A COMPLETE DAY TRADING SYSTEM

Succeed as a Full-Time Day Trader, by managing your trades with Pivots, VPA, and Tape Reading. Whilst optimizing your risk and personal psychology.

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CHAPTER 6

PRICE-BASED ANALYSIS

Price-based analysis, or value-based analysis as I prefer to call it, takes into consideration the price levels that are most apt to generate transactional volume. As I discussed in Chapter 4, the auction is in search of value. Value is price, and value over time is established by repeated transactions at a given price. As value is found and rejected and the price moves toward new areas of value, a very intricate process begins to unfold.

The market is steered by Market Makers using incredibly complex algorithms. These systems have access to the entire depth of the market (the previously referenced Level 2). Every order on the book is available to be scrutinized. You must become aware of this system to avoid being trapped by these algorithms.

Have you ever been stopped out to the penny? I know I certainly have been. Since that seems almost impossible statistically, why then does it happen so often? The answer is because these programs can see where orders are starting to congregate. Since so many traders all use the same trading systems and strategies, this creates obvious locations for Market Makers to grab liquidity or supply when needed. If that supply doesn't exist, these algorithms can move the price to entice or shake out weak hands, leaving only the strong hands to survive. While there is nothing wrong with being paper handed,[124] you need to make sure you aren't fodder for the algorithms.

124 A paper hand is a trader who for whatever reason (generally due to a lack of confidence) sells too soon and misses out on a potentially profitable trade.

WEAK HANDS

A weak hand is what STF (smaller time frame) traders are usually called. These are traders like us who are not looking to hold positions for a long time. Any adverse movement and our risk tolerance is very low. What truly defines a weak hand is the ability to tolerate risk. It is not about the size of your account. Even the smallest account can be a strong hand if you never sell your position. And subsequently, a massive account can also be a weak hand if your tolerance for risk is small.

An unfortunate reality that many traders need to grasp is that as a weak hand, you frankly have no power over the market. You have no influence on the price of a stock nor on the perception of its value. You are merely plankton in an ocean full of whales.

In both poker and trading, weak hands can get pushed out by the strong hands. You will feel as though some unknown entity in the market is hunting your stops. Guess what: it is!! However, it's not what you think. It's not a personal attack on you by some greater market authority. You, similar to plankton, will swarm together with other weak hands, and you will quite often do that in obvious places. The whales comprehend this and are using the tools I'm teaching you RIGHT NOW. They know where your stop will be set because that's where everyone else's stop is located. And, akin to a whale, they will scoop down and eat the entire school of plankton and then move on.

Therefore, it is so important to understand this game. To be one of the plankters (that's the fancy name for an individual plankton) that survive, you don't need to beat the whale, but you do need to know where they are going to feed. Let them feed, then ride their wake as they move to the next feeding ground.

You can recognize the weak hands by watching the volume and the key price levels. You will be able to spot the levels being tested on low volume. If there is no support from LTF participants, the weak hands will be in jeopardy and, if necessary, they will bail quickly.

Just above the key price levels being tested will be the stops set by the short sellers. This zone is defined by the rectangular box outlined in red in Figure 6.1. (If you are reading the paper edition of this book rather than the e-book edition, the colors in Figure 6.1 will of course not be displayed in your version. The box framed in red is the rectangular box in the top left-hand part of the chart.) As the top of this range is set, the prior range's floor will become the ceiling.

You will see in Figure 6.1 that the price of the stock bottomed, and then rose and set a range top with an isolated pivot just under the zone marked by red dotted lines. On the pullback short sellers came in setting a second stop zone which is identified by the box outlined in yellow (the larger of the two rectangular boxes on this chart, part of which is below the box marked by red dotted lines).

The downside wicks highlighted with a circle do not represent major buyers, they result from the short sellers who came in under the rectangle outlined in red and are now covering and taking profit. These short covers lead to a short squeeze. Short squeezes occur when the weak hands are forced out as the price comes against them. Ironically enough, most short squeezes are caused by shorts covering. Notice that as the price moves into the rectangular box outlined in yellow, there is a sudden acceleration through the two zones. There is no Bull rally here, so the price quickly stalls after the squeeze ends. Larger short sales are added into the mix and the price begins to fall again. This occurs after momentum runs out and we lose the range marked by green dotted lines. This causes Bulls to stop out and more short sellers come in to establish a down trend.

Stops will move the price of a stock and, in contrary fashion, profit taking will cause the price to stall. At times, the most effortless way to make the price move is to stop out the opposition. Getting them out of the way frees up the ladder for an easier move.

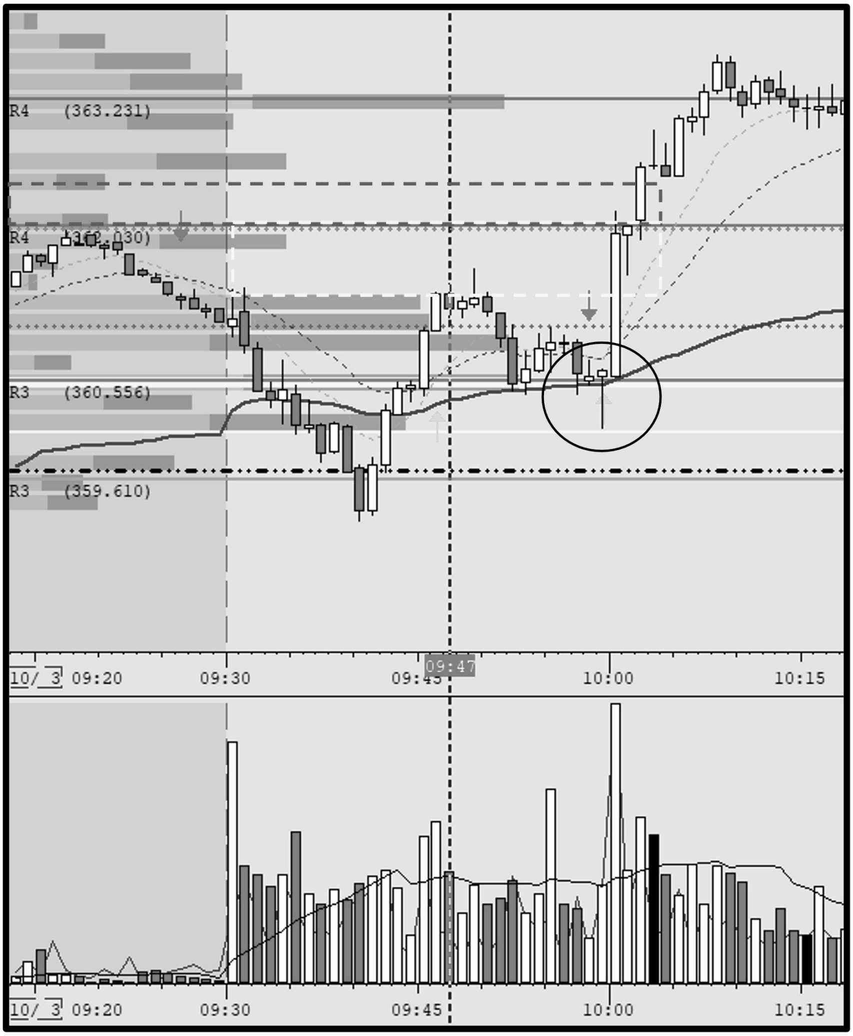

Figure 6.1 – Chart illustrating the process of weak participants being shaken out on a test of the Central Pivot. (chart courtesy of DasTrader.com).

STRONG HANDS

A strong hand is what the institutional traders (the Wall Street investment banks, mutual fund companies, hedge funds, some proprietary firms, etc.) along with some retail traders are called. As I mentioned, if you are plankton, then they are the whales. These are the participants you should be watching. How they respond to the price of a stock will move the market. Remember though, you need to stay out of their way, so you don't get eaten up.

How do you avoid getting eaten? The key is simpler than you might think. All you have to do is wait. But that is easier said than done, huh? You must patiently wait for them to make a move and reveal their strong hand. Then and only then can you make your move.

The stop zones that you identify are the same areas that these large accounts will also be paying attention to. Don't forget that a short seller is a buyer. Accordingly, if a larger Bull participant wants to go long, they will initiate a position when the price of the stock makes a new high into one of these stop zones. When all the shorts begin to cover, they instantly will propel the price upward. This gives the Bull an equally instant pop in profit and the Market Maker can sell their shares to the shorts that are continuing to cover with market orders. Then, the higher the price goes, the more shorts there will be that get squeezed. All of this will provide the additional fuel necessary to cause the price to go into a discovery phase (the imbalance phase of the market auction cycle discussed in Chapter 4) and run up higher and higher until value is established by an LTF Bull participant starting to sell.

Always keep in mind that there are participants of all sizes. I have referenced whales but there are participants at every price level. Don't lose your perspective. You are small. Most of us STF traders are small. Don't try to rush or force trades. You'll just get eaten. You must wait – patiently – for them.

In Figure 6.2, the three stop zones are defined with dotted lines. In what follows, I want to highlight some important aspects of them.

The first stop zone, outlined in yellow, was established during the open auction. Bearish traders placed stops in this zone for the initial hour of trading. The loss of this zone in the opening minutes led to a sell off back to R3 and 2 sessions ago's daily low. (If you are reading the paper edition of this book rather than the e-book edition, the colors in Figure 6.2 will not be displayed in your version. The zone outlined in yellow is the large rectangular box situated in the middle of the chart and running across of the chart from the time of 9:30am till 10:15am.)

The price action set out on this chart is a good example of the weak hands getting flushed out as the stronger hands buy in. The box outlined in green shows the stop zone below the bids (the box outlined in green is the rectangular box on the bottom left-hand side of the chart). The price dropped to a daily level[125] to fill a short sellers lingering large bid, and that flushed out all the weak hands that were sitting in the stop zone framed by the green dotted lines. The box outlined in red shows the test (the box outlined in red is the smaller square box to the right of the box outlined in green). Immediately after this test, the price moved all the way up to its premarket's highest price. The flush was necessary. Too many short sellers were in play and too many weak bidders were taking profit. To move the price back up, the sellers had to get covered, so they

125 If you go back in time on a daily chart, you will usually find specific price levels where candles have often closed or opened in the past. Where these correlate can be assumed to be levels of resistance and support and are referred to as daily levels.

came closer to the price, and concurrently the weak bidders needed to be stopped in order to clear their partials off the books. Without the bidders, the shorts can be squeezed.

I've circled in Figure 6.2 the perfect buying opportunity created by the back test of R4. Earlier, the shorts were squeezed and R3 held. The new high and break of R4 is a strong sign that the Bulls are stepping up. With that bid holding, the shorts will begin to cover and the price will quickly ascend upward.

These stop zones can be used all day. Any retest of these areas will hold considerable weight intraday. You must wait for the price to enter one of these zones though, and then make a decision about your entry once you know whether the price will hold or reject the zone.

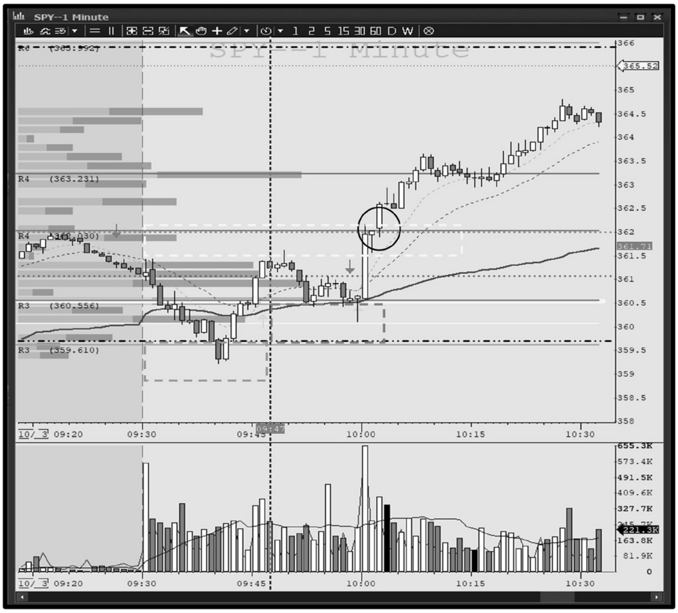

Figure 6.2 – Chart illustrating showing a quick move down to fill shorts and stop out Bulls before starting an all-day rally (chart courtesy of DasTrader.com).

STOP ZONES AND KILL ZONES

A kill zone is a term that I "stole" from my Average Joe/Bear Bull Traders colleague, Ed Martin. I use this lingo when I am visualizing areas that have a high probability to have choppy price action. Stop Zones form at the edges of ranges and become the areas that will trigger many stops. Stops will come in the way of market orders which allow for price movement. As the price action reveals the LTF participants, you can begin to isolate where their stops will most likely be. Focusing on that location will give you the ability to start putting a trade idea together.

If the same price is being bid every time, and there is plenty of volume near the stop zone, then you can figure out how well the LTF participants are doing in defending that position. Since you now know where they are bought in, you can thus identify a clear area where they will most likely have to stop out. This will be your stop zone.

Remember, the best opportunities for you to make successful trades arise when the big accounts are forced to make decisions.

Take a look at the price action set out in the chart comprising Figure 6.3. I want to use this price action as an example of how what I've just written about works in practice.

If you were considering entering a trade on this stock, you need to find where the Bulls first bought in. You will note in the chart that there was a strong pre-market move that was back tested with a hammer before the price continued moving up (what is marked by a green circle on the left-hand side of the chart).

An obvious stop zone was formed just above a daily level (the narrow and long rectangular box framed with dotted lines at the very top of the chart). It was established in the pre-market and confirmed during the Opening Range Breakout.[126] You would have wanted to enter a long position if the price had broken through this level and held. However, the price instead set a pivot there, and then the ask began stepping down, offering at lower intervals with each pull back.

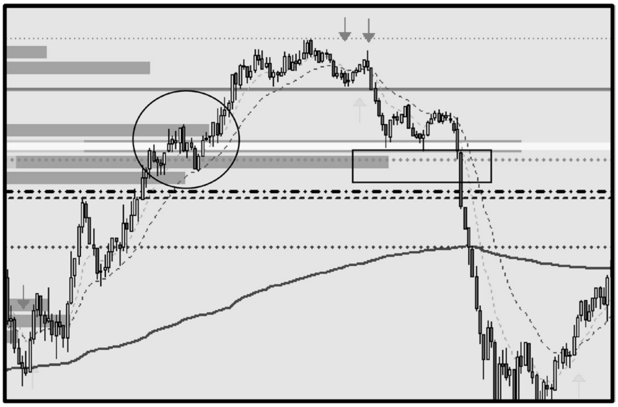

Figure 6.3 – Chart illustrating a stop zone marked by the rectangle. A circle marks the range that established that zone as buyers bought for the next leg up. Once the price moves below that zone a large sell off begins as Stronger Hands are shaken out. (chart courtesy of DasTrader.com).

126 Dr. Andrew Aziz writes in *How to Day Trade for a Living*, "Another well-known trading strategy is the so-called Opening Range Breakout (ORB). This strategy signals an entry point, but does not determine the profit target ... The ORB is an entry signal only, but remember, a full trading strategy must define the proper entry, exit and stop loss. Right at the market Open (9:30 a.m. New York time), Stocks in Play usually experience violent price action that arises from heavy buy and sell orders that come into the market. This heavy trading in the first five minutes is the result of the profit or loss taking of the overnight position holders as well as new investors and traders. If a stock has gapped up, some overnight traders start selling their position for a profit. At the same time, some new investors might jump in to buy the stock before the price goes higher. If a stock gaps down, on the other hand, some investors might panic and dump their shares right at the Open, before it drops any lower. On the other side, some institutions might think this drop could be a good buying opportunity and they will start buying large positions at a discounted price. Therefore, there is a complicated mass psychology unfolding at the Open for the Stocks in Play. Novice traders sit on their hands and watch for the opening ranges to develop and allow the more experienced traders to fight against each other until one side wins. Typically, a new trader should give the opening range at least five minutes (if not more). This is called the 5-minute ORB. Some traders will wait even longer, such as for thirty minutes or even for one hour, to identify the balance of power between the buyers and sellers. They then develop a trade plan in the direction of the 30-minute or 60-minute breakout. The longer the time frame, the less volatility you can expect."

An obvious downside stop zone was formed just below the previous day's closing price (the smaller rectangular box framed with dotted lines on the middle right-hand side of the chart). As circled on the right-hand side of the chart, a large buyer revealed their position as they defended the price. A short position subsequently entered into the scene when that buyer stopped out.

You will see on the right-hand side of Figure 6.3 that the Bull did in fact lose the battle. These stop outs triggered the start of a large sell off.

Here are three "truths of trading" that you must accept: (1) Stops fuel price movement. (2) For every winner, there will be a loser. (3) When large stop zones are triggered, both demand and the amount of participation will increase substantially. This is fear and greed at its finest. It's imperative that you are aware of these kill zones. Paying attention to them will not only keep you from getting stopped out, but it will also give you some possible entry locations to play the break as others get stopped out.

BUYERS ARE SELLERS

There is one concept that is very critical to understanding price analysis. It is the reality that buyers are sellers and vice versa. I mentioned this a few pages ago in the context of short selling. It is important to stress this point because to anticipate where someone is going to get forced out of a position, you need to first realize their role and thus where they must stop out.

The moment a participant enters the market and buys shares, they are now by default a seller. Any buyer, no matter how large their position, has a maximum loss that they can incur. When the LTF participants hit their maximum loss, their stop outs will have a massive impact on the price of the stock. On the smaller time frames, it will cause squeezes and slams.[127] On the larger daily time frames, it will cause transitions between ranges.

Uniquely, this is also true for short selling. In most instances, being a seller does not automatically make you a buyer. The exception is if you are a short seller. Short sellers must cover their positions and carry a maximum loss. Therefore, a short seller is in fact by default a buyer. Accordingly, short sellers are a vital part of the game. You need their stops to help propel the market upward.

The ideal location for a breakout trade is an area or zone where it is obvious that many of the stops set by short sellers will be triggered. These "short stops" are often required in order to move a stock up to its next value area. Remember – all stops move the price, but the stops set by short sellers fuel especially strong upward expansion.

To be able to read these stops correctly, I like to identify ranges and then map them out into zones. This helps me visualize these areas.

I briefly reviewed ranges in the prior chapter. With value-based analysis, you can easily spot where the strong and weak hands are camping out.

Ranges can be identified using three major indicators:

1. Isolated pivots (discussed in the commentary accompanying Figure 5.21).
2. High value areas.
3. The confirmation of the strength of a specific level through multiple tests of it.

127 A slam is the opposite of a squeeze, in the way the shorts squeeze by taking profit to abrasively. The longs can do the same. By taking profit too aggressively, the price can slam quickly down.