depth D1 is the distance with which the pullback retraces E1 (think in percentage terms, rather than price values).

D2 is the depth with which the pullback retraces E2. And D3 is the depth with which the pullback retraces extension E3.

As with projection, we are not greatly interested in the absolute values of depth; rather we note significant changes of depth from one price swing to another.

Note that D2 is a much smaller percentage of its extension E2 (approx 20%), when compared to D1 (approx 40%). D2 has smaller depth than D1, indicating a potential weakening of the bears, and therefore strength within the price trend.

Note that D3 is significantly larger than D2, indicating potential strength within the bears, and therefore potential weakness within the price trend.

The same concept applies to the downtrend.

D5 is showing greatly reduced depth when compared with D4 (remember we compare D5 as a percentage of E5 (approx 20%) with D4 as a percentage of E4 (approx 60%)). Reduced pullback depth in a downtrend is a sign of potential weakness in the bulls, and therefore potential strength in the downtrend.

D6 is showing a much greater percentage depth than D5, indicating potential strength in the bulls and therefore potential weakness in the trend.

Increased depth is a sign of potential trend weakness. Decreased depth is a sign of potential trend strength.

Let's now examine depth on the same chart we used for projection, displayed again as figure 3.76 below.

Depth A is the percentage with which the pullback retraces the range of Extension A. In this case Depth A is a pullback equivalent to 45% of the Extension A range.

Depth B is the percentage with which the pullback retraces the range of Extension B. In this case Depth B is a pullback equivalent to 40% of the Extension B range.

Depth C is the percentage with which the pullback retraces the range of Extension C. In this case Depth C is a pullback equivalent to 85% of the Extension C range.

As with our projection analysis, we're not interested in absolute quantities, but rather in observing changes within the depth when comparing the current swing with previous swings.

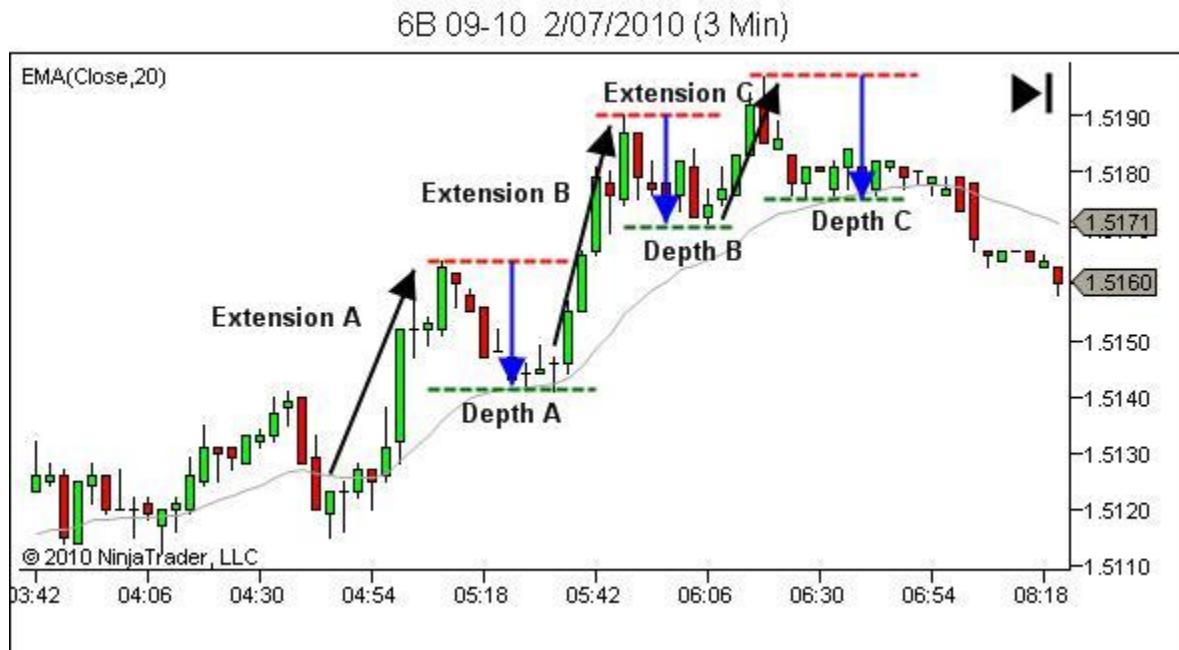


Figure 3.76 - Depth on a Chart

The increased depth of pullback C indicates increasing bearish pressure and a potential weakening of the trend.

It's wrong to make assumptions such as a 38% pullback is shallow, a 50% pullback is normal and a 62% pullback is extreme. The depth of pullback that should be considered normal is dependent on the current market environment.

In a volatile trend environment, deep pullbacks may be the norm, as demonstrated below in figure 3.77.

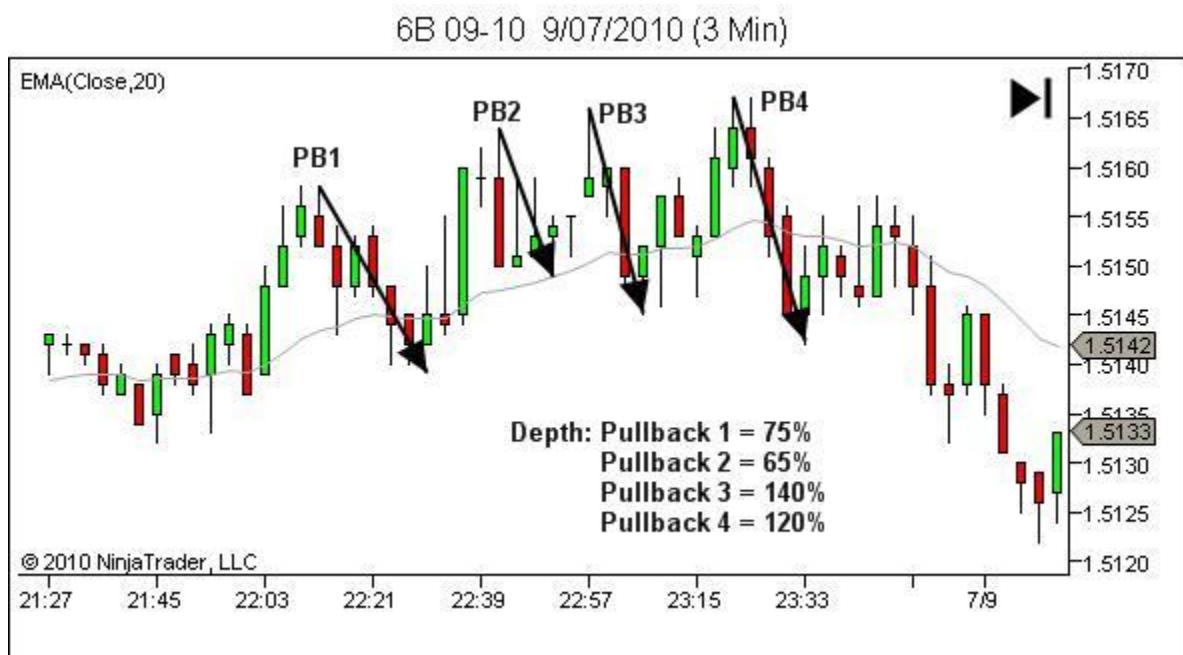


Figure 3.77 - Deep Pullbacks within a Volatile Trend Environment

In this trend, pullback depth of 65-75% was considered normal. Weakening of the trend was observed only when we had deeper pullbacks, PB3 and 4, which exceeded the length of their extensions. This was a clear sign of the balance of power shifting towards the bearish side. The trend is showing clear signs of ending.

To summarise projection and depth...

What we're seeking through our analysis is evidence that something has changed – a shallower or deeper pullback or extension. If sentiment had remained as before, then the pullback or extension would have been in line with previous pullbacks and extensions. The fact that something has changed in the market indicates a change in sentiment. Analyse the change – what does it mean from the perspective of supply and demand? What does it mean from the perspective of other traders and their decisions, thoughts and emotions?

While these changes are often evident through your momentum analysis, it's not always the case. And in many cases analysis of projection and depth is the easiest way to spot shifting sentiment within the price action.

Failure to Continue

Closely related to momentum and projection/depth, is a concept which I call *Failure to Continue*.

You'll often see patterns on the chart which create an obvious expectation (within the uninformed crowd) for future price movement. When that future price movement fails to meet expectations, the market provides us with clues as to the strength or weakness of the underlying price trend.

Refer to figure 3.78 below for an example.

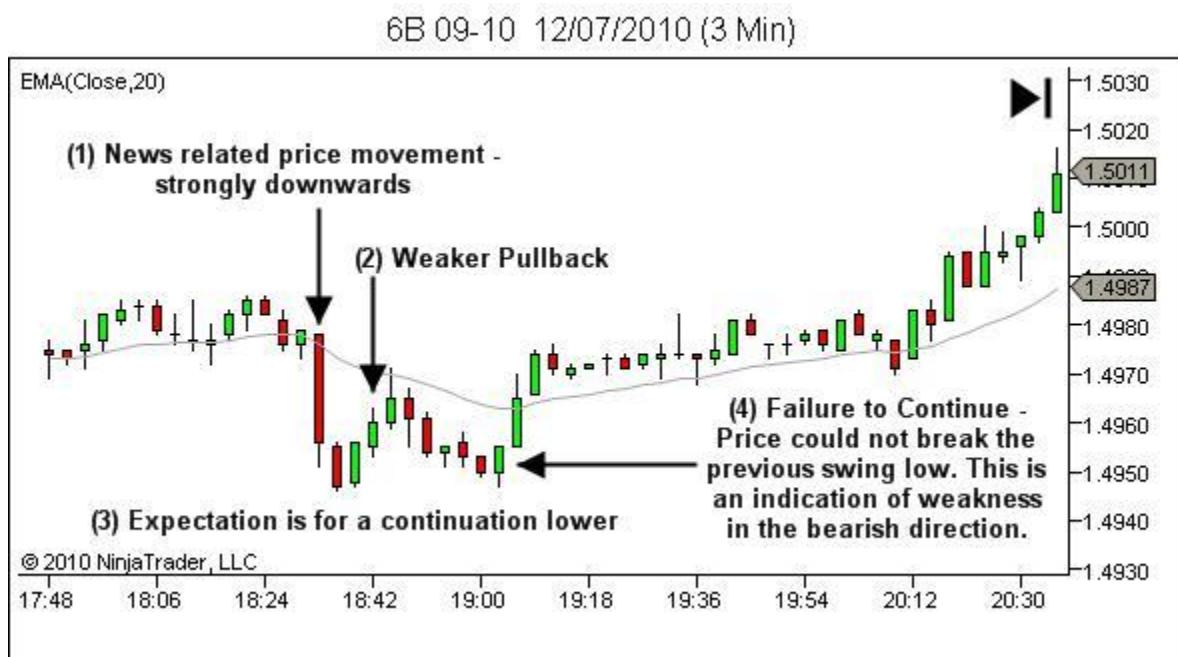


Figure 3.78 - Failure to Continue

Following a strong fundamentally-influenced impulse downwards, and a weaker pullback, the obvious expectation is for a continuation of the move down breaking to new lows.

Failure to meet that expectation demonstrates weakness in the bearish direction.

This weakness may be easily observed through analysis of price swing momentum, or analysis of projection and depth. Often however, the easiest way to observe this weakness is through a simple failure to meet expectations, or *failure to continue*.

Failure to Continue doesn't only involve failure to break a high or low, as in the above example. It might also display as a break of that level which quickly fails.

Any time obvious expectations fail to continue, the market has given you a strong clue as to *future trend* direction.

Miscellaneous

Momentum, Projection/Depth and Failure to Continue are not the only analysis methods available to identify shifting sentiment (strength or weakness) within a market. Additional analysis tools such as volume or market internals may be incorporated, depending on your experience levels and your chosen markets.

What we are seeking in our analysis of price action is evidence of change in sentiment – a strengthening or weakening of the trend.

With my background primarily being in forex, these changes had to be determined solely through price action, as demonstrated already. Volume and market internal indicators were not available.

With my trading now being primarily in the futures markets, additional analysis tools are available. I will not be detailing their use in this book, as they are not considered an essential part of the strategy. Change in sentiment is evidenced through price action – any other analysis tools provide secondary indications only.

That being said, if you have these tools available you may wish to consider their use.

For volume analysis I would recommend studying Volume Spread Analysis, perhaps starting with the book, "Master the Markets" by Tom Williams.

For market internals, I would recommend studying the YTC Scalper supplementary ebook. Alternatively, try "Read the Greed – Take the Money" by Mike Reed, to see his use of the NYSE Tick indicator. Refer to the Resources page of my website for links.

The key point to remember should you use these additional tools is that we are using them solely to find changes in the sentiment of the market – something that is different, such as an NYSE Tick that has struggled to break above the zero level for the last 2 hours suddenly spiking up to 1000.

3.3.3 – Principles of Future Trend Direction

Having analysed the past trend direction and identified any signs of strength or weakness within that trend, we now work to determine the likely *future trend* direction.

Most traders simply operate on the assumption that an existing trend will continue in its current state, until a break of their objective trend definition – “*the trend is your friend*”.

While that’s generally good advice, as the higher probability is most often for a continuation of the trend, I feel it’s wise to also recognise the true nature of this *friendship*. If the trend is your friend then it’s certainly not the nicest one you’ve got; more like one of those friends who will stab you in the back at the first opportunity if you don’t take care.

Signs of strength and weakness within the trend alert us to those times when the trend is not our friend, and higher probabilities are available through counter-trend corrections or reversals.

We assess the likely *future trend* direction in accordance with the following principles:

Within the S/R framework:

- **First Principle** – We expect an up or down trend to continue in its current state until the next S/R barrier, unless displaying evidence of weakness within the trend.
- **Second Principle** - When an up or down trend shows evidence of weakness, we expect a higher likelihood of a complex correction* rather than a reversal, until such time as the market shows both price acceptance and strength in the new trend direction.

(* *a complex correction being one of extended duration, or multiple swings*)

- **Third Principle** – A sideways trend within the framework is expected to continue in its current state, unless displaying evidence of strength towards the range boundary.
- **Fourth Principle** - When a sideways trend shows evidence of strength towards the range boundary, we expect a break of the boundary. We observe the behaviour of price post-breakout for clues as to future direction:
 - Weakness following the breakout – the expectation is for a breakout failure and reversal back within the trading range

- Weakness on the pullback – the expectation is for a breakout pullback and continuation.

At the edges of the S/R framework:

- **Fifth Principle** – We expect a test of our framework S/R to hold, unless strength is displayed on approach to the S/R boundary.
- **Sixth Principle** - If strength is shown on an approach to an S/R barrier, we expect a breakout and watch the behaviour of price post-breakout for clues as to future direction:
 - Weakness following the breakout – the expectation is for a breakout failure and reversal back through the area of S/R.
 - Weakness on the pullback – the expectation is for a breakout pullback and continuation.

These principles are demonstrated below in figures 3.79 to 3.90.

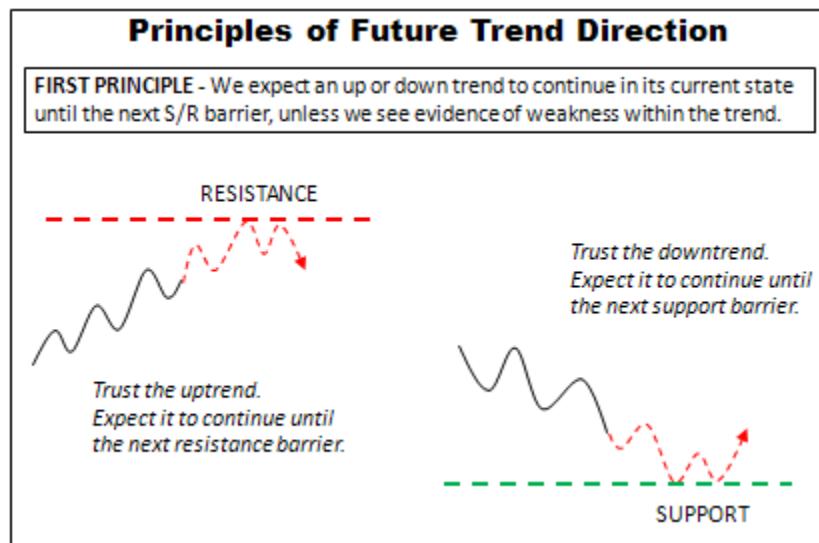


Figure 3.79 - Principles of Future Trend Direction – First Principle

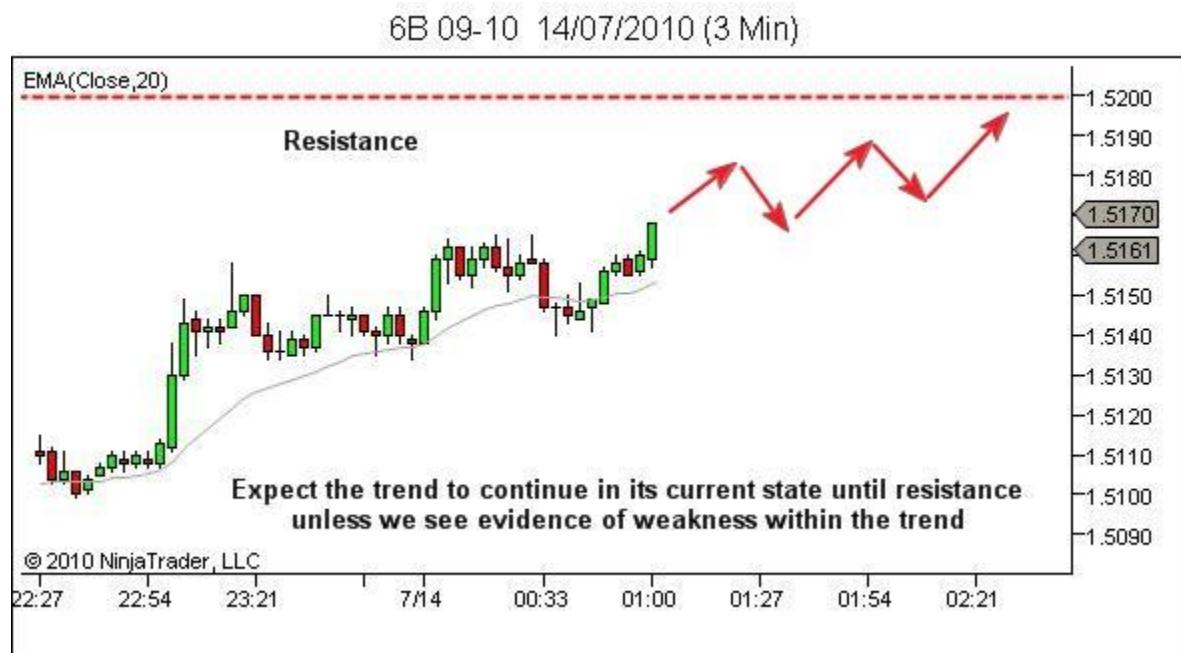


Figure 3.80 - Principles of Future Trend Direction – First Principle – Chart Example

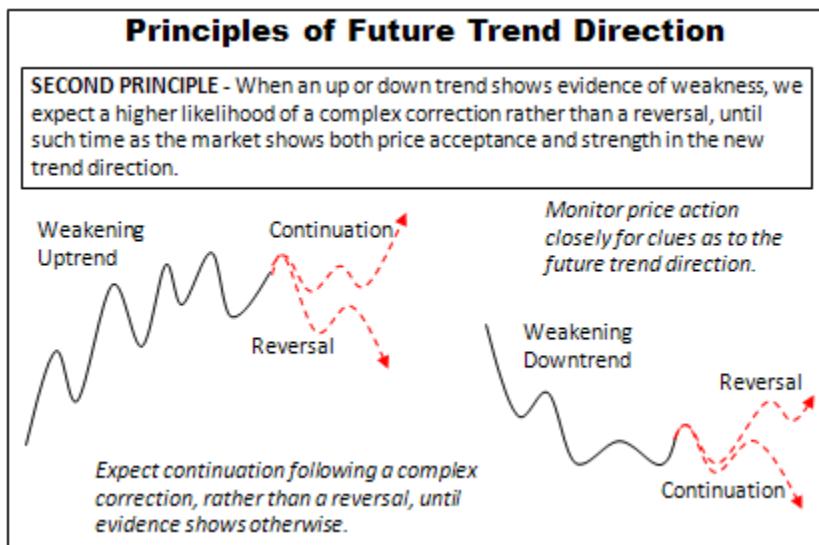


Figure 3.81 - Principles of Future Trend Direction – Second Principle



Figure 3.82 - Principles of Future Trend Direction – Second Principle – Chart Example

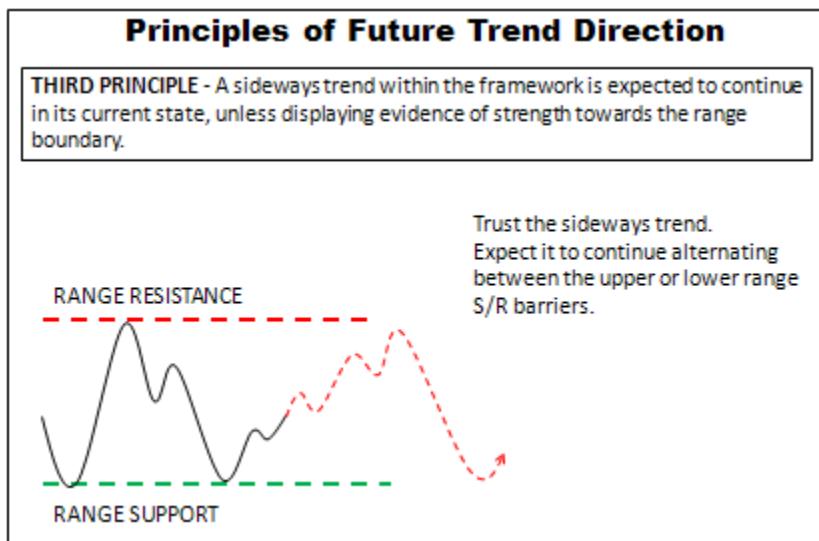


Figure 3.83 - Principles of Future Trend Direction – Third Principle

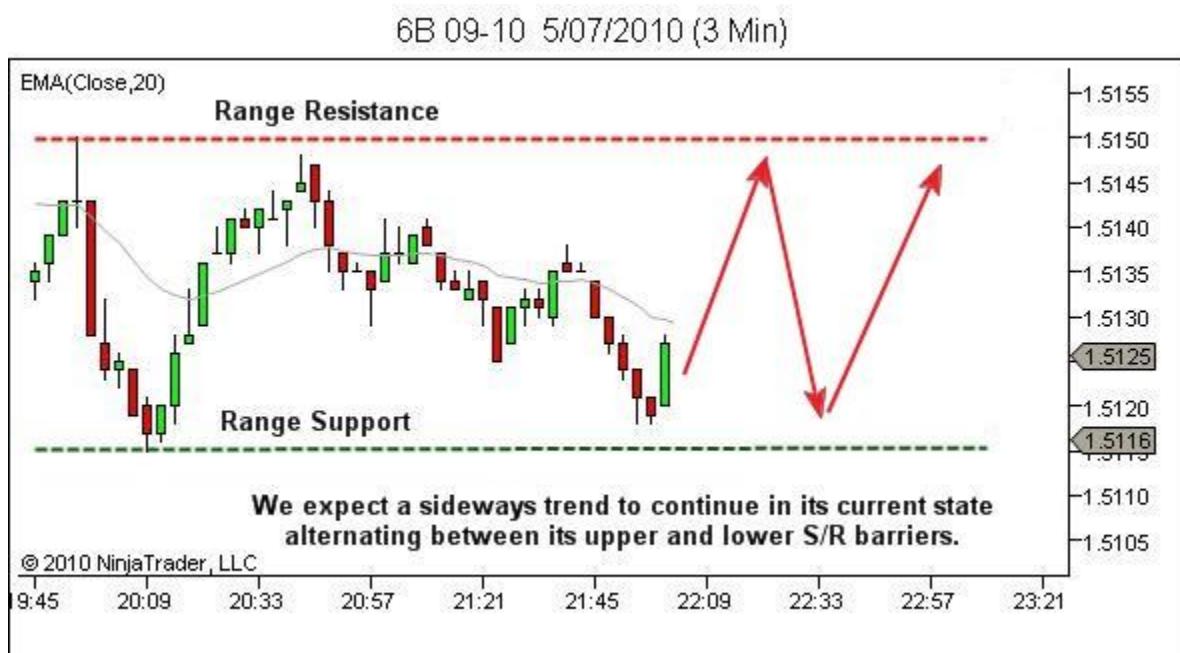


Figure 3.84 - Principles of Future Trend Direction – Third Principle – Chart Example

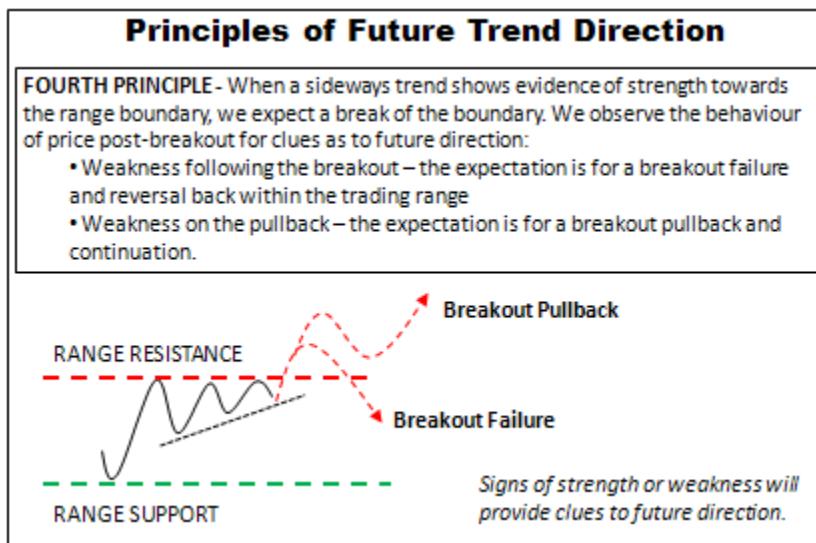


Figure 3.85 - Principles of Future Trend Direction – Fourth Principle



Figure 3.86 - Principles of Future Trend Direction – Fourth Principle – Chart Example

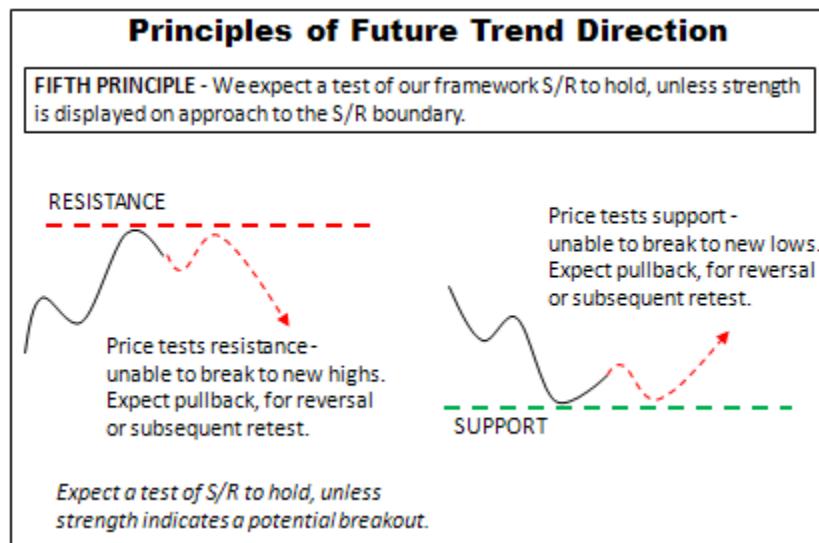


Figure 3.87 - Principles of Future Trend Direction – Fifth Principle



Figure 3.88 - Principles of Future Trend Direction – Fifth Principle – Chart Example

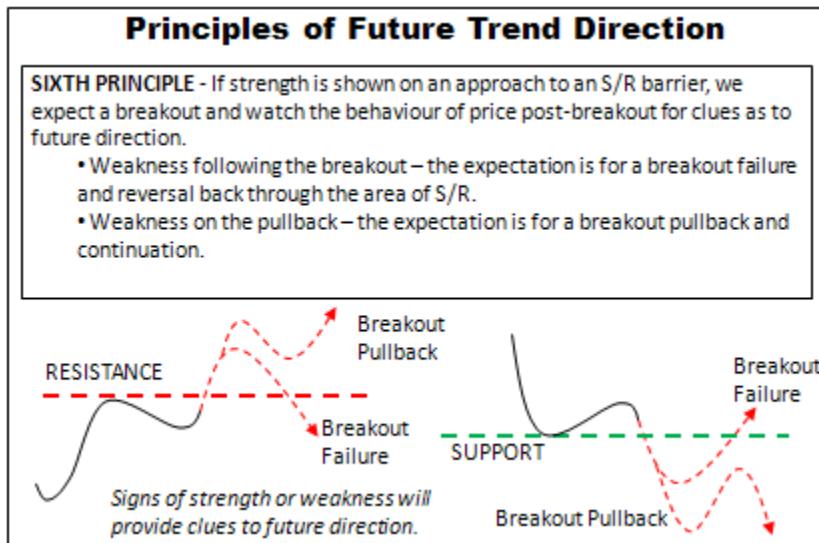


Figure 3.89 - Principles of Future Trend Direction – Sixth Principle



Figure 3.90 - Principles of Future Trend Direction – Sixth Principle – Chart Example

These six principles will provide you with your initial assessment of *future trend* direction.

Remember though – this is only an INITIAL assessment.

Keep it simple; and don't stress too much about getting it wrong. We'll soon be updating our assessment bar-by-bar as more price action unfolds on the right hand side of your charts.

You'll soon know if you got it wrong, as new signs of strength or weakness will confirm or reject your previous assessment, and provide you with opportunity to update your assessment of *future trend*. To make this easier though, it helps to visualise the future...

3.3.4 – Visualising the Future

Having established our bias for *future trend* direction, we will shortly be reassessing the bias as the market prints new price bars (or candles). Will the new data confirm our bias remains intact, or will it provide some new information which alerts us to potential changes within the supply/demand relationship?

In order to make this assessment easier, we should have some expectation of future orderflow.

How do you expect future price action to behave?

This is simply a process of considering the following:

- **What price action would validate your assessment of *future trend*?**
- **What price action would invalidate your assessment of *future trend*?**

Let's demonstrate this through asking these questions about some of our earlier charts...

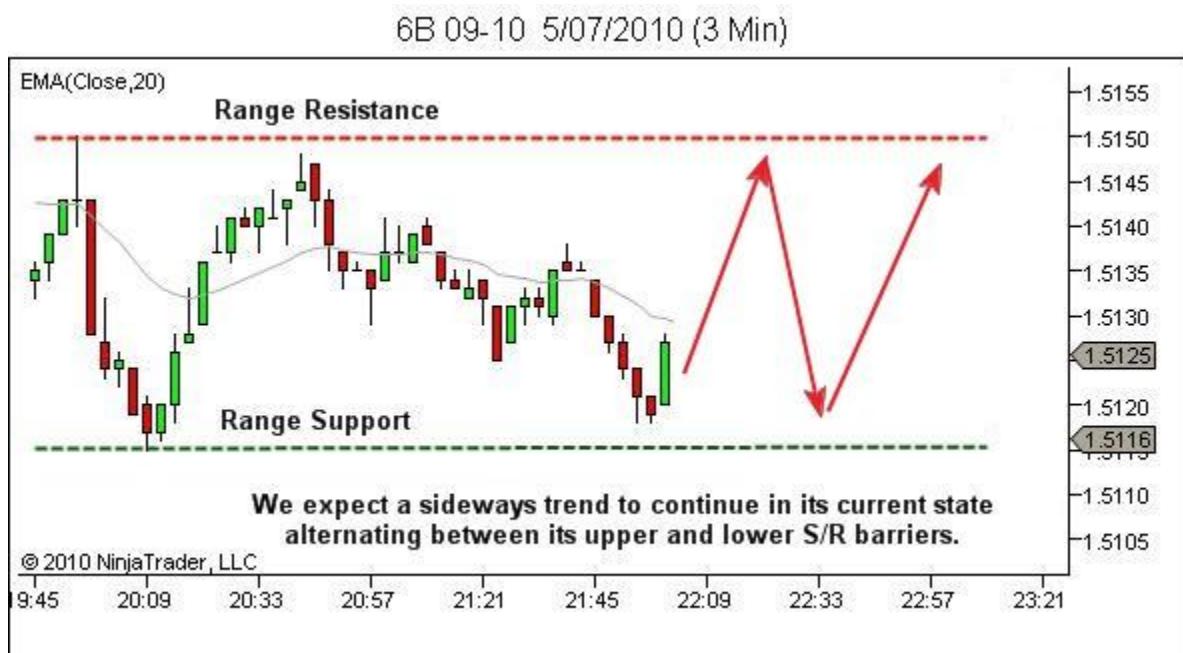


Figure 3.91 - Visualise the Future – Example 1

In figure 3.91, we expect a continuation of the sideways trend.

What price action would validate my assessment of *future trend* direction?

The large-range bullish green candle off support should lead to initiation of the move back up towards resistance. I expect to see further follow-through to the upside, with slowing momentum leading into resistance, as happened in the earlier upswing towards the left of the chart. Traders in a long position off support will be targeting the upper resistance. Their sell orders, along with shorts entering at that area should be sufficient to hold price and prevent further rally.

What price action would invalidate my assessment of *future trend* direction?

If price fails to follow through, and falls below the latest green bullish candle, I'll need to reassess the bias. Potentially the bearish pressure is stronger than anticipated and it's time to consider a potential break downwards. This occurrence would shock anyone in a long position and have them standing by for a quick exit if the lows should then break, adding to bearish pressure and aiding the breakout.

I'm now prepared for the future price action – aware of what it should look like if my assessment of the *future trend* is correct – and aware of what it will look like if my analysis was wrong.



Figure 3.92 - Visualise the Future – Example 2

In figure 3.92, price has broken a resistance level for a second time. This second break, although initially weak, is now displaying strength. This is likely showing price acceptance of the breakout area, and I expect the breakout to hold and continue higher.

What price action would validate my assessment of *future trend* direction?

The upper tail is showing some evidence of supply. I expect a pullback to commence within the next candle or two. However that pullback must be showing weakness, through either a shallow slope (weak bearish momentum) and/or reduced depth.

What price action would invalidate my assessment of *future trend* direction?

Strength on a pullback would indicate supply coming into the market at these higher prices. If that occurs, it's likely the strength shown on the second breakout was simply stops getting triggered, and the market has not attracted sufficient new longs to support continuation. A strong pullback would have me reconsidering my expectations, with a breakout failure confirmed by a break below the large green breakout candle.

As you can see, visualisation is just a simple process of asking what you are expecting to see happen in the immediate future. We don't remain fixed to this viewpoint – in fact, we even

consider what price action would invalidate our plan, ready to dump it at the first sight of it no longer describing the current market.

This process is simply a result of experience. More examples will be provided, covering the whole process of analysis. The real learning though, will occur as you work through your charts. As you gain more and more screen time, your ability to read the market and accurately assess future orderflow (and update that assessment in real-time) will improve.

3.3.5 – What Happens After S/R Holds?

Having provided the six principles which I use to define future price action, there is one area on the charts that often causes people some difficulty. So, let's address it here before we go on with the analysis process and examples.

What happens after a successful test (Fifth Principle) or a successful breakout failure (Sixth Principle)?

Is price expected to form an immediate reversal and change of trend?

Or do we expect the trend to remain intact, and set up another test of S/R?

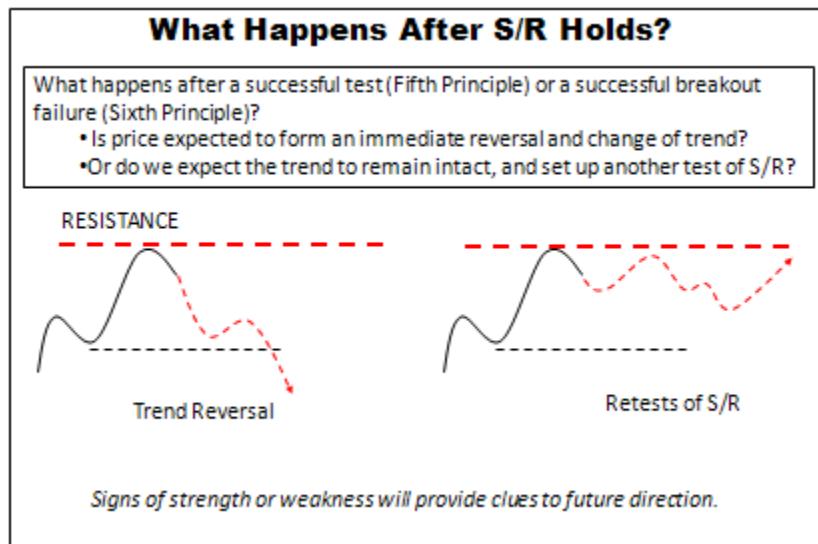


Figure 3.93 – What Happens After S/R Holds

I consider S/R as barriers to the trend. They provide some counter-trend orderflow, but are NOT automatically assumed to reverse the trend, until we see evidence of likely (or confirmed) reversal.

Evidence of a reversal obviously requires price acceptance past the point of trend change; a sign of strength in the new trend direction.

Evidence of a likely reversal occurs when we see price swings showing clear strength in the reversal direction, and weakness in the original trend direction, even though price has not yet past the point of trend change.

Until we see these signs, we assume the trend will prevail and return for either another test, or attempt at a breakout.

So... following a successful test or breakout pullback... we watch price action for clues as to which side is showing greater strength, the bulls or the bears. Signs of strength or weakness will alert us to the likely *future trend* direction.

And if for a period of time we're a little unsure... so be it. In this case though, my advice is to always trust the trend.

Let's approach this from a slightly different perspective, and I'll try to make it simpler.

- In the absence of weakness in the trend (when having tested S/R) expect a continuation of the trend (First Principle) which will take us back for another test of S/R (Fifth or Sixth Principle).

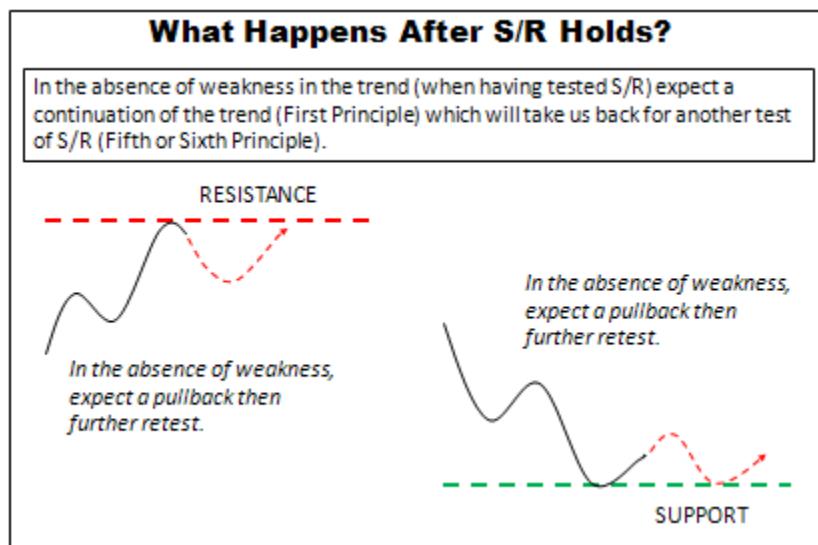


Figure 3.94 – What Happens After S/R Holds – In the Absence of Weakness

- If weakness is present in the trend (when having tested S/R), but there are no signs of strength in the reversal direction, expect a complex pullback (Second Principle) prior to taking us back for another test of S/R (Fifth or Sixth Principle).

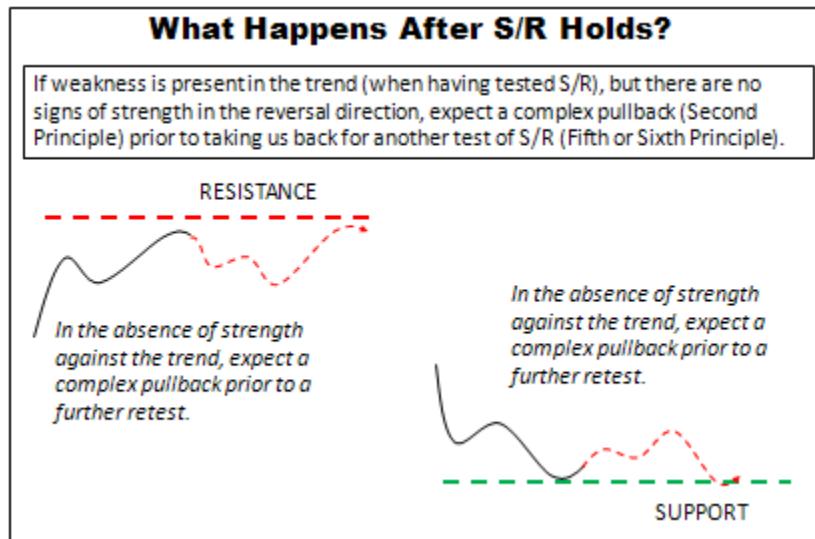


Figure 3.95 – What Happens After S/R Holds –
 In the Absence of Strength Against the Trend

- If strength shows against the trend, expect a reversal. In this case, any retest of the S/R can be treated like a pullback in the direction of the new trend (First Principle).

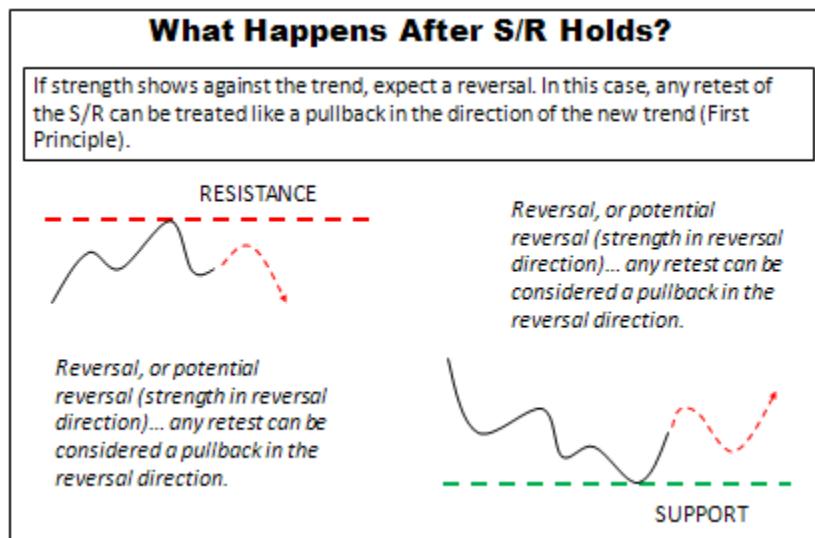


Figure 3.96 – What Happens After S/R Holds –
 In the Presence of Strength Against the Trend

This post-S/R area can be a little confusing at times. Sometimes it takes a whole price swing or two to work it out. Remember though... you'll be updating your assessment bar by bar. Just make your best assessment, knowing that if you get it wrong you'll soon know and be able to adjust your bias.

And if in total doubt, always trust the trend until it is broken.

I'll be sure to include an example in chapter 5, Trade Examples.

3.4 – Initial Market Analysis Process

Having looked at the theory behind our initial analysis, let's combine it all into one Initial Market Analysis Process. A checklist will be produced which will also later become part of our Procedures Manual.

3.4.1 – Initial Market Analysis Process Summary

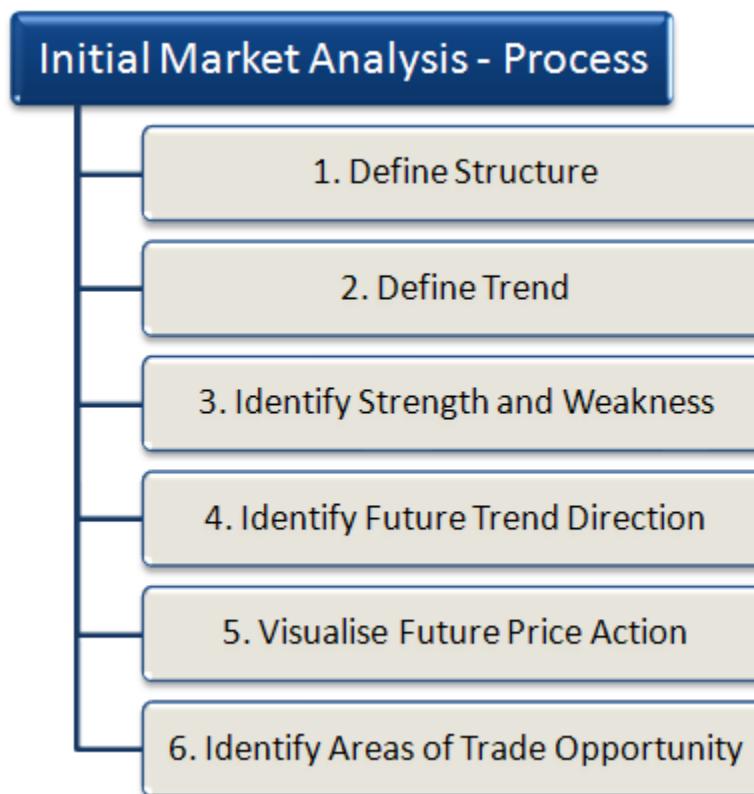


Figure 3.97 - Initial Market Analysis Process

Initial Market Analysis involves a six step process, as per figure 3.97.

The following checklist will walk you through the actions required for each step.

3.4.2 Initial Market Analysis Checklist

Step 1 - Define Structure

Define a structural framework within which our *trading timeframe* price action will move.

Actions:

- Identify areas of Support or Resistance on the *higher timeframe* (30 min) chart
 - Swing highs and lows

Step 2 -Define Trend

Assess the movement of past price action within our market structure framework.

Actions:

- Identify significant swing highs and lows on the *trading timeframe* (3 min) chart.
- Identify the trend direction
 - Up, down or sideways.

Step 3 - Identify Strength & Weakness

Analyse price movement within the trend to identify signs of strength or weakness.

Actions:

- Analyse momentum of recent price swings
 - Compare the momentum of the current price swing with the momentum of the previous price swing in the same direction? Is price faster or slower than before? What does that mean?
 - Compare the momentum of the current price swing with the momentum of the previous price swing in the opposite direction? Is price faster or slower than before? What does that mean?
 - Is the current price accelerating or decelerating? What does that mean?
- Compare projection and depth of recent price swings

- Increased projection is a sign of potential trend strength. Decreased projection is a sign of potential trend weakness.
- Increased depth is a sign of potential trend weakness. Decreased depth is a sign of potential trend strength.
- Identify signs of *failure to continue* (ie. failure to meet expectations).
 - Failure to continue is a sign of weakness
- Identify signs of strength or weakness via any miscellaneous methods
 - Volume analysis
 - Market Internal indicators

Step 4 - Identify Future Trend Direction

What is the likely path of future price action?

Actions:

- Determine the likely path of future price action, in accordance with the following six principles:
 - Within the S/R framework:
 - **First Principle** – We expect an up or down trend to continue in its current state until the next S/R barrier, unless displaying evidence of weakness within the trend.
 - **Second Principle** - When an up or down trend shows evidence of weakness, we expect a higher likelihood of a complex correction rather than a reversal, until such time as the market shows both price acceptance and strength in the new trend direction.
 - **Third Principle** – A sideways trend within the framework is expected to continue in its current state, unless displaying evidence of strength towards the range boundary.
 - **Fourth Principle** - When a sideways trend shows evidence of strength towards the range boundary, we expect a break of the boundary. We observe the behaviour of price post-breakout for clues as to future direction:

- Weakness following the breakout – the expectation is for a breakout failure and reversal back within the trading range
 - Weakness on the pullback – the expectation is for a breakout pullback and continuation.
- At the edges of the S/R framework:
 - **Fifth Principle** – We expect a test of our framework S/R to hold, unless strength is displayed on approach to the S/R boundary.
 - **Sixth Principle** - If strength is shown on an approach to an S/R barrier, we expect a breakout and watch the behaviour of price post-breakout for clues as to future direction:
 - Weakness following the breakout – the expectation is for a breakout failure and reversal back through the area of S/R.
 - Weakness on the pullback – the expectation is for a breakout pullback and continuation.

Step 5 - Visualise Future Price Action

How do you expect price to behave? Visualise the future price action, based upon your expectations for *future trend* direction and its interaction with the market structure S/R levels.

Actions:

- What price action would validate your assessment of *future trend* direction?
- What price action would invalidate your assessment of *future trend* direction?

Step 6 - Identify Areas of Trade Opportunity

- Coming soon. ☺

I'm perhaps jumping the gun a little here, as we haven't talked about how to do this yet. But I've decided to include the step heading now, as it is part of your initial analysis process.

As to how to do that, well... that's for Chapter 4.

For now, we're just learning how to read price as it moves across our screens.

Next Process Step?

That concludes our initial analysis.

From here we conduct our ongoing analysis process - an ongoing process of updating our assessment of likely *future trend* and areas of trade opportunity, based upon new information provided by each and every candle.

That's the subject of sections 3.5 (Ongoing Market Analysis - Theory) and 3.6 (Ongoing Market Analysis Process).

Before we look at that though, let's look at an example of the full process of initial market analysis – defining the structure, identifying the trend, and determining the expected *future trend* direction.

KEEP IT SIMPLE

The initial analysis process has taken many pages to describe, as I've attempted to do so in as thorough a manner as possible (for an ebook). As you'll see in the following example though, the process itself is quite simple and should take no more than a minute or so on initial opening of your charts.

Be careful not to get caught up in complexity. The process should be SIMPLE. If it's not, then you're probably trying too hard to predict exactly where price is going. This is not about prediction. We're simply assessing the likely future path. We'll then be monitoring ongoing price action to confirm that path, or amend it.

Don't be afraid to get it wrong. Ongoing analysis will be self-correcting.

If you're finding it too hard, just refer back to our simple checklist steps...

That's all there is to it.

3.4.3 - Initial Market Analysis Example



Figure 3.98 - Initial Analysis Example – Define Structure

Figure 3.98 shows the *higher timeframe* (30 min) chart for the market on July 28th, 2010, right at the UK session open (08:00 GMT, 17:00 my timezone).

Step 1 – Define Structure

I've placed the support and resistance areas on the chart above in order to define the market structure.

You'll note they've been labeled as Spt A, Spt B, Spt C and Res A. Please note that while conducting my own analysis and trading, I don't usually label S/R levels with names. This has been done in order to make it easier to refer to the S/R levels during this example.

We have support (Spt A) below price at around 1.5560, formed by the previous Asian session lows.

Further support is lower at Spt B (1.5505) from the prior US session lows, and Spt C (1.5440) which defined the prior UK session lows.

I've placed resistance Res A at 1.5625. Although this does not yet meet the definition of a swing high (due to only one lower candle high to the right of the swing high), it is the Asian session high point and will therefore be a potentially significant level.

The market has been in a longer timeframe uptrend (for two months now), so the 30 min chart shows no higher resistance; with the next daily chart resistance not being until 1.5820.

Step 2 - Define Trend

The *trading timeframe* (3 min) (figure 3.99 below) shows a recent change from uptrend to downtrend as swing low B formed below swing low A (the last swing low before the highest high at Res A).

Swing low B was followed by lower high C. And price has now broken below B.

Classic lower highs and lower lows!

The market is in a downtrend.

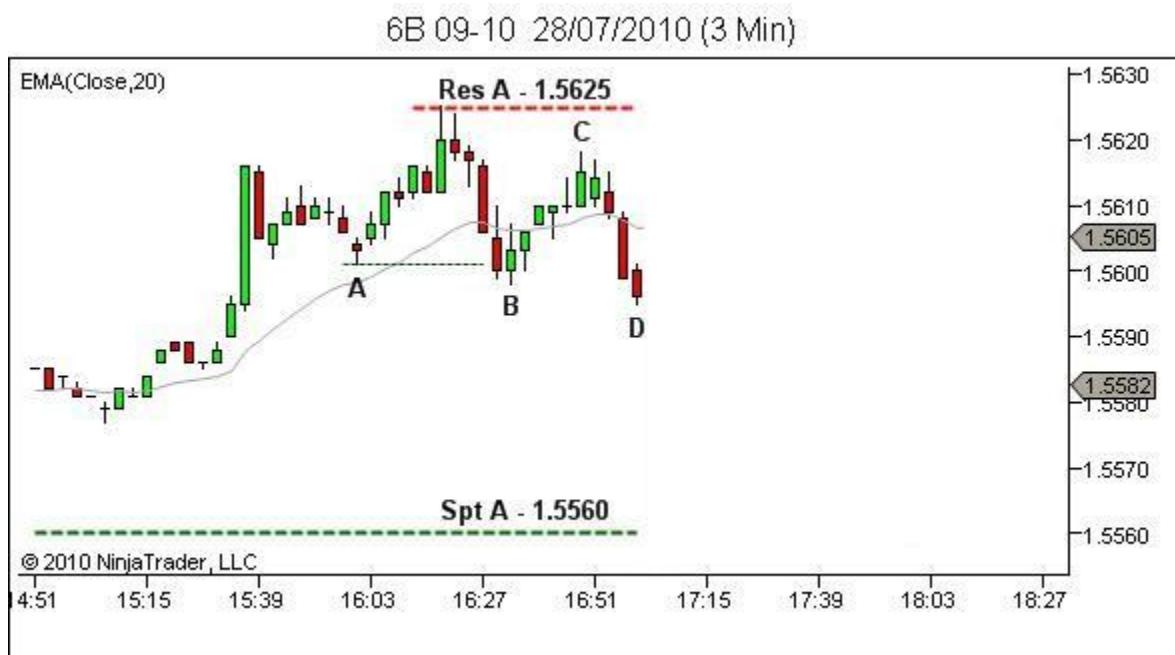


Figure 3.99 - Initial Analysis Example – Identify Trend

Step 3 – Identify Strength and Weakness

Analysis of momentum on the *trading timeframe* (3 min) (figure 3.100 below) shows strength initially on the bullish side, through stronger momentum on swing (a) and weaker momentum on swing (b).

However the sentiment has since changed. Comparison of swing (a) with (c) and (e) shows a reduction in bullish momentum. Comparison of (b) with swings (d) and (f) shows a clear increase in bearish momentum.

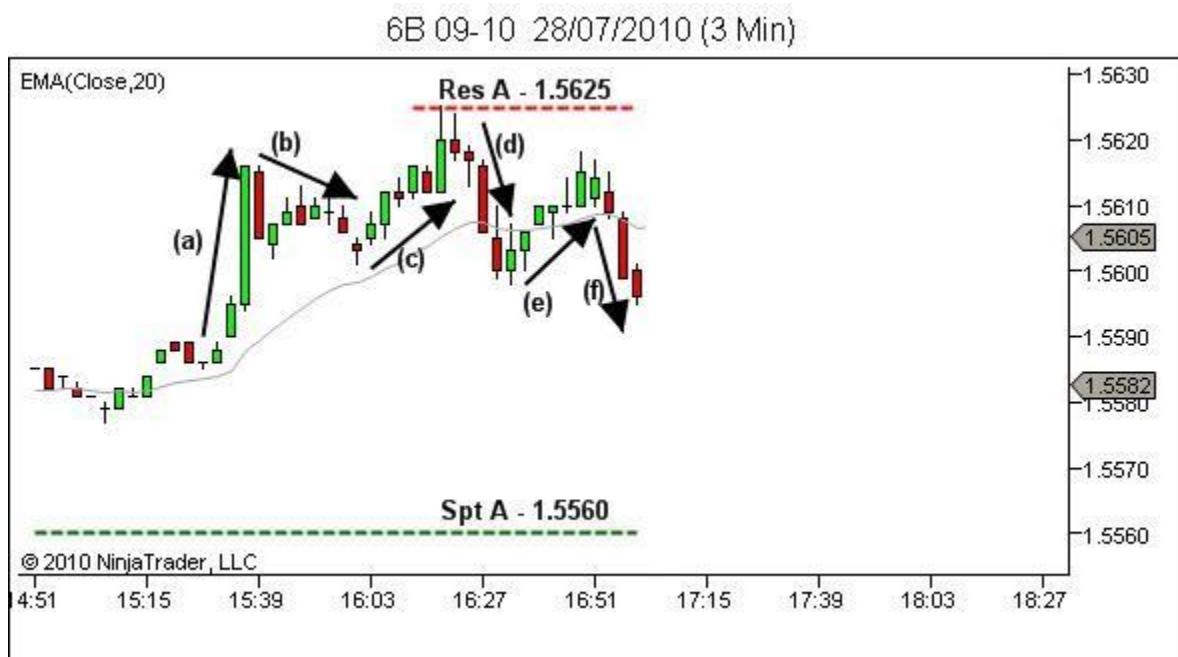


Figure 3.100 - Initial Analysis Example – Identify Strength & Weakness – Trading Timeframe

This is confirmed on the *lower timeframe* (1 min) chart shown below as figure 3.101, in which bearish swings (d) and (f) both show greater strength than bullish swings (c) and (e).

This places the strength on the bearish side and the weakness on the bullish side.



Figure 3.101 - Initial Analysis Example – Identify Strength & Weakness – Lower Timeframe

Of note though is the weakness of the projections P1 and P2 in comparison to the much greater depth D1, displayed on the *trading timeframe* (3 min) below in figure 3.102.



Figure 3.102 - Initial Analysis Example – Identify Strength & Weakness – Projection & Depth

Seemingly contradictory, this is not unusual just prior to the open of the major trading session of the day.

Strength is to the bearish side, but not by a great margin.

Step 4 - Identify Future Trend Direction

Price action is not currently near any of our S/R levels.

The trend is down.

The strength is still to the down side as well, albeit not showing great strength.

My expectation is in accordance with the First Principle of *future trend* direction:

- **First Principle** – We expect an up or down trend to continue in its current state until the next S/R barrier, unless displaying evidence of weakness within the trend.

My expectation is for price to continue its current trend state, until reaching the area of Spt A at or around 1.5560, as displayed below in figure 3.103.



Figure 3.103 - Initial Analysis Example – Identify Future Trend

Step 5 – Visualise Future Price Action

How do I expect future price action to behave? What price action would validate this analysis?

- We need to see a continuation of strength on the bearish swings and weakness on the bullish swings.
- The opening of the UK session is a time of critical importance. It may result in short-term volatility. Any push higher on the open should be quickly and strongly rejected, and should not break above the last swing high.

What price action would invalidate this analysis?

- Further analysis will be required if the market shows any sustained strength on the open of the session, in particular if it breaks the last swing high.

An important point to note here is that the opening of a forex session is often a difficult time to conduct analysis (as is the opening of any other instrument, such as the daily emini futures open). Volatility can increase dramatically for a short period of time, as new traders establish themselves both long and short. Some traders will stand aside for the first five minutes or so of a session, to allow price to determine its proper direction. I prefer to conduct my analysis anyway, allowing me to be prepared for any trade opportunity that should develop during the opening few minutes, however I always show greater caution.

In this example though, it's fairly simple. Any push to lower prices should hold its level easily, as stops are triggered from the pre-session longs, adding to bearish orderflow. Any push higher will not benefit from extra 'stops' orderflow until it breaks to new highs above Res A. So a push higher should fail quickly, or else will provide evidence of potential new buying (bullish strength), and therefore require a reassessment of my analysis.

Analysis should be conducted pre-session with expectation of possible short-term volatility, and consideration as to who will be trapped and/or stopped out if that volatility eventuates.

Step 6 – Identify Areas of Trade Opportunity

Sorry, not yet... We'll get to that in Chapter 4.

We now move on to ongoing analysis.

Remember – the analysis we have conducted so far is just my initial assessment of likely *future trend* direction. I'll be updating that assessment bar by bar as new data unfolds. So, if I'm wrong I'll see it in a very timely manner, allowing me to reassess and adjust my expectations. And if I'm right, I'll be prepared for any trade opportunity that will present, as price follows my expected path.

3.5 – Ongoing Market Analysis – Theory

Our initial analysis resulted in an initial assessment of the *future trend* direction. Ongoing analysis requires a bar by bar reassessment of our previous analysis, as more price action unfolds on the right hand side of our chart.

New data will arrive, one candle at a time. Each new candle being a source of information; most of which will offer nothing new or relevant; but some of which will alter our analysis, either strengthening or weakening our assessment of market sentiment and future price direction.

Every new candle is potentially significant.

Failing to monitor price with each new candle means we will be forced to be reactionary – surprised by price action developments and chasing setups and entries after they've become obvious to the crowd.

Ongoing monitoring ensures we maintain focus and maintain situational awareness - staying ahead of the current price action – assessing where it's likely to travel, how that will impact the decision making of other traders, and where that will create trade opportunity.

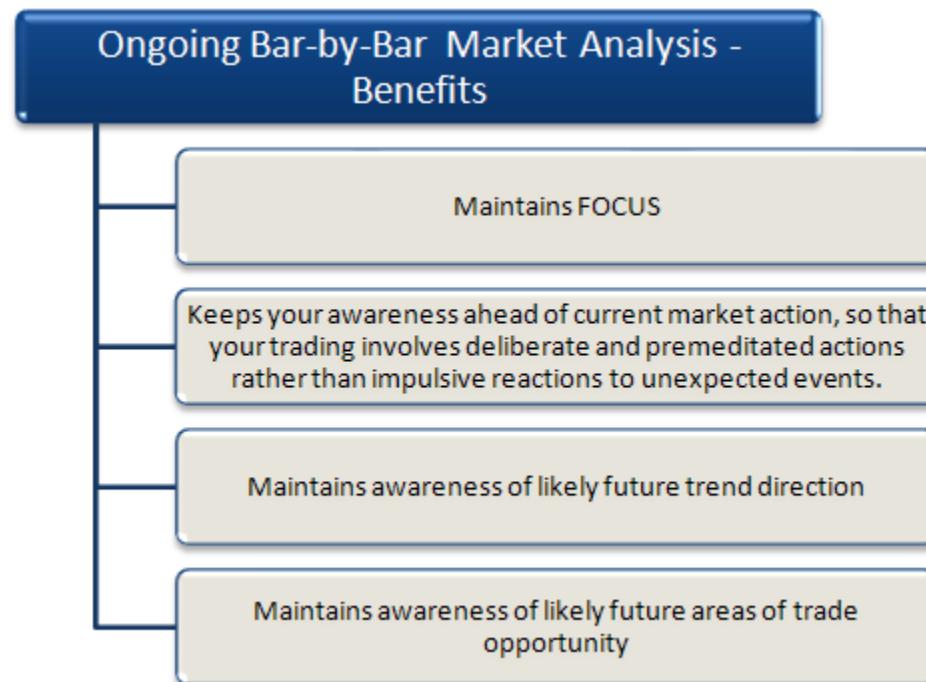


Figure 3.104 - The Benefits of Ongoing Price Action Analysis

Ongoing price action analysis can be conducted on all timeframes, however our main interest is with the *trading timeframe*. We question EVERY candle, to determine what it means with regards to the shift in sentiment between the bulls and the bears; and whether or not it changes our expectations for the future.

This is a step by step process, the first part of which is assessing the sentiment of the current candle pattern.

3.5.1 - Determine Candle Pattern Sentiment

We define each candle as one of nine types, as demonstrated in figure 3.101 below:

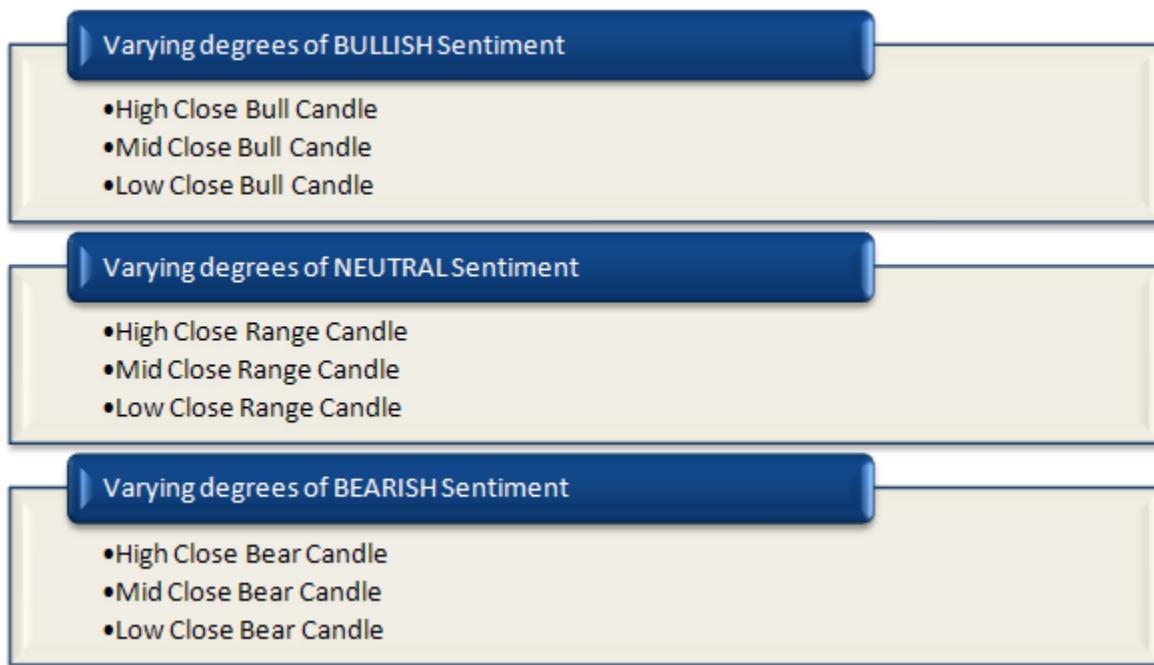


Figure 3.105 - Candle Classification and Sentiment

Classifying the candle in this way gives us an immediate feel for the sentiment of the short-term candle pattern.

All Bull Candles are bullish, but the sentiment varies slightly depending on its close position (high, mid or low).

All Range Candles are neutral, but the sentiment varies slightly depending on its close position (high, mid or low).

And the same applies to Bear Candles, which are bearish, although varying slightly in sentiment depending on their close position (high, mid or low).

The classification is made through observing the following characteristics of the latest candle:

- Close Comparison
- Close Position

Let's learn how to read candles in a way that I consider **superior to standard candlestick analysis...**

Close Position

The Close Position allows us to determine the sentiment of a single candle.

We define a candle as a High Close candle, Mid Close candle or Low Close candle, depending on where price closes within its high to low range.

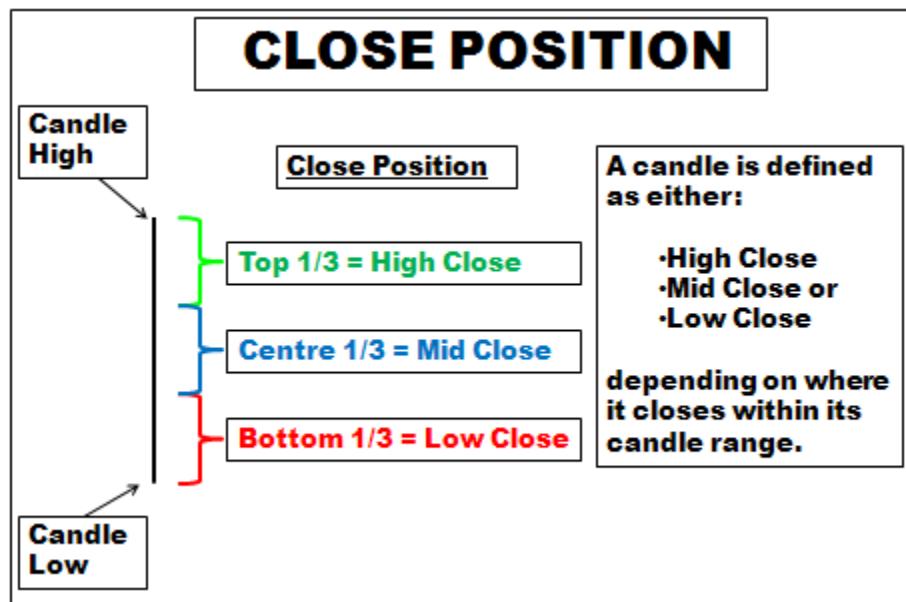


Figure 3.106 - Close Position - Definition

A **High Close candle** is one in which the closing price is within the upper third of the candle range. Examples of high close candles are demonstrated via candles (a) to (f) in figure 3.107 below. Note that all candles close in the upper third.

A high close candle displays bullish sentiment, for the period of that candle. However, you'll note different degrees of bullishness within each candle. For example, comparing (a) and (b) we see that (b) was able to drive prices higher from its open, showing very little resistance from the bears, whereas (a) initially fell from its open before being able to fight its way back higher. Candle (a) is potentially a little less bullish than candle (b).

All of these candles from (a) to (f) are bullish; with a small difference in degree of bullishness.

A **Mid Close candle** is one in which the closing price is within the middle third of the candle range. Examples of mid close candles are demonstrated via candles (g) to (l) of figure 3.107.

The sentiment of a mid-close candle is considered more neutral, as price has been driven both higher and lower, before closing somewhere mid range.

Note again the slight difference in sentiment between candles. Although all are neutral, (i) for example is more on the bullish side of neutral compared with (l) which is on the bearish side of neutral.

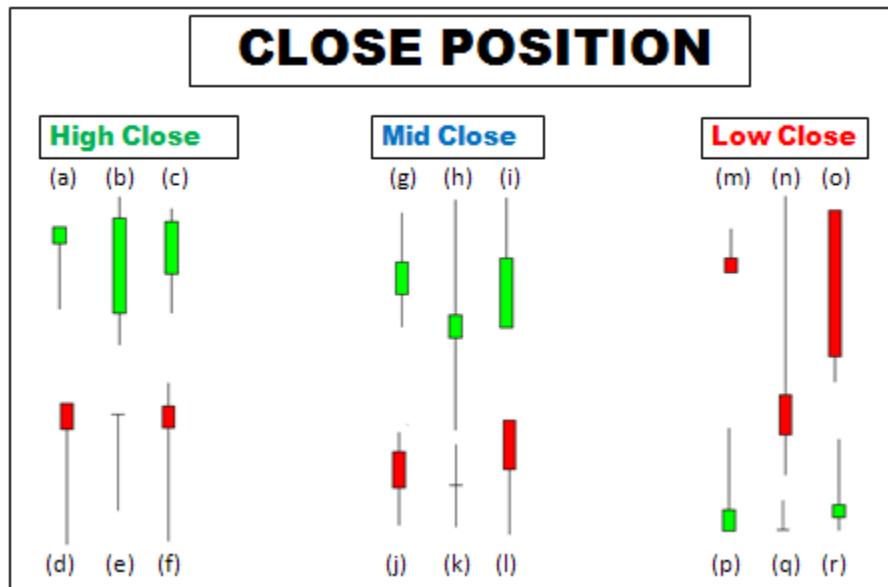


Figure 3.107 - Close Position - Examples

A **Low Close candle** is one in which the closing price is within the lower third of the candle range. Examples of low close candles are shown in figure 3.107 as candles (m) to (r).

The sentiment of these candles is bearish. Again note the slight difference in sentiment. While all indicate bearish sentiment, candle (m), for example, was only able to achieve a narrow range, while candle (o) demonstrated significant bearish pressure which drove price down a significant distance.

Observing and classifying the candle in accordance with the Close Position, provides us with a quick assessment of the sentiment of that individual candle – bullish, neutral or bearish. And the path taken by price within the candle creates slight variations in the degree of bullish/neutral/bearish sentiment.

We now improve on this classification of sentiment, through considering the relationship between the last two candles.

Close Comparison

We define a candle as a Bull Candle, Range Candle or Bear Candle, depending on where price closes with respect to the previous candle's range.

A **Bull Candle** is one which closes above the high of the previous candle's range. This is demonstrated via (a) to (c) in the examples shown below (figure 3.109). Note that all three candles close above the high of the previous candle. A Bull Candle is considered to be displaying bullish sentiment.

A **Range Candle** is one which closes within the range of the previous candle. This is demonstrated via (d) to (f) in the examples below. Note that all three candles close within the range of the previous candle. A Range Candle is considered to be displaying neutral sentiment.

A **Bear Candle** is one which closes below the low of the previous candle's range. This is demonstrated via (g) to (i) in the examples below. Note that all three candles close below the low of the previous candle. A Bear Candle is considered to be displaying bearish sentiment.

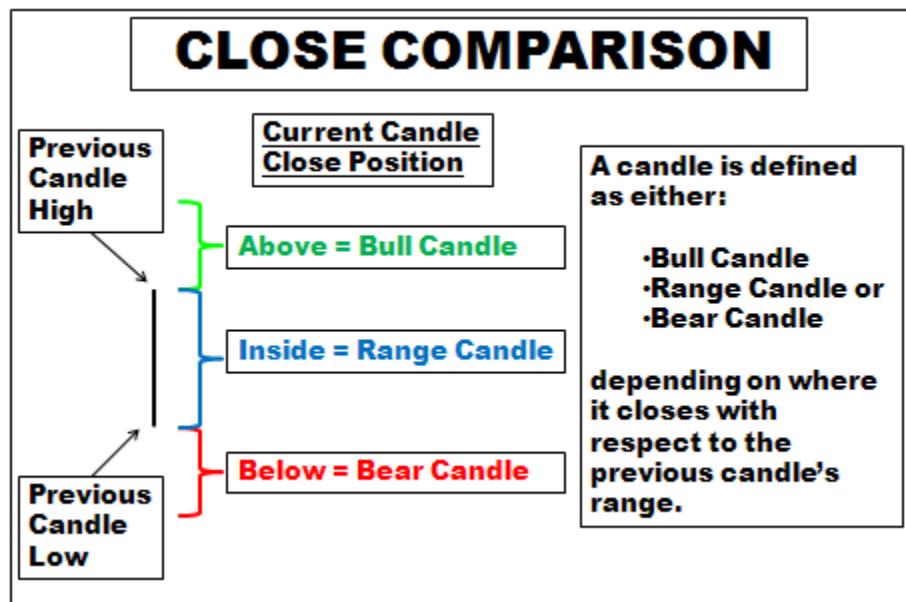


Figure 3.108 - Close Comparison - Definition

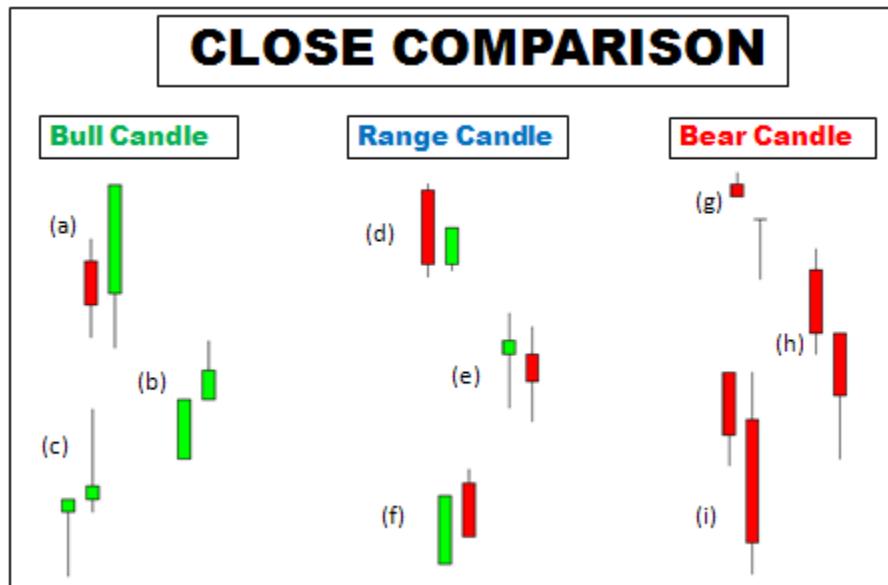


Figure 3.109 - Close Comparison - Examples

Determining Pattern Classification and Sentiment

Let's determine the sentiment of the latest 2-candle pattern. The starting point is simple. We look at the Close Comparison:

- Bull Candle = bullish 2-candle pattern sentiment
- Range Candle = neutral 2-candle pattern sentiment
- Bear Candle = bearish 2-candle pattern sentiment

The Close Position (single candle pattern) will then be considered in order to determine the different degrees of bullishness or bearishness.

Refer back to the examples in figure 3.109 on the previous page.

While (a) to (c) all demonstrate a Bull Candle, and therefore bullish pattern sentiment, there are varying degrees of bullishness in each, which become obvious when adding in the Close Position to the pattern definition.

Candle (a) is what I refer to as a **High Close Bull Candle**. Both the high close and the bull candle components represent bullishness. Combined, these two indicate strongly bullish sentiment.

Compare this with (b) which shows a **Mid Close Bull Candle**. Price once again closed above the prior candle, but this time with a neutral close at mid-candle. Although still bullish, sentiment is less bullish than example (a).

In (c) we see a **Low Close Bull Candle**. Yes, it closed above the previous high, but higher prices were clearly rejected driving price to close near the low of the last candle. We have bullish sentiment (bull candle) combined with a bearish sentiment (low close). This is a weak bullish move.

Combining our close position analysis with our Bull Candle provides us with varying degrees of bullishness.

The same concept applies for our Range Candles, demonstrated via examples (d) to (f) above. A range candle on its own implies neutral sentiment, but by also considering the Close Position we gain some greater insight into the varying nature of that neutral sentiment.

Looking at (d) for example, we see a **High Close Range Candle**. The latest candle is a high close candle, closing right on the highs. Individually this appears bullish, but comparing it with the previous candle we see the fact that the high close candle is simply retracing approximately

50% of the previous strongly bearish low close candle. Combined, this is probably slightly on the bearish side of neutral.

Likewise with example (f), a **Low Close Range Candle**; this combination is more on the bullish side of neutral.

While example (e), a **Mid Close Range Candle**, is clearly neutral with price testing higher and lower twice now before settling closer to mid-range of both candles. Neither side is showing dominance.

A Bear Candle is one which closes below the lows of the previous candle. On the surface, that sounds bearish, but the degree of bearishness will vary when also considering our Close Position analysis.

Example (i) is a **Low Close Bear Candle**, demonstrating extremely bearish sentiment, as both the Close Position and Close Comparison components imply bearishness.

Contrast that with example (g), a **High Close Bear Candle**, which has clearly rejected lower prices and closed up at its highs. Still bearish, but showing some sign of bullish orderflow opposing our bearish sentiment. This 2-candle pattern displays weak bearish sentiment.

Whereas example (h) is somewhere in-between, demonstrating a **Mid Close Bear Candle**. Once again we have some bullish orderflow pushing price off the lows and opposing our bearish sentiment, but to a lesser degree than example (g).

The next step... consider our 2-candle pattern sentiment in the context of current market price action.

But What About Candlestick and Price Bar Reversal Patterns?

If you're a fan of candlestick reversal patterns, or price bar reversals, take note of these as well. They're a great way to determine sentiment. My aim, through defining every candle based upon its Close Position and Close Comparison, is to have you assessing sentiment after every candle. Reversal patterns don't allow you to do this. For this reason, I believe this form of analysis is superior to simple candlestick analysis.

However, if you relate particularly well to these candlestick reversal patterns, by all means use them.

Please refer to my free video series, if you wish to study these patterns:

- Candlestick Reversal Patterns: <http://www.yourtradingcoach.com/Videos-Technical-Analysis/Candlestick-Charting-Videos.html>
- Price Bar Reversal Patterns: <http://www.yourtradingcoach.com/Videos-Technical-Analysis/Complete-Price-Bar-Reversal-Video-Series.html>

Miscellaneous

Feel free to also consider any additional analysis tools which you may choose to use, such as volume or market internals. What are they telling you about the sentiment of this particular candle or candle pattern?

Candle Pattern Sentiment Wrap-up

The process of ongoing price action analysis starts with determining the sentiment of the current candle pattern. We do this through the process of analysing the Close Position and the Close Comparison applicable to that pattern.

As demonstrated in the previous examples, this is a quick process that should take no more than a couple of seconds.

It provides us with a feel for the short term sentiment of the current candle pattern. Who is in control of price – the bulls or the bears? And to what degree are they in control?

Chart based examples will follow shortly, once the whole process is defined.

3.5.2 – Consider the Context

‘Consider the Context’ means we consider where the current price pattern appears with respect to the background market environment and price action, and what that means.

The same pattern can have numerous meanings, depending on where it occurs in the market.

Referring to figure 3.110 below, we can see that the Low Close Range Candle on the left hand side is occurring after a weakening of an uptrend right into an area of resistance. The first bullish candle broke above recent price action and penetrated the resistance area by a couple of pips before being rejected. Trapped longs will be exiting on any break below this candle. Although a low close range candle is generally considered to display neutral sentiment, when we consider the location of the pattern it has reasonably bearish connotations.

Compare that to the low close range candle on the right hand side, which is occurring within the middle of a period of narrow range sideways congestion. The occurrence of this pattern in this location shows absolutely no sign of any potential change to market sentiment. This is clearly neutral.

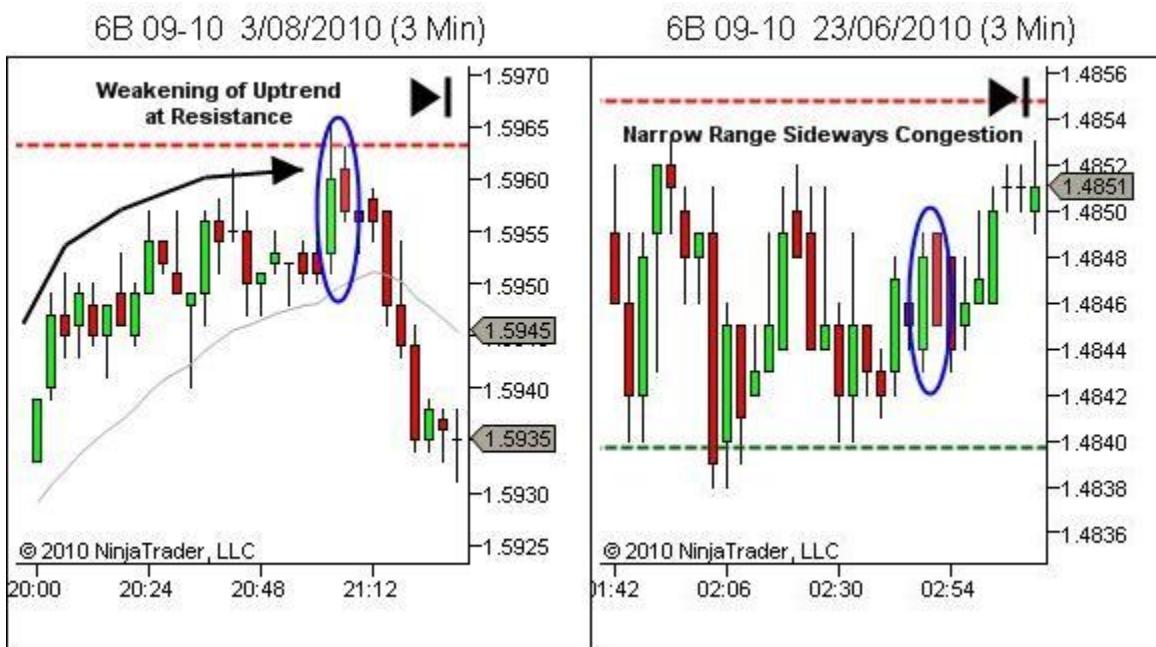


Figure 3.110 - Placing the Pattern into Context with Background Market Structure and Price Action

In considering the context of background market structure and price action, I primarily look at where price is in relation to three main areas – the location within the S/R structure, the location within the trend, and where we are in reference to key swing highs or lows.

You'll note as we discuss these areas of influence that they simply raise a lot of questions rather than provide you with answers. Fixed rules don't apply here. There is no rule that states "if a bullish sentiment pattern occurs at position xyz on a chart, then it means ..."

Every occurrence of every pattern is unique.

By placing the pattern into the context of background structure and price action, we are ultimately attempting to gain a *feel* for how it impacts upon the strength and weakness of the underlying trend, and how that might impact upon our expected *future trend*.

While many elements of a price pattern can be objectively seen on a chart, determining the influence that pattern will have on *future trend* direction is a purely subjective process.

You gain that *subjective feel* through questioning what you see on the charts.

Where is price in relation to S/R? Where is it in the trend? Where is it in relation to key swing highs and lows? And what does this mean?

Support and Resistance

- Where is the pattern occurring with respect to *higher timeframe* support and resistance?
- Has the market shown strength or weakness on approach to the S/R area? Is the current candle pattern sentiment continuing this strength or weakness, or has something changed?
- Is the pattern showing signs of orderflow opposing the move into S/R, such as tails rejecting price at or near the S/R level?
- Has the pattern breached the area of S/R? If so, is it now showing signs of acceptance or rejection of this new area?

Trend

- Where is the pattern occurring within the current trend?
- Is it on an extension? Is it early in the move, or late and overextended? Has it projected past the previous swing high/low?
- Is it on a pullback? Is it early in the move, or has it continued deeper than anticipated? Is it a single swing pullback, or is this pattern a part of a multiple swing retracement?
- Or is the pattern within a sideways trading range or other form of consolidation pattern?

Swing Highs and Lows

- Is price testing any areas of swing highs or lows? Of particular importance are those which lead to a change of trend definition; how is price reacting at those swing highs or lows?

For an uptrend:

- Pullbacks to previous areas of swing low support should be watched closely. We expect them to hold. Is the price action showing signs of the level holding, or is it threatening to break? If it breaks, is price showing signs of rejection (opposing orderflow / difficulty continuing) or is price accepting this new area?
- Pullbacks to previous swing highs (within an uptrend) are not as critical, but should still be watched for their reaction.
- Extensions are expected to break the previous swing high. Is price action supporting that premise, or is the candle pattern showing weakness. If it can't exceed the previous swing high, we need to be alert for further signs of weakness which may forecast a complex correction or reversal.

For a downtrend:

- Pullbacks to previous areas of swing high resistance should be watched closely. We expect them to hold. Is the price action showing signs of the level holding, or is it threatening to break? If it breaks, is price showing signs of rejection (opposing orderflow / difficulty continuing) or is price accepting this new area?
- Pullbacks to previous swing lows (within a downtrend) are not as critical, but should still be watched for their reaction.
- Extensions are expected to break the previous swing low. Is price action supporting that premise, or is the candle pattern showing weakness. If it can't break the previous swing low, we need to be alert for further signs of weakness which may forecast a complex correction or reversal.

For a sideways trend:

- Is price testing a range boundary?
- Has the market shown strength or weakness on approach to the boundary? Is the current candle pattern sentiment continuing this strength or weakness, or has something changed?
- Is the pattern showing signs of orderflow opposing the move into the range boundary, such as tails rejecting price at or near the level?

- Has the pattern breached the area of range S/R? If so, is it now showing signs of acceptance or rejection of this new area?

3.5.3 – Does it Support our Premise?

Having considered the sentiment of the pattern, and where that is occurring with respect to our market structure, we now ask whether or not it supports our premise?

By premise, I refer to our expectation for *future trend* and the price action that would support that trend.

Is this pattern meeting our expectations for future price action?

- Yes... We await the next candle.
- No... Decide whether to hold for the next candle, or to reconsider from the start of our Initial Market Analysis.
- Unsure... Just wait... there will be a new candle along shortly.

You'll know when something is not right – the price action will surprise you.

Expecting a slow crawl into an area of resistance, you'll suddenly see a strong impulse right through the area closing on its high.

Expecting a breakout of a level, you'll observe a second failure to push through the level. Unexpected weakness!

Expecting continuation of an uptrend, the next price extension stalls at the previous swing high, showing unexpected bearish orderflow.

Evidence of something surprising does not necessarily invalidate your plans for future price trend – but it should put you on high alert and have you watching the following price action closely.



Figure 3.111 - Expectations Invalidated

In figure 3.111 above, assume we had expectations for the *future trend* to continue pushing resistance and eventually breaking through to higher prices.

Then, to our surprise, the next candle is a low close bear candle, displaying strong bearish sentiment. Even more so in this case, as placing the latest pattern into the context of the market structure and previous price action, we see that price has pushed with strength off the resistance area and dramatically forced a change of trend by breaking and holding below the recent swing low.

Clearly, this does not support our original plan.

We're out of sync with the current price action. It's time to revise our expectations.

3.6 – Ongoing Market Analysis Process

We'll now summarise the process and provide a checklist, as we did with the Initial Analysis.

3.6.1 – Ongoing Market Analysis Process Summary

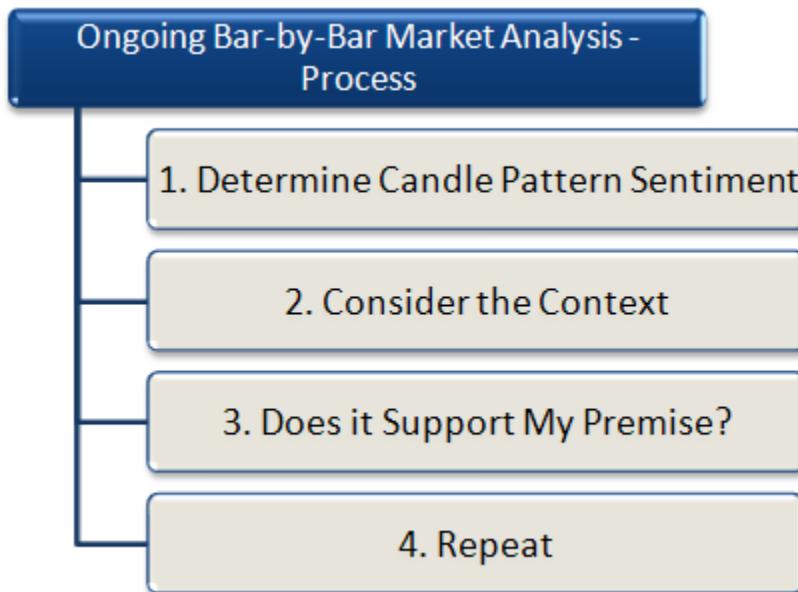


Figure 3.112 - Ongoing Market Analysis Process

Ongoing (Bar by Bar) Market Analysis involves a four step process, as per figure 3.112.

The following checklist will walk you through the actions required for each step.

3.6.2 - Ongoing Market Analysis Checklist

Step 1 – Determine Candle Pattern Sentiment

Classify the candle pattern and determine the short-term sentiment of price.

Actions:

- Classify the candle pattern

- High / Mid / Low Close
- Bull / Range / Bear Candle
- Determine the sentiment of the pattern

Step 2 - Consider the Context

Every pattern is unique and MUST be considered in the context of the background market environment in which it occurs.

Actions:

- Where is the current price action in relation to key market structure features:
 - Support or Resistance
 - Trend
 - Swing Highs and Lows
- What does this mean with respect to the sentiment of the pattern and the potential future price action?

Step 3 - Does it Support my Premise?

Is the market action continuing as expected, or is something indicating we're out of sync with market flow?

Actions:

- Does the current price action and sentiment support our previous expectations for future price action?
 - Yes
 - Await further price information.
 - No
 - Decide whether to hold for the next candle, or to reconsider the Initial Market Analysis.
 - Unsure
 - Wait for further price information.

Step 4 - Repeat

Actions:

- Repeat the process as new information appears on the chart.

KEEP IT SIMPLE

As with the initial analysis process, this ongoing analysis has taken many pages to describe. However, what may appear to be quite a complex process is in actual fact quite simple to perform.

My analysis has developed over the years as a subjective and intuitive process.

The complexity appears as a result of trying to get the essence of that process into writing, in as reproducible form as possible.

Once again, the ongoing analysis should take no more than maybe 10-15 seconds. Any more than that and you're trying too hard to find certainty, where there is none.

Experience will rapidly improve your ability to read the market flow. And in time you'll do so without checklists. In the meantime, use them as a prompt.

- You already have an expectation for where price is going.
- Is the latest price action supporting that premise, or does it need to be reconsidered?

That's the two sentence summary version of 'Ongoing Bar-by-Bar Market Analysis'.

Keep it simple. And as before, don't be afraid to get it wrong. Ongoing analysis will be self-correcting.

3.6.3 – Ongoing Market Analysis Examples

Let's continue with the example used in section 3.4.3, Initial Market Analysis Example.

The following chart reproduces our expectations for *future trend* direction.



Figure 3.113 - Ongoing Analysis Example – Future Trend Expectations

My expectation is for price to continue its current trend state, until reaching the area of Spt A at or around 1.5560.

What price action would validate this analysis?

- We need to see a continuation of strength on the bearish swings and weakness on the bullish swings.
- The opening of the UK session is a time of critical importance. It may result in short-term volatility. Any push higher on the open should be quickly and strongly rejected, and should not break above the last swing high.

What price action would invalidate this analysis?

- Further analysis will be required if the market shows any sustained strength on the open of the session, in particular if it breaks the last swing high.

Let's now see the following price action



Figure 3.114 - Ongoing Analysis Example – Bar by Bar Analysis (1 of 3)

We'll progress bar by bar through the chart considering the first three steps of the ongoing market analysis process:

- 1) Determine Candle Pattern Sentiment
- 2) Consider the Context
- 3) Does it Support my Premise?

Where a candle shows significant information, I'll go through this three step process. When a candle provides little new information, or provides similar information to surrounding candles and can be grouped together, I'll just summarise my thoughts in order to save time.

As you read through this, please recognise that it's not a mechanical process I go through with a checklist on the completion of each candle. The notes here are an approximation of the thought processes when a checklist is followed. The reality is that with experience, much of the analysis occurs in real-time as the candles are being formed – not just at the end of each candle.

In any case, although it's lengthy, my hope is that it helps you see how the process modifies your premise candle by candle, and helps to maintain focus.

Candle A

- High Close Bull Candle – Very bullish opening move
- Not near S/R. No change to trend definition. Of note, the candle *failed to continue* below the low of the previous candle, and rallied sufficient distance to retrace two previous low-close bearish candles. It has not exceeded the recent swing high.
- While more bullish than I'd like to see, potential volatility was anticipated at the session open. The premise is not invalidated unless the swing high is broken. However I am on high alert and need to see this rally stall quite quickly.

Candle B

- Mid Close Range Candle – Neutral sentiment; bullish side of neutral due to the bullish close position of candle A and the tail below candle B.
- No change to trend definition. Failure to continue higher. The pullback has shown some selling and has potentially stalled.
- This supports my premise. Failure to continue higher shows a lack of commitment from the initial opening bulls. Ideally, this weakness will continue and price will fall from here. However, price action may continue for a second thrust higher. The premise remains valid unless the swing high is broken. *Future trend* direction remains down.

Candles C & D

- Both Mid Close Range Candles - showing neutral sentiment and continued weakness in the bullish direction.
- Pullback has stalled. Price tested below B and attracted some buying, but only sufficient to get to a mid-close.
- Premise remains. Still expecting the trend to continue down.

Candle E

- Low Close Bear Candle – Strong bearish sentiment.
- Downtrend continues through a push to new lows. Previous swing low broken, as expected. This candle will have trapped longs who failed to get out on the break below the session opening candle A. This will provide some short-term resistance at around the 1.5590 level.
- This supports my premise beautifully. I expect the downtrend to continue to lower support.



Figure 3.115 - Ongoing Analysis Example – Bar by Bar Analysis (2 of 3)

Candle F (summary)

No change from Candle E.

Candle G

- High Close Range Candle – Neutral sentiment, slightly bearish.
- Downtrend remains intact. Narrow range showing no commitment from the bulls but short term profit taking by the bears.
- This supports my premise. Strength continues in the bearish direction. Any pullback forming from G will need to display weakness. Expect some resistance from the lows of A due to trapped longs. Price should not exceed 1.5590/600.

Candles H & I (summary)

No change in premise from Candle G. The pullback has confirmed weakness in the bullish direction.

Candle J

- Low Close Bear Candle – Bearish sentiment continues as per E and F.
- Downtrend continues with a break to new lows.

- Price action still supports my premise. Strength still exists on the bearish side. Pullbacks are still weak. Expect a slowing into support. If we have another pullback it should be weak again.

Candle K

- High Close Bull Candle. Well that one was a surprise. Bullish sentiment.
- Complete reversal of previous low close bear candle. Did not break the highs of I, which would be significant, although change of trend would not be triggered till a break of A. Shorts now trapped which will slow any retest of the J lows.
- My premise was for strength on the downside, with weak pullbacks. This strong pullback will need to fail quickly in order to maintain my expectations. I am on high alert. Further follow through to the upside will require a reassessment of my *future trend* direction. Immediate reversal lower is required to confirm my current plan.

Candles L to Q (summary)

Candles L to Q failed to continue higher. Bullish candle K was unable to overcome the bearish downtrend orderflow. The fall to Q was weak; not surprising given the trapped shorts from the J/K reversal.

The strength of K followed by the weakness of L to Q would have me tentatively watching for a reversal in the vicinity of Q (retest of J lows). Had a reversal occurred there, I would have changed my expectations to a complex retracement, possibly back up to the vicinity of A (in accordance with the second principle of *future trend* direction).

Candle R

- Low Close Bear Candle – Bearish sentiment.
- Candle R continues the move to support. Although there is some acceleration through R, it is most likely due to stops and breakout entry orders below J.
- As we are approaching S/R, the original premise has played out and it's time to find the future path. It's time to reconsider our analysis from first principles. The approach to S/R is not overly strong, so I am looking for a test which holds (in accordance with the fifth principle of *future trend* direction). If I'm wrong and price does breach the support level, I expect the breakout to be rejected, although I will watch the breakout price action for further clues.



Figure 3.116 - Ongoing Analysis Example – Bar by Bar Analysis (3 of 3)

Candles S to U (summary)

- The market tests the level to the pip on candle T. The premise was for a test which held. That has occurred. Price action needs to be watched CLOSELY here, as always in an area of S/R. Any break above the low candles will bring in a new premise; expecting a correction higher involving either a complex retracement before setting up a retest of support, or if showing signs of bullish strength then a possible reversal expecting the *future trend* to rally up to overhead resistance Res A.

Candle V

- High close bull candle – bullish sentiment
- Bullish pressure rallies price, breaking above the recent 3 candle congestion at lows. Note that it has not changed the trend definition, and won't do so until a break above L. A small tail at the top of the candle shows some selling, not entirely unexpected as we're in the vicinity of R's break below the J/K reversal.
- Does this support my premise? As mentioned above, the break above the lows has given me a new expectation for *future trend* – expecting continuation higher for a complex pullback, or potential rally to Res A. Given the fact that V has hit a small pocket of resistance (J/K swing

low) I'll expect a short pause before continuing. Any pullback should be weak in order to confirm my premise. A break below T will invalidate the premise and require reassessment.

Candles W to a (summary)

Candles W to Candle (a) form a weaker retest. This bearish price swing has low momentum and an inability to retrace the whole body of V. Support has been found at the lows. We now have strength on the move up from T to V, and weakness from W to (a). Strength is on the bullish side and weakness is on the bearish side. My premise is supported and I expect price to soon display a continuation higher.

Candle b

- High Close Bull Candle – very bullish.
- Stops triggered above X helping to propel the market higher.
- This is very much supporting the premise for trend reversal and a move to resistance Res A.

Candles c to e (summary)

Strength has come into the market. A change of objective trend definition has been confirmed to upwards. Although a pause or pullback is likely before the resistance level, my premise is for continuation to resistance. If strength continues like this right to resistance, I'll be anticipating a breakout. Post break-out price should be watched closely for signs of weakness on either the breakout or the breakout pullback.

This example so far has been one in which the premise (our expectation of *future trend* direction) proved valid. Let's quickly review a situation where the premise is proven invalid and requires amendment.

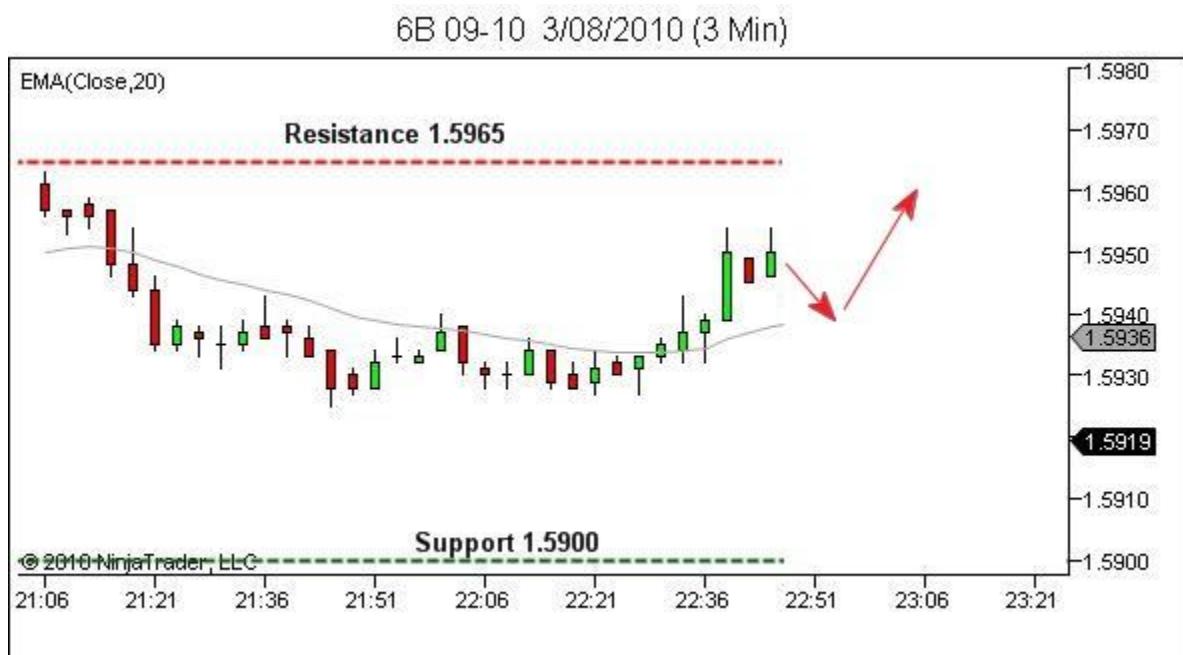


Figure 3.117 - Ongoing Analysis Example 2 – Initial Market Analysis

Figure 3.117 above shows the market on August 3rd, 2010. Support exists below price at 1.5900. Resistance is above at 1.5965.

An earlier attempt to breach resistance had failed (just off the left of the chart), followed by a period of weakness as price held an extended pullback. Recent bullish strength has come into the market and set up for a second test of the resistance area.

Our premise for the *future trend* direction is a continuation of the trend to the area of resistance.

Given the weakness developing in the last two candles (low close range candle & mid close bull candle), I'll expect a pullback prior to the test. Pullback price action should show weakness, ideally holding above the upper level of the previous congestion (in the vicinity of 1.5935), for the premise to remain valid.

Let's look at subsequent price action and talk through the significant candles.



Figure 3.118 - Ongoing Analysis Example 2 – Candle by Candle

Candle A

- Low Close Bear Candle – bearish sentiment, although the lower tail is a positive sign, showing buying pressure on the pullback.
- This candle has commenced our pullback. Note it is also testing the point of initial impulse upwards (the low of the large green candle). Some support can be expected here, as evidenced by the lower tail.
- This price action supports my premise. I'm expecting strength on bullish extensions and weakness on bearish pullbacks, continuing the trend to resistance.

Candles B to D (summary)

Candles B to D all display neutral sentiment and confirm the weakness of the pullback. Price action should be rallying from here, to support our premise of a second push to the resistance area.

Candles E to G (summary)

This pullback is holding at the lows for longer than I like, however Candles E to G are showing increasing bullish sentiment, from bullish/neutral for E and F (both high close range candles) to bullish for G (high close bull candle). The key feature of these three candles is the tails, in which

lower prices were tested and rejected. If it can't go down, it's going up!!! The initial analysis bullish strength has been followed by a weak pullback to G, and although longer in duration, it appears to be over now with some strength coming back into the market. Continuation is expected from here to the resistance zone.

Candle H

- High Close Bull Candle (just) – Bullish, but weak.
- Did not break swing high at A.
- No change to the premise, although I would have preferred to see a stronger push and a break of the candle A highs within this or the next candle. Continuation of the extension should have more strength than this.

Candle I

- Low Close Bear Candle – bearish sentiment.
- Price reversed, breaking and closing below candle H lows. Swing high A and swing low G have not been tested yet. We have a potential 123 pattern forming, with H producing a lower high unless price rallies strongly in the next candle.
- This latest candle does NOT support my expectations. The rally should have occurred on strength. The momentum of G to H is observed to be shallower than the large green candle surge prior to A. Weakness has appeared on the rally. My expectation is now for a complex pullback (second principle); a second leg down holding above the G lows, before again resuming the push for resistance. To support my premise price must show reducing strength into the lows of G, then reverse. To invalidate my premise, price will break the lows of G.

Candle J

- Low Close Bear Candle – bearish sentiment.
- Price has just broken the G lows (by one pip). Note that the trend has not changed yet, until breaking the lows of the earlier extended pullback / consolidation.
- At this stage I have no real premise. I need more information. I'll wait to see a test of these lows, which will establish either a sideways range if they hold, or a downtrend if they break.

Candle K

- Low Close Bear Candle - Sentiment is bearish.
- The lows have failed and the trend has changed to down.
- The last bullish move (G-H) showed weakness. The current bearish move is showing strength. *Future trend* direction is down, with an expectation of a continuation of the downtrend to the support level 1.5900.

It's a pretty simple process really. As mentioned before, if you feel you're getting stuck with too much complexity, drop back to basic principles

- **You already have an expectation for where price is going.**
- **Is the latest price action supporting that premise, or does it need to be reconsidered?**

The process will also get easier with experience. Volume Five – Trader Development will discuss ways to maximise your learning. But you don't have to wait till then. Practice now as much as you can.

3.7 – Practice

Market Analysis should be practiced as much as possible. The practice never ends, as there is always more to learn. It's a process of constant growth and personal development, as we gain more experience in reading the flow of the market through years and years of exposure.

- Experience leads to a better read and a more accurate assessment of likely future price direction.
- A more accurate assessment of likely future price direction leads to better identification of trade opportunity.
- Better identification of trade opportunity leads to greater profitability.

Live trading provides us the opportunity to continually practice our analysis; and our market review sessions and simulator replays provide the opportunity to compare our performance with hindsight perfection. Replaying the patterns of market behavior reinforces our intuitive ability to read and follow the flow of price.

However you don't need to be trading live to benefit from this. Practice can be achieved right now through conducting live market analysis (with no expectation of trades). Just follow price action. Determine where it's going next through applying your Initial Market Analysis process. Then adjust your expectation of future price action bar by bar as new candles appear on the right hand edge of your charts.

Take some time out to practice. Just follow price action. Decide where you expect it to go from here; and adjust that through bar by bar ongoing analysis.

Once again, I would like to reiterate the importance of SIMPLICITY. Don't make this more complicated than it needs to be. Just question each bar – does it support your initial assessment. If so, great! If however it does something unexpected, then decide whether to change your expectations for future price direction, or wait for more information. If you're unsure, then just wait. Another candle will be along shortly.

And do not concern yourself with setups or trades. Just follow price action.

3.7.1 Market Structure Journal

There is a free ebook available on the YourTradingCoach website, titled “The Greatest Trading Book – Ever!” Download a copy from the following address, read it, and start creating your own Market Structure Journal.

<http://www.yourtradingcoach.com/products/ebooks/the-greatest-trading-book-ever.pdf>

A Market Structure Journal is a folder of chart printouts, annotated with market structure observations. This document will be a key part of your practice.

Keep charts and notes demonstrating any key observations you make about how your market reacts at certain points.

- What signs does the market give, that indicate a trend will just keep running?
- How does the market behave on retests of climactic reversals?
- How does the market react at key times of day, such as the open of each new forex session?
- How does the market react on testing daily highs and lows?
- How does a typical pre-FOMC or pre-NFP range day react? Are the tests of the range boundaries typically single touch clean rejections, or are they spiky with multiple tests of the S/R region before reversing?

And so on!

Record any observations on the charts.

I also recommend adding any key observations into a single “Lessons Learnt” spreadsheet. This is a great review and study tool, for strengthening your read of market action.

Implement a Market Structure Journal now. Become a student of market analysis. Study it. And make it a regular part of your practice.

Repetition and reinforcement will greatly improve your ability to intuitively perceive patterns of market behavior, as they occur; vastly improving the quality of your analysis and your assessment of likely future price action.

3.8 – Conclusion

In this chapter we learnt how to analyse market movement. There was no expectation of how or where to trade – that comes later – this chapter was about just getting in sync with price movement. Seeing where it has been; and getting a feel for where it's going to go.

We observed where price has been through placing our price action into a framework of support and resistance; and identifying the trend within that framework – either up, down or sideways.

We learnt how to assess the strength or weakness of the trend, through analysis of momentum, projection & depth and failure to continue.

We learnt how to determine the likely path of price, based upon the six Principles for identifying the *future trend* direction.

And we learnt how to update our analysis bar by bar; through analysing the internal sentiment of individual candles or candle patterns, in order to determine whether they support or reject our initial assessment.

Once you are comfortable with this process, it's time to start trading.

3.9 – Addendum to Chapter 3 – Alternative Questions for the Conduct of Price Action Analysis

Over the years I've trialed numerous other methods of discretionary analysis; the best by far comes from bar by bar assessment of price action in order to (a) maintain focus and (b) maintain your assessment of the likely path for future price action.

The process described in Chapter 3 is the process I use on a daily basis. However there are other ways to do a bar by bar assessment.

You may wish to incorporate other methods you currently use (preferably not lagging indicator based methods). Or you may wish to consider some of the following list.

While these aren't part of my *official* process, I do make use of these questions from time to time, in particular when I'm just not feeling in sync with the current market action.

Alternate questions are useful in that sometimes they trigger a different understanding of price action; allowing you to see the market in a new and better way.

There is some overlap in questions; but each is asked in a slightly different way.

If you like any of them, use them. If not, just stick to the normal process.

Alternate Questions and Methods for Price Action Analysis

1) Winners and Losers in the Market

- a. Who is dominating the current swing, bulls or bears?
- b. Are they correct?
- c. If they're wrong:
 - i. Where is this move likely to stall? Where is the opposite order flow likely to enter the market?
 - ii. Where will these traders have positioned their stops?
- d. If they're right:
 - i. Where are these traders targeting? Where are they going to take profits or lighten their position?
- e. If they're in the right direction, but late:
 - i. Where is the worst place to be entering late in this move? Where will the late traders be stopped out?

2) Trapped Traders

- a. Where is the last group of trapped traders?
- b. Where are they hoping to get out? How will that affect price?
- c. Where will they give up and bail out? How will that affect price?

3) Expectations - Most Likely Price Movement

- a. What do you expect the market to do from here?
 - i. Why do you expect that?
 - ii. How would price have to behave prior to that move occurring?
 - iii. Is price behaving this way?
- b. If the most likely scenario does not eventuate, what else could the market do?
 - i. How would price have to behave prior to that move occurring?
 - ii. Is price behaving this way?
- c. Is there a third possibility for a potential market move?
 - i. How would price have to behave prior to that move occurring?
 - ii. Is price behaving this way?

4) Expectations – Bullish, Bearish, Neutral

- a. What would a bullish market do here?
 - i. How would price have to behave prior to that move occurring?
 - ii. Is price behaving this way?
- b. What would a bearish market do here?
 - i. How would price have to behave prior to that move occurring?
 - ii. Is price behaving this way?
- c. What would a neutral market do here?
 - i. How would price have to behave prior to that move occurring?
 - ii. Is price behaving this way?

5) Bulls Vs Bears

- a. Who is in control – the bulls, the bears, or neither?
- b. Why?
- c. How dominant are they?
- d. What beliefs led to this current market action?
- e. Is control changing?
- f. What would have to happen to indicate a change of control between the bulls and bears?
- g. What would cause the maximum fear in the current dominant power?

6) Professionals Vs Novices

- a. Where did the professionals enter?
 - i. Where's their stop?
 - ii. What will happen if price hits their stop?
 - iii. Where's their target?
 - iv. What will happen if price hits their target?
- b. Where did the novices enter?
 - i. Where's their stop?
 - ii. What will happen if price hits their stop?
 - iii. Where's their target?
 - iv. What will happen if price hits their target?
- c. Where will the professionals enter?
 - i. What does it mean if price reaches this area?
 - ii. What does it mean if price doesn't reach this area?
 - iii. Where will they place their stop?
 - iv. What will happen if price hits their stop?
 - v. Where will they place their target?
 - vi. What will happen if price hits their target?
- d. Where will the novices enter?
 - i. What does it mean if price reaches this area?
 - ii. What does it mean if price doesn't reach this area?
 - iii. Where will they place their stop?
 - iv. What will happen if price hits their stop?
 - v. Where will they place their target?
 - vi. What will happen if price hits their target?

7) Best vs. Worst

- a. Where is the best place to be entering, or adding to a position?
- b. Where is the worst place to be entering, or adding to a position?

8) Market Structure

- a. Where did we open today relative to yesterdays close, low and high? What does this mean?
- b. Where are we trading relative to yesterdays close, low and high? What does this mean?
- c. Where are we trading relative to today's opening price and the opening price range? What does this mean?

Resources

Trading Website: www.YourTradingCoach.com
Trading Course: www.YTCPriceActionTrader.com
YouTube Videos: www.youtube.com/YourTradingCoach

'Because You'd Rather Be Trading For A Living...'