How to Trade Price Action

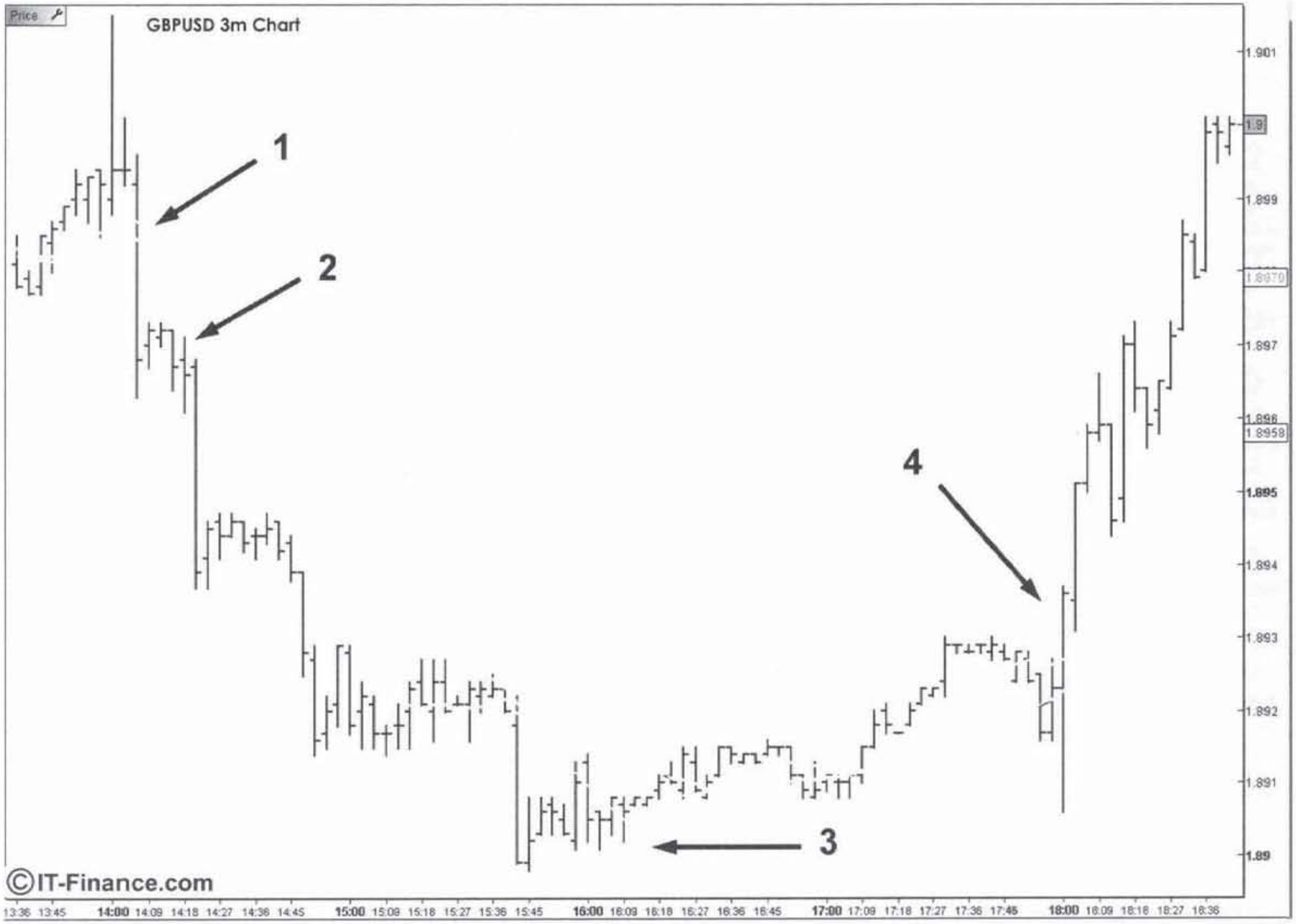
The sharp moves often seen in the FX markets can be difficult to trade and properly adjust to, even for advanced traders, but learning to read and interpret the price action in situations like these gives us a big leg-up. In a steep decline, for example, one must be careful to measure the reaction of the longs to know if the move has a chance to turn into a rout. By looking at the reaction of the longs as soon as the rate begins to extend south, you may be able to determine if the market is sitting on a large number of long positions or not.

Usually, if a spike lower is followed by a sharp V-shaped recovery, then you should be wary of shorting the pair. Masses of buyers entering the market at lower levels tells you that the market is not particularly long, and the lower prices represent "bargain" levels for those wishing to accumulate long positions.

On the other hand, if after the initial move lower any uptick is sold into, you can be fairly sure that the market is caught long and wrong. The longs realize that they hold bad trades, and are eagerly awaiting any uptick to offload some of their positions. This is when smart traders and dealers smell blood and go in for the kill.

Take a look at chart A.5 to see how the market reacts during sharp moves.

1. Sellers come into the market for whatever reason (news, etc.) and overwhelm any bids, driving the pair lower. When the pair slows down and consolidates the move, the reaction of the market here is critical.
2. No sharp recovery is seen, indicating that the nobody considers this correction to be a "cheap" buying level, and more likely than not some trapped longs are feeling the heat. The pair moves in a steady fashion as shorts take profit, reload, and short again. The pair will continue to move lower as long as there are more sellers than buyers, and it falls until some sort of equilibrium point is reached.
3. Normally the rate would rebound a bit from this area as shorts buy back their positions, but seeing the attractive round number nearby, stop hunters and retail "chasers" join the short selling party. The pair briefly breaches the round number, takes out any remaining stops and rebounds as dealers buy back their shorts. The longs have now either been stopped out or cut their losses.


Price
GBPUSD 3m Chart
1
2
3
4
1.901
1.9
1.899
1.8970
1.897
1.896
1.8958
1.895
1.894
1.893
1.892
1.891
1.89
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13:36 13:45 14:00 14:09 14:18 14:27 14:36 14:45 15:00 15:09 15:18 15:27 15:36 15:45 16:00 16:09 16:18 16:27 16:36 16:45 17:00 17:09 17:18 17:27 17:36 17:45 18:00 18:09 18:18 18:27 18:36

Chart A.5

After the last flurry of selling, the market is left leaning on the short side, with no fresh supply hitting the market. This imbalance in turn creates the perfect "short squeeze" set up. Since the market tends to follow the 'maximum pain' theory, it will now probably head north to try and cause some pain to the other side of the market. As soon as the dealers understand that the selling pressure has ended and the original longs have long been shaken out (remember, they have access to order flow), they slowly start to bid up the pair.

4. Expecting a continuation of the move, new shorts (chasers) are taken on a final move lower. The market at this point is oversaturated with shorts and a sharp V-shaped recovery takes place. Like dominos toppling over, the shorts are easily squeezed by the dealers. Squeezes tend to be sharp and vicious, reflecting the panic the shorts are in. Never underestimate the results of disorderly forced buying/selling, and never fade a squeeze; lest you end up getting "squeezed".

In this case, the original orderly down-move took approximately 2 hours to unfold while the short squeeze retraced the entire move in a mere 30 minutes. Simply comparing the two halves of the chart reveals the difference between orderly market moves and forced buying/selling (stops). A testament to the power of fear.

Moves like these are typical of a purely speculative market where "hot money" is out chasing prices and no real money or long-term fundamentally inspired bets are being placed. Basically the day to day chop of the FX markets.

So how does one trade these choppy markets?

TECHNICAL HELP

Moving averages are one of the oldest tried-and-true indicators, but since they are lagging indicators to the short term trader they seem to be of little use. As with all price-driven indicators there are trade-offs, and one has to look at the MA itself to find good uses for such a tool.

The most widely looked at MAs are the 50, 100, and 200 day MA which are a simple, yet efficient ways to gauge trends, their strengths (measured as a % away for the MA), and reasonable support levels. All day-traders should know where these levels sit on the daily charts, because as widely followed indicators they attract stop hunters and should therefore be avoided.

Since moving averages essentially relate the past price action, they can also be used effectively intra-day for entering and exiting positions in one-way markets. During sharp moves, it can be difficult for a trader to properly enter a position since retracements are far and few, and the "it can't go higher/lower" mentality may set in.

For example, even though you were bearish on cable, at the end of the day you find yourself on the sidelines looking at a 200 point drop, or worse, caught trying to pick a bottom.

In this scenario, the MAs can be used as dynamic resistance levels to trade off of, with much better results than the stop-happy static support/resistance levels known to the whole market. Using the 10 and 20 you can effectively choose when to open and close your position based on price action, not just an arbitrary number. Refer to chart A.6.

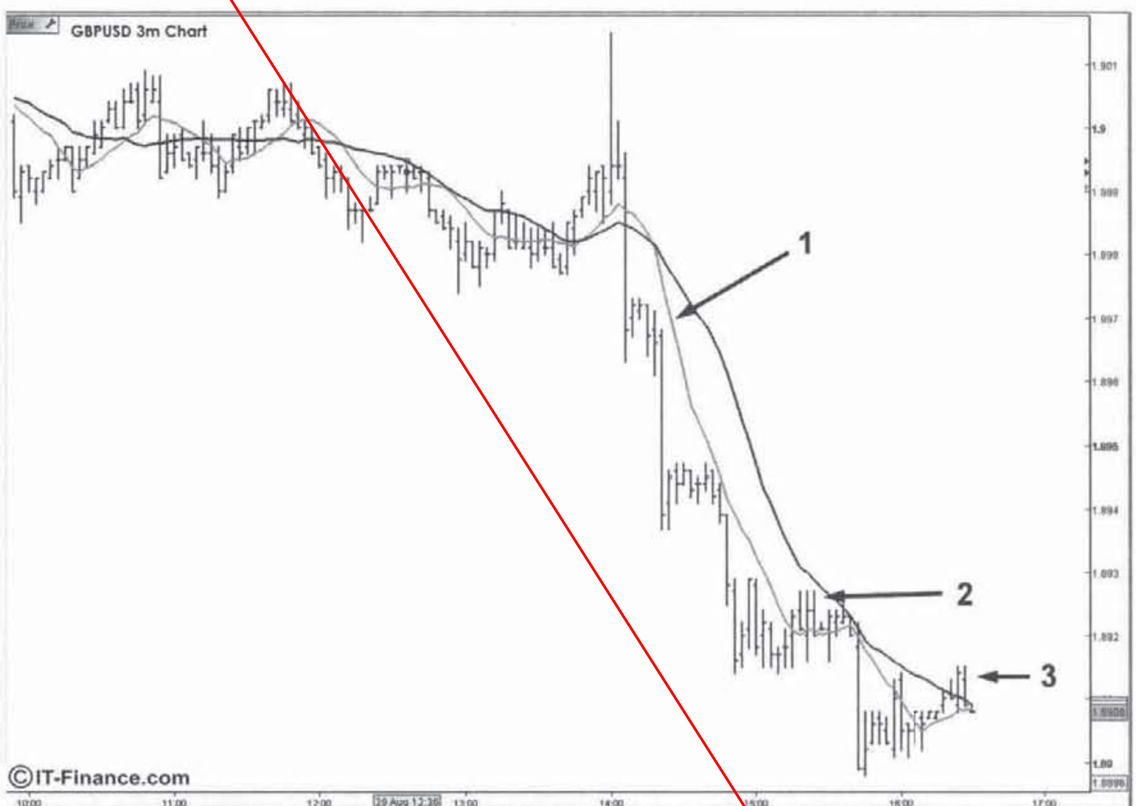

Chart A.6 Using moving averages during sharp moves.

1. The market breaks lower and you miss the initial short, but after a bearish cross you have the opportunity to enter a position once the price tests the 10d ma. This is the first dynamic resistance and should be sold into (a second can be sold at the 20). In this instance you have numerous chances to enter shorts. Notice how this beats simply selling the next break lower.
2. Once in a trade, choose to exit 1/2; of the position when the 10 is breached (closed bar), and the other half when the 20 gives way (3). After the 20 gives way the price action is telling you that there are more buyers than sellers out there, and the dynamics of the move have changed.

The advantages of using MAs in this manner is that it gives you dynamic levels to trade off and gauge price action, rather than agreeing on arbitrary levels or your 'gut' to tell you when you should take profit. By taking these decisions off of your shoulders and turning them into a systematic ones, you are less prone to take profits too early and it has the added benefit of placing less strain on your psyche. Take a look back at chart A.5 to see how effective the MAs were in protecting profits.