Scalping: Playing the lean

It's not about the charts, says this trader. Scalping requires an understanding of the order book rather than support and resistance levels.

BY JOHN GRADY

If you're a day trader who has always approached the market from a technical analysis perspective, you might want to contemplate spending a little less time looking at the charts and a little more time learning how to read the order book.

Major players tend to look at charts very infrequently. They're aware of major support and resistance, but once they've made a mental note of where these levels are, they stop looking at charts and start watching the bids and offers.

Contrary to popular belief, scalpers generally are not looking to capture the bid-ask spread. Although scalpers might take one tick if that's all they think they can get, they are typically shooting for anywhere from three to seven ticks, depending on current volatility. If the market is roaring in one direction, they will certainly take 15 or 20 ticks, rather than simply getting out just to take a profit. However, such moves are few and far between. In general, scalpers are looking to exit as soon as they feel the momentum has died.

The scalper does not use a trailing stop. If he is fairly certain a move is over and he's sitting in a six-tick winning trade, he sees no reason to risk three ticks to capture another unlikely three ticks. He will take his six-tick profit, move to the sidelines, and watch. If the move continues, he can always buy again. If it doesn't, he covered at the right price.

The following scalp strategy is based on the concept of "leaning" on bids and offers. It's a setup scalpers look for every day — a setup that can lead to the infamous false breakout.

One important aspect of this type of trading is that you must have access to a market-depth trading platform — that is, one that shows multiple levels of bids and offers — to execute any scalping

Strategy snapshot

Strategy:	Leaning on the bid/offer.
Strategy type:	Intraday/scalping.
Logic:	If traders keep selling into a bid just below a major resistance level (based on the order book, not just a chart) and the price refuses to "go offer," it's usually a good indication of strength — a sign someone is going to try to run that level. The opposite would be true for an offer that refuses to go bid just above a major support level.
Entry:	In the case of a long setup, attempt to enter just below or at the resistance level (no higher than a tick or two above). Reverse for a short setup.
Exit:	Within three to seven ticks, in normal volatility conditions.

strategy. If you're using an execution platform that only shows the inside bid and offer, you are operating at a huge disadvantage and you will probably never make money as a day trader.

Trading the lean

When entering with this strategy, you want to either go with the trend of the day or with a range breakout. For example, say the market has been fluctuating between 5 and 15 over the past hour and has slowly been narrowing toward 15. You are looking to buy the break through at 15 — as it occurs, not too long after the fact.

The longs tipped their hand before the break. No matter how many times sellers hit the 26.5 bid, the price wouldn't go offer.

For example, on the morning of Monday, Aug. 25, 2008, the U.S. 10-year T-note futures (TYU08) made a large spike up after the release of economic data (Figure 1). The market stopped at 116-27.5 (a clear resistance level on any chart) and quickly sold off to 116-24. After a few minutes, price started to grind back up again. When the market reached 116-26.5 bid, 116-27 ask, it stopped and traded at those two prices for a while.

FIGURE 1: INTRADAY T-NOTE

The analysis follows the price action in the 10-year T-note futures on Aug. 25, 2008. After an early-session run-up after an economic report release, the market settled into a tighter range.

Source: TradeStation

There were 1,700 contracts offered at 116-27.5 and it was obvious traders would be leaning on that price — which represented resistance not because it was a line on a chart but because of the large offer. In other words, shorts were hoping the offer at 27.5 would keep the market down and were using it as resistance.

In this situation, scalpers short at 26 or 27 are trying to limit their risk to two or three ticks. If it looks like 27.5 is going to go bid (i.e., become the current bid price), they will try to cover there. Scalpers who are looking to get long will also try to buy at 27.5 because they know

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T-note futures prices

Treasury futures prices indicate a percentage of "par" price, which for any Treasury bond or note is 100. T-bond prices consist of the "handle" (e.g., 100) and 32nds of 100. For example, 98-14 is a price that translates to 98-14/32nds or $984.38 for a $1,000 T-bond. T-notes (the market referenced in this article) are priced in a similar fashion, except they can include one-half of a 32nd — for example, 98-14+ is 98-14.5/32nds, or 984.53 in decimal form. For simplicity, the prices in this article leave off the "/32" at the end.

the shorts are leaning on that offer.

This is an ideal situation because it represents a spot where new money is buying and scared money is exiting. That combination is what causes sharp price moves in one direction.

In contrast, the average trader might be looking to make a trade once there is a breakout through 27.5. A scalper is not looking to buy or sell the breakout. He's looking to buy or sell before the breakout or catch the breakout itself.

In this situation, the longs tipped their hand before the break. No matter how many contracts were sold into 26.5, the price wouldn't go offer: *sell 500, stays 26.5 bid; sell 500 more, stays 26.5 bid; sell 300, stays 26.5 bid.* If traders keep selling into a bid and "they" keep buying and bidding that price, it's usually an indication of

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Order depth

The accompanying charts show snapshots of the 10-year T-note order book from Friday, Sept. 12, a day on which the market's momentum was to the downside. The middle columns show price levels (116030 represents 116-3/32, and so on). The blue columns to the left show bids; the red columns to the right show offers.

The market sold off sharply — 213 contracts traded at 116-01 and then heavy buying took place at 116-01.5 (6,828 traded). This buying stopped the sell-off and the market retraced back to 03. However, the retracement was short-lived and the market couldn't stay bid at 02.5 (notice the 10,381 contracts traded at this price); no matter how many bids hit into 02.5, the market would not go up.

Finally, the longs lost the battle. The 1,336 at 01.5 traded and the market went 01.5 offer (Figure B). Anyone leaning on that price was up the creek. The 01s got slammed and the market went straight to 115-31.

FIGURE A: SEPT. 12, BEFORE THE BREAKOUT

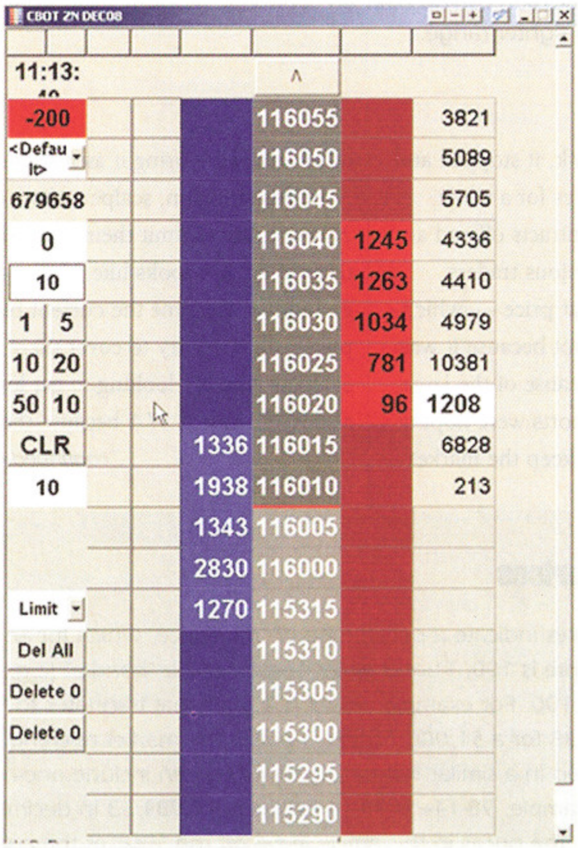
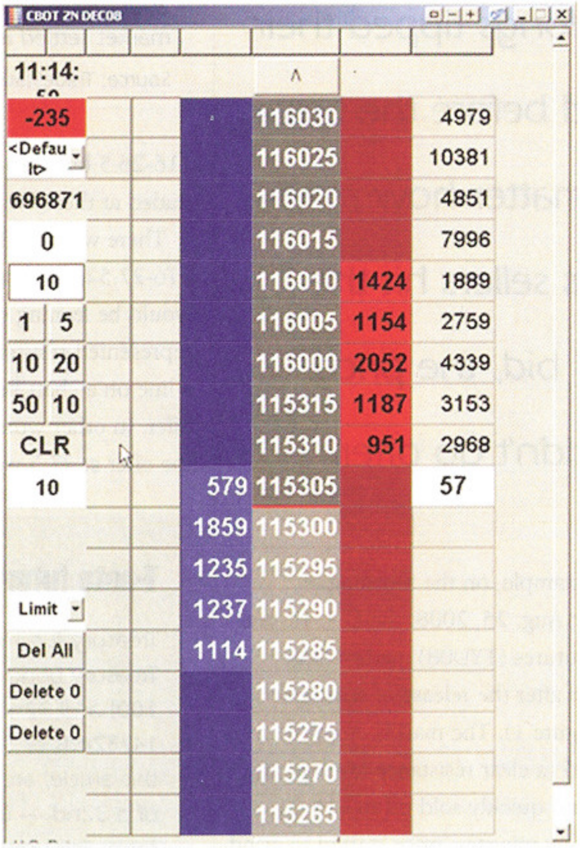


FIGURE B: SEPT. 12, AFTER THE BREAKOUT



Source: X Trader

serious strength. When this type of action takes place just below a major resistance level, it's probably a sign someone is going to try to run that level.

In this case, you want to buy at 26.5 or 27 or catch the break at 27.5 or 28 (maybe 28.5, tops). You don't want to buy at 29, 30, or 31 because this is where big money will exit. If someone was long 3,000 contracts going into that break, he is not looking for 10 ticks — he will try to cover on the immediate move up and will work offers between 29 and 31. Otherwise, if the market suddenly stops and he tries to dump 3,000 contracts, he could end up pushing the market against himself. Even if his selling doesn't stop the market, you don't want to buy when someone is dumping 3,000 contracts. You want to buy when everyone is buying — at 27.5.

The notion "Don't follow the herd" is nonsense. The saying *should* be "Follow the herd and make a sharp right just before you reach the edge of the cliff."

Following the herd is a great way to make money. The herd often includes major players who have access to millions of dollars and who buy and sell thousands of contracts or shares — traders who can actually move the market. You have to anticipate what the herd is going to do and then do it with them.

Of course, you don't want to follow the herd if it means you'll be the one holding the bag. This is why you shouldn't buy at 30 or 31. But you certainly don't want to be standing in front of a stampede; you don't want to sell at 27.5 or 28 in this situation. If you know traders are leaning on a price, don't join the offer in an attempt to keep the market down. You will lose that battle.

Flipping

This scenario also offers an opportunity for really big traders to hammer the shorts. It's quite possible the offer at 27.5 is not real — someone might be showing size with no intention of actually selling.

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The trader who is long 3,000 contracts at 26 might be the 1,700 offer at 27.5. When the market gets heavily bid at 27, he will pull his 1,700 offer and bid 2,000 at 27.5. This is called "flipping." In one instant, the player has transformed the immediate market from a bearish to a bullish condition. Traders who are unaware of such tactics will be in for a rude awakening.

However, no flipping has to take place for the shorts to get hammered. What often happens is someone with a lot of money buys everything in sight, which was what happened on Aug. 25.

There were 1,700 contracts offered at 27.5 and 2,000 offered at 28 — and they were all taken out at once. A huge trader just plowed through the market — bought 3,700 contracts and bid for 2,000 more at 28. No one even had a shot at 27.5 or 28. Shorts scrambled for the door and the market was instantly 29.5 bid, 30 offer.

How will you know if an offer is real or not? You won't. How will you know if someone is going to buy everything in sight? You won't. All you can do is look for the kind of action described at 26.5 (no matter how many contracts were sold into that bid, the market just wouldn't go down) and go long somewhere between 26.5 and 28.

No chasing

Although this was not one of those times, there are plenty of times you can catch the breakout as it's happening. If you miss the break and the market is suddenly trading 29.5 bid by 30 offer as it did this day, don't go long. If you miss it, you miss it. You can be sure the guy who bought 3,700 contracts at 27.5 and 28 already had offers at 29, 29.5, and 30 before he bought. His whole intention was to cause a sharp upward spike and cover as people panicked. Other longs who were waiting for that rally were also covering at those prices. This is why you see many "false" breakouts (as if there is such a thing), and why technical analysis kills many day traders.

On this day, the market touched

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116-31 and then dropped all the way back to 116-25. If you're long in a scenario like this, you want to cover when the big money is covering. If you're long at 27 and the market spikes up, under no circumstance should you let it come all the way back to you. You might not want to have an offer working at 29 as the market is pushing up, but if you see it touch 31 and sell off back to 29.5, then you want to get out at 29.

The technical trader who likes to buy support and sell resistance will short at 27.5, and if his risk-control rules call for a five-tick stop-loss and a 10-tick profit target, he'll exit the trade at 30 for a five-tick loss and curse profusely while watching the market fall right back to 25.

The technical trader who likes to play breakouts will buy at 30 with the idea that resistance should become support, so when the market falls back to 27 (below the initial resistance of 27.5) he will exit for a six- or seven-tick loss. He's cursing twice as much as the short trader because he doesn't understand why the breakout didn't work — and he has to watch as the market touches 25 and then trades all the way back up through 30.

Neither of these traders know what happened because they don't understand the mindset of scalpers.

Trading beyond the chart

Knowing where the numbers are is not the problem for most day traders. It takes a minute to look at a chart and make a note of major price levels. The problem for most day traders is that they do not know how to read the order book. Their decision to buy or sell a certain price is based upon nothing more than the fact the price is a "support" or "resistance" level on a chart.

A big scalper knows where the levels are, but because he knows how to read the volume in the order book, he also has a good feel for whether the level will hold or if a breakout will occur. Quite often, he is the volume. The average trader can only buy or sell maybe five or 10 futures contracts or a few hundred shares of stock. He cannot move markets.

If you want to make money day trading, you have to think like the traders who buy and sell thousands of contracts and shares. And if you want to know what they are thinking, you have to watch the bids and offers, not the charts.

For information on the author see p. 8.

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