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Tips for Traders | 6/29/2009 10:24:00 AM

How to Predict Price Direction: An Aussie Dollar Case Study

While giving a Market Maps live pre-market session late last week, I began my look at the currency markets with a 20-minute chart of the Australian dollar against the US dollar. The live sessions always begin at 6:30 am CST and run just over an hour. Besides allowing people to literally watch me prepare my charts for the day's trading before the markets open, these sessions are filled with my own trading tips and techniques. When I see areas that I think trades could develop, I point those areas out and describe what would have to happen for me to enter a trade at or near that area. If I spot a quality trade entry while marking up my charts during the live session, I enter the trade and mark my charts accordingly while everyone watches. This allows people to see how I plan my trades using limit entry orders, how I use market structure to protect my stop loss orders, and why I choose the profit areas I do when entering a trade.

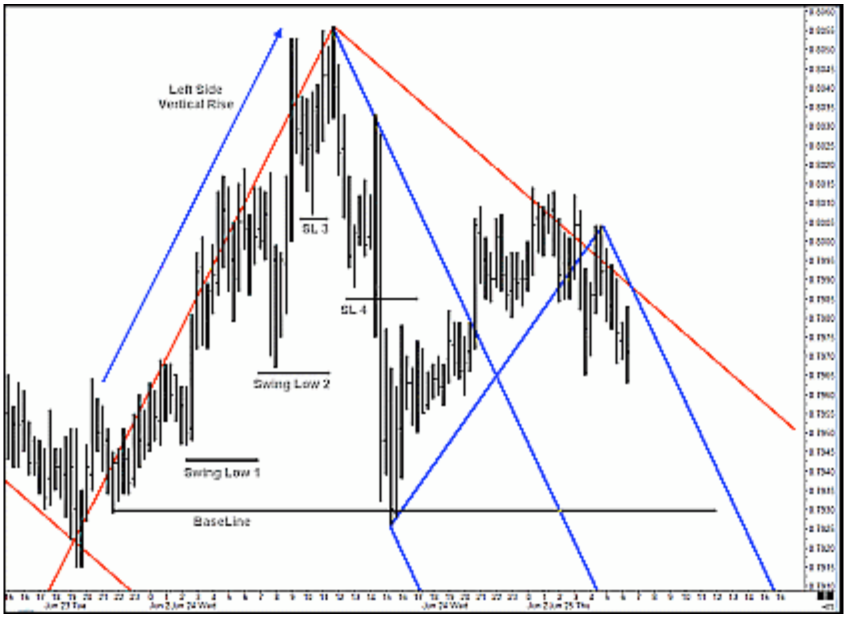
I was recently interviewed by the CME Group and one of their more interesting questions was: "How many currency pairs do you suggest a new or inexperienced trader watch and can you tell us which pairs you would recommend?" I tell traders who I mentor that watching too many currency pairs can be very distracting. More is not always more! I tell my less experienced students to begin with three currency pairs: The euro FX, the Canadian dollar, and the Australian dollar (all against the US dollar). The EUR/USD is the most liquid trading pair in the world and it does a good job as a proxy for general US dollar movement. Both the Canadian and Australian dollars give a trader great trending action and great range trading opportunities. Although most markets are currently filled with nice big swinging trends, this tends to come and go, and it is a good idea for all traders to know how to trade both trends and ranges so they can take advantage of any market condition.

Let's look at a trade I took during one of last week's live Market Maps sessions:

This is a 20-minute chart of the Australian dollar against the US dollar. Price had been in a very strong uptrend for some time, but then it began to show signs of the trend slowing. If you look at the upside movement on the left side of the chart, you'll see that price broke back below two prior swing lows from the left-hand run up in price. Then, price began making lower highs and lower lows. This chart image was taken just after I began the live session, when I began pointing out market structure on the Australian dollar as I charted it. When I noticed that price had just taken out another prior swing low (marked "Swing Low 4"), I added the red, down-sloping Median Line and its parallels. You should immediately note that price tested the red, down-sloping upper Median Line parallel a number of times several hours earlier (but of course, I was sound asleep!). As price continues making new lows for the move, it is pulling away from this red, down-sloping parallel. The current price action does not make me feel that I'll likely see a re-test of this red upper parallel soon.

But I like the market structure too well to simply shrug my shoulders, quit, and move on to the next currency pair. Instead, let me show you what I do.

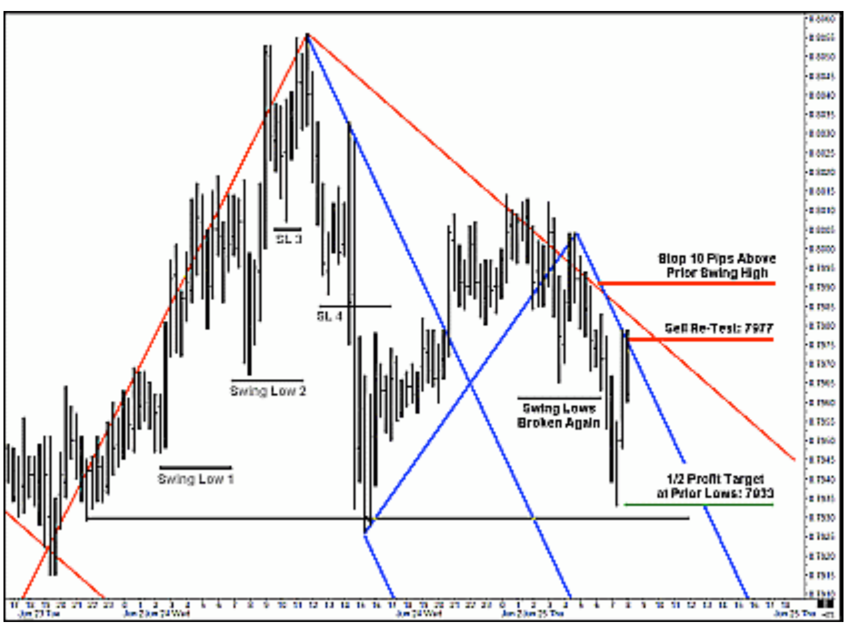
As I zoom in on the current action, I note that price took out three prior swing lows from the left side vertical move. While the difference between two prior swing lows and three prior swing lows may seem trivial, I always look for price to break below at least two prior swing lows before considering that a strong uptrend may be over. The opposite would be true in a strong downtrend, so the additional swing low gives me just a bit more comfort with my feeling that a top may be forming.



I look at the action on the right side of this chart and notice that price left double tops about six or seven bars back and then began to accelerate to the down side. I decided to use these double tops as part of the three alternating pivots needed when drawing a Median Line, and then I pick out a suitable prior high and prior low and draw in a blue, down-sloping Median Line (and its parallels) which is smaller and lies inside the larger, red, down-sloping Median Line. This new Median Line has several hits or touches on its “tail,” the line connecting the “A” pivot and the midpoint of the line connecting pivots “B” and “C,” and this makes me feel more comfortable that this new Median Line is vibrating at the same frequency as price. My eyes also tell me that price is more likely to interact with this more narrow Median Line as I add it to my chart. Remember, I am charting live in front of several hundred people, so I also explain what I am thinking while I add each line.

After noting that I am interested in the area where price would interact with the blue, down-sloping upper Median Line parallel, I move on to the Canadian dollar and begin marking up that chart from scratch. After analyzing the Canadian dollar chart and pointing out several interesting market structures on it, I move on to the euro FX chart and begin marking it up. First, I note all the important market structure and begin drawing in Median Lines, Fib retracements, and simple trend lines. I like to think of the market structure on any chart as the skeleton and the lines I draw on the chart as the muscle and skin. If you don't understand the market structure on a given chart, you'll often end up drawing lines that are useless, because these lines need to take advantage of the underlying market structure, not fight it.

Once I am done with the euro FX chart, my intuition tells me to come back to take a quick look at the Australian dollar chart, and as you’ll see below, I find that price has plunged lower, nearly testing the major market structure of a prior major swing low and a smaller swing low. There are probably limit buy orders in this area, and you can see that though price tried to test and break through this area of support I marked with a horizontal line, it then bounced higher and is now testing the blue, down-sloping upper Median Line parallel. In fact, price has now tested this blue upper parallel twice. The latest bar left double tops, and after testing the upper parallel, it closed on its lows, a sign that the sellers were in control of this market.



As I explain my thinking to the live audience, I am eyeing this chart with a trade plan in mind. I want to sell a re-test of the blue, down-sloping upper Median Line parallel, at .7977. My initial stop loss order will be ten pips above the prior swing high, at .7792.

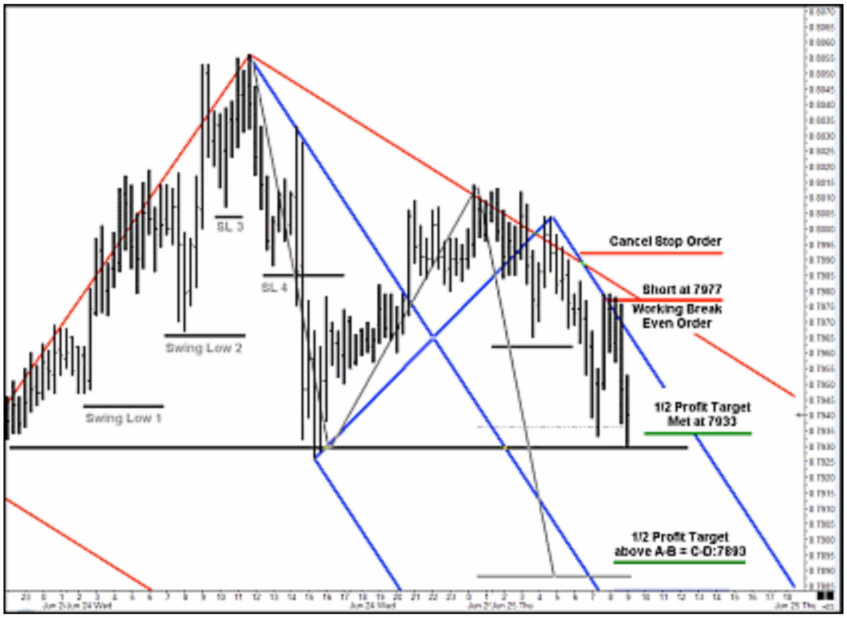
Because I have to mark up charts in the commodities groups (copper, gold, lean hogs, oil, and soybeans) as well as the bond and stock index futures, I won't be able to monitor this trade moment to moment, so I'll set some money management rules accordingly and enter them into my trading platform:

1. If my limit sell order at .7977 is executed, once I have 15 pips of profit in this trade, I will automatically move my initial stop loss order to a break even stop order.
2. If my limit sell order at .7977 is executed, I will place a limit buy order for half the position five pips above the horizontal line I added on the chart as important support (and a few pips above the spike low several bars back) at .7933.

But what is a logical area to take profits on the second half of the position?

Let's look at another chart, and do a simple geometric expansion where the distance price travels from its highest high to the support at the horizontal line is measured and then that same distance is projected down from the most recent major high, coming down the red, down-sloping upper Median Line parallel. This projection (A-B = C-D) coincides with the blue, down-sloping Median Line, so I decided to put the limit buy order for the second half of my position five pips above this level, at 7893.

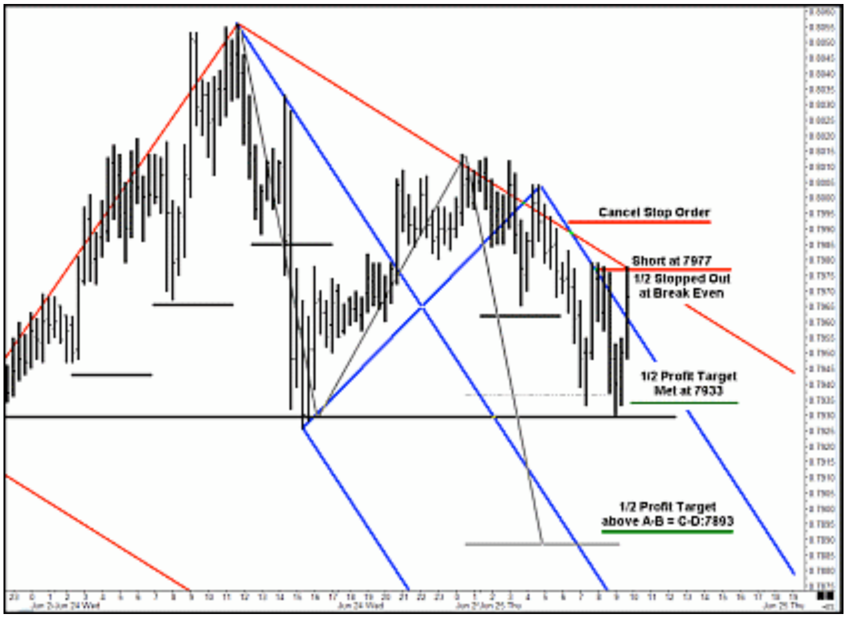
I check that all my contingent orders are in place and then move on to begin charting the commodities group. After charting crude oil futures, I come back to check the Australian dollar chart. Here's what I see:



I was quickly filled on my limit sell order at .7977, and while we all watched, price ticked .7935, .7936, .7937, .7936, .7935, .7934, .7935, .7934, and finally, .7933 followed by .7932. Although many people watching live have been telling me I am filled on my first profit order, I check my audit trail to make certain I am filled on my limit buy order at .7933 (price is printing .7930). Then I check that my initial stop loss order was moved to break even and that it is now only half as large as it was in the beginning of the move. Once I am certain my second profit target is in the market, I go back to charting commodities and then move on to the bond and stock index futures.

At the end of that morning's Market Maps session, I pop back to the live Australian dollar chart and we all note that although my first profit target has been hit, price is now consolidating.

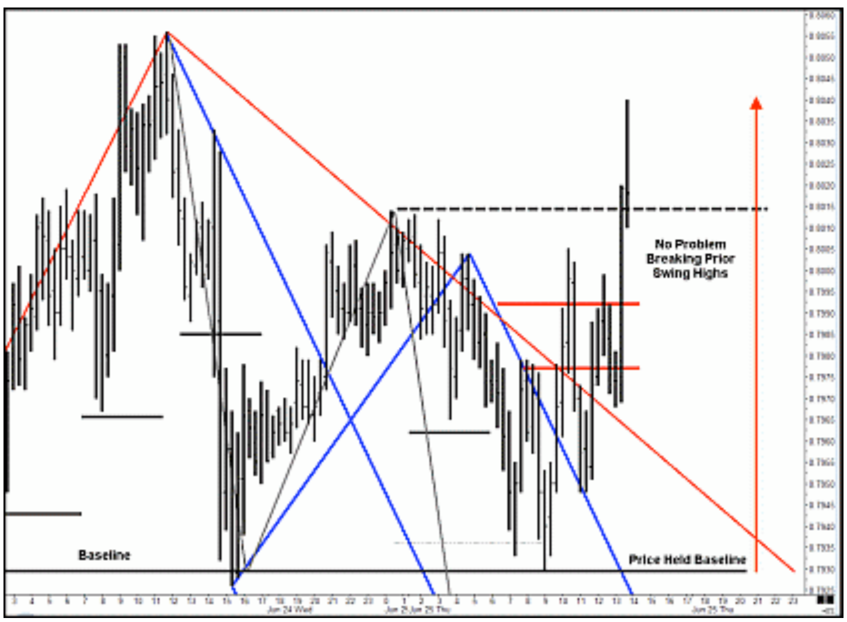
Let me show you how the trade unfolded after the Market Maps session ended:



About ten minutes after the end of the market maps session, price began to trade higher and soon stopped me out of the second half of the position. One of the important concepts I had mentioned during the session was that if you were in the process of building the size of your account, as most new or inexperienced traders are, there is some level of unrealized profit that you reach in each trade where: 1) you can no longer let the trade turn into a loss (hence the use of break even stops relatively early in the life of this trade); and 2) you must book some profit for all the time and focus you put into the trade (and also because you had your capital at risk for some amount of time and should be paid for risking that exposure). As your account size grows, these numbers change along with the rest of your money management methods, but this is a good rule of thumb to use when starting out.

I felt that if I was an inexperienced trader, once I had reached 15 pips, I should move my initial stop loss order to a break-even stop order. And I felt it would be important to use a profit target on the first half of this position that would have a high probability of being executed, so I placed it above the prior swing low, as well as above the major support. Even though price hit my break-even profit stop, I had already taken 34 pips profit on half the trade, more than I had initially risked per contract (17 pips per contract gained after risking 15 pips per contract).

Let's see if the move up was a wash and rinse or if the up move continued:



As you can see, after filling my profit order on the first half of my position at .7933, price headed higher and filled my break-even stop loss order quickly. It turned back a bit, but then shot higher and started a series of higher highs and higher lows. This was a good example of locking in some profits ahead of major support so that I didn't have to walk away after expending all the time and energy and the exposure to my capital with no profits to show for it. The 17 pips per contract would not make me rich, but I consider it a potential loss rolled forward, meaning I am trading with the market's money when I enter my next trade.

I wish you all good trading.

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