Price Action - The Footprint of the Money

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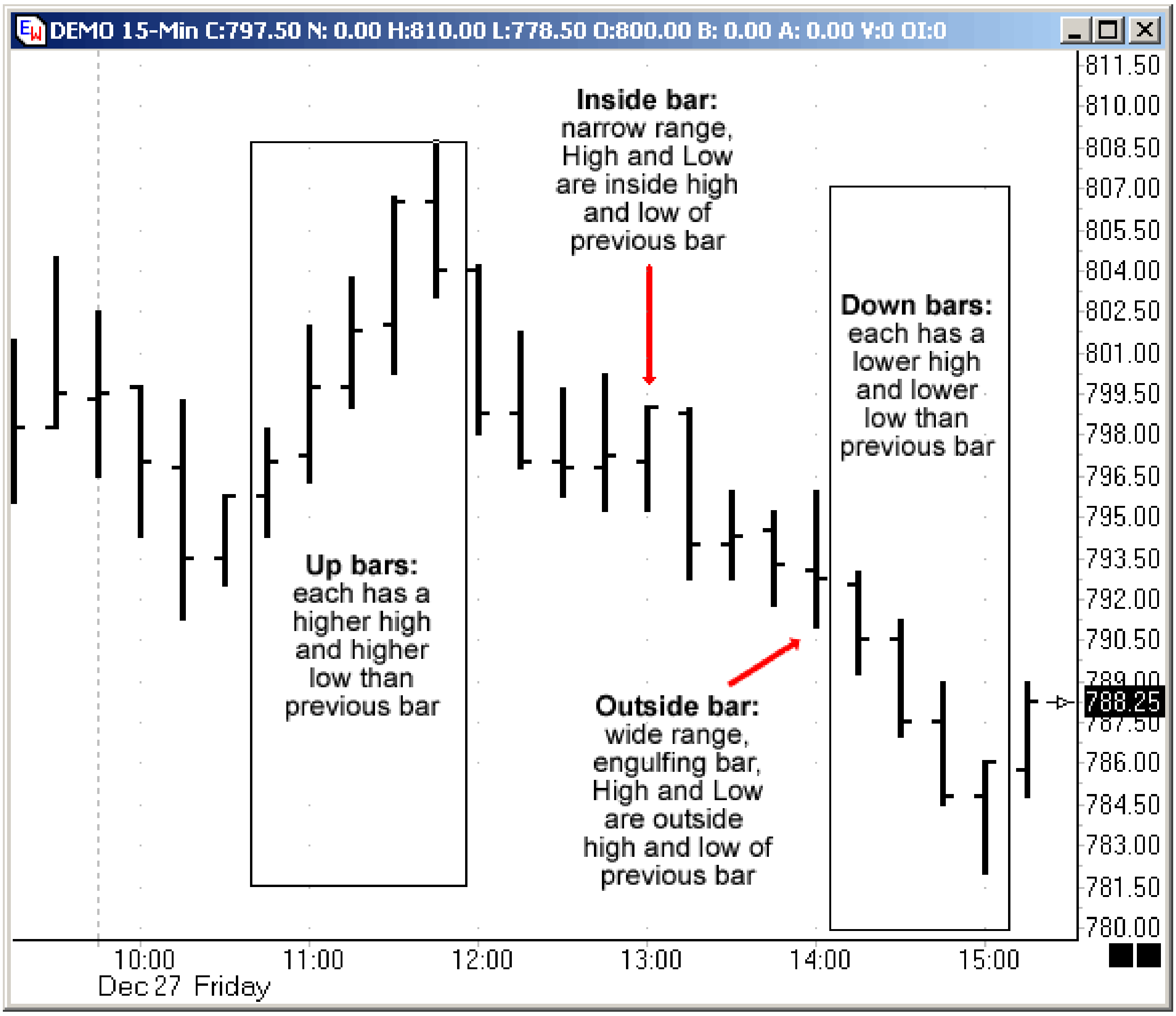
"What is Price Action?" is a frequently asked question by aspiring traders. Traders who ask, feel it is a well kept secret when all they receive for an answer is: 'Swing highs, swing lows, test of top/bottom, etc., are all price action.' The answer still leaves them in the dark. Understanding price action enables a trader to minimize questionable entries and improve exits. Price action is the footprint of the money.

Let's start with the very basics. The bars on the following chart are labeled as traders commonly referred to them.



<u>Up Bar:</u> is a bar with a higher high and higher low than the previous bar. The bars marked off are in an up trend. Notice how the close is higher than the open until what turns out to be the last bar of the trend where the close is lower than the open. There were more sellers then buyers on the last bar.

<u>Down Bar:</u> is a bar with a lower high and lower low than the previous bar. The bars marked off are in a down trend. Notice how the close is lower than the open until what turns out to be the last bar of the trend where the close is higher than the open. There were more buyers then sellers on the last bar.

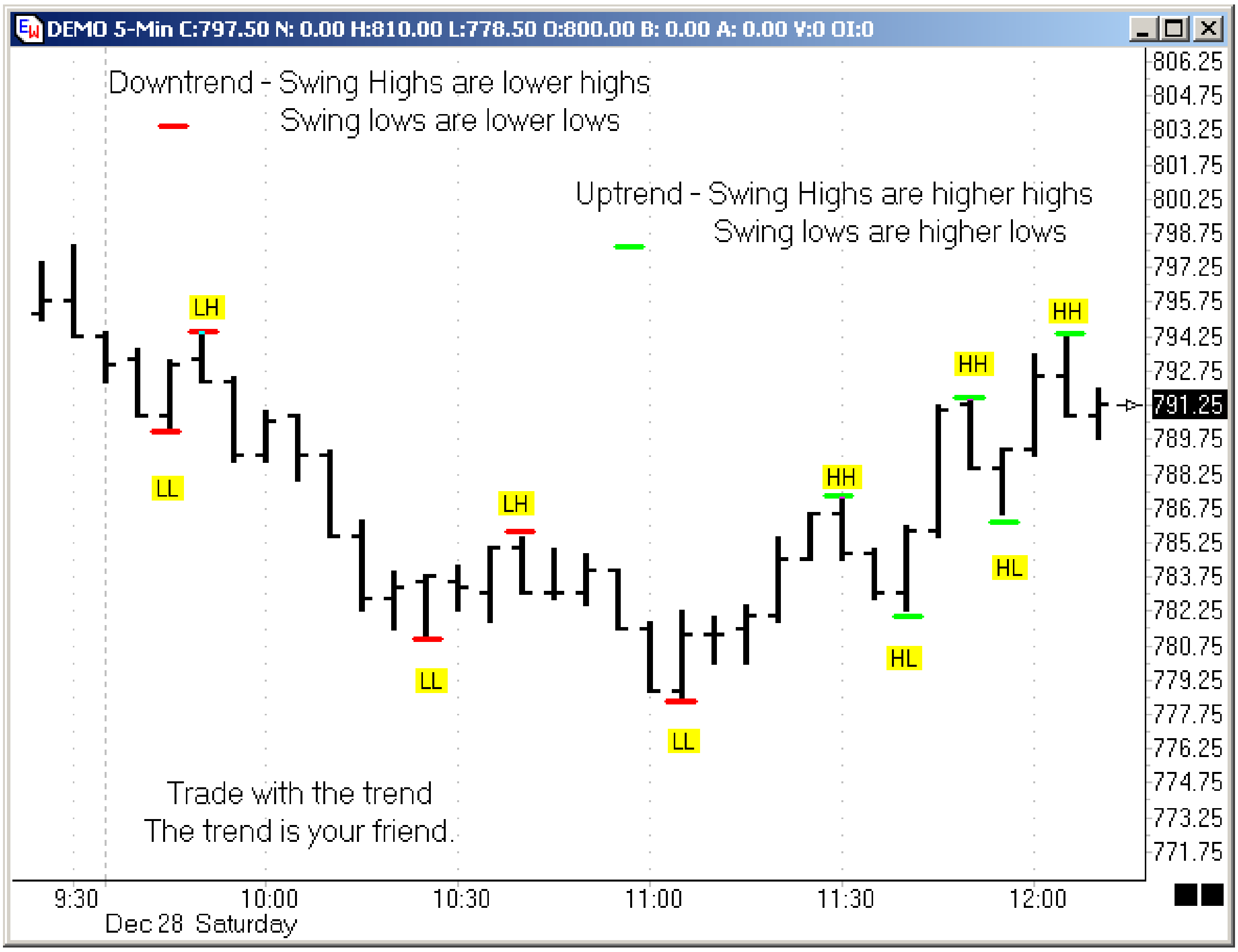
Inside Bar: also called a narrow range bar, is a bar with the high that is lower than the previous bar and low that is higher than the previous bar. Some traders do not consider an inside bar that has either an equal high or an equal low as an inside bar, others do. Inside bars usually represent market indecision. As on any bar, the closer the open and close are to each other shows just how undecided the market is as neither the buyers or sellers are in control. Buyers are in control on the inside bar marked on the chart because the close is at the top of the bar.

Outside Bar: also called a Wide Range or Engulfing Bar, is a bar with a high that is higher than the previous bar and with a low that is lower than the previous bar thereby engulfing the previous bar. Since the open and close are close together on the marked bar, neither the buyers or the sellers are in control and the market is undecided which way to go.

When the open is in the bottom quarter/third of the bar and the close is in the top quarter/third of the bar, it is said to be bullish engulfing with the buyers in control. When the open is in the top quarter/third of the bar and the close is in the bottom quarter/third, it is said to be bearish engulfing with the sellers in control.

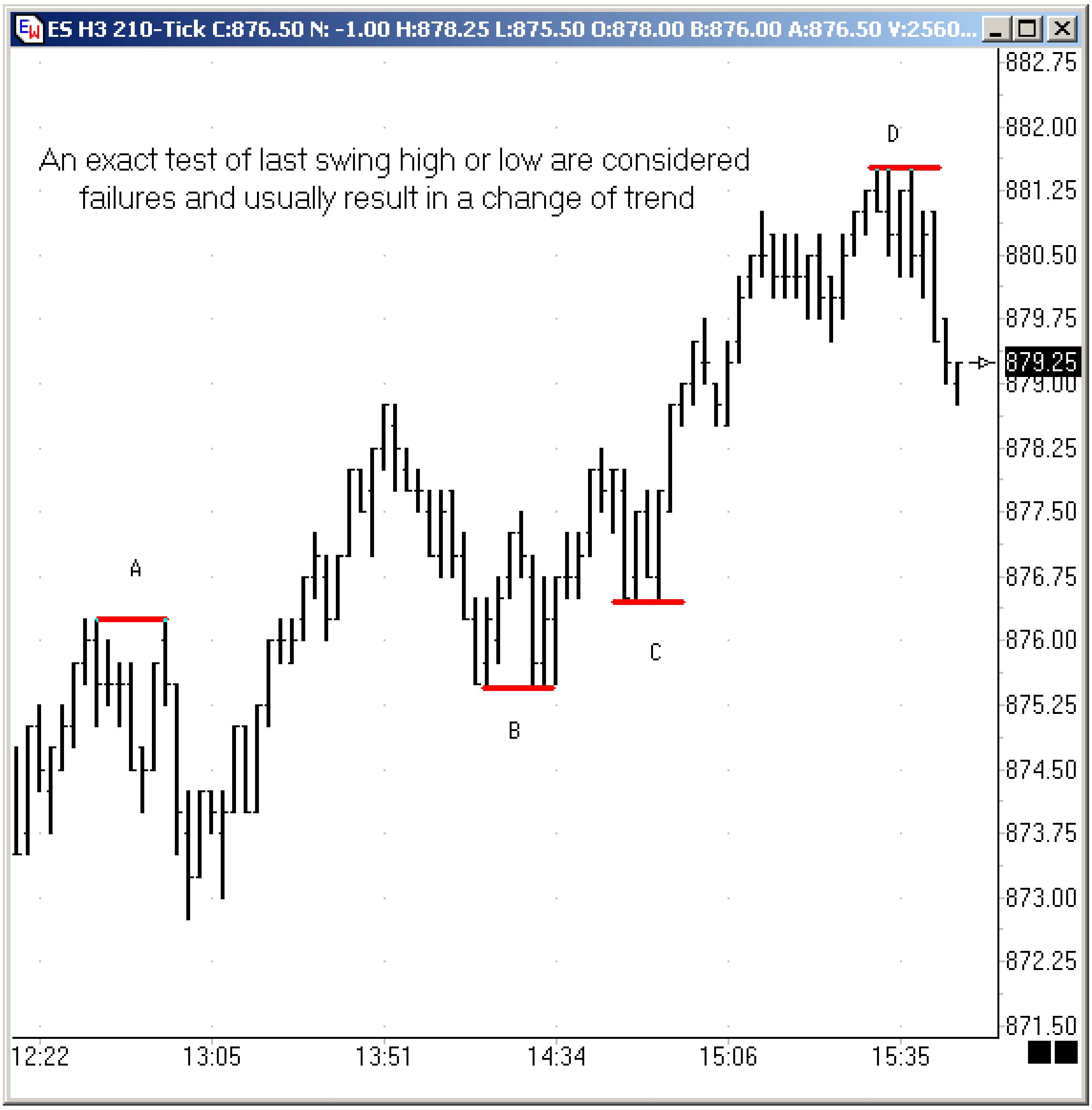
Another definition used for this bar – especially if candlestick charts are used - is that the open and close have to engulf the previous bars open and close and not just the high and low of the bar. With this definition, the wide range bar or engulfing bar does not need to have a higher high or lower low to qualify. The first definition most probably came about with bar charts where it is harder to notice the open and close.

The following chart has the swing highs and lows marked in both an up trend and a down trend. Price on a given time frame is in an up trend if it is making a higher highs (HH) and a high lows (HL) and in a down trend if it is making lower highs (LH) and lower lows (LL). If price is doing anything else, it is in a consolidation pattern - range, triangle, pennant, rectangle etc.



The trend is considered in place until price is no longer making higher highs and higher lows in an up trend or lower highs and lower lows in a down trend. After a trend is broken, there is usually a period of consolidation that is easier to see on a lower time frame. With practice, you will be able to visualize this going on without looking at the lower time frame.

When price is in a consolidation pattern that is often referred to as chop, it is usually in a range with no trend pattern to the swing highs and lows.

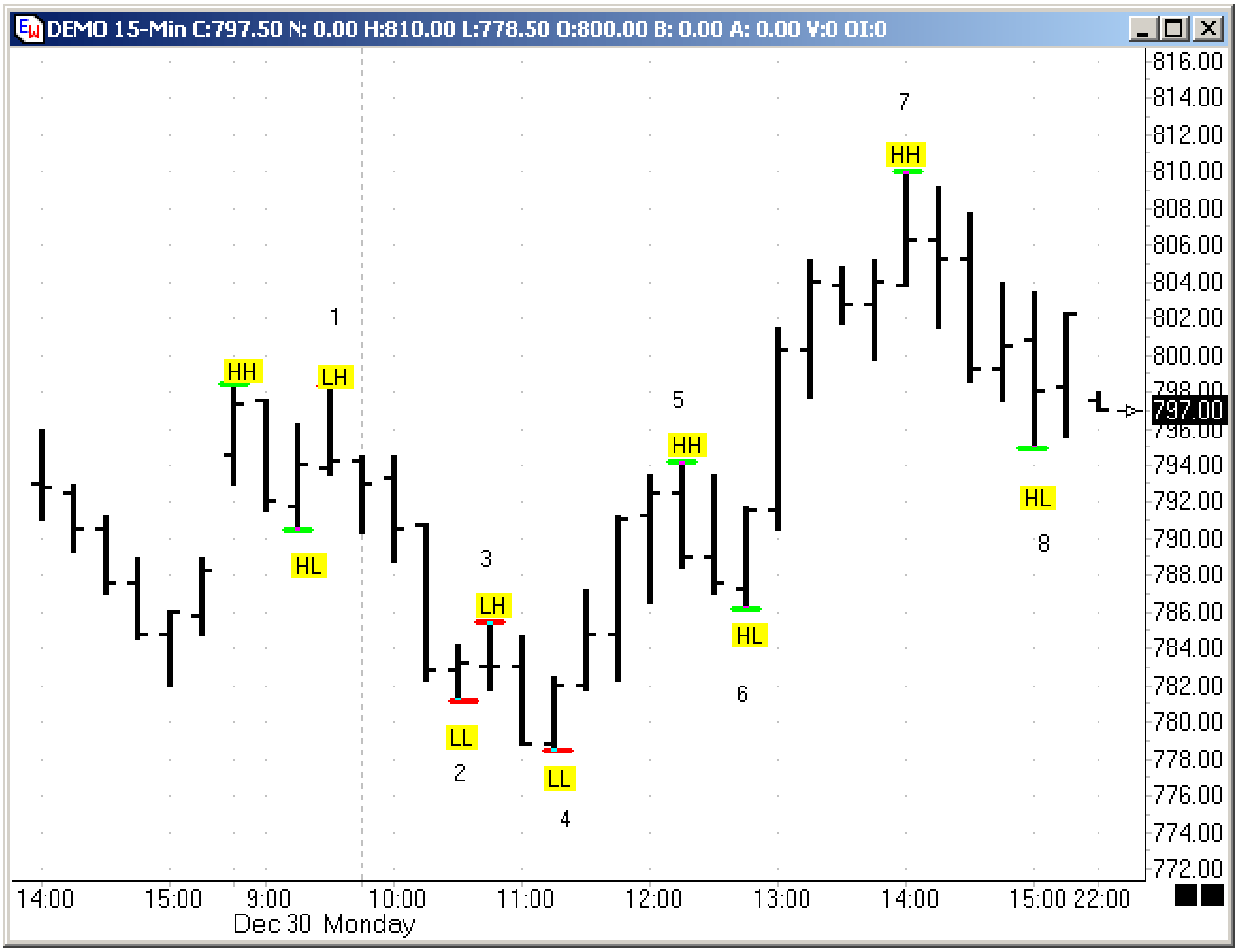


The above chart shows how an exact test of high or low may mean a change in trend as it failed to make a higher high on test of last swing high or a lower low on test of last swing low.

A. Price was making HHs and HLs until price tested the prior swing high at A.
B. Price made a LL and LH until price tested the prior swing low at B.
C. Price made a LH (The bar that does not touch line at C) until price tested the prior swing low at C.
D. Price was making HHs and HLs until price tested the prior swing high at D.

It is possible for one time frame to be in one trend and another time frame to be in a different trend or show consolidation. This is where the phrase 'trend within a trend' regarding price action and the different time frames comes from. An example would be that while price may be rising on a daily chart, the intra-day chart will show retracements, corrections of various types and consolidation periods

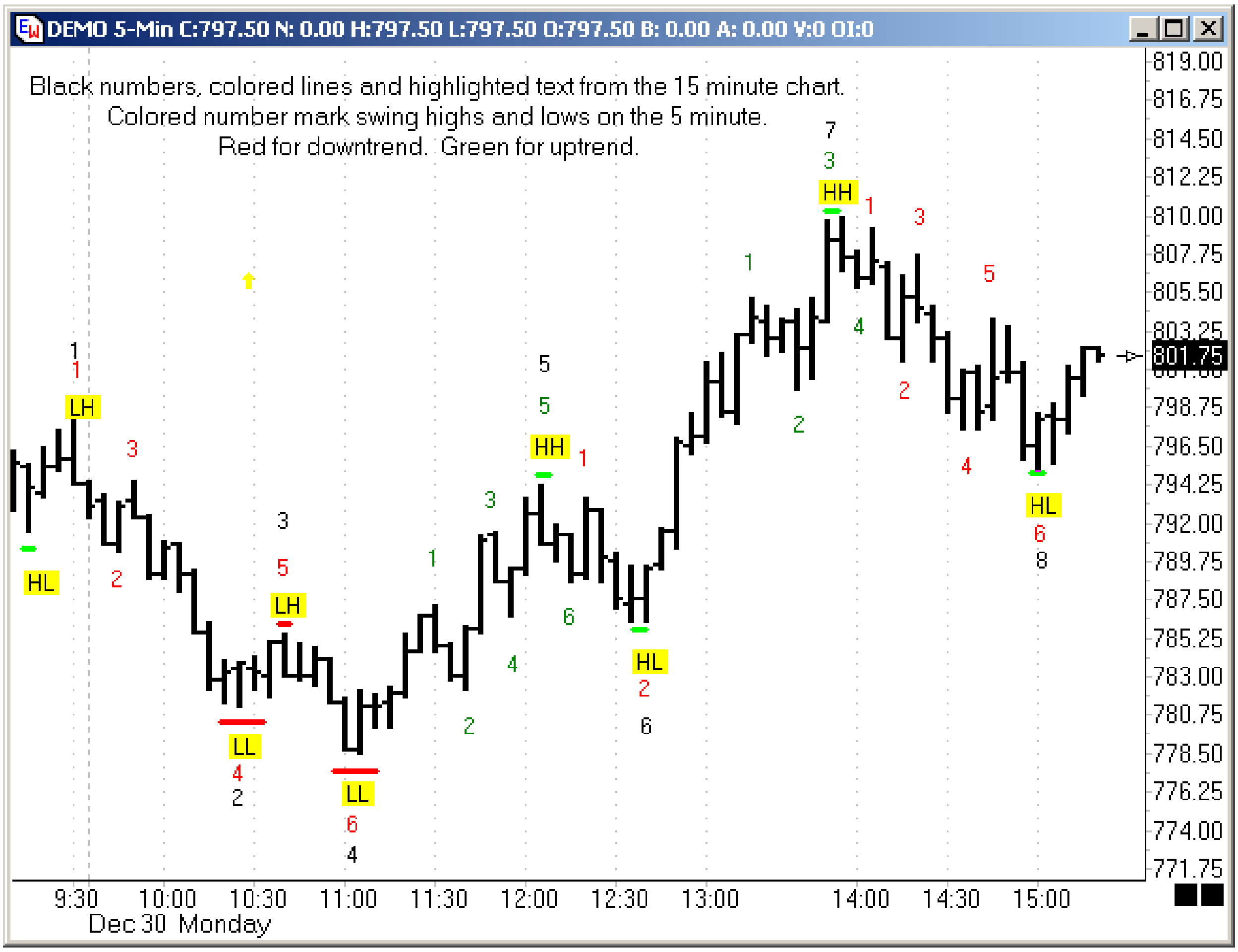
The true meaning of this and how it can influence your trading, eludes many. The following exercise is an excellent way to learn what the phrase 'trend within trend' means visually.



Pull up a 15 minutes chart and mark the highs as higher high (HH) or lower high (LH) and the lows as lower low (LL) or higher low (HL). (The note tool was used in Ensign to mark these charts.) You can also print out the chart and mark it by hand. Use red lines if price in a down trend and green lines if price in an up trend. Remember price is in an up trend if it is making HH - and HL and in a down trend if it is making LH and LL. If price is doing anything else, it can be a consolidation pattern - range, triangle, pennant, rectangle etc.

Points labeled 1-4 on the example chart are in a down trend. Points labeled 5-8 are in an up trend.

Now take the same chart and change the time frame to a 5 minutes chart, keeping the colored notes and numbers from the 15 minute by using the padlock with the L to lock lines in Ensign. Mark the new highs and lows with green numbers for an up trend and red numbers for a down trend.



Now we can see by the yellow HH and LL what trend is on the 15 minute at the same time we are able to see the trend on the 5 minute.

Both charts are in a down trend until the 5 minute makes a HH at the first green #1. The down trend is broken when the LH at black #3 is exceeded. Price then goes on to make a HL starting an up trend that continues until price makes a lower high at the red #1. The 15 minute just made a HH at the black #5 and will not make a HL until black #6. At this point, we are expecting a HL on the 15 minute, and are waiting for a long signal on the 5 minute. Some traders would take the entry on the pair of reversal bars at red #2, others would wait until the last swing high at red #1 is exceeded.

The time frames are now in agreement (shown by green #1-#4) up to the black #7 HH. After the HH at #7, the 5 minute goes into a down trend (shown by red #1-#6) to what is still a HL on the 15 minute at #8. So, while the 15 minute price action shows only two trends, the 5 minute shows five different trends!

While you may trade the trends on the smaller time frame, waiting for price action to show it is going to move in the same direction as the larger time frame is trading with the trend. The trend is your friend!