Forex Game Theroy

Introduction

Most trading methods are built on concepts that are either unproven or don't make sense.

I've seen lots of trading methods over the years captivate traders because of how easy they look to trade. These methods are usually very simple and tend to be mechanical. Unfortunately, forex trading is not simple. To make money requires you to think deeply about how the market works.

The only way to do this is if you understand the facts about the market.

These facts are all laid out for you in this book.

It took me a long time to figure out what I'm presenting to you in this book. To begin with, when I first learned some of the things, I couldn't comprehend how I was going to use this new understanding to formulate trading strategies or understand the market better. It just seemed like there were too many variables for me to do anything differently than what's already available.

In time though, I began to think about the ideas and concepts that are true for everyone in the market.

Most people know that 90% of traders lose money consistently, so this means lots and lots of traders are doing something wrong. Over the coming pages you'll learn not only what everyone's doing wrong, but also come to understand why they've done things wrong for such a long time.

Let's get to it.

Understanding The Game

Forex trading is a zero sum game.

What this means is one persons gain is another persons loss. If you placed a trade which ended up making £10,000, that money has come from other traders losing money from closing their trades at a loss.

If you lose £10,000, other traders in the market have taken that money from you because you got the market direction wrong. It's important to note, this is true for everyone in the market. It doesn't matter if your a professional trader working in a bank or a retail trader trading from home, the only way to make money is by making other traders lose money and vice versa.

This is something a very small percentage of traders understand, yet remains the most important fact of the forex market.

The Trend Has Been Made Up To Make You Lose Money

This is going to be a controversial topic because I know the concept of trend is deeply rooted in the mind of nearly all forex traders.

What I'm going to show throughout this chapter and throughout the book, is why the definition and understanding you currently have of the trend has been made up to make you lose money.

Whilst your reading through this chapter I want you to think about something?

When does a movement become a trend, or are all movements themselves trends?

Think about this as it's a key concept I want you to take away from the book.

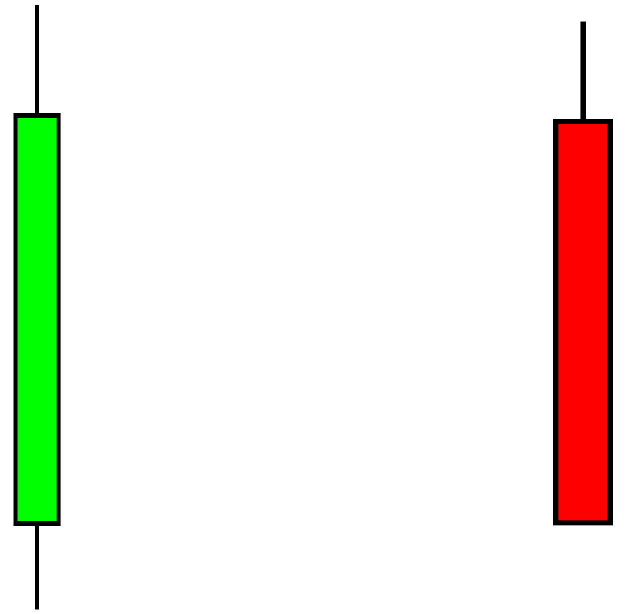
Defining A Trend

Defining a trend is critical in understanding why people lose money in the markets.

Most traders define a trend using large range candlesticks.

Large Range Candlesticks

Large range candlesshow a large price change has occurred.



Example of bullish and bearish large range candlestick.

These candles are what define a trend. Without large range candlesticks, it would be pretty difficult to see which direction the market is trending in.

Now since most traders define how strong a trend is by seeing these large range candles, they play an important part in how the traders perceive what's going on in the market.

We'll come back to this later on in the book.

For now, there is something even more important which you need to understand about large range candlesticks.

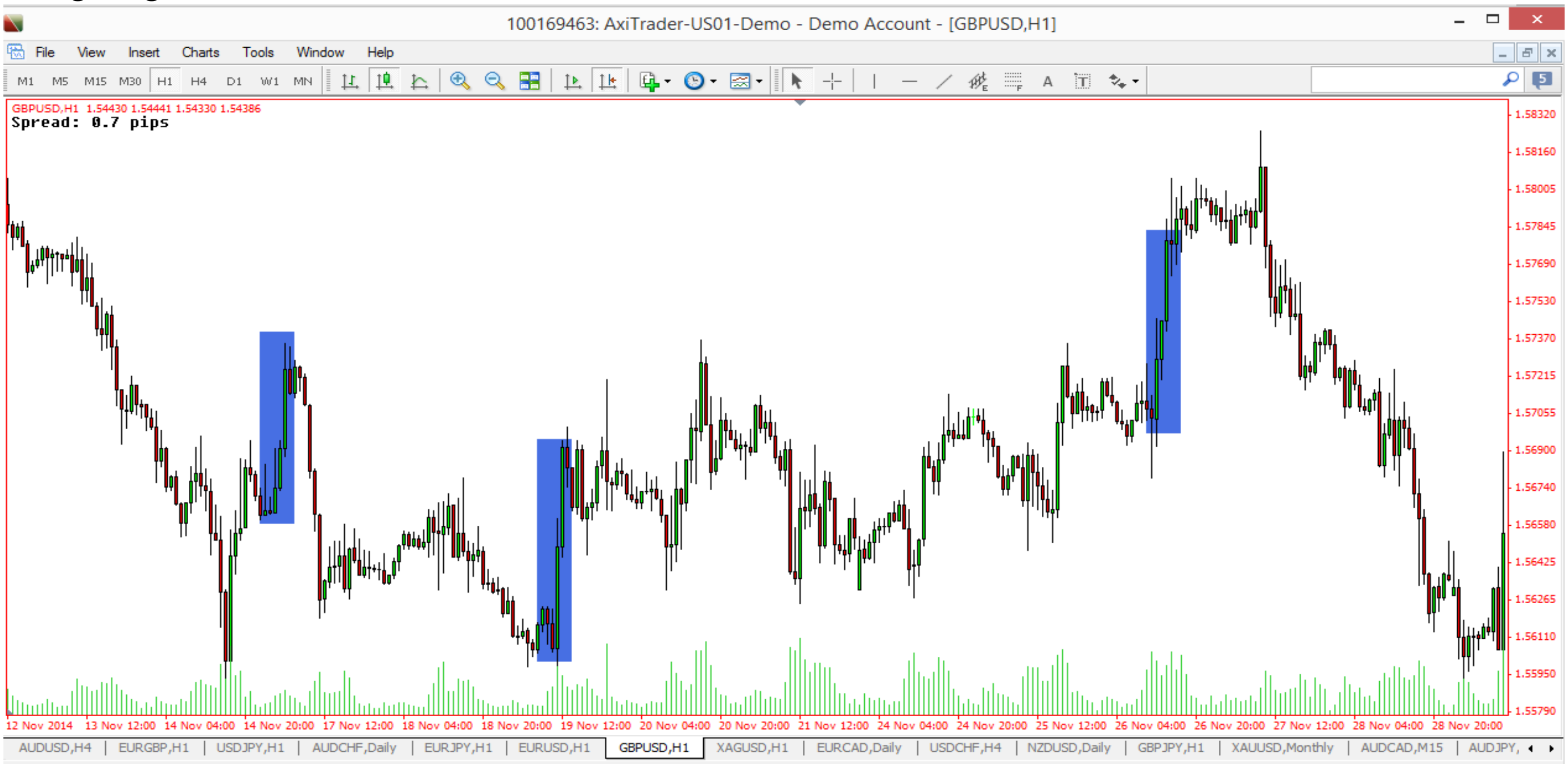
When traders see a large range candlestick form they'll place trades in the direction of the candlestick.

The reason they place trades upon seeing these candles is that they have reactive personality traits in regards to their trading.

The traders who place trades when they see large range candlesticks are not placing trades based upon any rational or logical method of technical analysis, but instead on emotion, fear to be specific. Traders see these candles and believe if they don't get in and place a trade right now, they are going to miss out on making a lot of money.

The size of the large range candle has a dramatic effect on the level of fear the traders trading the candles have of missing out on making what they believe to be a significant amount of money.

The bigger the size of the large range candle, the more certain traders become the market is going to move either up or down. This why when news events are released, typically, it will produce a large range candle with high volume. The volume comes from the reactive traders placing trades who have just seen the market move a large distance and assumed it's going to continue in the same direction.



The movements above are what reactive traders typically see as trading opportunities.

The traders are drawn to placing trades on these types of movements because in each case it looks like the market is moving up strongly in one direction.

Take note of the fact soon after these movements occur, the market either stalls or moves in the opposite direction. This is purposely done by the banks to make the reactive traders lose money.

Here's the up-move you can see on the far right of the last image.

You can see how bullish this up-move would have looked to traders in the market. Upon seeing this move up take place, a huge amount of traders will have placed buy trades because it looks like the price is certain to keep moving higher.

These reactive traders are present across all time frames too. Don't think that just because I'm showing this example on the 1-hour chart it means you can only find reactive traders on the 1 hour.

You can see these big movements with multiple large range candles across all time frames. The effect these movements have on traders are the same regardless of the time frame being observed.

<u>The Three Phases In Every Trend</u>

In this chapter, I'm going to show you the three phases that occur with every trending movement in the market.

I'll start by explaining what each of the three phases are and why they occurs. Then I'll run through some examples of movements that clearly show the three phases taking place.

All movements that make up a trend consist of three phases.

These three phases occur one after another to form the movements we see on our charts.

Note:
My definition of a trend is a price movement from one point to another without a significant pullback or consolidation taking place during the movement.

<u>Phase 1 Imbalance</u>

The imbalance phase is the cause behind all trend changes you see in the market. The reason its called the imbalance phase is because of what needs to happen for the price to actually change direction.

The only way the price can change direction is if orders come into the market that are bigger than the orders causing the market to move in its current direction.

Example:

If the price of EUR/USD is currently rising, it means the buy orders coming in are bigger than the sell orders coming in. For the price to now start falling, the sell orders need to become bigger than the buy orders. When this happens, the buy orders are consumed, and the price will begin to fall, thus an imbalance has occurred.

Anytime you see price change direction it's because of this imbalance phase occurring.

It happens at the beginning of all movements in the market, no matter which time-frame is your seeing the movement on.

Phase 2 Liquidation

The liquidation phase only occurs because of the imbalance that takes place in the first phase.

In the imbalance phase, one set of orders come into the market that are bigger than the orders pushing the market in its current direction. This is what causes the first bit of movement in every price reversal. When the price starts to reverse and move in the opposite direction, the traders who had trades placed before the reversal occurred begin to close their trades at a loss.

When these traders close their trades, orders are put into the market that pushes the price further in the direction of the reversal.

Example:

Let's say EUR/USD is currently rising. People are placing buy trades because they believe the price will continue moving higher in the future. The banks decide to place sell trades which causes price to reverse and start falling. Now all the traders who placed start to lose money and watch as their loss grows bigger and bigger.

Eventually, the loss on their trades has become so great they decide to close.

Closing a buy trade requires the trader to use a sell order because he has to sell what he brought at a worse price than what he brought it for.

Now because the trader has unknowingly placed a sell order into the market, it means the price will fall further even quicker because the imbalance between the sell orders and buy orders will have become even greater.

The important thing to realize about the liquidation phase is the movement generated by the traders closing losing trades is entirely dependant on how many traders placed trades in the direction the price was moving before the reversal took place.

The more traders that were in trades before price reversed, the bigger the movement caused by their liquidation, as a larger amount of orders will come into the market.

Phase 3 Awareness

The awareness phase is the sum total of the movement generated by the first two phases.

The imbalance phase and the liquidation phase has caused price to move far enough to make people believe a trend is taking place. When people see a trend is forming, they'll begin placing trades in the direction of the trend, as they believe the price is now more likely to continue moving in the same direction than reverse.

When these traders place their trades, price moves even further in the direction it moved during the first two phases, as the imbalance between the buy and sell orders grows even bigger.

By the time the awareness phase has begun, the majority of traders who had trades placed in the direction of the previous movement before the reversal occurred have closed their trades at a loss and are now starting to place trades in the direction of the trend.

Recap:

- The first phase is caused by one set of orders coming into the market that are bigger than the orders causing price to move in its current direction.

- The second phase is caused by traders who had trades placed before the first phase began closing their trades at a loss due to the fact the price has reversed from its previous direction.

- The third phase is traders becoming aware that a new trend is taking place because of the movement generated by the first two phases.

The Truth About Trends

Look at the image above and imagine you're trying to figure out which direction the market is about to move in.

Does it look like a huge drop is about to take place?

No, why?

Because the market hasn't fallen enough for you to believe a trend actually exists.

No lower low has been made (the lowest low at this point is marked with an X) so it still looks like the market could run back up to the highs, and maybe begin to form a consolidation.

It's imperative to understand nobody sees a trend until the market has moved a large enough distance in one direction for them to confirm in their heads a trend does exist.

At the beginning of the book I asked you “At what point does a movement become a trend, or are all movements considered trends?”

And the answer is...

All movements are trends but not to every trader AT THE SAME TIME.

Think about this:

A trader using the 5-minute chart is not concerned with what the trend is on the daily chart. The reason being is his time horizon for placing and holding trades is a lot shorter than someone who trades off the daily time frame.

Additionally, a trader who trades on daily is not going to be concerned with what the trend is on a 5-minute chart because he's placing trades based on a completely different time horizon.

The important thing to understand about both sets of these traders is the decisions they make based on the trend taking place on their time-frame will end up influencing how the traders using the other time-frames see the trend.

If a large down move occurs on the 5-minute chart, lots and lots of traders will begin selling.

Their selling may push the market down enough for traders on the 1 hour to identify the movement as a new trend or reversal, which causes them to also start selling. The selling coming in from these then pushes price down enough so that the traders on the daily begin placing sell trades because they think a trend is taking place, which ends up pushing the price down even further.

Because everyone is trading off different time-frames, it means all traders have a different perception of the price action taking place in the market.

Before this downtrend got underway on EUR/USD, most of the orders entering the market are buys.

Why?

Because the first down move from the 1.39 high is only seen as a downtrend to a certain portion of traders, mainly those on the lower time-frames, like the 15 minute and 1-hour charts.
The majority of the traders operating on the daily and weekly charts would not consider this a new downtrend because price has not fallen enough for them to see a trend is taking place.

Another thing to consider is how the traders on the longer time frames like daily and weekly charts probably haven't closed their losing trades when the first move down took place from the 1.39 high.

The reason why is because of their time horizon and risk tolerance.

Someone trading on the daily is affected by price action differently than someone trading the 1 hour. For example, a bearish large range candle that forms on the daily will make the reactive traders on the daily place trades. But the traders on the other time-frames don't see a bearish large range candle, they see a small downtrend.

One last important thing to understand is how professional traders take profits off their trades.

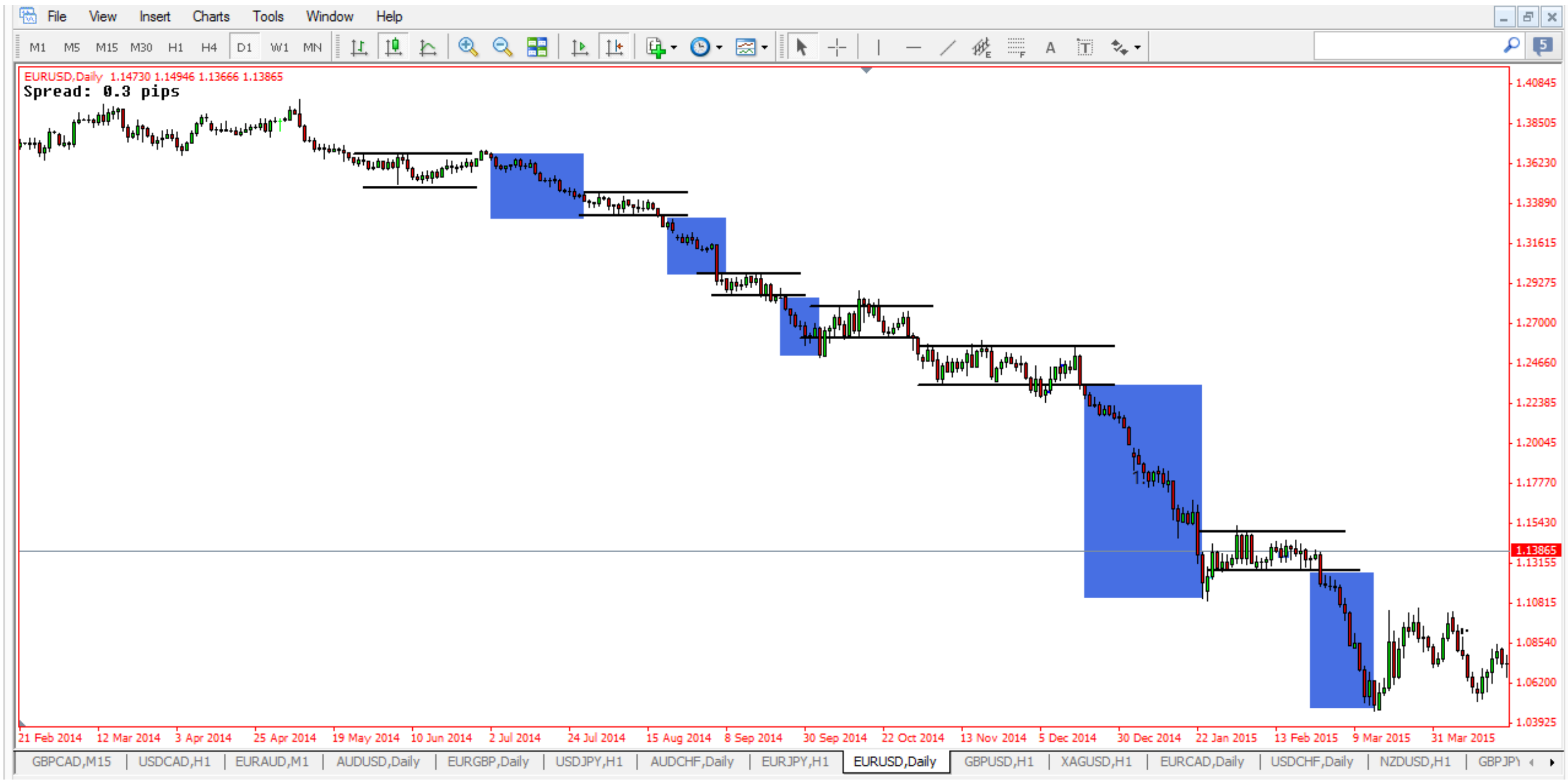
If you sold 100,000 euros at the point marked with the two ticks in the image by the time the market has reached the lows of the downtrend your trade will be in profit of around 1 million. This means there needs to be sell orders coming into the market which total 1 million or more for you to close the trade and make your profits.

For this to happen, there needs to be lots and lots of people selling. The only way a large number of people will sell is if they think a new downtrend is taking place.

This is why the banks and other large institutions need to make sure retail traders have the wrong understanding of the trend. They need retail traders to be placing trades late into the lifespan of a trend because if they don't, they won't be able to take profits off their trades, which get increasingly bigger the further the price moves in the direction of the trend.

<u>The Only Fractal Pattern In The Markets</u>

You may of heard about fractals before. What I'm going to show you now is not the common understanding of fractals as talked about by Bill Williams, but the fractal pattern of psychology in the market.



The image above is taken from the daily chart of EUR/USD.

It shows a huge downtrend that took place a few years ago.

You can see I've marked each separate down move in this downtrend trend with a blue box. These down moves all follow the three phases I talked about earlier; Imbalance, liquidation, and awareness.

Now I want you to look at the consolidations that take place in between each move.

These consolidations are what cause each move down.

When the market stops and enters a consolidation, reversal traders always believe the market is getting ready to move in the other direction. In addition to this, the consolidation puts the trend traders who always place trades late into movements at a loss on their trades, due to the way the market swings against the trend when it first enters a consolidation.

What you essentially end up with is two sets of buy orders coming into the market.

One set from the reversal traders who have placed trades under the impression price is about to reverse, and the other set from the trend traders closing their losing sell trades.

These buy orders are what the bank traders use to place more sell trades in the direction of the trend.

It's important to keep in mind where the consolidations are found in the context of the trend affects what decisions the banks make using the orders generated by the trend and reversal traders.

If you see a consolidation form at the beginning of a trend, the banks will most likely use it to build positions in the direction of the upcoming trend.

If you see consolidations deep into the life of a trend (a trend that's been in place for a long time), it's likely to have been caused by bank traders taking profits off their trades.

To know why we have to go back to what I talked about earlier.

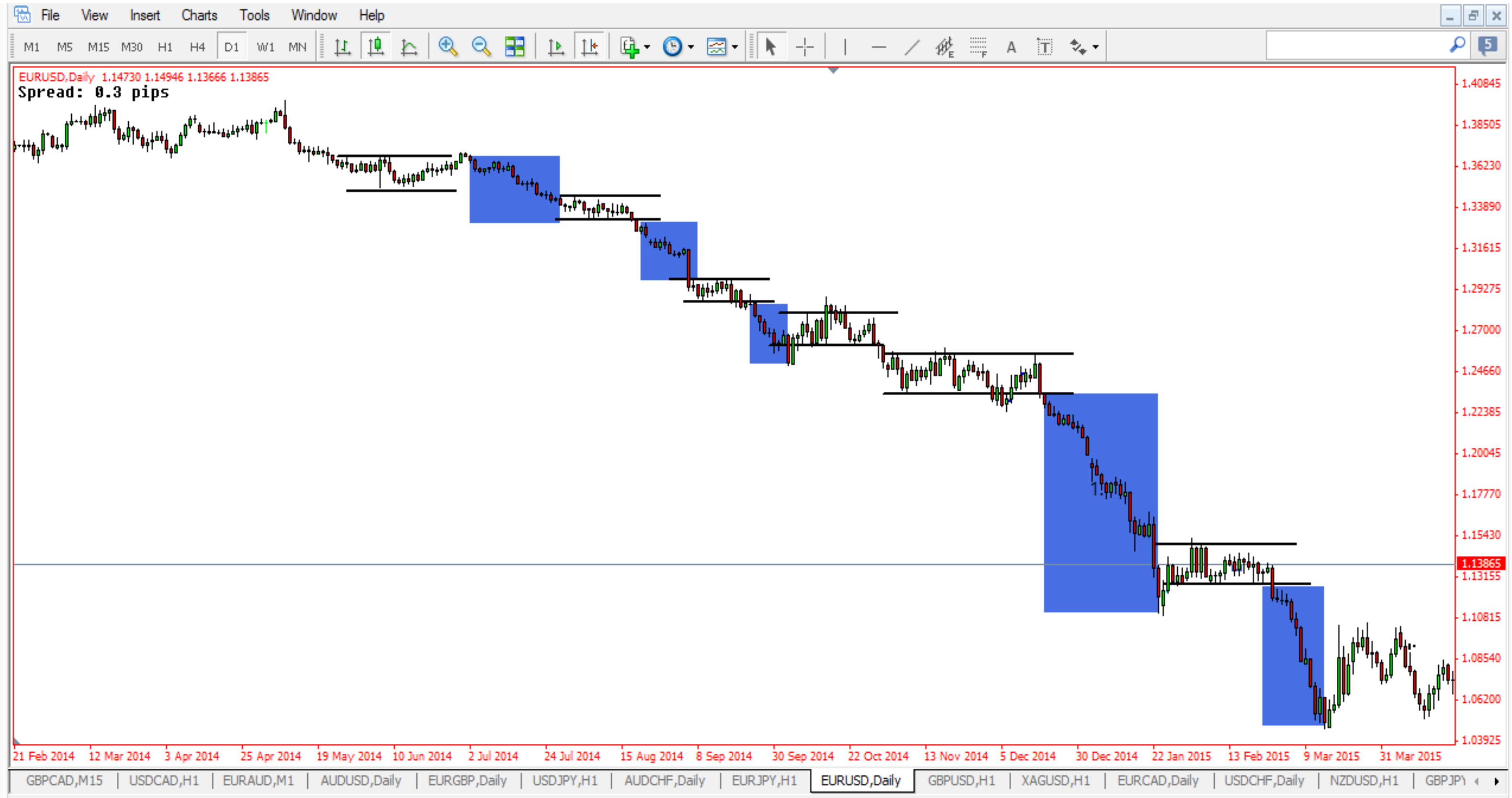
As a trend increases in length more and more people become aware of its existence, meaning more traders start buying or selling in the direction of the trend.

At the beginning stages of a trend, not everyone has identified the market is in a new trend, a lot of them think the initial down or up move is just a retracement to whatever the previous trend was.

This means the majority of traders have not started placing trades in the direction of the new trend and will instead have been placing trades in accordance to what the previous trend was.

In the case of the EUR/USD downtrend, by the time people had seen that the market had been falling for what they consider to a long time they'll begin placing sell trades onto any retracement or consolidation that forms, as their belief the downtrend is going to continue has become so great due to the length of time price has been declining.

If you look at the image of the EUR/USD downtrend below, you'll see in the middle of the chart there's a place where two consolidations form right next to each other with only a small down-move taking place in between.



Because there's no down move (or a very small down-move) in between these two consolidations, it increases the length of time that the market is not trending.

The longer price isn't trending, the higher the number of people who believe price is going to rise. Essentially meaning more people are going to lose money if the market drops lower.

Look at the down move that follows the two consolidations. It's the biggest yet, almost as big as all three previous down moves combined.

This is because there were far more traders closing losing trades when the price fell out of the consolidation than there were on any of the previous consolidations, due to the length of the time the price wasn't trending.

Self Similar Structure

Now we're going to take a deeper look into some of the individual down moves I marked in blue on the previous images.

The image above is the last down move you can see in the image on the previous page, only we're looking at it on the 1-hour chart instead of the daily chart.

We can see this one down-move follows the same structure as the whole downtrend.

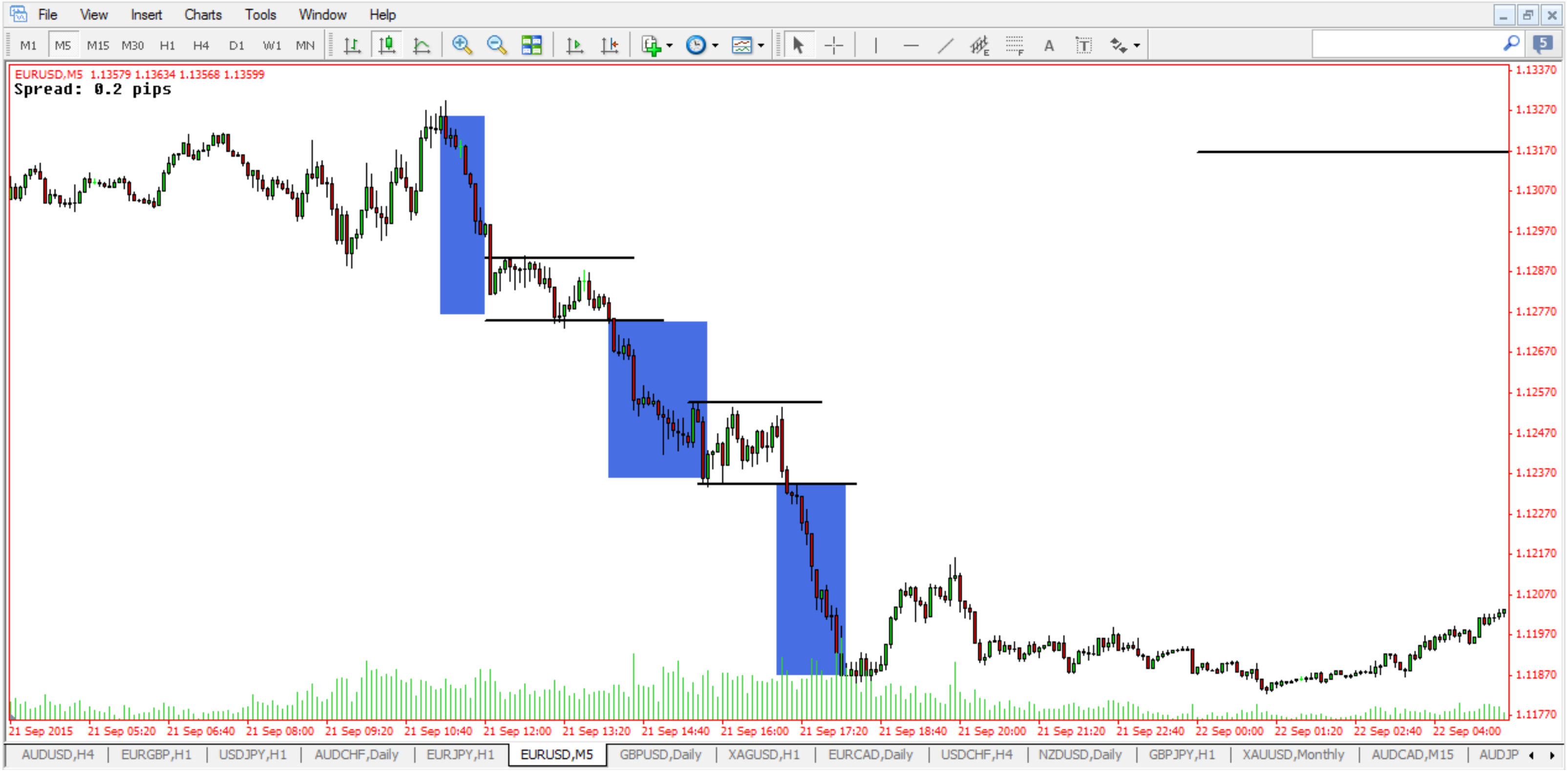
Down movements followed by consolidations.

What's happening on this down move is the same as what we see happening on the daily chart. The only difference is it's happening to a smaller subset of traders.

Each move down follows the three phases talked about earlier with the length and duration of the drop being dependant on the number of people who placed buy trades when the price stopped falling and started consolidating/retracing.

It's important to note, at this point in the downtrend, not many traders buy when price starts to consolidate, due to it being obvious on all time-frames the market has been in a downtrend for a significant length of time.

When the price has been moving in one direction for a really long time, people will automatically begin selling on any up or down move they see as they believe the trend is definitely going to continue.



Now we're going to look at a down move on the 5-minute chart that is part of a larger down move seen on the 1-hour chart.

Amazingly, even on a time frame as low as this we still see the same structure.

The same process is occurring only to an even smaller subset of traders.

The reason I've shown you these images of the trend structure on the 1 hour and 5-minute charts is so you can see how different types of traders affect one-another in the market.

The actions of the traders on the lower time-frames like the 1 minute and 5-minute charts cause movement that affects the traders trading the higher time frames, like the 30 minute and 1-hour charts. The traders on these time-frames then react to the movement caused by the traders on the 1 minute and 5-minute charts, which causes enough price movement for the traders on the daily and weekly charts to begin placing trades.

This is how the market works. Everyone's actions have a cause and effect relationship with all the other traders in the market.

Trend Traders And Reversal Traders

In this chapter, we're going to look at how trend and reversal traders make trading decisions.

Most traders use either a reversal strategy or a trend trading strategy.

By understanding how these traders make decisions, the better equipped we become to take advantage of them. Even though all strategies typically have different entry/exit criteria, certain conditions need to be met that are true for all trading strategies that encompass a certain type of trading.

Trend Trading

Trend traders attempt to capitalize on a movement after it has already begun. For example, a moving average crossover only produces a signal after the market has moved enough for one average to cross the other.

Would a trend trader buy if the market was flat ?

No, because there's no trend. He needs to see the market move in one direction for a certain length of time before he decides to buy or sell. He needs confirmation in his head that a trend is actually taking place, which can only happen if the market has already moved.

Would a trend trader buy now ?

Yes, because now the market has moved, the trend trader sees an opportunity to potentially make money.

The important thing is we could be seeing this on a 15-minute chart, so only the traders on the 15 minute will have identified this movement as a trend.


Daily Chart traders only see this

If you were trading on the daily chart you would probably see something like this.

Do you think this movement looks like a trend for the traders on the daily chart?

No, right?

This movement is far too small to be considered as a new trend.

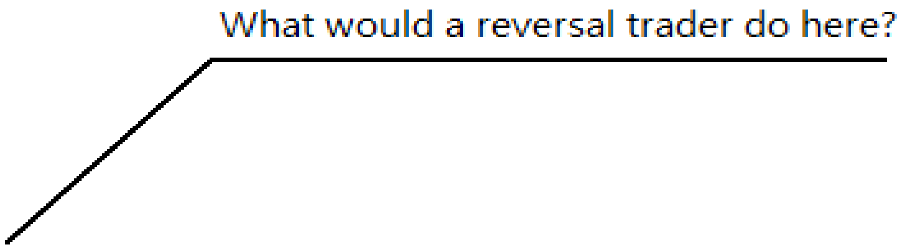
To the traders on the lower time frames, this movement would be a significant uptrend. What this means is anybody who's using a trend trading strategy on these lower time frames is likely to enter the market.

If they were using a moving average strategy, for example, this movement would be enough for one average to cross the other. However, if the trader was using a moving average strategy on the daily chart, the movement above would not have been enough for the averages to cross.

Reversal Traders

Reversal traders are always trying to trade either in the direction of a trend or counter to it.

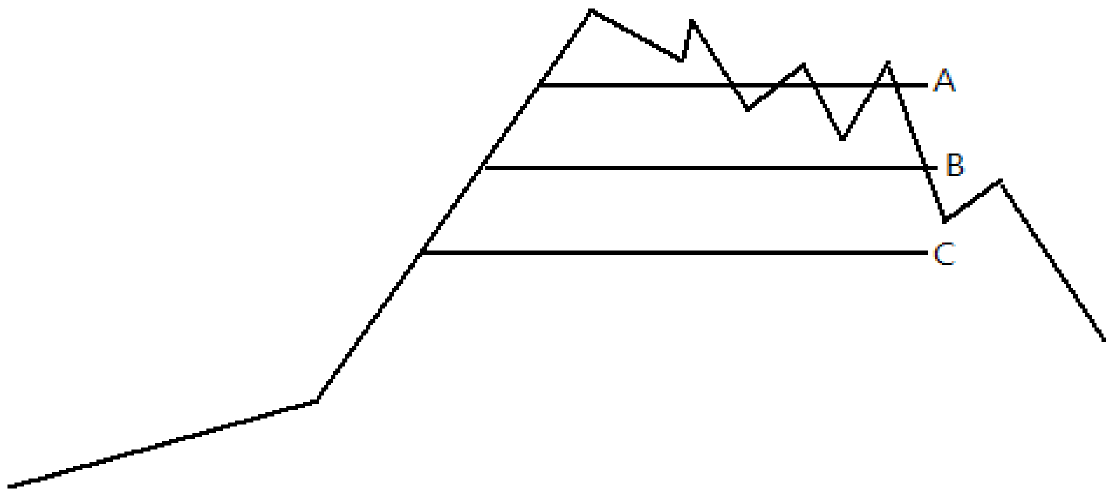
If the market is in a downtrend, the reversal trader is attempting to sell in any up move. So his analysis also incorporates the concept of trend, but in a different way to how a typical trend trader uses it.



What do you think a reversal trader would do if this was all he could see?

It depends on what the previous trend was, right?

If the market had been going up for a long time before it stopped, the reversal trader would probably try to enter into a buy trade. If before this the market was in a downtrend, he would place a sell trade, because he's sees the movement as a retracement to the trend.



This image shows how a typical reversal trader thinks.

To begin with, the market is rising, so the trader believes he is in an up-trend.

He wants to find a place to get into this trend and hopefully make some money, so he draws his lines or rectangles off the past price history and waits for the market to return so he can get his buy traded placed.

The price falls back to line A, and he ends up losing money. It's not a problem, though, because the market still looks like it's just a retracement to the up-trend.

He places another trade at line B. He loses again, but this time, the drop that breaks his line is far more significant than the drop that broke line A. A drop like this would consist of one or more bearish large range candles that we know people use to determine what the current trend is. This causes the trader to change his outlook on the future market direction.

The fact the drop was much bigger than the drop that caused him to lose on the first trade at line A means he now sees the market as being in a downtrend rather than being a retracement to the up-trend.

Now the whole process of the reversal trader drawing his lines and rectangles occurs again, only now he is trying to get short into a downtrend instead of trying to get long in an up-trend.

You frequently see people identify the trend on one time frame (the daily chart for example) and then try and trade in the direction of the trend on a different time-frame like the 1-hour.

They don't understand the two trends are completely independent of one another.

The market could be in an up-trend on the 1 hour chart and in a downtrend on the daily, but because the trader gets his trend from the daily, he will keep placing sell trades on the 1 hour thinking daily trend is going to continue, even though the trend on the 1 hour is up.

Eventually, the market has moved sufficiently in one direction on the 1 hour for the trader to identify the 1-hour trend is, in fact, the current trend, at which point, he will begin trying to pick reversals in the direction of the new 1-hour trend instead of the previous trend.

Another way the perception of traders gets altered is by consistently losing trades.

When traders consistently lose money trading the same movement or in the same direction, they'll reach a point where their beliefs about the direction will change.

If I think the market's going to change into a downtrend when it's currently in an up-trend and place sell trades against this uptrend because I believe the trend is going to change, if I kept losing on all of these sell trades my belief the market is going to go down will eventually be drained, which means at some point I will accept that the market isn't going to go down anymore but instead continue going up.

So now I'll begin placing buy trades because I feel like the price is going to move up.

The problem is, in the time it's taken me to realize the market is moving higher, this up-trend is near the end of its lifespan, which means soon it'll begin to fall and I'll still be placing buy trades under the impression it's going to continue higher.

How Time Affects Perception

Time is a topic not often discussed in the world of forex.

It's strange because time is a crucial concept affecting every trader's analysis of the market.

For example, the longer the market moves in one direction, the more and more people who believe it's going to continue moving in the same direction.

Most market crashes are caused because of this assumption.

People believe that since the market has risen for a long time, it's certain to keep going up in the future. They start buying expecting higher prices when eventually there's no one left to buy, and the risk-reward situation becomes skewed to the downside, causing people (usually banks) to start selling.

This concept of time also applies to other market structures.

Look at the two consolidations that took place during the USD/JPY up-tend.

Look at how long both of these consolidations lasted. Combined, the market was in a consolidation for 273 days. How do you think this affects people's view of which direction the market is likely to move in?

Both of these consolidations accomplish two things:

One, they shake the late buyers out of their trading positions, and second, it makes people forget about the previous up-trend.

If the consolidation goes on for long enough, people will start to believe the market is going to continue consolidating. It's the same as when people assume up-trends and downtrends that have been in place for a long time are likely to continue.

The institutions taking profits off their buy trades is what caused the consolidations to form, but the amount of time the market stays in a consolidation is directly linked to making traders believe that the trend is either over or the market is likely to reverse lower.

If the traders who are in long trades believe the trend is over, they will close their trades.

Closing a buy trade results in a sell order coming into the market.

This is exactly what the institutions want.

All these sell orders allows them to place buy trades, so they'll keep buying from all these traders knowing eventually their buy orders will become bigger than the sell orders and the market will move up, making everyone who placed a sell trade during the consolidation lose money and close their trades.

This example is not an isolated incident.

This consolidation could have easily been found on any currency on any time frame. The psychology of the traders being affected would be the same.

A trend cannot continue without people consistently losing money. This can only be achieved by the market either retracing or consolidating. If there's a retracement, the length and velocity will determine how many traders will lose due to what the retracement will make them believe about the future market direction.

If there's a consolidation, the defining characteristic is length. The longer the market consolidates, the more people who believe it's going to continue consolidating, therefore the larger the number of people that are going to lose once the consolidation ends.

Another thing to take into consideration is where retracements and consolidations appear in regards to the trend.

Lets take a look at a retracement that occurred at the beginning of the long up-trend on USD/JPY.

What do you think this retracement achieved?

First, it made everyone who brought on the initial up-move lose money. Then, as the market grinds lower, people begin to see it as a new downtrend, so they start selling.

The further price falls, the more people who start selling because the trend becomes more obvious and pronounced to everyone on every time-frame.

Here's what the down-move looks like to traders on the daily.

Which direction do these traders believe the price is going to move in?

Down, why?

Because on the weekly time-frame the down-move looks like a continuation of the downtrend due to the fact the market didn't make a higher high.

The institutional traders have set this up to generate more sell orders for their buy trades.

The bank's buying is what caused the up-move to begin with, and it's their profit-taking that causes the down-move. The banks wanted the price to fall back to where they placed their first buy trades so they could buy again using the sell orders coming in from traders selling on the move lower.

The banks know if they place enough buy trades eventually all the sell orders from the traders selling will be consumed and the resulting up-movement will make all the people who sold during the move down close their trades at a loss, which will then cause further up movement and make the banks a lot of money.

<u>How Do People Identify When A Trend Has Begun?</u>

Hopefully, by now, I've given you enough background on why the concept of trend has been purposely created to make you lose money. In this chapter, I'm going to spend some time talking about how people identify when a trend has begun.

Look at the price action I've marked with the two lines.

Would you see this movement as an up-trend?

At what point do you think the sideways price action marked between the lines is identified by traders as a trend?

When the market breaks the highs, right?

This is the most common form of trend identification, a high broken by higher high.

Until price breaks these highs nobody sees the market as having any direction to it. When the highs get broken with bullish large range candles, which we know all traders use to define the trend, this sends a signal out to all traders that the market now has an upwards bias to it.

Lots of traders will now begin placing buy trades because the higher high makes them think the price is in an up-trend

The giveaway as to what was likely to unfold upon the price breaking the consolidation came from the down-move with the arrow pointing to it.

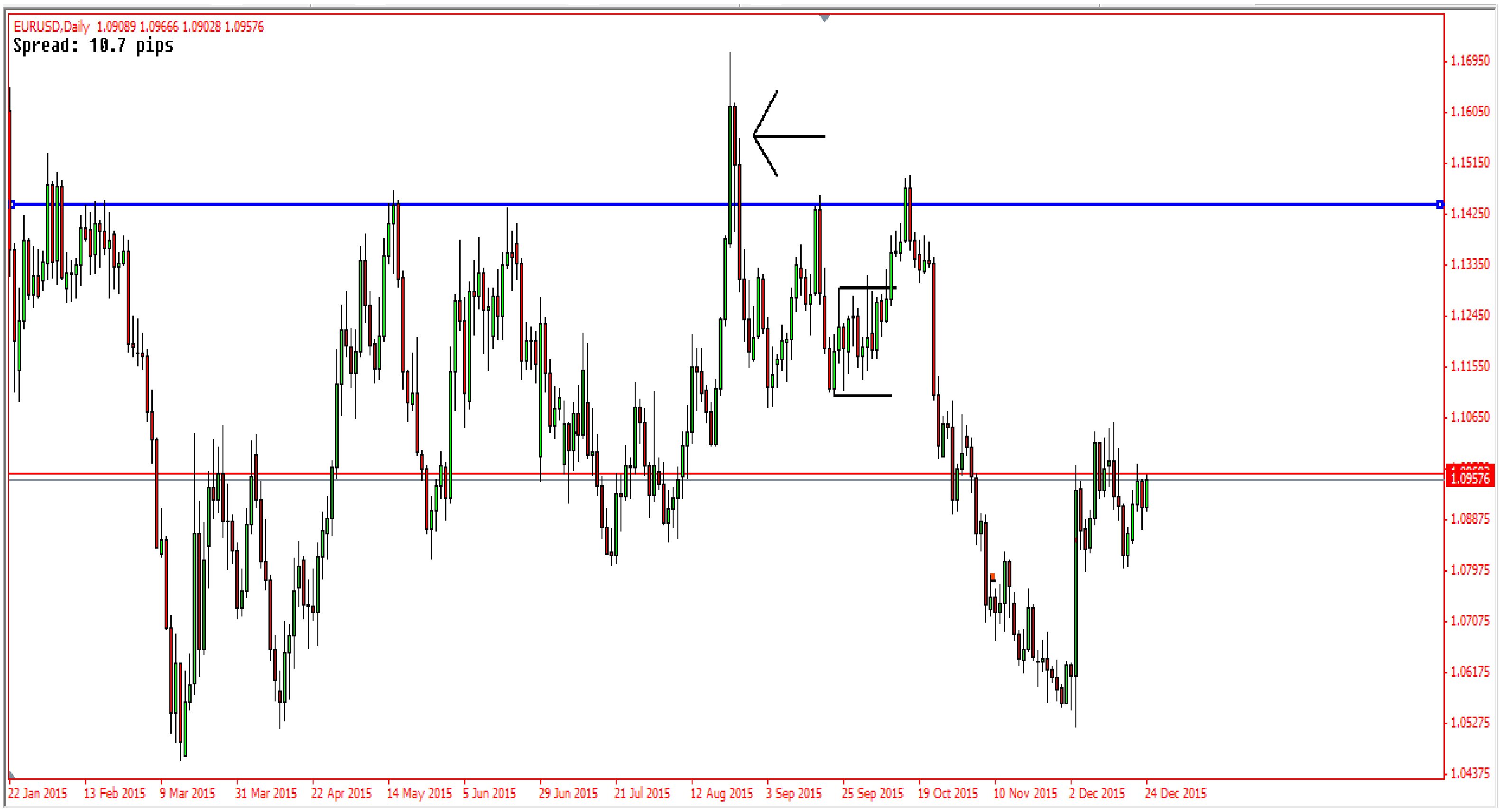
Look at the vertical move up. Reactive traders would have had a field day trading this due to the fact the price rose by such a large amount in a short space of time.

The down move that followed was caused by the bank traders selling into the reactive traders who were buying.

Up movements like this are usually referred to as being parabolic. These types of movements cannot be sustained due to no retracement or consolidation taking place during the time the price rises.

If there's no retracement or consolidation, it means there aren't any traders losing money when the price is moving up. A movement cannot continue unless people are continually losing money. They lose money when the price stops moving in the direction of the movement either by consolidating or retracing.

Since the market dropped due to bank traders placing sell trades, it means they want the price to move lower. If the price comes back into the region where they sold before, they are likely to sell again, which is what ends up happening soon after the price breaks out from the consolidation.



This image shows how the banks ended up selling at a place where they sold 5 times in the past.

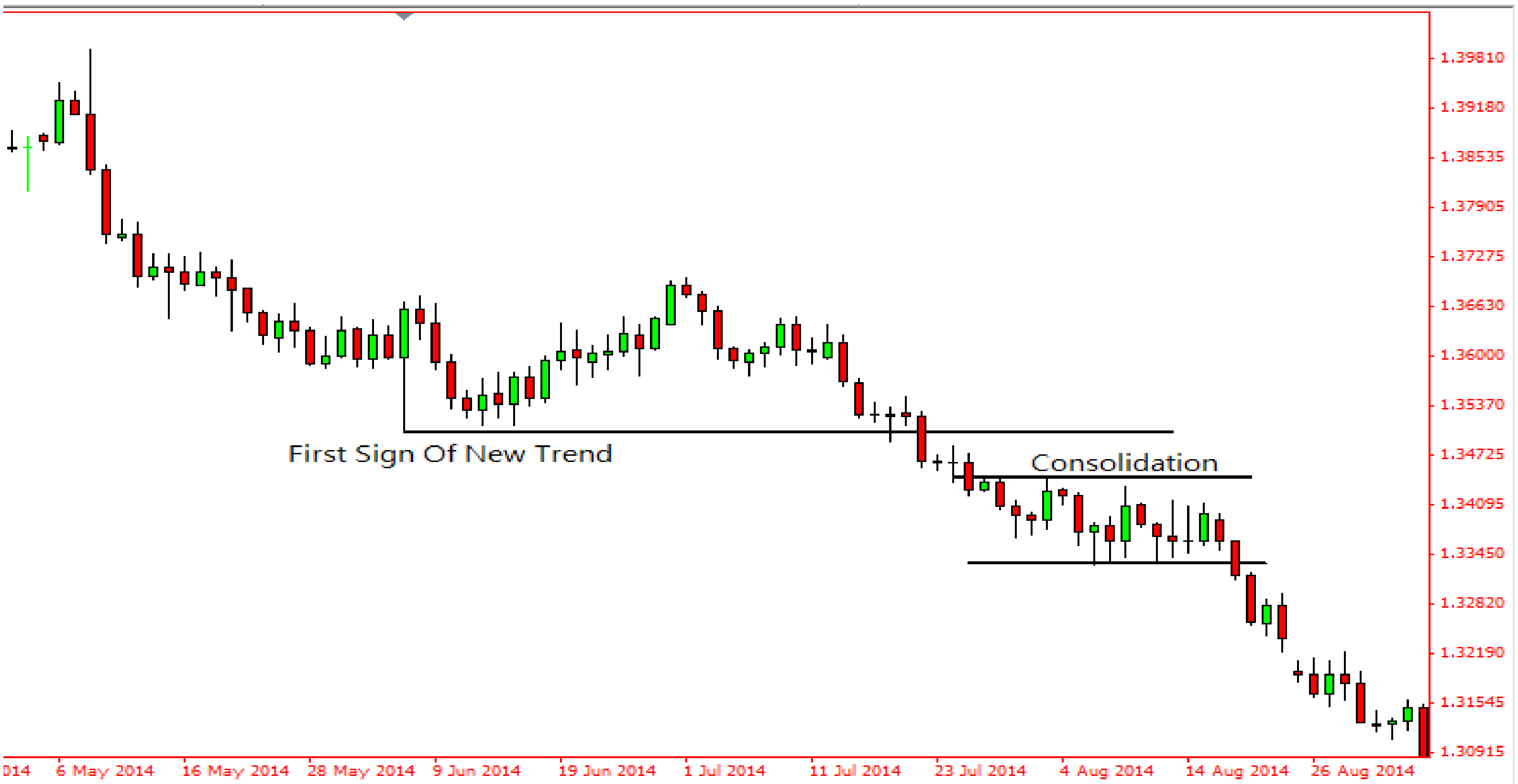
The blue line I've marked is not a resistance level, it's a way to show you where the selling was coming during the consolidation. Notice how the blue line connects the swing highs of 4 previous down-moves?

These down-moves were caused by the banks placing sell trades.

The parabolic up-move that broke these highs caused people to believe a breakout was taking place. If the bank traders sell against this parabolic up move, they know they can make a lot of money because when the price falls all the breakout traders will be forced to close their trades at a loss.

This is how you would have known the market was unlikely to continue moving higher after the market broke out from the consolidation marked with the lines.

The breakout was simply a way to get more people to place buy trades so the banks could get more sell orders placed.



Here we have the beginning of the EUR/USD downtrend seen on the daily chart.

No-one would have seen the market as being in a downtrend until the price breaks below the low I've marked with a line in the image.

Look what happens once the low is broken.

The market begins consolidating. If you look closely, you'll see the highs of the consolidation fall right in line with the point where the trend traders would have just begun placing sell trades.

This is no coincidence. The reason the highs of the consolidation come to this point is to make the trend traders close the sell trades they've just placed. When the trend traders who sold close their trades, it results in buy orders coming into the market. With lots of buy orders coming in, the institutions can place their own sell trades.

When their sell trades are placed the market begins to move lower, which means any reversal traders who placed buy trades when the consolidation was taking place will begin closing their trades at a loss. That then puts sell orders into the market and fuels the next move down.

Small Range Consolidation Setup

Engulfing candles, everyone knows them and what they look like. If your reading this book, you might even trade them. What you probably don't realize is engulfing candles are the single most important candlestick you can see on the charts because of what they make traders do.

The way engulfing candles are traded by most people is in conjunction with things like Support and Resistance, Fibonacci, Supply And Demand, or as a single candlestick pattern on its own.

The problem with all of these methods is they can't tell you when people are going to lose money, and since we are participating in a market where one trader's loss is another traders gain, that's the most important thing to know.

The important thing about the method I'm going to show you isn't what the engulfing candle itself looks like, but understanding what the engulfing candle means to the rest of the market structure.

You're looking for something to happen in the market that is going to shock a lot of traders into closing their trades.

You cannot predict a reversal until it starts happening. The first phase of movement in every trend is the imbalance phase when one set of orders becomes bigger than the other followed by the liquidation phase, which is where the traders who had trades placed before the market turned begin closing at a loss.

Our aim is to get a trade placed before phase two begins. We know we can't predict a reversal before it occurs, but we can do our best to get into the reversal before most other traders.

If we can get a trade placed before phase two occurs, it's possible for us to make a decent profit because we know we're getting a trade placed at the point where lots of other traders will be closing their trades at a loss which will push the price lower and cause our trades to go into profit.

In the image, you can see I've marked a bearish candle with an arrow.

The reason why this bearish candle is so important is that it's the candle that causes the traders who placed buy trades in the consolidation to begin closing their trades at a loss.

Before this candle appeared, the loss of the traders who brought when the market was consolidating would have been relatively small, and the tight price action would mean the traders would not have closed their trades.

When the bearish candle appears, the trader's loss suddenly goes from being small and manageable to being much much bigger. When people are unexpectedly faced with a large loss after having a small loss, their fear will drive them to close their trade straight away because they don't want to lose a large amount of money.

This is what we want to happen. If we can identify when people are likely to close their trades, then we can take their money. How much we can make depends on how many people are going to close.

Trading this structure requires you to enter on the candle which is SHIFTING the psychology of the traders who are on the opposite side of the market. In the example, it would be the big bearish candle with the arrow pointing to it.

This candle isn't a bearish engulf, but it is the point at which traders go from being at a small loss to a large loss. As this candle is forming, the loss suffered by the traders gets bigger and bigger until eventually, they decide to close their trade, pushing the price down and our own sell trade into profit.

This consolidation took place on the daily chart of EUR/USD.

Again, the bearish candle with the arrow pointing to it is the candle that causes any trader who brought in the consolidation to be put under pressure to close their trade at a loss.

Because this is seen on the daily chart, it means the movement generated when the market does fall is much greater than if we were seeing this consolidation take place on a lower time frame like the 1 hour.

You can see the market enters a small consolidation phase after the bearish candle closes. This is nothing to worry about. All that's happening is the institutions are taking profits using the sell orders generated by the traders who are losing money. Unless the market moves back up and breaks the high of the bearish candle there is no reason to close your trade.

Rules And Stop Location

There are a couple of rules you need to follow to get this strategy right.

The first is to make sure the candle that marks the shift in the psychology of the traders closes near the lows of the consolidation for a sell trade scenario or near the highs for a buy trade scenario.

The reason why this is important is down to the psychology of the traders who are going to lose money and close their trades.

If the market closes down at the lows or the highs, it means more traders are going to close their trades. If you think about how a consolidation is constructed, you'll understand there are three parts:

The highs, the lows, and the middle.

If the candle that's making people close their trades ends up closing in the middle, fewer traders are going to close their trades as their loss isn't that big yet. If it closes at the highs or lows, their loss is much bigger, and additionally, more people are likely to lose anyway as the market is further away from the middle of the consolidation where a large number of traders will have placed buy trades or sell trades (depending on which trend is taking place).

The stop location on these small range consolidations is above the high of the candle for a sell set-up or below the low of the candle for buy set-up. If you get the trade right, you'll see another large range candle follow immediately after the candle that causes a lot of traders to lose money.

Summary

The purpose of this book was not to teach you a strategy you could use to always place winning trades. That would be impossible as the market is always changing. The main point I'm trying to make with this book is to show you how people lose money in the markets.

I understand this book may have been a difficult read in terms of information and understanding. A lot of people may have not fully grasped what I'm trying to get across with the book, but I hope that this book combined with the articles on my site, will give people the knowledge they need to make consistent profits from the market.

Thanks for reading.