Price-action lines are simple setups that work surprisingly well on a five-minute E-mini candlestick chart. With patience, practice and a flexible mindset, they can be a versatile tool for the discretionary day-trader.

Taking action in the E-mini

BY AL BROOKS

You learn a lot about what doesn't work day-trading the S&P market for two decades, but luckily, if you don't try to get too complex, you also can stumble upon a setup or two that work quite well. Once such technique is based on price action around easily identifiable support and resistance levels. Applied to a five-minute candle chart, it can identify reliable entry and exit points in E-mini S&P 500 futures.

At the heart of this strategy are price-action lines. This is a broad category of support and resistance identifiers that include trendlines, trend channel lines and regression lines.

This non systematic approach offers considerable flexibility for traders willing to take the time to learn its details and practice its application. This article will follow a typical trading day, broken down into a series of charts, to demonstrate how to use price-action lines for entries and exits.

BULL OR BEAR?

First, a bull or bear leg is identified with a trendline. For a bull leg, the trendline is drawn by connecting two significant lows with a straight line. This line is then usually extended up and to the right. For a bear leg, the trendline is drawn by connecting two significant highs.

Note that the trendline can be horizontal when drawn across the lows of a double bottom in a bull flag, for example.

The objective is to observe how the price acts on subsequent tests (touches, penetrations or approaches) of the trendline. In the case of a support line, if it bounces off the line, this is often a buy signal. If instead it collapses in a big range bar through the trendline and the bar closes near its low, the bull swing might be over.

However, this is generally unknown until more price action unfolds. It is possible that the market is creating a trend with a wider channel and a flatter slope. Such a scenario would require a new trendline and another period of observation.

Once it appears likely that the market is in a bull swing, start the trendline at the low of the bar that started the swing. For the second bar, look for the first bar that has a low below the low of the prior bar. This line becomes the first bull trendline drawn amid the new price action.

As time unfolds, this bull trendline should be redrawn. In most cases, each subsequent line typically has a flatter slope, but in a runaway bull swing, the trendlines can get steeper. It is common for there to be a higher low within a few bars of the start of the trend, and frequently you will have to switch to using this bar for the first bar of the bull trendline because it will result in a line with a flatter slope and will likely provide more reliable signals.

The first chart in "Getting started" (right) shows an example of a bull trendline drawn across the lows of bars "3" and "5" and then extended a few bars up and to the right until it is penetrated by bar "8." As a visual aid, it is helpful to use a thick line between the two bars that provide the high or low points and a thin line to indicate where the line was extended to the right.

CHANNELING PRICE

A trend channel line is a line drawn on the other side of the bars used to form the trendline. In a bull leg, the trendline connects the lows and the trend channel line is drawn across the highs. Usually, but not always in this case, it is parallel to the original trendline.

To create a trend channel line that is parallel to the trendline, draw the most logical trendline, create a parallel line, then drag it to the other side of the trend, creating a channel. Make sure the trend channel line is positioned so that it contains all of the other highs in the bars between those used to make the trendline. Often, the channel created by these two lines will contain the price action for many more bars. In a bull trend, the trendline is below the lows and the trend channel line is across the highs, while the opposite is true for a bear channel.

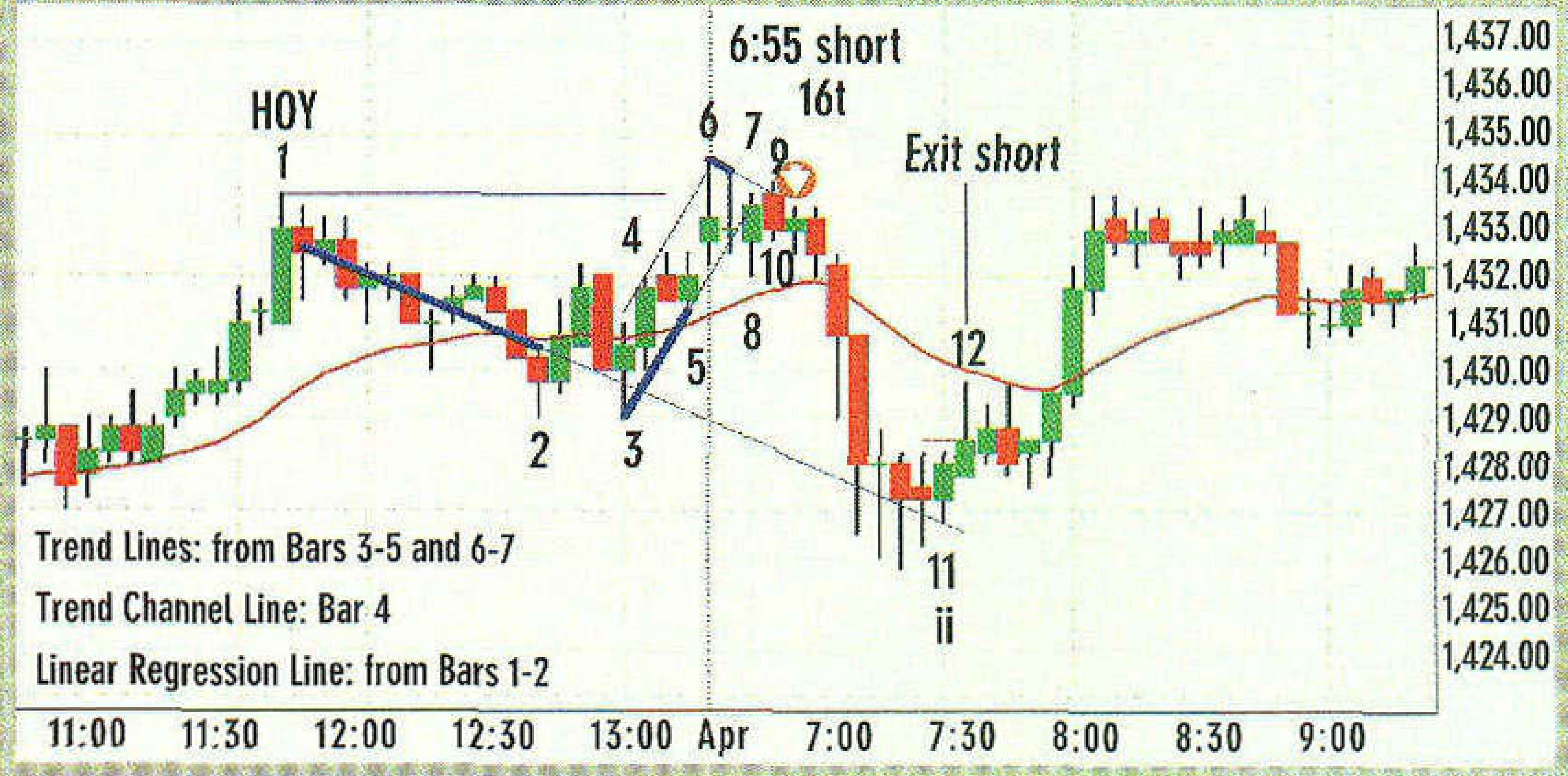
The first chart in "Getting started" shows an example of a trend channel line parallel to a trendline. It was dragged to the high of bar "4" so that it would be above all of the highs between bars "3" and "5," which are the starting and ending points of the trendline.

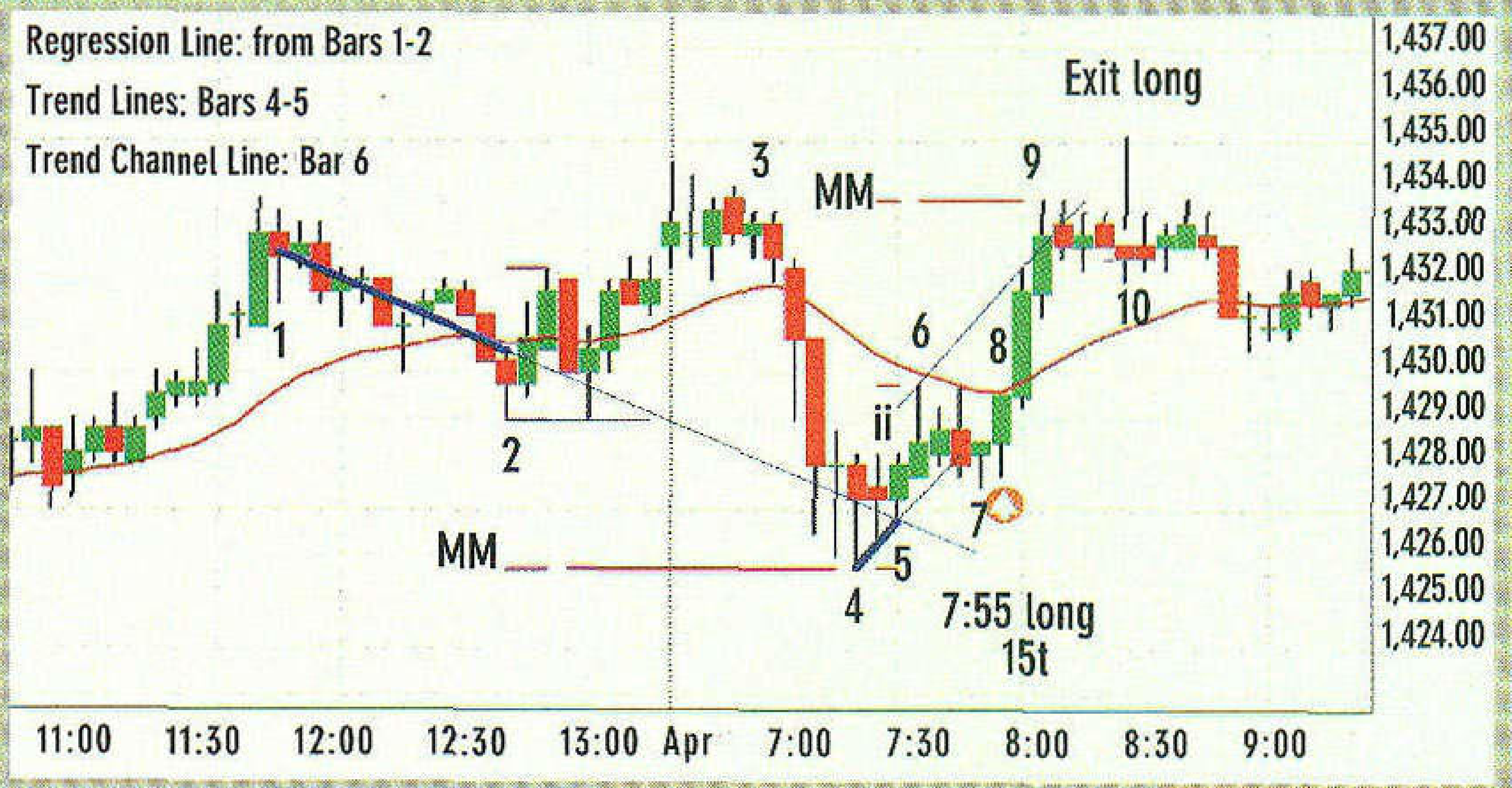
Sometimes, however, no good trendline is apparent, even though prices appear to be moving in a channel. In these cases, you can still draw a trend channel line by connecting significant highs in a bull leg and significant lows in a bear leg.

Note that this is opposite of trendlines, which are drawn using lows in a bull market and highs in a bear market. An example of this type of trend channel line is shown in the first chart in "Back in action" (page 43) between bar "2" and bar "5."

GETTING STARTED

The first chart below shows how a bull channel sets up a quick bear trade that ends after price bounces off the regression line drawn earlier in the chart and extended to the right. The second chart shows how a bullish trendline drawn almost immediately following the reversal and a trend channel line contain the price action for several more bars.





Source: Tradestation

Less frequently, a regression channel line will be the most useful line for monitoring price action. It's helpful during times when market action makes it appear that trendlines will be too steep for the market to ever reach them.

First, two points are needed. The first point is the first bar of the new swing. The second bar is the bar at end of the first leg of the new swing; however, this bar will change as the trend proceeds and the line will be redrawn. Typically, you will have the option to use several different prices, such as the open, high, low or close, to calculate the regression. A good choice is the midpoint of each bar.

After these lines are calculated and drawn, like the others, they should be extended to the right and price action should be monitored as it approaches these levels.

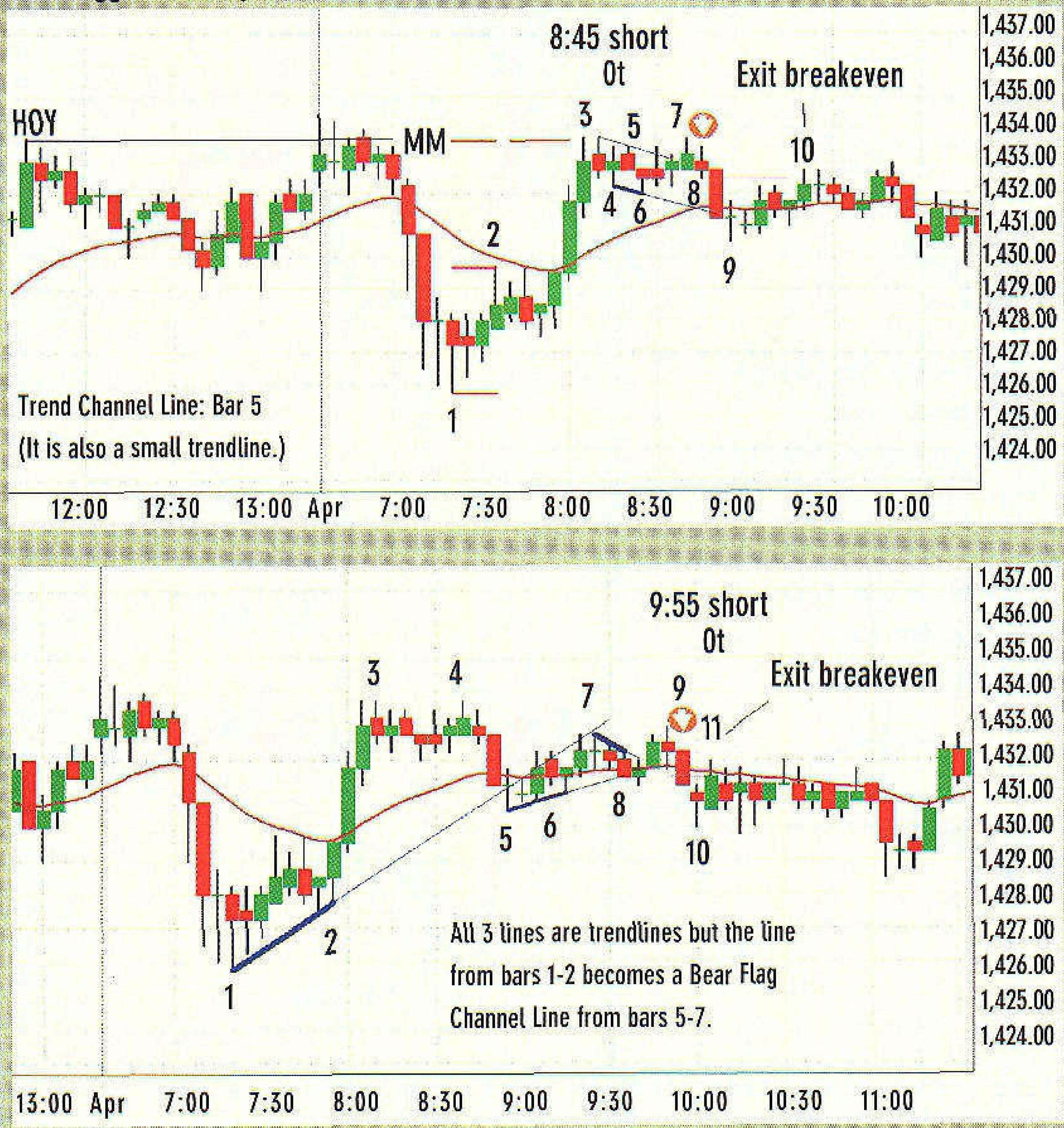
The first chart in "Getting started" again demonstrates this tool. A regression line is drawn between bars "1" and "2." This is a good place for this line because a bear trend channel line drawn to connect the lows of the spike down bars would be too steep for the market to likely reach it, rendering it useless for generating signals.

MONITORING PRICE

All three price-action line types are most often useful during the next three to 10 bars, but sometimes the

SIDEWAYS HURTS

The first chart shows a short trade that ended up scratched. Although the bounce off the trendline appear significant, the market languished afterward. Again in the second chart, it appeared there was an opportunity for a short trade but the market still dragged sideways.



Source: Tradestation

market will come back to test lines created hours earlier in the day. You would never catch this unless you extended the lines to the right of their component bars. In the second chart in "Getting started" bar "4" demonstrates just such a test, while in the second chart in "Sideways hurts" (above), a bull trendline from bar "1" and bar "2" becomes a bear flag channel line later in the day at bar "7."

The key point as price action plays out is to keep drawing lines because the best line — defined by the line most useful in identifying entries and exits — usually only becomes evident after observing it through several tests.

As price action approaches the lines, look for approaches (near touches), which are touches and penetrations that quickly fail and reverse. The bar that tests the line is the signal bar, and the bar used for entry is the entry bar.

A signal bar can sometimes be the final bar of a multi-bar pattern. For example, a pair of inside bars, or an "ii," forms a two-bar signal (as shown in the second chart in "Back in action") where bar "5" is the signal bar. Almost all entries should be made on a stop placed one tick beyond the signal bar.

For a buy signal, the buy stop is one tick above the high of the signal bar. If the entry were selected correctly, rarely will more than four ticks have to be risked. If it's a solid trade, the market will not come back because by then the rest of the market will have identified the condition and orders will gobble up any one- or two-tick pullback.

For example, if the market falls away from a bear trend after poking above it, this is a often a signal to sell one tick below the low of the bar that just tested the line. This happened in the first chart in "Back in action" at bar "7." The high of the bar went above the bear trendline drawn across the highs of bars "3" and "6." There was also a horizontal bear trendline drawn across the double top (bear flag) formed by bars "4" and "6." In this case, bar "7" approached that line but could not reach it and then the market resumed its drop.

CONFIRMATION AND EXIT

Fibonacci extensions and retracements aren't always reliable entry and exit signals by themselves, but they can sometimes provide reliable confirmation for trades based off price-action lines. For example, in the first chart in "Sideways hurts," bar "3" was a Fibonacci level (a measured move above bars "1" to "2") and in the first chart in "Back in action," bar "9" was one tick below a 62% retracement of the day's range. It also tested the breakout of bar "1," which led to the day's bull move.

Whenever considering an entry, it's always good to have two or more reasons for the trade. In the first chart in "Getting started," bar "6" penetrated a bull trend channel line but closed below the midpoint of the bar, indicating that the bears were gaining strength. Also, bar "6" poked above the prior day's high (HOY, or high of yesterday) on the chart). Even though bar "6" closed below its midpoint, the close was still above the open of the bar, indicating strength. Also, while it's a subjective determination, the bull channel appeared fairly steep.

Whenever there is still reasonable strength in a bull, it's good to have a second signal for a sell. Thanks to its close near the low and off the small trendline drawn across bars "6" and "7," bar "9" provides our second signal with a close near its low.

Once the trade looks promising, it's time to start looking for an opposite swing set-up. If the opposite signal is weak, it can be used to exit (but not reverse) the original position. If it is strong (two or more reasons), a reverse is in order. An example of a good reverse is shown in the first chart in "Back in action" where bar "10" was an inside bar and bar "9" was a 62% Fibonacci pullback. In this case, a reversal was placed after the price action penetrated the trend channel line.

Although a particular money management strategy depends on account size and risk tolerance, a workable approach is to trade in multiples of two contracts, looking to scalp half for four ticks and swing the other half, using a breakeven stop after taking profits on the scalp portion.

On most days, the potential profit on the swing and scalp portions are usually each equal in points to roughly the daily range. "Opportunity knocks," right, shows that this day had the potential to make eight swings for 39 ticks, and all eight were also good scalp entries.

With a strategy based on price-action lines and careful and swift adaptation to price action, an alert and disciplined trader can come out in the black more often than not. **FM**

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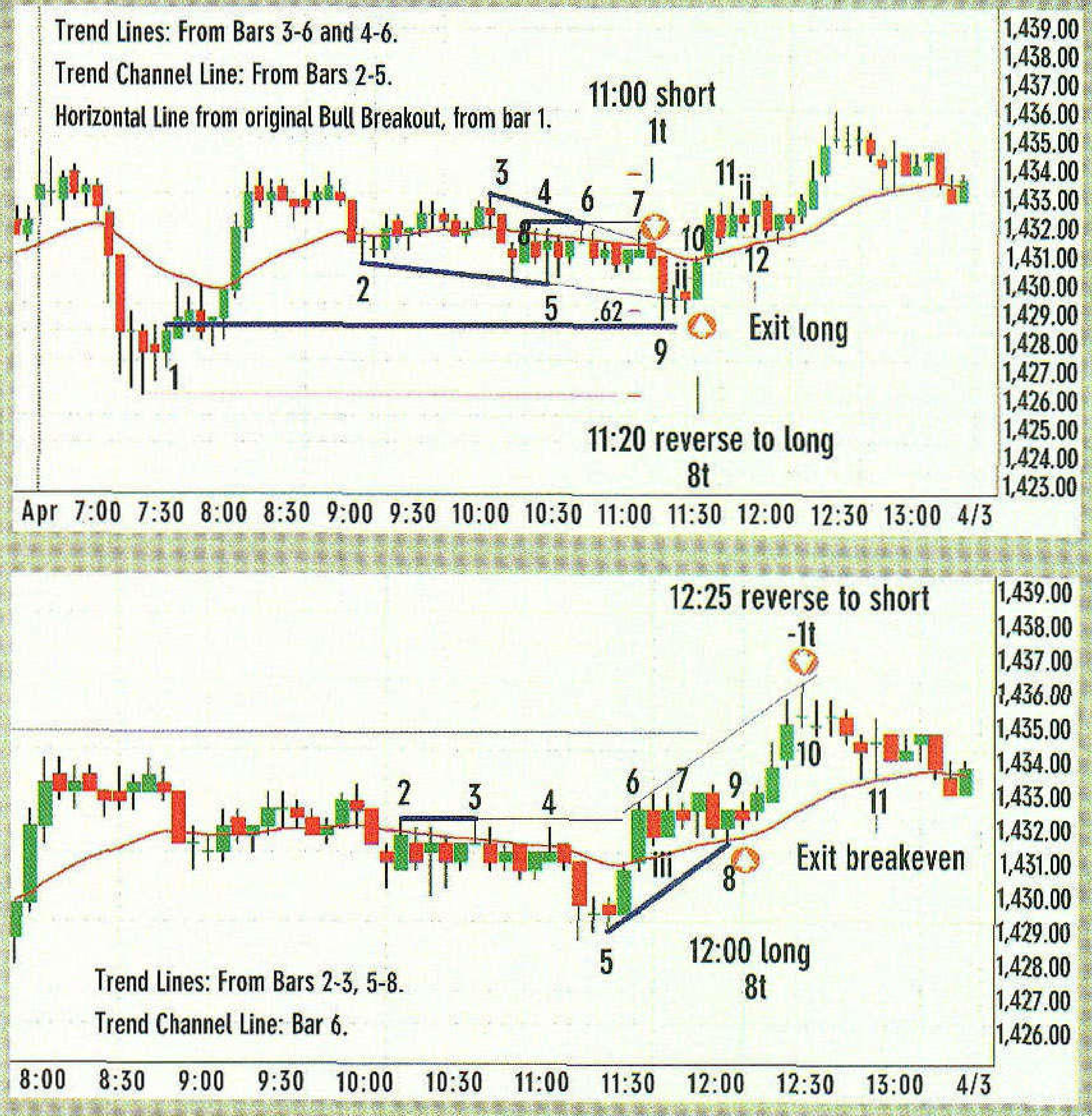
BACK IN ACTION

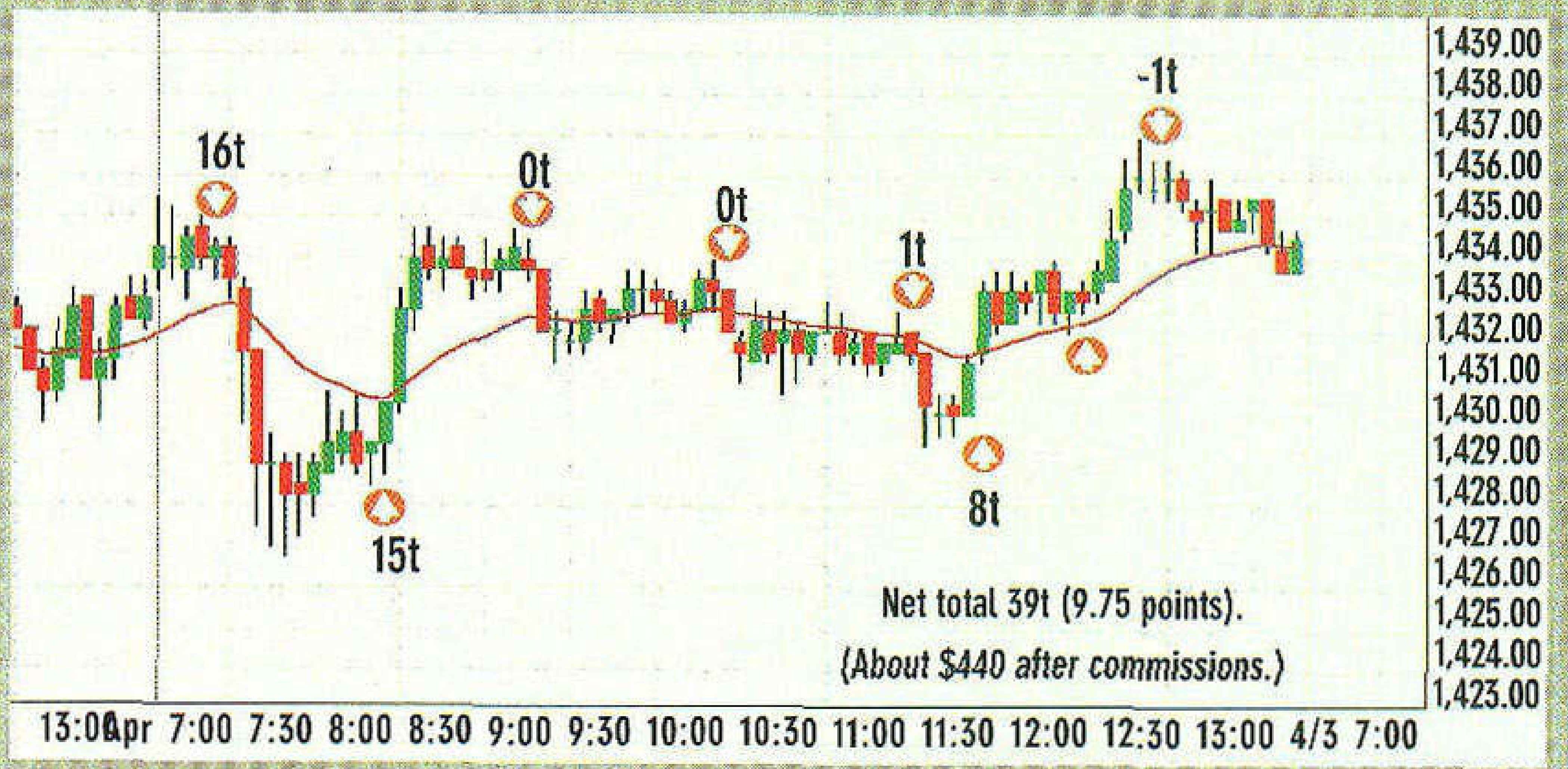
We are tipped off to a sell when price closes down while bouncing off one down trendline one bar after approaching another. The second chart shows how new trendline and trend channel lines drawn along the new up swing provide the support to for a new long trade.



Source: Tradestation

OPPORTUNITY KNOCKS

There's a lot of opportunity to capture short-term swings in the E-mini when trading off five-minute charts.



Source: Tradestation