

 TraderTom

Brief Manual on Price Action

By Tom Hougaard

1 Price Action – an Introduction

I am often asked what instruments and tools I use to trade with. I answer I don't use anything. When I tell someone that I don't use anything, they are often intrigued, so they will offer a plethora of suggestions:

Question: What about Stochastics?

Answer: Nope.

Question: Moving Averages?

Answer: No.

Question: Volume?

Answer: Nope.

Question: What about Fibonacci?

Answer: In day-trading, no. When I do longer time frame analysis, then I will consider Fibs. Question: So what do you use?

Answer: I use price action and mechanical entries.

Question: What does that mean?

Exactly! What does that mean?

I realise that price action means something different, depending on who you ask. I decided to put together a few pages to explain what price action means to me.

2 Definition of Price Action

I am not sure there is an official definition of what price action means. To me price is the raw data of a bar chart. It consists of 4 pieces of data: Open, High, Low, and Close. Price Action is the art of observing these data with reference point to your stored past observations in order to derive a high probability of what will happen next.

To be a price action trader to me is the art of reading the markets based purely on price data. So you may ask why I don't use indicators. It is easy for me to answer that.

3 What are indicators made from?

I defend my decision not to use indicators by saying that all indicators are made from the mathematical structure of the following components:

1/ Price Data

2/ Time Data

3/ Volume Data

Think of the moving average – a favourite of many traders: it is made up of time and price. It is the average price over a set period of time. It uses time and price. I use time and price too. I just don't have a line showing me the average price.

Think of Stochastics – an oscillator ranging from 0 to 100, attempting to alert traders to markets being “oversold” or “overbought”. It is made from 2 components: Time and Price. I use time and price as well. I just don't believe that Stochastics gives me an edge. I don't believe the market can be overbought without become even more overbought, and vice versa with “oversold”.

I could go on. From time to time (no pun intended) an indicator will use volume, but they are usually specialised pieces of software, such as “Volume Spread Analysis”, and they usually come with a healthy price tag.

4 A Typical Trading Day

I think the best way to describe what price action is, is to show it on a chart.

On the following pages I will explain the trading bars one by one. I have used a 5-min chart for this analysis. I like the 5-min bar, but you can use the principles of price action on any time frame.

The chart below is that of the German DAX index from the 25th October 2016. For now you will only see the first hour of the trading day. By the time we join in on this chart, the market has been open for 25 minutes (counting from when the underlying stocks opened).



Although I don't use indicators, I do believe the market has "memory". It means that the market will remember past important price levels. So for example, yesterday's high and low will be important for me to know about ahead of the trading day.

Below you see the chart from the day before. You can see the market making a strong start to the day. At the price of 10,820 the market is meeting "resistance" in the form of selling. 2 hours later the market attempts to trade near the 10,820 level again, twice, after which the market reverses. The market loses all its gains from the day. You can conclude that at price 10,820 there were more people interested in selling than in buying.



As we head into the trading day, we are aware of the importance of 10,820 as well as the low of 10,755.

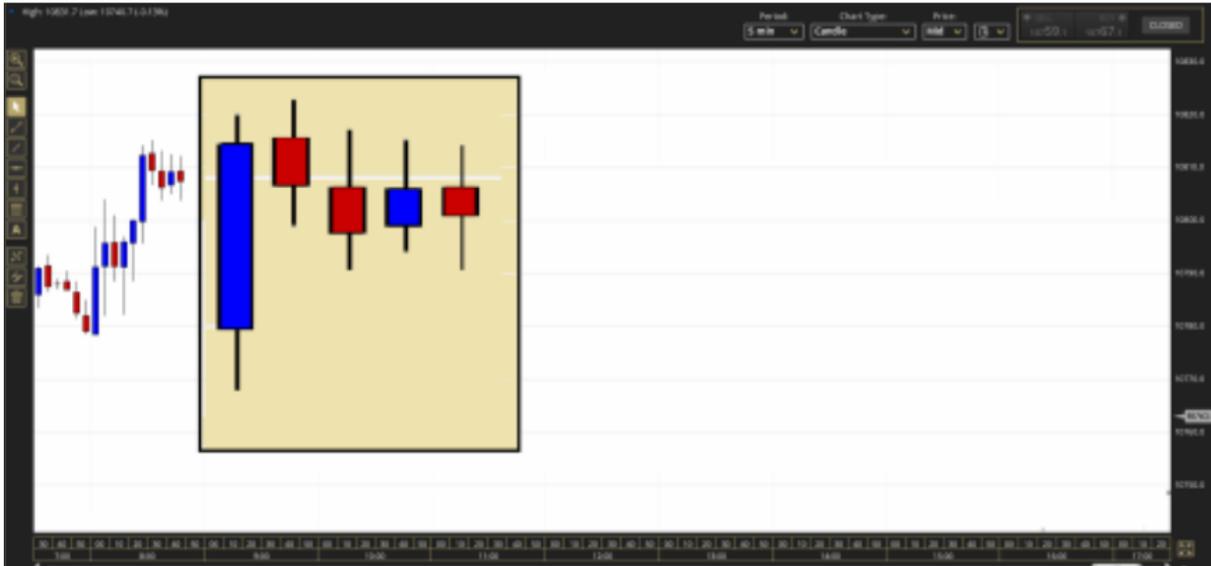
Turning our attention to the chart below, the next bar is a BULLISH bar. It closes near the high of the 5 minute bar. There is very little "tail" on top of the body of the bar. The

low of the bar is higher than the previous bars low. It also breaks out above the highs of the last 4 bars. The message I receive from this bar is:

1. The market is strong
2. The market is able to break above the last 4 bars high.
3. The market is closing near the high of the bar.
4. All is well, UNLESS the low of the bar is exceeded. This would mean that there was not enough strength from the buyers to absorb the sellers.
5. I would expect the market to test the highs of yesterday.



The next chart shows how the market goes into a sideways consolidation. Bar 1 is the long blue bar. Bar 2 is the next bar, and so forth. You can see how bar 2 in the sand coloured box makes a higher high and a higher low, but it has a negative close.

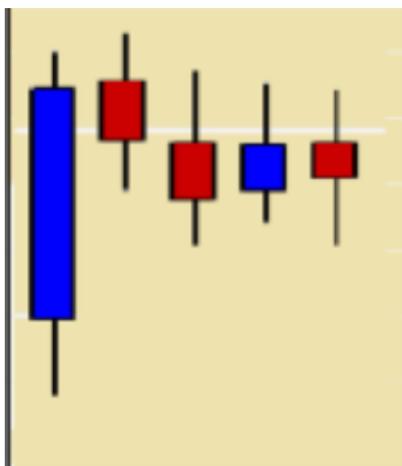


In my experience you often see corrections take the form of 2 waves. However, as I am writing this material, I realise how dangerous it is to make a statement like this. The market can do whatever the market wants to do. It can make a 1-wave correction. It can make a 3-wave correction.

I think every bar tells a story. Is the market bullish? Is the market bearish? Is the market marking time? I am constantly aware of the small nuances that the market is telling me.

For example from the chart above, I have cut out the box which shows the consolidation. I will refer to them as bar 1 to bar 5. The first bar is the long blue bar.

Bar no 3 makes a lower high and a lower low. I understand that this may not be what you consider a “lower high lower low”, but when it comes to trading price action as a day-trader, I do pay attention to this.



Bar no 4 makes a lower high, but it also makes a higher low. The 5th bar attempts to

push the market down below the low of bar no 4, but it fails.

When the market is in a strong bull trend, which it is on this morning in the DAX, I would expect the market to at least make a re-test of the highs.

This leads me to an important observation: The market has a tendency to only reverse after the important price levels have been re-tested.



The next bar on the chart above is a bar that tests the highs of the previous day. It is a great example of how the market has memory. Of course it isn't the market that has memory, but the traders buying and selling. They remember past highs and lows (or they look at the chart).

The low of this bar is still higher than the previous bar. It also broke above the last 5 bars highs. Although it has a long tail, I still expect the market to continue to move higher.

Only if the market begins to trade below the low of the bar will it potentially change the tune of the market. In my courses I teach a setup, which preys on situations like this. However, this would require that the market closes below the low of this bar.



The next 3 bars show an inside bar, a big spike higher – which fails, and a “neutral” bar. The spike will be interpreted as bearish by many traders, but this is not always the

case. What is significant about this bar is that it pushed above the previous high (from yesterday), and it failed to gain follow-through. However, the trend is still very much bullish, and there is no discernible weakness yet.

It means that short positions at this point are highly speculative. Traders who engage in short positions at this point will have high risk (of being stopped out – but small monetary risk) but also a good reward prospect as the target would have to be the opposite end of the trading range.

5 Explanation of Target

Let me explain that quickly: When the market has exceeded an important price point, either to the upside or to the downside, but it FAILS to follow through, the target (the magnet) is the opposite side of the trading range.

Here is an example (on the next page) from today in the FTSE index. I am currently short the FTSE because of the price action pattern you are seeing here: Market made a top, fell, rallied again, and failed to make progress above the old highs. I shorted when the market closed below the horizontal black line around 11:40am. My target is the old low. It may not happen, but that is the “magnet” of the market.

This took place on a 1-min chart. I often use the 1-min chart with the 5-min chart. The signals come quick on the 1min chart. My risk is small in monetary terms, but the risk of being stopped out is high. However, the potential reward is much bigger than the risk. I estimate I need to risk 8 points here. I have the prospect of 25 points.

At this point I have already placed my stop loss at break-even.



When you consider the simplicity of this approach, you also have to ask yourself a basic question: How many times does this happen across all the FX markets, the commodity markets and the index markets alone in a week?

Obviously I can't give you an exact number, but it happens a lot!

6 A Typical Trading Day - continued

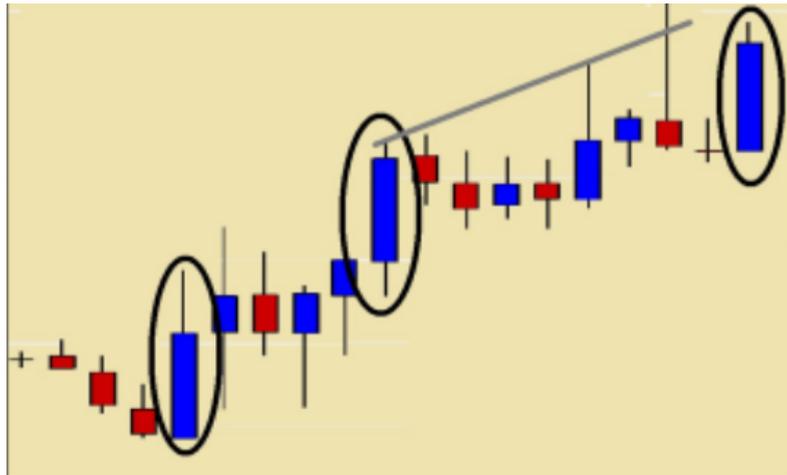
Back to our price action examples on the DAX...



The next bar is another push higher. There are still buyers about, even though the market made a bearish Doji (Candlestick terminology). Do you notice the 3 circles in the coloured area?

I have shown in the sand-coloured area the same chart as you see on the left of the chart. The 3 circles highlight the 3 most important bullish bars on the chart. What I notice is that at no point have the lows of these important bars been tested. At no point have the market traded below the lows of the big bullish bars.

I also notice the small trend line I have drawn is being penetrated, only to fail. When I see that pattern, I will focus on what happens afterwards. In this case I will focus my attention on the lows of that candle. I will most likely want to sell short the market, if the price trades below the low of the candle which has broken up through the trend line, but failed to carry on higher. I will either have an order lying waiting underneath the lows by a few points. It means that if the market reverses down, I will automatically be pulled into the trade. The stop-loss will get triggered automatically too.



You may take the next sentence with a pinch of salt, but have you ever heard about the pattern called “3 pushes”. Many patterns are simply a way of categorising observations into easy-to-remember clues about the market.

The DAX has here pushed higher in three separate pushes. However, before you line up the big short position, you have to look at the chart on the previous page and conclude that it is a bullish chart. It is only because you know the market has just tested the highs from yesterday that there is reason for caution. However, most resistance fails, eventually!

7 Geometry of Trading

I studied the geometry of trading for many years. The topic is captured so well in a book by Larry Pesavento called *Pattern Recognition with Fibonacci Ratios*. I may not use it in my day-to-day trading, but I am certainly aware of it, and I use some of the tricks from this particular form of market analysis.

One item I can recommend is the use of “measured moves”, sometimes known as “1 to 1”, sometimes known as “equal retracements”, sometimes known as “harmonic moves”. In Denmark we have a saying: *kært barn har mange navne*. Translated it means that a sweet child goes by many names.

On the next page you will see an example from a previous trading day of a Harmonic Retracement. I use it for several things:

1/ It gives me a good place to position my stop-loss on my longer-term positions. The idea is that you need to give the market space to breathe, so to speak. So by placing the stop-loss outside the range of the last retracement you give yourself a good chance of not being stopped out. Should you get stopped out, it often also means that

the trend has changed. This is called “over balancing” – obviously an expression from the world of geometry. There is no longer balance in the retracements.

2/ It also gives me an entry signal. If I bet the current retracement will be equal to with the last retracement, then I know exactly where to place my entry order.

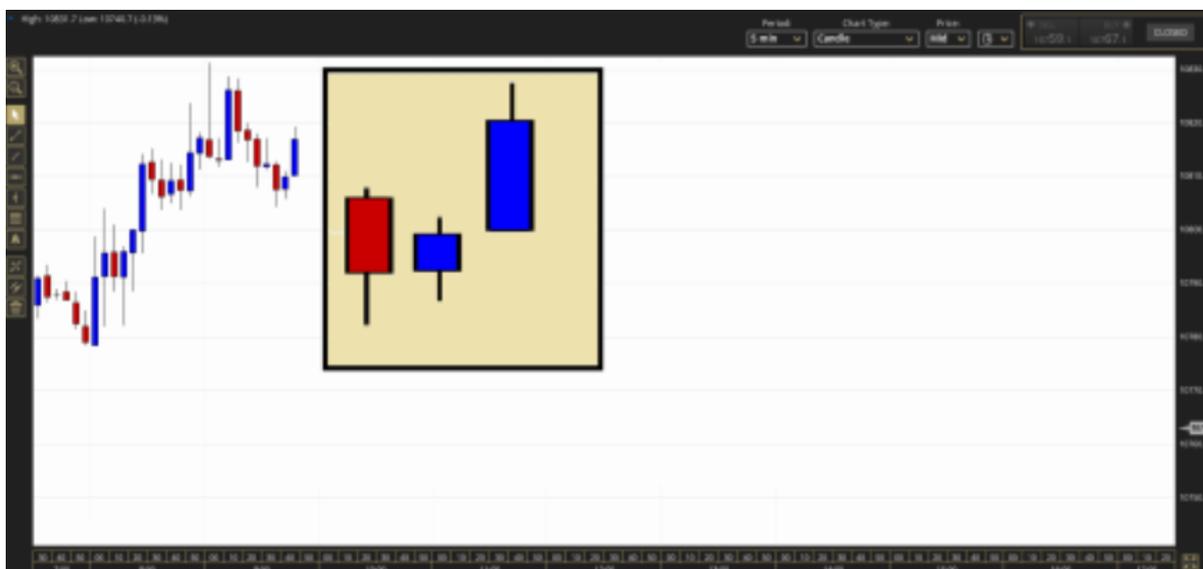


This leads me back to the charts of the DAX from the 25th October. I am still bullish overall, but the market has now closed below the low of the bar, which tested the highs from the previous day. This is normally a bearish development, and it requires a short position, with a stop loss above the highs of the day. The flip side is that the market hasn't really shown any real negative tones yet. I could at this point place a short position for a swing lower, and buy the DAX on a harmonic retracement. Either and both are valid.



8 Reversal Day or Trend Resumption

At this point we don't know if the market will resume its trend up, or if it will reverse down. Here we see 3 bars in the sand-coloured box. They are a close-up of what you see on the chart to the left of the box.



If you look carefully at the last 7 bars, you will see the following:

1/ the market has made lower highs and lower lows on three consecutive bearish bars. The 4th bar is a higher low. This higher low fails, and the market continues lower, creating a two-wave correction.

The second last bar is the bar I am interested in. This is a potentially bullish bar for a scalp trade. It is an inside bar, i.e. it has a higher low, but it doesn't have a higher high. If the market breaks above the high of this bar, it is good for a scalp trade.

The next bar, the last bar you can see, shows the market make a move higher, and it enables me to make some observations of the market:

1/ the market may have seen a top, as it failed to push above and CLOSE above yesterday's high. A short signal is in play now.

2/ the market is not showing any material weakness yet. Only a move below the price of 10,805 could set a movement lower.

9 Some Explanations – Scalp Trade – Extended Bar

What is a scalp trade? It is my attempt to take a few points from the market. If the market reacts well, I may sit with the trade. I am often using orders to get into the market on scalps. For example in the example above I used an order to get in on the long position, on both the harmonic Buy Signal, and on the inside bar breakout – after ab-cd move. An ab-cd move is another word for a two-wave correction.

What is an Extended Bar? An extended bar is a bar which has very little “tail”, and which is visibly bigger in body than the candles which come beforehand.

The Dax rallied for 15 minutes and then reversed. The last bar you see in the sand-coloured box is an extended bar. It is not the best looking EB I have seen, but it is close enough to being perfect.

The DAX displays a harmonic move higher, in line with the last push higher to the top (nearly). The DAX then breaks below the last swing low. I see this as a SELL SHORT SIGNAL. At this point I can guarantee you that a Stochastics indicator would suggest you buy. It would have gone “oversold”.



After the short signal there is some follow-through, followed by two blue bars. At this point I will have a stop-loss above the high of the Extended Bar. If this means using a larger stop, I will decrease my stake size.

I would not be tempted to exit my short position because of the two blue bars. It is perfectly normal to see some retracement after an Extended Bar. At this point in the

trading day, with the DAX trading below 10,800, and making lower highs and lower lows, the trend looks set for lower prices.



10 Managing the Position

I use a technique which trails the stop lower. It is a simple technique.

If the current bar goes below the low of the previous bar, I will move my stop loss down to the top of the current bar. If it doesn't make a new low, then I will leave my stop loss alone.

If you study the sand-coloured box on the next page, you will see a close-up of the last 8 bars. On the way down I trail my stop, but I only move my stop loss if the bar makes a new low.

An Extended Bar that comes after the market has already trended for at least 10-15 bars is more often than not an "exhaustion" bar. If you study the move higher in the morning, you will see that after every Extended Bar the market pauses before moving higher.

The same happens more or less on the way down. The last Extended Bar on the chart below comes after the market has already trended for an hour. Therefore, if I am not already short the market, I would be hesitant to short here, even though the bar is negative.

11 A Brief Tale from a Master

One evening I sat and traded with Bryce Gilmore. He is the absolute wizard of geometry trading. Incidentally Larry Pesavento and Bryce Gilmore are best friends and shared an office and trade together. On this evening Bryce had a short signal, but he didn't take it. I asked him what he was waiting for, and he answered: "I am waiting for the market to paint a red bar on the 1min chart. That way I know there is some weakness in the market." Wise words.



The rest of the trading day is displayed on the chart below. I have highlighted with black horizontal lines some of the trades I have taken on this day. I don't deny that this is an intensive form of trading. It suits me.



12 Price action on Different Time Frames

Price Action can be used on any freely traded instrument. On the chart below (next page) you are looking at Crude Oil on a 10min chart. It is day of 4 distinct stages:

- 1/ initially a Trading Range Day (TRD)
- 2/ market break down at 10am. The bars are predominately bearish bars.
- 3/ a tight channel marks the retracement of the bear trend – then resumes trend
- 4/ a trading range again



Although this is a chart from a commodity rather than an index, it can be traded exactly as I would trade an index. On the chart above, which is a 10min chart rather than a 5min chart, I see:

- 1/ a harmonic retracement around 18:00
- 2/ a failed breakout at 18:00
- 3/ an extended bar at 08:00
- 4/ a harmonic retracement around 12:00 which is equal to retracement at around 10:00

13 In Closing

I hope this gives you some appetite to study Price Action further.

I run 1-day and 2-day courses on trading techniques and price action. You can read about the course on my website www.tomhougaard.dk

Happy Trading

Tom Hougaard