USING MOMENTUM LIKE A FLOOR TRADER TO INCREASE PROFITS

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Using Momentum Like a Floor Trader to Protect Profits
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Historically, the futures exchanges in Chicago have provided the facilities to trade commodities in the purest form, open outcry. Not that many years ago, all futures trades were executed using open outcry in the trading pits of the exchanges. I had the privilege of spending quite a few years at the CME and CBOT watching the auction process in real time. Though they were loud and often chaotic, these were the arenas for fair trade. Now that nearly all trading is done electronically, the valuable information derived from trading pits is no longer available in the same manner. Traders must use new techniques to extract the same, very powerful market information that floor traders have always used to generate profits.
Floor traders had the luxury of watching price action live. They knew the players. They knew who was buying and selling, and how much. The advantage of seeing order flow allowed them to determine who was controlling momentum as well as when the direction of a trend was turning.

There are endless trading strategies and millions of traders around the globe. They are all trying to accomplish the same goal: profit. Traders no longer must use a human broker on an exchange floor to execute trades. Screen trading has taken the place of pits. Information that floor brokers spread all over the globe is not accessible anymore.

Now more than ever, charting plays a significant role in trading. The most commonly used tools for chartists are bars and candlesticks. There are also seemingly countless indicators that accompany or overlay the graphs. Choosing a tool and indicator(s) that suit your trading style can be a difficult task.

Traders must process incredible amounts of information and then make decisions based on a list of rules or patterns. It is important to recognize and then organize all the data markets provide. The idea is to read the charts to use market data as a floor trader would in the pits.

It is best to take a pragmatic approach to problem solving, so why not do it when trading? First, we need to understand the forces that move markets. Markets have been around forever. Simply, they are places where buyers and sellers come together. When there are more buyers than sellers prices rise, and prices decline when there are more sellers than buyers. The forces of supply and demand move markets directionally. To catch a trend, a trader needs to determine if either bulls or bears are controlling momentum. Momentum is defined as a move from fair value. Thus, priority one is to define value.

Define Fair Value

Many charting and trading platforms provide not only total volume, but volume at each price. The price with the highest volume is the fairest price. It is that price that buyers and sellers agree upon most often. If we can determine the fairest price we can define fair value. A fair value area contains about 70% of the total volume around the mean or high-volume price. As a proxy for actual trading volume refer to this equation, Time + Price = Value. Logically, the more time spent at a price, the more trades will accumulate at that level. More volume, more value.

Order flow comes from two types of traders. Day traders are short-term oriented and usually carry no positions overnight. Long-term or institutional traders often hold positions for days and weeks to ride trends. When institutions buy, they buy in bulk. Markets rise simply because demand outnumbers offers. When these long-term traders sell, price drops due to oversupply. So, now the question becomes, how do we spot when big money is entering or exiting the market? After all, they are the ones that move markets directionally.

Determine Momentum

On the trading floor brokers tried to be discreet when filling big ticket orders for clients. For example, a broker has 1,000 contracts to buy. He may split the order into five trades of 200 contracts. By doing this he may have a better chance of executing the entire trade at one price. On the other hand, if he tries to buy 1,000 futures all at once, other buyers might see the large bid and pay up, which would raise prices before the order is filled. Plus, after seeing a large buyer, traders with short positions might cover their positions as well, and that adds even more to the demand. It is advantageous to execute large trades when volume is at its highest. The most liquid times of day are the
first hour and last half hour of regular trading hours. These are the times that institutions typically do most of their business. So, if we want to track momentum we should pay special attention to price action early and late in the day (open and close). Momentum would favor long positions if the low of the day was made in the first hour and if the high of the day was made in last 30 minutes. And shorts should pay if the high is made in the first hour of the session and the low made late in the day. This type of price action is common during trends.

Another logical signal for reading short-term momentum depends on where a market closes in relation to the fairest price that day. A close above the high-volume price indicates bulls are in command and the market will likely probe higher in search of sellers. Conversely, a close under the fair price suggests sellers have momentum in their favor. Thus, the market is apt to drop in price to entice buyers.

The S&P chart below shows six days using 30-minute bars. The yellow rectangles highlight the first hour of regular trading hours. The colored boxes cover daily value areas. Note that during the rally the lows were made in the first hour and the closes were either at or above the fairest prices of the day.
Trade Location

One of the more difficult issues traders face is choosing prices that are apt to be extremes or highs and lows over a given time frame. Pinpointing daily entry and exit levels, also known as support and resistance areas, requires some history of the market you are trading.

When charting, it is important to label prices where momentum kicks in. Areas where buyers take control of momentum often provide support when retested. Resistance levels form at levels where sellers previously showed to force a market lower.

Extremes (highs or lows) made in the first hour of regular trading hours frequently provide reversals when retested. Generally, the high volume and most liquid time of the day is the first hour of the day session. This may explain why we see reversals when early extremes are retested.

In the 10y note chart below, the prices highlighted in yellow show the first hour range. On 3/13, the high was made during the first hour. The high (resistance) for the following day was made when that extreme was tested. On 3/17, the lower extreme was made in the first hour. When that extreme was tested on 3/20, it was the low (support) for the day.
Extremes often form at old high-volume prices as well. Note the green rectangle covering three consecutive sessions (3/10-3/14) of overlapping value areas. Value areas are the colored rectangles that include about 70% of the volume each day. When value areas overlap for consecutive sessions, volume accumulates in a relatively tight range. High volume prices tend to provide support or resistance when revisited. This high-volume zone was retested on 3/15 and provided support for the day, and it was also the onset of a trend higher. “Momentum begins and ends at high volume prices.” A market will typically continue in a direction until it runs into an old high-volume area.

Extremes also regularly form when old very low volume prices are retested. On 3/15 the Federal Reserve Committee raised interest rates. The chart shows a spike higher that afternoon. The lowest dip after the rally is noted. That same level provided support the very next day. When momentum accelerates, low-volume zones are left behind. Reversals often occur when such areas are retested.

The crude oil chart below shows a few more examples of support and resistance. Like the chart above, when a first hour extreme was retested it provided resistance. On 3/20 the market found support when it retested an old very low volume price from 3/14.

The high on 3/21 was made when the three sessions of overlapping value (3/15-3/17) were revisited. And on 3/23 the overnight high was made when a very low volume price from 3/21 was retested.
Define Risk

Once a position is taken the next step is to determine risk. Risk can be defined as that point at which momentum reverses. Value areas are often used to define risk. In a rising market the bottom of the previous value area defines risk; during a declining market the top of the previous value area defines risk.

The corn chart below illustrates how to trail a stop when in a short position. As the market declines the stop is moved lower or to the top of fair value each day. This technique allowed the trader to stay with the short position until negative momentum turned positive or violated the top of a previous value area (3/27).
The silver chart below shows how to trail a stop during a rally.
Enhance Timing

There is an old saying that many traders have heard: “Never wrong, just early.” It means if you are in a losing trade, hold on to it for days or weeks until it becomes profitable.

Obviously, this is a dreadful approach to trading. Timing is fickle and difficult to quantify. Markets trend or consolidate, move or coil, rest or run. Either way you look at it, catching a trend early requires good timing.

My search for an answer began with two questions. Is the market ripe to run? Has the market established a fair value area? Markets tend to develop overlapping fair value areas over consecutive days before the onset of a trend.

The 30-minute bar chart below includes daily value areas for S&P futures from early to mid-February. A value area is a Market Profile term and it covers a standard deviation of volume around the mean or high-volume price. It is deemed a fair area where buyer and seller agree on price most often. In this example, the value areas cover regular trading hours and are color coded to distinguish days of the week.

The large green rectangle encapsulates four days of severely overlapping value areas. Such periods of consolidation over three or four sessions frequently precede above average vertical moves. In this case the trend higher resumed after a respite.

For timing breakouts, search markets that have below average day ranges that overlap over a few sessions. When a market violates the top or bottom of a three- to four-day value area, volume tends to rise and a trend often ensues.
Projecting Profit

Once momentum becomes clear it is important to project how far it will move before it stalls or reverses. The most practical approach involves vertical measurements for a few time frames. Keep a log of average ranges by day, week and month. When a market breaks free from a fair value area over a two- to three-day period, the first objective should equal the length of an average day range.

Refer to the soybean meal chart below for an example. The consolidation phase lasted more than a week. The projected move should span about the length of an average week. The idea is that while a market goes through a consolidation phase it is storing pent up energy. The amount of time spent consolidating is often directly related to the length of the vertical move.
Conclusion

To compete with professional traders, we must learn to interpret all the market generated information available. Practice like a pro to become one.

Refer to this acronym when creating strategy:

**VERTEX**

- **Value** (high volume zone)
- **Energy** (momentum)
- **Risk** (change in momentum)
- **Timing** (ripe to trend / ready to coil)
- **Entry** (support / resistance)
- **Xit** (profit projection & protection)

If you can answer these variables for each market you trade, you are well on your way to building a sound foundation.

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