Spotting Early Breakouts

Forex Volatility Patterns

Want to catch 40 to 100 pips in each trade? Here's how you can find those entry and exit signals to make your forex trading a success.

Capturing volatile breakouts and reversals in currency pair trades has long been a challenge for active foreign exchange traders. But how often do traders actually trade high-volatility patterns correctly? Trendline projections in lagging indicators such as moving averages/exponential moving averages (MAs/EMAs) often whipsaw traders out of positions and need to be modified for successfully trading volatile currency pair chart patterns.

To successfully trade the spot FX market, traders can use precision technical analyses to pinpoint specific entries, but only when signals are combined in a systematic, professional manner. Many traders tend to use multiple indicators and time frames incorrectly, causing needless stops and losses in their currency trades. Developing an arsenal of easy-to-understand signals that clearly identify entry and exit triggers is critical to forex trading success.

ARE YOU GETTING STOPPED OUT?

Single indicator–based trading seldom produces consistent trade results, particularly in the currency markets, due to the range-bound nature of many pairs. Traders get stopped out because they overtrade weak single indicator–based signals (such as moving average crossovers), or fail to exit their positions using careful, technical exit signals in combinations that produce clearly defined exit signals.

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by Ken Calhoun

For example, when trading strongly trending pairs, it becomes especially important that traders enter breakouts early enough to be able to capture a sizable part of the move before it pivots back into its previous trading range. By combining two or more technical indicators (such as ADX, MACD histograms, cup patterns, and trading ranges), traders can harness the power of confirming technical signals to help improve their trade accuracy for both range and trend trading.

COMBINING FOREX TECHNICAL SIGNALS

What pattern combinations work best? There are three primary volatility patterns that produce strong signals for identifying volatile forex moves: ADX + cup breakouts, ADX + MACD histogram, and 10-day average trading range (ATR) pivots. Each of these three patterns can be used to trade specific entry and exit signals on an intraday or swing trading time horizon.

One key is to experiment with and test various parameter and step intervals to find out which works best for the specific pair(s) that the individual trader is trading. The goal is to produce as many correct positive signals (and as few false positives) as possible, using carefully designed signal combinations to capture 40- to 100-pip moves in each pair.

FOREX PATTERN 1: ADX + CUP BREAKOUTS

This pattern is particularly effective for pairs that are trending strongly, as seen in this British pound/US

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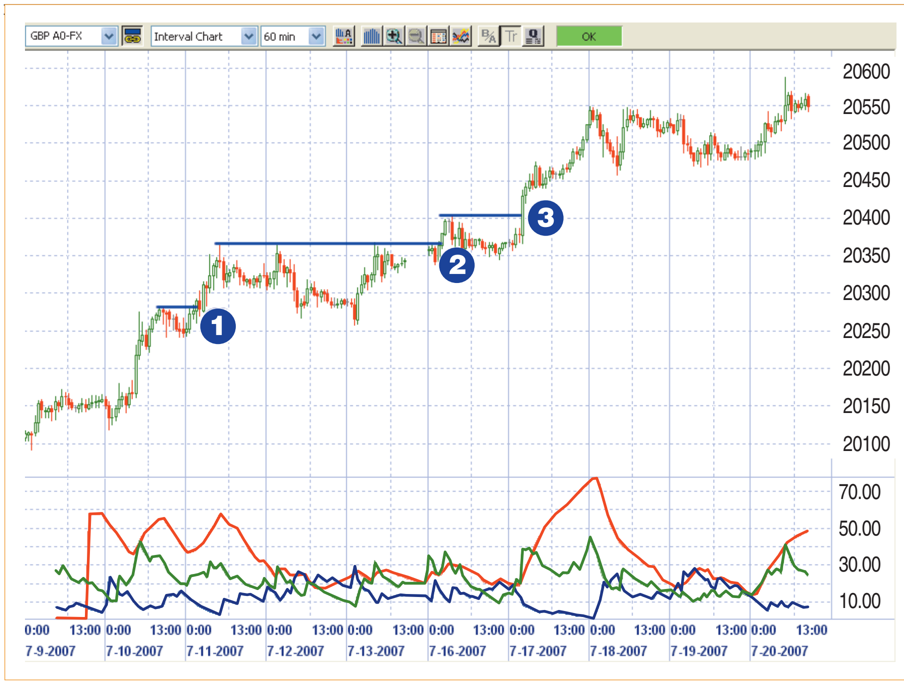

FIGURE 1: GBP/USD HOURLY. Here you see long breakout signals indicated by the combination of bullish cup breakouts accompanied by ADX > 40 values.

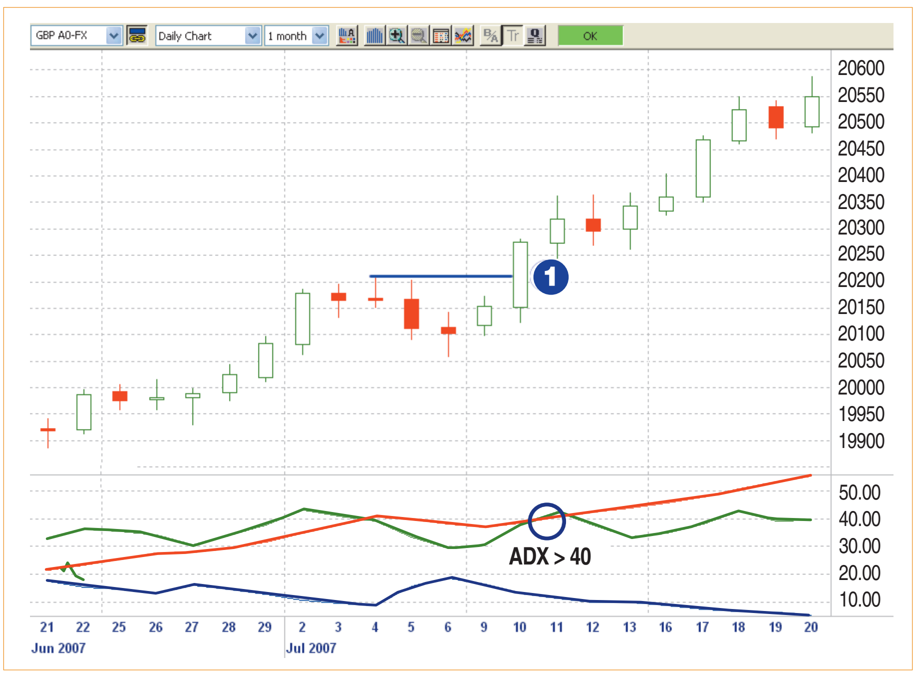

FIGURE 2: GBP/USD DAILY. When using daily charts with the bullish cup + ADX > 40 breakout long signals, a strong trend entry can be obtained by looking for movement over prior resistance levels.

dollar (GBP/USD) example (Figure 1). Buy signals are generated whenever the ADX gets over a value of 40 and the pair breaks over resistance in each major bullish cup breakout entry (1, 2, 3). The key to using this pattern successfully is to wait until the ADX gets over 40 before entering each cup breakout pattern. Sell signals work the same for downtrending pairs, again with ADX > 40 on each successive bear cup breakdown under previous support levels.

Many forex trading systems are based on lagging indicators such as relative strength index (RSI), moving average crossovers, and stochastics, which produces less consistent results. Few include cup breakout patterns in combination with momentum indicators like ADX. The combination of these two signals can successfully identify breakouts and breakdowns, as they are occurring, for trending currency pairs.

Another benefit to this signal combination is that it also works on a variety of time intervals, including five- and 15-minute periods, as well as daily candle patterns. You can see this illustrated in Figure 2, where the ADX > 40 and bullish cup breakout candle on July 10 also generated a successful buy signal (1).

FOREX PATTERN 2: ADX + MACD HISTOGRAM

Using a modified ADX and MACD histogram combination on a 60-minute daily candle chart can help filter out weak signals and identify trade setups as they appear. In the GBP/USD chart in

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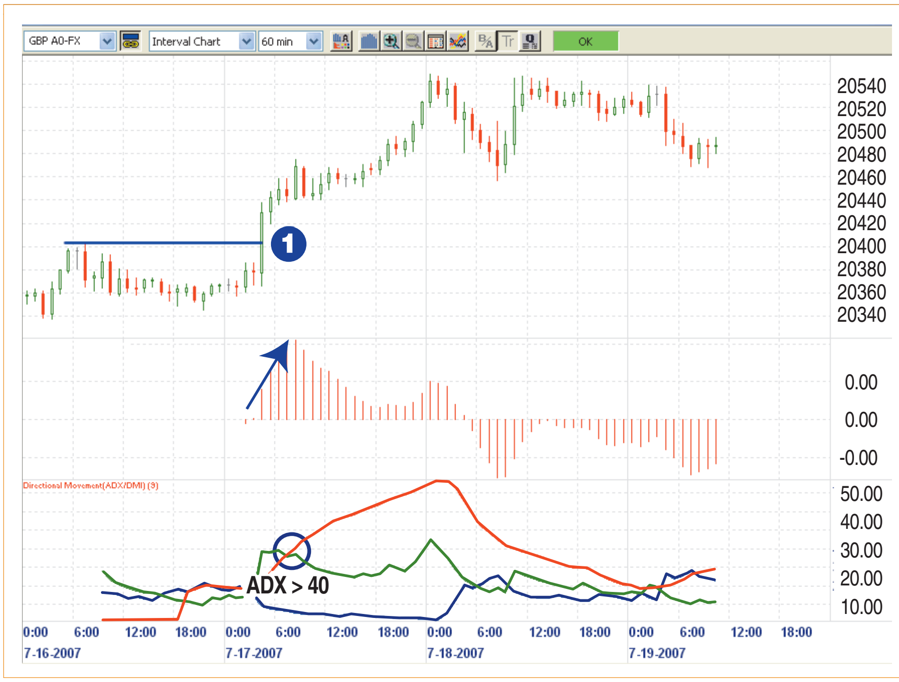

FIGURE 3: GBP/USD HOURLY. The MACD histogram can be an effective tool for identifying long entries when combined with ADX > 40 on this hourly chart.

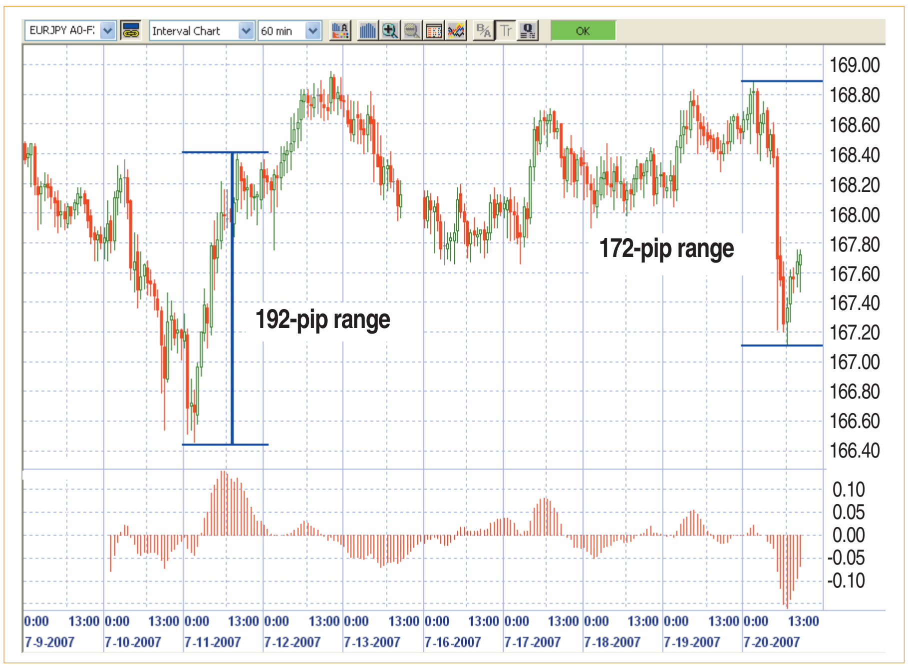

FIGURE 4: EUR/JPY HOURLY. Looking at where the maximum past range day occurred on this chart (7/11/2007) provides a signal for when to trade pivots for the current trading session.

Figure 3, the buy signal (1) was generated once the ADX > 40, with a confirmation from an uptrending slope of the MACD histogram. Note the ADX setting of step 9, with the MACD (12, 26, 9). Both technical indicators need to be in agreement for the entry criteria to be valid. The optimum time horizon for this technical trading setup is from four hours to a three-day round-trip currency trades.

It is critical for traders to experiment by varying the step parameters of their indicators (for example, for ADX, consider testing signals generated by using step parameter values of 11, 13, and 17), to adjust for changing market conditions and establish volatility profiles that work best for individual currency pairs.

Many traders rely upon single technical signals or simplistic confirmations from lagging moving average indicators, which often generates false entry signals. Instead, traders are encouraged to look for signal strength from combining a minimum of two specific technical momentum indicators (including ADX and MACD) for trade confirmations.

By testing a variety of step parameters, traders can experiment and discover which parameter settings generate the highest percentage of winning entries for each pair traded. Traders should test and check their signals for validity on at least a weekly basis to achieve the best fit possible for all data parameters.

FOREX PATTERN 3: 10-DAY MAXIMUM TRADING RANGE PIVOT (MTRP)

For longer-term trades, averaging three- to 10-day round trips, a 10-day hourly candle chart is used. Buy and sell technical signals are generated by the movement of the currency pair to the edge of its maximum daily trading range (ATR) for pivots and reversal entries. This is the preferred strategy for range-bound pivot trading, versus the trending trades we saw in the previous two strategies.

One dangerous technical trap to avoid is looking solely at the previous day's trading range to determine the current session's anticipated range. It's important to look at several days' worth of trading data (I recommend using a full nine days of immediate past data on a 10-day chart) and look at the daily ranges of each session, then deriving the mean from those values.

For example, in this euro/Japanese yen (EUR/JPY) pair (Figure 4), you can see that the current day's range is a full 172 pips (168.82 – 167.10). The maximum prior trading range for this pair, when looking at the single biggest previous day's range that occurred on July 11, is 192 pips (168.42 – 166.5).

By looking at a more representative sample of data, for example, a full nine days of immediate past average ranges on a 10-day chart, the trader is now equipped with a more valid set of data upon which to base trading decisions.

To trade using the maximum trading range pivot (MTRP) method, the trader simply places an entry for a reversal/pivot entry once the currency pair has reached the average range value and has then retraced at least 20 pips from the prior support/resistance level. Using the EUR/JPY pair example (Figure 4), the trade entry for July 20, 2007, would be 167.35 for a long entry (168.15 + 20 pips = 168.35).

The rationale behind this method is that the pair will not continue to trend once it has reached the previous maximum trading range and has moved back into the range by at least 20 pips. This pivot back into the range, following an extended move equal to or greater than the past maximum trading range, provides a high-probability trade setup.

RISK MANAGEMENT

For intraday currency trades, an initial and trailing stop value of 30 pips is used. For longer-term multiday swing trades, an initial and trailing stop value of 120 pips is used. There's a price point that proves the trader wrong, which is always simply the loss of a support or resistance level.

How does a trader set the correct value using trailing stops? It helps to set the level just beyond the obvious immediate support/resistance levels, which is why a setting of 30 pips maximum is used for all trades. Managing risk keeps traders in the game, with each miss costing less, providing more opportunities to capture successful breakouts and pivots.

MAKE VOLATILITY WORK FOR YOU

Once a trader learns how to capture volatile moves, the next step is to leverage this success by increasing the number of lots traded. By waiting until the most volatile patterns emerge using ADX, MACD histograms, and maximum trading range pivot entries, traders can improve their odds of successfully trading the currency markets on both intraday and multiday time frames.

The key to successfully using volatility patterns with currency pairs is to wait until the specific trade setup appears, then leveraging by adding to winning positions once they've moved at least 50–70 pips in your favor, then trailing close stops within 30 pips to lock in gains. So far, many currency traders have experienced large drawdowns by taking small profits too quickly, overtrading choppy patterns, and letting losers run to over 150 pips before stopping out.

Reversing this approach by leveraging the most-volatile patterns with a combination of technical indicators can help shift the odds in the direction of successful continuation and pivot moves in the pair being traded. This will bring maximum trading gains.

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REFERENCE

Stock Trading Success DVD with Steve Nison and Ken Calhoun, www.stocktradingsuccess.com.
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