You don't need a complicated approach to trade the E-minis. By keeping a close eye on price action and taking the time to learn a few simple setups, you are well on your way to reliably capturing numerous intraday profit opportunities

Trading breakouts and micro trendlines

BY AL BROOKS

Everything on a price chart *represents either a trend or a* non-trend. Non-trending swings are trading ranges, and non-trending bars (bars with small or non-existent bodies) are dojis. When the market is in strong trend mode, look for setups to trade with the trend, such as buying near the high of the swing. Don't place countertrend trades in a strong trend. When the market is in a trading range, that is the time to look for countertrend moves.

One of the most useful techniques involves what happens during a breakout. A price action trader rarely enters on a breakout to a new swing high or low because they're always looking for the earliest possible entry to minimize risk (see "Price action fundamentals," right). This usually means entering on some minor pullback before or after the breakout.

For example, if you just bought a flag breakout before a new swing high, sell part of the long to the breakout traders who are getting long at the new high. Don't buy at a price where people are taking profits on their longs because then the risk of failure is too great; too large a stop would be needed, and you would have to trade fewer contracts, limiting flexibility.

ENTRY SETUPS

Two of the most reliable entries are failed breakouts and breakout pullbacks because both involve trapped traders who will be forced to liquidate and move the market in my direction.

A breakout is a breakout of anything, including a trendline, a trend channel line, a swing high or low, the high of today or yesterday, a trading range, or any pattern identified on the chart. A failed breakout is a breakout that reverses within a bar or a few bars of the breakout. For example, if there was a breakout to a new low of the day and the breakout bar became a strong bull reversal bar, then if the next bar trades one tick above that breakout bar, the breakout has failed.

If within a bar or two of the tentative failure, the market again trades one tick below the low of the prior bar, then that failed breakout has also failed. This scenario is called a breakout pullback. Because it is with the trend (in the direction of the trend that led up to the pattern) as well as a second attempt, it is a very reliable signal.

A setup related to the breakout pullback occurs just before a breakout rather than after. If the market quickly moves to the verge of breaking out but instead forms a flag just before the breakout, this is close enough to a breakout pullback and it should behave like one. One of the most useful rules in trading is that if something resembles a reliable pattern, it will likely behave like the reliable pattern. In any case, nothing is ever perfect or certain, so close is usually close enough.

Second attempts are especially reliable because the market is always trying to do something twice. If the second attempt fails, the market will usually try to do the opposite. That is why so many pullbacks have two legs. The market is making a second attempt to reverse and when that second attempt fails, the countertrend traders liquidate and the trend resumes. This is also why High 2 and Low 2 entries are so reliable in pullbacks (see "Five minutes to fame in the E-mini," *Futures*, May 2005).

The second-attempt tendency also explains why a trend reversal through a trendline is usually followed by a test of the old extreme. If the test fails to resume the trend, the trend will try to go the other way, and it usually will make two attempts in the new direction, forming a two-legged correction or even a new trend. For example, if there was a bear trend and then a rally broke the bear trendline, there almost always will be a test of the low. If the test does not quite reach the low and forms a higher low, the market will then rally at least one more time, creating a second leg up. On the other hand, if the test dropped below the old low before reversing up, it usually will have two legs up from there.

While these setups produce numerous trade opportunities on the five-minute E-mini chart, it's strongly recommended that you spend most of the day watching and waiting for a High 2 pullback in a bull trend or a Low 2 in a bear trend. On a trading range day, take a second entry on a reversal from a new swing high or low. Also, entering with the trend on micro trendline failed breakouts is another great trade.

A micro trendline is a trendline that is drawn across two to 10 bars where most of the bars touch or are close to the trendline, and then one of the bars has a false breakout through the trendline. This false breakout sets up an entry with the trend (usually a High 1 or a Low 1). If it fails within a bar or two, then there is usually a countertrend trade where the initial trendline breakout pulled back and now is providing a breakout pullback entry.

Once you can consistently make one or two points a day, it is far better to work on increasing your position size than it is on increasing the number of trades per day or setups that you trade.

Trading 10 E-mini contracts and netting only one point a day is about \$100,000 per year, and 100 contracts is \$1 million. However, most traders have a hard time sitting there, doing nothing. It may feel far more fun to trade all day than it is to sit there for hour after boring hour, but if you want to trade for a living that is what you must be willing to do until you are consistently profitable.

SETUP EXAMPLES

In the first hour of trading, just about every market has a breakout, usually related to the prior day. There is often a gap opening, which is a breakout beyond the close of the prior day, but it often also is a breakout of a swing high or low, a trading range, or a trendline.

PRICE ACTION FUNDAMENTALS

These are the basic building blocks of price action trading.

- Trade off five-minute E-mini charts
- The only indicator is the 20-bar exponential moving average
- Enter on a stop at one tick beyond the signal bar
- Initially risk eight ticks in the E-mini, but can be as high as 12 if the bars and the average daily range are large
- After the entry bar closes, tighten stop to one tick beyond the entry bar
- After taking a four-tick profit on the scalper's portion of the position, move the stop to break even on the remaining (swing) portion
- For most trades, if you pick the correct entry, the market immediately goes your way and does not come back to let other traders come in at a better price

Often, the market attempts to close some or all of the gap, which means that the market attempts to make the breakout fail. This is a possible setup if there is a good signal bar or a second entry. Then, after moving to close the gap, the market will reverse after testing the gap or a trendline or the exponential moving average (EMA). This sets up a breakout pullback entry in the opposite direction (failed breakout fails) where the market just pulls back and the breakout resumes.

The first chart in "Price breaks" (page 34) is the five-minute E-mini chart. During the course of a typical day, trendlines may have to be drawn only a few times to confirm what appears to be happening. The goal is to find overshoots of trendlines and trend channel lines and then enter on the failed breakout. Sometimes the overshoot may not be clear without the line. Once the breakout has been confirmed, however, the line can be erased.

The next two charts in "Price breaks" display many lines that were useful as this particular day unfolded. Note that in practice, it's better to erase lines as they are confirmed and certainly many are so obvious, they don't need to be drawn at all.

Trend channel lines can be drawn using swing points or by using a parallel of a trendline. In the example shown, there are several failed breakouts of trend channel lines, such as Bars 7, 15, 20, 25, 26 and 30. This should encourage a trade in the opposite direction if there is a good signal bar or a second entry. If the move that you want to fade is not strong, take a first entry, such as selling on Bar 8 and 25. If the trend is strong, wait for a second entry. The Bar 21 short is a variation of a second entry because it was a failed second attempt at where Bars 20 and 21 tried to extend the rally. The move up to Bar 30 was strong and required a second entry, which was set up by the inside trend bar that followed it. The first entry was Bar 29, which failed and became an outside up bar. Bar 26 was a great first entry long because it was a bull reversal bar that was a failed breakout of a bear trend channel line during a bull trend day. (It was the second higher low after a higher high and it was close to the bull trendline.)

There were several micro trendline entries, and the best ones followed the Bar 13 higher low, which was a possible bull setup. A higher low pullback after a break of the bear trendline is a second attempt to move the market down. When it fails, the market usually makes at least a second leg up. The four bars before Bar 14 all had lows that were close to the trendline, while Bar 14 dipped below the line but had a bull close. This is a setup for a long on the failed breakout below the micro trendline in a bull move. Bars 16, 19, 27, 28 and 29 are failed breakouts of bull micro trendlines. The break below the trendline can occur by simply a sideways bar without the bar extending below the low of the prior bar, and this is still a valid long setup (Bar 28, for example).

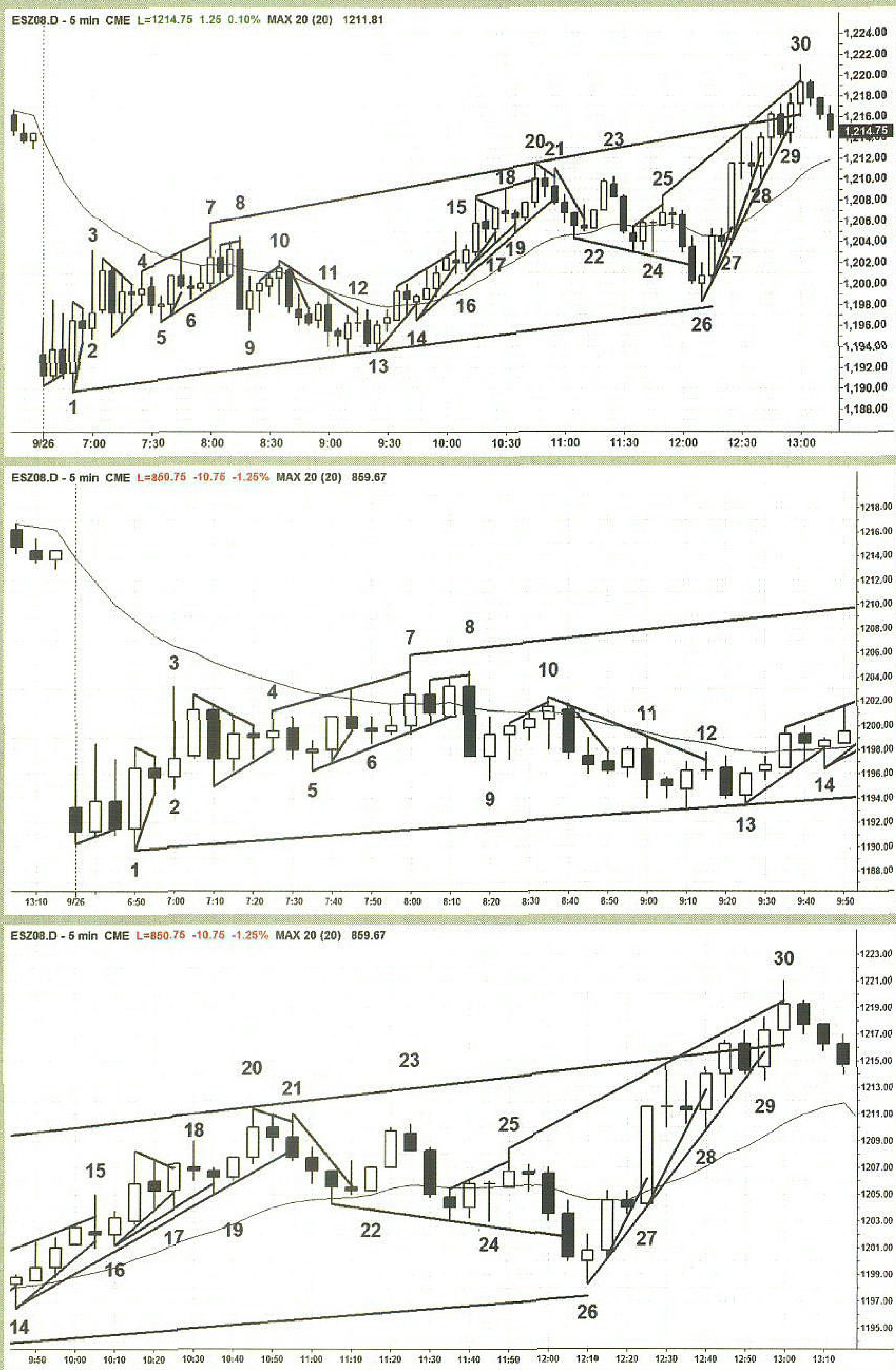
The Bar 16 long is especially strong because the Bar 15 outside down bar was a Low 2 short in a possible trading range day. A failed Low 2 usually runs for at least a couple more legs. It is the second attempt to go lower, and when a second attempt fails, the market usually tries to do the opposite. Bars 5 and 29 are also failed Low 2s, and Bar 12 set up a short on a failed H2 in a trading range.

FINDING FOCUS

When there are multiple trendlines and trend channel lines, it may be difficult to determine which ones are important. The short answer is, they all are. You should always prefer to trade with the trend, and that makes the H1 and L1 entries off micro trendline failed breakouts great setups. They are attempts to reverse the trend that quickly fail and usually result in a quick scalp at a minimum. Second entries on trend reversals also are reliable but sometimes the market takes five or 10 minutes before it takes off, so being in a countertrend position during this initial period can be stressful. Examples of second entries for trend reversals are Bars 2 (long), 13, 21 and 30.

PRICE BREAKS

The first chart shows a single day's price action in the E-mini S&P 500 with the EMA. The next two charts include the micro trendlines that captured the dynamics of the trading session's many moves. Drawing such trendlines helps you gauge the probability of whether your best chance is with the trend or against it. Notice the two main trendlines extend for the entire day.



Source: TradeStation

As far as which direction you should be trading, a reasonable guide is to look at the major reversals, which usually lead to at least two legs. Because a gap down is essentially the same as a large, invisible bear trend bar, any sideways to higher price action breaks a bear trendline and forms a large flag. There should be a breakout that tests the gap low. The first major turning point of the day shown occurred on the failed breakout at the open. The first bar was a bear trend bar that failed on the second bar, a bull trend bar. The third bar was also a bear trend bar, creating a second attempt to drive the market down. Two failed attempts usually result in the opposite happening, so there should be at least two legs up, which there was. During this stretch, you should focus on long setups.

This first up move ended around the EMA at the failed trend channel line overshoot at Bar 7, which should lead to at least two legs down, which it did. This is also a large breakout pullback. This suggests that the gap down opening was the correct direction for the day and the rally was only a test of the breakout from the previous day's close. Most of your trades on the way down to test the low should be on the short side.

The test of the low of the day failed in a higher low at Bar 13. This means that there should be at least a second leg up from there and you should focus on longs.

The rally up to Bar 20 was strong and, therefore, its high will likely be tested after a pullback. But when a strong rally ends, especially in three pushes, the pullback usually has at least two legs. Most climax reversals result in at least two legs and at least an hour or so of countertrend movement. During the pullback, you should focus on shorts.

Bar 26 was the end of the second leg down and formed another higher low in what is turning out to be a bull trend day.

It was also a wedge reversal up — three pushes down and a trend channel line overshoot and reversal both are effectively wedge climaxes — and should have at least two legs. During this phase, your focus should be on long entries.

Bar 30 ended a strong rally and it was a wedge top. There should be two legs down and then a test up because the move up was so strong.

Although this was a bull trend day, it was not a strong bull. It is a trend channel type of bull trend day. On strong trend days, you should only trade with the trend. During these weaker forms of trends, you can safely take trades in both directions.

When there appear to be too many lines presenting too many choices, first look for a micro trendline, and if one is present, fade the false breakout. Bar 13 is interesting because it is a "failed failed" breakout. Bar 12 was the failed breakout of a micro trendline, and although the short yielded a scalper's profit, the market quickly reversed up two bars later, which means that the failure to break above the trendline failed and was followed by a failure to resume the bear trend. It can be viewed as a breakout pullback from the Bar 12 breakout above the micro trendline.

Any three-push move should be treated exactly like a wedge even if it does not have a wedge shape. Bars 7, 20, 26 and 30 are good examples. Bar 15 is a failed wedge and a failed wedge top usually runs in approximately a measured move up. Since the wedge was from Bars 14 to 15, the move up to Bar 20 was close to a measured move up. Close is close enough.

If you pay attention to every bar and every possible trendline and trend channel line, you will find failed breakout and breakout pullback trades all day in every market. Some days it's simply just how the market moves. However, until you are consistently profitable, you should restrict yourself to one market and only the best two or three setups every day. **FM**

Al Brooks is the author of "Reading Price Charts Bar by Bar: The Technical Analysis of Price Action for the Serious Trader" (John Wiley & Sons). It will be available in 2009.