Trapping the intraday range

Keeping track of a currency pair's daily range and waiting for a pullback help take advantage of the intraday forex trend.

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The strategy outlined here uses simple analysis of the daily ranges in a currency pair to set up an intraday trade in the direction of the trend established early in the New York forex trading session.

The strategy is based on three principles: 1) a market move has only two possible directions; 2) the market is in perpetual motion, and 3) the market completes certain trading ranges over certain periods of time (a day, a week, a month, or a year).

On a practical level, principle 1 means that whenever there is an existing market position with a certain profit target and protected by a stop-loss level, the market will eventually reach one of those trading points. It also implies that price action on the way between the two points is "market noise" and should be disregarded.

Principle 2 means that over any period of time the market is progressing either toward the target or the stop level and that one of these points will be reached within a reasonable period of time.

Principle 3 allows traders to evaluate the specific probabilities a market will reach certain price levels within a certain time frame.

Let's see how these three principles might translate into an intraday forex trading strategy.

Strategy concept

The 24-hour forex trading day encompasses all the trading sessions around the globe, starting at 5 p.m. ET and ending the same time the next day. The trading day is split into three distinct sessions: the Far East and Asian session, the European session, and the North American session.

Let's say data collected over the past couple of months shows the average daily trading range for a certain currency pair was 120 pips (points). Over the same period of time the smallest daily range was 80 pips.

Now assume a typical market situation is occurring around 10 a.m. ET (Figure 1): The current intraday trading range is 60 pips (the distance between points C and D); the currency pair first formed its intraday low and later formed a top before drifting 30 pips lower — meaning that at this moment the price is right in the middle of the day's trading range (point E).

The daily range statistics imply the currency pair still has the potential to expand its range today because the current range is much smaller than the two-month average range (120 pips) and even smaller than the minimum range (80 pips) from that period; price must move at least 50 pips up or down from its current level just to match the minimum range.

The odds of an upside extension are better than the odds of a downside extension because the trend for the day is up. In this situation, the day's low becomes a significant support level and a long trade is opened, with a protective stop just below the support

FIGURE 1 — PATTERN TEMPLATE

This common intraday market pattern, from points A to G, represents: the day's opening price (A); the Asian session top (B); the intraday low (C); the intraday top (D); the intraday retracement low (E); the intraday high (F), and the day's closing price (G). The intraday trading range before the North American market open is represented by distance 1 and the complete daily trading range is represented by distance 2. To generate a reliable trading signal, distance 1 must be less than 70 percent of the two-month average daily trading range. It is also the buy zone for a long intraday trade.

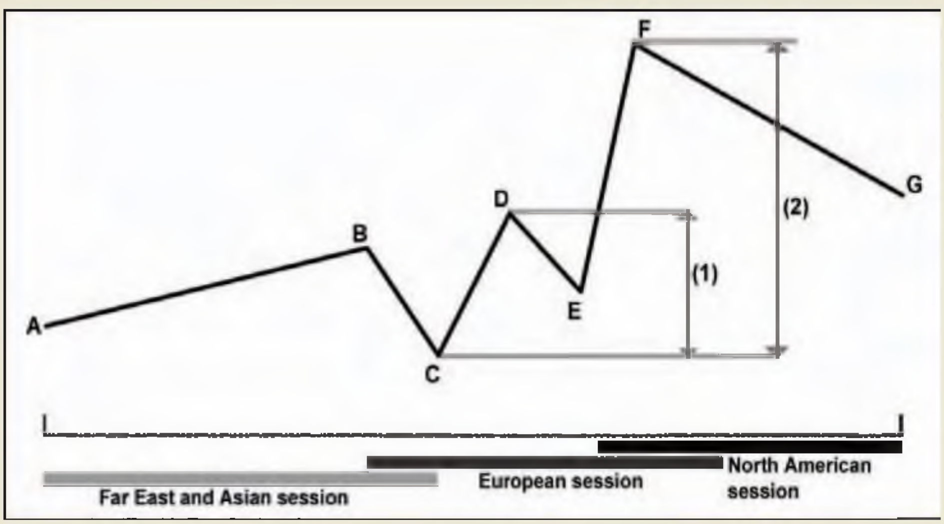
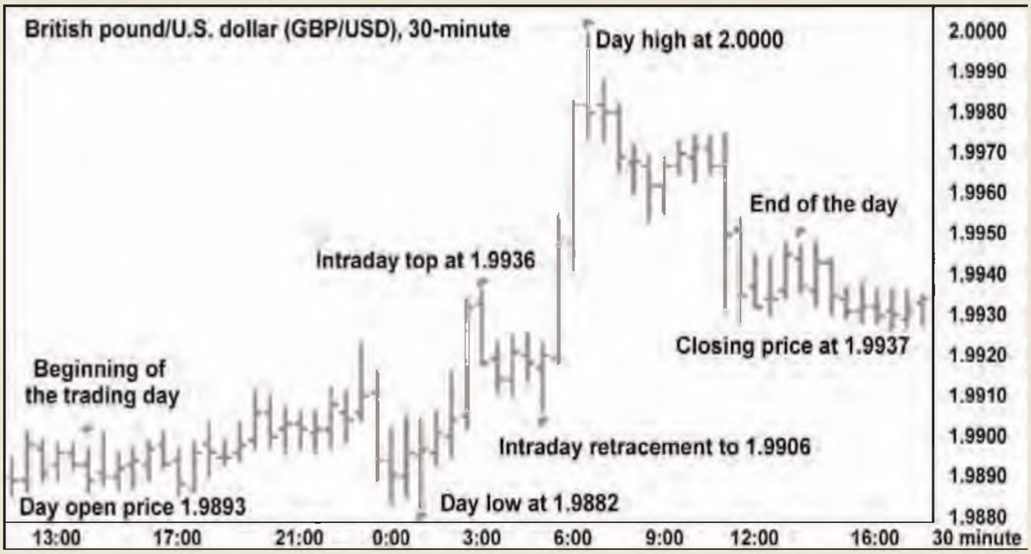


FIGURE 2 — LONG POUND-DOLLAR TRADE

By the beginning of the New York session, the GBP/USD pair had formed a 54-pip intraday range and the direction of the main move was up.



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level (risk approximately 30 pips) and a profit target of 50 or more pips.

The profit target could be set anywhere between the point at which the pair matches the minimum daily range over the past two months or the price at which it matches the average range (point F). Optionally, a target could be based on other levels (trendline, alternate support-resistance levels), as well as on time-based criteria — for example, liquidating the position at the closing price of the day (point G).

If the market penetrates the support at the day's low, the stop will get hit for a 30-pip loss. However, this does not negate the odds the market will reach its average or minimum daily range values before the end of the day; rather, it suggests a high likelihood the pair will extend its range to the downside by at least another 50 pips.

In this situation, you have a couple of choices. The first is to reverse the position immediately at the stop-loss price with the expectation the market will return the 30-pip loss, or perhaps more. The only problem is the appropriate stop level for the new trade would be above the high of the day, which would establish the risk of losing another 50 pips.

The second choice is to wait until the market makes a retracement back into its intraday trading range and then follow the rules used to establish the initial long position, except this time taking a short position.

Next, let's look at some specific rules that can be used to trade this approach.

Trading rules and customization

The strategy contains both systematic and discretionary components. The systematic elements cannot be changed under any circumstances, but the discretionary elements can be modified depending on a trader's specific money management rules, trading preferences, and market conditions.

The systematic rules are:

1. The position must be opened in the direction of the main move early in the New York session.
2. The initial position should be taken only if the current intraday trading range is less than 70 percent of the average daily trading range for the currency pair over the past two months.
3. Place a protective stop on the opposite side of the current intraday trading range — i.e., above the current intraday high (for short trades) or below the current intraday low (for long trades).
4. The risk on a single trade must not exceed 40 percent of the two-month average daily range for a particular currency pair.
5. Profit target: Liquidate the position when the currency pair matches its two-month average daily trading range.

Discretionary components

Because it is known in advance where the sell stop will be placed, the initial long position can be executed anywhere between point B + 1 pip and C. ("B+1 pip" is used because the position can be taken only in the direction of the main move. Remember, however, that bid-ask spreads must always be taken into consideration.)

It depends on a trader's personal risk preference, money management technique, and price availability, but as long as the difference between a buy order and stop level does not exceed 40 percent of the average daily trading range, a profit target can be set in advance. For example, a long trade could always be opened automatically using a limit order placed 25 to 35 percent of the average daily trading range above the stop level.

The time window for opening the initial position can be shifted. For the most part, however, the earlier in the day, the safer the trade.

A position reversal, if appropriate, can be executed simultaneously with the initial stop-loss order or after a retracement back into the intraday range.

The profit target can also be chosen in advance. For example, profits could be taken after a completion of 80 to 90 percent of the average daily trading range. However, if the desired level has not been reached before the end of the

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day, the position should be liquidated at the close.

Strategy setup and trade examples

Now let's look specifically at rules for a long trade, based on the information from Figure 1 and the rules and guidelines from the previous section. A long position can be opened early in the New York trading session if:

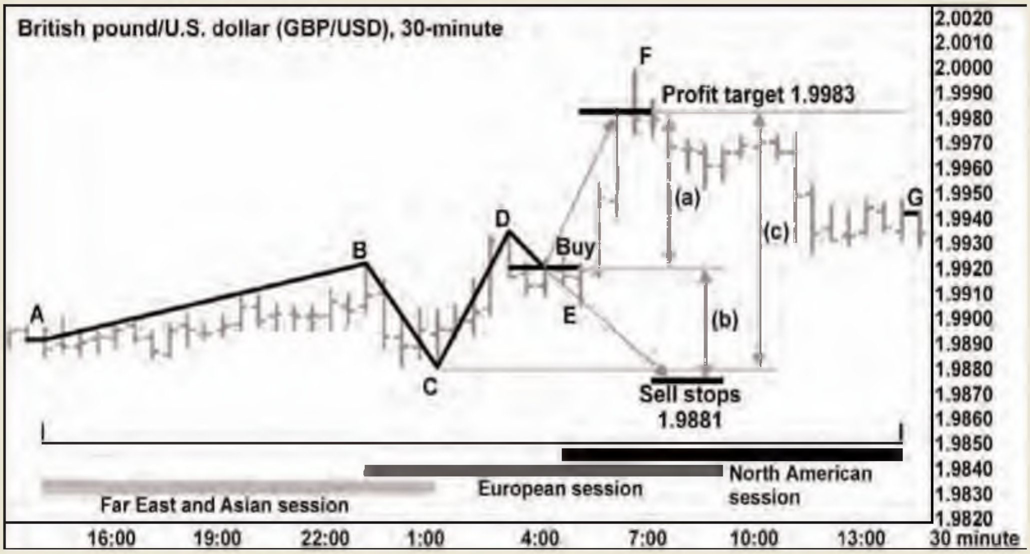
1. The primary direction of the intraday move is up.
2. The intraday trading range is less than 70 percent of the average daily trading range over the past two months.
3. The market makes an intraday retracement toward and comes within 30 pips of the low of the day.

Stop-loss and profit-target placement:

4. Place a stop-loss order just below the intraday low (around 30 pips below the initial buy level).
5. Exit as soon as the currency pair completes 90 percent of its two-month average daily trading range.
6. If price does not reach the profit target, exit the position at the close of the day.

FIGURE 3 — POUND-DOLLAR WITH TEMPLATE

To take a long trade with a 30-pip risk, the trade would be initiated 30 pips above the stop level, which would be just below intraday low. A profit target could be set anywhere between points D and F.



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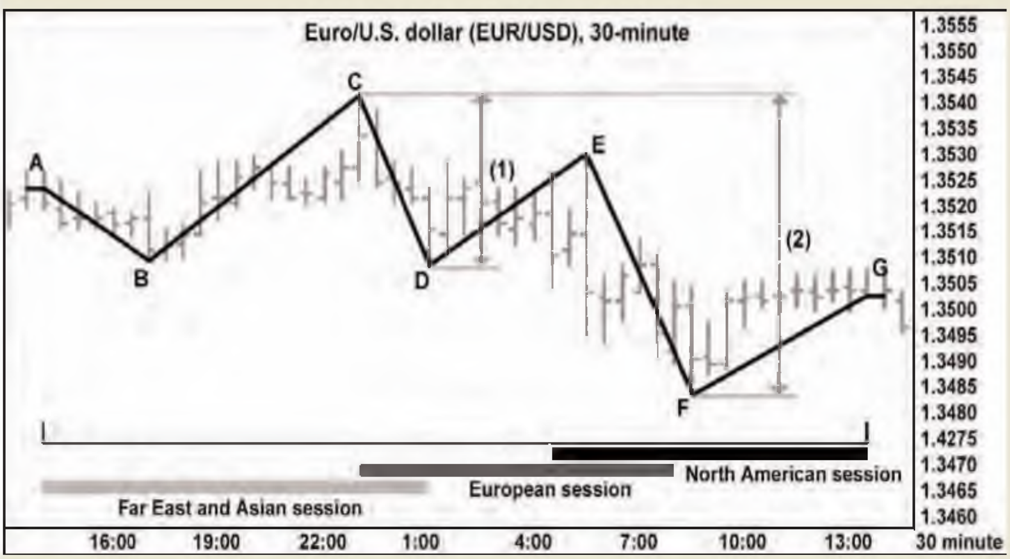
Figures 2 and 3 illustrate this strategy in the British pound/U.S. dollar pair (GBP/USD), using a 30-minute chart from May 9, 2007. This trading day opened at 1.9893 and had formed a 54-pip intraday range by the beginning of the New York session. First, the market made an intraday low at 1.9882 and then a top at 1.9936. The direction of the main move was up by the beginning of the New York trading session. This information, along with the two-month average daily range number for GBP/USD is everything you need to know to make a trade decision.

Figure 3 places the trade template from Figure 1 over the price chart from Figure 2. For instance, if a trader is willing to assume a 30-pip risk, the initial buy position should be established 30 pips above the level where the stop is placed. Because the stop must be placed just below the intraday low, the entry level would be calculated as follows: (C - 1 pip) + 0.0030 = 1.9881 + 0.0030 = 1.9921.

This allows you to place two simultaneous orders: a limit order to buy at 1.9921 and a

FIGURE 4 — SHORT EURO-DOLLAR TRADE

A short would be executed between points D and E, with a target equal to 90 percent of the two-month average trading range.



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sell stop order at 1.9881. If the market then retraces from point D to point E and triggers the limit order, a buy order gets executed automatically and is automatically protected by the sell-stop order.

A profit target is set in advance anywhere between points D and F. In this case, the target is located at 1.9983, which represents a move (from the intraday low) of approximately 90 percent of the two-month average daily trading range.

Figure 4 illustrates a short trade example in the euro/U.S. dollar (EUR/USD) pair from June 6, 2007. Point A is the opening price of the trading day (1.3525); point B is the intraday (Asian session) bottom at 1.3510; point C is the intraday top at 1.3542; point D is the subsequent intraday bottom at 1.3509; point E is the top of the retracement at 1.3530; point F is the eventual intraday bottom at 1.3484; point G is the day's closing price of 1.3502; distance 1 is the intraday trading range before the open of the New York session; and distance 2 represents the complete daily trading range.

The initial short position has to be taken somewhere between points D and E to target 90 percent of the two-month average trading range, which in this case is 0.0066 — significantly smaller than the average range that was used to illustrate the first trade example above. As a result, the strategy has to be adjusted for the change in volatility. If the risk is downsized to 0.0020, the initial sell position could be taken at the 1.3520-25 level to target 90 percent of the average two-month trading range (around the 1.3495 level) and the stop must be placed above the intraday high at 1.3545.

Simplicity and practice

It is quite likely that there will be a problem initially with recognizing the different opportunities, but once you get used to it, the trading process should become routine.

Most importantly, working with clearly defined stop-loss and profit targets based on recent price behavior provides a solid footing for placing trades.

For information on the author *see p. 6.*

Related reading:

"Currency personalities"
Currency Trader, September 2005.
Unique fundamental circumstances and the transition from one trading center to the next create distinct currency "personality traits" traders can use to their advantage.

"Intraday CMO-FX"
Currency Trader, November 2006.
This Currency System Analysis article tests an intraday system based on the Chande Momentum Oscillator (CMO).

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