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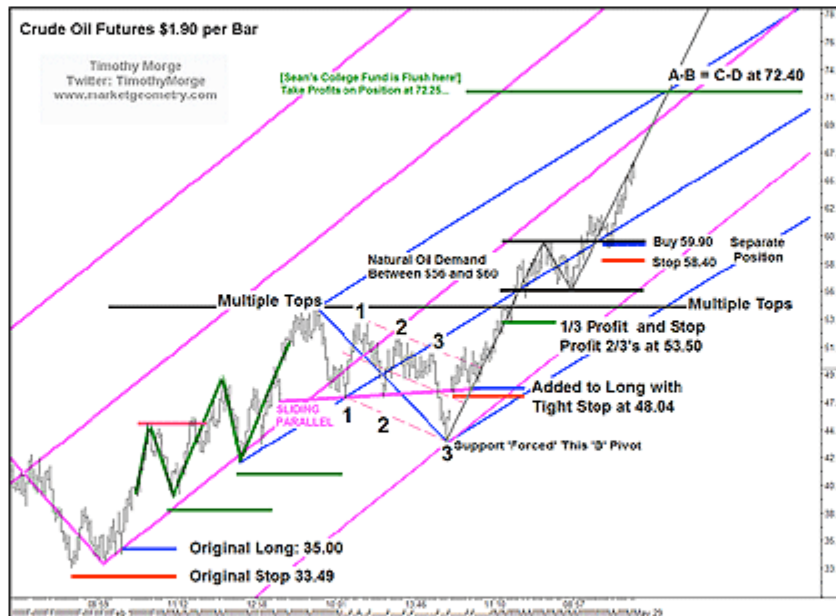
Tips for Traders | 6/1/2009 10:13:00 AM

How to Catch a Trade in a Vertically-Trending Market

One of the most exhilarating rides we can take as traders is when a profitable position we have on goes “vertical.” It's like being on a roller coaster: You can see the edge of the fall coming, you can feel the breeze in your hair start to pick up, and then suddenly, your stomach lurches and you feel the move accelerate! You're in a freefall, and the further you fall, the faster you fall, and the more profits you put in your pocket! There are very few parts of trading that give me any adrenaline rush after being a professional trader for 38 years, but catching a move just before it goes “vertical” is still one of them!

But there are problems with vertically trending markets: They often take off before you find and execute a high-probability trade entry, and sometimes you take profits right before they tip over the edge and go vertical. Many traders just cannot find high-probability entries once a market goes vertical. Let's see if we can look at some recent trades in a pair of markets that are now trending in a vertical fashion and find ways to enter in the middle of these vertical trends.

This first chart is crude oil futures, plotted using bars that are $1.90 in price from high to low. By choosing price range bars, I have taken time out of this chart. I use this charting technique when markets trade in fits and starts, because the dead periods can skew the charts, making drawing tools less accurate.



My original long entry in crude oil futures was very near the bottom, at $35 a barrel. Once I was long, you can see that price began to climb higher fairly quickly. On a “normal” chart that uses time versus price, this move looks more vertical in some areas and then stalls and range trades in other areas, but using these price range bars, the move seems to unfold in a more orderly fashion.

Price climbed above $53 a barrel and then formed a series of three lower highs and three lower lows, which is a classic pullback in an up-trending market. I was able to draw a new blue, up-sloping Median Line and note

how the outer warning line from the original red, up-sloping Median Line, which acted as support, forced me to use this third lower low as Pivot B when creating the new up-sloping Median Line. I find lines that are built on forced support or resistance pivots particularly useful.

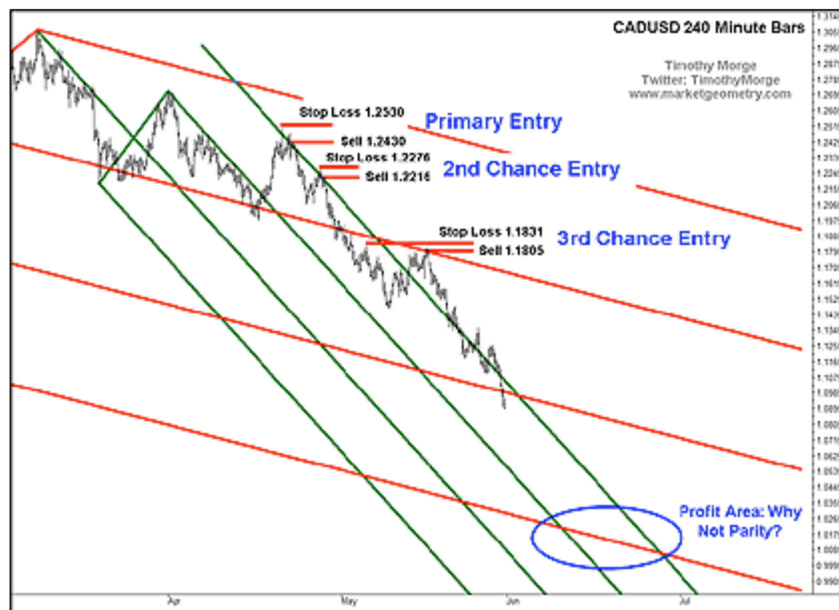
After price made its third lower low, it gapped higher, and when price pulled back, I added to my long crude oil position on the first pullback with a tight stop just above $48 a barrel. Once price sprinted higher and approached the multiple tops, I took profits on one third of my position at $53.50 a barrel. When price spiked higher above the multiple tops, trading as high as $60 a barrel, I put a profit stop on my position at $53.50 a barrel.

Oil prices then entered into a trading range between $56 and $60 a barrel, but when they broke well above the top of this range, I put in an order to buy additional crude oil futures just below the top of the prior range, at $59.90 a barrel, with a stop on this new addition at $58.40 a barrel. If price was going to trade higher from this point, the top of the prior range would act as support, and if price broke well below the prior high, I wanted to quickly take my loss on these additional contracts.

As you can see, the top of the prior range did act as support, and though I was able to get long my additional contracts at $59.90, my stop loss was never in danger of being executed as crude prices closed the week at $66 a barrel!

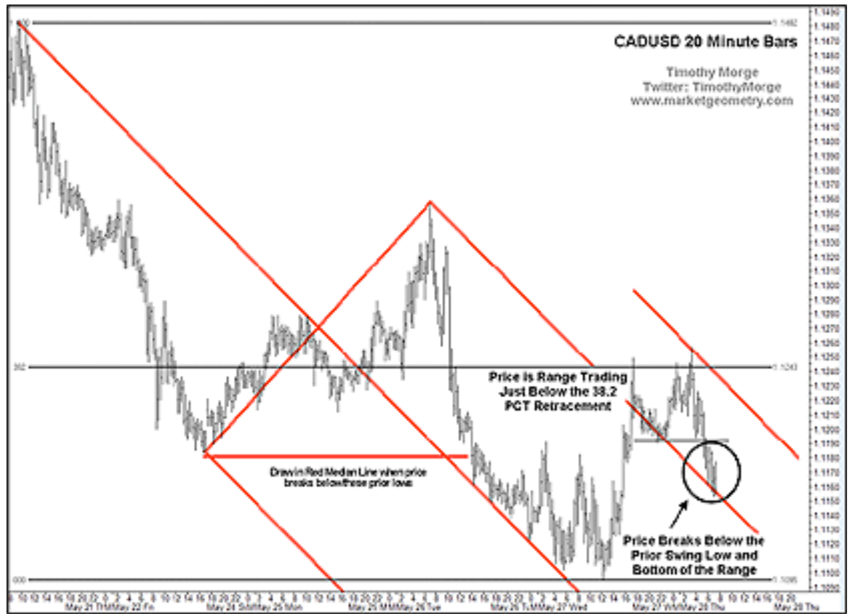
Now let's look at a related market that has gone vertical and see if I can show you how to find quality entries once a market goes vertical. Let's take a look at the Canadian dollar against the US dollar:

Here's a look at the 240-minute bar chart of the Canadian dollar against the US dollar. You can see I found three great entries in this longer-term chart to enter and then add two additional legs to my longer-term portfolio position in this currency. When crude oil is trending, you can bet I am also trading the Canadian dollar, either against the US dollar or against the Japanese yen.



By using the outer warning line and waiting for my favorite entry, the “test and retest” of the warning line, I easily found the first two entries in this monster move down (meaning the Canadian dollar is strengthening against the US dollar). The third entry came at a test and retest of the major red, down-sloping Median Line. These are very high-probability trade entry set ups and if the stops are acceptable relative to my perceived profit targets, meaning the risk/reward ratios are higher than 4 or 5 to 1 when position trading, I take these trades every time I see them.

But what do you do if you are using smaller time frame charts and price has already gone vertical? Is it possible to identify high-probability trade entry areas with quality stop loss orders? Let's look at 20-minute charts of the Canadian dollar and see if we can find quality entry areas, even though prices have gone vertical:



Price falls in a near vertical fashion and then forms a countertrend rally to about 1.1360 before trading to new lows. When they break below the prior lows around 1.1180, I add a new down-sloping red Median Line and its parallel lines. Now I watch as price comes down to test the down-sloping red Median Line several times (these tests tell me the line is meaningful, because it is acting as support) and then price turns and heads higher, testing and breaking above the red, upper Median Line parallel.

Now I add a simple calculation: From the lowest low to the latest swing high, I find where the 38.2% geometric, or Fib, retracement lies. This area will attract many limit sell orders, and I'll want to watch this area carefully to see if there are enough limit sellers to stop the advance of price. Price tried three times to break and hold above this level, but it was unable to stay above it. There are lots of limit sell orders sitting at this 38.2% retracement area.

I add a Sliding Parallel, a line that has the same slope as the Median Line but starts right at the third attempt to break above the 38.2% area, because I may be able to use this line if price shows any signs of weakness.

My sign of weakness, or "tell," comes when price breaks below the recent trading range to test the upper Median Line parallel from above. Note that this upper parallel now acts as support, so it gives me confidence that these sets of lines, including the sliding parallel, is carrying the same frequency as price. Given the chance, I am willing to enter trades off of these red, down-sloping lines, but I have to find a high-probability trade entry set up that I recognize.

Now price gives me the opportunity I always look for: A high-probability trade entry at a tested line. I get long Canada and short US dollars at 1.1230, which is at the re-test of the red, down-sloping Sliding Parallel and my initial stop loss is above the three attempts to get and hold above the 38.2% retracement area, as well as above the 38.2% retracement area, where I believe there are lots of limit sell orders that will protect my initial stop loss order at 1.1262.

Remember: Markets that are selling off in a vertical fashion that are unable to climb above the 38.2% retracement are extremely weak and are likely to continue to move lower in a near-vertical fashion once the shallow pullback is complete (the reverse is true in strong up-trending markets). If you can identify a high-probability entry at or near the 38.2% area after it has been successfully tested, it is generally a tremendous entry opportunity. Let's see how this one worked.

As you can see, once price failed to make it back to test the 38.2% retracement area, it returned to its vertical down move. If you managed to get on board at or near the 38.2% retracement area, as I did, it's now a matter of deciding how and where to take your profits. You can take your profits at prior lows, or you can attempt to let your profits run all the way down to a measured move, where A-B x 1.618 from C gives a target of about 1.0835.

Or you can keep boxing in profits, lower your stop profits every time price leaves a clear swing high, and simply let the trade run lower until your profit stop gets executed. I am currently using a profit stop above a prior swing high at 1.0951, so if my profit stop gets executed, I am short this position at 1.1230 and I'll get profit stopped out at 1.0951 for a net gain of 279 pips.

Any of these profit methods would have been more than acceptable. As long as you use a consistent method to take profits and keep a quality risk/reward ratio, you can make good profits trading in vertical markets. Stop loss orders are a must, as they are any time you take any trade, but they are especially important in vertical markets, because the moves in both directions can be explosive. It is extremely important to control your losses and keep them small relative to your profits.

I hope this article gives you some ideas that will allow you to find quality entries in vertically-trending markets,

even after they have started their vertical moves.

I wish you all good trading.

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