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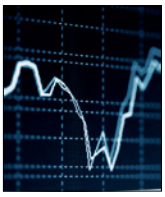


People are creatures of habit and most retail investors will almost always place their stop loss orders at very predictable places.

By knowing specific levels where you will enter or exit without having to consult 2 or 3 indicators you will have an edge and a fighting chance in the forex.

THE ART OF DAY TRADING THE EUR/USD

In the stock market, the ultimate stock to day trade is whichever best fits your trading style and produces enough profits to buy 100 new shares faster than trading any other stock. We are market technicians and our favourite FX pair is the EUR/USD on the 30-minute chart. Technical analysis is not so much about the actual lines on the chart as it is trading the reaction of other traders at those lines.

By the end of this article you will have a clear understanding of how to eliminate the guesswork in trading and always be on the right side of the market.

This particular strategy will appeal to reactive traders who do not front run price action. The entries will be inferior but the hit rate superior. The equity curve will not be subject to the wild swings sometimes experienced by anticipatory traders who constantly try to pick tops and bottoms but before we get into the meat of the strategy and when it is most profitable we need to make a few assumptions. We will list days when you should not trade at all and then talk about the time of day when you should look for setups. You will also learn about the key numbers for the EUR/USD and how they constantly show up as support and resistance. Throughout the article we will give examples of the mechanics behind price movements and how to interpret price action, but let us first talk about indicators.

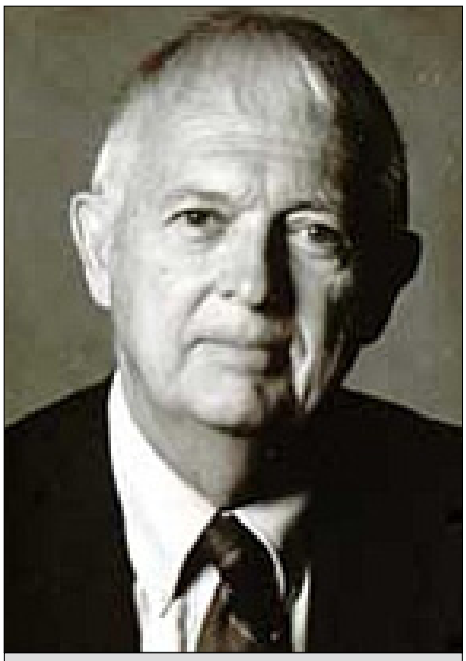
INDICATORS

There are no indicators cluttering up our charts and the reason is that they are always lagging. Also, there is no such thing as overbought and oversold conditions. The only thing overbought and oversold means is that the market is higher or lower than you thought it was going to be. The markets are always exactly where they are supposed to be because they have found that equilibrium where there is an equal disagreement on value but an agreement on price. Before any indicator moves, price moves. Indicators are a derivative of price. An oscillator is always one moving average subtracted from another moving average and always a lagging indicator. So what better way to trade the markets than to trade price by itself?

Financial markets are trying to predict a future that is contingent on traders' decisions in the present and with the leverage in the FX market it is imperative to use hard stops and to execute flawlessly. Failure to do so would quickly annihilate most accounts. By knowing specific levels where you will enter or exit without having to consult two or three indicators you will have an edge and a fighting chance in this business.

TIME OF YEAR

It is well known that in trading you need to follow the money in order to make any. On Royal Ascot days, for example, the City will be slower than usual. In August, money leaves Manhattan for the Hamptons. On UK bank holidays


R. Earl Hadady

the FX market feels like a ghost town because so much of the total volume goes through London. Also, in the days leading up to Christmas, volumes will be light much like on Jewish holidays. As a percentage, observant Jewish traders are not a significant number but the absence of their bids and offers increases the risk of volatility and will discourage other players to trade creating a snowball effect. Severe snow storms make it hard for traders to reach their desks and at the time of writing this article Wall Street has been closed for a second day as Hurricane Sandy has forced much of Manhattan to evacuate and left millions without electricity. On days like these, patterns become less predictable and this is not an ideal time for trading.

TIME OF DAY

Liquidity follows the movement of the sun because wherever people are awake there is business activity. The EUR/USD is very quiet during the Asian session because economic data that affects the fundamentals of those currencies is released in either the European or U.S. session. Once traders in Europe get to their desks a flurry of activity hits the tape as they start filling customer orders and jockey for positions. At noon activity slows down as traders step out for lunch and then picks back up again as the U.S. comes online. If there is important U.S. data we can expect quiet markets just ahead of the number, typically released at 13:30 GMT. U.S. economic data has the ability to either reinforce an existing trend or reverse it depending on by how much it missed or beat expectations. By 5:00 GMT liquidity leaves the market once again as European traders close out positions and head home.

THE OPENING PRICE PRINCIPLE

Our strategy is based to some extent on The Opening Price Principle, which was developed by Earl Hadady for trading commodities in the 1950's. Using scatter diagrams he showed in a small pamphlet that 65 percent of the time, the opening price was within 20 percent of the low or high of the day. This is a huge edge and gives our system a high expectancy if traded with proper money management. The idea of The Opening Price Principle is illustrated in chart 1.1 by colouring the bars of the Asian session brown. This is the time of day when the market chops around; randomly filling orders

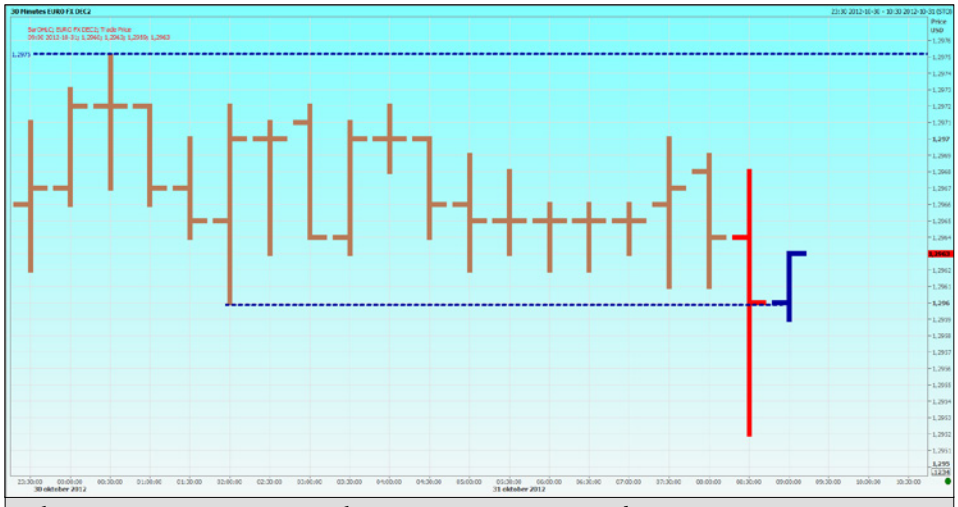


Chart 1.1 EUR/USD 30-min chart @ 7:34 GMT on October 31, 2012

but still long enough for stop orders to build on both sides of the overnight range as Asian traders put on positions. As we enter the most liquid hours for the pair at 7:00 GMT the bars turn red if we move lower and blue if we move higher. If the EUR/USD trades above the opening range by 9:00 GMT the odds are better than 65 percent the market closes positive. Similarly, if the market is trading under the opening range by 9:00 GMT chances are better than 65 percent that the market closes negative.

THE PATH OF LEAST RESISTANCE

We are only interested in high probability setups when the time of day favours big moves. In order for our hit rate to improve further we want to see price break out one side of the overnight range, get rejected and come back inside the range. Regardless of why selling dried up as illustrated in chart 1.1 we note that the bears failed at taking prices lower and the bulls have now seized control of the order flow. For how long is anyone's guess but we are more than happy to give the new trend the benefit of the doubt as long as the bulls take out the highs of the most recent bar. New highs would mean everyone who sold the market early doors is now in a losing position and the higher we trade the more they will suffer. Most people will stay in a trade until the pain of losing one more dollar is more painful than staying in the trade and that is when they will get out. Momentum traders know this and will be eager to run the market against them until they find an area where they can trigger buy stops and when they do they will be the offer that gets taken out by the buyer.

As shown in chart 1.1 the overnight range had been a mere 15 pips as it traded sideways between 1.2954 and 1.2969. When the lows of the range were broken, stop loss orders were triggered and as more selling continued to hit the bids in search of lower prices or of demand which became less present we saw the market print a low of 1.2946 before turning around. The market always follows the path of least resistance and sometimes will even rally due to a lack of presence of sellers more so than the presence of aggressive buyers. Of course, we have no idea why the order flow turned all of a sudden but it could have been because of a trend line, a moving average, a Fibonacci retracement level, the release of economic data or any of all the other indicators and tools traders use to get them in and out of trades.

STOP HUNTING

In order to understand where the market wants to go we need to identify the most obvious areas where there are stop loss orders. Market makers feed off of retail traders' stops and retail investors typically write cheques to their

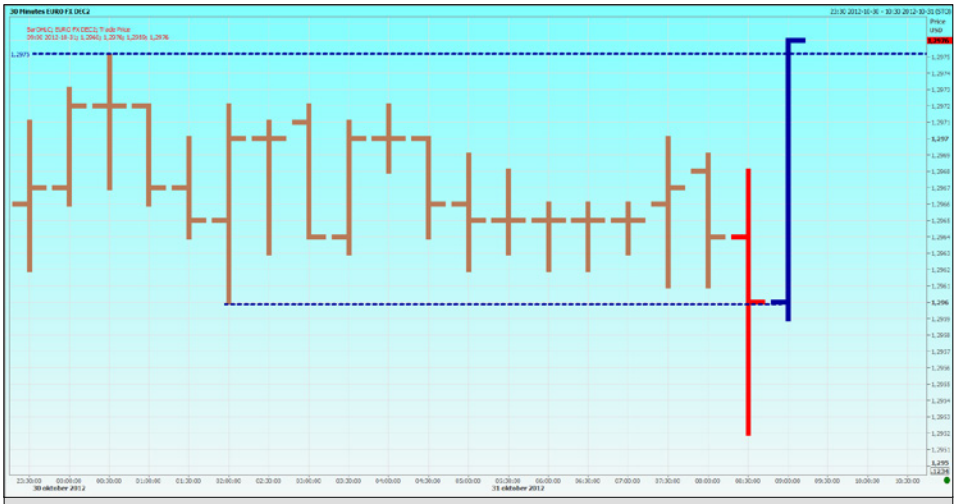
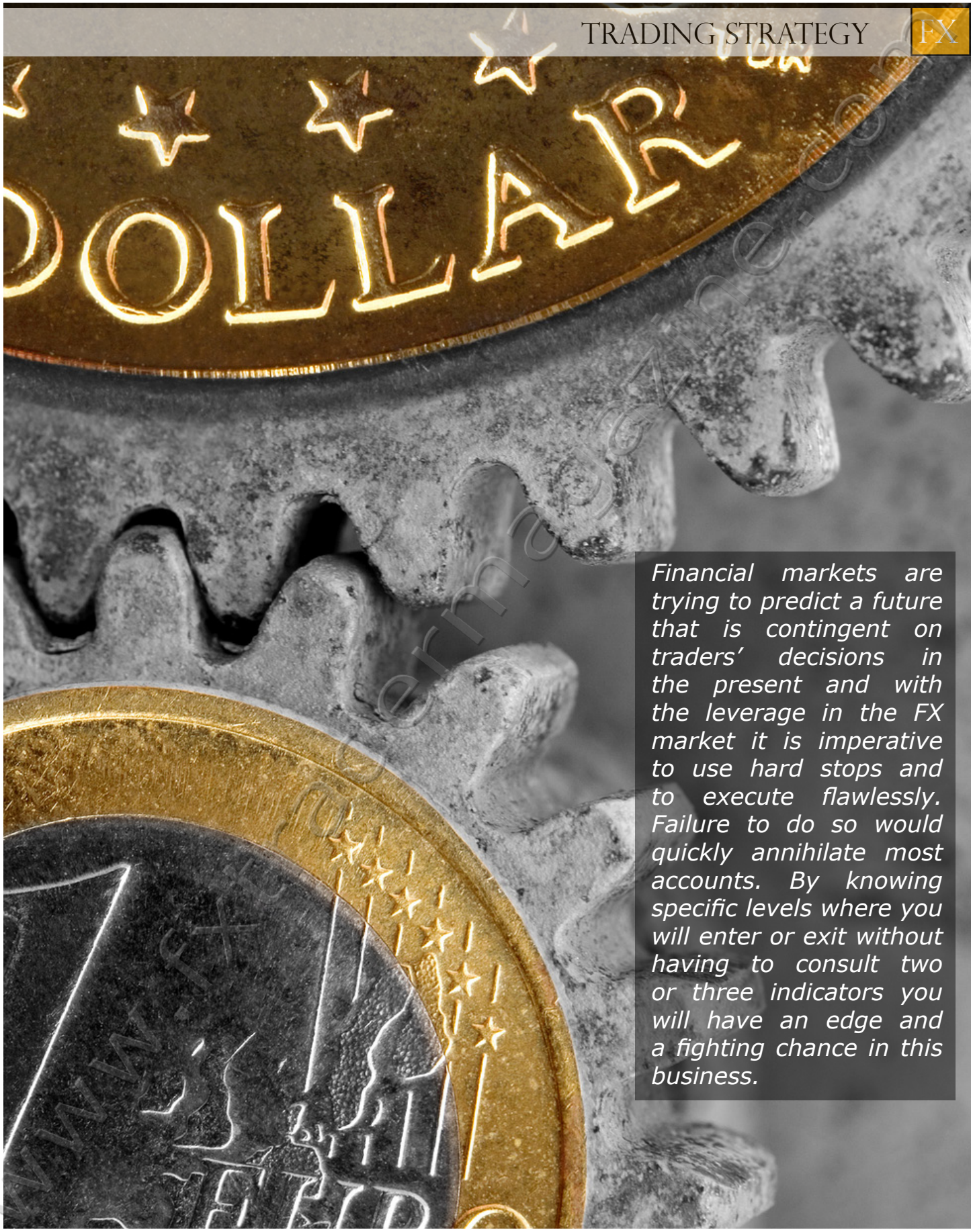


Chart 1.2 EUR/USD 30-min chart @ 7:57 GMT on October 31, 2012



Financial markets are trying to predict a future that is contingent on traders' decisions in the present and with the leverage in the FX market it is imperative to use hard stops and to execute flawlessly. Failure to do so would quickly annihilate most accounts. By knowing specific levels where you will enter or exit without having to consult two or three indicators you will have an edge and a fighting chance in this business.

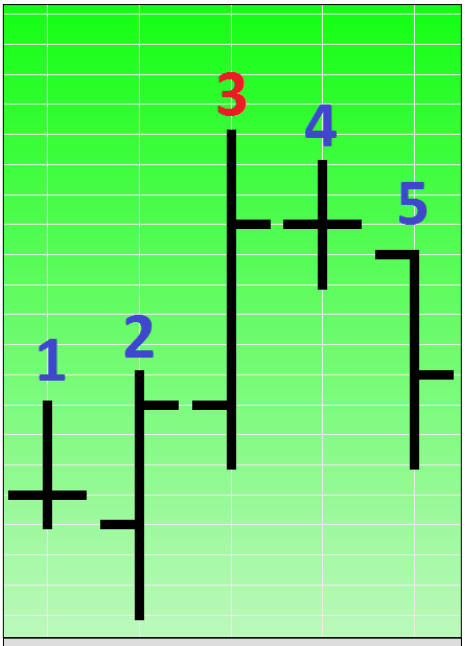


Chart 1.3 A buy fractal

brokers on a continual basis. People are creatures of habit and most retail investors will almost always place their stop loss orders at very predictable places, typically a tick or two below the most recent swing low or a tick or two above the most recent swing high. Market makers know this and also have access to clients' order books. So it should come as no surprise that the market will go to the most obvious stop loss areas over and over again.

ENTRIES AND MONEY MANAGEMENT

As the market comes roaring back inside the range as shown in chart 1.2, we had orders to go long one tick above the high of the first 30-minute bar in the European session with more to buy at the top of the Asian range. The reversal shows that psychology has completely changed and clearly caught a few traders off guard. The stop will initially be a tick under the low of the previous bar and once the next 30-minute bar starts printing, the stop is moved to a tick under the low of the bar that just closed. In essence we are trailing the stop at a distance that allows the trade to breathe as long as it makes higher lows.

FRACTALS

A fractal is a trend change and can be traded in all time frames. A buy fractal is illustrated in chart 1.3 and requires a minimum of five bars where the middle finger has two preceding lower highs followed by at least two lower highs. The place to buy is a tick above the high of the middle finger. Whenever a 30-minute candle generates a buy or a sell signal there is usually a fractal setup in one time frame or another preceding it.

By trading the 30-minute time frame the market has enough time to digest new information, filter out noise and still catch the bigger intraday trends. Chart 1.4 shows a smaller time frame buy fractal (chart 1.3) setting up inside of the second 30-minute candle. Because the trigger of a buy fractal is always a tick above the high of the middle finger it often coincides with one 30-minute candle trading through the highs of the previous one.

KEY NUMBERS

Next we pay close attention to the key numbers for the EUR/USD. The 00-level being the most obvious and important one, followed by the 50-level. The next two key numbers that will manifest on your chart as support and resistance over and over are 35 and 65. Minor key numbers are 25 and 75. So even though there may be a perfectly valid setup to go long at 1.2862, we may hold off in some instances until we get through 1.2865 with conviction. Key numbers can also be used as levels where we bank profits if momentum looks

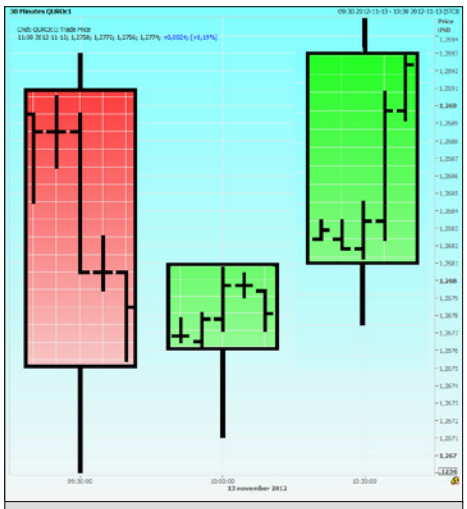


Chart 1.4 Inside the 30-minute candles there are smaller time frames at work.

to be waning or as levels where we can tuck our stops behind in order to control risk and protect profits.

AVERAGE TRUE RANGE

The average true range (ATR) is a measure of volatility and a guide to how much more potential upside or downside is left in any given trading session provided the market has already printed the low or the high of the day. The ATR is the final piece of the puzzle and what determines if there is enough gravy left in the trade for us to put it on. The ultimate profit objective for any day trade is always the number of pips left of the projected daily range. The higher the volatility the more profitable this strategy tends to be. The lower the volatility the more false breaks and range trading we have to endure, none of which are favourable to our protective stop placements and profit targets. Low volatility, for the most part, does not offer the type of convincing directional moves that we want. As a rule of thumb we do not trade this strategy if the ATR based on the past 50 days is less than 100 pips.

EXITS

When exiting a trade there is no such thing as a perfect play.

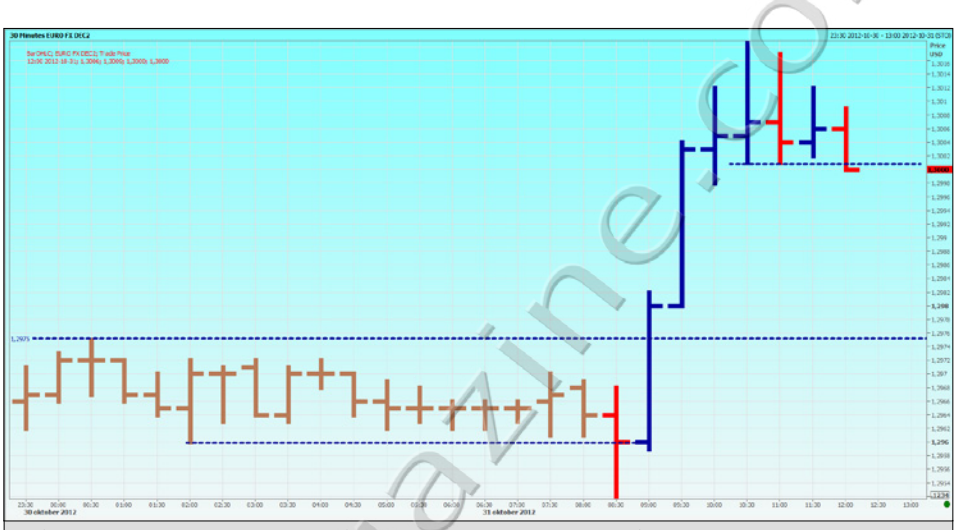


Chart 1.5 EUR/USD 30-min chart @ 10:37 GMT on October 31, 2012

Sure, you can quantify the success rate of your entries with respect to the time frame and money management but not for exits. First of all, an exit cannot be isolated from the conditions that got you into the trade in the first place. Second of all, you are really only concerned with the market action as long as you are in the trade and your money is at risk. What happens after your exit does not affect your result and is therefore irrelevant. The reasons we exit trades before hitting targets are typically because of lack of momentum at key numbers, imminent event risk, a reversal bar or diminishing reward to risk.

SUMMARY

To summarize our strategy we know what time of day to look for setups and we know what days to avoid trading altogether. We know we have an edge by trading long above the opening range and short below it after 9:00 GMT. We know that the odds increase of a strong trend if there has been a stop sweep on either side of the overnight range followed by a reversal. When trading in the direction of the trend we always have logical reference points for placing stops and can easily quantify risk. We know the size of our account and can then position accordingly and avoid the risk of ruin in case of a string of losses. We also know the key numbers and by how much the pair typically moves in a day. The outcome of a particular setup or pattern is contingent on other traders' decisions after our entry but as long as we have an edge we want to keep playing the game.

Patric Tengelin