X MARKS THE TRADING SPOT

BY TIMOTHY MORGE

There's a growing group of veteran floor traders in Chicago that have switched to looking and trading the markets in a whole new light. They're what other locals are calling the "forkers," traders that use "pitchforks" or median lines as their principal trading tool. The group has grown large enough that they've begun proudly wearing buttons reading, "I'm a forker!" Now the Chicago Mercantile Exchange (CME) co-sponsors seminars that teach this simple but powerful tool that is so effective when used to day trade markets in an off-floor environment.

In the CME trading pits, these were veterans of daily battles, where each local had to fight, tooth and nail, for profits. In my seminar, I begin by reminding them of two of their favorite childhood games: hunting for buried treasure and hide and seek. To find out how remembering these childhood games can translate into making consistent profits in the currency markets, read on.

Median lines can be used to find high-probability trade setups that repeat over and over again. These tools work across the board in all timeframes and on all tradable instruments – including stock index, interest rate and currency futures, and individual stocks and their ETF cousins – once you learn some basic methodology.

My first rule when taking a trade is no edge, no trade! I see too many traders simply selling or buying each time price approaches the median line or one of its median line parallels. Dr. Alan Andrews, the inventor of median lines, taught that three things could occur at the median line or at its parallels. Price will reverse, gap through the line or will congest. Do the math and see that simply buying or selling at each test of the lines has

Starting Out

Median lines are simple to draw. Choose a high, low and high pivot or choose a low, high and low pivot. It's best to start with what looks to be an important swing high or low. (See *Figure 1* for points labeled A, B and C for an example. Look at the blue lines for this explanation.)

Once you have chosen three points (a high, a low and a high), connect the last two points with a line [B-C]. Find the mid-point of the line connecting the two [B-C] points. Then draw a line from the first [A] through the mid-point of the connecting line between the two [B-C] points. Extend this line (now called a median line) out in space. Similarly, draw lines parallel to the median line that begins at the [B] point and then the [C] point. You now should have what many call a pitchfork. The line that starts at the upper pivot and runs parallel to the median line is called the upper median line; the line that starts at the lower pivot is called the lower median line.

about a 50-percent probability of being profitable. However, there are ways to use these tools that give reliable, repeatable results.

Finding Treasure

To teach traders how to find high-probability trade setups, I speak about the market in terms of the energy that price carries as it moves forward. 0Median lines and their parallels are areas where price may run out of energy, so I begin with these areas as my starting point when looking for trade setups. Just thinking that price *may* run out of energy isn't enough for me, however; I want to see more before I put any of my money on the line.

One of the easiest high-probability trade setups to identify are areas where two median lines [or their parallels] cross; a zone called "confluence." It's best if these crossing lines "oppose," meaning one has an upward slope and one has a downward slope. In essence, once you find the dominant median lines or pitchforks for a given chart, it's just like reading a childhood treasure map: ***X*** marks the spot!

Another way to form confluence is to use major Fibonacci retracements or projections if one of these areas is close to an area where price will likely intersect with the median line or its parallels. Of course, if I can identify an area where I have opposing lines crossing, along with a major Fibonacci retracement or projection, I like the trade setup even better. If all of this sounds as if I set very high standards for acceptable trade entry setups, it's because I want my trade entries to have a probability of success of seventy percent or higher.

Figure 1 shows an area of confluence, where ***X*** marks the spot. Let's see how this could be used to set up a potential trade in the euro currency. The euro made a nice run higher before selling off to test the 61.8-percent retracement from the high at Pivot B to the low at pivot A. Once prices held at this level – leaving a double bottom – they climbed higher, retesting the prior high at pivot B. During the first 15 minutes of the CME day pit session, prices tried to test the prior highs a third time but found good sellers, and that bar closed near its lows. As this first bar of the day session closes, I draw in a new red down-sloping median line or pitchfork, which shows me the probable direction of price *if* the euro had just seen a change in trend or direction. The slope of this red down-sloping median line also tells me just how fast price should travel, if indeed the trend has changed.

The Trade Entry Spot

Now look to the right of the last bar on *Figure 1* and you'll see two lines that intersect, one a blue up-sloping median line and the other, a red down-sloping upper median line parallel. *If* price tests the area of confluence where these opposing lines cross at 129.56, it's highly likely that price will be contained. Price *should* run out of directional energy at this area roughly 75 to 80 percent of the time, if price gets there. It doesn't take much imagination to see the ***X*** that marks the spot here! The treasure comes in the form of a high-probability trade setup.

The area of confluence, where these two opposing lines intersect, occurs at 129.56, and it also has a time element to it: If price tests this area two bars from now, it will be running into opposing forces right at the time *both* lines predict it should run out of directional energy, and that would further enhance the probable outcome of this trade. Because this is such a high-probability trade setup, I'll be willing to get short the euro at three ticks below this area of confluence, instead of right at the confluence. So my limit sell order will go at 129.53.

Transmit Both Orders Simultaneously

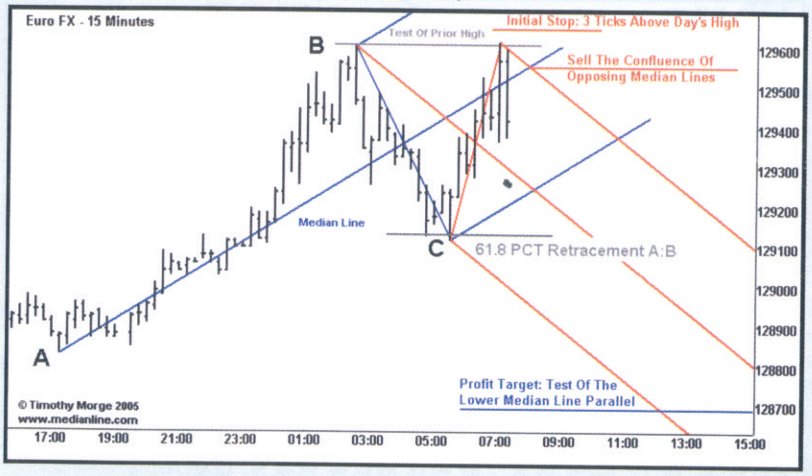
Here is the second rule: Never enter a trade without entering a stop-loss order at the same time you enter your limit entry order. The last thing I want to do is put in a limit sell order, and just as I type it in, watch the market zoom through where I would put in my stop loss order *before* I can even enter it. So when using an electronic platform, type in both orders, hold each until both are ready to go, and then transmit them at the same time.

Hiding Stops

Where should the stop-loss order be placed? Well, I've already showed you how I play hunting for buried treasure. Now let's remember how to play hide and seek. In this game, you go hide while someone else counts to 25, and then he/she tries to find you.

In many senses, this is a good way to think about your stop-loss placement. There are going to be people looking for your stop, so rather than using arbitrary or "cash-amount" stops, always try to find a market formation behind which you can "hide" your stop-loss order. In this case, there will be sellers at or near the area of confluence that we are trying to sell. If price gets above this area of opposing median lines, the next area to hide stops would be

FIGURE 1: EU - Minute Euro Chart: Trade Setup



Source: Timothy Morge

the high at Pivot B, which was just re-tested on the opening. So if price manages to get back up there, this area will provide some protection for us to hide behind – in the form of sellers looking to sell the test of the prior highs, as well as the high of this morning's session. I'll "hide" my initial stop loss order at 129.66, three ticks above the morning high and retest of the prior swing high.

What's the Target?

The last important piece of an initial trade setup plan is the risk/reward ratio. I personally don't take a trade unless I am making a minimum of two dollars for every dollar I risk. To find the risk reward/ratio of this trade, I first must identify a profit target. The most logical profit target is a test of the red down-sloping lower median line parallel. I expect price will test and break through the up-sloping blue median line because it retested the prior swing high on the opening, and if the high of the day holds, a major move to the downside should unfold.

To calculate where price would intersect with the red down-sloping lower median line parallel, I look at the recent size of average bars, and then overlapping them about 30 percent, I use my cursor to see how far price will likely move to the right as it travels low enough to intersect with the red lower median line parallel. That comes out to roughly 128.70.

Doing the Math

Now let's calculate the risk/reward ratio. I'm willing to sell at three ticks above the intersection of opposing lines, at 129.53. My initial stop loss is at 129.66, so I am willing to risk 13 ticks on this trade. If I get filled, my initial profit target is at 128.70. I am looking to make 83 ticks on this trade. That means my risk/reward ratio works out to 83/13, which is roughly 6.4, a more-than-acceptable ratio. I enter my limit sell order at 129.53 and my initial stop loss order at 129.66 at the same time. Note that I *do not* enter my profit order, because I have no position yet.

The Trade Unfolds

Two bars later, price rallies to and stops right where ***X*** marks the spot, getting me short euro at 129.53 (see ***Figure 2***). Price runs out of directional energy right where it should and turns lower, closing on its low. As soon as I confirm that I am short euro, I put in my profit order, a limit buy order at 128.70. Price makes a narrow range bar and then spikes lower. It is testing the red down-sloping median line, which is a *potential* area for price to run out of downside directional energy, but not the area where *I* think price will run out of energy. But when price then makes two bars that are well above this area, with about the same range and alternating closes, I sit up and take a closer look at the chart. Can I move my initial stop-loss order closer to the current price action without getting too close to the inherent noise of this market?

I note that the last bar formed the second of two bars with the same high at 129.47, something chartists call "double tops." Double tops also are areas where new traders will likely have sell orders resting in the market, because this area is seen as an area of overhead resistance. There also is overhead resistance at the red down-sloping median line parallel. Because price closed on its low during the last bar, I am going to hide my stop-profit order three ticks above the just formed double tops, at 129.50 (marked Cancel Profit Stop 1 on *Figure 2*). I now am playing with the market's money, and that's always the first goal once I identify and enter an acceptable trade. I must work my way to break even or better stop-loss orders as quickly as possible without getting too near the noise inherent in the market.

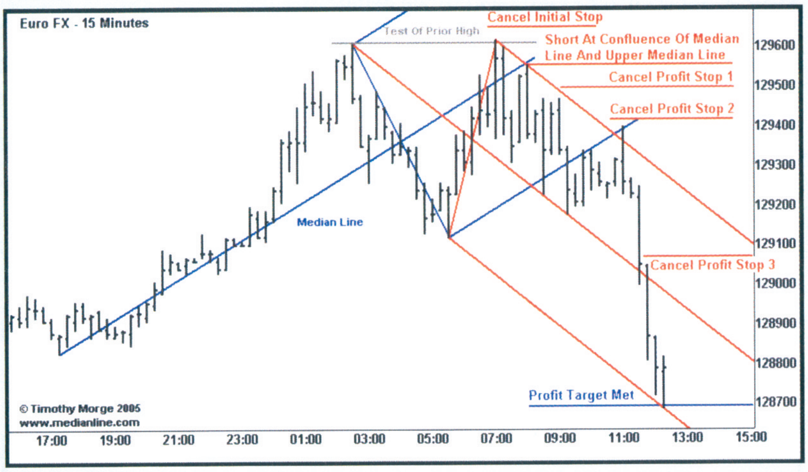
Price again spikes lower, testing the down-sloping red median line, but so far it is unable to close below this line. Price then consolidates, forming an energy coil, which indicates that price is restoring energy. Then, price *did* run out of energy right where the upper median line parallel predicted it would.

The next bar is a narrow range bar that closes below the low of the wide range bar that just tested the red upper median line parallel. Because a narrow range bar is a warning sign that price is again restoring energy, I reevaluate my stop-profit order. Now that price has tested the upper median line parallel once, I am willing to hide behind the 129.40 high of that wide range bar, so I move my stop-profit order down to three ticks above this high, to 129.43 (Cancel Profit Stop 2). If price climbs above the just-tested red upper median line parallel, I'm more than willing to exit this trade via a stop-profit order and keep the potential ten ticks of profit I'll still have in this trade.

Locking in More Profit

Price then makes two very wide-range spike bars lower. The first wide-range bar tests the red median line again, and the second wide-range bar spikes through the red median line and closes well below it. Once this second wide-range bar closes, I immediately move my stop-profit order to three ticks above the 129.05 high of the just-closed wide-range bar (Cancel Profit Stop 3 at 129.08). Why? I now have more than 60 ticks of potential profit in this trade, and price has made the majority of the move in two spike bars.

FIGURE 2: EU - Minute Euro Chart: Trade Unfolds



Source: Timothy Morge

If price retraces higher just as fast, I must protect *some* of these profits. Readers can see that price tested the red down-sloping median line three times before finally breaking and closing below it. So I think I can "hide" just above this median line, which comes in at 129.01. I am "boxing in" profit, using market formations to hide my stop orders, working my way towards my profit target at 128.70.

Two bars later, price tests the red down-sloping lower median line parallel, in the process filling my profit order at 128.70. Once I confirm that my profit order has been filled, I cancel my stop-profit order and double check that I am flat. I net 83 ticks on this trade, which is $1,037.50 per contract before brokerage fees.

Putting the Trade Together

The keys to this trade are easy as one, two, three: 1) Identify a high-probability trade setup (*X marks the spot!*) 2) Find market formations to "hide" initial stop behind and 3) Make certain that the trade setup is above minimum acceptable risk/reward ratio of 2:1. Also, make sure the size of the potential loss per contract will not wipe you out.

These trade setups repeat over and over across various markets. Once you learn to identify them and also exhibit the patience for them to unfold, you will see just how powerful these simple trading tools are. Just ask the "forkers," and I'm sure they'll send you a button reading, "I'm a forker!" SFO

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