

CHAPTER 1

Making Order Out of Short-Term Chaos

There are two primary ways we make money trading: catching a big price move with a small position or having a large position and catching a small move.

—Bill Meehan

If what I have written so far has meshed with your speculative goals, it is time to learn how markets operate. Speculation—stock and commodity trading—is not for everybody; it may not be for you. I have even wondered at times if it is for me!

It's striking how little has changed in this chapter. The concepts presented here are the same now as 10 years ago, or 20, or 100. This is the foundation for my trading. My view is that there is definite market structure and a map or way that price moves from one point to another. Once you identify that, it will hold just as true in the pit session markets as it will in the electronic session markets. There is a language to how prices move that is based on an alphabet of each day's opening, high, low, and closing price. It has been my mission to decode these hieroglyphics so we can all "read" the markets better. I am still at that task, like some archeologist hunched over the Sumerian Records, seeking truth.

The curve ball we have been thrown since the first edition of this book is this: Thanks to computers, trading pits have given way to electronic trading. These new electronic markets now open somewhere in the world just a few hours after they closed. The influence of pit trading in open outcry markets has vanished.

HOW I LEARNED ABOUT THE MARKET

My career as a trader began in Portland, Oregon, where I had met a Merrill Lynch broker who thought we could make some money together. He was half right: We got lucky

immediately. He made good money on his commissions and I lost money. Worse yet, the money wasn't mine; a fellow I had never met had asked me to invest it. In hindsight, the initial beating I took was more than fortunate, it was life changing.

That event hardened my desire to learn the business; after all, if it was that easy to lose, it had to be pretty easy to win, right? My broker was as new to the game as I was and really had very little advice or suggestions. His market insight was to buy good stocks and hold on to them (a brilliant insight), but my aptitude or desire was to make money from catching short-term market swings. Thus began my education as a short-term trader.

I had no teacher and knew no other traders, so I naturally turned to books to help solve my problems, just as you have in buying this book. The authors all made it sound so easy. I read Joe Granville's classic work on technical analysis and began keeping track of daily open, high, low, and closing prices on stocks as well as other indicators that Joe said we should follow. Joe, a true legend, is still worth reading. Before I knew it, I was not only totally consumed by the markets but spending five to six hours a night and all my weekends trying to beat Wall Street, in the meantime gaining a fortune and beginning to lose a marriage.

My first wife, Alice Fetridge, had become a "chartist's widow" yet still supported my habit. We eventually left Portland and moved to Monterey, California. We both had jobs, and I was also working on my law degree. I even sat for and passed the "Baby Bar Exam" (the test given to night school and correspondence students). By then, however, I had pretty much given up on becoming a lawyer, especially after working for one. I had thought being a lawyer meant being in court, saving people's lives; the reality was that it mainly meant collecting money from judgments, finding deadbeats, and representing bums and outright criminals. It was not like trading.

Fortunately in Monterey, I met two brokers who, like me, kept charts. Joe Miller and Don Southard were soon swapping war stories with me, teaching what they knew about the markets. We were all big followers of Joseph Granville's on-balance volume (OBV) work and kept OBV charts on the 30 to 50 stocks we followed. I also started to keep moving averages, another tool espoused in all the books back then, just as they are today.

My stock trading met with some success, but what accelerated my career was a book by Gil Haller, unabashedly called *The Haller Theory of Stock Market Trends* (Gilbert Haller, 1965). I learned a lot about stocks and speculation from the book, then got to know Gil and to this day appreciate the support and encouragement he provided. Gil's concept—we are talking 1963—was to buy stocks that had already moved up a lot. This is now a methodology used by the funds to buy what they call "momentum stocks." Haller was doing it way back in 1964 and making a living. But, he didn't live the way I wanted to! His desk was an old door atop cinder blocks, stationery was the back of a letter someone had written to him. Gil was not cheap, just a frugal spender who precisely counted and saved every extra penny.

Eventually, I began to envision a theory of how markets work: In the short term, markets spurt in rallies and declines, moving above and below a balance point I could call the "average" price. My object was to determine when price was low and should move back to the average. That meant I needed to identify an overextension of price and

then have something that would tell me when this move was over and the spring back to the average had begun. Because it all seemed so easy, I was sure there must be some master theory or code to how all this was done. There must be some basic undeniable way the market—all markets—moved from point A to point B, I reasoned.

What I eventually found out is that this original thesis is true: There is a way markets move. The good news is that there is a structure in how prices move from point A to point B. The bad news is that the structure is imprecise. Nevertheless, there is a semblance of order to price action, and, like a foreign language, it can be learned. It has taken most of my life to figure out the basics of this language that the market speaks, and I am more than happy to help you learn to use my magic decoding ring.

CHARTING THE MARKET

If you have begun your study of the markets, you already know it is a visual world, where charts prevail. As shown in Figure 1.1, the common charts represent each day's opening price with a horizontal slash mark to the left side of each bar and the closing price with a horizontal slash on the right side of the bar. The topmost point of the bar reflects the highest price reached by the stock or commodity during the day while the bottom of the bar represents just the opposite, the lowest price the commodity traded at on that day.

The opening price, as you will see later on, is the most important price of the day. I developed this notion with Joe Miller, Don Southard, and Curt Hooper, a naval postgraduate student who—in 1966—was the first person I ever worked with while

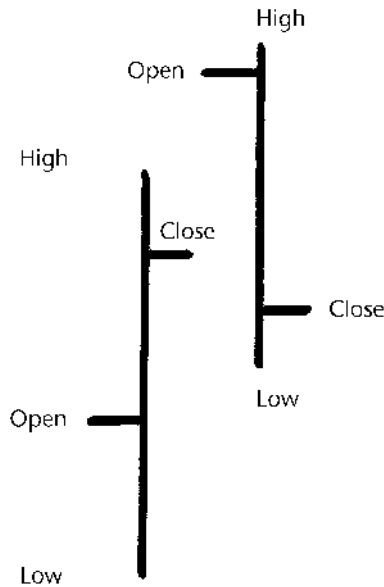


FIGURE 1.1 Typical Chart Showing Openings, Closings, Highs, and Lows

using a computer to arrive at answers. While we were impressed with OBV, we wanted a more reliable formula, and once we learned that the original OBV work came from two guys from San Francisco, Woods and Vignolia, we thought that we, too, could create a better approach.

Our chart-reading problem begins and leads to chaos when we start combining these daily bars of price action on a chart. These graphic representations of price action were “read” for years by folks calling themselves “chartists.” By and large, chartists were about as welcome as your unemployed brother-in-law until the early 1980s.

This crowd gleaned over chart formations, found patterns, and gave them names like wedges, head and shoulders, pennants, flags, triangles, W bottoms and M tops, and 1-2-3 formations. These patterns were supposed to represent the battle of supply and demand. Some patterns indicated selling, others professional accumulation. Fascinating stuff, but wrong-headed. These same precise patterns can be found in charts of things that do not have a supply/demand factor.

Figure 1.2 shows a chart of the 150 flips of an old silver dollar that graphs out to look much like a chart of Pork Bellies. Next, Figure 1.3 is a chart or graph of temperature extremes, or is it Soybeans? Who knows? What we do know is that plotted data of nonmarket or economically driven information charts out just like data for stocks and commodities, producing the same patterns that are supposed to reflect buyers and sellers. I caution you against confusing chart forms with intelligence.

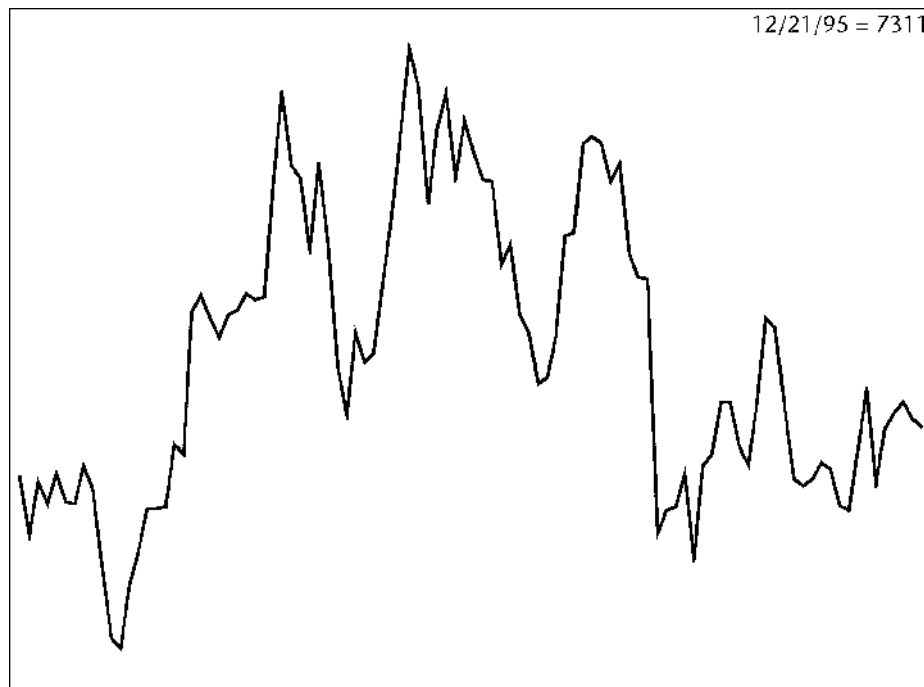


FIGURE 1.2 A Flip of the Coin Heads and Tails on Accumulative Basis

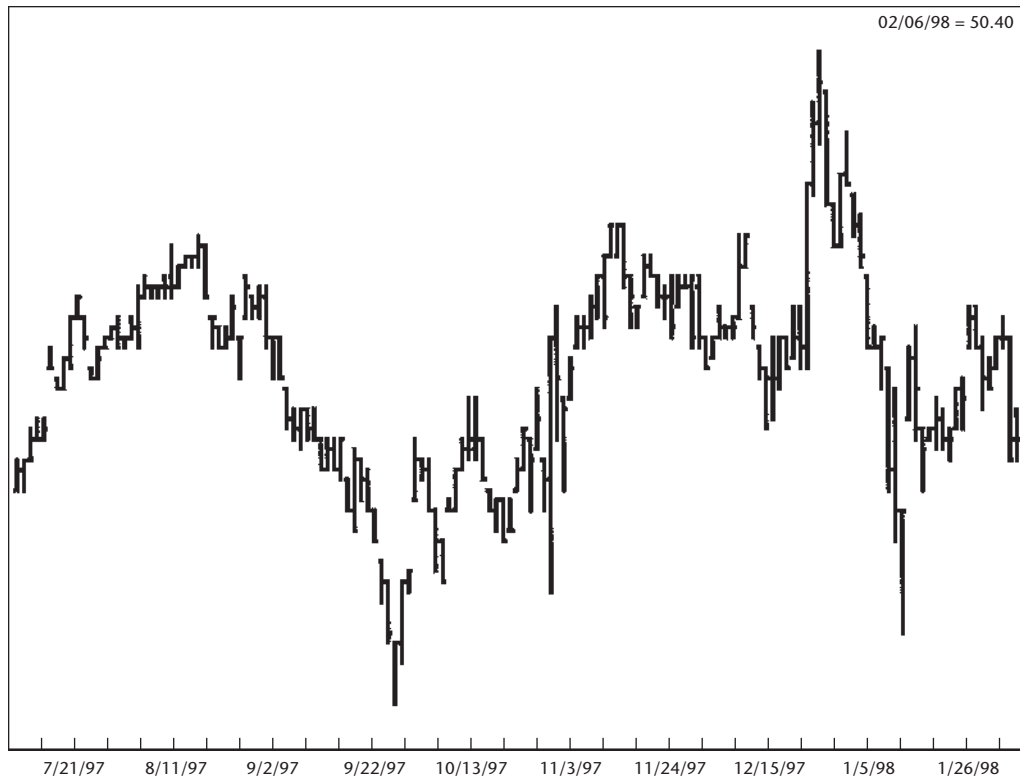


FIGURE 1.3 A Stock? No, Daily Temperature; High for the Day; Low for the Day; Last Reading

Chartists became “technical analysts,” severing their ties from Ouija boards and charts in favor of computers. Computers made chartists look and sound more respectable, like scientists. In fact, many books came out with titles like *The New Science of . . . or Scientific Approaches to . . .* Is there science to this madness?

By and large, I think not.

Prices do not dance to the beat of some mystical, magical drum that hides deep in the recesses of a plush room in New York City, and has a rhythm only a few insiders recognize. Prices jump all over the place, and our charts become erratic because human emotions are influenced by news and brokers’ hot tips of immediate boom or gloom.

THE NONRANDOM MARKET

For the most part, commodity prices are like a drunken sailor, wandering down the street without any knowledge of where he is going, or where he has been. Mathematicians would say there is *no correlation* between past price activity and future trends.

TABLE 1.1 Commodities: Closing Price Compared to Opening Price

Commodity	Percentage of Times That Close > Open
Bellies	51
Cotton	53
Beans	51
Wheat	52
British Pound	56
Gold	52
Nekii	55
Eurodollar	57
U.S. Bonds	52
Standard & Poor's 500	53
Average % Higher	53.2

My trading friend Vic Niederhoffer has written extensively about this to his beloved “Spec-List” followers as well as in his magnum opus, *The Education of a Speculator* (John Wiley & Sons, 1997). I suspect we differ on how prices meander around the charts, but I will suggest there is *some correlation*. Why? Because, although that drunken sailor does swagger, stagger, and seemingly move in a random fashion, there is method to his madness. He is trying to go someplace, and we can usually find out where. We must understand his madness to know where he is headed.

While price action involves a large degree of randomness, it is far from a totally random game. If I cannot prove that point, right now, early on in this book, the remaining chapters should be devoted to learning how to throw darts. In a random game, the dart thrower will outperform the experts.

Start with a given—if we flip a coin 100 times, it will come up heads 50 times and tails 50 times. Each time it comes up heads, on the next flip we will have 50 percent heads and 50 percent tails. If heads has now appeared two times in a row and we flip again, the results continue to be 50/50 that a head will appear on the next flip. As you have probably heard, the coin, die, or roulette wheel has no memory. The odds are fixed, as this is a random game.

If that were true of the market and prices close higher 50 percent of the time, then after each up close we would expect to see another up close 50 percent of the time, and following that up close again 50 percent odds of another up close. The same thing should apply to a down close: 50 percent of the time following one down close, we should see a repeat; and again 50 percent of the time following two in a row, a third down close should appear. In our real world of trading, it does not turn out that way, which can only mean *price action is not totally random!*

Table 1.1 shows the percentage of time that prices closed higher in a wide variety of markets. There were no criteria; the computer just bought on the open each day and exited on the close. Instead of having a 50/50 result we have a slight skewing, in that 53.2 percent of the time price closed higher than the opening. This shouldn't be.

Well, if this “shouldn't be,” how about buying on the opening following a down close? In theory, we should see the same percent of up closes shown in Table 1.1. The problem is

TABLE 1.2 Commodities: Percentage of Times Higher Closing Prices Follow One-Down Closes and Two-Down Closes

Commodity	Number of Times after One-Down Close	% Up Next Day	Number of Times after Two-Down Closes	% Up Next Day
Bellies	3,411	55	1,676	55
Cotton	1,414	53	666	55
Beans	3,619	56	1,612	56
Wheat	3,643	53	1,797	55
British Pound	2,672	57	1,254	56
Gold	2,903	58	1,315	55
Nekii	920	56	424	60
Eurodollar	1,598	59	708	56
Bonds	961	54	446	52
Standard & Poor's 500	1,829	55	785	53
Average + Close		55.8		55.2

(for college professors and other academics who are long on theory and short on market knowledge) that it does not turn out this way. Table 1.2 shows the number of times price closed higher following a number of down closes.

This is not earth-shaking news to a trader; we know market declines setup rallies. The exact percentages were not known in the past, and I would never use these tables to take or stay in a trade. That is not the point: The point is we should have seen an average up close of 53.2 percent following the one minus close as well as two consecutive minus closes. The fact we did not suggests that the market is not random; patterns do “predict” and now we can proceed, sans darts.

Here is an update on the Dax index from 1998 to mid 2011: If you buy after every down close, and exit on the same day's close, there are 1,591 trades with 52 percent winners but a staggering loss: $-\$60,558$. Allow for two consecutive down closes and we find 724 trades with 52.2 percent winners and we also see losses, but a lot less: $-\$1,568$.

If you have the patience to wait for three down closes in a row you are rewarded with 334 trades, and 55 percent made substantial money: $+\$25,295$. Want to do better than that? Some days of the week the Dax is more prone to rally than others, so let's buy only on Tuesdays, Thursdays, and Fridays when there have been three down days in a row. The results are far better: 204 trades, 58 percent accuracy, and a net profit of $\$44,795$.

What you see is that years later and in a different market, not active when this book was first written, the same principles are still afoot in price action.

UNDERSTANDING MARKET STRUCTURE

Whereas chartists have strange names for almost every market wiggle and waggle, they have seemingly missed the major point of the market, which is that price (as represented

by daily bars, where the top of the bar is the highest point prices traded on that day and the bottom of the bar the lowest price traded) move in a well-defined and amazingly mechanical fashion. It is similar to learning to read a new alphabet—once you understand the characters, you can read the words, and once you know the words you can read the story.

The first letter to master tells you what market activity causes the formation of a short-term high or low. If you learn this basic point, the meaning of all market structure will begin to fall into place.

I can define a short-term market low with this simple formula: Any time there is a daily low with higher lows on both sides of it, that low will be a short-term low. We know this because a study of market action will show that prices descended in the low day, then failed to make a new low, and thus turned up, marking that ultimate low as a short-term point.

A short-term market high is just the opposite. Here we will see a high with lower highs on both sides of it. What this says is that prices rallied up to the zenith of that middle day, then began to move back down, and in the process formed a short-term high.

I initially called these short-term changes “ringed” highs and lows in deference to the work done in the 1930s by Henry Wheeler Chase. In the days before computers, we kept

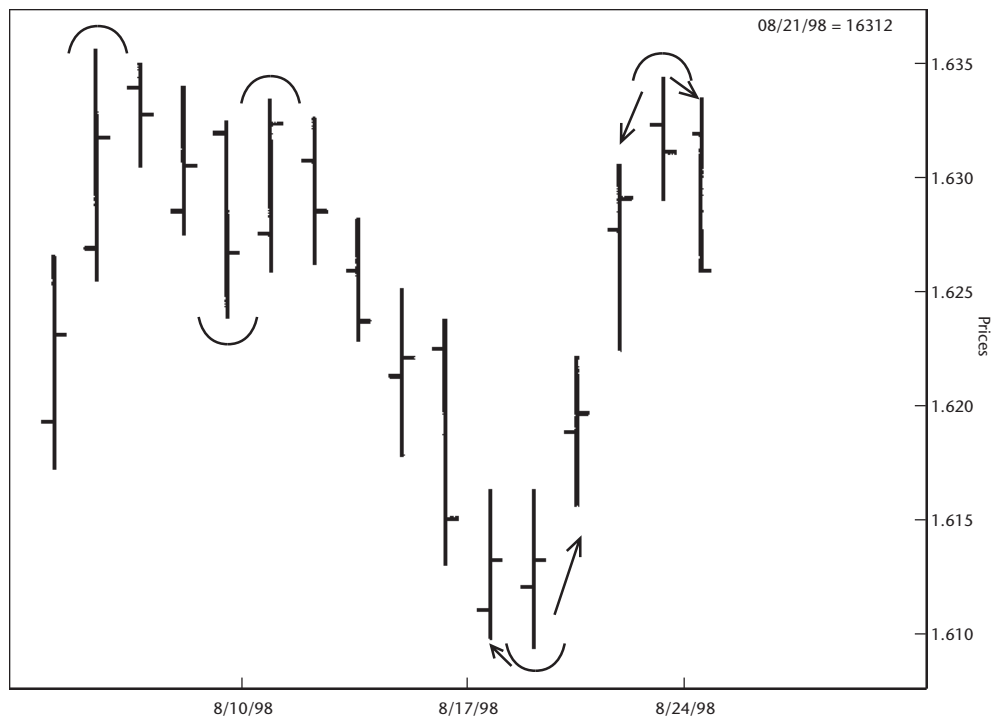


FIGURE 1.4 British Pound (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)

notebooks of prices, and to identify such termination of a move, we simply circled or “ringed” these points in our workbooks so we could see them more easily.

Figure 1.4 shows several short-term highs and lows. Take a minute now to see what this pattern is all about.

If you understand this concept, we can begin the building process of putting these elements together. You may have already figured out the sequence; the market swings from short-term highs to short-term lows. This is exciting; we can actually measure market movement in a mechanical and automatic way. There is no need for complex chartist talk, nor will we be as inclined to fall into the illusory world of the chartist or technician.

Two specific types of trading days can cause confusion with our basic definition. First, there is what we call an inside day. It is so named because all the trading on this day took place inside the previous day’s range. These days are identified by having a lower daily high and a higher daily low. In a study of nine major commodities covering 50,692 trading sessions, I noted 3,892 inside days, suggesting that we will see these days appear about 7.6 percent of the time.

For our purposes in identifying short-term swing points, we will simply ignore inside days and the possible short-term points they produce. An inside day means the market has entered congestion, the current swing did not go further, but then again it did not reverse, thus until this condition is resolved, we must wait and not use the inside day in our identification process.

Next we have outside days. These days are easy to spot because they have both a higher high than the prior day and a lower low! When these days occur (and they do so about 3 percent of the time), we will have to study the flow of prices during that day by looking at the way price moved from the opening of the day to the close of that same day. In that study of 50,692 trading sessions cited earlier, there were 3,487 outside days, suggesting they are not as frequent as inside days, yet account for almost 7 percent of all days.

With the preceding information in mind, turn your attention to Figure 1.5, which illustrates these inside and outside days. Remember, we are attempting to identify the short-term swings as traders move price from one terminus to another.

By now you should understand the basic concept, and be able to see how prices move in swings. In Figure 1.6 I have marked off these terminal points and connected a straight line from point to point to show the swing patterns.

Defining Intermediate Highs and Lows

Now the fun begins! Consider this, if we can identify a short-term high as any day with lower highs (not counting inside days) on both sides, we can take a gigantic step forward and identify an intermediate-term high as *any short-term high with lower short-term highs on both sides* of it. Hold on to your seat belts because we can take yet another step and say any *intermediate-term high with lower intermediate-term highs on both sides* is—you’ve got it—a *long-term high*.

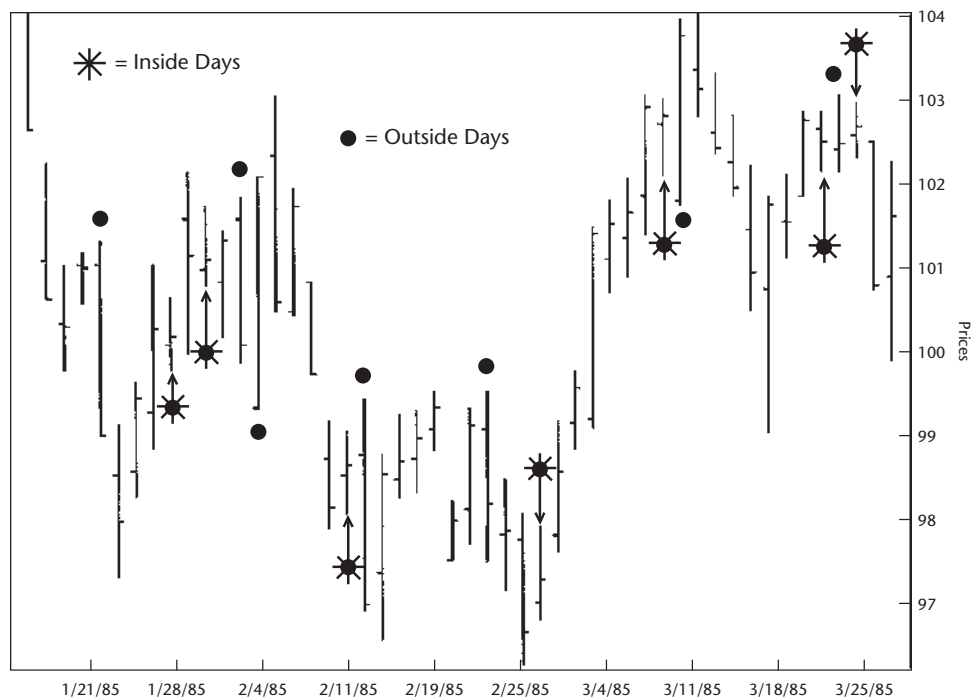


FIGURE 1.5 Pork Bellies (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)

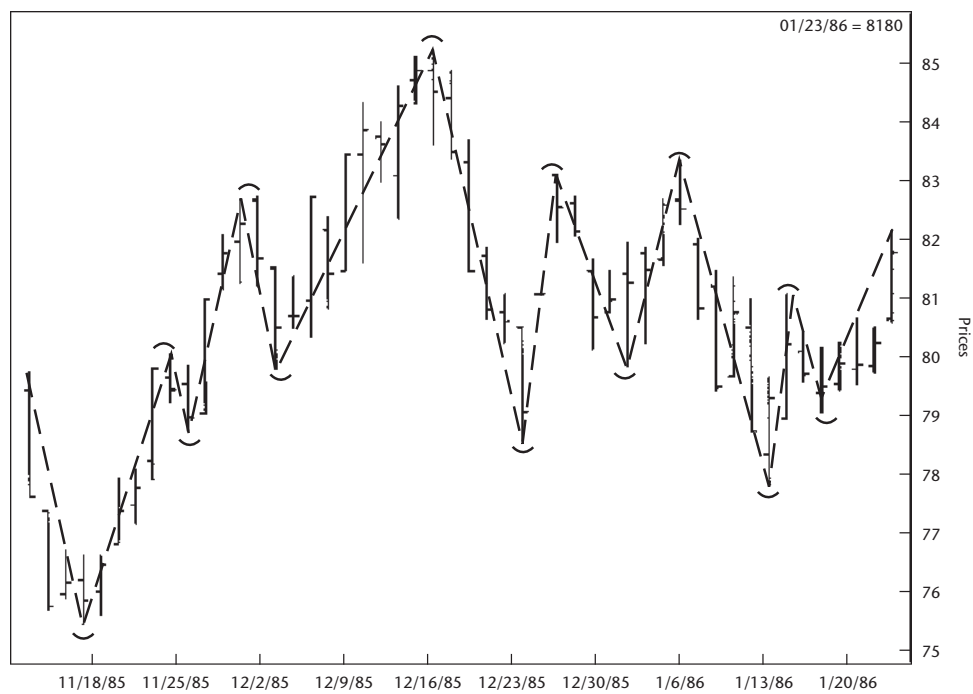


FIGURE 1.6 Pork Bellies (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)

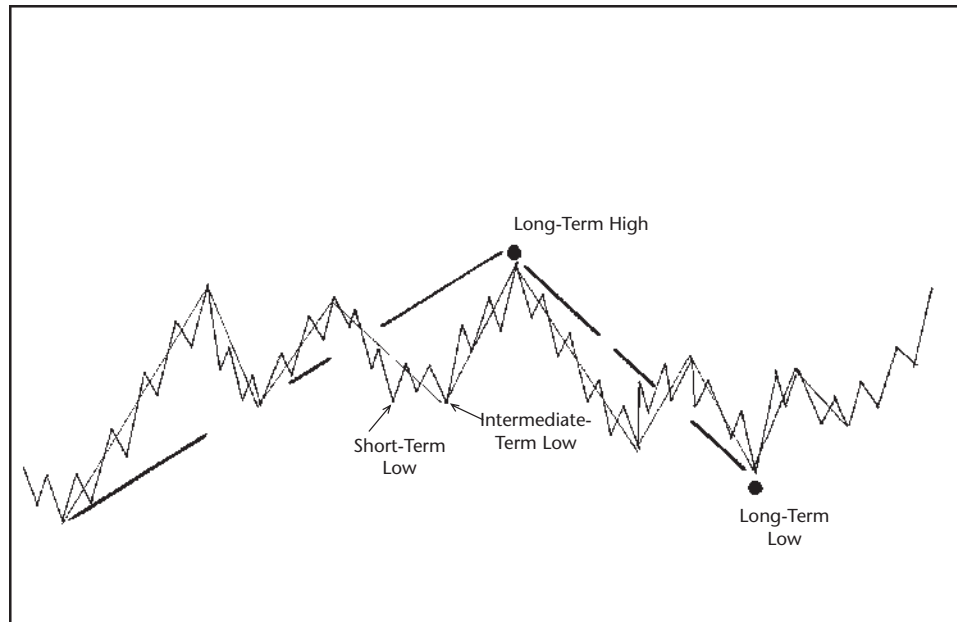


FIGURE 1.7 Charting Creates Order Out of Chaos

In just one paragraph, we have been able to define the three dominant swings in a market, going from short-term to intermediate to long. The identification of market lows is done in just the same fashion: First find a day with higher lows on both sides—this is a short-term low. Then find a short-term low with higher short-term lows on both sides and you have found an intermediate-term low. Locating a long-term low is simple: It is any intermediate-term low with higher intermediate-term lows on both sides.

It is time for a picture of what this all looks like. In Figure 1.7, I have marked off all short-term swings, then located the intermediate-term points, and finally gone to the next level and marked off the longer-term points. This chart tells all; it is really all there in a simple format. If you look at it now, you will understand market structure and will see that we can create order out of much of the chaos.

With the preceding in mind, I have moved from a sample chart to a real one of the Swiss Franc and Coffee (see Figures 1.8 and 1.9). My first step was to circle or ring all short-term swings; then I began the overlaying pattern of higher/lower short-term points. After that, I identified the next layer of higher/lower intermediate-term points to arrive at the long-term points. While words are great, until you study these charts, it will be difficult for you to get the picture. Go study.

Why This Is Important

Once you have this basic understanding of market structure you can identify, very early on, these market turns. You will always know that a short-term low has been made when

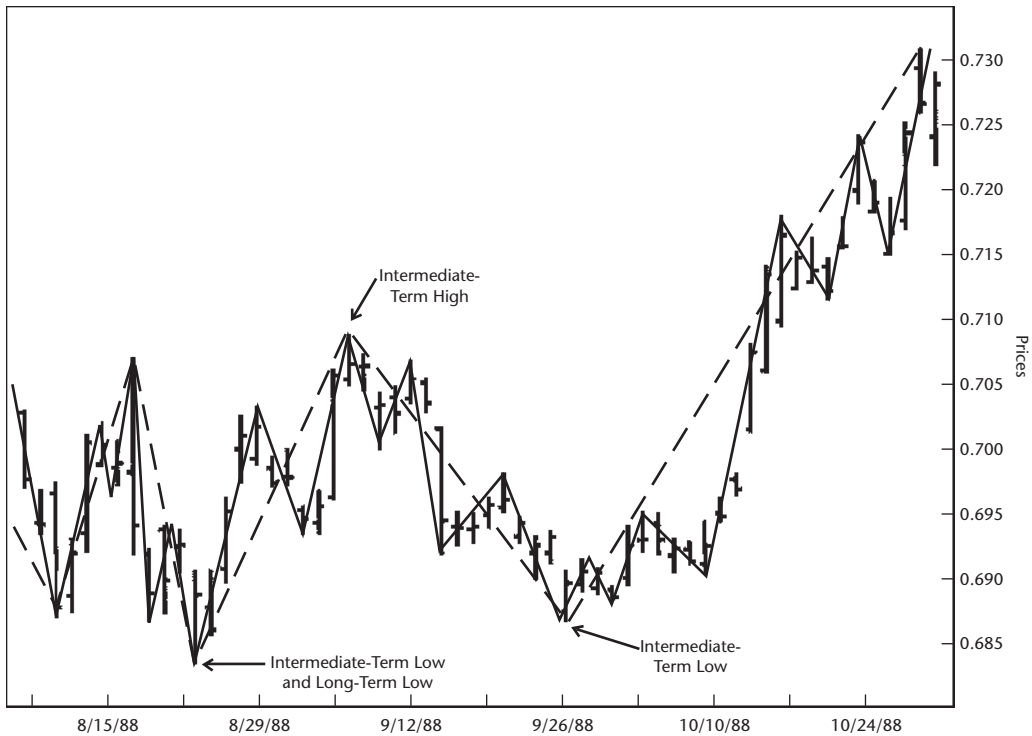


FIGURE 1.8 Swiss Franc (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)

you rally above the high of a day with a lower low than the prior day. By the very nature of this penetration, we know the short-term down swing has terminated. By the same token, whenever price declines below the low of a day with a higher high than the prior day, a short-term high has been formed. This means we can know, during the trading session, when these points are established.

As short-term traders, we also can tell when intermediate-term highs and lows are made. How? Simple, if the formation of a short-term high will confirm an intermediate-term high, which in turn confirms a long-term high, we can get in at some optimal turning points.

Figure 1.10 shows how this can all be combined. By going above the high of the day marked at (A), we have formed a short-term low that is in turn higher than the prior short-term low. This means the low at (B) is a long-term low and we can be buying at the start of an up-leg in what is a type of long-term move.

It is really all about nesting swings together, fitting the pieces of the puzzle into their proper place, to give us an understanding of the structure of market activity. The beauty is you can now identify, at all times and for all markets, whether the trend (based on price structure) is up or down and pick your points to get in and out.

For years, I made a pretty good living using just the formation of these points as buy and sell entries. These points are the only valid support and resistance levels I have



FIGURE 1.9 Coffee (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)

ever found. They are highly significant and the violation of these price points provides important information of trend and trend change. Thus I can use them for my stop-loss protection and entry techniques.

MARKET STRUCTURE WILL NEVER CHANGE

Since the market staggers from one point to another, we can identify these swings. That is a powerful statement as identification leads to being able to quantify and define, on a mechanical basis, all market movement. These swings allow us to then determine (1) the trend of the market and (2) when trend has changed. The beauty of market structure is that it clearly delineates price action for us.

This is how it works: Markets move in cycles, swings, sprints if you will, from one point to another. I will teach you how we can identify virtually all of the swing points and then, once that has been done, identify when these swing points set up buy and sell signals. With that in mind let's start at the beginning . . . with the initial understanding of market swings.



FIGURE 1.10 Pork Bellies (Daily Bars). Graphed by the Navigator (Genesis Financial Data Services)

We can identify virtually all short-term market highs and lows with one very simple rule:

A market has made a short-term low when we have a day (or bar if you are using different time periods) that has a higher low on both sides. By the same token a short-term high will be a day (or bar) that has lower bars on both sides of it.

Sounds simple doesn't it? There is a wealth of information and market understanding in these swing points. I want to make certain you understand this concept before we proceed further. Figure 1.11 shows an example of swing points marked off, so you understand how they can be identified on a chart. (I am using charts here from the Australian markets; it does not matter what country or what time frame . . . market structure is always at work.)

This is where it all begins. It is critical you understand that prices run in swings or streaks. We can say a "run" to the upside is over when price fails to move higher the next day *and* falls below the prior day's low. Price action alone will unfold to reveal the swings of price movement.

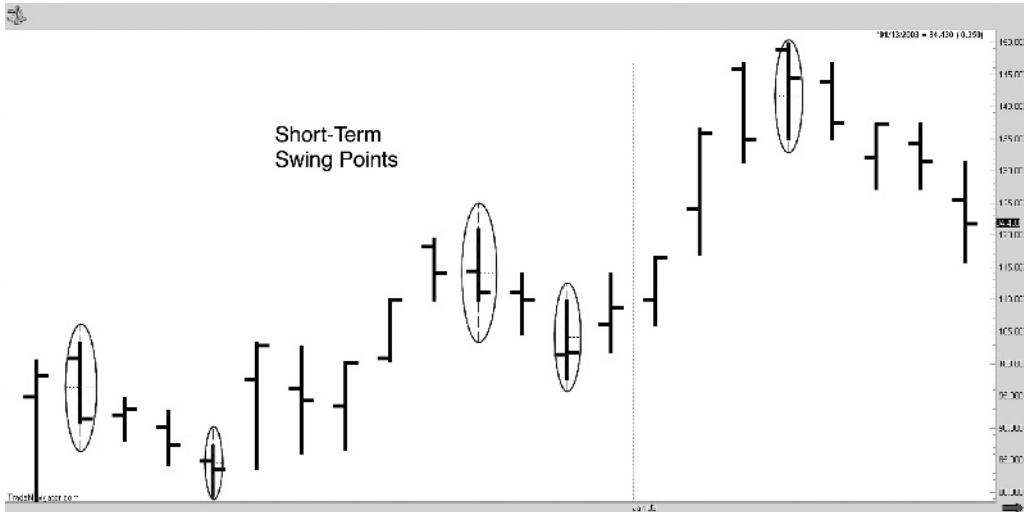


FIGURE 1.11 Rio Tinto: Short-Term Swing Points

Once we have that understanding we can then start to lay in the blocks of market structure by simply connecting these swings, as shown in Figure 1.12.

It's critical to understand the formation of these short-term highs and lows, so we can know precisely when the short-term high or low becomes locked into place.

In the case of a short-term high, we know that a day is a short-term high the instant the low of that day has been violated by price falling below that low. It is not just the fact

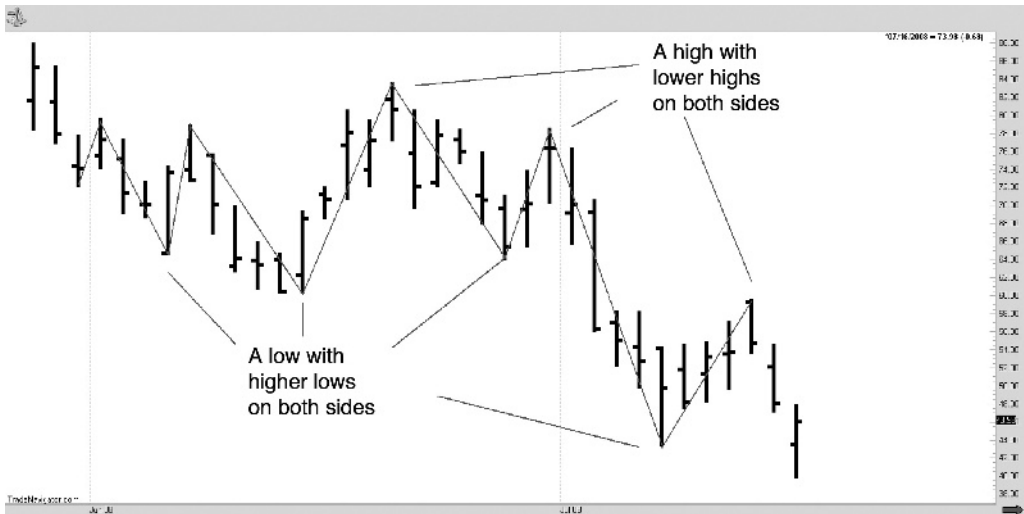


FIGURE 1.12 BHP: Short-Term Swing Points

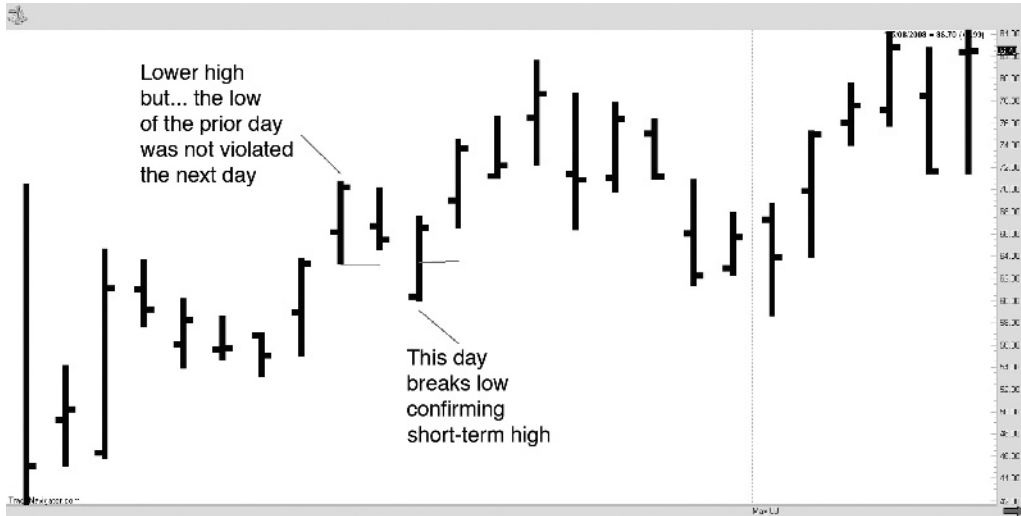


FIGURE 1.13 BHP: How Short-Term Highs and Lows Form

that we have a lower high, but that also that the low of the high day has been penetrated. Figure 1.13 illustrates this: As they say, a picture is worth a thousand words.

In the case of a short-term low (Figure 1.14), we know that a day is a short-term low the instant the high of that day has been violated by price to the upside. It is not just the fact that we have a higher low, but that also the high of the low day has been penetrated.

We can wrap all of this up by putting it this way: When a market has been in a downtrend and a day exceeds the lowest day’s high, then the short-term downtrend has ended.

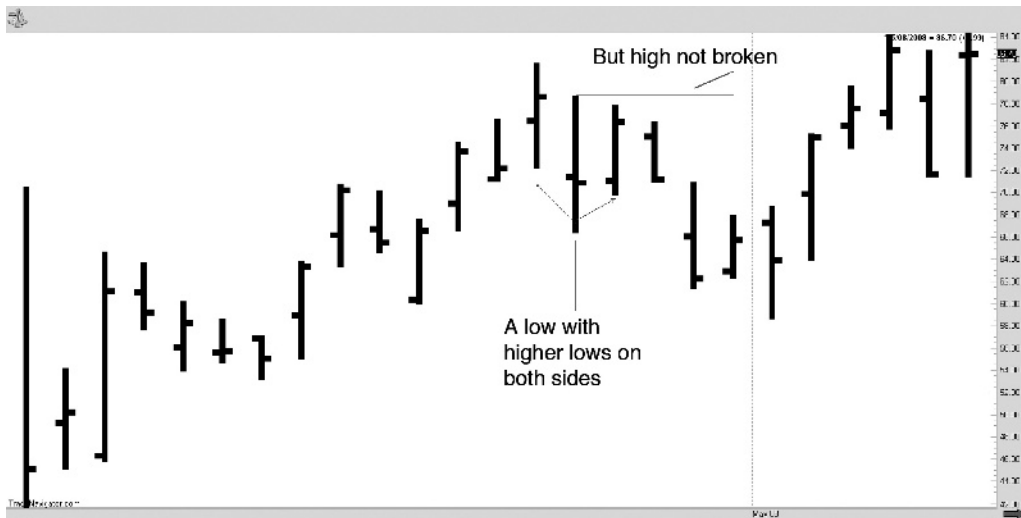


FIGURE 1.14 BHP: Noted Bar’s High Not Penetrated—Not a Short-Term Low

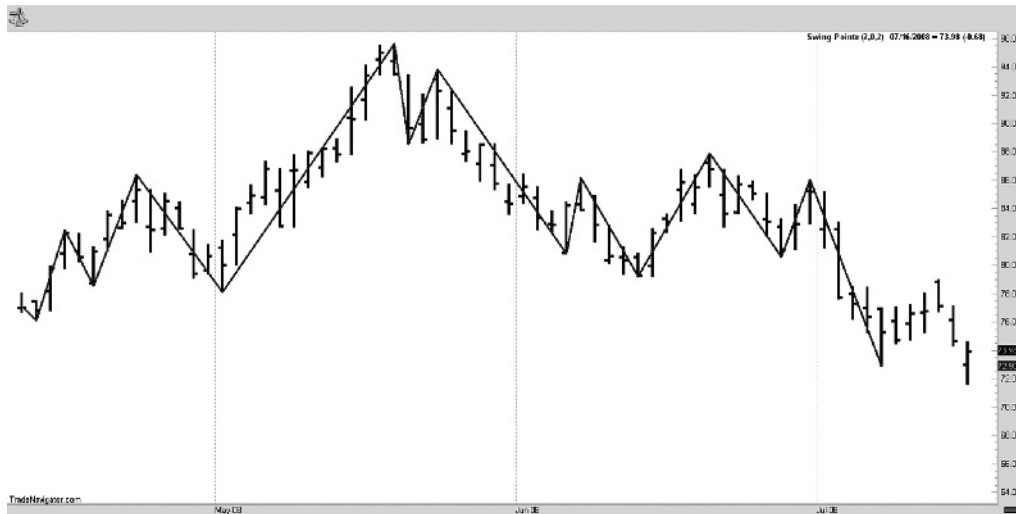


FIGURE 1.15 Connecting Short-Term Highs and Lows

The end of a short-term uptrend will be known when the low of the highest point seen in the rally is violated to the downside.

Figure 1.15 is here to help reaffirm the information above. You have learned how to correctly spot all short-term swings in the marketplace, but is there more here than what you are seeing? Yes, indeed there is, because if we know that a short-term high is a day with lower highs on both sides, then we can also state this:

- A short-term high with lower short-term highs on both sides is an intermediate-term high.
- By the same token, a short-term low with higher short-term lows on both sides is an intermediate-term low.

Now with that simple definition in mind, let's look at the same chart, where I have now marked off the intermediate-term points. See Figure 1.16. What we have been able to do is quite amazing. Without using a calculator, computer, or a mathematical formula, we have been able to define short- and intermediate-term trends of the market. As I understand this, market structure allows us literally to determine *the real trend of any market*. Up to July 2008, a trader would probably say the market was sideways or trendless. Market structure, though, was clearly showing we had formed an intermediate-term high in the middle of June, which was lower than the prior intermediate-term high! This was telling us the stock was in a downtrend and could be sold short.

Before we get into our exact entry point, I want take this one step further. If a short-term high can be used to identify an intermediate-term high, doesn't it then make sense to take it to the next level, which is that intermediate-term highs and lows can be used to find long-term highs and lows?

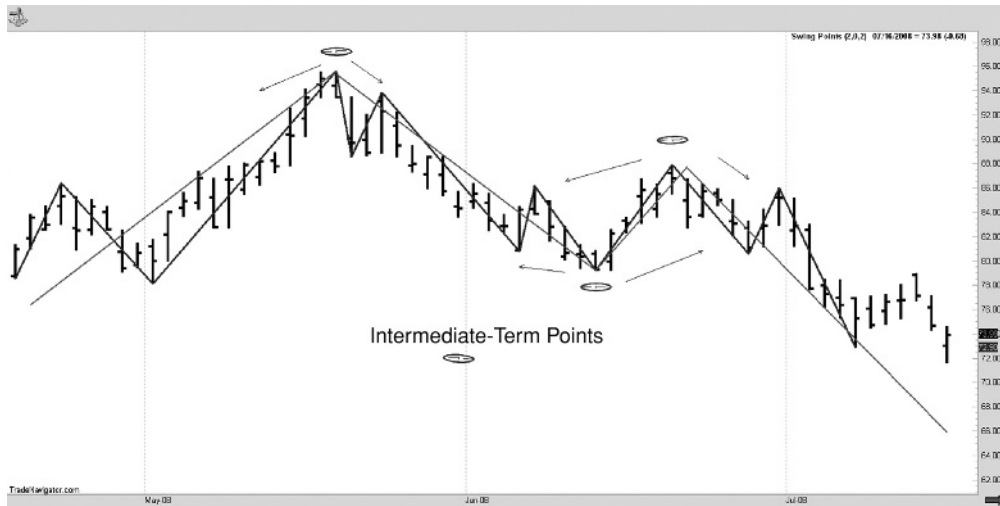


FIGURE 1.16 BHP Intermediate-Term Points

- An intermediate-term high with lower intermediate-term highs on both sides of it is just naturally a long-term high by our definition, thanks to understanding market structure.
- An intermediate-term low with higher intermediate-term lows on both sides of it is just naturally a long-term low by our definition, thanks to understanding market structure.

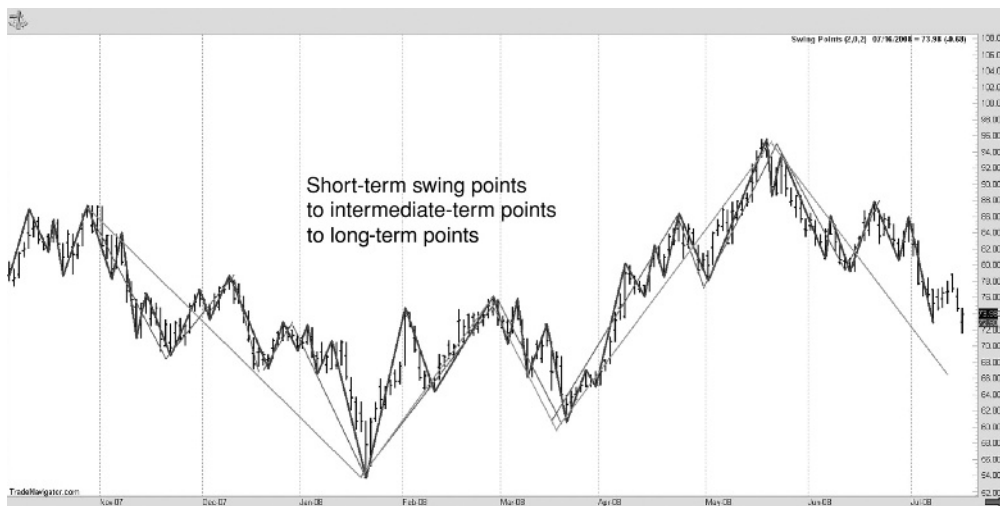


FIGURE 1.17 BHP: Short-, Intermediate-, and Long-Term Swings

Look at what we have done in Figure 1.17. We have been able to identify all the short-term swings in the market, which gives further evidence to enable us to determine the intermediate swings, which then are used to identify long-term swing points!

There are many things you can do with these individual points, but I would like to make this as simple as possible by driving home the basics of the concept. The most profitable trades, and certainly the easiest ones to locate, are going to be based on the intermediate-term trend of the market. These offer more profit opportunity. However, they don't occur every day, which is frustrating to people who want to trade 10 times a day or 10 times a week. It's been my experience that is not how you make serious money in this business. The money comes from loading the dice in your favor and seldom rolling them. The more times you trade, the more opportunities you have to stuff up your speculative activities. In other words, the more decisions you have to make, the more open you are to making the wrong ones.

SHORT-SELL PATTERN

Now, let's start with what the ideal short-sell pattern would look like. What you will be looking for is an intermediate-term high that is lower than the prior intermediate-term high. This pattern clearly tells us the trend of the market is down. The formation of the lower intermediate-term high should carry the momentum on the longer-term time frame illustrated for us by market structure.

The conceptual pattern for the best buying opportunity occurs when we are forming an intermediate-term low higher than the last intermediate-term low, telling us the intermediate-term trend is up. It is a question of swings: Which is the larger current swing in the market? Find it and you know the current trend of that time period. With just these two patterns you have the optimal approach to trading, as you are indeed trading with the power of the intermediate-term trend.

Now let's take a look at what a buy signal looks like, so you can see what I am talking about. In Figure 1.18, you are looking at price bars reflecting the open of trading, the highest and lowest prices reached during the day and then the final settlement price: the close. (Keep in mind these could be five-minute, daily, monthly, or weekly bars: The same rules apply to each.)

Understanding market structure revealed a dynamic move to the upside in BHP. This was known. We had a higher short-term low, higher than the prior one, confirming the intermediate-term low. That in turn told us the trend of the market was up, and purchases could be made. The entry point, and it is a precise one, comes at the high of the day that has a higher high on the right side of it. In this case it came on April 1 at 66.80.

Notice these signals do not come every day. A trader will need a great deal of patience to work this particular price formation. But as you can see, it is well worth waiting. Also this allows one to follow several stocks and commodities, taking the best possible trades as shown by the formation of intermediate-term highs and lows.

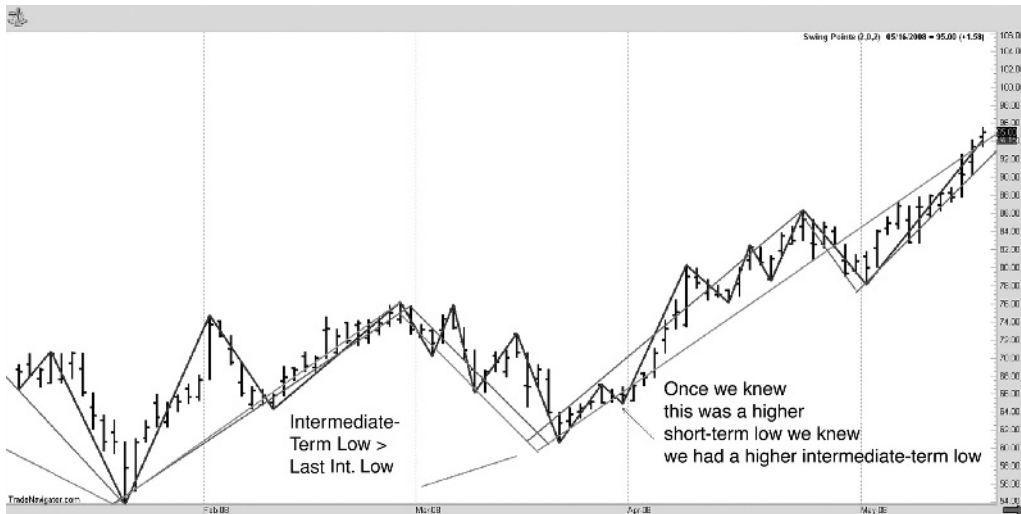


FIGURE 1.18 BHP: Market Structure Reveals Upside Move

Okay, we are in the trade on the long side. The next questions are: How do we get out? Can we develop a target for this trade? What should our trailing stop be?

TARGET TIME AND TRAILING STOPS

Markets don't always go to targets, which is why it is critical you also learn to have a trailing stop.

Price targets can be determined in several ways. Many people think Fibonacci ratios and such have value and work for targets. I don't. I have done several thorough research projects on this and could not demonstrate that they work. Nor have I seen any other real research to back up any significant Fibonacci levels. But to each his own. As they say, this is just one man's opinion.

What I have found is that markets do have a strong tendency to rally above the last intermediate-term high by the same amount it moved from the intermediate-term high to the lowest point prior to advancing to new highs.

In other words, if we have an intermediate-term high, you take the distance from the high to the intermediate-term low, then add that value to the intermediate-term high. That gives us our target or upside potential.

I just use my "Target Shooter" (from the Genesis software). Applied now to the same chart we were just looking at (Figure 1.19), we see where our target would have been.

All that's left for us is to have some form of protective stop in the event the trade doesn't work if we don't exceed the prior intermediate-term high. Trading is like boxing, "Come out fighting and protect yourself at all times." Stops and trailing stops are our protection, for a battle where there is no referee.

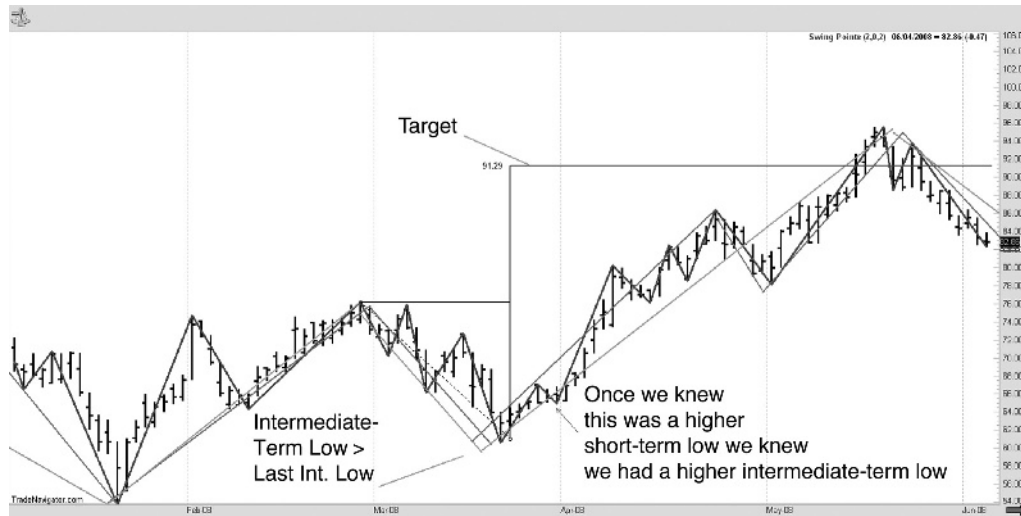


FIGURE 1.19 BHP Intermediate-Term Target Diagram

We can also use market structure for our trailing stop, as shown in Figure 1.20. The higher “ringed,” or short-term, lows are our stop loss point for this trade.

Another idea or approach using market structure would be the formation of the next intermediate-term high (after our entry) as our exit prior to reaching the target, that is, our trailing stop.

Trading is an imperfect world and that’s where art meets science—determining which point you want to use—how bullish or bearish you think the market is will determine how long you want to hold your position. There are four possibilities:

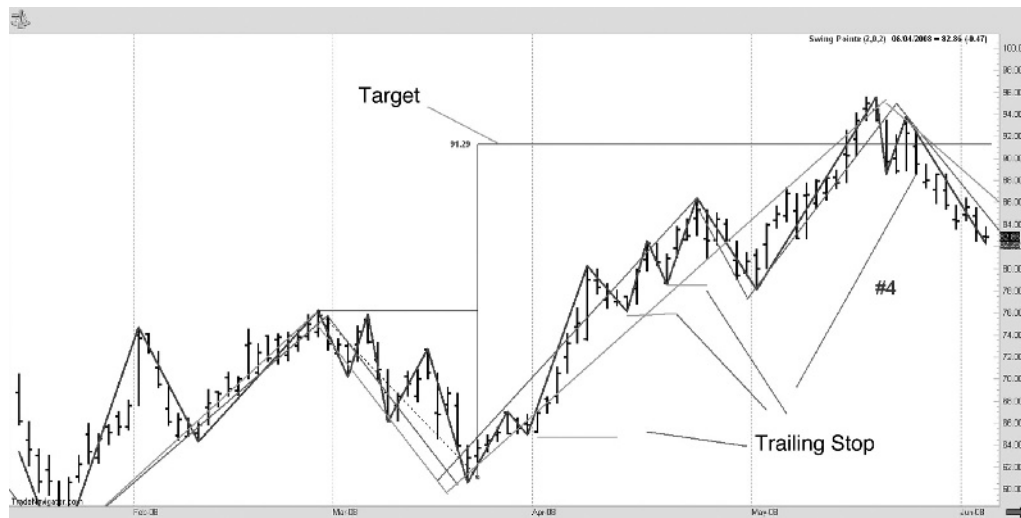


FIGURE 1.20 BHP: Lows Become Trailing Stops



FIGURE 1.21 Rio Tinto: Intermediate-High Sell Pattern

1. Trading below the most recent short-term low
2. Trading below the second short-term low back in time (foregoing a stop at the current low if you are really bullish)
3. Forming a subsequent intermediate-term high
4. Going to the target

Along the way, as the trade is maturing, you may see additional higher short-term lows being formed, producing another entry. Each successively higher pattern in turns has short-term targets you can use as long as it does not exceed the longer, intermediate-term target. As I said, there is a lot more depth to market structure than you might suspect.

That is the basic buy pattern to use as your template for trading in stocks or futures, daily or intra-day, it makes no difference . . . this is how prices move. Now let's turn our attention to selling opportunities.

Rio Tinto's pattern is shown in Figure 1.21, but it doesn't matter what stock is analyzed. This could be the price of soybeans or silver, copper or cocoa. All markets have the same structure. The problem comes from making certain your short-term highs and short-term lows fit into the intermediate. Sometimes, thanks to inside and outside bars, it is not perfectly clear. But nothing in the markets is always clear all the time

Nonetheless, this pattern is so repetitive you should not have much problem finding it, time and again. *If it's not clear, why trade?*

In Figure 1.21, I have marked with lines on the chart the intermediate swings based on the short-term swings. As you see, a lower intermediate-term high was formed in March of 2004. We knew then that we had an intermediate-term high lower than the prior

one. So we knew we were in a down-trending market and wanted to take short-selling opportunities.

The question, of course, is where to enter once we know an intermediate-term high is in place. On March 9 prices fell below the prior day's low, which made the March 9 high a short-term high. That short-term high was lower than the prior short-term high made on March 3. So we knew at that point in time that the March 3 high was an intermediate-term high. We also knew it was lower than the prior intermediate-term high. So we could have easily taken a short position, which I have marked off at 124.55. The pattern was complete.

Once in the trade, the initial stop should be the intermediate-term high sold off . . . in other words, the high of March 3 cannot be exceeded. If it is, price has moved back to the upside. We would want to reverse to being long as we would then know the intermediate-term trend was up. *Why?* Because an intermediate-term low, higher than the last one, would have been established.

So that is your initial stop. To give the trade even less room you could place the stop above the high of March 8, as exceeding that bar's high would mean we have a higher short-term low and probably have formed an intermediate-term low.

Isn't it neat how all of the information from these simple swings tells us the structure, and the structure shows us the trends of the marketplace?

Let's next turn our attention to targets and trailing stops for this trade (see Figure 1.22).

The target is arrived at by taking the swing from the low in February to the March 3 high, then subtracting that from the February low to give us a target at 85.42. In fact, price did go there, but I'm certain we would have been out of the trade before then, unless you had some compelling reason stay short.

Why do I say that? Because I think most likely you would have been stopped out with a trailing stop; a short-term swing high formation of the intermediate-term low (which



FIGURE 1.22 Rio Tinto: Trailing Stops and Targets

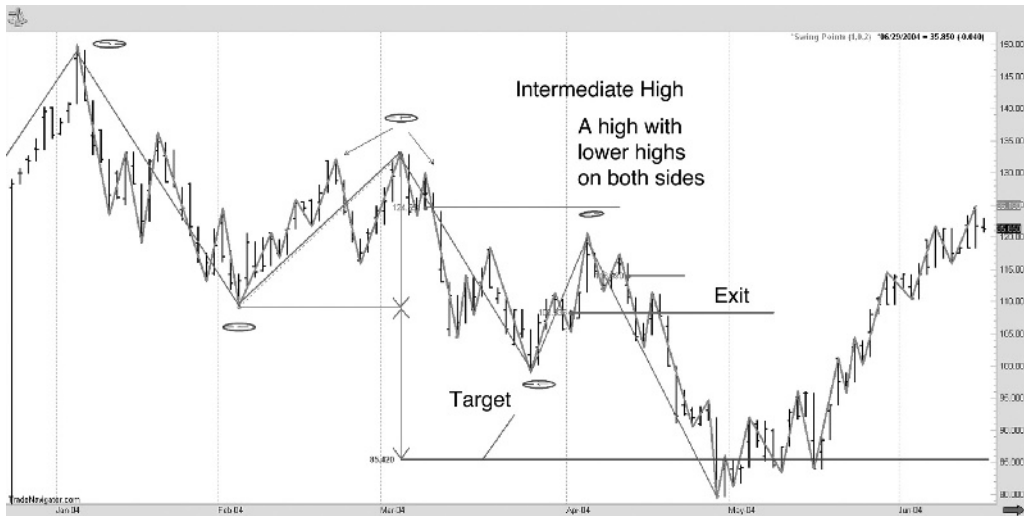


FIGURE 1.23 Rio Tinto: Exiting the Trade

also set up another short-selling opportunity). To better explain this, let's take a look at Figure 1.23, which show a continuation of the trade.

All was going well with our trade into late March until prices began to rally, warning an intermediate-term low had been formed. (I have marked the intermediate swings with the flying-saucer-shaped figures). We knew that once we got above the high of April 4, we had a higher short-term low, and thus would have had to exit at that bar's high the next day. Perhaps there are some other techniques you could have used, but sticking strictly with market structure that would have been our exit point. After all, we are short-term traders, and short-term traders are in the business of taking profits and not in the business of forcing the market to do what it won't do.

Another excellent selling opportunity was established, as yet another lower intermediate-term high was formed according to our rules. Notice it was lower than the one we originally took for our short position. So, we knew the larger trend was to the down side. This trade was also profitable and went immediately to our exit. Regardless of the trailing stop you would have been using, such as exiting at a higher short-term low or breaking above any short-term high, none of those events took place. We got lucky: Prices simply went to the target.

RECAP

A quick review of what I hope you have learned is that the market will tell us exactly how it is structuring itself for the next move . . . it really does reveal almost everything to us if we will take the time and patience to look and study its moves. In fact, there is a rhyme and reason, logic and science to what I call market structure.

This can be applied to any time frame: intraday, daily, weekly, and even monthly.