Nick McDonald
Nick McDonald is a leading independent trader with a global following via the company he founded, www.tradewithprecision.com. A specialist in technical trading strategy for any market and any time frame, Nick possesses a unique approach to modern technical trading which forms the basis of the strategies that he teaches. Nick is in high demand as a speaker on the global trading circuit with speaking engagements on multiple continents each and every year.

The Path To Trading Success

PART 6: PRICE ACTION MASTERY – PART 2

In this article we will continue our discussion on price action mastery and we will introduce the next two key price action mastery components: 1) price support and resistance and 2) price retracements.

➔ PRICE SUPPORT AND RESISTANCE

Price support and resistance occurs when a security's price tests (i.e. touches, or breaks by a few ticks, but is unable to penetrate and bounces off) a price level at least two times. The more tests occur at that price level, and the more precise those tests are, the stronger the support or resistance.

Resistance occurs when price cannot penetrate up through a horizontal price point and consequently forms a flat line of price action. Support occurs when price cannot penetrate down through a horizontal price point and consequently forms a flat line of price action.

When a resistance level is eventually broken it will often turn into a support level. This is also true for support turning in resistance. You can clearly see this in action on the chart contained in Figure 1 where there were five tests of the resistance level at 0.5262. Once that resistance level was eventually broken 0.5262 then became support and was tested a further two times, holding strong on both of these tests.

Price support and resistance is an extremely important component of price action mastery. In fact it's so important that we rank it a close second behind trend.

COMMON MISCONCEPTIONS AROUND PRICE SUPPORT AND RESISTANCE

In the author's opinion when it comes to price support and resistance traders often make two critical errors: 1) they place too much emphasis on sloping levels of price support and resistance (i.e. what are often referred to as trend lines) and 2) they consider one test of a price level to be enough to constitute price support and resistance.

SLOPING LEVELS OF PRICE SUPPORT AND RESISTANCE (TREND LINES)

The author believes that trend lines are a too subjective form a support or resistance and consequently he

F1) SUPPORT AND RESISTANCE IN ACTION

A clear example of a resistance level holding during five separate tests. Once the resistance level was broken it then became a support level, where it was again tested twice more. There are also two examples of how a higher high in an uptrend should not be considered resistance.
Source: TradeStation

F2) THE SUBJECTIVITY OF TREND LINES

Three different traders could validly draw three different trend lines on the same chart. This highlights the subjectivity which is associated with trends lines and this is the reason why the author doesn't use them in his trading. Horizontal levels provide a far more objective assessment of price support and resistance levels.
Source: TradeStation

never uses them in his trading. The subjectivity of trends can be clearly seen on the chart contained in Figure 2 where it is demonstrated how three different traders could possibly draw three different trend lines on the same chart.

The same cannot be said for horizontal price support and resistance. More often than not the majority of traders will agree on the same level when drawing a flat line to connect two or more price points and therefore increasing the objectivity of horizontal support or resistance. In order to increase your level of consistency as a trader you should attempt to remove as much subjectivity as you can from your trading and this is exactly why we never use trend lines in our trading; they are simply too subjective!

ONLY ONE TEST OF A PRICE LEVEL

An uptrend is formed by a series of higher highs (HH) and higher lows (HL) in price. A very common misconception amongst traders is to consider these HH's in an uptrend as levels of potential resistance. As stated in our definition of price support and resistance there must be at least two tests of the same price level before that level can be considered support or resistance.

In a trending market it's more likely than not that previous HH's will be broken. If this were not the case then trends would never eventuate i.e. when a market is making HH's and has just made a HL, the most likely scenario is for a new HH to be made and for the trend to continue until the price action tells us otherwise. Refer to the chart contained in Figure 1 for two examples of HH's not acting as resistance.

4TH COMPONENT: PRICE RETRACEMENTS

Price does not move in straight lines, instead it moves in waves. For example the waves in an uptrend will consist of a long upward thrust (to form a HH) followed by a shorter downward retracement (to form a HL), which will be followed by another long upward thrust and so on. The point at which the shorter downward retracement ends and the new long upward thrust begins the author will call the "point of equilibrium". As a trend trader his aim is to join the uptrend as close as possible as he can after the point of equilibrium has occurred.

One of the simplest, but most effective, techniques for establishing a likely zone in which the point of equilibrium will occur is by plotting a ten and 20 period moving average (MA) on your charts.

Continuing with the uptrend example, when an uptrend is underway the 10MA will be above the 20MA and there will be space in between the two. This space is what the author refers to as the retracement zone. In an established uptrend there is a good probability that price will reach its point of equilibrium in or very near to the retracement zone. Once price has retraced back to the retracement zone he would start to look more closely for other layers of evidence which would indicate to him that a trade opportunity is setting up. Refer to the chart contained in Figure 3 where the author has marked the point of equilibrium and retracement zone in action.

F3) RETRACEMENT ZONE

This is an example of how the equilibrium point often occurs within the retracement zone in an uptrend. The black line represents the 10MA, the blue line the 20 MA and the red line the 50MA. As a trend trader the author wishes to attempt to enter a position as soon as possible after the equilibrium point has occurred.

Source: TradeStation

CONCLUSION

Let us conclude this article by providing a word of warning. Remember that any successful strategy must contain a number of technical factors lining up before a trade can be taken. Never attempt to trade these key price action mastery components in isolation. Just because price has retraced back into the retracement zone in an established uptrend isn't enough reason to enter a trade. In this instance you would only have two technical factors lining up. We need many more than that to have a high probability trading strategy.

In the next article the author will discuss the last two key price action mastery components: 1) multiple timeframes and 2) candles.