Introduction to Price Action Analysis

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Part 1: Introduction to Price Action Analysis

Price action is basically how prices move. It works best in markets where liquidity and volatility are highest, like the FX market. Price charts are graphical displays of the underlying reality of actual price movements.

There are three types of charts.

1) Line charts

Line charts represent price changes with a line, and thus provides an opportunity to see patterns and trends in a clear manner.

2) Bar charts

In a bar chart, each bar represents a fixed time frame of our choice.
3) Candlestick charts

Candlestick charts are essentially similar to bar charts as each candle represent price action over one specific period.

Support and Resistance

In price action trading, support and resistance play an important part in the analysis.

Support refers to a price level where buyers are interested and are buying into the market, thus pushing the price higher. Resistance refers to a price level where sellers are interested and are selling into the market, thus pushing the price lower.

Support and resistance are horizontal lines drawn by connecting the lows with previous lows (support line), and the highs with previous highs (resistance).

When price crosses below the previous support level, the support will now become resistance. When price crosses above the previous resistance level, the resistance will now become support.
Trends and Trendlines

The trend of a market is the general direction of its price. In trading price action, traders often tend to trade with the trend.

In an uptrend, there is formation of higher highs and higher lows. Bullish trendlines are drawn by connecting the lows with a straight line. A bullish trendline is said to complete when the trendline connects at least three lows.

In a downtrend, there is a formation of lower highs and lower lows. Bearish trendlines are drawn by connecting the highs. A bearish trendline is said to complete when the trendline connects at least three highs.

In a ranging market, the price trends sideways.
Channels

It is possible to draw channels to contain the price action. Channels are drawn similarly to trendlines, with an additional line drawn parallel to the trendline.

Channels help traders to identify the upper and lower boundaries of which the price will be contained.

Retracements

Retracements are corrections to the main trend. Price will often undergo retracements within the larger trend. Retracements provide traders who missed the previous entry another opportunity to ride onto the trend. Some experienced traders trade on the retracement too.
Reversals happen when the entire trend change direction. There are several key reversal patterns that traders look out for in price action analysis. These patterns will be discussed below.
Consolidations

A consolidation is simply a ranging market. Consolidations usually happen after a huge upward or downward movement.

Fibonacci Numbers

Leonardo of Pisa was the Italian mathematician that came up with a number sequence known as Fibonacci numbers. Fibonacci numbers are interesting, as they allow us to derive Fibonacci ratios, which have been observed to occur everywhere in nature.

Traders believe that markets also tend to follow Fibonacci ratios, and use the numbers in measuring the strength of retracements.

Common Fibonacci Ratios
- 23.6%
- 38.2%
- 50%
- 61.8%
Fractal Nature of Price Action

Due to the fractal nature of trends, all these can be applied to any time frame. Traders should monitor the market over multiple timeframes as it is important to know the bigger picture at all times while trading.

Part 2: Trading Price Action

Trading price action allows analysis without lagging indicators. Price action analysis allows traders to read market direction and be the first to enter and take profit. Also it allows trading in different market conditions in a clean and simple chart.

Price action traders should take note of the follow key factors.

Direction, Level, Timing

Direction
- Trade with the direction of the market.
- Buy when the market is bullish.
- Sell when the market is bearish.
- Stay out when the market is trading in a tight range.

Level
- Refers to the best price to join in the market based on the direction which was previously determined, i.e. Support and Resistance.

Timing of Entry
- Timing is a function of price action build up.
- Enter trades when the price build-up is strong.
Factors affecting Price Action

Volatility
- A measure of price variation over time.
- Can directly impact how much profit traders make from each trade.
- Deduced from
  - the range formed by the bars, and
  - the average size of each bar over a period of time.

The larger the range of pips formed by the bars and the more the average pips per bar, the more volatile the market.

Liquidity
- Amount of market interest that is present.
- The higher the trading volume and number of traders involved, the more liquid the market will be.
- Generally, liquidity is lower when banks are on holidays.
- On a daily basis, liquidity is peak when the 2 largest markets, London and New York, are open.

Why trade when the market is liquid
- When a market is liquid, prices tend to move gradually and steadily.
- When there is low liquidity, prices tend to move abruptly and irregularly.
- It is important to take note when markets are closed for holidays.
- It is advise against trading during periods of low liquidity.

Clearance
- Number of pips price can possibly move before meeting a significant support or resistance level.
- Identify clearance to decide target profit.
- More traders are likely to join the market in the same direction with more clearance.
- Spot traders will be quicker in profit taking and have lower holding time due to price action analysis.
Introduction to chart patterns

Continuation Patterns

Key Reversal Patterns
Part 3: Conclusion

Price action is the first tool in any trader’s toolkit for a very simple reason: everything else is based upon it. If everything else is the derivative, then price action is the main driving force.

1. **Know your price patterns, and know them well.**
2. Draw your trend lines correctly, as well as conventionally.
3. Price patterns do fail. Have a plan of attack for other potential scenarios.
4. Price action can lead to massive gains. If you see price reacting off of a surpassed level, take the hint.
5. Fibonacci numbers are a guide. Use them to make sense of common occurrences, and adopt techniques that make complete sense to you.
6. Trade the professional move. When price leaps out of an obvious range, go with the flow. Momentum is hard to kill.
7. Trading for fun is an easy way to plow forward. Trading out of desperation leads to more desperation.
8. If you don’t understand it, don’t trade it.
Email us @ research@nusinvest.com if you have any questions!
We will do our best to answer your queries!

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