1.2 Market First - Long Term Technical Analysis

Chapter 1: Introduction

Less is better. If the indicator is not listed… I don't use it.

The Elusive Silver Bullet

Struggling traders are always looking for a "silver bullet" solution. Instead of focusing on perfecting a systematic decision making process, they are drawn to the next "shiny object". When they stumble across someone who claims to be successfully using a particular indicator, they cling to it like gospel. If I had a nickel for every "indicator-du-jour" question, I would be rich. There are many great indicators, but you only need one or two of them. The number of ways to measure price, volume and time is finite and most indicators are variations of other indicators.

When you are exploring different indicators it is important that you understand what the indicator is measuring. Know what makes it different than other indicators and why this metric is more reliable. Understand how to identify trade signals and know the ideal (and inferior) price conditions for optimal performance. In general, no indicator performs well during tight ranges/price compressions and all indicators perform well during strong trends. The key distinction in my opinion is how well the indicator predicts reversals (trend changes).

1OP Indicator

I only use one indicator and it is called 1OP. It took me years to develop it and while I don't reveal how it is calculated, I do teach traders how to use it. It is uncorrelated to other indicators and often it is inversely correlated to the market. I will discuss it in the next section and how I use it for longer term technical analysis. This next point is critically important. No indicator trade signal (not even 1OP) should ever be the sole reason for entering a trade. All indicators require price confirmation.

Everything Else Is Standard

Apart from 1OP, the rest of my technical analysis is based on moving averages, trendlines, horizontal support and resistance levels and price action. I have found that keeping my analysis simple and my charts "clean" produces the best results. This is what my annotated daily chart of the SPY looks like.

I like keeping my charts clean

Chapter 2: Moving Averages

Major moving averages are important on daily charts because traders use them.

Daily Moving Averages (MA)

Longer term moving averages are significant because traders use them. The 20-day, 50-day, 100-day and the 200-day simple moving averages (SMA) are used for daily charts. For purposes of these articles, I will refer to the simple moving average as MA and the exponential moving average as EMA.

These major moving averages are used by most traders and institutions. That reliance makes them relevant and you will often see the S&P 500 migrate towards these levels.

Detecting Moving Average Breach During Market Decline

When the market is declining from a high, these major moving averages will act as support. If I am looking for a continued market drop, I do not want the SPY to gradually drift down to it or to sit on that major moving average. This would be a sign of support and if I see this type of price action I should be watching for a bounce. A strong market decline will attack that MA with a long red candle and it will breach it on the first effort. A close below it would be bearish, especially if the close is materially below it and if there is follow through selling the next day. A series of consecutive closes below that MA serve as technical confirmation that the market is weak. During the decline, if horizontal support and longer term up trendlines are breached, they will also serve as technical confirmation that the decline is strong.

Detecting Moving Average Support

If the move down to a major moving average is tenuous and the candles are mixed and overlapping, the trend is weak and the moving average is likely to hold. The ideal pattern for bulls is a brief intraday attempt to test the MA that does not quite reach it before the market bounces. This is a sign that buyers are aggressive and that they don’t want to miss this buying opportunity.

Detecting Moving Average Resistance

In this scenario, the market has dropped below the major moving average. If the climb back to it is tenuous with mixed overlapping green and red candles, it is not likely to get through, particularly if the market has spent more than a week below it. If the market backs off of that MA before it even tests it, you will know that sellers are aggressive. They do not want to miss the opportunity to sell stocks at that level so they do not even wait for it to be touched.

Detecting Moving Average Breach During Market Rally

If the market has been in a prolonged decline, it will eventually find support. During the rebound the market will attack the MA with a series of long green candles. You do not want a gradual move higher, you want an explosive move. If a downward sloping trend line or a horizontal resistance level is breached as well, you can expect a breakout above the MA. When you see this pattern, the SPY needs to close well above the MA and you want to see follow though buying the next few days.

How the stock approaches the MA is important. Breaches will attack it.

Trading Moving Average Breakouts & Breakdowns

If the market drifts down to a major MA and it chops back and forth, it is likely to spend time there and the day-to-day movement above and below the MA becomes irrelevant over time. In this case you could see the Bollinger Bands compress and the market will fall into a trading range. In this scenario you need to draw horizontal support and resistance lines at the recent high and low. Until the market breaks out of that compression you have to assume it will continue. Once those support/resistance levels are breached, the SPY will be far enough away from them to have the "escape velocity" it needs and you can expect follow through in that direction.

When the 50-day MA is greater than the 100-day MA and the 100-day MA is greater than the 200-day MA, the market is in a strong long-term uptrend. The opposite would be a sign of a strong market downtrend.

Golden Cross

When the 50-day MA is below the 200-day MA and it crosses back above the 200-day MA, it is referred to as a Golden Cross and it is bullish. In order for that to happen, the price of the underlying stock has been above the 200-day MA for some time and that support level is confirmed. This is a fairly reliable technical indicator, but it does not happen that often.

Death Cross

When the 50-day MA has been above the 200-day MA and it crosses below the 200-day MA, it is referred to as a Death Cross and it is bearish. In order for this to happen, the stock will also be less than the 200-day MA a Death Cross and it is bearish. In order for this to happen, the stock will also be less than the 200-day MA and it has stayed below it for some time. This validates resistance at the 200-day MA. Traders watch for Golden Crosses and Death Crosses and that makes them relevant.

Exponential Moving Averages

Exponential Moving Averages (EMAs) place greater weight on the more recent data points, so they adjust quickly and they tend to follow the market more closely. Short term traders use the EMA (8) to confirm trend strength/weakness and for entry/exit. For instance, if a trader is long SPY and it is in a nice uptrend they will ride the position until the SPY closes below the EMA (8). If the trader is short SPY they will stick with the short and they will exit when the EMA (8) is breached to the upside. This is effectively a trailing stop. Very short-term traders also use a EMA (3)/EMA (8) cross for entry and exit.

Conclusion

I do not use MAs for any time frame other than a daily chart. What makes the MAs relevant is that other traders use them and I do not feel they are as widely used on shorter time frames. I use other indicators on a short-term basis and I have found them to be more reliable.

Death Cross. The 50-day MA crosses below the 200-day MA

Chapter 3: Trendlines

This is the most widely used form of technical analysis.

Trendlines are constructed by connecting the highs or lows on a chart. They are easy to spot on a chart and traders rely on them when they devise their trading game plan. That makes them relevant.

Let's define some terms so that it is easier to talk about trendlines. There are 4 types of trendlines that we look for. This verbiage is not an industry standard, but they are terms I use. The first word indicates what we are connecting. All trendlines we are either connecting **Highs** from a bar or they are connecting the **Lows** from a bar. The **(+)** indicates an ascending (rising) trendline and a **(-)** indicates a descending (declining) trendline.

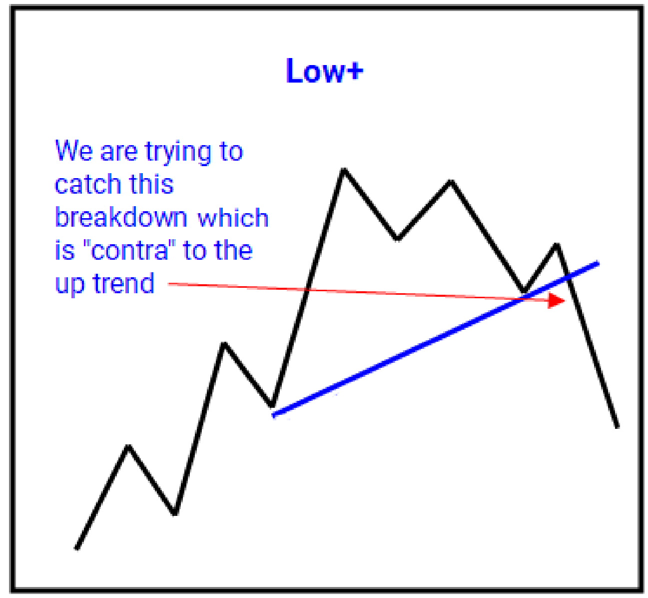
Here's why we need different terms. There are bullish ascending trendlines where we look for breakouts (**High+**) and there are bearish ascending trendlines where we look for breakdowns (**Low+**). There are breakouts, breakdowns and fakes. If I told you that stock XYZ had an ascending (up trend) breakout, that could be bullish (**High+**) or bearish (**Low+**). If I told you that stock XYZ had an uptrend trendline fake, that could be bearish (**High+**) or bullish (**Low+**). In the chat room we post trading set-ups and it is critical for us to communicate efficiently. When we mention that stock XYZ had a **High+ Top** you will be able to instantly visualize that set-up without even looking at a chart. Let's define some terms.

High-

These trendlines connect the "highs" and the trendline slopes downward (descending). When that trendline is broken, it will often signal that a trend reversal is likely. Breakouts above the trendline are "contra" to the prevailing trend. If the breakout was just a little "dead cat" bounce and the stock continues lower we would call that a "**High- Fake**" when the stock drops back below the trendline. Don't worry if you can't visualize this right now. There will be plenty of examples.

Low+

These trendlines connect the "lows" and the trendline slopes upwards (ascending). When the trendline is broken, it will often signal that a trend reversal is likely. Breakouts below the trendline are "contra" to the prevailing trend. If the stock breaches the trendline on a little profit taking and then resumes the uptrend, we call it a “**Low+ Fake**” when it gets back above the trendline.

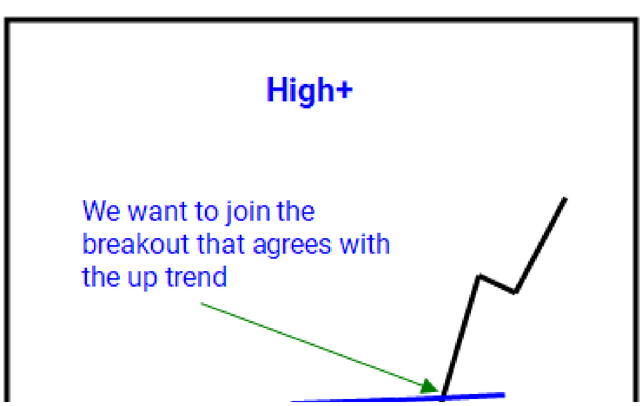


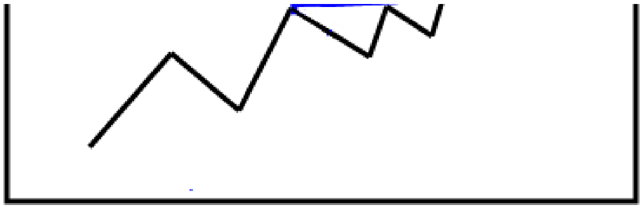
High+

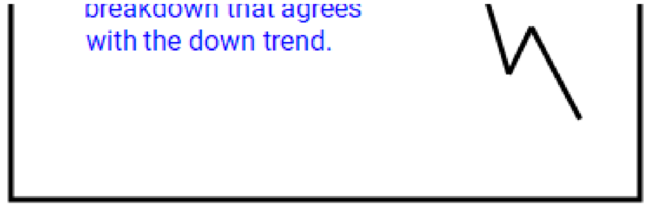
These trendlines connect the “highs” and the trendline slopes upwards (ascending). They are less common than a **High-** because they are chasing after an uptrend. When the highs are connected, the line is often moving away from price, not towards it like **High-**. In general, these upside breakouts tend to be a little less reliable because the breaches often happen near the end of the move (buying climax). For that reason, we want to watch for “**High+ Tops**” as a possible sign of a top and a trend reversal.

Low-

These trendlines connect the “lows” and the trendline slopes downwards (descending). They are less common than a **Low+** because they are chasing after a downtrend. When the lows are connected, the line is often moving away from price, not towards it like **Low+**. In general, these downside breakouts tend to be a little less reliable because the breaches often happen near the end of the move (selling climax). For that reason, we want to watch for failed breakdowns as a possible sign of a trend reversal. If the stock breaks down and then crosses back above the trendline, we call this a “**Low- Bottom**“.



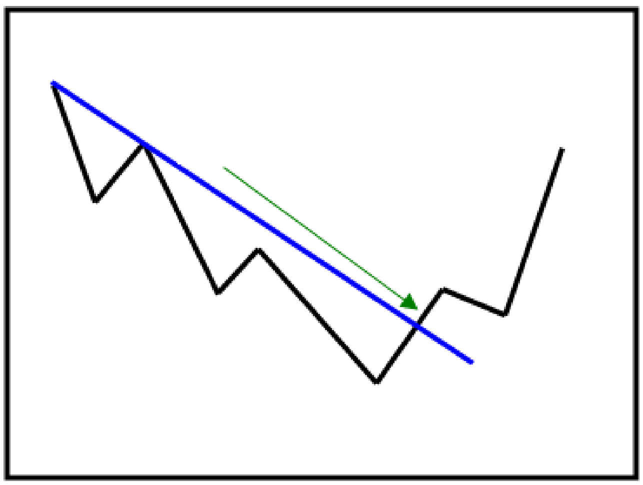


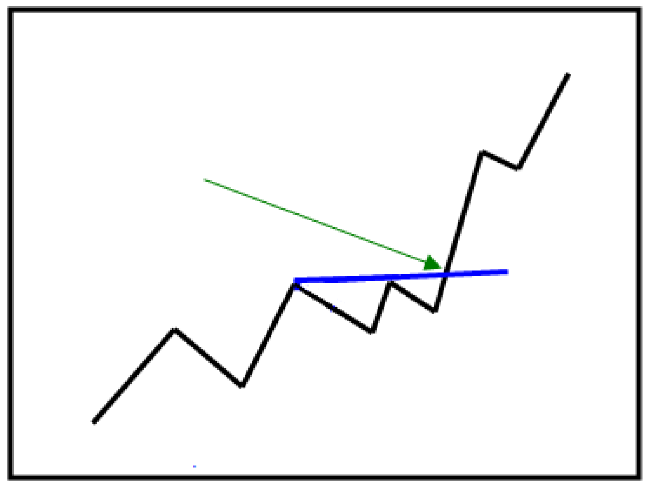


Breakout

Typically when a stock penetrates a price point, traders refer to it as a breakout. They use this universally (up or down) and this use is not efficient. For our purposes, a breakout signifies that the stock is moving higher. Since the market goes up more often than it goes down, it makes sense that this word is usually associated with a bullish (upside) event.

Breakouts



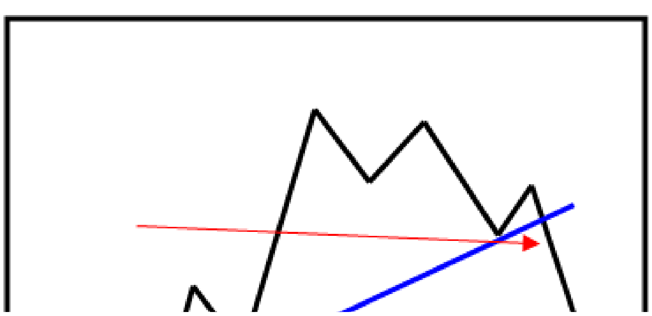


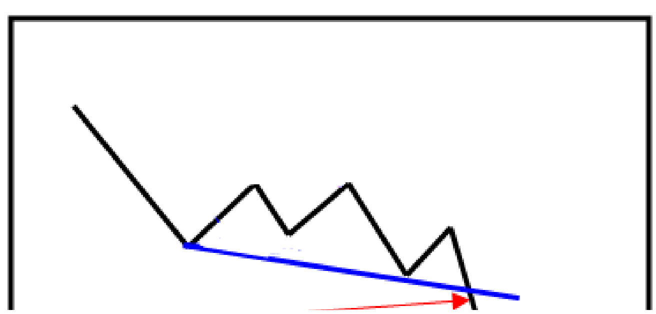
When a trendline is breached to the upside it is bullish and we refer to these a breakouts.

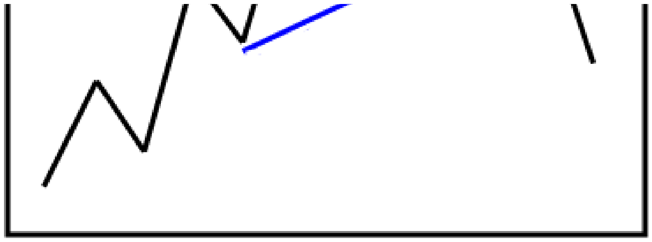
Breakdown

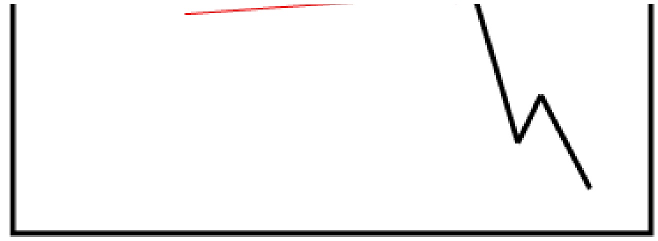
We use this term when the stock falls below a price level. The suffix “down” immediately tells us that this is a bearish event because the stock is moving lower.

Breakdowns









When the price breaks below a trendline we refer to it as a breakdown.

High- Fake

We use this term to signify that a **High-** breakout was a headfake to lure in bullish speculators. The stock fell right back below the down trendline and the selling has resumed. These patterns are rare and they typically happen when the stock is testing a long term downtrend. Traders are aware of the trendline and they are anxious to buy when it is breached. They enter on that breakout and it fails immediately. The selling pressure created when bullish speculators are flushed out drives the stock below the trendline. This pattern is not common for the same reason that **High+** breakouts are less common. Once the stock breaks out above the downward sloping trendline, it will be harder and harder for it to catch the trendline because it is moving lower. In a matter of days, it will be out of reach. Just because this pattern does not happen often, it doesn't mean that it is not relevant. Selling pressure has been confirmed and a **Low+** could be close (chart below). If you can search for a High- Fake and a Low+ breakdown that are days apart, you have a very powerful pattern.

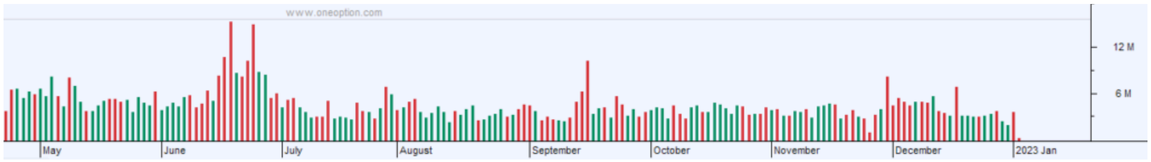
High- Fakes happen near a long term downtrend. If there is a long term wedge formation, it could breach a Low+ trendline.

Low+ Fake

We use this term to signify that a **Low+** breakdown was a head fake to lure in bearish speculators. The stock popped right back above the upward sloping trendline and buyers have returned. These patterns are rare and they typically happen when the stock is testing a long term up trendline. Traders are aware of the trendline and they are anxious to short when it is breached. They enter on that breakdown and it reverses immediately. The buying pressure created when bearish speculators are flushed out drives the stock back above the trendline. This pattern is not common for the same reason that **Low-** breakdowns are less common. Once the stock breaks down below the upward sloping trendline, it will be harder and harder for it to catch the trendline because it is moving higher. In a matter of days, it will be out of reach. Just because this pattern does not happen often, it doesn't mean that it is not relevant. Buying pressure has been confirmed and a **High-** could be close. See if there is a longer term wedge pattern that has formed. If you can search for a **Low+ Fake** and a **High- Breakout** that are days apart, you have a very powerful pattern.

High+ Top

When a stock breaks out (going higher) through an upward sloping trendline, that is bullish. However, we know that this breakout could be getting close to a buying climax. The stock has had to run hard and it has been difficult for this trendline to catch-up. Just by nature of this pattern, much of the rally could be exhausted. If the stock falls back below that trendline, there is a good likelihood that a top is forming and that is why we prefer this description.



When the stock moves above the trendline, it is a High+ Breakout. When the stock moves back below the trendline it is a High+ Top

Low- Bottom

When a stock breaks down (falling) through a downward sloping trendline, that is bearish. However, we know that this breakdown could be getting close to a selling climax. If the stock rallies back above that trendline, there is a good likelihood that a bottom is forming.

The Low- trendline tries to join the downward trend and we get a breakdown. These breakdowns often happen near a selling climax. If the stock rallies back above the trendline it is very possible that a bottom is forming.

High- vs High+

Both of these trendlines are trying to catch bullish breakouts. The **High-** Is connecting the highs and the slope is negative. That means these trendlines are driving into the price of the stock and they are likely to intercept it if the price just stops going down. On the other hand, the **High+** is trying to catch a train that has already left the station. It takes a very long time for these trendlines to intercept price so they are less common than the **High-**. Think of it this way. If a stock finds support and it goes sideways, a **High-** will eventually intercept the stock price. It is on a collision course. On the other hand, the **High+** will keep moving higher, distancing itself from the stock when it goes flat. In the chart below you can see how early the **High-** is and how late the **High+** is in catching that move.

High- is on a collision course with the train and High+ is trying to catch it once it left the station.

How Trendlines Form

Upward sloping trendlines that connect the **lows** are also called **Low+** trendlines and they are a sign that buyers are engaged. Every time the stock pulls back, buyers are eager to buy shares and the stock can't get back to that prior horizontal support level before it is scooped up. The "trend is your friend" and you always want to join that longer term tailwind. The longer and tighter the trendline, the better. Tight, orderly trendlines are a sign that buyers are aggressive. Every time that sellers exit, that order is immediately "gobbled up". Consequently, you do not see any dips and the trend forms. Trendlines will help you avoid picking "tops". We do not attempt shorts until we have technical confirmation that the **Low+** trendline has been breached. When these ascending trendlines are breached, they are often a sign that the uptrend could be changing. How that trendline is breached often determines if the up trend is ready to reverse. The trendline needs to be attacked with long red candles and heavy volume, and follow through is critically important. In the left side of the chart below, you can see how the SPY is bought before it can even test the trendline. On the right side you can see that the **Low+** trendline was attacked with a long red candle that closed on its low. That is a nice "clean" breach and the follow through selling legitimized it.

Always follow the trend and do not try to predict "tops" or "bottoms"

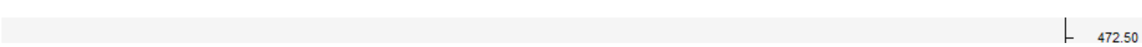
Downward Sloping Trendlines

Downward Sloping Trendlines

Downward sloping trendlines that connect the **lows** and that have a **negative slope** are called **Low-**. When they are breached to the downside, they are bearish. These descending trendlines that connect the lows are not as reliable for shorting breakdowns as the upward sloping **Low+** trendline breaches that connect the lows. That downside breach is often a selling climax and the stock reverses back above those downward sloping trendlines. In the chart below, you can see how the breakdown below the descending trendline that connects the lows represented a selling climax and the SPY bounced right back above it.

Downward sloping trendline breaches that connect the lows are not as reliable for shorting

Downward sloping trendlines that connect the **highs** are a sign of selling pressure. They have a negative slope and they are called **High-**. Sellers are eager to unload shares and the bounces can't get back to the previous high (horizontal resistance). When these downward sloping trendlines are breached to the upside it could be a sign that the trend is about to reverse and it is bullish. How that trendline is breached often determines if the trend is going to change and we will discuss this in detail. Upside breakouts for descending trendlines that connect the highs (**High-**) are much more reliable than breakouts above an upward sloping trendline that connects the highs (**High+**). In the chart below, you can see how the downward sloping trendline that connects the highs is breached convincingly with a gap up and a long green candle that closes on its high. The next day, we had follow through buying and that confirmed the breakout.



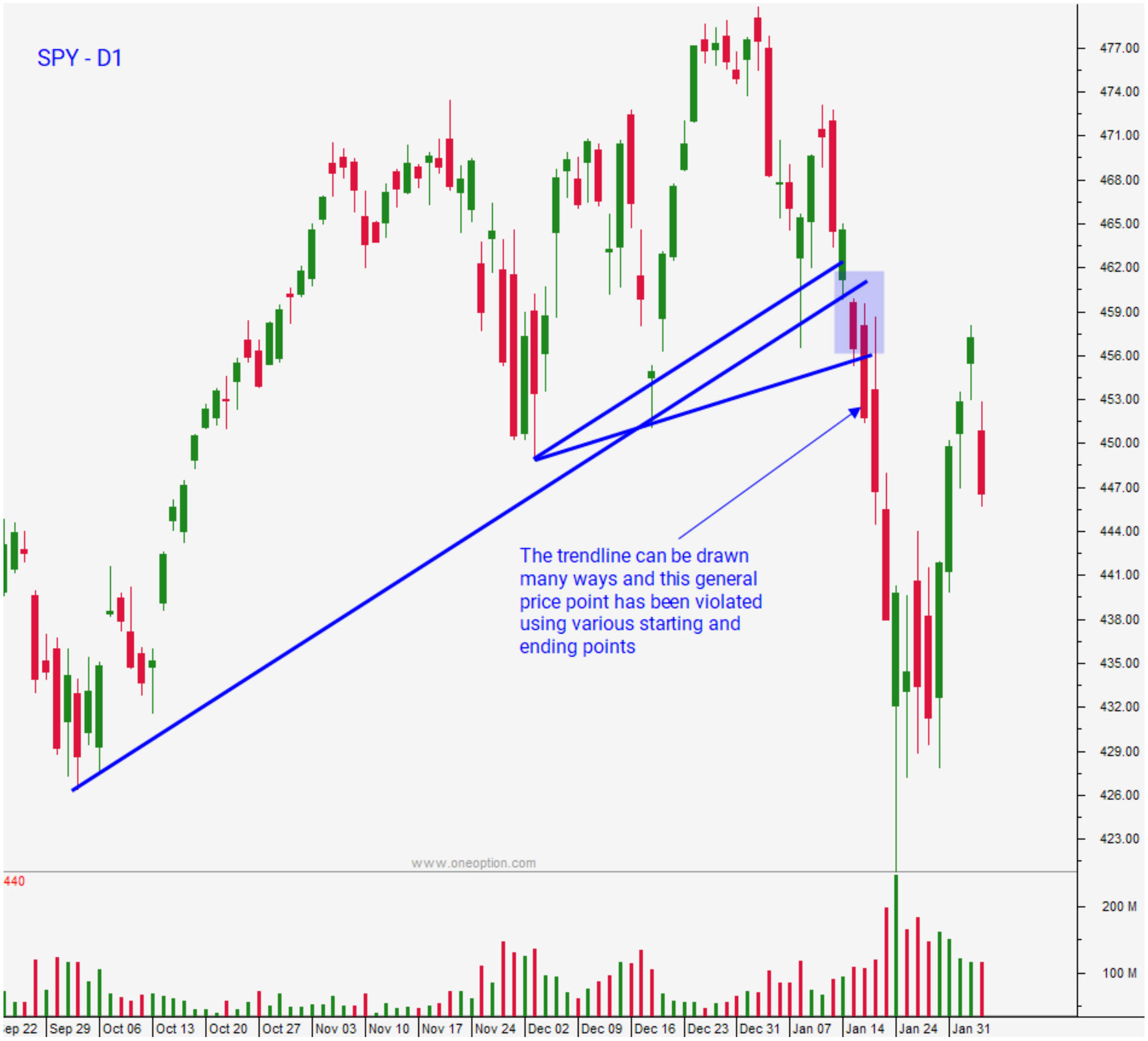
Upside breakouts for downward sloping trendlines that connect the highs are more reliable

Upward Sloping Trendlines

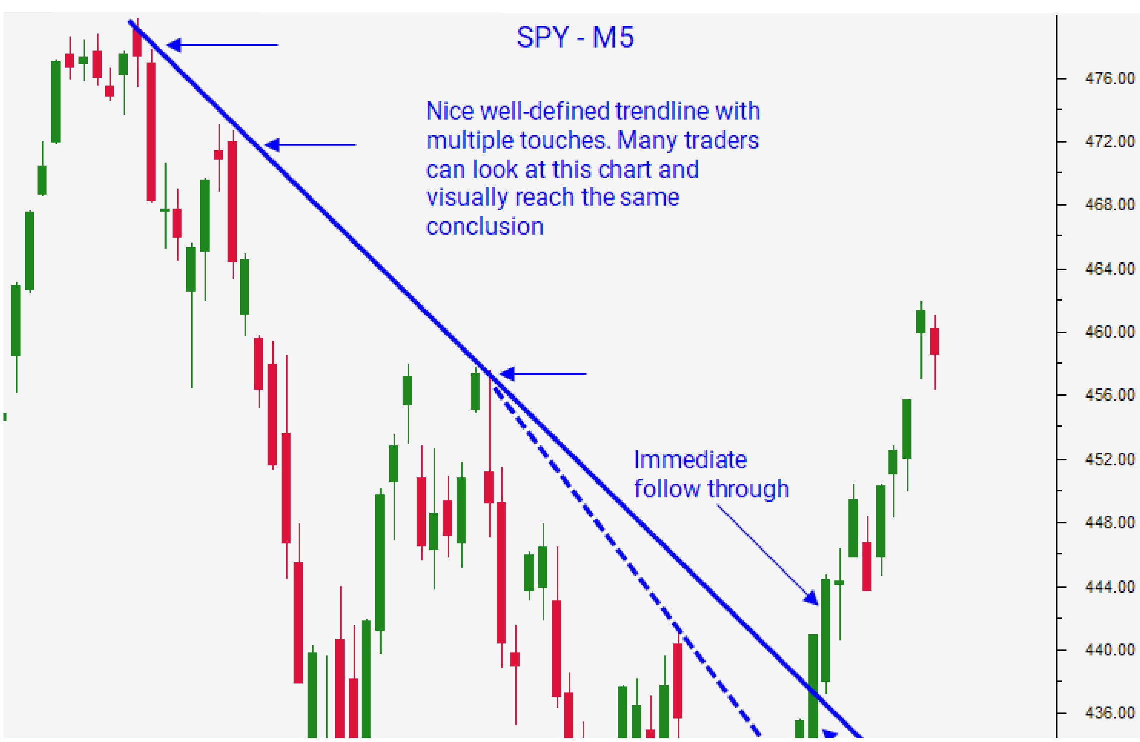
Upward sloping trendlines (ascending) that connect the highs are called **High+**. Those breaches are not as reliable for buying as the downward sloping trendlines that connect the highs. The trendline is chasing the trend and the highs when connected are often moving away from price, not towards it. Often the upward sloping trendline breach results in a buying climax and the stock quickly falls back below it. These “over and back” crosses (**High+ Top**) are worth keeping an eye on because they could be signaling a trend reversal or a “top”.

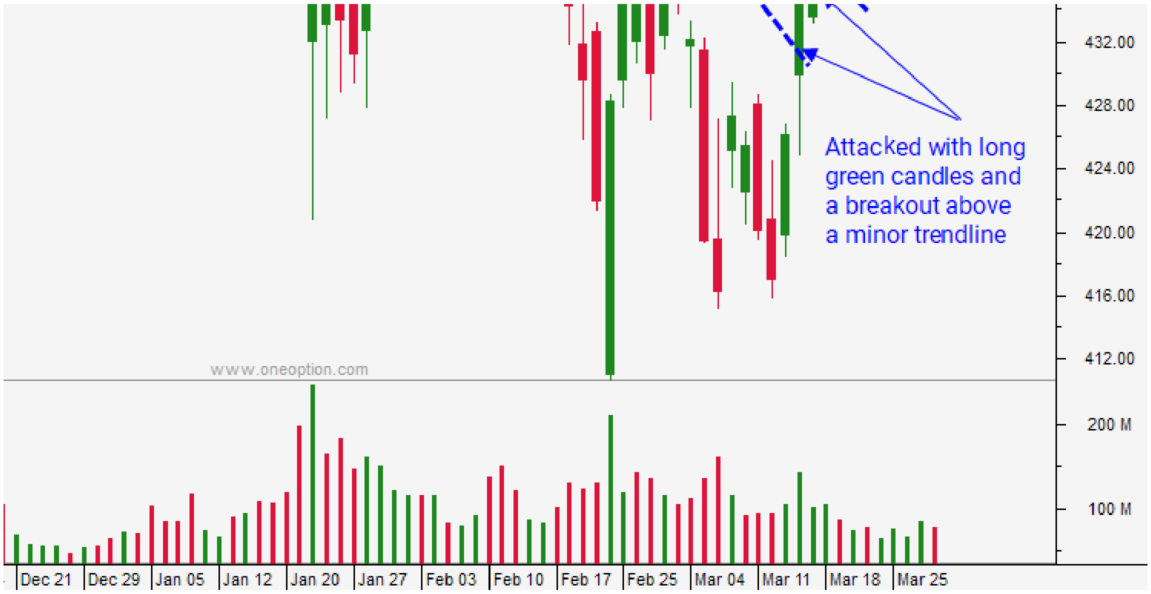
Upward sloping trendlines that connect the highs are not as reliable for buying breakouts

Large institutions draw trend lines using algorithms. They know the key price points to draw from and they monitor trendline breaches knowing that activity is likely to increase around those levels. The price action around those breaches is important. Sometimes we see trendline breaches that gain momentum after the breach and sometimes they quickly reverse. It is important to wait for confirmation (follow through) when trading trendlines breaches to avoid false breakouts. Each institution has its own code and often when stocks break a price point, other trendlines with different starting points will also be breached. In January of 2023 Option Stalker Pro will introduce our algo lines and you will be able to see the relevant lines on the chart. We will only use D1 trendlines, but they will be displayed on intraday charts if they are in view.



When multiple trendlines converge around a price point it becomes more relevant





Many traders can visually spot this same trendline and that increases its relevance.

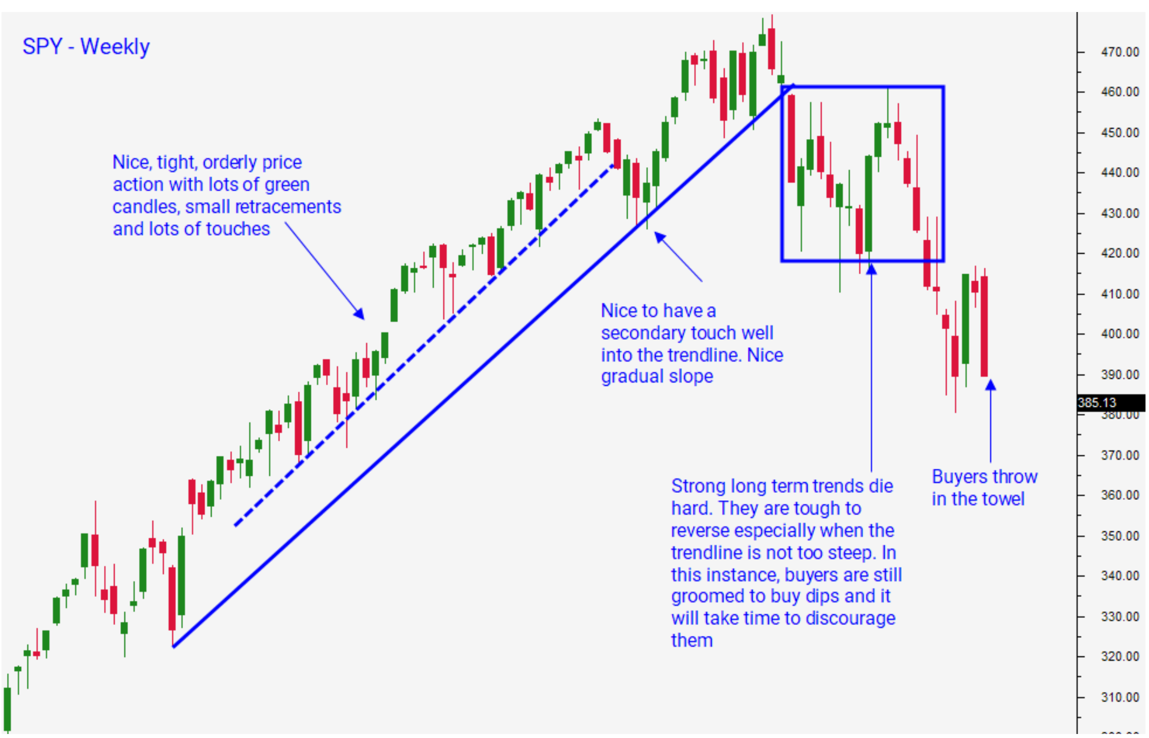
Steep Trendlines

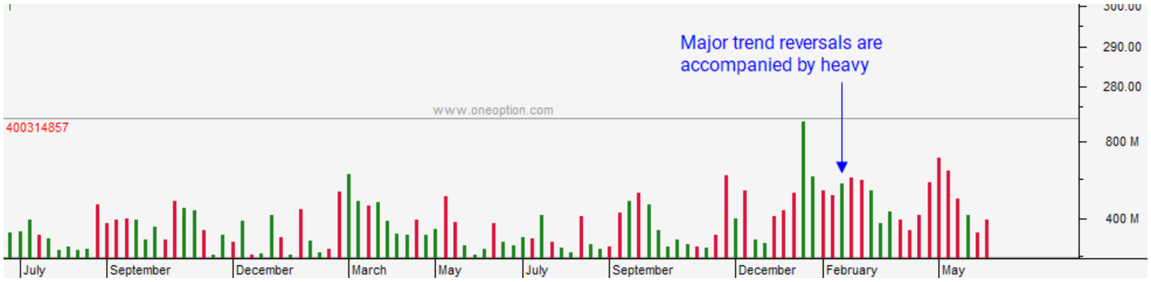
Steep trendlines are less reliable in terms of trading breakouts because they are easily breached. Imagine a stock that has plunged 30% in a matter of days. A move of that nature is going to have plenty of retracement and every little bounce will penetrate a down trendline. A very steep trendline does indicate that the momentum in that direction is likely to continue longer term and it could produce a bearish flag formation so watch for a very short term trendline breach like the one in the chart below. Nice gradual trendlines with no more than a 45 degree angle are more reliable. They tend to stay intact longer and they produce better reversals on the breakouts.

Steep trendlines are not reliable for trading breakouts because they are easily breached. Look for opportunities to join that trend.

Price Action & Trendlines

Orderly price action is always preferred to choppy price action. We want charts that start a trend and then continue it for at least a few weeks. The candles should be of a similar color and have minimal overlap and minimal retracement. The more touches a trendline has, the more significant it is. I prefer to have at least one touch point towards the middle of the trendline versus two touches right at the start of a trendline. This secondary point serves as confirmation and it validates the trendline. Long term trendlines that match this description are hard to reverse and it is critically important to wait for technical confirmation. In the chart below, you needed to wait for a double top lower high and volume.

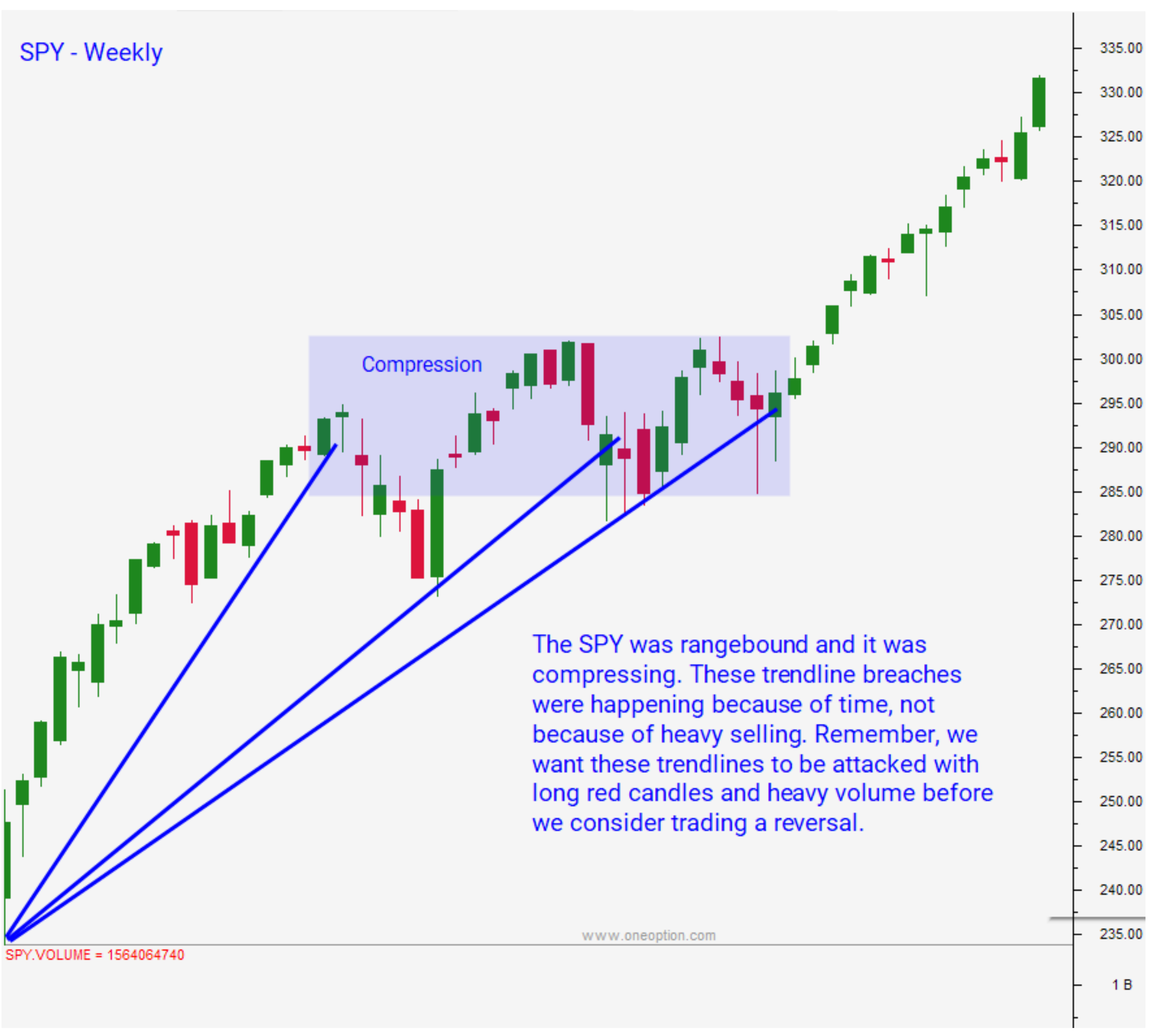


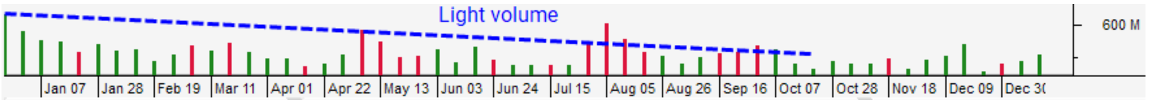


Long-term orderly trendlines with a gradual slope are extremely powerful and tough to reverse.

Time Breaches

Time breaches occur when a stock has dropped dramatically and a base has formed. As the support continues to hold, the stock will flat line and eventually a downward sloping trendline will be breached. For stocks that have dropped, we prefer a nice bounce off of the base on heavy volume for upside trendline breaches. If the stock breaches the trendline because of time, we consider those to be of low quality. In the chart below you can see how the SPY was compressing in a range and the upward sloping trendlines were breached because of time, not because of heavy selling. This is a low quality breach and it is not trade-worthy. Notice how those breaches took place during a resting point and how the SPY continued higher.





Trendlines that are breached during a horizontal price compression are not valid. Long candles and volume are needed.

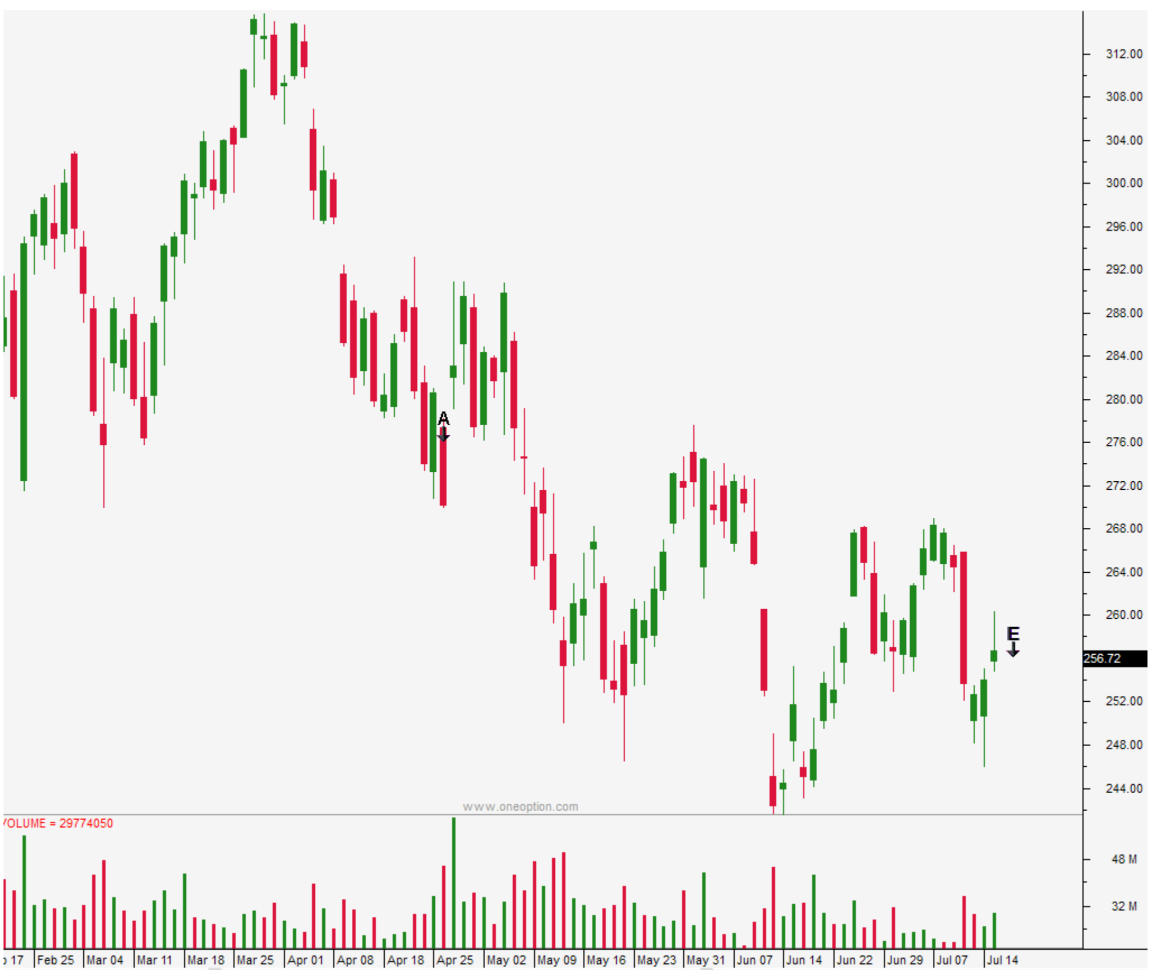
Nested Trendlines

Sometimes there will be a trendline within a trendline. The trendline can be in the same direction, but of shorter duration. The longer the trendline and the more touches, the more valid it is. Often a longer term trendline will have a shorter term contra trendline that has formed inside of it. A bullish flag formation would be one example. Traders always want to give the longer term trendline more consideration and that is why bullish flag formations are so reliable. This gives the trader a chance to join the longer term up trend on a pullback and the shorter term downward sloping trendline breach provides an excellent entry point. In the chart below we will look at the opposite pattern where the longer term trend is down. The SPY was not even able to challenge the downward sloping trendline when sellers stepped in. The short term uptrend line (dotted) provided an excellent entry for a bearish position when it was attacked by that long red candle.

Longer term trendlines carry more weight and short term contra trendline breaches present an opportunity to join the long term trend

Trading Channels

When a trendline that connects the highs runs parallel to a trendline that connects the lows, a trading channel is formed. Trading channels with many touches on both ends that are close to parallel are stubborn (hard to reverse). At first glance, the price action seems random because the bars are mixed and overlapping. A closer look reveals that there is a gradual trend. Recognizing this pattern early can set up nice trades. The key is to follow the trend. For instance, in a downward sloping channel your plan is to short on rallies that stall at the upper end of the trading channel and to take gains at the lower end of the trading channel. If the trading channel has a fairly steep trend of greater than 30 degrees, it is best not to “get cute” buying bounces off of the low end of the channel. Remember, the trend is your friend and the trend is down in this case. A selling climax could be pending and you do not need that risk exposure. In the chart below, the price action looks random. When we add the trendlines, we have clarity and it is easier to structure trades when the channel is revealed.



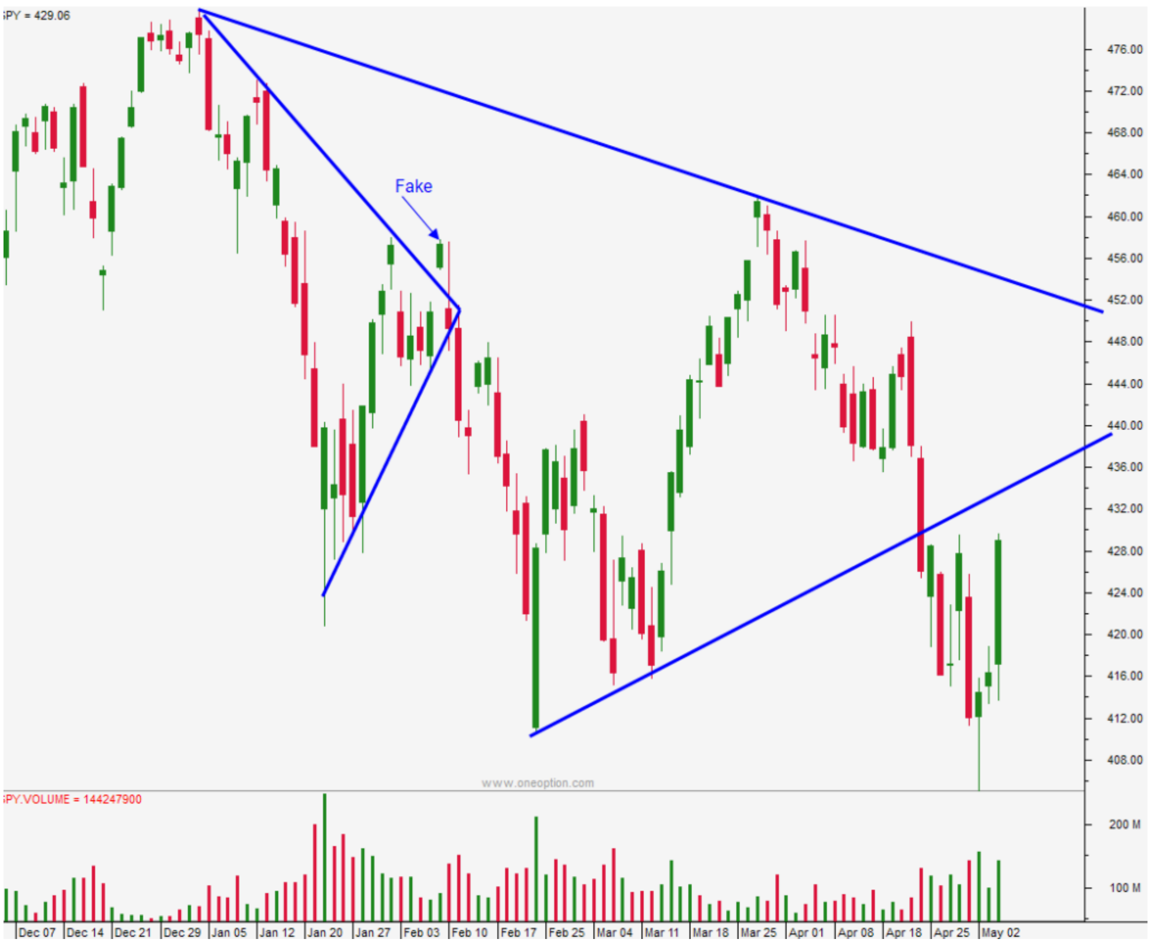
At first glance the price action seems random. Trading channels take time to form and recognize

The trendlines add structure and clarity to the price action. Always trade in the direction of the channel.

Downward sloping channels tend to end with a breakdown below the lower end of the trading channel. That selling climax attracts buyers and the market reverses back into the channel. Often the market can run back to the upper end of the channel. The selling climax and the bounce confirm support and often the downward sloping channel turns into a horizontal trading range. This same behavior applies to upward sloping trading channels. If the trading channel has a positive slope, it is likely to breach the upper trendline on a buying climax. Those climaxes reverse in 4-5 bars and the market retraces back into the channel. It could fall as far as the lower end of the channel and then transition into a horizontal trading range. The ideal trading channel will have many touches on both extremes, a slope that is less than 45 degrees and the trendlines will be close to parallel. I will provide examples in future articles.

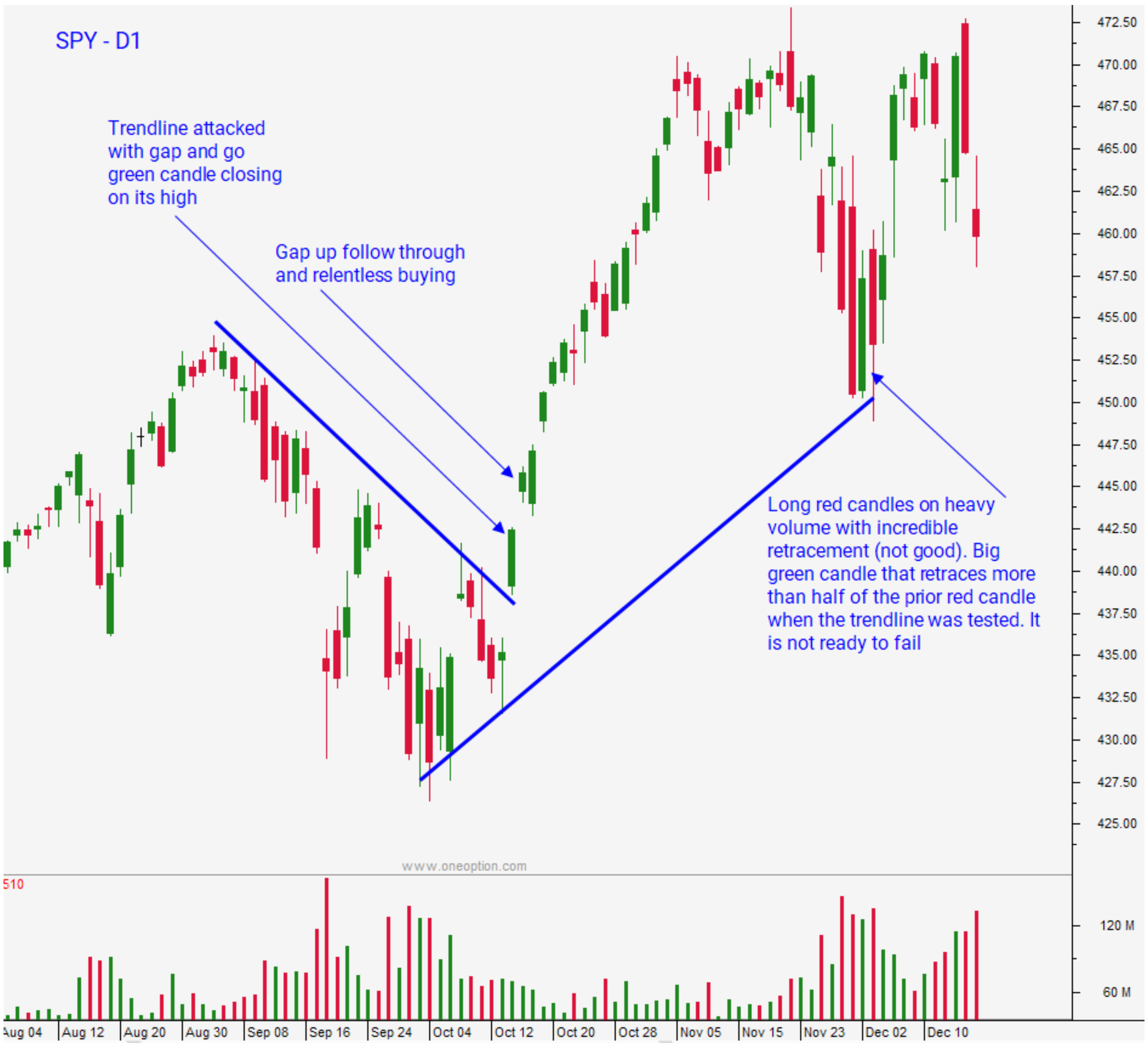
Wedges

Wedges are formed when two trendlines are converging. Longer term trendlines carry more weight in a wedge formation and they indicate which breakout is most likely. There is no need to guess, wait for technical confirmation. A bullish flag formation is an example where the longer term trendline is upward sloping and the shorter term trendline is downward sloping. Wedges where both trendlines are equal in length and in slope can breakout either way so you need to be patient. It is important to wait for the breakout and follow through. In the chart below you can see how one of the wedge breakouts was a fake. Make sure you have follow through. There are often shorter term wedges that are nested within longer term wedges. Nice tight wedges where the slope of both trendlines are less than 30 degrees produce excellent breakouts. With all trendlines, more touches are better. Just before the trendlines converge the SPY is in a horizontal price compression. The spring is coiled and ready to release. Below are two examples. The short term wedge has very steep trendlines. Both can easily be breached and you can see the **High-Fake**. In this case it is very important to wait for follow through because it could easily go the other way. In the second example the trendlines are longer term and they have a more gradual slope. This breakdown would be more reliable, but we still need follow through. In this case, the follow through was not very good and we can see green candles and overlap.



Like with any trendline, longer term trendlines with more touches are more reliable. Make sure to wait for follow through on these breakouts

The price action into a trendline will often indicate if it is just being tested or if a breach is likely. Remember, the trend is your friend and we want to buy bounces off of a longer term **Low+** trendline. If the price action jumps off of an upward sloping trendline and there are candles with long tails above the trendline, it is likely to hold. Stubborn price action with little momentum into the trendline and with multiple tests also suggests that it will hold. On the other hand, stacked red candles with little to no overlap that attack the trendline on heavy volume are a sign that a trendline breach is likely. If that breach happens on the first attempt with a convincing close below it, you are likely to get follow through selling and the odds of a trend reversal is high. Mixed overlapping candles on light volume are a sign of weak trend strength and it could be vulnerable.



Examples of a good breakout and a trendline that is not ready to fail

Conclusion

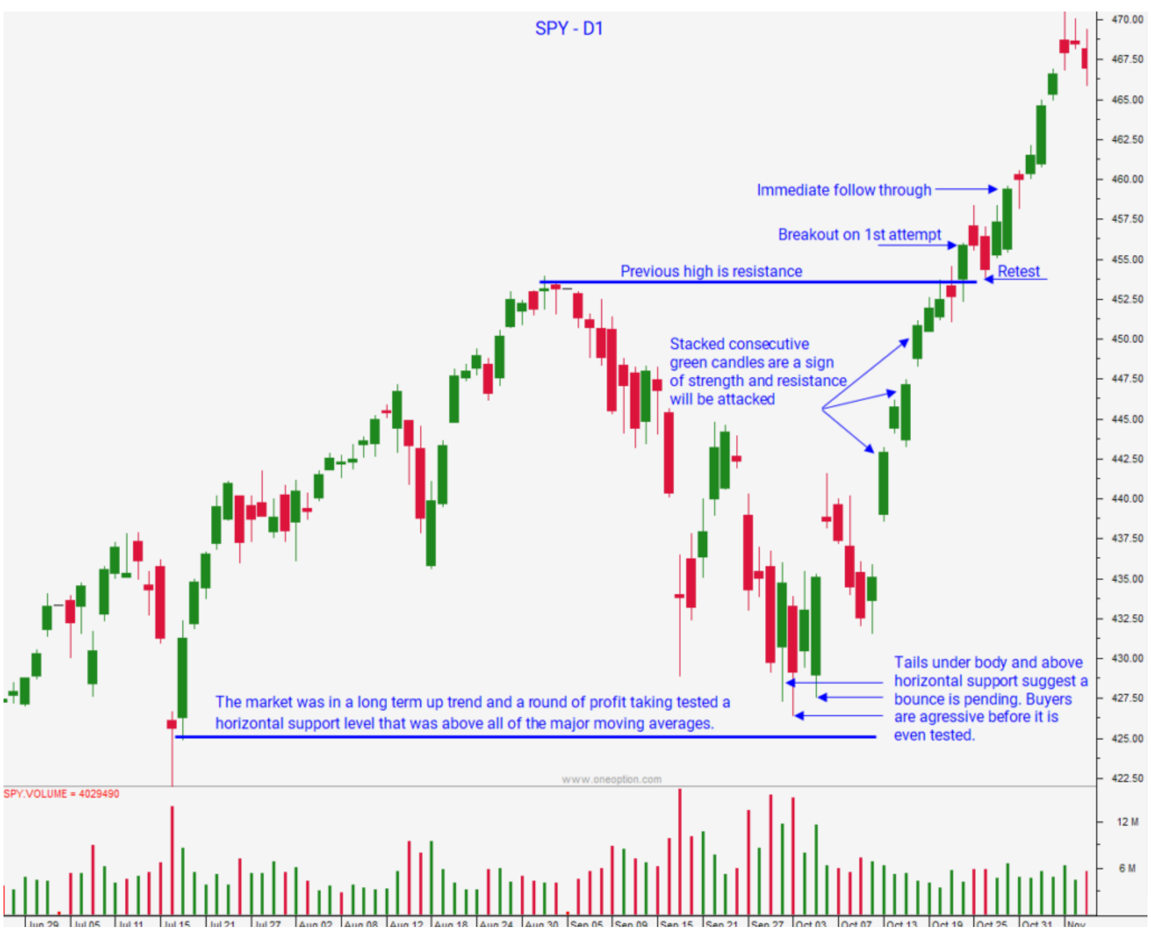
There are many types of trendlines and they are a very important part of our technical analysis. Upward sloping trendlines that connect the lows (**Low+**) and downward sloping trendlines that connect the highs (**High-**) are more reliable than their counterparts. Professional traders and institutions use them and that makes them relevant. The trend is your friend and you should always look to join that tailwind. We don't trade trend reversals until we have a technical breakdown on heavy volume with follow through and we want that trendline attacked with long candles and no retracement.

Chapter 4: Horizontal Support & Resistance

These technical levels are easy to spot on a chart and they are widely used.

Horizontal support and resistance levels are easy to spot on a daily chart. Longer term horizontal levels with many touches are more significant than shorter term horizontal levels with only a few touches. Traders lean on these levels and that makes them significant.

If the market has been above a horizontal support level, traders will assume that it will not be breached, especially if it is above all of the major moving averages as well (sign of strong trend). As the market drifts down to horizontal support, look for mixed, overlapping candles in this scenario. That will be a sign that the trend strength is weak on the way down. Ideally, the horizontal support level will not even be touched. That would be a sign that buyers are eager to buy at that level and they don't want to risk missing the bounce so they error on being early. Tails under the body of the candle will be a sign that buying pressure is building.

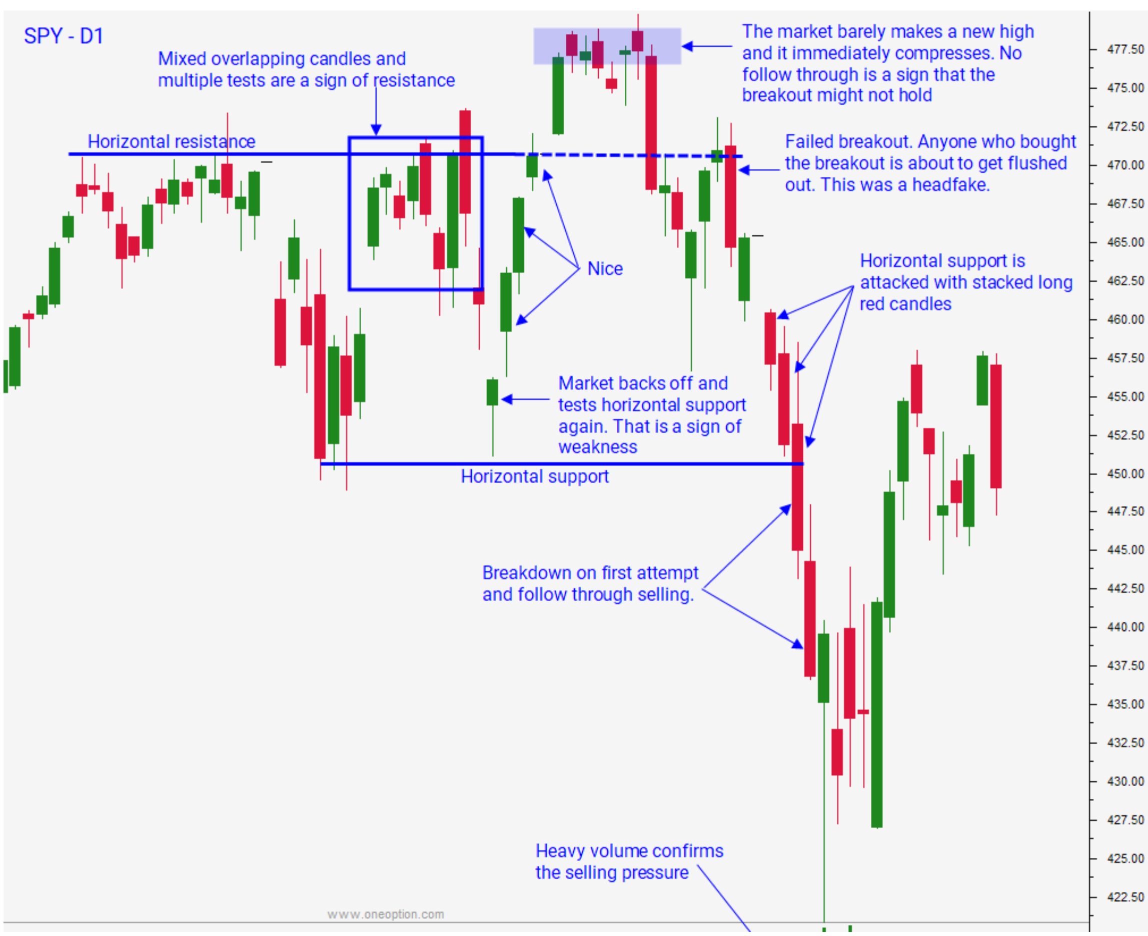


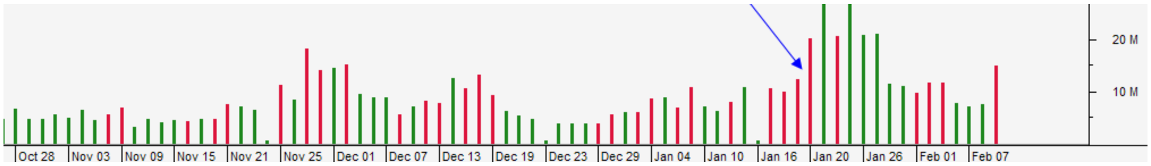
Buyers are eager to buy the dip and this support is not even touched

In the chart above, the market had been in a very strong long-term uptrend. Once that horizontal support was confirmed, it rebounded quickly. The previous high serves as horizontal resistance. The stacked consecutive green candles with little to no overlap suggest strong trend strength and that previous high is going to be attacked. Notice how the market blew through the previous high on the first attempt. One brief retest of the breakout through resistance and it was off to the races.

Case Studies: Testing Support & Resistance

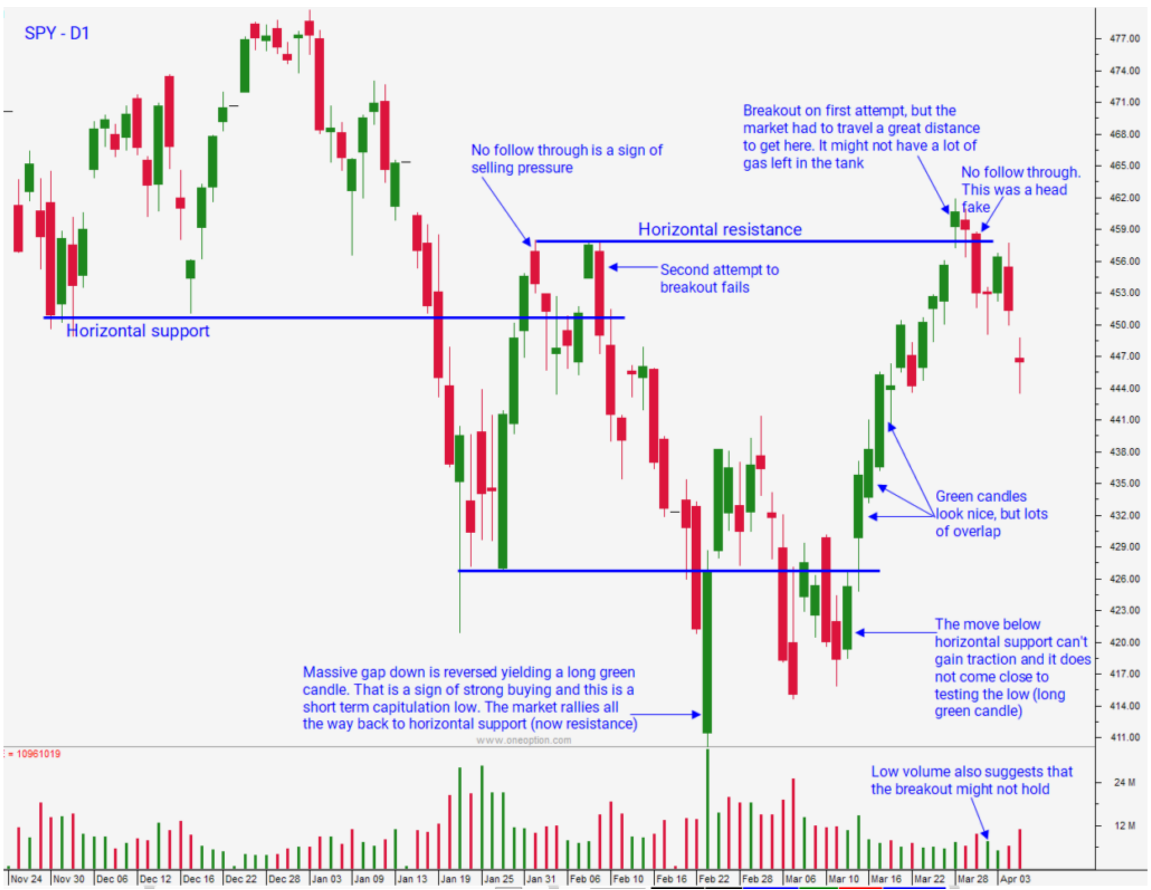
When the market tests horizontal resistance with mixed overlapping candles it is a sign that the attack on that level is weak. It is not likely to have the fire power it needs to get through. This is often the case if the market has had to travel far to reach that resistance level. If multiple attempts can’t force a breakout, it is a sign that the selling pressure is building. In the chart below you can see how the market eventually backed off and it took a running start at the resistance level. The stacked green candles looked impressive, but they barely broke through resistance. The breakout is important, but so is the follow through. In this case there wasn’t any. A brief compression above the breakout and the market rolled right over. That breakout was a head fake. Traders who bought the new high were about to get flushed out.





Horizontal levels that are NOT attacked are likely to hold

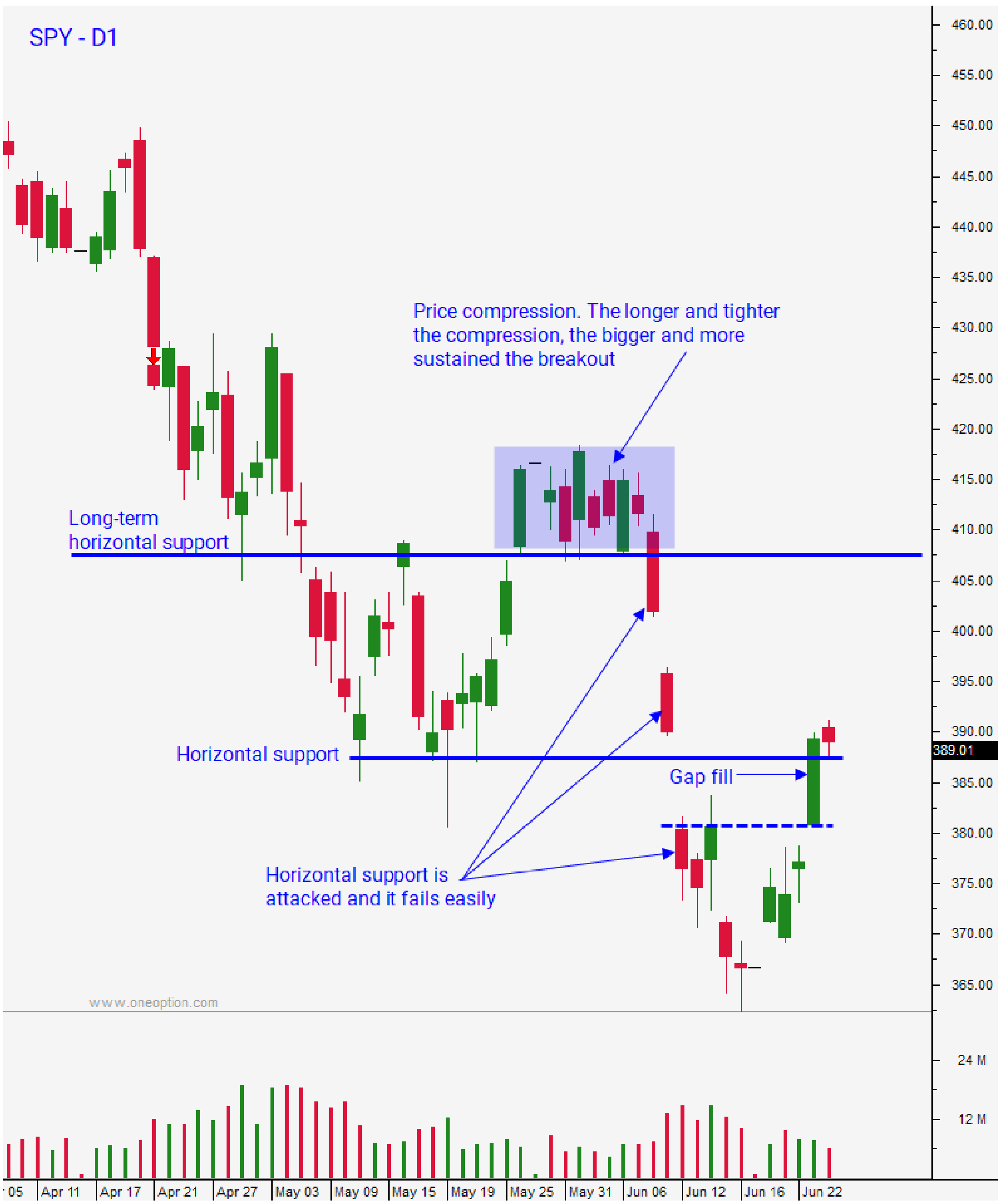
Let’s continue to reference the chart above. This was actually a market transition and we can see the first signs that a long-term trend is about to reverse. Off of that failed breakout, the selling pressure was heavy. We can see that from the stacked red candles and the breach of horizontal support on the first attempt. There was immediate follow through. After a very long uptrend, buying dips had been a successful strategy and buyers were not going to throw in the towel so quickly. The bounce was violent, but sellers returned and now we will shift our focus to horizontal resistance.



The horizontal support breaches were signaling a trend change

Let’s continue to reference the chart above. We can see that the selling pressure is persistent and that horizontal resistance is forming. We can also see that horizontal support has formed and that it is being tested with greater frequency. The market is transitioning from a 12-year raging bull market to a bear market and we are witnessing extreme volatility as buyers and sellers do battle. This battleship will be hard to turn and buyers have not thrown in the towel yet. Sellers are also flexing their muscles and a large range between horizontal support and resistance has formed. At either extreme, there is no follow through at this stage.

Eventually, the sellers win and horizontal support is attacked with stacked red candles. That support failed easily and the downtrend continued. This low officially put the SPY in bear market territory after a 12-year bull market. In the chart you will notice a blue shaded area. This is called a compression and it is the next topic we need to cover.

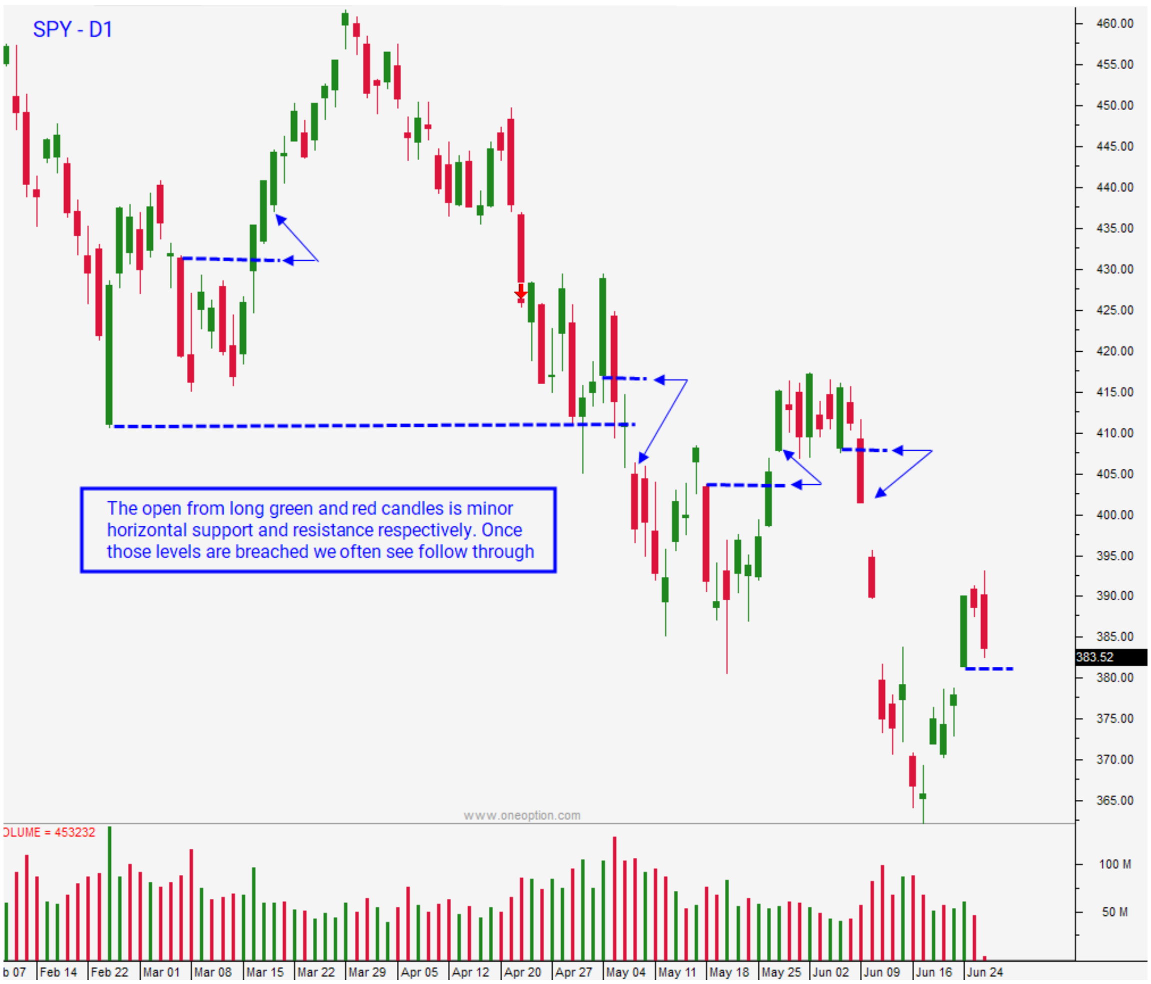


Eventually sellers win the battle and horizontal support is attacked with stacked red candles

Compressions are very tight ranges with defined horizontal support and resistance. They are a sign that buyers and sellers are in equilibrium. The longer and tighter the compression, the bigger and more sustained the breakout. With regards to the market, we do not want to trade compressions. This is a time to be passive. Wait for the breakout and follow through. Once we know the direction, the move is likely to be sustained. In Option Stalker Pro you can see compressions on the chart using the 1OSqz indicator. Grey dots mean that the market is moving normally. Yellow dots mean that the market is compressing. Green and red dots signal a big breakout from the compression. We can spot the compressions easily on a SPY chart, but we can use Custom Search to find them for stocks. Once we identify them, we drop horizontal alerts lines above the compression and below the compression so that we know when there is a breakout.

The tight compression was breached on heavy volume.

Long green and red candles can also mark horizontal support and resistance levels. They are less common on a daily chart, but when you have them you should watch what happens after they have formed. In general, the long candle forms because the price action in that direction has been very steady. A long green candle indicates steady buying all day long. The SPY opened on its low and closed near its high. A long red candle indicates steady selling pressure. The SPY opened near its high of the day and closed near its low. These long candles lose their relevance quickly and they are used more in analyzing price action during the next few bars.



The open from long green and red candles can also serve as horizontal support and resistance respectively

The open of a long green candle is significant because that was where buyers were excited. They came in and supported the market all day. If that open fails, it is a sign that the buyers at that level have been exhausted and that this horizontal support level has failed. The half-way point of that long green candle is significant, but less so.

The open of a long red candle is significant because that is where sellers were excited. They unloaded the SPY all day. If the market rallies above the open from that long red candle it is a sign that sellers at that level have been exhausted and that this horizontal resistance level has failed. The half-way point that level have been exhausted and that this horizontal resistance level has failed. The half-way point of the long red candle is significant, but less so. It does provide valuable price action information so we will discuss it later in that section.

Conclusion

Horizontal support and resistance levels are important on longer term and shorter term time frames. They are easy to spot, and how the market approaches those levels is more important than the level itself. If resistance is attacked with stacked consecutive long green candles, we are likely to blow through it. If the move from the recent low covers a lot of territory and the candles are mixed and overlapping, resistance is likely to hold. Even if the market breaks through horizontal resistance, we still need to see follow through in the next few bars. That continuation confirms the breakout. Heavy volume on a breakout also legitimizes the move. Price compressions are a sign of equilibrium. Wait for a breakout and confirmation and expect follow through. The longer and tighter the compression, the bigger and more sustained the breakout.

Chapter 5: Volume reveals conviction

Heavy volume moves tell us that the move is legitimate and light volume tells us it can't be trusted.

Almost every technical indicator has two components: price and volume. That alone should tell you how important volume is to our technical analysis. Volume is very easy to analyze and it is either heavy, average or light. It does not require lengthy explanations so it does not get the attention it deserves. Consequently, it is overlooked by novice traders. Let's not make the mistake of glossing over this topic.

VOLUME CONVEYS VERY IMPORTANT INFORMATION AND IT NEEDS TO BE A MAJOR PART OF YOUR TECHNICAL ANALYSIS!

I hope that got your attention. Volume tells us how excited buyers and sellers are. That in turn helps us gauge the strength of a trend. Our goal as traders is to predict price movement and sustained heavy volume helps us to determine direction.

If a manufacturer reduced the price of their product there would be no way to measure the success/failure of the promotion without volume. They wouldn't know if the product is moving or sitting on the shelves. Volume helps them determine the demand for it at that price and how much of it they need to produce. If the product is flying off of the shelves and the line is out the door and around the corner, they can safely predict that this promotion will be successful. We can't assess the quality of a market move without looking at that this promotion will be successful. We can't assess the quality of a market move without looking at volume.

What if there is light volume and no move?

This is common when the market is compressing in a tight range. It is a sign of equilibrium and neither side has an advantage. At some point a news item will spark a breakout one way or the other. Set alerts above and below the compression and wait. Since there is light volume, the trading range could last a long time.

What if there is heavy volume and no move?

This is a good scenario. The heavy volume indicates that buyers and sellers are interested. Shortly, one side or the other will prevail and that breakout is likely to have follow through ("legs"). On the breakout, the losing side will scramble to adjust and the winning side will add to positions. The breakout on volume will hit everyone's radar and the frenzy is on! Custom Search in Option Stalker Pro will find stocks with heavy volume that are in a compression. Set your alerts above and below the compression and wait for the breakout.

Why do light volume rallies happen?

We often see light volume rallies at the end of a long term uptrend. Because the trend is strong, sellers are extremely passive and they are holding out for a higher price. Even a small buyer can drive the price higher. Imagine this attitude on the part of the seller, "If you want it, come and get it at this nice high price. If you are not interested at that level, I will just hang on to it." This is what we call a sellers boycott. They are simply not interested in selling unless they get what they consider to be a premium. At that high price, buyers are not willing to load up so the volume remains light. A light volume spike to a new high could be a buying climax so pay attention to those because a drop is likely very soon. Of course, a light volume trend lower in a bear market would indicate that buyers are not interested. They are expecting lower prices and they will wait for signs of support. This is a "buyer boycott" and it can be characterized by this attitude, "If you are that anxious to sell, come and get me all the way down here."

Why do light volume bounces happen?

When we refer to a "bounce", it suggests that the rebound is temporary and that the longer term down trend will prevail. Most traders don't understand bounces. "Why is anyone buying this crap when the market is clearly going down?" The market does not go straight up or straight down. At some point during a big decline, short sellers will start taking profits. That buying provides support and other short sellers will also start to take gains. This will cause a bounce. Institutions are always "testing the water" and they can spark short term bounces as well. They will try to spark short covering to shake traders out of positions. Remember, short sellers are looking for signs of support because they are eager to take gains. The institutions are more interested in the magnitude and the duration of the bounce. They are constantly trying to gauge how aggressive buyers and sellers are and they watch volume very closely. A brief and shallow light volume bounce that only lasts six bars will tell them that the selling pressure is heavy. The institutions will exit what they bought and short even more. They don't care if they lost money trying to spark a bounce because that will provide them with important information. Chances are, if the longer term trend is down, they have huge short positions. If the bounce has good height and big volume, there is a likelihood that it could last a long time. In that event, they will start reducing longer term short positions. The same principles I've described would apply to light volume dips in the context of a longer term up trend.

Does a light volume rally mean sell short?

Absolutely not! Light volume in and of itself does not constitute a trading opportunity. These moves can continue for long periods of time and they can inflict incredible pain if you are early. Sometimes, the volume will increase during the move and it will transition into a legitimate trend.

How should we swing trade heavy volume declines?

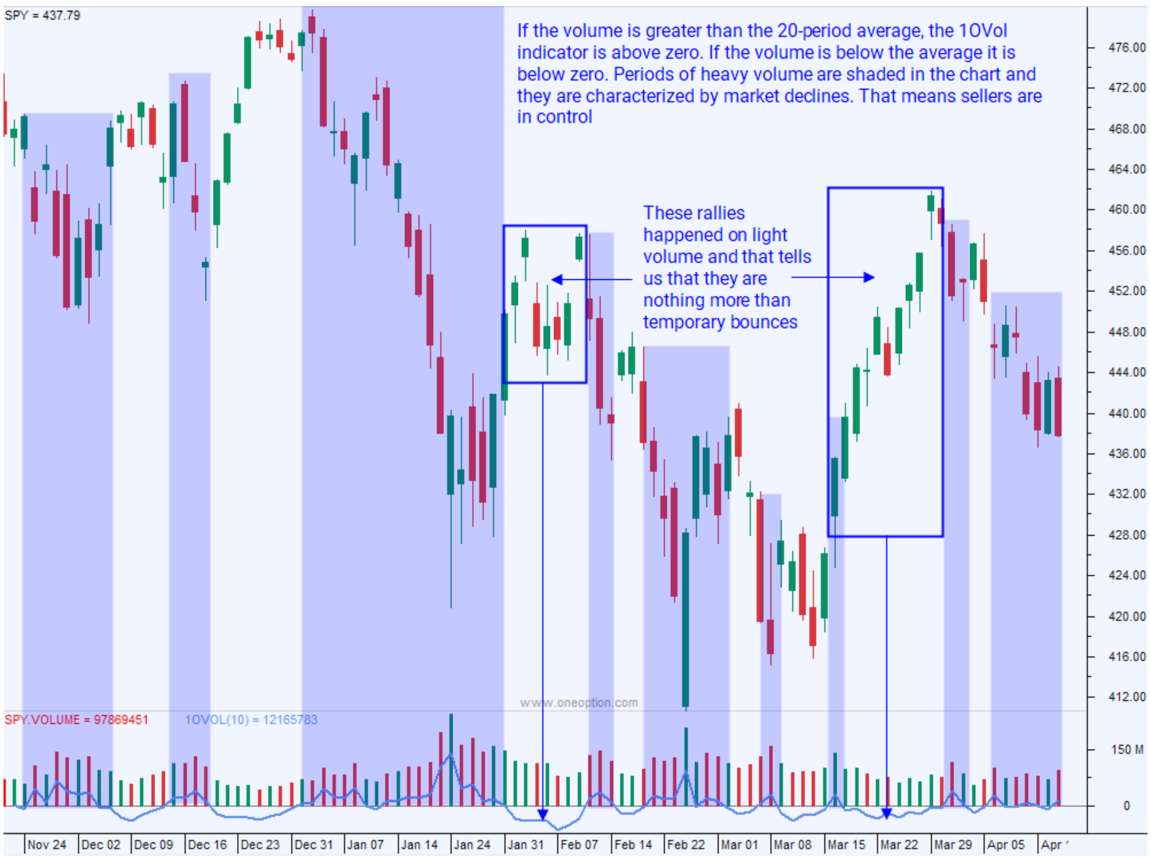
If the market is in a long term down trend it will be confirmed by heavy volume. Your objective is to short bounces when they stall and break technical support. Take gains during big drops and go to cash. Repeat. During bounces you can evaluate the magnitude of the bounce and the volume. If the height of the bounce recaptures much of the recent decline (rally above the open from a previous long red candle) and if it comes on heavy volume, it is likely to last a while. If the move starts to gain traction, you can join it with small size (relative to your recent short positions) and know that this is going to be a short term trade. Be ready to take gains at the first sign of trouble and be ready to go short on a technical breakdown. For most swing traders who can't watch the market during the day, I would discourage this tactic. You are "getting cute" and trading against the longer term down trend. When the bounce reverses you will be scrambling to exit longs instead of focusing on entering short positions. If the bounce is shallow and the volume is light, it is not likely to last long. That would be a sign that sellers are still nearby and you might need to re-establish your short position quickly. Watch for these tiny bounces when the momentum is very strong (stacked red candles) and try to stick with the short position. That price action tells us that sellers are very aggressive. Use these same concepts (in reverse) during heavy volume long term up trends. In a strong up trend, swing traders want to "buy dips and sell rips".

How long can light volume moves last?

The Fed printed money like mad after the 2008-2009 financial crisis and credit risk was low for a decade. Bond yields were near 0% and investors had to stay in equities to generate a return. Corporations were issuing cheap debt and using the proceeds to buy back shares. These forces kept a very strong bid to the market and the dips were brief and shallow. The end result was a very light volume rally that lasted for nearly a decade. Don't discount the longevity of light volume moves. Draw your trendlines and wait for those technical breaches.

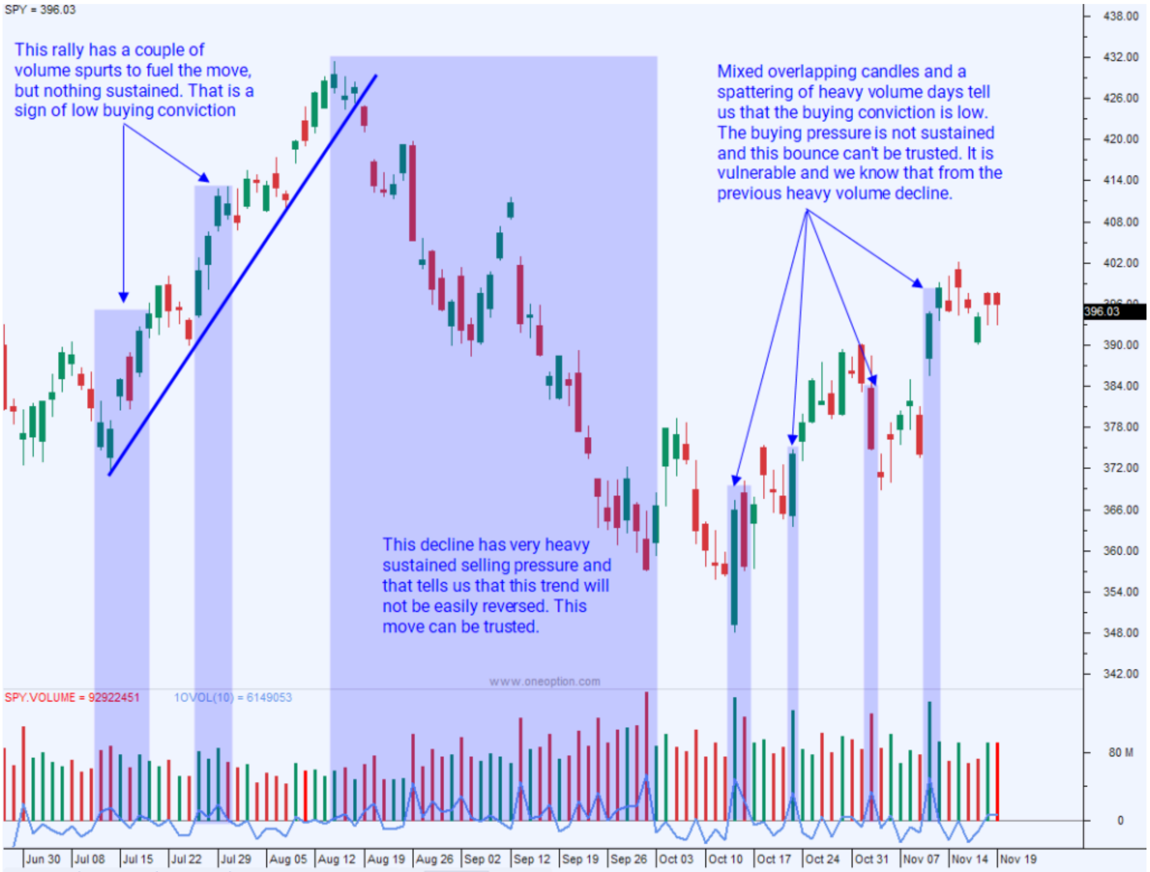
So let's take a look at the volume during the last year and how it helped us to determine which side to be on. The context of the chart below is that the market was in a VERY strong two-year up trend and that it was

The context of the chart below is that the market was in a VERY strong two -year up trend and that it was starting to transition to a bear market. To this point, the dips were brief and shallow. Notice how the drops came on heavy volume and the rallies came on light volume. Initially, the bounces had nice height. Long term bull markets die hard because buyers are still trained to buy dips. 1OVol is our proprietary indicator. If it is above zero, the volume is greater than the 20-period average. If it is below zero, it is below average. When the market bounced in the chart below, the heavy volume only lasted a day or two. When the market dropped, the volume was heavy for many days in a row. This tells us that sellers are in control and to favor the short side. The blue boxes highlighted bounces. Notice how light the volume was. Once the D1 up trendlines were breached, the bottom fell out quickly and the volume spiked.



Heavy volume is a sign of conviction and it helps us to predict direction.

At this stage, traders are starting to respect the trend reversal from bullish to bearish. They can see that the heavy volume from the first half of the year is happening on the drops. They also noticed that the market was making lower highs and lower lows. The rally at the beginning of the chart took place on light volume. There were only a few days where it spiked. The bounce lasted for a month and it had good height. Traders that tried to stick with short positions took extreme "heat". Some did not expect the bounce to last so long or to bounce so high so they exited short positions. That probably extended the life of the bounce. When that up trendline was breached, the selling pressure was fast and furious and the S&P 500 lost almost 1000 points (large shaded blue area). In the last two months the market has staged another light volume rally. Notice how there are only a few heavy volume days within this move. There are also mixed overlapping candles and that is a sign of weak trend strength. Swing traders should be in cash waiting for the up trendline to be breached. Seasonal strength could fuel the move into year-end. Don't be early with short positions, but know that a nasty drop is looming.



Notice how the rallies only have a spattering of heavy volume days and now the drops have consistent heavy volume for many days.

Volume is so easy to analyze that there are not many articles written about it. It is either heavy, average or light. Don't discount the importance of volume just because it does not get the same attention as price action. Start your analysis with volume and make it a priority. That's how important it is. Volume tells you how aggressive buyers and sellers are at a particular price level and it will help you to gauge direction. With regards to position sizing, you want to ramp up when you are trading in the direction of a long term trend with heavy volume. During light volume contra trend moves you want to be in cash or in very small positions.

Chapter 6.1: Price action - Introduction

How we get from point A to point B matters. It provides us with context.

There are an incredible number of technical indicators that measure price and volume, but there is nothing as “pure” as being able to read price action. Indicators are based on a theory and they require computation. It is critically important to understand the theory behind the indicator and to have faith in it. Without trust, an indicator is worthless. That trust is established over time and with extensive testing. Many indicators work well in certain situations and they do not perform well in others. Often, the variables for the indicator need to be adjusted to suit a trader’s style or to adapt to changing market conditions. Rule bases need to be established to improve signal reliability. All indicators require historical data and consequently they are backwards looking. Learn how to read price action and you will not have these issues.

Each candlestick is a paragraph with its own supply and demand message. When candlesticks are combined, they teach a lesson, much like a chapter in textbook. When you finish reading the book, you understand the relevance of each chapter and you are ready to apply what you have learned. Reading price action requires practice. The same concepts apply to longer term charts and shorter term charts and you do not have to understand variables, calculations or limitations like you do for indicators. The last candlestick has meaning. It tells you if the storyline is continuing on the same path or if it is changing. That makes this method of technical analysis current. Throughout my career I have studied and used many indicators. I have even developed my own (1OP). I have not found any indicator that predicts price movement as well as being able to read price action.

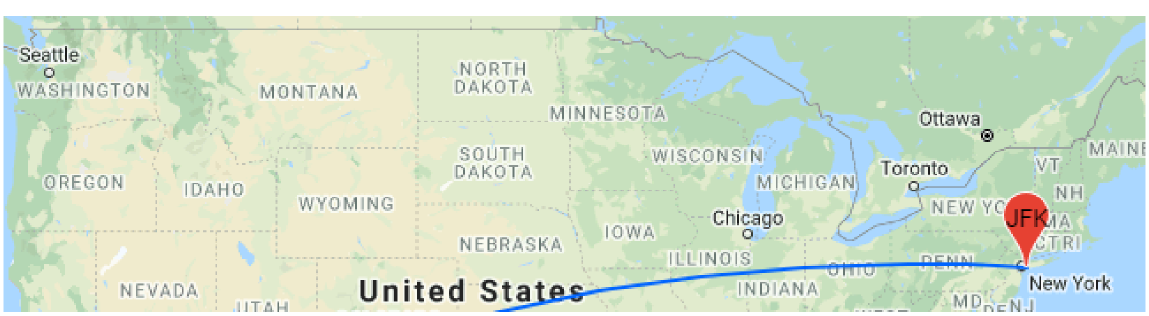
I am going to cover this concept in great detail and it will be one of the longer educational sections in The System. There are some nuances for very short-term trading using five minute charts and I will cover them extensively in that section. Let’s start with longer term analysis of SPY and I will show you how we can read price action to help us determine market direction.

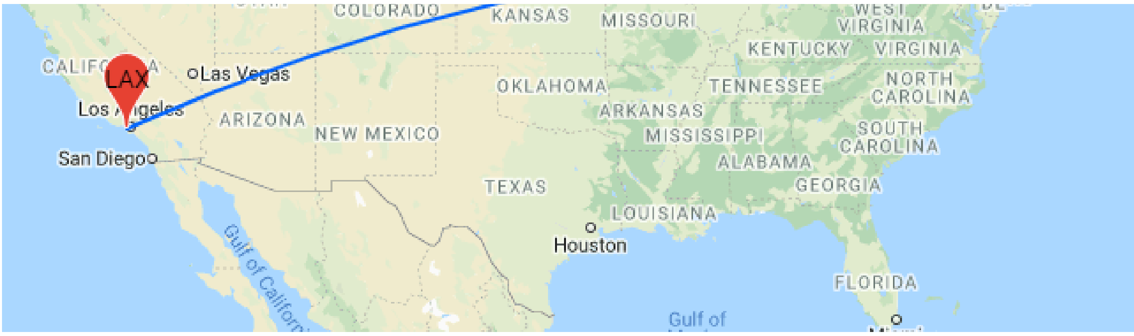
Chapter 6.2: Price Action - Your Market Roadmap

How we get from point A to point B helps us determine where point C is and how we will get there.

Price action describes the journey from point A to point B. Did we take a high speed jet in a straight line or did we take a motorhome with many side trips along the way? Many traders get hypnosis when they look at charts and all they see are random green and red rectangles. I hope that this metaphor gets you in the right mindset because learning how to read price action is critically important. This skill will replace most, if not all, of the technical indicators you use. Our goal is to put the current price action into the longer term context so that we can predict how long it will take us to get to point C and how we will get there. In some cases we will deduce that we can't predict where point C is, and that is also useful information.

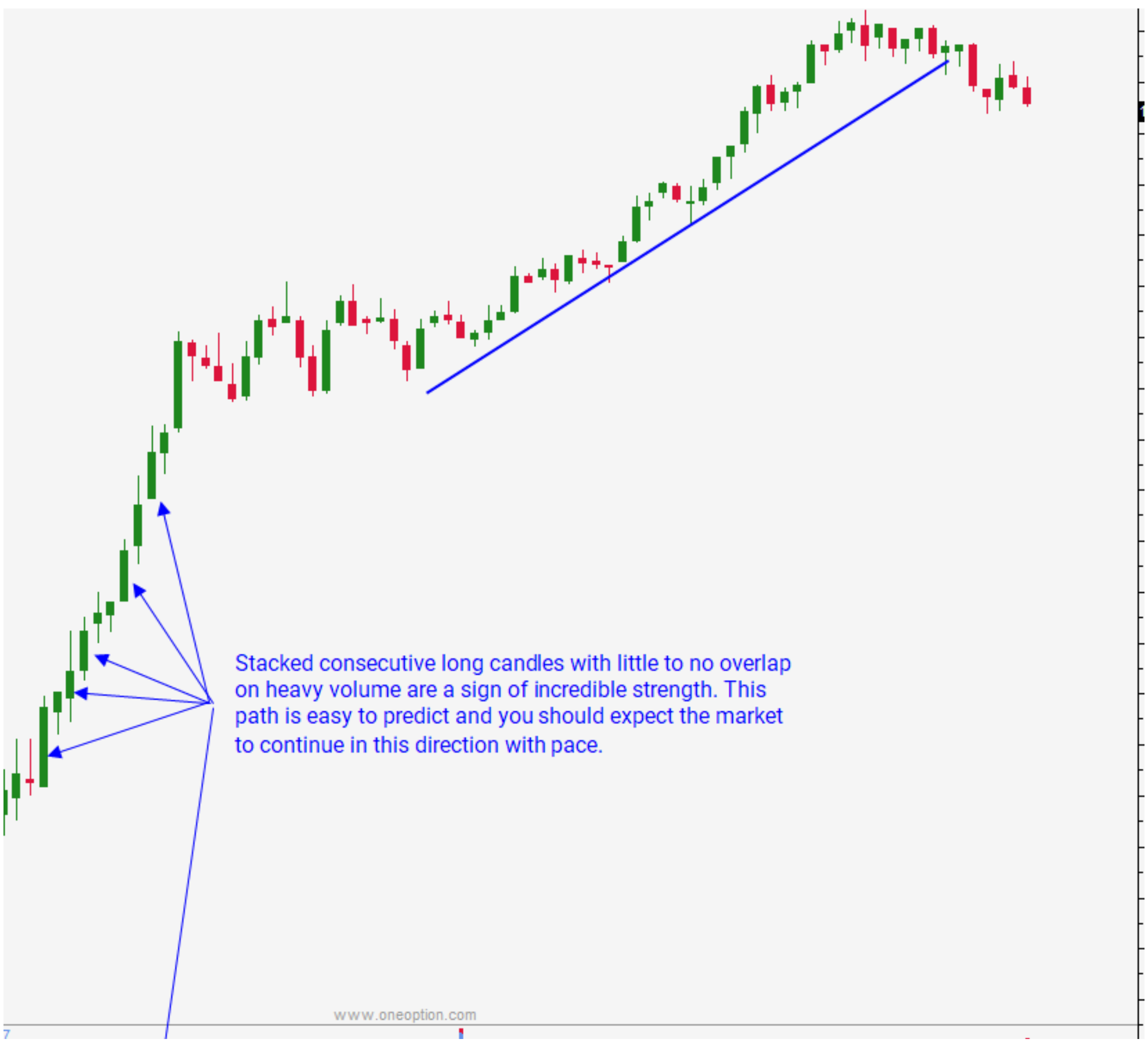
If I am observing a journey from LA to Chicago that started a few hours ago, I would deduce that we are probably in a jet because the path is direct and there is only one mode of transportation that could get us there that quickly. If the last stretch of the journey to Chicago took place at the same speed, I would be able to continue that straight line and predict possible destinations with a high degree of accuracy. When the speed between two points starts to decelerate and we lose altitude we could be getting close to the end of the journey. In the case below, the flight might be headed towards New York.

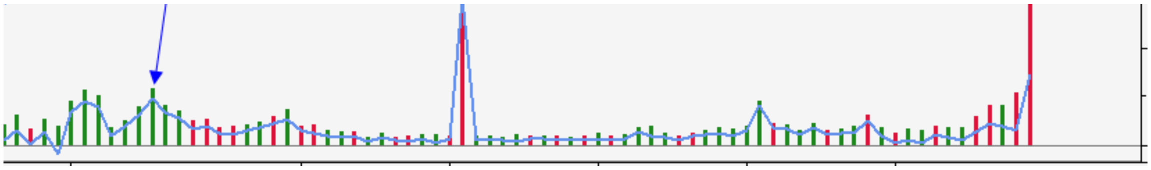




The velocity and path of this journey make it easier for us to project possible destinations.

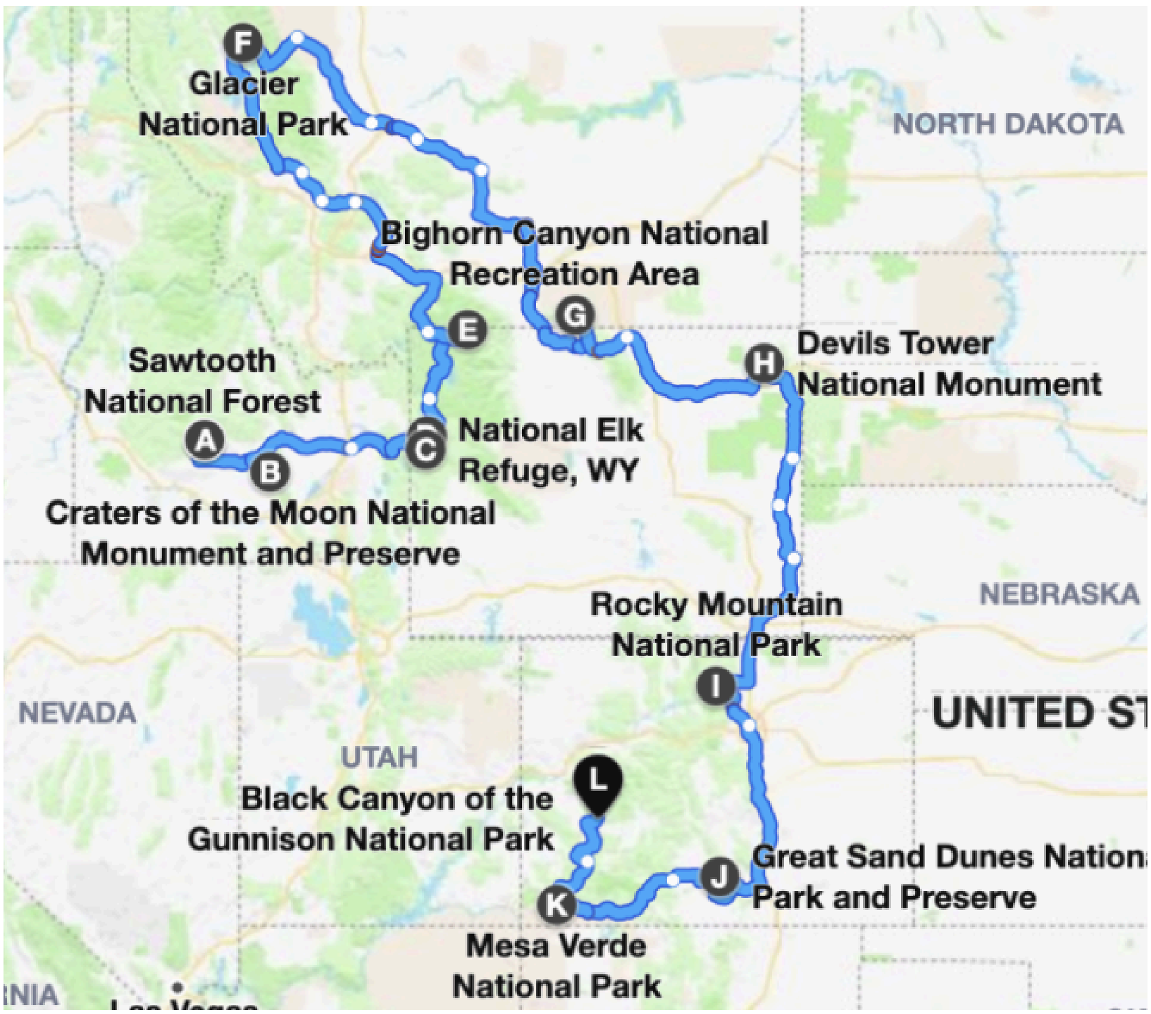
For the sake of simplicity, I will only be referencing bullish price action, but the same principles apply to bearish trades. A stock that makes the journey above would have long green candles stacked consecutively with little to no overlap. That is the fastest and most direct way to get from point A to point B. The volume and momentum tell us that we are traveling at a high altitude. Jets (and stocks with this pattern) don't depart from their path and that makes it easier for us to predict direction. This pattern of stacked consecutive candles with little to no overlap is powerful and this formation typically leads to a sustained move.





Stacked candles of a single color with little to no overlap on heavy volume signal strong momentum

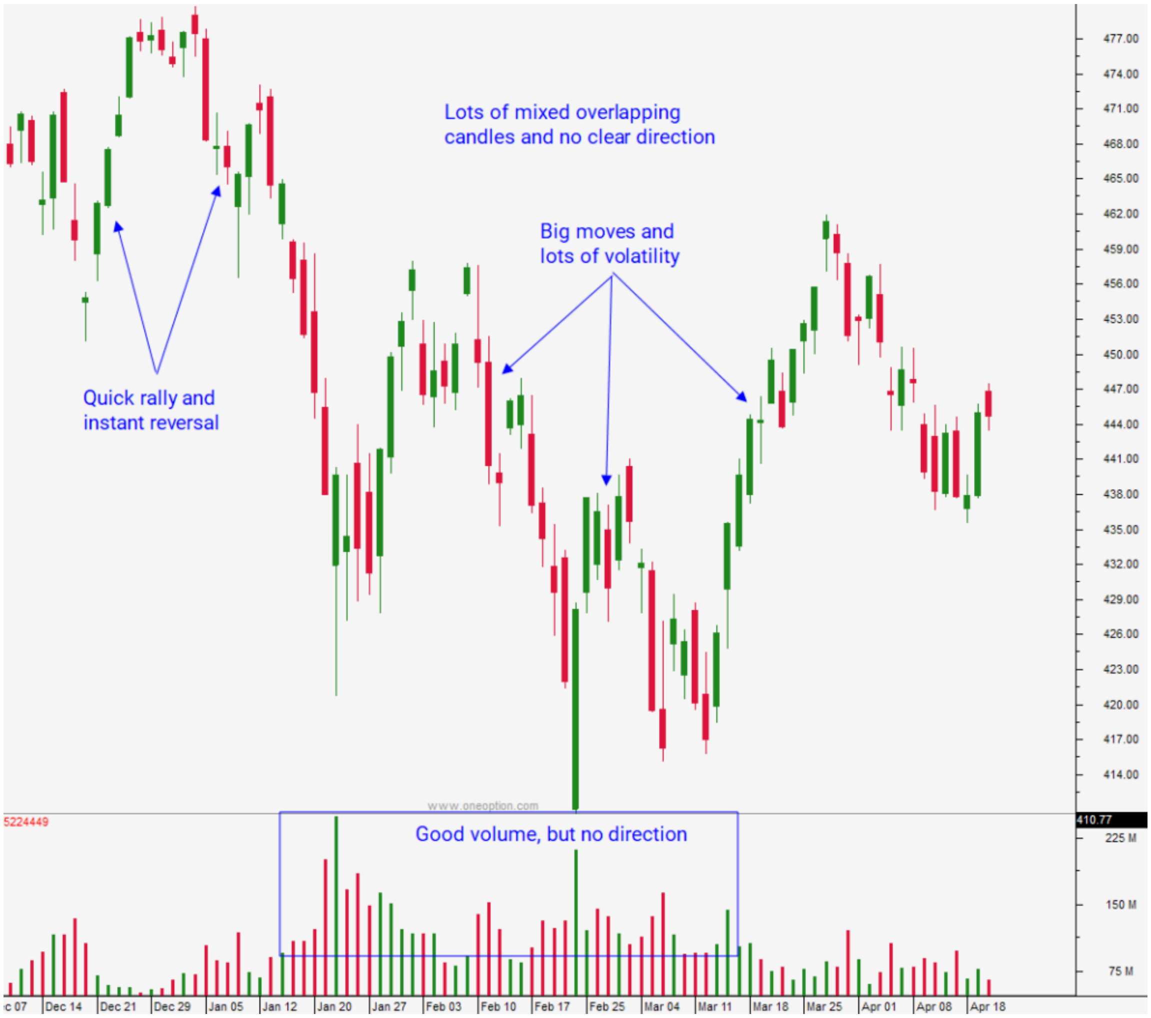
If I am observing a different journey from Sawtooth (A) to Devil's Tower (H), I notice that the speed is much slower and that there have been a number of right angle turns. I might deduce that this is ground travel, but the direction from point H is uncertain. Our job is to predict the next destination in a journey with accuracy. I can't do that with any degree of certainty, so I would take a pass.



It would be very difficult to predict the next destination for this journey

If we found a similar journey for the SPY, it might look like the chart below. You would see mixed green and red candles with lots of retracement and low volume. There is no directional momentum and it is very difficult to predict where the SPY is going to go next. That means we should tread very cautiously. There may be short periods of time in this journey where we can predict the movement.

but we had better not overstay our welcome.



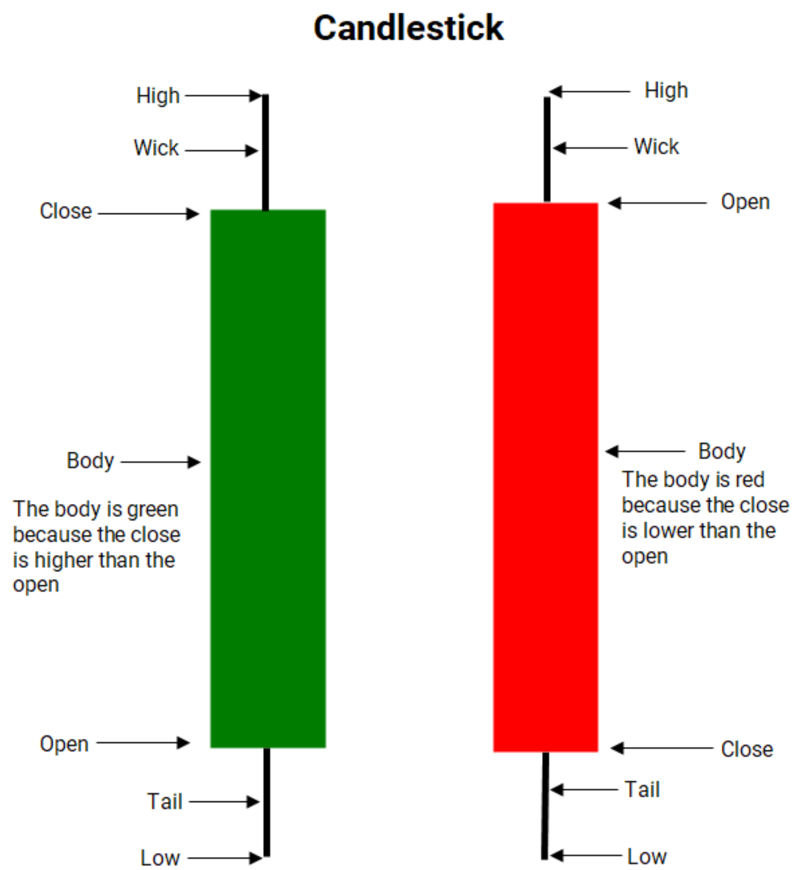
The price action is very random with big moves in both directions of equal speed and magnitude.

The goal for this article was to change your mindset. Stop looking at the candles as green and red rectangles and start looking at them as a roadmap. The travel pattern that got you to this point is likely to continue and it will determine our ability to predict the next leg of the journey. We want nice tight, orderly price action because that tells us that institutions are active. This pattern makes it easy for us to predict future price movement. We can’t predict the flight of a bat and we don’t even try to because we’ve been able to observe it. On the other hand, we can predict the flight of a flock of geese in a tight “V” formation. That is what we search for.

Chapter 6.3: Price Action - What Is The Candle Telling Us

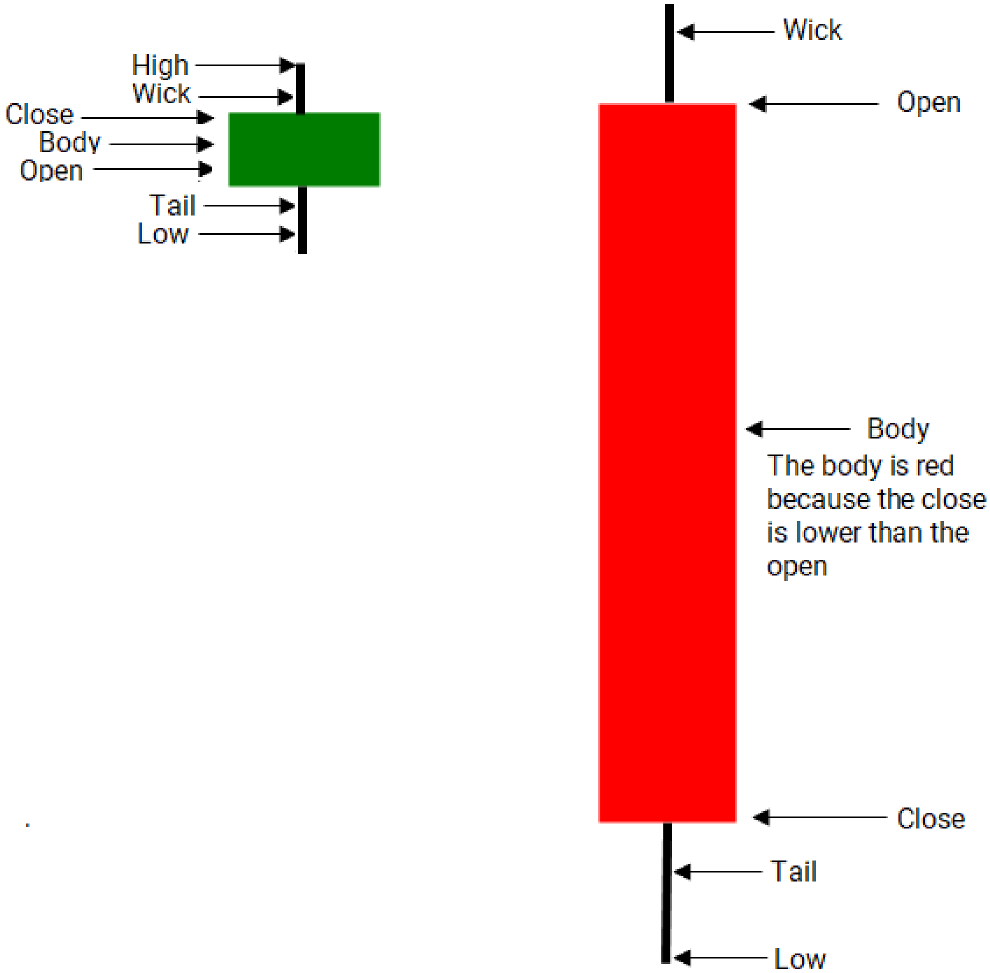
There is important supply and demand information within each candle.

In this article I want to start with some basic concepts. It is much more important to understand the message from each candle than it is to memorize the names of patterns like 3 Crows Flying, Spinning Tops or Abandoned Baby. The chart below will help us understand the basics.



Green candles close higher than the open and red candles close lower than the open.

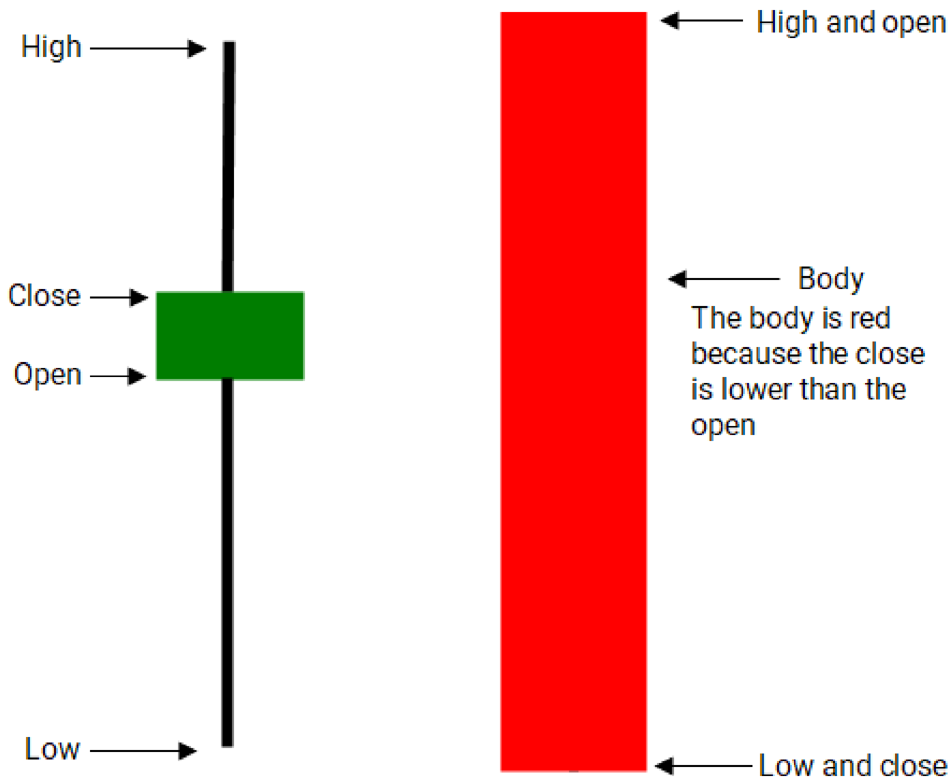
The diagram above is just a couple of colored rectangles to the untrained eye. The open of the candle is the opening price. If the candle closes higher than the open it is green and if the candle closes lower it is red. The key elements to each individual candle are the length of the body and the length of the tails (below the body) and wicks (above the body).



The length of the body and the tails/wicks provide valuable information.

Let's suppose that the green candle above has the smallest possible body and virtually no tail or wick. A candle with a very tiny body is called a doji. What might a candle like that be telling us? It is a sign that buyers and sellers are in equilibrium. They are paired off and neither side has an advantage. When you see a group of tiny bodied candles consecutively, it is a compression. A breakout from the compression could go either way. The candle on the right in the image above has a relatively long body and it is red. What might it be telling us? At the start of the candle sellers took control. They overpowered buyers and they kept driving the price down. The candle almost closed on its low and that is bearish. How do we distinguish a body that is long, medium or short? We can look at the previous 30 candles and judge them on a relative basis or we can compare the length to the 20-period average ATR (average true range). If the body of the candle is greater than the 20-period ATR I would consider it to be long. Typically, long candles stick out like a sore thumb on a chart. Long bodied candles are important because they reveal that buyers (if green) or sellers (if red) are clearly in control.

Candlestick Tails/Wicks



Long tails and wicks are a sign of volatility and indecision. Long bodied candles with no tails or wicks are a sign of strong directional movement.

The length of the tails (under the body) and wicks (above the body) are also very important. In the case of long tails, sellers were able to drive the price down, but buyers scooped up shares at that level and the stock finished well off of the low for the bar. The opposite is true of long wicks. Buyers were driving the price higher, but at those levels sellers were engaged and they drove the price back down. The stock closed well off of its high for that bar. The left candle in the image above tells us that there is uncertainty and buyers and sellers are battling it out. If the range (high minus low) is greater than the 20-period ATR it tells us that the stock was all over the board. It closed in the middle of the range and we can expect volatility until one side or the other has an upper hand. In the diagram above, the candle on the right has no wick or tail. What does that tell us? If it was a tiny bodied candle, it would be a sign that there was not much of an influence either way. The stock did not move much from start to finish. If that candle body was long relative to other candles, it provides a clear message. The body of the candle is red in this case and it tells us that sellers were in complete control. From the start of the candle to the end if it, they kept hammering bids and the stock was not able to come up for air (no tail). If this candle also had heavy volume you would look for follow through selling in subsequent candles.

Now that we understand the basics for individual candles, we will look at groups of candles in the next article.

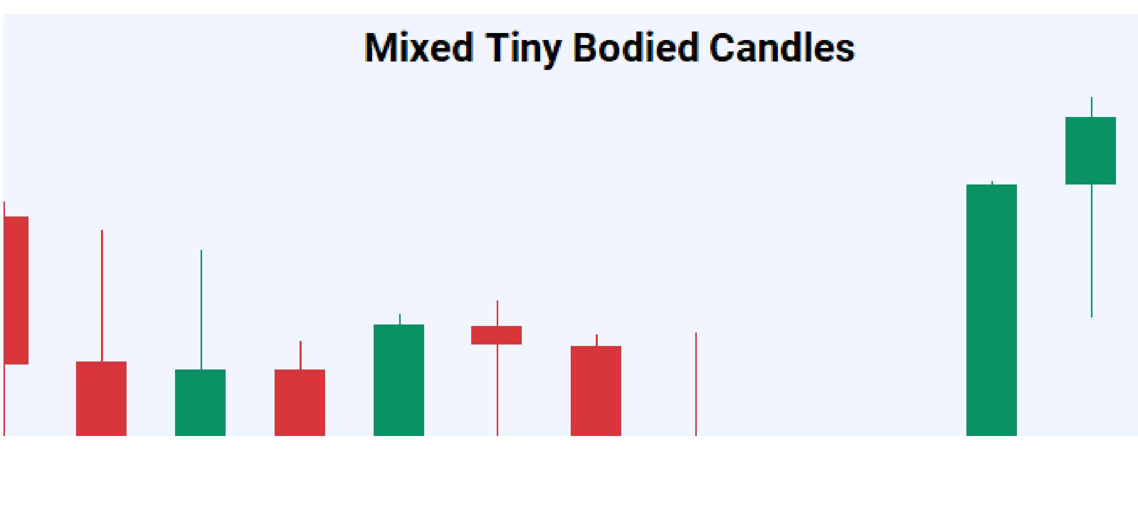
Chapter 6.4: Price Action - Groups Of Candles Make Patterns

Small groups of candles tell us a lot about trend strength and momentum. We will focus on them and then we will see them in common technical patters.

In the previous article, we discussed the information that we can gather from individual candles. Now let's consider what a group of a candles together might tell us.

Mixed Tiny Bodied Candles

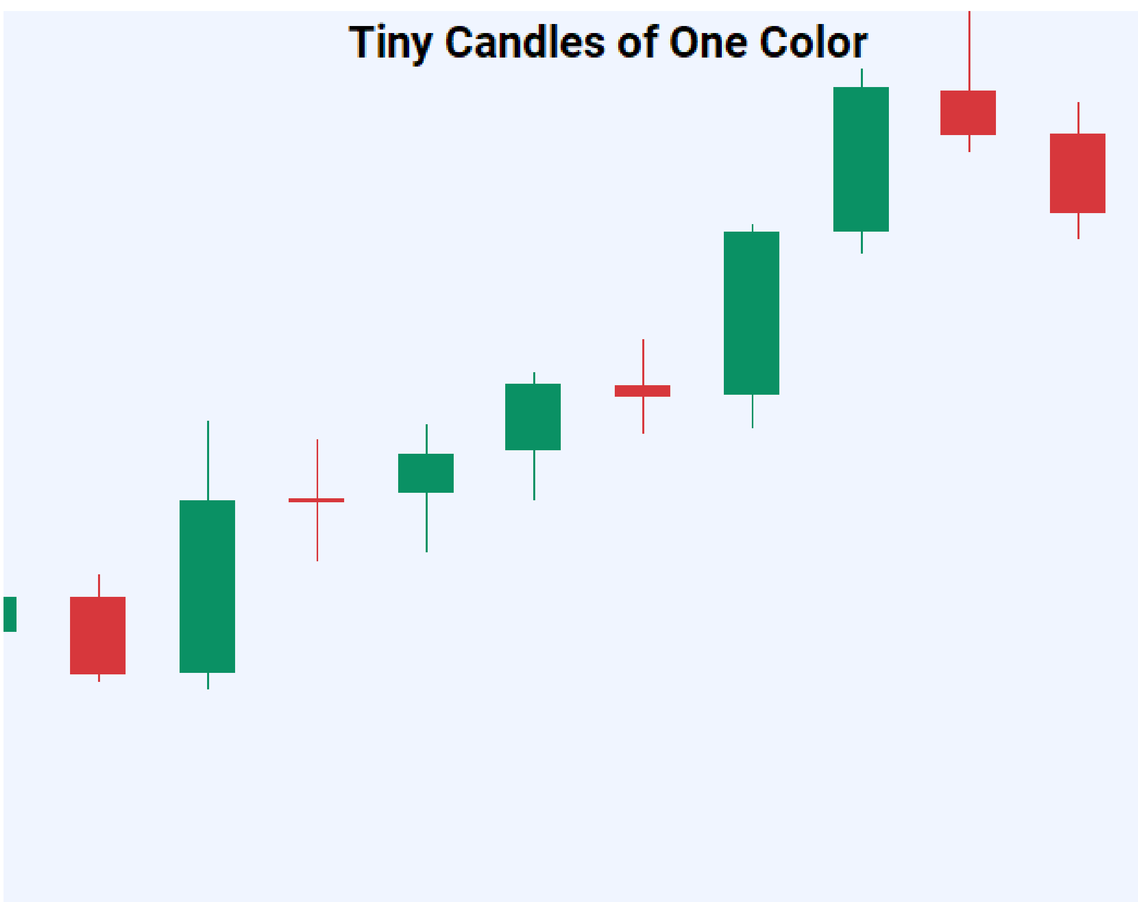
Consecutive tiny bodied mixed candles are a sign of weak trend strength. Even if the market has a gradual directional bias, these candles indicate that neither side has conviction. After a strong trend, this pattern will be a sign that the momentum is waning and it might be prudent to take partial gains on positions. In the example below, the market had been trending lower. The green candles are erasing (overlapping) the red candles and that tells us sellers are losing control.



In general, tiny bodied mixed candles are a sign that the trend is weak. If they surface after a big move, it could indicate a reversal is near.

Tiny Candles of One Color

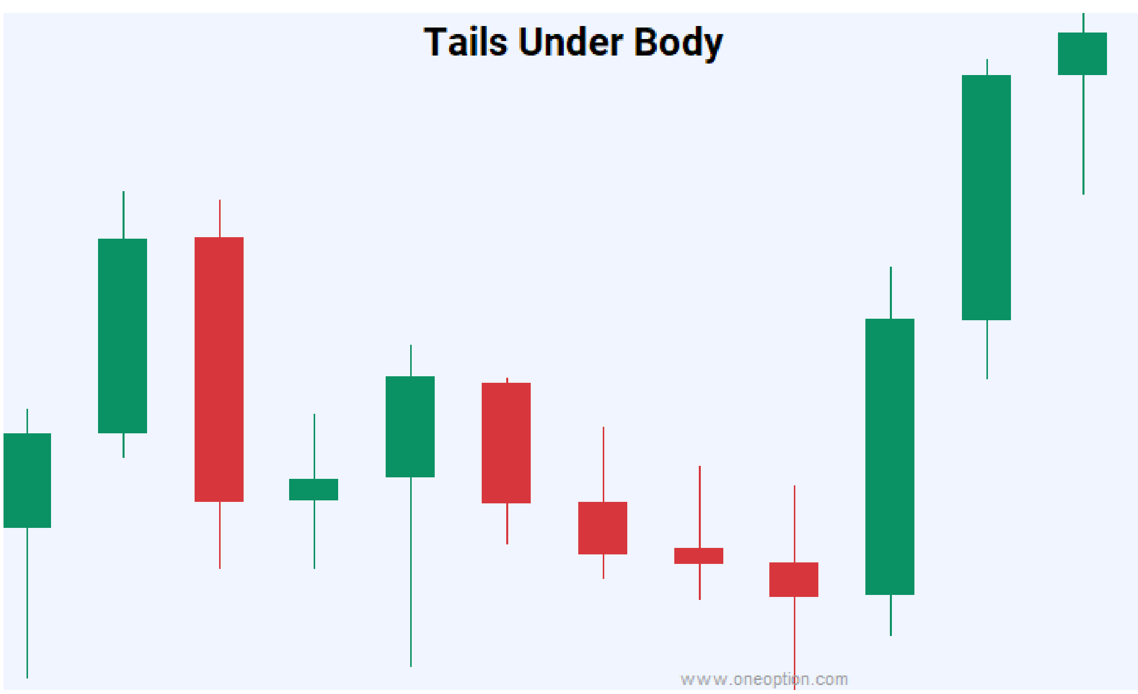
If the candles are tiny and of a single color, the trend can continue, but traders need to tread cautiously. In the example below, we are seeing green candles and some dojis. This grind higher is on borrowed time. If sellers were not engaged, the candles will be tall and there would not be any resistance. Since they are small, we know that sellers are close at hand. The other “tell” is volume. Buyers have a very low level of conviction in this instance. If they were aggressively buying we would see heavy volume. If you see long green candles at the end of this pattern that are instantly reversed by red candles, the move is exhausted and a reversal is possible. Typically, a move of this nature will transition into a sideways range where we see mixed candles. The candles are small so we know that neither side is overly aggressive and that is why this pattern usually ends in a horizontal trading range.



Tiny bodied candles of a single color are often seen at the tail end of a move.

Tails Under Body

When we see long tails under body after a big drop, it is a sign of support. Conversely, long wicks above the body after a big rally would signal resistance. The chart below happened at the end of a big market drop. Sellers continued to pound bids, but buyers were interested. They scooped up shares at that price and it was a sign that support was forming. After a big market drop, you need to be very cautious buying dips just because you see tails under body. The magnitude of the drop is a sign of heavy selling and you need to respect it. Make sure a base forms. Often it is best to wait for a bounce and a retest of that support before buying. We want that higher low double bottom after heavy selling. If the drop was relatively small (dip), the tails under body could provide a good entry point, especially if the longer-term trend is up.

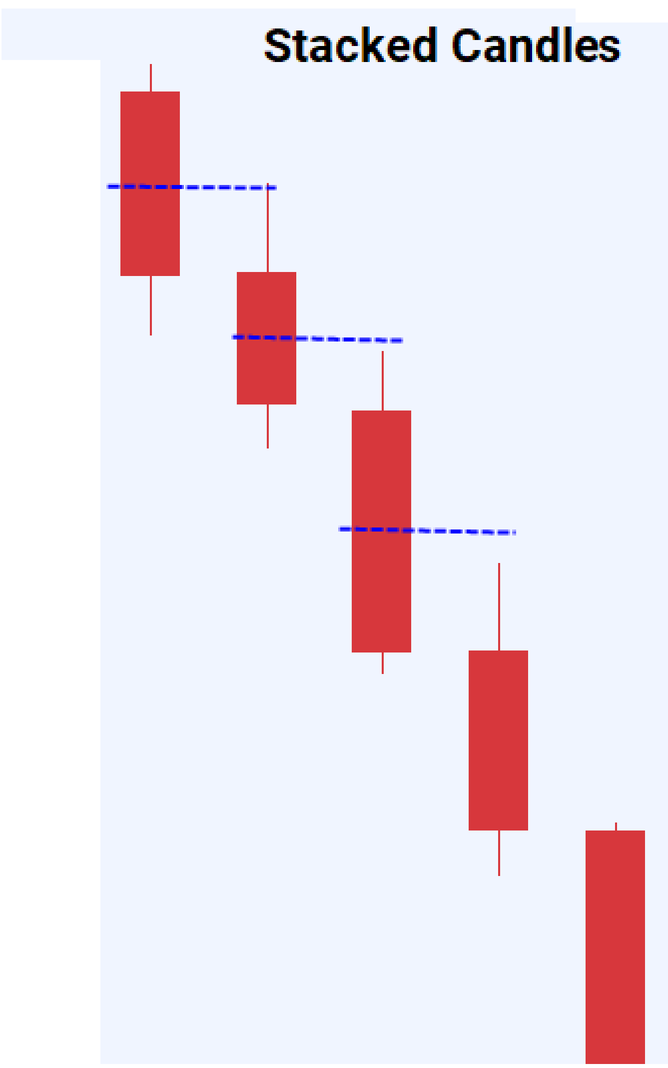


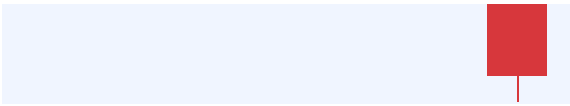
Tails under body are a sign of support. Sellers are not able to drive the stock lower and the candles do

Tails under body are a sign of support. Sellers are not able to drive the stock lower and the candles do not close on the low.

Stacked Candles

Stacked consecutive candles of a single color with little to no overlap on heavy volume are incredibly powerful. This is a sign that the trend strength is extreme and you should expect follow through in that direction. In the chart below you can see how the candles do retrace. The wick of the second candle goes into the body of the first candle. In general, we want the half-way point preserved. That shows that sellers have layered offers higher up and they are eager to short any bounce. When they can't get filled at the higher price they lower their offers. Consequently, the previous candle is not completely retraced. This is a sign of strong selling pressure. In the chart below you can see how all of those half-way points are preserved. If one of the candles gapped up on the open above the close of the prior candle we would have overlap. That is acceptable, but not ideal because it does show that there is some buying pressure. Imagine that there are no wicks or tails in the chart below. That is the ideal pattern. Sellers are so aggressive that the candles never retrace. They are hitting every bid in sight and they are clearly in control. In general, when we have a long red candle, we want all of it preserved with very little retracement. The same rules would apply to stacked green candles and they are equally powerful.



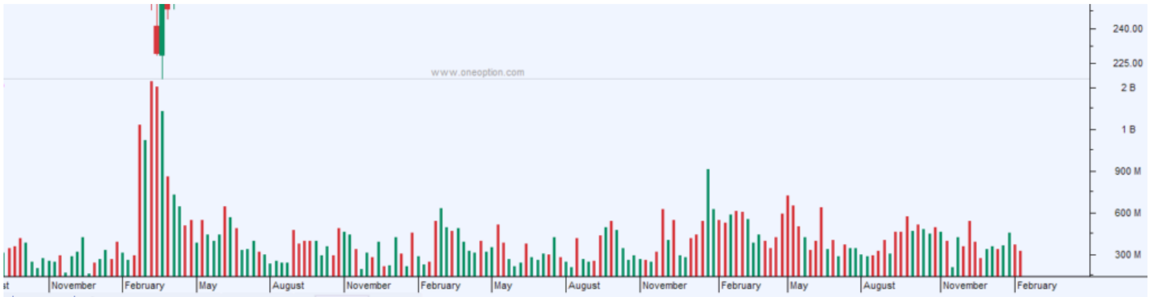


Consecutive long bodied candles of a single color with little overlap or retracement on heavy volume are extremely powerful and you should expect continuation in that direction.

Longer-term groups of candles form patterns. My intent is not to write a book on these patterns. If I see them, they are of interest to me and can spot them on a chart, but I don’t go looking for them. These are some of the more common ones you will see.

Double Tops & Bottoms

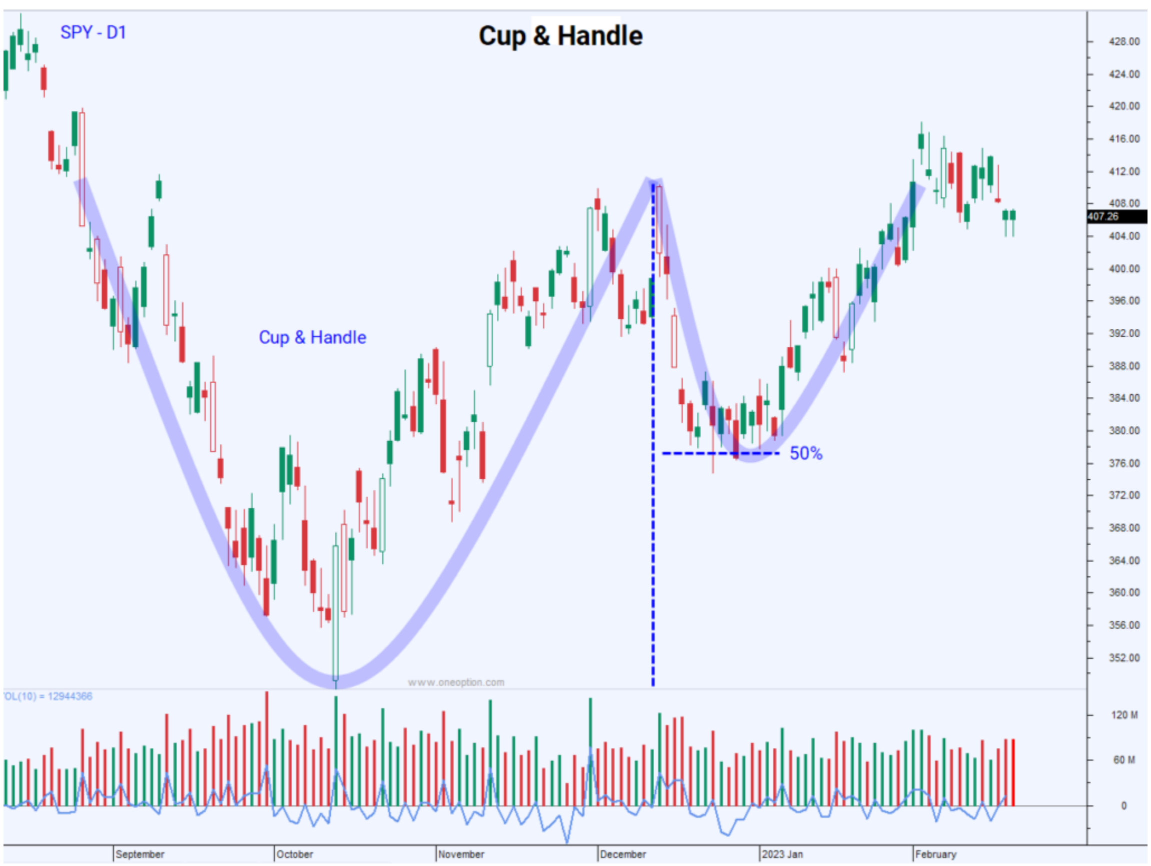
Double Tops and Double Bottoms are significant technical patterns because they are a sign of trend exhaustion. In the chart below you can see that the SPY peaks and it drops. Dips are a normal part of any up trend and the market tries to recover and to resume the rally. In this instance it can’t get back to the peak and it makes a lower high double top. This is more significant to me than a double top where the SPY was able to get back to the previous high. The fact that it did not hit resistance earlier tells me that sellers are not as aggressive. A lower high is formed because sellers are so anxious that they don’t believe the market will get back to the old high so they start selling before it gets there. You can see how the selling pressure builds and this is the start of a bear market. In the far right side you can see a higher low double bottom. From the low, the market is able to bounce. That is normal in a down trend. However, when sellers try to drive the market down, buyers surface. Again, I prefer a higher low double bottom to a double bottom because it tells me that buyers are super aggressive. They do not believe they will have a chance to buy at the low so they start bidding before it even gets there. When a double low forms, buyers are not as aggressive and sellers are able to push the market back down to that old low. In the chart you will also notice a Head & Shoulders and an Inverted Head & Shoulders pattern. Those don’t interest me much because it is the lower high double top and the higher low double bottom portion of that pattern I am focusing on.



Lower high double tops are more bearish than double tops. Higher low double bottoms are more bullish than double bottoms.

Cup & Handle

Cup & Handle formations are another form of a double bottom higher low. The inverse pattern would also be of interest and it would be a bearish pattern. Technicians get all excited when these patterns conform perfectly. The base of the handle needs to represent a 50% retracement. From my perspective, it does not matter. This is a higher low double bottom, or a lower high double top if it is upside down. Don't get too carried away with these names, just know that these are signs of a new trend and that a breakout through horizontal resistance (horizontal support if it is upside down) is likely. That breakout above the lip and handle is bullish and that will start the next leg higher.



A Cup & Handle is just a fancy label for a double bottom higher low. It is bullish because sellers were not able to drive the price back down to the low. Buyers showed interest way before that and they are not able to drive the price back down to the low. Buyers showed interest way before that and they are aggressive. A horizontal breakout will lead to the next leg higher.

Bullish Flag

Bullish flag formations are powerful. They involve trendline analysis, so please make sure to read that article. The long-term trend is up and "the trend is our friend." Dips are common during an uptrend. We are looking for short-term down trends in the context of a longer-term up trend. During the dip, we do not assume that this is a bull flag, we wait for technical confirmation. For all we know, this might be more than a dip and the trend could be reversing. When these shorter-term down trendlines are breached, we have an excellent entry point to join the longer-term up trend. The key is to have a really steady flag pole (upward sloping longer-term trend). If the flag pole is wimpy (mixed overlapping candles on light volume), we have to be suspicious of the bullish flag. If the flag pole features stacked green candles on heavy volume with multiple technical breakouts along the way, the dip is more likely to be just that… a dip. That means that the High- breach will be a good buying opportunity. Can you spot any other good bull flags in the chart below? At very least, we would expect the breakout to challenge the recent high. If we quickly blow through that prior high, we should expect that the next leg of the move higher is going to begin. If the move to the previous high has mixed tiny candles, a gradual drift higher and light volume, it is struggling to make a new high. That is a sign of resistance and we need to take profits near that high. Knowing that a retest of the high is likely for a bull flag, allows us to quantify how far the stock is likely to move (at minimum) and we can use that information to structure our options trade.

The flag pole (up trend) is the key to this pattern. It needs to be strong with great momentum and stacked "greens". That is a sign of aggressive buying. The pullback from the high should be brief, shallow and unorganized (no long (reds"). All of these increase the odds that the High- breakout will be a good one.

Bearish Flag

In the chart below, we have a Bear Flag. Consistent with what I just described for a bull flag, we need a sturdy flag pole. In this case, the SPY had dropped 20% in a few months with long red Key Bars. The market does not go straight down or straight up. We have the makings for a decent set up. Notice how the market drops to the low and then we start seeing tails? This is a sign of support and if you are short, you should be taking gains on shorts. There are 3 stacked green candles off of the low and this looks great – right? If those were the only bars we could see, yes. After a 20% market drop (rare) we should expect some short covering (profit taking). This is not nearly enough evidence for me and I am not going to stand in front of this freight train. That is as far as the bounce gets and the SPY starts to compress in a tight range with mixed candles. This is a sign of resistance. That red Key Bar that breaches the Low+ trendline is exactly the way we want to attack trendlines. Strong flag pole, wimpy bounce and an attack on the contra trendline. Those are the keys to a good bear flag. If we have a weak flag pole (wimpy down trend), and an organized bounce off of the low that takes a long time to reverse, we have a weak set up and any attempt to retest the low is likely to turn into a higher low double bottom.

Your best bear flag formations will have a strong flag pole (down trend), a brief and shallow bounce and an assault on the Low+ trendline.

Wedge

A wedge forms when High- and Low+ trendlines converge. When the slope and the duration of both trendlines is equal, the wedge is balanced. As with all trendlines, if the wedge trendlines are very steep, the breakouts are less meaningful. These can easily be breached both ways and the market is extremely volatile. That volatility will subside and eventually a more meaningful wedge will form. It will be a longer-term wedge and it is likely to compress around the mid-point. This is a compression. Buyers and sellers are active and one side will eventually prevail. We don’t guess the direction of the breakout, we wait. If one of the trendlines is “older”, it tends to prevail, but not always. Remember that if the older line is breached, it is also more significant because it is older. Here’s a word of caution, often the first move on a balanced wedge is a fake. FOMO traders will load up in that direction. It fails quickly and those traders will be flushed out, creating pressure in the opposite direction. Then, the other side of the wedge is breached and that is the real move. This is why it is critically important to wait for follow through on breaches. “Be the second mouse.”

A balanced wedge is a sign that buyers and sellers are paired off. The first move is often a fake so wait for follow through.

Ascending Wedge

An ascending wedge has two ascending trendlines, a High+ (upper) and a Low+ (lower). The High+ is more gradual in slope and the Low+ is steeper. This wedge is a price compression and it is a sign that a breach is coming. Some ascending wedges result in a pullback and some produce a breakout. The stock is in a strong up trend and that is reflected in the steeper Low+. This is longer-term bullish and any dip is likely to lead to a bull flag. There are times when the stock will blow through the High+. This is a sign of incredible strength. We want that to happen on long green candles and heavy volume. Zoom out to get the context of where this pattern is appearing. Is it at the lower end of the long-term range or the upper end of a long-term range. What is the overall strength of the stock on a long-term basis? Has the move higher come in “fits and spurts” (pops and drops) or is it tight and organized with consecutive greens. These patterns will help you to determine which move is more likely. Don’t guess, wait for the breakout or the breakdown. In general, we know that High- and Low+ breaches are more reliable than High+ and Low- breaches. For that reason, I expect these to produce short-term contra trend moves and I will not chase High+ or Low- breaches unless I have those high volume long stacked candles.

An ascending wedge is a bullish formation. The Low+ is steeper than the High+ and the trend is up. This is a compression, wait for a breach.

Descending Wedge

The descending wedge has a steep High- (upper) compared to the Low- (lower). The trend is down and that is bearish. All of the characteristics mentioned for the ascending wedge apply here as well, so let’s focus on the trend and find some clues. We know that weaker trends have a lot of retracement. Notice that the bounces have nice height and good duration. Towards the end of the wedge, the market is making lower lows, but they are marginal new lows (barely through the previous low). This is a sign of support. Also notice how the volume is drying up. That is a sign that sellers are not as aggressive and we can see a higher low double volume is drying up. That is a sign that sellers are not as aggressive and we can see a higher low double bottom. This tells us that a High- breakout is more likely than a Low- breakdown. From the trendline article, we also know that Low- breakdowns are not as reliable as a Low+ breakdown. For a Low-, we need to see those stacked "reds" on heavy volume and we do NOT have that here.

Descending wedges are price compressions. As the wedge forms, look for signs that indicate which way the wedge is likely to be resolved. Don't guess, draw your trendline alerts and wait for the breach.

We started off this article describing groups of candles. These are the building blocks you need to learn. If you master these formations, you do not need to memorize the longer-term patterns I highlighted. Those building blocks will help you to analyze the current price movement and to draw good conclusions. When you zoom out to get the longer-term context, you will start to notice double tops/bottoms and wedges on the chart.

Chapter 6.5: Price Action - Applying Our Lessons - Part 1

Let's conduct longer-term technical analysis for the market using price action. We will go through an entire year and this is the first of four parts.

The principles for reading price action can be used for any time frame. If you are a day trader, you would use five-minute charts. If you are an investor, you would use weekly charts. My longer-term swing trades last from 3-4 weeks so I will use daily charts to read the price action in this section. Later in the course we will use shorter time frames for overnight swing trades and for day trades.

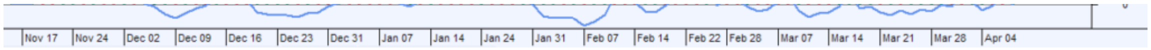
Before we get started I want to mention a few things. The same chart will be posted throughout this article. The longer term chart allows us to see how the current price action fits into the longer term picture (we call this context). I posted the same chart many times so that you do not have to keep scrolling back in the article to see the data point I am referencing. In the chart you will see hollow candles. These are key bars and they have long bodied candles, short tails/wicks and above average volume. As you know from the previous articles, these candles are very important to us. Finally, we are not using any other forms technical analysis (trendlines or moving averages). This section is purely reading price action. We will add those other forms of technical analysis when we apply everything we've learned.

In the next section we will reference points 1-4.

1. The long red candle should be bearish, but notice how we had a long red candle the day before that. When this second long red candle formed, the market gapped higher and all of the losses from the prior day were erased on the open. Eventually, the second red candle did close below the prior red candle. While this price action appears bearish (two long red candles in a row), the overlap tells us that this is not a strong move. Why? If sellers were truly aggressive, the second red candle would never have gapped up the following day. They would have kept the pressure on.

This buying pressure is confirmed the next day when the green bar (hollow) closes above the midpoint of the second red candle. We want those midpoints on these key bars preserved. These are long bodied, mixed candles and they suggest volatility.

2. The market rallied off of the recent low and the long green candle is encouraging. It closed just below horizontal resistance on the daily chart. Unfortunately, it was erased the next day by a long red candle and the midpoint of the green candle was breached (bearish). The interpretation of these two candles and the context from the start of the chart is that conditions are very volatile and there is not a clear sense of market direction. I would not be taking longer term swing trades in this environment because the market could go either way and a big move could be pending.
3. The market is compressing at horizontal resistance and it made a marginal new high (barely got through the old high). The price action before the compression included a bullish hammer and stacked green candles with little to no overlap. This would normally be bullish, but notice how the rally took place on very light volume. The market was not able to advance after making the new high and the tiny bodied candles suggested that sellers were nearby. Why? If buyers were truly aggressive, they would have been able to add to the breakout after those stacked green candles and the volume would have been heavy.
4. This long red candle is confirmation that we needed to remain cautious. To that point, we have mixed long candles and extreme volatility. The light volume rally to the new high could not be trusted and now it looks like sellers are going to take a turn. The long red candle breached the halfway point of the prior long green candle, it broke horizontal support at the bottom of the compression (shaded blue) and the red candle closed on its low. From a longer term swing viewpoint, it is still too early to take short positions. The recent volatility tells us that the long red candle could quickly be erased. It did come on heavy volume and that gives it more legitimacy. We want to see that midpoint preserved for a few days. If the SPY can't rally above that midpoint, we might have a shorting opportunity.



In the next section we will reference points 5-8

5. The midpoint of the long red candle held for a few days and we could have taken bearish swing positions when we had confirmation that sellers were in control. There was some overlap in the candles on the way down, but the volume was very heavy and there were not any green candles. The long bullish hammer was the first sign of support. The low from the bullish hammer held and subsequent candles had tails. Sellers remained aggressive, but the fact that the candles could not close on the low of the day indicated that buyers were interested and that support was forming (tails under body). We can also see mixed, overlapping candles and that tells us that the momentum is starting to wane. From a longer term swing trading standpoint, this is a time to take gains on short positions. Given the magnitude of the drop, the heavy volume and the lower highs, it would be too early to take long swing positions. This is a time to evaluate.

6. The market is trying to bounce after a big drop, but the level of conviction is low. We know that from the light volume. The relative high at this price level retreated instantly/significantly and buyers attempted a breakout a second time. The third attempt failed quickly. The bearish hammer was formed by a gap down. During the day the market tried to rally above the resistance level and we know that from the long wick. Sellers did not squander this opportunity and they pounded the market down, forming the bearish hammer. The next day a long red candle was formed and we saw follow through selling.

7. Conditions remain volatile and the price action from the start of the chart has been all over the board. We can see that a negative bias is starting to form. The market is making lower highs. As long as the midpoint of the long red candle is preserved for a few days, we can take short swing positions.

8. The bottom fell out of the market and it gapped down to a new low for the year. The opening price that day was also the low that day and this giant candle closed on its high. That was a sign of major support. Buyers gobbled up stocks and that candle closed above the midpoint of the previous red candle. This is a very significant intraday reversal because it took place on heavy volume. Swing traders needed to take gains on shorts and a bounce is likely. It is too early to buy from a swing trading standpoint. This is a horizontal support level, but the bias has been to the downside. As I mentioned in the previous article, we need additional confirmation that support is in after big drops. It would be foolish to think that the market is going to rally and never look back after the selling we have witnessed the last few months.

In this section we will reference points 9-12

9. The market has breached the midpoint of the long green candle from the low of the year and sellers continue to probe for support. Notice in the chart that the volume during this probe has been light (blue line < 0). That tells us that sellers are not as aggressive. Also notice that we are finding support above the low of the year. This is a sign that buyers are defending that support and that they do not believe they will have a chance to buy at that level. A higher low double bottom is starting to form.

10. The market is bouncing and it has been able to rally above the open from the prior long red candle. The first green candle is a bullish hammer and the market closed on its high that day.

11. While these 3 candles are encouraging, it is still too early to trade from the long side. Notice how the green candles have overlap. Each day the market gapped lower, support was confirmed and then the market closed above the prior day's high. Overlap like this is a sign that the trend is weak. That is confirmed by the light volume. Swing traders can try long positions here, but they need to maintain tight stops and exit at the first sign of trouble. If the market can continue to grind higher on heavy volume, it will confirm the strength and only then can we get more aggressive with longs. At this point we have to respect the negative bias from the start of the chart.

12. The rally continues on light volume and the candles have overlap (weak trend). The red candle off of the relative high is a warning sign. If the midpoint is preserved for a few days, it would be a sign that buyers do not have the power to challenge the high. This entire move for the last few weeks could

that buyers do not have the power to challenge the high. This entire move for the last few weeks could be nothing more than a bounce that has run its course. Swing traders with long exposure should start exiting trades. A week has passed since the long red candle and the market is making lower highs. Swing traders should be contemplating short positions.

In the next article we will continue our price action analysis. As we look back on the entire chart, we can see that the last bar on the chart is lower than the first bar on the chart. There is a negative bias, but the price action is extremely choppy. The market is taking four steps down and then three steps back. The volume spikes are happening on the drops and that also confirms selling pressure. This is a very difficult swing trading environment and we have to pick our points carefully.

Chapter 6.6: Price Action - Applying Our Lessons - Part 2

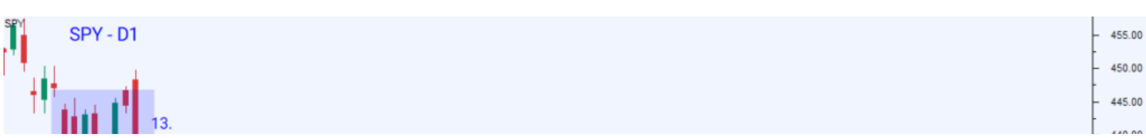
In this article we are going to continue our analysis of price action for the market on a longer term basis. Please make sure to read Part 1.

We know from our analysis in the previous article that the market has a negative bias and that the conditions are extremely volatile for swing trades that last 3-4 weeks. We are only going to conduct price action analysis, but in future articles we will use all forms of technical analysis. The hollow candles in the chart are important since they have long bodies, short tails/wicks and relatively heavy volume. I will post the same chart many times so that the points are easier to reference.

13. The market is backing off from a recent high. These mixed candles are fairly long and this is a very wide range. It is a sign of indecision and volatility. A big move is likely.

14. A long red candle transitions us from one range to the next and it appears that sellers have the upper hand. However, we are still seeing giant mixed candles. We can favor the short side since the mid-point of the long red candle that transitioned us from one range to the next is still intact, but this is extreme volatility. Favor the short side, but keep it light.

15. Once again the market has gapped down and a new range has been established at a lower level. We are seeing tails under body and lots of mixed candles. That is a sign of weak trend strength and it is confirmed by the light volume (blue line < 0). We can expect a bounce, so any short positions should be closed. It is way too early to go long. Since the beginning of the chart, the market has dropped 10%. We needed to use a swing trading tactic where we short bounces once they lose momentum and then we take gains and go to cash when we see signs of support.



16. The market bounced off of the low of the year and it filled in a tiny gap. That bounce quickly found resistance and we know that from the compressed range and the mixed candles. The volume on this bounce was very light. The long red candle breached the compression (blue shaded area) on heavy volume. The mid-point held and this was a good area to enter swing shorts.

17. The market bounced off of a new low for the year on light volume and the mid-point of the red candle (16) has been preserved. The market did fill in an earlier gap, but there is still one that has not been filled. Buyers did not have the fire power to do so. The long green candle was immediately erased by a long red candle and sellers are still in control. We should expect follow through and we could test the low of the year.

18. Before the market could test the low of the year, buyers surfaced. The first candle is a doji and it does not present any problem. The next two candles are a bit more bullish. In both instances, the market opened below the prior close (gap down) and then the candle closed on the high of the day. The market also closed well above the low of the day and it is a sign that buyers are engaged. This could be a higher low double bottom that is forming and bearish swing traders should be taking gains on short positions.

19. The last two green candles have opened below the prior close and they have rallied during the day to close above the opening price. Support is starting to form and this looks like a higher low double bottom. Bearish swing traders should take remaining gains on short positions. It is way too early to get long. We need to have much more confirmation before we consider that.

20. The market has been able to rally off of the low on light volume. The mid-point of the long green candle has been preserved. The market has been down 25% since the start of the year and that should keep us in a bearish mode. The bounce did not get very far and we are seeing a compression.

21. During this breakout we are seeing overlapping candles and that is a sign of weak trend strength. Each of these green candles started the day in negative territory. Sellers tested the bid early and buyers were able to power the market higher. This move feels like it is getting tired, but we do not have any technical confirmation to short.

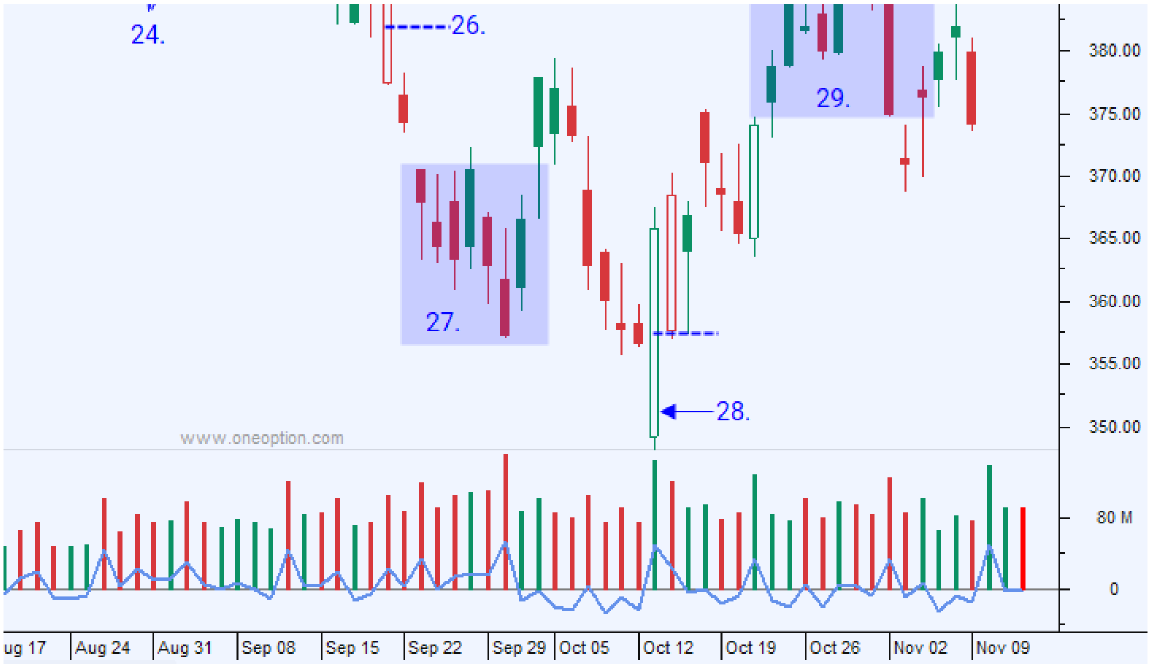
22. This is a nice gap down from the high. If the gap is preserved for a few days it will be a sign that buyers do not have enough power to fill it and that will set up a good shorting opportunity.

The last bar on this chart is significantly lower than the first bar. The market has been very weak and this is officially a bear market (down more than 20%). A bearish opportunity could be setting up as we continue our price action analysis in the next article.

Chapter 6.7: Price Action - Applying Our Lessons - Part 3

In this article we are going to continue our analysis of price action for the market on a longer term basis. Please make sure to read the first 2 articles.

We know from our analysis in the previous article that we are officially in a bear market (down 20%+) and we might be on the brink of a shorting opportunity. We are only going to conduct price action analysis, but in future articles we will put all of the pieces together and use all forms of technical analysis. The hollow candles in the chart are important since they have long bodies, short tails/wicks and relatively heavy volume. I will post the same chart many times so that the points are easier to reference.



23. In the previous chart we suspected that a light volume bounce might be running out of steam. We are in a bear market so we need to favor the short side. The gap down in the third candle on the chart was the clue and now we want to see that gap hold for a few days. That would be a sign that buyers do not have the power to fill it. Our suspicions were confirmed by the long red candle. It's time to take swing shorts here and we want to see half of that long red candle preserved.

24. The mid-point of the long red candle held and we saw continued selling. In the first candle with the blue arrow everything looks great. We had that first long red candle (23.) and then a doji below the low of that candle and then this long red candle. Everything is going great for a short position. However, notice how the next day the market gapped higher (solid red candle). Sellers regained control and the candle closed on its low, but there were some signs of buying. Also notice now the third candle with the arrow was red, but it had a massive gap up and then it spend the day drifting lower. It closed near its low, but buyers are interested. How do we know? If there were no interest on the part of buyers we would not have gapped higher. Orders to sell would have been layered above the close the previous day and there would not have been a gap up. Swing traders should take some gains here. A bounce looks likely.

25. The market staged a nice little rally and there were a few nice long green candles. The mid point of the long red candle (23) was preserved, but we did rally above the open from the long red candle (24). This long red candle (25) is very damaging for bulls. It erases the previous 3 long green candles and it closes on its low. We need confirmation before we can re-enter shorts. The next candle is a doji at the low from the prior red candle and that is fine. The next candle after that is red and it takes out the low from (24). This is a good entry point for shorts. This is also happening on heavy volume so it legitimizes the move.

26. This long red candle closes on its low of the day on heavy volume. We want the mid-point preserved and it confirms our short position.

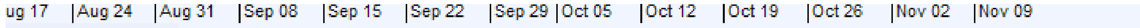
27. The market is working its way lower, but we are starting to see overlap and green candles. That is a sign that support is forming. We can expect a bounce and this would be a good area to take partial gains. We want the mid-point from the red candle (26) preserved.

28. The market gapped down to a new low of the year. The open of that candle was also the low for that candle and a massive gap reversal was underway and buyers were aggressive. By the close, this turned into a giant bullish engulfing candle off of the low of the year. This is a sign of support. The next day a long red candle appeared, but the half-way point of the green engulfing candle was

preserved. The price action for the next few days stayed well above the mid-point of the long green candle and that is a sign of support.

29. The long green candle before the blue shaded area came on heavy volume and it closed above the open from a previous red candle (28). We are seeing long mixed green and red candles and that is a sign of volatility. The price action all year has been bearish. It is too early to consider longs, but we should expect volatility.

30. This long green candle came on heavy volume. It closed above the compression and the open from 3 prior long red candles. We are also seeing follow through buying. This is a time to wait on the sidelines. If the bounce stalls and we see tiny bodied candles and light volume, we can expect another wave of selling. If the rally continues on high volume, it might have room to run.



Reading price action takes some time to learn, but how we get from point A to point B matters. How the current price action fits into the longer term context also matters. These candles help us to gauge momentum. We can tell when it is building or waning. If you learn how to read price action and you combine that skill with basic technical analysis (trendlines, horizontal support/resistance and major moving averages) you don't need any indicators.

This was a very difficult year for longer term swing trading. Extreme volatility was evident and we saw long mixed candles, big drops and violent bounces. Using price action alone we were able to identify the directional bias and we were able to find many "sweet spots" that yielded big gains. You had to take the gains and then wait for the next window.

Chapter 6.8: Price Action - Is This Breakout Real Or Fake?

Breakouts can look very convincing, but time will tell the true nature of the move. Here's what to look for.

On November 10th the market had a breakout above a downward sloping trendline, above the 100-day MA and above a horizontal resistance level. This was a reaction to a "lighter than expected" CPI and the breakout came on heavy volume. The market has been in a longer term bearish trend. That context is very important because the move could have been caused by short covering.

Not all breakouts are real.

Why do we care if it was short covering?

Short term traders do not have staying power. They are in and out of positions and they are trying to capture short term moves. If this was short covering, the breakout could easily fail as that buying dries up. For a sustained move higher we want long term buyers. If Asset Managers feel that the market will be trading higher than this level a year from now, they will start to scale in on the notion that seasonal strength with fuel a year-end rally. Under-allocated Asset Managers will get nervous that they missed a nice entry point and they will buy this breakout.

How will we know if Asset Managers are buying?

After a nice breakout through multiple resistance levels we will see small dips and increasing volume on rallies. The mid-point of the long green November 10th candle could be tested, but that retest will be gobbled up immediately. Then we will see follow through buying on good volume and the bounce will have follow through immediately (2-3 days).

Why does the follow through have to happen immediately?

It is a sign that buyers are aggressive. They do NOT believe they will have a better opportunity to enter and they do NOT want to miss this entry point. They will layer bids at lower levels, but when they are not filled they will start to raise the bid. That process fuels the move higher and the feeding frenzy is on.

What happens if we do not see follow through buying and the volume dries up?

If the market can't add to the gains it will be a sign that the November 10th breakout was just a short covering bounce to squeeze short term traders (this includes trading institutions). It would be a sign that Asset Managers are NOT aggressive and that they do NOT feel like this is the last chance to buy that Asset Managers are NOT aggressive and that they do NOT feel like this is the last chance to buy stocks at this level. Traders will recognize that there is no follow through and that the volume is light. They will recognize this as a short covering bounce and they will get more aggressive with their shorts.

Given this information, here is our trading game plan on November 17th.

We did not see follow through buying. Instead we had tight ranges on light volume with a bearish bias. This tells us that Asset Managers are not buying aggressively and that the chance for follow through is unlikely. The breakout was likely just short covering and traders/institutions will get more aggressive trading from the short side.

This morning the SPY will open just above major technical support at $390. That support will be tested. Buyers want to see a heavy volume bounce off of that level and they want to fill the gap quickly this morning. The SPY needs to close above the close from Wednesday. Shorts want to see a wimpy, light volume bounce on the open with mixed overlapping candles. That will be a sign that the bounce is going to reverse quickly and that the move is weak. A gap and go lower with stacked red candles through $390 would be bearish.

Swing traders were stopped out of the long position yesterday for no gain when the SPY closed below $396. If you sold bullish put spreads, we need to see the bullish scenario above play out to stick with the positions. If the SPY closes below $390 today you need to close those spreads out.

Day traders should watch $390 this morning. Given the price action the last week, I suspect that this breakout is going to fail. If it does and the volume starts to increase, focus on the short side.

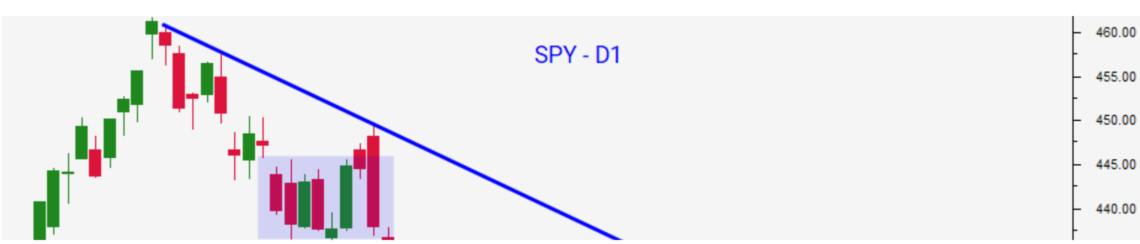
Support is at $390. Resistance is the close from Wednesday.

Chapter 6.9: Price Action - Putting It All Together

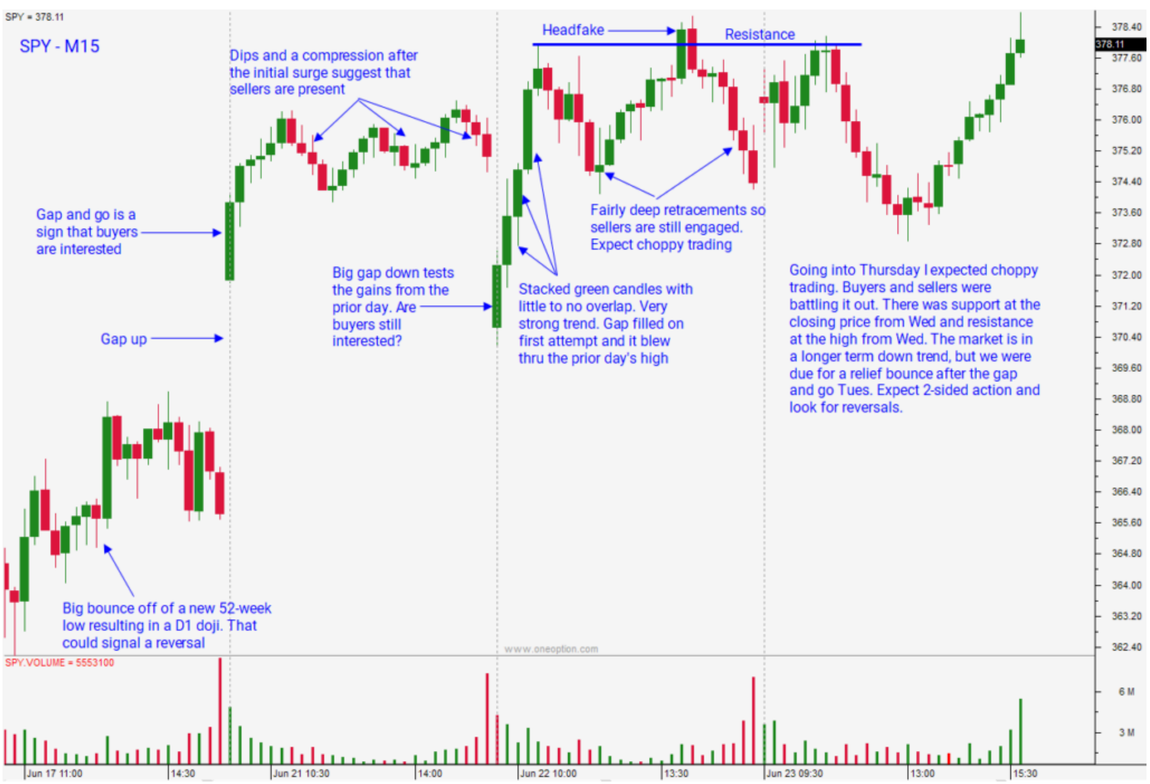
The longer term price action set the tone for this trading day.

By now you know my mantra… market first, market first, market first. That is the starting point for every trade and that is why this lesson is at the beginning of the course. This can be used for stocks as well, but it is critical that you get your market bearings each day before you trade stock.

Context is critically important when you are reading price action. What do the longer term daily charts look like? Is the market in a strong trend? Is the market trapped in a trading range longer term? Did we get to the current price with a Lamborghini or a bicycle? Are the candles mixed (weak trend) or are they of a single color (strong trend)? Is there overlap with other candles (weak trend) or are they stacked (strong trend)? All of these questions need to be answered so let's start with a longer term chart of the SPY and then let's drill down to an M15 chart and finally an M5 chart. You can see my comments in the charts below. By the way, all of these comments were posted live in the chat room during the last week so I am not playing "Monday morning Quarterback". Reading price action is a skill that can be learned and it works. Below the charts you can read the scenarios I am expecting today with the probability of each. At the very bottom I conclude this section with a chart of what happened and a live video that I recorded on the opening bell where I described the price action bar-by-bar.

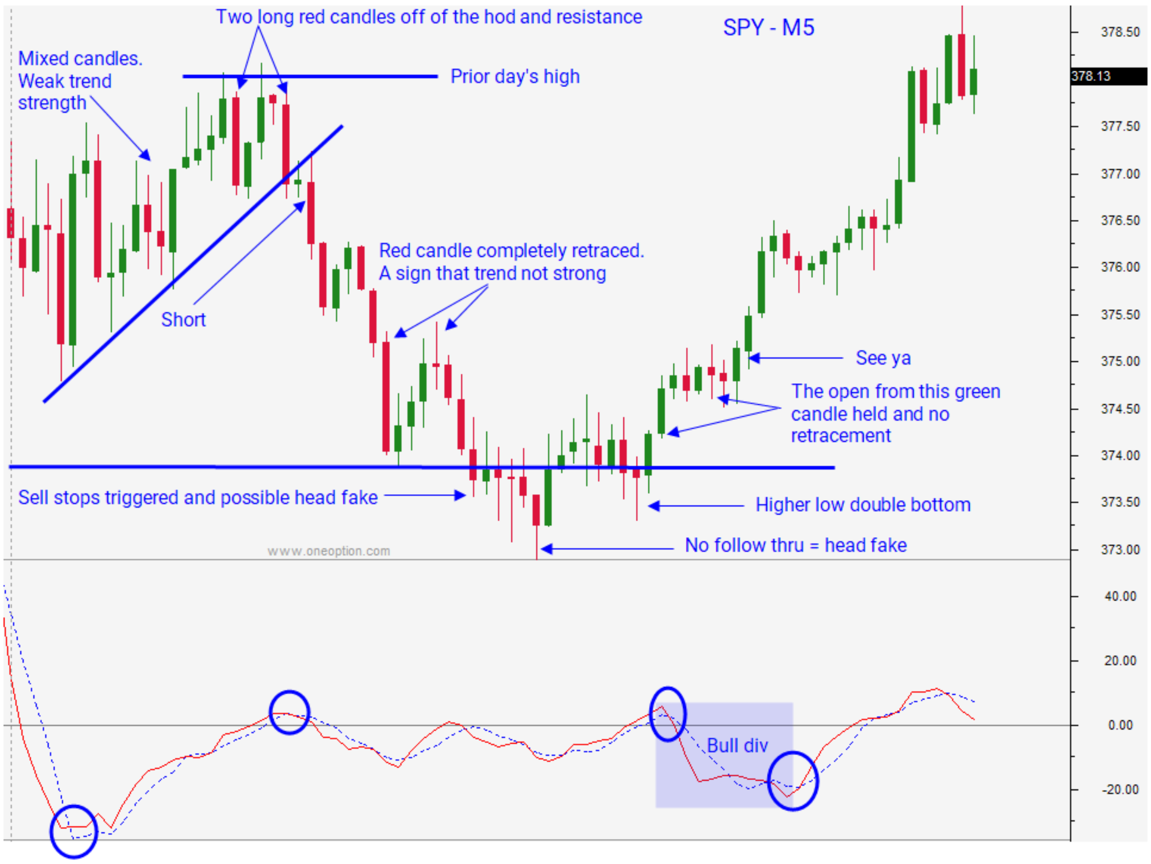


Start with the longer term price action



Zoom into a shorter time frame like M15

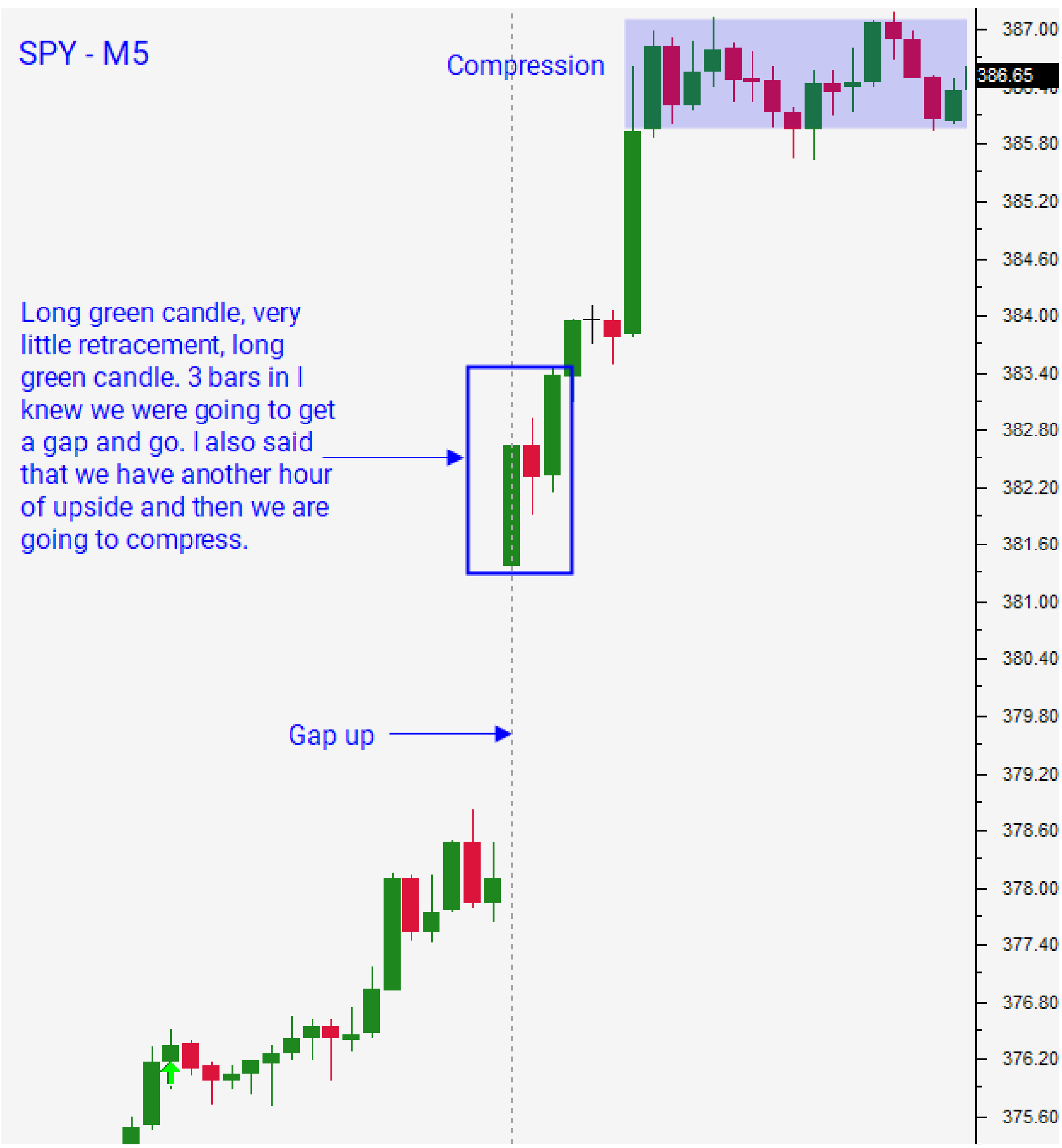
Zoom into a shorter time frame like M15

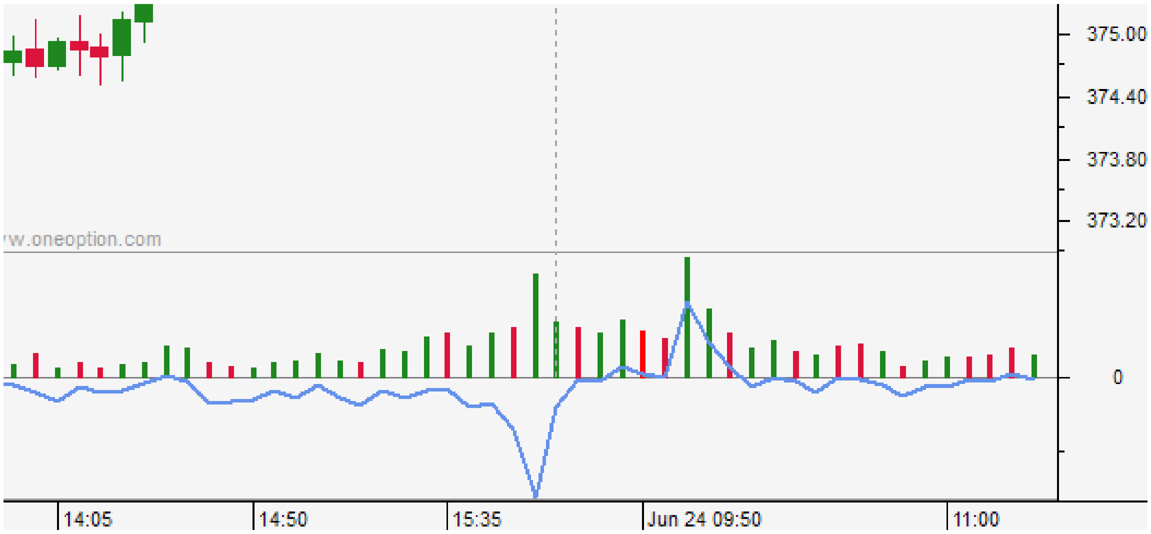


Drill down to the M5 chart

Today the SPY is going to challenge a resistance level at $380 and it will open above it. Stacked green candles with little to no overlap in the first 30 minutes would be a sign of heavy buying. That scenario is unlikely because we know that sellers are present based on the recent price action. If we get that pattern the SPY will start to fill in the D1 gap and we could have a few more days of follow through. There is no reason to chase anything in this market so I will be passive if this scenario plays out (20%). A gradual drift higher on the open with mixed overlapping candles would be a sign of weak trend strength. When that move stalls, a good shorting opportunity would set up. Look for a bearish hammer/bearish engulf off of the high of the day as a sign that a reversal is pending. This scenario has a 20% chance of playing out. A more likely scenario is a bid check. The market tries to fill in some of the overnight gap up. Mixed overlapping candles will be a sign that the trend strength during the dip is weak. That will give us time to find stocks with relative strength and we can separate the fakes from the real deal. Once the market finds support we can expect a rally and it will be time to buy these stocks. We do not want the retracement to be deep (more than half of the gap up preserved) or to last more than an hour. If that happens it would suggest decent selling pressure. This scenario has a good chance of playing out and it presents the best opportunities for us (30%). A strong gap reversal would have long red candles and brief pauses. Half of the overnight gains would easily be stripped away. This would suggest that sellers are fairly aggressive. The gap fill would be fairly deep and the pullback will would suggest that sellers are fairly aggressive. The gap fill would be fairly deep and the pullback will take a couple of hours to run its course. In this scenario you would focus on shorts. We want the bounces to last less than 30 minutes. This scenario has a 20% chance of playing out. The final scenario is a complete gap reversal. Stacked long red candles consecutively in the first 30 minutes with little to no overlap would be a sign of heavy selling. We have seen decent buying and the big down gap reversal two days ago tells us that buyers are aggressive enough to prevent that. This scenario only has a 10% chance of playing out.

It is critically important to get the longer term context and then to drill down to the shorter time frames. Understand the possible scenarios and know the characteristics of each one. When they start to unfold, you will know what to expect and what action you plan to take. You should also know which scenario is most desirable and which one is most likely (they are not always the same). The chart below is how the day actually played out.





After 3 bars I could tell a gap and go was likely

The scenario we got was not the one we wanted. Gap and go patterns force us to chase early in the day and that is never wise. We do not have time to properly vet (observe) stocks and it is difficult to separate the real from the fake. This pattern also has a tendency to run to its destination and compress. That makes it difficult to trade the rest of the day. That means we have to trade smaller size early (because we don't ever want to chase) so that we can make some money early in the day. It also means that we should take gains after 90 minutes of trading because the rest of the day the market will compress. Being able to read price action told us which scenario was going to play out and what actions we should take. The SPY stayed in that tight compression the rest of the day and there was a breakout in the last 10 minutes of trading. In the recording, you can clearly hear these predictions after 15 minutes of trading. I'm not clairvoyant, I just know how to read price action.

CLICK HERE TO WATCH THE VIDEO

Chapter 7: The 1OP Indicator

This is a proprietary indicator with unique qualities

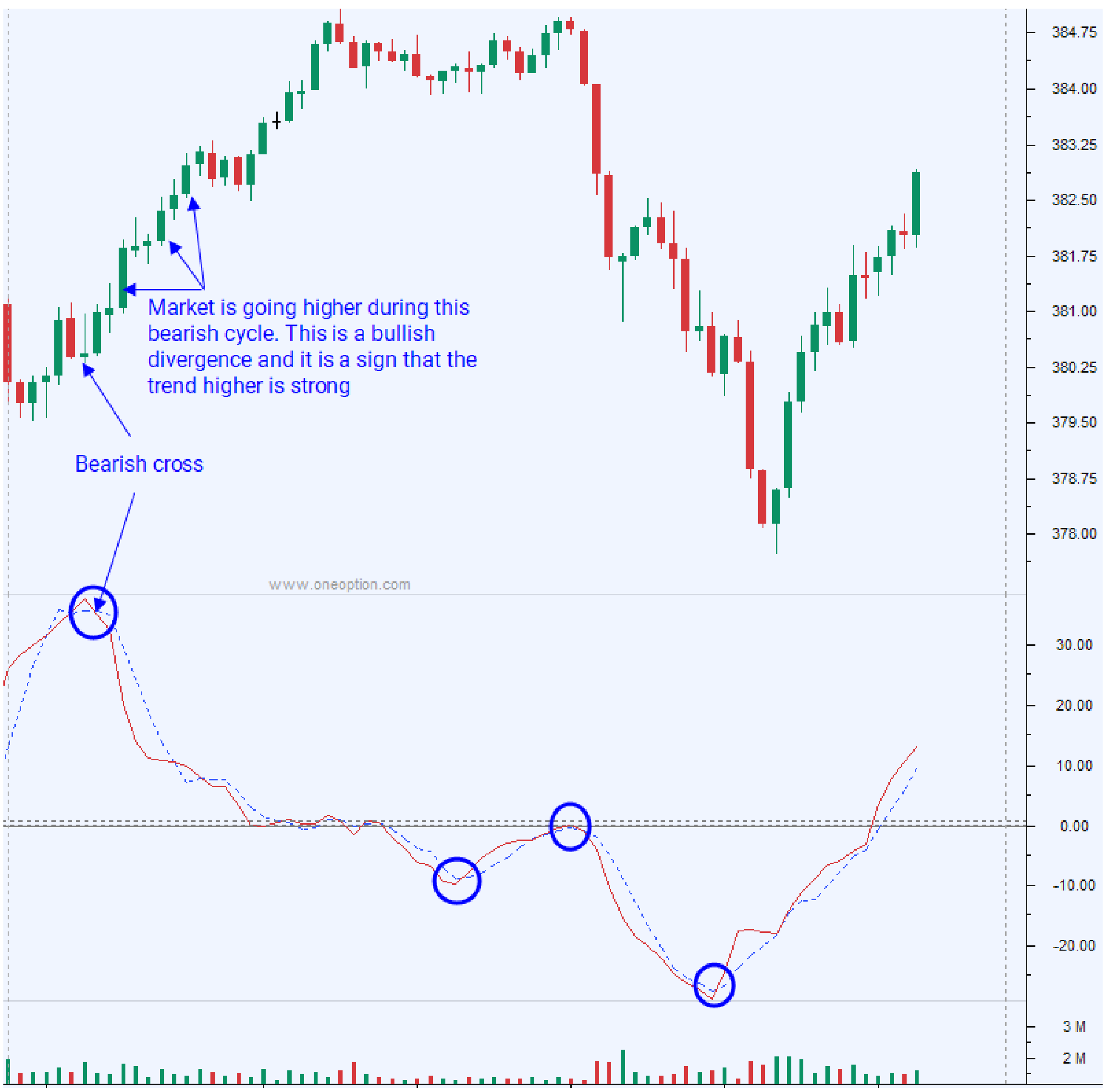
1OP stands for **1OP**tion. As you will see, it does not correlate with other indicators and about 20% of the time it is inversely correlated with the market. Most other technical indicators mimic each other and they lag. In my opinion, that limits their usefulness. 1OP is predictive, not reactive, and that makes it unique. I don't divulge what 1OP measures or how it is calculated, but I do teach traders how to use it. I use it more for short term trading and it was designed and optimized for day trading the S&P 500. That said, I do use it for confirmation on a longer term basis so I want to introduce it.

Like most indicators it has a fast line (1OP2, default color: red) and a slow line (1OP1, default color: blue). When the fast line crosses the slow line, a trade signal is generated. Under ideal conditions the indicator will have cycles with nice tall peaks and deep troughs. When the indicator is in a deep trough and 1OP2 crosses above 1OP1, a buy signal is generated. When the indicator has a tall spike and 1OP2 crosses below 1OP1, a sell signal is generated.

We like nice deep troughs, big spikes and defined crosses

In the image above you can see the big spikes and deep troughs with nice clean crosses. The market had a nice range and good movement within the range. Notice how the 1OP crosses pinpointed those reversals before they started. The market is fluid and ever changing. Sometimes the trend is strong and other times the market volume is light and the price action is choppy.

When the market is in a strong trend we can tell by the price action. We will see stacked, consecutive candles of a single color on heavy volume. That is when we can expect a divergence. This pattern is particularly useful because it confirms the trend strength. During a bearish 1OP cycle we would expect the market to drop. When 1OP is falling and the market is moving higher, we have a bullish divergence (chart below). This is a sign that the up trend is very strong and that the next bullish cross will be good. Conversely, if we have a bullish cycle and the market drops, we have a bearish divergence. That tells us to trade from the short side and to expect more selling.



Divergences can be expected during strong trends and they confirm the strength of that trend

When the market is flat during a bullish cycle, we call that “benign”. It will tell us that the next bearish cross is likely to be a good one. It is fairly uncommon for more than two cycles to be benign. When that happens it is a sign of slow market conditions. With each passing cycle that does not produce, the odds of one that does produce increases.

When the trend is weak and the cycles do NOT produce we consider them to be benign

In this example we have a very long bearish cycle that is benign. The market did not retreat and we should be watching for the bullish cycle to produce. After the bullish cross, the market marched higher. Notice how the 1OP indicator has numerous “mini” crosses. This is a sign of weak trend strength.

When one cycle is benign it increases the odds that the next one will produce.

There are times when the market price action is poor. Tiny-bodied, mixed candles, tight ranges and low volume are typical under these conditions. When 1OP is tight to the zero line and there are many mini crosses you should not rely on the indicator and you should keep your trading to a minimum. This is a sign that the market trend strength is poor and that a compression is likely.

1OP will help you avoid trading light volume chop. Lots of mini crosses around the zero line are a warning sign.

There is one other important concept to trading 1OP. Remember, it is early/predictive. That means that we need technical confirmation before we take a trade signal. 1OP allows us to prepare for that move. If we are long and we see a bearish cross, we can start taking gains on our long positions and we can start looking for shorts. If we are short and we see a deep drop and a bullish cross, we can take gains on our shorts and we might start considering longs. In the section below we are not going to add technical confirmation, we are just going to look at the 1OP cycles on the SPY using a daily chart.

These are longer term bullish and bearish cycles for the SPY. During this particular stretch there were not any divergences.

In the chart above, you can see how well the crosses predicted the next move in the SPY. You can see that there are some mini crosses, but the market was very volatile and there were many mixed candles. In general, 1OP moved well and it had nice ranges.

The last few months 1OP has had many mini crosses and that is not what we want.

In the chart above, the 1OP indicator had nice peaks and troughs early and the second red shaded area was a bullish divergence. You can see how the next bullish cross produced a nice rally. The last green shaded area is unusual and we do not typically see extended periods where the indicator is not moving above and below zero. There are many mini crosses and this has been a very long bullish cycle. In the early stages of the bullish cycle the market dropped hard and it looked like a bearish divergence. In the last couple of months the market has bounced and it is almost back to the area where the cycle started. When the indicator is in sync with the market, it is a valuable tool and we can see the big peaks and deep troughs during the cycles. When 1OP has many mini crosses and the indicator does not have nice movement, we have to rely on other forms of technical analysis.

I mentioned earlier that I don’t use 1OP much on a long term technical basis, but it is useful for confirmation. On a longer term basis I lean more on major moving averages and trendlines… because that is what other traders use. 1OP was designed as a short-term indicator and you will see how effective it is for day trading and short term swing trading. As I shift to short term analysis, I lean on 1OP heavily.

Chapter 8: Long-term Context Drives Short-Term Trading

Zoom out and identify the pattern. Then determine your micro trading game plan.

For those of you who have been at this for more than a year, you've learned a lot. The tendency is to use all of your analytical skills and tools to nail every move. Here are a couple of likely scenarios you might find yourself in and a solution that will keep you on the straight and narrow. **This could be one of the most important lessons you learn from me.**

The first scenario is the FOMO trader. The market is breaking out to a new 52-week high and they are ready to buy anything that moves. They are looking for stocks that are breaking out through technical resistance on heavy volume and that have relative strength. When the market gaps up and the stock is stacking green candles, they buy the stock in the first 30 minutes of the day. After a couple of hours they regret that decision. The market and the stock have pulled back and they could have entered better. The market action dies down and the stock lost its momentum. Now they are stuck with an overnight trade that they did not plan on swing trading. After a couple of days, the stock has given back some of its gains and they take a loss. In some cases it gets back to their entry price and they scratch it. What happened? Everything looked so great and then it turned to mush right after they got in. This scenario can be very frustrating and they are left wondering what they could have done differently.

The next scenario is the contrarian trader. They wonder how the heck the market got this high when the Fed is still raising rates and when inflation is still running way above the 2% target. Two of the largest bank failures have happened this year and there could be a credit crisis. There is plenty of selling pressure and they can see that in the sluggish price action. When the market surges higher, much of the gain is erased in the next few days. They sense that the market move higher is going to run out of steam at some point and there are signs of resistance. Last Friday the market had a down day and it came after it made a 52-week high. This could be the first sign of a top so they start to take some short positions. Red candles off of a relative high often produce a pullback and we can see that on a D1 chart. As the profit taking continues, the market drifts lower and they add to short positions. Out of nowhere, the market gaps higher on the open just when the short positions were starting to gain traction. They know they are trading against the trend and they did not get the breakdown so they take a loss.

"I can't buy and I can't short, so what in the hell am I supposed to do?"

The first thing you have to do is to take a giant step backwards. Get the longer term market context and understand the prevailing price action. The market has a tendency to continue to do what it has been doing. You just need to figure out a game plan that will take advantage of the current price action.

In the chart below you can see the prevailing market trend. You can draw a nice upward sloping D1 trendline. When you do that the market direction is clear. We couldn't say that at the beginning of the year because the market was still forming a base. As you draw those trendlines, you will notice lots of mixed green and red candles with overlap and there are many periods where the volume is low. This tells you that we are in a choppy trend higher. The market takes three steps forward and two steps backwards. There are plenty of opportunities to get long and there are always second chances to enter the trade. This realization allows you to take a deep breath. The next time you have the urge to chase, you need to realize that there will be a better entry point. This market is not off to the races. Chasing breakouts is nerve wracking and every time you do it, the stock pulls back and you have to take heat. You convince yourself that this is "normal" and you prepare yourself for it. You might have even conditioned yourself to expect the position to move against you. The solution to this is pretty easy and for many of you, the tactic I am about to explain could turn your trading around.

Buy dips and take gains when the bounce stalls. Repeat.

Bear markets are pretty rare and many of you honed your skills during one. That is excellent because you have respect for the market and you understand that it can move both ways. You also appreciate the importance of "Market First". This knowledge makes you different from all of the other traders who went bust last year or those who are just getting started now and who will only know a bull market. Unfortunately, there is some "post tramatic stress disorder (PTSD)" that you have to work off. Make no mistake, the market has formed a base and it is grinding higher.

So the pattern is very easy to see on a longer-term chart. The market takes three steps forward and two steps backwards. The problem is that most breakouts happen on the third step forwards. You see the technical breakout and that relative high is what gets the stock on your radar. It has heavy volume and relative strength so you buy. Then the stock loses its momentum and you get scared. Because you are buying a breakout, the next level of support is far away once that breakout fails. You have done your "walk away" analysis and you know your picks are solid. You will just have to weather the storm… again. The drop in the stock is nerve wracking, but you stick it out. During that process you wonder why you always seem to enter trades poorly. When the stock does come back to your entry price, you are on "pins and needles" and you think to yourself, "I am not going to let it go against me again." At the first sign of trouble, you pull the plug. Then you watch the stock stage a nice rally and you are on the sidelines fuming. So how do we solve this problem?

The key is in that D1 chart I posted above. The breakout is nice and it gets the stock on our radar, but there is no follow through. Instead of jumping on the stock during that breakout, be ready to buy dips. If you look at the vast majority of stocks on a D1 and an M5 chart, the candles are not all green. There is a mix of red and green candles. That means that stocks do not go straight up and that there are pullbacks. Now you just have to figure out a way to get alerts when the stock pulls back and it forms support.

I have a couple of favorite variables I like to use. RS/RW is one and LRSI is another. When I see a strong stock, I set an alert and I do not take a position. If I am day trading, the stock is typically strong when I spot it. M5 RS/RW is > 0 and M5 LRSI is > 80. I want to know when M5 RS/RW has gone < 0 and then >0. That is the dip I am looking for and I will be alerted when it happens. If I am using M5 LRSI and it goes < 20 and then > 20, I will get an alert. The beauty of the alert is that it did not cost me a dime to set it. I can keep searching for new prospects. I have no emotional attachment to the stock because I have no position. I am also not tying up capital, I do not have to manage the position and I retain complete control. When the alert is triggered, I can evaluate the market and the stock and then decide if I want to take the trade or if I want to reset the alert. If the market has been in a steady and organized down trend while I am waiting, I am not likely to take the trade and I will set another alert. In this situation, I would like to see the stock holding its own. That is what stocks with relative strength do and I know that it will be a great prospect when the market finds support. The dip in the stock will provide me with an excellent entry point. I will wait until I have market support and when I do buy the stock, I will know that when the market rebounds I will have a tailwind. I will also know that the stock wants to move higher. If you do not have this alert functionality in your current platform, take the Option Stalker Pro free trial. It has been a game changer for many traders and the user interface is easy to learn.

This is a time to add longer term swing trades to your trading game plan. For these trades you use a

This is a time to add longer term swing trades to your trading game plan. For these trades you use a longer time frame like M30 or H1. You want the dip in the stock to be significant. That pullback will put you closer to a support level you can lean on so your stops can be tighter. You will also be able to gauge the upside potential because the stock is likely to challenge the recent high. Know that you have been able to pick great stocks. Your walk away analysis bears that out. It is just a matter of time until buyers return. When they do, you will be entering at a great price.

Your entire mental state will change if you use this approach. Instead of chasing, you will retain control at all times. You will set the alert and wait for that dip. Then you will evaluate what happened from time you set the alert until the time it was triggered. What did the stock do? What did the market do? Does everything still look good? Did the stock find support? When you take that trade you will have a very high level of confidence. You will also understand that the market and the stock are not going to go straight up. Set similar alerts for the upside. If the stock loses its relative strength M5, an alert is triggered. If it still looks good, set another alert. Set an M5 alert so that if LRSI goes > 80 and then it falls below 80 it is triggered. A triggered exit alert does not mean you have to bail on the position; you are simply evaluating the price movement. Take gains when the momentum stalls and then wait for the next dip.

How do I know if the dip still has more downside? If you see stacked red candles and heavy volume, it is a sign that there is heavy selling pressure. Then you need to expect more selling. Reset the alerts and consider using an M15 or M30 time frame. If the stock has mixed overlapping candles and light volume on the pullback and if the drop is brief and shallow, it still has buyers and support will form quickly. When you see this you know you are close to taking action.

At the very beginning of the article I mentioned a second scenario. It is the contrarian trader who is always looking for a market top. It is important to be aware of the fundamental market forces that are in play, but learn to trade what is in front of you and not what you think. The sooner you realize that you don’t know shit… the better. Until we see a long red candle closing through that up trendline on very heavy volume, you have to trade as if every dip is a buying opportunity. The vast majority of you should not even think about the short side right now (shorting is only for seasoned Pros). The market is in an uptrend and the spikes higher can be violent. When they happen, you are trying to manage losses on shorts instead of focusing on new long positions. Keep it simple and don’t short.

The market has regained its footing after 2022 and the price action has been bullish… so roll with it. Don’t buy breakouts, set alerts instead. When the alerts are triggered, reevaluate the market and the stock. If all looks good, take the trade. You should have a market tailwind and natural strength in the stock to fuel the move higher. As you get back to the recent high, watch the price action. If the stock powers through, wait for the momentum to stall and take gains.

This is your roadmap. I hope this lesson helps. To watch a video I recorded with an example click here.