VOLATILITY PATTERNS

How to approach Forex Volatility

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This manual is not a trading textbook. This is about some important concepts about the Forex market **volatility** and the execution of a range trading strategy according to volatility. I will get straight to the strategy without storytelling.

In fact, I am deceived by most trading related textbooks I have read. Authors recurrently cover market structures, tell stories to lengthen their books, discuss some strategies, but dismiss their proper **implementations**.

The majority of traders do not make it in the financial market because they fail to implement properly their strategy. They ignore market volatility and place trades whenever their strategy gives them signals. Volatility is the most important variable in the market when it comes to short-term trading. It is more important than the strategy itself.

The strategy will be worthless if you fail to implement it properly. Many beginners go to trading forums and ask "when is the right time to trade Forex?"; of course it depends on the strategy they are using. If you have a strategy and ignore when to execute this particular strategy, you will naturally fail to extract money from the market in a long run.

An effective implementation of a given strategy would cover these questions:

1) When to actually execute the strategy?
2) When not to execute the strategy?
3) How should be market volatility when executing the strategy?

These questions are more important than questions like where to place stop-loss and target orders, or when to open a trade. If you do not answer to (1), (2) and (3) properly, it will be difficult to make it in a long run no matter how perfect your entries are.

PART 1 - Volatility

1.1. What is volatility?

Volatility is the degree of variation in price of a given asset on a defined timeframe. When price moves quickly, market volatility increases. When price consolidates, market volatility decreases. It is like the speedometer in our cars.

I usually add an Average True Range (ATR) on my charts to gauge approximately market volatility or market nervousness. However, it is not necessary, when you look at a chart you are able to tell if price is spiking, trending or consolidating.

Volatility is part of any strategy. It gives an expectancy toward future price action. In general, when market volatility is low, we expect significant support and resistance levels to hold price in a range. And when market volatility is high, we expect price to break these levels.

1.2. Volatility patterns

Fortunately, in the Forex market, daily volatility is predictable. We tend to see volatility peaks around major **markets openings**, which are the New York Stock Exchange (NYSE), the London Stock Exchange (LSE) and the Japanese Exchange. At the **late hours** of these markets, volatility tends to decrease.

These fundamental patterns are the most exploitable patterns in the Forex market. Yes, at least more exploitable than deceitful technical signals you are looking for. And they happen almost every day. However, there are exceptions. For example, we do not expect volatility peak to happen when countries of these big markets are on bank holiday.

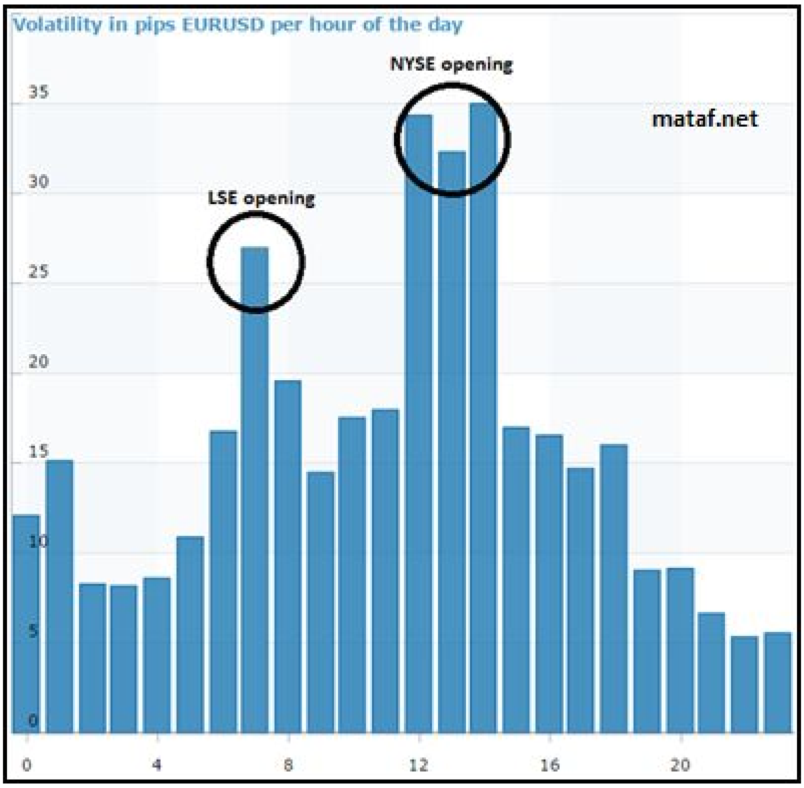

Figure 1

Figure 1 shows the 4-weeks hourly volatility for the EUR/USD pair. It is the average in pip of the difference between the highest and the lowest price of each hour of the day, over four weeks. Each bar represents the average in hourly range over four weeks.

There are two major peaks corresponding to the LSE and the NYSE openings. I usually write "UK open" and "US open".

Since the EUR/USD is the most traded pair, we consider its volatility as "market volatility". In fact, the hourly volatility chart of the other pairs gives approximately the same pattern.

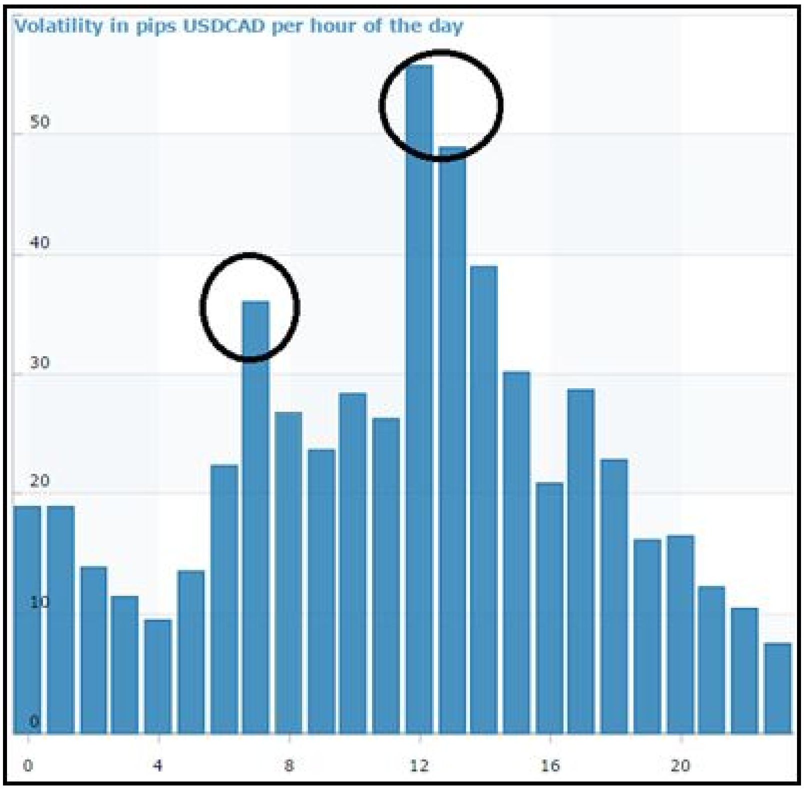

Figure 2

Figure 2 shows the 4-weeks hourly volatility for the USD/CAD pair.

These charts were taken in May 2016. Take a look at Mataf.net's volatility tool and type four (for four weeks) in the entry box. You will see approximately this same pattern in hourly volatility, with the two major peaks (UK and US opens) and a decreasing volatility starting from the mid-US session.

We also have decreased volatility during the Asian session when there is no major news release coming from the Reserve Bank of Australia (RBA) or the Bank Of Japan (BOJ).

Figure 3

These charts tell us market volatility is predictable. This leads us to define two principles:

1.3. Principles

First Principle: Around major markets openings (active time), market volatility tends to surge. We expect to see range breakouts, spikes or rallies. It is the best time to trade breakouts i.e., buying new highs and selling new lows.

Second Principle: During the late hours of major markets sessions and when major markets are closed (quiet time), market volatility tends to decrease considerably. We expect to see a trading range or a congestion in price action. It is the best time to range-trade i.e., buying the lows and selling the highs.

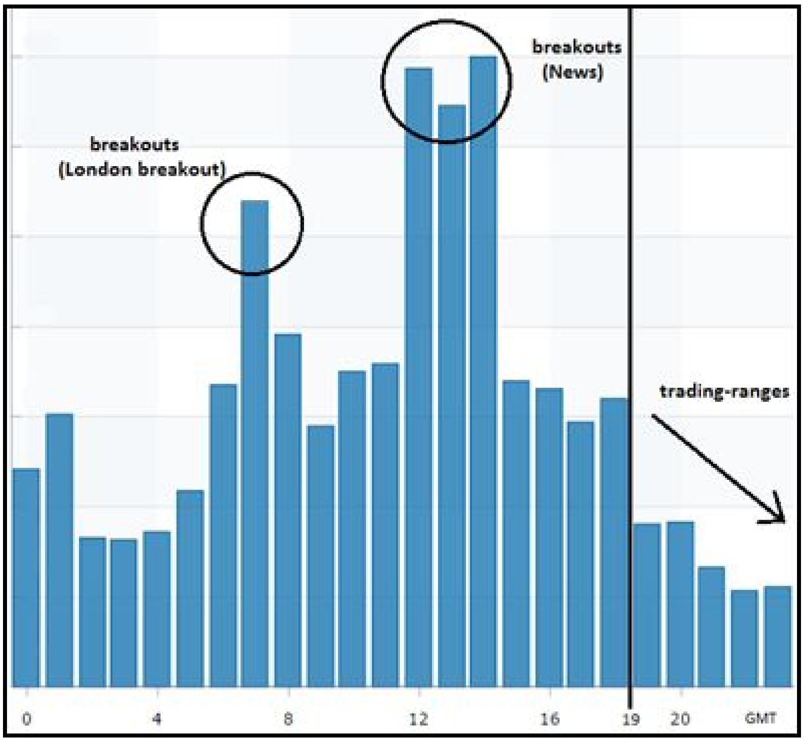

Figure 4

Any trading strategy or system **has to adapt** to these variations in volatility to perform over time. If you are struggling with a particular strategy, maybe you are ignoring these changes in volatility. Review and optimize your trading.

1.4. How can volatility patterns help in improving your trading?

One cannot apply a strategy any time and expect to be profitable. When we simulate an automated and intraday trading system over three months without time filtering, we will notice the system is only profitable at certain hours of the day. This simply reflects intraday volatility variations.

You have to determine if your trading strategy is a trend following method or a range trading one.

If your strategy is a trend following approach, you will want to only trade around major markets **openings** to maximize profits. Otherwise, you will tend to give back profits as price slows down in the mid-session and market volatility decrease.

If your strategy is a range trading or reversal approach, you will want to only trade during **quiet market** time and avoid trading around market openings or around news releases.

If you are scalping, i.e. taking generally less than 5 pips in profit per position, focus on major markets openings and after major news releases to take advantage of tight spread.

Fewer trades maximize profits. Most of my trading sessions last less than one hour.

For our strategy in this manual, we are interested in the second principle. It is a range trading strategy...