CHAPTER 1

Price Action

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For a trader, the fundamental issue that confronts him repeatedly throughout the day is the decision of whether the market is trending or not trending. If it is trending, he assumes that the trend will continue, and he will look to enter in the direction of the trend ("With Trend"). If it is not trending, he will look to enter in the opposite direction of the most recent move ("fade" or "Countertrend"). A trend can be as short as a single bar (on a smaller time frame, there can be a strong trend contained within that bar) or, on a 5-minute chart, it can last a day or more. How does he make this decision? By reading the price action on the chart in front of him.

The most useful definition of price action for a trader is also the simplest: it is any change in price on any chart type or time frame. The smallest unit of change is the tick, which has a different value for each market. Incidentally, a tick has two meanings. It is the smallest unit of change in price that a market can make, and it is also every trade that takes place (so if you buy, your order will appear on the Time and Sales table, and your fill, no matter how large or small, is one tick). Since price is changing with every tick (trade) during the day, each price change becomes an example of price action. There is no universally accepted definition of price action, and since you need to always try to be aware of even the seemingly least significant piece of information that the market is offering, you must have a very broad definition. You cannot dismiss anything because very often something that initially appears minor leads to a great trade. The broadest definition includes any representation of price movement during the course

of trading. This includes any financial instrument, on any type of chart, in any time frame.

The definition alone does not tell you anything about placing a trade because every bar is a potential signal both for a short and a long trade. There are traders out there who will be looking to short the next tick, believing that the market won't go one tick higher, and others who will buy it believing that the market will likely not go one tick lower. One side will be right, and the other will be wrong. If the buyers are wrong and the market goes one tick lower and then another and then another, they will begin to entertain the prospect that their belief is wrong. At some point, they will have to sell their position at a loss, making them new sellers and no longer buyers, and this will drive the market down further. Sellers will continue to enter the market, either as new shorts or as longs forced to liquidate, until some point when more buyers come in. These buyers will be a combination of new buyers, profit-taking shorts, and new shorts who now have a loss and will have to buy to cover their positions. The market will continue up until the process reverses once again.

Everything is relative, and everything can change into the exact opposite in an instant, even without any movement in price. It might be that you suddenly see a trendline seven ticks above the high of the current bar and instead of looking to short, you now are looking to buy for a test of the trendline. Trading through the rearview mirror is a sure way to lose money. You have to keep looking ahead, not worrying about the mistakes you just made. They have absolutely no bearing on the next tick, so you must ignore them and just keep reassessing the price action and not your profit and loss (P&L) on the day.

Each tick changes the price action of every time frame chart from a tick chart or 1-minute chart through a monthly chart, and on all charts, whether the chart is based on time, volume, the number of ticks, point and figure, or anything else. Obviously, a single tick move is usually meaningless on a monthly chart (unless, for example, it is a one tick breakout of some chart point that immediately reverses), but it becomes increasingly more useful on smaller time frame charts. This is obviously true because if the average bar today on a 1-minute Emini chart is three ticks tall, then a one tick move is 33 percent of the size of the average bar, and that can represent a significant move.

The most useful aspect of price action is watching what happens after the market moves beyond (breaks out beyond) prior bars or trendlines on the chart. For example, if the market goes above a significant prior high and each subsequent bar forms a low that is above the prior bar's low and a high that is above the prior bar's high, then this price action indicates that the market will likely be higher on some subsequent bar, even if it pulls back for a few bars near term. On the other hand, if the market breaks out to the

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upside, and then the next bar is a small inside bar (its high is not higher than that of the large breakout bar), and then the following bar has a low that is below this small bar, the odds of a failed breakout and a reversal back down increase considerably.

Over time, fundamentals control the price of a stock, and that price is set by institutional traders (like mutual funds, banks, brokerage houses, insurance companies, pension funds, hedge funds, and so on), who are by far the biggest volume players. Price action is the movement that takes place along the way as institutions probe for value. When they feel that the price is too high, they will exit or even short, and when they feel it is too low (a good value), they will go long or take profits on their shorts. Although conspiracy theorists will never believe it, institutions do not have secret meetings to vote on what the price should be in an attempt to steal money from unsuspecting, well-intentioned individual traders. Their voting is essentially independent and secret, and comes in the form of their buying and selling, but the results are displayed on price charts. In the short run, an institution can manipulate the price of a stock, especially if it is thinly traded. However, they would make relatively much less money doing that compared to what they could make in other forms of trading, making the concern of manipulation of negligible importance, especially in stocks and markets where huge volume is traded, like the Eminis, major stocks, debt instruments, and currencies.

Why does price move up one tick? It is because there is more volume being bid at the current price than being offered, and a number of those buyers are willing to pay even more than the current price if necessary. This is sometimes described as the market having more buyers than sellers, or as the buyers being in control, or as buying pressure. Once all of those buy orders that can possibly be filled are filled at the current price (the last price traded), the remaining buyers will have to decide whether they are willing to buy at one tick higher. If they are, they will continue to bid at the higher price. This higher price will make all market participants re-evaluate their perspective on the market. If there continues to be more volume being bid than offered, price will continue to move up since there are an insufficient number of contracts being offered by sellers at the last price to fill the requests to buy by buyers. At some point, buyers will start offering some of their contracts as they take partial profits. Also, sellers will perceive the current price as a good value for a short and offer to sell more than buyers want to buy. Once there are more contracts being offered by sellers (either buyers who are looking to cover some or all of their long contracts or by new sellers who are attempting to short), all of the buy orders will be filled at the current price, but some sellers will be unable to find enough buyers. The bid will move down a tick. If there are sellers willing to sell at this lower price, this will become the new last price.

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Since most markets are driven by institutional orders, it is reasonable to wonder whether the institutions are basing their entries on price action, or whether their actions are causing the price action. The reality is that institutions are not all watching AAPL or SPY tick by tick and then starting a buy program when they see a two-legged pullback on a 1-minute chart. They have a huge number of orders to be filled during the day and are working to fill them at the best price. Price action is just one of many considerations, and some firms will rely more on it, and others will rely on it less or not at all. Many firms have mathematical models and programs that determine when and how much to buy and sell, and all firms continue to receive new orders from clients all day long.

The price action that traders see during the day is the result of institutional activity and much less the cause of the activity. When a profitable setup unfolds, there will be a confluence of unknowable influences taking place during the trade that results in the trade being profitable or a loser. The setup is the actual first phase of a move that is already underway and a price action entry lets a trader just jump onto the wave early on. As more price action unfolds, more traders will enter in the direction of the move, generating momentum on the charts, causing additional traders to enter. Traders, including institutions, place their bids and offers for every imaginable reason, and the reasons are largely irrelevant. However, one reason that is relevant, because it is evident to smart price action traders, is to benefit from trapped traders. If you know that protective stops are located at one tick below a bar and will result in losses to traders who just bought, then you should get short on a stop at that same price to make a profit off the trapped traders as they are forced out.

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Since institutional activity controls the move and their volume is so huge and they place most of their trades with the intention of holding them for hours to months, most will not be looking to scalp and instead they will defend their original entry. If Vanguard or Fidelity have to buy stock for one of their mutual funds, their clients will want the fund to own stock at the end of the day. Clients do not buy mutual funds with the expectation that the funds will day trade and end up in all cash by the close. The funds have to own stock, which means they have to buy and hold, not buy and scalp. For example, after their initial buy, they will likely have much more to buy and will use any small pullback to add on. If there is none, they will continue to buy as the market rises.

Some beginner traders wonder who is buying as the market is going straight up and also wonder why anyone would buy at the market instead of waiting for a pullback. The answer is simple. It is institutions working to fill all of their orders at the best possible price, and they will buy in many pieces as the market continues up. A lot of this trading is being done by institutional computer programs, and it will end after the

programs are complete. If a trade fails, it is far more likely the result of the trader misreading the price action than it is of an institution changing its mind or taking a couple ticks of profit within minutes of initiating a program.

The only importance of realizing that institutions are responsible for price action is that it makes placing trades based on price action more reliable. Most institutions are not going to be day trading in and out, making the market reverse after every one of your entries. Your price action entry is just a piggyback trade on their activity, but, unlike them, you are scalping all or part of your trade.

There are some firms that day trade substantial volume. However, for their trades to be profitable the market has to move many ticks in their direction, and a price action trader will see the earliest parts of the move, allowing her to get in early and be confident that the odds of a successful scalp are high. That firm cannot have the market go 15 ticks against them if they are trying to scalp 4 or 8 ticks. As such, they will enter only when they feel that the risk of an adverse move is small. If you read their activity on the charts, you should likewise be confident in your trade, but always have a stop in the market in case your read is wrong.

Also, since often the entry bar extreme is tested to the tick and the stops are not run, there must be institutional size volume protecting the stops, and they are doing so based on price action. In the 5-minute Emini, there are certain price action events that change the perspective of smart traders. For example, if a High 2 long pullback fails, smart traders will assume that the market will likely have two more legs down. If you are an institutional trader and you bought that High 2, you do not want it to fail, and you will buy more all the way down to one tick above that key protective stop price. That institution is using price action to support their long.

The big legs are essentially unstoppable, but the small price action is fine-tuned by some institutional traders who are watching every tick. Sometimes when there is a 5-tick long failure setting up and the price just keeps hitting 5 ticks but not 6 where you can scalp 4 ticks out of your long, there will suddenly be a trade of 250 Emini contracts, and the price does not tick down. In general, anything over 100 contracts should be considered institutional in today's Emini market. Even if it is just a large individual trader, he likely has the insight of an institution, and since he is trading institutional volume, he is indistinguishable from an institution. Since the price is still hanging at 5 ticks, almost certainly that 250 lot order was an institutional buy. This is because if institutions were selling in a market filled with nervous longs, the market would fall quickly. When the institutions start buying when the market is up 5 ticks, they expect it to go more than just 1 tick higher and usually within a minute or so the price will surge through 6 ticks and swing up for at least many more. The institutions were

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buying at the high, which means that they think the market will go higher and they will likely buy more as it goes up. Also, since 4-tick scalps work so often, it is likely that there is institutional scalping that exerts a great influence over most scalps during the day.

Traders pay close attention to the seconds before key time frames close, especially 3-, 5-, 15-, and 60-minute bars. This is also true on key volumes for volume bar charts. For example, if many traders follow the 10,000 shares per bar chart for the Ten Year Note futures contract, then when the bar is about to close (it closes on the first trade of any size that results in at least 10,000 shares traded since the start of the bar, so the bar is rarely ever exactly 10,000 shares), there may be a flurry of activity to influence the final appearance of the bar. One side might want to demonstrate a willingness to make the bar appear more bullish or bearish. In simplest terms, a strong bull trend bar means that the bulls owned the bar. It is very common in strong trends for a reversal bar to totally reverse its appearance in the final few seconds before a 5-minute bar closes. For example, in a strong bear, there might be a High 2 long setting up with a very strong bull reversal bar. Then, with 5 seconds remaining before the bar closes, the price plummets, and the bar closes on its low, trapping lots of front running longs who expected a bull trend reversal bar. When trading Countertrend against a strong trend, it is imperative to wait for the signal bar to close before you place your order, and then only enter on a stop at 1 tick beyond the bar in the direction of your trade (if you are buying, buy at 1 tick above the high of the prior bar on a stop).

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What is the best way to learn how to read price action? It is to print out charts and then look for every profitable trade. If you are a scalper looking for 50 cents in AAPL or $2 in GOOG on the 5-minute chart, then find every move during the day where that amount of profit was possible. After several weeks, you will begin to see a few patterns that would allow you to make these trades while risking about the same amount. If the risk is the same as the reward, you have to win much more than 50 percent of the time to make the trade worthwhile. However, lots of patterns have a 70 percent or better success rate, and many trades allow you to move up your stop from below the signal bar extreme to below the entry bar extreme while waiting for your profit target to be reached, reducing your risk. Also, you should be trying to enter trades that have a good chance of running well past your profit target, and you should therefore only take partial profits. In fact, initially you should only focus on those entries. Move your stop to breakeven and then let the remainder run. You will likely have at least a couple of trades each week that run to four or more times your initial target before setting up a reverse entry pattern.

Fibonacci retracements and extensions are a part of price action, but since most are just approximations and most fail, do not use

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them for trading. If one is good, it will be associated with a chart pattern that is reliable and tradable on its own, independent of the Fibonacci measurement or any indicators. Elliott Wave Theory is also a type of price action analysis, but for most traders it is not tradable. The waves are usually not clear until many, many bars after the ideal entry point, and with so many opposite interpretations at every instant, it requires far too much thought and uncertainty for most active day traders.

Should you be concerned that making the information in this book available will create lots of great price action traders, all doing the same thing at the same time, thereby removing the late entrants needed to drive the market to your price target? No, because the institutions control the market, and they already have the smartest traders in the world, and those traders already know everything in this book, at least intuitively. The reason that the patterns that we all see unfold as they do is because that is the appearance that occurs in an efficient market with countless traders placing orders for thousands of different reasons, but with the controlling volume being traded based on sound logic. That is just what it looks like, and it has forever. The same patterns unfold on all time frames in all markets around the world and it would simply be impossible for all of it to be manipulated instantaneously on so many different levels.

If everyone suddenly became a price action scalper, the smaller patterns might change a little for a while, but over time, the efficient market will win out, and the votes by all traders will get distilled into standard price action patterns because that is the inescapable result of countless people behaving logically. Also, the reality is that it is very difficult to trade, and although basing trades on price action is a sound approach, it is still very difficult to do real time. There just won't be enough traders doing it well enough, all at the same time, to have any significant influence over time on the patterns. Just look at Edwards and Magee. The best traders in the world have been using those ideas for decades and they continue to work, again for the same reason . . . charts look they way they do because that is the unchangeable fingerprint of an efficient market filled with a huge number of smart people using a huge number of approaches and time frames, all trying to make the most money that they can.

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TREND BARS AND DOJI BARS

The market is either trending on the chart in front of you, or it is not. When it is not, it is in some kind of trading range, which is composed of trends on smaller time frames. On the level of an individual bar, it is either a trend bar or a trading range bar. Either the bulls or bears are in control of the bar, or they are largely in equilibrium (a one bar trading range).

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For a trader, it is most useful to think of all bars as being either trend bars or nontrend (trading range) bars. Since the latter is an awkward term and most are similar to dojis, it is simpler to refer to all nontrend bars as dojis (doji bars) (see Figure 1.1). If the body appears tiny or nonexistent on the chart, the bar is a doji, and neither the bulls nor bears controlled the bar, and the bar is essentially a one bar trading range. On a 5-minute Emini chart, a doji body is only a tick or two large. However, on a daily or weekly Google chart, the body can be 100 ticks ($1) or more and still have the same significance as a perfect doji, and therefore it makes sense to refer to it as a doji. The determination is relative and subjective, and it depends on the market and the time frame.

If there is a body, then the close trended away from the open, and the bar is a trend bar. Obviously, if the bar is large and the body is small, there was not much trending strength. Also, within the bar (as seen on a smaller time frame), there may have been several swings of largely sideways movement, but this is irrelevant because you should focus on only one chart. Larger bodies in general indicate more strength, but an extremely large body after a protracted move or a breakout can represent an exhaustive end of a trend, and no trade should be taken until more price action unfolds. A series of strong trend bars is the sign of a healthy trend and will usually be followed by a further extreme, even if a pullback immediately ensues.

An ideal trend bar is one with a moderate-size body, indicating that the market trended away from the open of the bar by the time the bar closed. The minimum is a close above the open in a bull trend bar, indicated by a white candle body in this book. The bulls can demonstrate stronger control

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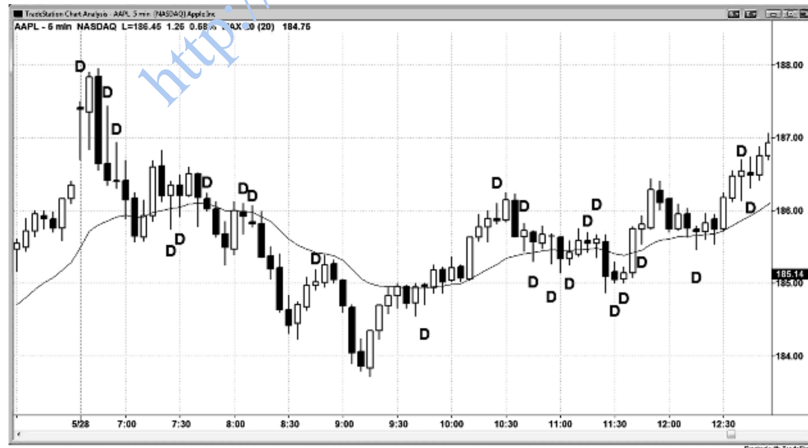

FIGURE 1.1 Examples of Dojis

by having the body be about the size or larger than that of the median body size over the past 5 or 10 bars. Additional signs of strength include the open being on or near the low, the close on or near the high, the close at or above the closes and highs of several prior bars, the high above the high of one or more prior bars, and the tails being small. If the bar is very large, it might represent exhaustion or a one bar false breakout that is trapping new bulls, only to reverse down in the next bar or two. The opposite is true for bear trend bars.

Everything is relative and subject to constant reassessment even to the point of totally changing your opinion about the direction of the market. Yes, every bar is either a trend bar or a doji bar, and a doji bar means that the bulls and bears are in balance. However, sometimes a series of dojis can mean that a trend is in effect. For example, if there is a series of dojis, each with a higher close and most with a high above the high of the prior bar and a low above the low of the prior bar, the market is displaying trending closes, highs, and lows, so a trend is in effect (see Figure 1.2).

For trading purposes, it is useful to think of all bars are either trend bars or dojis (or nontrend bars, shown in Figure 1.1 with a "D"), and the labeling is loose. One bar with a small body could be a doji in one area of price action but a small trend bar in another. The only purpose for the distinction is to help you quickly assess whether one side is in control of the bar or if bulls and bears are at a stalemate. Several of the bars in Figure 1.1 could arguably be thought of as both trend bars and dojis.

The 5-minute chart on the right of Figure 1.2 had four dojis in a row, starting at Bar 1, each With Trending closes, highs and lows. The 15-minute

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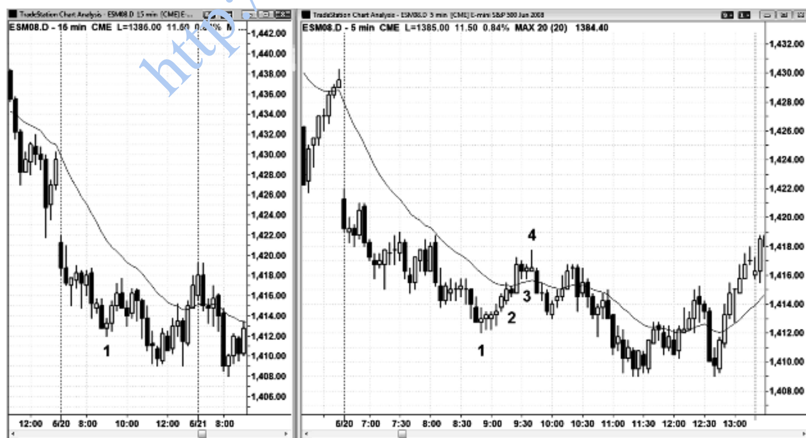

FIGURE 1.2 Trending Doji Bars

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chart on the left of Figure 1.2 shows that they created a bull reversal bar at what was then a new swing low and a bear trend channel line overshoot (not drawn). Individual dojis mean that neither the bulls nor the bears are controlling the market, but trending dojis indicate a trend.

Bar 4 was a doji, which is a one-bar trading range, but it still can be a good setup bar, depending on context. Here, it was a Failed Final Flag (an ii flag) and an EMA Gap Bar short setup, and therefore a reliable signal.

Just like dojis don't always mean the market is trendless, a trend bar does not always mean that the market is trending. Bar 1 in Figure 1.3 is a strong bull trend bar that broke out of a line of dojis. However, there was no follow through. The next bar extended one tick above the trend bar and then closed on its low. The longs exited at one tick below this bear pause bar and new shorts sold there as well, viewing this as a failed bull breakout. No one was interested in buying without more bullish price action, and this caused the market to drop. The bulls tried to protect the low of the bull breakout bar by forming a small bull trend bar (Bar 2 was a setup for a Breakout Pullback long but it was never triggered), but the market fell

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FIGURE 1.3 Trend Bars Do Not Always Indicate a Trend

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though its low, and these new early bulls exited again there, and more new shorts came in. At this point, after the bulls failed in two attempts, they would not be willing to buy without substantial price action in their favor, and both they and the bears would be looking for at least two legs down.

BAR BASICS: SIGNAL BARS, ENTRY BARS, SETUPS, AND CANDLE PATTERNS

Traders look for setups all day long. A setup is a chart pattern composed of one or more bars that leads a trader to believe that an order can be placed that has a good chance of resulting in a profitable trade. In practice, every bar on the chart is a setup because the next bar always can be the start of a strong move in either direction. If the trade is in the direction of the recent or prevailing trend, it is a "With Trend," and if it is in the opposite direction, it is a Countertrend setup. For example, if the recent trend is up and you buy, the setup was a With Trend setup. If instead you shorted, the setup that you used as the basis for your trade was a Countertrend setup, and your short was a Countertrend trade.

A signal bar is always labeled in hindsight, after the bar has closed and after a trade is entered. As soon as your entry order is filled, the prior bar becomes a signal bar instead of just a setup bar, and the current bar is the entry bar. A beginner trader should only enter when the signal bar is also a trend bar in the direction of his trade. For example, if he is shorting, he should restrict himself to signal bars that are bear trend bars, because then the market has already demonstrated selling pressure, and the odds of follow-through are higher than if the signal bar had a close above its open. Similarly, when a beginner is looking to buy, he should only buy when the signal bar has a close above its open.

Almost every bar is a potential signal bar, but the majority never lead to an entry, and therefore do not become signal bars. As a day trader, you will place many orders that never get filled. It is usually best to enter on a stop at one tick above or below the prior bar, and if the stop is not hit, cancel the order and look for a new location for an order. For stocks, it is often better to place the entry stop at a couple of ticks beyond the potential signal bar because one tick traps are common, where the market breaks out by only one tick and then reverses, trapping all of the traders who just entered on stops.

If the entry stop order is hit, you based the trade in part on the prior bar, so that bar is called the signal bar (it gave you a signal that you needed to place an order). Often a bar can be a setup bar in both directions, and you will place entry stops beyond both extremes and will enter in the direction of either bar breakout.

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Much has been written about candle patterns, and it feels as if their unusual Japanese names must mean that they have some mystical power and that they are derived from special ancient wisdom. This is just what novice traders are looking for . . . the power of the gods telling them what to do, instead of relying on their own hard work. For a trader, the single most important issue is determining whether the market is trending or in a trading range. When it comes to analyzing an individual bar, the issue is also whether it is trending or not. If either the bulls or bears are in control, the candle has a body and is a trend bar. If they are in a state of equilibrium and the body is small or nonexistent, it is a doji. Many candle traders use the term "wick" to refer to the lines that usually extend above and below the bodies, presumably to be consistent with the concept of candles. Others call them "shadows." Since all of us are constantly looking for reversal bars and reversal bars look more like tadpoles or small fish, a "tail" is a more accurate descriptive term.

You should only think of bars in terms of price action and not a collection of meaningless and misleading candle names (misleading to the extent that they convey imagery of a mystical power). Each bar or candle is only important in relation to price action, and the vast majority of candle patterns are not helpful most of the time because they occur in price action where they have no high-probability predictive value. Therefore, it will complicate your trading by giving you too much to think about, and they take your mind off the trend.

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Figure 1.4 shows a break above the bear trendline and then a two-legged selloff to a Lower Low below yesterday's low. The first leg was

FIGURE 1.4 15-minute Chart of Visa with a Perfect Trend Reversal

completed by the iii ending at Bar 2. Bar 3 was a strong bull reversal bar that reversed both yesterday's low and a test of the bear trendline, setting up a possible long. A buy stop at one tick above this bar would have been filled, and then Bar 3 becomes a signal bar (instead of just a setup bar), and the bar in which the trade was entered becomes the entry bar.

Bar 4 is an entry bar off of an ii setup for a second leg up.

Bar 5 is an entry bar off of an inside bar Breakout Pullback (the market barely broke above the Bar 2 iii). The bodies of the two pause bars are each inside bodies, so this setup effectively was the same as an ii pattern. Bars 4 and 5 are also High 1 longs.

SIGNAL BARS: REVERSAL BARS

The market can trend up or down after any bar, and therefore every bar is a setup bar. A setup bar becomes a signal bar only if a trade is entered on the next bar (the entry bar). A setup bar in and of itself is not a reason to enter a trade. It has to be viewed in relation to the bars before it, and it can only lead to a trade if it is part of a continuation or reversal pattern.

Since it is always wisest to be trading with the trend, a trade is most likely to succeed if the signal bar is a strong trend bar in the direction of the trade. Even though you are entering after only a one-bar trend, you expecting more trending in your direction. Waiting to enter on a stop beyond the signal bar requires the market to be going even more in your direction, increasing your odds of success. However, a trend bar that is in the opposite direction can also be a reasonable signal bar, depending on other price action on the chart. In general, signal bars that are doji bars or trend bars in the opposite direction of your trade have a greater chance of failure since the side of the market that you need to be in control has not yet asserted itself. It is always better to get into a market after the correct side (bulls or bears) have taken control of at least the signal bar. That trend bar will give traders much more confidence to enter, use looser stops, and trade more volume, all of which increase the chances that their scalper's target will be reached. However, a doji bar can be an excellent signal bar, depending on context.

The best known signal bar is the reversal bar, and the best bull reversal bars have more than one of the following:

- An open near or below the close of the prior bar and a close above the open and above the prior bar's close
- A lower tail that is about one-third to one-half the height of the bar and a small or nonexistent upper tail
- Not much overlap with the prior bar or bars

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The best bear reversal bars have:

- An open near or above the close of the prior bar and a close below the open and below the prior bar's close
- An upper tail that is about one-third to one-half the height of the bar and a small or nonexistent lower tail
- Not much overlap with the prior bar or bars

Reversal bars can have characteristics that indicate strength. The most familiar bull reversal bar has a bull body (it closes well above its open) and a moderate tail at the bottom. This indicates that the market traded down and then rallied into the close of the bar, showing that the bulls won the bar and were aggressive right up to the final tick. A reversal bar alone is not enough of a reason to take a trade. It has to be viewed in the context of the prior price action.

When considering a Countertrend trade in a strong trend, you must wait for a trendline to be broken and then a strong reversal bar to form on the test of the extreme, or else the chances of a profitable trade are too small. Also, do not enter on a 1-minute reversal bar since the majority of them fail and become With Trend setups. The loss might be small, but if you lose four ticks on five trades, you will never get back to being profitable on the day (you will bleed to death from a thousand paper cuts).

Why is that test of the extreme important? For example, at the end of a bear market, buyers took control and the market rallied. When the market comes back down to the area of that final low, it is testing to see whether the buyers will again aggressively come in around that price or if they will be overwhelmed by sellers who are trying again to push prices below that earlier low. If the sellers fail on this second attempt to drive the market down, it will likely go up, at least for a while. Whenever the market tries to do something twice and fails, it usually then tries the opposite. This is why double tops and bottoms work and why traders will not develop conviction in a reversal until the old trend extreme was tested.

If a reversal bar largely overlaps one or more of the prior bars or if the tail extends beyond the prior bars by only a couple of ticks, it might just be part of a trading range. If so, there is nothing to reverse because the market is sideways and not trending. In this case, it should not be used as a signal bar, and it even might turn into a setup in the opposite direction if enough traders are trapped. Even if the bar has the shape of a perfect bull reversal bar, since no bears were trapped, there will likely be no follow-through buying, and a new long will spend several bars hoping that the market will come back to his entry price so he can get out at breakeven. This is pent-up selling pressure.

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If the body is tiny so that the bar is a doji, but the bar is large, it should not be used as a basis for a trade. A large doji is basically a one bar trading range, and it is not wise to buy at the top of a trading range in a bear or sell the low of a trading range in a bull. It is better to wait for a second signal.

If a bull reversal bar has a large tail at the top or a bear reversal bar has a large tail at the bottom, the Countertrend traders lost conviction going into the close of the bar, and the Countertrend trade should only be taken if the body looks reasonably strong and the price action is supportive (like a second entry).

If the reversal bar is much smaller than the last several bars, especially if it has a small body, it lacks Countertrend strength and is a riskier signal bar. However, if the bar has a strong body and is in the right context, the risk of the trade is small (one tick beyond the other side of the small bar).

In a strong trend, it is common to see a reversal bar forming and then seconds before the bar closes, the reversal fails. For example, in a bear, you could see a strong bull reversal bar with a big down tail, a last price (the bar hasn't closed yet) well above its open and above the close of the prior bar, and the low of the bar overshooting a bear trend channel line, but then in the final few seconds before the bar closes, the price collapses and the bar closes on its low. Instead of a bull reversal bar off the trend channel line overshoot, the market formed a strong bear trend bar, and all of the traders who entered early in anticipation of a strong bull reversal are now trapped and will help drive the market down further as they are forced to cover at a loss.

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A big bull reversal bar with a small body also has to be considered in the context of the prior price action. The large lower tail indicates that the selling was rejected and the buyers controlled the bar. However, if the bar overlaps the prior bar or bars excessively, then it might just represent a trading range on a smaller time frame, and the close at the top of the bar might simply be a close near the top of the range, destined to be followed by more selling as the 1-minute bulls take profit. In this situation, you need additional price action before entering a Countertrend trade. You don't want to be buying at the top of a flag in a bear or selling at the bottom of a bull flag.

In Figure 1.5, Reversal Bar 1 largely overlaps the four prior bars, indicating a two-sided market so there was nothing to reverse. This is not a long setup bar.

Reversal Bar 2 is an excellent bear signal bar because it reverses the breakout of Reversal Bar 1 (there are trapped longs here off that bull reversal bar breakout) and it also reverses a breakout above the bear trendline down from the high of the day. The trapped longs will be forced to reverse to sellers as they exit.

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FIGURE 1.5 Reversal Bars in Sideways Markets Must Be Analyzed in Context

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When the market is in a trading range in a downswing, it is forming a bear flag. Smart traders will look to sell near the high, and they would only buy near the low if the setup was strong. As trite as the saying is, “Buy low, sell high” remains one of the best guiding principles for traders.

Reversal bars with big tails and small bodies must be evaluated in the context of the prior price action. Reversal Bar 1 in Figure 1.6 was a breakout below a prior major swing low in a very oversold market (it reversed up from a breakout below the steep trend channel line of the prior eight bars). Profit takers would want to cover their shorts and wait for the excess to be worked off with time and price before they would be eager to sell again. It was a doji bar and therefore a possible bear flag, and traders need a second signal before going long. Two bars later, the market broke below a small bar (a one bar bear flag) but this bear breakout failed on the next bar, trapping shorts and giving longs the second signal that they need for at least a scalp up.

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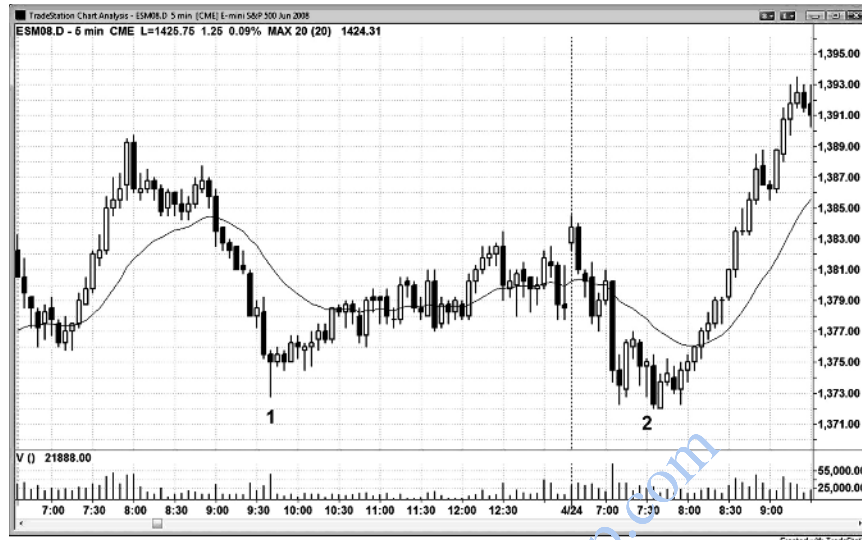

FIGURE 1.6 Reversal Bars with Small Bodies Must Be Analyzed in Context

Reversal Bar 2 overlapped about 50 percent of the prior bar and several of the bars before it, and it did not spike below a prior low. It likely just represents a trading range on the 1 minute chart, and no trades should be taken until more price action unfolds.

Although a classic reversal bar is one of the most reliable signal bars, most reversals occur in their absence. There are many other bar patterns that yield reliable signals. In almost all cases, the signal bar is stronger if it is a trend bar in the direction of your trade. For example, if you are looking to buy a possible bear reversal, the odds of a successful trade are significantly increased if the signal bar has a close well above its open.

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SIGNAL BARS: OTHER TYPES

Remember, a signal bar is a setup bar that led to an entry. However, not all trades are worth taking, and just because a stop was triggered and turned the prior bar into a signal bar, that does not make the trade worthwhile (for example, many signals in Barb Wire are best avoided). All signal bars are meaningless in the absence of price action that indicates that a reversal (trend reversal or reversal at the end of a pullback) is likely.

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Besides a classic reversal bar, other common signal bars (some are two bar patterns) include:

Small Bars

- Inside bar
- ii or iii pattern (two or three increasingly smaller inside bars in a row)
- Small bar near the high or low of a big bar (trend bar or outside bar) or trading range (especially if there is a body in the direction of your trade indicating that your side has taken control)

Note that doji bars are rarely good signal bars because they are one bar trading ranges, and when the market is in a trading range, you should not be looking to buy above the high or go short below the low. They can be decent signal bars if they occur near the high or low of a trading range day, or if they are a With Trend setup in a strong trend. In a trading range, it can be fine to sell below a doji if the doji is at the high of the range, especially if it is a second entry. The bigger trading range trumps the tiny trading range represented by the doji bar, so selling below the doji bar is also selling at the top of a large trading range, which is usually a good trade.

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Other Types of Signal Bars

- Outside bar (see next section)
- Double Bottom Twin: consecutive bars in a strong bear with identical lows and preferably small or nonexistent bottom tails (a type of bear flag)
- Double Top Twin: consecutive bars in a strong bull with identical highs and preferably small or nonexistent top tails (a type of bull flag)
- Opposite Twins: Up Down Twin Top and Down Up Twin Bottom (consecutive trend bars in opposite directions with small tails and nearly identical highs and lows)
- Reversal bar failure (for instance, buy above a bear reversal bar in a strong bull)
- Shaved bar (no tail at one or both of its extremes) in a strong trend
- Exhaustion Bar (huge trend bar)

There are many types of small bars and many different situations in which they occur, and all represent a lack of enthusiasm from both the bulls and bears. Each has to be evaluated in context. A small bar is a much better setup if it has a body in the direction of your trade (a small reversal bar), indicating that your side owns the bar. If the small bar has no body, it is usually better to wait for a second entry, since the probability of a successful trade is much less and the chance of a whipsaw is too great.

An inside bar does not have to be totally inside (high below the prior bar's high and a low above the prior bar's low). One or both of its extremes can be identical to that of the prior bar. In general, it forms a more reliable signal when it is a small bar and when its close is in the direction of the trade you want to take (it is always better to have bull setup bars when you are looking to buy and bear bars when you are looking to sell).

When an inside bar occurs after a big trend breakout bar, it could be simply a pause by the trend traders or a loss of conviction that will lead to a reversal (failed breakout). A reversal is more likely when the small bar is an inside bar and if it is a trend bar in the opposite direction of the large breakout bar. A With Trend inside bar increases the chance that the breakout move will continue, especially if the market had been trending in that direction earlier in the day (for example, if this might be the start of the second leg that you were expecting).

Small inside bars after breakout trend bars are somewhat emotional because a trader will consider entering in either direction on a stop and will have to process a lot of information quickly. For example, if there is a bull breakout during a down day, he will often place an order to buy at one tick above the high of the inside bar and a second order to sell at one tick below its low. Once one order is filled, the other order becomes the protective stop. If he was filled on a breakout failure (that is, on the sell order), he should consider doubling the size of the buy stop order, in case the failed breakout becomes a Breakout Pullback (a failed failure is usually a reliable trade). On the other hand, if he was first filled on the buy (With Trend) order, he usually should not reverse on his protective stop, but he might if the day had been a bear trend day. Once there has been a second or third bar without a failure, a failure that then occurs has a higher chance of simply setting up a Breakout Pullback entry rather than a tradable failure. In general, good traders make quick subjective decisions based on many subtle factors, and if the process feels too confusing or emotional, it is better to not place an order, especially complicated orders like a pair of breakout orders or an order to reverse. A trader cannot invest too much emotion in a confusing trade because he will likely be less ready to take a clear trade that may soon follow.

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An inside bar after a swing move might mark the end of the swing, especially if its close is against the trend and other factors are in play, like a trendline, trend channel line overshoot, a High or Low 2, or a new swing high in a trading range. Also, any small bar, whether or not it is an inside bar, near an extreme of any large bar (trend bar, doji, or outside bar) can set up a reversal, especially if the small bar is a small reversal bar. In general, traders should be looking to buy low and sell high. In a trading range (a trading range day or a trading range in a trend day), the only small bar entries should be fades at the extremes. For example, if a small bar is a

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swing high or follows a bear trendline test or bull trend channel line overshoot and reversal, only look for a short entry. If it is a swing low, only look for a buy.

In a trend (even one during a trading range day), a small bar can setup an entry in either direction. For example, if there is a strong bull move and no prior bull trendline break, an inside bar near the high of a large bull trend bar or a small bar that extends above the high of the trend bar should only be viewed as a buy setup. If it is an inside bar, especially if it is a bull trend bar, it is a great long setup. If it is simply a small bar that extends above the high of the bull trend bar, it might be a safe long setup if the trend is strong enough. In general, it would be better to wait for a pullback, unless the small bar was a bear reversal bar, in which case it could trap bears, and it might make sense to buy on a stop at one tick above its high.

An ii pattern is an inside bar that follows a larger inside bar. It is two in a row with the second being inside the first and of the same size or smaller (an iii is even stronger, with three in a row). After a protracted move, especially if there has been a trendline break, a With Trend breakout from an ii pattern is often just a scalp and has a good chance of reversing before or after the profit target is reached (a Failed Final Flag). However, a Countertrend breakout (or a reversal from a Failed Final Flag) often leads to a large reversal. The pattern often develops in a final flag because it finally indicates balance between the bulls and the bears; the strength of the weaker side has caught up to that of the stronger side, at least temporarily. As such, if the With Trend side takes control, the odds are high that the Countertrend side will try to take it back after the With Trend breakout. The stop on an ii pattern is beyond the opposite side of both bars (not just the second bar, which technically is the signal bar), but sometimes you can use a smaller stop (beyond the second of the two bars instead of beyond both bars) if the bars are relatively large. After the entry bar closes, tighten the stop, and consider reversing at one tick beyond the entry bar. Keep looking to reverse on any failure in the next several bars since failures are common soon after ii breakouts, especially if the pattern forms in the middle of the day's range.

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A 5-minute ii pattern is often a 1-minute Double Bottom/Top Pullback, which is a reversal pattern and might explain why a small ii can lead to a large Countertrend move.

When there is a strong bull, there will sometimes be two consecutive bars with identical highs, and usually with small tails at the tops of the two bars. This is a Double Top Twin buy setup and is a Double Top on the 1-minute chart. Place a stop to go long at one tick above the high of the bars because you will be buying a failed Double Top, and there will be protective stops there from traders who shorted it, adding fuel to the move. Likewise,

in a strong bear, look to short on a stop at one tick below a Double Bottom Twin sell setup.

Up Down and a Down Up Twins setups go by several names, and each is an overlapping pair of trend bars with opposite directions and bodies of about the same size (Opposite Twins). In an Up Down setup, the first bar is a bull trend bar, and the second is a bear trend bar, and this combination is a sell setup if the market is not in a trading range. A Down Up Twin is a bear trend bar and then a bull trend bar and forms a buy setup. They are each basically a two bar reversal pattern and they correspond to a 10-minute reversal bar (just imagine how the two 5-minute bars would look when combined into a single 10-minute bar).

When a trend bar in a strong trend has a shaved body (no tail) at one or both ends, it indicates that the market is one-sided and strong. However, a shaved top on a 5-minute bull trend bar in a runaway bull is stronger than a shaved bottom, because the extreme strength is right into the close of the bar, and it is more likely to continue than strength that occurred five minutes earlier. Therefore, a shaved top is a good setup for a long, but it is often impossible to place a buy stop order because the next bar will already be above the high before you can place your order. If the bar has a one tick tail at its high or a shaved bottom, it is still strong, but in general, that alone would not be reason enough to buy above its high. Also, the bar has to be analyzed in context. If the bar is in a trading range, it would be foolish to buy above its high because trading ranges tend to test the extremes repeatedly, and you should not be buying near the high when the odds of the bar being a test are greater than the odds of the bar being a successful breakout.

Similarly, a bear trend bar with a shaved bottom in a runaway bear is a setup to short at one tick below its low.

Not all small bars are good fade setups. There is one particular situation where they should not be used as signal bars, and that is when the bar is a small doji (small, relative to the recent bars), especially if there is no body, it is near the EMA and occurring approximately between 9 A.M. and 11:00 A.M. PST in a Barb Wire pattern. These have a very high failure rate and always require more price action before placing a trade.

Although most large trend bars that are With Trend in a trend are strong, if a bar is unusually large, it often represents a climactic exhaustion. For example, in a bull, it often means that the last buyers bought. If there are no more buyers, the market will go down. Any standard reversal setup can serve as a signal bar, but a second entry with a strong reversal bar is always the safest setup when trading Countertrend.

Big trend bars on breakouts often fail on the next bar, trapping traders into the wrong side of the market. This is especially common on quiet trading range days.

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FIGURE 1.7 A Small Bar Can Be a With Trend or Countertrend Setup

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In a trend, a small bar on a pullback is only a With Trend setup. In Figure 1.7, Bars 1, 2, 4, and 6 were small bars in pullbacks, and the only trade they offer is a short on a stop at one tick below the low. Even though they are mostly doji bars, they are With Trend and therefore reasonable shorts.

A small bar can also setup a Countertrend trade in a trend if it occurs at a swing low and there are other reasons for trading Countertrend, like a prior trendline break. Bar 3 was a swing low, a reversal up from a Low 2 short, and the second leg down of a second leg down, making it a High 4 long setup. Bar 5 was a High 2 after a strong move up to Bar 4 (it broke a trendline), making a second leg up likely. It was also at the low of a trading range.

The only time that you would sell a small bar at a low is in a bear. Bar 8 is not particularly small, but it was an inside bar, which functions like a small bar, and it was a bear trend bar, making it a safe short at the low of the day. It was also a Breakout Pullback short setup and a Microtrendline (Low 1) short.

In Figure 1.8, Bar 1 is a failed bear reversal bar long setup in GS. The small bear reversal bar formed after the large bull trend bar broke out of a trading range on a bull trend day (most bars are above the rising EMA). Early shorts entered on the reversal bar before it triggered a short signal (the next bar did not trade one tick below its low), and these overly eager shorts were now trapped. There was likely a 1-minute reversal pattern that trapped shorts into one of the many small losing 1-minute Countertrend

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FIGURE 1.8 Failed Reversal Bars Are Often Setups in the Opposite Direction

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trades that occur all day long in strong trends and just eat away at your account, small piece by small piece. They would exit at one tick above the bear reversal bar, which is where and why smart traders went long. A reversal bar alone is not enough reason to enter, even if it is in an area where a reversal might reasonably take place. Here, it appeared to be setting up a failed trading range breakout but the short entry below the bar was never triggered, and it therefore set up an entry in the opposite direction.

In Figure 1.9, Bar 3 is a huge trend bar that collapsed below the low of the open and through a bear trend channel line and was followed by a bull inside bar with a shaved top, meaning that buyers were aggressively buying it right into its close. This is a great setup for at least a two-legged rally. It was also the bottom of a Spike and Channel Bear Trend, and the reversal should test the Bar 2 start of the channel, which is did.

The failed Bar 4 reversal bar was a great long entry on the Bar 5 outside bar in this strong bull (a failed Low 2 top in a strong bull). The Low 2 trapped naïve traders who sold under the reversal bar, but they failed

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FIGURE 1.9 Strong Trend Bars Can Indicate the End of a Trend (Exhaustion, Capitulation)

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to wait for a prior demonstration of bearish strength. You cannot sell in a strong bull if there has not been a prior bull trendline break.

Note that none of the dojis before and after Bar 1 are good signal bars because they are in the middle of the day's range and next to a flat EMA.

In Figure 1.10, POT gapped below yesterday's low and reversed up beyond the EMA. The market yesterday broke a few bear trend lines,

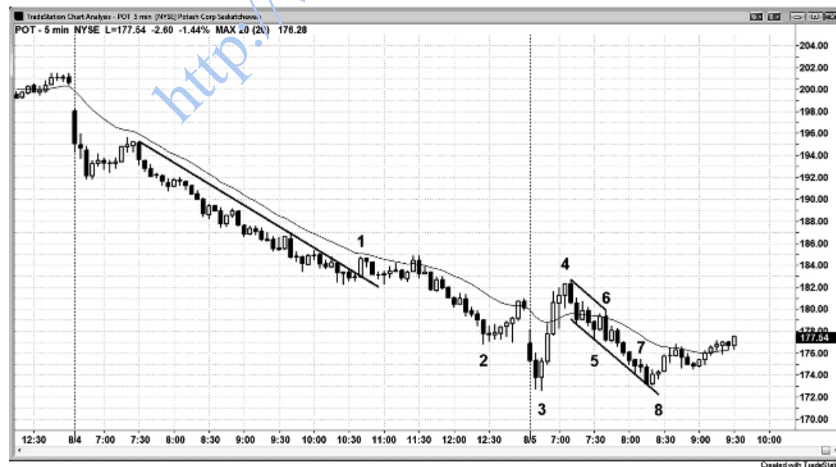

FIGURE 1.10 Countertrend Trades Need a Prior Trendline Break

indicating that there was a reasonable chance for a tradable long, if there is a good buy setup and a good signal bar. Both are needed.

Bar 3 was a clear long, reversing up from below yesterday's low with a strong bull reversal bar. The rally up from Bar 2 broke the bear trendline of the prior hour or so (the line is not shown).

The Bar 4 EMA Gap Bar short was followed by a possible High 2 long at Bar 6, except that there was no signal bar. Bar 5 was a bear trend bar and not a bull signal bar, which is needed when you are buying in a bear trend. The trendline from Bars 4 to 6 allowed for the creation of the trend channel line attached to the Bar 5 low.

Bar 7 took out the high of the prior bar but that bar had a bear close. A pullback after a probe below a trend channel line is not reason enough to buy. You need a bull signal bar.

Bar 8 was a small bull inside bar after a larger bull inside bar, and that bar followed a second probe below the trend channel line. This might also be a Higher Low test of the Bar 3 low of the bear trend. The rally to Bar 4 broke all bear trendlines, so you should be looking to buy a test of the Bar 3 low, and the Bar 8 ii bull inside bar was a great long setup.

An aggressive trader could have bought the Double Bottom Pullback reversal in GS above the Bar 5 ii in Figure 1.11, but there was not yet a trendline break in the small bear down from Bar 4.

There was a second entry above the Bar 6 ii setup. This flag drifted far enough to break a small trendline down from Bar 4, plus it was a second entry.

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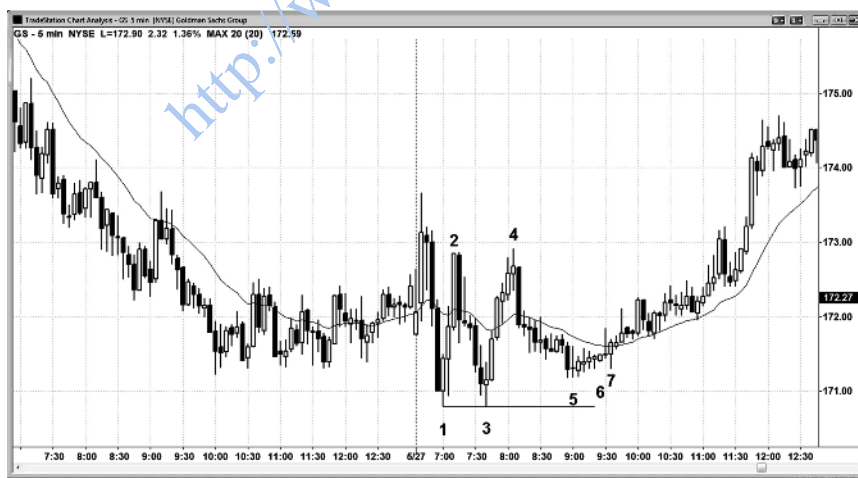

FIGURE 1.11 Double Bottom Pullback Buy Setup

Bar 7 set up a third entry on the failed failure (the market failed on the upside breakout and this failed on the downside on the next bar), which is a very reliable Breakout Pullback long setup and a Microtrendline High 1 buy.

Double Bottom Pullbacks have a pullback that typically extends more than 50 percent and often almost the entire way to the Double Bottom. This Double Bottom was exact to the tick. The Higher Low often forms a rounded bottom, and traditional stock traders would describe it as an area of accumulation. The name is irrelevant; what is important is that the market failed to put in a Lower Low on this second attempt down (Bar 3 was the first), so if it can't go down, the bears will step aside, and the market will probe up (in search of sellers willing to sell at a higher price). Instead of finding sellers, the market found buyers willing to buy at the higher price.

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FIGURE 1.12 Failed Final Flag Buy Setup

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The Bar 2 signal bar in Figure 1.12 was a tiny bar (11 cents in a $185 stock), but if you look at a line chart of the closes, the small Higher Low was clear at point 2. The High 2 from two bars earlier did not have a good prior trendline break, so it was not an ideal Lower Low, Failed Final Flag long entry. Bar 2 is a second entry and a small Higher Low, which is a good setup with minimal risk. Also, it is almost an ii pattern, and close is close enough in trading.

The High 1 at Bar 1 was not a good entry since there was no bull trend bar, which is needed to reverse a strong bear. Also, it followed five bear bodies so there was not yet any up momentum prior to the setup, and this is always needed when looking to buy a bear.

On the 5-minute chart on the right of Figure 1.13, there were two ii patterns (the first is an iii). As you can see from the 1-minute chart on the left, the first one was a Double Bottom Pullback buy pattern, and the second was a failed Low 2.

In both cases, the bull trend bar at the end of the ii was a great setup for a long entry. Even though small bars have less directional significance, it is always better to have the final one being a trend bar in the direction of your intended entry.

In Figure 1.14, Bar 1 was a Double Bottom Twin setup (consecutive bars with identical lows, in a strong bear). Sell at one tick below its low.

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FIGURE 1.13 An ii Buy Setup Is Often a Double Bottom Pullback on a Smaller Time frame

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FIGURE 1.14 Double Bottom Twin Sell Setup

You could also sell below the two bar Breakout Pullback setup on the next bar, giving you an earlier entry. This was also a Microtrendline Low 1 short.

Bar 2 was another example.

Bar 3 was a Double Top Twin setup for a long trade, and it was also a Microtrendline long (a High 1).

LEH had a Down Up Twin Bar reversal on a test of the bear trend channel line in Figure 1.15. The selloff was climactic because it was

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FIGURE 1.15 Up Down Twin Buy Setup

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unsustainable behavior. Sixteen of the prior 17 bars all had a high that was below the high of the bar before. A climax is usually followed by a two-legged correction that lasts for many bars (at least an hour on a 5-minute chart).

In Figure 1.16, Bar 4 was an Up Down Twin Bar reversal on a break above yesterday's high and a bull trend channel line, and after the breakout of a small flag (Bar 3).

Bar 1 was not a good Down Up Twin buy setup because there was too much down momentum in the prior two bear trend bars on their breakout from the Lower High. It was followed by another Down Up Twin buy setup (back to back happens occasionally), but four overlapping bars is a bear flag and you cannot buy at the top of a trading range in a bear. These patterns are only Countertrend signals if there is a reason to expect a reversal; the first pause after a strong breakout is a breakout pullback, and it is usually followed by more trending.

Bar 2 was a good short because there were trapped bulls who bought above the back to back Down Up Twin reversals, and because it ended a two-legged pullback to the EMA in a bear (the two up legs were the two bull trend bars separated by a bear trend bar in the bear flag).

Bar 2 resembles the second bar of an Up Down Twin sell setup, but its close and low were too far below the low of the prior bar; besides, traders were already short before the close of the bar, based on the bear M2S (Low 2 Short at the Moving Average).

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FIGURE 1.16 Up Down Twin Sell Setup

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FIGURE 1.17 Shaved Tops and Bottoms Indicate Conviction and Urgency

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A bar with no tail at either end in the middle of a strong trend is a sign of strength, and traders should enter With Trend on its breakout. In Figure 1.17, Bar 1 had no tail at both its high and low, indicating severe selling pressure (they sold it from start to finish), so it was likely that there would be more selling to come. Traders have to be fast in placing their sell stop orders because the market is moving fast.

Bar 2 had a shaved top in a bear, but since the market was not in free fall at this point, that was not the reason for a short. However, it was a short entry based on taking out the low of a small inside bar in a bear (a Low 1).

Bar 3 was a bull trend bar with a shaved top and bottom, but it was not in a bull trend, and therefore it does not function as a buy setup. However, there was still a buy on the next bar because it was a High 2, and a Down Up Twin reversal at a Lower Low, which was also a failed breakout of a trading range. The first EMA pullback broke the bear trend line so the move down to Bar 3 was a two-legged Lower Low, which is usually good for at least a scalp.

Bars 4 and 5 were not shaved bar sell setups because they were not in a free fall bear.

AAPL demonstrates many common signal bars on this 5-minute chart (Figure 1.18). Bar 1 is a doji with a tiny body and was the third overlapping bar (Barb Wire). It would be foolish to buy above its high because you would be buying the top of a bear flag (Barb Wire below the EMA), despite the tempting doji bar that will make many candle worshipers enter into a bad long trade.

FIGURE 1.18 A Variety of Good Setups

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Bar 2 was a good reversal bar with a long tail that went far below the low of the prior bar and reversed up, and it had a decent-size bull body. The tail at the top showed some weakness, but this was erased by the trend bars that followed it. It was a High 2 long Opening Reversal at a new swing low and a trend channel line breakout (not shown, but it could be drawn across the lows of the prior three bars).

Bar 3 was an outside up bar and a Microtrendline long after a pause bar that followed the breakout to a new high of the day. Outside bars in new trends often trap traders out of great trades because they happen so quickly. Many traders don't have enough time to reverse their perspective fast enough from bearish to bullish, and then they have to chase the market up.

Bar 4 was a bear doji at a new high, but the up momentum is so strong and the reversal bar was so weak that a short could be considered only on a second entry.

Bar 5 was a bull outside up bar that tested the EMA and the breakout from the opening range, and it was the First Pullback in a strong up move and a High 1 long. Bar 6 was a relatively small bear reversal bar and a second entry short after taking out the Bar 4 swing high and yesterday's high. It was also the second leg up from the Bar 5 First Pullback and from the Bar 2 low, and second legs are often reversals. Also, it was a Low 4 and a Wedge shaped, Three Pushes Up from the Bar 3 low that started the

bull breakout above the opening range. With this many factors operating, a trader should expect at least two legs down.

Bar 7 was an ii short at a time when you were expecting two legs down and more of a test of the EMA than what happened on the prior test at Bar 5. It was a small piece of Barb Wire, but the risk was small. The bar after the small entry bar extended above the entry bar but not above either of the ii bars where the protective stop would be. Normally you would tighten the protective stop after the entry bar closes, but when the entry bar is small and it only ran for a few cents, you should give it more room and risk to beyond the high of the ii bars. This is Barb Wire, and it is prone to run stops, so if you are going to take the short, you have to give it a little room. The ii breakout reverses back up a couple bars later, which is expected when an ii is in the middle of the day's range. Also, the market completed its goals of two legs down and a penetration of the EMA. The traders who went long on the High 2 above Bar 7 were immediately trapped by the large outside down bar, and astute traders would go short below the Bar 7 low. The new longs who were trapped and panicked would sell out their losing longs below Bar 7, creating a high probability short.

Bar 8 was a Lower High second entry short after two legs up and a trendline break (the pullback from Bar 6). This is a possible trend reversal and you have to take it seriously. Even though it is a doji, which is a one bar trading range and you should not be shorting below a trading range, it is at the top of a large trading range, and it is a second entry. Also, back-to-back dojis and three sideways bars in a row at a possible turning point is similar to an ii pattern (two bars with small bodies), and therefore become an acceptable short setup.

Bar 9 was a Down Up Twin Bar reversal (which, if you think about it, is a reversal bar on a 10-minute chart), after a new swing low and test of the Bar 5 low (an attempt to form a Double Bottom Bull Flag). It is also a second leg down from the Bar 6 high.

Bar 10 is a Breakout Pullback and a Double Bottom Twin short, which is a pair of consecutive bars with the same low in a strong bear.

Bar 11 is a bull reversal bar after a third push down, but the prior bar was a big doji, and Bar 11 had a large bear tail and small body, and it largely overlapped the two prior bars. This is not a strong reversal but does show some sign of bullish strength. The odds of a trading range are greater than the odds of a significant reversal.

Bar 1 in Figure 1.19 is a break below a bull reversal bar (failed reversal bar) in a strong bear and is a great short because the early bulls who bought will be trapped and forced to sell at one or more ticks below its low.

A doji is a one bar trading range, and selling below a small bar at the top of a trading range is always a good trade, especially in a strong bear, as

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FIGURE 1.19 A Reversal Bar Can Be a with Trend Setup Instead of a Countertrend Setup

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was the case with Bars 2 and 3, both of which followed large dojis. Bar 3 was also a Low 2 in a bear.

Bar 1 in Figure 1.20 is a Down Up Twin buy reversal after taking out the low of the open, and it was a Higher Low.

Bar 2 is a small bear reversal bar at the high of a large bull trend bar, and it tested the EMA. It failed to reverse the market and set up a buy at one tick above its high for a second leg up (it marked the end of the one bar first leg).

Bar 3 was an bear inside bar after a break of a bull trend channel line and yesterday's high, setting up a short of the Wedge.

Bar 4 was a doji bar after two other dojis, and a bar with a tiny body is not a good setup bar when the lows, highs, and closes are trending up. The needed second entry setup came two bars later, completing the Lower High that followed a trendline break.

Bar 5 is a one tick failed breakout of the top of an ii, setting up a Failed Final Flag, which was reversed by the Bar 6 reversal bar. This also reversed a breakout to a new low of the day, and formed a Double Bottom Bull Flag with Bar 1, and it was a Five Tick Failed Breakout.

FIGURE 1.20 Detailed Analysis of Many Setups

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Bar 7 was a doji bar that set up a M2B (a High 2 above the EMA) and a Higher Low long after the bull leg from Bar 6. Even though it had a small body, it was a second entry and was With Trend.

Bar 8 was an inside bear trend bar that was the end of the second leg up and a test of the high of the day. It also was after a trend channel line breakout. However, the momentum up from Bar 7 was strong, so it is better to wait for a second entry, which came with the Bar 10 outside down bar and failed bull reversal bar. The move up from Bar 7 was strong so many longs bought the small (especially compared to the two bear trend bars that came before it) bull reversal bar (Bar 9 was a High 1), but were immediately trapped by the Bar 10 outside bar down. The bears seized control of the market, so there should be two legs down from here. An outside bar that traps traders usually leads to two more legs.

Bar 11 was technically a High 3, but should be expected to behave like a High 2, since the Bar 10 outside bar bull trap should be considered the start of the downswing (not the Bar 6 actual swing high).

Bar 11 was a bull inside bar (ioi) and the second attempt to reverse the breakout below Bar 7, and it reversed the trendline break. It was an EMA Gap 2 Bar on a nontrend day and a High 2 after the Bar 10 bear outside bar that trapped longs.

Bar 1 in Figure 1.21 was a big bull trend bar, but there was so much momentum leading up to it that only a second entry short (Bar 2) could be considered.

FIGURE 1.21 Good and Bad Setups

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Bar 3 was a bear trend bar, but the next two bars were small doji bars so there was no long setup. Small dojis are rarely ever good Countertrend entry bars, and it is almost always better to wait for another setup.

Bar 5 was a good bull reversal bar after a bear trend bar in a bear and also Three Pushes Down from the rally following the Bar 4 low (there was also a trend channel line breakout and reversal, from the line that could be drawn starting at Bar 4). This was an acceptable long scalp. Bar 6 was a large bear trend bar with a big bottom tail after a collapse at the end of the bear. It was also an overshoot of several bear trend channel lines (not shown). With four large bear trend bars in a row, only a second entry long can be considered, which came on the Bar 7 outside up bar. The Bar 7 low was a small Higher Low, which is the start of the second leg up.

Bar 1 in Figure 1.22 was a relatively small bar after a big bear trend bar broke out of a large flag (a failed breakout setup), and it was an exact test of the earlier low. On a trading range day with Bar 1 setting up these two reversals, it was a reasonable long setup.

Bar 2 followed a large bull trend bar breakout of a Tight Trading Range and formed a Higher High (nine bars earlier). It was a bear reversal bar that setup a failed breakout short that led to a strong bear into the close (the market closed 30 points lower, but this is not shown because it would shrink this bull trend bar to the point of looking unremarkable instead of how it appeared in real time).

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FIGURE 1.22 Failed Breakouts

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OUTSIDE BARS

If the high of the current bar is above the high of the previous bar and the low is below the low of the previous bar, then the current bar is an outside bar. Outside bars are complicated to read, and there are many subtleties in their analysis. The increased size of the bar means that bulls and bears are willing to be more aggressive, but if the close is near the middle, it is essentially a one bar long trading range. At other times, they can act as reversal bars or trend bars. Traders must pay attention to the context in which they occur.

Traditional technical analysis teaches that outside bars are setup bars for a breakout in either direction, and you should put an entry stop above and below. Once filled, double the size of the unfilled stop and make it a reversal order. However, it is almost always unwise to enter on a breakout of a 5-minute outside bar, especially if the outside bar is large (a breakout of a 1-minute outside bar is often a good trade) because of the greater risk that the distant stop entails. If for some rare reason you did enter on the breakout of an outside bar and the protective stop is too large, consider using a money stop (like two points in the Emini) or trading fewer contracts. Since an outside bar is a one bar trading range and it is better to not buy at the top of a sideways market or sell below it, it is almost always imprudent to enter on a breakout of the bar.

Sometimes you have to enter on an outside bar (not on its breakout) because you know that traders are trapped. This is especially true after a

strong move. If an outside bar occurs as the second entry in a strong reversal from a trendline break or trend channel line overshoot, it can be an excellent entry bar. For example, if the market just sold off below a swing low for the second time and reversed up from a trend channel line overshoot, you are likely looking to buy, and you keep moving a buy stop order to one tick above the prior bar's high until you get filled. Sometimes the fill will be on an outside up bar. This is usually a good reversal trade, and it is due to strong buyers and not just anxious trading range traders getting in and then quickly getting out in a panic once they realized that they made the mistake of buying near the high of an outside bar in a trading range.

If an outside bar is in the middle of a trading range, it is meaningless and should not be used to generate trades, unless it is followed by a small bar near the high or low of the outside bar, setting up a fade. An outside bar in a trading range just reaffirms what everyone already knows . . . that both sides are balanced and both will sell near the top of the range and buy near the bottom, expecting a move toward the opposite end of the outside bar. If the market instead breaks out in the other direction, just let it go and look to fade a failed breakout of the outside bar, which commonly happens within a few bars. Otherwise, just wait for a pullback (a failed failure of the breakout becomes a Breakout Pullback).

If the bar after the outside bar is an inside bar, then this is an ioi pattern (inside-outside-inside) and can be a setup for an entry in the direction of the breakout of the inside bar. However, only take the entry if there is a reason to believe that the market could move far enough to hit your profit target. For example, if the ioi is at a new swing high, a downside breakout could be a good short since it is likely a second entry (the low of the outside bar will probably be the first entry). If it is in Barb Wire, especially if the inside bar is large and in the center of the outside bar, it is usually better to wait for a stronger setup.

When a With Trend outside bar occurs in the first leg of a trend reversal and the prior trend was strong, it functions like a strong trend bar and not a trading range type of bar. It usually leads to two legs after the outside bar because the outside bar is an attempted With Trend entry that failed. Everyone suddenly agrees about the new direction, and therefore the move will have so much momentum and extend so far that it will likely get tested after a pullback, creating a second leg. The outside bar will act as the start of the trend rather than the actual old trend extreme. For example, if the beginning of the bar triggers a Low 1 (or Low 2) short in a bear rally, but by the end of the bar, the bar has become an outside up bar that ran the protective stops on the shorts and then closed on its high, this bar will have formed a Higher Low in the new bull. This failure puts everyone in agreement that the new trend is strong, and once everyone agrees, the first

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leg up will likely require a test in the form of a second leg up. This failure, and not the actual bear low, is the start of the up leg, so there should be two legs up from here. This will appear as three legs up on the chart, but functionally, it is two legs up from the outside bar low, which is the point where it became clear that the bulls seized control.

Why is the move often strong? The Low 1 enticed the old bears to short. Then the entry bar will quickly reverse to an outside bar up, trapping the bears in and trapping the bulls out. Invariably, the market will trend up hard for many more bars as everyone realizes that the market has reversed and they are trying to figure out how to position themselves. The bears are hoping for a dip so they can exit with a smaller loss and the bulls want the same dip so they can buy more with limited risk. When everyone wants the same thing, it will not happen because both sides will start buying even two or three tick pullbacks, preventing a two to three bar pullback from developing until the trend has gone very far. A smart price action trader will be aware of this possibility at the outset, and if she is looking for a two-legged extended up move, she will watch the first Low 1 and Low 2 carefully and anticipate its failure. She will place her entry orders just above the high of the prior bar, even if it means entering on an outside bar up (especially if it is the entry bar for the shorts).

The single most important thing to remember about outside bars is that whenever a trader is uncertain about what to do, the best decision is to wait for more price action to develop.

A strong trend that goes sideways midday often has a second leg later in the day. This is a Trend Resumption move in Figure 1.23. Note that outside bar breakouts in a strong trend usually result in a two-legged move. Bar 1 is an outside bar, and smart traders would have orders to go short at one tick below its low because the enthusiastic longs will exit there and not look to buy until more support develops.

Bar 2 was the second leg down (the first leg was the High 1 outside bar two bars earlier). After a two-legged move from a breakout, the market will usually try to correct.

Bar 5 was an outside down bar but the market was basically sideways with lots of overlapping bars, so it is not a reliable setup for a breakout entry. The inside bar that followed it (ioi) was too large to use as a breakout signal, because you would be either selling at the bottom of a trading range or buying at the top, and you only want to buy low or sell high.

Outside bars are tricky because both the bulls and bears were in control at some point during the bar, so the movement over the next few bars can have further reversals. Bar 1 in Figure 1.24 is an outside bar that formed an inside-outside-inside (ioi) pattern. The Bar 2 breakout of the inside bar following Bar 1 failed, which is common. Bar 2 would have been a terrible long because the inside setup bar was too large and it would have forced

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FIGURE 1.23 Strong Trends Often Go Sideways in the Middle of the Day and Then Resume

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FIGURE 1.24 Outside Bars Can Be Tricky to Read

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the trader to buy near the high of the range. A small failure bar is a great entry because the risk is small. The short down from Bar 2 broke below the outside bar, triggering longs to exit and resulting in two small legs down to Bar 4. This was also a failure of the reversal up from the bear trend channel line.

Bar 4 is almost an outside up bar, and in trading if something is almost a reliable pattern, it will likely yield the reliable result. Bar 4 was the second bull bar in the second leg, and the second attempt to reverse the low of the day, and so it was a great setup for a long.

Bar 5 is an outside bar followed by a small inside bar near its high. Again, this yields a great short with minimal risk. Once the market ran the stops below the outside bar, traders would expect two legs down, because bulls were trapped into longs on the strong bull trend outside bar. This time, the two legs formed dojis (Bars 8 and 9) and a small Double Bottom, which was not the down momentum that traders were expecting. This loss of down momentum was followed by the Bar 10 Double Bottom Pullback long and a failed Low 2 short, so there are trapped shorts. Bar 9 was also a High 2 long on the pullback from the bull up from Bar 4, forming a Higher Low on the day after a protracted rally following the break of the bear trendline. This High 2 is reason enough to buy.

In Figure 1.25 Bar 2 was an outside bar up that trapped traders who shorted the Low 1.

The next bar was a bear reversal bar at the high of the outside bar, setting up a great short fade. Even on days like this with a sideways open, the

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FIGURE 1.25 Outside Bars

moves on the open are usually good enough to provide at least a scalper's profit. Trading the upside breakout of the Bar 1 bear trend bar by the outside bar on a big gap down opening is a good bet, since the market will try to close the gap and now you also have trapped bears. The odds of success were increased by the Bar 2 entry bar breaking below the inside before breaking above. That downside move trapped more shorts since it was the second attempt down (the first bar of the day was the first attempt).

The Bar 4 outside bar was part of Barb Wire, and the next bar was not a small bar that could be faded. In fact, it was an even larger outside bar, trapping both the longs and shorts who entered on the Bar 4 outside bar as it broke above and below its prior bar.

The bar after Bar 5 was a great setup. It was a small bar near the low of the outside bar, making it a low risk long. It was also a High 2 and a Higher Low.

Bar 6 was a bear reversal bar and a Low 2 bar near the high of an outside bar and a good short.

Bar 7 broke to a swing high and reversed down as an outside bar. The next bar was a small bar near the low, but there was no reversal above its high, and so there was no long entry. The two bars before Bar 8 also tried to trigger the long, but they too failed to hit the entry stop above that small inside bar that followed Bar 7. Even though this is Barb Wire, it is a possible short after so many failed attempts to hit the buy stops. Also, a down move would create a second leg down from the Bar 7 high, and this was a great day for second legs. Bar 8 was also something of a Microtrendline short.

The selloff to Bar 3 in Figure 1.26 broke a major trendline, alerting traders to short a test of the Bar 2 high. Bar 3 was an outside bar that was a reversal bar and an entry bar.

Bar 4 was a large bull trend bar (climactic) that formed a Higher High, and it was followed by a strong bear inside bar that was the signal for the short. Traders were expecting two legs down from such a strong setup. As such, smart traders will be watching for the formation of a High 1 and then a High 2 and readying themselves to short more if these long setups fail and trap the bulls.

Bar 5 was a short setup for a failed High 1, and Bar 6 was a great bull trap. It was a failed High 2 and the long entry bar reversed into an outside bar down, trapping longs in and bears out. This outside bar acted like a bear trend bar and not just an outside bar. Because it is an outside bar, the entry bar and its failure happen within a minute or two of each other, not giving traders enough time to process the information. Within a bar or two, they realize that the market, in fact, has become a bear trend and the longs are hoping for a two- or three-bar pullback to exit with a smaller loss and the bears are hoping for the same rally to allow for a short entry with a smaller

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FIGURE 1.26 An Outside Bar Is a Good With Trend Entry Bar at the End of a Two-Legged Pullback

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risk. What happens is that both sides start selling every two- or three-tick pullback, so a two- or three-bar rally does not come until the market has gone a long way.

Note that the High 2 long was a terrible setup because five of the six prior bars were bear bars and the other bar was a doji. A High 2 alone is not a setup, especially after a climax top and possible major reversal down. There first has to be earlier strength, usually in the form of a High 1 leg that breaks a trendline or at least an earlier strong bull trend bar.

THE IMPORTANCE OF THE CLOSE OF THE BAR

A bar usually assumes something similar to its final appearance seconds to a minute or more before the bar closes. If you enter before the bar closes, you might occasionally make a tick or so more on your trade. However, once or twice every day, the signal that you thought was going to happen does not and you will lose about eight ticks. That means that you need about eight early entries to work as planned for every one that does not, and that simply won't happen. You can enter early With Trend in a strong trend, and you will likely be fine. However, when there is a strong trend, you have so much confidence in the signal that there is no downside to waiting for the bar to close and then entering on a stop beyond the bar. You cannot be deciding on every bar if an early entry is appropriate because

you have too many other important decisions to make. If you add that to your list of things to think about, you will likely end up missing many good trades every day and forgo far more in missed opportunities than you could gain on an occasional early entry.

This holds true for all time frames. For example, look at a daily chart, and you will see many bars that opened near the low but closed in the middle. Each one of those bars was a strong bull trend bar with a last price on the high at some point during the day. If you bought under the assumption that the bar was going to close on its high and bought near the high and instead it closed in the middle, you would realize your mistake. You are carrying home a trade that you never would have entered at the end of the day.

There are two common problems that regularly occur on the 5-minute chart. The most costly is when you try to pick a bottom in a strong trend. Typically you will see a Lower Low after a trendline break, and traders will be hoping for a strong reversal bar, especially if there is also a bear trend channel line overshoot. The bar sets up nicely and is a strong bull reversal bar by the third minute or so. The price is hanging near the high of the bar for a couple of minutes, attracting more and more Countertrend traders who want to get in early so that their stop will be smaller (their stop will be below the bar), but then with five seconds remaining before the bar closes, the price collapses, and the bar closes on its low. All of those early longs who were trying to risk a tick or two less end up losing two points or more. These longs let themselves get trapped into a bad trade.

The other common problem is getting trapped out of a good trade. For example, if you just bought and your trade has had three to five ticks of open profit but the market just can't hit six, allowing you to scalp out with four ticks of profit, you start to become nervous. You look at the 3- or 5-minute chart with about 10 seconds before its bar closes, and it is a strong bear reversal bar. You then move your protective stop up to one tick below that bar, and just before the bar closes the market drops and hits your stop only to pop up several ticks in the final two seconds of the bar. Then, within the first 30 seconds of the next bar, the market quickly goes up to 6 ticks where smart traders took partial profits while you are sitting on the sidelines. Good entry, good plan, bad discipline. You just let yourself get trapped out of a good trade. If you had followed your plan and relied on your initial stop until the entry bar closed, you would have secured your profit.

There is one other point about bar closes. Pay very close attention to the close of every bar, especially for the entry bar and the bar or two later. If the entry bar is six ticks tall, you would much prefer seeing the body suddenly increase from a two-tick trend bar to a four-tick trend bar in the final seconds of the bar. You will then likely reduce the number of contracts that you will scalp out. This is true for the next couple of bars as well. If

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there are strong closes, you should be more willing to swing more contracts and hold them for more points than if these bars had weak closes.

The 5-minute Emini in Figure 1.27 has been in a strong bear for weeks, and it is now starting to have bigger pullbacks and each new Lower Low is being bought, leading to profitable Countertrend trades. The bulls are more confident, and the bears are becoming more willing to take profits. The thumbnail on the left is a 3-minute chart, and the one on the right is a close-up of the 5-minute chart.

Bar 5 broke above a trendline, and Bar 8 exceeded another by a fraction of a tick.

Bar 10 was an ii, and if you look at the bodies alone, it was an iiii (four inside bars in a row, each smaller than the prior!), which could lead to a great Failed Final Flag and then a two-legged rally and probably a gap bar above the EMA (it happened at Bar 12), which will likely be exceeded after a pullback to a Higher Low (maybe the Bar 13 test of the trendline).

Bar 11 was a strong bull reversal bar and a second attempt to reverse up from a Lower Low (the iiii was the first). This is a very high probability long, but the stop would have to be beneath its low, three points below the entry price. This is more than what is typically required in the Emini (normally two points works for most trades), but that is what the price action shows is needed. If you are nervous, just trade half-size, but you must take a strong setup like this one and plan on swinging half.

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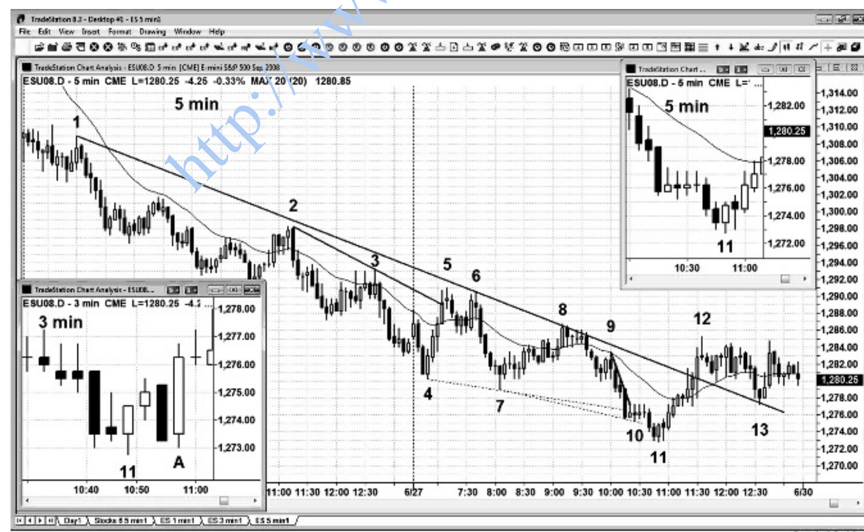

FIGURE 1.27 A Strong Bear, But They Are Starting to Buy New Lows

This is a perfect example of a common problem that traders face when they try to reduce risk by watching a smaller time frame chart. There was also a 3-minute reversal bar at Bar 11, but the stop below the entry bar was hit by a bear trend bar with shaved tops and bottoms, indicating very strong sellers. At this point, it would be very difficult to reconcile that with the 5-minute chart where the stop had not been hit. The large size of the stop required on the 5-minute chart would make traders more willing to exit early and take a loss. If a trader was also watching the 3-minute chart, he almost certainly would have exited with a loss, and he would have been trapped out of the market by that strong bear trend bar. The next bar on the 3-minute chart was a very strong outside bull trend bar, indicating that the bulls were violently asserting themselves in creating a Higher Low, but most of the weak hands who were stopped out would likely be so scared that they would not take the entry and instead wait for a pullback.

Stop runs on the 3-minute chart are very common at important reversals, and smart traders look at them as great opportunities because they trap weak longs out of the market, forcing them to chase the market up. It is always better to just watch and trade off one chart because sometimes things happen too quickly for a trader to think fast enough to place his orders if he is watching two charts and trying to reconcile the inconsistencies.

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EXCHANGE TRADED FUNDS (ETFs) AND INVERSE CHARTS

Sometimes the price action becomes clearer if you change something about the chart. You can switch to a bar or line chart or a chart based on volume or ticks, or a higher or lower time frame or simply print the chart. Several ETFs are also helpful. For example, the SPY is almost identical in appearance to the Emini chart and sometimes has clearer price action.

Also, it can be helpful to consider the chart from an opposite perspective. If you are seeing a bull flag but something doesn't seem quite right, consider looking at the SDS, which is an ETF that is based on the inverse of the SPY (but with twice the leverage). If you look at it, you might discover that the bull flag that you were seeing on the Emini and SPY might now look like a rounding bottom on the SDS. If it does, you would be wise not to buy the Emini flag and instead wait for more price action to unfold (like waiting for the breakout and then shorting if it fails). Sometimes patterns are clearer on other stock index futures, like the Emini Nasdaq-100, or its ETF, the QQQQ, or its double inverse, the QID, but it is usually not worth looking at these and it is better to stick with the Emini and sometimes the SDS.

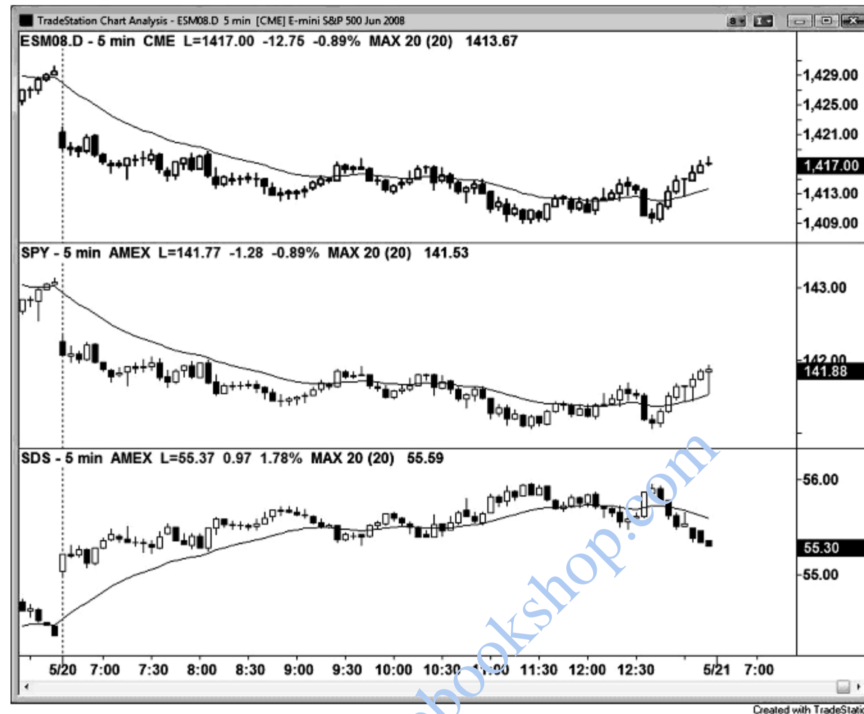

FIGURE 1.28 The SDS Is Essentially the Inverse of the Emini, and It Can Help You Decide on an Emini Setup

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The top chart of the Emini in Figure 1.28 is essentially identical to that of the SPY in the middle chart, but the price action on the SPY is sometimes easier to read. The bottom chart is the SDS, which is an ETF that is the inverse of the SPY (with twice the leverage). Sometimes the SDS chart will make you reconsider your read of the Emini chart.

SECOND ENTRIES

Bottoms on the daily chart usually require a second reversal off the low to convince enough traders to trade the market as a possible new bull. This second entry is almost always more likely to result in a profitable trade than is a first entry. The sellers are making a second attempt to drive the price down and if the market fails in two attempts to do something, it usually will attempt to do the opposite.

If the second entry on any time frame is letting you in at a better price than the first, be suspicious that it might be a trap. Most good second entries are at the same price or worse. A second entry trader is someone entering late, trying to minimize risk, and the market usually makes you pay a little more for that additional information. If it is charging you less, it might be setting you up to steal your money in a failed High/Low 2.

Traders looking for second entries are more aggressive and confident, and will often enter on smaller time frame charts. This usually results in traders on the 5-minute charts entering after many other traders have already entered, making the entry a little worse. If the market is letting you in at a better price, you should suspect that you are missing something and consider not taking the trade. Most of the time, a good fill equals a bad trade (and a bad fill equals a good trade!).

If you are fading a move, buying a pullback in a bull, for example, and the move had about four strong trend bars or two or three large trend bars, there is too much momentum for you to be placing an order in the opposite direction. It is better to wait for an entry, then don't take it, and then wait for a second pullback bar and then enter on the market's second attempt to reverse.

Since second entries in good setups usually succeed, if one fails, assume that you are reading the market incorrectly and do not take a third entry unless it is a Wedge (a failed trend channel line breakout).

There were many second entry trades today in Figure 1.29, and all but one were at the same price or a worse price than the first entry. Look at the

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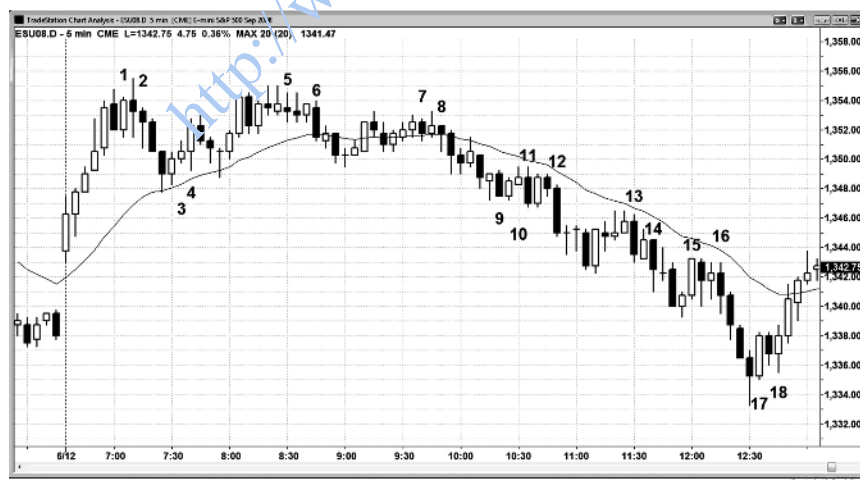

FIGURE 1.29 Second Entries Are Usually Great Signals

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Bar 10 long. The market is letting you buy at one tick better than the traders who bought at Bar 9. In general, the “Good fill, bad trade” maxim applies. Whenever the market is offering you a bargain, assume that you are reading the chart incorrectly, and usually it is better not to take the trade.

Bar 1 in Figure 1.30 was a Low 1 short at a new high on the day, but it followed five bull trend bars, which is too much upward momentum to be looking to sell. Smart traders would wait to see if the bulls would fail in a second attempt to rally before going short, and this happened on the second short entry at Bar 2.

Bar 3 was a first entry long on a new low of the day, but after six bars without a bullish close, it makes more sense to wait for a second long entry, which occurred on Bar 4. In general, four or more trend bars against your intended direction means that a second entry is usually preferable.

Bar 5 was a High 2, but it followed four bear trend bars, which is too much down momentum. A second entry never developed, so smart traders averted a loss by waiting, although going long on a reversal out of an ii flag (7 bars earlier) after a long move is usually a good trade.

The Bar 7 ii was a possible Failed Final Flag. Traders could have gone long on Bar 8, but the prior reversal bar had too much overlap with the bar before it and the move down from Bar 6 was too strong. Bar 9 offered a second entry, following the prior bar’s attempt to sell off.

Bar 10 was a Low 1 following two earlier bear bars since the Bar 8 low, but there were six bars with higher lows, indication too much bullish strength. There was a second entry at the Bar 11 bear reversal bar.

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FIGURE 1.30 When the Market Is Strong, Wait for a Second Entry Before Fading

LATE AND MISSED ENTRIES

If you look at any chart and think that, if you had taken the original entry, you would still be holding the swing portion of your trade, then you need to enter at the market. However, you should only enter with the number of shares or contracts that you would still be holding had you taken the original entry, and you should use the same trailing stop. For example, if you see a strong trend underway in GS, and had you taken the original entry with 300 shares and you now would only be holding 100 shares with your protective stop at $1.50 away, you should buy 100 shares at the market and place a $1.50 protective stop. Logically, buying a swing size portion now or holding a swing position from an earlier entry doesn't make a difference. Although it might be easier emotionally to think of the trade with the open profit as risking someone else's money, that is not the reality. It is *your* money, and what you are risking is no different from buying now and risking the same $1.50. A trader knows this and will place the trade without hesitation. If he does not, then he simply does not believe that he would still be holding any shares had he entered earlier, or he needs to work on this emotional issue.

In Figure 1.31 GS ended in a strong bear yesterday that might have bottomed before the close when the rally into the close broke the bear trendline. There was a second long entry at Bar 1 following a strong bull trend bar and a High 2.

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FIGURE 1.31 It's Never Too Late to Enter a Strong Trend

P1: OTA
c01 JWBT048-Brooks March 1, 2009 7:19 Printer: Yet to come

Today's open sold off for three bars to test the EMA and yesterday's close and then reversed up for an Opening Reversal and a Higher Low after a two-legged sideways correction.

If a trader had missed the long and saw this chart around Bar 4 after a series of bull bars, he would probably be wishing that he had caught the open so that he would at least have the swing portion of his position still working. If he normally trades 300 shares and he would normally only have 100 left around Bar 4 with a breakeven stop from the Bar 3 entry that he missed, he should buy 100 shares at the market and use that stop at the high of the Bar 3 signal bar (maybe 10 cents below the high, since GS often runs stops). He should also look for pauses and pullbacks to add on. After adding on at the High 2 after Bar 6, he could move the stop for the entire position to one tick below the Bar 6 signal bar and then trail it up.

Entering late and using the original stop is absolutely identical to being long the swing portion of the original position, using the same protective stop.

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