GFF
BROKERS

Using Price Action to Identify Trends

GFF Brokers

What this eBook is about

This eBook focuses on the use of **price action techniques to identify trends and micro-trends**. *Price action* analysis is a technical form of analysis that is based strictly on the patterns of prices on charts *without* the use of indicators. The aim of price action analysis is to establish a simple and "accurate" form of analyzing market behavior by solely observing price movements without the filter of lagging or predictive indicators.

Note how the term "accurate" is in quotes. As in any analytical method, accuracy is relative to the *interpretive context* set forth by the method. That being said, a method can be accurate according to its own rules, but the rules of a given method are not always compatible with the reality of a given situation.

How this eBook is organized

- Part 1 – Description of Price Action, Trends, and Micro-Trends
  This section will attempt to address questions about price action analysis in relation to trend assessment.

- Part 2 – Rules to Determine Trend (and Micro-Trend) Possibilities
  This section establishes rules to determine the *possibility* of up-trends, down-trends, and consolidated or range-bound markets.

- Part 3 – Real market examples
  This section will show the theory applied to real market charts.

- Part 4 – Risks and Conclusion

PART 1 Describing Price Action, Trends, and Micro-Trends

What are the benefits and drawbacks of price action analysis?

Price action analysis is a technical form of analysis that is based strictly on price movements on charts *without* the use of indicators.

Benefit: The goal of price action analysis is to establish *simplicity* and relative accuracy in the process of analyzing market behavior. Because you are looking solely at price movements and patterns, the analytical process tends to be simpler and more "objective" as you are looking at the source and not a filtered interpretation of the source. Keep in mind, however, that "objectivity" is a way of contextualizing realty and not reality itself. Additionally, the possibility of confusion caused by having to qualitatively assess different or contradictory indicator data is greatly reduced.

Drawback: The drawback of using price action analysis is that you will not be able to analyze markets through the lens of certain indicators that might be useful.

However, note that there are hundreds of indicators with variable settings, and that indicators will often conflict with other indicators or will add (sometimes unnecessary) complexity to the analytical process. Given that there is not one indicator (or combination thereof) that can always be reliable, the usefulness of one or several indicators is a matter of preference rather than effectiveness.

Therefore, it might help to analyze price movements in a manner that is clean (without several indicators "littering" the screen) and simple. As we will discuss, it is not a way of predicting markets but rather a means of contextualizing market action. Nothing is foolproof, and all is subject to interpretation and preference.

Trends and micro-trends

In a market context, "trend" means a continuation of price movement where highs and lows are moving either consecutively higher (as in an up-trend) or consecutively lower (as in a down-trend). A micro-trend is basically a trend that is smaller or embedded within or against a larger trend.

This is also where things get confusing. Let's say you've identified a trend. Which trend are you looking at and what forces might be moving that particular trend? It's not that difficult to find instances where charts in various time frames—minutes, hours, daily, weekly, monthly—show contradictory trends existing simultaneously.

The strength or validity of a given trend or micro-trend is relative and subjective. The existence of a trend "now" is speculative and uncertain. So having a set of signal to identify the *possibility* of trend movement is often the only thing you have to rely on.

Notice that we are making a distinction between trends and micro-trends rather than just calling a trend a "trend" and assuming that it co-exists simultaneously with other larger and smaller trends. We are doing this for a couple of reasons. First, most retail traders in the futures markets day trade or swing trade. This means that long-term trends that position traders or commercial hedgers follow typically fall outside the desired scope of most retail traders.

Second, micro-trends are vulnerable to—or are themselves—"noise." Short term noise tends to fall closer to the random and indeterminate side of things. Therefore, as a short-term micro-trend trader, you might want to acknowledge that you are probably trading noise, and that noise tends to exhibit more randomness than any longer-term or economically-driven market movement.

Why "trend" is problematic

We have all heard the phrase "the trend is your friend." Most of us generally understand what this means, but when it comes to actual trading, it is very difficult to do. The reason for this is that multiple trends exist, and it's almost impossible to tell whether you are in a current trend, a counter-trend within a much larger trend, or at the starting point of what may become a reversal or a range-bound (sideways) market.

As the famous trend-follower, Ed Seykota, mentions in ironic fashion, "there is no such thing as trend." In other words, trends are always confirmed in hindsight; it's always a thing of the past. You are either on the right side of a trend, not in a trend at all, or on the wrong side of a trend. You will find out eventually, but for the moment, you can't really tell or predict it.

Imagine a scenario where there's a strong fundamental reason for a market to be in an up-trend. According to price action and technical indicators, however, the market is in a down-trend. When might the up-trend begin, and how would you know? Perhaps there are many potential "support" areas that might mark the beginning of a reversal toward an up-trend, but which one? What if the fundamental bias ends up being only partially correct, or vulnerable to the effects of other emergent and correlated economic factors? Or, what if the current selling pressure is just an exaggerated reaction on the part of investors and speculators? But again, what if it isn't?

Price action as a tactical means to anticipate movements

If trends can't be predicted or verified with any real certainty, then the only effective solution seems to be the use of analytical techniques to *anticipate* trend continuation or reversal.

When it comes to anticipating price movement, there are numerous ways to do this, with or without indicators. Although price action methods will not yield the same data that certain indicators were designed to provide, they also help prevent confusion caused by having too many indicators or the tunnel-vision perspective that certain indicators can give. There's a flip side to every benefit.

How you use price action analysis is up to you. If you decide to incorporate it into your trading, be advised that risk management practices—including statistical performance testing—is solely in your court. Do your homework. We are just providing you with an analytical method that may be helpful if it resonates with your thinking and your own trading approach.

PART 2: Rules to determine trend (and micro-trend) possibilities

The following rules are traditionally-based. They are practical, not absolute, and their purpose is not to convey an accurate reality but instead to create a "context" for further analysis.

1. **Up-Trend = consecutive higher highs and higher lows**

Figure A) Market Trending Up

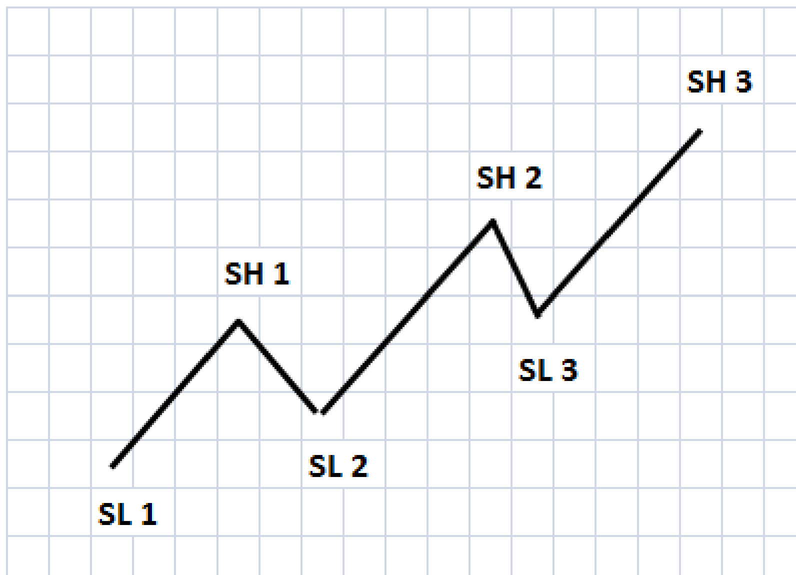


Figure A illustrates an ideal up-trending market.

- The swing highs and swing lows are consecutively higher; each consecutive swing low does not violate the previous swing low, and each consecutive swing high exceeds the previous swing high.

- If a current swing low falls lower than the swing low immediately preceding it, then the up-trend bias is placed on hold; we would now have to wait for the next swing high to confirm whether there is going to be a) a trend reversal, b) consolidation or range, or c) a continuation of the up-trend.

- If a current swing high fails to break above the swing high immediately preceding it, we would then have to wait for the next swing low to see if it falls below the last swing low; if the next swing low falls below the previous swing low, we then assume the possibility of a down-trending market.

2. Down-Trend = consecutive lower lows and lower highs

Figure B) Market Trending Down

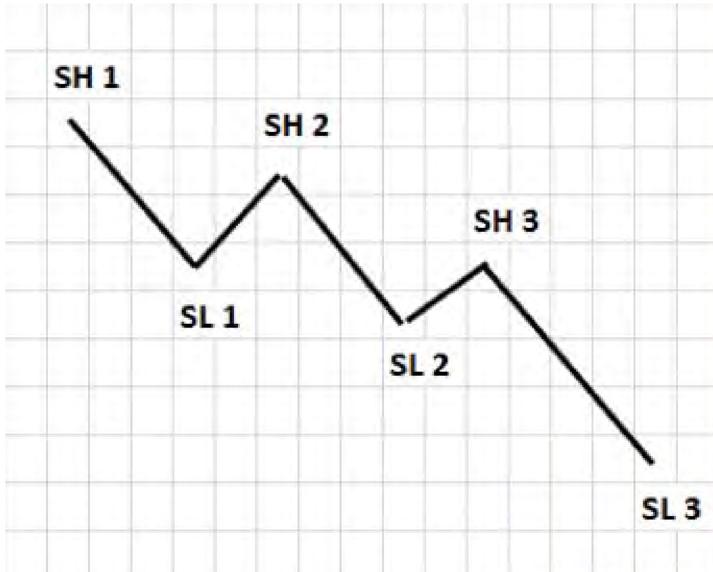


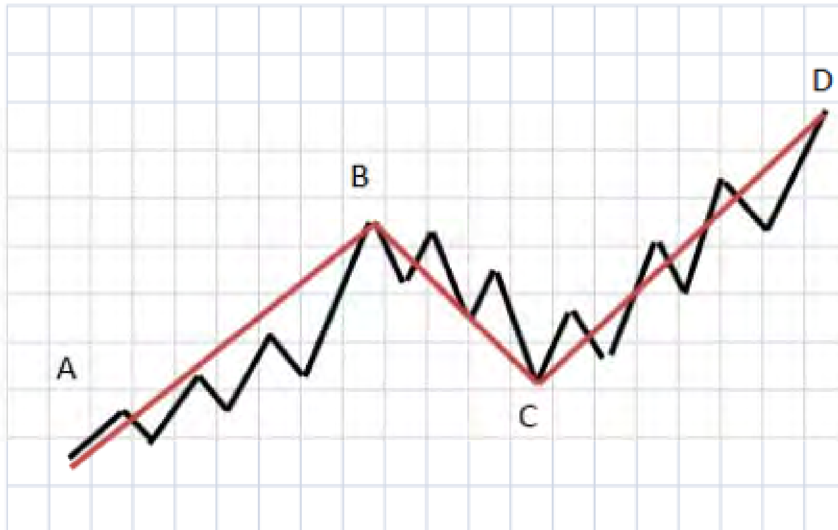
Figure B illustrates an ideal down-trending market. The swing highs and lows are consecutively lower. The same rules mentioned above apply but in reverse.

- The swing lows and swing highs are consecutively lower; each consecutive swing high does not violate the previous swing high, and each consecutive swing low exceeds the previous swing low.

- If a current swing high exceeds than the swing high immediately preceding it, then the down-trend bias is in question; we would now have to wait for the next swing low to confirm whether there is going to be a) a trend reversal, b) consolidation or range, and c) a continuation of the down-trend.

- If a current swing low fails to break below the swing low immediately preceding it, we would then have to wait for the next swing high to see if it breaks above the last swing high; if the next swing high breaks above the previous swing high, we then assume the possibility of a market reversal.

Figure C) Trends and micro-trends

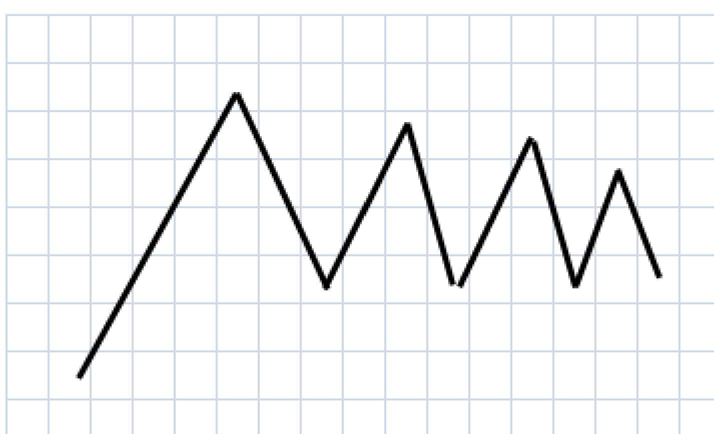


In a real market environment you will be looking at one or many time frames. Within just one time frame, whether it is a Weekly, Daily, 4-Hour, 1-Hour or as little as a 1-Minute time frame, you will see smaller trends within larger trends.

In Figure C, the red line represents the larger trending movement (an uptrend) and the black lines represent the smaller trend movements. You can see that in the larger trend, A-B contains many smaller waves and retracements that form an uptrend, B-C has the characteristics of a downtrend for those who trade smaller time frames, and C-D on a micro scale appears to be an uptrend. This brings up the importance of knowing which time frame you are using to contextualize your trades.

3. Consolidating and range-bound markets

Figure D) Consolidating Market (one of many possible combinations)



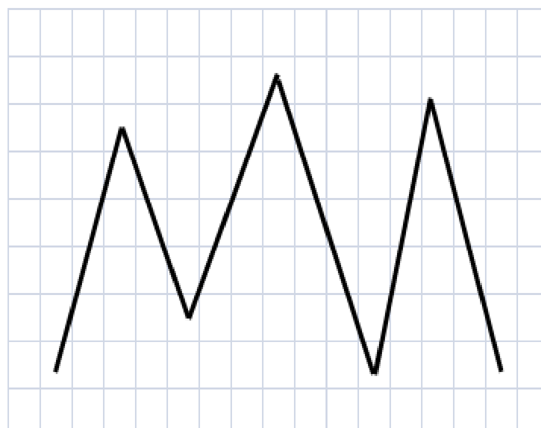
In a consolidating market, the *sequence* of swing highs and lows exist in such a way that no significant directional bias can be detected. Often, the swing highs and lows remain within a contained and/or indecisive range.

Sometimes a swing high will exceed or stay below a previous swing high and swing lows will sometimes fall below and/or remain above a previous swing low. In other words, support and resistance levels do not always match and are subject to an extension of the consolidation range. But overall, the subsequent highs/lows and closing prices will occur in such a manner that directional movement would seem indecisive.

We also tend to distinguish consolidations from range-bound markets based on the size of the swing movement (this is a subjective choice in which we prefer to ascribe the term "consolidation" to movements that are narrower in range, although we acknowledge that range-bound movements are consolidations when viewed from a larger timeframe; it's all relative). There are many classical patterns that can emerge from consolidations including triangles, wedges, ledges, diamonds, etc.

Consolidations are subject to breakouts in either direction.

Figure E) Range-Bound Markets



The characteristics of a range-bound market are similar to consolidations but take place in a more expansive range and movement in time. Figure 43– A shows what an "ideal" trading range looks like while Figure 3 – B illustrates a more realistic range with asymmetrical and uneven support and resistance areas.

PART 3: Real Market Examples

The reality of trending and consolidated or range-bound markets is much more complicated.

Example 1 Crude Oil, December 2015 contract

- For a scalper looking at this 5-minute chart, the signs are of a potential up-trend reversing from a down-trend.
- Note the low (L) at the 9:00 mark which had been tested twice; the price action rises and violated the trend line above.
- A local high (H) is established and quickly followed by a pull-back.
- That high is exceeded again with price ending at the highest point at the end of the chart.

What happens when we zoom out to a 4-hour chart?

- From a 4-hour perspective the current price movement appears to be either:
    - A down-trend which, according to our manner of context, has yet to form a pull-back (which might begin with the current micro up-trend that we've identified in the 5-minute chart); or
    - A pull-back from a potential up-trend breaking out of the last month's range-bound movements.

- There's also a possibility that these movements stem from exaggerated buying activity only to fall back into the former range-bound movements.

What does the daily chart look like?

- This perspective paints a different picture altogether: it looks like the current price levels are already within a larger range-bound market.
- If the same trader had the capacity to trade this chart, s/he would have to decide whether a breakout of the top part of the range would bring more buyers or sellers to the markets.
- If the trader were looking only at the 4-hour chart, would s/he be at risk by assuming that a break below the low (on the 4-hour charts) constitutes a potential sell signal (considering the range-bound conditions)?

ES December 2015 contract on 10/15/2015

- Note the test of the lows in the range illustrated by the yellow arrow.
- The blue arrow shows a downside break only to establish an even wider range-bound area.
- The higher low marked by the dialogue box and up-trend line shows a potential signal for up-ward movement, but how valid is this interpretation?
- Price is currently testing the upper high of the current range, but would this constitute a potential up-trend?
- This is a case where an examination of the fundamental factors might be informative; but fundamentally, the uncertainty is also reflected in the price action (which is not always the case, contrary to standard technical assumptions).

AUD/USD April 29, 2011 – February 14, 2012

On a macro scale, what you have here are two range-bound price levels interrupted by a downtrend which, arguably, is nothing more than a range extension. However, on various micro scales, you have lots of other kinds of movements.

- A: This is a large trading range (see the two green lines marking support and resistance).
- B: Smaller trading range nested within the larger trading range (see red line marking resistance).
- C: Down-trending movement AND range extension starting with the SH1 and ending at SL2.
- D: An even larger trading range.
- E: Intermediate scale consolidation illustrating a classic ascending triangle pattern.
- F: Micro uptrend leading to the range's resistance area (and possible continuation of the trading range as the price began moving downward once again).

EUR/USD, 2011-2012 – Up-trending Market

- A: Support is broken by a few pips but then proceeds to consolidate upward.
- B: The support level is broken and a downtrend is confirmed; this downtrend has an ideal sequence in which swing highs are consecutively lower without violating previous swing highs and swing lows are consecutively lower.
- C: The previous swing high has been violated and with strong follow-through; uptrend is certain.
- D: Prior swing low has been violated and uptrend is less certain; we wait to see of the next swing high breaks above the last swing high to maintain our uptrend bias.
- E: Bar breaks above previous swing high with follow-through; uptrend remains intact.

PART 4: Risks and Conclusion

Looking at the real market examples, you can see that one of the risks of using price action to identify trends is that price movements are never clear and often exceed anticipated highs and lows. However, this is the case for any method of technical analysis whether you are using no indicators or multiple indicators.

As far as trading risks, you will need to determine what your entry point would be (i.e. breakouts, anticipated breakouts, etc.) and how to position your size so that your entries and exits conform to your predetermined risk parameters and equity limits. Of course, there are plenty of other risks and you should be aware of as many as possible before trading. After all, to trade presupposes a willingness to engage risk head on.

When deciding on a method to trade trends (or trade against them), it will help you to do as much thorough research as possible. This means back-testing and forward-testing as much as possible just to get a basic idea of the statistical probabilities of your approach. Bear in mind that if you are testing in a simulated environment, the difference between real and simulated fills as well as the costs can be quite huge. The more frequent the trades, the larger the discrepancy.

The only way to test how a method will work in a live market is to trade in a live environment. This means that you should have adequate risk capital to match the kind of method you are using and the amount of trades you are expected to place according to your method.

Price action analysis is a simple way of determining the *possibility* of trends (not trends themselves). Remember that trends are determined in hindsight. You can only *position* yourself *in anticipation* of trends when they occur. When they don't, have a back-up plan (and sufficient capital).

We wish you the best.

GFF
BROKERS