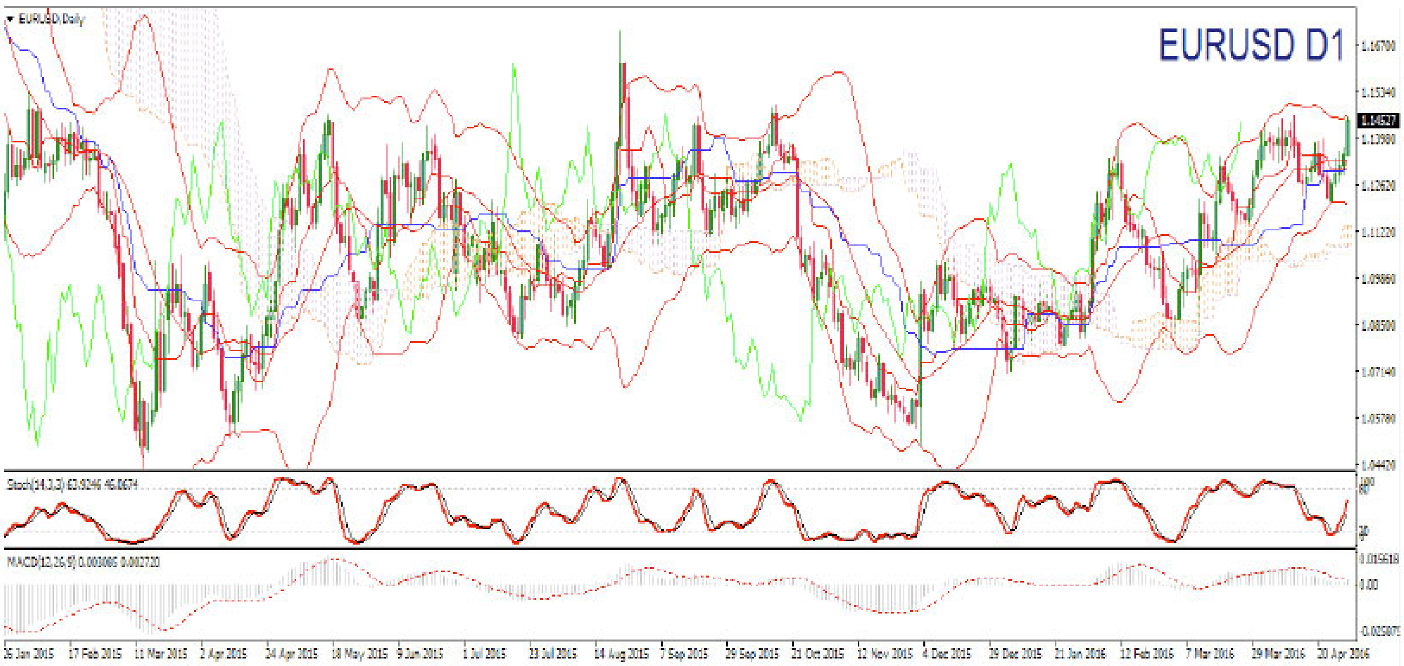
How To Trade With Market Structure

So many aspiring traders seem to believe that indicators, chart overlays or complex numerical solutions are the key to consistent profits in the financial markets. Their charts often look like this:



EURUSD D1 – Pepperstone MT4

With a chart like this, it's almost impossible to understand where the market might be heading. And it certainly doesn't facilitate decision-making. What this chart is really saying is "help! I don't trust the market, and I don't have the confidence to act". I have been down that path, and it wasn't until I stripped everything down to the bone and focused on the bare market structure, that I started to make progress.

EURUSD D1 without indicators – Pepperstone MT4

The chart above shows nothing but the pure market structure of the Euro. By learning how to read it, you will have the ultimate "plug and play" solution for your trading because you will be able to:

- read any chart
- of any asset
- on any time frame

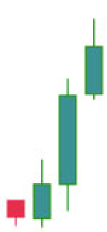
…Just like a good boy scout can read a map of the Australian outback! The benefits are enormous:

- you gain confidence
- you gain consistency

What is market structure?

Market structure refers to the visible evolution of market movement and places where those movements stopped. The key elements of market structure are the peaks & troughs price has made over time, by moving upwards & downwards.

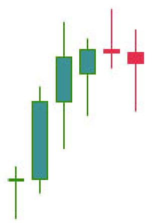
First, let's define price structures, beginning with continuation:



The first up candle breaks the high of the previous candle, creating an upwards lead. The subsequent candles confirm this lead, creating continuation.

Continuation means a consecutive candle in the same direction, *which does not violate the prior candle’s low (in an upward lead) or high (in a downwards lead).*

Let's now define a lead change as the violation of a previous candle's low (in an upwards lead) or the previous candle's high (in a downwards lead):



In alead change, the candle breaks the previous candle's low, creating a new high. Obviously, a new high candidate cannot be confirmed until the next candle closes.

Now that we understand the concept of new highs and lows, we can define the market structure as the current disposition of demand and supply in the form of subsequent highs and lows. From a price action point of view, we can broadly speak of a trending structure, a ranging structure or something that's not clearly one or the other.

USDCAD D1 – Pepperstone MT4

In a clear trending structure, we have subsequent lower highs and lower lows.

Another term used is: support becomes resistance (downtrend) or resistance becomes support (uptrend).

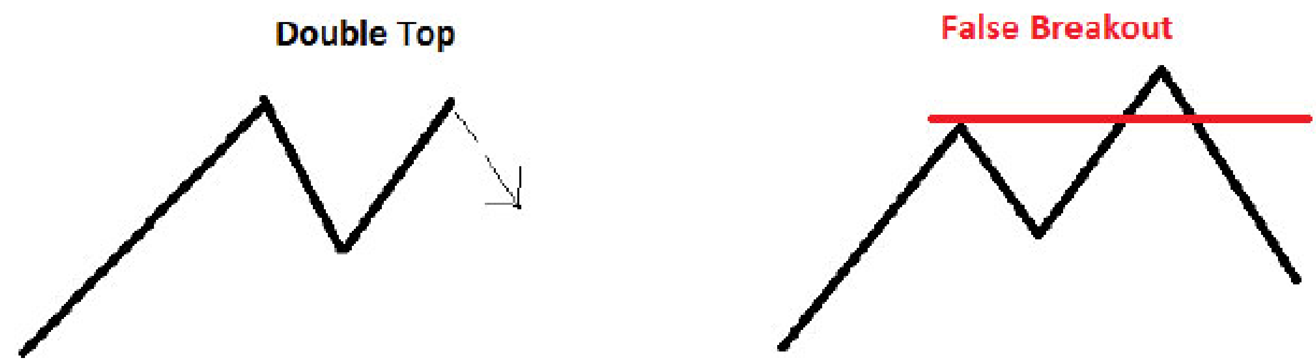
USDCAD D1 – Pepperstone MT4

“Where does price find support?” = “Where did price bounce evidently out of trend?”

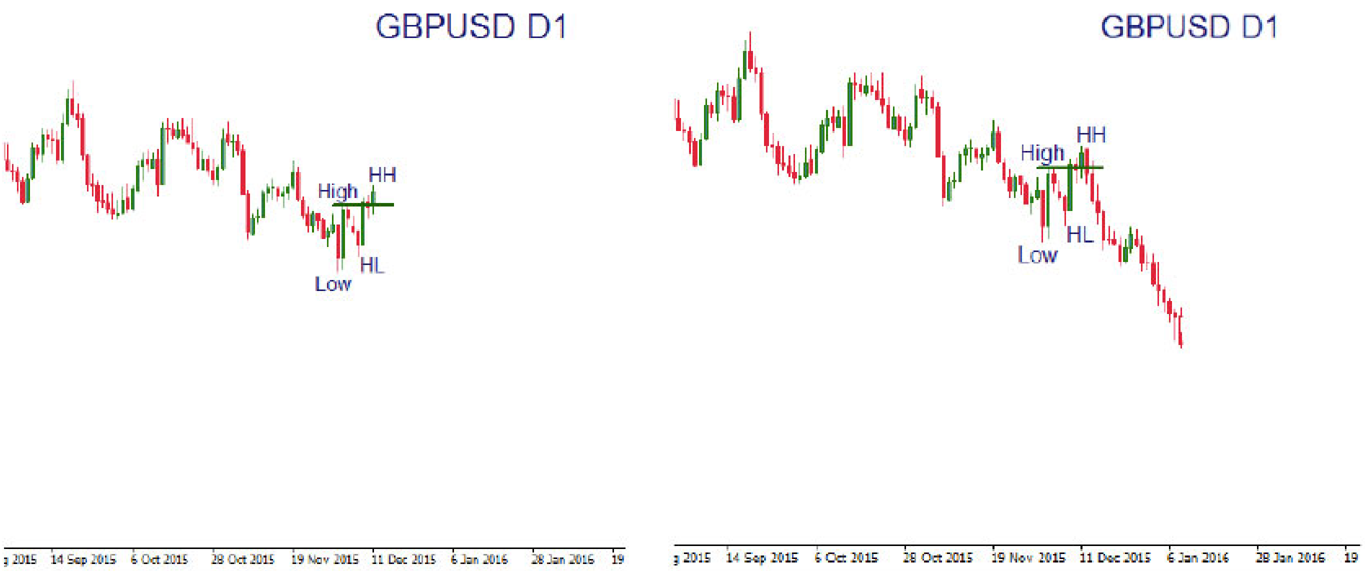
USDCAD D1 – Pepperstone MT4

When do you know there's a trend? When you can see one! Or at least when you have a completed 1-2-3 pattern (so price pushing below point 2 and finding sellers on the re-test).

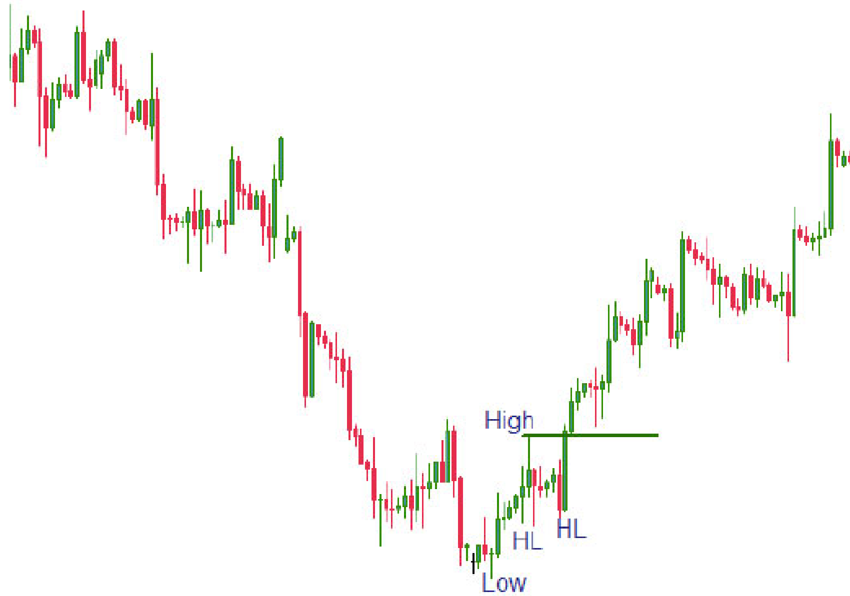
So why is it a good idea to wait for the Trending Pattern to complete, before stepping in to trade it as such? Here are the two main problems you can encounter:



And for a real life example, on GBS/USD: price makes a 1-2-3 but falls back down.



So now we know that a trend reversal requires 2 higher lows and 2 higher highs before we can start looking for pullbacks or breakouts into the new trend:



GBPUSD building a strong reversal setup.

Now that we know what is required to flip a trend on its head, we can also use the failed 1-2-3 reversal pattern as an entry into an established trend. As price pulls back and attempts a 1-2-3, no doubt confusing many novice traders and luring them into reversal trades, the savvy trader will simply be looking to take the opposite side of the trade. Here is an example:

What is the key to identifying and playing high probability pullbacks like the ones above?

a. trust the trend in place: think continuation and not reversal.
b. stalk evident levels (like failed 1-2-3s) where shorter term traders will be expecting a reversal. Frequently, that's exactly where the trend traders will engage with the trend once more.

Now let's take a look at a clear range structure:

You need a clear ceiling (resistance) and a clear floor (support) to define a range

Trade Evident Trends

If there are various situations that offer trading opportunities, then why do most traders say “the trend is your friend”? When we think about a clear trend, we should think about it in terms of how clear the underlying sentiment is. There is usually a very good reason for one-way flows in any market.

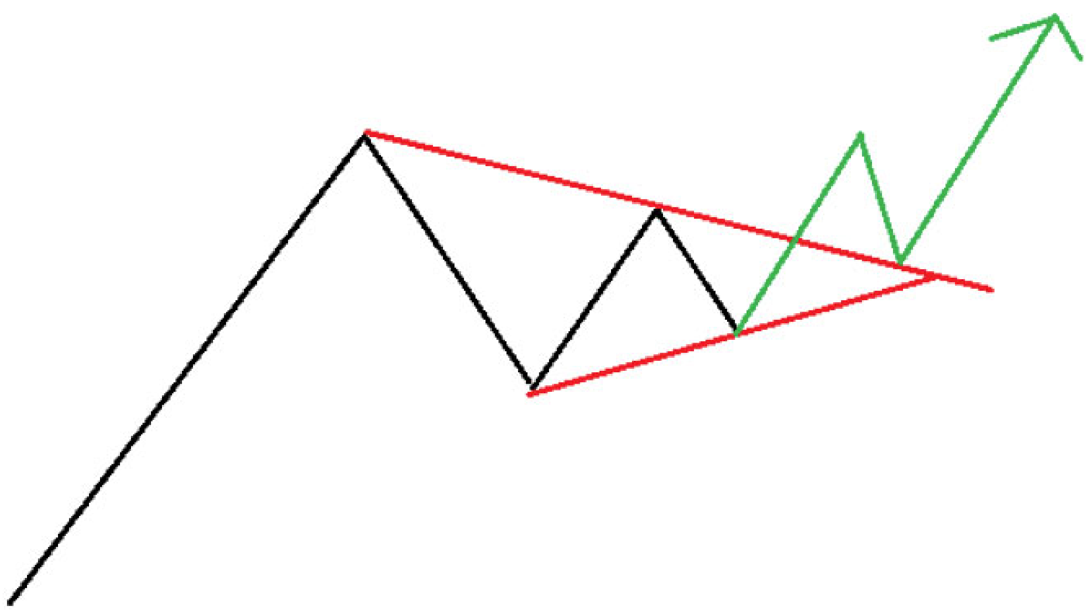
GBPJPY 1H Chart – Pepperstone MT4

If there are one-way flows, then the easiest choice should be to “go with the flow”. Think continuation, rather than reversal. Instead of watching a market rise and asking yourself where it will stop, ask yourself “where is a good place to join the flow?”

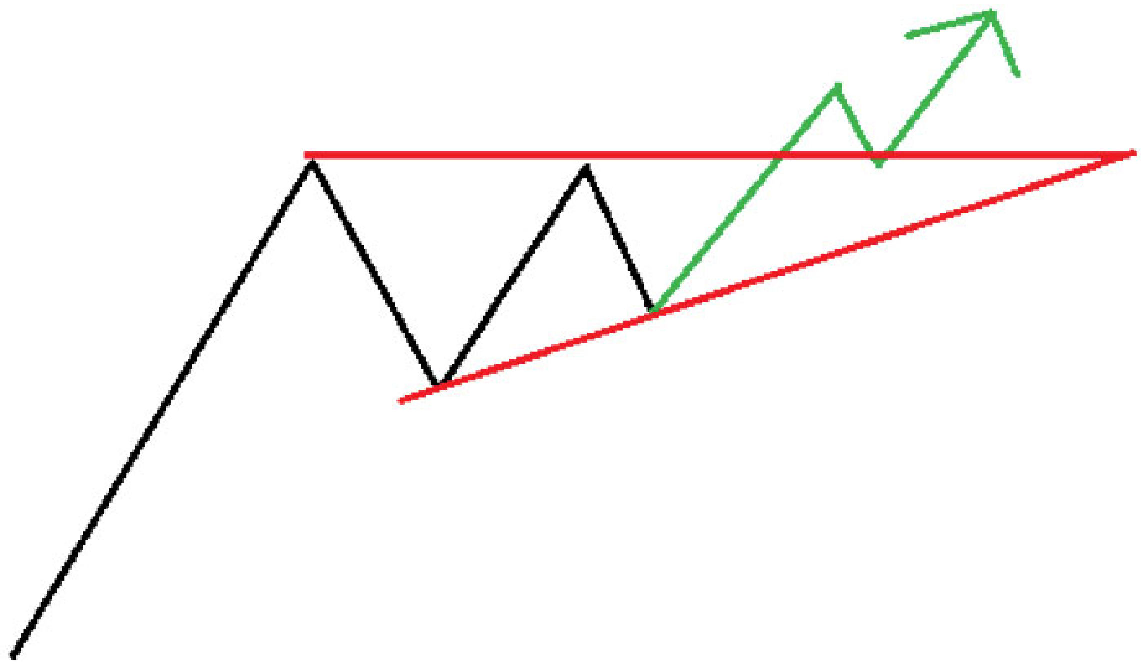
Especially in the currency market, where it's more difficult to assess the actual fundamental flavour at any given time, confusion leads to more powerful price-led trends, creating a larger degree of overshoot. Some say that currency trends are vicious; they’re fickle and come out of nowhere. The matter of fact is that if there is a trend, we want to join it and not fight it.

Spot consolidations

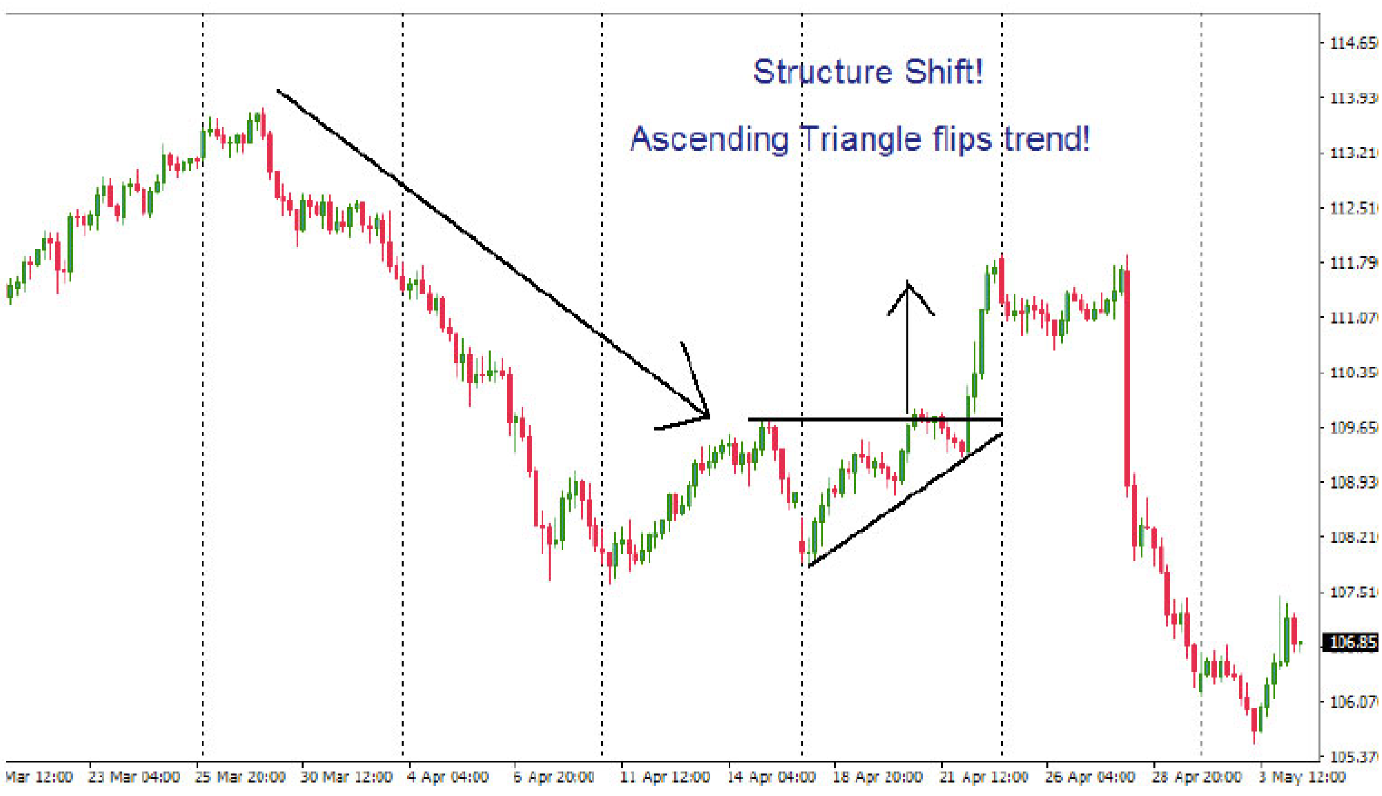
Prices hardly ever continue straight in one direction for extended periods of time. There are usually corrections, pullbacks and fake-outs, which make trend following a little more difficult than simply entering at will in any given trend. We can say that the market needs to *digest*the move it just made. It needs to consolidate the gains (or losses) before moving further. One of the main qualities a trend trader must have is to be able to recognize when a trend is pausing and when it is resuming (if it ever resumes). Let's cover a few consolidation-contraction patterns:



The symmetrical ascending triangle: lower high, higher low. Expect a break higher. Invert for descending triangle.



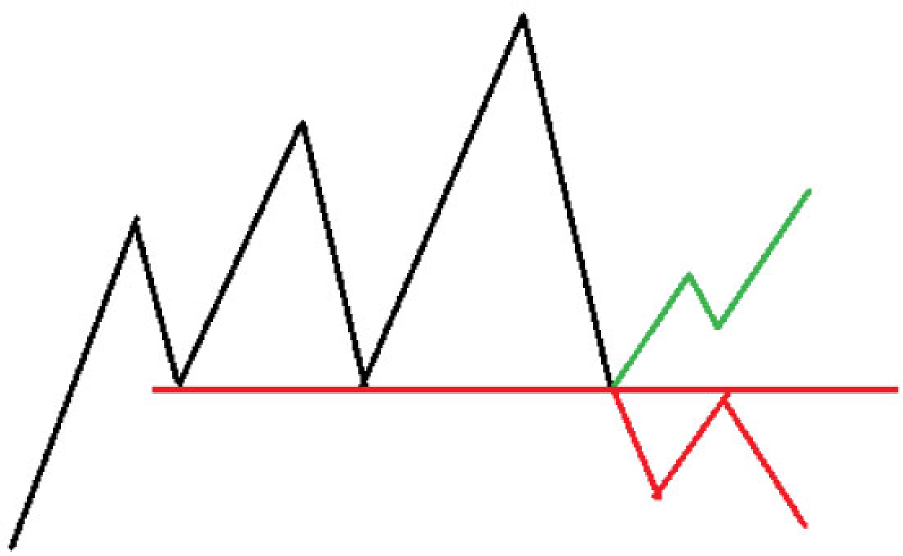
Right Ascending Triangle: a double top with a higher low. Invert for descending triangle.
Here is a real life example on USDJPY:



And sometimes you need to drill down to a lower timeframe to catch the entry before momentum kicks price too far away:

Rally-Base-Rally: after an impulsive move, price consolidates. Expect a break higher. Invert for the Drop-Base-Drop. Here’s a real life example:

And now let's cover an expansion pattern: the broadening formation.



Clear megaphone formation on GBPUSD Daily Chart

Also called the “megaphone” pattern: when you see higher highs AND lower (or equal) lows,, cease and desist until you get a read on the new direction. It's a volatility expansion but the market has no real direction yet. Stay away, don’t trade it, and wait until a clear trending structure forms.

GBPUSD 4H chart – Pepperstone MT4

From the initial broadening formation, the market then prints 2 consecutive “inside” weeks, with price chopping around in the megaphone formation. Essentially, volatility is contracting and price is getting ready for a break on either side. That’s when we start paying attention to structure again.

GBPUSD 4H chart – Following price, we violated the potential downwards move, initiated a transition (where we stay flat, waiting for further market structure clues as to the future direction) and then receive the green light to start buying.

Long or Short?

Even with an accurate understanding of swing highs, swing lows, consolidations, contractions and expansions, it may still be unclear which way to point. Should we be looking for longs, or should we be looking for shorts?

NZDUSD 4H – Pepperstone MT4

Once again, the structure of the market can come to our aid. In particular, just by observing the open of each day and week, it becomes clear which direction the market is facing.

NZDUSD 4H Chart with Week Open lines drawn – Pepperstone MT4

It should be self-explanatory: it's visually evident that as long as price is below the weekly open, it makes more sense to look for shorts. When the price is above the weekly open, it makes sense to look for longs.

NZDUSD 1H Chart with Weekly & Daily Opening lines – Pepperstone MT4

Once again it should be easy to notice that when price is above both weekly AND daily open lines, there’s quite a strong force at work. These are the best days to look for continuation. The weekly and daily opening lines also allow you to discern retracements from reversals:

- if price is above the weekly open, but is below the daily open à retracement
- if price is below the weekly open, but is above the daily open à retracement
- if price shifts from above to below the weekly open à reversal short
- if price shifts from below to above the weekly open à reversal long

What’s behind market structure?

So now we have all the key building blocks in place to understand market structure:

- continuation
- swing highs & swing lows
- weekly & daily opening levels

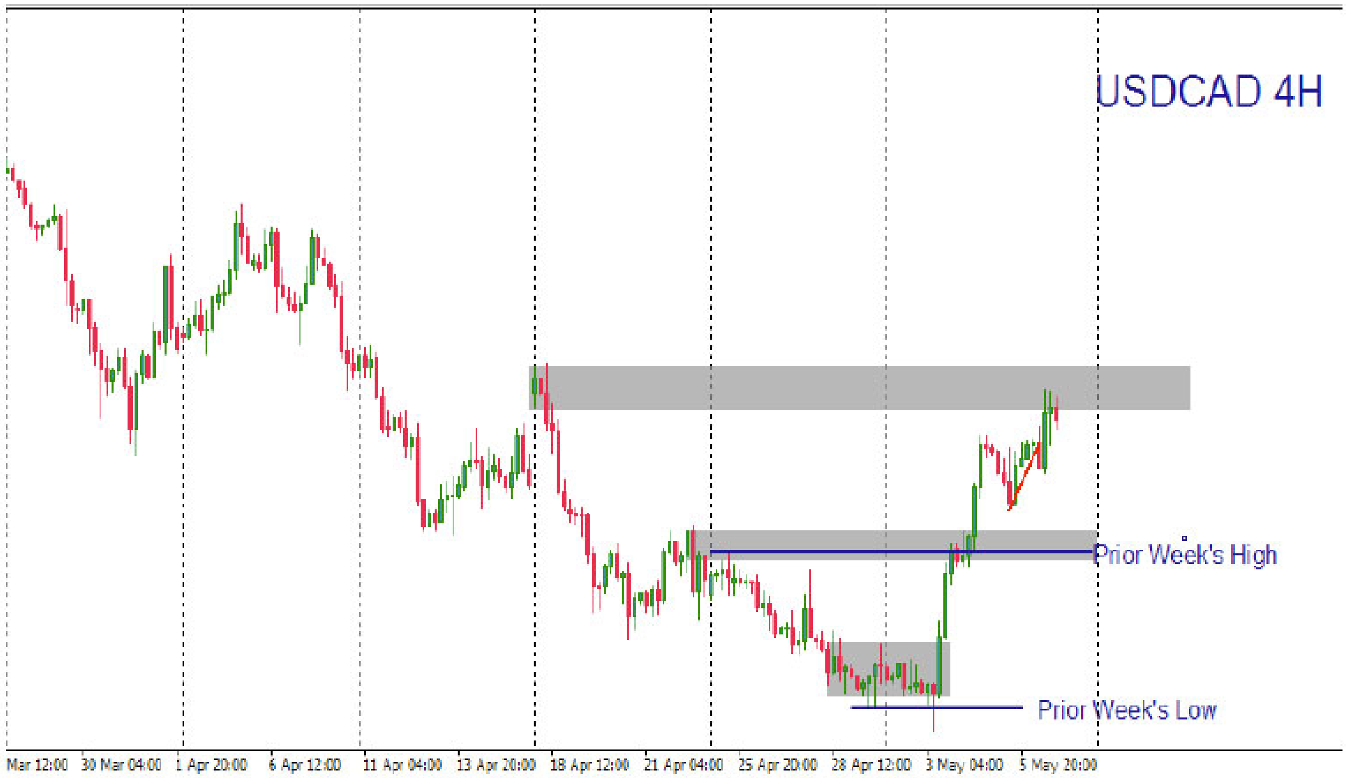
But why are these points important? What lies behind market structure and makes the market move in this repetitive way? The answer lies within the behavioural traits of market participants.

These kinds of price levels or zones are usually associated with a relatively large number of transactions (from both buyers and sellers) and that makes them consistent focal points. Because these areas tend to promote more trading, these areas see even more trading volume and have a tendency to reinforce themselves. This is why areas of support and resistance usually repeat or stay in force.

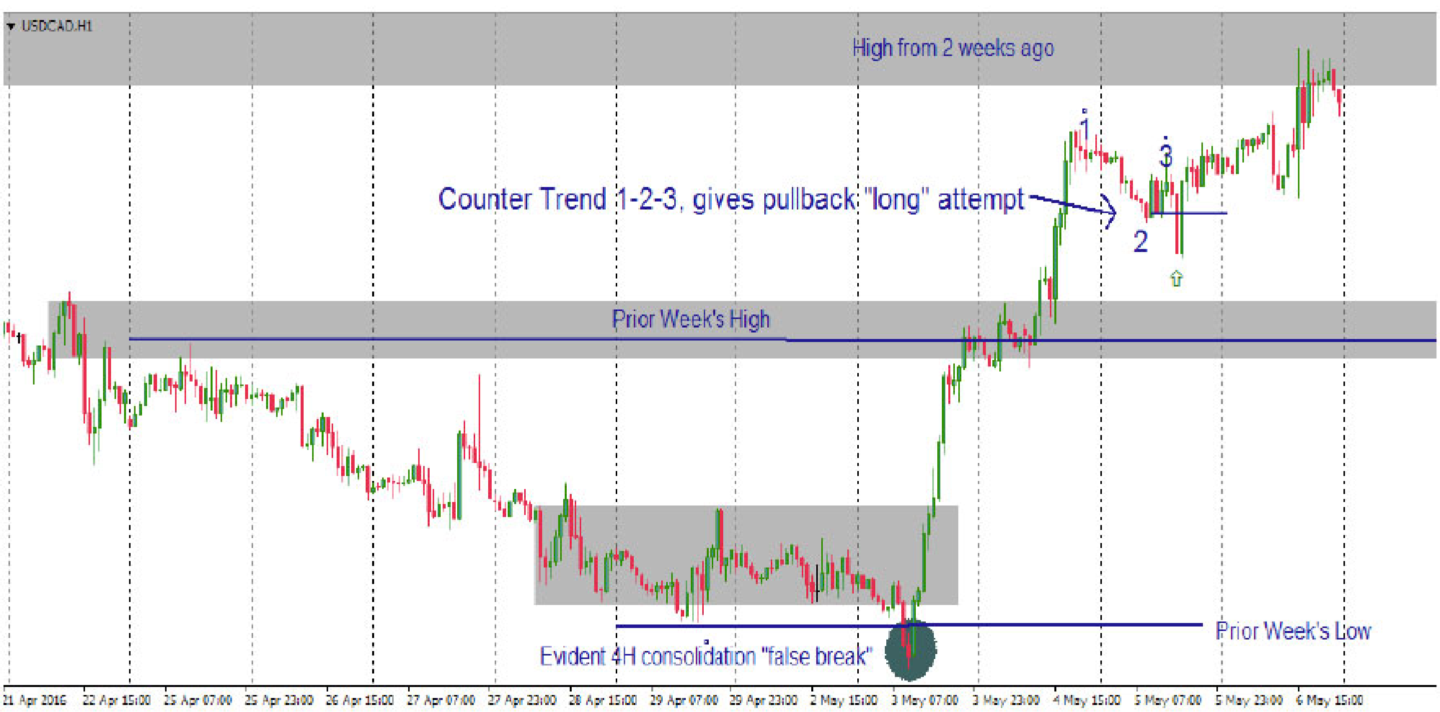
Then, there comes the time when the agents of support or resistance simply exhaust themselves and the price pattern breaks through the zone. This brings us to an important twist. These focal points harbour buyers and sellers. Often, once the buyers are exhausted, the zone becomes a good selling point (and vice versa). This might not seem very logical at first, but when we take into consideration the market's psychology, it can make more sense.

NZDUSD Daily Chart – Pepperstone MT4

In the chart above, let's assume traders sell at point 1. The market has a good decline, going to point 2 and the traders are feeling good. Then the market takes a bad turn and rises above their entry point, going towards point 3. Now the traders are concerned about holding onto a losing proposition, but still don't want to book a loss. They hold, hoping that the market will turn around and reach their entry point, so they can reverse their positions at point 4. So at point 4, the marketplace is flooded with buy orders. At point 1, we had resistance. At point 4 (same area) we have support. The opposite would be true for a support-becomes-resistance.



USDCAD 4H Chart – an established downtrend, until price false breaks the previous week's low, and flips to positive on the current week. We start looking for counter trend longs up to the previous week's high print. That's where the first important decision will be made.



USDCAD 1H Chart – drilling down a little more, we can see how price continued to print higher lows and higher highs through the previous week's high, and then gave an evident pullback situation on the hourly chart. But the move has been quite aggressive with very strong momentum. In times like this, you can also drill down to smaller time frames, so long as you understand which way you're pointing, and what levels you should be watching.

USDCAD 15Min chart – so long as we keep an eye on the important levels, and we play in line with evident momentum, we can drill down to sub-hourly time frames to look for high probability entries. We are still counter trend, until we break & hold above the prior week's high.

USDCAD 15Min Chart – price offers a 15min entry above prior week's high and through the Asian session's high, and then pulls back the next day offering a nice evident entry where many short term, novice traders would have been looking to fade the newly established upwards trend. Instead, we know that we are above a prior week's high and momentum is to the upside, so we simply look to buy these dips and also buy evident consolidation breaks.

Keep it simple and subtle

By clearing your charts and paying attention to market structure, you will avoid confusion and always be preparing your trades using the same angle;

You will always know which way to be pointing;

You will always know how to discern a retracement from a reversal;

You will have the possibility to trade any asset, on any time frame.