

Trading Made Simple...

“NO INDICATORS NECESSARY!”

TONI HANSEN'S ULTIMATE GUIDE TO
CONSISTENT MARKET PROFITS WITHOUT
INDICATORS

Presented by Toni Hansen



tonihansen.com

swingtrader.net

Sponsored by the Chicago Board of Trade

* This guide is meant to supplement the video CDs recorded at the Denver Trading Group. Some slides from the actual presentation have been removed, while others have been added to clarify certain points of interest.

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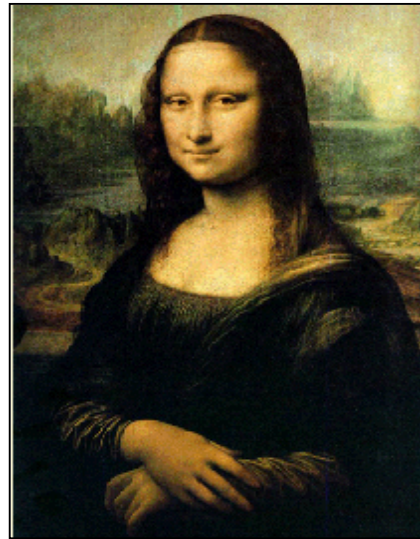
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THE ART OF ANALYSIS

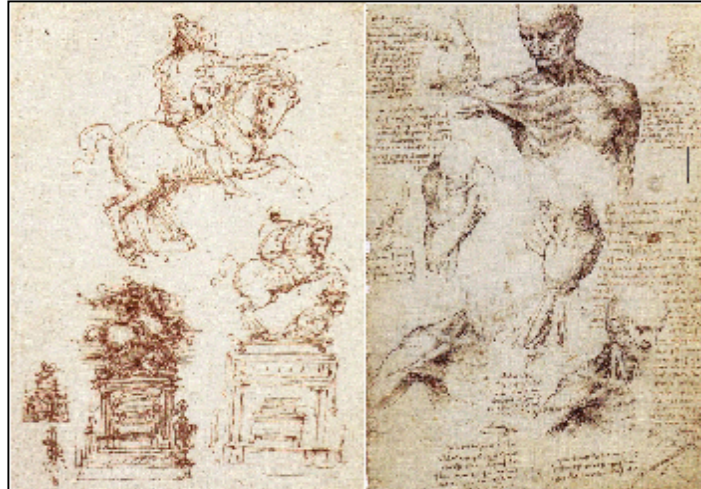


What type of artist are you?

In an age where painting consisting of a dozen brush strokes by an elephant sells for about \$300 a piece, it's difficult for many to realize what it takes to become a truly talented artist as opposed to an artist that just happens to have a good publicist. Unfortunately, when it comes to the art of trading, it doesn't matter what kind of publicist you have. If you can't master the skill set, you are just tough out of luck. At least if you pay for the elephants' paintings, you are also helping out a good cause, but unskilled traders are often not going to find themselves in a position where others are going to be pleased to help bail them out and support them as charity cases. It's much better to simply never reach that place to begin with!

If your skills as a trader are equivalent to my artistry above on the left, you may not want to quit your day job! At least don't expect to be able to make a consistent living at it. It takes a great deal of experience and practice to master the art of technical analysis and even more to reach the level of a professional trader.

Detailed studies of structure and anatomy set Leonardo da Vinci apart.



One of the best-known artists in our day and age is Leonard da Vinci. If you pick any stranger on the street and ask them about da Vinci, the chances are they will be able to tell you at least something about him. Although Jackson Pollock is also rather famous in the art world, his name does not permeate mainstream society. Even before the release of *The Da Vinci Code*, most of us were familiar with da Vinci's mastery of the human body and his eye for detail.

When I was in Paris a few years ago, before the publication of Dan Brown's infamous novel, I was lucky enough to view an exhibition devoted to a series of da Vinci's sketches and drawings. The details and accuracy apparent in even the "simplest" of these is truly remarkable. Da Vinci was so intimately at one with portraying reality on paper and canvas that he could even capture the effect of horses galloping. Sure, this seems easy enough these days, but we are blessed with motion pictures and computers that allow us to slow down movement to view such details, which most of us would not be able to otherwise portray by simply relying on the naked eye

Such detailed studies and analysis of living beings required an artist such as da Vinci to explore the structure and anatomy of their subject matter and to learn how the bones and musculature work together to create the whole being. Many traders think in terms of generalities. "Well, that looks like a head and shoulders pattern, so I need to short it." It doesn't matter what the details are in the pattern itself, even if the pattern might be the equivalent of a sketch of a horse with the knee joints bending the wrong direction. After all, the horse still has legs, right?

They miss out on the fact that the legs are those of a crippled animal and not one that is likely to survive, let alone thrive.

TYPES OF MARKET ANALYSIS

- ® **Fundamental Analysis:** Based upon the belief that the markets “misprice” a security in the short term, but that the “correct” price will eventually be obtained.

- ® **Technical Analysis:** Rooted in the premise that the price of a security already reflects all relevant factors such as earnings and cash flow.

There are two main schools of thought when it comes to analyzing the market as the most accurate means of reading the activity in a security to provide a trader or investor with an understanding of the bigger picture and view of where prices are heading next. Each of these has its die-hard supporters and those who go to great to great lengths to debunk the other.

The first of these is fundamental analysis, of which I have very little to say. Fundamental analysis is based upon the idea that what is currently shown in a security’s price action is “mispriced” and that by exploring a company’s earnings, growth, etc., an investor can make an educated decision on when and where to execute a position in that security. Now, I do know of many investors that will swear by this, but I also know that many of my best positions would have been considered to be horrible choices by fundamental analysts and many stocks that were actually topping had wonderful fundamental reviews.

The second genera of market analysis, called technical analysis, is based upon the premise that the price of a security already reflects all of the relevant factors that fundamental analysis attempts to address. A number of traders that I know who do rely heavily on fundamental analysis focus on longer term positions and combine fundamental analysis with technical analysis.

TECHNICAL ANALYSIS

Technical analysis, in its purest form, considers *only* the *actual price action* of a market or security to determine a directional bias. This price action is displayed using various methods of charting.

Technical analysis is a very visual method for analyzing the market. Coming from a background in the arts, I found this methodology to be particularly appealing. Since I deal primarily with shorter time frames in my everyday trading, the fundamentals of the company I am trading are irrelevant. All that matters to me is how market participants are behaving at that particular point in time. Technical analysis allows me to view this market behavior in the form of a picture.

Many technical analysts use a number of various indicators to help them determine the most likely direction of an upcoming move in a security. These include everything from moving averages to stochastics. In its purest form, however, technical analysis only considers the actual price action of a security to determine its directional bias. The price action itself is the equivalent of the bones of a security's price development. Understanding the interplay of these pieces of the puzzle is a great way to allow a trader to gain real confidence in individual setups and to differentiate between a thoroughbred and a cripple.

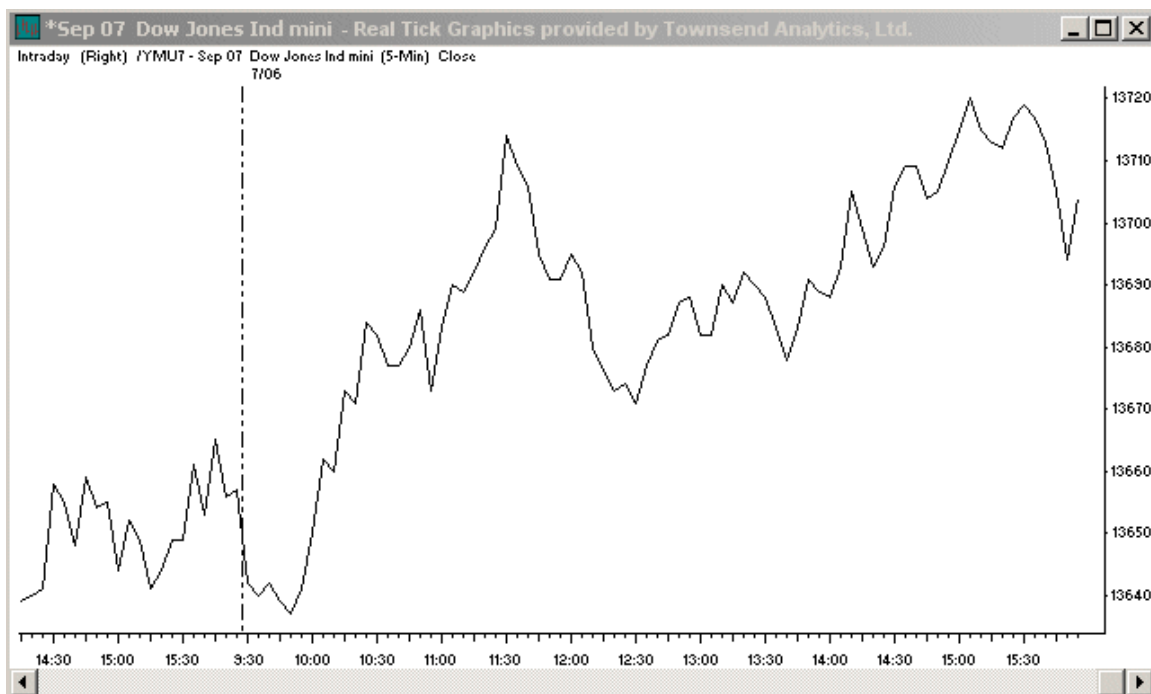
CHARTING AND TECHNICAL ANALYSIS

The primary visual tool of a technical analyst is a chart displaying a security's price action. There are four major types of charts utilized by technical analysts: line charts, point and figure charts, bar charts, and candlestick charts. Other styles exist, but these are by far the most popular.

- 1) Line Charts
- 2) Point & Figure Charts
- 3) Bar Charts
- 4) Candlestick Charts

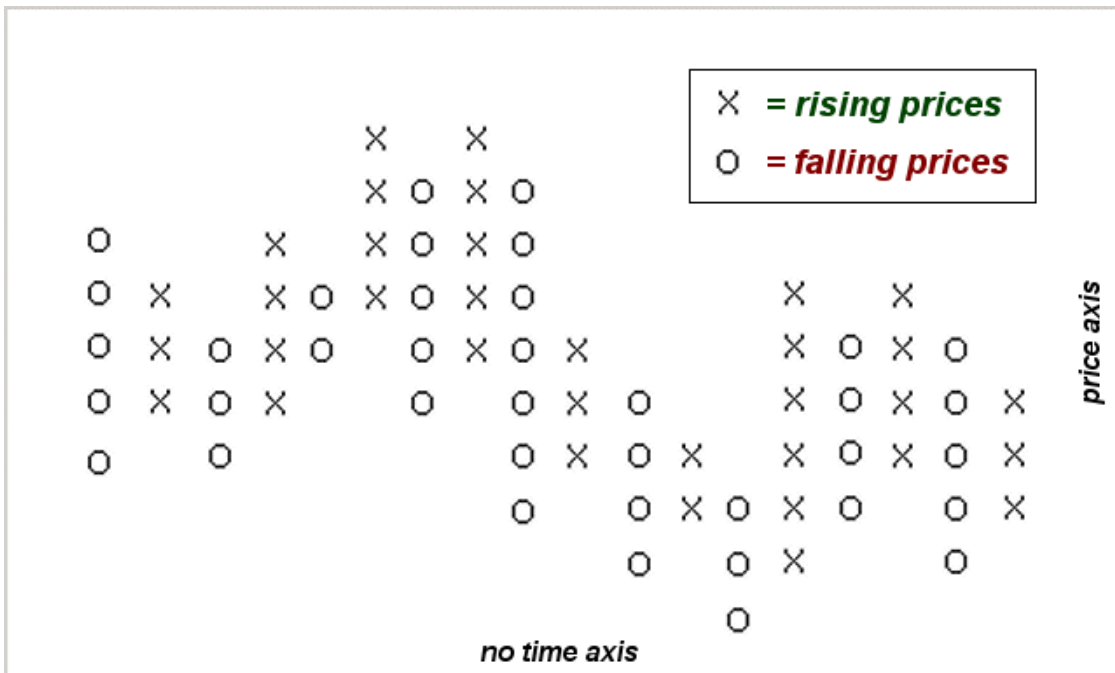
LINE CHARTS

Line charts are a very simplistic form of charting. A line chart is created by connecting a series of price points with a line. These price points are typically the closing prices of a certain increment of time. On a daily chart, for instance, this means that the points which are connected are the closing prices from each day of data.



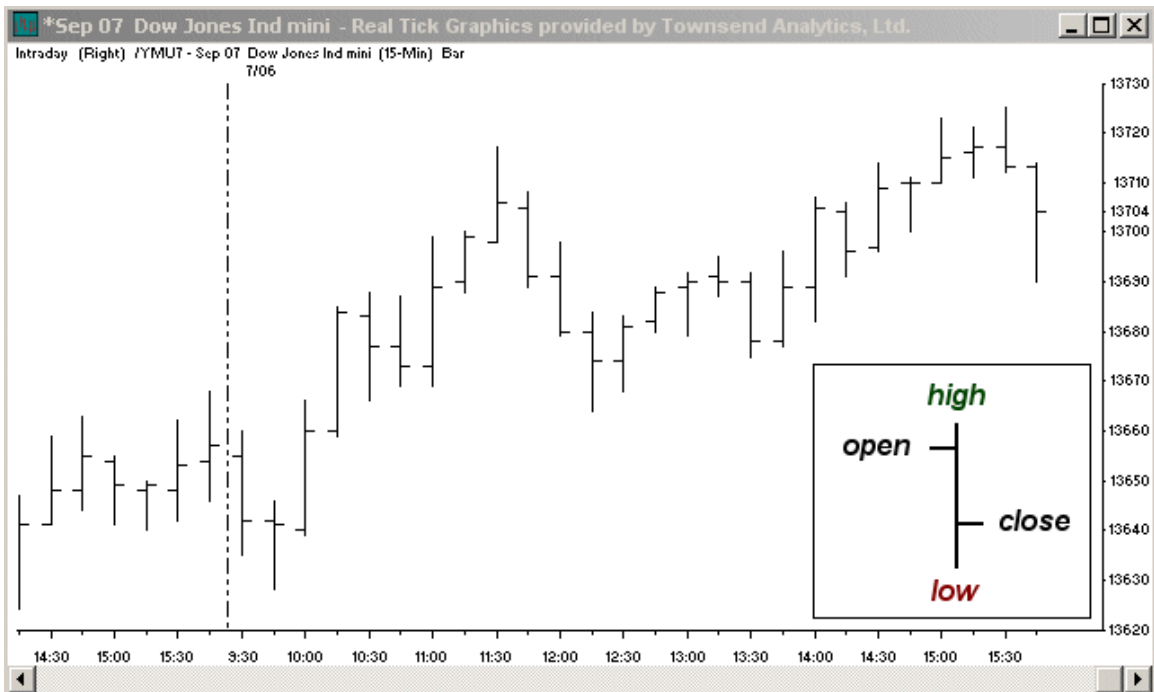
POINT & FIGURE CHARTS

A second method of charting uses what are known as point and figure charts. Best-suited for longer-term investments, this style has grown in popularity with the advent of advanced charting platforms. These charts emphasize only the closing prices in a security and focus on trend development. They consist of a series of Xs and Os, whereby the X and O only appear if the security moved at least one unit of price in either direction. The unit of price movement is up to the chartist. An “X” is used to indicate an upside move, whereas an “O” is used to indicate a downside move. If a security moved up one price unit three times it would appear as a column of three Xs. If the price reverses direction, the chart shows a new column of Os. If the unit of price is 10 cents, then the three Xs would mean an upside move of 30 cents and another X would not be displayed until the security moved higher by another 10 cents. If it moved lower by 10 cents, on the other hand, then it a new column would begin with an O designation.



BAR CHARTS

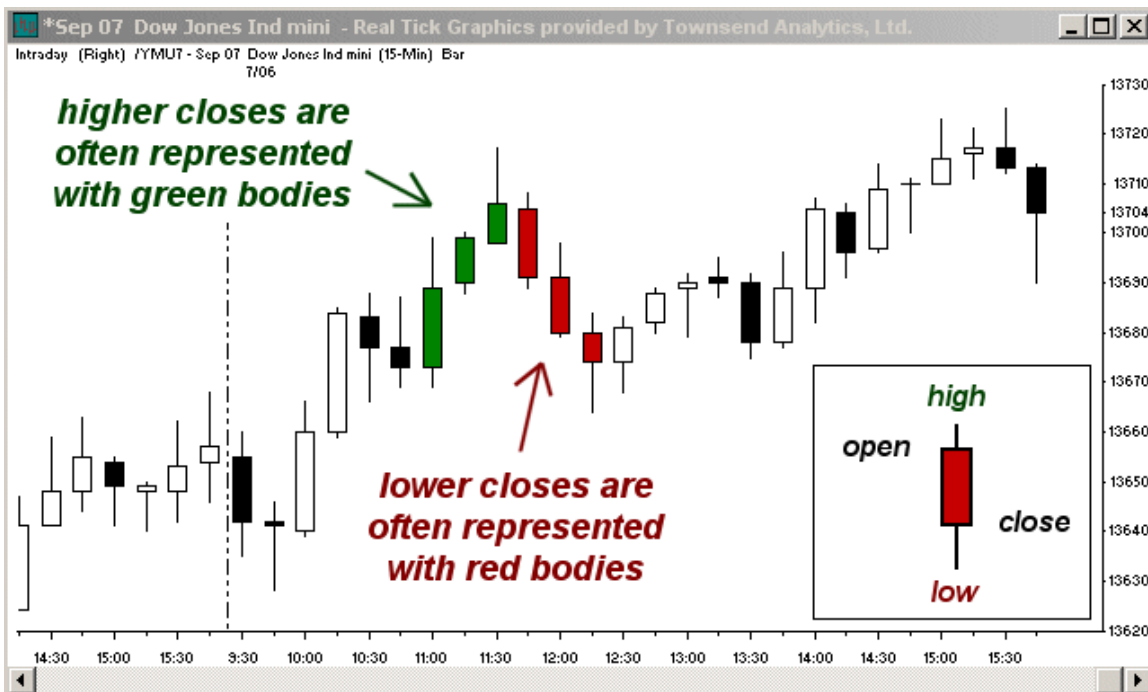
A third popular charting method is the bar chart. In a bar chart, each increment of time on a chart is represented by a separate character called a “bar.” The bar is a vertical line with two small horizontal lines sticking out of each side of the vertical one. The opening price for the bar is shown by the left horizontal line, while the closing price is on the right. In the chart below, each bar displays the price activity during a 15 minute segment of time. The highs and lows of the bar indicate the other prices which traded during this period of time.



CANDLESTICK CHARTS

Although bar charts are used fairly often by chartists or analysts, to me they are sort of like looking at a stick figure drawing. Most of my friends prefer line charts to bar charts, but even more popular among my peers is a fourth category of charting that builds upon the ideas put forth on bar charts. These are called candlestick charts and they serve to “flesh out” the bar charts and provide a more visually stimulating form of charting.

Candlestick charting has been in use since at least the early 18th century and traces its development to Japan. The first known book on technical analysis comes from this region and was written in 1755 by a successful rice trader named Munehisa Homma. In it he discusses the bullish (yang) and bearish (yin) cycles of the rice market, addressing the need to understand market psychology in order to trade successfully. All a chart does is provide a trader with a visual representation of this market psychology, showing them where areas of euphoria, fear, and hesitation are occurring in a security.



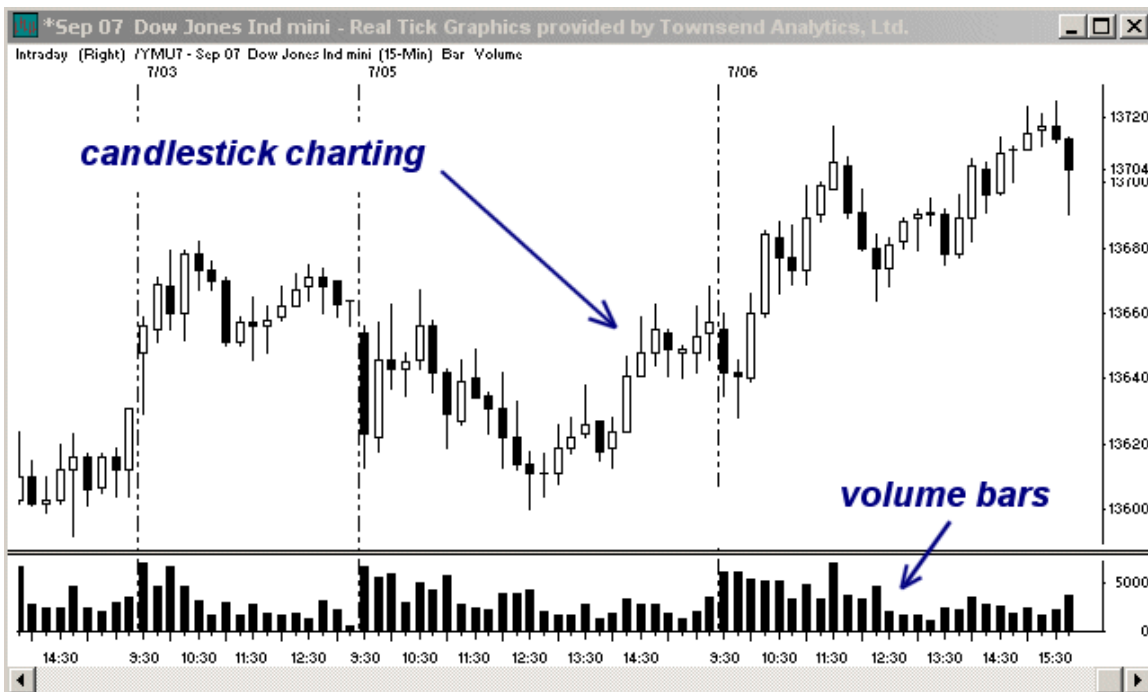
Candlestick charting is my preferred method of charting and the one that I use on a daily basis. Each character in a candlestick chart is also called a “bar”, but instead of showing an opening price on the left and closing price on the right, the open and closing prices are represented through the use of color. Notice that many of the bars on a candlestick chart have a vertical rectangle with upper and lower lines coming out of it. Each of these bars is known as a “candlestick.” The rectangular segment of the bar is called the “body” of the candlestick, while the lines which stick out of the highs and lows of the body are called “tails” or “shadows.”

When a candlestick bar closes higher than it opens, then the typical colors used are either white or green. These are called “open” candlestick bars. When a candlestick closes lower than it opens, then they are usually represented by either black or red candlestick bars and are called “closed” candlestick bars. A bar which opens and closes at the same price is known as a “doji.”

CANDLESTICK CHARTS & VOLUME

In addition to the candlesticks themselves, I also add volume to my charts. This allows me to see not only the price movements, but how seriously traders or investors are committed to these moves. There are probably as many ways to display volume on a chart as there are the chart styles themselves, but I like to keep it very straightforward. Each vertical bar under each candlestick bar shows exactly how many shares or contracts exchanged hands during that particular time period. In the chart below of the YM, which is the mini-sized Dow, it means that each bar is showing the volume during a 15 minute span of time.

If the price movement in a security is the equivalent of the bones to a pattern in the market place, then volume is the muscle. These two building blocks provide the framework for differentiating between the development of one directional bias in the market or in an individual security as compared to another. They alone can be used to tell a trader or investor whether to buy or sell and when to initiate these actions to achieve the most favorable outcome.



OBJECTIVES

- ® Learn the building blocks of price development
- ® Develop an understanding of the ebb and flow of market moves
- ® Recognizing pattern perfection vs. mediocrity

As we move on from a basic introduction to market analysis, there are several major objectives which I wish to achieve in this presentation. The first is to familiarize you with the core building blocks of price development. In other words, within the charts of a security, what do the bones and muscles really look like.

Next, I want you to be able to develop an understanding of the ebb and flow of market moves. This means an understanding of how the bones and muscles of a price move fit together to create an actual pattern in the market. Additionally, how does one pattern evolve and flow from one into another.

Finally, how can a trader differentiate between an ideal set of criteria to form a perfect specimen of a trade as opposed to something that is crippled and more likely doomed to fail.

THE 4 BUILDING BLOCKS OF TECHNICAL ANALYSIS

- 1) Pace / Momentum
- 2) Volume
- 3) Support & Resistance
- 4) Trend Development

When examining price and pattern development in the market, there are four major characteristics that I focus on. They are pace/momentum, volume, support/resistance levels, and trend development. Each of these can be either a pro or a con for a bull or a bear, depending upon how each of the pieces fit together. One trait, in and of itself, is often not particularly helpful in assessing the odds of a market move in one direction or the other. They are just one piece of a larger puzzle. The more pieces a trader has in front of him or her, the easier it is for them to guess what the final picture will look like. Some of these pieces are more telling than others.

BUILDING BLOCK #1 – PACE/MOMENTUM

The first building block of a market or security's movement is pace. To me, this is probably the largest piece of the puzzle that a trader or investor has at his or her disposal, and yet it is the one that is most often overlooked and almost never addressed in traditional market literature. It has long baffled me how traders who have read hundreds of books and spent thousands of dollars on market education will come to me and tell me that they had never even heard of this concept until they had read something I had written or listened to a presentation I gave, although many will express the "feeling" of such knowledge, without having ever seen it discussed before. I've read so few market books in my lifetime that I cannot say whether or not it is a concept anyone else has ever written about, but I doubt that it is truly a novel idea. Most of the "discoveries" I have made as a self-taught trader are those that I have later run across in discussions with other traders who will say, "Oh, yes, such-and-such wrote... about it..." Despite its apparent obscurity, I view this particular building block to be indispensable in terms of generating a successful outcome on a trade or investment.

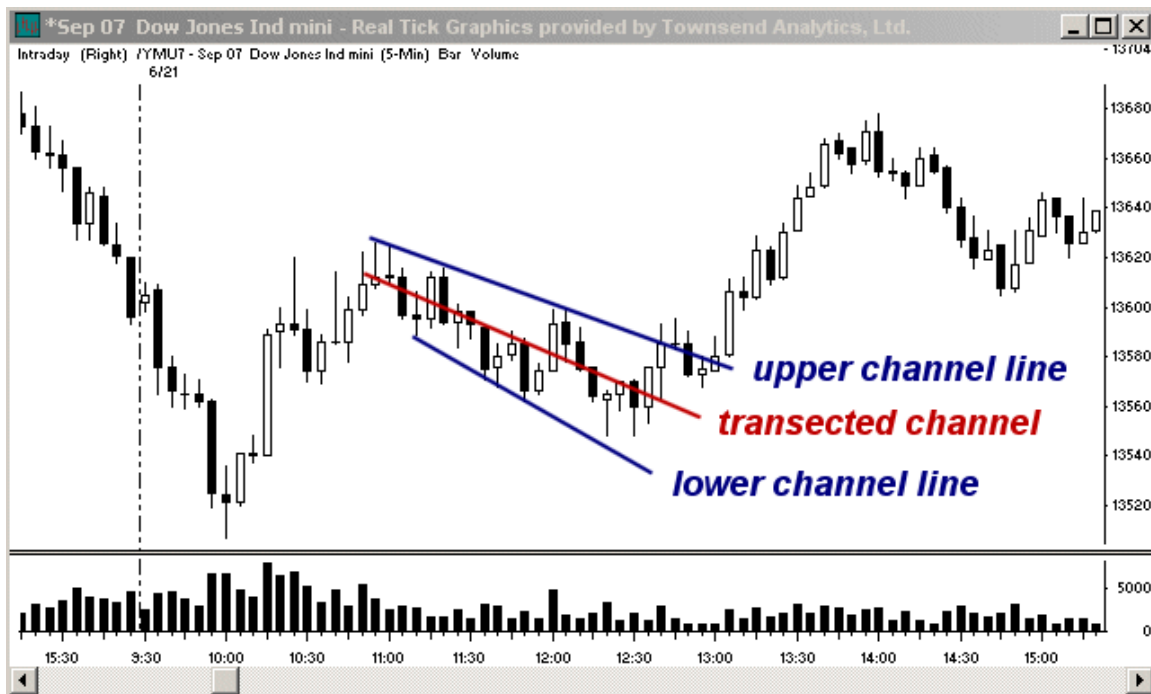
Pace is a measurement of the momentum of a trend move in a security as compared to not only the average move, but also the most recent move on a given time frame.

The term "pace" could also be substituted by the word "momentum." Essentially, when I am looking at the pace of a move in a security, what I am examining is how fast that move is occurring as compared to before. In making this determination, I am looking at not only how fast or slow a current move is as compared to the one which just preceded it, but also how it compares to an average move in the security as a whole. For example, is the buying advancing more quickly than the previous selling? If so, is that upside move still lagging as compared to an average price move in the security?

TIP FOR MEASURING PACE #1

- ® Do not measure from the highs to the lows of a trend move, but instead transect the trend move for the most accurate representation of pace within that market or security

When a trader first begins to apply the concept of pace or momentum to their trading, a typical mistake that many have made is to look at a move in a security and then draw a line connecting the highs to the lows of that move. The result is a very skewed and distorted version of momentum. Even a gradual overall move can look extreme when put in such a light. Instead, look at the move as a whole and transect it to generate an accurate representation of the true momentum of a move.

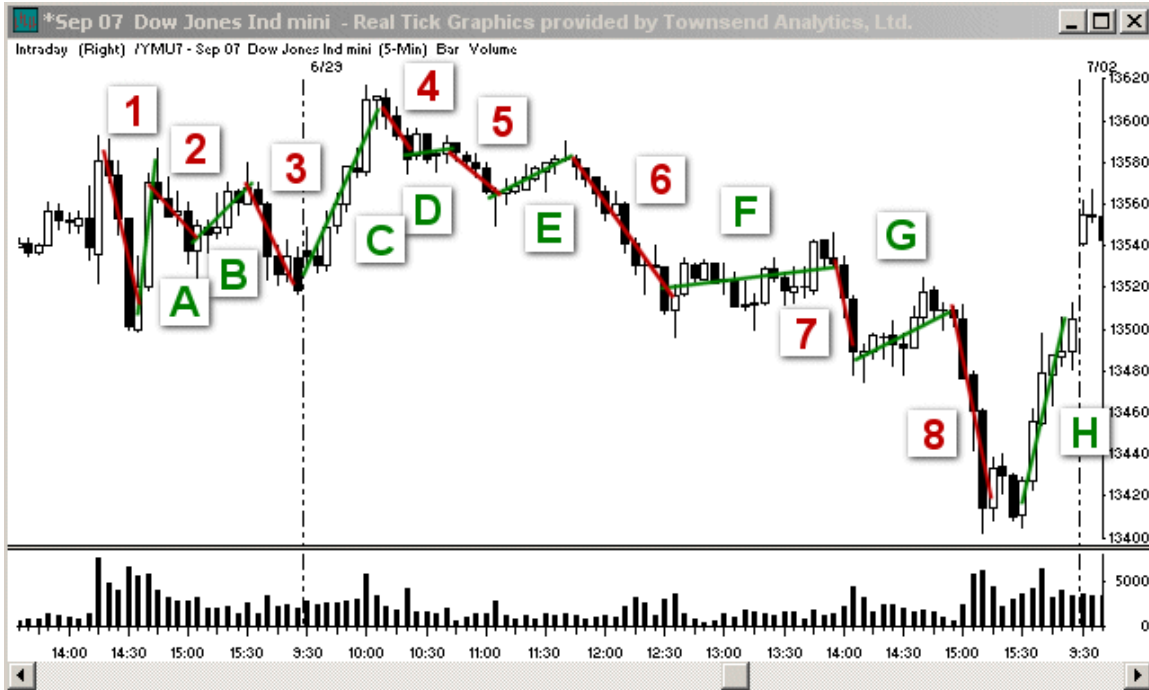


The image above of the YM portrays what a transected move in a security looks like. The upper and lower lines are the trend channels for this intraday descent. By cutting this channel into an upper and lower half, I now have an accurate representation which displays the overall pace of the downside move.

By taking this same method and applying it to the previous moves within a security, I can take note of the evolution of these moves from one into the next and use these comparisons to give me a good idea as to which direction the security will move next.

MEASURING PACE

This 5 minute chart of the YM illustrates the evolution of one momentum move into the next and the subsequent reaction and follow-through.



The initial drop transected in the image above is labeled #1. When the index bounced back higher in A, it did so at a comparable rate of change as the original descent. It is typical that when these back and forth movements are nearly identical that a trading range will then begin. The second move does not have to last as long as the first though. A downside drop of \$1 may take an hour, but the second move might only go \$0.75 in 45 minutes before reversing again. These are still comparable-paced moves. When the security turns back around, the previous lows will have a higher chance of holding, assuming they hit at all. It is not uncommon to see smaller moves follow, such as with #2, B, and #3 when the trading range narrowed.

Even though the range shown above attempted an upside breakout at C, the momentum of that upside move was not any stronger than the third decline. Unless the index could significantly slow coming off the highs of C, then it was doomed to fall into an even larger range.

When the fourth descent began, it again displayed a comparable pace as the previous upside, favoring a range bias. The larger move lost downside momentum, however, when the YM based at D.

A sideways move in a security which takes place at a much more gradual pace than is average for a security will typically break with a stronger one. While this did happen in #5, leading to a stronger drop than the upside from the D congestion, moves 4, D, and 5 combined now created a slower downside pace than the more rapid upside from C.

As the YM continued to turn around off the highs, the upside remained weaker than the downside moves. E provided a second example of a slower upside move than the previous two declines and allowed the index to again break lower into noon. When I am watching for a breakout pattern for a continuation move, I want to see this slower corrective action, because then the breakout itself can gain momentum more easily and I can avoid a lot of the choppy trading that is more common on the reaction or correction following a stronger than average move.

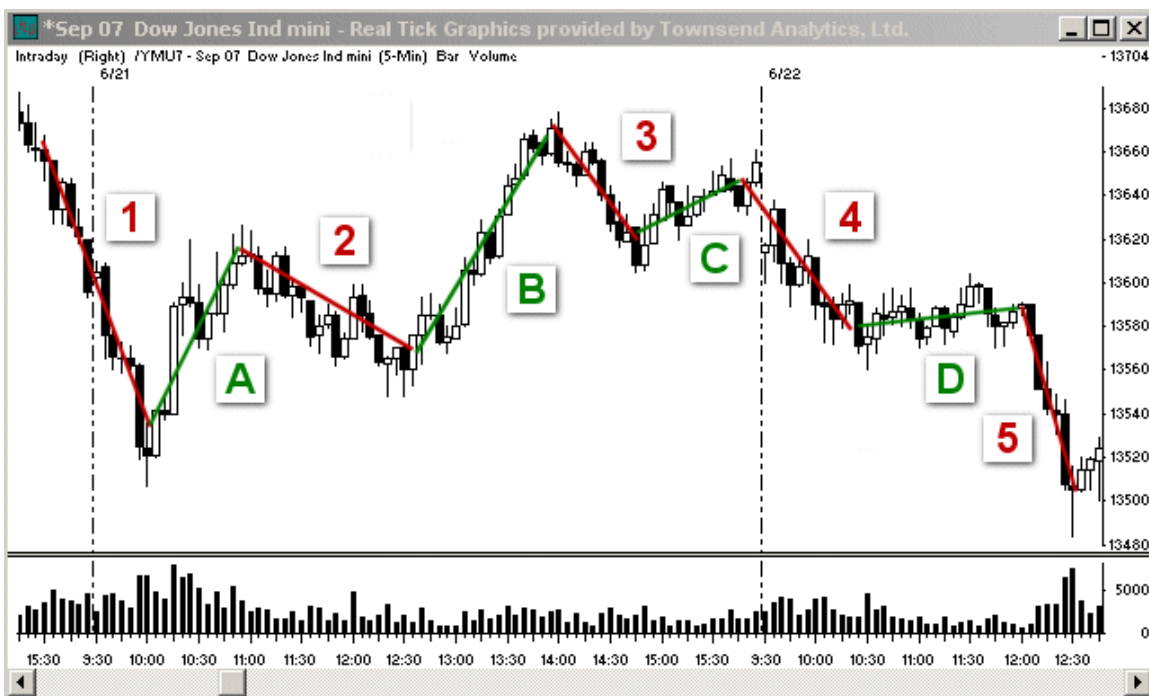
Throughout the remainder of the session these slower upside and more rapid downside moves persisted. Even though there were some brief periods of sharper upside within the F and G corrections, when the entire moves themselves were transected the result were that these upside moves were still more gradual than the downside ones.

When the YM finally bounced at the end of the day it did not form a sharp pivot V low. Since the selling was significantly stronger than even most of the moves intraday, it took some congestion along the lows during the final hour of trading to round it off. This created a change of momentum on the 1 minute time frame going into 15:30 ET. It then popped higher into the next day.

TIP FOR MEASURING PACE #2

- ® Ignore any “wayward” ticks or extreme 1-2 bar moves and focus on “the meat” of a trend move.

This second concept for measuring the pace of a trend is very similar to the first. When I am looking at a momentum move, I care more about what the momentum of the move as a whole is and not just a brief aberration within a larger move. As such, I tend to ignore any rapid spikes within a trend move in favor of transecting the bodies of a price movement.



In the waves of buying and selling on the chart above, it is fairly easy to transect the majority of the moves without any hesitation. In the first upside move, however, there is a rapid spike at A before it puts in a slightly higher high half an hour later at about 11:00 ET. In measuring the entire momentum of this upside, it is necessary to ignore the spike and favor a transaction of the entire rally. What the slowing does say at highs on the smaller time frame though is that it can more easily retrace a larger chunk of that upside move than if the first highs at

about 10:30 ET had held. If that been the case, then the index would have more likely based and not pulled back and retraced as great of a percentage of the A upside move when it corrected at #2 on the pullback.

TIP FOR MEASURING PACE #3

- ® Weigh the most recent segment of a trend move more heavily than the overall move when determining the immediate reactive move.

This takes us to the third idea to keep in mind when monitoring pace. Even though you should pay attention to the larger overall move to indicate the retracement odds on a larger time frame move, pay the greatest amount of attention to the most recent segment of a price move in order to determine the most immediate reaction to that type of move. For instance, even if something spikes quickly higher as it did in the previous example at A, if that pace slows on another test of highs or rounds off at those highs, then it can create a more rapid drop off the high even though the typical response to a sharp upside move is a more gradual correction.

MEASURING PACE – TRANSECTED MOVES

In this example of a downtrend move, I have transected the move as a whole by drawing both an upper trend channel line, as well as a lower trend channel line. I then drew a third line to divide the two into equal halves. This gives us the pace of the overall downtrend. Within the downtrend itself, however, there are a number of minor trends into the upper and lower ends of the trend channel.

As the trend channel progresses, the YM began to hug the upper trend line to the downtrend channel. The momentum within this smaller trend is very similar to the pace on the overall trend. It is only when we then compare that smaller trend to the other movements within the larger trend channel that we can see how important this smaller trend from about 9:50 ET to 9:57 ET really is.



MEASURING PACE - INDIVIDUAL MOVES

In this example of a downside move, there are a number of very strong selloffs which began the previous afternoon around 15:50 ET. The momentum of each of these moves increases as the selloff continues into the next morning. At 9:45 ET, however, the upside momentum began to pick up. The YM bounced more quickly off this low than it had at 9:35 ET. Even though it still put in a lower high, instead of dropping quickly again on a fourth move, the index hugged the upper trend channel line.

Again notice how, instead of measuring from the highs to the lows of the fourth downside move, I transected the bodies of the pullback and ignored the tails. This gave the best representation for where the momentum in the index really was. In this case, it meant that the downside was waning and the bulls were beginning to gain a foothold. Essentially, the momentum of the selling had shifted and was no longer strongly bearish. Instead it was showing greater hesitation on downside activity despite nearly retaking the previous low into 9:57 ET.



BUILDING BLOCK #2 – VOLUME

Volume is a measure of the number of shares or contracts that exchange hands in a given time period. It is instrumental in representing the level of emotional commitment of market participants.

In addition to monitoring the momentum or pace of market activity, measuring the volume within a move in the market can also provide great insights into the larger directional bias of a security or index. Volume can be a bit of a tricky tool to learn to use because influxes and decreases in volume can mean different things, depending upon where they take place in a larger trend move and what the pace of a move is that accompanies certain types of volume.

Although I delve into the individual nuances of volume in my CD course ***The 5 Technical Signals You Should Not Trade Without***, there are several cases in which volume can be easily read by even the greenest of traders or investors. These include declining volume within a congestion zone, which can be used to support a directional bias for a breakout from the congestion, declining volume within a trend move, and volume spikes on downside moves to indicate exhaustion on a trend move. These can be used in conjunction with one another to not only time the entry on a position, but the exit as well.

ANTICIPATING BREAKOUTS

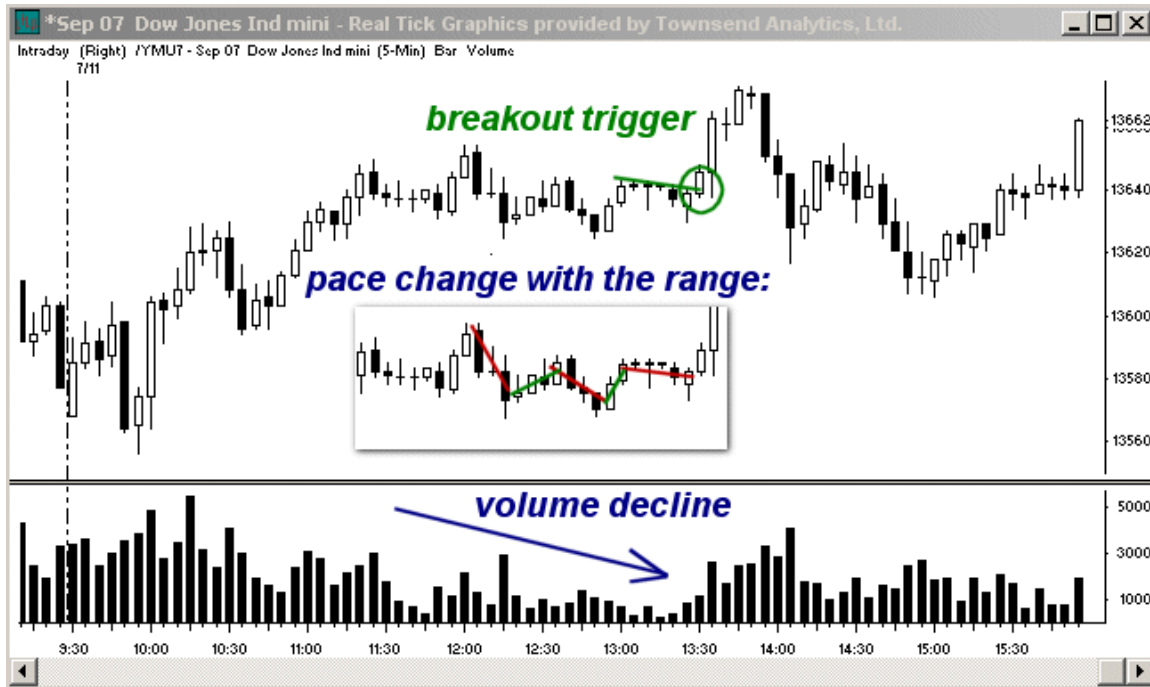
- ® Often the volume in a gradual trend channel will drop to extremely light levels just prior to the channel breaking higher or lower. This is usually the best time to enter a position.
- ® Pace will also tend to slow even more at this time and the security will start to favor one end of the channel over the other.

One of the first, and perhaps most popular, uses of volume data is as an indication of building momentum or a lack of pressure to go against the predominant trend or directional bias of a security or index. When a market vehicle such as the YM falls into a period of congestion or range-bound trading, it is very typical to see a marked decline in volume as the congestion progresses. If a security is basing along highs and volume declines throughout the congestion zone, then the odds are higher that the congestion zone will break in the direction of the previous trend move. In this case it would mean an upward resolution to the range.

The key component that cannot be left out of this analysis, however, is an assessment of the pace on the minor trends which make up the larger trading range. For an upside breakout from a range at highs to have the highest probability of sustaining itself long enough for the trader or investor to reap adequate gains, the last downside or sideways trend within the range should be slower than the upside one which preceded it. It is also that last pullback from the upper trend channel that should contain the lightest volume of the range.

Many traders and investors become very nervous when volume drops off to “nearly nothing” in a security they are following. It is a representation of uncertainty. People like to see confirmation and no volume means no confirmation. In fact, however, this is often the best time to work on maneuvering into a new position! It is at this point in a pattern’s development that you won’t have to worry about chasing or fighting to get a fill. Slippage is virtually nil when a security is stuck in a range and volume has dropped to a low hum. Sure, you

may have to enter a long on the ask or a short on the bid, but typically you can get within a tick or so of whatever is printing on time and sales.



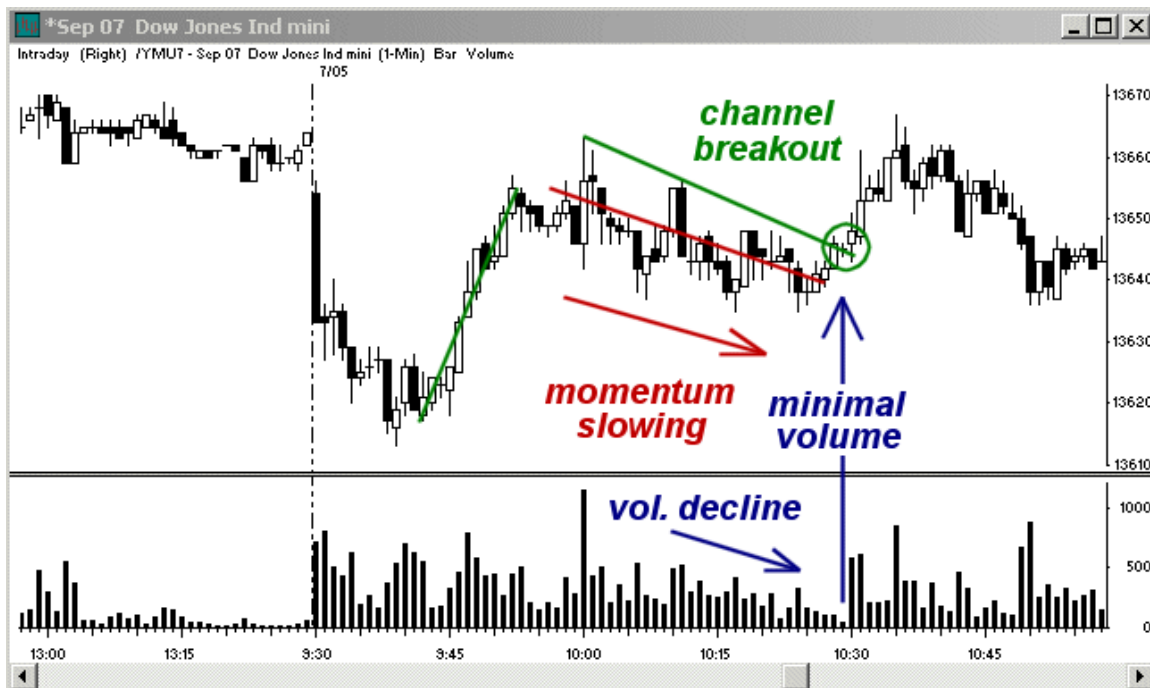
The chart above of the YM shows a good example of how declining volume will foretell the direction of a breakout when it is combined with the right pace development. When the YM fell into a trading range, it initially experienced some stronger downside moves within the range which were on stronger volume than the upside moves. When the range neared completion, however, the last pullback occurred on lighter-than-average volume. In fact, it was the lightest volume activity of the entire session.

The buy trigger took place as the channel for the last pullback along the highs of the channel broke higher. Volume did begin to pick up in this example right away, but sometimes it can take a few bars before it will increase noticeably. Once a trader becomes very comfortable with this concept of diminishing volume, s/he can actually act in anticipation of the breakout and enter before the trend channel gives way. It is best to not attempt this without a great deal of study and experience, but it is something to begin to pay attention to.

ANTICIPATING BREAKOUTS - VOLUME DECLINE

- ® When the pace of a trend channel is average to slower than average, then volume will typically decline, creating favorable conditions for a continuation pattern.

The same concept which works within a trading range also applies well to trend channels which are slower than average and are favoring a continuation move in the opposite direction. The chart below depicts one such example. After rounding off at morning lows, the YM moved sharply higher out of 9:45 ET on July 5th. The rally was substantially stronger than average. The YM began to correct after closing in on the opening highs. It started to display a lot more uncertainty, pulling back with a lot of overlap from one bar to the next. By transecting the entire channel of the pullback and comparing it to the transected upside move, it becomes more obvious that the correction off the highs at 10:00 ET was a lot more gradual than the earlier upside move.

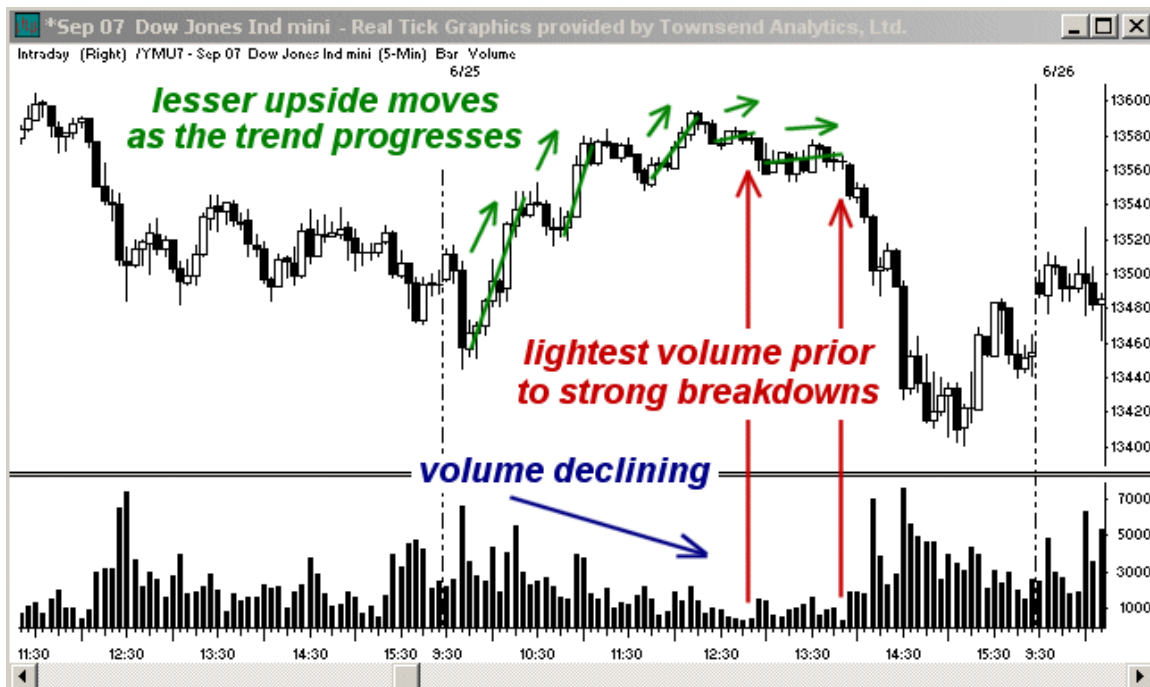


The correction began with high volume at 10:00 ET. This was the result of several economic data releases which took place at that time. Following these reports though, the volume declined as prices fell. The lightest volume came right at the end of the correction and prior to the upper trend line breaking. One trait that is less-than-ideal in this example is that the final pullback within the channel for the pullback off highs did not have a noticeably slower pace than the prior two. It attempted to compensate by not falling as far as the earlier moves.

ANTICIPATING REVERSALS

- ® Slowing volume on a stronger overall trend move which accompanies slowing pace will indicate an upcoming trend reversal. The concept is similar to a slower channel breakout.

The concept of declining volume also works when applying it to some types of price reversals. In the previous example we saw one instance of this when the downtrend that was in play on the correction off the morning highs began to favor another move higher due to its volume decline. The moves lower were to a lesser degree than the one before it on each of the waves of selling within that pullback. A more obvious example of this same concept is applied to the stronger trend and subsequent reversal which took place on June 25th in the chart below.



After briefly falling out of the open, the YM made a remarkable recovery, rallying sharply into about 10:30 ET on strong volume. Within a rather brief period of time the YM had regained all of the losses from the prior afternoon.

A small correction off highs followed into about 10:45 ET and then a second wave of upside occurred. This time the market only managed a rally that was approximately 2/3 of the initial upside even though the pace of the upside move was not diminished. The volume on this second move, while higher than the pullback, was less than the first move higher.

At 11:00 ET a second correction began within the intraday uptrend. When the third move within the trend kicked off it could no longer maintain the strength of the previous two rallies and the upside pace began to weaken. The YM barely managed to establish a new high on the day, coming into price resistance from mid-day in the previous session, and the third rally was only about 50% of the initial rally. Once again the volume on this move, while higher than during the correction, was a great deal weaker than during each of the prior two upside moves.

Most trend moves occur in waves of two or three, after which time they tend to favor a break in the trend channel and then form larger corrective moves. The slowing pace and declining volume aided this bias on the YM and the momentum continued to turn over into the early afternoon when the index no longer bothered to show much of a price move off support levels and instead began to hug them.

As seen in the earlier examples, declining volume within a base is a tell-tale sign of a continuation pattern under development. In this case, since the pace was stronger on the downside heading into the base at 12:30 ET, the continuation would be to the downside even though it was only a 1 minute continuation pattern to begin with. A larger one on the 5 minute time frame followed into 13:30 ET. Both are marked with red arrows in the image above.

EXHAUSTIVE VOLUME

- ® On an average to stronger than average downside move, exhaustion is typically represented by a large volume surge.

While monitoring declining volume can be immensely helpful for anticipating the beginning of a new trend move, it can also be used to help determine the end of one. I actively trade futures and take a lot of breakouts as well as many pivot types of trades, meaning absolute trend reversals and turns in the market. Paying attention to volume spikes is one way to gain insight as to when a move is coming to an end and when it can begin to correct off a low.

When a security begins an exhaustion move on the downside, it often culminates in a strong increase in volume to show panic on the part of the bulls. This leads to over-extension on the downside and will often be followed by either a trading range, slowdown in the selloff, or a bounce following the sharp downside momentum. I prefer to watch for the largest volume moves on somewhat larger time frames than I am focusing on trading in order to signify “real” exhaustion. If the volume spike is only on a 1-5 minute time frame, it may lead to a correction on that time frame, but may not be enough to end a trend on a 15 minute time frame or higher.

Let’s look at the following chart of the YM for several examples of exhaustion moves. The first was a minor one heading into 11:00 ET. This was the second drop off highs on the 5 minute chart, but in the larger picture it represented only a minor correction. Even though the volume did spike at that point, the index was still able to move into lower lows.

Another increase in volume into 12:30 ET took place at the same time as the market hit price support from around 14:30 ET the previous day. When compared to the volume from that low, as well as the morning volume, however, the increase at 12:30 ET was still not that intriguing. It did lead to another correction off lows, however, in which the market formed a two-wave base before falling again into 14:00 ET.

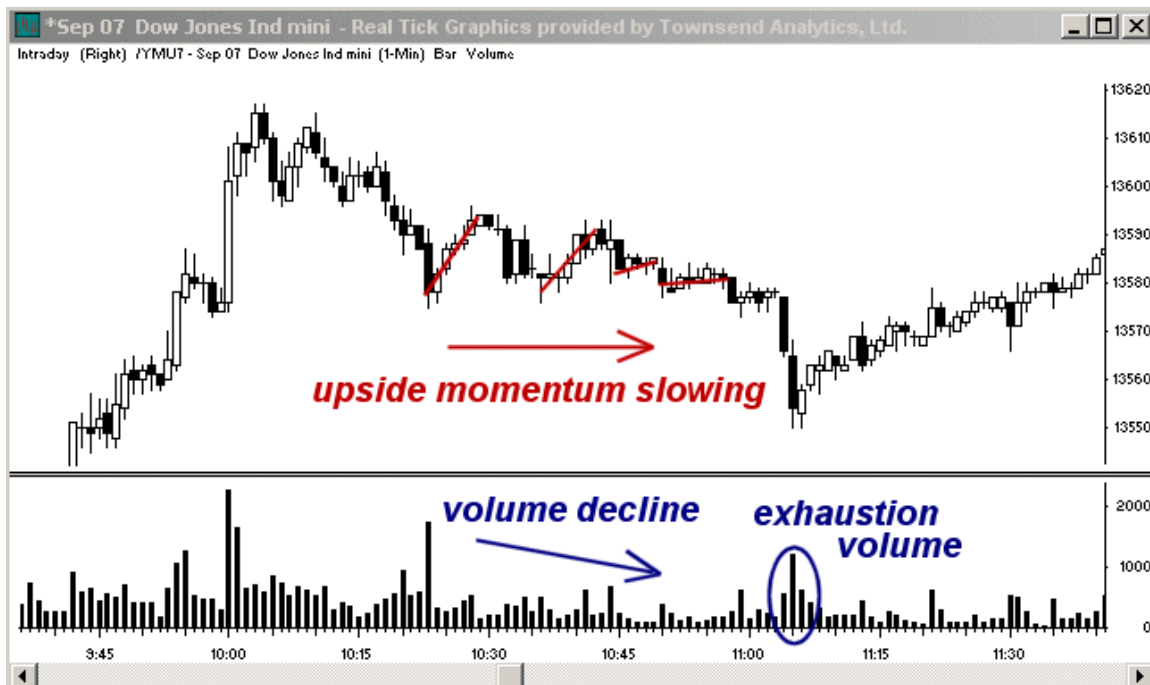
In this mid-afternoon descent the momentum began to increase on the downside, but the move barely broke previous lows. While this action occurred on the heaviest volume since the morning reversal, it was still lighter than the prior afternoon and early morning. After this spike the index experienced declining volume with slower upside pace to create a final downside move into 15:00 ET.

This time the pace of the move was not only the strongest of the day, but the volume was as well. It was finally on par with the most extreme moves shown. This gave it a better chance of finding support and seeing an end to the selloff. It was not certain immediately, however, that the move would create as sharp of a rally as it did. After all, faster than average moves tend to correct with slower ones. This happened in this case as well. The index did not reverse immediately upon hitting support and exhaustion, but instead had to retest the level a second time with slower selling in order to turn over the pace and open the door for a stronger reversal. This created a rally into the final 30 minutes of trading and followed through into the next morning.



VOLUME & TREND CHANNELS

The following chart is a strong example of how the concepts of declining volume and extreme volume activity can work together. The move off highs increased in momentum into about 10:23 ET. At that point the upside then began to slow as the YM fell into a descending triangle. At first there was a decent bounce into 10:30 ET, but then the upside slowed on the next bounce into 10:45 ET. This change in pace continued while the volume also continued to decline. Once it had reached its lightest level of the session, the range began to break lower. It then spiked shortly after 11:00 ET to indicate exhaustion as the YM returned to the earlier congestion from 9:45-9:50 ET. Since the momentum into that low was the most extreme downside move of the session and the exhaustion was not followed by rounded lows of a slowdown in selling, it took about 8 times longer to regain the ground it lost after 11:00 ET as it did to lose it in the first place.

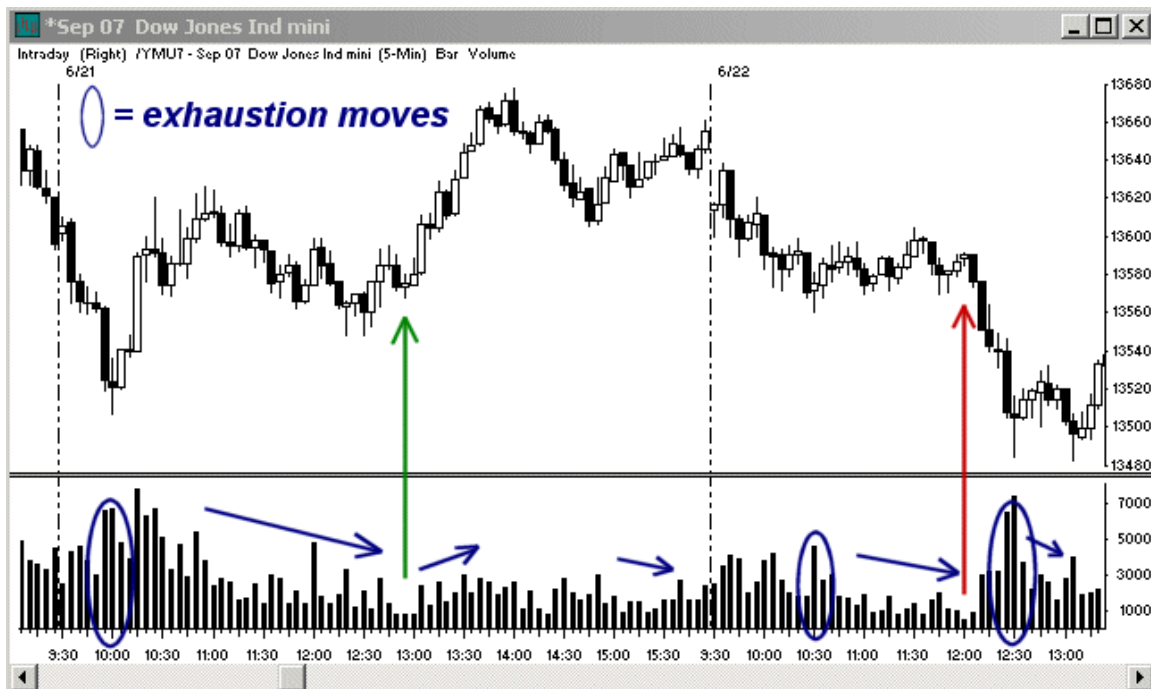


VOLUME – THE BIG PICTURE

The tendency for volume to drop throughout a slower trend move such as a sideways trend or gradual down or uptrend is one that is highly repetitive. When the move is a breakdown it is also likely that any strong descent will come to a close following a sharp increase in volume.

In the chart of the YM shown below, the YM began the session on June 21st in the midst of a rapid price decline. The volume escalated to a point that it was the highest volume on a 5 minute time frame for the next several days. This volume triggered exhaustion and the index turned over into the remainder of the morning.

At about 11:00 ET the YM began to correct off its morning highs. While the initial 5 minute bar was a very rapid one, the overall pace of the correction was very gradual. The YM moved slowly lower throughout the mid-day as volume declined, which showed a lack of eager sellers. The YM then began to hug the upper end of the correction channel shortly after 12:30 ET and into 13:00 on the lightest volume of the session up until that point. Hence, even though the YM was pulling off the resistance of the upper channel line, the sellers were still standing aside and the door was opened for a strong upside breakout and continuation move into the mid-afternoon. The volume increased as the moved progress, showing confirmation of the breakout.



Volume again declined in the YM in the afternoon on June 21st. The index had fallen rather sharply off highs, taking back a good chunk of the previous upside move. When it found support and began to bounce, the overall momentum was not equal to that of the descent. This time around the declining volume indicated a lack of motivated buyers.

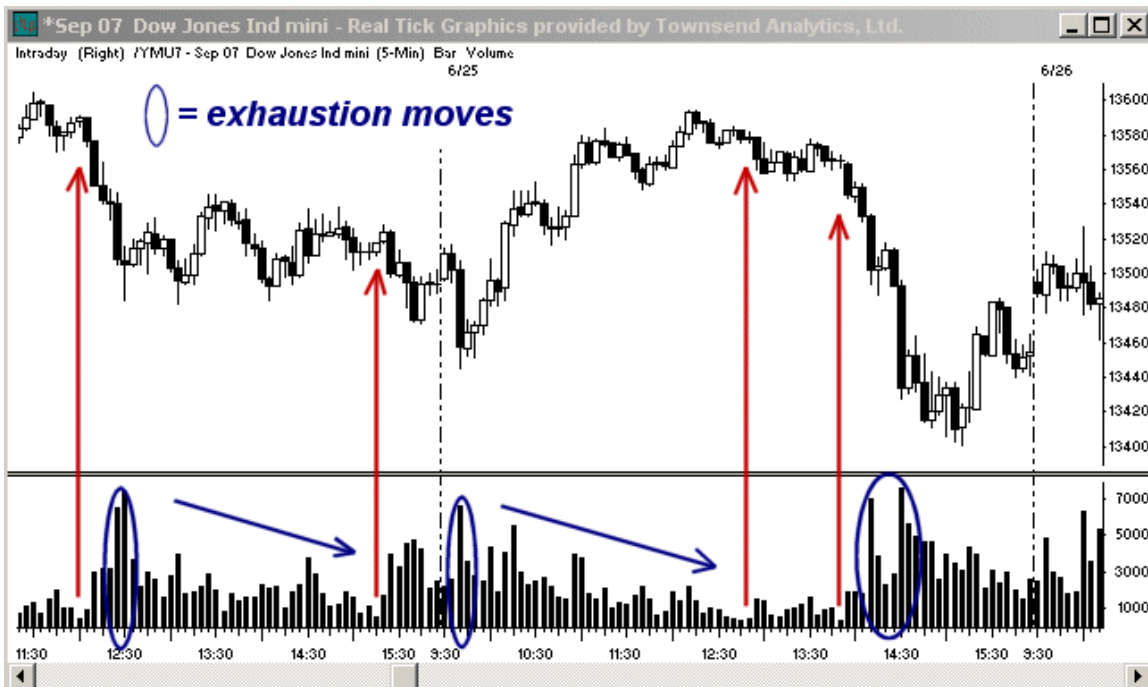
The same concept played out a third time on June 22nd. The pattern which developed throughout the latter half of the morning was similar to the one the previous morning if you simply flipped it upside down. As the YM fell into a trading channel near the lows of the session, the volume began to decline. That slowdown was particularly evident into 12:00 ET when the YM attempted a small upside move off the lower trend channel. The bulls wanted nothing to do with this nonsense and within a few minutes the lows of the day gave way.

The selling escalated into the early afternoon as the stronger pace led to a move greater than the initial decline. As on the morning of the 21st, volume spiked. Another correction off the lows began. Many times a steeper than average trend move can take a bit of time to gain steam. The move on the 21st off those morning lows merely led to a longer trading range. The YM chose to deal with this bias by retesting the lows at 13:00 ET, although notice that this retest of lows

was on only about 50% of the volume as the initial test of support and the original afternoon exhaustion move.

This next image is a continuation of the action from the prior one. The first arrow points to the price decline of the 12:00 ET breakdown, while the first oval illustrates the subsequent exhaustion move.

This slowing volume prior to a breakdown is repeated again after 15:00 ET on June 22nd. The market had fallen into another congestion zone and the YM experienced a change of momentum when the move higher out of 15:00 ET was slower overall than previous selloff. The exhaustion this time around did not come in until the next trading day. This is marked by the second oval.

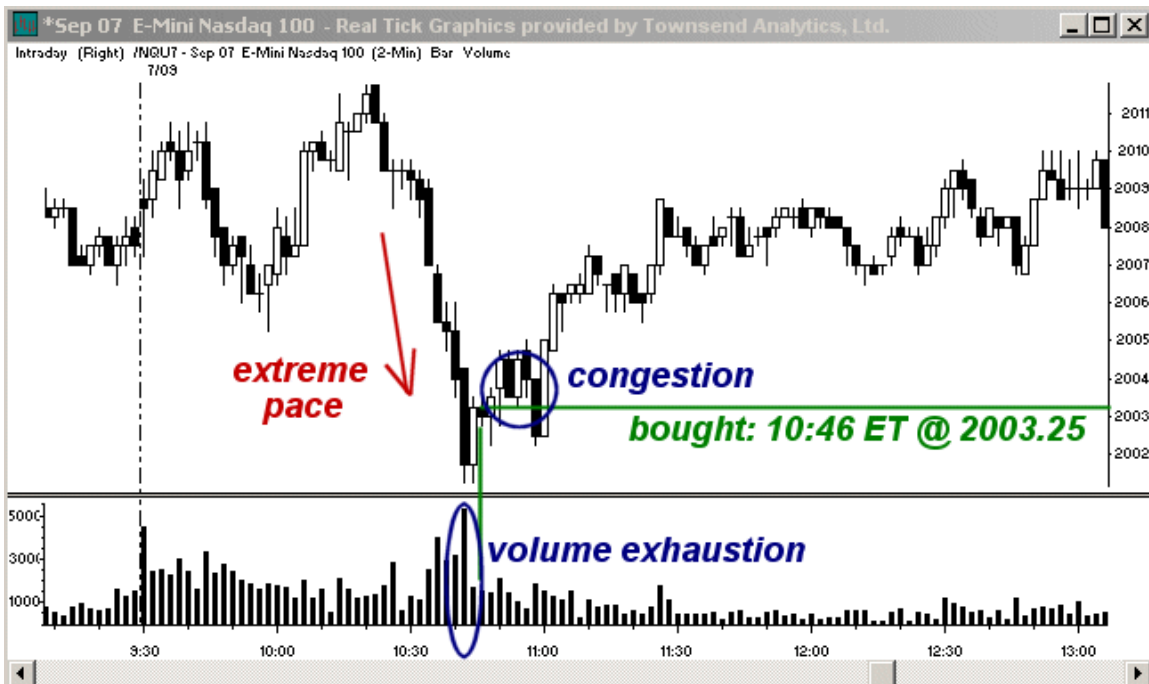


Mid-day on June 25th was the chart I showed you earlier about combining pace with volume. After three waves of upside, whereby each upside move was more gradual and to a lesser degree than the past, the market needed a break. The volume was already neglecting to confirm the move higher. In fact, volume declined throughout the upside, even though it was higher on the continuation moves within the morning uptrend itself.

When the pace finally turned over and began to form continuation patterns on the downside, the volume again dropped throughout the congestion. The YM experienced its first 5 minute exhaustion bar shortly after 14:00 ET. Although the volume did reach comparable levels as earlier declines, this time around the increased momentum left the door open for even more. It took a second exhaustion bar at about 14:30 ET to get them to reconsider the option of taking a break for a bit. Although new lows were still made after 14:30 ET, the momentum slowed, leading to congestion for about half an hour and a nice bounce shortly thereafter.

COMBINING PACE & VOLUME

The chart below shows an example of a trade I took on July 9th which combines both pace and volume activity. After trapping new bulls with a slightly higher high around 10:15 ET, the market turned over very quickly. Volume increased throughout the selloff, but it hit its highest level going into 10:45 ET. This volume spike on a stronger-than-average downside move is a textbook example of an exhaustion move. The increased momentum on the same bar as the volume spike, whereby the candlestick bar opens near highs and closes near lows, creates an “exhaustion bar,” which in this case completes the overall exhaustion move.



I look for patterns such as this to play reversal patterns and pivots in the market. As soon as I began to see buying come in, I placed an order in the NQ at 10:46 ET at 2003.25. As you can see on the chart, this was very close to the low of the exhaustion move. The main con on this setup is that the momentum was very strong heading into the low and there was no slowdown in the momentum at the low. This means that any rally or move off the support is going to typically take

longer to move off the lows than it did to hit them in the first place. The result was that shortly after my entry I had to sit through a period of congestion before the buying could continue. An alternate entry would have been to have waited and taken a position once the congestion broke higher, but while congestion is more likely, it does not happen each and every time. The index could have popped off the low and then just fallen into a larger trading range, although the pop would still not likely have been as strong as the decline.

A more ideal setup for a pivot off lows is to watch for the exhaustion move and then let the indices establish some very slightly lower lows on decreased overall momentum. This can allow the index you are trading to bounce more quickly without as much hesitation. Although you will not have as many setups overall by relying purely on this method, your overall success ratio will improve and you will be less likely to enter a position at the wrong time, only to see a larger exhaustion move occur.

An example displaying this slowing downside momentum is shown on the next page with a trade I took in First Solar Inc. (FSLR). After a very rapid downside move on increased volume, the momentum slowed with two more additional tests of lows. The first two lows saw increased volume as shown on the 1 minute time frame, but the retesting led to lighter volume the third time around. When the channel heading into the third low on lighter volume broke higher it triggered a very nice buy setup. FSLR quickly rallied into the 5 minute 20 sma resistance and after a brief respite it then moved even higher into the early afternoon (not shown here.)



BUILDING BLOCK #3 – SUPPORT & RESISTANCE

Support & Resistance levels are price zones in the market where a security is liable to react in some manner that affects the trend which is in play as the support or resistance level hits.

In addition to using price and volume when making decisions in the market, the third characteristic of a security's price action that I examine is where the support and resistance levels are located. These are levels in the market which are likely to cause some sort of reaction in the security's price.

Support can be thought of as the floor in a high-rise apartment building, while resistance can be thought of as the ceiling. Yes, there is space both above the ceiling and below the floor of the apartment, but a person will not easily move through either without some assistance.

The larger the time frame the support or resistance level hits on, the more difficult it is to break the support or resistance level. For instance, the floors and ceiling of a scale model of an apartment are going to be easier for us to break than in one which is full size.

REACTIONS TO SUPPORT & RESISTANCE LEVELS

The three main types of action to occur at a support or resistance levels are listed below:

Reactions to Support or Resistance:

- ® Pivot or price reversal
- ® Trading range begins
- ® Trading range ends

The first reaction is rather straight-forward and is the one which most traders are the most familiar with. This consists of a true change in the direction of price action, or a pivot. In other words, when a security is moving lower and then hits a support level, it bounces. How fast and how strongly it bounces off the support levels depends upon the pace of the move into it. The slower the move into support, the faster the bounce can be and vice versa.

Support and resistance levels can also stall a price move and lead to the beginning of a trading range. While there is typically some price correction with smaller pivots off these levels, the main outcome is usually that the security would be unable to sustain the move and fall flat within a sideways trading channel after the bounce attempt. For instance, if XYZ fell from \$52 into support at \$50, then it may form a trading range with \$50 as the lower end of the range and \$50.30 as the upper end of the range.

A third reaction to support or resistance is a breakout from a trading range. This type of reaction is most common when using an indicator such as a moving average. The security may be in a trading range at highs on a 15 minute time frame, for instance, and as it approaches the 15 minute 20 simple period moving average it breaks higher as it reacts to that support level.

PRICE SUPPORT & RESISTANCE ZONES

Support & Resistance levels must be thought of as *zones* and not exact price levels.

A lot of the time a support or resistance level can be narrowed down to an exact price. For instance, a moving average is assigned an exact price at a given time. It is very rare, however, for a support or resistance level to hold to the penny or to the tick or pip. Instead, there is often some difference between a support or resistance price level and the highs or lows which end up holding at that support or resistance level.

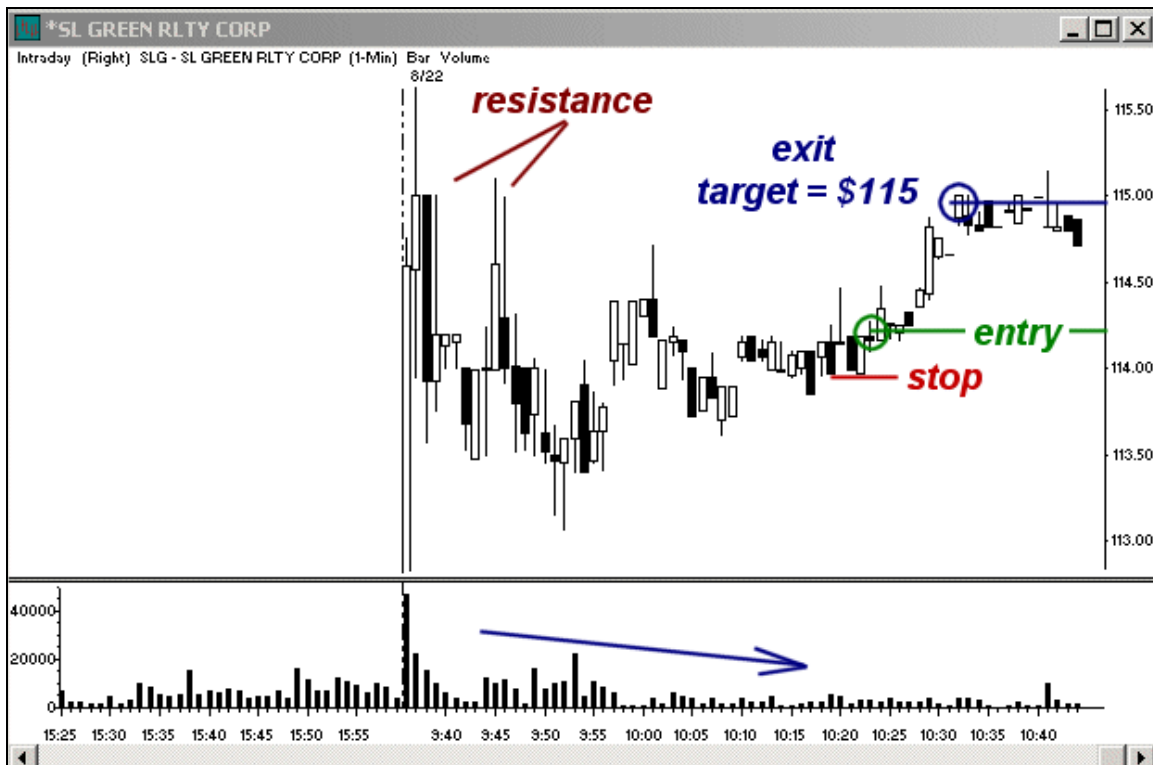
The pace of a move into a support or resistance level must be factored into the zone. The stronger a move is into a support zone for instance, the more “give” that support has and the more likely it is to try to push the limits of the support level before rebounding. In some cases, if it pushes hard enough, then the support will break. If the move into a support level is gradual, however, it may not even hit the exact support price. For instance, if there is support at \$50, then while a stronger than average move might push the price down to \$49.82, a slower than average move may only hit \$50.07 before it bounces back. By trading at \$49.82, it does NOT signify that a support level has broken. Nor does it mean that by trading at \$50.07 that it will be able to test the \$50 level again before a stronger move higher.

Thinner stocks can have a more difficult time with these levels, so if I am long a security that is thinly traded and have a whole number target level such as \$100, then I am likely to offer out at \$99.86-\$99.94 to have the best chance of getting a fill at the resistance, whereas if I waited to place the order when the stock was trading at those prices I may have to deal with a 20 cent spread and end up losing 50 cents or more just trying to get out.

A good example of using these types of orders was on a trade I took on August 22nd in SL Green Realty Corp. (SLG). This is a stock which can often have a spread of 20 cents or more. I bought it at \$114.24. By looking at the 1 minute

time frame I noticed that it had resistance at the morning highs, which was just under the 20 day simple moving average. I choose \$115 as my target zone since I figured these upper levels of resistance would stall or end the move. I went ahead and placed my exit order almost right away upon entering the position to best guarantee that when SLG went into the \$115 zone that I would be likely to get a fill. I placed my order at \$114.94.

Even though SLG did hit \$115 exactly, it did so with only a few trades. You can see that a little later on there was a high at \$115.15, but this was just one tick with no other trades above \$115 until after it had corrected longer. It did go on to hit \$115.44 after awhile, but this was again just one tick with most trades taking place at \$115.20 at that time. SLG then quickly fell back into the \$114 zone and continued lower throughout the afternoon. If I had tried to finesse a better exit as opposed to taking a fill into the \$115 resistance, then I could have easily given up at least half my gains waiting on a fill.



TYPES OF SUPPORT & RESISTANCE

Certain types of support and resistance will hold more accurately than others. Support and resistance based upon price levels will hold more closely to their real value than those based upon indicators.

Types of Price Support & Resistance:

- ® Prior highs or lows
- ® Whole numbers
- ® Prior zones of congestion
- ® Gaps

There are quite a few types of price support and resistance to look for when examining a position. I mentioned several of them while discussing the trade on SLG.

The first form of price support and resistance is a previous high and low. In SLG this meant the highs made earlier in the session at 9:37, 9:45, and 10:01 ET. Often when a security comes back into a previous high after retracing by at least 50% off that high, it will not push through the resistance level as much as it will the second or third time around. For instance, if the resistance zone is \$115, but XYZ pushes into \$115.25 when it first hits, this does not mean that \$115.25 is the exact price of the resistance, but rather part of the resistance zone. In this case that zone happens to be a whole number, which is the second type of support or resistance.

Often securities gravitate towards round numbers or halves if the prices and volatility are smaller. So, on a second test of highs, XYZ would not only be testing the previous high resistance zone which encompasses \$115.25, but it would also be testing the \$115 price resistance. It would then be less likely on

this second test of the resistance to hit \$115.25 exactly, but could more easily hit only \$114.98.

The other two main types of price support and resistance take place when a security is retesting a zone of previous congestion and when a gap zone has closed.

PRICE SUPPORT & RESISTANCE

The NQ below has several very strong examples of price support and resistance from previous price pivots. The NQ had bounced off support around 15:15 ET on July 10th. It retested this level again 15-20 minutes before the close. While the absolute price on the second low traded under the earlier one by a few ticks, the support zone held. When it moved back over that same level the next day it also held as support on a pullback. This time when the NQ dropped back into that support around 9:45 ET on the 11th the momentum was a bit stronger than before and so it pushed through it by a few more ticks than before, but it still held, basing along the support before breaking to new lows.

Just as a previous low will serve as support when it is tested again, once that pivot breaks to new lows (which typically happens on the third or fourth test of support) that price level then becomes resistance. This occurred in the NQ shortly after 10:00 ET on the 11th. The momentum on this rally was stronger than average and the NQ based again for a few minutes before busting back higher above the previous support turned resistance.



PRICE RESISTANCE AT PREVIOUS HIGHS

When a security or the overall market makes a “V” formation where it drops at an average to stronger-than-average pace, then it will often fall a few cents or ticks short of the previous high when it comes back into that level once again. This happened in the YM on July 5th. The Dow had fallen throughout the morning, but then began to turn around into the afternoon. The momentum increased on the upside following a continuation pattern into 14:00 ET. Despite the strength, the YM fell a few ticks short of the absolute morning high when it tested it shortly before 15:00 ET. It had even tried about 15 minutes earlier and failed.

I shorted the YM just after the second attempt at the morning highs on the 1 minute time frame. My entry was a little delayed. While I did not end up with significant gains on this position, the market did pull lower for another half an hour before the YM finally did hit the morning highs. This is not at all assured, however, and often such a retest for a more absolute test of the previous high will not happen when the market forms a “valley” type of move off highs and then back to them again after a strong correction. As a result, if I am long into such resistance, I will typically place my target slightly under the previous high.

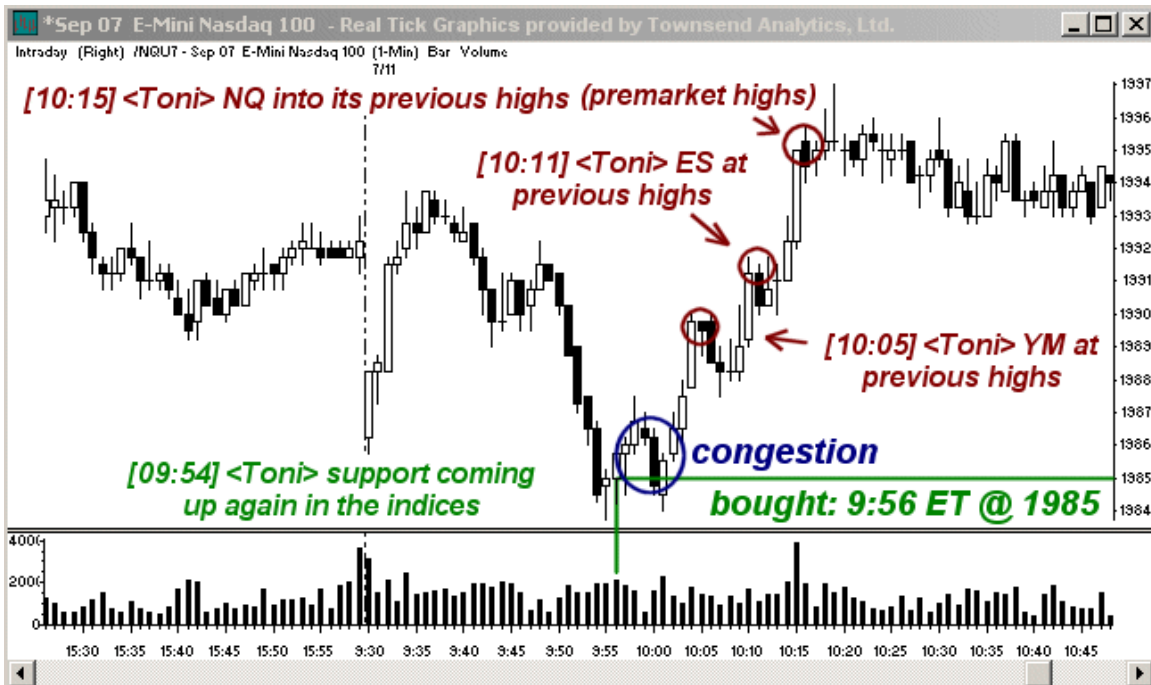


PRICE SUPPORT & RESISTANCE

In addition to intraday pivot highs and lows, paying attention to the premarket levels can also be very helpful in placing new positions and managing those already open. The most typical use of premarket data for this purpose takes place in the index futures, although premarket data in individual stocks can also be quite helpful.

We already looked at this chart of the NQ intraday in terms of support from the previous session, but it looks quite different here on the all-sessions chart. I initiated a position in the NQ at 9:56 am ET at 1985 based primarily upon the premarket low which would serve as strong support. I waited for the first hint of buying as that support zone hit to place my order and kept a stop under the lows of the session.

The momentum coming out of the pivot off lows held up very strongly, eventually taking the NQ all the way back to premarket resistance from the congestion which had held until shortly after 6:30 ET. In the two charts below I included my live market observations. The second image is more detailed and shows how the previous highs on both the YM and ES stalled the move in the NQ, even though it took the previous highs in the NQ itself to stall that index.



CONGESTION SUPPORT & RESISTANCE

The second type of price support and resistance is very similar to the previous one except that instead of looking at exact highs and lows where a security or the overall market reversed, you have to look at levels where the security stalled and congested. This means the levels in the market where there was a lot of back and forth action with high levels of overlap in price over a period of time.

I have circled the major congestion zones which took place on the 10th and 11th of July. There is a bit of a wider support or resistance level created by these types of price support and resistance zones. Often the rule of thumb that I use is to figure that the middle of the congestion zone will serve as the best price level for support or resistance when that congestion zone is tested again.

The first congestion level on the 10th was not tested again until mid-morning on the 11th. It did not quite hit, thanks in part to the premarket levels which served as additional price resistance in that same vicinity. The subsequent congestion zones held much more faithfully. The one which formed at 15:00 ET on the 10th served as resistance 30-45 minutes later when the NQ bounced back into that price zone. Another congestion zone formed at this level and it served as resistance on the bounce off the morning lows the next day. The small congestion level on the 11th at 9:45 ET also stalled the NQ when it hit it again just before 10:15 ET. In that instance, however, it was not strong enough to reverse the index, merely to stall its rally for a few minutes.



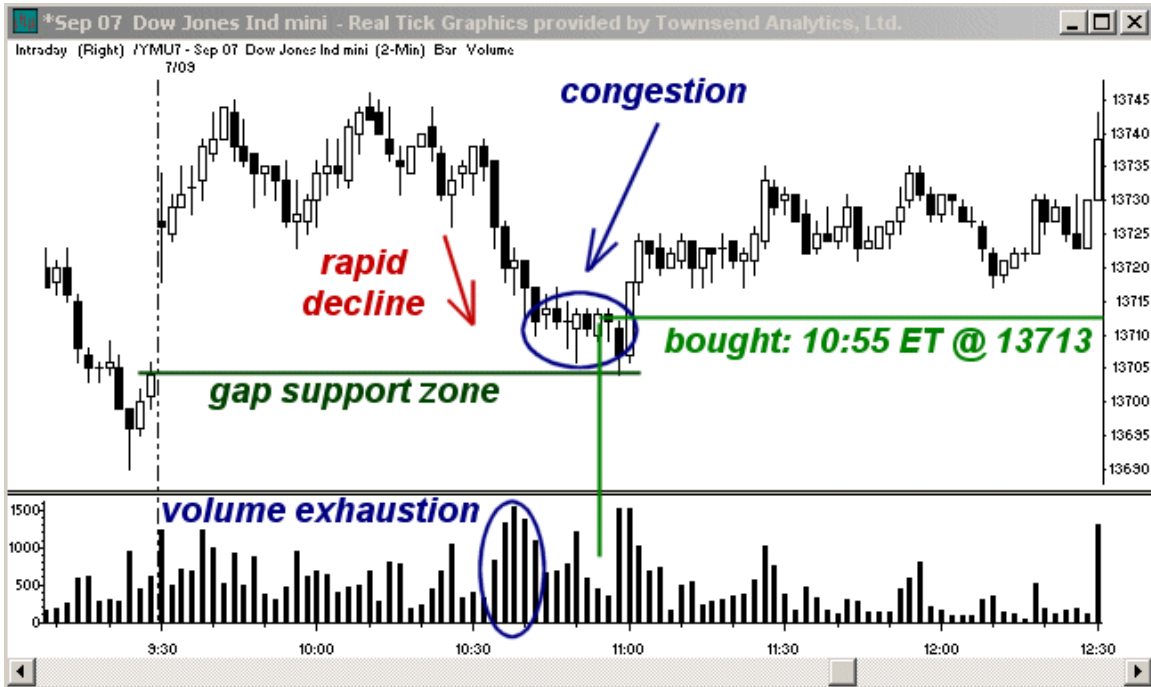
PACE, VOLUME & SUPPORT

One of the best ways to achieve results in the market is to combine each of the tools I've covered so far. In the following sample of a trade in the YM I combined a change in momentum with volume and support to time a reversal for a long position going into 11:00 ET on July 9th.

The first thing to catch my eye was the volume increasing as the YM fell. Typically a volume spike on a downside move indicates exhaustion and acts as a precursor to a corrective move out of that exhaustion. In this case a correction to the selling would mean either a sideways range or a bounce. A few things occurred which began to lend favor to a stronger price reversal or bounce.

The YM did not have a lot for support on the decline once the morning lows gave way. The next support level was the closure of the morning gap, which is one of our price support levels. The volume increased before this support level hit, but the gap zone acted as a magnet and continued to pull the YM into its zone. The volume let up and the YM made two very slightly lower lows to finally close the gap just prior to 11:00 ET.

The slightly lower lows created a change in momentum and I took advantage of it by entering on the long side. Going into my position I understood that because the absolute closure of the gap had not quite taken place and I was entering only after the second low and not the third. This meant that it was still possible to see that gap zone close more securely, so I held through a bit of a flush. When the market popped at 11:00 ET it managed to make its way back into the middle of the morning congestion fairly quickly and then continued into the morning highs as early afternoon rolled around.



BUILDING BLOCK #4 – TRENDS

A strong bias in price direction can be gleaned by merely watching price, volume and support and resistance, but to take it a step further and avoid those setups which appear perfect and yet still fail requires the addition of a fourth building block to a security's pattern: the trend.

Trends are the primary direction of price movement at any given time.

- ® Uptrend
- ® Downtrend
- ® Sideways trend

A trend is the direction prices are moving at any given time in a security or index. There are three types of trends: an uptrend, a downtrend, and a sideways trend.

An uptrend is a series of higher highs and higher lows, whereas a downtrend is a series of lower highs and lower lows.

A sideways trend is a bit trickier. It takes place when prices are moving sideways within a trading range. It may have comparable highs, comparable lows, both comparable highs and lows, or it may have highs and lows that do not correspond well to the previous peaks and valleys. This does not matter in the definition of a sideways trend, as long as it moves sideways without breaking out of support or resistance and then forming higher highs and higher lows for an uptrend, or lower highs and lower lows for a downtrend.

Trends are fractal in nature, meaning that many trends can be taking place at the same time.

Trends are fractal in nature, so several trends can be taking place at the same time, but on different time frames. A security may be in an uptrend on a 1 minute

time frame, for instance, and in a downtrend on a 5 minute time frame. While the smaller trends can be used for scalps and the like, when you are trading in the direction of the larger trends or at least with the larger trend development, meaning waiting for trend exhaustion before playing reversal patterns, then your chances for success are the highest. If you are buying within a 1 minute uptrend and the larger time frame is bearish, then you are not likely making the most efficient use of your time or your funds. Instead it would make more sense in most cases to wait for the 1 minute uptrend to exhaust itself and to place a short to take advantage of the larger bearish bias.

REPETITIVE NATURE OF TRENDS

Trends are *repetitive*, but the trend development and trend placement of a pattern in the market or a specific security are keys to the success or failure of a trade.

In addition to being fractal, trends are also repetitive and tend to develop in very methodical ways. Once you get the hang of how a trend can develop, it becomes much easier to infer correctly an upcoming price move. Most trends develop in the form of two or three waves in the trend's primary direction, although the momentum within each trend move often shifts, so stronger trends tend to correct more slowly and vice versa. Additionally, when a smaller trend slows momentum within a larger trend, that larger trend will have the greater potential for a stronger reversal or correction than if the smaller trends in the direction of the larger trend remained stronger. We looked at this in depth on the sections regarding pace and volume.

TWO WAVE CORRECTION

One of the easiest types of development to recognize in the market is a *two-wave corrective move*, which can lead to some of the best continuation patterns.

Trend moves typically take three waves to form, but when a security corrects within a larger trend, it is common to see it take only two waves to correct. These smaller trends are the type I tend to favor because they often offer the chance to get into a position at the best possible location ahead of a stronger price move.

Although corrections do tend to take two waves to form, it would be unwise to simply buy a channel break after a second wave of selling with no other criteria present. There is no reason to assume at that point that the larger trend has not reversed and that the move is no longer a corrective trend with two waves, but rather a larger price reversal with three. In order to determine whether a two-wave pullback is indeed a buying opportunity, one must look a bit deeper, employing each of the previous outlined tools to analyze the two-wave correction itself. The remainder of this presentation will be spent on addressing and developing a firm understanding and familiarity with this type of trend formation to allow you to identify it in real time.

Criteria for a two-wave pullback buy setup:

When looking at two waves of correction for a buy setup I expect to see several key events take place. The best reversal patterns following two waves of selling will have the following characteristics:

- 1) **Slower downside momentum on the second wave of selling as compared to the first.** (Preferably this second move will be on average to lighter than average momentum. The slower the momentum on the second decline, the more rapid the subsequent reversal higher is likely to be.)

- 2) **Heavier volume on the first drop as compared to the second.** The volume does not necessarily have to be lighter than average on the second decline, particularly if it retests or slightly breaks the previous low, but if it is heavier than the first then it will have a difficult time gaining any upside momentum.

- 3) **Ideally the low of the second decline will not be significantly lower than the first.** It does not have to be a lower low though.

TWO WAVE CORRECTION - YM 2 MINUTE

A great example of a strong two-wave pullback that offered a nice buying opportunity is shown below in the YM. After turning over at highs around 13:45 ET, the YM sold off strongly into 14:00 ET. Volume increased a great deal as the downside move exhausted itself into the earlier congestion. The stronger than average momentum pushed the YM slightly under those earlier lows around 13:00 and 13:30 ET, but the zone from that support held and the index bounced into 14:30 ET and took back more than half its losses before heading lower for a second round of selling. Retracing 50% or more of the initial drop ahead of the second is a big pro.

Despite the strong volume into 14:00 ET, the upside following that initial decline took place on lighter volume, indicating a lack of strong buyers as the index progressed upwards. Choppy trading in the mid-day zone back to highs led to some rounding off with what is known as a head and shoulders pattern on the 1 minute time frame from about 14:20 to 14:45 ET. This reversal pattern led to the second decline into 15:00 ET.



When the YM dropped this second time around, the volume increased, but only slightly as compared to the earlier selloff. Moreover, there was a greater degree in overlap from the prices within the second decline as compared to the first. This is evident by examining each of the two-minute bars from the second decline as compared to the first. In the first there was hardly any overlap in price from one bar to the next throughout the entire selloff. When the downtrend continued into 15:00 ET, however, the prices overlapped by 50% or more from one bar to the next on nearly each and every bar of that descent. This slowing pace on the second move lower opened the door for a stronger start to any correction off the low that would be forthcoming, particularly since the YM only established slighter lower lows instead of breaking the previous lows by a more substantial degree.

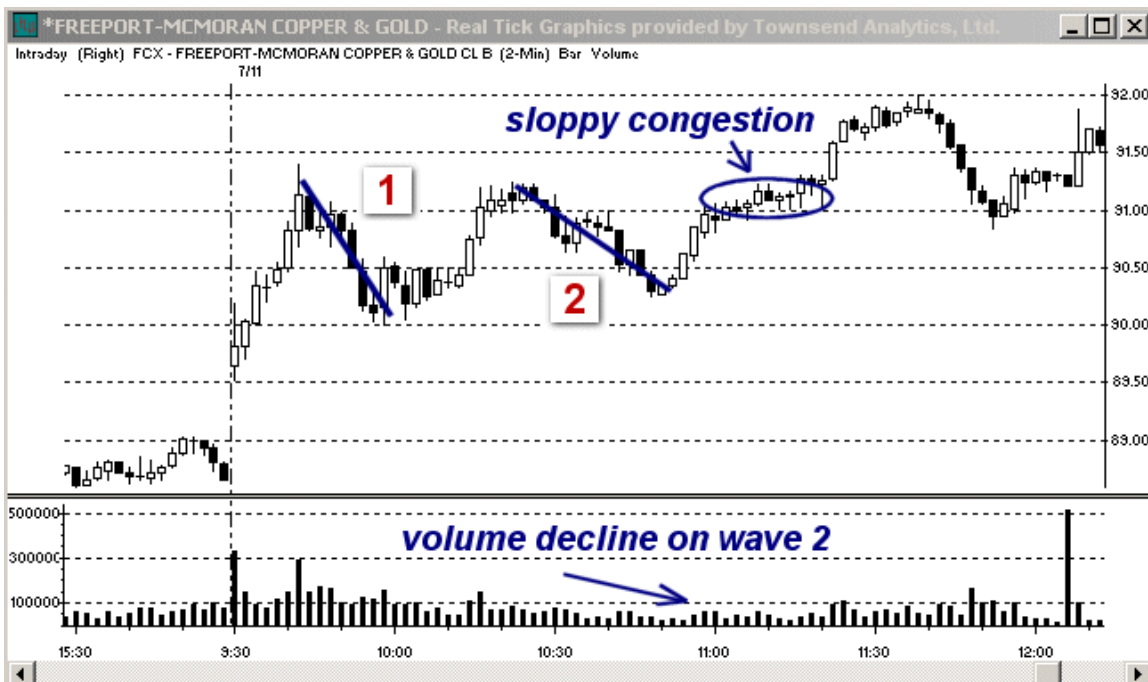
As the YM headed lower into 15:00 ET the volume increased, but not to the same extent as in the 14:00 ET decline. The lighter volume suggested that fewer market participants were trapped or willing to let go of their positions into 15:00 ET as compared to earlier. This is very favorable for the bulls and when the upper trend channel from the second decline broke higher it confirmed the setup. The stop on such a move is under that second low, but sometimes you can drop down to a smaller time frame to narrow down a tighter stop if the index had bounced slightly and then based before taking off. In such a case a stop under base on the smaller time frame can be used.

Since the second move lower in this case was not slower than average, the YM did take some time before it was able to return to the upper half the price range shown in this example, but the overall momentum of the rally was on par with the larger decline and had reacted nicely to initial price resistance from the congestion that occurred between the two waves of selling. Instead of showing any strong adverse reaction to this resistance zone, the YM fell into a trading range along the resistance before breaking it and moving higher again into the close.

TWO WAVE CORRECTION - FCX 2 MINUTE

In this second example of the two-wave corrective trend, Freeport-McMoran Copper & Gold (FCX) caught my eye for similar reasons as in the YM, although there are some slight differences. While the YM had a slightly lower low on its second decline, FCX formed a higher low while the two highs of the trend were very comparable at about 9:45 ET and 10:25 ET. A number of things remained the same, however, and it was these similarities which made FCX a strong buy candidate. When FCX pulled off highs for the second time intraday it did so with consistently declining volume. This lack of strong selling was echoed by a slower move off the second high than seen with the first.

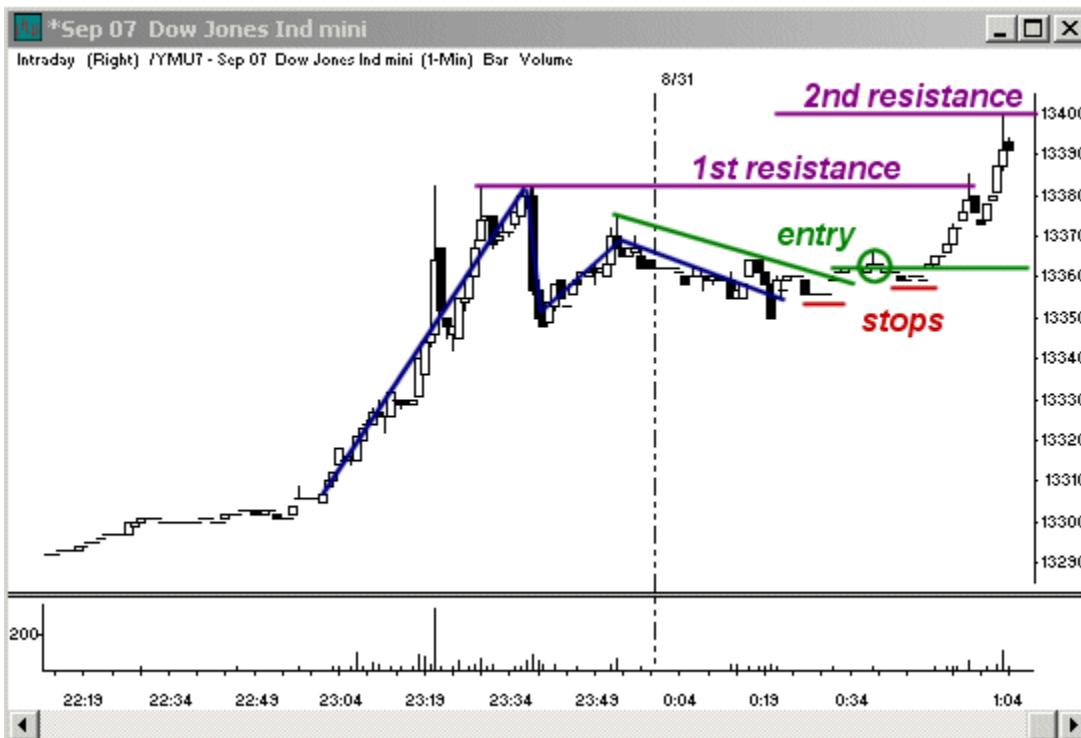
The initial setup on this move was into 11:00 ET when the channel from the second pullback broke higher. Congestion occurred when FCX returned to its highs for a third time since the stock still had a good deal of territory to cover before it had returned to those levels and was a bit exhausted. Sloppy congestion followed and FCX then broke higher with a nice continuation into the \$92 whole number resistance.



TWO WAVE CORRECTION - YM AFTERHOURS

The two-wave corrective pattern takes place on every time frame one can dream up in the market and occurs in every market vehicle from securities to futures to options to the FOREX market, etc. They even take place outside regular trading hours in the afterhours market. Granted, due to thinner trading, they may not look as pretty as during the regular session, but they work all the same!

This example of a two-wave pullback took place in the late evening hours and into the early morning on August 31st. I happened to be up late as usual and was passively following the futures market, whose charts I happened to have open. The strong rally into the end of the day on the 30th caught my attention since this level of activity at that time of the night was rather unusual.



I continued to monitor the progress of the afterhours trading and before long the YM had pulled up off an initial drop into 23:30 ET and was falling more gradually on a second wave of selling into the first 15-20 minutes of the new day. It is difficult to read the volume in this particular example, however, the momentum on the second move lower beginning at about 23.50 ET was easily visible by simply transecting the downside move.

After allowing the YM to attempt to retest the lows from the first pullback, I settled on an entry over the trend channel from the second pullback. This triggered over 13360 and the slower momentum of the second drop allowed the YM to follow through quickly to the previous highs where it served as initial resistance and then into the 13400 price resistance and upper target before it then pulled back (not shown here).

TWO WAVE CORRECTION – CENX DAILY

This same type of trend development is also a great tool to use when swingtrading. Swingtrading is a style of trading whereby a trader's aim is to hold a security for several days to several weeks, looking to capture a strong momentum move on a daily time frame. The daily chart of Century Alum. Co. (CENX) offers a typical example of the two-wave corrective trend which triggers a swingtrade for a multi-day hold.

CENX is a stock which had been in an uptrend for approximately a year. In early June it reversed strongly off the 52-week high. The strong momentum, coupled with the sharp increase in volume, would make a return to new highs a bit of a challenge. In order to rise to the occasion CENX would need to reverse the momentum that was favoring the bears after that first drop in June. The first step in this change of pace was the slower yet steady retaking of more than 50% of the losses off the June lows. It took 6-7 days to do so. This reversal took CENX back into price resistance from the congestion which had formed throughout May. CENX then completed the momentum change by pulling back off mid-June highs at a slower pace than compared to the initial drop when it corrected off May's price resistance at the start of June.



Notice that when I drew in the momentum line for the correction, I ignored the extreme tail on the last day of the correction. While this tail can be very important in terms of intraday activity on the day of that tail, when it comes to the daily correction at the end of June it merely represented a flush move and it is imperative to monitor the body of a price correction and ignore extreme tails under most circumstances. This is particularly true if the tail takes place on light volume. In this case, there was no increase in volume at all on the daily when CENX flushed into that second low, which is a great sign for the bulls.

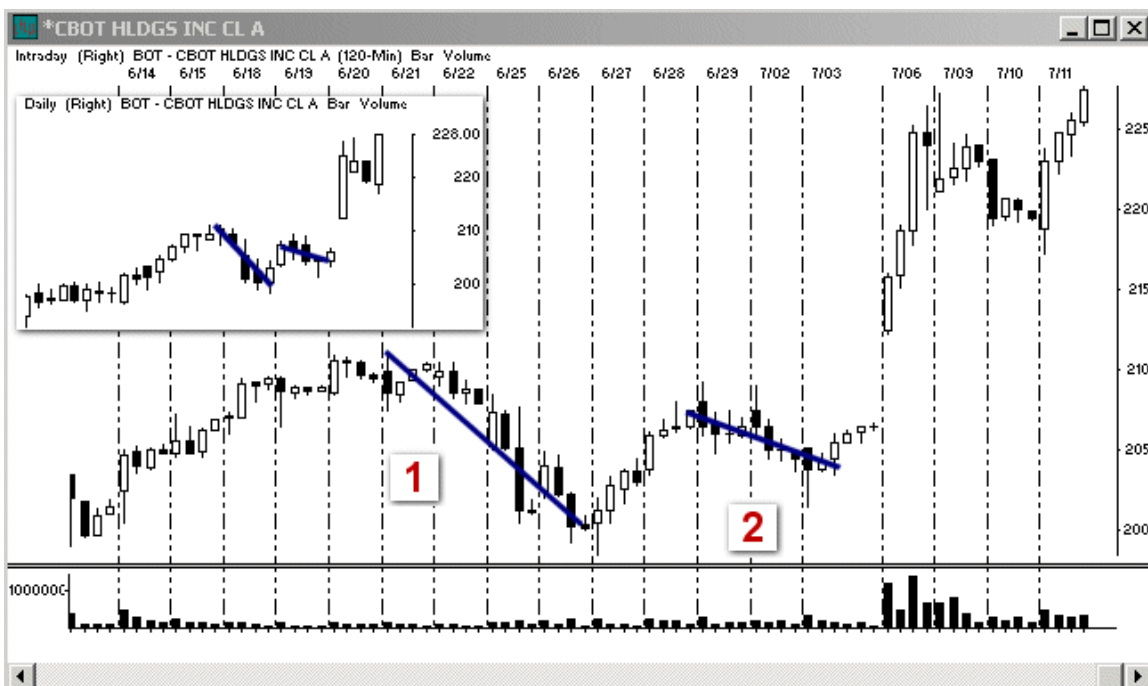
The buy trigger on this daily chart took place when the upper trend channel line from the second wave of selling broke higher. When an extreme tail or flush is involved, I will almost never place my stop under that low, but rather drop down to a smaller time frame to locate an appropriate support level nearer at hand. On a daily time frame it is often from the day on which the trend channel broke, providing a narrower daytrade type of stop to a swingtrade setup. If no support is available intraday, however, as may happen if the security just keeps moving steadily throughout the session, then I will drop back to look at the previous day for pivot lows or support from the lows of an earlier trading range intraday.

Initial resistance on this daily setup was at the previous highs, but since CENX did not break the first pullback's lows by anything other than the flush, it allowed the stock to move fairly easily to new 52-week highs. In fact, CENX made it to \$67.85 over the course of the several days that followed my pulling this chart as an example for this class.

TWO WAVE CORRECTION - BOT DAILY/120 MIN.

An example of a two-wave daily setup which was very similar to CENX took place on CBOT Holdings Ind. (BOT) at about the same time as in CENX. This time the daily trigger took place with a gap, although an earlier intraday trigger could have been used the day before. As in CENX, the second move on BOT was on much more gradual momentum than on the initial descent off highs in mid-June. BOT did not have the volume influx into the first low like CENX experienced, but neither did the volume increase into the second low, which remained a positive for the setup.

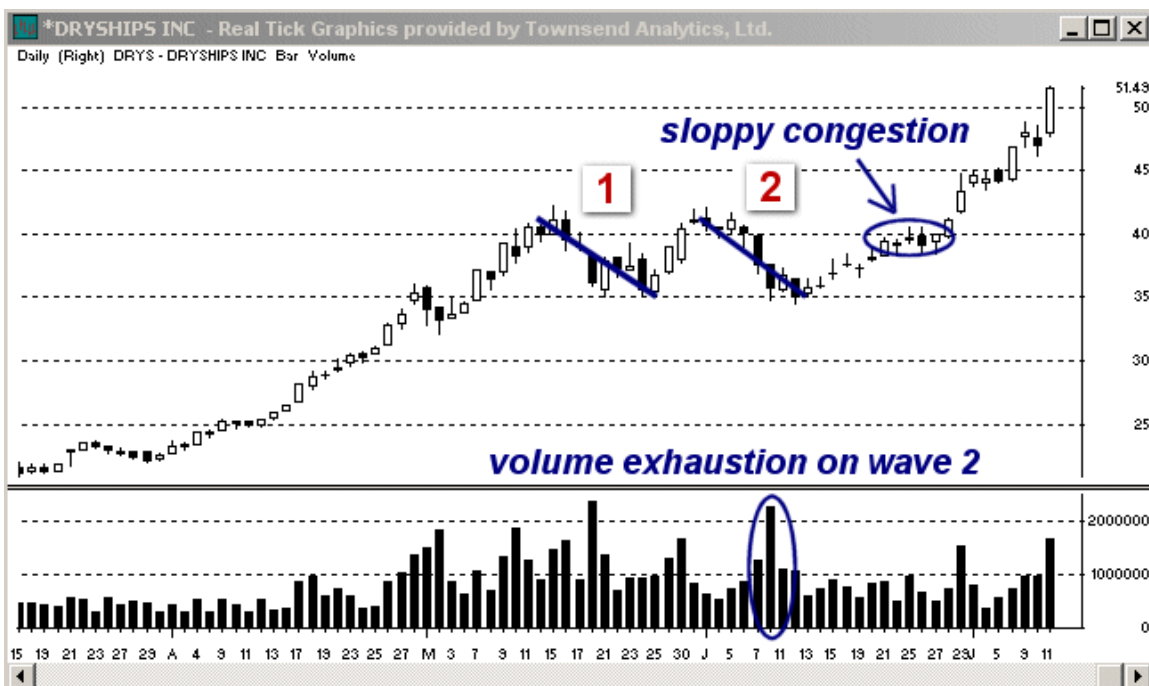
Like CENX, BOT experienced a flush before the upside continued. It was not as extreme as in CENX, however, and after the morning of July 3rd the bulls began to take over. Steady buying took BOT through the upper trend channel of the second wave of selling and gapped it higher into the 6th of July. BOT had a huge run on the 6th and managed to move into \$230.63 over the course of a week, but the buyout by the CME ended its trading on July 12th.



TWO WAVE CORRECTION - DRYS DAILY

In each of the previous examples the selling on the second wave of downside was quite a bit more gradual than on the first decline. This allowed the bulls to regain control rather quickly. Things don't always work out quite that well though, so it's important to familiarize yourself with other variations of this two-wave trend development as well.

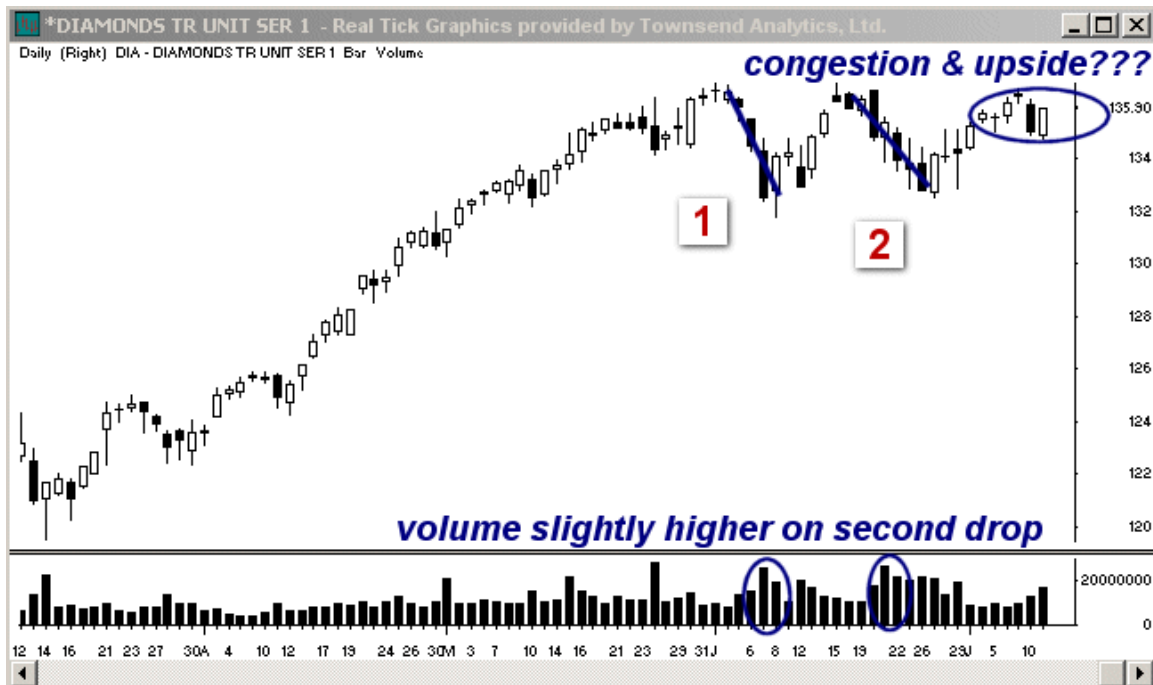
The following example in Dryships Inc. (DRYS) has a very similar pattern to that seen earlier in FCX with two notable differences. First of all, the second decline took place not only with a similar pace on the descent as compared to the first one in mid-May, but it also retraced the entire first drop. Secondly, the volume on the second drop was actually a bit stronger than on the first. The result was a much slower move out of the second wave of selling than seen in earlier examples. As on FCX though, DRYS managed to congest at the earlier highs and then break higher. The momentum of the breakout in DRYS was stronger than on FCX and DRYS quickly moved to \$65.38 in the weeks which followed before again correcting on the daily time frame.



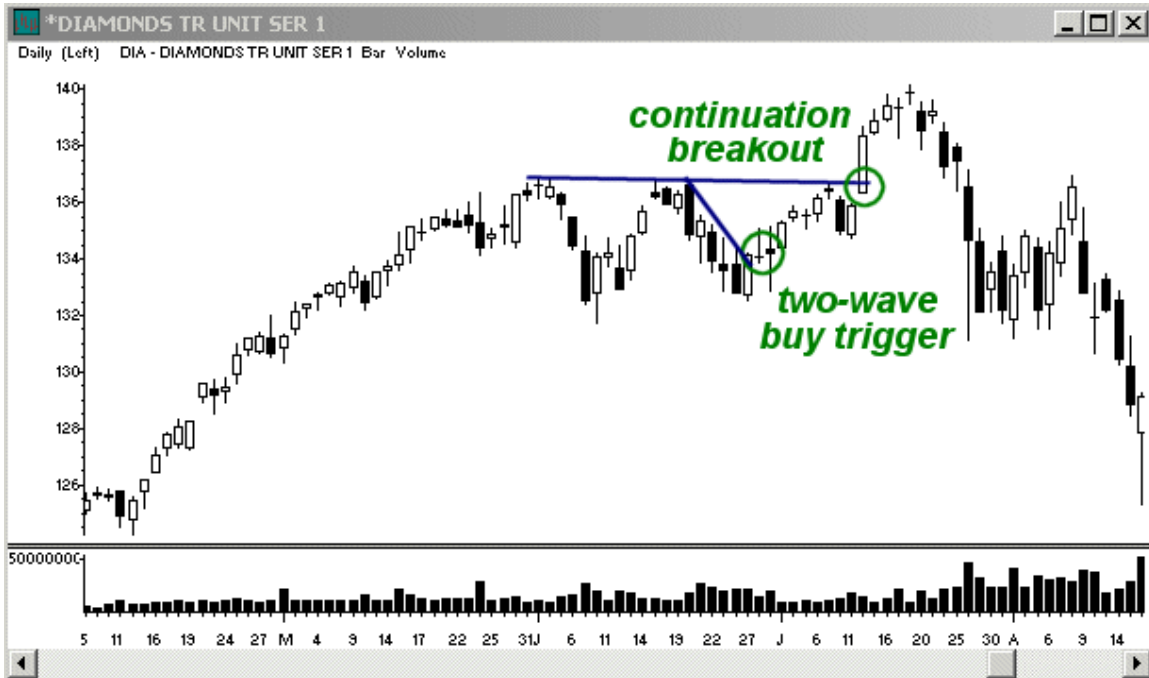
While DRYS worked out quite well, an equal or fast decline on the second wave of selling, combined with stronger volume on the second wave, can greatly increase the risk on the pattern as a buy setup and create false triggers and failed trades. A positive note for DRYS was that the buying ahead of the second wave of selling was still very strong. Nevertheless, a setup such as DRYS could have just hugged the support in the \$35 zone or crept gradually higher before giving way to a strong continuation on the short side. DRYS had the benefit of the weekly time frame in its favor, but it can still make a trade such as this more difficult since securities with this type of activity tend to get off to a much slower start. They can take quite some time between the channel break on the second wave of selling and the increase in momentum before offering the reward favoring such patience. I am not always the most patient and most often will try to catch patterns such as this on the continuation out of the congestion, even if it's sloppy congestion, after the second low has been established as opposed to the break of the channel from the second move lower.

TWO WAVE CORRECTION - DIA DAILY

As I was compiling my trades and examples for this presentation, a setup very similar to that seen in DRYS was under way in the Dow Jones Industrial Average (\$DJI). On a second wave of stronger selling, the DIA which tracks the Dow slowed somewhat compared to the first pullback and established a slightly higher low. The upside off the second low was a bit stronger than the one in DRYS. Typically when a security has to move from the lows of the second move and back into the highs, followed by a stall at those highs, then it is still good for one more run. We saw this on FCX, although DRYS did manage to perform a bit better. This left the door open, however, for one more run in the Dow. The day after I captured this image the congestion broke higher and triggered just such a move. Over the next 4 days the Dow climbed, peaking with a high on the DIA at \$140.46. The momentum slowed as the rally progressed and the DIA then rounded off at those highs before giving way to the mid-summer reversal.

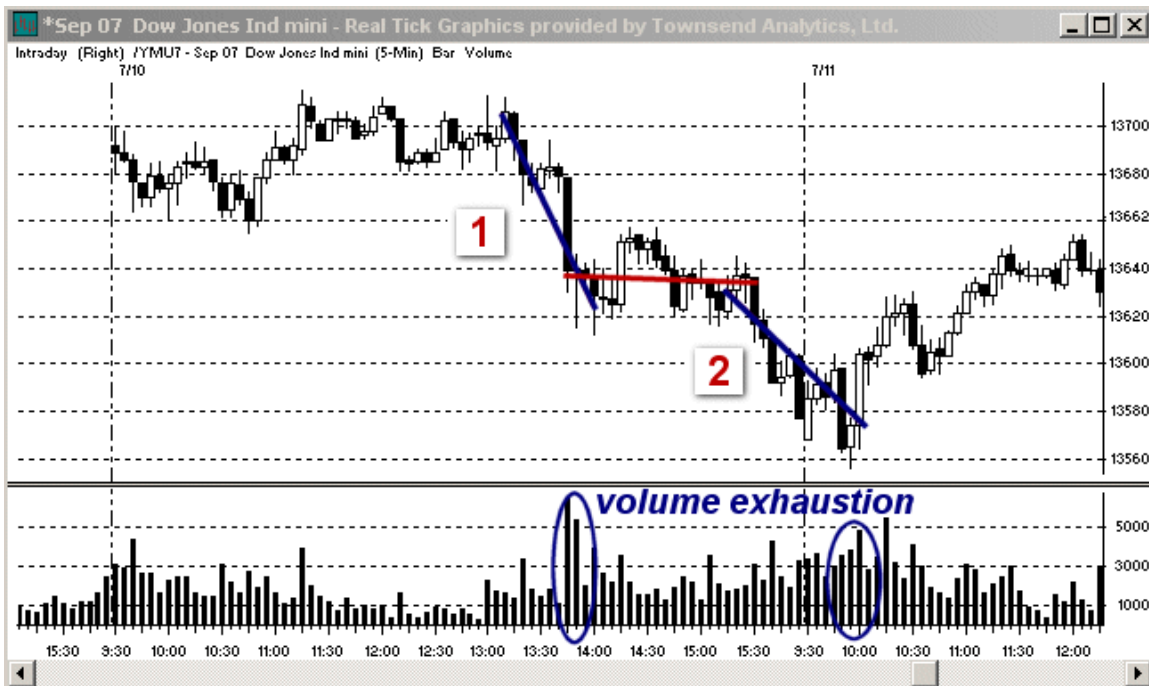


The image below displays the follow-through in the DIA in the days following the two-wave reversal and subsequent breakout from the larger trading range.



TWO WAVE CORRECTION - YM 5 MINUTE

The corrections between the two waves have been more than 50% of the initial decline in each of the previous examples of a two-wave trend move followed by a reversal. This does not always have to be the case, although I do tend to prefer it. Sometimes though it just doesn't happen and you have to make due with what the market gives you. On the 10th and 11th of July the market was not as generous on its two-wave decent and the correction off the lows of the first drop into the afternoon on the 10th could not even make it back halfway before giving in to a second wave of selling into the close, which then carried through into the next morning.



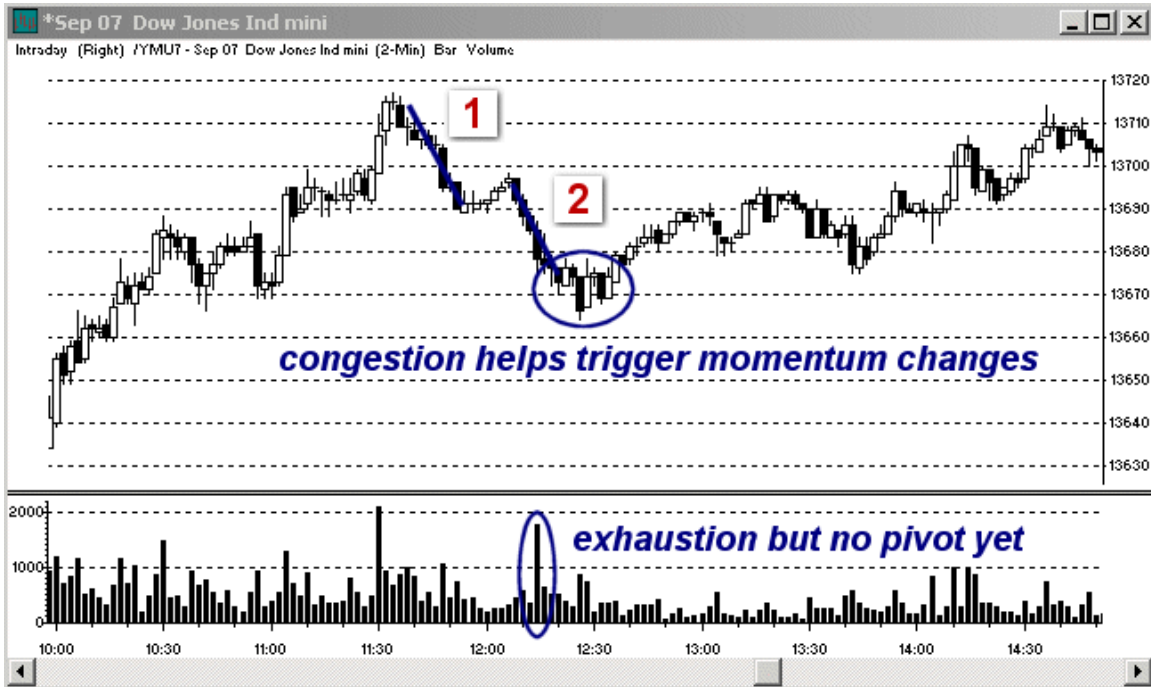
At first there was very little to suggest that this second wave of selling would be followed by a break in the downtrend as opposed to segueing into a third round of selling. Even though the second move started with as strong of a pace on the downside as on the first, it slowed into the close. Into the next morning there was a great deal of overlap from bar to bar in terms of the prices being traded. This is typical ahead of a reversal. Additionally, despite it being the end of the day and

beginning of a new session, periods which often experience the highest volume levels, the YM was unable to create as large of a spike in terms of volume as it did on the first drop the previous day. This combined with the slowing pace and congestion, helping the YM move higher the next morning, despite the fact that the second drop was still on the fast side. This meant that the YM had to deal with price resistance from the congestion between each of the two waves of selling. After the correction at that resistance, the index was again free to move higher. Even though it did not make it much further that day, it held up near the day's highs and then moved sharply higher again into July 12th.

TWO WAVE CORRECTION – YM 2 MINUTE

The previous YM trade showed a two-wave decline on a 5 minute time frame. The one below shows the same pattern, but on a 2 minute time frame and with a few additional cons. To begin with, the selling in the second wave of downside was just as strong, if not stronger than in the first, which was not the case on the 5 minute YM. The volume also spiked on the second drop and was lighter on the first. This marked another con. There was still a great deal of support from earlier in the morning, however, due to the congestion from 10:30 ET into 11:00 ET.

The market needed to compensate for its shortcomings in order to accomplish a decent pivot off that price support. The way that it managed to do so was by slowing the downside pace and rounding off at mid-day lows into the morning support. By throwing an area of congestion into the mix at 12:30 ET it allowed the momentum to shift and soon the YM was back to testing the congestion which had occurred around 12:00 ET between the first two waves of selling. Eventually the YM made it back to the zone of the morning highs. It would have had a much more difficult time succeeding in this quest had it just held the low at 12:25 ET with the exhaustive volume and then fallen flat or pulled up gradually. Without rounding off at the lows a bear flag would have had a higher probability of forming and breaking the index even lower into 13:00 ET.

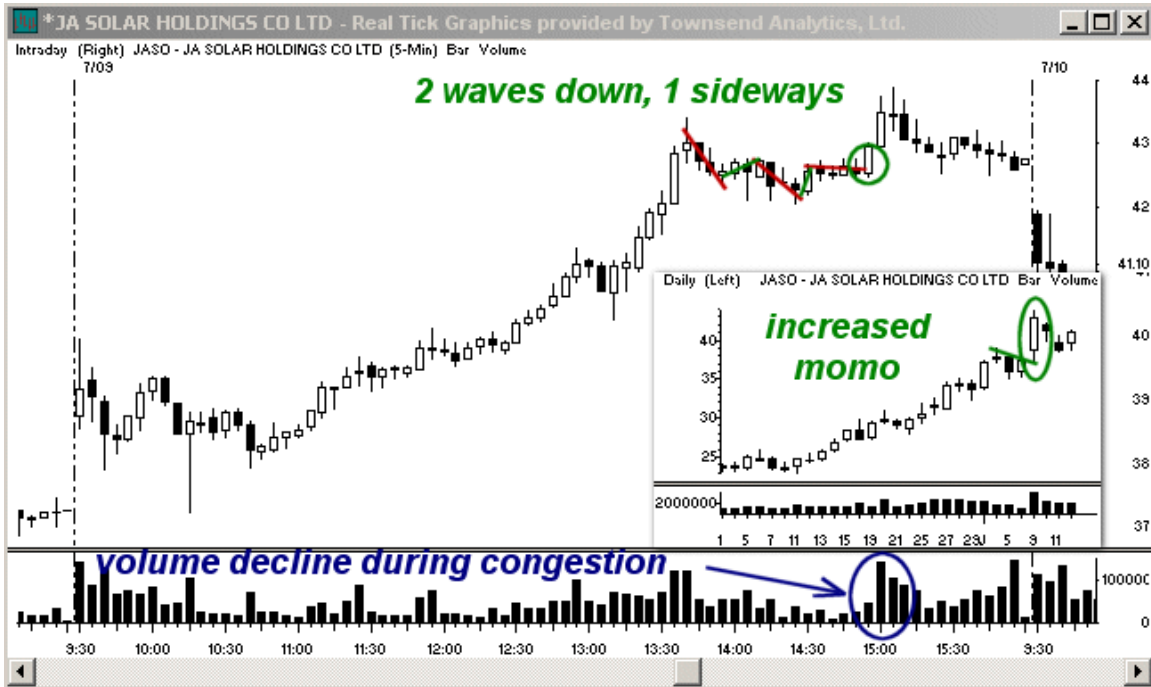


TRENDS DISSECTED - JASO

The two-wave trend action also can be considered as a part of a larger trend move and the last two moves within any trend can be analyzed according to the same criteria.

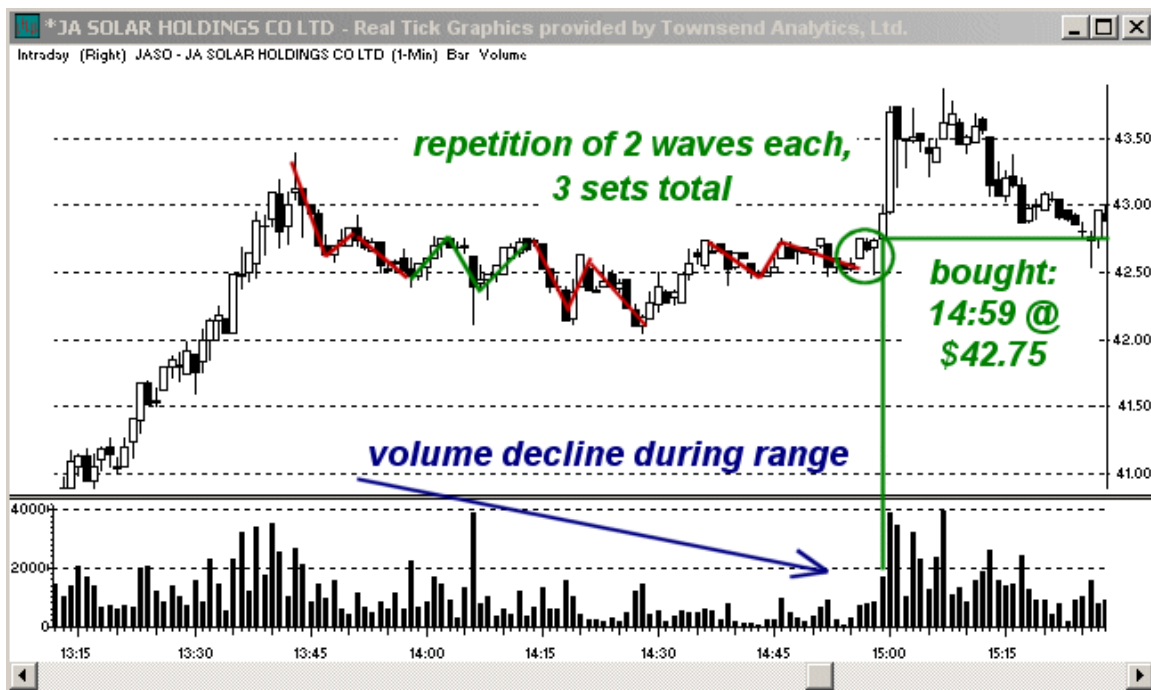
When examining trading ranges or larger trend moves for reversals or breakouts, you can also use the same methods as outlined above to assess the most probable direction of price movement by simply looking at the prior two moves within any trend and applying the same standards.

A good example of breaking down the two-wave move into a larger one took place on July 9th in JA Solar Holdings Co. Ltd. (JASO). JASO was a very “hot” stock on the 9th. It broke out of a three day correction with strong volume on an upside gap and then continued to climb higher throughout the late morning and into the early afternoon. Just prior to 14:00 ET, JASO fell into a trading range. While it did have a two-wave pullback into 14:30 ET on a 5 minute time frame, it is not these two waves we are concerned with, but rather the activity which took place on the smaller time frames. On the 5 minute chart alone JASO had a very nice pattern developing. As it congested near highs the volume declined, showing a lack of motivated sellers. When JASO broke higher into 15:00 ET its volume surged, confirming the breakout.



FRACTAL TWO-WAVE TRENDS - JASO

On the 5 minute chart of JASO there are only three corrective moves off the highs which are visible. The first two are to the downside into 14:30 ET and then the third is a sideways move into 15:00 ET. When we drop down to a 1 minute time frame, however, a larger picture develops in which each of the waves of correction on the 5 minute time frame can also be broken down into segments of two when examined on a 1 minute time frame.



The correction off highs in JASO began with the start of the pullback from the day's highs at about 13:45 ET. After both a lower low and a lower high JASO pulled up and managed a comparable high at 14:15 ET. This broke apart the earlier two-wave decline and marked a congestion zone, which also happened to have two waves of correction. Then JASO broke down again into 14:30 ET with another lower low and lower high. This marked the second descent seen on the 5 minute time frame.

After the initial descent of two and two, JASO pulled up strongly off the 14:30 ET low into the previous highs on the 1 minute time frame. It then fell into another two-wave corrective pattern, trading sideways into 15:00 ET within the upper half of the move off the lows of the range. JASO triggered a buy when this final and more gradual two-wave move broke higher. I was a little bit on the slow side, but managed to pick it up at \$42.75 at 14:59 ET. I merely scalped the move into \$43.50 due to a lot of market resistance and the intraday extension, but this was still pretty decent given that I was only risking about \$0.25-\$0.35. Notice that the volume did not increase much until a minute or two after the two-wave trigger. This belated volume surge increased when the earlier highs broke. This is a common entry zone for breakout players and a stop level for those who tried to short. Both are good reasons not to enter a position at that time and to instead focus on the pullback types of entries to reap the greatest reward.

TRENDS - COMPARISONS

Comparative analysis is extremely important when studying the market.

- ® Equal/Measured moves
- ® Comparable continuation qualities
- ® Average price movements

Understanding trend development and trend placement can be daunting and confusing and seem like more of a guessing game to even those traders who consider themselves to be professionals. In addition to the tools I've laid out so far, there are also a few things to watch for when dealing with trend activity which may help you develop a keener eye. All of these deal with past behavior in the particular security in question and how to utilize that behavior to give you a clearer picture of how an upcoming price move is likely to unfold.

EQUAL (AKA MEASURED) MOVES

First is the concept of an equal or measured move, which is an observational tool that can be utilized for target placement and exit strategies, as well as allow for a number of opportunities to catch price reversals in a security.

The idea of watching for equal moves in the market is a fairly simple one. It involves identifying the trend move ahead of a congestion zone and then comparing the subsequent breakout from that congestion to the move ahead of it. It is in this type of analysis that pace or momentum is an essential player. When a security breaks free of a trading range or comparable congestion zone such as a bull or bear flag then the momentum on that breakout must be comparable to the momentum of the move heading into the correction zone in the first place. When this is true, then the breakout from the correction will often be almost identical to the move which preceded it.



For instance, if a security moves higher by 10 points and then pulls back 2 points, when it breaks higher again, if the momentum is similar to the action in the initial 10 point move, then the security can easily move higher by another 10 points. Since it had corrected two points this would mean that it would break the highs by 8 points. What is remarkable about this method for assessing targets is that the equal move can hold within a few cents or a few ticks as long as the pace of the continuation is similar to the previous trend move.

This is what happened in the example of the E-Mini Russell 2000 (ER) posted above. The ER had rallied five points beginning shortly before 10:00 am ET. Then at 10:30 ET the index fell into a two-wave trend correction into 11:00 ET. At 11:00 ET the second wave of selling broke higher and was soon followed by a break in the highs of the late morning range. The overall momentum on the breakout, while it began more quickly than the previous upside, smoothed to mimic the earlier buying. Measuring from the second low of the range, the ER was able to break solidly with another five point move, stalling exactly at that equal move resistance shortly after 11:30 ET.

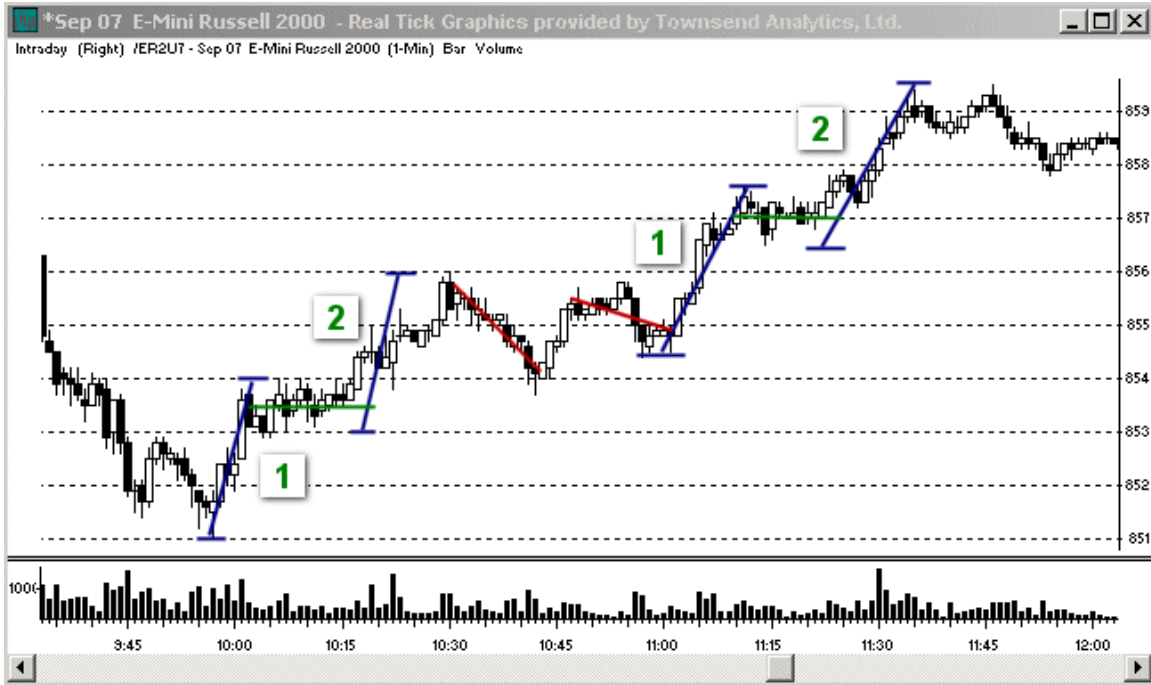
This method for assessing targets and price resistance works very well when a corrective move such as a trading range breaks, as long as the break is at a comparable pace as the previous trend move. When the momentum is not the same, however, the results are not as accurate. As a general rule of thumb, if the breakout from the correction is stronger than the move into the correction, then the breakout can establish a move which is stronger and goes further than a mere equal distance. If the breakout is much more gradual, however, then the security will have a more difficult time even reaching that equal move resistance level and is likely to stall or reverse off a closer resistance level such as a previous high or whole number price resistance.

COMPARING PRICE MOVES

Another way to compare trading activity to indicate upcoming price biases is to look at how a security has trended in the past. For instance, many times a security which is moving into a base will have several waves of buying. These are typically two to three waves of upside. If a security establishes two upside moves on a smaller time frame before a longer congestion, then the chances are high that a breakout from the congestion will also take the form of a two-wave trend move.

The image below is the same as in the equal move example, except this time I've broken down each of the upside moves to detail the activity within the initial rally ahead of the base as well as the breakout from that base. Since it took two waves of buying before the ER stalled at 10:30 ET, it allowed the ER to break higher, correct with a smaller base at 11:15 ET, and then follow-through with a second wave of upside after the breakout.

Often traders do not get as much out of a position as they should because they will exit all of their position at the first resistance following a breakout when they see the buying stall. In this case that would have meant the 857 zone at 11:15 ET. By taking into account the previous trading action, it can allow a trader to have greater confidence in the chances that, while there may indeed be some corrective action following an initial breakout, many of these breakouts will continue with another wave of buying before hitting a larger target such as the equal move shown in the previous image.



AVERAGE PRICE MOVES

When considering a security to trade, be sure to look back to gain a perspective for what an average move is in that particular security. These can change over time.

A third way to use previous price action when making an assessment of price action is to pay attention to how far an average move is in the security you are examining. For instance, does a stock often stall in 20 cent increments or 50 cent increments? If so, the more room you have until the next 20 or 50 cent level hits, the better your chances for success are on a new position. This can also give you an idea of what to expect in terms of how the security will follow through.

If you know ahead of time that a security typically moves 50 cents and stalls, but your target is \$1.50 away, then it can be easier to hold through the congestion and slower trading at each of the 50 cent levels without allowing yourself to get shaken out. You are less likely to panic if you have gone through all the possibilities ahead of time. If you are risk adverse, you may consider using these price levels to protect some of your gains, or wait until each level breaks and then adjust trailing stops accordingly.

When comparing typical price moves in a security, keep in mind that the average move varies from one security to the next and it can also change over time. If a stock typically moves in 50 cent increments, but then begins to see a surge in volume due to news, it may stop stalling at the 50 cent levels and instead be drawn to the whole numbers with very little reaction to the halves. Alternately, as prices decline in a security, something that may have easily had one dollar swings a year ago may have slipped far enough that it now only trades in 20 cent increments, stalling at the 20, 40, 60 and 80 cent levels in between the whole numbers.

In the NQ you will usually see it move in 5 point increments, but as volatility increases it will sometimes favor 10 point moves on a 5 minute time frame before stalling.

EBB & FLOW OF PRICES

While traditional market analysis breaks down price action into a number of specific and easily recognizable patterns, it is imperative to *think in terms of the big picture* and realize that the market is one fluid entity.

The key idea that I want you to take away from this presentation is that while traditional market analysis breaks down price action into specific patterns, such as head & shoulders, or cup-with-handle setups, it doesn't really matter what the name is that you give to a set of criteria. Instead, what matters the most is to think in terms of the big picture.

A head & shoulders pattern is a short setup which consists of an initial high, a higher high, and then a lower high. Two patterns which may traditionally be called a head & shoulders pattern, however, may have two very different outcomes. One may work, while the other fails miserably, even though they both gave a traditional short trigger. The difference between the two will have only been seen by breaking down the pattern and examining its individual traits. One reason a head & shoulders pattern might fail would be if the momentum was faster on the upside on the third high than it was on the downside off the second high, while in the setup which succeeds the move higher into the third high will have been much more gradual than the decline off the second high. The last two waves in the same direction in the head and shoulders pattern itself are typically the key, just as they are in any of the examples discussed earlier.

It is extremely important to realize that it is not what a pattern looks like at a glance or what you call it, but rather what the components are that make up the setup and how those components fit into a larger trend. Each of the characteristics that I've discussed in terms of how price action and volume work together need to be assessed in the setting of how they then figure into a larger trend development. By insisting upon a high combination of favorable characteristics and steering clear of those which have more than just one or two

cons, then your success at choosing, as well as managing the correct positions in the market will increase dramatically.

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