

School of Pipsology

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School of Pipsology

Forex education is crucial for beginners.

BabyPips.com's **School of Pipsology** is designed to help you acquire the skills, knowledge, and abilities to become a successful trader in the foreign exchange market. Our definition of a successful trader is having the ability to do three things:

1. **Make pips**
2. **Keep pips**
3. **Repeat**

If you can repeatedly do these three things, then you're on your way!

Remember when you attended grade school? No? Well, this is how it worked.

In the United States, you start schooling at the age of five and enter Kindergarten. The next year you enter 1st Grade. If you pass, the next year you enter 2nd Grade, and so on, all the way up to the 12th Grade. Depending on what grade you were in, you would attend one of three *schools*:

1. **Elementary school** (Kindergarten - 5th grade)
2. **Middle school** (6th grade - 8th grade)
3. **High school** (9th grade - 12th grade)*

This is how our lessons are broken apart so you can relive the past and also be able to learn and study forex trading techniques at your own pace.

You will learn how to identify trading opportunities, how to time the market, and when to take profits or close a trade. But that's not all folks. You will also learn the art of risk management: how to maximize your profits and keep your losses to a minimum. Our curriculum here at the School of Pipsology will make a bold attempt to cover all aspects of forex trading.

*Our high school will have more than 12 grades.

Preschool: Types of Trading

Congratulations! You've gotten through the Quickstart Guide and are ready to begin your first day of class. You did go through the Quickstart Guide right? By now you've learned some history about the Forex, how it works, what affects the prices, blah blah blah.

We know what you're thinking...BORING!

SHOW ME HOW TO MAKE MONEY ALREADY!

Well, say no more my friend; here is where your journey as a forex trader begins...

This is your last chance to turn back. Take the red pill, and we take you back to where you were and you will forget all about this. You can go back to living your average life in your 9-5 job and work for someone else for the rest of your life.

OR

You can take the green pill (green for money! yeah!) and learn how you can make money for yourself in the most active market in the world, simply by using a little brain power. Just remember, your education will never stop. Even after you graduate from BabyPips.com, you must constantly pursue as much knowledge as you can so that you can become a true FOREX MASTER! Now pop that green pill in, wash it down with some chocolate milk, and grab your lunchbox...School of Pipsology is now in session!

*note: the green pill was made with a brainwashing serum. You will now obey everything that we tell you to do! Mwuhahaha! <--evil laugh

Two Types of Trading

There are 2 types of analysis you can take when approaching the forex: Fundamental analysis and Technical analysis. There has always been a constant debate as to which analysis is better, but to tell you the truth, you need to know a little bit of both. So let's break each one down and then come back and put them together.

Fundamental Analysis

Fundamental analysis is a way of looking at the market through economic, social and political forces that affect supply and demand. (Yada yada yada.) In other words, you look at whose economy is doing well, and whose economy sucks. The idea behind this type of analysis is that whoever's economy is doing well; their currency will also be doing well. This is because the better a country's economy is, the more trust other countries have in that currency.

For example, the U.S. dollar has been gaining strength because the U.S. economy is gaining strength. As the U.S. interest rates keep increasing, the value of the dollar continues to increase. And that is what we call fundamental analysis.



Later on in the course you will learn which specific news events drive currency prices the most. For now, just know that the fundamental analysis of the forex is a way of analyzing a currency through the strength of that country's economy.

Technical Analysis

Technical analysis is the study of price movement. In one word, technical analysis=charts. The idea is that a person can look at historical price movements, and based on the price action, can determine on some level where the price will go. By looking at charts, you can identify trends and patterns which can help you find good trading opportunities.

The most IMPORTANT thing you will ever learn in technical analysis is the trend! Many many many many many many people have a saying that goes, "The trend is your friend". The reason is that you are much more likely to make money when you can find a trend and trade in the same direction. Technical analysis can help you identify these trends in its earliest stages and therefore (did I just say therefore?) provide you with very profitable trading opportunities.

Now I know you're thinking to yourself, "Geez, these guys are smart. They use big words like "therefore". I can never learn this stuff." Never fear my friend; you too will be just as uhh...smart as us. By the way, do you feel that green pill kicking in yet? Bark like a dog!

So which type of analysis is better?

I'm glad you asked that question. The answer is neither. You need **both** types of analysis to become a successful trader. Here's an example of how focusing only on one type of analysis can turn into a disaster.

Let's say that you're looking at your charts and you find a good trading opportunity. You get all excited thinking about the money that's going to be raining down from the sky. You say to yourself, "Man, I've never seen a more perfect trading opportunity. I love my charts." You then proceed to enter your trade with a big fat smile on your face (the kind where all your teeth are showing). But wait! All of a sudden the trade makes a 30 pip move in the OTHER DIRECTION!

Little did you know that there was an interest rate decrease for your currency and now everyone is trading in the opposite direction. Your big fat smile turns into mush and you start getting angry at your charts. You throw your computer on the ground and begin to pulverize it. You just lost a bunch of money, and now your computer is broken. And it's all because you completely ignored fundamental analysis.

Ok ok, so the story was a little over dramatic, but you get the point. Just remember to incorporate both types of analysis before you trade.

Summary:

- There are 2 types of analysis: Fundamental and Technical
- Fundamental analysis is the analysis of a market through the strength of its economy. (i.e. the dollar gets stronger because the US economy is getting stronger)
- Technical analysis is the analysis of price movements. Technical analysis = charts.
- Technical analysis also helps us identify trends which can help us find profitable trading opportunities.
- To become a successful trader, you must always incorporate both types of analysis.

“When the student is ready, the teacher will appear. “

Buddhist Proverb



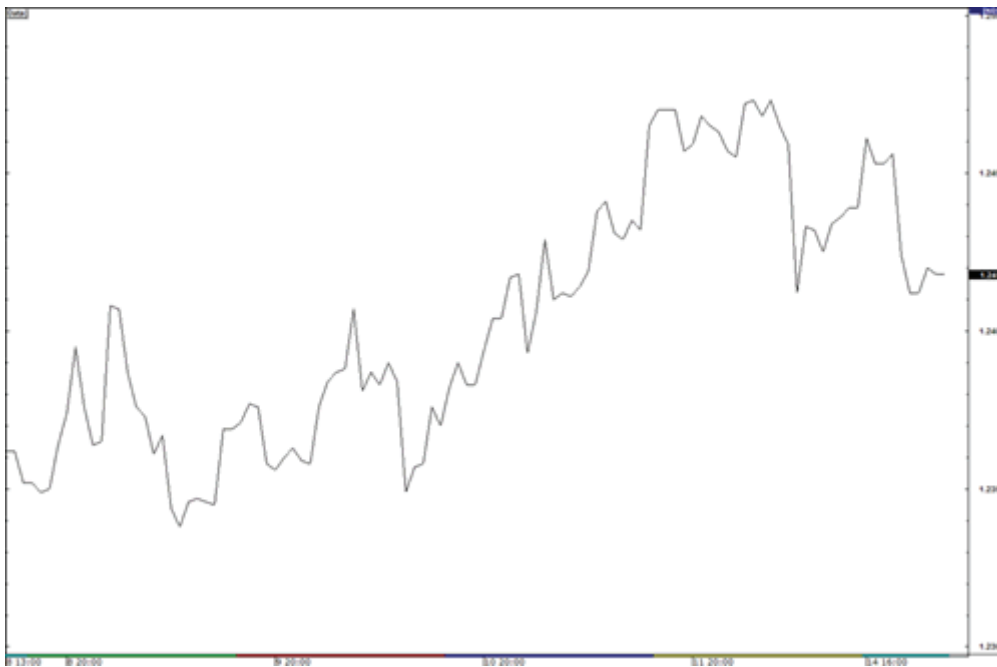
Kindergarten: Types of Charts

Let's take a look at the three most popular types of charts:

1. Line chart
2. Bar chart
3. Candlestick chart

Line Charts

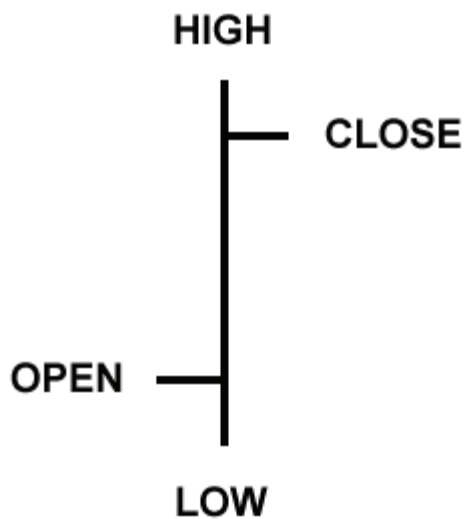
A simple line chart draws a line from one closing price to the next closing price. When strung together with a line, we can see the general price movement of a currency pair over a period of time. Here is an example of a line chart for EUR/USD:



Bar Charts

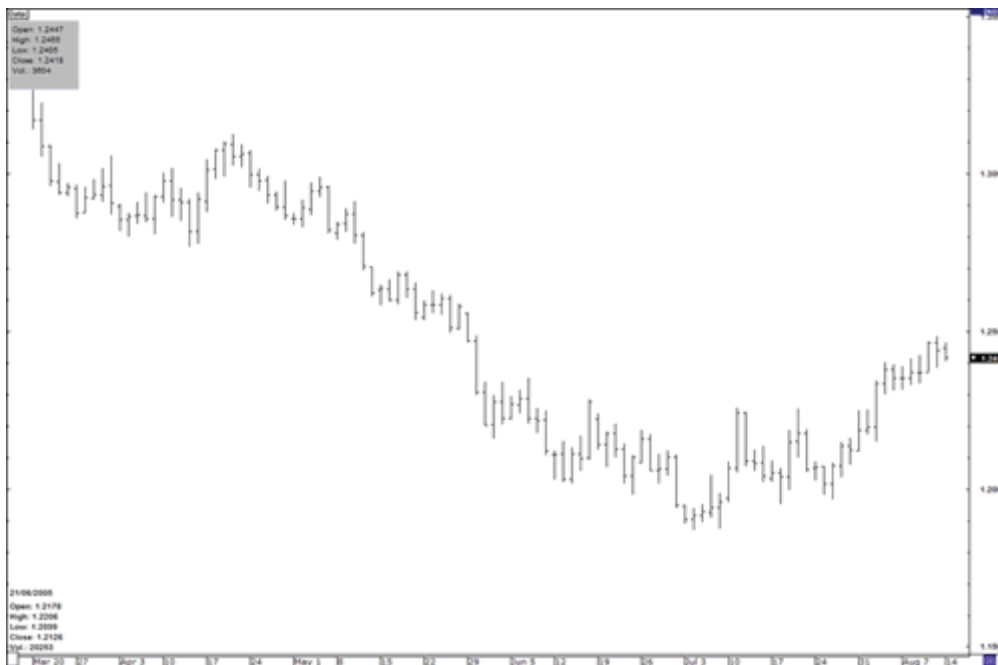
A bar chart also shows closing prices, while simultaneously showing opening prices, as well as the highs and lows. The bottom of the vertical bar indicates the lowest traded price for that time period, while the top of the bar indicates the highest price paid. So, the vertical bar indicates the currency pair's trading range as a whole. The horizontal hash on the left side of the bar is the opening price, and the right-side horizontal hash is the closing price.

Bar charts are also called "OHLC" charts, because they indicate the **O**pen, the **H**igh, the **L**ow, and the **C**lose for that particular currency. Here's an example of a price bar:



- Open:** The little horizontal line on the left is the opening price
- High:** The top of the vertical line defines the highest price of the time period
- Low:** The bottom of the vertical line defines the lowest price of the time period
- Close:** The little horizontal line on the right is the closing price

Here is an example of a bar chart for EUR/USD:



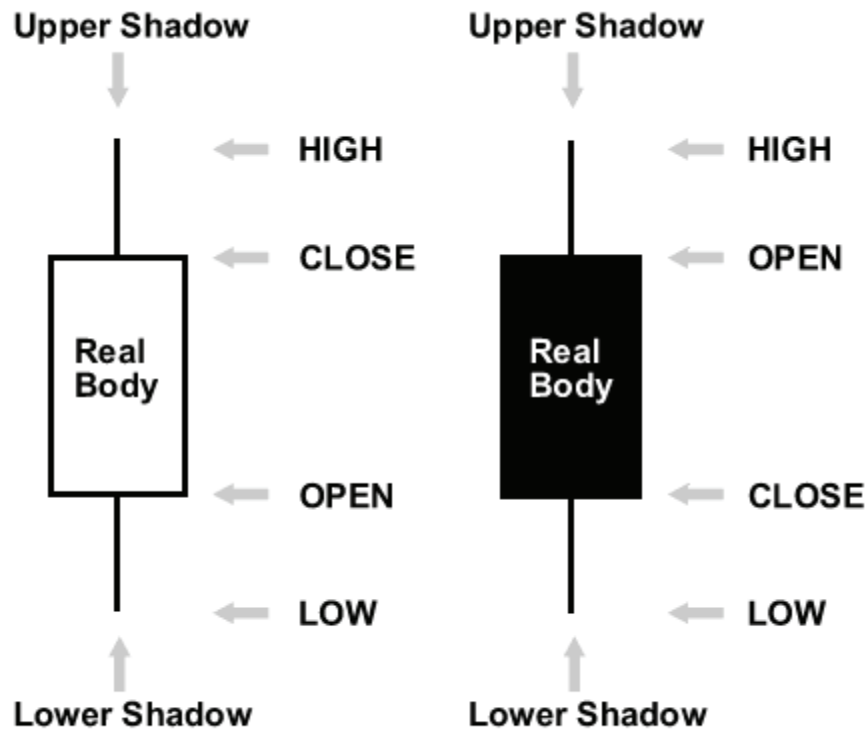
NOTE: Throughout our lessons, you will see the word “bar” in reference to a single piece of data on a chart. A bar is simply one segment of time, whether it be one day, one week, or one hour. When you see the word ‘bar’ going forward, be sure to understand what time frame it is referencing.

Candlestick Charts

Candlestick charts show the same information as a bar chart, but in a prettier graphic format. Candlestick bars still indicate the high-to-low range with a vertical line.

However, in candlestick charting, the larger block in the middle indicates the range between the opening and closing prices. Traditionally, if the block in the middle is filled or colored in, then the currency closed lower than it opened.

In the example below, the 'filled color' is black. For our 'filled' blocks, the top of the block is the opening price, and the bottom of the block is the closing price. If the closing price is higher than the opening price, then the block in the middle will be "white" or hollow or unfilled.

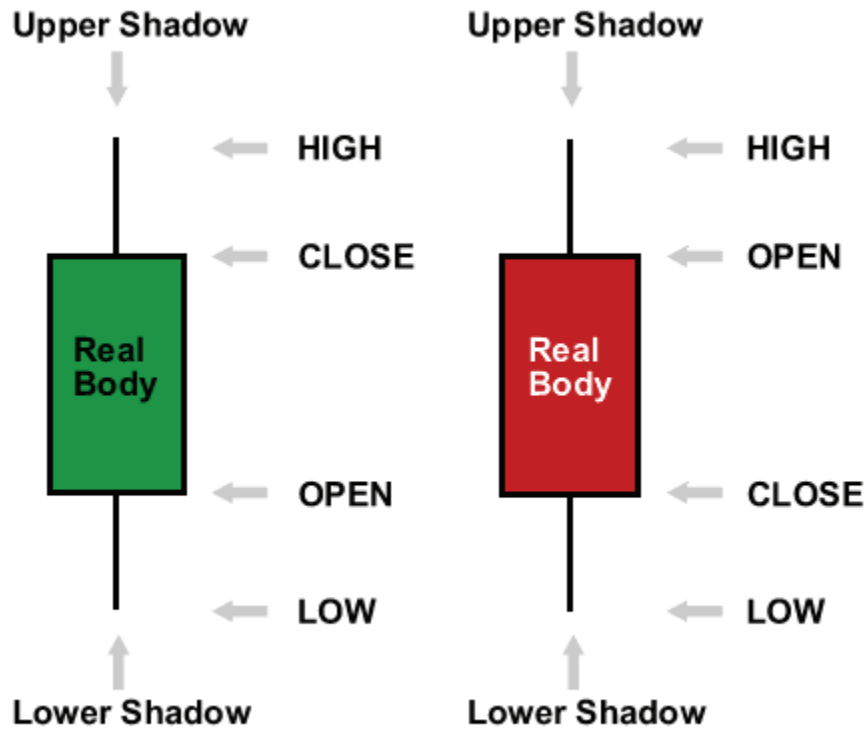


We don't like to use the traditional black and white candlesticks. We feel it's easier to look at a chart that's colored. A color television is much better than a black-and-white television, so why not in candlestick charts?

We simply substituted green instead of white, and red instead of black. This means that if the price closed higher than it opened, the candlestick would be green. If the price closed lower than it opened, the candlestick would be red. In our later lessons, you will see how using green and red candles will allow you to "see" things on the charts much quicker, such as uptrend/downtrends and possible reversal points.

For now, just remember that we use red and green candlesticks instead of black and white and we will be using these colors for now on.

Check out these candlesticks...babypips.com style! Awww yeeaaah! You know you like that!



Here is an example of a candlestick chart for EUR/USD. Isn't it pretty?



The purpose of candlestick charting is strictly to serve as a visual aid, since the exact same information appears on an OHLC bar chart. The advantages of candlestick charting are:

- Candlesticks are easy to interpret and it's a good place for a beginner to start figuring out chart analysis
- Candlesticks are easy to use. Your eyes adapt almost immediately to the information in the bar notation.
- Candlesticks and candlestick patterns have cool names such as the shooting star, which helps you to remember what the pattern means.
- Candlesticks are good at identifying marketing turning points – reversals from an uptrend to a downtrend or a downtrend to an up-trend. You will learn more about this later.

Now that you know why candlesticks are so cool, it's time to let you know that we will be using candlestick charts for most, if not all of chart examples on this site.

Summary:

- There are three types of charts:
 1. Line charts
 2. Bar charts
 3. Candlestick charts
- We will be using candlesticks from now on

“The best way to predict the future is to create it.”

Peter F. Drucker

1st Grade: Japanese Candlesticks

While we briefly covered candlestick charts in the previous lesson, we'll now dig in a little and discuss them more in detail. First let's do a quick review.

What is a candlestick?

More than 200 years ago, the Japanese were using their own style of technical analysis in the rice market. This style evolved into the candlestick technique now used worldwide. Candlestick charts are a useful stand alone tool.

They can be merged with other technical tools to create the ultimate fighting technique. Certain candlestick combinations may imply a period of consolidation. Others may hint of a forceful price move.

Candlesticks are formed using the open, high, low and close.

If the close is above the open, then a hollow candlestick (usually displayed as white) is drawn.

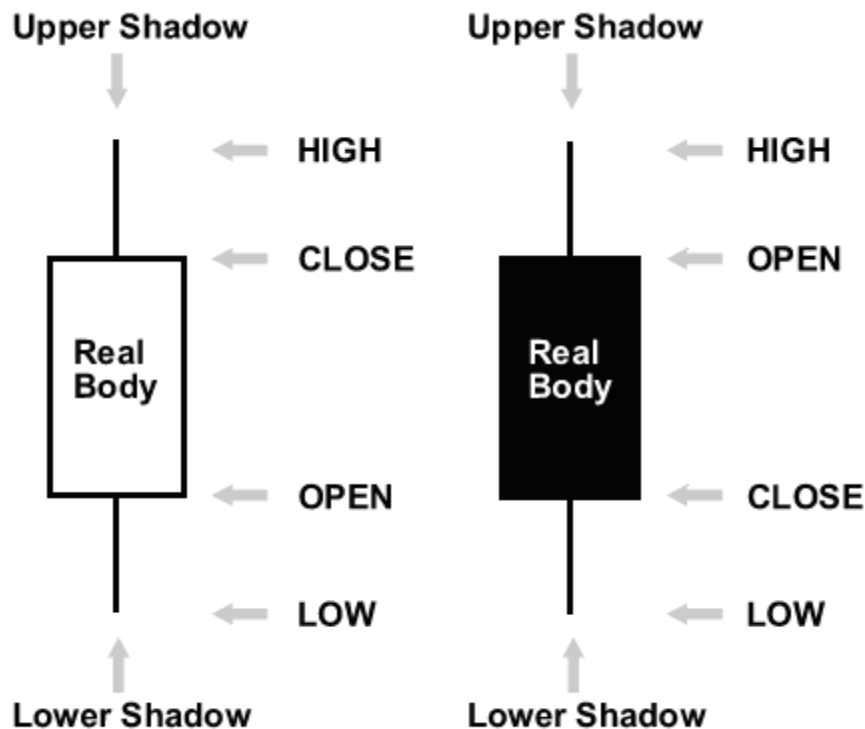
If the close is below the open, then a filled candlestick (usually displayed as black) is drawn.

The hollow or filled portion of the candlestick is called the body (also referred to as the "real body").

The long thin lines above and below the body represent the high/low range and are called shadows (also referred to as wicks and tails).

The high is marked by the top of the upper shadow and the low by the bottom of the lower shadow.



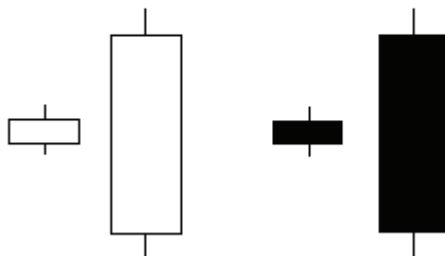


And knowing this provides you with important information about price action and forms the essence of candlesticks.

Long versus Short Bodies

The longer the body is, the more intense the buying or selling pressure. Conversely, short candlesticks indicate little price movement and represent indecision between the bulls and the bears. Bulls are buyers and bears are sellers.

Long vs. Short



Long white candlesticks show strong buying pressure. The longer the white candlestick, the further the close is above the open. This indicates that prices increased considerably from open to close and buyers were aggressive. In other words, the bulls are kicking the bears' butts big time.

Long black candlesticks show strong selling pressure. The longer the black candlestick, the further the close is below the open. This indicates that prices fell a great deal from the open and sellers were aggressive. In other words, the bears were grabbing the bulls by their horns and body slamming them.

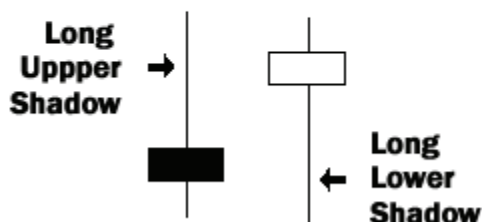
Long versus Short Shadows

The upper and lower shadows on candlesticks can provide valuable information about the trading session. Upper shadows represent the session high and lower shadows the session low.

Candlesticks with short shadows indicate that most of the trading action was confined near the open and close.

Candlesticks with long shadows show that trading action extended well past the open and close.

Long Shadows



Candlesticks with a long upper shadow and short lower shadow indicate that buyers dominated during the session and bid prices higher. However, sellers later forced prices down off of their highs and the weak close created a long upper shadow.

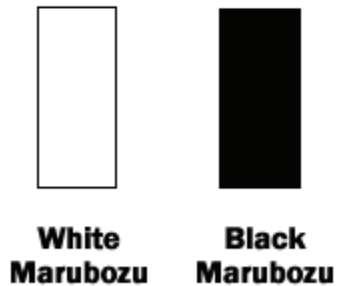
On the other hand, candlesticks with long lower shadows and short upper shadows indicate that sellers dominated during the session and drove prices lower. However, buyers later resurfaced to bid prices higher by the end of the session and the strong close created a long lower shadow.

Basic Patterns

Marubozu

Marubozu means there are no shadows from the bodies. The high and low are represented by the open or close

Marubozu



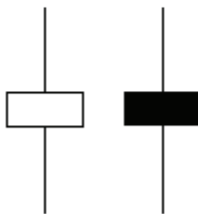
A White Marubozu is a long white body with no shadows which indicates a bullish trend. It forms when the open equals the low and the close equals the high. This indicates that buyers controlled the price action from the first trade to the last trade. It usually becomes the first part of a bullish continuation or a bullish reversal pattern.

A Black Marubozu is a long black body with no shadows. It forms when the open equals the high and the close equals the low. This indicates that sellers controlled the price action from the first trade to the last trade. It usually implies bearish continuation or bearish reversal.

Spinning Tops

Candlesticks with a long upper shadow, long lower shadow and small real body are called spinning tops. The color of the real bodies are not very important. The pattern indicates the indecision between the bullish and bearish trends.

Spinning Tops



The small real body (whether hollow or filled) shows little movement from open to close, and the shadows indicate that both bulls and bears were active during the session.

Even though the session opened and closed with little change, prices moved significantly higher and lower in the mean time.

Neither buyers nor sellers could gain the upper hand and the result was a standoff.

After a long advance or long white candlestick, a spinning top indicates weakness among the bulls and a potential change or interruption in trend.

After a long decline or long black candlestick, a spinning top indicates weakness among the bears and a potential change or interruption in trend.

Doji

Doji lines are patterns with the same open and close price.

Ideally, the open and close should be equal. While a doji with an equal open and close would be preferred, it is more important to capture the essence of the candlestick.

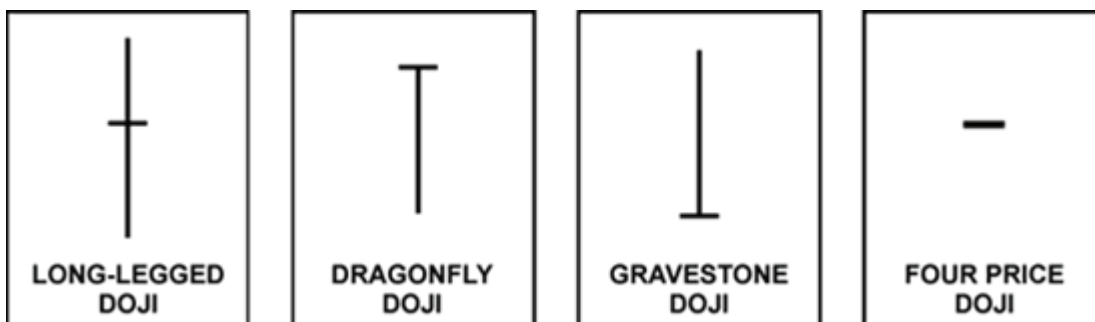
Doji convey a sense of indecision or tug-of-war between buyers and sellers. Prices move above and below the opening level during the session, but close at or near the opening level. The result is a standoff.

Neither bulls nor bears were able to gain control and a turning point could be developing.

Determining the importance of the doji will depend on the price, recent volatility, and previous candlesticks. Relative to previous candlesticks, the doji should have a very small body that appears as a thin line.

A doji that forms among other candlesticks with small real bodies (such as spinning tops) would not be considered important. However, a doji that forms among candlesticks with long real bodies would be deemed significant.

There are four special types of Doji lines. The length of the upper and lower shadows can vary and the resulting candlestick looks like a cross, inverted cross or plus sign. The word "Doji" refers to both the singular and plural form.

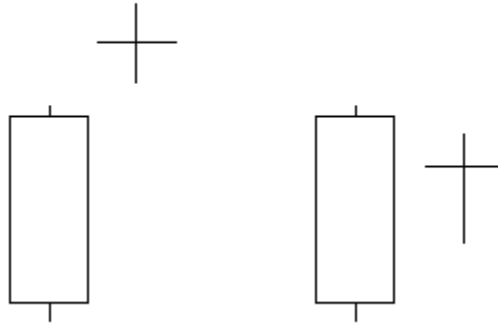


Doji and Trend

The relevance of a doji depends on the preceding trend or preceding candlesticks. After an advance, or long white candlestick, a doji signals that the buying pressure is starting to weaken.

After a decline, or long black candlestick, a doji signals that selling pressure is starting to diminish. Doji indicate that the forces of supply and demand are becoming more evenly matched and a change in trend may be near. Doji alone are not enough to mark a reversal and further confirmation is needed.

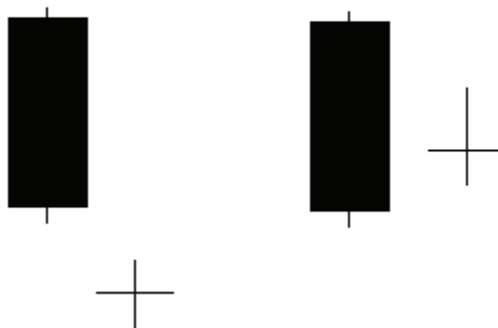
Long White Candle + Doji



After an advance or long white candlestick, a doji signals that buying pressure may be thinning and the uptrend could be coming to an end.

Where a price declines simply from a lack of buyers, continued buying pressure is needed to sustain an uptrend. Therefore, a doji may be more significant after an uptrend or long white candlestick. Even after the doji forms, further downside is required for bearish confirmation. This can come as a long black candlestick or a decline below the long white candlestick's open.

Long Black Candle + Doji



After a decline or long black candlestick, a doji indicates that selling pressure may be diminishing and the downtrend could be coming to a close.

Even though the bears are starting to lose control of the decline, further buying strength is required to confirm any reversal. Bullish confirmation could come from a long white candlestick or advance above the long black candlestick's open.

Before turning to the reversal candlestick patterns, there are a few general guidelines to cover.

Reversal Patterns

Prior Trend

For a pattern to qualify as a reversal pattern, there should be a prior trend to reverse. Bullish reversals require a preceding downtrend and bearish reversals require a prior uptrend. The direction of the trend can be determined using trendlines, moving averages, or other aspects of technical analysis.

Long Shadow Reversals

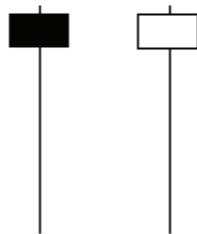
There are two pairs of single candlestick reversal patterns made up of a small real body, one long shadow and one short or non-existent shadow. The long shadow should be at least twice the length of the real body, which can be either black or white. The location of the long shadow and preceding price action determine the classification.

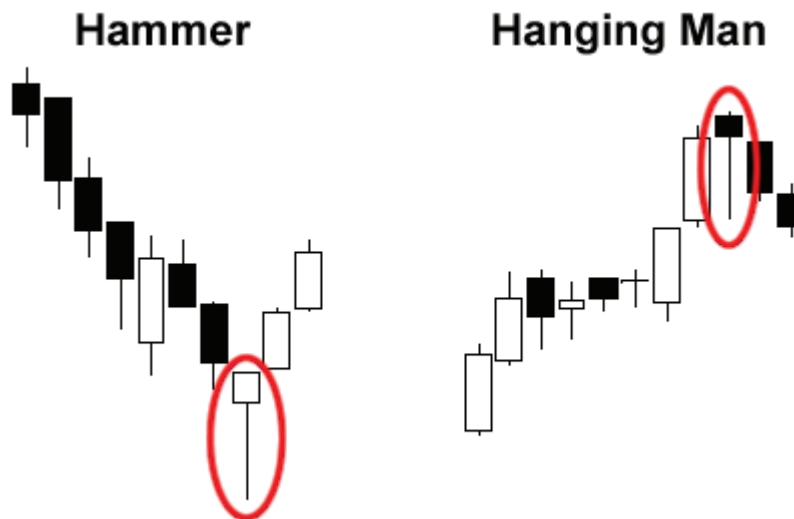
The first pair, hammer and hanging man, are identical with small bodies and long lower shadows. The second pair, shooting star and inverted hammer, are also identical with small bodies and long upper shadows. Only preceding price action and further confirmation determine the bullish or bearish nature of these candlesticks. The hammer and inverted hammer form after a decline and are bullish reversal patterns, while the shooting star and hanging man form after an advance and are bearish reversal patterns.

Hammer and Hanging Man

The hammer and hanging man look exactly alike, but have different implications based on the preceding price action. Both have small real bodies (black or white), long lower shadows and short or non-existent upper shadows. As with most single and double candlestick formations, the hammer and hanging man require confirmation before action.

Hammer & Hanging Man





The hammer is a bullish reversal pattern that forms during a downtrend. It is named because the market is hammering out a bottom.

After a decline, hammers signal a bullish revival. The low of the long lower shadow implies that sellers drove prices lower during the session. However, the strong finish indicates that buyers regained their footing to end the session on a strong note. While this may seem enough to act on, hammers require further bullish confirmation. The low of the hammer shows that plenty of sellers remain. Further buying pressure is needed before acting. Such confirmation could come from a long white candlestick.

Recognition Criteria:

- The long shadow is about two or three times of the real body.
- Little or no upper shadow.
- The real body is at the upper end of the trading range.
- The color of the real body is not important.

The hanging man is a bearish reversal pattern that can also mark a top or resistance level. Forming after an advance, a hanging man signals that selling pressure is starting to increase. The low of the long lower shadow confirms that sellers pushed prices lower during the session. Even though the bulls regained their footing and drove prices higher by the finish, the appearance of selling pressure raises the yellow flag. As with the hammer, a hanging man requires bearish confirmation before action. Such confirmation can come from a long black candlestick.

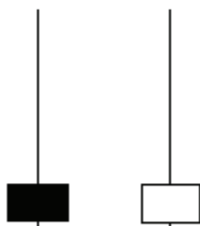
Recognition Criteria:

- A long lower shadow which is about two or three times of the real body.
- Little or no upper shadow.
- The real body is at the upper end of the trading range.
- The color of the body is not important, though a black body is more bearish than a white body.

Inverted Hammer and Shooting Star

The inverted hammer and shooting star look exactly alike, but have different implications based on whether you're in a downtrend or uptrend. Both candlesticks have small real bodies (black or white), long upper shadows and small or non-existent lower shadows. These candlesticks mark potential trend reversals, but require confirmation before trading.

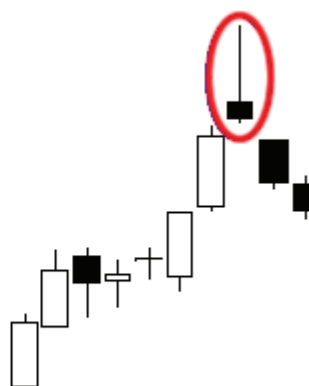
Inverted Hammer Shooting Star



Inverted Hammer



Shooting Star



The shooting star is a bearish reversal. It occurs in an upper trend which indicates that the price opens at its low, rallies and pulls back to the bottom. A shooting star can mark a potential trend reversal or resistance level. The resulting candlestick has a long upper shadow and small black or white body. After a large advance (the upper shadow), the ability of the bears to force prices down raises the yellow flag.

To indicate a substantial reversal, the upper shadow should be relatively long and at least 2 times the length of the body. Bearish confirmation is required after the shooting star and can take the form of a long black candlestick.

The inverted hammer looks exactly like a shooting star, but occurs after a downtrend. Inverted hammers indicate a possibility of the reversal of the downtrend.

After a decline, the long upper shadow indicates buying pressure during the session. However, the bulls were not able to sustain this buying pressure and prices closed well off of their highs to create the long upper shadow. Because of this failure, bullish confirmation is required before trading. An inverted hammer followed by a long white candlestick could act as bullish confirmation.

“Shoot for the moon.
Even if you miss, you'll land among the stars.”

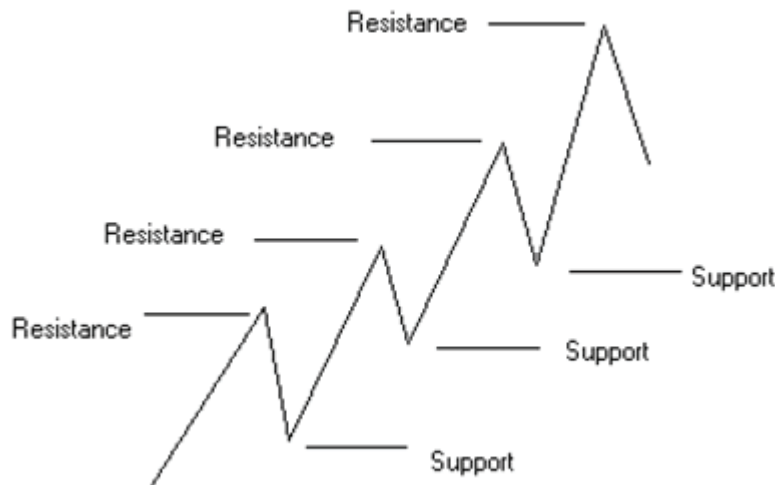
Les Brown



2nd Grade: Support and Resistance, Trend Lines, and Channels

Support and Resistance

Support and resistance is one of the most widely used concepts in trading. Strangely enough, everyone seems to have their own idea on how you should measure support and resistance. Let's just take a look at the basics first.

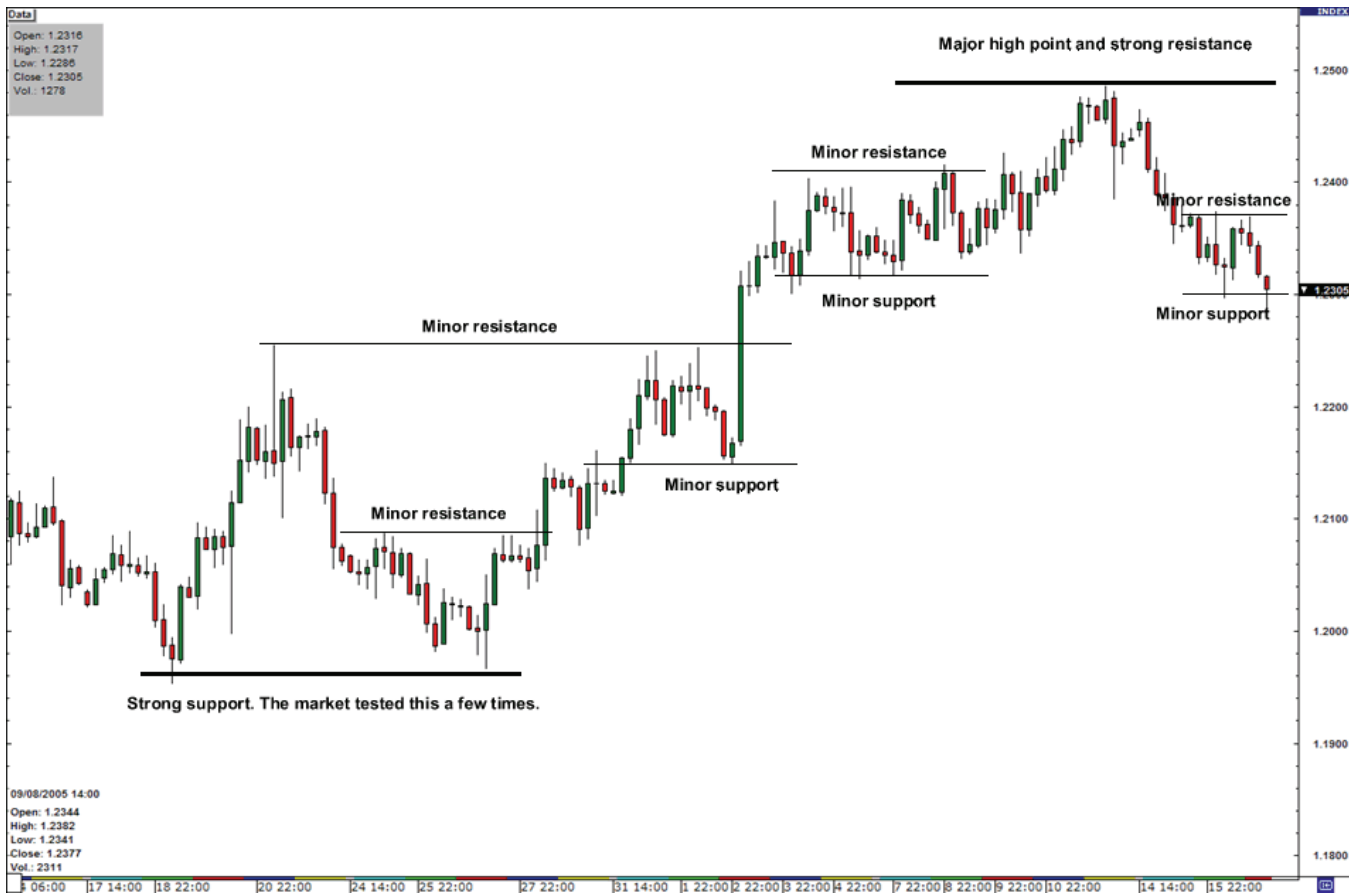


Look at the diagram above. As you can see, this zigzag pattern is making its way up (bull market). When the market moves up and then pulls back, the highest point reached before it pulled back is now resistance.

As the market continues up again, the lowest point reached before it started back is now support. In this way resistance and support are continually formed as the market oscillates over time. The reverse of course is true of the downtrend.

There are two interesting points to remember:

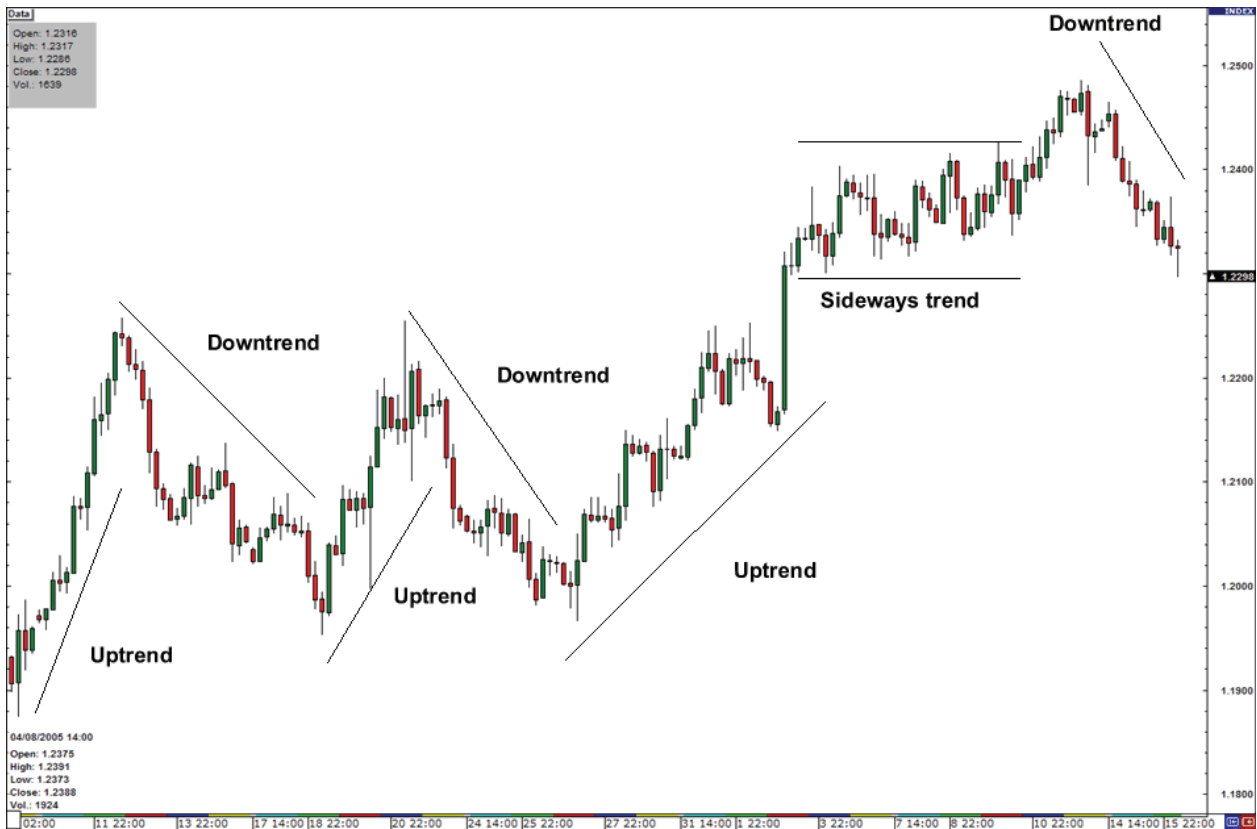
1. When the market passes through resistance, that resistance now becomes support.
2. The more often price tests a level of resistance or support without breaking it the stronger the area of resistance or support is.



Trend Lines

Trend lines are probably the most common form of technical analysis used today. They are probably one of the most underutilized as well.

If drawn correctly, they can be as accurate as any other method. Unfortunately, most traders don't draw them correctly or they try to make the line fit the market instead of the other way around. In their most basic form, an uptrend line is drawn along the bottom of easily identifiable support areas (valleys). In a downtrend, the trend line is drawn along the top of easily identifiable resistance areas (peaks).



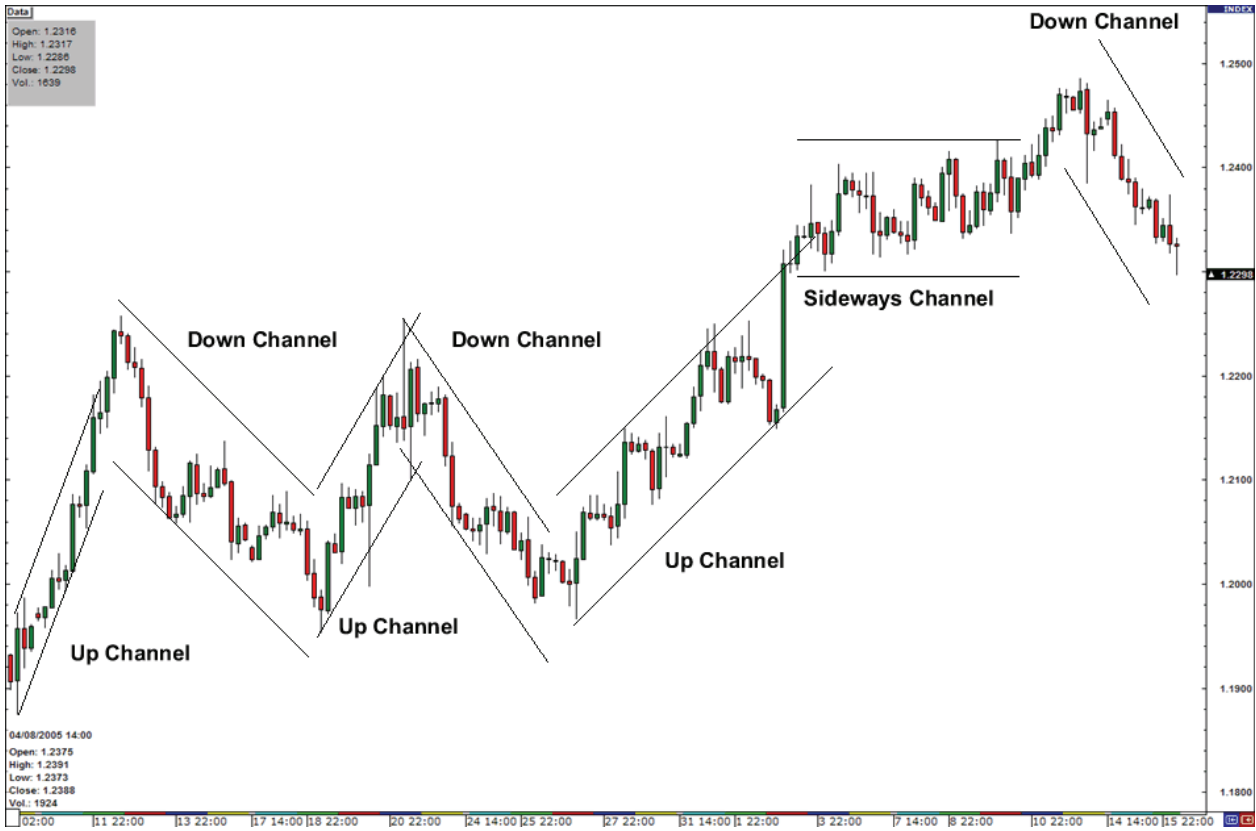
Channels

If we take this trend line theory one step further and draw a parallel line at the same angle of the uptrend or downtrend, we will have created a channel.

To create an up channel, simply draw a parallel line at the same angle as an uptrend line and then move that line to position where it touches the most recent peak. This should be done at the same time you create the trend line.

To create a down channel, simple draw a parallel line at the same angle as the downtrend line and then move that line to a position where it touches the most recent valley. This should be done at the same time you created the trend line.

When prices hit the bottom trend line this may be used as a buying area. When prices hit the upper trend line this may be used as a selling area.



“When life gives you lemons, make lemonade.”

Origin Unknown

3rd Grade: Fibonacci

We will be using Fibonacci ratios a lot in our trading so you better learn it and love it like your mama Fibonacci is a huge subject and there are many different studies of Fibonacci with weird names but we're only going to cover a few specific points.

But who is Fibonacci and how can he help you with your trading?

Leonardo Fibonacci was a great Italian mathematician who lived in the thirteenth century who first observed certain ratios of a number series that are regarded as describing the natural proportions of things in the universe, including price data. The ratios arise from the following number series: 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144

This series of numbers is derived by starting with 1 followed by 2 and then adding $1 + 2$ to get 3, the third number. Then, adding $2 + 3$ to get 5, the fourth number, and so on.

After the first few numbers in the sequence, if you measure the ratio of any number to that of the next higher number you get .618, e.g. 34 divided by 55 equals 0.618. . If you measure the ratio between alternate numbers you get .382, for example, 34 divided by 89 = 0.382 and that's as far as into the explanation as we'll go. If you divide any Fibonacci number by the preceding number, after 2 the number is always 1.6 and after 144 the number is always 1.618.

These ratios are referred to as the "golden mean." Additional ratios were then derived to create ratio sets as follows:

Price Retracement Levels

0.236, 0.382, 0.500, 0.618, 0.764

Price Extension Levels

0, 0.382, 0.618, 1.000, 1.382, 1.618

You won't really need to know how to calculate all of this. Your charting software will do all the work for you. But it's always good to be familiar with the basic theory behind the indicator so you'll have knowledge to impress your date.

The first set of ratios is used as price retracement levels and is used in trading as possible **support and resistance levels**. Traders all over the world watch these levels and place buy and sell orders at these levels which becomes a self-fulfilling expectation.

The second set is used as price extension levels and is used in trading as possible **profit taking levels**. Again, traders all over the world are watching these levels and placing buy and sell orders to take profits at these levels which becomes a self-fulfilling expectation.

Most charting software include both Fibonacci Retracement Levels and Price Extension Levels. In order to apply Fibonacci levels to price charts, it is necessary to identify Swing Highs and Swing Lows.

A Swing High is a short term high bar with at least two lower highs on both the left and right of the high bar.

A Swing Low is a short term low bar with at least two higher lows on both the left and right of the low bar.

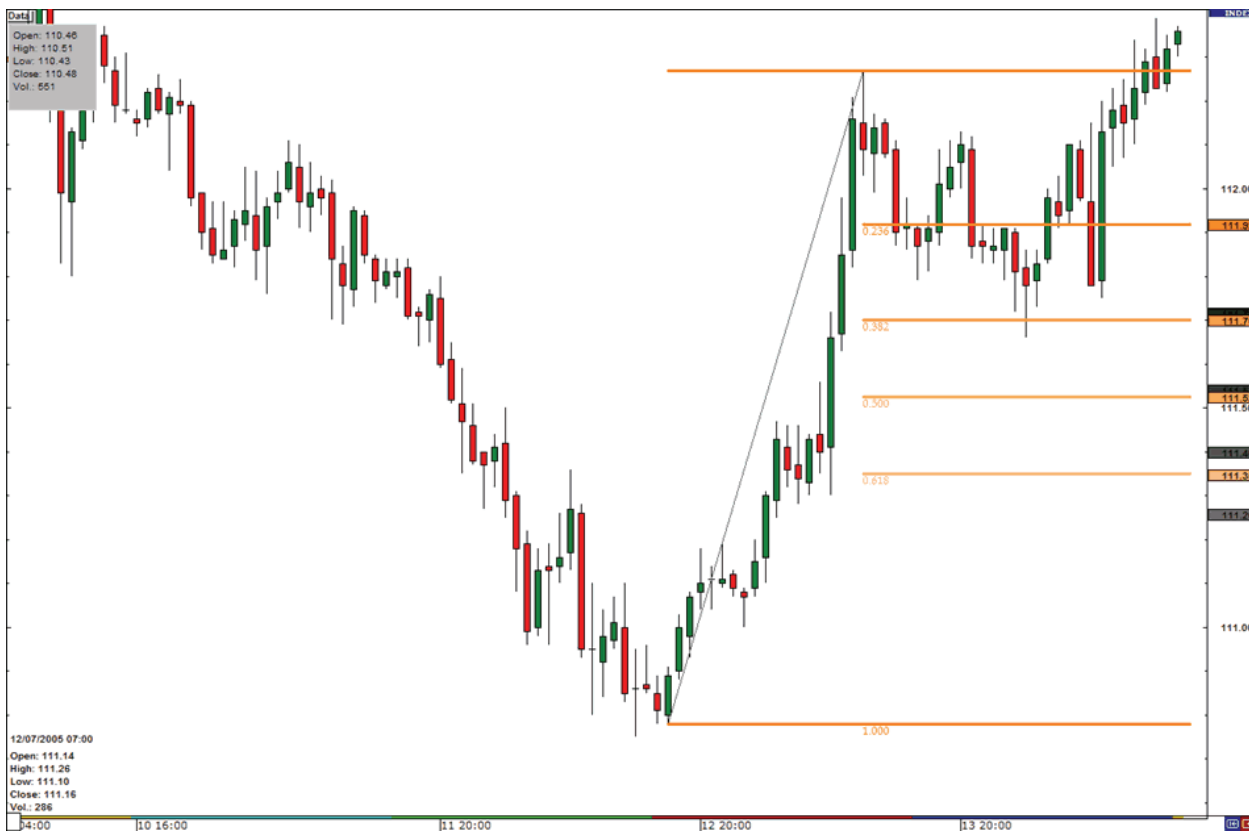
Fibonacci Retracement Levels

In an uptrend, the general idea is to go long the market on a retracement to a Fibonacci support level. In order to find the retracement levels, you would click on a significant Swing Low and drag the cursor to the most recent Swing High. This will display each of the Retracement Levels showing both the ratio and corresponding price level. Let's take a look at some examples of markets in an uptrend.

This is an hourly chart of USD/JPY. Here we plotted the Fibonacci Retracement Levels by clicking on the Swing Low at 110.78 on 07/12/05 and dragging the cursor to the Swing High at 112.27 on 07/13/05. You can see the levels plotted by the software. The Retracement Levels were 111.92 (0.236), 111.70 (0.382), 111.52 (0.500), and 111.35 (0.618). Now the expectation is that if USD/JPY retraces from this high, it will find support at one of the Fibonacci Levels because traders will be placing buy orders at these levels as the market pulls back.



Now let's look at what actually happened after the Swing High occurred. The market pulled back right through the 0.236 level and continued the next day piercing the 0.382 level but never actually closing below it. Later on that day, the market resumed its upward move. Clearly buying at the 0.382 level would have been a good short term trade.



Now let's see how we would use Fibonacci Retracement Levels during a downtrend. This is an hourly chart for EUR/USD. As you can see, we found our Swing High at 1.3278 on 02/28/05 and our Swing Low at 1.3169 a couple hours later. The Retracement Levels were 1.3236 (0.618), 1.3224 (0.500), 1.3211 (0.382), and 1.3195 (.236). The expectation for a downtrend is if it retraces from this high, it will encounter resistance at one of the Fibonacci Levels because traders will be placing sell orders at these levels as the market attempts to rally.



Let's check out what happened next. Now isn't that a thing of beauty! The market did try to rally but it barely past the 0.382 level spiking to a high 1.3227 and it actually closed below it. After that bar, you can see that the rally reversed and the downward move continued. You would have made some nice dough selling at the 0.382 level.



Here's another example. This is an hourly chart for GBP/USD. We had a Swing High of 1.7438 on 07/26/05 and a Swing Low of 1.7336 the next day. So our Retracement Levels are: 1.7399 (0.618), 1.7387 (0.500), 1.7375 (0.382), and 1.7360 (0.236). Looking at the chart, the market looks like it tried to break the 0.500 level on several occasions, but try as it may, it failed. So would putting a sell order at the 0.500 level be a good trade?



If you did, you would have lost some serious cheddar! Take a look at what happened. The Swing Low looked to be the bottom for this downtrend as the market rallied above the Swing High point.



You can see from these examples the market *usually* finds at least temporary support (during an uptrend) or resistance (during a downtrend) at the Fibonacci Retracement Levels. It's apparent that there are a few problems to deal with here. There's no way of knowing which level will provide support.

The 0.236 seems to provide the weakest support/resistance, while the other levels provide support/resistance at about the same frequency. Even though the charts above show the market usually only retracing to the 0.382 level, it doesn't mean the price will hit that level every time and reverse.

Sometimes it'll hit the 0.500 and reverse, other times it'll hit the 0.618 and reverse, and other other times the price will totally ignore Mr. Fibonacci and blow past all the levels like similar to the way Allen Iverson blows past his defenders with his nasty first step.

Remember, the market will not always resume its uptrend after finding temporary support, but instead continue to decline below the last Swing Low. Same thing for a downtrend. The market may instead decide to continue above the last Swing High.

The placement of stops is a challenge. It's probably best to place stops below the last Swing Low (on an uptrend) or above the Swing High (on a downtrend), but this requires taking a high level of risk in proportion to the likely profit potential in the trade. This is called reward-to-risk ratio. In a later lesson, you will learn more money management and risk control and how you would only take trades with certain reward-to-risk ratios.

Another problem is determining which Swing Low and Swing High points to start from to create the Fibonacci Retracement Levels. People look at charts differently and so will have their own version of where the Swing High and Swing Low points should be. The point is, there is no one right way to do it, but the bad thing is sometimes it becomes a guessing game.

Fibonacci Price Extension Levels

The next use of Fibonacci you will be applying is that of targets. Let's start with an example in an uptrend.

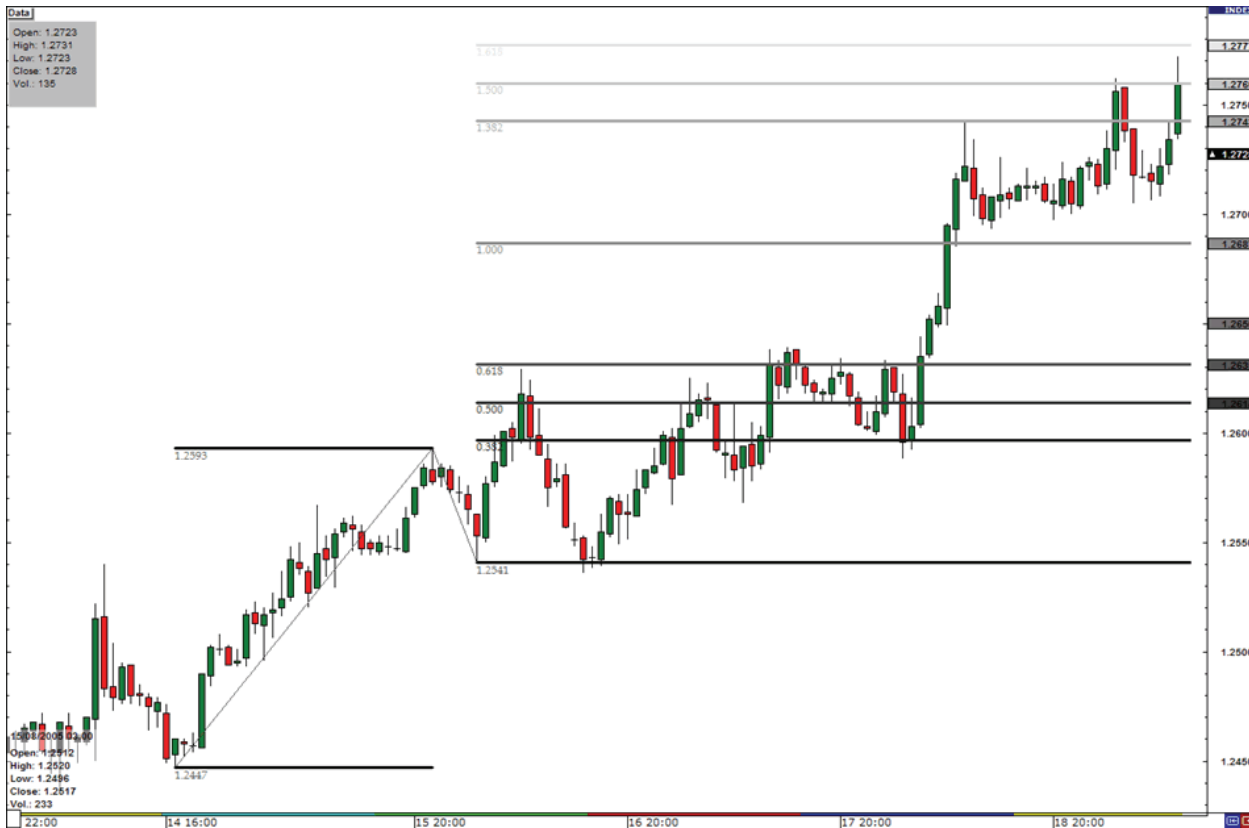
In an uptrend, the general idea is to take profits on a long trade at a Fibonacci Price Extension Level. You determine the Fibonacci extension levels by using three mouse clicks. First, click on a significant Swing Low, then drag your cursor and click on the most recent Swing High. Finally, drag your cursor back down and click on the retracement Swing Low. This will display each of the Price Extension Levels showing both the ratio and corresponding price levels.

On this 1-hour USD/CHF chart, we plotted the Fibonacci extension levels by clicking on the Swing Low at 1.2447 on 08/14/05 and dragged the cursor to the Swing High at 1.2593 on 08/15/15 and then down to the retracement Swing Low of 1.2541 on 08/15/05. The following Fibonacci extension levels created are 1.2597 (0.382), 1.2631 (0.618), 1.2687 (1.000), 1.2743 (1.382), 1.2760 (1.500), and 1.2777 (1.618).



Now let's look at what actually happened after the retracement Swing Low occurred.

- The market rallied to the 0.500 level
- fell back to the retracement Swing Low
- then rallied back up to the 0.500 level
- fell back slightly
- rallied to the 0.618 level
- fell back to the 0.382 level which acted as support
- then rallied all the way to the 1.382 level
- consolidated a bit
- then rallied to the 1.500 level



You can see from these examples that the market often finds at least temporary resistance at the Fibonacci extension levels - not always, but often. As in the examples of the retracement levels, it should be apparent that there are a few problems to deal with here as well.

First, there is no way of knowing which level will provide resistance. The 0.500 level was a good level to cover any long trades in the above example since the market retraced back to its original level, but if you didn't get back in the trade, you would have left a lot of profits on the table.

Another problem is determining which Swing Low to start from in creating the Fibonacci Extension Levels. One way is from the last Swing Low as we did in the examples; another is from the lowest Swing Low of the past 30 bars. Again, the point is that there is no one right way to do it, and consequently it becomes a guessing game.

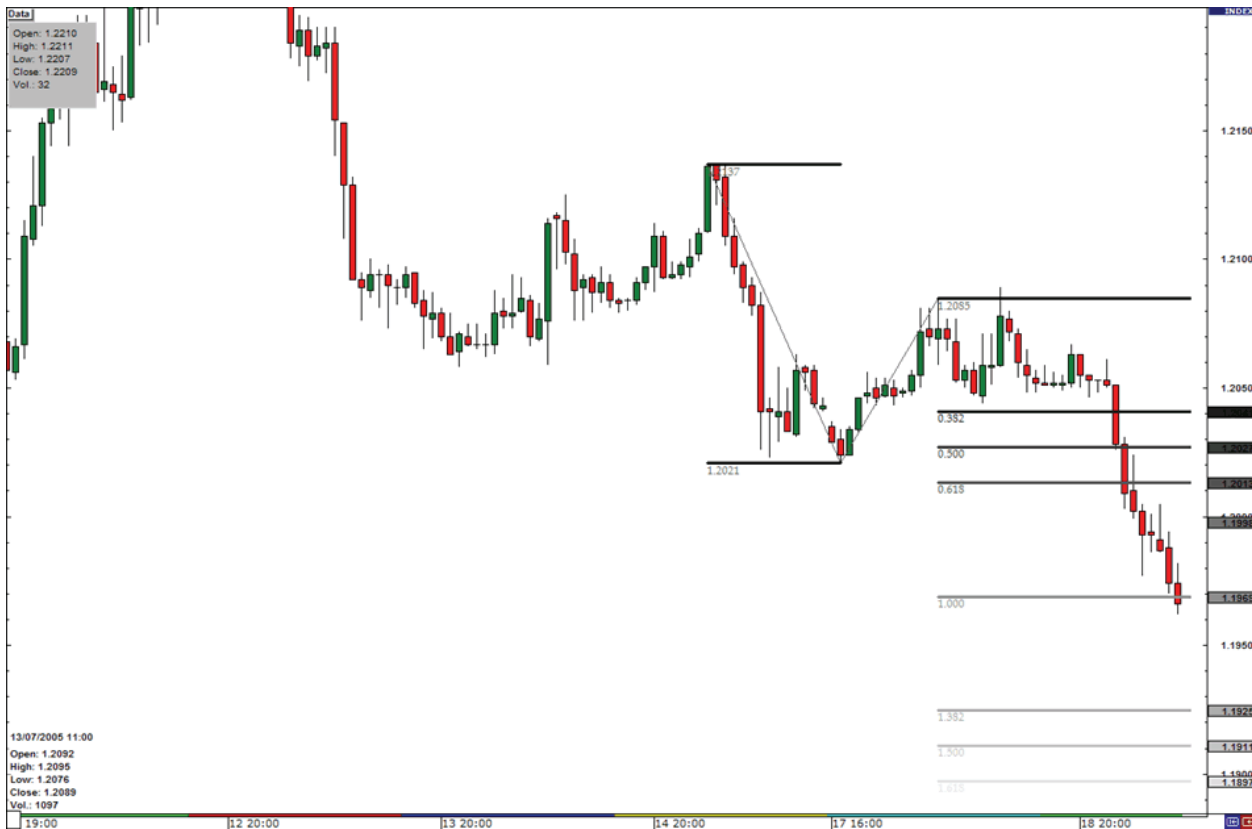
Alright, let's see how Fibonacci extension levels can be used during a downtrend. In a downtrend, the general idea is to take profits on a short trade at a Fibonacci price extension level since the market often finds at least temporary support at these levels.

On this 1-hour EUR/USD chart, we plotted the Fibonacci extension levels by clicking on the Swing High at 1.21377 on 07/15/05 and dragged the cursor to the Swing Low at 1.2021 on 08/15/15 and then down to the retracement Swing Low of 1.2541 on 07/17/05. The following Fibonacci extension levels created are 1.2041 (0.382), 1.2027 (0.500), 1.2013 (0.618), 1.1969 (1.000), 1.1925 (1.382), 1.1911 (1.500), and 1.1897 (1.618).



Now let's look at what actually happened after the retracement Swing Low occurred.

- The market fell down almost to the 0.382 level which for right now is acting as a support level
- The market then traded sideways between the retracement Swing High level and 0.382 level
- Finally, the market broke through the 0.382 and rested on the 0.500 level
- Then it broke the 0.500 level and fell all the way down to the 1.000 level



Alone, Fibonacci levels will not make you rich. However, Fibonacci levels are definitely useful as part of an effective trading method that includes other analysis and techniques. You see, the key to an effective trading system is to integrate a few indicators (not too many) that are applied in a way that is not obvious to most observers.

All successful traders know it's how you use and integrate the indicators (including Fibonacci) that makes the difference. The lesson learned here is that Fibonacci Levels can be a useful tool, but never enter or exit a trade based on Fibonacci Levels alone.

Summary:

- Fibonacci retracement levels are 0.236, 0.382, 0.500, 0.618, 0.764
- Fibonacci retracement levels are used support and resistance levels.
- Fibonacci extension levels are 0, 0.382, 0.618, 1.000, 1.382, 1.618
- Fibonacci extension levels are used as profit taking levels.

“Opportunity is missed by most people because it is dressed in overalls and looks like work.”
Thomas Edison

4th Grade: Moving Averages

A moving average is simply a way to smooth out price action over time. By “moving average”, I mean that you are taking the average closing price of a currency for the last ‘X’ number of periods.



Like every indicator, it is used to help us forecast future prices. By looking at the slope of the moving average you can make general predictions as to where the price will go.

As I said, moving averages smooth out price action. There are different types of moving averages, and each of them have their own level of “smoothness”. Generally, the smoother the moving average, the slower it is to react to the price movement. The choppiest the moving average, the quicker it is to react to the price movement.

I’ll explain the pros and cons of each type a little later, but for now let’s look at the different types of moving averages and how they are calculated.

Simple Moving Average (SMA)

A simple moving average is the simplest type of moving average (DUH!). Basically, a simple moving average is calculated by adding up the last “X” period’s closing prices and then dividing that number by X. Confused??? Allow me to clarify. If you plotted a 5 period simple moving average on a 1 hour chart, you would add up the closing prices for the last 5 hours, and then divide that number by 5. Voila! You have your simple moving average.

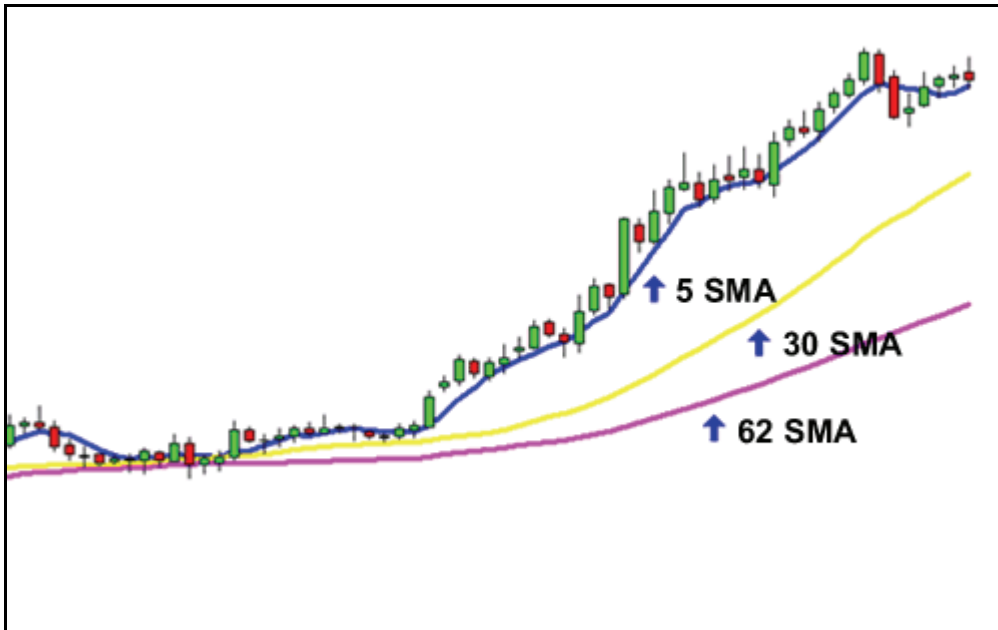
If you were to plot a 5 period simple moving average on a 10 minute chart, you would add up the closing prices of the last **50** minutes and then divide that number by 5.

If you were to plot a 5 period simple moving average on a 30 minute chart, you would add up the closing prices of the last **150** minutes and then divide that number by 5.

If you were to plot the 5 period simple moving average on the a 4 hr. chart.....OK OK, I think you get the picture! Let's move on.

Most charting packages will do all the calculations for you. The reason I just bored you (yawn!) with how to calculate a simple moving average is because it is important that you understand **how** the moving averages are calculated. If you understand how each moving average is calculated, you can make your own decision as to which type is better for you.

Just like any indicator out there, moving averages operate with a delay. Because you are taking the **averages** of the price, you are really only seeing a "forecast" of the future price and not a concrete view of the future. Disclaimer: Moving averages will not turn you into Ms. Cleo the psychic!



Here is an example of how moving averages smooth out the price action. On the chart above, you can see 3 different SMAs. As you can see, the longer the SMA period is, the more it lags behind the price. Notice how the 62 SMA is farther away from the current price than the 30 and 5 SMA. This is because with the 62 SMA, you are adding up the closing prices of the last **62** periods and dividing it by 62. The higher the number period you use, the slower it is to react to the price movement.

The SMAs in this chart show you the overall sentiment of the market at this point in time. Instead of just looking at the current price of the market, the moving averages give us a broader view, and we can now make a general prediction of its future price.

Exponential Moving Average (EMA)

Although the simple moving average is a great tool, there is one major flaw associated with it. Simple moving averages are very susceptible to spikes. Let me show you an example of what I mean: Let's say we plot a 5 period SMA on the daily chart of the EUR/USD and the closing prices for the last 5 days are as follows:

Day 1: 1.2345
Day 2: 1.2350
Day 3: 1.2360
Day 4: 1.2365
Day 5: 1.2370

The simple moving average would be calculated as
 $(1.2345+1.2350+1.2360+1.2365+1.2370) / 5 = 1.2358$

Simple enough right? Well what if Day 2's price was 1.2300? The result of the simple moving average would be a lot lower and it would give you the notion that the price was actually going down, when in reality, Day 2 could have just been a one time event (maybe interest rates decreasing).

The point I'm trying to make is that sometimes the simple moving average might be *too* simple. If only there was a way that you could filter out these spikes so that you wouldn't get the wrong idea. Hmmmm...I wonder....Wait a minute.....Yep, there is a way! It's called the Exponential Moving Average!

Exponential moving averages (EMA) give more weight to the most recent periods. In our example above, the EMA would put more weight on Days 3-5, which means that the spike on Day 2 would be of lesser value and wouldn't affect the moving average as much. What this does is it puts more emphasis on what traders are doing NOW.



When trading, it is far more important to see what traders are doing now rather than what they did last week or last month.

Which is better: Simple or Exponential?

First, let's start with an exponential moving average. When you want a moving average that will respond to the price action rather quickly, then a short period EMA is the best way to go. These can help you catch trends very early, which will result in higher profit.

In fact, the earlier you catch a trend, the longer you can ride it and rake in those profits! The downside to the choppy moving average is that you might get faked out. Because the moving average responds so quickly to the price, you might think a trend is forming when in actuality; it could just be a price spike.

With a simple moving average, the opposite is true. When you want a moving average that is smoother and slower to respond to price action, then a longer period SMA is the best way to go.

Although it is slow to respond to the price action, it will save you from many fake outs. The downside is that it might delay you too long, and you might miss out on a good trade.

	SMA	EMA
Pros:	Displays a smooth chart, which eliminates most fakeouts.	Quick moving, and is good at showing recent price swings.
Cons:	Slow moving, which may cause a lag in buying and selling signals.	More prone to cause fakeouts and give errant signals.

So which one is better? It's really up to you to decide. Many traders plot several different moving averages to give them both sides of the story. They might use a longer period simple moving average to find out what the overall trend is, and then use a shorter period exponential moving average to find a good time to enter a trade.

In fact, many trading systems are built around what is called "Moving Average Crossovers". Later in this course, we will give you an example of how you can use moving averages as part of your trading system.

Time for recess! Go find a chart and start playing with some moving averages. Try out different types and look at different periods. In time, you will find out which moving averages work best for you. Class dismissed!

Summary:

- A moving average is a way to smooth out price action.
- There are many types of moving averages. The 2 most common types are: Simple Moving Average and Exponential Moving Average
- Simple moving averages are the simplest form of moving averages, but they are susceptible to spikes.
- Exponential moving averages put more weight to recent prices and therefore show us what traders are doing now.
- It is much more important to know what traders are doing *now*, than what they did last week or last month.
- Simple moving averages are smoother than Exponential moving averages.
- Longer period moving averages are smoother than shorter period moving averages.
- Choppy moving averages are quicker to respond to price action and can catch trends early. However, because of their quick reaction, they are susceptible to spikes and can fake you out.
- Smooth moving averages are slower to respond to price action but will save you from spikes and fake outs. However, because of their slow reaction, they can delay you from taking a trade and may cause you to miss some good opportunities.
- The best way to use moving averages is to plot different types on a chart so that you can see both long term movement and short term movement.

“The only limits to the possibilities in your life tomorrow
are the butts you use today.”

Les Brown



5th Grade: Common Chart Indicators

Congratulations on making it to the 5th grade! Each time you make it to the next grade you continue to add more and more tools to your trader's toolbox. "What's a trader's toolbox?" you say. Simple. Your trader's toolbox is what you will use to "build" your trading account. The more tools (education) you have in your trader's toolbox (YOUR BRAIN), the easier it will be for you to build.

So for this lesson, as you learn each of these indicators, think of them as a new tool that you can add to that toolbox of yours. You might not necessarily use all of these tools, but it's always nice to have the option, right? Now, enough about tools already! Let's get started!

Bollinger Bands

Bollinger bands are used to measure a market's volatility. Basically, this little tool tells us whether the market is quiet or whether the market is LOUD! When the market is quiet, the bands contract; and when the market is LOUD, the bands expand. Notice on the chart below that when the price was quiet, the bands were close together, but when the price moved up, the bands spread apart.

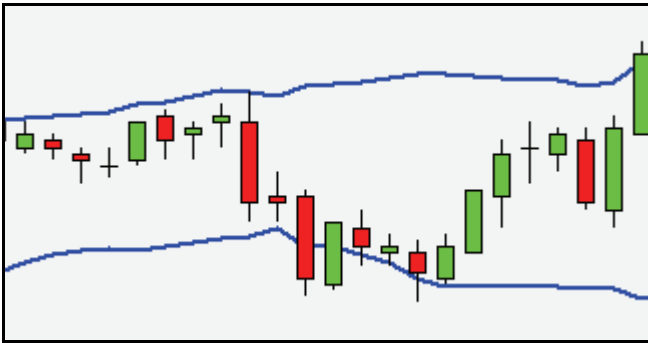


That's all there is to it. Yes, I could go on and bore you by going into the history of the Bollinger band, how it is calculated, the mathematical formulas behind it, and so on and so forth, but I really don't feel like typing it all out. My fingers are cramping.

In all honesty, you don't need to know any of that junk. I think it's more important that I show you some ways you can **apply** the Bollinger bands to your trading.

Note: If you **really** want to learn about the calculations of a Bollinger band, then you can go to www.bollingerbands.com

The Bollinger Bounce



One thing you should know about Bollinger Bands is that price tends to return to the middle of the bands. That is the whole idea behind the Bollinger bounce (smart, huh?). If this is the case, then by looking at the chart above, can you tell me where the price might go next?

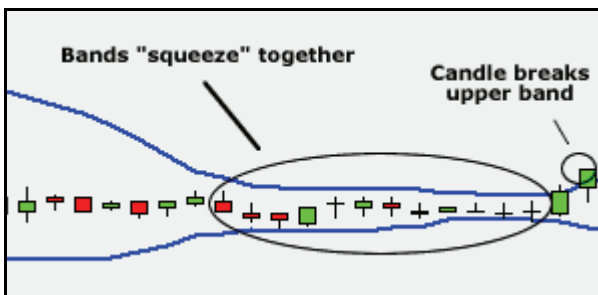


If you said down, then you are correct! As you can see, the price settled back down towards the middle area of the bands.

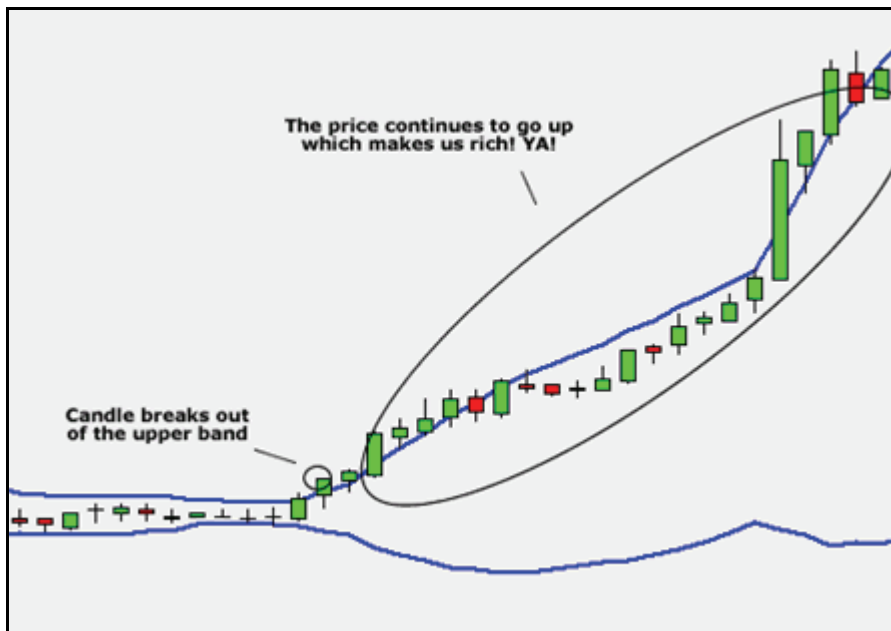
That's all there is to it. What you just saw was a classic Bollinger bounce. The reason these bounces occur is because Bollinger Bands act like mini support and resistance levels. The longer the time frame you are in, the stronger these bands are. Many traders have developed systems that thrive on these bounces. This strategy is best used when the market is ranging and there is no clear trend.

Now let's look at a way to use Bollinger Bands when the market **does** trend.

Bollinger Squeeze



The Bollinger squeeze is pretty self explanatory. When the bands “squeeze” together, it usually means that a breakout is going to occur. If the candles start to break out above the top band, then the move will usually continue to go up. If the candles start to break out below the lower band, then the move will usually continue to go down. Looking at the chart above, you can see the bands squeezing together. The price has just started to break out of the top band. Based on this information, where do you think the price will go?



If you said up, you are correct! This is how a typical Bollinger Squeeze works. This strategy is designed for you to catch a move as early as possible. Setups like these don't occur everyday, but you can probably spot them a few times a week if you are looking at a 15 minute chart.

So now you know what Bollinger Bands are, and you know how to use them. There are many other things you can do with Bollinger Bands, but these are the 2 most common strategies associated with them. So now you can put this in your trader's toolbox, and we can move on to the next indicator.

MACD

MACD is an acronym for **M**oving **A**verage **C**onvergence **D**ivergence. This tool is used to identify moving averages that are indicating a new trend, whether it's bullish or bearish. After all, our #1 priority in trading is being able to find a trend, because that is where the most money is made.



With MACD charts, you will usually see three numbers that are used for its settings. The first is the number of periods that is used to calculate the faster moving average, the second is the number of periods that is used in the slower moving average, and the third is the number of bars that is used to calculate the moving average of the difference between the faster and slower moving averages.

For example, if you were to see “12,26,9” as the MACD parameters (which is usually the default setting for most charting packages), this is how you would interpret it:

1. The 12 represents the previous 12 bars of the faster moving average.
2. The 26 represents the previous 26 bars of the slower moving average.
3. The 9 represents the previous 9 bars of the difference between the two moving averages. This is plotted by vertical lines called a histogram (The blue lines in the chart above).

There is a common misconception when it comes to the lines of the MACD. The two lines that are drawn are NOT moving averages of the price. Instead, they are the moving averages of the DIFFERENCE between two moving averages.

In our example above, the faster moving average is the moving average of the difference between the 12 and 26 period moving averages. The slower moving average plots the average of the previous MACD line. Once again, from our example above, this would be a 9 period moving average.

This means that we are taking the average of the last 9 periods of the faster MACD line and plotting it as our “slower” moving average. What this does is it smoothes out the original line even more, which gives us a more accurate line.

The histogram simply plots the difference between the fast and slow moving average. If you look at our original chart, you can see that as the two moving averages separate, the histogram gets bigger. This is called divergence because the faster moving average is “diverging” or moving away from the slower moving average.

As the moving averages get closer to each other the histogram gets smaller. This is called convergence because the faster moving average is “converging” or getting closer to the slower moving average. And that, my friend, is how you get the name, **Moving Average Convergence Divergence!** Whew, I need to crack my knuckles after that one.

Ok, so now you know what MACD does. Now I’ll show you what MACD can do for YOU.

MACD Crossover

Because there are two moving averages with different “speeds”, the faster one will obviously be quicker to react to price movement than the slower one. When a new trend occurs, the fast line will react first and eventually cross the slower line. When this “crossover” occurs, and the fast line starts to “diverge” or move away from the slower line, which often indicates that a new trend has formed.

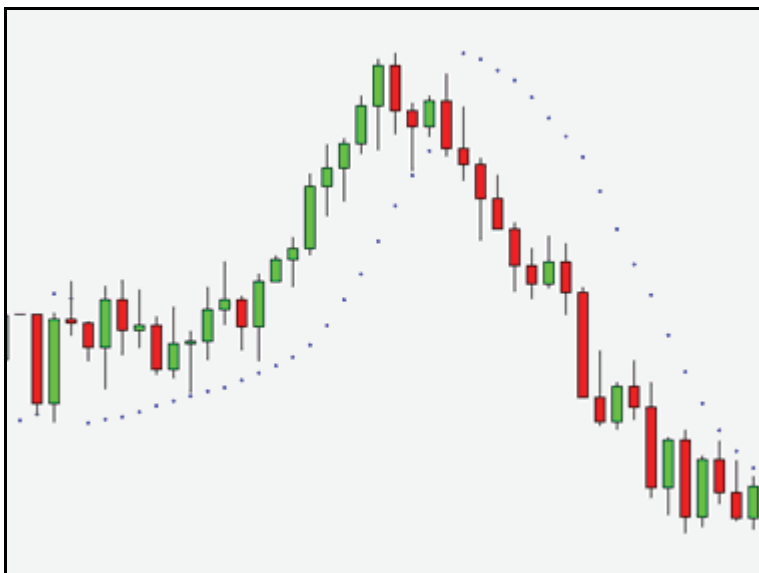


From the chart above, you can see that the fast line crossed under the slow line and correctly identified a new downtrend. Notice that when the lines crossed, the histogram temporarily disappears. This is because the difference between the lines at the time of the cross is 0. As the downtrend begins and the fast line diverges away from the slow line, the histogram gets bigger, which is good indication of a strong trend.

There is one drawback to MACD. Naturally, moving averages tend to lag behind price. After all, it's just an average of historical prices. Since the MACD represents moving averages of **other** moving averages and is smoothed out by another moving average, you can imagine that there is quite a bit of lag. However, it is still one of the most favored tools by many traders.

Parabolic SAR

Up until now, we've looked at indicators that mainly focus on catching the beginning of new trends. And although it is important to be able to identify new trends, it is equally important to be able to identify where a trend ends. After all, what good is a well-timed entry without a well-timed exit?



One indicator that can help us determine where a trend might be ending is the Parabolic SAR (**Stop And Reversal**). A Parabolic SAR places dots, or points, on a chart that indicate potential reversals in price movement. From the chart above, you can see that the dots shift from being below the candles during the uptrend, to above the candles when the trend reverses into a downtrend.

Using Parabolic SAR

The nice thing about the Parabolic SAR is that it is really simple to use. Basically, when the dots are below the candles, it is a buy signal; and when the dots are above the candles, it is a sell signal. This is probably the easiest indicator to interpret because it assumes that the price is either going up or down. With that said, this tool is best used in markets that are trending, and that have long rallies and downturns. You **DON'T** want to use this tool in a choppy market where the price movement is sideways.

Stochastics

Stochastics is another indicator that helps us determine where a trend might be ending. By definition, stochastics is an oscillator that measures overbought and oversold conditions in the market. The 2 lines are similar to the MACD lines in the sense that one line is faster than the other.



How to Apply Stochastics

Like I said earlier, stochastics tells us when the market is overbought or oversold. Stochastics are scaled from 0 to 100. When the stochastic lines are above 70 (the red dotted line in the chart above), then it means the market is overbought. When the stochastic lines are below 30 (the blue dotted line), then it means that the market is oversold. As a rule of thumb, we buy when the market is oversold, and we sell when the market is overbought.



Looking at the chart above, you can see that the stochastics has been showing overbought conditions for quite some time. Based upon this information, can you guess where the price might go?



If you said the price would drop, then you are absolutely correct! Because the market was overbought for such a long period of time, a reversal was bound to happen.

That is the basics of stochastics. Many traders use stochastics in different ways, but the main purpose of the indicator is to show us where the market is overbought and oversold. Over time, you will learn to use stochastics to fit your own personal trading style.

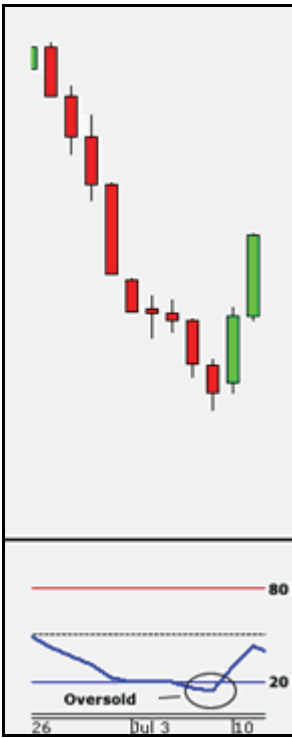
Relative Strength Index (RSI)

Relative Strength Index, or RSI, is similar to stochastics in that it identifies overbought and oversold conditions in the market. It is also scaled from 0 to 100. Typically, readings below 20 indicate oversold, while readings over 80 indicate overbought.



Using RSI

RSI can be used just like stochastics. From the chart above you can see that when RSI dropped below 20, it correctly identified an oversold market. After the drop, the price quickly shot back up.



RSI is a very popular tool because it can also be used to confirm trend formations. If you think a trend is forming, take a quick look at the RSI and look at whether it is above or below 50. If you are looking at a possible uptrend, then make sure the RSI is above 50. If you are looking at a possible downtrend, then make sure the RSI is below 50



In the beginning of the chart above, we can see that a possible uptrend was forming. To avoid fake-outs, we can wait for RSI to cross above 50 to confirm our trend. Sure enough, as RSI passes above 50, it is a good confirmation that an uptrend has actually formed.

Putting It All Together

In a perfect world, we could take just one of these indicators and trade strictly by what that indicator told us. The problem is that we DON'T live in a perfect world, and each of these indicators has imperfections. That is why many traders combine different indicators together so that they can "screen" each other. They might have 3 different indicators and they won't trade unless all 3 indicators give them the same answer.

As you continue your journey as a trader, you will discover what indicators work best for you. I can tell you that I like using MACD, Stochastics, and RSI, but you might have a different preference. Every trader out there has tried to find the "magic combination" of indicators that will always give them the right signals, but the truth is that there is no such thing.

I urge you to study each indicator on its own until you know EXACTLY how it reacts to price movement, and then come up with your own combination that fits **your** trading style. Later on in the course, I will show you a system that combines different indicators to give you an idea of how they can compliment each other.

Summary:

- Everything you learn about trading is like a tool that is being added to your trader's toolbox. Your tools will make it easier for you to "build" your trading account.
- **Bollinger Bands**
 - Used to measure the market's volatility
 - They act like mini support and resistance levels
 - Bollinger Bounce
 - A strategy that relies on the notion that price tends to always return to the middle of the Bollinger Bands
 - You buy when the price hits the lower Bollinger band
 - You sell when the price hits the upper Bollinger band
 - Best used in ranging markets
 - Bollinger Squeeze
 - A strategy that is used to catch breakouts early
 - When the Bollinger bands "squeeze" the price, it means that the market is very quiet, and a breakout is eminent. Once a breakout occurs, we enter a trade on whatever side the price made its breakout.
- **MACD**
 - Used to catch trends early and can also help us spot trend reversals
 - It consists of 2 moving averages (1 fast, 1 slow) and vertical lines called a histogram, which measures the distance between the 2 moving averages.
 - Contrary to what many people think, the moving average lines are NOT moving averages of the price. They are moving averages of other moving averages.
 - MACD's downfall is its lag because it uses so many moving averages.
 - One way to use MACD is to wait for the fast line to "cross over" or "cross under" the slow line and enter the trade accordingly because it signals a new trend.

- **Parabolic SAR**
 - This indicator is made to spot trend reversals; hence the name Parabolic **Stop And Reversal** (SAR)
 - This is the easiest indicator to interpret because it only gives bullish and bearish signals.
 - When the dots are above the candles, it is a sell signal.
 - When the dots are below the candles, it is a buy signal.
 - These are best used in trending markets that consist of long rallies and downturns.

- **Stochastics**
 - Used to indicate overbought and oversold conditions
 - When the moving average lines are above 70, it means that the market is overbought and we should look to sell.
 - When the moving average lines are below 30, it means that the market is oversold and we should look to buy.

- **Relative Strength Index (RSI)**
 - Similar to stochastics in that it indicates overbought and oversold conditions.
 - When RSI is above 80, it means that the market is overbought and we should look to sell.
 - When RSI is below 20, it means that the market is oversold and we should look to buy.
 - RSI can also be used to confirm trend formations. If you think a trend is forming, wait for RSI to go above or below 50 (depending on if you're looking at an uptrend or downtrend) before you enter a trade.

- Each indicator has its imperfections. This is why traders combine many different indicators to “screen” each other. As you progress through your trading career, you will learn which indicators you like the best and can combine them in a way that fits **your** trading style.

I know this has been a very loooooooooooooonnnnnng lesson, and I encourage you to go back and read over anything you haven't fully understood yet. Sometimes it just takes a couple times of reading before you truly grasp something.

Once you understand the concepts of these indicators, go to a chart and start playing with them. Really study how each indicator reacts to the price movement.

When you fully understand an indicator, then it will become another tool for your trader's toolbox. For now you should just take a break. Grab some coffee or get something to eat. I know your eyes are hurting! Let this lesson soak in, and then come back when you're refreshed!

“The price of success is hard work, dedication to the job at hand, and the determination that whether we win or lose, we have applied the best of ourselves to the task at hand.”

Vince Lombardi



6th Grade: Oscillators and Momentum Indicators

We've covered a hella lot of tools that can help you analyze charts and identify trends. In fact, you may now have too much information to use effectively.

In this lesson, we're going to look at streamlining your use of these chart indicators. We want you to fully understand the strengths and weaknesses of each tool, so you'll be able to determine which ones work for you and your trading plan...and which ones don't.

Leading versus Lagging Indicators

Let's discuss some concepts first. There are two types of indicators: **leading** and **lagging**.

A leading indicator gives a buy *signal before* the new trend or reversal occurs.

A lagging indicator gives a signal **after** the trend has started and basically informs you "hey buddy, pay attention, the trend has started, you're missing the boat."

You're probably thinking, "Ooooh, I'm going to get rich with leading indicators!" since you would be able to profit from a new trend right at the start. You're right – you would "catch" all of the trend every single time IF the leading indicator was correct every single time. But it's not. When you use leading indicators, you will experience a lot of fake-outs. Leading indicators are notorious for giving bogus signals which will "mislead" you.

Get it? Leading indicators that "mislead" you? Haha. Man I'm so funny I even crack myself up. The other option is to use lagging indicators, which aren't as prone to bogus signals. Lagging indicators only give signals after the price change is clearly forming a trend. The downside is that you'd be a little late in entering a position. Often the biggest gains of a trend occur in the first few bars so by using a lagging indicator you could potentially miss out on much of the profit. Which sucks.

Oscillators and Trend Following Indicators

For the purpose of this lesson, let's broadly categorize all of our technical indicators into one of two categories:

1. **Oscillators**
2. **Trend following or momentum indicators**

Oscillators are leading indicators.

Momentum indicators are lagging indicators.

While the two can be supportive of each other, they're more likely to conflict with each other. I'm not saying that one or the other should be used exclusively, but you must understand the potential pitfalls of each.

Oscillators/Leading Indicators

An oscillator is any object or data that moves back and forth between two points. In other words, it's an item that is going to always fall somewhere between point A and point B. Think of when you hit the oscillating switch on your electric fan.

Think of our technical indicators as either being "on" or "off". More specifically, an oscillator will usually signal "buy" or "sell", with the only exception being instances when the oscillator is not clearly at either end of the buy/sell range.

Does this sound familiar? It should! Stochastics, Parabolic SAR, and the Relative Strength Index (RSI) are all oscillators. Each of these indicators is designed to signal a possible reversal, where the previous trend has run its course and the price is ready to change direction.

Let's take a look at a few examples.

On this 1-hour chart of USD/EUR below, we have added a Parabolic SAR indicator, as well as an RSI and Stochastic oscillator. As you have already learned, when the Stochastic and RSI begin to leave their "oversold" region. That is a buy signal.

Here we get buy signals between the hours 3:00 am EST and 7:00 am EST on 08/24/05. All three of these buy signals occurred within one or two hours of each other, and this would have been a good trade.



We also got a sell signal from all three indicators between the hours of 2:00 am EST and 5:00 am EST on 08/25/05. As you can see, Stochastic indicator remained in the overbought for a pretty long time. About 20 hours. Usually when an oscillator remains in the overbought or oversold levels for a long period of time, that means there is a strong trend occurring. In this example, since Stochastic stayed overbought, you see there was a strong uptrend present.

Now let's take a look at the same leading oscillators messing up, just so you know these signals aren't perfect. Looking at the chart below, you can quickly see that there were a lot of false buy signals popping up. You'll see how one indicator says to buy, while the other one is still saying sell.



Around 1 am EST on 08/16/05, both RSI and Stochastic gave buy signals, while Parabolic SAR still showed a sell signal. Yes, Parabolic SAR gave a buy signal 3 hours later at 4 am EST, but then Parabolic SAR turned into a sell signal one bar later. If you actually look at the bar with the Parabolic SAR below it, notice how it's a strong looking red bar with very short shadows. Also, notice how the next bar closed below it. This would not have been a good long trade.

On the last two oversold (buy) signals given by Stochastic, notice how there is no indicator at all for RSI, but Parabolic SAR is giving sell signals. What's going on here? They are each giving you different signals!

What happened to such a good set of indicators?

The answer lies in the method of calculation for each one. Stochastic is based on the high-to-low range of the time period (in this case, it's hourly), yet doesn't account for changes from one hour to the next. The Relative Strength Index (RSI) uses change from one closing price to the next. And Parabolic SAR has its own unique calculations that can further cause conflict.

That's the nature of oscillators – they assume that a particular chart pattern always results in the same reversal. Of course, that's hogwash.

While being aware of why a leading indicator may be in error, there's no way to avoid them. If you're getting mixed signals, you're better off doing nothing than taking a 'best guess'. If a chart doesn't meet all your criteria, don't force the trade! Move on to the next one that does meet your criteria.

Momentum/Lagging Indicators

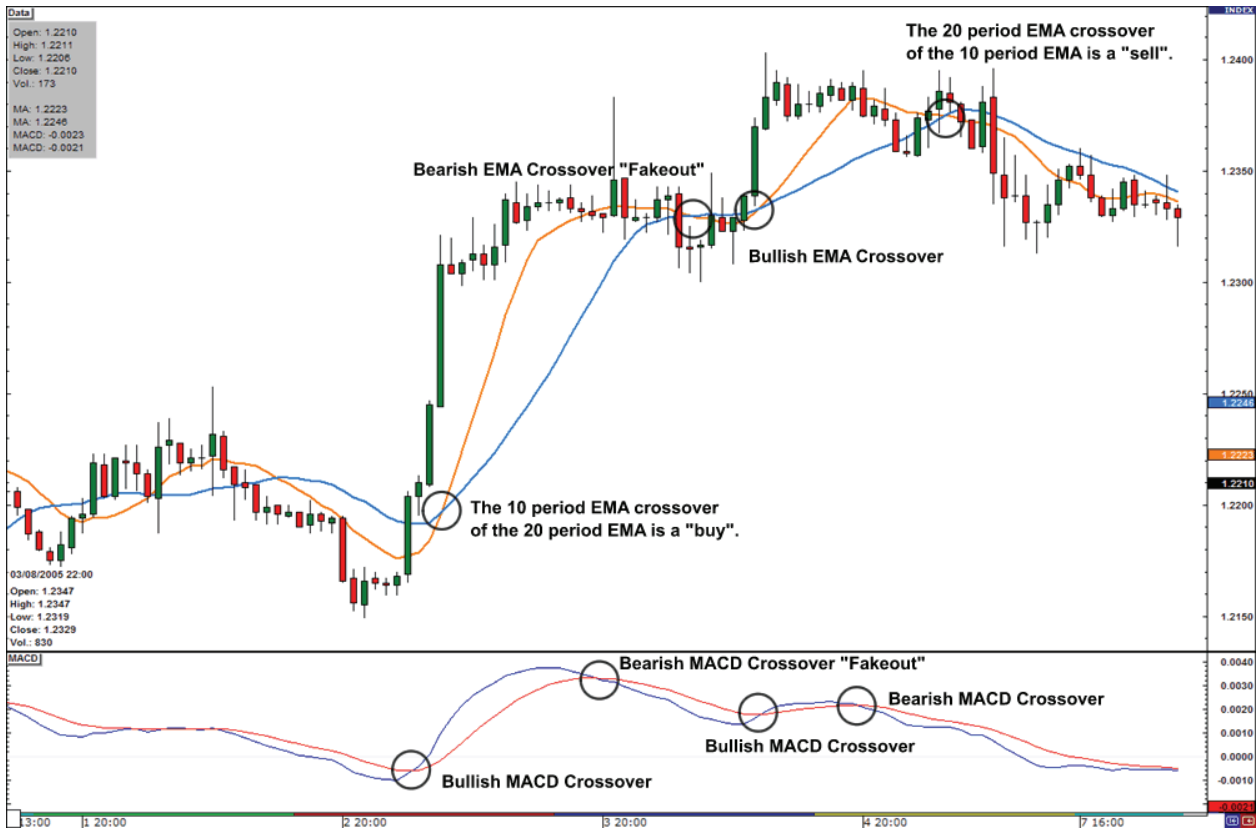
So how do we spot a trend? The indicators that can do so have already been identified as MACD and moving averages. These indicators will spot trends once they have been established at the expense of delayed entry. The bright side is that there's less chance of being wrong.

On this 1-hour chart of EUR/USD, there was a bullish crossover for MACD at 3:00 am EST on 08/03/05 and the 10 period EMA crossed over the 20 period EMA at 5:00 am. These two signals were all accurate, but if you waited for both indicators to give you a bull signal, you would have missed out of the big move. If you calculate from the start of the uptrend at 10:00 pm EST on 08/02/05 to the close of the candle at 5:00 am EST on 08/03/05, you would've watched a gain of 159 pips while sitting on the sidelines.



Let's take a look at the same chart so you can see how these crossover signals can sometimes give false signals. I like to call them "fake-outs". Look at how there was a bearish MACD crossover after the uptrend we just discussed.

Ten hours later, the 20 EMA crossed below the 10 EMA giving a “sell” signal. As you can see, the price didn’t drop but stayed pretty much sideways, then continued its uptrend. By the time both indicators were in agreement, you would’ve entered a short trade at the bottom and set yourself up for a loss. Bummer dude.



The Million Dollar Question

How do you figure out whether to freakin’ use oscillators, or trend following indicators, or both? After all, we know they don’t always work in tandem.

This is probably the most challenging part about technical analysis. And why I call it the million dollar question.

We will provide the million dollar answer in a future lesson.

For now, just know that once you're able to identify the type of market you are trading in, you will then know which indicators will give accurate signals, and which ones are worthless at that time.

This is no piece of cake. But it's a skill you will slowly improve upon as your experience grows.

Summary:

- There are two types of indicators: leading and lagging.
- A leading indicator gives a buy signal before the new trend or reversal occurs.
- A lagging indicator gives a signal after the trend has started
- Technical indicators into one of two categories: Oscillators and trend following or momentum indicators.
- Oscillators are leading indicators.
- Momentum indicators are lagging indicators.
- If you're able to identify the type of market you are trading in, you will then know which indicators will give accurate signals, and which ones are worthless at that time.

“The only place success comes before work is in the dictionary.”

Vince Lombardi



7th Grade: Important Chart Patterns

By now you have an arsenal of weapons to use when you battle the market. In this lesson you will add yet another weapon: **CHART PATTERNS!**

Think of it as a land mine detector because once you learn it, you will be able to spot “explosions” on the charts before they even happen, making you a lot of money in the process.

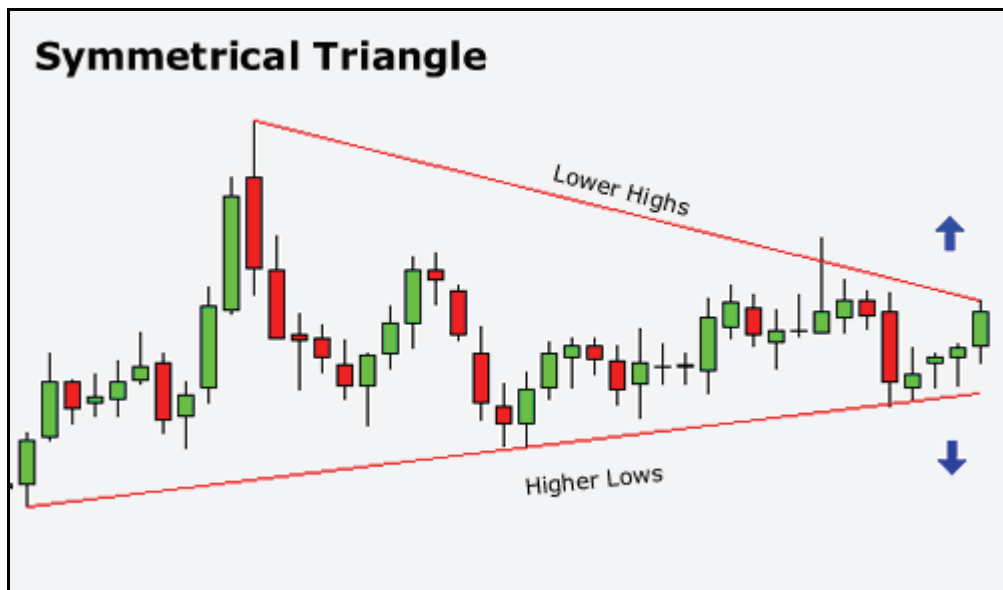
In this lesson, I will teach you basic chart patterns and formations. When correctly identified, it usually leads to a huge breakout or “explosion” in this case. Remember, our whole goal is to spot big movements before they happen so that we can ride them out and rake in the cash! Chart formations will greatly help us spot conditions where the market is ready to break out.

Here's the list of patterns that we're going to cover:

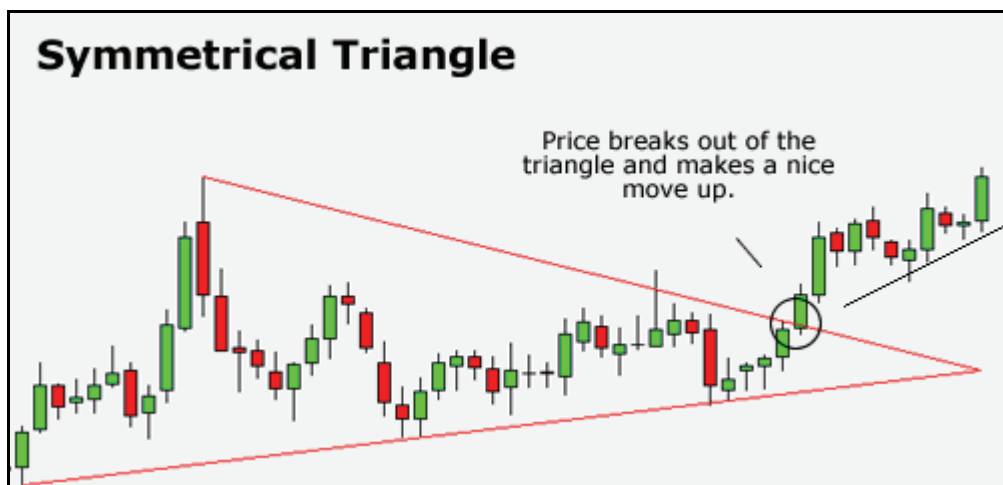
- **Symmetrical Triangles**
- **Ascending Triangles**
- **Descending Triangles**
- **Double Top**
- **Double Bottom**
- **Head and Shoulders**
- **Reverse Head and Shoulders**

Symmetrical Triangles

Symmetrical triangles are chart formations where the slope of the price's highs and the slope of the price's lows converge together to a point where it looks like a triangle. What is happening during this formation is that the market is making lower highs and higher lows. This means that neither the buyers nor the sellers are pushing the price far enough to make a clear trend. If this was a battle between the buyers and sellers, then this would be a draw. This type of activity is called consolidation.



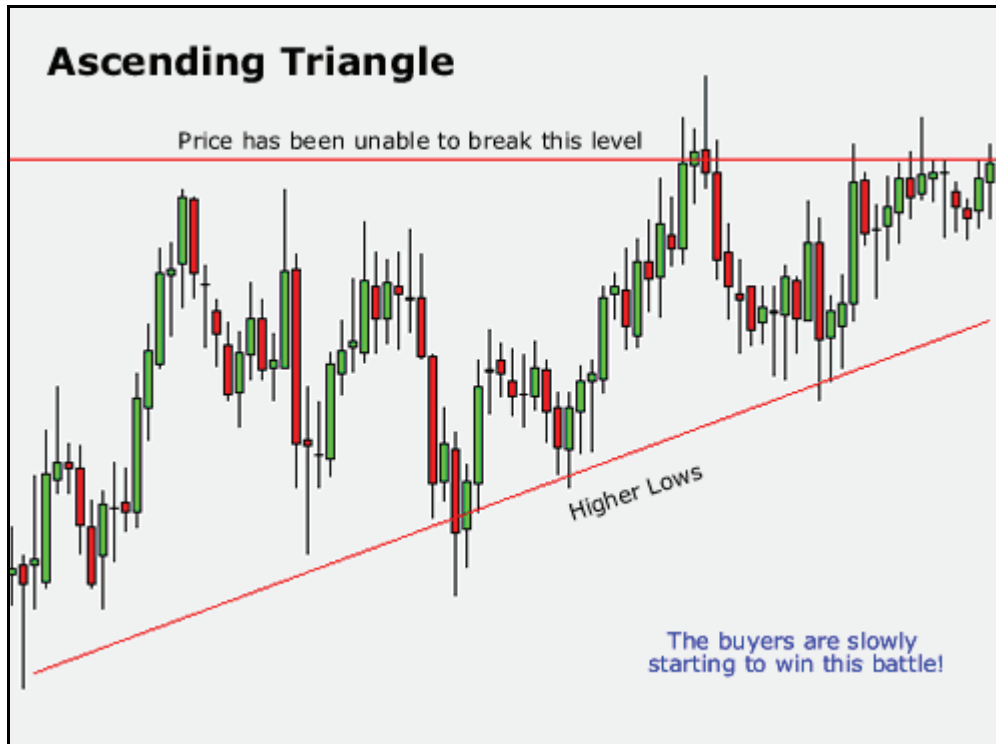
In the chart above, we can see that neither the buyers nor the sellers could push the price in their direction. When this happens we get lower highs and higher lows. As these two slopes get closer to each other, it means that a breakout is getting near. We don't know what direction the breakout will be, but we do know that the market **will** break out. Eventually, one side of the market will give in. So how can we take advantage of this? Simple. We can place entry orders above the slope of the lower highs and below the slope of the higher lows. Since we already know that the price is going to break out, we can just hitch a ride in whatever direction the market moves.



In this example, if we placed an entry order above the slope of the lower highs, we would've been taken along for a nice ride up. If you had placed another entry order below the slope of the higher lows, then you would cancel it as soon as the first order was hit.

Ascending Triangles

This type of formation occurs when there is a resistance level and a slope of higher lows. What happens during this time is that there is a certain level that the buyers cannot seem to exceed. However, they are gradually starting to push the price up as evident by the higher lows.

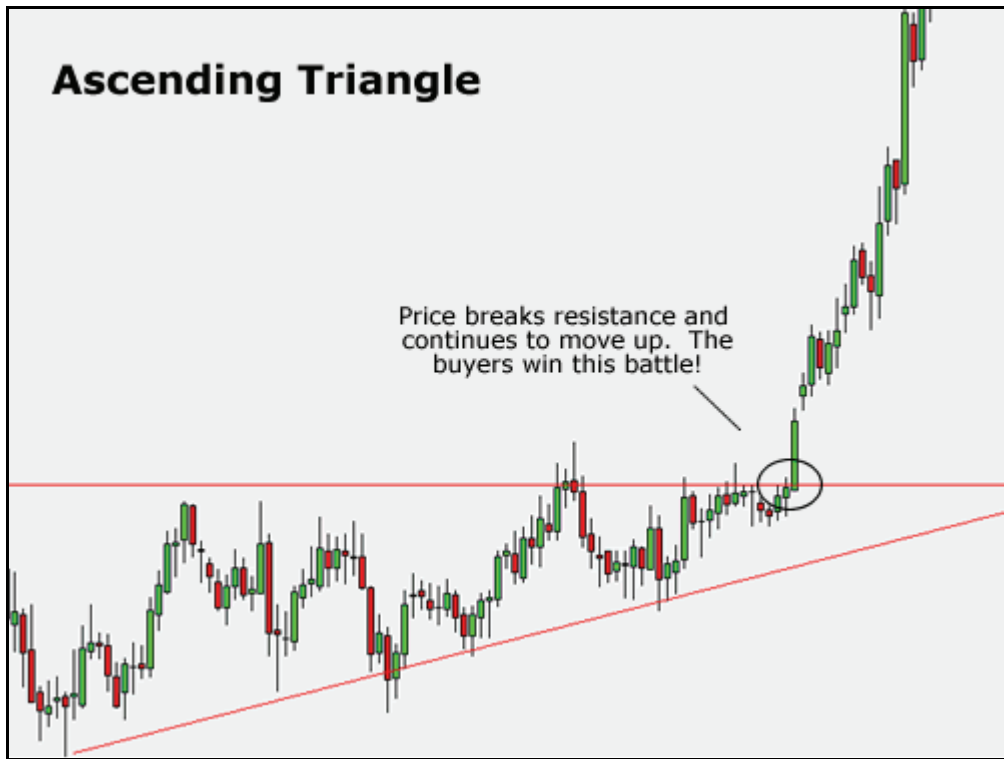


In the chart above, you can see that the buyers are starting to gain strength because they are making higher lows. They keep putting pressure on that resistance level and as a result, a breakout is bound to happen. Now the question is, "Which direction will it go?" "Will the buyers be able to break that level or will the resistance be too strong?"

Many charting books will tell you that in most cases, the buyers will win this battle and the price will break out past the resistance. However, it has been my experience that this is not always the case. Sometimes the resistance level is too strong and there is simply not enough buying power to push it through.

Most of the time the price will in fact go up. The point I am trying to make is that we do not care which direction the price goes, but we want to be ready for a movement in EITHER direction. In this case, we would set an entry order above the resistance line and below the slope of the higher lows.

Ascending Triangle



In this scenario, the buyers won the battle and the price proceeded to skyrocket!

Descending Triangle

As you probably guessed, descending triangles are the exact opposite of ascending triangles (I knew you were smart!). In descending triangles, there is a string of lower highs which forms the upper line. The lower line is a support level in which the price cannot seem to break.



In the chart above, you can see that the price is gradually making lower highs which tell us that the sellers are starting to gain some ground against the buyers. Now most of the time, and I did say MOST; the price will eventually break the support line and continue to fall.

However, in some cases, the support line is too strong, and the price will bounce off of it and make a strong move up.

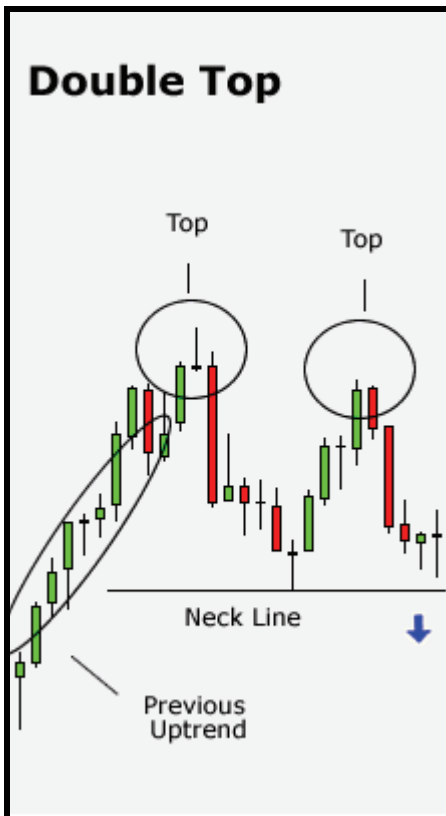
The good news is that we don't care where the price goes. We just know that it's about to go somewhere. In this case we would place entry orders above the upper line (the lower highs) and below the support line.



In this case, the price did end up breaking the support line and proceeded to drop rather quickly. (*note- The market tends to fall faster than it rises which means you usually make money faster when you are short).

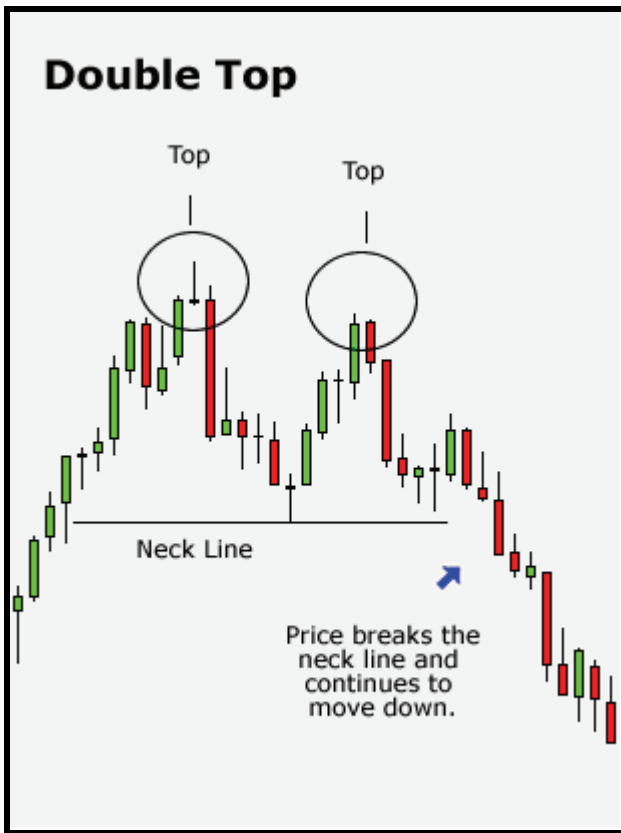
Double Top

A double top is a reversal pattern that is formed after there is an extended move up. The “tops” are peaks which are formed when the price hits a certain level that can’t be broken. After hitting this level, the price will bounce off of it slightly, but then return back to test the level again. If the price bounces off of that level again, then you have a DOUBLE top!



In the chart above you can see that two peaks or “tops” were formed after a strong move up. Notice how the 2nd top was not able to break the high of the 1st top. This is a strong sign that a reversal is going to occur because it is telling us that the buying pressure is just about finished.

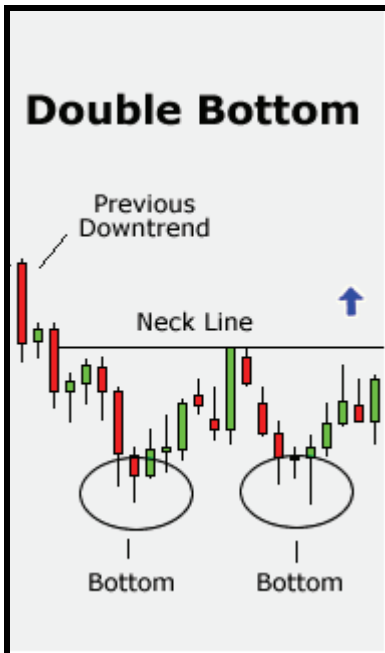
With double tops, we would place our entry order below the neckline because we are anticipating a reversal of the uptrend.



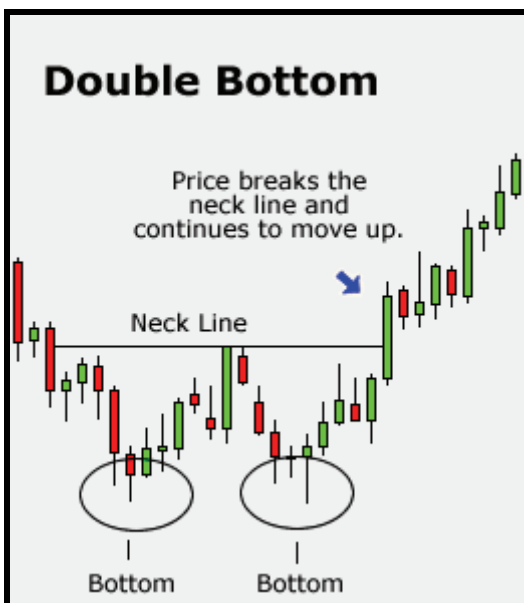
Wow! I must be a psychic or something because I always seem to be right! Looking at the chart you can see that the price breaks the neckline and makes a nice move down. Remember, double tops are a trend reversal formation. You'll want to look for these after there is a strong uptrend.

Double Bottom

Double bottoms are also trend reversal formations, but this time we are looking to go long instead of short. These formations occur after extended downtrends when two valleys or “bottoms” have been formed.



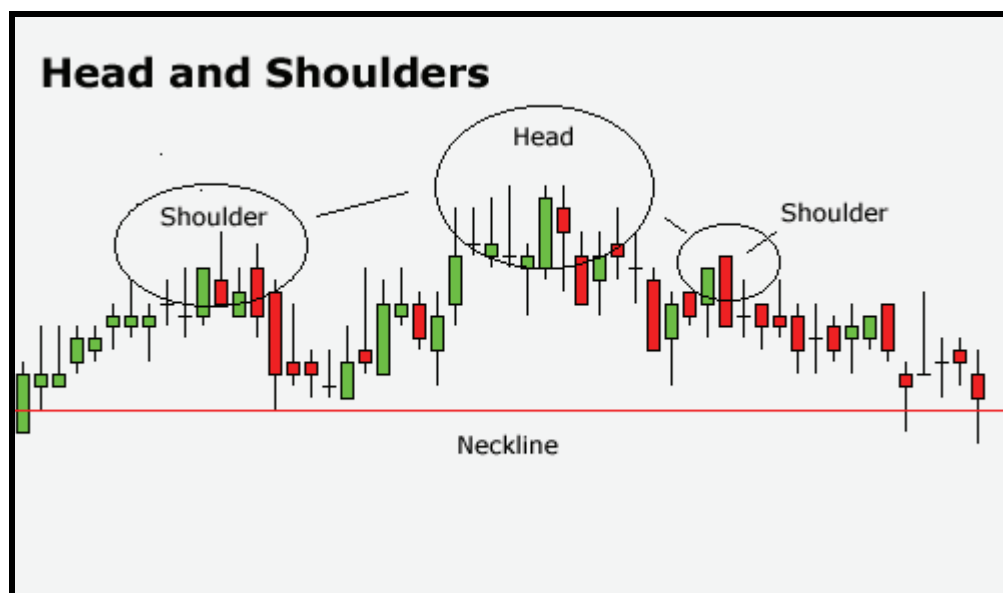
You can see from the chart above that after the previous downtrend, the price formed two valleys because it wasn't able to go below a certain level. Notice how the 2nd bottom wasn't able to significantly break the 1st bottom. This is a sign that the selling pressure is about finished, and that a reversal is about to occur. In this situation, we would place an entry order above the neckline.



Would you look at that! The price breaks the neckline and makes a nice move up. Remember, just like double tops, double bottoms are also trend reversal formations. You'll want to look for these after a strong downtrend.

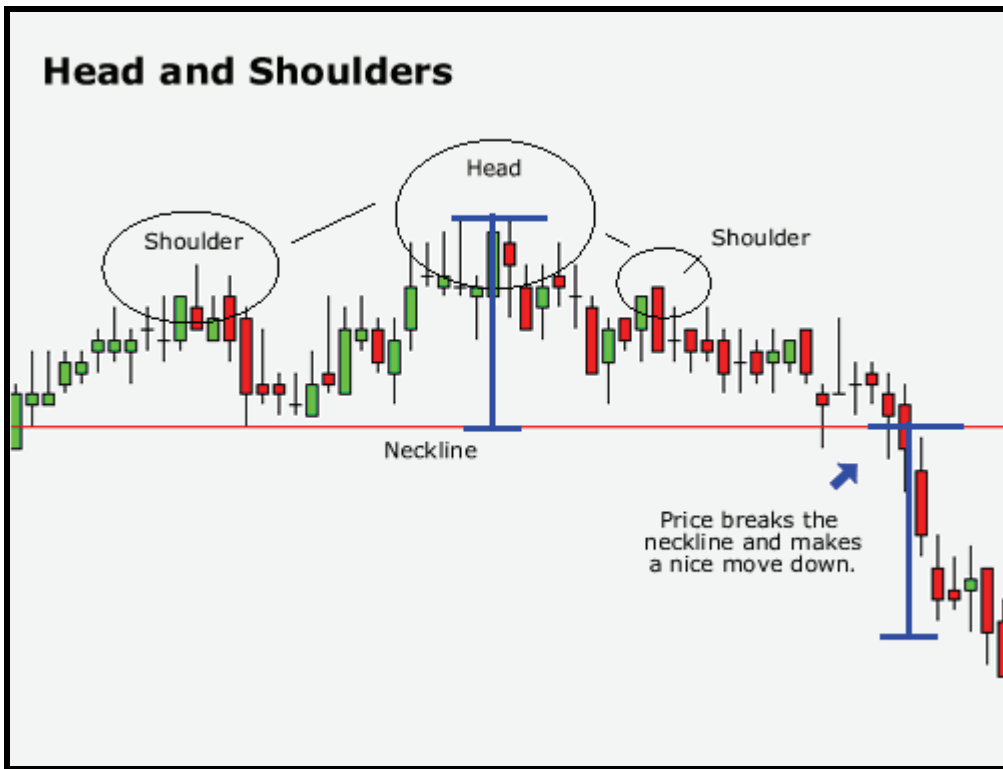
Head and Shoulders

A head and shoulders pattern is also a trend reversal formation. It is formed by a peak (shoulder), followed by a higher peak (head), and then another lower peak (shoulder). A "neckline" is drawn by connecting the lowest points of the two troughs. The slope of this line can either be up or down. In my experience, when the slope is down, it produces a more reliable signal.



In this example, we can visibly see the head and shoulders pattern. The head is the 2nd peak and is the highest point in the pattern. The two shoulders also form peaks but do not exceed the high of the head.

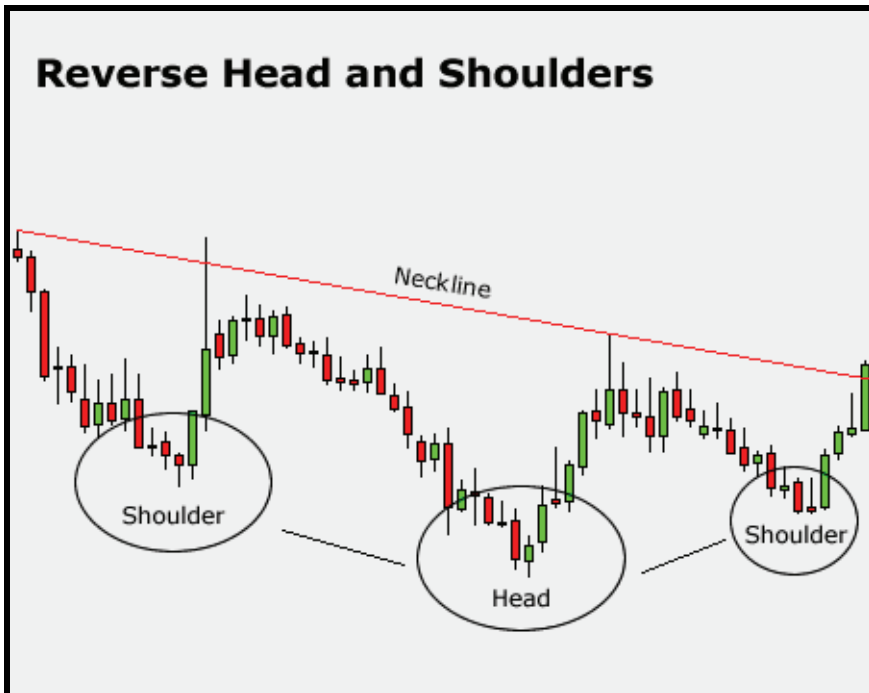
With this formation, we look to make an entry order below the neckline. We can also calculate a target by measuring the high point of the head to the neckline. This distance is approximately how far the price will move after it breaks the neckline.



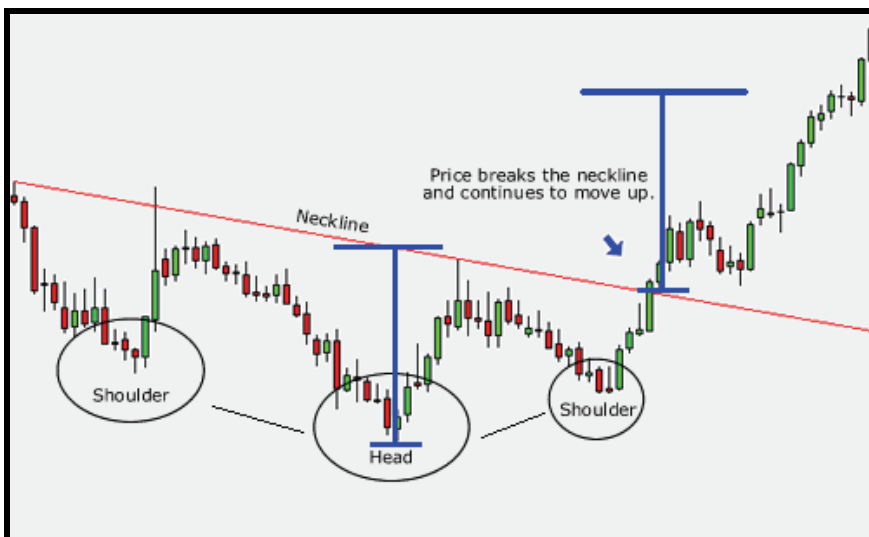
You can see that once the price goes below the neckline it makes a move that is about the size of the distance between the head and the neckline.

Reverse Head and Shoulders

The name speaks for itself. It is basically a head and shoulders formation, except this time it's in reverse. A valley is formed (shoulder), followed by an even lower valley (head), and then another higher valley (shoulder). These formations occur after extended downward movements.



Here you can see that this is just like a head and shoulders pattern, but it's flipped upside down. With this formation, we would place a long entry order above the neckline. Our target is calculated just like the head and shoulders pattern. Measure the distance between the head and the neckline and that is approximately the distance that the price will move after it breaks the neckline.



You can see that the price moved up nicely after it broke the neckline. I know you're thinking to yourself, "the price kept moving even after it reached the target."

And my response is, "**DON'T BE GREEDY!**"

If your target is hit, then be happy with your profits. However, there are strategies where you can lock in some of your profits and still keep your trade open in case the price continues to move your way. You will learn about those later on in the course.

Summary:

Chart formations are like bazookas because they often create huge explosions on the chart.

Symmetrical triangles

- Consists of lower highs and higher lows
- Place entry orders above the lower highs and below the higher lows

Ascending triangles

- Consists of higher lows and a resistance line
- It usually means that the price will break the resistance line and go higher but you should place entry orders on both sides just in case the resistance line is too strong.
- Place your entry orders above the resistance line and below the higher lows.

Descending triangles

- Consists of lower highs and a support line
- It usually means that the price will break the support line and go lower but you should place entry orders on both sides just in case the support line is too strong.
- Place your entry orders above the lower highs and below the support line.

Trend Reversal formations

Double Top

- Happens after an extended uptrend.
- Formed by 2 peaks that can't break a certain level. This level becomes a resistance line.
- Place our short entry order below the low point of the valley in between the 2 peaks.

Double Bottom

- Happens after an extended downtrend.
- Formed by 2 valleys that can't break a certain level. This level becomes a support line.
- Place our long entry order above the high point of the peak in between the 2 valleys.

Head and Shoulders

- Happens after an extended uptrend.
- Formed by a peak, followed by a higher peak, and then another lower peak. A neckline is formed by connecting the low points of the two troughs or “valleys”.
- Place your short entry order below the neckline.
- We calculate our target by measuring the distance between the high point of the head and the neckline. This is the approximate distance that the price will move after it breaks the neckline.

Reverse Head and Shoulders

- Happens after an extended downtrend.
- Formed by a valley, followed by a lower valley, and then another higher valley. A neckline is formed by connecting the high points of the 2 peaks.
- Place your long entry order above the neckline.
- We calculate our target by measuring the distance between the low point of the head and the neckline. This is the approximate distance that the price will move after it breaks the neckline.

“We are what we repeatedly do.
Excellence, then, is not an act, but a habit.”

Aristotle



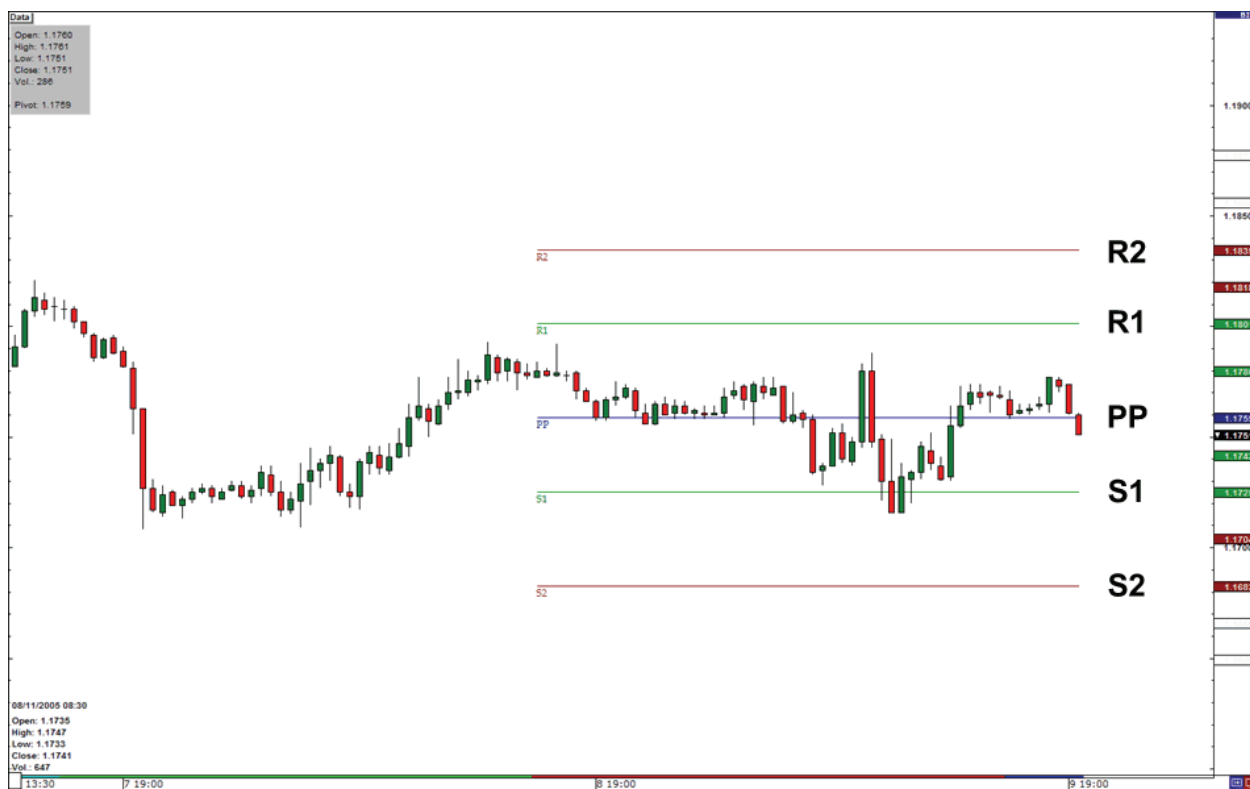
8th Grade: Pivot Points

Professional traders and market makers use pivot points to identify important support and resistance levels. Simply put, a pivot point and its support/resistance levels are areas at which the direction of price movement can possibly change.

Pivot points are especially useful to short-term traders who are looking to take advantage of small price movements.

Pivot points can be used by both range-bound traders and breakout traders. Range-bound traders use pivot points to identify reversal points. Breakout traders use pivot points to recognize key levels that need to be broken for a move to be classified as a real deal breakout.

Here is an example of pivot points plotted on a 1-hour EUR/USD chart:



How to Calculate Pivot Points

The pivot point and associated support and resistance levels are calculated by using the last trading session's open, high, low, and close. Since Forex is a 24-hour market, most traders use the New York closing time of 4:00pm EST as the previous day's close.

The calculation for a pivot point is shown below:

$$\text{Pivot point (PP)} = (\text{High} + \text{Low} + \text{Close}) / 3$$

Support and resistance levels are then calculated off the pivot point like so:

First level support and resistance:

$$\text{First support (S1)} = (2 * \text{PP}) - \text{High}$$

$$\text{First resistance (R1)} = (2 * \text{PP}) - \text{Low}$$

Second level of support and resistance:

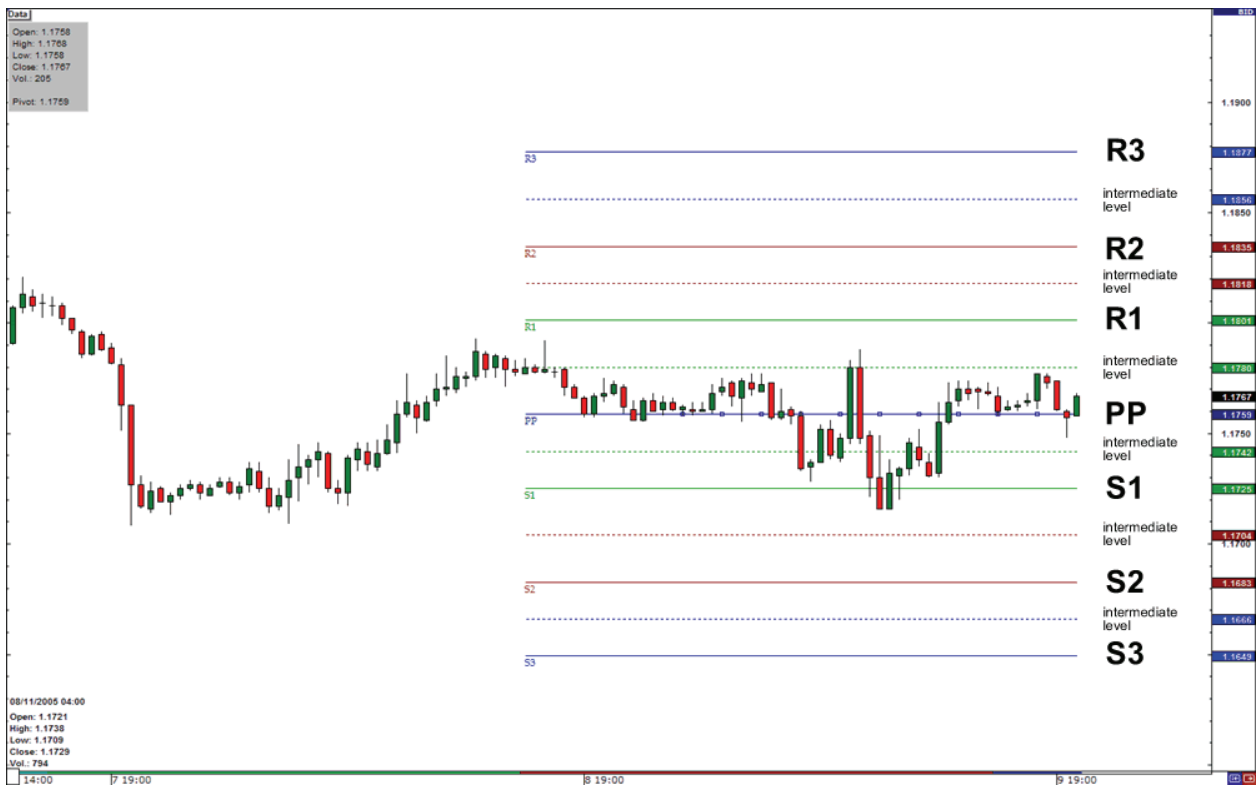
$$\text{Second support (S2)} = \text{PP} - (\text{High} - \text{Low})$$

$$\text{Second resistance (R2)} = \text{PP} + (\text{High} - \text{Low})$$

Don't worry you don't have to perform these calculations yourself. Your charting software will automatically do it for you and plot it on the chart.

Also keep in mind that some charting software also provides additional pivot point features such as a third support and resistance level and intermediate levels or mid-point levels (levels in between the main pivot point and support and resistance level).

These "extra levels" aren't as significant as the main five but it doesn't hurt to pay attention to them. Here's an example:



How to Trade Forex with Pivot Points

Breakout Trades

The pivot point should be the first place you look at to enter a trade since it is the primary support/resistance level. The biggest price movements usually occur at the price of the pivot point.

Only when price reaches the pivot point will you be able to determine whether to go long or short and set your profit targets and stops. Generally, if prices are above the pivot it's considered bullish, and if they are below it's considered bearish.

Let's say the price is hovering around the pivot point and closes below it so you decide to go short. Your stop loss would be above PP and your initial profit target would be at S1.

However, if you see prices continue to fall below S1, instead of cashing out at S1, you can move your existing stop-loss order just above S1 and watch carefully. Typically, S2 will be the expected lowest point of the trading day and should be your ultimate profit objective.

The converse applies during an uptrend. If price closed above PP, you would enter a long position, set a stop loss below PP and use the R1 and R2 levels as your profit objectives.

Range-bound Trades

The strength of support and resistance at the different pivot levels is determined by the number of times the price bounces off the pivot level.



The more times a currency pair touches a pivot level then reverses, the stronger the level is. Pivoting simply means reaching a support or resistance level and then reversing. Hence, the word “pivot”.

If the pair is nearing an upper resistance level, you could sell the pair and place a tight protective stop just above the resistance level.

If the pair keeps moving higher and breaks out above the resistance level, this would be considered an upside “breakout”. You would also get stopped out of your short order but if you believe that the breakout has good follow-through buying strength, you can reenter with a long position. You would then place your protective stop just below the former resistance level that was just penetrated and is now acting as support.

If the pair is nearing an lower support level, you could buy the pair and place a stop below the support level.

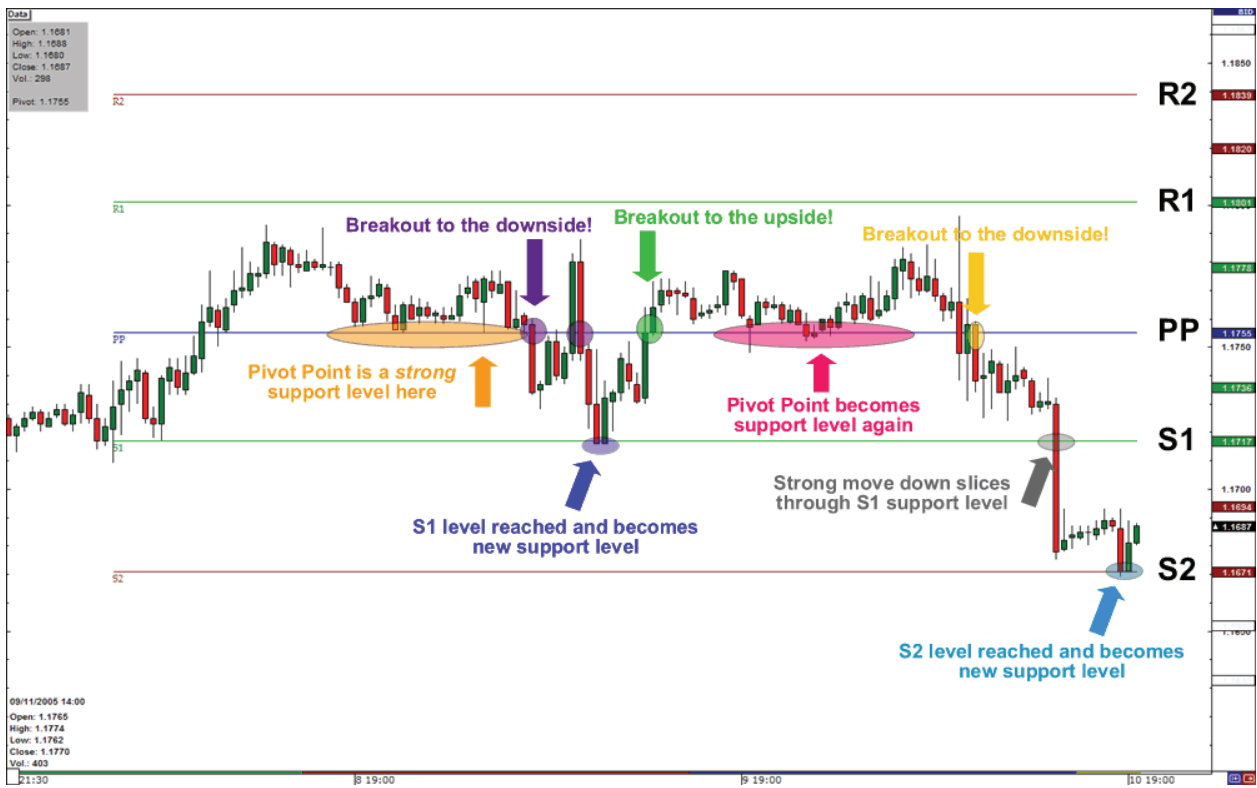
Theoretically Perfect

In theory, it sounds pretty simple huh? Dream on pal. In the real world, pivot points don’t work all the time. Price tends to hesitate around pivot lines and at times it’s just ridiculously hard to tell what it will do next.

Sometimes the price will stop just before reaching a pivot line and then reverse meaning your profit target doesn’t get reached. Other times, it looks like a pivot line is a strong support level so you go long only to see the price fall, stop you out, then reverse back into your direction.

You must be very selective and create a pivot point trading strategy that you intend to strictly follow.

Let’s go look at a chart to see just how difficult and easy pivot points might be.



Oooh pretty colors! Me likes. Look at the orange oval. Notice how the PP was a strong support but if you went long on PP, it never was able to rise up to R1.

Look at the first purple circle. The pair broke down through PP but failed to reach S1 before reversing back to PP. On the second break down though (second purple circle), the pair did manage to reach S1 before once again reversing back to PP.

Look at the pink oval. Again, PP acted as strong support but never was able to rise up to R1.

On the yellow circle, the pair broke out to the downside again, sliced right through S1, and managed to fall all the way down to S2.

If you ever attempted to go long on this chart, you would have been stopped out every single time.

Personally, I would have not even thought about buying this pair?

Why not? Well I have a little secret. What I didn't show you regarding this chart was that this pair was trending down for quite some time now. Remember the trend is your friend. I don't like to backstab my friends, so I try my best to never trade against the trend.

On the next lesson, you will learn how to use multiple timeframes to trade with the correct trend direction so you're able to minimize possible mistakes such as the one above.



Pivot Point Tips

Here are some easy to memorize tips that will help you to make smart pivot point trading decisions.

- If price at PP, watch for a move back to R1 or S1.
- If price is at R1, expect a move to R2 or back towards PP.
- If price is at S1, expect a move to S2 or back towards PP.
- If price is at R2, expect a move to R3 or back towards R1.
- If price is at S2, expect a move to S3 or back towards S1.
- If there is no significant news to influence the market, price will usually move from P to S1 or R1.
- If there is significant news to influence the market price may go straight through R1 or S1 and reach R2 or S2 and even R3 or S3.
- R3 and S3 are a good indication for the maximum range for extremely volatile days but can be exceeded occasionally.
- Pivot lines work well in sideways markets as prices will most likely range between the R1 and S1 lines.
- In a strong trend, price will blow through a pivot line and keep going.

Summary:

- Pivot points are a technique used by professional traders and market makers to determine entry and exit points for the trading day based on the previous day's trading activity. It's best to use this technique after determining the direction of the trend.
- As the charts above show, pivots can be extremely useful in Forex since many currency pairs usually fluctuate between these levels.
- Range-bound traders will enter a buy order near identified levels of support and a sell order when the pair nears resistance.
- Pivot points also allow breakout traders to identify key levels that need to be broken for a move to qualify as a bona fide breakout.
- The simplicity of pivot points definitely makes them a useful tool to add to your trading toolbox. It allows you to see possible areas that are likely to cause price movement. You'll become more in sync to market movements and make better trading decisions.
- Learn to use pivot points along with other technical analysis tools such as candlestick patterns, MACD crossover, moving average crossovers, Stochastics overbought/oversold levels. The greater the confirmation, the greater your probability of success!

“Obstacles don't have to stop you. If you run into a wall, don't turn around and give up. Figure out how to climb it, go through it, or work around it.”

Michael Jordan



9th Grade: Trading Using Multiple Timeframes

Welcome back to school freshman! As part of your initiation to high school you must pay BabyPips.com \$1 million dollars so that we can sit in a mansion in St. Thomas and sip Mai Tais all day, MWUHAHAHA! (There's that evil laugh again).

But seriously, you can send it to my Paypal account at bigpippin@babypips.com. I'll be waiting for it.

Seriously. No joke. I'm not kidding. What? You thought this stuff was free? Wait a minute..this stuff is free.... Sigh, nevermind. Okay back to work...

Which Timeframe Should I Trade?

One of the main reasons traders don't do well as they should is because they're usually trading the wrong timeframe for their personality.

New traders will want to learn how to get rich quick so they'll start trading small timeframes like the 1-minute or 5-minute charts. Then they end up getting frustrated when they trade because it's the wrong timeframe for their personality.

Okay, so you're probably asking what the right timeframe is for me? Well, buddy, if you had been paying attention, it depends on your personality. You have to feel comfortable with the timeframe you're trading in.

You'll always feel some kind of pressure or sense of frustration when you're in a trade because real money is involved. But you shouldn't feel that the reason for the pressure is because things are happening too fast that you find it difficult to make decisions or so slowly that you get frustrated.

When I first started trading, I couldn't stick to a timeframe. I started with the 15-minute chart. Then the 5-minute chart. Then I tried the 1-hour chart, the daily chart, and 4-hour chart.

Finally after a long period of timeframe unfaithfulness, I felt I was most comfortable trading the 1-hour charts. The timeframe as longer, but not too long, and trade signals were fewer, but not too few. I had more time to analyze the market and didn't feel rushed anymore.

On the other hand, I have a friend who could never ever ever trade in a 1-hour timeframe. It would be way too slow for him and he'd probably think he was going to rot and die before he could get in a trade. He prefers trading a 10-minute chart. It still give him enough time (but not too much) to make decisions based on his trading plan.

Another buddy of mine can't figure out how I can trade a 1-hour chart because he thinks it's too fast! He trades only daily, weekly, and monthly charts. His name is Warren Buffet. You might know him.

Trading timeframes are usually categorized into three types:

1. Long-term
2. Short-term or swing
3. Intraday or day-trading

Which one is better? **It depends on your personality!**

Let me give you a breakdown of the three to help you choose:

Timeframe	Description	Advantages	Disadvantages
Long-term	Long-term traders will usually refer to daily and weekly charts. The weekly charts will establish the longer term perspective and assist in placing entries in the shorter term daily. Trades usually from a few weeks to many months, sometimes years.	Don't have to watch markets intraday Fewer transactions means less paying of spreads	Large swings which require large stops Usually 1 or 2 good trades a year so patience is required Bigger account needed to ride longer term swings Frequent losing months
Short-term	Short-term traders use hourly time frames and hold trades for several hours to a week.	More opportunities for trades Less chance of losing months Less reliance on one or two trades a year to make money	Transaction costs will be higher (more spreads to pay) Overnight risk becomes a factor
Intraday	Intraday traders use minute charts such as 1-minute or 5-minute. Trades are held intraday and exited by market close.	Lots of trading opportunities Less chance of losing months No overnight risk	Transaction costs will be much higher (more spreads to pay) Mentally more difficult due to frequency of trading Profits are limited by needing to exit at the end of the day.

You have to decide what the correct timeframe is for YOU.

You also have to consider the amount of capital you have to trade. Shorter timeframes allows you to make better use of margin and have tighter stop losses. Larger timeframes require a bigger account so you can handle the market swings without facing a margin call.

When you finally decide on your preferred timeframe is when the fun begins. This is when you start looking at multiple timeframes to help you analyze the market.

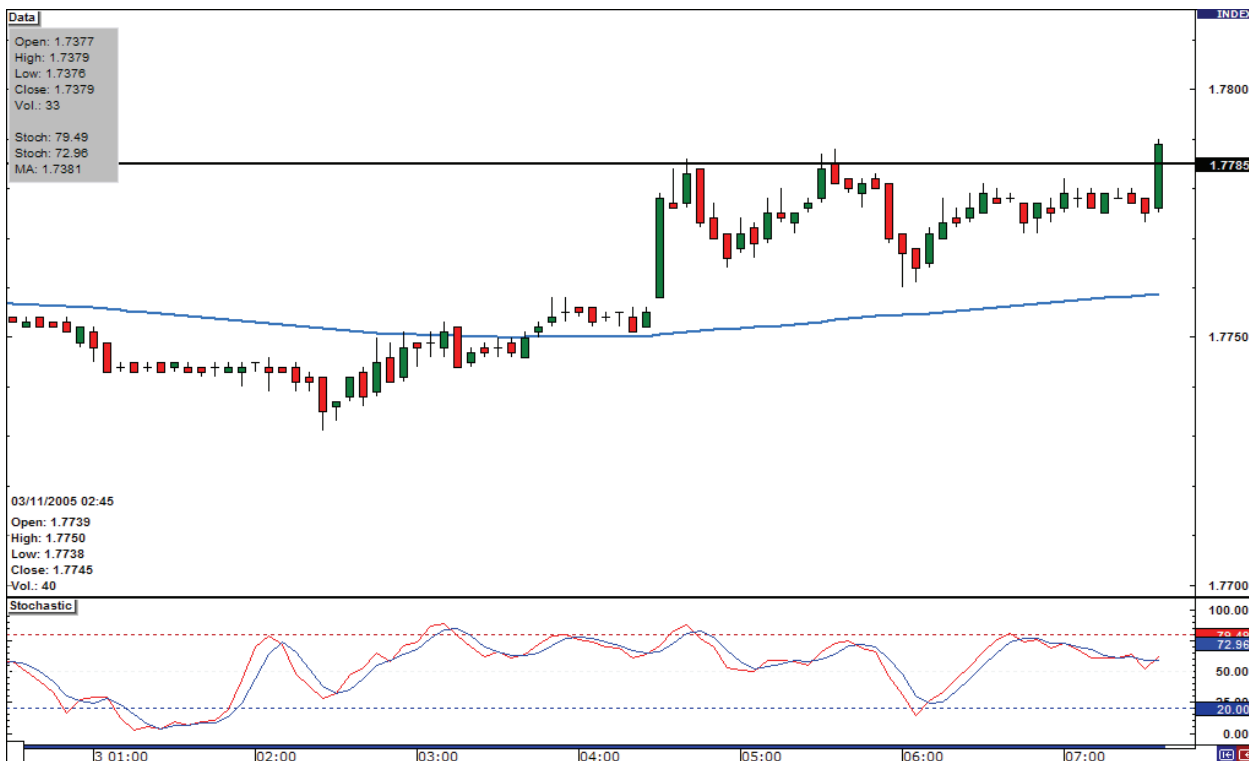
Trading Using Multiple Timeframes

If you have ever looked at chart on different timeframes, you probably noticed that markets can move in different directions at the same time. A moving average may rise on a weekly chart, giving a buy signal, but fall on a daily chart, giving a sell signal. It may rally on an hourly chart, telling us to go long, but sink on a 10 minute chart, telling us to short. What the hell is going on?

Let's play a quick game called "Long or Short". The rules of the game are easy. You look at a chart and you decide whether to go long or short. Easy. Okay ready?

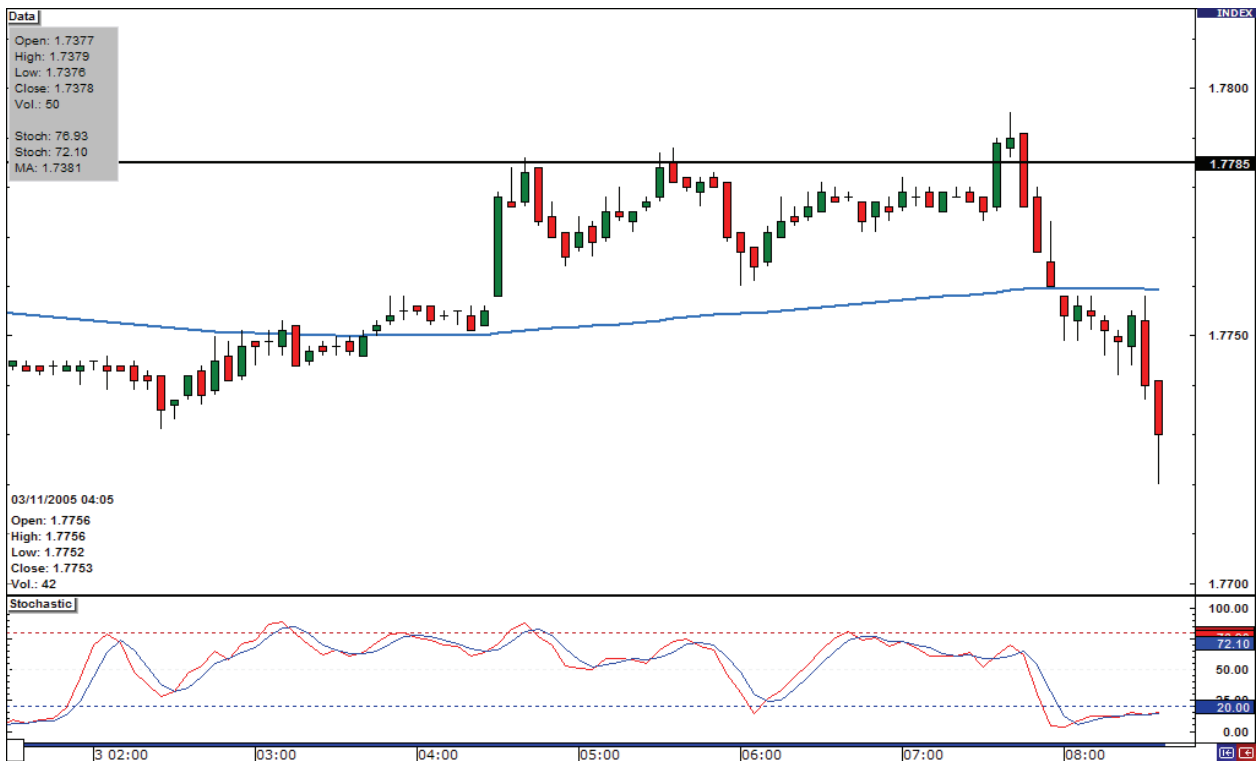
5 Minute Chart

Let's take a look at a EUR/USD 5-minute chart on 11/03/05 around 4 am EST. Oooh it's so nice. It's trading above its 100 simple moving average which is bullish and look! It just broke out and closed above its previous resistance! Perfect time to go long right? I'll take that as a yes.



Oh! You are WRONG! Look what happens next! It's goes up a little bit but then drops like rock. Oh too bad.

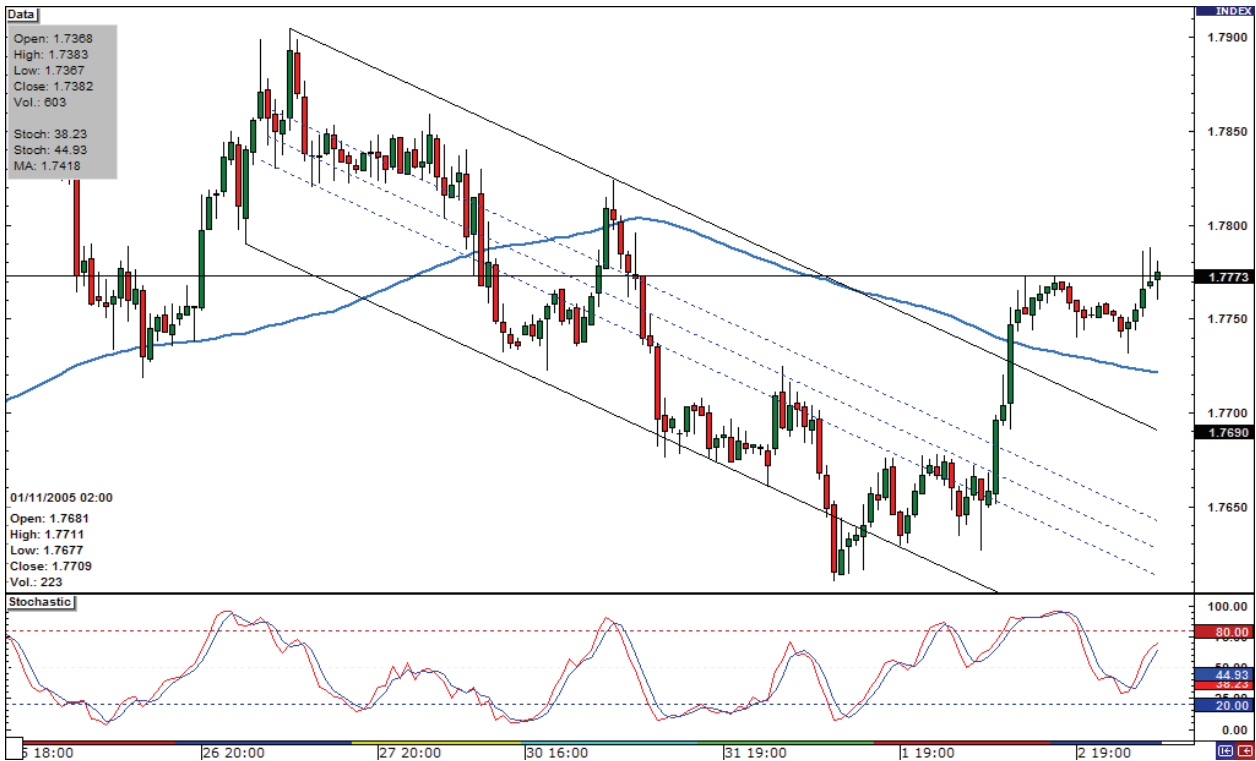




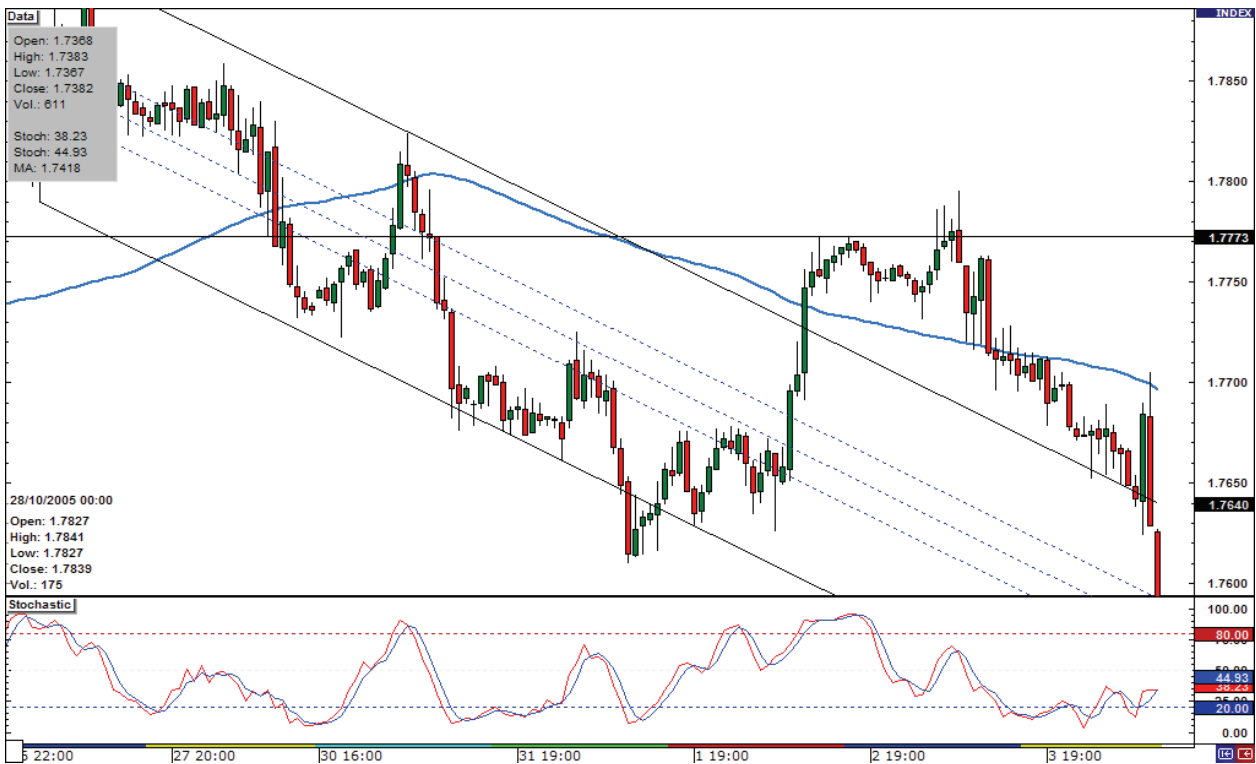
60 Minute Chart

Let's look at the same exact chart on a higher timeframe. It's the same date, 11/03/05 and the same time, around 4 am EST.

Holy cow! The pair broke out of its down channel which is bullish. It's trading above its 100 simple moving average which is bullish. The last candle broke and closed above its previous resistance which is bullish. Looks like a bull, smells like a bull. Nothing but up from here right? You say long.



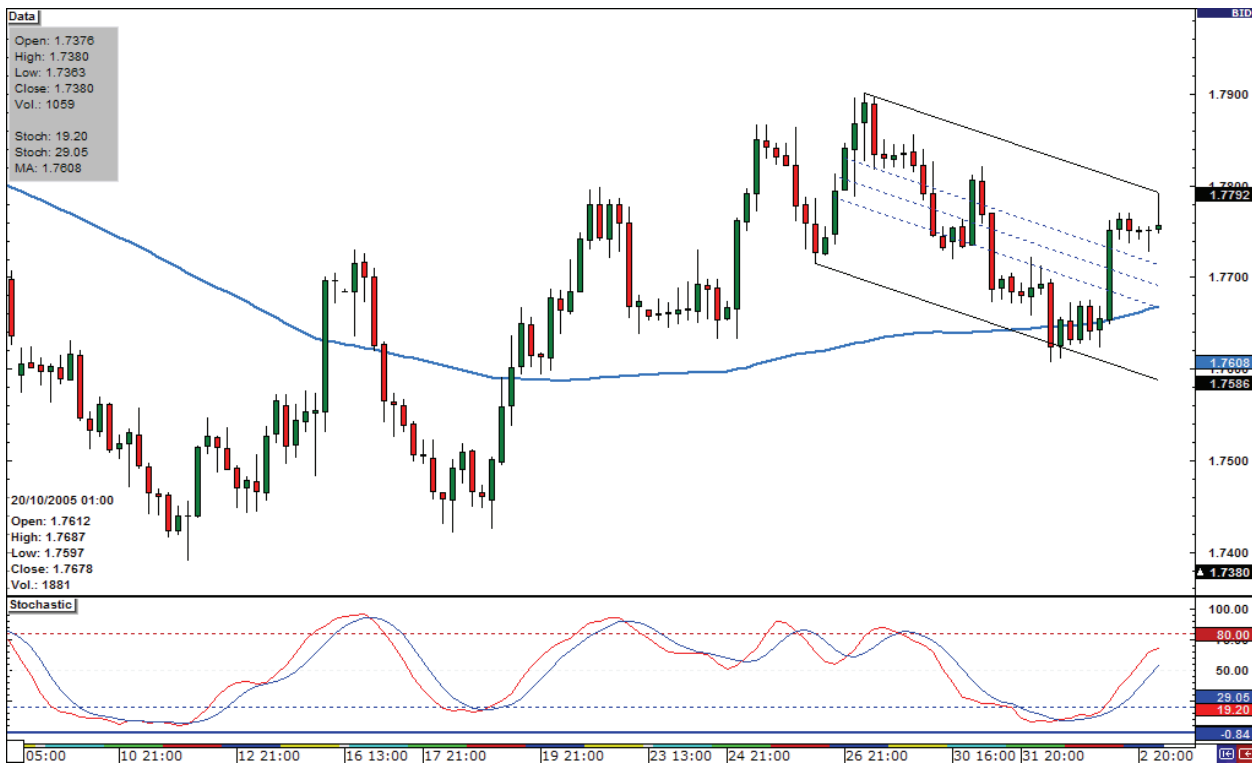
OOOHHHHH! Zero for two! How do you like your steak cooked? Because from the looks of this chart...the bull got slaughtered. The pair even dropped back into its old down channel. Look at that last candle, it was dropping so much, it couldn't even stay inside my chart! Amazing!



4 Hour Chart

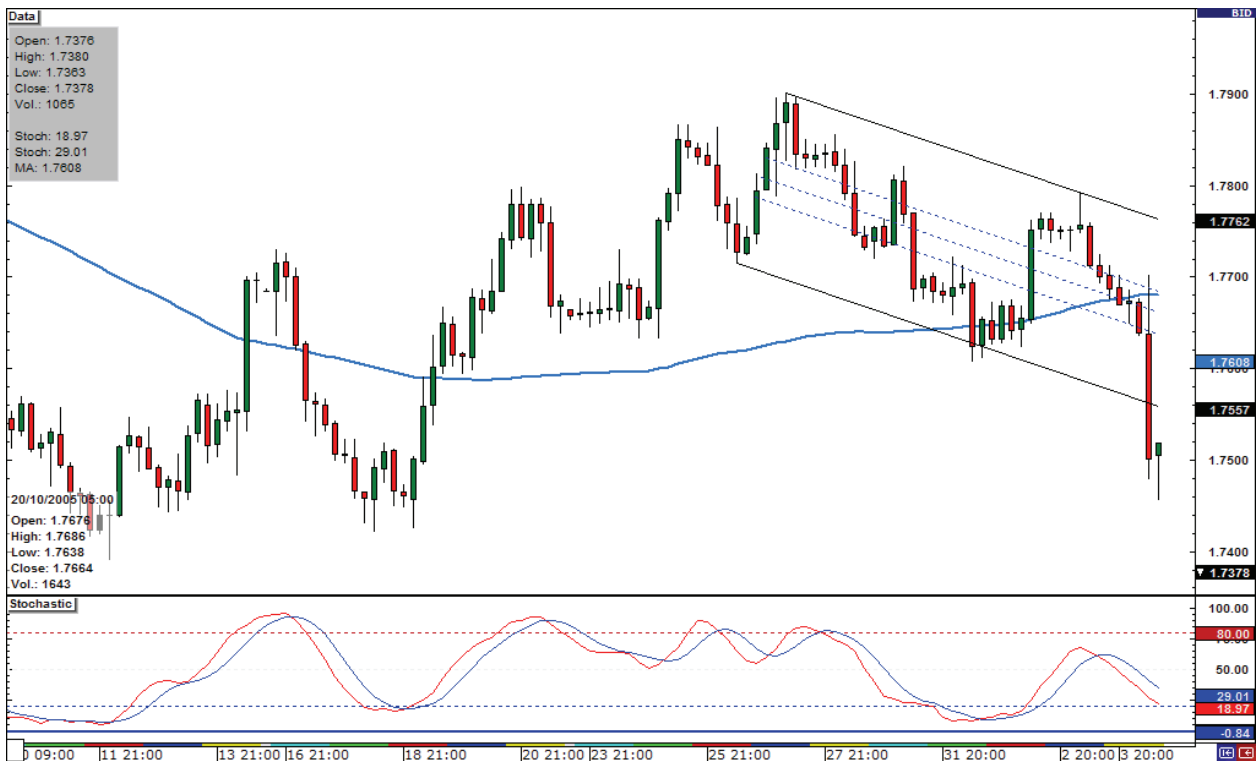
Okay, we've now moved up to an even higher timeframe chart. A 4-hour chart. It's still the same date and time, just a higher timeframe. If you had looked at this chart first, would you still have been quick to go long on either the 5-minute or 1-hour chart?

It's currently trading in a down channel which is bearish. The pair is hitting the upper trend line of the down channel which is extremely bearish. Yes, it's still trading above the 100 simple moving average which would count as bullish, but that channel would still make me cautious. Especially since it's trading around the upper trend line.



Look what happens! Droppin' like its hot! The pair stayed true to its channel. It hit the upper trend line and traveled down.





Daily Chart

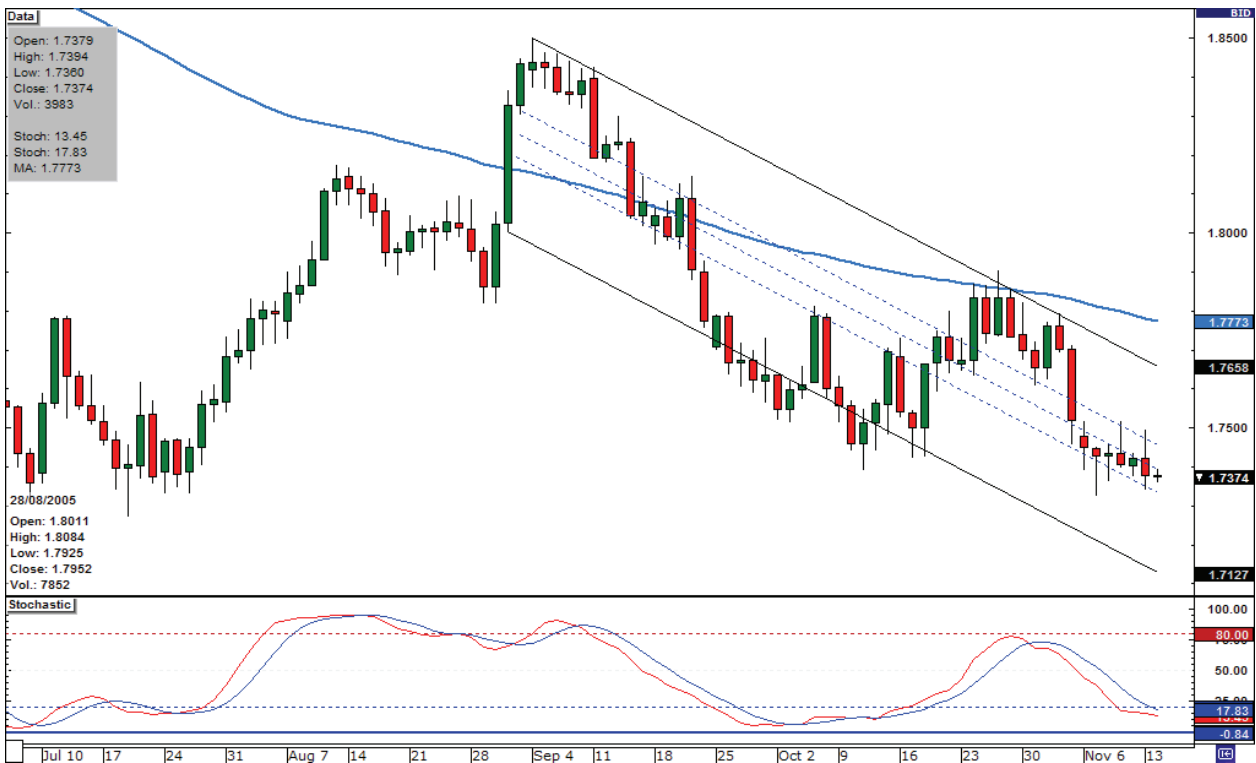
For fun's sake, let's go up one more timeframe to the daily chart.

Wow, will you look at that? The pair is trading in an obvious down trend. It's below its 100 simple moving average and its in a down channel. On this chart, the trend direction is so obvious! Do you also notice the last candle? It tested the upper trend line and reversed. Not a very good bullish sign.

Let's look at what happens next.



Hallelujah! The downtrend continues!



All of the charts were showing the same date and time. They were just different timeframes. Do you see now the importance of looking at multiple timeframes?



I used to just trade off 15-minute charts and that was it. I could never understand why when everything looked good the market would suddenly stall or reverse.

It never crossed my mind to take a look at a larger time frame to see what was happening. When the market did stall or reverse on my 15-minute chart, it was often because it had hit support or resistance on a larger time frame.

It took me a couple hundred bucks to learn that the larger the timeframe, the more important support and resistance levels were. Trading using multiple time frames has probably made me more money than any other one thing alone. It will allow you to stay in a trade longer because you're able to identify where you are relative to the big picture.

Most beginners look at only one timeframe. They grab a single timeframe, apply their indicators and ignore other timeframes. The problem is that a new trend, coming from another timeframe, often hurts traders who don't look at the big picture.

Take a broad look at what's happening. Don't try to get your face closer to the market, but push yourself further away.

Select your preferred timeframe and then go up to the next higher timeframe. There you make a strategic decision to go long or short based on the direction of the trend. You would then return to your preferred timeframe to make tactical decisions about where to enter and exit (place stop and profit target). Adding the dimension of time to your analysis gives you an edge over the other tunnel vision traders who only trade off on only one timeframe.

There is obviously a limit to how many timeframes you can study. You don't want a screen full of charts telling you different things. Use at least two, but not more than three timeframes because adding more will just confuse the geewillikers out of you and you'll suffer from paralysis analysis and go crazy.

We like to use three time frames. The largest time frame I consider my main trend, the next time frame down as my medium trend and the smallest time frame as the short-term trend.

You can use any time frame you like as long as there is enough time difference between them to see a difference in their movement. You might use:

- 1 minute, 5 minute, and 30 minute
- 5 minute, 30 minute, and 4 hour
- 15 minute, 1 hour, and 4 hour
- 1 hour, 4 hour, and daily
- 4 hour, daily, and weekly and so on.

When you're trying to decide how much time in between charts, just make sure there is enough difference for the smaller time frame to move back and forth without every move reflecting in the larger time frame. If the timeframes are too close, you won't be able to tell the difference which would be pretty useless.

Summary:

- You have to decide what the correct timeframe is for YOU.
- Once you've found your preferred timeframe, go up to the next higher timeframe. There you make a strategic decision to go long or short based on the direction of the trend. You would then return to your preferred timeframe to make tactical decisions about where to enter and exit (place stop and profit target).
- Adding the dimension of time to your analysis gives you an edge over the other tunnel vision traders who only trade off on only one timeframe.
- Make it a habit to look at multiple timeframes when trading.
- Choose a set of time frames that you are going to watch, and only concentrate on those time frames. Pick three time frames: 1hr, 4hr, daily; 5 min, 15min, 1hr, and so on. And only use those time frames. Learn all you can about how the market works during those time frames.
- Don't look at too many time frames, you'll be overloaded with too much information and your brain will explode.
- Stick to two or three timeframes, any more than that is overkill.
- I can't repeat this enough. Get a bird's eye view. Using multiple timeframes resolves contradictions between indicators and timeframes. Always begin your market analysis by stepping back from the markets and looking at the big picture.
- Use a long-term chart to find the trend, and then return closer to the market to make decisions about entries and exits.

“The secret of success in life is for a man to be ready
for his opportunity when it comes.”

Benjamin Disraeli



10th Grade: Elliott Wave Theory

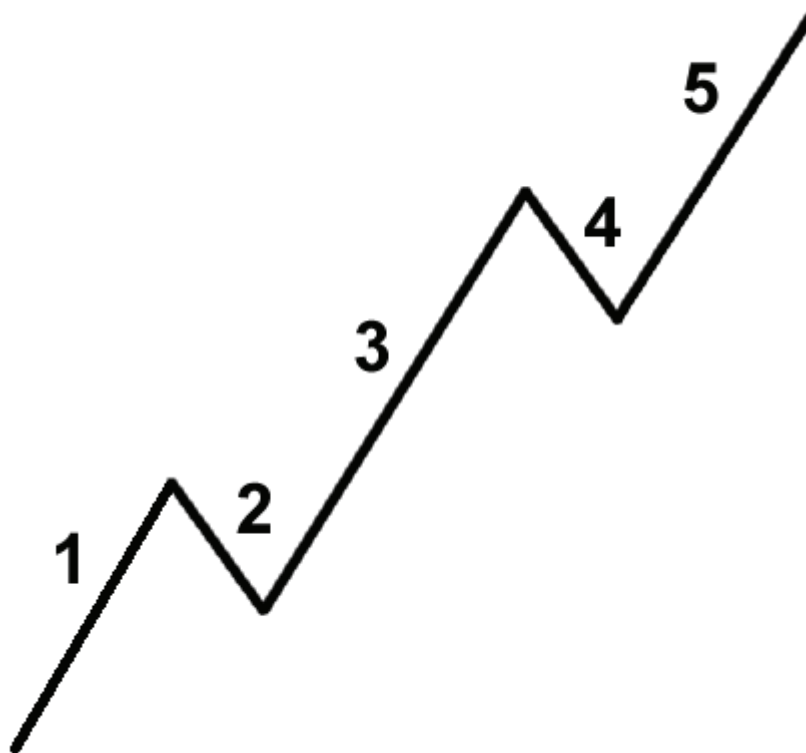
Back in the old school days during the 1920-30s, there was this mad genius named Ralph Nelson Elliott who discovered that stock markets, thought to behave in a somewhat chaotic manner, actually, did not.

They traded in repetitive cycles, which he pointed out were the emotions of investors and traders caused by outside influences (ahem, CNBC) or the predominant psychology of the masses at the time.

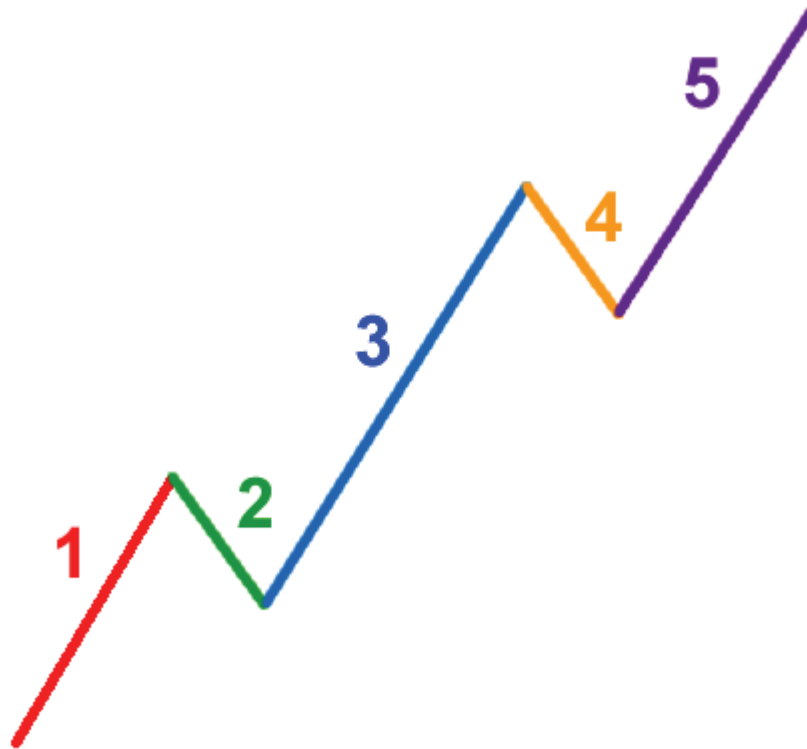
Elliott explained that the upward and downward swings of the mass psychology always showed up in the same repetitive patterns, which were then divided into patterns he called "waves". He needed to claim this observation and so came up with a super original name calling the Elliott Wave Theory.

The 5 – 3 Wave Patterns

Mr. Elliott showed that a trending market moves in what he calls a 5-3 wave pattern. The first 5-wave pattern are called **impulse waves** and the last 3-wave pattern are called **corrective waves**. Let's first take a look at the 5-wave impulse pattern. It's easier if you see it as a picture:



That still looks kind of confusing. Let's splash some color on this bad boy.



Ah magnifico! Me likes colors. It's so pretty! I've color-coded each wave along with its wave count. Here is a short description of what happens during each wave. I am going to use stocks for my example since stocks is what Mr. Elliott used but it really doesn't matter what it is. It can easily be currencies, bonds, gold, oil, or Tickle Me Elmo dolls. The important thing is the Elliott Wave Theory also works for forex.

Wave 1

The stock makes its initial move upwards. This is usually caused by a relatively small number of people that all of the sudden (for a variety of reasons real or imagined) feel that the previous price of the stock is a bargain and now it's worth buying, causing the price to go up.

Wave 2

The stock is considered overvalued. At this point enough people who were in the original wave consider the stock overvalued and take profits. This causes the stock to go down. However, the stock will not make it to its previous lows before the stock is considered cheap again.

Wave 3

This is usually the longest and strongest wave. More people have found out about the stock, more people want the stock and they buy it for a higher and higher price. This wave usually exceeds the tops created at the end of wave 1.

Wave 4

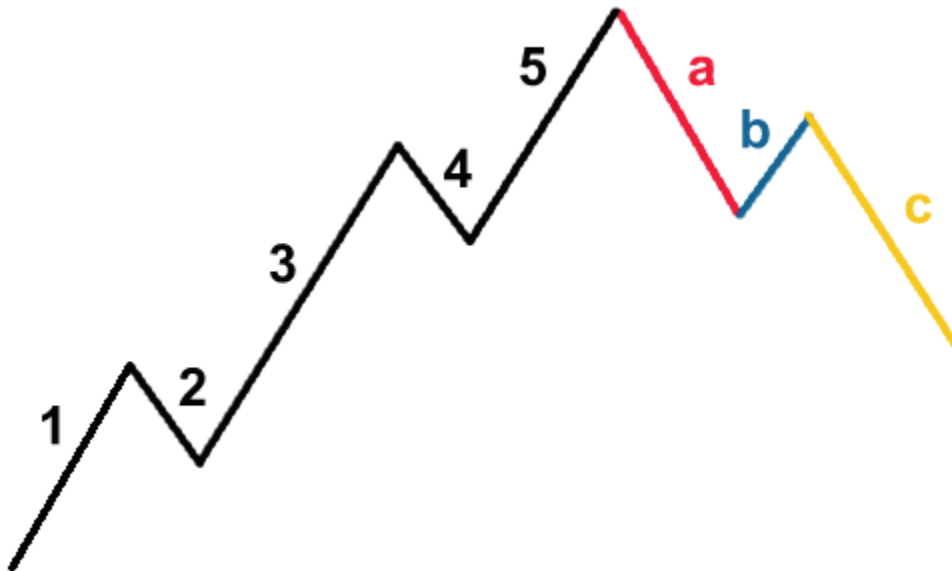
At this point people again take profits because the stock is again considered expensive. This wave tends to be weak because there are usually more people that are still bullish on the stock and after some profit taking comes wave 5.

Wave 5

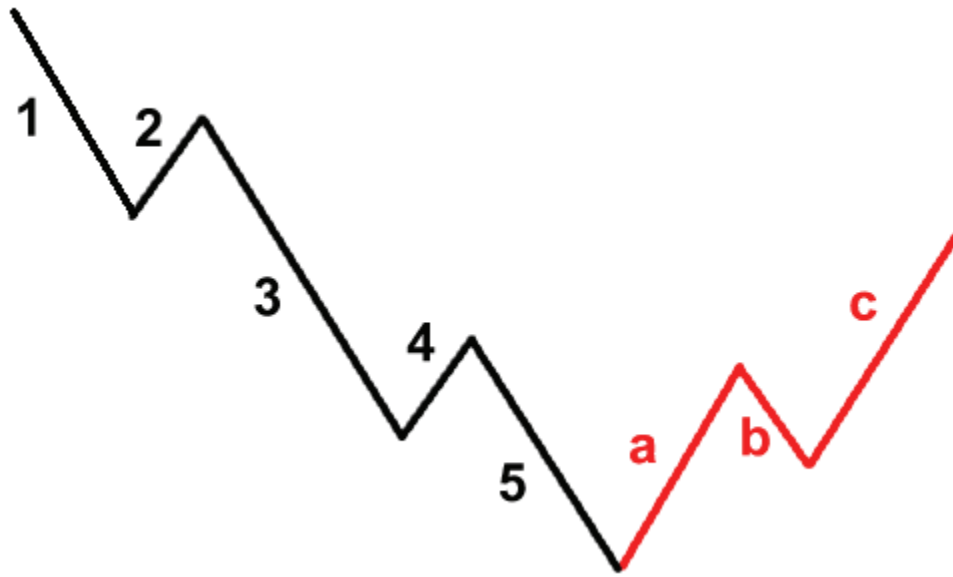
This is the point that most people get on the stock, and is most driven by hysteria. People will come up with lots of reasons to buy the stock, and won't listen to reasons not to. This is where the stock becomes the most overpriced. At this point contrarians will probably notice and start shorting the stock and move into an ABC pattern.

ABC Correction

The 5-wave trends are then corrected and reversed by 3-wave countertrends. Letters are used instead of numbers to track the correction. Check out this example of smokin' hot 3-wave corrective wave pattern!

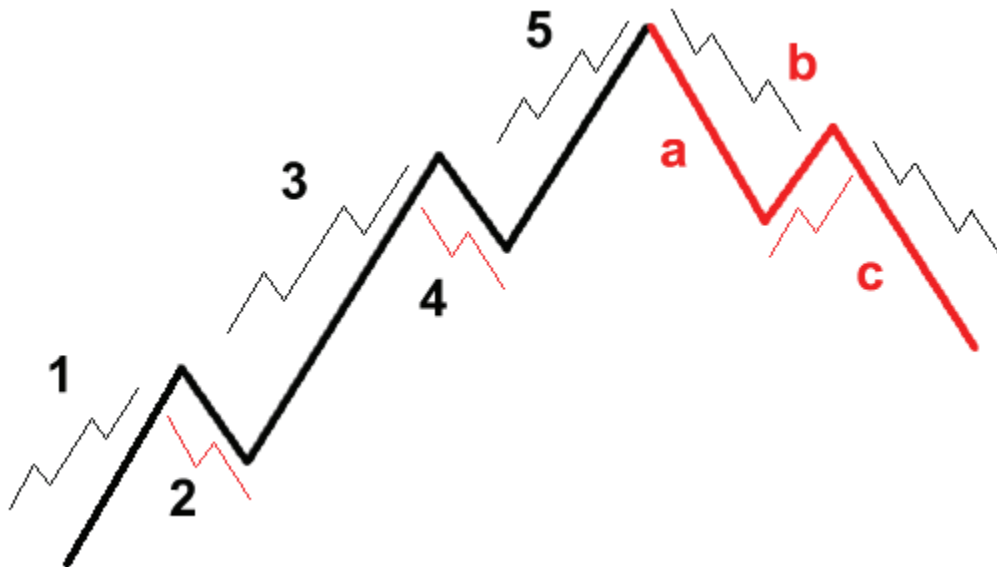


Just because I've been using a bull market as my primary example doesn't mean the Elliott Wave theory doesn't work on bear markets. The same 5 – 3 wave pattern can look like this:



Waves within a Wave

The other important thing you have to know about the Elliot Wave Theory is that a wave is made of sub-waves? Huh? Let me show you another picture. Pictures are great aren't they? Yee-haw!



Do you see how Wave 1 is made up of a smaller 5-wave impulse pattern and Wave 2 is made up of smaller 3-wave corrective pattern? Each wave is always comprised of smaller wave patterns.

Okay, let's look at a real example.



As you can, waves aren't shaped perfectly in real life. You'll also learn its sometimes difficult to label waves. But the more you stare at charts the better you'll get.

Okay, that's all you need to know about the Elliott Wave Theory. Remember the market moves in waves. Now when you hear somebody say "Wave 2 is complete." You'll know what the heck he is talking about.

If you wish to become an Elliott Wave Theory guru, you can learn more about it at www.elliottwave.com.

Summary:

- According to the Elliott Wave Theory, the market moves in repetitive patterns called waves.
- A trending market moves in a 5-3 wave pattern. The first 5-wave pattern are called impulse waves. The second 3-wave pattern are called corrective waves.
- If you look hard enough at a chart, you'll see that the market really does move in waves.

“Unless you're willing to have a go, fail miserably, and have another go, success won't happen.”

Phillip Adams

11th Grade: Create Your Own Trading System

Let's get into my favorite part of trading...creating your own trading system!

If you do a simple search in Google for "forex trading systems" you'll find many many many many many people out there who claim to have the "Holy Grail" system that you can purchase for "only" a few thousand dollars.

These systems supposedly make thousands of pips a week and *never* lose. They will show you supposed "results" of their perfect system and it will make your eyeballs turn into dollar signs as you sit there and say to yourself, "wow I can make all this money if I just give this guy \$3,000. Besides, if his system making thousands of pips a week, I'll be able to make my money back in no time."

Slowww down cowboy. There are some things you should know before you give them your credit card number and make that impulse buy.

The truth is that many of these systems DO in fact work. The problem is that traders lack the discipline to follow the rules that go along with the system.

The second truth (there's such thing as a second truth?) is that instead of paying thousands of dollars to buy a system, you can spend your time developing your own system for free, and use that money you were going to spend as capital for your trading account.

The third truth is that creating systems is not even that difficult. What *is* difficult is following the rules that you set when you do develop your system.

There are many articles that sell systems, but I haven't seen any that **teach** you how to create your own system. This lesson will guide you through the steps you need to take to develop a system that is right for you. At the end of the lesson, I will give you an example of a system that I trade just so I can show you how awesome I am! (Insert evil laugh here.)

Goals of your trading system

I know you're saying, "DUH, my goal of my trading system is to make a billion dollars!" While that is a wonderful goal, it's not exactly the kind of goal that will make you a successful trader.

When developing your system, you want to achieve 2 very important goals:

1. Your system should be able to identify trends as early as possible.
2. Your system should be able to avoid you from whipsaws.

If you can accomplish those two things with your trading system, I GUARANTEE you will be successful. The hard part about those goals is that they contradict each other. If you have a system in which its sole purpose is to catch trends early, then you will probably get faked out many times.

On the other hand, if you have a system in which its sole purpose is to avoid whipsaws, then you will be late on many trades and will also probably miss out on a lot of trades.

Your task, when developing your system, is to find a compromise between the two goals. Find a way to identify trends early, but also find ways that will help you distinguish the fake signals from the real ones.

Always remember these two goals when you create your system. They will make you a lot of money!

The 6 Steps to Setting Up Your System

The main focus of this article is to guide you through the process of developing your system. While it doesn't take long to come up with a system, it does take some time to extensively test it. So be patient; in the long run, a good system can and will make you a lot of money.

Step 1: Time Frame

The first thing you need to decide when creating your system is what kind of trader you are. Are you a day trader or a swing trader? Do you like looking at charts every day, every week, every month, or even every year? How long do you want to hold on to your positions?

This will help determine which time frame you will use to trade. Even though you will still look at multiple time frames (go back to 7th grade if you forgot), this will be the main time frame you will use when looking for a trade signal.

Step 2: Find indicators that help identify a new trend.

Since one of our goals is to identify trends as early as possible, we should use indicators that can accomplish this. Moving averages are one of the most popular indicators that traders use to help them identify a trend. Specifically, they will use 2 moving averages (one slow and one fast) and wait until the fast one crosses over or under the slow one. This is the basis for what's known as a "moving average crossover" system.

In its simplest form, moving average crossovers are the fastest ways to identify new trends. It is also the easiest way to spot a new trend.

Of course there are many other ways traders' spot trends, but moving averages are one of the easiest to use.

Step 3: Find indicators that help CONFIRM the trend.

Our second goal for our system is to have the ability to avoid whipsaws, meaning that we don't want to be caught in a "false" trend. The way we do this is by making sure that when we see a signal for a new trend, we can confirm it by using other indicators.

There are many good indicators for confirming trends, but I really like MACD, Stochastics, and RSI. As you become more familiar with various indicators, you will find ones that you prefer over others, and can incorporate those into your system.

Step 4: Define Your Risk

When developing your system, it is very important that you define how much you are willing to lose on each trade. Not many people like to talk about losing, but in actuality, a good trader thinks about what they could potentially lose BEFORE thinking about how much they can win.

The amount you are willing to lose will be different than everyone else. You have to decide how much room is enough to give your trade some breathing space, but at the same time, not risk too much on one trade. You'll learn more about money management in a later lesson. Money management plays a big role in how much you should risk in a single trade.

Step 5: Define Entries & Exits

Once you define how much you are willing to lose on a trade, your next step is to find out where you will enter and exit a trade in order to get the most profit.

Some people like to enter as soon as all of their indicators match up and give a good signal, even if the candle hasn't closed. Others like to wait until the close of the candle.

In my experience, I have found that it is best to wait until a candle closes before entering. I have been in many situations where I will be in the middle of a candle and all my indicators match up, only to find that by the close of the candle, the trade has totally reversed on me!

It's all really just a matter of trading style. Some people are more aggressive than others and you will eventually find out what kind of trader you are.

For exits, you have a few different options. One way is to trail your stop, meaning that if the price moves in your favor by 'X' amount, you move your stop by 'X' amount.

Another way to exit is to have a set target, and exit when the price hits that target. How you calculate your target is up to you. Some people choose support and resistance levels as their targets. Others just choose to go for the same amount of pips on every trade. However you decide to calculate your target, just make sure you stick with it. Never exit early no matter what happens. Stick to your system! After all, YOU developed it!

One more way you can exit is to have a set of criteria that, when met, would signal you to exit. For example, you could make it a rule that if your indicators happen to reverse to a certain level, you would then exit out of the trade.

Step 6: Write down your system rules and FOLLOW IT!

This is the most important step of creating your trading system. You **MUST** write your trading system rules down and **ALWAYS** follow it. Discipline is one of the most important characteristics a trader must have, so you must always remember to stick to your system! No system will ever work for you if you don't stick to the rules, so remember to be disciplined. Oh yea, did I mention you should **ALWAYS** stick to your rules?

How to Test Your System

The fastest way to test your system is to find a charting software package where you can go back in time and move the chart forward one candle at a time. When you move your chart forward one candle at a time, you can follow your trading system rules and take your trades accordingly. Record your trading record, and **BE HONEST** with yourself! Record your wins, losses, average win, and average loss. If you are happy with your results then you can go on to the next stage of testing: trading live on a demo account.

Trade your new system live on a demo account for at least two months. This will give you a feel for how you can trade your system when the market is moving. Trust me, it is a lot different trading live than when you're back-testing.

After two months of trading live on a demo account, you will see if your system can truly stand its ground in the market. If you are still getting good results, then you can choose to trade your system live on a **REAL** account. At this point, you should feel very confident with your system and feel comfortable taking trades with no hesitation. At this point, **YOU'VE MADE IT!**

My “So Easy It’s Ridiculous” System

In this section I will give you an idea of what a trading system should look like. This should give you an idea of what you should be looking for when you develop your system.

Trading Setup

- Trade on daily chart (swing trading)
- 5 EMA applied to the close
- 10 EMA applied to the close
- Stochastic (10,3,3)
- RSI (14)

Trading Rules

1. Stop Loss = 30 pips

2. Entry Rules

1. Enter long if:

- The 5 EMA crosses above the 10 EMA and both stochastic lines are heading up (do not enter if the stochastic lines are already in the overbought territory)
- RSI is greater than 50

2. Enter short if:

- The 5 EMA crosses below the 10 EMA and both stochastic lines are heading down AND (do not enter if the stochastic lines are already in oversold territory)
- RSI is less than 50

3. Exit Rules

- Exit when the 5 EMA crosses the 10 EMA in the opposite direction of your trade OR if RSI crosses back to 50

As you can see, we have all the components of a good trading system. First, we've decided that this is a swing trading system, and that we will trade on a daily chart. Next, we use moving averages to help us identify a new trend as early as possible.

The Stochastics help us determine if it's still ok for us to enter a trade after a moving average crossover, and it also helps us avoid oversold and overbought areas. The RSI is an extra confirmation tool that helps us determine the strength of our trend.

After figuring out our trade setup, we then determined our risk for each trade. For this system, we are willing to risk 30 pips on each trade. Usually, the higher the timeframe, the more pips you should be willing to risk because your gains will typically be larger than if you were to trade on a smaller timeframe.

Next, we clearly defined our entry and exit rules. At this point, we would begin the testing phase by starting with manual backtests.

Here are a couple of examples:



If we went back in time and looked at this chart, we would see that according to our system rules, this would be a good time to go long. To backtest, you would write down at what price you would've entered, your stop loss, and your exit strategy. Then you would move the chart one candle at a time to see how the trade unfolds.



In this particular case, you would've made a massive pip gain. You could've bought yourself something nice after this trade! You can see that when the moving averages cross in the opposite direction, it was a good time for us to exit. Of course, not all your trades will look this sexy. Some will look like ugly heifers, but you should always remember to stay disciplined and stick to your trading system rules.



In this example, we can see that our criteria is met and at this point we would enter short. Now we would record our entry price, our stop loss and exit strategy, and then move the chart forward one candle at a time to see what happens. I'll bet you a \$1000 that I'm right on this trade.



Well, isn't that amazing?! It just so happens that I'm right again! You can see that we would've stayed in this trade until the moving averages crossed again and RSI went back to 50.

I know you're probably thinking that this system is too simple to be profitable. Well the truth is that it is simple. You shouldn't be scared of something that's simple. In fact, there is an acronym that you will often see in the trading world called KISS. It stands for Keep It Simple Stupid!

It basically means that trading systems don't have to be complicated. You don't have to have a zillion indicators on your chart. In fact, keeping it simple will give you less of a headache.

The most important thing is discipline. I can't stress it enough. Well, yes I can. **YOU MUST ALWAYS STICK TO YOUR TRADING SYSTEM RULES!**

If you have tested your system thoroughly through backtesting and by trading it live on a demo for at least 2 months, then you should feel confident enough to know that as long as you follow your rules, you will end up profitable in the long run.

Trust your system and trust yourself!

Summary:

There are many systems out there that work, but many traders lack the discipline to follow the rules and as a result, still end up losing money.

Your trading system should attempt to accomplish 2 goals:

1. Be able to identify a trend as early as possible
2. Be able to find ways to avoid whipsaws (confirm your trend)

There are 6 steps to developing your system:

1. Find your timeframe
2. Find indicators to help you identify trends early
3. Find indicators to help you avoid whipsaws and confirm your trend
4. Define your risk
5. Define your entry and exit
6. Write your trading system rules down and ALWAYS stick to those rules!

There are 3 phases to testing your system:

1. Backtest- go back in time and move your chart forward one candle at a time. Trade your system according to its rules and record your trades to see if it ends up being profitable.
2. If it is profitable, then you trade your system live on a demo account for at least 2 months. This will help you get an idea of how you would trade your system when the market is moving. It is a lot different trading live than manually backtesting.
3. Once you've demo traded your system for at least 2 months and you are still profitable, you are then ready to trade your system live with real money. However, you must always remember to stick to your rules no matter what!

**“Make a decision to be successful right now.
Most people never decide to be wealthy and that is why
they retire poor.”**

Brian Tracy



12th Grade: Market Hours

So far, all the lessons we have taught you deal with “how” to trade the forex market. But another important lesson that you need to learn is “when” to trade the forex market.

Yes, it is true that the forex is open 24 hours a day, but that doesn't mean it's always active the whole day. You can make money in the forex when the market moves up, and you can even make money when the market moves down. However, you will have a very difficult time trying to make money when the market doesn't move at all. This lesson will help determine when the best times of the day are to trade.

Market Hours

Before looking at the best times to trade, we must look at what a 24hr. day in the forex world looks like. The forex can be broken up into three major trading sessions: the Tokyo Session, the London Session, and the U.S. Session. Below is a table of the open and close times for each session:

Market Hours		
Time Zone	EST	GMT
Tokyo Open	7 PM	0:00
Tokyo Close	4 AM	9:00
London Open	3 AM	8:00
London Close	12 PM	17:00
U.S. Open	8 AM	13:00
U.S. Close	5 PM	22:00

You can see that in between each session there is a period of time where two sessions are open at the same time. From 3-4 a.m. EST, both the Tokyo and London markets are open, and from 8-12 a.m. EST, both the London and U.S. markets are open. Naturally, these are the busiest times during the market because there is more volume when two markets are open at the same time.

Trading Sessions				
Session	EUR/USD	GBP/USD	USD/CHF	USD/JPY
Tokyo	66	79	100	66
London	80	99	121	74
U.S.	67	78	101	60

Average pip range of the 4 majors during each session

As you can see, the London session usually shows the most movement.

Best Days of the Week to Trade

Ok, so now we know that the London session is the busiest out of all the other sessions, but there are also certain days in the week where all the markets tend to show more movement. Below is a chart of average pip range for the 4 major pairs for each day of the week:

Trading Sessions				
Day of the week	EUR/USD	GBP/USD	USD/CHF	USD/JPY
Sunday	24	31	36	25
Monday	92	110	141	95
Tuesday	102	128	162	104
Wednesday	101	123	158	106
Thursday	83	98	121	77
Friday	80	96	117	72

Average pip range of the 4 majors for each day of the week

You can see that during the middle of the week is where the most movement is seen on all 4 major pairs.

So based on these three simple pieces, we've learned when the busiest times of the market are. These are the best times to trade because they give us a higher chance of success.

When to trade if you want to LOSE money

Here at Babypips.com, we don't like to force our opinions on you. Instead, we want you to make your own decisions when it comes to your own trading career. If you really do not want to trade during the busier times of the market where you will make money *easier*, then by all means, feel free to trade on these times mentioned below. We guarantee you'll have a more **difficult** time trading!

- **Fridays:** Fridays are very unpredictable. This is a good day to trade if you want to lose all the profit you made during the rest of the week.
- **Sundays:** There is very little movement on these days. Trade this day if you want to start off your week with NEGATIVE pips.
- **Holidays:** Banks are closed which means very little volume for whatever country is having the holiday. Holidays are great to trade when you would rather lose your money than take a day off and enjoy the other finer things in life.
- **News Reports:** No one really knows where the price will go when a news report comes out. It's true that news reports will affect the long term trend of the price, but as far as short term goes, currencies tend to pull surprises no matter what the news report stated. You should only trade these events if you are a psychic and are always right when predicting the future. And by the way, if you ARE a psychic, call me up because I could use your talents!

What to do if you can't trade during the busy market hours

If you live in a crappy time zone or you have a day job, then you probably can't sit in front of a computer during the busy market hours. If this describes you, then I have a few solutions for you:

1. Move to a better time zone (Move to London preferably. Sure you'd have to pack up and start a whole new life, but hey, at least you can trade right?)
2. Trade at work (be sure you have some "real" work ready just in case your boss sneaks up behind you and asks what you're working on)
3. Become a swing trader- As a swing trader you won't have to constantly watch the markets and you can check on look at them when you get off of work.
4. Trade a different session even if it's not the busiest one- If you can't trade the London or U.S. session, then trade the Tokyo session. However, you should be disciplined and trade it everyday. You will start to learn how it moves and can develop strategies that are specific to that session.

Personally, I think 3 and 4 are your best options, but again, the choice is up to you. Even if you can't trade, it's good to watch the charts for a full session. By getting use to seeing the price movement in action, you can actually see the real story of the currency. Trust me, watching the charts live is very different then looking at past charts.

Even if you can't actually trade the market, make mental notes of when you would take trades while you're watching the charts live. Practice makes perfect, and the more you do it, the better you'll get at it.

The Choice Is Yours

There you have it! We've given you all the information you need regarding when the best times to trade are. All you have to do now is decide whether or not you would rather trade when it's easier to make money, or if you'd rather do it the hard way.

THE CHOICE IS YOURS!

Summary:

Busiest/Best times to trade:

- When 2 sessions are overlapping: 3-4am EST and 8am-12pm EST
- The London session is the busiest out of the other two.
- The middle of the week typically shows the most movement.

Worst times to trade:

- Fridays
- Sundays
- Holidays
- News Events
- During Desperate Housewives episode

“The successful warrior is the average man,
with laser-like focus.”

Bruce Lee



13th Grade: Money Management

This section is one of the most important sections you will ever read about trading.

Why is it important? Well, we are in the business of making money, and in order to make money we have to learn how to manage it. Ironically, this is one of the most overlooked areas in trading. Many traders are just anxious to get right into trading with no regards to their total account size. They simply determine how much they can stomach to lose in a single trade and hit the “trade” button. There’s a term for this type of investing....it’s called GAMBLING!

When you trade without money management rules, you are in fact gambling. You are not looking at the long term return on your investment. Instead you are only looking for that “jackpot”. Money management rules will not only protect us, but they will make us very profitable in the long run. If you don’t believe me, and you think that “gambling” is the way to get rich, then consider this example: People go to Las Vegas all the time to gamble their money in hopes to win a big jackpot, and in fact, many people *do* win. So how in the world, are casino’s still making money if many individuals are winning jackpots? The answer is that while even though people win jackpots, in the long run, casino’s are still profitable because they rake in more money from the people that *don’t* win. That is where the term “the house always wins” comes from.

The truth is that casinos are just very rich statisticians. They know that in the long run, they will be the ones making the money—not the gamblers. Even if Joe Schmoe wins \$100,000 jackpot in a slot machine, the casinos know that there will be 100 more gamblers who *WON’T* win that jackpot and the money will go right back in their pockets. This is a classic example of how statisticians make money over gamblers. Even though both lose money, the statistician, or casino in this case, knows how to control their losses. Essentially, this is how money management works. If you learn how to control your losses you will be profitable.

You want to be the rich statistician...NOT the gambler because in the long run, you want to “always be the winner.”

Drawdown and Maximum Drawdown?

So we know that money management will make us money in the long run, but now I’d like to show you the other side of things. What would happen if you didn’t use money management rules? Consider this example:

Let’s say you have a \$100,000 and you lose \$50,000. What percentage of your account have you lost? The answer is 50%. Simple enough. Now, what percentage of that \$50,000 do you have to make in order to get back to your original \$100,000? It’s not 50%--you’d have to make back 100% of your \$50,000 to get back to your original \$100,000. This is called drawdown. For this example, we would’ve had a 50% drawdown.

The point of that little illustration is that it is very easy to lose money and a lot harder to make it back. I know you're saying to yourself, "I'm not going to lose 50% of my account in one trade." Well I would certainly hope not! However, what if you lost 3, 4, or even 10 trades in a row? That couldn't possibly happen to you, right? (*sarcasm used*) You have a trading system that wins 70% of the time, so there is NO way you could lose 10 trades in a row. (*even more sarcasm used*) Well while you may have a good system, consider this example:

In trading, we are always looking for an edge. That is the whole reason why traders develop systems. A trading system that is 70% profitable sounds like a very good edge to have. But just because your trading system is 70% profitable, does that mean for every 100 trades you make, you will win 7 out of every 10?

Not necessarily! How do you know which 70 out of those 100 trades will be winners? The answer is that you don't. You could lose the first 30 trades in a row and win the remaining 70. That would still give you a 70% profitable system, but you have to ask yourself, "Would you still be in the game if you lost 30 trades in a row?"

This is why money management is so important. No matter what system you use, you will eventually have a losing streak. Even professional poker players who make their living through poker go through horrible losing streaks, and yet they still end up profitable. The reason is that the good poker players practice money management because they know that they will not win every tournament they play. Instead, they only risk a small percentage of their total bankroll so that they can survive those losing streaks.

This is what you must do as a trader. Only risk a small percentage of your "trading bankroll" so that you can survive your losing streaks. Remember that if you practice strict money management rules, you will become the casino and in the long run, "you will always win."

Here is a little illustration that will show you the difference between risking a small percentage of your capital compared to risking a higher percentage.

Trade #	Total Account	2% risk on each trade	Trade #	Total Account	10% risk on each trade
1	\$20,000	\$400	1	\$20,000	\$2,000
2	\$19,600	\$392	2	\$18,000	\$1,800
3	\$19,208	\$384	3	\$16,200	\$1,620
4	\$18,824	\$376	4	\$14,580	\$1,458
5	\$18,447	\$369	5	\$13,122	\$1,312
6	\$18,078	\$362	6	\$11,810	\$1,181
7	\$17,717	\$354	7	\$10,629	\$1,063
8	\$17,363	\$347	8	\$9,566	\$957
9	\$17,015	\$340	9	\$8,609	\$861
10	\$16,675	\$333	10	\$7,748	\$775
11	\$16,341	\$327	11	\$6,974	\$697
12	\$16,015	\$320	12	\$6,276	\$628
13	\$15,694	\$314	13	\$5,649	\$565
14	\$15,380	\$308	14	\$5,084	\$508
15	\$15,073	\$301	15	\$4,575	\$458
16	\$14,771	\$295	16	\$4,118	\$412
17	\$14,476	\$290	17	\$3,706	\$371
18	\$14,186	\$284	18	\$3,335	\$334
19	\$13,903	\$278	19	\$3,002	\$300

You can see that there is a big difference between risking 2% of your account compared to risking 10% of your account on a single trade. If you happened to go through a losing streak and lost only 19 trades in a row, you would've went from starting with \$20,000 to having only \$3,002 left if you risked 10% on each trade. You would've lost over 85% of your account! If you risked only 2% you would've still had \$13,903 which is only a 30% loss of your total account.

Of course, the last thing we want to do is lose 19 trades in a row, but even if you only lost 5 trades in a row, look at the difference between risking 2% and 10%. If you risked 2% you would still have \$18,447. If you risked 10% you would only have \$13,122. That's less than what you would've had even if you lost all 19 trades and risked only 2% of your account!

The point of this illustration is that you want to setup your money management rules so that when you do have a drawdown period (losing streak) you will still have enough capital to stay in the game. Can you imagine if you lost 85% of your account? You would have to make 566% on what you are left with in order to get back to breakeven. Trust me, you do NOT want to be in that position. In fact, here is a chart that will illustrate what percentage you would have to make to breakeven if you were to lose a certain percentage of your account.

Loss of Capital	% required to get back to breakeven
10%	11%
20%	25%
30%	43%
40%	67%
50%	100%
60%	150%
70%	233%
80%	400%
90%	900%

You can see that the more you lose, the harder it is to make it back to your original account size. This is all the more reason that you should do everything you can to protect your account. So by now, I hope you have gotten it drilled in your head that you should only risk a small percentage of your account in each trade so that you can survive your losing streaks and also to avoid a large drawdown in your account. Remember, you want to be the casino...NOT the gambler!

Risk to Reward

Another way you can increase your chances of profitability is to trade when you have the potential to make 3 times more than you are risking. If you give yourself a 3:1 risk/reward ratio, you have a significantly greater chance of ending up profitable in the long run. Take a look at this chart as an example:

10 trades	Loss	Win
1	\$1,000	
2		\$3,000
3	\$1,000	
4		\$3,000
5	\$1,000	
6		\$3,000
7	\$1,000	
8		\$3,000
9	\$1,000	
10		<u>\$3,000</u>
Total	\$5,000	\$15,000

In this example, you can see that even if you only won 50% of your trades, you would still make a profit of \$10,000. Just remember that whenever you trade with a good risk to reward ratio, your chances of being profitable are much greater even if you have a lower win percentage.

Summary:

- **Be the casino, not the gambler!** Remember, casinos are just very rich statisticians!
- Drawdown is a reality and WILL happen to you at some point. The less you risk in a trade, the less your maximum drawdown will be.
- The more you lose in your account, the harder it is to make it back to breakeven.
- Trade only a small percentage of your account. The smaller the better. 3% or less is recommended.
- It is desirable to trade when you have a high risk to reward ratio. The higher the ratio, the less you have to be right.

“Formal education will make you a living.
Self-education will make you a fortune.”

James Rohn



14th Grade: Plan Your Trade and Trade Your Plan

Uh oh! You've learned so much and have come so far in your education, and yet you're still haven't graduated high school. No, you're not dumb, BUT you didn't have a trading plan. My point is that you can fill your mind with plenty of information, but without a good trading plan and the discipline to stick to it, you will NEVER be profitable.

Think of your trading plan as your map to success. It will be a constant reminder of how you will make money in this market. Of course it's not required, and if you can make your living by trading without a plan, I will bow down and hail you as the Market Zeus of the Forex. So you CAN trade without a plan if you want, but before you make that decision, let me give you a few reasons WHY you should have one.

Why Have a Plan?

Reason 1: It keeps you in the right direction

Consistency is very important to have in your trading routine because it allows you to truly measure how successful you are as a trader. If you have a sound trading system but always break your rules, how can you ever really know how good your system really is? Your trading plan will keep you on target. Read it every day and stick to it.

Reason 2: Trading is a business and successful businesses ALWAYS have plans

I have never seen a successful business not start out with a plan. Do you honestly think Wal-mart was just created on a whim and then magically became successful? Or what about McDonalds? I'm sure almost anyone can make a better hamburger than McDonalds, but the difference between them and the individual is that they have a successful business plan that guides them to success. In the same way, you can relate the McDonald's story to your trading career. Whether it's by luck or experience, everyone can make money in the forex. However, the difference between a losing trader and a successful trader is the PLAN. If you have a good trading plan and you are disciplined enough to stick to it, you will be successful!

What Should Be In Your Trading Plan?

Trading plans can be as simple or complex as you want it, but the most important thing is that you actually HAVE a plan. With that said, here are some of the essentials that every trading plan should have.

1. A trading system

This is the heart of your trading plan. This system should be one that you have thoroughly backtested, and have traded for at least two months on a demo account.

Include all the necessary information about your system such as: time frames you use, criteria for entries and exits, how much you risk during each trade, which currency pair(s) you trade and how many lots you trade.

Example: I am an intra-day trader and I trade off of the 10 minute charts. I enter when there is a moving average crossover and all my indicators support the direction. I only trade the EUR/USD and I risk no more than 2% of my account on each trade. For now, I trade 5 mini lots and will increase my lot size according to my 2% money management rules.

2. Your trading routine

This is a crucial part of your plan because it will determine three very important things: when you will analyze the market and plan your trades, when you will actually watch the market to take trades, and when you will evaluate your actions during your trading day.

3. Your mindset

Ask any trader out there and they will all tell you that one of the hardest things to do when trading is to take out your emotions from it. This section of your trading plan will describe what frame of mind you will be in when you are trading.

Example:

- I will see what is on the charts and not what I want to see.
- No matter how biased I am towards a direction, I will make sure to trade only what my eyes see and not what my feelings tell me.
- I will not get “revenge” on the market if I lose on a trade.
- I will not beat myself up if I make a losing trade. Instead I will take it as a learning experience and move on.

4. Your weaknesses

Yes, we all have our weaknesses. We just don't like talking about them. But ask yourself this, “How will you ever get better, if you don't admit to what you need to work on?” This section will be an objective way to keep track of things that you need to work on in order to become a better trader.



Example:

- I tend to overtrade. Whenever I lose on a position, I get upset and immediately try to get “revenge” on the market.
- I tend to exit early on trades.
- I don’t stick to the rules of my system every time
- I don’t stick to my money management rules every time

5. Your goals

“To make a lot of money” is not a good goal. Sit down and really think about what you want to accomplish as a trader. Do you want to trade for a living? How much return can you realistically expect from trading based on your knowledge and experience? Your goals don’t even have to be about making money. Maybe you would like to be more disciplined or gain more confidence. These goals can be personal. What do YOU want to get out of this? Use these goals as your motivation when times get tough. These goals will be your vision, and you must always keep your eyes on the prize!

6. Your trading journal

This will be a valuable tool to helping you become a better trader. Make sure you log all your trades and why you took them. Later down the road you can look back and evaluate your trades and see how you are progressing. I’ve looked back at my trade journal and have seen just how much I’ve grown as a trader. My first entries were very basic and as I’ve progressed, my trades make more sense to me now. I’ve gained a lot of confidence throughout my career and by looking back at my trades, I’ve really been able to evaluate myself and see if I am getting closer to my goals. This tool will help you tremendously in the long run, so take a few minutes each day and log your trades. You’ll be happy you did!

Summary:

Your trading plan will be your trading “bible”. Read it everyday and stick to it. You can have all the trading tools in the world, but if you don’t have a plan on how you will use them, you will never be successful. Remember, you are starting a business, and if you want your business to succeed, you need to have a PLAN!

“Plan your work and work your plan.”

A work planner and plan worker

