Swing Trading Techniques

Howard Friend takes some time to compare trend traders with swing traders. He also provides insight into swing trading using Bull and Bear Trap strategies...

Trading Approaches – Trend Trading

There are many different approaches to trading with trend following being one of the most popular. Being a long-time student of market behaviour, I can endorse the widely held view that markets have a strong tendency to trend and trading in the direction of the trend can keep you on the right side of the P & L ledger.

The goal of the trend trader is to identify the current trend, take a position in the trend's direction and hold that position until the trend has changed. Then, a position is taken in the direction of the new trend.

To define a trend, I would use the simplest form of trend recognition – an uptrend is a series of higher peaks and troughs and a downtrend is a series of lower peaks and troughs. Charts 1 and 2 show examples of trends – a bear market in the S & P 500 and a bull market in EUR/USD.

Chart 1 – S & P 500 Index weekly chart (above)

Note in Chart 1 that selling on the break of the first swing low (S) and remaining short through all of the corrective bounces to swing highs (R) could have yielded large profits for the trend trader over a long period of time.

Chart 2 – EUR/USD weekly chart (left)

In Chart 2, large profits could have been made on the long side over this long period of time, buying the first break of resistance (R) and holding through all of the corrections (S).

Chart 3 – USD/JPY weekly chart (below)

SOURCE **BLOOMBERG FINANCE LP**

A Pitfall of Trend Trading – The Whipsaw

Trend trading is not without its pitfalls. All is rosy in the garden while trends are powerful enough to produce large profits as shown in the previous examples. The difficulty is that this is not always the case. Often, a buy or sell signal from a break of a support or resistance level does not see sufficient follow through buying or selling. Instead, the market reverses in what is known as the 'whipsaw.' These are the bane of the trend trader! Witness the many whipsaws that occur on this USD/JPY chart.

TEXT **HOWARD FRIEND**

Another Pitfall of Trend Trading – Inefficient Use of Capital

Another problem that the trend trader faces is the inefficient use of trading capital. While markets 'tend to trend,' there are long periods when they are stuck in trading ranges effectively going nowhere. By definition, the trend trader has to sit through these corrections waiting for the trend to resume with trading capital tied up limiting opportunities that may arise elsewhere.

Solution – Timing Trend Entry and Exit

The solution to this problem is to time the market so that trading capital is not constantly tied up. In an uptrend, this would involve buying near a corrective low and exiting near a swing high, but this strategy can have its own drawbacks. When a correction begins, no one is sure how far it will go or how long it will last.

Technicians use percentage retracements (for example – Fibonacci) in an effort to gauge where a correction should end, but no hard and fast rules exist except perhaps for the Dow theory rule that retracements should be limited to 2/3 of the previous swing. If the 2/3 level is breached, the trend has probably changed direction.

Swing Trading – A More Flexible and Surgical Approach

This brings me to the swing trading approach that I believe to be more flexible and surgical than trend trading.

The objective of the swing trader is not to jump on a trend and ride it through all of the corrections as a trend trader. A swing trader tries to capture those explosive 2 to 4 bar price swings that are so common. Many of the trades a swing trader takes will be in the direction of the trend, but some will be counter-trend. The swing trader is more concerned with price momentum than trend, looking for the path of least resistance at any given time.

Are there conditions that make an explosive price move likely?

I believe there are and I aim to demonstrate why I think this occurs. The trading set-ups I am about to show you are based on my theory that many of these explosive moves occur as the result of false breaks of support and/or resistance. It seems that for a market to make a large move in a given direction, a significant number of traders must be incorrectly positioned. Bulls and bears need to be fed and the fresh meat they consume comes from vulnerable traders!

Trading Rules

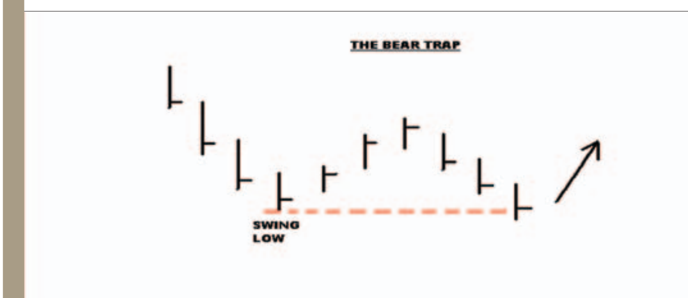
What trading rules could be employed to benefit from these market traps? How do we know when a Bull or Bear Trap has been sprung? Let's consider the Bear Trap buy signal and two of the entry triggers I use.

TRAPPED!

Introducing the Bull and Bear Trap!

When a support level such as a swing low is breached, the market often attracts fresh interest from both buyers and sellers. The 'buy low' crowd come in looking for value at previously cheap levels, while the breakout/trend following crowd sell the breakout looking for an extension of the decline. If the downside break fails to see follow-through selling, frustrated short sellers cover their positions bidding the market up creating a whipsaw. The market advance is exacerbated by the 'wait and see' crowd who come in after most of the cards have been played, and the 'buy low' crowd who add to their longs having been rewarded for their bravery in resisting the downside break. The resulting rally often lasts for several price bars, presenting a lucrative trading opportunity for the swing trader.

Graphic illustration of the Bear Trap (reverse criteria for Bull Trap)



Here are some examples of the Bull and Bear Trap in action:

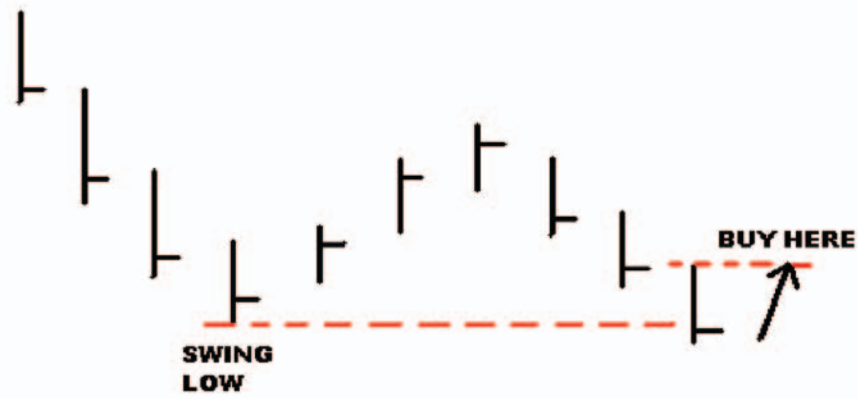
EUR/USD daily chart

S&P 500 Weekly chart

EUR/JPY Monthly chart

SOURCE BLOOMBERG FINANCE LP

Graphic illustration of the Type 1 Bear Trap buy signal



Type 1 Bear Trap Buy Signal

The first and most obvious strategy is to go long on a break above the high of the breakdown bar. When a swing low is broken, draw a line above the high of the bar on which the break occurs – this will be the buy trigger. If the market breaks above this line, all of the sellers of the break (of the swing low) will be trapped and their positions will be losing money. They will be covering their short positions, bidding up the price, and it is this move we are trying to capture.

I would place a stop-loss below the low of the last 2 bars for protection. If the market falls back through this point, the original downside break would be validated and more selling would likely follow.

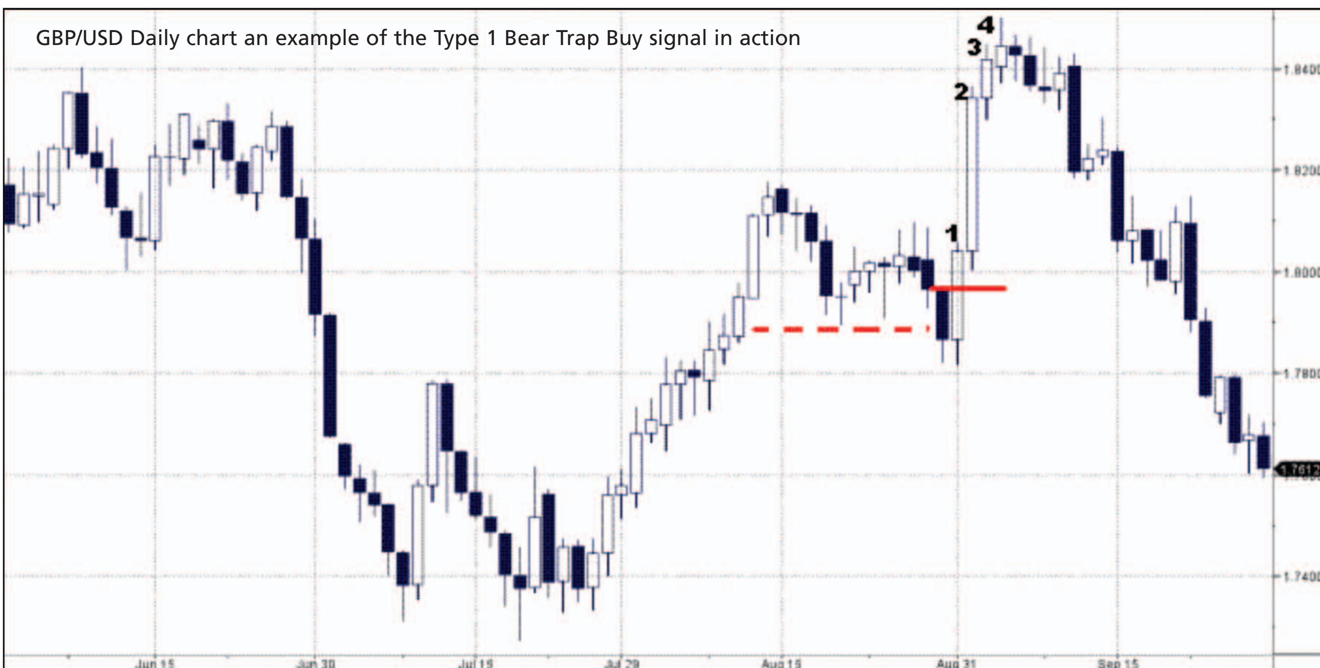
It is worth noting that as this strategy is taken intra-bar, i.e. you are buying 'on a stop entry' before the close of the bar, the possibility of an intra-bar whipsaw against you exists.

This would involve going long at the trigger, getting stopped out on a pullback to a new 2-bar low, before the market rallies over the next few bars as one would expect. In my experience, this does not happen very often and is a negligible risk, but one that should be considered.

Type 2 Bear Trap Buy Signal

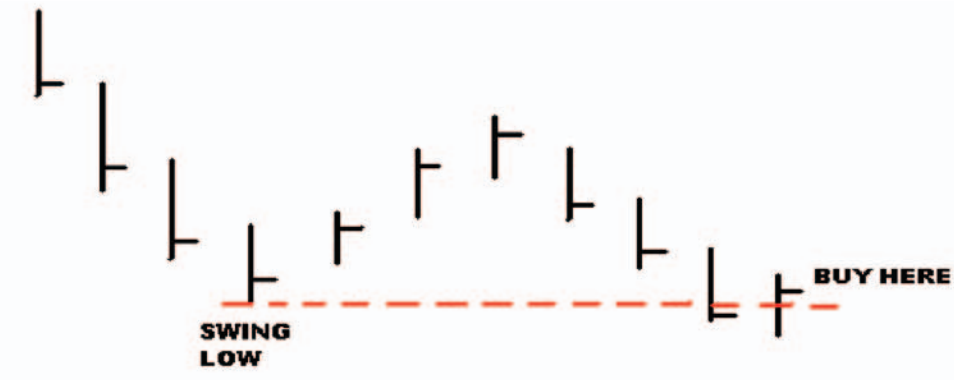
An alternative entry method would be to go long on the first close back above the broken swing low, provided it is backed up by another sign of strength such as a close in the top half of the range or a higher close. This signal may not be as strong as the

GBP/USD Daily chart an example of the Type 1 Bear Trap Buy signal in action



SOURCE BLOOMBERG FINANCE LP

Graphic illustration of the Type 2 Bear Trap buy signal



first one because not all of the sellers of the original break are underwater at this stage, but it does offer early indications of bear failure. Again, I would place a protective stop below the low of the last 2 bars, just in case.

Where to Take Profits?

Once a position is established, where should it be exited? The Holy Grail of the swing trader, I would say, is the strong 2 to 4 bar price swing and I would certainly be looking for a powerful move in my favour within 4 price bars. I would use this move to exit the position.

I would also want to take some profits at previous swing highs or swing lows, as traders tend to lighten up positions at these points. The key is to take some profits off of the table as market swings can reverse more quickly than one would like. Take your profits and wait for another set-up!

I hope that I have given you food for thought and that you will look at price charts and trading opportunities from a new exciting perspective. I wish you all the best in your trading! **TFJ**

Howard Friend is Chief Market Strategist at MIG Investments SA based in Neuchatel, Switzerland. He has worked as trader and market analyst for over 20 years and has developed proprietary trading methods to time the markets.

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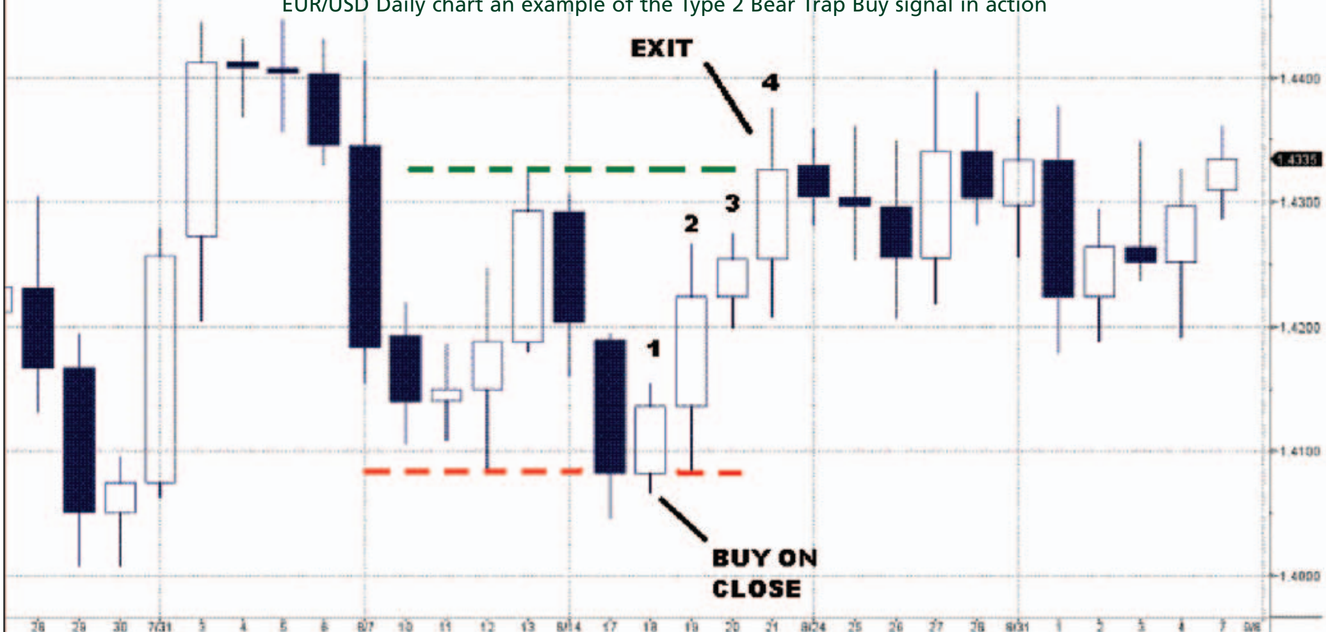
EUR/USD Daily chart an example of the Type 2 Bear Trap Buy signal in action



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