

Tips for Traders | 7/15/2008

How to Find the Correct Place to Stand and Profit from the Lever that Moves the Market

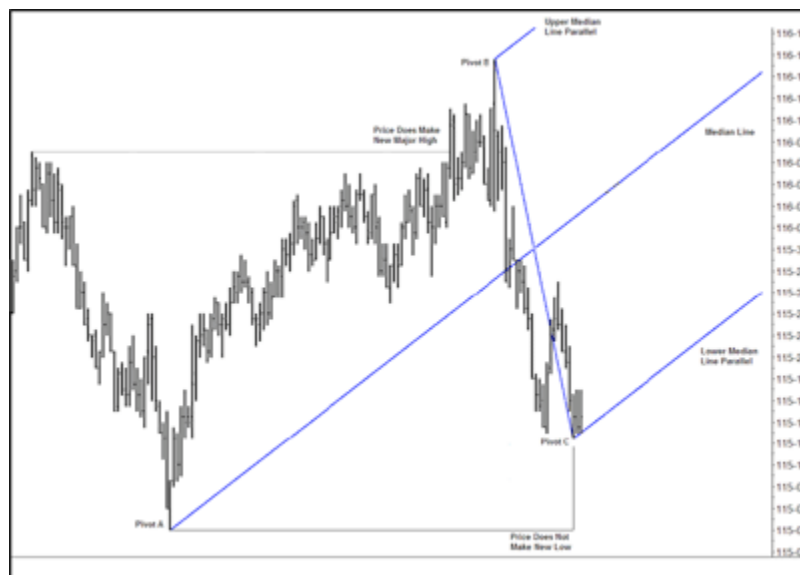
While teaching my one-on-one mentoring sessions, one of my students mentioned that he had been looking at the US 30 year bond futures and wasn't seeing any entries. He had heard me mention that there are times when I have been an extremely active day trader in the bond futures and he wanted to know what time frame and charting technique I was using. I explained to him that in the early 1990's, I was a very large intra-day trader in both the copper and natural gas but they opened later in the morning. Looking for something to trade in the first few hours of my trading day, I began to watch the bond futures and set a task for myself: Find a high probability entry technique that gave me on average 4-6 entries a week during those first few hours [7:20 am CST until 9:30 am CST] that led to trades that generally ran their course quickly; in short, I wanted to find a nice scalping technique that would let me take on average 6-8 ticks out of the bonds with a high probability of success.

After several months of research, I found a repeatable pattern and then spent a few more months fine tuning the entry and the associated money management techniques to go with it. I only use this technique, which I began calling a 'corner trade', when day trading the bonds. And when the bond market gets inactive, I don't bother trading it. And note that although my long term historical risk reward ratio on all of my actual trades runs right at about 3.5 to 1, corner trades in the bonds often carry a risk reward ratio of well under 2 to 1. But the probability of them being profitable is well above 80 percent if you correctly identify the 'corners'.

For many years, I made more than enough to live on trading this entry alone, though my large trading profits come from my more traditional trading entry techniques: Test and re-test, sliding parallel entries, and simple Median Line Test trades.

Since beginning to show this technique to this first mentoring student, I am now teaching it to a second student in mentoring, and both are picking it up quite fast. This is particularly pleasing. It tells me that not only can I make money trading the technique, but that it is also teachable—in other words, it's not my ability to scalp the bond market that is behind the profits but it is an actual repeatable entry that can be taught and traded by others.

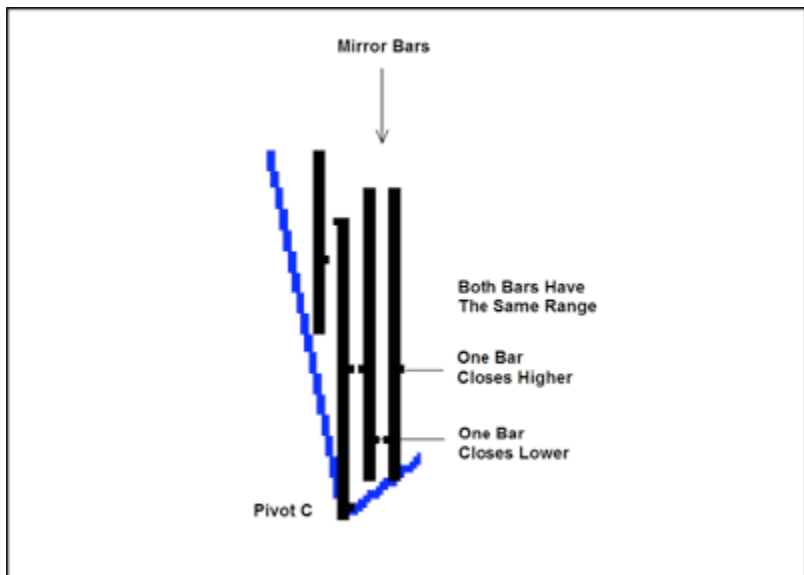
Let's take a look at a 352 tick US 30 year bond futures chart from the CBOT:



This is a 352 tick chart of the US bond futures traded on the CBOT. That means that each bar has 352 ticks [each tick is an up or down movement] and when the 353rd tick happens, it starts a new bar. This takes 'time' out of this chart and that's important because the bond markets are prone to periods of inactivity and that would skew any lines I draw, even though nothing is going on-it's simply the charting package printing a bar every XX minutes. By only forming the bars from actual trades [or ticks], I can take the skew out of the charts and the lines I use to trade are much more reliable in this market.

You can easily see that bond prices made a nice climb higher, breaking above the prior major Swing High before pulling back. Now price is consolidating, leaving near double bottom lows-and it is consolidating well above the prior major Swing Low. Note that I added a blue up sloping Median Line set to show me the probable path of price if these lows hold and price begins to climb higher.

Let's zoom in on this area of consolidation so I can point out some important features of this formation:

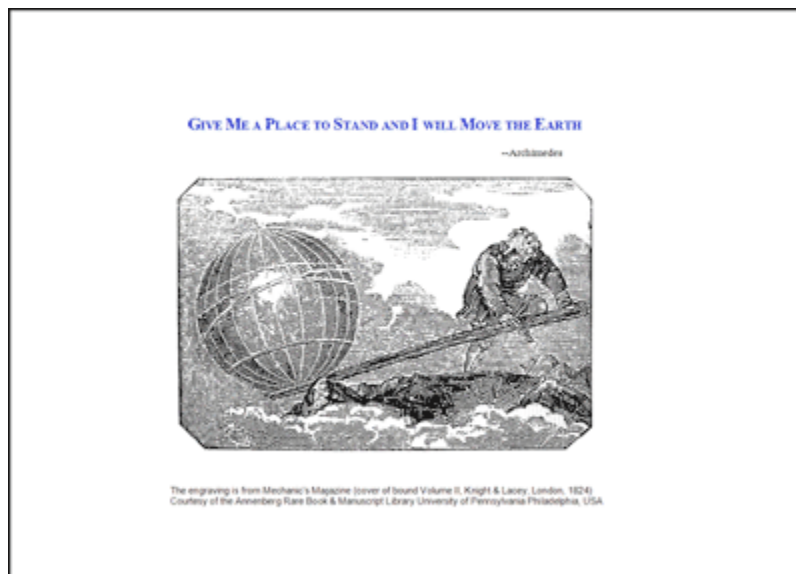


This is your first look at a formation that could spawn a 'corner trade' in the bond futures. Note that the two bars that follow the low bar marked 'Pivot C' are labeled 'Mirror Bars', which is a formation I have done a great deal of statistical research on over the years. Mirror bars are a 'marker' or 'flag' for me, telling me price is about to make a major move. And they always have the same two qualities: They have the same range and they have alternating closes, meaning one bar closes higher and one bar closes lower [It does not matter in what order the alternating closes come, just that they are alternating closes].

It is important to note that bond corner trades do not always have to include mirror bars. But they often do include them right at the corner where the 'C' Pivot is formed. If mirror bars are not present, I often see a series of bars with identical lows [when I am expecting price to head higher] or identical highs [when I am expecting price to head lower]. This clump of double, triple, or quadruple extremes is a marker in the bond market that I found that spawned the corner trade idea, so watch for them to form and then start stalking a corner trade.

But what's really behind the corner trade? Why does it work? What is the math or physics—or simply put what is going on in the market that makes this trade entry so effective?

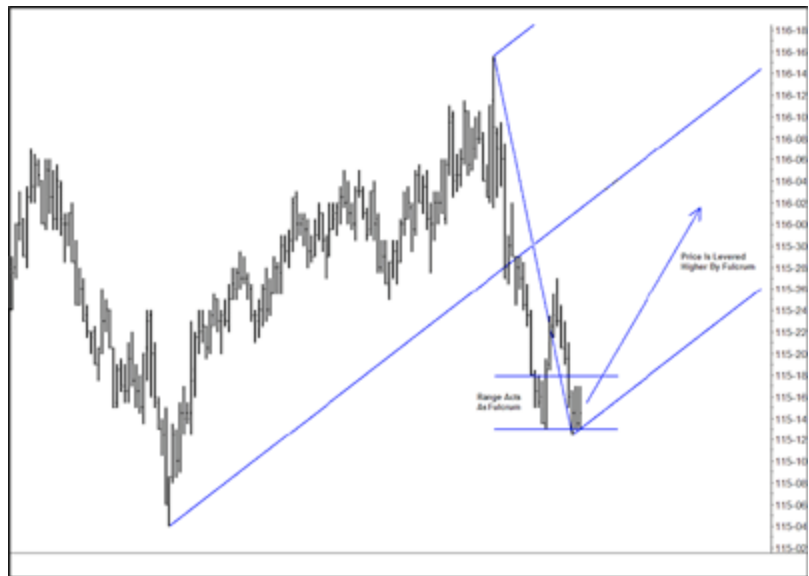
Let me show you an image and quote that might turn the light bulb on for you:



Archimedes was a well-known student of Euclid—you remember Euclid, right? He's the mathematician that REALLY came up with those geometric progressions 38.2, 61.8, 127.2 and 1.618 around 300 BC that have somehow become associated with an Italian mathematician by the name of Fibonacci that lived about 1500 years later.

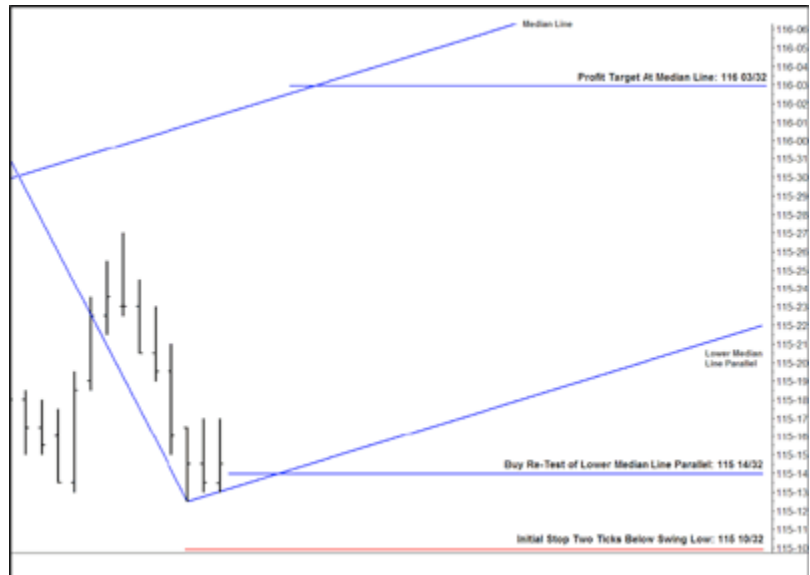
In plain words, Archimedes stated that if you could give him some place with firm footing and a stout lever, he could use the lever as a 'machine' and lift many times his own weight—today, we'd call the machine a fulcrum and lever. Perhaps his boast of 'moving the world' was a bit much, but you get the idea. Firm footing and the right conditions, coupled with some leverage can do amazing things! And that is the basis behind a corner trade. It's not complicated, it's not magic, it's not proprietary—it's simple common sense applied to the markets!

Alright what does this common sense approach look like when applied to a chart of the bonds?



Here's the same chart, but now we are looking at it through the eyes of Archimedes and applying his fulcrum and lever principle to the bonds. The series of nearly same size bars in the consolidation range—that is well above the prior Swing Low—serves as the fulcrum [or firm footing] and the energy price is storing as it trades within this narrow range is going to be the lever that propels price significantly higher out of this range [if I am correct about which side breaks out on!].

Now let's zoom in closer and see what type of money management and risk reward needs to be applied to make this high probability set up work [and remember, this works in the bond market, it's made for the bond market and I don't even bother to attempt to try it in other markets, because I have much better entry techniques in those markets. This entry exploits a formation I have been watching and trading in the bond market for over 15 years.]:



When the second mirror bar forms, it closes higher. It also re-tests the up sloping lower blue Median Line Parallel.

I want to buy the re-test of the up sloping Lower Median Line Parallel at 115 14/32.

My initial stop loss order is two ticks [two full 32nds, not two ? ticks or 2/64ths] below 115 12/32, the Swing Low at Pivot C at 115 10/32.

My profit target on this trade is at the test of the up sloping Median Line, which is at 116 03/32. Here's a very important point: On this particular trade, the Median Line was narrow enough that it was realistic for me to put my target at the Median Line; on many corner trades in the bonds, I am risking 3-5 full ticks to make 6-8 ticks and I will simply be trying to lock profits in at that 6 to 8 tick area because there is no structure or target to use. I am fully aware before each trade that this is a trade entry that is made for quick profits and has a high probability of success IF I don't try to hold the position too long-so the mantra for this trade is 'Get in, get out, nobody gets hurt!'

The risk reward on this particular corner trade is quite high relative to the average corner trade. I am risking four ticks and I am trying to make 21 ticks, which gives me a risk reward ratio of better than five to one. As I mentioned earlier, because it is such a high probability trade entry once you master it, I often take corner trades with a risk reward a bit below two to one.

Let's see how if the market let's me in this corner trade:



Price did come back to test the up sloping Lower Median Line Parallel and my limit buy order at 115 14/32 was filled. I always work both my limit buy orders and my initial stop loss orders at the same time, to limit any potential losses should unexpected news come out while my limit buy order is being filled. Once filled, I enter my limit sell order at 116 03/32. I then double check my orders one last time to make sure I have the position I 'think' I have, that my stop loss order IS in the market working to protect me and that my position size and all my orders are for the same number of contracts.

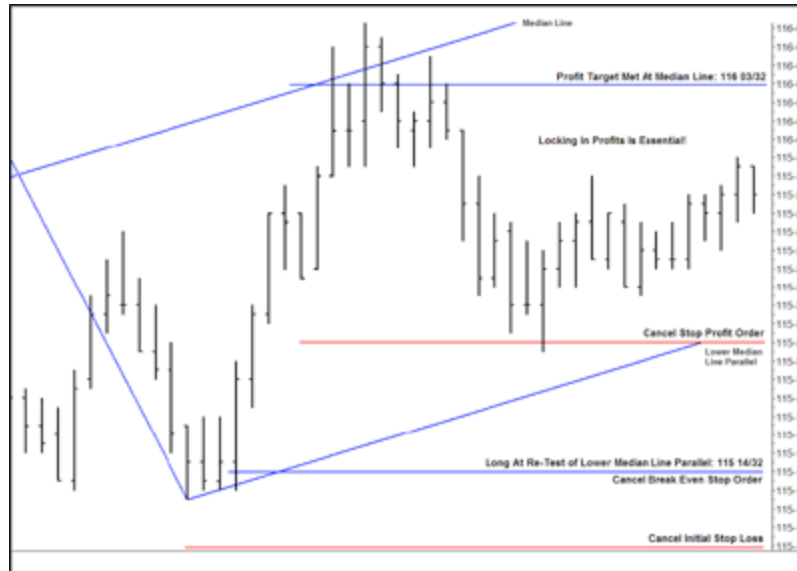
Once my limit buy order was filled at 115 14/32, price climbed higher and easily broke above the double tops of the mirror bars. And price closed near its highs. Everything looks good so far!



Now that the wide range bar has closed and I have checked my orders, I look again at where price closed. Remember, on these corner trades, I am trying to 'rip out' 6-8 full ticks and exit quickly. Even though my profit target on this trade is all the way up at 116 03/32, I see that the close of this bar is at 115 19/32, which is five full ticks from my original entry price. I am so close to the price area I shoot for on the average corner trade, I can't let this trade turn into a loser now. I cancel my initial stop loss order at 115 10/32 and move it to break even, at 115 14/32. Now the most I can lose on this trade is my brokerage fee. I'm willing to give the trade a bit more time to mature, because it is doing everything it is supposed to do when it 'levers' out of the corner, but I am unwilling to take a loss once I have a potential five full ticks in the position after a bar closes.

The next bar shoots higher, breaking well above the up sloping Median Line and filling my limit sell order at 116 03/32. I check that I am flat and that all my orders are now cancelled and do a quick profit calculation in my head. Then I check to see that my electronic platform shows a similar profit. If there is an error, I want to catch it now, not tomorrow morning when I open my statements!

Let's see how the market unfolded once I was out of my position:



Price made one more attempt to trade higher and then entered a very quiet period for the rest of the day. This underscores the idea behind the trade: Early on in the day, bonds often form these 'corners' and if you can find a firm footing, you can use the leverage of the breakout from the consolidation to push your position to a quick profit. It's generally a 6-8 tick profit and it has a lower risk reward ratio than I normally see in my other trading, but it has a very high probability of profitability. I only apply this technique to the bond markets, because I have better entry techniques in the other markets I trade—but I love taking these trades when I am day trading bonds. It was wonderful to have two of my mentoring students ask about these techniques from some of my older articles, because the bond market is alive and well again and they're lots of opportunities!

I wish you all good trading!

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