TREND RECOGNITION

TRADE WITH THE TREND

Trading With Odds in Your Favor

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Quite often people try to pick the bottom or the top of a trend but usually they fail to do that. And these are situations in which the odds of being right are actually against you. The chances of being right in your trading decisions increase if you stick with the major(prevailing) trend on the market. This article shows some examples using the recent trends in USD/JPY market to emphasize how important is to align yourself with the prevailing trend on the market.

What is a high probability trade? – this is a trade when the chances of success (the chances of being right) are in your favor. Quite often people try to pick the bottom or the top of a trend but usually they fail to do that. And these are situations in which the odds of being right are actually against you. The chances of being right increase if you stick with the major trend on the market. Let's take a look at a most recent example – the Japanese yen market (USD/JPY pair) where the prevailing trend has been on the downside for many months.

Daily chart of USDJPY for the past 12 months:

Source: MetaTrader

Are you going to try to pick the bottom of this strong downmove? I know many of my friends have attempted to trade from the long side for many months here. And with such a powerful downtrend in place, it is almost a suicide to hold an overnight long position. But that is what many people actually do. Some of my friends who trade this market have accepted my observation that the Bank of Japan forex interventions are totally ineffective in the Short-Run but even they have tried to pick the bottom. Some of them said that they wanted to buy but because they believed the BoJ interventions were inefficient they would just do nothing.

What are the trades where the odds are likely to be in our favor? During a downtrend, the high probability trades are those when we consider a short position when small recovery rallies develop. The major sell signals marked on the chart above are those when the daily Stochastics indicator has given sell signals (after being overbought 1st). These sell signals have all come after significant rallies lasting from several days to a few weeks. Minor sell signals are marked when the prices have touched the declining 21-day moving average from late April to late October 2010. These sell signals of minor importance have come after rallies lasting just a few days. But what both signals on the chart have in common is that they are aligned with the major trend which in this case is strongly on the downside. Notice that no buy signals from the oscillators are considered reliable under such market conditions.

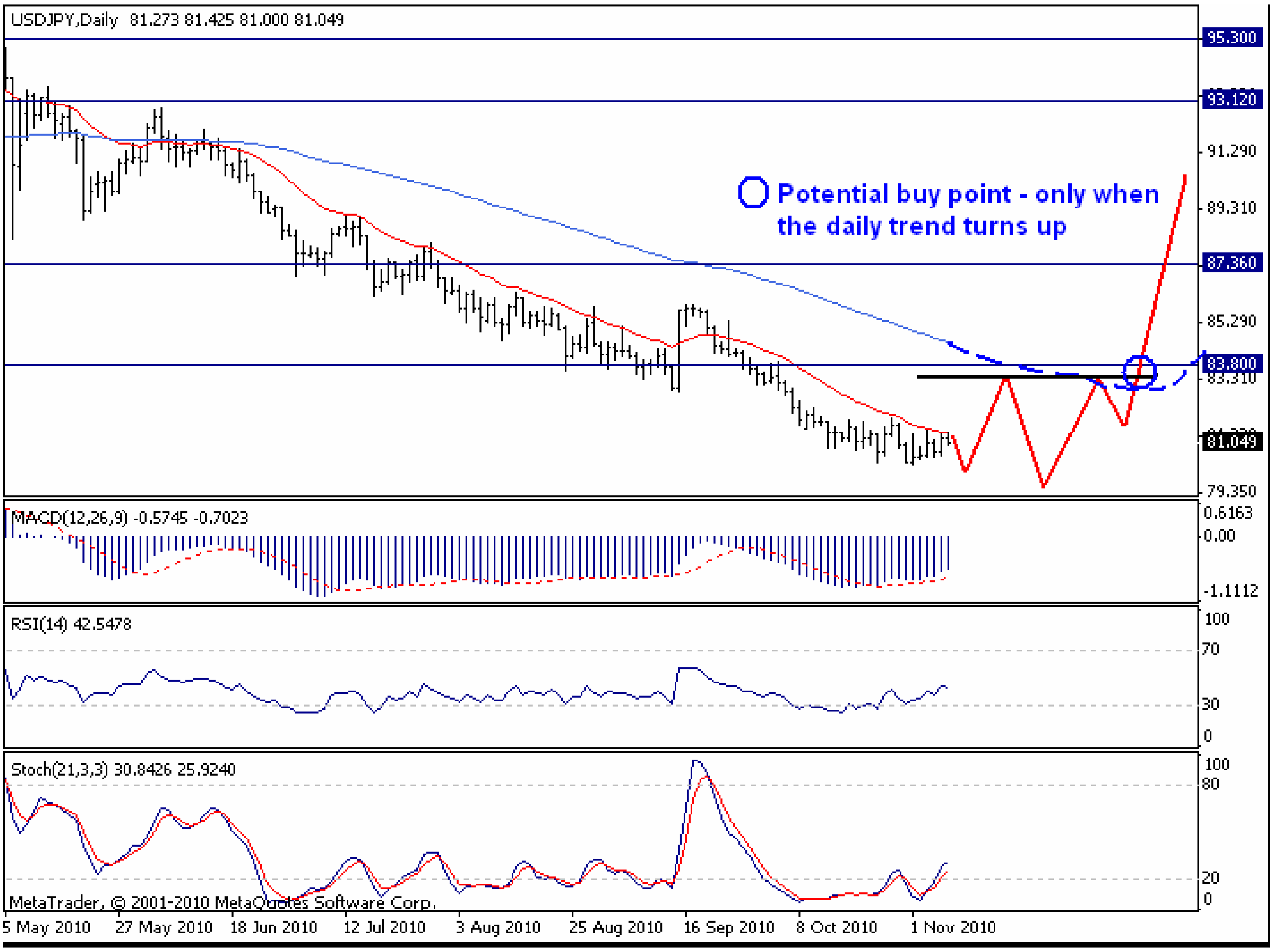
Now, take a look at the next chart: this is the hourly chart of USDJPY for the last few weeks. The trend on the hourly chart is sideways. Normally in a sideways market one can attempt both long and short positions. However, with the larger trend pointing strongly on the downside, the risk is smaller if you just omit the buy signals from the hourly oscillators and consider only the sell signals from them.

Hourly chart of USDJPY as of Nov 8th 2010.

Source: MetaTrader

I have marked the situations where I think the chances of being right are greater than the chances of being wrong. The indicated signals are actually the sell signals from the hourly Stochastics. As described above the buy signals from this indicator are omitted as they are not considered to be high probability trades.

And finally, a question may be asked when one can consider a long position in such a market? Should we only trade from the short side in USDJPY or stay out of the market? Well, of course, one can attempt both long and short positions but the ones that have higher odds of being successful are those that are in alignment with the larger trend. And in this case this larger trend is down. Going back to the daily chart, we need to see the market spends several weeks or several months of sideways trading, building a base below the 100-day moving average and then breaks higher – only then a long position will be favored as a high-probability trade.



Source: MetaTrader

Conclusion

Most people try to trade both with the trend and against the trend. Of course, depending on how successful is your analysis you can always trade in both direction. However, the odds of being right are greater if you trade with the prevailing trend. And usually that is best done when you try to enter (long or short) on pullbacks. These are the trades that can bring you the most money and if you are patient enough, there are always such high-probability opportunities. The problem is that sometimes it is too difficult for us to wait on the sidelines and do nothing for several days, or several weeks or several months (depending on your time frame horizon). But when one "needs" to trade every day, we can doubt their goal in trading is to make money. The goal of such traders is simply "to be in the game".

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