Beginner's Guide to the Framework of Price Action

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<u>Contextual Knowledge</u>

Before you ever start trading, it is important to get rid of any misconceptions you have in order to truly gauge what you are up against

Institutions own about 78% of the market value of the U.S. broad-market Russell 3000 index, and 80% of the large-cap S&P 500 index. In dollars, that is about $21.7 trillion and $18 trillion, respectively. By comparison, institutions hold about 58% of the companies in the S&P Euro index

What does this mean for you?

REALITY CHECK: It is important to understand the money momentum behind financial markets and how insignificant you are

"As individual traders our influence in the market is literally nothing., we will succumb to the will and wants of the market at any given time"

Who are we up against when we enter a trade?

Billion Dollar Hedge Funds and Institutions

A little background to see scope the playing field...

Leverage Leverage Leverage

Hedge funds use several forms of leverage to chase large returns. They purchase securities on margin, meaning they leverage a broker's money to make larger investments. They invest using credit lines and hope their returns outpace the interest

Hedge Funds, Institutions and Algorithm Trading

What is Algorithm Trading?

A lot of the big players in financial markets are trading using algorithms.

"Algorithmic trading (also called automated trading, black-box trading, or algo-trading) uses a computer program that follows a defined set of instructions (an algorithm) to place a trade. The trade, in theory, can generate profits at a speed and frequency that is impossible for a human trader. "

Given instructions, a computer program (an algorithm) will automatically monitor the stock price (as well as other preset conditions) and place the buy and sell orders when the defined conditions are met. The trader no longer needs to monitor live prices and graphs or put in the orders manually. The algorithmic trading system does this automatically by correctly identifying the trading opportunity.

Two Sigma is an extremely quant-based top 5 Hedge Fund that trade financial markets with algorithms with over 60B AUM

Fun Fact

Eighty percent of daily volume in the U.S. is done by machines, so what you get is a lack of focus on earnings, a lack of focus on outlooks and you just get short-term movements based on very specific data that is released every day

What does this mean for you?

1) Financial Markets never move in a random fashion due to algo trading

2) As indivudal Traders, we only make up at most, 5-10% of all the trades taken everyday

3) Entry and Exit Prices / Support and Resistance Levels are based on algorithms and work on logic

This is what individual traders are competing against when they enter a market, a computer algorithm that runs on logic and preset instructions that is capable of trading in high frequencies with precise entries and exits

Let it Humble you

The information and statistics mentioned above is not here to discourage you. It serves to tell you that markets are brutal and it will move in whatever direction it wants to

Our Advantage here as small traders is that we can sit on the side, read into things like technical analysis and/or price action until we see an opportunity to ride a wave

Large institutional traders are bound by the rules associated with their funds and often have to take a long or short position, sitting on the sidelines is not an option for them so everything in between is fair game

The Search for Ultimate Truth in Trading

On your personal journey to start trading, you are going to meet people who will tell you that trading is easy if you can recognize certain candle stick patterns or just trade purely off of Technical Analysis

This guide is put here to tell you yes.. BUT NO

Trading requires a holistic view and requires considerations on many sides

DO YOUR DUE DILIGENCE, A MONEY MAKING SKILL ISN'T EASY TO AQUIRE
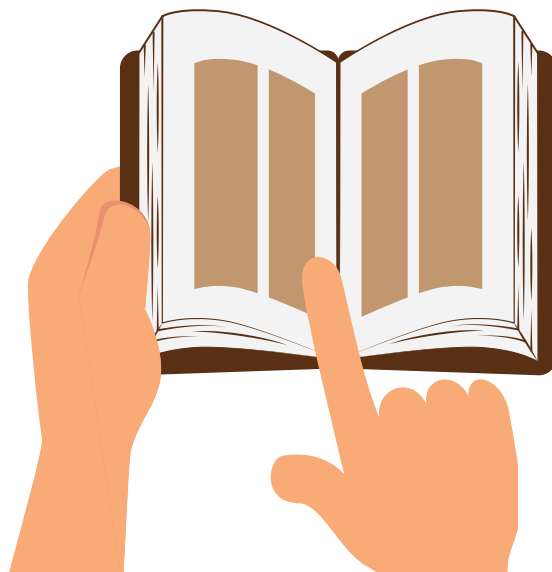
What is Price Action?

As a human being with a rational mind, you have the ability to take a step back and look at the trades being executed by all of these algorithms and come up with a narrative and an edge. This is called **Price Action**

Price Action is any Representation of Price Movement

That sounds very vague...so what is price action really?

Price action is not generally seen as a trading tool like an indicator, but rather the data source off which all the tools are built. Swing traders and trend traders tend to work most closely with price action, eschewing any fundamental analysis in favor of focusing solely on support and resistance levels to predict breakouts and consolidation

Looking at the way the price moves bar by bar, candle by candle is a great way to get a good understanding of where the market is going. Pair that with supports and resistances, you've got a strong basis for understanding market movement

I stumbled into this piece of writing written by someone that goes by Balaji and I thought I'd include it in this guide.

"The beauty of price action is its enormous flexibility, and various application through different methods and strategies. It can be modified, restructured, can be back tested using programming skills. In this way Price action is not just a discretionary trading strategy, but overall fine tuning aspect which anyone can use and modify according to their ideas. We can create our own strategies by using Price action which fits our personality, Trading style and further characters.

Price action trading can be both discretionary and systematic which adds another dimensional advantage over indicators."
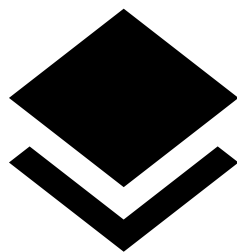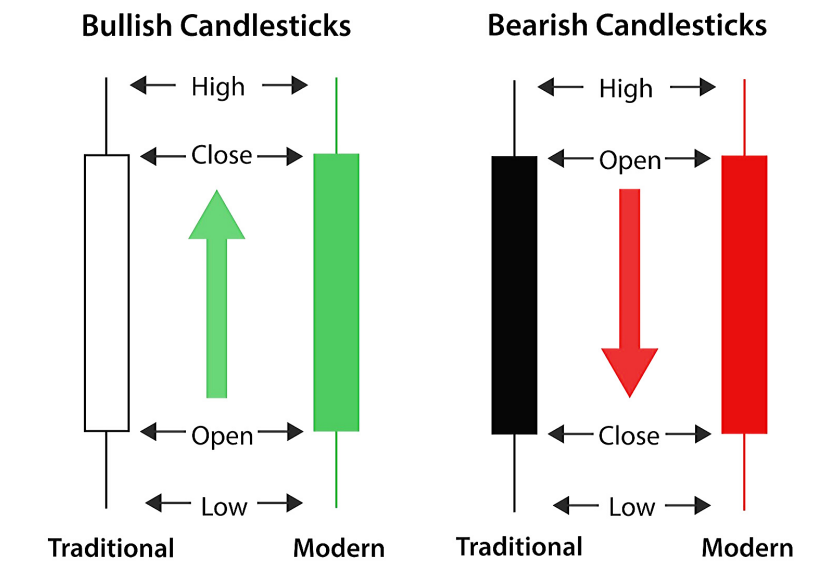
The explanation by Balaji goes hand in hand with this idea of there is no such thing as an ultimate truth when it comes to trading. You can enter trades solely based on price action or you can use it in tandem with technical indicators

Bar Formation on a Financial Chart

What is a Bar?

A bar is the main component used for visually representing a single period of price action in bar charts. The bar is a vertical line with two small horizontal dashes which represent the open and closing prices. The vertical ends of the bar depict the high and low prices for the time period the bar represents. The length of the bar shows the price range in that time frame

Bullish Candlesticks

High
Close
Open
Low

Traditional   Modern

Bearish Candlesticks

High
Open
Close
Low

Traditional   Modern

Bearish Bars (Red Bars) : You look at it from the top down, the price started at a higher number and as people sold, the price of the stock went down where it can close

Bullish Bar (Green Bars) : the price opens from the bottom and it climbs up as people start buying

Price Action Simulation Scenario

In looking at price action to determine a narrative for what has been occurring in the market, you can look at how bars are forming as a basis to your understanding

From the Length of the bar you see how each side (which will be separated into bears and bulls) wants the price to move

For example: If a bull bar starts at lets say $350 and it gets pushed/closes at $355, this tells you that people who are bullish on the buy side are willing to buy the stock 5 dollars higher than when it opened. This creates a range and shows where the bull buyer target prices are at. On the flip side, lets the next bar opens bearish at $355 and it closes at $352, you can infer that on the sell side, they thought that the price at $355 was overvalued and sold until the price hit $352 where the bulls will probably attempt to buy in

The number of consecutive bars that are actually forming whether it be bullish or bearish bars, can reveal information about the price action of a stock

For example, if there are 2 big green bars forming and a small red bar forms followed by another big green bar, you can infer that the market is leaning towards bullish

Continued...

You can look at the idea of bar length formation over time and translate it into your head as momentum up for the price to go up and go down and see to what extent does it want to move in a certain direction

<u>Bar Formation Key Takeaway</u>

A bar is the main component used for visually representing a single period of price action in bar charts

Bar Formation shows you when the buyers are buying and the sellers are selling

The range of prices that these bullish and bearish bars open/close at gives you an idea of what each side thinks is reasonable in the current market

You can always create a narrative that helps you understand what big players are thinking by looking at the way a bar is being formed across multiple time frames

The combination of length and number of consecutive bear/bull bars can give you an idea of sentiment within a timeframe

Determining Market Psychology

Market psychology can be seen as the frame of mind / context / sentiment that the market is currently in based on how investors are feeling

Greed, fear, expectations and circumstances are all factors that contribute to the groups overall investing mentality or sentiment. Think about it in terms of earning reports, GDP, Donald Trump and how they affect the market

Steps to understand the Market psychology using Price action:

1) Open a clean chart of whatever stock you are looking at and take out all the indicators

2) Go on a longer time frame and mark up support and resistances

3) Look to create a narrative about the movement of the price. Consider macro factors that lead to price movements and consider investor sentiment

4) Write down your thoughts and ideas then rinse and repeat

<u>Price Action Case Study 1</u>

There are two consecutive bear bars, two legs down as well as pull back one and pull back two. You can take a look at this chart and think, "The price is going down but it there's a doji going up and maybe it'll bounce. Perhaps I should enter here and ride it up? The price went all the way down here and it seems like it isn't going to drop any further.. Low risk high reward right?

But what does the price action tell you?

The price action tells you based on this chart that, the price has been dropping, its a sellers market because you see strong bearish bars that are significantly larger than the bull bars that formed. The wicks show that the price has been testing lower levels but it just could not close yet. Then, on the right side of the chart you see another long bear bar going down which further confirms the idea that the market is showing bearish sentiment. If you take a look at the second to last bar on this chart, its longer than the usual bull bar but notice that it opened lower than the previous close. In this chart you see lower highs and lower lows which point towards a downtrend. Keep those ideas and narratives in mind and use your intuition.

Would something that has been falling heavily just go back up like that?

Maybe if I buy this
Sell Climax,
it will be a V bottom,
and I will win big!

Here is the continuation of the last chart we were looking at.

After the sell climax which is highlighted green, you see that bear bars are continuing to form consecutively with little to no pressure from the bulls in the market.

As you can see, the previous analysis we had on the partial chart bar by bar was correct. The market had a bearish sentiment and there was a lot of downward momentum set by the size and number of bearish bars.

Key Takeaway

It is extremely helpful to look at the way the charts are developing bar by bar and make assumptions as you go along. This way you get to develop a tested narrative and work on building your personal intuition when it comes to trading.

Drawing Supports and Resistances

Understanding conceptually and being able to draw the right support and resistance is a fundamental skill you need in order gauge price action.

In stock market technical analysis, support and resistance are certain levels of the price of an asset at which it is thought that the price will tend to stop and reverse. These levels are denoted by multiple touches of price without a breakthrough of the level.

So how do you draw Supports and Resistances?

1) Open up a chart that you want to look at. For this example we open up a clean Tesla chart on the monthly time frame

2) Identify all the points in the chart where the prices swing and swing low. You will be able to see how these points usually end up at similar price levels. These will be your support and resistance levels
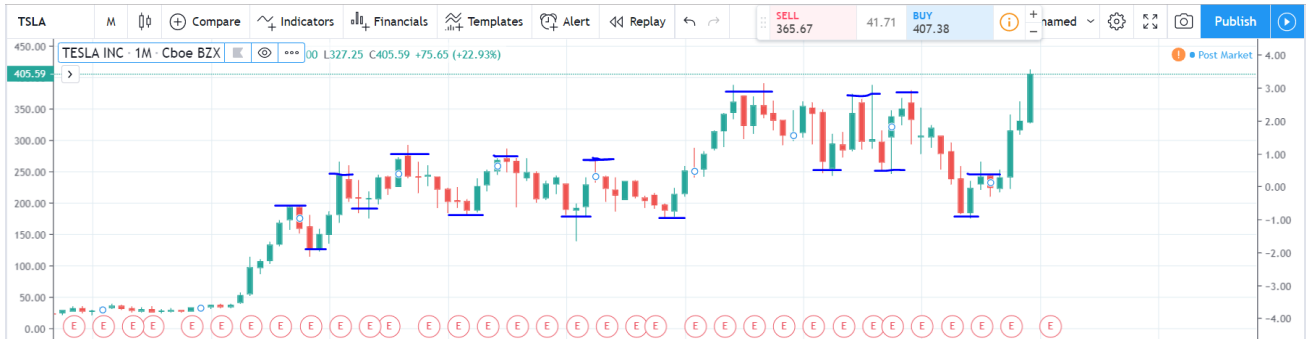
3) Connect the swing highs to other swing highs and swing lows to other swing lows and you end up with your support and resistance levels

One goal you want to have while drawing your support and resistance levels is to have as much touches at the price level as possible. Rule of thumb is at least two but three or more is better.

This logic works on anytime frame, in this case we were looking at Tesla on a Monthly time frame but when you go into smaller times, please note that levels should be adjusted accordingly.

Price Action Case Study 2

Premise: Weekly Chart to ATH at $393.15

If you take a look at the price movement for Tesla on the one week timeframe as well as it falls within resistance level A and support level B and briefly dips down to support C.

What can you tell from this chart when you incorporate reading bar length as well as support and resistances?

From left to right --

(First 5 bars) There is a big bullish (green) bar that forms and hits resistance level A. The next bar that forms shows that the bears (red) bar tried to start selling from a point above the resistance line but the bar really opens beneath the resistance line and lower than where the bull bar closed.

This shows that the market is leaning closer to bearish (sellers market). The next green bar that opens, opened lower than the previous close and is significantly shorter than the first long green bar that touched the resistance. Then you see a strong bear bar going all the way down.

When you take into consideration the length of the green bars as well as their open and closing price, you can get a the basis of the picture that the market is leaning towards bearish

Key Takeaways

You can think about a price action and bar formation as a constant battle between the bulls and bears.

The size and direction (bullish or bearish) can give you an idea where market momentum is.

TRADING IS A BUSINESS. WE SHOULD ALWAYS APPROACH THE MARKET WITH A PLAN.

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