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PRICE ACTION CONFIDENTIAL TRAINING

Market Masters, LLC
www.marketmastersacademy.com

What is Price Action?

- P.A. (Price Action)
- P.A is the study of market action, primarily through the use of charts for the purpose of forecasting future price trends.



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Philosophy

- The *three* premises on which the P.A approach is based:
 - 1) Market action discounts everything
 - 2) Prices move in trends
 - 3) History repeats itself



Philosophy-Market Action Discounts Everything

..... is probably the cornerstone of Price Action

- Unless this premise is fully understood and accepted nothing else that follows makes such sense.
- Anything that can possibly affect the price, is actually reflected in it. Therefore, the study of PRICE ACTION is all that is required.



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Philosophy-Market Action Discounts Everything

- Factors that affect price
 - Fundamentals
 - Politics
 - Psychology
 - Macroeconomics



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Philosophy-Market Action Discounts Everything

- Price action reflects shifts in Supply (S) and Demand (D)

If $D > S \Rightarrow$ BULL MKT

If $S < D \Rightarrow$ BEAR MKT

If $D \sim S \Rightarrow$ SIDEWAYS MKT

- The technician is indirectly studying fundamentals
- Charts simply reflect the bullish or bearish psychology of the marketplace



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Philosophy-Market Action Discounts Everything

- Technicians or chartists do not concern themselves with the reasons why prices rise or fall
- By studying price charts and a host of supporting technical indicators the technicians in effect lets the market tell him which way it is most likely to go



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Philosophy-Market Action Discounts Everything

- The concept of trend is absolutely essential to the TA approach.
- Again, unless one accepts the premise that markets do in fact trend, there is no point to continue.
- Purpose of charting price action is to identify trends in early stages in order to trade in their direction.



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Philosophy-Price Move in Trends

- Most trading techniques are trend-following in nature: intent to identify and follow existing trends
- A trend in motion is more likely to continue than to reverse (Newton's first law of motion)
- A trend will continue until we see definite signs of reversal



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Philosophy-History Repeats Itself

- **Technical Analysis and the study of market action has to do with human psychology, which tends not to change**
- **Identified price patterns over the past 100 years that appear on price charts demonstrate high probability of predicting mkt action once they are fully formed.**
- **Since these patterns have worked well in the past, it is assumed that they will continue to work well in the future.**
- **The future is just a repetition of the past.**



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Philosophy-Technical vs Fundamental Analysis and Forecasting

- To determine the Direction Prices will follow Fundamentalists; study the CAUSE of market movement Technician; study the EFFECT.
- Market price tends to lead the known fundamentals
- The charts and fundamentals are often in conflict with each other usually at the beginning of important market moves. Once they are back in synchronization it is too late for the trader to act.



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Philosophy-Technical vs Fundamental Analysis and Forecasting

- **Analysis Vs Timing**
- **Flexibility and Adaptability of Technical Analysis**
- **Technical Analysis applied to different trading mediums and time dimensions**
- **Economic forecasting**



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Philosophy-Some Critiques on the Technical Analysis Approach

- Self-fulfilling prophecy
- Can the past be used to predict the future?
- Random walk theory



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Dow Theory – Basic Tenets

- Charles Dow is considered the father of Technical Analysis
- Basic tenets; (1) *The Averages Discount Everything*; The market action reflects every possible factor (known and unknown) that affects overall supply and demand.
- The Market has Three Trends; Definition of trend: successive higher (lower) peaks and troughs.
- A Trend has three (3) Parts: Primacy (tide)/ Secondary or Intermediate (waves)/ Minor (ripples)



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Dow Theory – Basic Tenets

TREND	PERIODICITY	TIMEFRAME
PRIMARY	MONTHLY	> 1 year & possibly several years
SECONDARY	WEEKLY	3 weeks to 6 months
MINOR	DAILY	up to 3-4 weeks



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Dow Theory – Basic Tenets



In a cycle there exist many sub-cycles (L-T, M-T, S-T)



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Dow Theory – Basic Tenets

Major Trends Have Three Phases;

- 1) Accumulation; steady markets- smart money buying
- 2) Public Participation; essential for trends to be sustained
- 3) Distribution; smart money sell off- reversal of trend



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Dow Theory – Basic Tenets



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Dow Theory – Basic Tenets

The averages must confirm each other;

No important trend signal could take place unless all major averages give the same signal, that is, confirm each other.

For example...

US market:

S&P500

DOW30

Nasdaq



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Dow Theory – Basic Tenets



When volume is expanding in the direction of the major trend is a sign of a healthy trend



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Dow Theory – Basic Tenets



When volume is expanding in the direction of the major trend is a sign of a healthy trend



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Dow Theory – Basic Tenets

A trend is assumed to be in effect UNTIL it gives Definite signals of reversal

A number of technical tools are available to traders to assist in the difficult task of spotting reversal signals:

- Support & Resistance
- Levels
- Price patterns
- Trend lines
- Moving Averages



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Dow Theory

- Dow used closing prices to define penetrations and trends (No intraday penetrations)
- Dow theory does not anticipate trends. It's a trend followed by theory designed to capture the middle portion of the trend.



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Dow Theory Applied to Futures Trading

Dow's work considered the behavior of stock Averages. While most of it has significant application to futures markets, there are some important distinctions between stocks and futures trading:

- Dow assumed that most investors follow only the major trends and used intermediate corrections for timing purposes only and considered minor trends as unimportant.
- For the FUTURES market, the minor trend becomes extremely important as most traders trade the intermediate and minor trend.



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Dow Theory – Trend Reversals

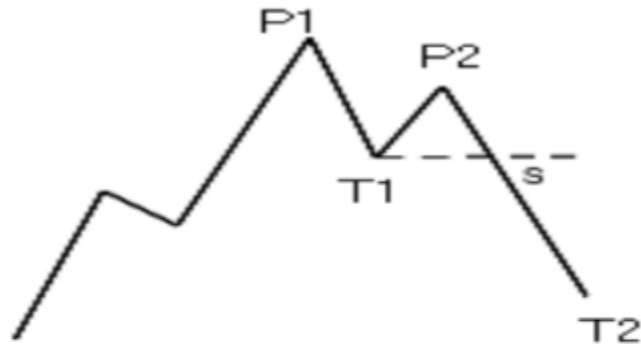
- The most difficult task for a trend follower / Dow theorist is being to distinguish between a normal secondary correction in an existing trend and the first leg of a new trend in the opposite direction.
- Dow theorists often disagree as to whether the market gives an actual reversal signal.
- This demonstrates in "Failure Swing" and "Non Failure Swing"



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Dow Theory – Trend Reversals

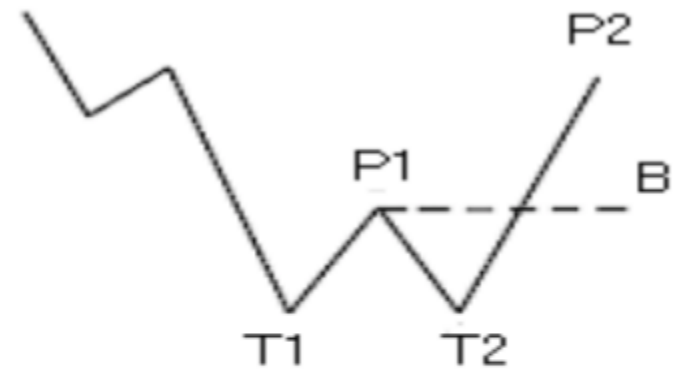
- 1) **FAILURE SWING:** Refers to the failure of the Peak P2 to overcome P1, followed by the violation of the low at T1. This move constitutes a sell signal at S.



$P_1 > P_2$

$T_1 > T_2$

$S = T_1 \Rightarrow \text{SELL}$



$T_1 < T_2$

$P_1 < P_2$

$S = P_1 \Rightarrow \text{BUY}$



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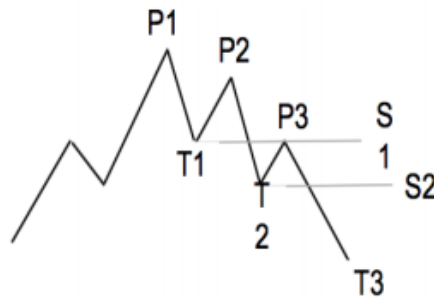
Dow Theory – Trend Reversals

NON – FAILURE SWING: Refers to the violation of the high at P₁ with the move at P₂ before falling below T₁.

- Traders:

- (a) Some see a SELL signal at S₁.

- (b) Others would need to see a lower high at P₃ before turning bearish at S₂

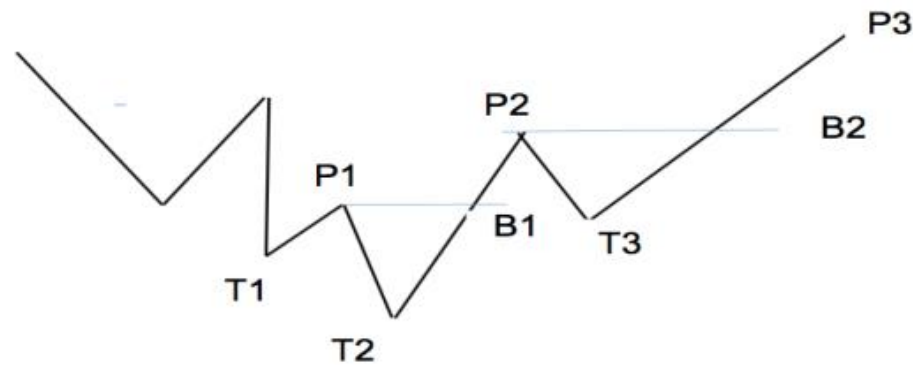


(A) $S_1 = T_1 \Rightarrow \text{SELL}$ (B) $P_3 < P_2 \quad S_2 = T_2 \Rightarrow \text{SELL}$



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Dow Theory – Trend Reversal



(A) $T_1 > T_2$ $P_1 < P_2$

$B_1 = P_1 \Rightarrow \text{BUY}$

(B) $T_3 > T_2$

$B_2 = P_2 \Rightarrow \text{BUY}$



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Chart Construction

TYPES OF CHARTS AVAILABLE

1. BAR CHART
2. LINE CHART
3. POINT AND FIGURE CHART
4. MARKET PROFILE

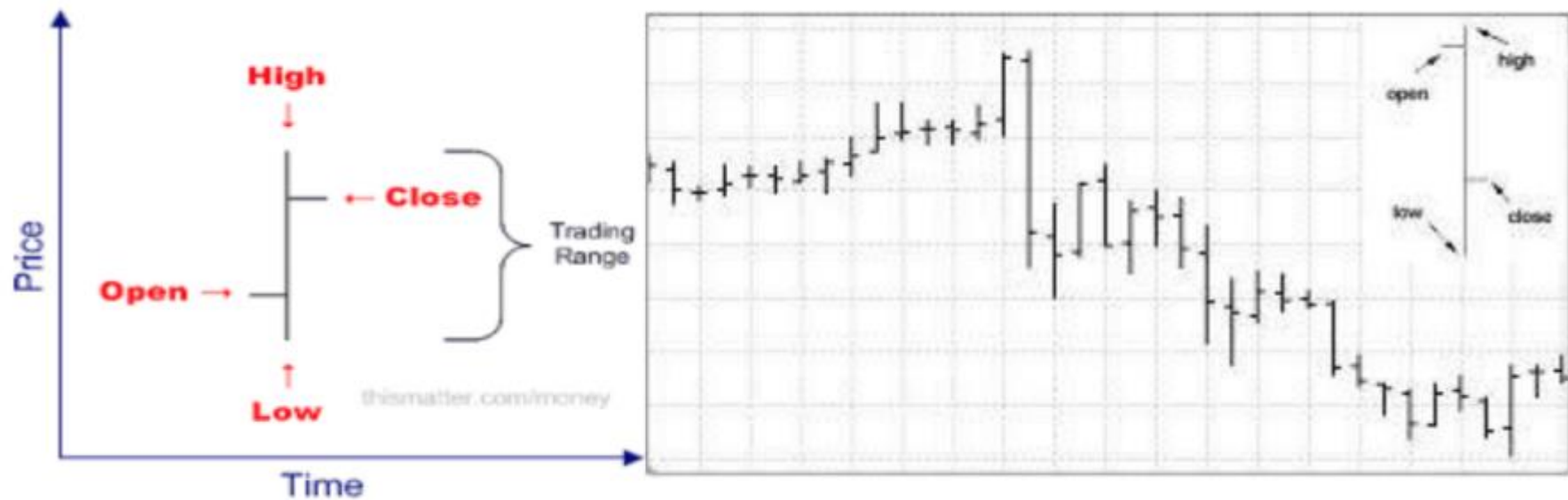


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Chart - Types

1. BAR CHART:

Each periods range is represented by a vertical bar.

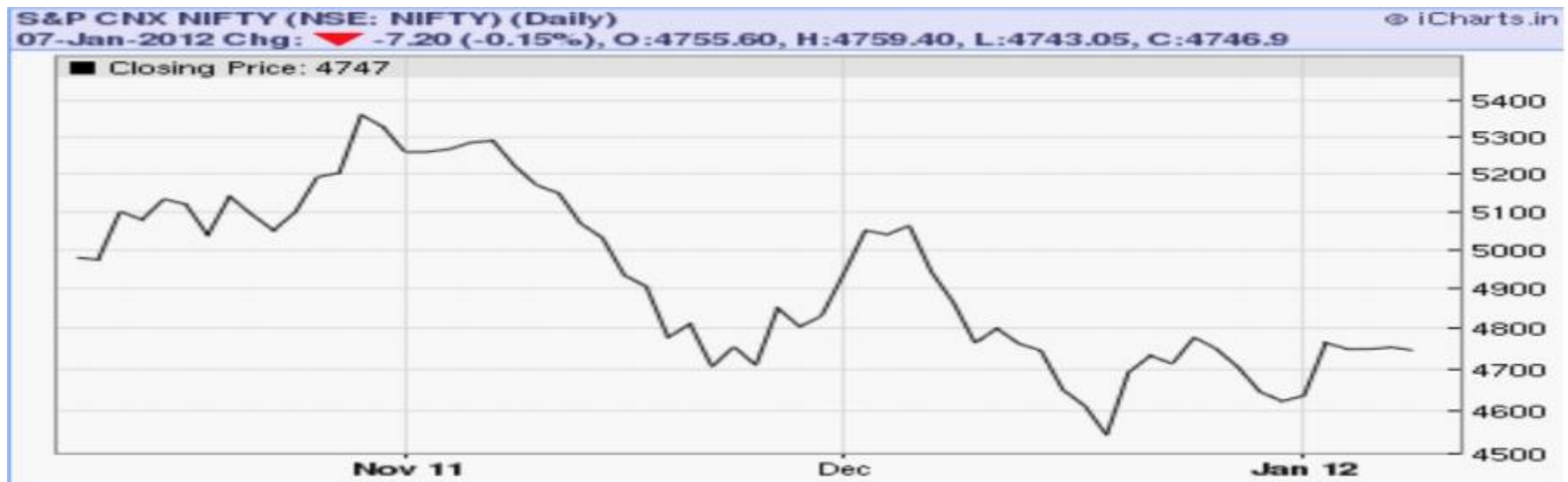


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Chart - Types

2. LINE CHARTS:

Only the closing price is plotted for each successive period. Closing Price is considered as the most critical price of the trading period.

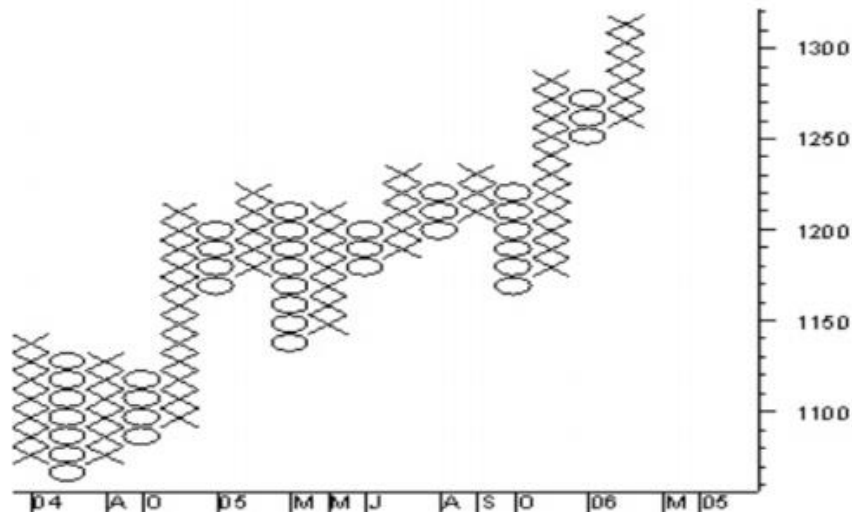


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Charts - Types

3. POINT AND FIGURE:

- Shows the price action in a more compressed format.
- "X" columns show declining prices, without taking into account the time factor
- BUY & SELL signals are more precise and easier to spot than other chart types.

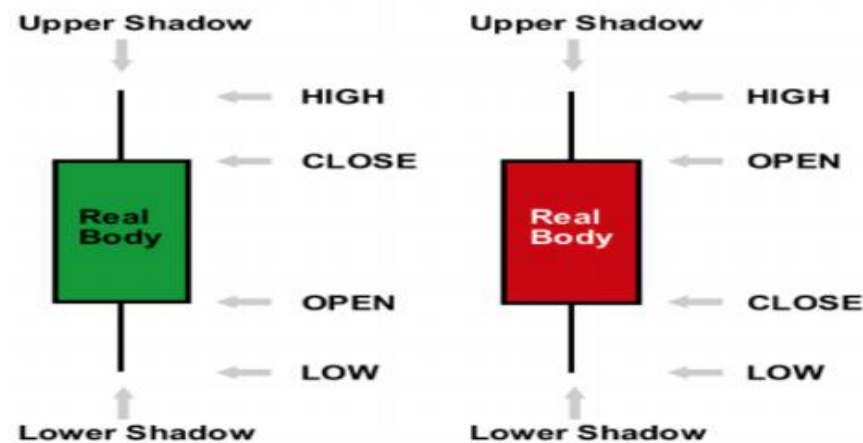


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Charts - Types

4. CANDELSTICKS CHART:

- The Japanese version of the bar chart.
- It records the same four prices as the Bar Chart
- Shadow: Shows, the periods price action- H&L
- Real Body: Measures the distance between the open and close price (o,c)
- If $o > c \Rightarrow$ white, green, blue body, $o < c$ the key to candlesticks is the relationship between open and close price.



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Charts - Types



5. MARKET PROFILE:

- Is the statistical approach to the analysis of price data.
- Is a decision support tool requiring the user to exercise **NORMAL PERSONAL JUDGMENT** in the trading process.
- Is not a trading system nor it provides trade recommendations. The aim is to allow the user to witness the market's developing value on price reoccurrence over time.



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Trends

1. DEFINITION

Market moves are characterized by a series of zigzags. These zigzags resemble a series of successive waves with fairly obvious Peaks and Troughs. The direction of those Peaks and Troughs constitute the market Trend. The movement can be UP, DOWN or SIDEWAYS.



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Trends

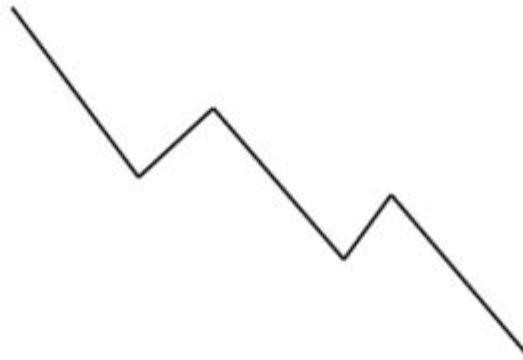
Examples:

UPTREND



Successive HIGHER
Peaks and Troughs

DOWNTREND



Successive LOWER
Peaks and Troughs

SLIDEWAYS-TRADING
RANGE



Successive HORIZONTAL
Peaks and Troughs



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Trends

2. BASIC CONCEPTS OF A TREND

- Always trade in the direction of a trend
- Never buck the trend
- The trend is your friend

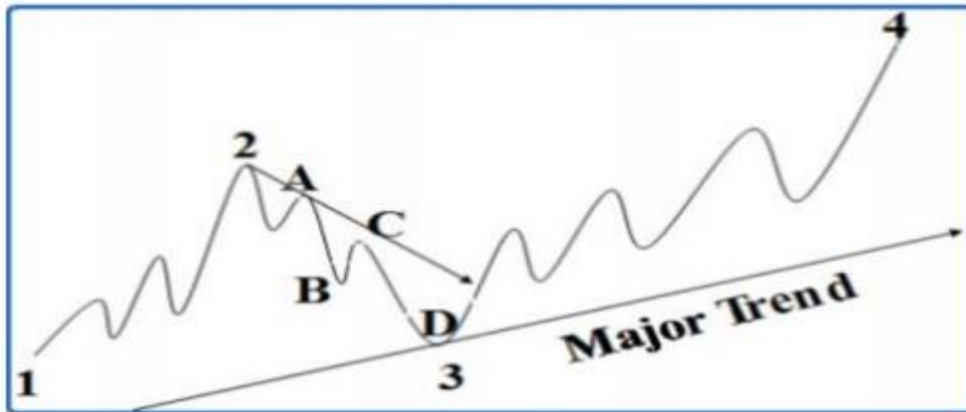


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3. CATEGORIES-CLASSIFICATIONS

- a) Major: >1 year
- b) Intermediate: 3 weeks-6 months
- c) Near Term: < 1 month (2-3 weeks)



1,2,3,4 : major trend
2,3: Intermediate correction (wave) to
major trend
A,B,C: near term Trend



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Trends

4. Support and Resistance Levels Definitions:

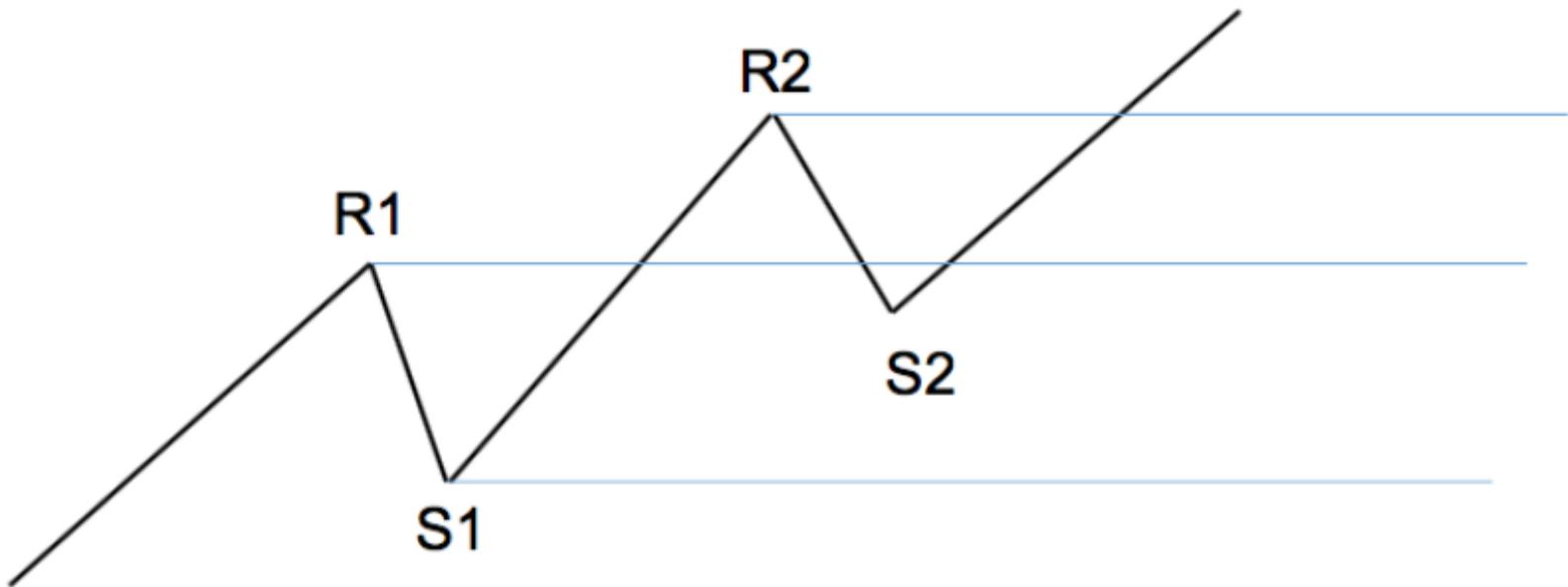
Support: the level below the current price level where Demand is greater than supply and prices bounce back up.

Resistance: The level above the current price level where Supply is greater than Demand and prices bounce back down.



Trends

4. Support and Resistance



Exercise: Draw Support and Resistance Levels in a down trend



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TRENDS-Support and Resistance

- **Changing Roles:** Whenever a support or Resistance level is penetrated by a significant amount, the reverse their roles and become the opposite (Psychology Reasoning)
- **Significance is based on:**
 1. Time spent on the level
 2. Volume on the level
 3. How recently the trading took place
- **Significance is subjective and can be determined by the trader**
- **Round Numbers as support and Resistance Level.**



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TRENDS-TREND LINES

Definition: A Trend Line is the line that connects the Peaks or the Troughs of a moving zigzag pattern.

Throughs for advancing zigzags: UpTrend Line.

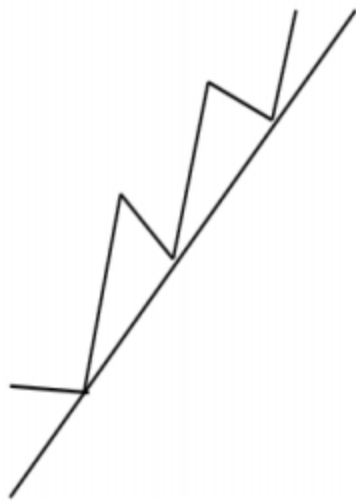
Peaks for declining zigzags: Down Trend Line

Both for horizontal zigzags: Sideways

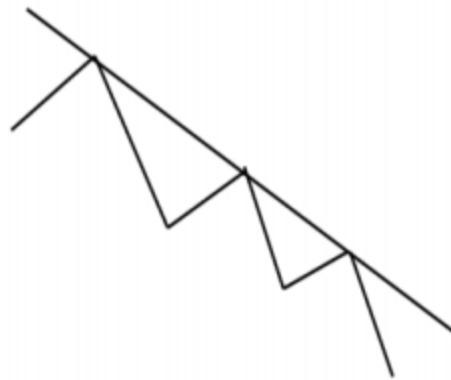


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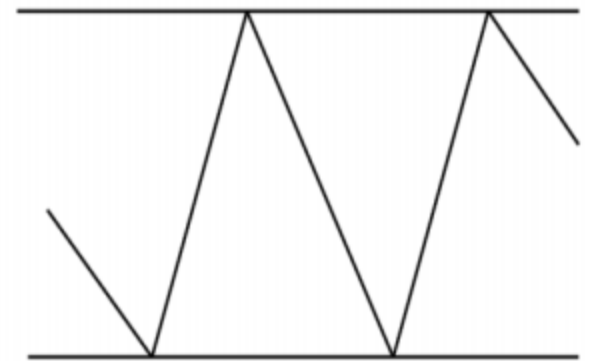
Trends – Trend Lines



UP TRENDLINE



DOWN TRENDLINE



SIDEWAYS



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Trends – Trend Lines

Drawing a Trend Line:

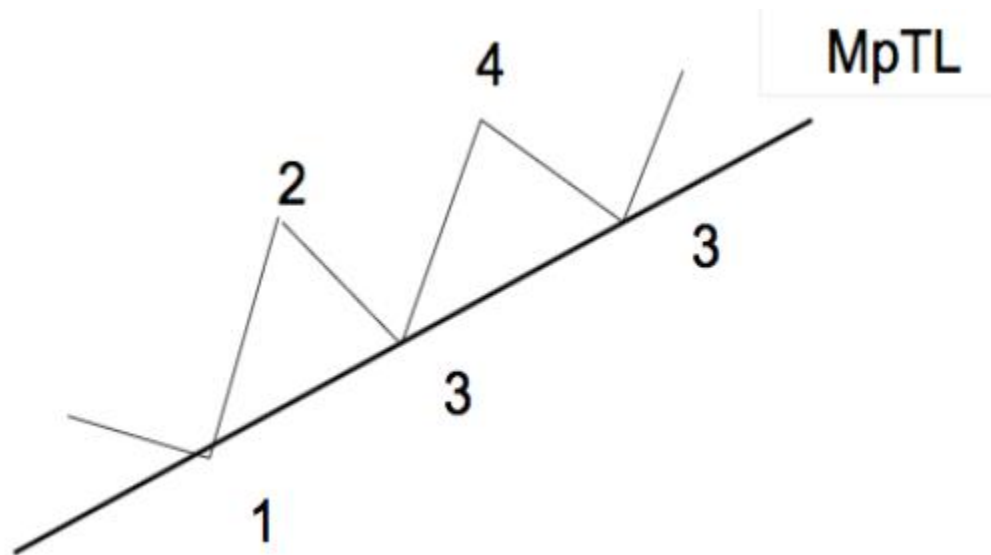
- **Experiment to find best fit**
- **There must be evidence of a trend: successive higher/lower troughs & peaks**
- **When to draw it? Before or After Penetration of previous Peak or Trough.**



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Trends – Drawing a Trend Line

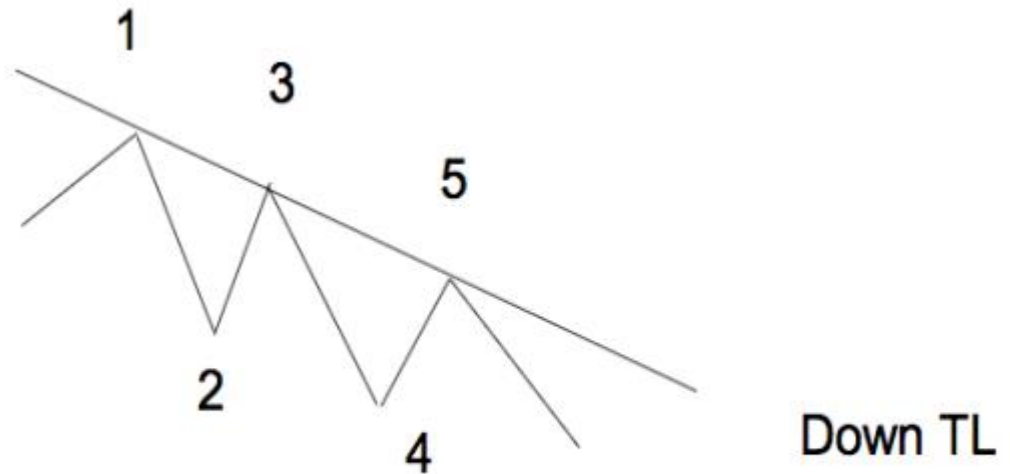
- One of the simplest technical tool but also on of the most valuable.
 - Up Trend Line: Drawn upwards and to the right along successive reaction lows.



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Trends – Drawing a Trend Line

Down Trend Line: Drawn downward to the right along successive rally peaks.



Tendative TL= 2 touches
Valid TL= 3 touches



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Trends – Drawing a Trend Line

Useful Guidelines:

- **Must be evidence of a Trend at least 2 successive higher highs and higher**
- **Must be a penetration of previous high (2) to draw a Trend Line**
- **An experienced trader can draw the Trend Line after the 50% retracement of wave 2,3 or when Price approaches the peak 2.**
- **Be reasonably sure that the reaction low 3 has been formed.**



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Trends – Drawing a Trend Line

Tentative Vs Valid Trend Line

- Tentative Trend Line has 2 touches (lows or highs)
- Confirmation of Trend Line is needed and is done with a third touch with prices bouncing off it
- Once the tentative Trend Line is touched and bounce off it then the Trend Line becomes **VALID**.



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Trends – Uses of a Trend Line

- **A trend in motion will tend to remain in motion. A Trend Line has a slope or rate of speed- very Important**
- **Helps to determine the extremities of the corrections**
- **Can tell us when that trend is changing**
- **Can provide a support or resistance boundary under or above the market that can be used as a buying or selling area**
- **Very often, the breaking of a Trend Line is one of the best early warnings of a change in trend.**



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Trends – Significance of a Trend Line

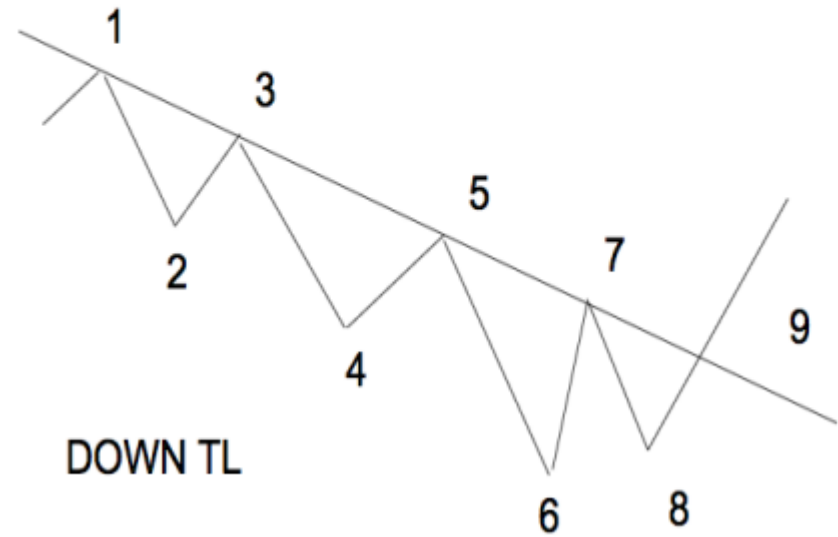
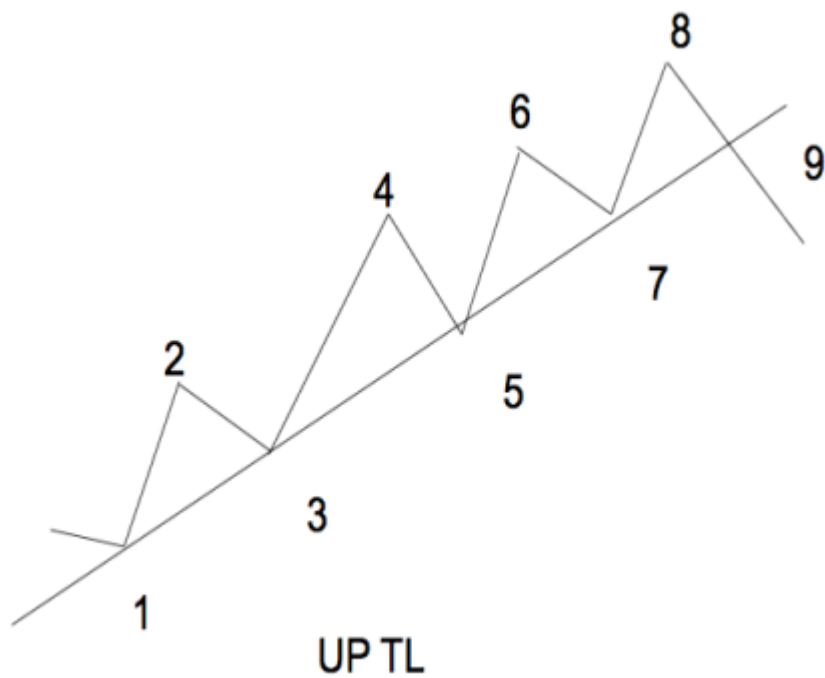
1. The longer in time it has been intact
2. The number of times it has been tested

The more significant the Trend Line the more confidence it inspires and the more important is its penetration.



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Trends – Breaking of a Trend Line



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Trends – Breaking of a Trend Line

General rule: A close beyond the Trend Line is more significant than just an intraday penetration.

- Variety of time and price filters can be employed in an attempt to isolate valid TL penetrations and eliminate bad signals or “whipsaws”. Eg. % penetration, number of closes above or below Trend Line.

IMPORTANT: The trader **MUST** determine what types of filters are best suited to his/her style!



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Trends – Breaking of a Trend Line



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Trends – Role Reversal

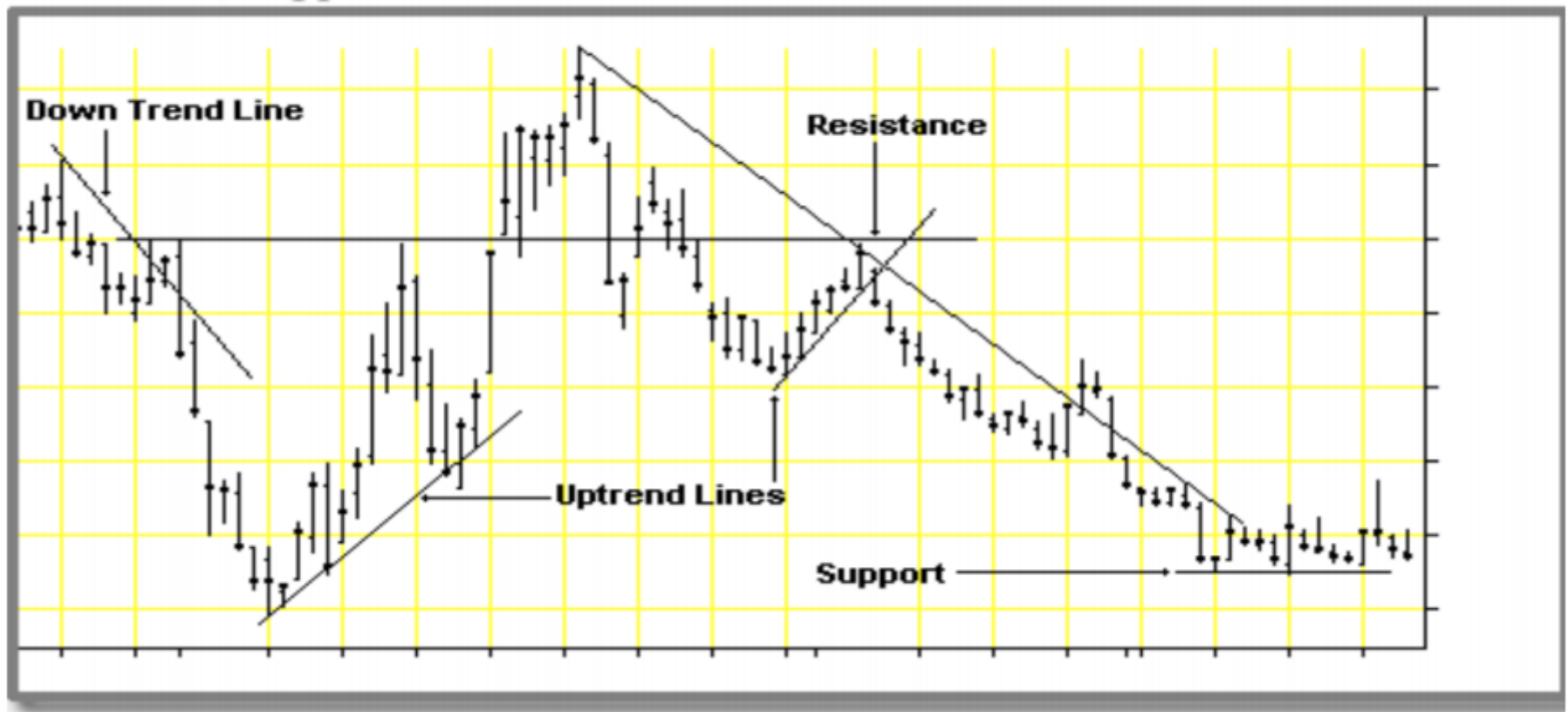
- As support and resistance levels can reverse roles the same principle applies with Trend Line.
- An Up-Trend Line (support line) will usually become a resistance line once it is decisively broken
- In drawing a Trend Line it is important to extend it beyond the breakout point.
- It is surprising how often old Trend Lines act as support or resistance lines in the future.



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Trends – Role Reversal

Trendlines, Support & Resistance

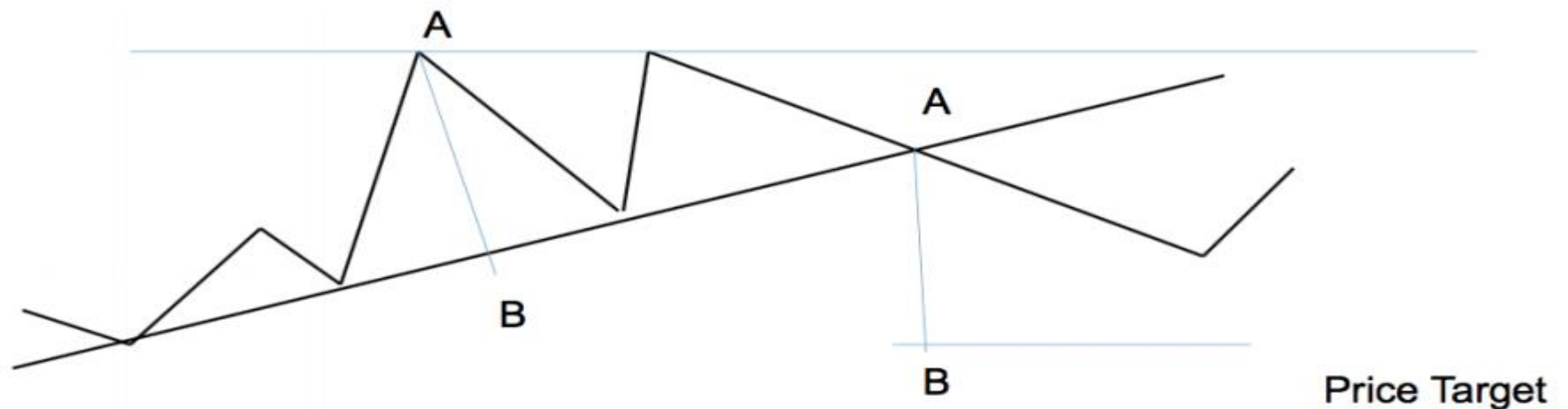


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Trends – Measuring

Trend Line can be used to determine price objectives

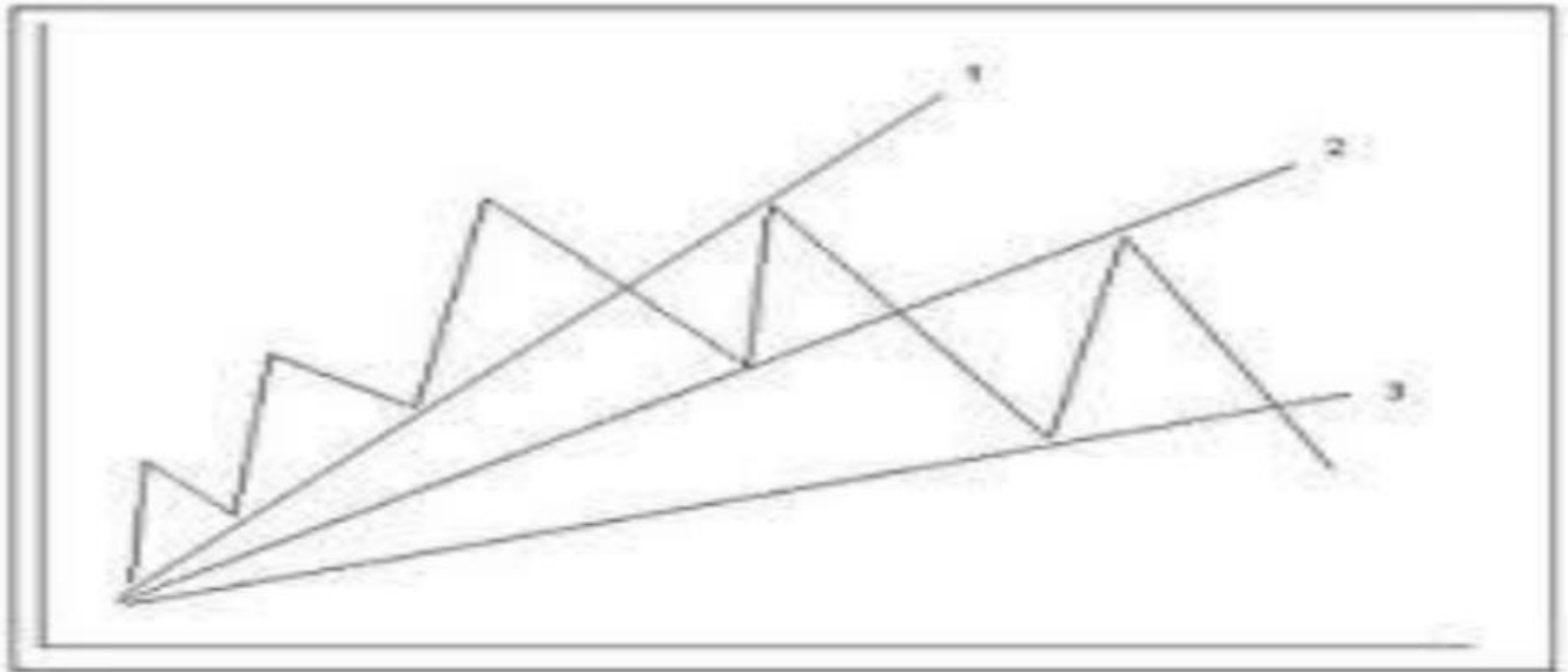
- Once a TL is broken, price is expected to move away from the TL a distance equal to the vertical distance that prices achieved on the other side of the line, prior to the trend reversal.



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Trends

The FAN Principle



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Trends

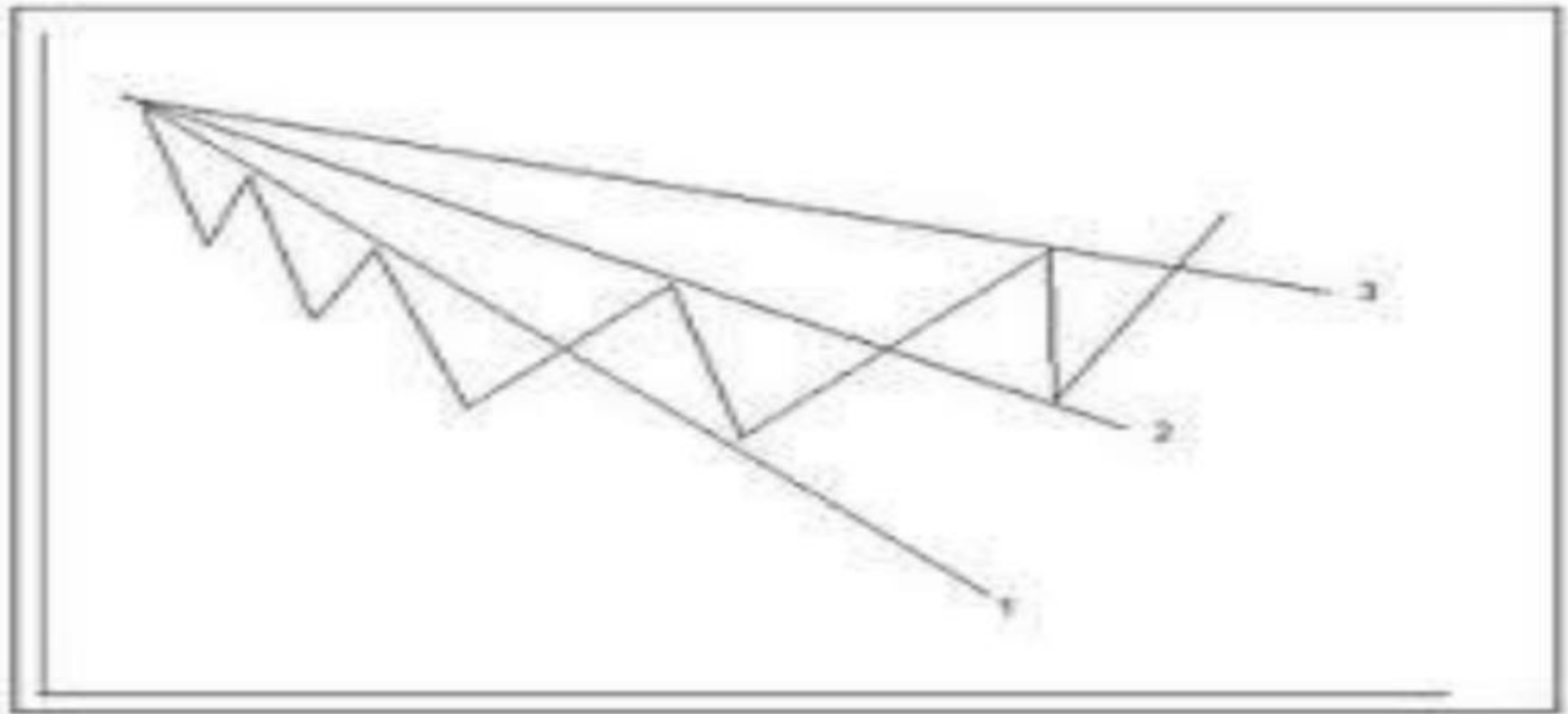
Use of Trendlines (TL):

1. Violation of TL₁
2. Rally back below TL₁
3. Draw TL₂
4. TL₂ broken
5. Failed rally attempt below TL₂
6. Draw TL₃
7. Breaking of TL₃: Usually an indication that prices will move lower



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The term “FAN Principle”, derives from the Trend lines that gradually flatten out, resembling a fan.

IMPORTANT: The breaking of the third line is the valid trend reversal signal



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Examples



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Trends

The Importance of the Number THREE

- Interesting how often number 3 shows up in Technical Analysis and the role it plays.
 - Fan Principle uses 3 lines
 - Trends have 3 major phases (DOW & ELLIOT WAVE THEORY)
 - Trends have 3 categories
 - Three kinds of GAPS (later)
 - Most commonly known Reversal Patterns: triple Top, H&S
 - 3 Trend Directions
 - Continuation patterns: 3 types of triangles
 - 3 Principle sources of information: P, V & Open Interest



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Trends

The Relative Steepness of the Trendline

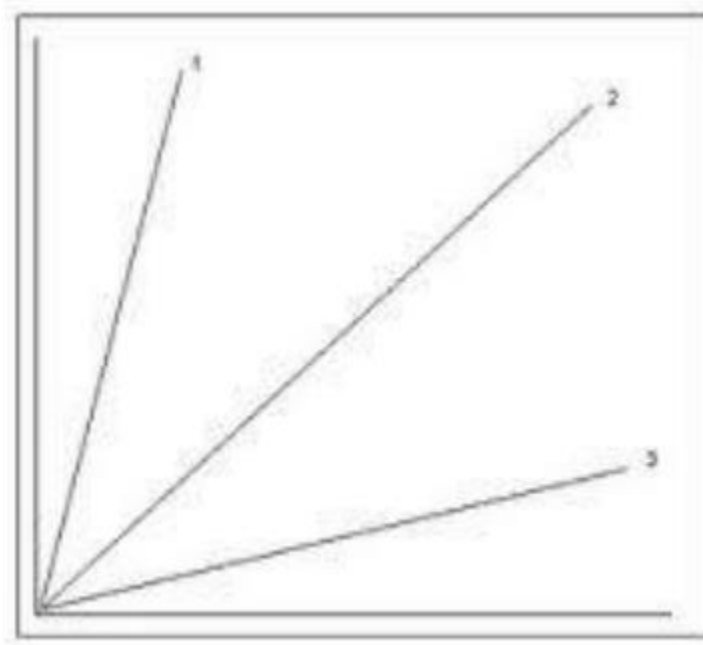
- The relative Steepness of Rate of Change (Δ) is important
- In General, most important Trend lines TEND to APPROXIMATE an average of 45 degrees.
- GANN THEORY: A 45 degree line, reflects a situation where prices are advancing or declining at such a rate that price and time are in perfect balance (equilibrium)
- Many technicians, use 45 degree lines from previous tops or bottoms as major Trend Lines.



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1. Too steep: Rate of ascent is not sustainable
2. 45 degrees line
3. Too flat: suggests that trend is too weak and probably suspect.



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Trends

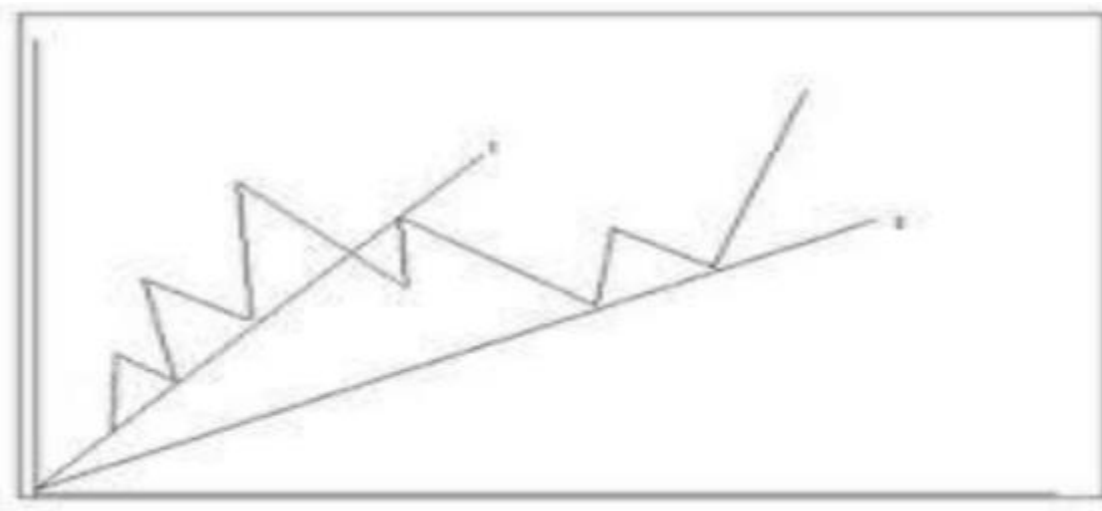


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How to Adjust Trend Lines

- Trend Lines have to be adjusted to fit a slowing or an accelerating trend.

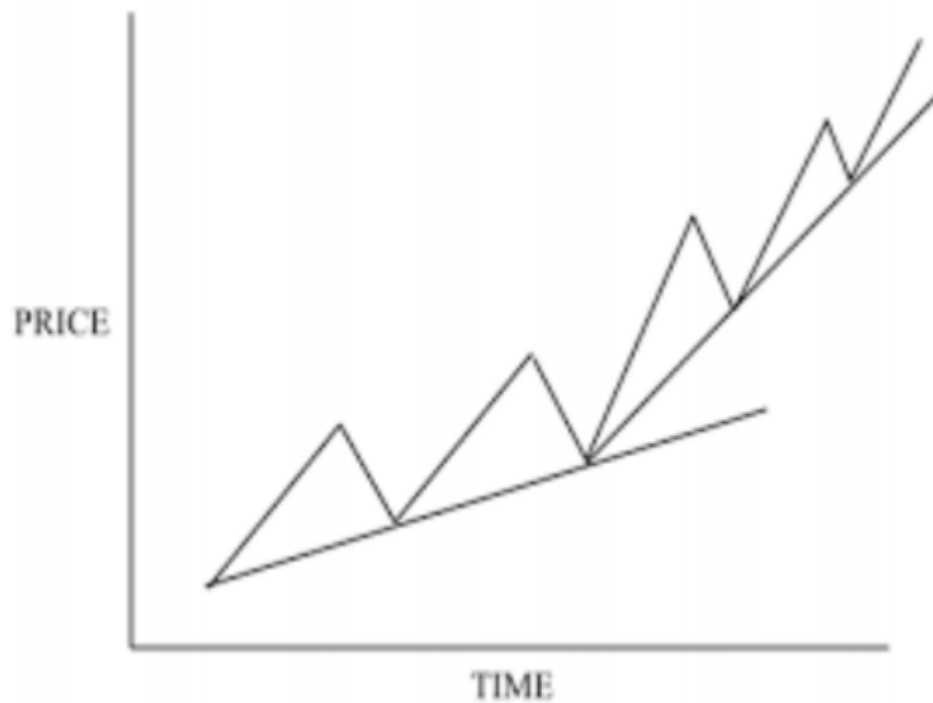


- Trend line is too steep
- Often the braking of a steep tr line is only an adjustment to a SLOWER and MORE SUSTAINABLE up trend line



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- Initial Trend line proved too slow as the uptrend accelerated
- A second steeper trend line should be drawn to more closely track the trend



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Trends

Technician Arsenal to adjust

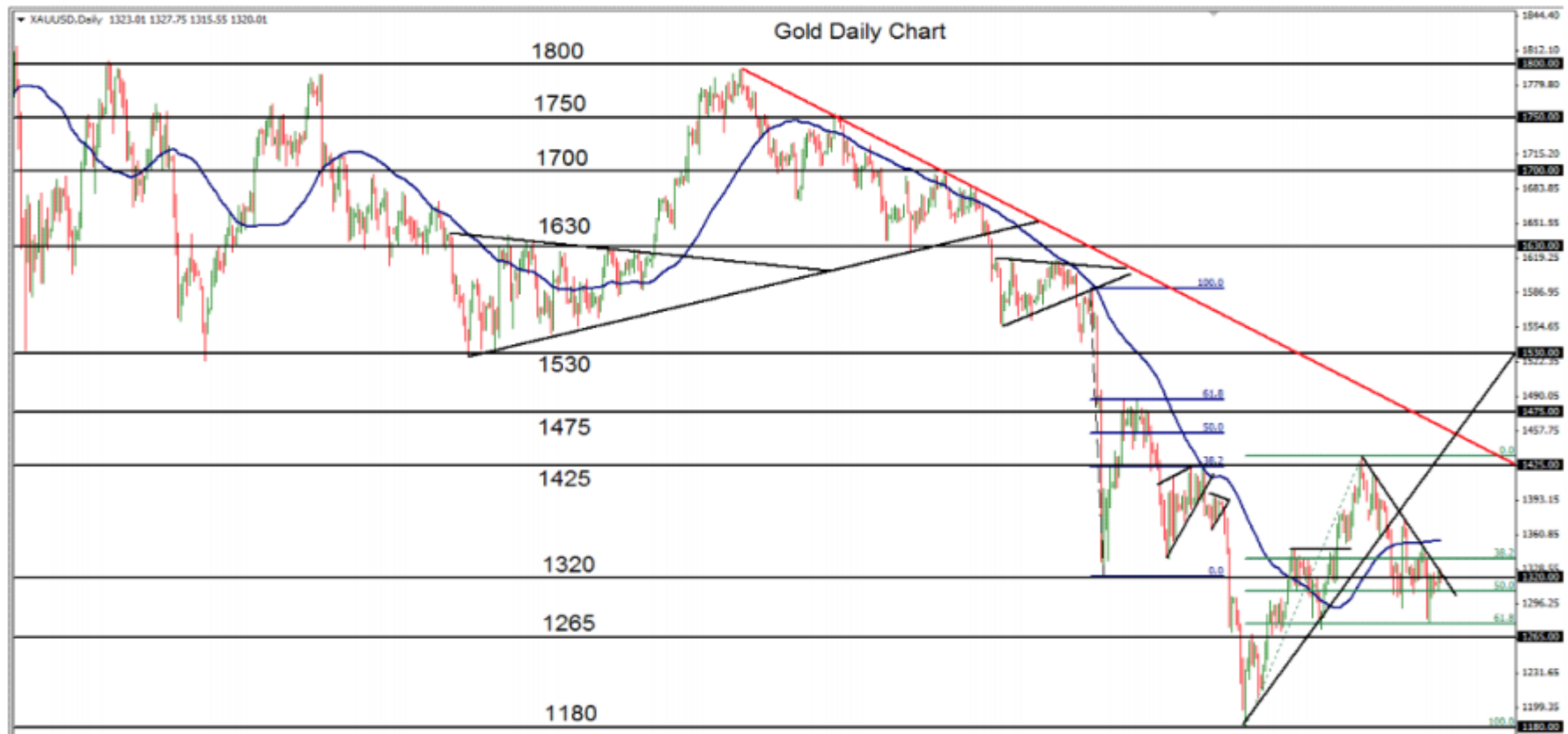
- Where steeper Trend lines become necessary, probably we need to resort to other tools from our arsenal.
- Moving Averages
 - All techniques we will learn work well in certain situations but not so well in others
 - An accelerated trend is one of these cases, where another tool like the MA would be more useful than a series of steeper and steeper Trend lines.
 - Major Trend line: connects the low points of the major uptrend Shorter and more sensitive
Trend Lines: used for secondary swings Even shorter line: used for short term movements.



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Trend Using Moving Average



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Trends

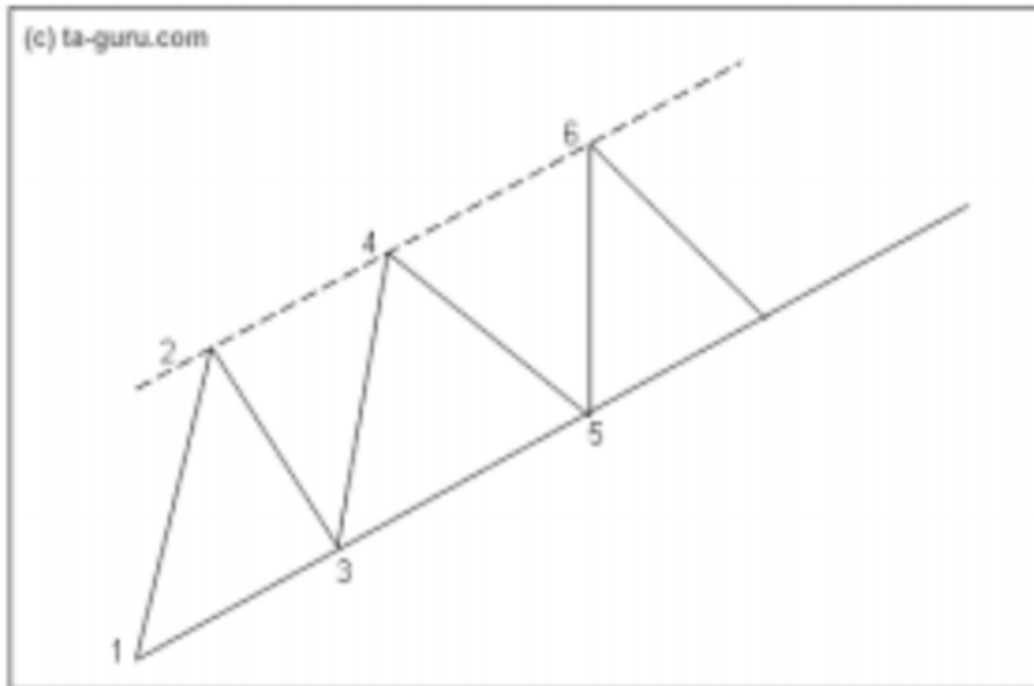
THE CHANNELS LINE

- The channel line or return line is a useful variation of the Trend Line technique.
- Prices, may trend between two parallel lines:
 - The basic Trend line; and
 - The channel line
- Once recognized, it can be used to profitable advantage



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- Once the basic Trend line is drawn (1,3), then
- Draw a parallel line of the basic Trend Line from the first peak (2)
- If the next rally reaches and back off, from 4 then a channel exists



Trends

How to Trade a channel

- Basic Trend Line, can be used to initiate positions
- Channel line can be used for short term profit taking
- Aggressive traders: can use the channel line to initiate a countertrend position. TO

COUNTER TRADE THE TREND CAN PROVE VERY COSTLY.

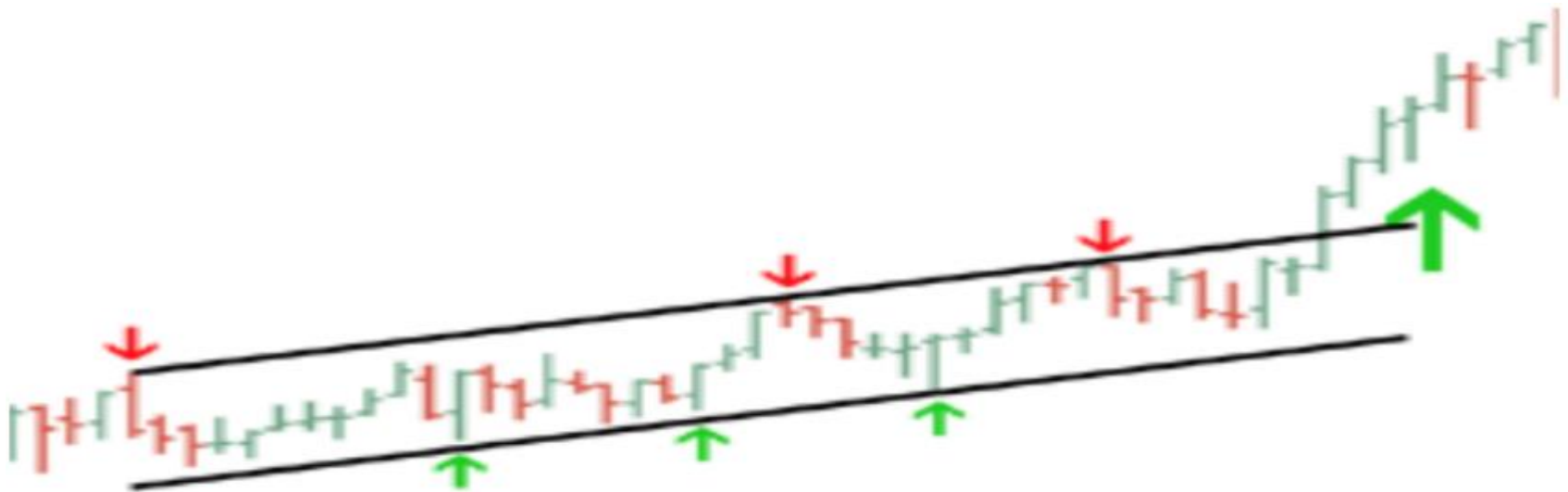


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Breaking of the channel line

- It signals acceleration of the existing trend
- Some traders use this to add to their existing positions.



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Channels: Spot failure to reach channel line

- Sign of weakening trend
- General rule of Thump:

The failure of any move within an established price channel to reach one side of the channel, usually indicates that the trend is shifting, and increases the likelihood that the other side of the channel will be broken.



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Trends

Adjusting Price Channel

- Same Principles as adjusting a Trend Line
- Once a new Trend line is drawn we redraw the channel line



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Trends

Measuring Price Channel

- Once a breakout occurs, from an existing price channel, prices usually travel a distance equal to the width of the channel.
- Important:
 - The basic Trend line is by far the more important and the more reliable. The Channel line, is a secondary use of the Trend line technique. But it works often enough to justify the use of it.



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Trends

PERCENTAGE RETRACEMENTS

- After a market move, Prices retrace a portion of the previous trend before resuming the move in the original direction.
- These countertrend moves tend to fall into certain predictable percentage parameters.
 - The best known is the 50% retracement
 - Also widely recognized: the one- third ($1/3$) and the two- thirds ($2/3$) retracements-min and max.



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Interpretation:

In a correction of a strong trend, the market usually retraces at least 33% of the previous move. Therefore, the trader is looking for a position area under the market in the zone of 33% to 50%. The maximum retracement is 66% for the previous trend to be maintained. This area becomes a relatively low risk position area. If prices, move beyond the 66% area, then odds favor a trend reversal rather than a retracement. The move usually then retraces the entire 100% of the prior trend.



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Trends

- The 33%- 50%- 66% retracements are derived from the Dow Theory.
- These percentage, are very close to the Fibonacci ratios (used by Elliott Wave Theory) which are 38,2%- 50%- 61,8%.
- GANN Theory, uses 8ths: It breaks the trend structure into eights: $1/8$, $2/8$, $3/8$,.... $8/8$. However, Gann attached special importance to the $3/8$ (38%), $4/8$ (50%) and $5/8$ (62%) retracements and also divided the trend into thirds – $1/3$ (33%) and $2/3$ (66%).
- STUDY:

GANN THEORY (for academic purposes only)

ELLIOTT WAVE THEORY (for academic purposes only)

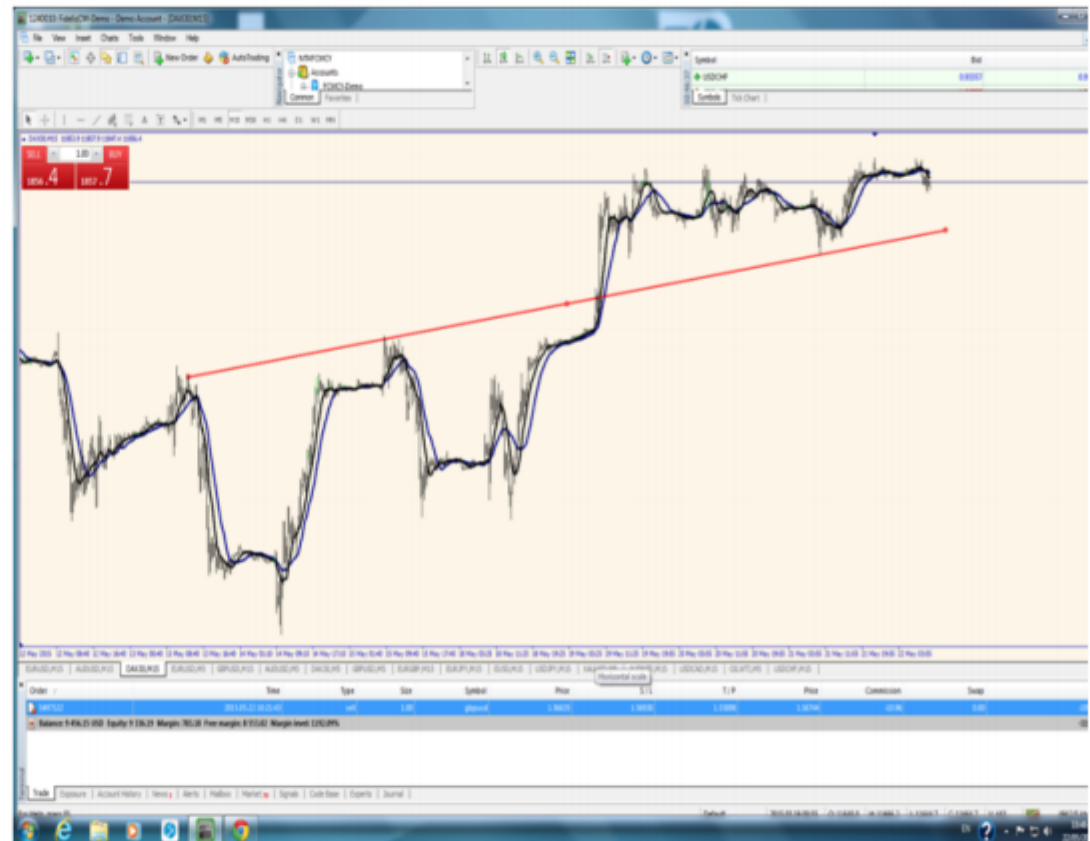
FIBONACCI NUMBERS and RATIOS (*)



Trends

INTERNAL TRENDLINES

- Variations of the trend line that do not rely on extreme highs or lows
- They are drawn through the price action and connect as many internal peaks or troughs as possible.
- Problem: They are very subjective since the rules of drawing are not clearly set as in the normal trend lines.



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Price Gaps

PRICE GAPS

DEFINITION: Price gaps, are areas on the chart where no trading has taken place.

- Upside gaps are often signs of market strength.
- Downside gaps are often signs of market weakness
- Gaps are more commonly seen on lower periodicity graphs but can appear on long term gaps also where they are usually very significant.
- Myth: “Gaps are always filled” NOT TRUE!!!
- Gaps have different forecasting implications depending on which types they are and where they occur.



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Price Gaps

Three Types of Gaps

- Three General Types of GAPS:
 - > the breakaway gaps
 - > runaway on measuring gaps
 - > exhaustion gaps

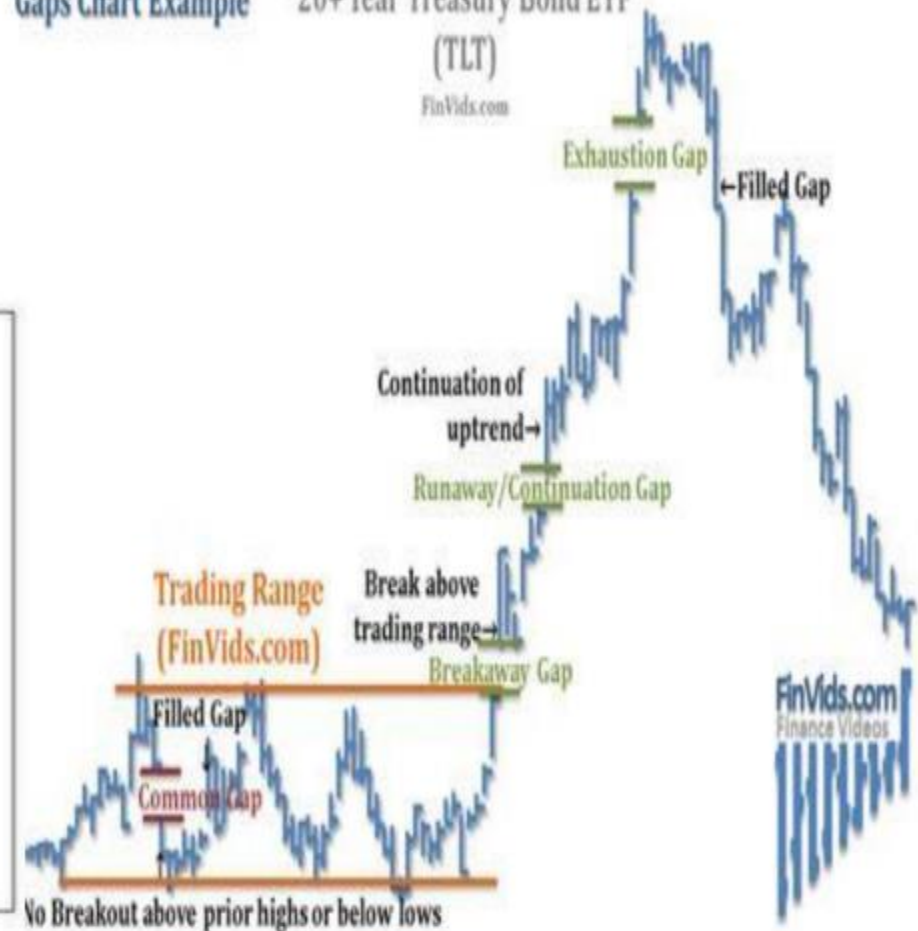


Three Types of Gap - Breakaway, Runaway and Exhaustion

Gaps Chart Example

20+ Year Treasury Bond ETF
(TLT)

FinVids.com



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Price Gaps

The Breakaway Gap:

- Usually occurs at the completion of an important price pattern on usually signals the beginning of a significant market move.
- Major breakouts from topping or basing areas are breeding grounds for this type of gaps.
- Breaking of a major trend line, signaling a reversal of trend.
- Breakaway gaps usually occur on heavy volume.
- More often than not, breakaway gaps are not filled. Prices, may return and may close a portion of the gap
- Rule: The heavier the volume the less likely for the gap to be filled.
- A close below an upward gap or above the downward the gap is a sign of weakness.



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Price Gaps

The Runaway or Measuring Gap.

- Occurs somewhere the middle of the move often the Breakaway gap occurred.
- This gap reveals a situation where the market is moving effortlessly on moderate volume: sign of market strength (up or down).
- Again this gap acts as support or resistance areas on subsequent market corrections and is not filled.
- A close below an upward gap or above a downward gap is a negative sign on the trend strength.
- Measuring: Since it usually occurs at about the halfway point in a trend, we simply measure the distance from the original trend signal or breakout and extend it (or double the distance) to set our targets.



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Price Gaps

The Exhaustion Gap

- The Exhaustion Gap appears near the end of a market move.
- Once the breakaway and measuring gaps have formed we should expect the Exhaustion gap.
- Once it is formed we should be on the lookout for the market to move lower within a week (daily chart).
- This is a classic example where falling below a gap in an uptrend or closing above a gap in a downtrend has very bearish or bullish implications respectively.



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Price Gaps

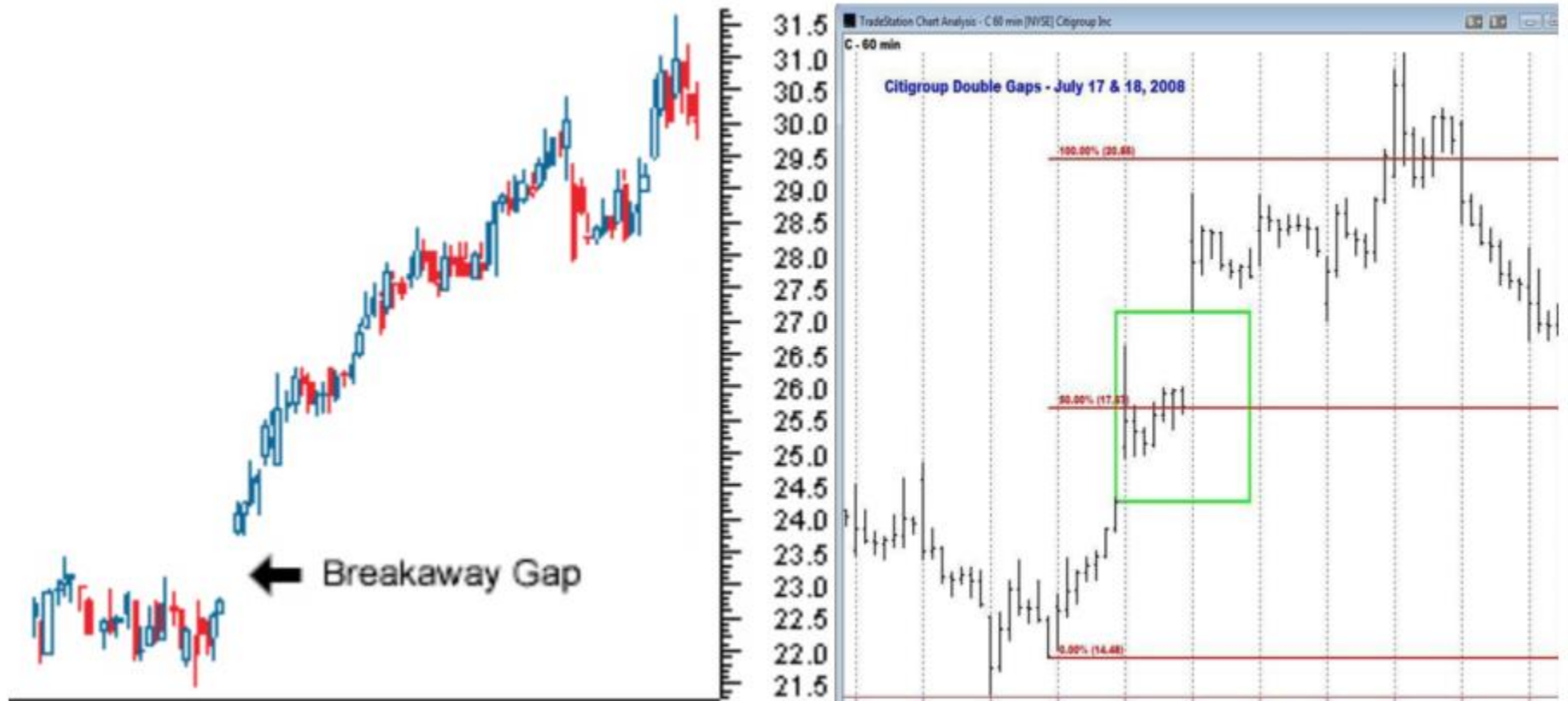
The Island Reversal

- After the exhaustion gap has formed, prices will trade in a narrow range for a while (up to two weeks on a daily chart) before gapping down or up (for previous downtrend).
- The narrow range between the two gaps looks like an island surrounded with water.
- The Island Reversal Pattern usually indicates a trend reversal of some magnitude. The major significance of the reversal depends on where prices are in the general trend structure.



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