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Thoughts on the Market

Weekly analysis, trading and selected writing. Issue 03.

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Introduction

To the reader

As I write the third issue of this newsletter I realize how much I learned in the past 3 weeks. At first I thought that my main learning will be in the research I make, the new books I read and re-read as I write my articles or maybe from the feedback I may get from other traders. All of this is important and I am sure will also contribute to my success as a trader. However, most importantly, I advanced as a trader because of new level of responsibility I have about it.

Analyzing the market more regularly, pulling the trigger on more entries according to my plan, journaling the results carefully.

What I write here is useful, first of all, to me. If you learn something along the way I am happy that I was able to help two traders instead of one if I would have kept my thoughts private.

I am grateful to anyone reading through this. Thank you for your time.

Evolving format

I am still at very early stages of this newsletter's development and I am constantly thinking how to improve it, make it more readable (and easier for me to write as well). I do realize that my writing style is quite wordy which can be beneficial in theoretical articles, such as our discussion of trader's mindset and psychology, as it is important to repeat the concept with only slight rewording to help the brain install it on a functional level. However, when discussing the chart analysis or trade examples, it is easy to get distracted by too much text besides the pictures and can also be hard to follow the chart bar by bar.

Accordingly in this issue I decided to make all the charts bigger and instead of writing the text besides them, annotate right on them. Where possible the text will be reduced as well, as I assume that the charts are interesting only to practicing or studying traders and detailed explanation of most basic concepts is not necessary.

At the same time I realize that every trader out there has his own way of calling things that developed through the years of daily analysis and trading practice. If any of the concepts or explanations are unclear I welcome questions through my email: newsletter@market.advance.life.

List of abbreviations

Any currency can be abbreviated with its first letter:

- U – USD, US Dollar
- E – EUR, Euro
- G – GBP, British Pound
- C – CAD, Canadian Dollar
- H – CHF, Swiss Franc, (because C is already used for Canadian Dollar)
- A – AUD, Australian Dollar
- N – NZD, New Zealand Dollar
- J – JPY, Japanese Yen
- M – MXN, Mexican Peso

Similarly any trading pair can be shortened to 2 letters. Examples:

- EURUSD – EU
- USDMXN – UM
- CHFJPY – HJ

Support and Resistance levels:

- S – Support
- R – Resistance
- SR – Support and Resistance (when referred to in general)
- TL – Trend Line
- Ch – Channel
- PP – Pivot Point

Time frames

- TF – Time Frame of the chart
- MN – Monthly
- W1 – Weekly
- D1 – Daily
- H4 – 4 hours
- H1 – 1 hour

What is support and resistance

The levels of support and resistance is probably one of the most frequently used concept in technical analysis. There are many definitions of SR levels and many different tools that traders use to define them. Many believe that when the price comes to a support level it should definitely bounce from it or at least pause. The same should happen when it comes to a significant resistance. One lesson I learned in the market is that if you decide what the price should or should not do you pave your road to failure.

Before we go any further I would like to state clearly that the following definition is mostly my own speculation based on my understanding of what drives the market prices. I am not denying the validity of any other definition of SR levels, but I could never find any practical use for most of it until I started studying Price Action. Let's try to take a different look at the whole concept.

What drives the price

First of all we must define how the price moves in the market. My understanding is that individual traders as well as institutional organizations are influencing the price with their beliefs about the market behavior supported with their finances. If I think the market should go up, I am not really driving the price anywhere. If, on the other hand, I put a couple million on the market to support my belief, the market will be affected, ever so slightly but the price will rise. Of course, depending on the size of that particular market, a couple million could be nothing but a drop in the ocean. But when the majority of the participants (in terms of their traded volumes, not the quantity of trades or individuals) also go long, the market balance will change and the price will go up.

If you are a believer in conspiracy theories and that the price will move where powerful organizations want it to move, you are not alone. The conspiracy certainly is there, and not very well hidden at that. You don't have to go further back than exactly 1 month from now and look at Swiss Franc pairs to see it in action. However, the point remains the same - for the price to move somewhere it needs to be fueled with high volumes of trading in that direction. The fact that you and I cannot produce such volume and essentially have no control over the market while some banks or even individuals can, does not change the overall picture.

SR as a point of balance in the market

My basic understanding of SR level is any price that has enough psychological significance to other traders. Knowing that we have traders behind every price move pushing it one way or another, any SR level occurs when the price finds a point of temporal balance between the bears and the bulls.

As an example, we can use a prior high in a bullish trend. As the price traded up, the balance was greatly tipped to the bullish side of the market. While that is happening we have a couple types of traders watching the market:

1. The bulls who were able to buy low enough and now enjoy the rally and watch their profits grow. Their main concern is not to lose the money they've already made, so they will be looking where to close part or all of their profit. Their profit taking means selling back what they bought which in turn will push the market down.
2. The bulls who missed the entry. They are very likely to experience a lot of frustration about their missed opportunity and will be watching for any correction to enter with the trend. Their entries during a correction will push the market up as they are buying.
3. The bears who are in the market and therefore watching their loss growing. Their main concern is to try and close at a better price, preferably a correction to the trend. The bears close their losses by buying back what they sold, and so they push the market up.
4. The bears who do not believe the trend has sufficient strength to go for long - they are looking for

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any signs of weakness so that they can start [fading](#) it. They are interested to sell at what they perceive as a strong resistance and they will push the market down.

Now let's say the market is reaching the monthly high price. The first group of traders, the bulls in profit, are concerned if the trend has enough strength to break above and so they start taking their profits (at least part of it) and they create downward pressure with their selling. The fourth group, the bears who do not believe in this trend, start selling expecting the price to be rejected from the monthly high.

As the price bounces from the monthly high and goes lower, therefore confirming the level of resistance there, it is important to note that the price is not coming down because there is something magical about that price level. **It is going down only because there are enough traders who decided around the same time that selling at this price is a good idea.** The bulls and the bears have been selling with completely different goals (profit taking opposed to fading the trend, expecting it to reverse) they were still pushing the market in the same direction.

As the price bounced from monthly high, it is going down in a correction. Let's say after 100 pips it stalled at 100 EMA that is going up together with the bullish trend. Now other 2 groups of traders come into action. Group #2 is happy to see that correction because they believe it is still a strong trend and so they start buying at what they perceive to be a much better price, assured by the fact that 100 EMA now provides some support for their buying decision. Group #3 is in pain - they have a considerable loss on the market. Because many of them had their Stop Losses just above the monthly high, they were afraid to be taken out at a great loss. Seeing the price correcting down they jump on the opportunity to accept a much slower hit on their balance. They see the price stalling at 100 EMA and they are afraid it will bounce back up, continuing the bullish trend. And so, they buy back their short positions, pressing the market up.

Once again, the price bounces from 100 EMA not because it is a magical level and we should always buy from it and trade solely by EMAs. **It simply a matter of enough traders believing the market will bounce from here - once again, the traders with completely different goals.**

How to calculate the levels

Following our definition of SR levels as the point of balance between the traders on the market, the next question we need to ask is what are the most likely price areas where this balance will be reached?

A level must be watched by sufficient amount of traders in order to have any effect on the price action. If we know that some level is being watched by majority of market volume, it is much more likely that the price will react around it.

As we discussed in our example just now, when we have a recent high while the price is rising in a bullish trend, it is very likely that a lot of traders will cover at least part of their buying profits around that level. At the same time, new buyers will be coming in just above it, anticipating the continuation of the trend on the breakout. The further price action will be defined by the amount of bulls buying above the high (whether to enter into the anticipated continuation of the trend or cover their selling losses) and the amount of sellers anticipating the reaction of the price at the local high (taking their buying profit or selling on the expectation of a bounce).

There are two different indicators I watch for SR levels that are not based on immediate price action. I use 3 EMAs with periods 20, 100 and 200 and Pivot Points. The reason for using either of those is the same: I believe there is enough volume on the market paying attention to these levels.

Then I use any levels where the price stalled or hesitated just recently. Many traders use big figure numbers (1.0000, 1.1000, etc.) but I could not find it particularly useful yet.

Practical usage

After identifying the basic levels of support and resistance we need to understand how to use them. All my trading career I was thinking that the right way to use them is to expect the price bounce when it gets to one. Anytime the price didn't bounce I was sure that my analysis was at fault - I didn't calculate the level well enough. Obviously it led to considerable frustration on my part and I quit using SR level for many years, seeking my Holy Grail someplace else.

It was only recently that I came back to using the concept with some success, completely revamping my understanding of it (as discussed earlier). I could only find practical usage to SR levels in my trading when I realized that they are not designed to show you where the price will reverse - or even more likely to reverse. To me, they simply indicate areas where I am more likely to get some hints about the current balance of power on the market. As simple as that - and seemingly insignificant as well.

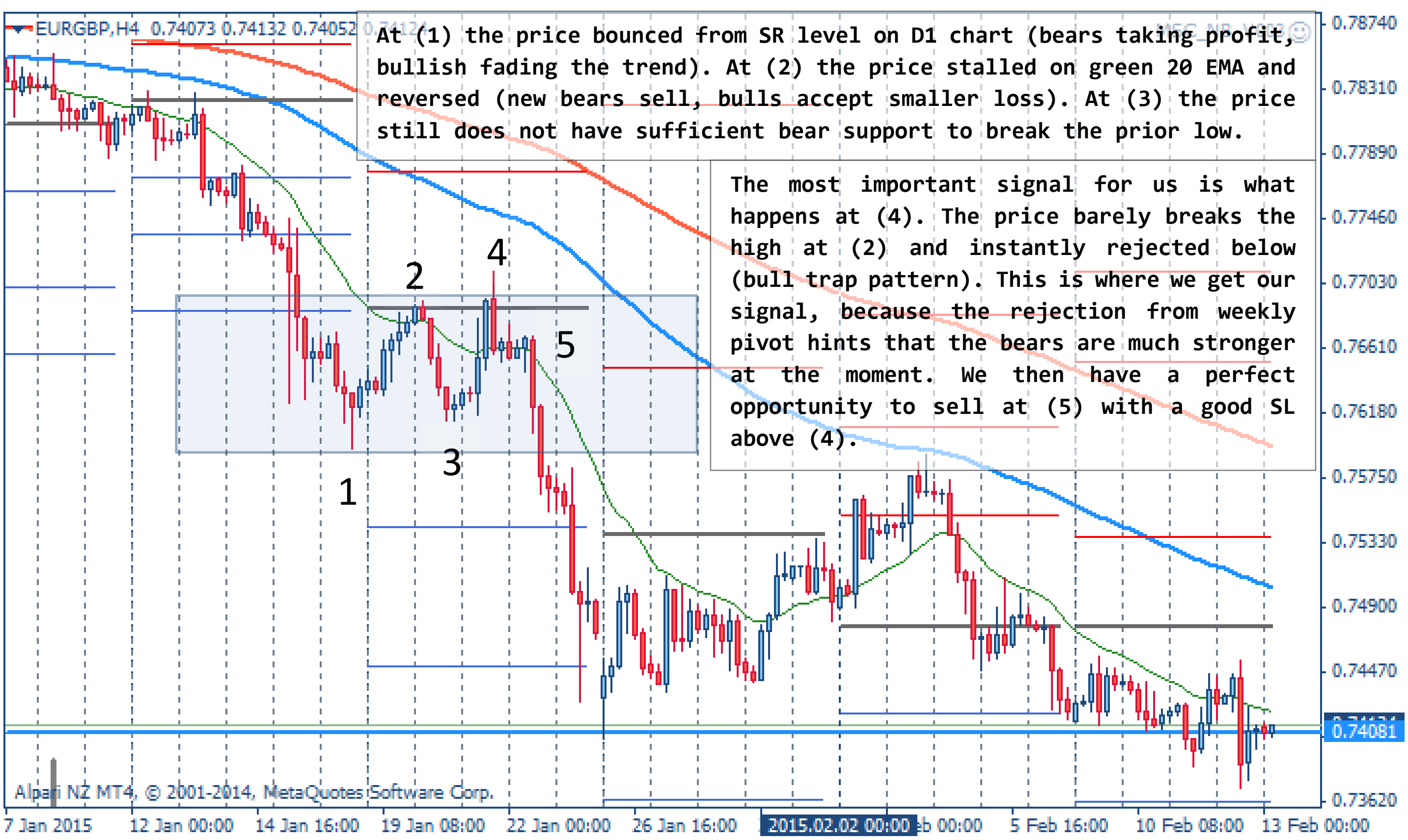
On the next page we will look at a couple charts clarifying the concept visually.

Charts

On this chart we can see automatic SR levels calculated with 3 EMA indicators and Pivot Points indicator. On D1 chart it is showing monthly pivots. First of all notice how many levels there are and the fact that the price rarely reacts to them in any substantial manner and you will understand my frustration when I was trying to "reverse the market" of these or any other SR levels.

Rectangles mark where EMAs or pivot levels did hold the price.

Let's take a detailed look at the price stalling between 2 SR levels (blue lines)



At (1) the price bounced from SR level on D1 chart (bears taking profit, bullish fading the trend). At (2) the price stalled on green 20 EMA and reversed (new bears sell, bulls accept smaller loss). At (3) the price still does not have sufficient bear support to break the prior low.

The most important signal for us is what happens at (4). The price barely breaks the high at (2) and instantly rejected below (bull trap pattern). This is where we get our signal, because the rejection from weekly pivot hints that the bears are much stronger at the moment. We then have a perfect opportunity to sell at (5) with a good SL above (4).

Three aspects of trading

Last week we explored three parts that in my opinion make up a successful trader. The most general assumption is that trading is about analyzing the market and predicting where the price will go. As we discussed, being an analyst is important - you do need a plan to execute in the market. However, that's where mostl traders are stuck - finding a method they believe will make them rich, taking a couple trades that do not work out and then jumping to another method, assuming that they do not have sufficient knowledge about the market and therefore cannot open "the right" trades. The belief that I found to be groundbreaking in my own trading, however, is that **there are NO "right" trades.** There are simply trades offered by your method of market analysis and you have to take them all, before you make any judgments.

Therefore, the most essential addition to the set of skills of any trader, who desires to make profit consistently, is *his ability to execute the trades with no hesitation*, trade the plan exactly as his rigid rules are saying to trade it. The plan might as well be faulty and simply not provide the trading edge necessary to win, but without executing a sequence of flawless trades (not from the profit/loss perspective, but in terms of absolute discipline in following the system's rules) you will never know that and very likely will switch to another Holy Grail only to find yourself with another set of potentially good rules that you cannot follow.

Five or even ten trades is not enough to judge any trading method. Your edge is not going to be visible and such a small set of data bears little to no statistical significance. Imagine a casino operating a slot machine with 4% advantage (meaning that they win 56 times out of 100 on average) calling a mechanic to repair the machine, or suing the gambler for somehow rigging it, just because after 10 customers the casino is in net loss. Changing the machine after each 10 customers if their gambling produces a loss is just as absurd as changing your system after you have a couple losses in a row, especially if you "jumped the gun" on half the trades.

Mastering trade execution and getting a method of analyzing the market that provides you with some consistent edge are essential for any good trader. However, there is another aspect to trading we briefly discussed in the previous issue and arguably it can be even more important because unwillingness or inability of learning that aspect can help you decide pursuing a career elsewhere, long before you leave your life savings in the market.

Trading is a business

Like in any business, in trading it is most important to stay in control of what you do. First of all it implies having control over yourself, getting your mindset right and acting appropriately on each trading opportunity the market is offering. But when we see that opportunity and ready to enter in our direction, what do we really control in that trade?

I prefer to think of the trader as a small business owner. Anyone can open a small shop as a pursuit of having more freedom in one's life, but interestingly enough 50% to 80% fail in the first 3 to 5 years. In trading I would argue that the failure rate is closer to 90%. My belief is that the reason for their failure (in business or trading) is defined primarily by the attitude they start with.

As we discussed before, the entrepreneurial freedom NEVER implies freedom from responsibility. In fact, starting out on your own increases the responsibility in almost all areas of your life:

1. Your level of income
2. Your medical insurance
3. Your taxes and book keeping
4. How you manage your time
5. Your own development

It is my opinion that the understanding and full acceptance of this responsibility is what defines you as a success or a failure in business or indeed in trading.

In this issue we start our detailed discussion of managing your trading like a business. Being in business means being in control and yet I find that most traders have none - often unknowingly giving up the only thing they have true control over in trading.

Being in control

If you are a small store owner and you are just starting out you can control quite a few things. First of all you control the stock in your store. You decide how you spend your initial investment. In trading that is your starting capital and in turn you control your Money Management and decide how many positions you can hold simultaneously.

In the store, when you spend $1000 to stock up, how do you know what your returns are going to be? Well, you know for a fact:

1. The rent you are going to pay this month
2. The salary to your employees
3. You know the average bills you have to pay
4. The advertising costs to attract the customers to your store

It is obviously an oversimplification, but it will do for our comparison. With that information on hand you add it to $1000 you just spent and now you know the amount of money you need to make in order to breakeven. Let's say it is $1500. Everything above that is your profit (don't forget the best part - the taxes!). Now, if you want to get $500, you have to sell your stock for $2000.

At that point you've already done your research and know that compared to your competition it is a reasonable price tag and given your location you should have no problem selling it at that price point. If (and it's a big "if") everything goes well, you just figured out your profit for the month.

Now, in trading you have some benefits, such as:

1. No additional rent is needed (unless you like working in the office)
2. There is no one to pay the salary to
3. The bills are the same as if you would be living your normal lifestyle
4. You have no product to advertise

In other words, you don't have that extra $500 minimum you need to make this month just to get out in breakeven. In fact, the only thing you need to do in to order to stay breakeven is to do nothing!

The bad news though is that you have no expectancy for the amount of money you are going to make this month. On the one hand, you know your statistical results over the past months and if you are extremely consistent they can give a good average expectation for your profit (or loss). While the store owner can try to increase his sales in numerous ways by expending more money into advertising, introducing new services, etc., we can only do trades, and usually trying to trade more actively than our system allows will not increase the income by the end of the month - quite on the contrary, you stand a good chance to lose what you earned while following your system as it is.

When a customer enters into our hypothetical store, we don't know what he is going to buy, if anything. He can go away empty handed or leave half his savings with us. We do know, however, that on this day we already invested ~$500/30 (our monthly expenses divided by the amount of days in this month) into our business in bills alone. We never know how this money is going to come back to us.

When you start your trade, similarly you have no idea what it produces. Yes, your edge provides you with statistics, saying that 12 trades out of 8 will make money, but you can never know the exact winners before they are closed and cashed in.

In reality, when you open your trade, **there is one and one only variable that you have certain control over: how much money you are willing to pay the market in order to find out if the trade is going to work.** In other words, your risk on that trade. You put your stop and you know where you get out if the trade doesn't work. Everything else is only your expectation.

Giving up the control

Imagine that in our little store we decide to cut the costs on the salary by declining the medical insurance to our employees and instead paying the direct costs for any accidents they have. Yes, we are happy to know that we saved $100 extra every month but now we never know the costs of doing business. Another unfortunate day a fridge falls down and crashes our clerk's leg, resulting in $100 000 hospitalization costs and ruining our business, all our savings - our car and the house taken away in addition.

Trading without a SL is exactly the same. If you give up control over the only variable you have in your hands in the market, you are going to do fine until one day you lose it all.

To emphasize the point, I offer this quote by Larry Hite in his interview in Market Wizards:

> I will tell you another story. I have a cousin who turned $5,000 into $100,000 in the option market. One day I asked him, "How did you do it?" He answered, "It is very easy. I buy an option and if it goes up, I stay in, but if it goes down, I don't get out until I am at least even." I told him**, "Look, I trade for a living, and I can tell you that strategy is just not going to work in the long run."** He said, "Larry, don't worry, it doesn't have to work in the long run, just till I make a million. I know what I am doing. I just never take a loss." I said, "OK..."
>
> In his next trade he buys $90,000 worth of Merrill Lynch options, only this time, it goes down, and down, and down. I talk to him about one month later, and he tells me he is in debt for $10,000. I said, "Wait a minute. You had $100,000 and you bought $90,000 in options. That should still leave you with $10,000, even after they expired worthless. How could you have a deficit of $10,000?" He said, "I originally bought the options at $4k. When the price went down to $1k, I figured out that if I bought another 20,000, all it had to do was go back to $2k for me to break even. So I went to the bank and borrowed $10,000."

Summary

The difference between any entrepreneur (traders included) and usual paid worker is in the acceptance of the risk and the responsibility. Most people prefer to live in the comfort of some assurance in life that they get a pay check every month as long as they follow the rules - and in the current economy that assurance is very tiny indeed. Any entrepreneur accepts and embraces the risk, giving up that assurance in exchange for control over his or her life.

As traders we can learn a lot in regular business. The costs of doing trading business must be defined as rigidly as possible.

We can:

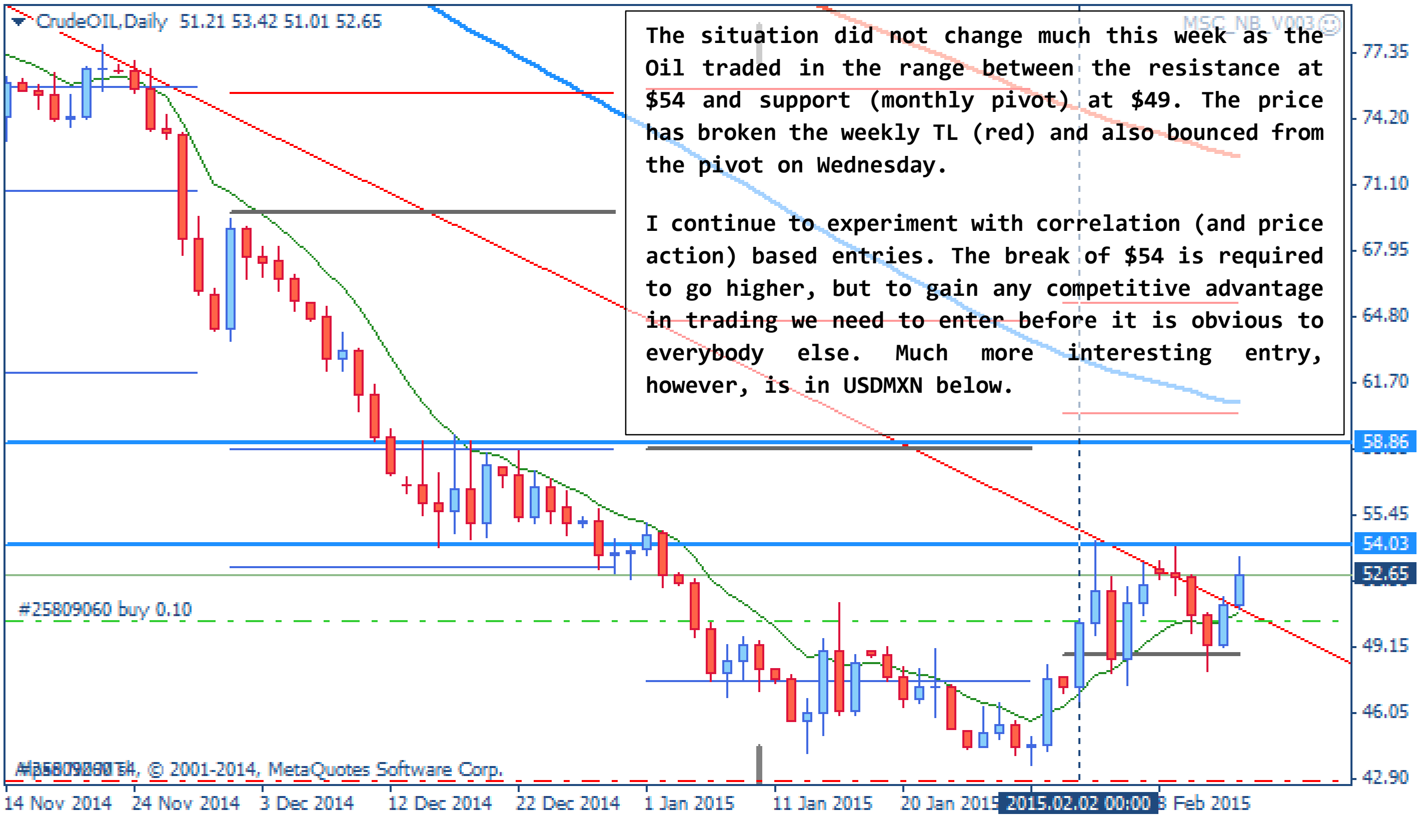
1. Set our monthly loss limit
2. Set our daily loss limit
3. Given the expected activity of our trading system, work out the amount of money we can risk in each trade, so that we do not exceed our daily loss limit after we fail a couple signals in a row

We cannot:

1. Set a rigid profit expectation for every trade
2. For every day
3. Even for every month

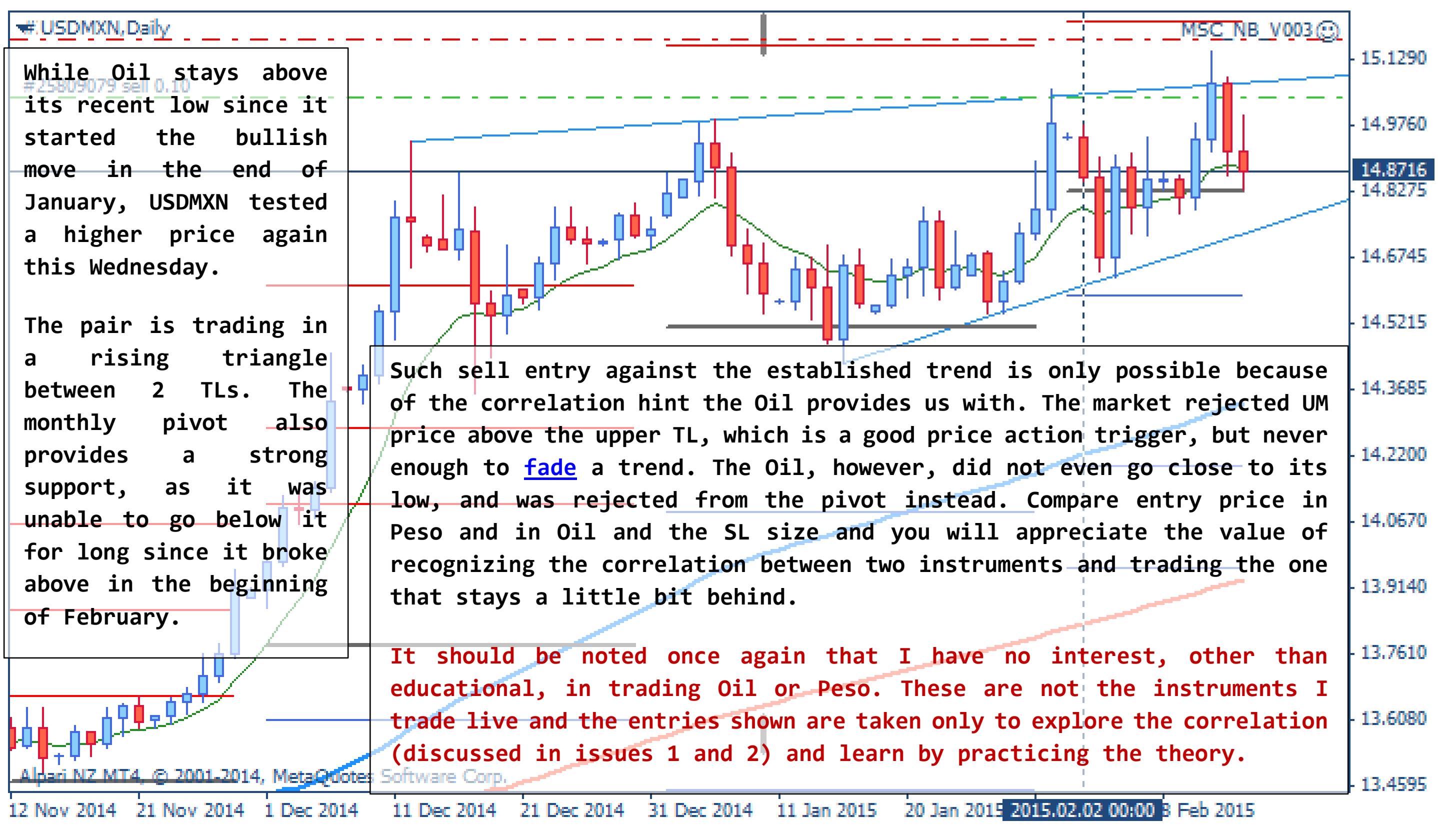
Unfulfilled expectations will lead to frustration and mental disturbance, undermining our success in trading.

USDMXN and Oil daily



The situation did not change much this week as the Oil traded in the range between the resistance at $54 and support (monthly pivot) at $49. The price has broken the weekly TL (red) and also bounced from the pivot on Wednesday.

I continue to experiment with correlation (and price action) based entries. The break of $54 is required to go higher, but to gain any competitive advantage in trading we need to enter before it is obvious to everybody else. Much more interesting entry, however, is in USDMXN below.



While Oil stays above its recent low since it started the bullish move in the end of January, USDMXN tested a higher price again this Wednesday.

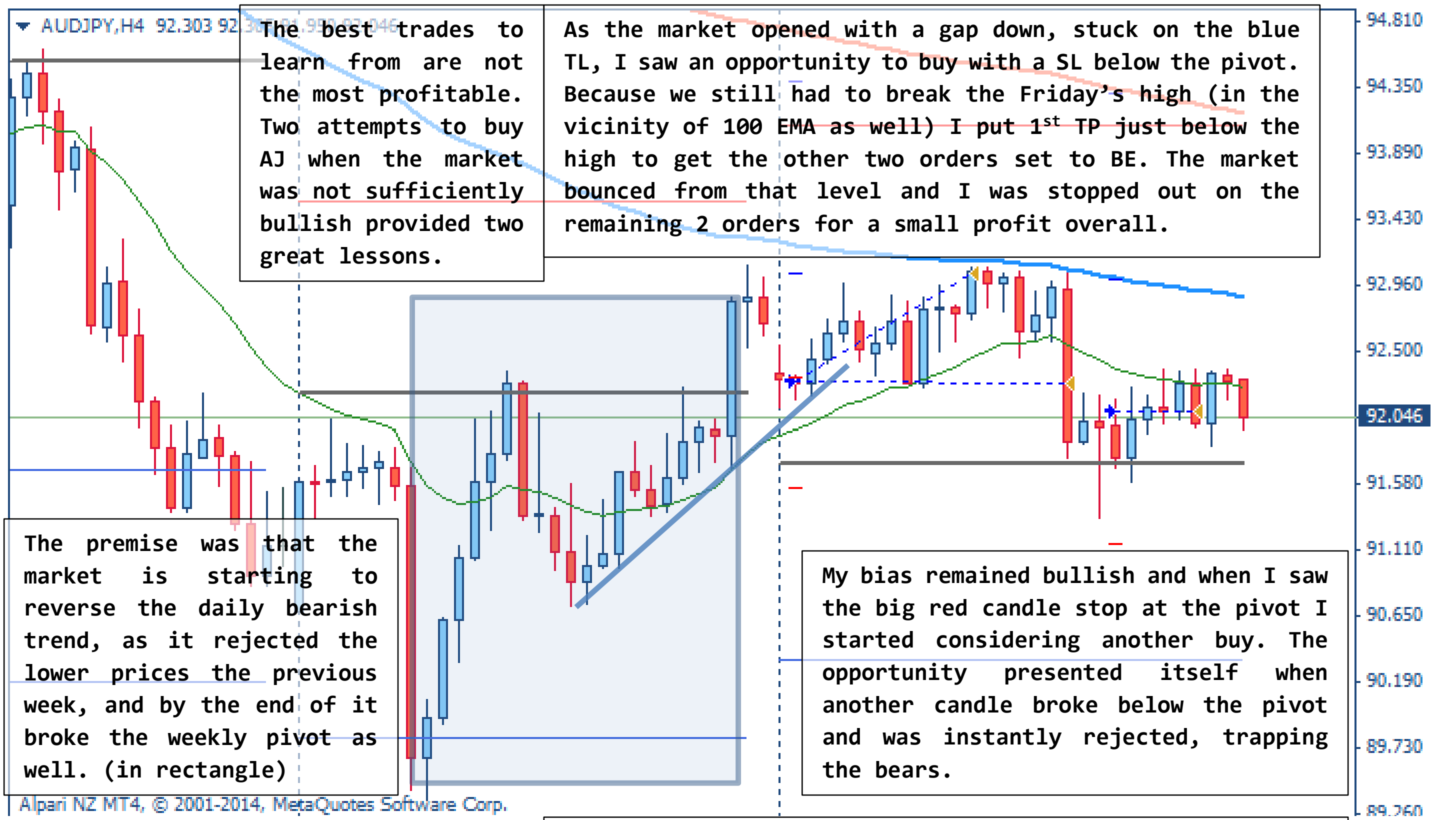
The pair is trading in a rising triangle between 2 TLs. The monthly pivot also provides a strong support, as it was unable to go below it for long since it broke above in the beginning of February.

Such sell entry against the established trend is only possible because of the correlation hint the Oil provides us with. The market rejected UM price above the upper TL, which is a good price action trigger, but never enough to fade a trend. The Oil, however, did not even go close to its low, and was rejected from the pivot instead. Compare entry price in Peso and in Oil and the SL size and you will appreciate the value of recognizing the correlation between two instruments and trading the one that stays a little bit behind.

It should be noted once again that I have no interest, other than educational, in trading Oil or Peso. These are not the instruments I trade live and the entries shown are taken only to explore the correlation (discussed in issues 1 and 2) and learn by practicing the theory.

Trades of the week

AUDJPY Buy



The best trades to learn from are not the most profitable. Two attempts to buy AJ when the market was not sufficiently bullish provided two great lessons.

As the market opened with a gap down, stuck on the blue TL, I saw an opportunity to buy with a SL below the pivot. Because we still had to break the Friday's high (in the vicinity of 100 EMA as well) I put 1st TP just below the high to get the other two orders set to BE. The market bounced from that level and I was stopped out on the remaining 2 orders for a small profit overall.

The premise was that the market is starting to reverse the daily bearish trend, as it rejected the lower prices the previous week, and by the end of it broke the weekly pivot as well. (in rectangle)

My bias remained bullish and when I saw the big red candle stop at the pivot I started considering another buy. The opportunity presented itself when another candle broke below the pivot and was instantly rejected, trapping the bears.

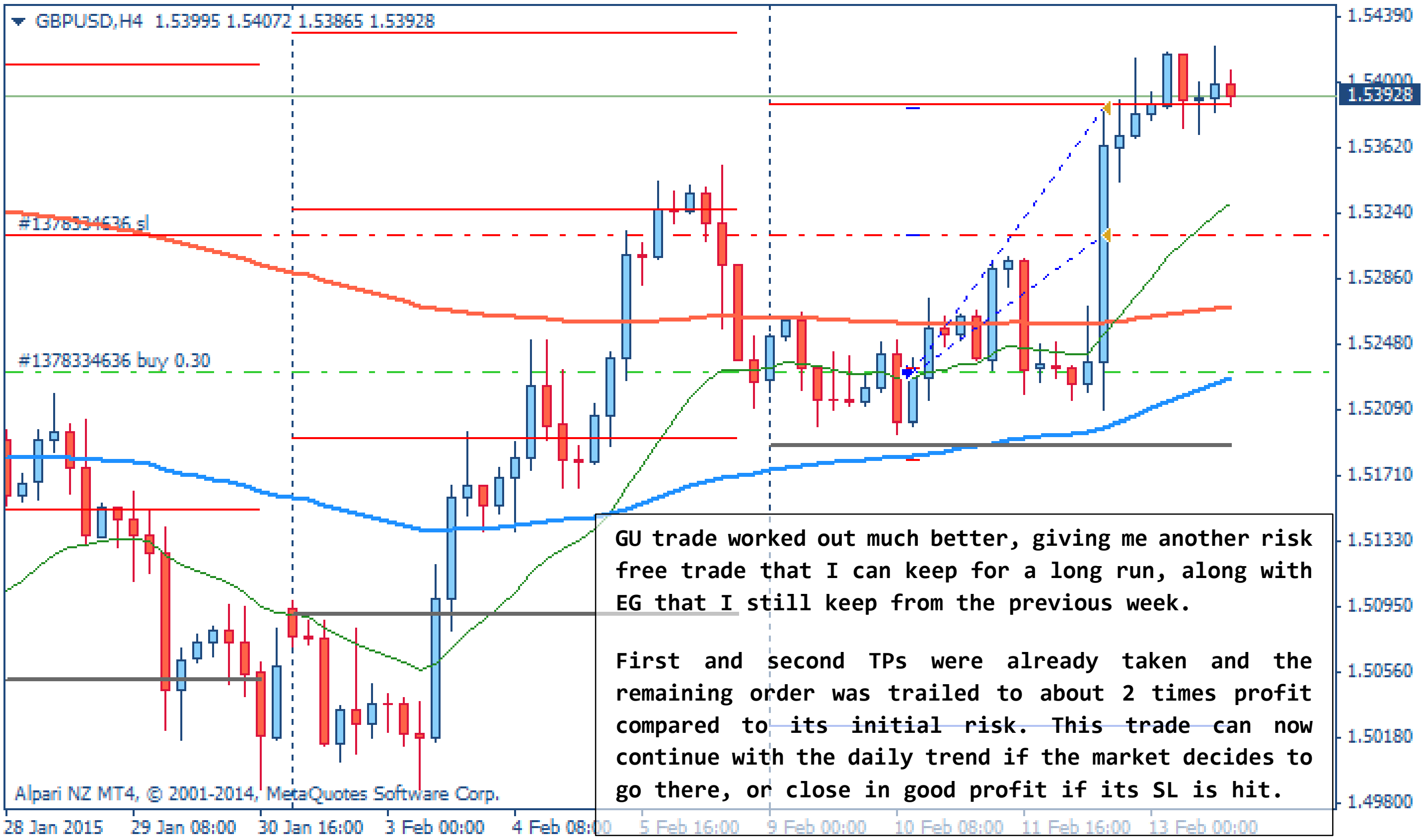
This trade was taken on H4 with a SL below the rejected bar. The best lesson here is the manual exit I took on the next day.

Psychologically I always found it very difficult to review my bias and close a trade that is not working out. Instead of seeing the market as it is and accepting any signals it provides I would spend hours reviewing any indicators that are not part of my system, reading the news online - anything only to prove to myself that my trade is correct!

When I saw the price being rejected from both EMAs two times in a row and then breaking below the pivot. As other AUD were also going down (and I was selling AU already) it was clear that my premise was not correct and the market is not going where I thought it would. It still took me some time to accept that I was wrong, but I reminded myself of the mistakes I made so many times before and closed the trades in breakeven

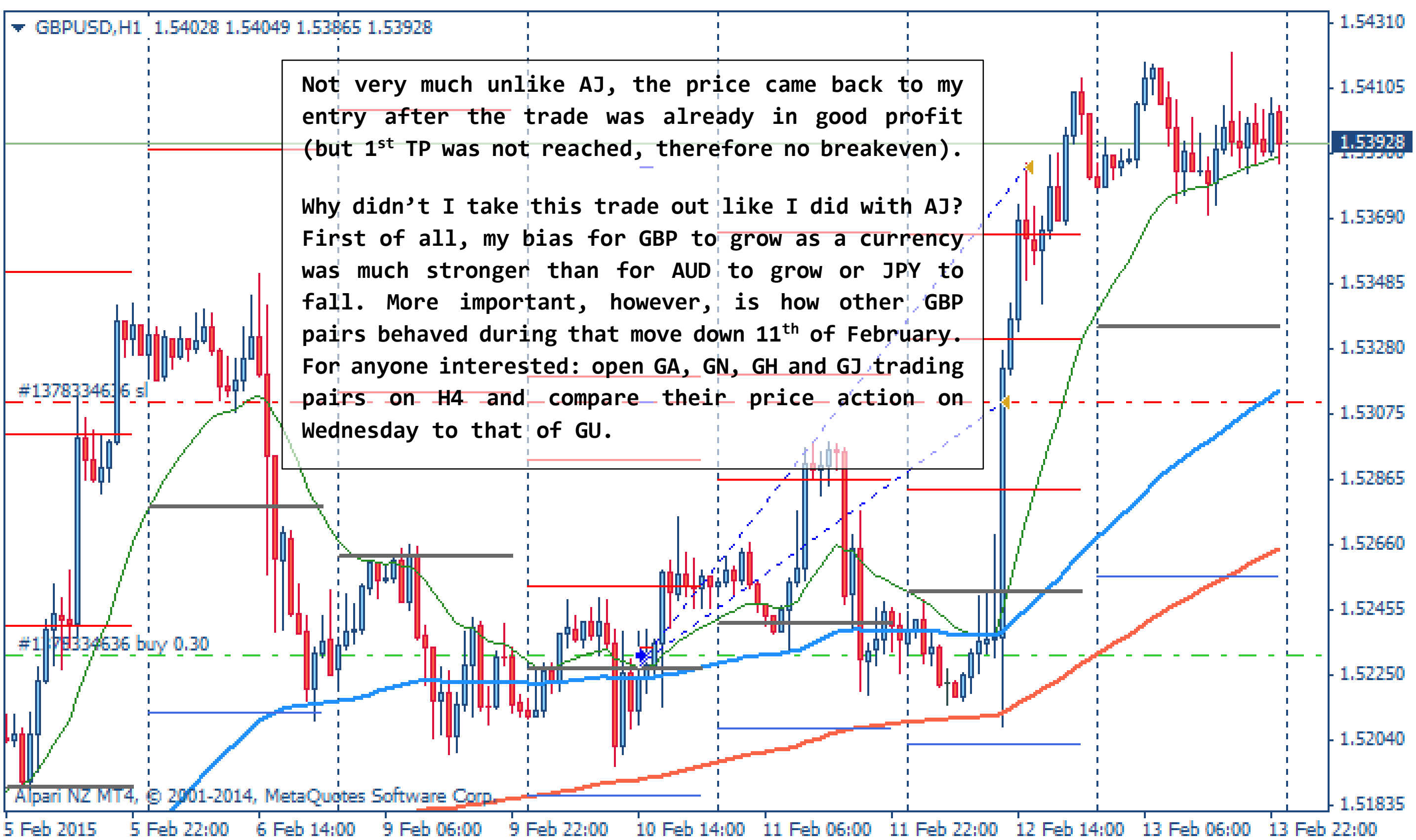
It does not matter what the market will do from here on - maybe it will continue up in an explosive move. I expected the price to go up much faster than it did and in order for my edge to stay intact, the EMAs should have been broken. **If your edge is gone, GET OUT.** It is as simple as that

GBPUSD Buy



GU trade worked out much better, giving me another risk free trade that I can keep for a long run, along with EG that I still keep from the previous week.

First and second TPs were already taken and the remaining order was trailed to about 2 times profit compared to its initial risk. This trade can now continue with the daily trend if the market decides to go there, or close in good profit if its SL is hit.



Not very much unlike AJ, the price came back to my entry after the trade was already in good profit (but 1st TP was not reached, therefore no breakeven).

Why didn't I take this trade out like I did with AJ? First of all, my bias for GBP to grow as a currency was much stronger than for AUD to grow or JPY to fall. More important, however, is how other GBP pairs behaved during that move down 11th of February. For anyone interested: open GA, GN, GH and GJ trading pairs on H4 and compare their price action on Wednesday to that of GU.