FIND THE SLAM DUNKS: COMBINE VSA WITH TECHNICAL ANALYSIS

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In any competitive sports game there must be a specific set of boundaries for the game to make any sense.

This actually is similar to the concept of a trend channel, also known as parallel trend lines, in trading. Let's use the game of basketball as an example. The game is played on a basketball court (playing field) that has set boundaries that allow the referee to see when each team is in the field of play or outside the playing field (out-of-bounds). If a team goes out-of-bounds the other team gets the ball. The basketball court also has an area around the basket called "the paint." This is where the highest probability shots are executed by the individual players. The dunk is the highest probability shot that can be taken and this always happens inside the paint, which is the high-probability scoring zone in the game of basketball. We are now going to apply this same approach to a price chart.

When a trend channel is drawn correctly, here is the information a trader can find: The so-called playing field reveals:

• The likely market trend into the immediate future,

• The likely future support and supply lines,

• Projected likely intermediate market tops and bottoms,

• Projected future overbought and oversold price levels,

• Future high probability buy and sell zones.

PUTTING THE BALL IN PLAY

Let's look at an example. Figure 1 reveals a continuous weekly chart of the E-mini S&P that starts in October 2004 and goes through the middle of September 2006. See the upward sloping playing field? We expect the price direction to continue higher into the near-term future unless a tremendous amount of supply comes into the market. The shaded circles represent the price bars used to form this channel. The bar that the vertical red cursor is on is the start of the playing field for this example. The lower blue line is the "support" line with the upper blue line known as the "supply" line.

When price approaches the upper supply line we expect supply to come into the market and hold the price within the boundary. However, if price exceeds this supply line the market is technically in an overbought condition and is likely to fall back into the playing field. When price does exceed the supply line this is a point where many breakout traders like to establish long positions, which, in turn, opens a window of opportunity to the professional trader to dump supply onto the market by selling positions bought at much lower prices. This supply then pushes the market back down into the playing field. We will take a closer look at the mechanics of this later. The same is also true in reverse; when the price approaches the lower support line, we expect demand to come in and hold that price level, but if the support line is broken the...

market is technically oversold and we expect price to move back up into the playing field. This is similar to the basketball analogy used previously; when the ball goes out-of-bounds, the other team gets the ball. So in this chart example we can see that the market bears take the price out-of-bounds near the right edge of the chart (technically oversold), demand comes into the market and the market bulls then take control; they are still in control as this article is written.

HOW THIS HELPS

All of a sudden, we can now see into the future and see where intermediate turning points are likely to happen! But let's remember back to our basketball example to where the high-probability shots occur…in the paint! Since the market is not going to gyrate perfectly in between our support and supply line, we need to find that high-probability zone akin to "the paint" in order to initiate trades from there. We now need to look at the dashed lines that separate the playing field into quadrants. The area in between the upper dashed line and the supply line is the area on the playing field similar to the paint in basketball terms; this is known as the "sell zone." The area in between the lower dashed line and the support line is known as the "buy zone." These buy and sell zones are where the highest probability/lowest risk trades exist because it is there that we truly start trading like professionals, buying weakness at the bottom areas of the playing field and selling strength at the top areas of the playing field. This is a terrific approach used all by itself but when we combine it with volume spread analysis, a methodology which identifies supply and demand from the "smart money," we can visually confirm the supply coming into the market at the sell zone areas (or also the overbought areas) and the demand coming into the market at the buy zone areas (or also the oversold areas), dramatically increase the odds of a successful trade!

SIDEBAR

DRAWING THE PLAYING FIELD

The first step that we need to take is to look at the chart and identify the obvious trend. Here are some general guidelines for drawing the playing field:

1) In an upward sloping playing field we need to connect two price lows and an intermediate high.

2) In a downward sloping playing field we need to connect two price highs and the intermediate low.

3) The more price touches that occur on the channel lines, the stronger that level is for support/resistance.

4) The steeper the slope of the channel, the less likely the price is to stay inside that playing field for any length of time.

5) The narrower the channel, the less likely the price is to stay inside that playing field for any length of time (this generally occurs when not enough price bars are used to draw the playing field).

6) The longer the timeframe, the more likely the price is to stay inside that playing field (i.e. a weekly chart will generally hold more consistently than a daily and a daily will hold more consistently than a 30-minute, etc.).

WHAT IS VOLUME SPREAD ANALYSIS?

Volume Spread Analysis (VSA) is a methodology that seeks to establish the cause of price movements, and from the cause establish the probable future direction of price movement. This cause originates from an imbalance between supply and demand in the market, which is created by the trading activity of "smart money." By

analyzing the relationship of three variables on any price chart, VSA can identify when "smart money" (professional operators) is actively accumulating positions (demand) or in the process of distributing their positions (supply).

FIGURE 1: Continuous Weekly Chart of the E-mini S&P

Source: TradeGuider Systems

DOES VOLUME WORK IN FX?

Many retail FX traders erroneously believe that volume cannot be utilized in the forex arena. Since there is no centralized exchange for the FX market, there is no way to receive any information on traded volume and therefore the vast majority of FX traders don't believe that they can use any form of volume analysis in this particular market. To omit the analysis of volume, in any market, is a critical mistake because this is the only technique that can be used to uncover the activity of the professional operators! Since we cannot receive traded volume figures we simply substitute this with activity volume (tick based volume).

Tick based volume is the information being used to show the volume histogram for our case study, seen in Figure 2. Please refer to the vertical red cursor on the chart to reference where the playing field became active. Remember one of our earlier rules: an upward sloping channel must connect two lows and an intermediate high. This became our active playing field on September 4, 2006 and the chart is still active to the right edge on September 14, 2006. This is ten consecutive trading days that the price has respected these boundaries and provided many high-probability/low-risk trades (shown with shaded circles). We could choose any one of these areas to study more closely, but we will look specifically at the area near the right edge of the chart where price exceeded our playing field into the overbought area, this occurred on September 12, 2006.

FIGURE 2: 180-Minute U.S. Dollars/Swiss Franc Chart

Source: TradeGuider Systems

We can see that just a few bars before price moved into the overbought area, labeled bar 1, we see a very high volume up bar on an ultra-wide price spread closing off the high of the bar. This puts the closing price just below the sell zone and from a VSA standpoint alerts us that there is potential supply coming into the market from the professional operators. We now need to watch the following bars to see how the market reacts to this potential supply. We also need to start looking more closely at lower timeframe charts to confirm this.

Why is there potential supply coming in from the professionals? Remember back to a previous statement that true weakness occurs on up bars. In order to sell all or part of the sizeable positions that the professional operator trades with, they must sell when the public is buying. If they did not sell into the public's buying, the price would quickly collapse and erode the profits achieved from buying low and selling high. The high volume shows that the public is likely involved and buying on this bar. Now, it should be obvious, that not

every high volume bar that a trader views is going to have major significance, to discern the difference requires experience with the VSA methodology. On bar 2, we see the price come up and touch the supply line and then close back down into the middle of the spread, this tends to confirm that there was selling on the previous bar.

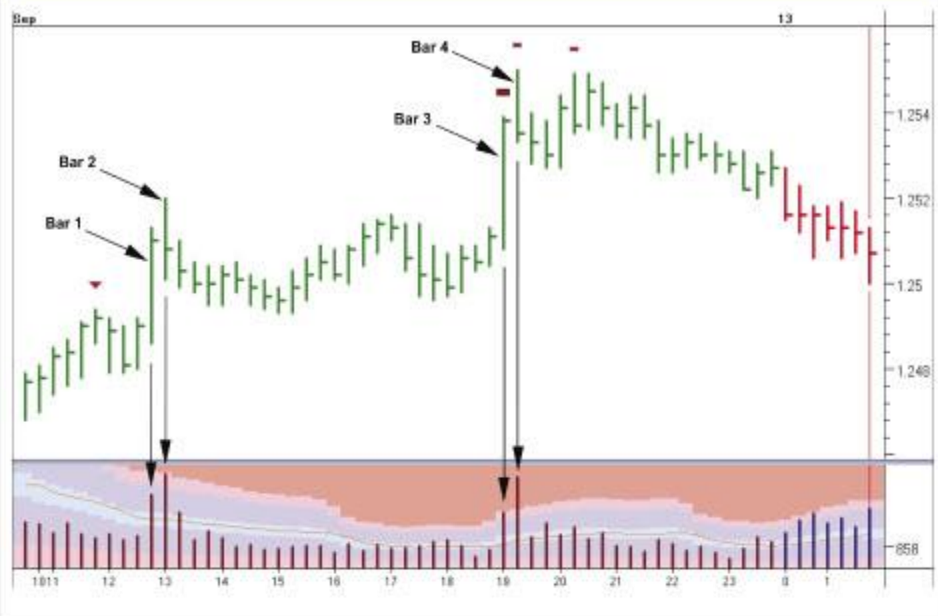
WHAT DOES THE SMART MONEY DO?

The question that traders need to ask themselves on this bar is: If the previous bar contained very bullish buying, how could the next bar be reluctant to continue going up and have the price close in the middle of the spread? The answer is then categorically given to us on bar 3; here we see a narrow spread, up bar, with very little volume (activity). This confirms that the "smart money" is withdrawing from the up move, this is what VSA terms as a "no demand" bar and it shows that the professional operators are not interested in participating in the market to the upside.

DRILL DOWN

After seeing the weakness appear on the higher timeframe, we need to analyze a lower timeframe chart to further confirm the weakness and increase the precision of our short entry. Looking at the 15-minute chart (Figure 3) allows us to zoom in on the price action after it reaches the critical sell zone area of the longer timeframe playing field. Since we are zooming into the 15-minute chart, after viewing the 180-minute chart, it is important to point out that bars 1 and 2 on the 15-minute chart are part of the bar that we labeled 2 on the 180-minute chart. Again, here on bar 1, we can see an up bar on high volume with an ultra-wide spread, with the next bar (bar 2) going higher but closing below bar 1 on ultra-high volume, strong markets don't behave like this! This also further confirms the selling on bar 2 of the 180-minute chart (Figure 2). We then see another up bar (bar 3) with an ultra-wide spread, on ultra-high volume. This is followed by a bar (bar 4) that looks very similar to bar 2 on this chart; this bar has a higher high, but closes below bar 3 on ultra-high volume. This bar is another classic sign of weakness.

FIGURE 3: 15-Minute U.S. Dollar/Swiss Franc



Source: TradeGuider Systems

We have entered into a price area on the chart where we would expect to find supply entering the market based on the playing field. We have then confirmed the supply entering the market from the professional operators on multiple timeframes; this is now an ideal place to establish a short position or liquidate a current long position. It is safe to take a short trade from either bar 2 or bar 4 on our 15-minute chart. As a trader, we never want to try to catch the exact top or bottom in a market, this will prove to be an elusive goal and lead to great frustration. Instead, we want to take high-probability trades when they are in the correct area of the playing field and price action is confirmed to be doing as we expect it; from there, we just need to use proper stop placement and trade alongside the "smart money."

SYNERGY: TRADE LIKE THE BIG BOYS

Synergy is the phenomenon in which two or more influences acting together create an effect greater than that predicted by knowing only the separate effects of the individual influences. By combining an approach that tells the trader where the market should encounter support and resistance areas (playing field) with a second approach that confirms the demand/supply entering the market from the professional operators (VSA), allows us to combine this information on our price chart and identify the very highest probability trades in any market and/or timeframe. Using this specific analysis approach, the retail trader will be trading just like a professional trader, buying what appears to the uninformed to be price weakness, and selling what appears to the uninformed to be price strength.