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Tips for Traders | 2/2/2009 10:36:00 AM

How to “See” the True Message of the Markets

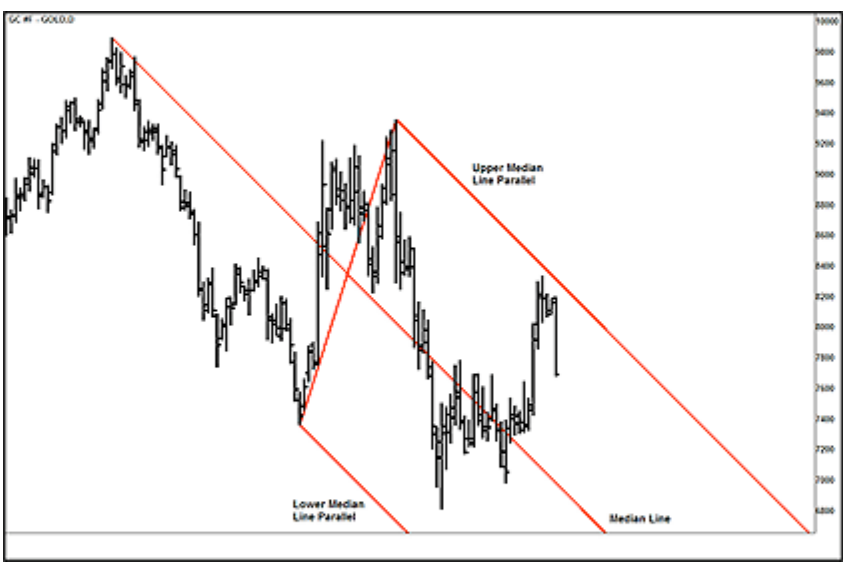
People “see” things all the time. We see a face on the shadowy pockmarked surface of the moon. We see horses and dragons and fairies when we look at the fluffy clouds in the summer sky, and we see crabs and horses and bulls when we look at the pinpricks of light standing out from the pitch black night sky. The problem with seeing things is that we may be projecting what we want to see instead of what’s really there.

Because I deal mainly with technical analysis of the markets, it is important that I do not project my feelings and opinions onto what I see when doing analysis—though that’s often a difficult task. There is real value in the results of objective technical analysis, but there can be great danger if a trader sees what they want to see in their technical analysis.

When I teach students to be better traders in my mentoring programs, one of the things we work on over and over is keeping objectivity in our analysis. I find this is best accomplished by always using a set of tools that you have mastered and know inside and out. And to keep emotions out of the analysis and trading, I find it’s best to develop a step-by-step approach. You’ve heard of “paint by the numbers?” Well, I try to help each of my students develop their own “trade by the numbers” routine; one that plays to their own strengths and avoids their weaknesses.

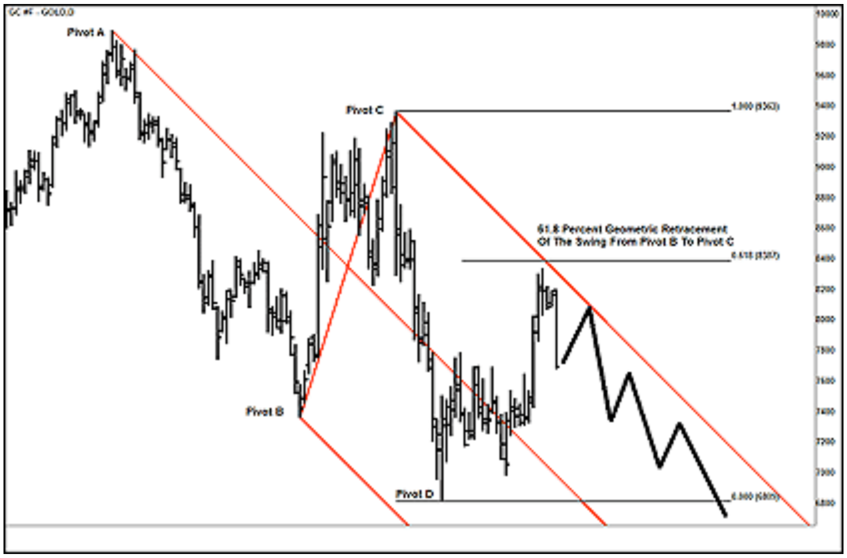
By laying out a detailed, step-by-step trade plan in writing before the trade begins, each trader has a market map in front of them, and if their emotions start to creep in, or if they lose their focus, they can easily get back in step with their original trade plan because they have it right in front of them on their desk.

The hardest part of any trading plan is keeping your head free from emotions and opinions until all the pre-trade analysis and planning is finished. Think about it: If you begin with an opinion and you are like most of us, you are much more likely to pay attention to the analysis that supports your pre-trade opinion. But opinion-free analysis is a learned habit, so I often spend a good deal of time with traders that are new to the mentoring process going over their analysis while they are still stalking a trade. Let me show you just what I mean:



Here is a chart of the daily gold futures from one of my newer students. You can see that he added a red, down-sloping Median Line to show what he feels is the most probable path of price. If he is correct, price should run out of upside directional energy at the red, down-sloping upper Median Line parallel—and that would be an area where he might look for a high-probability trade entry set up to enter a short position in the gold futures.

Let’s look at the second chart he presented me as part of his pre-trade analysis:



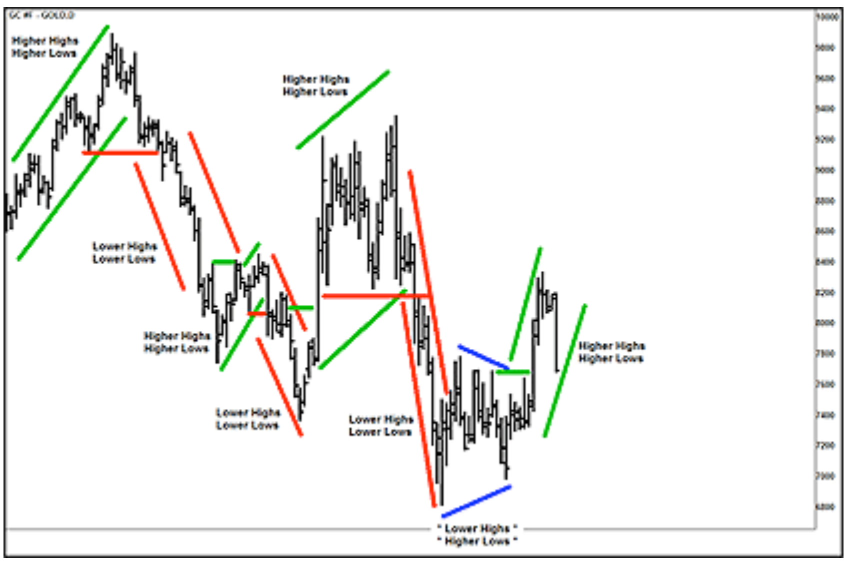
Before drawing in what he considered the likely path price would take, he took the high at Pivot C and the low at Pivot D and calculated the 61.8% geometric retracement (what many traders call the 61.8% Fibonacci Ratio.)

What actually happened?

Many traders feel that Fib ratios offer clues about whether a move higher in an established downtrend, for instance, is a pullback in the downtrend, or whether the move higher is a change in trend to the upside. In particular, some traders view the 61.8% Fib ratio as the dividing line. If price has been in a downtrend and manages to rally past the 61.8% Fib ratio, it's likely that the move higher is a new emerging uptrend, not a rally in an established downtrend. And you can see on the second chart in Part 1 of this article that this trader was pointing to price's failure to test or break above the 61.8% Fib ratio before turning back lower as a likely sign that the recent up move was merely a countertrend rally.

The new student then added what he considered to be the most probable path of price. After doing his pre-trade analysis, he had decided price was about to resume the downtrend. With this view in hand, he would be looking for price to test the red, down-sloping upper Median Line parallel after a slight rally. Note that he expected the next rally, the one that might test the upper parallel, to be lower than the prior swing high.

When I work on pre-trade analysis with a trader in mentoring, I am examining the trader's analysis and ability to "read," or "see" the market structure clearly. In my mind, I am asking, "Can the trader "see" the market structure clearly? Has he considered both the downside and upside scenarios during his pre-trade analysis? Is he projecting a realistic probable path of price? Is he being objective or is he choosing his analysis to support his view on the market?" Often, the only way for me to determine if the analysis is objective is to start from scratch and do my own analysis, in front of the trader. Let's see what steps I went through with this trader:



The first thing I generally do when analyzing a market is look closely at the market structure. I want to know the major swings, how they formed, and where the market is currently in terms of swing structure.

On the daily gold futures chart above, I removed the red Median Line and its parallels—and that makes it much easier for me to see and mark the major swing highs and lows. Note that I marked higher highs and higher lows in green, indicating price was in an uptrend. I marked lower highs and lower lows in red, indicating price was in a downtrend. And I marked congesting or contracting areas, where price was making higher lows and lower highs, in blue. This simple analysis gives me a feel for the length of swings for this particular market, shows me visually how price generally confirms trend changes in the market, and of course, it shows the current trend of the market.

All other analysis flows from this simple structure analysis. When I do my own pre-trade analysis on a given market, I may or may not have to draw in these swings—my eyes are well trained at this point, and it is easy for me to see market structure. But if it is a market I am not familiar with, or if the structure is not instantly visible to my eyes, I clear off any lines drawn on the chart and do this simple swing analysis—and the market structure instantly becomes recognizable.

Now that I have a general feel for the market structure and the current trend, I move on to more detailed analysis.

I add back in the red, down-sloping Median Line and its parallels. By adding in the lines the trader originally used to “see” the market, I have now connected him to his original thoughts and feelings about this market. And, remember that his secondary analysis used geometric ratios as a way to frame his view that this market was experiencing a pullback in a downtrend because price was unable to break above the 61.8% retracement of the swing lower from pivot C to pivot D.

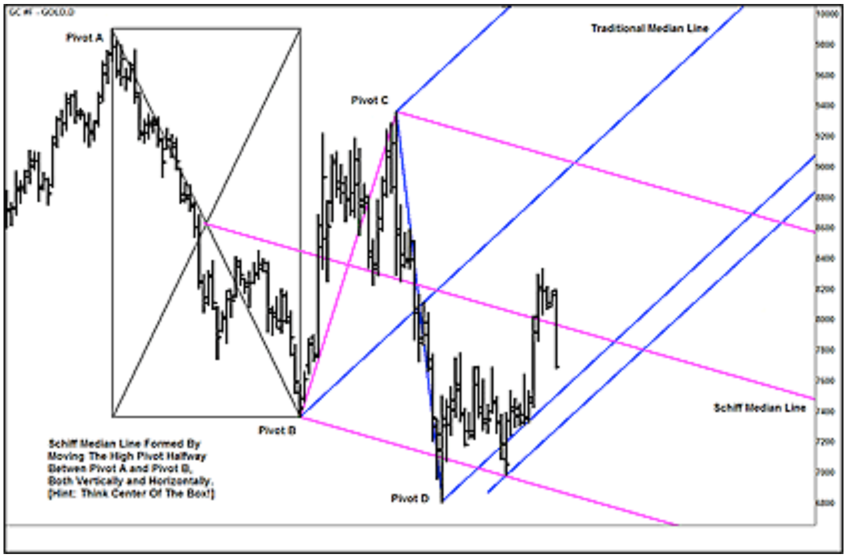
Like all traders, I have my own favorite way to use tools, and geometric ratios are no exception. My favorite use of these mathematical tools is a simple equal measured swing. I simply measure the distance price traveled when it moved down from pivot A to pivot B, then I go to the next major swing high at pivot C and project that same distance. If price moved the same distance starting at pivot C, where would a swing down of equal length end? I find that equal measured swings are often deadly accurate.

Looking at the chart above, you’ll see that the distance price traveled from pivot A to pivot B, when projected from the next major swing high at pivot C, would have given me a probable target for pivot D (well before it even formed) that matched where price ran out of downside directional energy and turned, forming the new pivot. I chose this type of analysis for two reasons: 1) I like using measured swings, and find that they project useful targets for the length of swings; and 2) Because the trader had originally used a Fib ratio to justify his pre-trade view, I used a tool from the same family when doing my own analysis while he watched—connecting him again visually to the work I was doing.

In my general analysis of the markets, I see price unfolding in swings that have a particular frequency or length. And often, these swings can be projected quite accurately if the right tools are used. If I project a measured swing, where the distance from A to B equals the projected distance from C to D, and I see the actual swing travels the distance I projected for swing C to D and then changes direction, I know two things from experience. First, price has probably completed the current swing in that direction, and second, an important high or low has most likely just been made by price because price ended its travel in one direction where it *should* run out of energy. The swings unfolding in this market will likely continue to unfold in an orderly fashion, and I should be able to project them successfully using these tools.

My first comment to the trader doing his pre-trade analysis, once I presented this chart, was that price may have completed its downside run for now, or in effect, completed its journey. I then noted that in my simple swing analysis, price was still in an uptrend. It may turn lower, but on my first two charts, I see no clues that price will turn lower.

Let’s see more of the detailed analysis I presented to him:

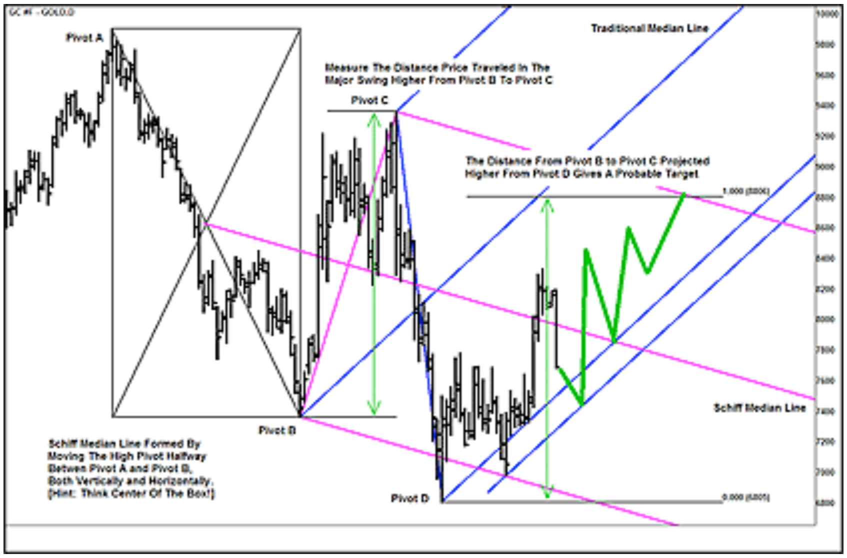


Price has fallen in a near-vertical fashion twice on this chart, and there is a tool that was modified to be particularly useful after near vertical falls: the modified Schiff Median Line. If you study the chart above, you’ll see that it is a derived version of the traditional Median Line, formed by moving the original starting point of the Median Line handle horizontally and vertically halfway towards the pivots that form the Median Line width. The easiest way I have found to illustrate the shift of the first pivot is the construction of a box that begins at the pivot A and continues to the pivot B on the diagonal, and by shifting the origin of the handle to the center of this box, a modified Schiff Median Line is formed.

I take the trader’s original Median Line and make it a Schiff Median Line. I chose this down-sloping Schiff Median Line over a traditional Median Line because it adjusts well to the near vertical falls this market has experienced and will do a better job projecting the probable path of price. By modifying the trader’s own Median Line, I also keep him in tune with my analysis, since I am building on his own analysis.

Now I want to consider both the downside and upside possibilities. I add in a blue, up-sloping Median Line and its parallels. As soon as I add this Median Line set, I note that price has violated the blue lower Median Line early on, but has now moved well above the lower parallel. Looking closer, I see that when price violated the blue, up-sloping lower Median Line parallel, it stopped at the down-sloping lower Median Line parallel, where price should run out of downside directional energy. I add in a line parallel to the up-sloping Median Line that goes through the low for this move at the down-sloping lower parallel. All further downside movement should find that this new up-sloping, sliding parallel line acts as support.

The probable path of price is becoming clearer to me, but perhaps one more chart will bring it into clearer focus for both the trader and for you:



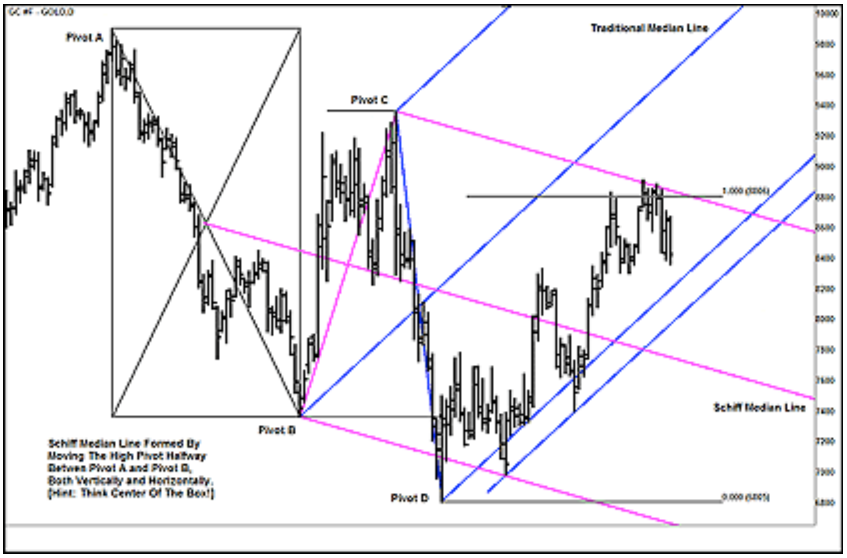
The finishing touches on this analysis are simple. I mentioned before that when I see that the measured length of the swing from pivots A to B equals the length of the swing from pivots C to D, I find the same tools will give me useful projections of the swings forward in time. On this chart, I measured the upside distance price travelled from swing B to swing C, and then projected that same distance upward from the low made at swing D. If I am correct, the swing currently unfolding to the upside from pivot D will be the same length as the swing higher from pivot B to pivot C. Note that I marked where this next swing higher should run out of upside directional energy, at about $880 per ounce.

I don't see any sign that the current uptrend is over or nearing completion, so if price pulled back a bit to test the up-sloping lower sliding parallel, and that line held, I would be interested in entering a long gold futures position. Remember that this is the pre-trade analysis, so it is too soon to talk about specific entry prices and initial stop loss orders, but as always, I would only enter the orders if the size of the initial stop loss was acceptable and the risk reward ratio was within my normal parameters.

You can see I added a wide green line that unfolds in a wave pattern to show what I consider to be the probable path of price. Once I add the probable path of price onto the chart, it becomes obvious that if I am correct about the projected price target at $880, price will also be running into resistance at the down sloping Schiff Upper Median Line Parallel—and that Upper Parallel marks where price should run out of energy—a great place to take profits.

I showed you charts and analysis that support both a down side move and an up side move. Remember that this analysis is meant as an exercise to help traders objectively identify market structure and then help them determine the probable path of price.

Let's see what the gold futures did over the next several weeks:



Price came down and tested the lower sliding parallel, and the key support held at that level. Upon successfully testing the sliding parallel, price turned back higher and made a very quick, nearly vertical run up of over $140 an ounce, right to the $880 per ounce area where I projected and marked the equal measured move. Then, after consolidating a bit, price traveled higher and tested the down-sloping Schiff upper Median Line parallel, where it ran out of upside directional energy.

Do not let your opinions get in the way of your trading! Do your best to do objective analysis, and more importantly, trade the market's actions, not your views or opinions. If you find yourself getting short three times in a row while the market continues to make new highs all morning, you are trading your opinions, not trading the market's action. The market is always right!

I wish you all good trading.

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