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Tips for Traders | 6/2/2008

How to Make Money While the Train is Refueling!

Trends are like rivers and streams: They move fast and furious for a time, then hit a snag and slow down and meander for a bit and then finally, they take off again. Many traders are pretty good at identifying and trading a trending market. But most traders are not very good at identifying the market congestion that is the equivalent of a river or stream that is meandering. And even fewer traders are able to make money in these consolidation areas. Let me show you how I make money in a market that is 'taking a breather' after a vertical move.

Let's look at a chart of a beautiful down trend in the e-mini S&P futures:

Price fell in a near vertical fashion from 1421 to 1388 with few pullbacks to give you any high probability trade entries unless you managed to get short near the beginning of the move. The reality of the markets is that there are times when you miss that one easy, early entry and then you are forced to watch it make a large move in one direction-without you! Every trader experiences this and most traders find it near impossible to watch the 'train leave the station' without them; that generally means that they force an entry or chase the market and those types of entries are not quality entries. It's always better to wait for high probability trade entries that you have seen over and over and then enter the market. It's better to miss a trade entry, even one that might have led to catching a large trending move, than to chase the market when it is moving fast, because when you chase the market, you generally end up with an entry that has poor trade location and you generally get stopped out of the market, even though you are trading 'with the trend'.

So how do you make money if you missed 'getting on the train' when it first pulled away from the station? My mother taught me that 'trees don't grow to the sky' and if you think about it, even trains have to stop and refuel. Let's see what a refueling stop in a trending market might look like and how you can make money while the train is refueling.

Let's take a look at the same e-mini S&P Futures chart, further down the tracks:

The first sign that price is re-storing energy is a change in the market's behavior. In this case the market has been making lower lows and lower highs, without any interruptions. When price begins to slow down and makes a series of higher highs and higher lows, it's a sign the market's behavior has changed. Is it a sign that the major down trend is over? It might be. Or it might be that the trend has simply run out energy and needs to refuel before continuing on.

How can you tell if the trend has ended or if the market is just taking on new fuel? If you look at the chart above, I'll point out some of my favorite sign posts. Price had been a very strong down trend and it had no problem staying within the boundaries of the green steep down-sloping Median Line and its Parallels. Price began to 'drift' out of the green median line parallel to the right; that was my first sign that the trend was running out of energy. Then it made a higher high as it traded through the right green parallel. Finally, although it had traded out of the green down-sloping median line and its parallels, it began trading in an energy coil [or trading range]: It was unable to make a new significant high and it was unable to make a new significant low.

Note that I added a blue up-sloping median line and a set of parallels that does a good job catching the highs and lows of this consolidation phase or energy coil. The trend may or may not have ended-we don't know yet-but this new blue median line set clearly shows me the probable path of price; IF price continues to follow it, we are seeing a change in trend. If price changes character again and stops following the path suggested by this new up-sloping blue median line and its parallels, we may be seeing a return to the down trend.

Now note that I added the 38.2% geometric retracement drawn from the 1421 high to the 1388 low. Price has pulled back from the lows, but it hasn't tested the 38.2% geometric retracement. A market that cannot break above the 38.2% geometric retracement is a very weak market-so when I am watching a market restoring its energy, I always want to know where that 38.2% geometric retracement is at. If price breaks and holds above it, I have a strong sign that the down trend may have ended. But in this case, price hasn't broken above the 38.2% geometric retracement-in fact, it hasn't even tested that area yet. At this point, even though this market has stalled and is restoring energy, it is showing every sign that it is still very weak. Until it shows me signs of strength, I am looking for a high probability trade entry to enter a short position.

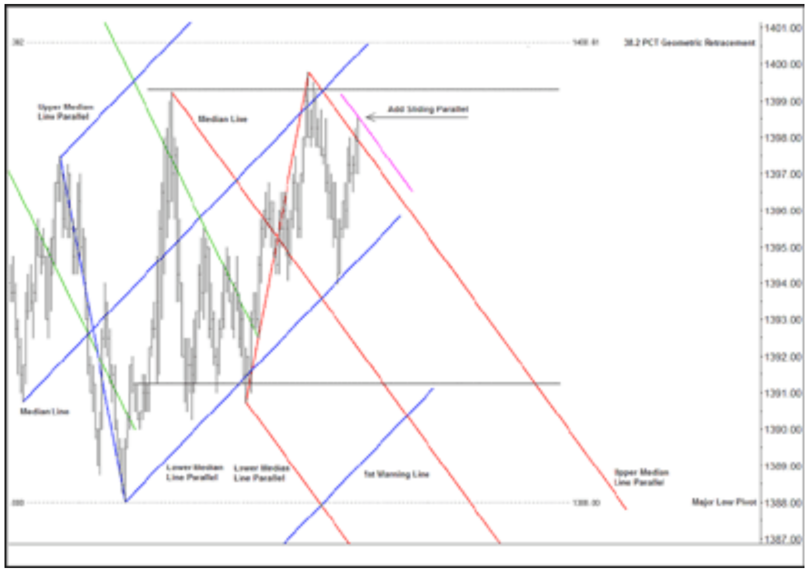
Let's take a closer look at the consolidation area from the chart from yesterday.

Now remember that I don't know if a change in trend is occurring or if price is just refueling before turning back lower. I already have a blue up-sloping median line and its parallels that show me the probable path of price IF a change in trend has occurred. To give me the probable path of price if the trend has NOT changed, I draw in a red down-sloping median line set. I now have price 'boxed in' by a blue up-sloping median line set and a red down-sloping median line set.

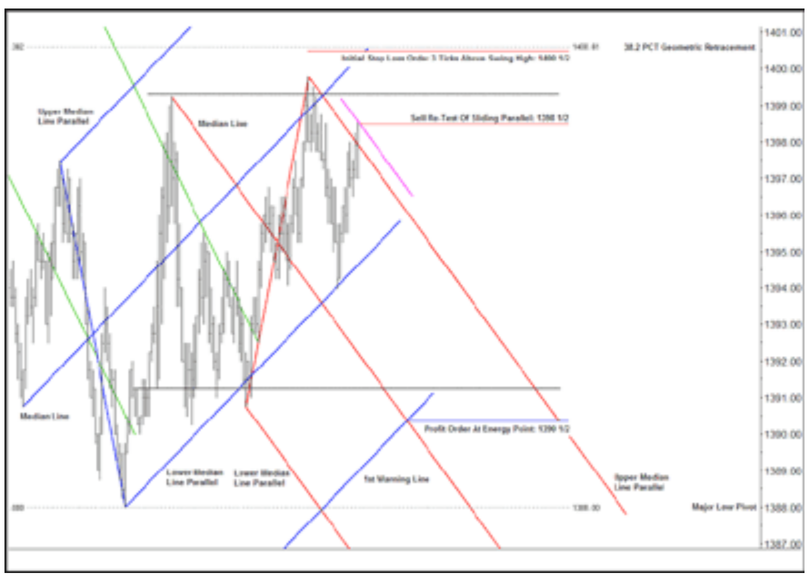
You can see that price tested the prior highs at the blue up-sloping Median line and then turned back down. It then tested the Lower median line parallel and found solid support. After trading higher, it tested the red down-sloping upper median line parallel, peeking briefly above it. But look at the close of the last bar on this chart: Buyers had every opportunity to take control of this market-they clearly had it above the red down-sloping parallel-but sell orders came in and the bar closed on its lows, back within the red down-sloping upper median line. This is a sure sign of weakness. The space between the red down-sloping upper median line parallel and where price closed I call down side separation and it is a quality I examine to determine whether the buyers or sellers are in control of a bar after it closes. In this case, the sellers were clearly in control.

Because sellers were in control of this bar as it tested up side resistance, I feel the market is likely to move lower. If I am right, I will need further measuring aids to give me areas of support and resistance as price trades lower, so I add in a blue up-sloping lower warning line, which has the same slope as the median line and is the same distance below the lower median line parallel as the lower median line parallel is below the median line. I now have an energy point, an area where an up-sloping line crosses a down-sloping line and I expect that this energy point will attract price, so I'll watch this area carefully.

Now I need a high probability trade entry set up that I have seen over and over—one that I trade regularly. I add in a sliding parallel above the upper median line that goes through the high of the bar that peeked above the down-sloping red parallel.



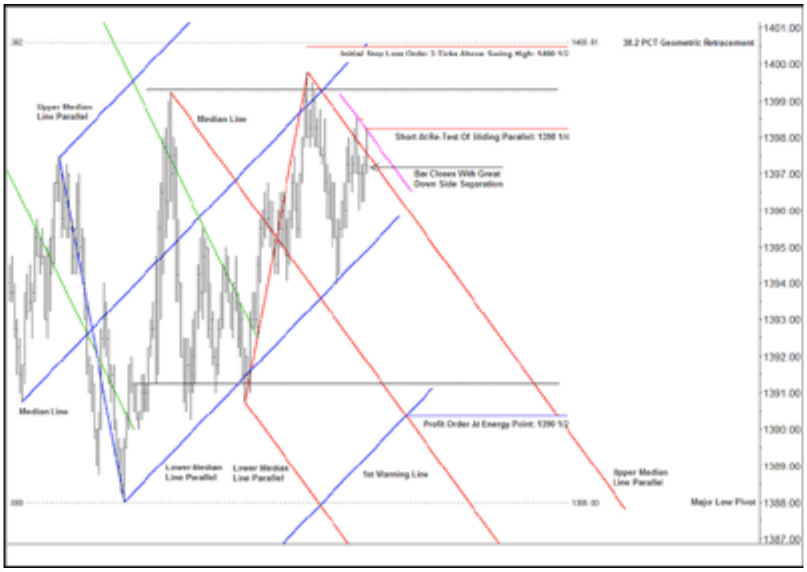
I am going to use this sliding parallel to set up a high probability trade entry with an initial stop loss order I can afford if I also find that the trade set up has an acceptable risk reward ratio.



The close of the last bar gave me a strong sign of weakness and convinced me the sellers were in control of this market. I want to get short now because I think this market is going to trade lower to at least test the bottom of the consolidation if not the energy point itself once it has restored its energy.

I want to sell a retest of the sliding parallel drawn off the spike high at 1398 ½. My initial stop loss order will be above the two recent swing highs price made during its congestion phase, at 1400 ½. If the market allows me to get short, my profit target will be at the energy point where two lines of opposing force meet, one up-sloping and one down-sloping, at 1390 ½.

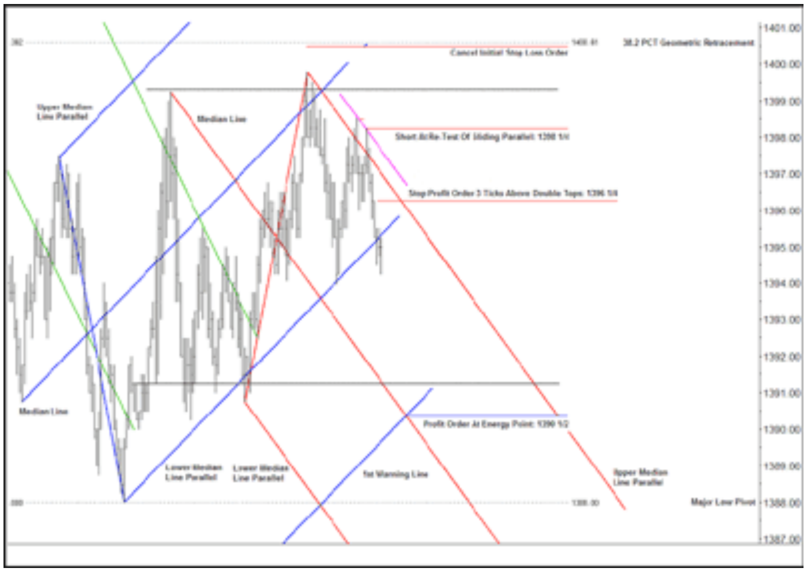
I am risking two e-mini S&P points to potentially make eight e-mini S&P Points. That means my risk reward ratio on this potential trade is four to one.



You can see that price did not immediately retest the down-sloping sliding parallel and after each bar closed, I ran my cursor over the sliding parallel to see where price would intersect with it. Note that I eventually had to lower my limit sell order by one e-mini S&P futures tick to 1398 ¼. Price then climbed back to test the down-sloping sliding parallel, getting me short at 1398 ¼. But price closed near its lows, back below both the sliding parallel and the down-sloping red upper median line parallel. This close again showed me that the sellers were in control of this market.

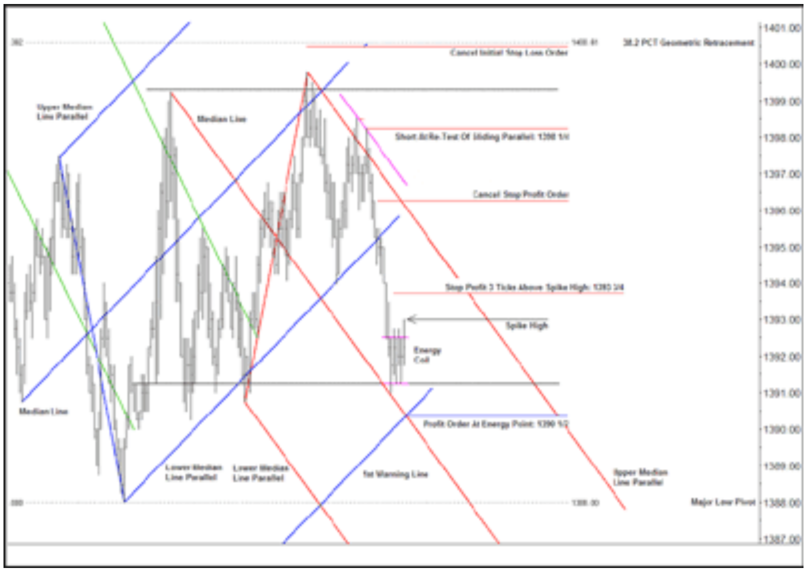
Once my price printed, I checked my electronic platform's audit trail, making sure the exchange said my limit sell order was filled and then I checked my initial stop loss order was in the market and working. Then I entered my profit order, my limit buy order, at 1390 ½.

Price traded lower in a near vertical manner leaving very little price structure for me to hide my buy stops above.



Remember, I want my stop orders to be protected by market structure that will draw in limit sell orders-these are areas where other traders are trying to initiate short positions. I caught the train and want to protect my profits-they missed the train and are looking for an area to get on board. If possible, I'll use their orders as a buffer to hide my stop order above.

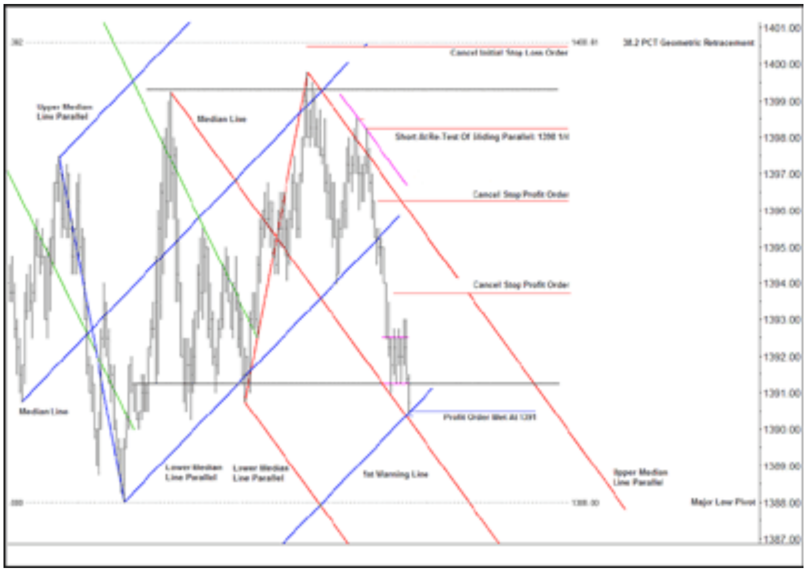
Price finally leaves double tops and then makes a new low. It isn't the prettiest price structure I can imagine, but it's all I have to work with and with more than four e-mini S&P points in profit at the moment, it's time to try to protect some of the potential profits. At minimum, I cannot let this trade turn into a loser, so the least I can do is move my initial stop loss order to a break even order. But with four points in this trade, I chose to cancel my initial stop loss order and replace it with a stop profit order three e-mini S&P ticks above the double tops, at 1396 ?. If this market turns around, I have now boxed in two e-mini S&P points, which is $100 per contract before brokerage.



Price continued lower until it tested the lower end of what I have marked as the energy coil. It stopped there and formed a new very tight energy coil, because it had expended all its down side energy in the near vertical fall. As it consolidates, it restores energy.

When I see the new energy coil form, I know it is time to reassess my risk profile. I note that the last bar on the chart peeked well above the tight energy coil but then closed back within the energy coil, below the lower half of the bar's range. I cancel my stop profit order above the double tops and put a new stop profit order three ticks above the top of this last bar's high, at 1393 ?. If price is able to climb above this tight energy coil and make a new high, I want to take my profits and run. By moving my stop profit order lower, I have now boxed in four ? e-mini S&P Points or $225 before brokerage.

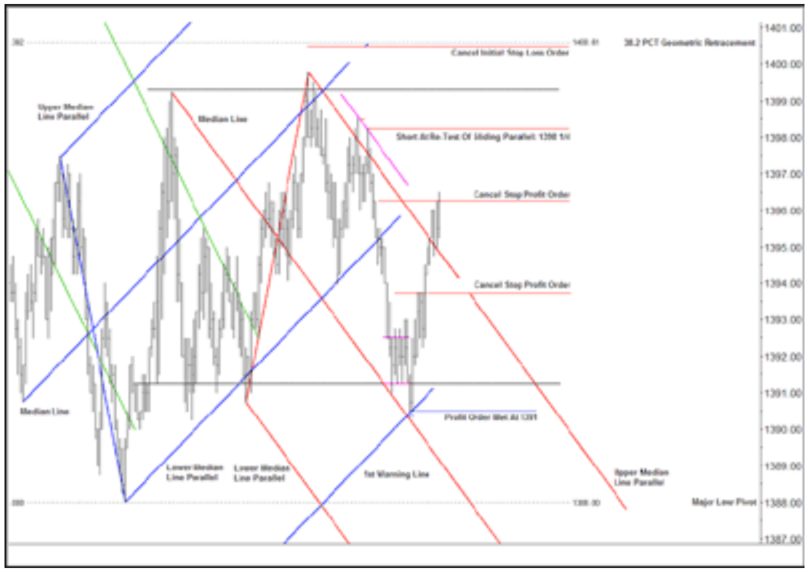
I note that price has now traded past the energy point by several bars and so as it trades lower, it will run into the support of the blue up-sloping first warning line.



Because this is an up-sloping warning line, the support moves higher as time or space moves price to the right. If this support line holds, my profits will quickly erode unless I am out of this trade soon. I measure where price would intersect with the up-sloping blue warning line and change my profit order to 1391.

Two bars later, price tests the blue up-sloping warning line and my profit order is filled. I check that my limit buy order is filled and that I bought and sold an equal number of contracts. Then I check that I am working no further orders and that my electronic platform shows my position as flat.

I got short this market at 1398 - and my profit order was filled at 1391, giving me a profit of seven - e-mini S&P points, which is $362 - per contract before brokerage. Let's see what the e-mini S&P futures did the rest of the day:



As you can see, price retested the blue up-sloping warning line one more time and then price climbed back higher, right back into the middle of the wide trading range. The keys to making a nice profit in this wide range were:

1. Recognizing that though price had been in a strong down trend, its behavior was changing.
2. Waiting for price to show me a sign of strength or weakness. Let the market tell you if the buyers or sellers are in control.
3. Once I saw a sign of weakness, I looked for a high probability trade entry set up that I use on a regular basis-one that is easy for me to recognize.
4. Once the market let me get short, it was essential for me to keep track of my risk and continually search for ways to 'box in' profits, in case price ran out of down side directional energy.
5. When price traded to the right of my original price target-the energy point-I recognized price would find support against an up-sloping warning line and so I aggressively moved my profit target.
6. Finally, attention to detail throughout the entire trade process, from planning the trade to checking orders after the trade was closed, made certain I didn't give away hard earned money on a mistake.

I hope you find this range trading example both interesting and informative. The market is not always in a trending mode, but that doesn't mean there isn't plenty of money to be made if you know what to look for and how to execute your trade plan.

I wish you all good trading.

Best,

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