intraday tactics on forex - applicable to all markets

UNDERSTANDING PRICE ACTION

Practical Analysis
of the
5-Minute Time Frame

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Preface

In these modern times of high-tech trading devices, with all the latest gadgets at the push of a button, price action traders may come off as somewhat old-school. With nothing in front of them but the bars in the chart, there is little in their workspace that bears witness of the digital wave. Are they mere relics from a fading past, soon to be extinct, or could it be that there is merit in this seemingly stubborn defiance of trading evolution?

One way to answer this is to point out the actual benefits of every indicator craze that has swept across the trading landscape for the past so many years. Not an easy chore by any means. A simpler solution, perhaps, is to focus attention on the price action trader instead and see if we can come to appreciate his one and only tool, the naked chart.

With the latter idea in mind, *Understanding Price Action* is written not just to establish the virtues of the price action method, but to serve as a practical guide on the matter. The core premise within is that any dedicated student, before long, should be able to trade confidently and profitably from a clean chart without ever feeling lost or otherwise deprived.

For the purpose of illustration, any price chart could basically do, but few are better suited for the job than the 5-minute chart of the eur/usd currency pair. A true creature of habit, this market has long since been the favorite of countless traders around the globe and it's hard to think of a more accessible platform for the technical discussions in the chapters ahead.

When taking up the task of writing this guide, the objective was not just to show a pallet of trading concepts on a number of cherry-picked charts, but to give a fair impression also of their practical implementation on a day-to-day basis. For this purpose, the book has been split into two parts.

Part 1 lays out the principles of price action and discusses entry and exit techniques on a broad range of educational charts. In Part 2 we will examine how these findings hold up on a more continuous basis. Included within is a series of *six months of consecutive 5-minute sessions* of the eur/usd. Besides providing a massive amount of study material, this series should leave little doubt behind as to the amazing continuity and exploitability of price action themes from one session to the next.

One of the most common questions I received in response to my first book, *Forex Price Action Scalping*, was if the principles and setups pointed out on a fast scalping chart (70-tick) could also be applied to the higher intraday frames, like the 2 or 5-minute, or even the hourly for that matter. There can only be one answer to this question: price action principles are transposable to *any* time frame of choice because they bear within them the universal laws of supply and demand. This is not bounded by the time in which it takes place, nor is it a prerogative of any one market. From one instrument or time frame to another, subtle adaptations may be called for, if only to accommodate for the differences in average range or motion; but the trading concepts of the price action method are just as applicable to futures, indices, stocks, commodities, bonds, or what have you, as they are to the Forex markets.

As will be demonstrated also, price action principles are not only free from the boundaries of market and frame, they stand above the nature of the trading environment as well. To illustrate this point, a special section is included on how to tackle a very persistent climate of low volatility by slightly tweaking standard procedure to better suit the conditions at hand. We will examine this adaptation process from the viewpoint of a faster intraday frame on several currency pairs and some popular non-Forex markets.

In regard to the absolute novice, it should be noted that to keep the focus at all times directed towards analysis, it is chosen not to disturb the pace of this book with endless pages of introductory fluff that is readily available either online or in more generic trading books. From a technical perspective, however, *Understanding Price Action* is written for both the novice and the experienced trader, and for all who have taken interest in exploring the benefits and possibilities of the price action method.

Excerpts from Chapter 3:

Price Action Principles—Practice

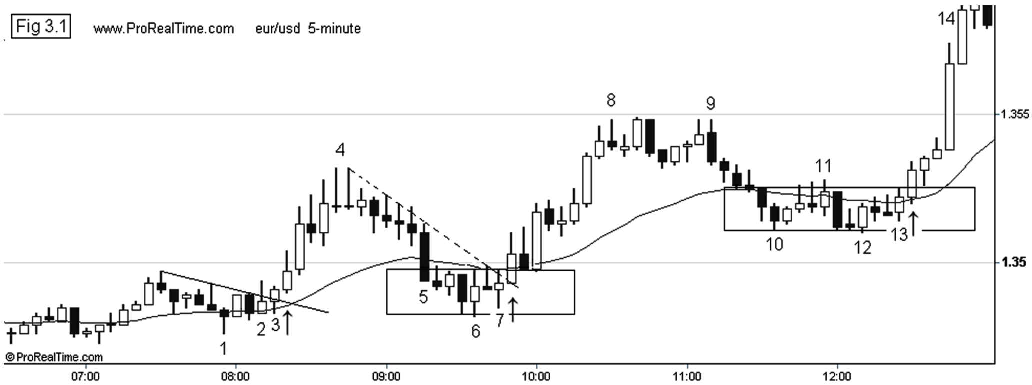

Figure 3.1 This chart serves well to illustrate the concept of the double-pressure pop stemming from a buildup situation (bull swings 3-4, 7-8 and 13-14). Without delving into details of entry and exit technique, let's find out if there were price action principles at work that may have hinted at the coming of these powerful breakouts.

A little before the European Open at 08:00, bulls had slowly taken the initiative (prices above the 25ema), but their dominance was far from outspoken. To their credit, they had managed to successfully fend off a bear attack in bar 1, which had put a mini higher low in the chart. A little bullish cue.

With prices back on the 25ema, a small pattern line may already have been plotted as depicted, but it wasn't a telling boundary by any means. The line did earn merit, though, when bar 2 briefly broke out on the upside, only to retreat and close below it. A point won by the bears.

Note: When plotting lines for visual assistance, there is no need to look for anything grand. Small boundaries (spanning about an hour of price action) can be very effective also. For bullish purposes, draw your lines either flat, or let them slope down across some descending highs, never up; vice versa for breaks on the bear side. But do keep in mind that any pattern line, big or small, is always a function of personal interpretation. If only for this reason, the mere perforation of a line may not make for the best of trading signals. The break of a 5-minute bar, on the other hand, is incontestable and the more crucial the position of this bar in relation to the neighboring price action, the bigger the impact of its break. This principle lies at the base of our operating tactics and the general idea will be to trade the break of such a bar more or less in conjunction with a pattern line perforation. On occasion, we may already enter before our pattern line itself is taken out, but more common is to hop along shortly after the event.

The first breakout situation is a good example of the latter. Note how bar 3 opened more or less on the pattern line (low of the white body), then went down a bit, only to close bullishly outside the pattern (high of the white body). This was a token of bullish resilience, but no crucial bar was broken yet. The very moment the high of bar 3 was taken out, however, bulls didn't waste time buying themselves in, leaving plenty of bears little choice but to quickly buy out. A classic double-pressure situation. (From what is shown on the left of this chart, it's hard to say whether this truly called for action.)

While there are countless ways to snap up prices in a pullback (4-6), the conservative route is to wait for the correction to hit upon a *technical* element in the chart (a test of support or resistance), and then see if prices can find some footing in it (buildup). If you take position merely on account of an attractive retracement level, say, a 50 percent correction of the foregoing swing, you are basically resorting to tactics of the hope-and-pray variety. Buying or selling straight into a technical test is not without danger either, for prices may very well march through it, if only to shake out the parties who came in with a tight stop. Hence the recommended approach of waiting for some bars to settle in the area first.

The 1-3 cluster from where the first bull swing had taken off is a good example of an *area* of technical support. On balance, the thicker such a block on the left, the harder it will be for prices to fully cut through it on their way down.

Quite like an angular line can help to mark a boundary of interest, wrapping a box around a cluster of neighboring bars can be very useful also, particularly when dealing with a potential reversal in the high or low of a pullback. A single horizontal line at the side of the anticipated break may suffice, but a box can really help to visualize the tension in the turn (5-6-7).

Underneath the dotted pullback line, bar 7 was a false low with its direct neighbor and a higher low inside the box. When this bar was taken out topside, so too was the resistance of the box pattern, the pullback line, the 25ema and the round number. Such a confluence of broken sweetspots present in a single breakout stands to work to the benefit of follow-through simply because it will have many traders focus their attention on the very same break; and contrarians are less likely to counter such event.

It took some pushing and pulling in the current highs of the market (double top 8-9), but once bar 9 was broken down, bulls finally let go and a bearish pullback ensued (9-10). Note that this correction only retraced about 50 percent of the foregoing swing 7-8, an indication that the bulls were keen on keeping the pressure up.

While conservatism in the markets is highly promoted, it is always a pleasant fact that many parties have no problem with aggression. For example, the typical buying of the proverbial falling knife on a 50 percent correction can be indirectly beneficial to the breakout trader's cause, for this kind of bravery is necessary to slow down the pullback's momentum, so as to set the stage for a sideways phase from where a more "conservative" trade may sprout.

A rather effective way to anticipate the break from this buildup is to monitor closely the current low of the pullback and the first high that follows it. The moment prices edge down from the latter, we can already wrap a box around both extremes and extend it to the right. (In this situation, the initial box could have been plotted around the low of bar 10 and the high of bar 11; prior to the actual breakout, however, I adjusted the top barrier a little to match the high of bar 13.)

With an empty box in place, the next few bars will usually start to pull and push within it—the first stage of buildup. There is no way of knowing, of course, how many bars will show up in the box, but each one will add to the pre-breakout tension. Prices could break out either way, but chances are good that the market will pick the side of least resistance, in line with the earlier dominant pressure. This implies also that there is a potential for a breakout trap at the "less favorable" side of the box.

At some point in a buildup progression, parties will have to step up to the plate and force their way out. But a mere break of a box barrier, even at the favorable side, may still not suffice to attract sufficient participation. Always preferable is to first see some *extra* tension in the box prior to the breakout; buildup within the buildup, so to speak. At times, this final tension can be subtle to detect, but it is never a matter of "feel". The bars will always guide the way.

Let's take a closer look at how this second box was built up. The 10-11 upswing was the first bull attempt to end the correction, but it didn't take long for bears to take over again and short prices back to the former low: a common seesaw motion in the potential turn of a pullback. Very interesting was to see bar 12 briefly break *below* bar 10, only to be bought up instantaneously, and quite aggressively at that. A textbook contrarian trap.

Not long after this false low incident, with prices pulling and pushing back inside the box, bar 13 provided another technical tell of significance. This bar, too, first surpassed the low of its little neighbor (technically a bearish feat) and then closed strongly up. This not only printed another false low in the chart, it put a higher low in the box. If we compare the implications of bar 13 with those of bar 7 earlier on, we can already see some nice price technical repetition at work.

The second box took twice as long to break as the first, but in many instances this only enhances the likelihood of a double-pressure pop. After all, the more trading done within the buildup, the more parties trapped on the wrong side of the market when prices finally break out, and their flights to safety can only add to the breakout pressure.

All this is not to suggest that the break trade above bar 13 was a guaranteed winner, but with (a) bullish pressure in the overall chart, (b) prices in a 50 percent retracement zone, (c) a false low at 12, (d) a false and higher low at 13, (e) an upside break of a box pattern, and (f) the 50-level magnet hanging above, at least the *prospects* for bullish follow-through were excellent. (Entry and exit specifics will be taken up in Chapter 5.)

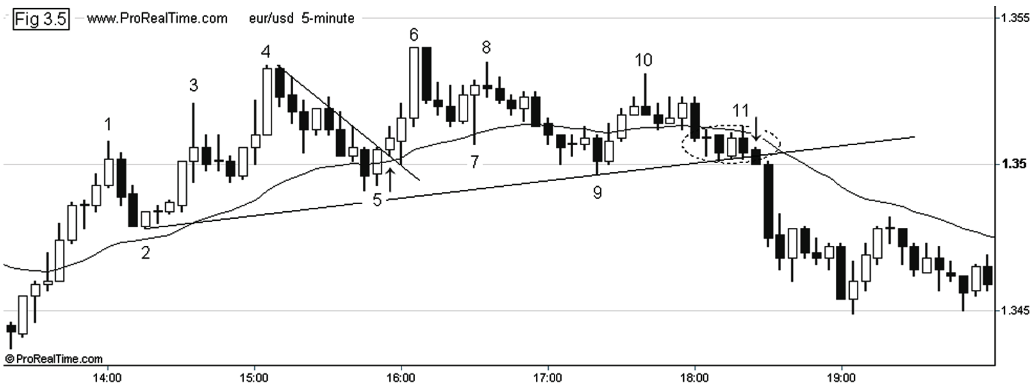

Figure 3.5 Examine for a moment what happened to a bull who bought himself in when bar 3 surpassed the high of 1, bar 4 the high of 3, and bar 6 the high of 4. These breaks may all have been in line with the current dominant pressure, but that doesn't necessarily make for great opportunity. There was no buildup prior to any of them and the moves that led up to each breakout were already quite "extended". That makes these breaks very prone to (temporary) failure.

Of course, it is not our business to comment on the tactics of our fellow traders in the field. Maybe they are tiny scalpers cleverly aiming for a couple of pip as stops are hit above a previous high or low; or maybe they are trading from a much bigger frame, with their stops safely placed well above or below the market. But from where we stand, trading such non-buildup breaks as mentioned above is a losing proposition on the whole.

Pullback 4-5 came to test the broken round number (adverse magnet), a feat that coincided with the first touch of the 25ema since the start of the bull rally—always an interesting development to monitor. Prices may have sunk a little through, but they held up well in the area of the big 1.35.

While it usually requires quite some buildup to set up a barrier break of a range (at least a small cluster of bars), pullback reversals, on the other hand, can be very swift. Sometimes it takes no more than a single "turnaround bar" in the 25ema to set up the reversal in tradable fashion (5). In a bull trend, a popular practice is indeed to trade the break of a bullish bar in the low of a bearish correction, with a stop below the low of the pullback. When going this route, however, traders are well advised to make distinctions between a highs-odds turn and its low-odds counterpart. Bar 7, for example, may have been a classic turnaround bar also (a so-called *doji,* showing a very small body on a long tail), but it set up very poorly for breakout purposes. First off, an entry above it would have been very close to the high of the foregoing swing (6), leaving prices little room to “reverse” before running into potential resistance. Second, the tall span of bar 7 would have demanded a rather wide *technical* stop. And third, this stop would have resided quite unpleasantly on the path to the 00-level adverse magnet. When compared to the break of bar 5, the break above bar 7 was of much lesser standing, if not plain unsavory.

The 25ema by itself never provides support or resistance, it is just an average. Yet in the continual seesaw motions of price action it is extremely common to see a pullback of about 40 to 60 percent coincide with the average closing price of the last 25 bars—and not seldom with some form of technical support as well. The *low* of bar 7 is a good example: it tested both the 25ema and the high of bar 5 and this simultaneously represented (a) a ceiling test (floor in the 4-5-6 arch), (b) a technical test of a former breakout and (c) a 60 percent retracement of the forgoing swing 5-6. This type of “obvious” support will surely have contributed to the aggression with which the low of bar 7 was bought (a popular scalper’s tactic). No such aggression came forth, however, on the *break* of bar 7.

On the way down, pullback 8-9 undercut the low of bar 7, but the more prominent low of pullback 4-5 stood its ground well. This may have kept the bullish pressure up for the moment, but it was hard to ignore the magnetic power of that round number level; prices kept coming back to it.

If an initial pattern line had been drawn to connect the turnarounds of 2 and 5, bar 9 will have fallen below the extension. This doesn’t automatically warrant adjustment, but we best keep the perforation in mind. Should future price action better line up with the new low, perhaps it is wise to adjust. Considering the squeeze progression in the ellipse later on, the line is indeed best plotted as depicted.

Before we take up the ellipse situation, let us first address the bull swing 9-10. This leg headed out quite happily but suffered a nasty blow when prices approached the former high of bar 8. Try to imagine how bar 10 must have shown a tall white body at some point, only to do a full turn and close on its low. Bearish dojis in the high of a bull swing (8 and 10), like bullish dojis in the low of a bear swing (7), can be somewhat intimidating. They are often looked upon as *reversal bars*, but by themselves these dojis do not deserve such status. To judge their potential impact, we should always regard them in the light of the overall picture.

Things indeed had started to look a little less promising for the bulls. Despite their repeated efforts to leave 1.35 behind, the adverse magnet never lost its pull. With now two lower tops standing (8 and 10), it was evident that supply kept coming in at lower levels. If this continued, it wouldn't take long before the bears would start to sink their teeth in the round number itself.

On the other hand, let us not overlook the fact that the three major lows of 2, 5 and 9 were all put in at higher levels, which was still a sign of underlying demand. Neutrally regarded, the chart showed a standoff situation with descending tops on one side and ascending bottoms on the other, in essence a triangle pattern. As with all triangular patterns, at some point they demand a conclusion.

The four bars within the ellipse set the stage for the chain of events about to unfold. With prices stuck between pattern line support on one side and resistance of the 25ema on the other, this was a make-or-break situation. As long as the line held up, there was hope for the bulls still, but it wasn't hard to imagine the consequences if they failed to defend it properly.

The bears, obviously, had a task of their own. With the bars caught in a classic squeeze, they now had their opponents in striking distance of defeat. It was crucial not to let them escape.

What will certainly help your understanding of price action is not just to look at the bars from a technical perspective but to really try to grasp the extent of psychological forces at work. In the marketplace, hopes and dreams are built and shattered by the minute and in this emotional rat race it is never sure to anyone which side the axe will fall. One thing *is* certain, though: the losses of one party will pay for the profits of the other. Arguably no technical development better illustrates the pivotal line between victory and defeat than a little squeeze progression in a critical level of support or resistance.

As prices flipped back and forth between the pattern line and the 25ema, ultimately the market had no choice but to pick sides. For a brief moment in time, bulls may have felt a sweet tingle of victory when bar 11 managed to break the high of the bullish bar before it. But alas, as is often seen in a squeeze, follow-through appeared nonexistent and the break turned out to be a trap.

This is a yet another fine example of how a tiny false break on one side of the price action can be a harbinger of a major break on the other. If you were a bull in position and you saw bar 11 produce that upside break only to fully turn around and end on its "lows" (lower region of the bar), how would you feel? And as the market then proceeded to take out this bar at the bottom, breaking a major pattern line and round number in the process, would you still stick around in hopes of sideline assistance? Or would you rather let go of the rope and sooth your aching hands. Or better still, take position on the short side yourself!

The total progression on top of the pattern line shows the typical features of a market slowly turning around from bullish to bearish. It is interesting to note also that throughout this pattern, plenty of bulls had taken position on bearish corrections to the round number, and they even bought a little below it. But the very moment this support caved in from a *buildup* situation, the chart dropped 50 pip without a bull in sight. This shows us most evidently that in the marketplace, it is never about price, it is all about pressure.

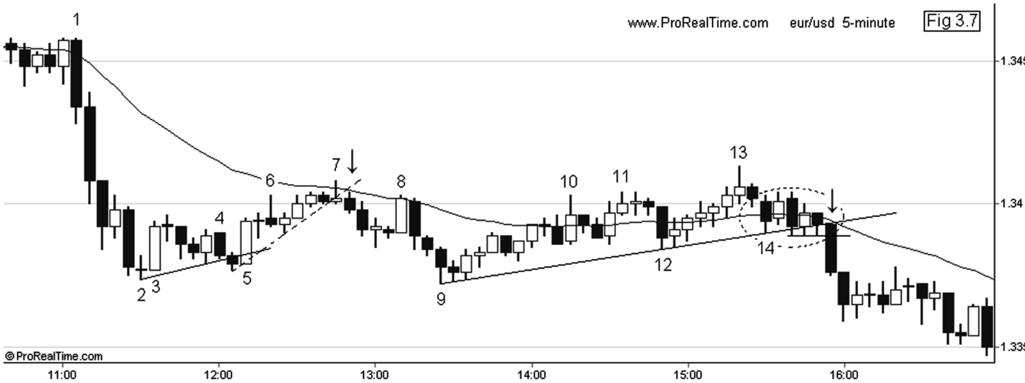

Figure 3.7 It took the bears a mere five candles in the UK morning to produce a vicious 80 pip rally that would put its undeniable mark on the rest of the session (1-2). Once the action calmed down a bit, bulls tried to regain some of the territory lost, but all they could manage, really, was to stem the decline. This formed what is generally referred to as a bear-flag progression (2-4). Common perception has it that a flag pattern builds up to a break in line with the pole from which it hangs (continuation break). This is indeed a regular occurrence, but some important distinctions need to be made; when acting on the implications of our technical patterns too eagerly, we may end up getting hurt more than benefit from them.

A first major factor in the way a break is received is its location in relation to the 25ema. On balance, the "further away" entry is taken from the average, the more riskier the trade, particularly when using tight stops. Even in a trending market, prices will always try to correct towards the 25ema, which basically turns the average into a perpetual magnet. With this tendency in mind, one of the most effective filters you can build into you trading method is to allow prices, in the vast majority of cases, to reach the average *first* before participating on a venture away from it. Such simple selectivity stands to improve the odds for a successful start of your trade most dramatically.

Another issue to take into account is the shape of the flag in relation to the size of the pole. When a relatively small flag hangs from a relatively large pole, participants may view the relation between the two as a bit "off" and thus be reluctant to trade the break of the flag. This concept is related to the principle of *harmony* and we will take it up in more detail in the section on our entry techniques in Chapter 5.

A flag break of the poisonous variety is shown below bar 4. Not only did this break originate from a rather small flag (in relation to its pole 1-2), just look at the distance away from the 25ema—that is huge!

Another thing that strongly contributes to the danger of trading a premature break is that contrarians are always on the lookout for them and, rest assured, they do possess a very keen eye for their favorite play. In other words, next to finding few companions to get his poor break going, the premature trader stands to encounter lots of participants of the dreaded other camp. Further adding to his troubles is the often treacherous behavior of his fellow traders at the first signs of faltering follow-through. Consider the 5-6 maneuver. That was not just the doing of powerful bulls, bears were toppling over one another in their hurried flight to safety.

Interesting to note also is that it took just one bar to fully crush the prospect of bearish continuation (5). We can refer to a bar of this caliber (in relation to the average size of neighboring bars) as a *powerbar*, meaning that it opens at one end and then closes strongly at the other. Looking closely, we can detect a virtual copy of this bar at 3. That, too, was a strong powerbar in defiance of the bearish pressure, but since it was the first to show up, its intimidating presence possessed less of a bite. Bar 5, on the other hand, showed up after a *sideways progression* had already stalled the bearish momentum (buildup), and it confirmed a failed flag breakout to boot. Understandably, this time around more bears will have taken heed of the adverse implications, not in the least since progression 2-5 bore all the characteristics of a W-reversal break.

To visualize the full W-pattern, start out with the left leg at 1, follow the up/down motions in the bottom of the bear rally and then imagine the upside break of bar 5 to provoke a bull rally all the way up to the level of 1. In practice, however, such symmetry is quite exceptional, and not very relevant either. In the vast majority of cases, the element of most significance in the W-pattern is not the right leg, but the *middle-part* progression following the left leg (2-5). The blockier this cluster shows up, the more likely that bears will bail out on an upside break of it. Moreover, when this block shows a powerbar on the right, as was the case with bar 5, bears with tight stops may not even wait for the middle-part's high to be taken out; they may use the break of the powerbar to exit immediately. (Naturally, in the highs of a bull swing, the same thing applies to an M-pattern situation.)

Do bear in mind, though, that when set against the dominant pressure, a middle-part break may still fail to attract *substantial* follow-through, or could even be a trap. In most cases it is recommended not to jump in on these breaks, but to use them mainly for exiting purposes when already *in* position. (See Chapter 6 on Manual Exits.)

On the way to fill the gap with the average, the 5-7 pullback had encountered little bearish opposition. But the tiny bars in the top of the correction let on that the bullish enthusiasm was wearing awfully thin. Surely the round number zone will have played its part here as well; sooner bears would short from that level than get out of the way above it. There are multiple ways to have traded this turn, but the conservative route is to wait for a decent sell signal first. This came presented when the bull break in bar 7 failed to attract any follow-through whatsoever and then was followed by a bear break in turn (false high confirmation). An added bonus, for the bears, was to see the break coincide with the perforation of the dotted pullback line.

On the way down again, suddenly a mean bullish powerbar came to attack the round number from below (8). It is never a pleasant sight to see a strong adverse move defy a fresh trade, but it is good to remember that the markets are not designed for comfort. By remaining calm and attentive, a bear could assess that none of the favorable elements on which his position was based had been overthrown by that bullying bar. The trend was still down, prices were still below the 25ema, the round number could work as resistance and so could the ceiling test with the low of bar 7, which was also a technical test of a former breakout.

Given all the violence from earlier on, it may seem a bit odd that no further follow-through came forth in the *new* low at 9, but it is actually quite common. We very often see the UK morning put in a strong rally in no more than a handful of bars, only to then absorb that action in a sideways meandering motion until the US Open at 15:30 CET. In these slower phases, breakout traders tend to be more picky and this usually sits well with the contrarian game. Their favorite practice, however, is to counter a break *against* dominance in a 40/60 percent retracement area (seen from the viewpoint of the rally). For example, notice the typical contrarian response when bar 11 had surpassed the high of bar 10, or when bar 13 had come to take out the high of bar 7. True, contrarians hadn't back away from the break in bar 9 either, if only for its total lack of buildup, but this had required more bravery to pull off, simply because the break through the session low was set *in line* with dominance.

There are bear and bull opportunities in any market, but when it comes to finding *substantial* follow-through (say, at least 20 pip), it is much advised to position oneself in line with the dominant pressure. In a lengthy sideways correction, it may take quite a while for a break to set up in high-odds fashion, but do not let this discourage you from staying put. In almost any session, sooner or later an opportunity will come. Always handy is to already put in a pattern line across the highs or lows of most relevance and then extend it to the right for future purposes (9-12-14 plus extension); with a fine line in place, it is then merely a matter of keeping good track of the buildup.

Note how the bars immediately fattened up around the US Open at 15:30, as is often seen also in the EU and UK Open. The five bars in the ellipse represent a pattern line battle. Although the 25ema was running flatly *through* this progression, this was a squeeze variant too, because the bars were now caught between support of the pattern line and resistance of the round number. Despite an initial perforation of the pattern line, bulls did their best to prevent the break from following through (note the three identical lows outside of it), but ultimately were forced to throw in the towel.

Excerpts from Chapter 5:

Trade Setups – Pattern Break

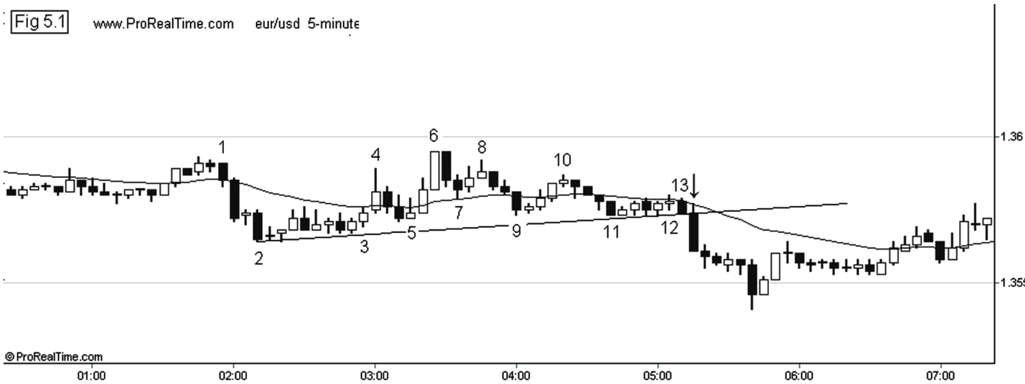

Figure 5.1 A typical characteristic of a sideways market is the way prices tend to alternate above and below a rather flat 25ema. In the early stages of it, in the absence of a dominant party, there may not be much telling who will come out on top. But by patiently monitoring the way the price action revolves around the average and by carefully tracking the highs and lows along the way, we can usually obtain a pretty good idea on the side of the market that is slowly getting the upper hand.

The first notable event in the session above was the sideways "correction" 2-3, hanging from the pole 1-2. Horizontal pullbacks are the market's way to absorb the implications of a foregoing move. Inevitably, at some point, prices can only do one of two things: they either break away in the dominant direction (think flag), or they break away at the other end, possibly setting up a reversal of sorts (think M and W-pattern middle-parts).

Bears will not have been amused to see the latter outcome come about (4). Just moments before they had been well on their way to the 50-level below, only to suddenly see their opponents aim for the round number above. (Note the completion of the W-pattern in the 3-4 swing.)

Following this countercharge was a lengthy skirmish over the possession of the 25ema, which ultimately resolved in favor of the bears. A development that may have played a decisive role in this victory was the fact that bulls, despite repeated attempts, had proved unable to reach, let alone retake, the round number of 1.36. At some point these misadventures were bound to affect their morale.

But let us zoom in on the initial bull attack first (4). When the average is perforated from below, and the next so many bars manage to close above it, we can refer to this as *bulls retaking possession of the average*. From here on, prices may still have a hard time reaching higher, but they do stand a pretty good chance of getting picked up whenever they hit back on the average, particularly on first touch; and even more so when this coincides with an element of technical support.

In a rather slow and compressed session, support or resistance is never far away. For example, when the low of bar 7 hit upon the high of bar 5, this was a spot-on ceiling test that coincided with a touch on the 25ema and a 50/60 percent correction of the 5-6 maneuver. In an earlier discussion, we referred to this threefold collision as a triple: a strong turning point candidate. Scalpers in particular love to take advantage of these little pullbacks to support, if only to rake in a handful of pip in the initial bounce. But for prices to head out more authoritatively, or lastingly, decent sideline assistance is usually required. In the session above, this never convincingly materialized for the bulls. Not long after taking possession of the average, they were twice forced to retreat below it (8-9 and 10-11)—and then failed to recoup third time around.

Note: As previously noted, there is no point in overanalyzing every little skirmish in the chart; most of the time there are no trades near and it will do to sit back with just an overview perspective on the open session. Yet always interesting to monitor in any chart are the attempts of either side to reach the next round number in line. Both parties have their own level to gun for, and these pursuits, in the end, will either fail or succeed. Of course, these levels do not have to be reached on any first try. But whenever we see one side *repeatedly* fail to make it to their magnet and then lose the initiative, a power shift is likely at hand. Put differently, *the failure of one side to reach their round number very often sets the stage for a successful attack on the number at the other end.*

This is essentially what happened in the chart above. Moreover, the failed attempts to reach the 00-level—at 1, 4, 6, 8, 10, and finally at

12—will not only have had an impact on the bullish morale, they will have boosted the confidence of the bears with equal prowess.

Initially, the pattern line may have been plotted slightly more ascended to connect the 2-3 element with the low of bar 9. But when the 11-13 progression took shape later on in the session, the situation called for a little adjustment. When drawn as depicted, the seven bars caught between the pattern line and the average represent a textbook squeeze. Whenever prices break away from such a "trapped" progression, the double-pressure response can be very powerful.

Textbook in it also was a failed attempt of the bulls to break away from the bearish grip (12). You may not think much of such a tiny false high, but it can be a great harbinger of bullish capitulation further down the line. Just try to imagine the predicament of the bulls: so far all their upside attacks had failed and now they were being reprimanded yet again, and in support of a pattern line to boot. If not even an upside break in support could tempt a sideline bull to come to the rescue, then what is a bull in position to think.

With a bear break now seriously on the boil, this leaves us to discuss our pattern break entry technique. Despite its excellent tip-off, bar 12 itself did not qualify as a signal bar. Should we have shorted below it, our entry would have been straight into the support of the pattern line. On certain occasions, a trader could decide to apply a little more aggression (we'll take it up later on), but this is seldom a smart idea in a relatively slow chart. Best to give the market a fair chance to set up the trade properly.

There were at least five reasons why bar 13 fit the description of a valid signal bar: (1) it was part of a solid squeeze; (2) it nicely filled the space between the 25ema and the pattern line, leaving virtually no room for another bar to get printed in the squeeze; (3) it confirmed the false high at 12; (4) it closed bearishly, in line with the anticipated break and right up against the pattern line; and (5) there was a highly favorable 50-level magnet waiting about 25 pip below. What more does a bear want to see to get ready for action.

In the vast majority of entries, position is taken the very moment the entry bar surpasses the high or low of the signal bar by a pip (fire short below bar 13). When this moment draws near, get ready with your cursor on the buy or sell ticket, but never front-run the event; fire only when the signal bar is truly taken out.

The very moment position is taken in the market, a preset bracket will automatically spring into action to eventually close out the trade for either a profit or loss. As already stated, there are countless ways to set these orders, but let us for now agree on the suggested 10 pip stop and the 20 pip target. As we will come see many times over in the pages and chapters ahead, this is an excellent bracket to work with on a “normally active” 5-minute frame. Should you prefer to manage your trades on a more discretionary basis, if only on occasion, this is of course heartily encouraged, but at this stage of our studies our purposes are best served by keeping things both simple and unambiguous. (Alternative management techniques will be taken up in Chapter 6 on Manual Exits.)

Note: In most breakout situations, and this regards all setups, we should only step in if the close of our signal bar is in line with the direction of the anticipated break. This means we will short below a bearish bar and enter long above a bullish one. At times, though, neutral dojis can qualify as signal bars as well, and on occasion we may even accept a short below a small bullish bar or go long above a small bearish one (think inside bars). But at all times it is highly recommended not to short below a strong bullish bar, or to enter long above a strong bearish one. These type of entries are less likely to provoke an *immediate* follow-through response and thus more likely to present the trade with a bad start. And that is a situation best avoided, especially when working with tight stops.

Excerpts from Chapter 5:

Trade Setups - Pattern Break Combi

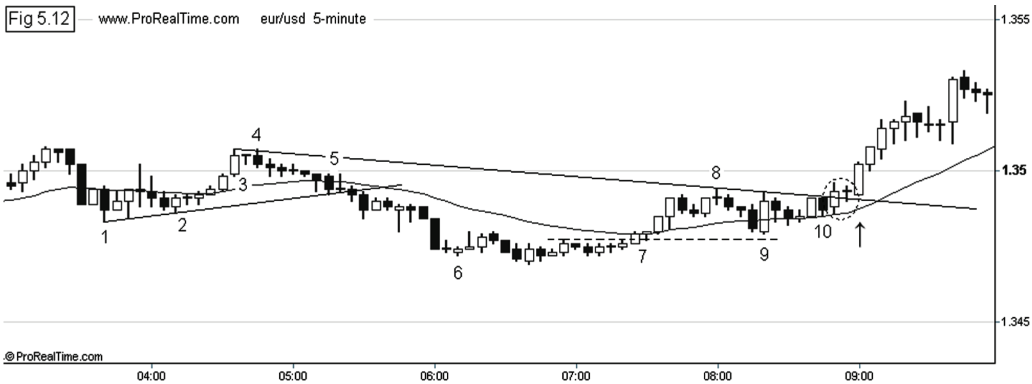

Figure 5.12 Traders familiar with Japanese candlestick analysis may have heard the combi referred to as a Harami, a Knight-with-Cross, or maybe a Spinning Tops setup; who knows what other fancy names have been coined to acknowledge this very potent pattern. Of course, the actual names are all irrelevant, and in many instances so is the pattern itself.

Zooming in on the action in the chart above, we can detect a number of combis that may have been playable on a tinier scale but didn't really set up well for anything substantial. Nimble scalpers may have taken their chances on the breaks of combi 2, 5 and 7, if only to extract a handful of pip in the wake of each break. An offer to have declined for sure, was the break of combi 3 at 4: this breakout appeared right in the level of a previous high, quite a few pip away from the 25ema, and suffered the adverse magnet of the round number to boot. A poisonous combi to trade, even for a quick scalp.

To minimize the danger of getting caught in a noncompliant break, always a mandatory routine is to monitor first how well the environment favors the wager at hand. Prior to taking position, we should check the pace of the market, the dominant pressures in it, the thickness of the buildup and the presence or absence of adverse magnets and obstructive elements on the way to target. With a little experience, such a checklist should take no more than a few seconds to run. But it can do wonders for your bottom line.

Granted, the ways to perceive price action are countless and what may seem a wholly unsavory proposition to one may very well represent a textbook opportunity to another. While all is indeed a matter of perception, there is never much reason to get caught in a very conspicuous *trap*, as in the bull break at 4, or the bear break at 6.

The breaks of combi 2, 5, and 7, stemming from buildup, all possessed merit, yet it seems fair to have questioned whether they set up thick enough to have anticipated a 20 pip break.

To understand the distinction between “thin” and “fat” setups, let us compare for a moment the cluster progressions 1-2 and 6-7 with the buildup leading up to the combi in the ellipse (8-10). The latter definitely showed a lot more substance. Note also that prior to breaking away in the ellipse, bulls had taken possession of the 25ema first, meaning their buildup resided favorably *on top of* the average, which wasn’t the case yet at 2 and 7. Within this cluster, another interesting tell was the aggressive way the bulls had responded to the bear break at 9, which had left a strong false low on the chart.

Since bar 10 showed up bearishly in our squeeze, it did not serve well as a signal bar for the bull-side breakout. So we can skip the offer above it, but we should not lose track of the action here; after all, with the combi setup in our toolbox, it may only take one extra bar for a *valid* break to set up (fire long above the inside bar in the ellipse).

Note: If your trading hours include the UK Open (09:00 CET) and the market sets up a solid trade right in it, don’t be shy to accept. While opening activity can be dangerously fickle, it does tend to respect a *properly* built up break. As will be demonstrated in the long series of consecutive charts in Part 2, the first decent trade of the EU/UK morning is likely to be found in and around the UK Open, when there is usually sufficient volume being pumped around to back up the break. However, do avoid shoddy breakouts or anything that sets up as a *continuation* trade in the high or low of a swing *leading up* to the UK Open. These type of breaks are more likely to provoke rebellion when the first wave of volume pours in.

Excerpts from Chapter 7:

Skipping Breaks and Trading Breaks for Failure

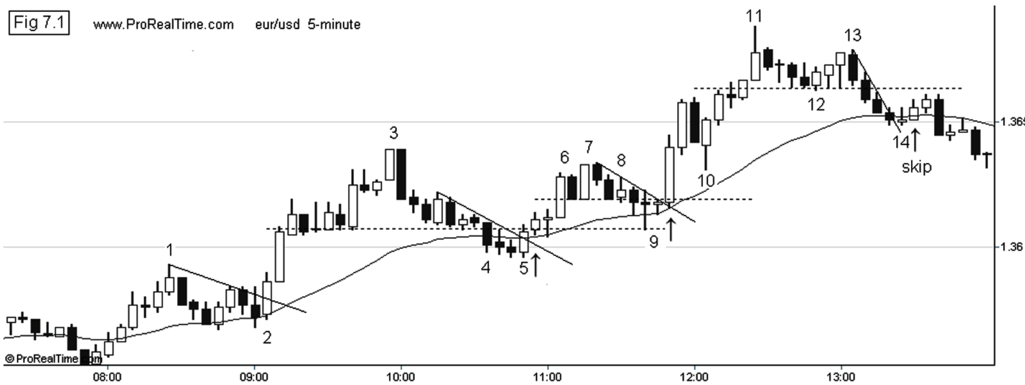

Figure 7.1 Trending sessions are easy to spot. Unless we are dealing with a lengthy flag we need only to follow the direction of the 25ema to understand who is currently in charge. And nine times out of ten, that is the line also to follow for our trades. This information is so easy to obtain, so unambiguous in nature, and such an excellent filter that it's hard to believe that anyone would willingly discard it. But many do by mistake.

Beyond question, one of the main causes for traders to get tricked into rebellion is the appearance of a so-called "reversal pattern". The bull trend in Figure 7.1 shows three such patterns (above the dotted lines), each with reversal features of its own. What these patterns share in common, though, is the typical horizontal barrier below them and the fact that all three were broken *towards* the 25ema. In contrast, bull-flag 1-2, was broken *away* from the average (hence it being referred to as a "continuation pattern").

More often than not, trading a break of a reversal pattern straight into a trending 25ema is a gamble more than a trade, and a poor one at that. But here's the interesting part: when such a break indeed harbors all the makings of a trap, we may soon have an excellent shot at trading the event for failure.

In a way, the tactics involved are not far removed from pullback reversal technique, but we do have to consider a specific signal bar requirement. This is best explained with some practical examples.

Let's start out with the break at bar 4. First off, there's no need for close scrutiny to see why this event was a trade-for-failure candidate: bears had shorted straight into a bullish triple of the 25ema, the round number and the 50 percent retracement of the 2-3 bull swing.

When aiming to trade for failure, it is vital not to run ahead of things but to calmly monitor the way the market handles the break first. In a bear break situation, special attention should go out to a bullish turnaround bar; the first to come along could already set up the re-break entry (5).

Of critical importance, though, is the high of this turnaround bar. Since we are looking to trade the break *below* the dotted barrier for failure, we have to make sure that our entry is back *above* it (failure confirmation). This implies that the high of our signal bar should reside either at the exact level of the broken barrier or slightly above it. Under no circumstances should we enter on a break of this bar below the barrier.

As long as we keep this requirement in mind, the situation can indeed be traded like a regular pullback reversal. A bullish bonus here was to see the 4-5 cluster take on the features of a mini W-pattern middle-part, or, if you wish, a thicker version of the morning-star pattern. Another favorable element was to see bar 5 set up a flag break entry as well. All told, this represented a trade-for-failure setup of the high-odds category (enter long above bar 5).

It may not be so obvious at first sight, but the break below the 6-7-8 block is almost an exact copy of the situation on the left. Once again bears had shown little regard for the bullish conditions. And again they had shorted straight into a trending average and into a 50/60 percent retracement of a foregoing swing (5-7); and while doing so, they had totally neglected the technical support of a ceiling test with our former signal bar (low of 9 tests high of 5).

What may have inspired this bearish bravery? Maybe these players had perceived the lower top at 7 to be a sign of bullish weakness. Maybe they were only gunning for the round number magnet about 15 pip below; who is to say what these bears were thinking. But we can form ourselves a pretty good idea of what they failed to consider: the hazards of defying the tide.

Of course, all this is not to suggest that you cannot trade against dominance with decent odds attached, but if you insist on going the obstinate route, seldom a smart idea is to pull the rebellious trigger straight into a trending 25ema.

Note: An interesting element within of the trade-for-failure concept is that due to the faltering breakout, we often see the blocky features of the perceived *reversal* pattern take on the more angular characteristics of a flag formation, which is a *continuation* pattern. In the 6-7-8 situation, it had taken just two extra bars to produce this transformation (combi 9 added). By the way, the entry here was offered above the inside bar of the combi, as in a regular combi breakout.

This was already the third pattern breakout of the session, but the bullish enthusiasm was no less powerful. Granted, bull parties did have a very nice 50-level magnet to shoot for. But what about the second leg of this breakout, the near vertical swing 10-11. Were bulls overdoing it?

It is a common observation that when prices accelerate in an already mature rally, say, in the third or fourth leg of it, this often indicates the final burst of the trending environment; while this principle by itself is rather fickle and not easy to exploit, it can serve as an excellent reminder not to be too eager in regard to the next continuation offer.

Aside from the acceleration issue, the break of bar 12 was an easy skip for several reasons. For starters, trading for continuation in the highs of a bull rally on such a shallow correction cannot be regarded as a high-odds play. And the entry was offered far away from the 25ema. Plus there was the issue of the broken 50-level magnet.

This brings us to the third reversal block of the session, the 11-13 situation. With prices run up well over 100 pip since the start of the UK Open at 09:00, the market had now entered what is often referred to as the “lunch-hour doldrums” (12:00-14:00). Indeed, in the majority of sessions there isn’t much firework going on in this low-volume environment; but with an uncontested rally on the board, and plenty of profits yet to be pocketed by the bulls, it is certainly not unthinkable for the lunch hours to put in their fair bit of action, too.

Recalling our discussions on the reversal exit in Chapter 6, the 10-13 progression is a perfect example of an M-pattern reversal in the making. Notice also how the right side of the middle-part had tried to break out on the bull side before spinning around bearishly in powerbar fashion (13). A bull in position could not have wished for a better hint to get the bearish message (reversal exit option below bar 13).

Was the break below bar 13 a shortable event as well? Frankly, when compared to the earlier reversal attempts, this offer definitely had more merit; but let us not forget that the session itself was still in bullish mode (higher lows throughout, trending 25ema). Thus, conservatively seen, the break is a skip. But it is hard to argue with a nimble scalper for taking his chances on a quick short into the double magnet of the round number and the 25ema.

With the average still trending up nicely, why not trade long again above bar 14? Apart from the fact that the M-pattern block already hindered the bullish outlook most considerably, the chart offers an *indisputable* clue that the time was not right for a buy-side wager: the bear break below the dotted line had not yet been proven false. Even if bar 14 had set up more powerfully as a turnaround bar (or perhaps was seen as part of a morning-star variant with its neighbors left and right), still the entry was offered *below* the barrier of the overhanging resistance. And that's a definite skip.