FOREX TRADING:

7 LESSONS FOR UNDERSTANDING THE FOREX MARKET TYPES

AXITRADER

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Foreword

Trading is an incredibly hard past time, but it doesn't have to be. Education is key to your development but with so many websites, videos, and general material it's hard to know what will help, and what will lead to information overload. In my experience it's always best to stick to the basics, I've seen so many examples in my career of traders who have jam packed charts with indicators, or learnt the ins and outs of various complicated trading strategies without understanding the basics of risk management, stops and limits, even in some cases how to actually place a trade.

The eBooks on offer here give you that information, they give you the basics and then look to build on that base knowledge to leave you in the best position to continue, or begin your trading journey. The information provided is not just for the novice either, the eBooks go a long way to cater for traders with different skill sets. I myself am a qualified technical trader, the information provided in this series is not just your bog standard technical analysis it's in depth enough to give the experienced trader useful tips, but digestible enough to be the perfect help for the beginner.

James Hughes

Chief Market Analyst

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The secrets to success are not really secrets at all!

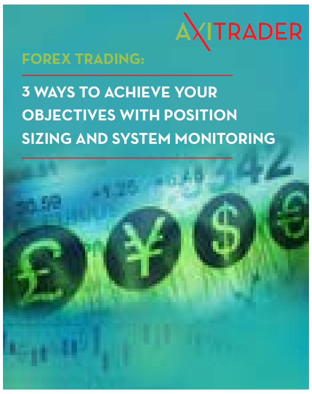
Traders who succeed in the forex market are those who have developed a successful strategy. And such strategies can be replicated and taught.

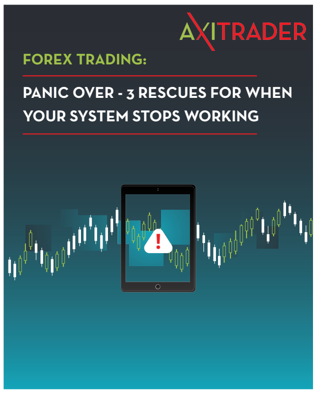
This ebook is the first in a series of five that focus on Building a Successful Forex Trading System. In this series of ebooks, you'll find information that's based on several years of studying top traders and the application of their principles.

These learnings have been shared with a single objective – To empower you with the knowledge that can make the difference between success and failure in forex trading.

In this ebook, you'll learn about the first key to building a successful forex trading system – Understanding the Forex Market Types. You will also learn about the rapidly evolving forex market, the obstacles to trading, how to overcome them and how to work out a strategy based on the different market types.

Others in the Series to Help You Build a Sucessful Forex Trading System



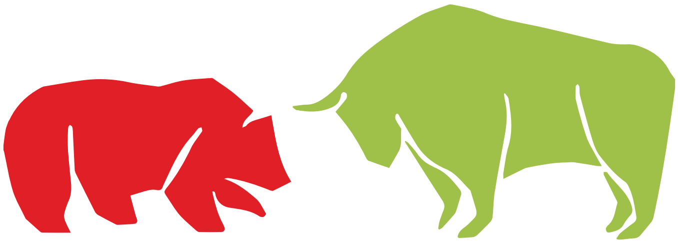


1 A Rapidly Evolving Market

At no point in history has foreign exchange dynamics changed as rapidly as it did in 2017-2018, the impact of which will be felt in 2019 and beyond. For one thing, blockchain technology and cryptocurrencies became much more mainstream than ever before. With growing trader interest in cryptos and altcoins being integrated in the forex market, we are increasingly seeing trading in BTC/USD and other crypto-fiat currency pairs.

However, the cryptocurrency space is a highly volatile one, which means that brokers and traders will need to adapt a very dynamic market to make the most of it.

On the other hand, regulatory bodies have been focused on making the trading environment safer, with new regulations aimed at safeguarding trader interests. Nowhere is this more apparent than in the MiFID II regulations that were enforced for the European Economic Area (EEA) in early 2018. MiFID II not only brings in a whole new level of transparency, it also aims to enhance the competitive environment, while improving service provision for traders.



Having said that, the reality is that the way we trade forex remains essentially the same. The markets move in the same way they always have, although geopolitical tensions and economic volatility does mean we need to be more alert about staying updated with market developments.

2 No One-Size Fits All Solution

If you've tried your hand at trading foreign exchange, you know that your forex trading strategy might work wonders one day and completely fail the next day.

Yes, we've all tried to find the Holy Grail of forex trading – a system that produces consistent results, week in, week out, with a limited drawdown and a nice upward-sloping equity curve.

But, there is a problem with the Holy Grail approach. The market conditions change more frequently than the weather. So, unless we first understand that there are different types of markets and what each type implies, we will never be able to execute winning trades.

TIP

There is no one-size-fits-all trading strategy. Different approaches work in different market conditions and for different trading style. Find what works for you.

The bottom line is that there is no one trading strategy that will work 100% of the times. Forex traders need to be both alert and flexible, modifying their approach based on the existing market type. Market type refers to the different stages or states that a market flows through.

3 *Forex Market Types*

> Expecting the same system to work in all market types is the definition of insanity.
>
> VAN K. THARP

The market type concept was made popular by trading coach and psychologist Van K. Tharp in his books and courses. Tharp believes that while it is insanity to expect a system to work in all conditions, if you can define the market type then it is relatively easy to design a system that provides an edge in that specific market.

The good news is that while the forex markets change quite frequently, they are predictable. For instance, a bull run turns to go sideways usually, before turning into a bear market, while a volatile market becomes normal before becoming quiet. And, quiet markets move towards a bull or bear trend.

So, the first key to building a winning forex trading system. While there are up to 25 different market types according to Tharp, there are six that should be of primary consideration when trading forex.

1. Bull normal
2. Bull volatile
3. Bear normal
4. Bear volatile
5. Sideways quiet
6. Sideways volatile

You can see market types in action if you study a price chart for a moment. You will notice that each currency pair is in constant flux. Sometimes, it is trending nicely; at other times, it coils into a tight range, or is choppy and volatile.

4 *The Problem & The Solution*

The core problem with most forex systems (and, incidentally, why most forex robots tend to fail in time) is that they are only designed for use on one or two market types. If you instead shift your focus to identifying market types and then applying a system to that market type, you might find your forex trading becomes more fruitful.

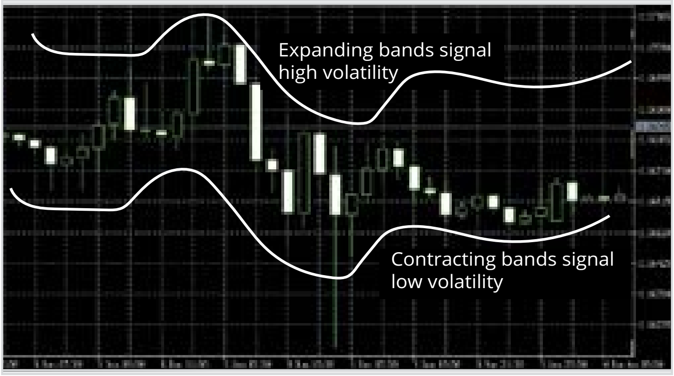
IDENTIFYING MARKET TYPES

Market types are not so difficult to identify. Normally it's just a matter of looking at a chart.

- If the market is going up quietly, then it is a bull normal market type.
- If it's going down, it's a bear normal.
- If it's in rapid descent or rapid ascent it's a volatile market.
- If the price is oscillating between two support and resistance levels, then it's a sideways market.
- If the sideways range is wide then it's sideways volatile, if it's tight then the market type is sideways quiet.

The trick is remaining aware. Be centred enough that you can do the following:

1. Notice the current market type
2. Notice when that market type has changed



There is a very useful tool you can use to help identify the market type – Bollinger Bands. The technique here is quite simple. Bring up a chart and apply the Bollinger Bands. Bollinger Bands are a volatility-based indicator. When they contract it is a sign that the market type is normal or quiet; when they expand it is a sign that the market type is more volatile.

TIP

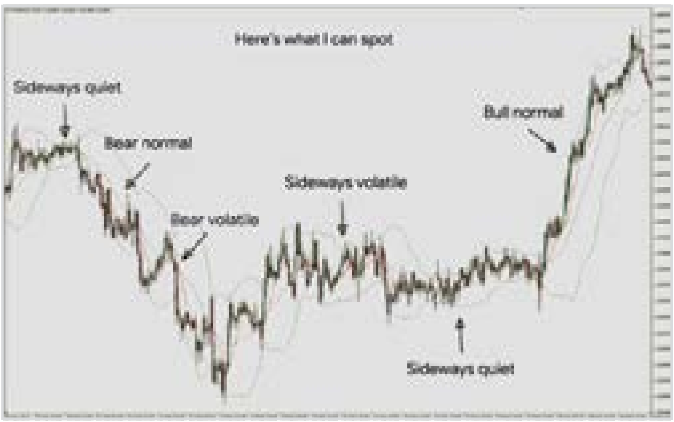
Bollinger Bands are a good way to identify market types. Learn to read them.

USING BOLLINGER BANDS

You can use Bollinger Bands to determine both volatility and price direction. If the price is bouncing off either side of the band, then the market is sideways; if it is trending in the direction of the Bollinger Band, then you likely have either a bull or bear market type. Look at the following EUR/NZD 30-minute chart and tell me what market types you can identify.

Did you get them all?

In the adjacent chart, you can see the Bollinger Bands contract into a sideways quiet, followed by a breakout to a bear normal, into a bear volatile. The next part is a bit harder to classify but it could be bull volatile or sideways volatile. Next, it moves into a sideways volatile followed by a sideways quiet and finally what you could call a strong bull. Now that you can identify market types, is there anything else you notice on the chart? Can you spot the transitions?



THE SECRET SAUCE – IDENTIFYING MARKET TYPE TRANSITIONS

The forces of nature drive the weather, from being sultry and sunny on one day to being stormy the next, only to clear up and the sun shining once again. Human emotion, or what we call sentiment, does the same to the forex markets, with the prices rising and falling and the markets transitioning from being calm in one timeframe to being volatile in another. So, while you do need to identify the market type, being able to identify when the market is transitioning from one type to another can give you a trading edge.

If you know that historically more often than not a bull volatile ends in a bear volatile, then you can plan accordingly. Similarly, if you understand that a sideways quiet usually results in a breakout to a bull or bear, then you could develop a system to capitalise on this knowledge. Trading is a statistical game and knowing probabilities is important.

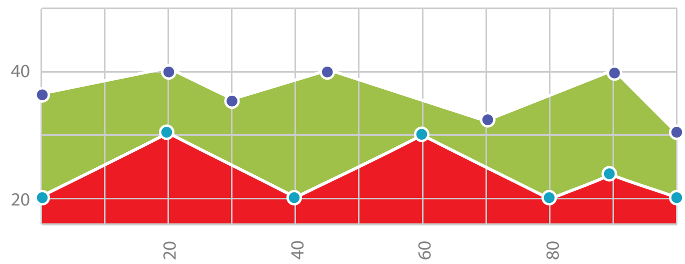
MARKET TYPES ACROSS TIMEFRAMES

Given that the market types vary over time, you might wonder which timeframe would be best suited to identify not just the type but also the transitions. The fact is that all charts will display all market types. So, really it comes down to preference.

TIP

Charts can help you discover almost any type of pattern or trend in the forex market. Learn to use charts to identify the different market types.

However, the lower the timeframe, the more agile you will need to be in adjusting to changes. Lower timeframes could also raise the possibility of fake-outs, so be wary. Higher timeframes give you more time to adjust to changing conditions and your trading efficiency (trading without mistakes) will be higher. Importantly, a higher timeframe is often the set-up for a lower timeframe.



For example, once you determine the market type on the weekly charts, you can slide down to the daily or hourly charts to snipe for an entry. It's good/handy/useful to define market direction on weekly or daily charts and then move to a lower timeframe, like the 15-minute chart, for an entry. Shorter-term market types seem to show up pretty clearly on the 15-minute chart, so it could be a good place to start. As a tip, you might notice the market changes type at certain times of the day. Knowing this can be very valuable for trading. You might not want to take a range trading position on the London open, for example.

DETERMINE STOP USING MARKET TYPE

If you know that a bull volatile typically turns into a sideways or bear volatile, then you can adjust your stop types based on that information. For example, you might switch to using a Parabolic SAR indicator with a steep gradient that keeps your stop nice and tight in a volatile market, or perhaps you limit your risk to one or two times your initial stop.

Having an appropriate exit system that is intelligently adjusted, depending on market type, is a good way to safeguard your profits on a trade.

TIP

Never enter a trade without first determining your stop loss level. Good risk management is the key to success.

5 Working Out a Strategy Based on Market Type

Remember how we said that there is no one-size-fits-all trading strategy and that looking to develop such a strategy could be like searching for the Forex Holy Grail? So, what you need to look at is working on a strategy for each market type and then identifying the type and implementing the concomitant strategy.

This might seem like a lot of work but it totally worth all the effort. Here's a look at some basic concepts that work in specific market types.

BULL NORMAL – BUY AND HOLD

Bull normal markets are well suited for trend-following. This means that you can simply buy and hold with a trailing stop-loss. To buy, look for a consolidation phase with a breakout or look for a pull-back. Buy and hold works as long as the market type does not change. Watch for a change to a volatile market.

TIP

If you find that that the bull market is coming to an end, it could be a good time to tighten your stop.

For instance, see the EUR/USD 15-minute chart. Notice the long bullish candles and widening Bollinger Bands towards the middle of the chart, signalling a move to a more volatile market type. Here would be a good time to tighten your stop.

BULL VOLATILE – LONG SWING TRADING

Bull volatile markets are suited to a more active trading style. Profit targets are the order of the day in this market type. Look for a pull back, a reversal, and then find a logical profit-taking objective on the long side. You may want to consider dropping to a lower timeframe to improve the risk/reward on the entry.

Here is a bull market that has turned volatile on the EUR/USD 30-minute chart. See how a buy and hold approach would have struggled while profit targets would have helped you capture the majority of each swing.

BEAR NORMAL – SELL AND HOLD

Bear normal markets are the opposite of bull normal markets. Sell short and hold with a trailing stop to help capture the majority of the move. An effective strategy is to sell breakouts and rallies, following a period of consolidation. See the 30-minute EUR/USD chart, where there is a consistent drop in value, representing a good example of this market type in action.

BEAR VOLATILE – SHORT SWING TRADING

In currencies, bear volatile is the opposite of bull volatile (this is not so true if you are trading stocks). Try a short swing trading approach with a profit target that gives you a good risk to reward on your trade. The 30-minute EUR/USD chart shows how prices fluctuate, providing opportunities to trade the swings. In this market, keep tight stops to protect yourself against a reversal, while being able to profit it the market type continues.

SIDEWAYS QUIET – TRADE THE BREAKOUT

There are two ways (at least!) to trade a sideways quiet market. You can move to a lower timeframe and use a band trading system (like in the sideways volatile section below). This approach can be very lucrative if the currency pair stays in this market type for some time. There will be lots of 2:1 and 3:1 risk/reward trades you can pick off in a row.

Often, sideways quiet markets result in a strong breakout and trend. Instead of trading the sideways quiet, you can stalk the shift to a new market type by trading breakouts. However, this strategy is not for the faint-hearted. You will need to be very patient and "stalk" the breakout, almost like a predator stalking its prey.

You will face fake-outs and false breakouts and then need to have the psychology to hold on for the big wins. But a breakout system that is executed with efficiency is perhaps one of the most powerful systems in the forex market, where trends can last a long time.

You can see the breakout from a sideways quiet market on the 15-minute EUR/USD chart.

SIDEWAYS VOLATILE – BAND TRADING

Sideways volatile markets can be targeted with a band trading approach. In the 15-minute EUR/USD chart, you could replace Bollinger Bands with moving average, to see how the moving average envelopes a majority of the price action and then use Bollinger Bands to see when the price touches an outer band. Now, look for a reversal off a support and resistance level to find a good risk/reward on your trade.

Sideways volatile markets offer great opportunities for range trading. For this, you will need to wait and watch for the edge of the range to move out of the Bollinger Band and then for the price to reverse back into the Band before placing a trade.

TIP

Different strategies work for different market types. Don't forget to account for your risk tolerance when choosing a strategy.

6 *Don't Throw the Baby Out with the Bath Water*

If you have a good strategy that works sometimes, don't give up on it.

Instead, identify the market types where the strategy performs well and trade those market types only.

It's like playing golf. You pull a different club out of the bag for each different scenario you face. You would never use a putter to hit a tee shot, or a driver when you are stuck in sand. The same applies to trading. Build a toolkit of systems that perform well in different conditions and use them as appropriate, depending on the market type.

7 The Hunt for the Holy Grail

Van K. Tharp still believes in Holy Grail systems.

But his definition is different. To Tharp, the Holy Grail is a system that performs exceptionally well in a particular market type.

Think of it this way. If you know that you are able to meet your trading objectives for a system operating in a certain market type, then all you need to do is hunt for the market type you wish to trade.

Imagine, if you were a golf player who excels at putting and could only play on the putting green – and still win golf tournaments.

In trading, you can take this approach. You make the rules of the game. So, if you only want to trade one market condition, you can.

Last Thoughts

Since you are the one in charge, it is crucial that you learn as much as you can about the forex market. Start with learning to identify the different market types accurately and then figure out which strategy works best for you in different market conditions.

The key is to know what works and when.

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