THE (ALMOST) COMPLETE GUIDE TO TRADING

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INTRODUCTION

Mastering trading in just twelve lessons is a tall order but not outside the realms of possibility. Many people complicate trading to such an extent that they make it virtually impossible to succeed.

Trading should be straightforward, clear and logical.

If you can understand the basic principles, on which trading is based, then you have a far greater probability of triumphing over those who do not.

Trading is a challenge to master - mostly because of the numerous red-herrings thrown at us. By keeping it simple, adhering to the basic principles, and refusing to be distracted by shiny pennies (aka irresistible indicators or holy grail strategies) anyone can become proficient at trading.

Becoming an accomplished trader won't be achieved overnight - or even over 12 nights. But this series covers almost everything you need to know about trading. It is only the application which may take a little longer.

Over the next twelve lessons you will learn how to read the markets. This is a crucial part of trading which is missing from most people's education. Then, from this solid foundation, you can apply the elementary (yet effective) trade management techniques to fine-tune your own strategy.

Being able to identify the higher quality charts is the bedrock to becoming a successful trader. Over the next twelve lessons we will endeavour to cover all the analytical tools you need to join this elite class.

LESSON 1 – TRADING BIAS

One of the most important aspects of trend trading is knowing the trading bias. This is crucial to understanding when we are in a bull or a bear market – in other words whether we should be considering 'buy' or 'sell' opportunities.

The very first thing I look for on a chart is where price is in regards to the 200 daily simple moving average.

- If price is below the 200 sma I will look for short/sell opportunities
- If price is above the 200 sma I will look for buy/long opportunities

In a nutshell this is all you need to know on this topic! But I know many readers are a little more curious and would like to know why this is the case.

Historical use

The main reason the 200 sma is used in this way is partly historical. Before we had software (to draw any moving averages we could wish for in a matter of seconds) these things had to be calculated and drawn by hand. So traders were extremely picky about what was useful information and what constituted "noise" (a lesson we would do well to remember today).

The 200 sma was found to be a good indicator of the overall trend direction. So long as price remained above it then the trend bias was considered bullish. And if price traded below it

then the trend bias was considered bearish. If price repeatedly intercepted the 200 sma then price was considered to be in a range/consolidation.

Trading bias – the 200 sma failsafe

Of course, a new trend can get started on the "wrong" side of the 200 sma. When a bear market follows a strong bull market then price can come down for several weeks or months before crossing below the 200 sma. And vice versa, of course.

This is the 200 sma failsafe – we may have to endure weeks of a new trend without being able to trade it (due to it being the "wrong" side of the 200 ma) but this is to protect us against the reversal being a temporary pullback.

Some pullbacks can be deep and prolonged and this can tempt some people to the 'dark side' of trading – they want to trade against the overall trend. But until price crosses the 200 sma we assume the bullish or bearish bias is still intact (although we won't necessarily be trading it).

- When price is above the 200 sma the bias is BULLISH
- When price is below the 200 sma the bias is BEARISH

So stick with the 200 sma failsafe. Yes, it may look like opportunities are passing us by, at times, but we need to be more selective. We need to be aware of the trading bias and not get distracted.

Follow the market makers

The other reason I adhere to the 200 sma rule is because many large banks and financial institutions do. These organisations have massive funds they hold at their disposal and so have a lot of influence.

Some funds which trade long-term positions may start accumulating large positions the "wrong" side of the 200 sma as they have the finance to do so. This can take them weeks or months. (They do it very slowly because they don't want others to see what they're doing – as this could result in them being unable to fill positions at the price they want).

But the majority of institutional traders trade with the bias. For this reason retail traders, with our relatively small account sizes, only look to enter a trade on the "right" side of the 200 sma as this is where the momentum is.

Note: the 200 sma is only of relevance when ENTERING a trade. Trade management should get you out of a trade long before price retraces to the 200 sma. We will be looking at how to manage and exit positions later in the series.

Summary of the trading bias

Always have the 200 simple moving average plotted on your daily chart. Regardless of what lower timeframe you trade, follow this rule:

- If price is above the daily 200 sma only look for, and trade, long/buy positions
- If price is below the daily 200 sma only look for, and trade, short/sell positions

We call this the trading bias – it helps stack the odds of a successful trade in our favour. This applies to any and every market you can think of.

LESSON 2 – ESTABLISHING THE TREND

In lesson one we looked at establishing the trading bias. We did this by setting up the rule to only to go long when price is above the daily 200 sma and only to go short when price is below the daily 200 sma.

The next step is to find out if a trend is in play. We want to trade "with the trend" as this is where the momentum is. If we tried to trade against it we're fighting a losing battle.

In lesson one we chose to trade with the 200 sma daily bias to stack the odds of a successful trade in our favour. Now we want to add to that by trading with the trend – by having further elements in our favour. We do this by looking at a higher timeframe.

The higher timeframe

If we make the assumption that we are trading from the daily timeframe then that means looking at a weekly chart for further confirmation. There are two quick-to-identify elements we can take from the weekly timeframe to see if price is heading in the same direction.

- The 200 weekly simple moving average
- Annual highs and lows

Note: If you are trading anything lower than a 4-hour chart you can use the daily chart as your higher timeframe. However, as you are only using one element (above or below the daily 200 sma) to identify the trend, it will not be as successful as using the weekly timeframe as a second confirmation.

Weekly 200 simple moving average

On your weekly chart you should plot a 200 bar simple moving average. In this case it serves only to give us the weekly bias – it is not used as much by institutions so is not useful for any other purpose.

The rules here are:

- There is a bullish bias if price trades above the weekly 200 simple moving average
- There is a bearish bias if price trades below the weekly 200 simple moving average

In this case the weekly 200 sma is a longer-term moving average. In a good trending market price should stay above or below it on a consistent basis – regardless of what may be happening on a lower timeframe.

Annual highs and lows

Because each bar represents a week we can see more data (with the same number of bars) on a weekly chart. This makes it an ideal place to add another piece of valuable information – the annual highs and lows from previous years.

Generally on a weekly chart we have between 3-5 years worth of data, which is quite enough for our needs at this stage. In fact, we're only interested in last year's high and low.

- If price is above last year's high the bias is bullish
- If price is below last year's low the bias is bearish

At this stage we're only interested in the annual high and low (from 1st January to 31st December). We just want to make sure we're not in any immediate trading range.

Note: We only use last year's high and low because we're not looking for support or resistance at this stage (see later in the series for this). We just want to try and establish the bias to help us with understanding the trend.

Identifying the trend

So, now we have two new rules which we can add to lesson one. This means we can now identify the trend.

A bullish/uptrend is confirmed by:

- Price trading above the daily 200 simple moving average AND
- Price trading above the weekly 200 simple moving average AND
- Price is trading above last year's high

A bearish/down trend is confirmed by:

- Price trading below the daily 200 simple moving average AND
- Price trading below the weekly 200 simple moving average AND
- Price is trading below last year's low

In other words to confirm the trend we want price on both our daily chart and our weekly chart to be on the same side of their 200 sma and beyond last years extreme.


weekly chart
2013
weekly 200 simple moving average
2
price is trading BELOW the weekly 200 sma: the bias is BEARISH
2013 low
3
price is trading BELOW the 2013 low: the bias is BEARISH
TheDynamicTrader.com
daily chart
price is trading BELOW the daily 200 sma: the bias is BEARISH
1
daily 200 simple moving average
4
with price below
1. the daily 200 sma
2. the weekly 200 sma
3. the annual low
the TREND IS DOWN so only look to sell/short this stock
BIAS and TREND are bearish
TheDynamicTrader.com

LESSON 3 – SUPPORT & RESISTANCE

Areas of support and resistance are the basis of technical trading.

When we look at price action it is always in relation to support and resistance. From this we can gauge whether price is more likely to go up, down, or sideways.

There are a number of tools we can use – in fact, we need to use them in conjunction with one another. In this lesson we will be considering support and resistance zones created by the following:

- The daily 50 simple moving average
- 52 week highs and lows
- Round numbers
- Trendlines

There are additional support and resistance levels we need to take into account, three of which we covered in lessons one and two:

- Daily 200 simple moving average
- Weekly 200 simple moving average
- Annual highs/lows

and pivot points (which we will be investigating in lesson 4).

With technical trading it is essential we look for price points and/or price zones where there may be support or resistance. In order for trends to develop these areas will be broken at some stage – but price can struggle to cleanly penetrate them.

Knowing this in advance is useful as we can either delay taking a trade (until price has cleared the area) or we can manage our open positions (to allow for the likely price retracement movement).

The daily 50 simple moving average

The daily 50 sma is a very good barometer to have plotted on our charts. In a good, trending market price should not stray too close to it but, if it does, it should offer strong support (in an uptrend) or resistance (in a downtrend).

If the 50 sma is breached by more than a couple of bars then it is likely that price will continue to retrace until it finds another level of support/resistance beyond the moving average. The wick of a candle penetrating the 50 sma is generally no cause for concern, it is more of an issue if the body of the bars breach it.

The daily 50 simple moving average rules are as follows:

- The 50 sma should act as support (in an uptrend) or resistance (in a downtrend)
- A small breach of no more than 1-2 bars is acceptable

Note: In lesson seven we will be covering chart and candlestick reversal patterns and you will be able to use these in conjunction with the 50 sma to determine, with more authority, if a small breach is likely to be just that (with price rebounding and continue in the direction of the trend).

52 week highs and lows

In lesson two we used the annual highs and lows to help us determine the trading bias (to assist in identifying the trend). To establish the trend price had to be beyond the extreme of the high or low.

Another price point which can offer support or resistance is the rolling 52 week high/low. For this we need to look back a year from today (rather than looking at what happened in a calendar year).

This is often easier to identify on the weekly chart. So go back a year from today and see what has happened to price action in that time. If price has been beyond the extreme of where we are trading today – at any time within the last 12 months – we need to carefully consider if a trade is still valid.

- A 52 week high above current price in an uptrend is resistance
- A 52 week low below current price in a downtrend is support

This leads us on to our next set of rule:

- Only take long trades when price has broken above the 52 week high in an uptrend
- Only take short trades when price has broken below the 52 week low in a downtrend

Round numbers

Round numbers are those counted in units of 10 for stocks (e.g. $10, $20, $50, $100 etc) or whole number and/or one decimal place fractions for currency (1.0000, 2.4000, or 200.00, 130.00).

Of these round number some have more weight than others.

- For stocks $100 is often referred to as “The Figure” and $50 as the “Half Figure”
- For stocks trading below $100 then units of 10 are of importance
- For stocks trading above $100 then half figures are more important (e.g. $550 has far more weight than $530)
- For currencies the Figure would be 1.0000, 2.0000 or 100.00, 200.00 (depending on the base and counter currencies)
- Half figures (such as 1.5000 and 150) still carry more weight than units of 10 (1.8000 or 180.00)

When price is approaching these numbers we should be wary of the ability of price to progress without some form of consolidation or pullback. This is not always the case, but it is best to prepare for it (and it not to happen) then to not be prepared and be affected by it.

Round number often offer the most support/resistance when in conjunction with other events (such as a 52 week high or low). When we get multiple or clusters of support and resistance these will make it even harder for price to break through.

Trendlines

Trendlines can form very strong lines of support (in an uptrend) or resistance (in a downtrend).

Trendlines can be difficult to draw – choosing the points to connect is not always obvious. Sometimes price can be trending well but it is impossible to draw an accurate line. This is usually, but not always, the case when price is moving very rapidly. Later, in lesson four, we will be looking at pivot points which can be helpful in choosing highs and lows to join to form a trendline.

The main rules for trendlines are as follows:

- In an uptrend you need at least two higher highs and one higher lows to draw a trendline (by connecting the lows)
- In a downtrend you need at least two lower lows and one lower highs to draw a trendline (by connecting the highs)
- The trendline should not intersect any part of a bar

Trendlines are not static. While trendlines should not be moved simply because they have been breached they should be reconsidered when a new higher high (in an uptrend) or new lower low (in a downtrend) develops – the trendline may need to be shifted.

When a trendline is breached (with a low in an uptrend and a high in a downtrend) then the point of support/resistance has been breached. This can either be used as an early warning system of a reversal (or too deep a pullback) or can be used as a stop loss.

Note: We will be discussing stop losses in lesson ten – but for now suffice to say if used as a stop loss level you will be stopped out fairly regularly. To stay in a trend (and a trade) longer you would be better to put your stop further away.

Summary of support and resistance

In lessons one and two we established how to identify a trend. Now we want to add to our rules to see how well price reacts to support and resistance levels.

- Use a breach of the daily 50 sma and trendlines as early warning systems that price may be undergoing a reversal
- Use round numbers and 52 week highs/lows to identify horizontal support and resistance
- Look for zones where multiple areas of support and resistance exist – they may form areas which are harder for price to penetrate

LESSON 4 – PIVOT POINTS

Pivot points (like 52 week highs/lows, annual highs/lows, and round numbers) are horizontal lines of support and resistance. However, they are considered stronger than these other price points due to the way they are created.

The areas of support and resistance we looked at earlier in the series are all important but they have certain weaknesses, too.

- 52 week highs/lows and annual highs/lows are merely a random moment in time – we like price to break beyond them only because then we have more confidence that the trend has momentum
- Round numbers are a psychological barrier so their significance depends on how traders, en masse, weight up their worthiness compared to other factors influencing price at that time
- Moving averages are lagging indicators so it is best to wait a little before considered these area broken
- Trendlines can be broken quite substantially but the trend can remain intact – this makes it difficult for them to be used confidently as a line of support or resistance (which is why we suggest using them more as an early warning signal)

Pivot points, on the other hand, produce quite memorable price levels which traders remember for a long time. An example of a memorable pivot point is an all time high – especially if it is just before a market crash. For many years after the event traders will still say of price that it has either broken this all time high, or has yet to break it.

On a day-to-day basis, however, we can use pivot points somewhat closer to price action. They fall into two categories – major and minor.

Major pivot points

Major pivot points can be determined by:

- 10 or more lower bars on both sides of a pivot high
- 10 or more higher bars on both sides of a pivot low

You can apply this logic to any timeframe.

This is telling us that price has not been able to penetrate the extreme (high or low) for at least 11 bars before and after the pivot. So when price eventually does approach the pivot high (or low) there is little precedent for price to break through. And if price does break through there may be difficulty in it crossing back.

Major pivot points – once broken – frequently turn support into resistance (in a downtrend) or resistance into support (in an uptrend). Price may well come back to retest the pivot price but it will often remain solid. The more touches the line has (either from above or below) the stronger the pivot point.

Minor pivot points

Minor pivot points do not offer major areas of support or resistance. A minor pivot point (fewer than 10 bars either side) is more likely to be simply a point that price needs to break to confirm the continuation of a trend. They generally do not have the strength to hold price for a significant period of time.

So minor pivot points are short lived reversals which have the following characteristics:

- They will have fewer than 10 lower bars on both sides of a high
- They will have fewer than 10 higher bars on both sides of a low
- They can be used to confirm a breakout
- They cannot be used to determine strong support and/or resistance

Drawing pivot points on to your charts

After identifying a few pivot points on to your charts you will begin to get good at recognising major pivots without the need to draw them. This will help declutter your charts – too many lines will make it difficult to focus on price action.

So saying, if a trend has many major pivot points this will help you clarify the tradability of the chart. Lots of major pivots means price is not trending well – the pullbacks are too deep.

Imagine you try to trade a daily chart will lots of major pivot points. Each time a higher high in an uptrend (or lower low in a downtrend) is printed this is followed by deep pullback. While a 10 bar pullback isn't too bad, a 20 bar pullback is a month with no profits on that trade. In a prolonged trend having this occur a couple of times shouldn't faze you, but if it's happening on almost every breakout it will become frustrating – your capital would probably be put to better use elsewhere.

Now imagine the chart you are trading only has minor pivot points. Here the momentum is with the trend. From time to time all charts will have small breathers – they allow for profit taking – and the subsequent breakout is another chance for breakout traders to open more positions. But if these pullbacks are no more than 10 bars (and the fewer the better) then our equity will only fluctuate by a small amount – and we have confidence that the trend will soon continue.

So, in summary, major pivot points are great at telling us where major areas of support and/or resistance may occur. We want to be on the "right" side of the pivot to trade with the trend. And minor pivot points can be used to confirm a breakout. Lots of minor pivots (and an absence of major ones) in a trend help us identify the quality of that trend. We will be looking at this in more depth later in the series (lesson eight).

We can add these rules for major and minor pivots to our list.

LESSON 5 – RECOGNISING CONSOLIDATION

Being able to differentiate between a pullback and a consolidation is very important when trend trading. One is an acceptable and expected part of trading while the other means there is no trend currently in play.

There are three ways to distinguish a pullback from a consolidation:

- Range
- Depth
- Duration

There can be times when the distinctions are negligible – then the main objective becomes how to recognise if the trend has continued its previous course or reversed to start a new one.

Range bound

The biggest difference between a pullback and a consolidation is the behaviour of price.

A pullback should be a move against the trend (to a reversal point) then a move back in the direction of the original trend. Once price breaks beyond the original pivot point (the start of the pullback) then the pullback is complete. A single reversal point is ideal but there are a few chart patterns which count as pullbacks if they are small and neat (to be covered later in lesson seven).
A consolidation is a move against the trend followed by a move back to the starting price level followed by a move back against the trend. These movements back-and-forth continue until price moves outside of the consolidation zone.

Of course, a pullback is not necessarily a linear move to a single reversal point followed by a linear move back. And a consolidation is not necessarily multiple touches of the two horizontal levels of support and resistance.

In essence the differences between the two are:

- A pullback will move towards a single reversal point before returning to (and breaking beyond) the starting price. Sometimes there will be multiple touches close to the reversal point with the main differentiating factor being that price should not return towards the original pivot point until the move is complete
- A consolidation must move to a reversal point, move back to within a close proximity to the original pivot, move back towards the reversal point, and a further move towards the original pivot. This movement can repeat itself until the consolidation is broken – but

there must be at least two touches in close proximity to the line of horizontal support and at least two touches in close proximity to the horizontal line of resistance

Depth

The depth of price action can also help determine whether the chart is in consolidation or a pullback. We can measure this by using pivot points.

In the previous lesson four we looked at major and minor pivot points. If the price correction (the move against the trend) has only one major or minor pivot point (at the extreme of the reversal) then it can be considered a pullback. If it has three or more major or minor pivot points (within a price range) then it can be considered a consolidation.

- If you can identify several major pivot points within the range then the consolidation is deep
- If there is just one major pivot point then the pullback is deep

Occasionally it can be difficult to judge, by the depth, if price is in consolidation or experiencing a pullback. There could be an instance, for example, where the depth of the move is narrow and bounces between multiple minor pivot points.

So we need to introduce the third factor – duration.

Duration

Time is the third tool needed to help us distinguish between a pullback and a consolidation.

A pullback should generally be less than 20-30 bars (the fewer the better). A consolidation is generally more than 60 bars. This leaves a grey area of between 30-60 bars. To decide whether price is in a pullback or a range we need to put all our rules together.

Differentiating between a pullback or consolidation

A pullback is where price generally forms a single reversal point then continues back in the direction of the trend.

A consolidation is when price ranges between horizontal lines of support and resistance – with multiple touches of (or close to) each.

However, if price is trading in a zone which is not with the trend – but it is not clear if it is a pullback or consolidation – then we apply the following rules:

- It's a pullback of it lasts fewer than 30 bars
- It is in consolidation if lasts more than 60 bars (without changing trend)
- If it is between 30 and 60 bars then:
  - if only minor pivot points are identified (or only one major pivot point) it is probably a pullback
  - if two or more major pivot points are identified it is probably a consolidation.

In lesson six we will be looking at how to recognise a fake breakout to help prevent us being whipsawed out of a trade.

LESSON 6 – FAKE BREAKOUTS

When trading breakouts the one thing we want to try and avoid is price tagging us into a trade – then reversing and being stopped out. When this happens it's called a fake breakout – or fakeout.

A fake breakout can be anything from a single tick (from the very tip of the wick of a single candlestick) to several bars.

Although we can never eliminate all scenarios there are a few rules we can put in place to help avoid the majority of fakeouts.

Breaching support or resistance

When in a trend we can expect price to experience many pullbacks. We know the pullback is complete – and the trend has continued – when price breaches the previous level of support (in a downtrend) or resistance (in an uptrend).

When price is in a period of consolidation it ranges between a line of support and a line of resistance. As long as price is contained between the two lines we know we are in consolidation. Therefore we know that a trend has likely started when price breaches either of those lines.

However, there will be occasions then the wick of a bar spikes beyond support/resistance before price reverses back into the consolidation zone. So just breaking support and resistance is not enough. We want to see the body of the candle on the other side of the line. This means that the meat of price movement has decided on the direction it is heading – giving price more momentum in the direction of the trend.

Head fakes

It is not always the case that price just spikes beyond our lines of support/resistance. Sometimes one or more whole bars will do so. If the body of a candle is small then it often referred to as an indecision candle. This means that the opening and closing price are similar or the same (during the trading session, of the bar, price has finished where it began). We will be looking at these types of bars in more detail in lesson seven.

For now we can simply say that a bar with a small body (or a small body compared to its range) has no conviction. So although the body may have crossed the line of support/resistance this is not much more convincing than price merely spiking across it.

We can have several of these bars beyond the line of support/resistance before price decides not to trend but to return to the consolidation range. This is called a head fake.

These bars are generally (but not always) much smaller than the ones that came before the head fake. And they will often form a fairly horizontal line so that, over the several bars, price moves very little. They may well move a little in the middle, in a shallow arc, which is one of the reasons how the head fake came about its name. Another reason is based on the ice hockey manoeuvre.

Head fakes can also come about due to another support or resistance level being in close proximity (but just beyond) the one it is currently trying to breach. For example, price may have broken a major pivot point but is just 10-20 ticks from a round number, 200 sma or

other areas of support/resistance. The head fake will form if these secondary support/resistance points are a more difficult barrier to breach – and so force price to return.

Retest

Even allowing for the body of a candle to breach support/resistance – and making sure the candle is of a good size without further support/resistance in it's path – this still leaves many breakouts susceptible to fakeouts.

One method is to wait for price to come back to retest the support/resistance line.

A retest consists of waiting for price to breakout, then return to (but not breach) the support/resistance line before bouncing off it and continuing with the trend. This will often be in the form of a small pullback – using the support/resistance line as its reversal zone.

Retests have the disadvantage that price may not come back and retest – the trend may take off in an exponential fashion. We would then have to wait for the next pullback and breakout to enter the trade.

On the other hand, it is safer – as price has shown that support has become resistance (or resistance has become support). And, if the trend is good, a few missed pips/points won't be too noticeable on our equity curve.

However, if the pullback has been short (both in duration and depth) it would be foolish to wait for a retest – as the momentum is already proven to be with the trend. So a retest

should only be used if price has been in a prolonged consolidation, or a deep pullback. Then the retest method would be much more worthwhile to protect against a fakeout.

Rules to avoid fakeouts

So now we have a set of rules to help us avoid fake breakouts:

- Wait for the body of a candle to move beyond previous support/resistance
- If the body is a good size the trend is likely to continue
- If the body is small wait for the next bar – if this is also small beware of a head fake – look for other areas of support/resistance in close proximity which may be stopping the trend from continuing
- If price has been in consolidation (or a very deep pullback) wait for price to retest support/resistance

LESSON 7 – CANDLESTICK AND CHART PATTERNS

Most candlestick and chart patterns are a combination or variation of just a few types – you really don't have to know them all. In fact, understanding what price action is saying is a far more simple way of anticipating future price movement than having to recall countless theory.

However, for anyone interested in learning everything there is to know about candlestick and chart patterns here are two excellent reads:

- Japanese Candlestick Charting (by Steve Nison)
- Encyclopedia of Chart Patterns (by Thomas N Bulkowski)

Both these authors have since written new books on the same topic which you may prefer.

In this section we will not only cover the only chart and candlestick patterns you will ever need but I will also explain why they are the most useful, the easiest to remember and why they are most likely to succeed.

Candlestick patterns

I will start with candlestick patterns because these can be very useful in combination with chart formations. In fact, it is very important not to think of candlestick patterns as being standalone objects. They can have wonderful and descriptive names – which may make them seem more important than they actually are.

Doji

One of the most popular, and easily recognisable, candlesticks is the doji.

A doji is categorised as an "indecision" candle because price opens and closes at the same (or similar) point. This means that although price ranged during the session it could not decide whether to be bullish (and close higher) or be bearish (and close lower).
A classic doji is where price opens and closes halfway between the high and the low of a relatively large-ranging session.

Dojis can have a bullish bias (opening high, ranging lower, then closing high) or a bearish bias (opening low, ranging higher, then closing low). But even these are considered indecisive.

Many bars can look like dojis but we should only attach meaning to them if they are at the extreme of a trend (or extreme of a counter trend/reversal). As dojis are not reversal candles

we should not expect price to reverse – but we should be ready if it decides to do so. Hence the categorisation of “indecision”.

There is another candlestick related to the doji which also signifies indecision:

- Spinning top – like a classic doji but with a slightly larger body

With dojis and spinning tops it is quite important for the wicks to be considerably longer than the body – and preferably with a bigger range than the bars before (or after) it.

Also in the doji family are a few more candles, but in this case are considered reversal patterns. Again, these are only of significance if at the extreme of a trend/countertrend.

Reversal of an uptrend:

- Hanging man – a larger body at the top of the bar with the wick below
- Shooting star – a larger body at the base of the bar with the wick above

Reversal of a downtrend:

- Hammer – a larger body at the top of the bar with the wick below
- Inverted hammer – a larger body at the base of the bar with the wick above

With the four reversal candlesticks it should be noted that:

- The wick of the candle should be at least twice the length of the body
- A confirmation bar is required (i.e. a higher bar in a downtrend and a lower bar in an uptrend)

Of all these candlesticks the most important one to know and be able to recognise the doji.

But please be aware that it is not unusual to have several doji in a row – either moving up, down or sideways. This is why we should not think of them as reversals but as indecision candles. You must always wait for the next bar to close to confirm the outcome.

Engulfing candles

Engulfing candles are also very easy to spot, with a little practise, and are very useful reversal signals. There are two types:

- Bullish engulfing candlesticks
- Bearish engulfing candlesticks

A bullish engulfing candlestick pattern is comprised of a large bodied bullish bar that engulfs a smaller bodied bearish bar in a downtrend (to signal a reversal from a downtrend to an uptrend).

A bearish engulfing candlestick pattern is comprised of a large bodied bearish bar that engulfs a smaller bodied bullish bar in a uptrend (to signal a reversal from an uptrend to a downtrend).

Note: A bullish bar is one where price closes higher than it opened and a bearish bar is one which closes lower than it opened. The higher a bullish bar closes to the high of the range the more bullish it is. And the closer a bearish bar closes to the low of the range the more bearish it is.

With engulfing patterns we only need to look at the bodies of the bars – we can ignore the wicks. The first bar's body must be smaller than the second bar's body – as well as being within the open and close range of the second bar – in order for the second bar to engulf it.

These engulfing patterns are very effective because the second candle gives us a decisive move in the opposite direction. However, there is no way of measuring how long the reversal will last – regardless of the relative sizes of the bars.

Chart patterns

Once candlestick patterns get to be more than two bars we can start calling them chart patterns. There's no difference in the formation (just a difference in terminology). In the West chart pattern names have been around longer than candlestick ones so it really is just a matter of preference.

Chart patterns are often grouped into "continuation" and "reversal" categories. Sometimes this can be useful and other times it can confuse – because some patterns can be both. This makes judging their success rate difficult.

So here I am going to show you how I use some of the most popular chart patterns. It includes all the ones I rely, and use, on a regular basis.

Flags

One of the most useful continuation patterns to know is the flag. They are very effective and straightforward to recognise.

There are two types of flag:

- Bullish flags
- Bearish flags

As the names suggest, a bullish flag indicates a continuation of a bull/up trend and a bearish flag indicates a continuation of a bear/down trend (after a brief pullback).

The textbook flag is often depicted with a linear counter move against the trend for a few bars followed by one large bar which engulfs the whole reversal move. In reality, while we do often see such uniform flag formations, more often than not they look a lot messier.

Here are some rules for flags:

- Between 2 and 11 bars making the pullback
- No part of the pullback bars should breach the extreme of the original pivot high/low
- A flag is confirmed when the body of the breakout candle goes beyond the original pivot

A flag is an effective pattern because price has only pulled back for a few bars – not enough to worry about price falling into consolidation. Generally the pullback will not be too deep,

either, but even if it is you can still trade the breakout (if you wish) as the duration has been short. Price has told us it's just taking a little breather before continuing with the original trend.

Double tops and double bottoms

Double tops and bottoms are often used as a trend reversal signal but I do not find them a reliable pattern for this. Afterall, they may turn in to triple tops/bottoms or consolidation. And generally trying to anticipate trend-changing reversals is not at all straightforward – or necessary.

So another way to use them is as a continuation pattern and look for:

- A double bottom in an uptrend
- A double top in a downtrend

When the neckline is broken (with the body of the breakout bar) then the pattern is confirmed and a continuation of the trend is likely to resume.

The two extremes of the double bottom/top should be within a few ticks of each other. This can be a little discretionary if one of the tops/bottoms is affected by a level of support or

resistance (such as a round number or moving average). But generally you should be able to draw a horizontal line to connect the two points.

Double tops/bottoms often work well as a continuation pattern because price is finding support (in an uptrend) or resistance (in a downtrend) with the overall trend winning the day.

Measured moves

A measured move is when we expect price to move a particular amount based on a previous move. Measured moves only anticipate price – not time.

Double tops and bottoms fall in the category of anticipating a measured move. The price difference between the extreme of the double top/bottom and the neckline of the double top/bottom is how much we would expect price to move after the completion of the pattern.

While measured moves give us a target for price we should never rely on them to transpire. Other factors can affect them and render them unfulfilled (such as a strong level of support/resistance situated between current price and the target price). However, provided you are aware of this, it is surprising how often the move materialises. Anticipation – but not expectation – is the key here.

Head and shoulders

Head and shoulder patterns are a bit more difficult to identify – even for more experienced traders. Sometimes they are very clear cut, other times one or both of the shoulders can be difficult to clarify.

Head and shoulders are reversal patterns – with price reversing from the turning point of the 'head' – but not necessarily trend-reversing patterns. As with double tops/bottoms they can also be used to confirm the trend direction.

There are two types of this pattern:

- Head and shoulders
- Inverted head and shoulders

A head and shoulders formation in an uptrend can signal a trend reversal. In a downtrend it is more likely to signal a continuation.
An inverted head and shoulders formation in a downtrend can signal a trend reversal. In an uptrend it is more likely to signal a continuation.

For a head and shoulders pattern you get a pivot high, pivot low, higher pivot high, pivot low, lower pivot high. The opposite is true for an inverted head and shoulders. The pattern is confirmed when price breaks the neckline.

The neckline for this pattern is found by drawing a line to connect the two pivot lows (for a head and shoulder) or the two pivot highs (for an inverted head and shoulders) and extending it to intersect price.

In a textbook head and shoulders pattern the neckline is a horizontal line (in addition, the shoulders are the same height, too). But this is not the case in practice. Shoulders can be lopsided and the neckline will usually be at an angle.

The measured move for this pattern will be calculated from the extreme of the head to where the neckline intersects the most recent bar. And the measured move is anticipated to begin from where price intersects the extended neckline.

So whether the neckline is ascending or descending can play a part in the success of the measured move (bearing in mind the move can also be affected by horizontal lines of support or resistance).

If the head and shoulders pattern is difficult to identify then don't worry – just look at price action and see what it is telling you. Price made a new high, retraced a little, made a higher high, retraced, could only manage a lower high, retraced. This tells you there is weakness.

And the opposite for the inverted head and shoulders holds true. This can be seen even if you are unable to clearly identify the two shoulders.

Finally, even if you miss the pattern altogether you should be able to see the flag formation of the second shoulder. If this is not clear, either, then neither pattern is helping with the analysis and this is often due to price consolidating. In which case we need to stand aside until a new trend develops.

Cup and handle

To identify a cup and handle you need to look for a large rounded bottom followed by a smaller (both in width and depth) rounded bottom.

On a daily chart cup and handles can be spiky rather than rounded – more of a goblet and v-shaped handle. They can be quite skewed as well. It is not unusual for the cup aspect to look similar to a double bottom or an inverted head and shoulders pattern.

For some reason, cup and handles are far more commonly identified at the start of a bull market. While inverted cup and handles do exists they are not often spotted.

A cup and handle is often easier to see on the larger timeframes (weekly or monthly charts) because there is less “noise”. While this isn’t ideal as a tradable pattern, due to the duration, once your eye is trained to see them you will soon start to notice them on a daily timeframe, too.

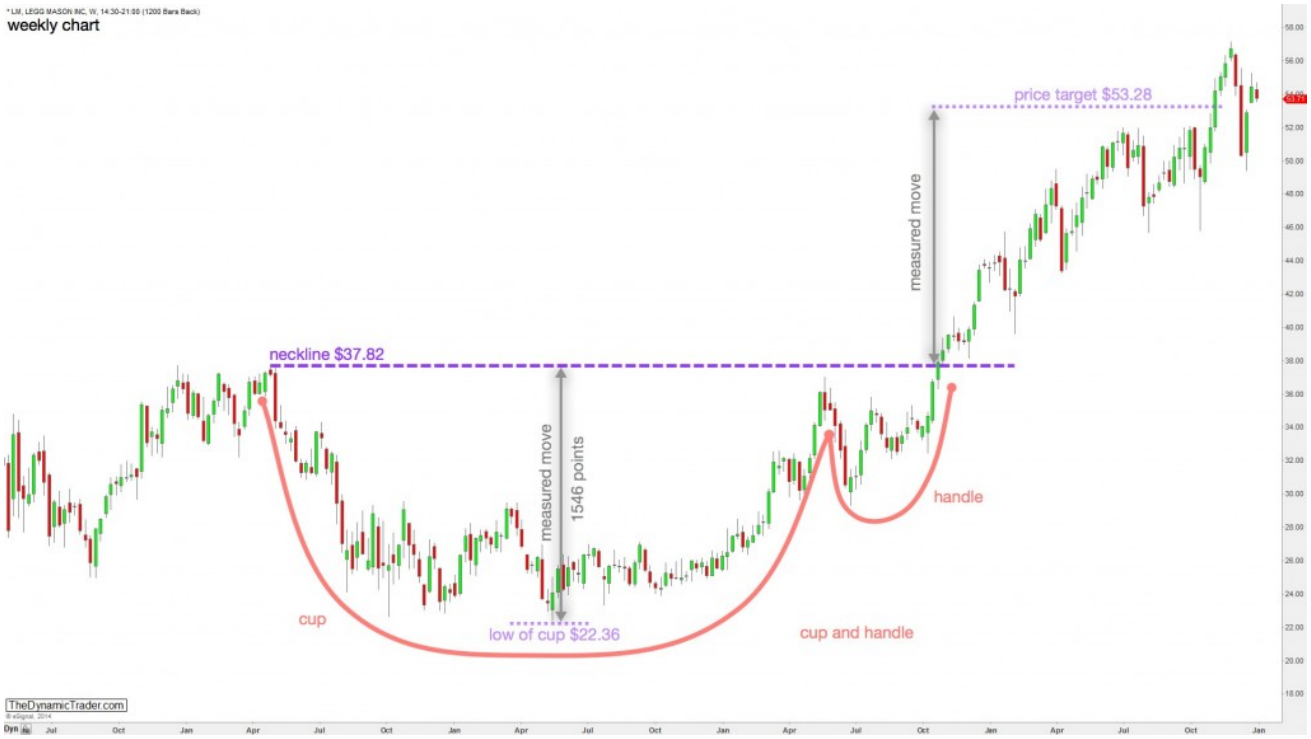
Cup and handles are a fairly reliable reversal chart pattern (with the reversal taking place at the base of the ‘cup’) although I rarely have the confidence to trade the breakout bar due to the duration of the formation. They can take several weeks to form, even on a daily chart. The measured move from the base to the top of the cup can be used to project a target price – but the move is often not as immediate as it is with other chart patterns.

A cup and handle formation in a downtrend can signal a trend reversal. In an uptrend it is more likely to signal a continuation.
An inverted cup and handle formation in an uptrend can signal a trend reversal. In a downtrend it is more likely to signal a continuation.

The most critical aspect of this pattern is the importance of the start of the cup being on the same horizontal level as the end of the cup before the handle forms. Then once the handle breaks beyond this horizontal neckline the formation is complete and the measured move begins.

Cup and handles are supposed to be a rare but powerful chart pattern. They tells us that price has moved smoothly and gently to an extreme then reversed its trend – again in a slow

and even manner. It tests the beginning price of the cup, reverses against it to form another, smaller arc/handle. Price does not come close to the extreme base of the cup, showing the previous trend has lost momentum and price has now reversed.



Summary

In this section we covered a number of price formations:

- Candlestick patterns
- Doji – including related bars: spinning top, hanging man, hammers and shooting stars
- Engulfing candles – either bullish engulfing or bearish engulfing
- Chart patterns
- Flags (bullish and bearish)
- Double tops and double bottoms
- Head and shoulders (and inverted head and shoulders)
- Cup and handle (and inverted cup and handle)

Chart and candlestick patterns can be a very useful addition to a trader's arsenal. They give us confidence about what is likely to happen next. However, they should never be used as a standalone indicator as they can be wrong more often than they are right.

For this reason it is not necessary to know all the different types of formations not mentioned here. In fact if you are happy interpreting what these few patterns are telling you about price action then you really don't need to know any at all!

So saying, it is helpful to have a shorthand so using the industry standard makes sense. It also makes communicating with other traders easier – as well as understanding your own notes (and reasons) for taking a trade.

In this lesson we looked at using candlestick and chart patterns to give us added confidence in anticipating the trend direction during possible pullbacks or reversals. If we can identify one or more then we know the move is more likely to occur than if a pattern is absent. In the next section we use our pullback and pattern recognition techniques to assess the linearity of a trend.

LESSON 8 – LINEARITY OF TRENDS

To assess the linearity of a trend we will be using some of the tools and skills we have learnt earlier in the series.

A linear trend is one which is as direct as possible with the smallest pullbacks. It can be fast moving or slow and there can be multiple pullbacks or just a few.

The main observation is that price prints higher highs (in an uptrend) or lower lows (in a downtrend) with counter-moves small in both duration and depth.

Duration

In lesson five we looked at defining a pullback as being no more than 20-30 bars. Anything longer than that and price started to move into the realms of consolidation.

- For a linear trend we want the majority of pullbacks to be fewer than 20 bars
- For an excellent linear trend we want the pullback durations to be fewer than 10 bars

Ideally we want to trade excellent linear trends. This doesn't mean to say we would exit a trade if a counter move developed into more than 10 to 20 bars. But if this were to happen frequently then we could not call the trend linear. A chart may still be worth trading, but profits will either take longer to be realised (if pullbacks are too long in duration) or be more erratic (if pullbacks are too deep in price).

If our pullbacks are fewer than 10 bars in duration then, of all the chart patterns we discussed in lesson seven, it is only a flag that can truly be formed in this time. This is one of the main reasons that a flag is such a popular, and useful, configuration for Dynamic Traders.

As trend traders we have to accept that pullbacks will occur. But we do not want to trade charts where those pullbacks are too long or deep. Identifying charts with a history of flags (either just a few or multiple) is critical to a trend traders success.

At the flag base we would want to see some sort of candlestick indecision or reversal pattern. Any of those configurations covered in the previous section are suitable (bearing in mind some apply only in an uptrend while others only pertain to a downtrend).

If you want to trade pullbacks you need to get proficient at identifying reversal points (see lesson nine). If you prefer trading breakouts (also covered in the next section) then recognising the reversal point is still extremely useful – as we will see when looking at the importance of depth.

Sometimes the 10 bar pullback/correction can be more of a sideways move so not instantly recognisable as a flag. But provided the depth is not too deep this is quite acceptable.

Depth

In lesson four we looked at major and minor pivot points and in lesson five we used pivot points to help determine the depth of the pullback. When looking at linearity we don't want to see any major pivot points during our trend – that would mean price is fluctuating far too much. We want the depth of the pullbacks to be shallow.

We defined minor pivots as those with fewer than 10 bars either side of the extreme bar – and this is the maximum we would want to see on a chart and still be able to call it an excellent linear trend (as mentioned above when considering duration).

Normally minor pivots give us areas of weaker support and resistance and we would generally use them only to confirm a breakout has occurred, or that a small reversal may be underway. Unless they coincided with other lines of support or resistance we would ordinarily reject them as not strong enough to hold a price correction.

However, with a linear trend we want price momentum to move in as tight a line as possible. So in this case we can use previous minor pivots as offering good support or resistance. As pullbacks should be small in both duration and depth we need something closer to price action than a major pivot.

- In an uptrend the previous minor pivot high should not be breached on a pullback
- In a downtrend the previous minor pivot low should not be breached on a pullback

If the previous pivot is breached then the trend is not considered linear – the pullbacks have been too deep in price.

Modest breaches

If price does breach the previous pivot this could be a signal to tighten any trailing stops (to be covered in lesson ten on trade management). But before doing so we need to consider the type of bar that was guilty of that transgression.

- Consider the bullishness or bearishness of the bar
- Consider the wick position and length
- Consider the candlestick formation

The first thing we need to consider is whether the breached bar is bullish (in an uptrend) or bearish (in a downtrend). For a definition on bullish and bearish bars you can revisit lesson seven under Engulfing Candles. If the bar is bullish (in an uptrend) or bearish (in a downtrend) it could well mean that the pullback reversal point has been reached.

The second consideration is whether it is just the wick of the bar that has breached the support/resistance zone and by how much. While not ideal the wick means that price has strayed during the trading session – but did not open or close beyond the desired level. A very long wick may be more of an issue.

And the third gauge is to assess if the bar can be identified as a reversal or doji candlestick pattern (covered in lesson seven). A reversal candlestick pattern would be preferable to a doji, but a doji would be acceptable (if only just beyond the pivot level).

Ideally we would want all three conditions to be true but any of the above bars could signify a return to the direction of the original trend. Even in the most linear of trends it can pay to be a little lenient.

Linearity

Finding an excellent linear trend to trade is ideal for long term or shorter term trend traders. They are not the norm but it's worth seeking them out as it makes trading so much less stressful and also more profitable.

In our trading room the minimum we look for is:

- The majority of historical pullbacks to be no more than 10 bars (preferable fewer)
- Previous minor pivot highs/lows to remain intact on pullbacks
- Modest breaches can be acceptable if a reversal looks likely

Excellent linear trends are usually over fairly quickly (often only a few months, if you are trading from a daily chart, at the most) so finding good linear trends (where the pullbacks are deeper and/or slightly more erratic) is well worthwhile, too.

A good linear trend can last for years (especially with stocks and commodities). So, although you will have to accept deeper pullbacks and/or times of prolonged (but not deep) consolidation, overall the gains made will be less stressful to accumulate than trying to get in-and-out of the trend multiple times.

During the last eight lessons we have discussed, in some depth, how to identify and evaluate breakouts and pullbacks. In lesson nine, we will look at the advantages and disadvantages of these two techniques to trade the trend.

LESSON 9 – BREAKOUTS AND PULLBACKS

There are only two ways to trend trade – on a breakout or on a pullback. Each has its advantages and disadvantages.

Generally traders prefer one method over the other and tend to stick with the one they're comfortable with. Others like to have both types of strategy to hand and will choose to use the one they feel is most appropriate to the situation.

The main thing to remember is you shouldn't switch halfway through a trade. So if you enter on a breakout strategy and want to add to your position then you need a further breakout to do so. And if you take out a new trade on a pullback strategy then any additional positions must be triggered using the same technique.

What is a breakout?

A breakout can be defined in one of two ways:

- A break beyond the previous bar
- A break beyond a previous pivot point

In the first definition a breakout is price moving higher than the previous bar (in an uptrend) or lower than the previous bar (in a downtrend). Price is making a new high or new low and has thus broken above/below the previous bar.

In the second option a pullback has to occur for price to subsequently make a higher high (in a uptrend) or lower low (in a downtrend). The pullback can be anything from a single bar to a minor or major pivot – or even a consolidation. Once price has broken above the pivot high (in an uptrend) or below the pivot low (in a downtrend) then price can be said to have broken out.

What is a pullback?

A pullback is a small but defined counter-trend move. If the counter move cannot be quantified as a pullback then price has either gone into consolidation or a trend reversal.

- It should not be more than 30 bars (although up to 60 is permissible) in duration
- The extreme should not breach major pivot points or strong zones of support/resistance.

We looked at how to identify a pullback in lesson five when considering the differences between pullbacks and consolidation. And we examined chart and candlestick patterns in lesson seven to help recognise common pullback criteria.

Identifying a breakout

Breakouts are straight forward to identify - regardless of your chosen definition. If you want price to make a higher high, or lower low, than the previous bar you just have to see if price obliges. If you want it to break a minor pivot, major pivot, or other area of support/resistance then, again, you just have to wait and see if price surpasses the previous price.

Although breakouts are simple to recognise this does not make them easy to trade.

Firstly you must protect yourself from being triggered into a fake breakout (see lesson six). This is essential to breakout traders. Avoiding as many fake breakouts as possible will help preserve your capital.

Second, price is likely to retrace at some point – which could be beyond your entry level. This is only likely to happen within the early stages of you entering a trade – once the trend becomes more established price will have moved a safe distance away. But at the beginning your position may move in and out of negative equity for several days or weeks. So you need to allow plenty of room by keeping your stops at a safe distance.

Consider these following rules if you want to trade breakouts:

- Wait for the body of the candle to breakout (not just the wick)
- Look for the bar to be bullish (in an uptrend) or bearish (in a downtrend)
- Only trade in the direction of the trend
- Trade with sufficient size stops to allow for the natural movement of the markets
- Trade longer-term

Identifying a pullback

Identifying pullbacks can be tricky. Sometimes they can be over before they've begun (in the case of a one bar pullback) and other times the extreme looks like it's been reached (a reversal candle in addition to a chart pattern) yet price continues deeper – maybe into a consolidation or trend reversal.

Although pullbacks are more difficult to identify than a breakout there are a couple of safety measures you can put in place.

First, many pullback traders will protect their capital by placing their stop just beyond the reversal bar and then wait for price to break above the bar (in an uptrend) or below the bar (in a downtrend) by a reasonable margin. If they are wrong their risk is reduced by the tight stop.

Second, you should look for multiple support (in an uptrend) or resistance (in a downtrend) points. The more reasons price has to reverse back in the direction of the trend the better. Trendlines can be used, but a trend has to be well established and linear before they can be relied upon.

Consider these following rules if you want to trade pullbacks:

- Understand continuation chart patterns and reversal candlestick formations
- Have a checklist of the multiple reversal criteria required, including

- Trendlines
- Minor and major pivots
- Moving averages as support/resistance
- Round numbers
- Annual and 52 week highs/lows

- Keep stops tight in case the pullback deepens

An overview of breakouts and pullbacks

Breakouts and pullbacks both have their advantages and disadvantages.

- Breakouts are easier to identify while pullbacks give the trader the opportunity to gain more pips/points
- Breakouts mean the momentum is with the trend while pullbacks could retrace further
- Breakouts need wider stops while pullbacks can reduce monetary risk by having tight stops

Deciding whether to trade just one or both does not need to be set in stone. As your skills develop you may discover you find more success with one method or the other.

In lesson ten, we will be taking this a stage further to see how we can enter and manage our trades to the best advantage.

LESSON 10 – TRADE MANAGEMENT

In this section we will be looking at how to enter and manage a trade. It will be based mostly on trading breakouts but, where applicable, the comparative steps for trading pullbacks will be included.

The following guidelines are not intended as a replacement for a well thought out and robust strategy. It is not, unfortunately, within the scope of this series to impart a complete and tradable system. Such an undertaking requires at least a small element of tuition and several weeks or months of support. So saying, this will give you a foundation on which to judge any trading systems you are currently trading or are considering in the future.

Selecting an entry point

Many traders focus entirely on the entry but Dynamic Traders know the exit is far more important than the entry. As the future is unknown we will never know for certain how a trade will develop so knowing when to get out is of paramount importance.

But this is extremely unhelpful to new traders (who don't know how to get into a trade). So I will be showing a few criteria for entering a trend on a breakout as well as on a pullback.

Breakout entries

Breakouts offer by far the more decisive entry points, as discussed in previous sections in this series. We know that a breakout has occurred because price has surpassed the previous high (in a uptrend) or low (in a downtrend).

However, knowing that a breakout has taken place is not the same as knowing when to enter – even after taking the possibility of a fake breakout into account.

So here are some rules to consider:

- Only enter in an established trend
- Check there are no support/resistance zones close by to the pending trend
- Check the breakout is beyond any recent pivot highs (in an uptrend) or pivot lows (in a downtrend)
- Wait for a least one breakout bar to close
- Check the body of the breakout bar is beyond the extreme of the previous bar
- Look for a bullish bar (in an uptrend) or a bearish bar (in a downtrend)
- Only enter after the first breakout bar if the pullback was small (fewer than 30 bars)

The first breakout bar is what is known as the signal bar. By the body of the bar exceeding the extreme of the previous bar the breakout is less likely to be a fake out. But we have to wait for the bar to complete in order to confirm this – it is possible (in fact probable) that price could retrace during the trading session back into the range of the previous bar. If the body of the breakout bar does exceed the extreme of the previous bar then we can look to enter from the following bar.

There are numerous methods to enter once this set-up has formed. You can choose to enter at a set number of ticks beyond the breakout bar or you may wish to calculate a percentage. The figure you choose can be close to price action as we've already waited for the breakout signal bar to close.

Pullback entries

It is often more difficult to identify the exact reversal point with pullbacks because price could always retrace further. However, the plan of action is quite similar.

First let's look at some of the rules:

- Only enter in an established trend with a history of small pullbacks
- Check price is unlikely to retrace further by identifying clusters of all possible levels of support/resistance
- Wait for the reversal candle to be confirmed (you will need at least 2 bars – including the reversal bar – to have completed)
- Look for a bullish bar (in an uptrend) or a bearish bar (in a downtrend)

- Only enter if you can clearly identify a reversal candle and/or continuation chart pattern

The bar that confirms your reversal point is the signal bar so you should not enter on that bar. You can enter from the next bar. As with a breakout entry you can choose to enter at a set number of ticks beyond the signal bar or you may wish to calculate a percentage.

Waiting for the extra bar to form gives you time to confirm that price has bounced from the extreme of the reversal. As with a breakout entry this does not mean your trade will necessarily be profitable – but it does mean that you have stacked the odds in your favour.

You will have lost out on a few ticks, if the trade is successful, but this is a small price to pay for a little extra confirmation that price is heading in the desired direction. Over multiple trades this trade-off will pay off – handsomely.

Setting stop losses

Setting stop losses is essential for all trades. Before you enter every trade you must always know the maximum amount you are prepared to lose. Once this has been calculated you only ever move stops closer to price action – never further away.

Stops should always be calculated as a percentage of your account size – never a fixed monetary or tick amount. This means you will have to adjust the number of positions you trade to fit the distance of the stop loss from the entry point – rather than fit the distance of the stop loss to suit a financial or tick quota.

Breakout stops

When trading breakouts stops need to be fairly large because price may retrace or move sideways for a while (for up to 60 bars) before the momentum continues.

This is not always the case – and is not the ideal – but you have to make allowances for this to happen. Otherwise you will find yourself being stopped out of a trade only to discover price eventually continues in the direction of the trend. Trend trading, and trading breakouts, requires patience and an equable nature.

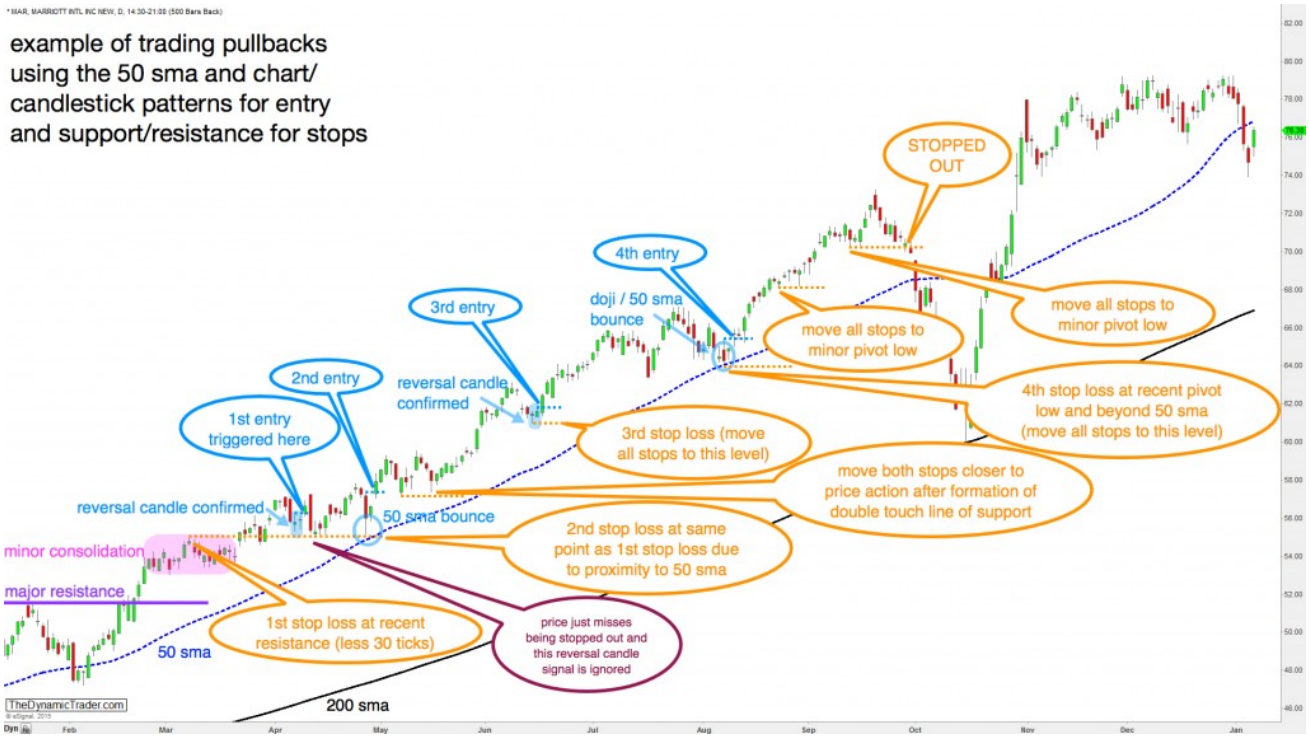
Depending on the personality of the trend you should be able to place your stops just beyond the previous major or minor pivot. This could be the extreme of the last pullback move. If there are other strong levels of support/resistance in close proximity to this you may want to make sure your stop is just beyond these, too.

Your stop needs to be just the other side of these levels of support/resistance because price can sometimes spike beyond them by just a few ticks. Allowing this extra room for manoeuver is necessary to accommodate the natural movements of price action.

Pullback stops

When trading pullbacks stops need to be tighter – because price has already retraced against the trend. You can use the previous pivot high or low if it is in close proximity to price. Or you can use a fixed number of ticks or a percentage. Using a percentage is more accurate but can be time consuming and fiddly to calculate.

You should also take into account other areas of support and resistance – and your stop should be just the other side of these levels (for example, by 30 ticks). But remember that you have already anticipated that the extreme of the pullback has already been achieved so don't let your stop stray too far.



Getting risk free

Once your trade has been triggered and price moves in the direction of the trade you need to start thinking about locking in some profit. In fact, before that the most important objective is to get the trade risk free by moving your stop to entry.

A standard formula for achieving break-even on a position is to move your stop to entry when your risk target has been reached. For instance, if your opening stop loss was 100 ticks from entry you would move your stop to entry when you were 100 ticks in profit. This is

a very solid and logical approach. But you may want to attain break-even before that (if price action does not look likely to stop you out prematurely)

Trailing stop losses

There are numerous methods for trailing stop losses, the most popular of which are:

- Fixed ticks
- Percentage
- Moving averages
- Pivot highs/lows

Fixed ticks trailing stops are common for very short term traders but not so suitable for longer-term trend traders. They are generally used when you want to keep stops tight. This method is not ideally suited to trend trading because being in a trade, while price fluctuates and experiences pullbacks, is not setting the trailing stops at a logical level.

Percentages are a little more systematic – if your initial risk is a set amount of your account you could keep this consistent throughout the trade. However, it's a bit fiddly to recalculate on a regular basis and not necessarily the most appropriate level when trend trading.

Moving averages can work well with trends. Make sure it is not too close or too far from price action. You may want to experiment with what suits your risk tolerance but try starting somewhere between the 50 to 100 simple moving average and see how you fare. The downside is this will change at the end of every session so you will have to amend your stops accordingly. Also you must remember with moving averages never to move your stop further away from price action. At the end of a trend the moving average could start to violate this rule – which you can remedy by leaving the stop where it is until either the moving average moves closer to price action again or you get stopped out.

Using pivot highs and/or lows is also a methodical approach – and less work as you only have to move them when a new pivot point is formed. Do take care, however, to keep your stops at a safe distance from price action – if a chart is making regular, small pullbacks the penultimate pivot may be far to close.

Finally, take into consideration other support/resistance levels – if a pivot is close to a round number, for example, make sure the stop is beyond the furthest of the two points.

For trailing stops there is no difference in technique regardless of whether you entered on the breakout or pullback.

Tightening stops

There may be times when you can see price approaching a strong level of resistance (in an uptrend) or support (in a downtrend) so you may want to tighten your stops.

This should only be done if the support/resistance is very strong – otherwise you may be stopped out prematurely.

A popular method is to move your trailing stop to a five or ten bar low (in an uptrend) or five or ten bar high (in a downtrend) or a minor pivot high/low closer to price action.

Exits

Positions should never be exited manually – you should always be stopped out by your stop loss.

Trend trading with trailing stops means that eventually price, and the trend, will reverse towards your stop – and this is how your trade should be exited.

This may not be the end of the trend – it could just be a deep pullback or a move into consolidation. But we cannot see what future price action will be so our stops protect our profits from a possible trend reversal.

Knowing when, and how, to exit a trade is how profits are made – regardless of your entry technique.

Managing your trades

Having read this section you are now able to compile a set of rules for how you want to enter, manage and exit your trades. Always have a set limit for individual trade risk and overall market risk. This must be a number you can live with if all your positions close at a loss.

Getting risk free on a trade is vital to minimise risk. There is a balance between setting the initial stop too close (and being stopped out before the trend has time to develop) and too far away (and realising a loss if the trend does not develop after all).

By learning to read price action (which has been the primary purpose of this programme so far) you can keep your initial and trailing stops at price points logical to the trend you are trading.

Once you understand how to read price action you can trade any trending market.

In the next section we will be looking specifically at foreign exchange, stocks and commodities – as these are the most liquid markets open to retail traders.

LESSON 11 – STOCKS, FOREX & COMMODITIES

All of the steps we have covered so far have been applicable to any market which exhibits a trend.

These techniques can be applied to any stock, currency, commodity, bond or anything which has an opening, closing, high and low price in a trading session. (Although they do work best on a daily timeframe, or higher, as intraday noise is minimised.)

Traders should be unafraid to move between markets – as retail traders our influence is minuscule so we have to learn to follow the money. We have to be ready to trade any market we can where the large institutions are currently providing liquidity.

This leaves us with three tradable options – stocks, currencies and commodities. Of these we will concentrate on a few essential extras required when trading stocks and forex – as these markets have the most liquidity – but will round-up with a very quick look at commodities.

Stock supplementary

In the past, stocks were often the first market people turned to when learning to trade. The world stock markets have been open to the public since inception (give or take a few regimes).

In addition to the steps we have covered in previous sections there are three additional aspects we need to know regarding analysing stocks.

- Volume
- Gaps
- Earnings

Volume

Volume is a fantastic tool not available on the forex market. We can see how much stock has been traded in any given session.

This gives us two valuable insights which holds true in both bull and bear markets:

- If volume is higher on a bar there is momentum with that bar
- If volume is higher on breakouts there is momentum with the trend

If trading breakouts it is ideal to see that volume is up on the breakout bar – it helps confirm that there is momentum behind the move. This, in turn, gives us confidence that the move will continue in the direction of the trend.

Even if we are looking at an individual bar (to confirm a reversal in a pullback, for instance) if there is higher volume on a bullish bar (in an uptrend) or bearish bar (in a downtrend) we can again have confidence that there is momentum behind the move.

In contrast, if a bullish or bearish bar (with the trend) is lower on volume we may question the validity of the bar – and look for other reasons to support (or negate) the quality of the move. The volume of the bar does not have to be high in general – just higher than recent bars.

Volume is also a good indicator of liquidity – the higher the volume generally means the more liquid the market. This should mean that we can buy and sell at the best price with smaller spreads. So bear in mind that the opposite may be true when trading stocks with low volume.

Gaps

Another aspect of stock prices which is not present with forex, on a daily basis, is gaps.

Gaps occur from one session to the next (usually overnight) if the opening price of the current session does not accurately reflect the closing price of the previous session.

This can be for a multitude of reasons, such as there being a news announcement made after the close or the stock being traded on multiple exchanges around the world. The opening of the next session will be amended to allow for such factors.

Overall, technical trend traders do not worry too much about the reason why gaps occur. We just have to know how they affect the trade and/or trend when they occur.

- Gaps in the direction of the trend are usually good
- Gaps on higher volume carry more weight than those on lower volume
- Gaps can mean we miss the preferred entry point
- Gaps can mean we miss the preferred exit point
- Gaps offer zones of support/resistance

Gaps in the direction of the trend are usually a good thing – it means there is extra strength in the direction of the trend as price has jumped in our favour. Sometimes it can mean an entry is missed or our broker fills at the best price (which is beyond what we would have liked). But, overall, it means the momentum is with the trend.

This is especially true if the gap occurs on higher volume, and more so if it is also a breakout bar.

If price gaps in the opposite direction to the trend we would want to see it exhibit lower volume in the hope that the gap will be filled, when price resumes the trend, on the next bar.

The gap is a zone of support/resistance. If price gaps in our favour this is a good thing but if it gaps against the trend it can act as a barrier which price may find difficult to cross to continue the trend – at least in the near term.

Earnings

There are multiple scheduled (and unscheduled) news items that will affect stocks. Some are already factored into price and most will only cause a small, near-term fluctuation. But a few are capable of moving price considerably in a very short time indeed (in minutes and, occasionally, seconds).

It is extremely difficult for the retail trader to get news items at the speed required to beat the institutions. Plus they are exposed to rumours we, at home, will never hear (or, at least, not until after the event).

So we can only protect ourselves against the scheduled items and the main one is the quarterly earnings announcement.

In the US there is an earnings "season" every quarter. This is not seen in any other country for two reasons: firstly, the US is by far the largest free market in the world (I imagine you already knew that!); and, second, all companies in the US have the same financial year so results will all come out within a short time of one another. Also, not all countries insist that quarterly results have to be announced.

When considering entering a trade you should look to see if earnings are due to be announced within the next week or two. If they are due within this time span then you should refrain from trading that stock until the volatility surrounding the announcement has abated.

- Do not enter a stock trade if earnings are due within the next 10 days.

If you are already in a trade then keep your stop at your normal distance. There is no need to tighten it at this stage – unless you have other reasons to do so. A standard stop should allow for fair movement without you being stopped out.

The reason you do not want to enter a trade, so close to possible volatility, is that you don't want to get whipsawed (triggered in then stopped out almost immediately). Stop losses at

trade entry are often tighter than during the trend because if you are wrong you want to get out with as little loss as possible as quickly as possible.

You can look to enter a stock the day after the earnings announcement (or two days after it if the announcement is made after the markets close).

Forex supplementary

Currency trading has become very popular in the last 10-15 years. Forex is the largest market anyone can trade – the amount traded daily far outpaces any other. And it seems to be growing at a phenomenal rate, too.

We will be looking at a few of the most important aspects of FX trading:

- Liquidity and spreads
- Fast trends
- Consolidation
- Non-farm payroll

Liquidity and spreads

One of the attractions to the retail trader is the high liquidity and low spreads of forex. This has made it a “must trade” market for anyone scalping or day trading. However, it is also excellent for trend trading.

Due to the limited number of currency pairs which hold any true liquidity it is fairly straightforward to track and manage trades. With the thousands of stocks on offer it can be hard to narrow down the tradable ones (without an advanced software scanning system). But with forex there are only 20-30 liquid ones – which can be regularly checked on a daily (or more frequent) basis.

Fast trends

Currencies can move very quickly – because you are trading one against another. If one of the currencies gains a little in strength and, at the same time, the second currency becomes weaker then the resulting effect is magnified.

Imagine two cars. With stocks it is as if one car remains stationary while the other drives away. With currency both cars can drive away – in the opposite direction at the same time.

But these quick moves can last for extended periods – from weeks to months. So trend trading forex can be very profitable as a small trade can grow very quickly – and keep on growing as the trend develops.

Consolidation

As with any market, currencies can spend large periods of time in consolidation. For the same reason that they can move very fast they can become stagnant.

Some traders try to trade range bound markets – and if the range is large this is possible. But, overall, it is simpler (and I would say safer) to stand aside during range bound periods. This can require some patience – and the ability to still be ready to act quickly when the trends return.

It is best not to limit yourself to just a few currencies – especially if they are correlated (such as the Euro and Swiss Franc) or against the same currency (such as the US dollar) – as you will have no trading options if consolidation sets in. It can also can make your portfolio overly susceptible to minor volatility.

Non-farm payroll – NFP

The one piece of fundamental news all technical forex traders should adhere to is NFP (non-farm payroll). New trades should not be entered in the days leading up to the announcement or on the day itself.

NFP is usually announced on the first Friday of the month. It is very well advertised so there should be no issue in missing it accidentally.

NFP doesn't just affect currencies (more specifically currency pairs). It affects stocks and most commodities (such as gold), too. So it is best to abstain from all new trades in the run up to the announcement.

Some of those who have been trading since the 1980s have said NFP has not had much impact on the markets as it has historically – especially if you have wider stops (as are appropriate on longer-term strategies). But it is still worth standing aside at these times.

Commodities

Commodities are also much more straightforward for retails traders to trade than they were a few years ago. And don't forget there are a few currency-commodity hybrids (such as gold and silver) which fall into this category.

There is nothing particularly special you need to know about trading commodities – the more popular ones (such as oil) are generally easier to trade than the more obscure ones (such as pork belly). This is because the less 'popular' commodities tend to gap a fair bit – mostly due to the very short trading sessions.

The types of products which are traded can be quite diverse and are grouped into categories, the most commonly known of which are Precious Metals, Base Metals, Soft, Grains, Energy, and Meat and Animal Proteins.

Commodities tend to be cyclical but the movements can last years – or even decades – so are well worth keeping an eye on. There can be extensive periods of relative inaction so it

can be easy to miss the boat – initially. But as the trends can last for many years there should be an opportunity to enter if you miss the first wave.

When certain commodities are in a strong bull (or even bear) cycle then stocks in the sector will often perform in tandem. This can be deceptive as, for many of these industries, it can take several years to put the infrastructure in place to take advantage of an increase in price (or remove it if the commodity demand falls).

For this reason it is often more appropriate to trade the underlying commodity rather than the stock. A decade or so ago this would not have been possible for the small time trader – but now it is we should take advantage of it. So, if you find yourself analysing commodity-driven stocks then look to the underlying commodity the company handles and consider trading that instead.

Finally, it is always worth knowing what currency underwrites the commodity you want to trade. The strength (or weakness) of this currency could affect price.

Stocks, forex and commodities

As technical traders we do not need to get caught up in fundamental analysis. We really don't need to know very much at all about the market we want to trade – all we're interested in is whether, or not, it's trending and if our broker allows us to trade it.

In fact, the more you know about a market the more you will try and second-guess what is coming – rather than relying on your technical skills. So it is best to avoid having an in-depth knowledge or opinion on the markets you want to trade.

So saying, there are a few things of which we need to be aware.

- For stocks this includes:
  Volume, gaps, and earnings
- For forex this includes:
  Liquidity and spreads, fast moves, consolidation, and non-farm payroll
- For commodities this includes:
  Hybrids, trading sessions (times and location), underlying currency, and cyclicality

In our final lesson we will be putting everything together in a handy summary and will use this to form the basis of our Trading Plan.

LESSON 12 – THE TRADING PLAN

Over the last several lessons we have looked at many aspects of trading. Now it is time to put it all together and create a Trading Plan.

This section is not just a summary of everything we have covered so far. As we have added to our knowledge we can now connect some items together in a slightly different manner. The rules and tools you have learnt so far are still relevant, however, and you may want to refer back to them to clarify any areas which have been abridged (to keep the plan as condensed as possible).

The trading bias – the trend – the trade – management

To put the odds of a successful trade in our favour we want all the following to be in place before taking a trade:

Going long

For a long/buy position price must be in a trend with no immediate resistance ahead:

1. Above the daily 200 sma
2. Above the weekly 200 sma
3. Above the daily 50 sma
4. Above the annual resistance
5. Above the 52 week high
6. Above any major pivot highs
7. Above any prominent round numbers (if applicable)
8. Above the trendline (if applicable)

In addition, if we are trading breakouts we want the breakout bar to exhibit:

9. Bullishness (the close of the bar to be in proximity to the high of the bar)
10. The body of the bar to be above the high of the previous bar and/or pivot high
11. Higher volume (if trading stocks)

If we are trading pullbacks we would want to see:

12. Bounces from an angled line of support (such as a trendline or moving average)
13. A bullish indecision or reversal candlestick pattern in close proximity to the line of support
14. Small breaches may be acceptable (if the breach consists of just the wick or a reversal candle)

Whichever method of entry is being used:

15. Look to trade linear trends

16. Remember to move stops closer to price action as the trend develops (using your preferred method, such as recent pivot lows)

The above conditions should ensure that we are not entering a trade during a prolonged pullback or consolidation. However we want to be able to recognise these situations, if we are already in a trade, to know whether or not we should tighten our stops.

We should try to stay in a long/buy position if the pullbacks are acceptable:
a. Pullbacks should be short (fewer than 30 bars)
b. Pullbacks should be shallow (no more than one major pivot low)
c. Pullbacks should not range (no multiple touches between a minor pivot high and low)
d. Pullbacks can create continuation chart patterns (bull flag, double bottom, inverted head and shoulders, cup and handle)
e. Small breaches are acceptable but we would want to see a bullish indecision or reversal candlestick pattern (doji, hammer, inverted hammer, spinning top, bullish engulfing candle)

If price does not conform to these conditions then the market is in consolidation.
We should consider tightening our stops to the nearest pivot low (or other chosen method – such as a 5 bar low).

If we get stopped out we can re-enter the trade if our bull trend conditions still apply (points 1-11) and we:
- Avoid fake breakouts (the body of a bullish bar should break above the pivot high)
- Avoid head fakes (look at the relative size/bar formation and any imminent resistance)
- Wait for a retest of the major pivot high (resistance should become support)

If the trend has reversed we can consider taking a short/sell position.

<u>Going short</u>

For a short/sell position price must be in a trend with no immediate support ahead:
1. Below the daily 200 sma
2. Below the weekly 200 sma
3. Below the daily 50 sma
4. Below the annual support
5. Below the 52 week low
6. Below any major pivot lows
7. Below any prominent round numbers (if applicable)
8. Below the trend line (if applicable)

In addition, if we are trading breakouts we want the breakout bar to exhibit:
9. Bearishness (the close of the bar to be in proximity to the low of the bar)

10. The body of the bar to be below the low of the previous bar and/or pivot low
11. Higher volume (if trading stocks)

If we are trading pullbacks we would want to see:
12. Bounces from an angled line of resistance (such as a trendline or moving average)
13. A bearish indecision or reversal candlestick pattern in close proximity to the line of resistance
14. Small breaches may be acceptable (if the breach consists of just the wick or a reversal candle)

Whichever method of entry is being used:
15. Look to trade linear trends
16. Remember to move stops closer to price action as the trend develops (using your preferred method, such as recent pivot highs)

The above conditions should help some way towards not entering a trade during a prolonged pullback or consolidation. However we want to be able to recognise these situations, if we are already in a trade, to know whether or not we should tighten our stops.

We should try to stay in a short/sell position if the pullbacks are acceptable:
a. Pullbacks should be short (fewer than 30 bars)
b. Pullbacks should be shallow (no more than one major pivot high)
c. Pullbacks should not range (no multiple touches between a minor pivot high and low)
d. Pullbacks can create continuation chart patterns (bear flag, double top, head and shoulders, inverted cup and handle)
e. Small breaches are acceptable but we would want to see a bearish indecision or reversal candlestick pattern (doji, hanging man, shooting star, spinning top, bearish engulfing candle)

If price does not conform to these conditions then the market is in consolidation.
We should consider tightening our stops to the nearest pivot high (or other chosen method – such as a 5 bar high).

If we get stopped out we can re-enter the trade if our bear trend conditions still apply (points 1-11) and we:
- Avoid fake breakouts (the body of a bearish bar should break below the pivot low)
- Avoid head fakes (look at the relative size/bar formation and any imminent support)
- Wait for a retest of the major pivot low (support should become resistance)

If the trend has reversed we can consider taking a long/buy position when it is appropriate.

A final word…

At last we have come to the end of our (almost) complete guide to trading in just 12 lessons. There has been a lot of information to take on board so be prepared for it to take some time before you are able to use it comfortably and confidently.

But thank you for sticking with us for the journey. We truly hope you have learnt a great deal and increased your education and awareness regarding trading the financial markets.

At the Dynamic Trader we have been training traders for many years so we know how much time and effort it takes to become a proficient trader. Which is why we aim to keep it simple and concentrate on what's important – and ignore all the fluff.

If you can understand and assimilate everything we have covered in the last 12 lessons you will have an excellent grounding in how to trade. I would strongly recommend you ignore all of the complex indicators on offer via your broker or software provider. There is no magic bullet to successful trading but if you can apply what you have learnt here you will be well on your way to profiting from the money markets.

Again, thank you very much for committing to the 12 lessons. We thoroughly enjoyed compiling the series for our members and followers so we hope you have found it equally instructive and informative.

We look forward to hearing any feedback, thoughts or comments you may have.

To your trading success…

Anne Chapman
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