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My Personal Trading and Investment Thoughts

Introduction to my "Failure Confirmation" Concept

This PDF is one in a series that I am writing about the base concepts of my trading style. This document provides some detailed analysis about what I am referring to when I talk about waiting for a "Failure Confirmation" before taking a trade set-up. The Failure Confirmation concept applies to both intra-day trades and longer-horizon trade set-ups – it doesn't matter the time frame, it only matters that you have a certain sequence of candles before you enter a trade.

"If It Can't Go Higher, then It Must Go Lower …"

Price is continually undergoing a process of price discovery in the marketplace (i.e., supply and demand driving price higher and lower). If you accept this as a market truism, then if price can no longer go higher, it must go lower (and vice versa).

The above statement is, in a phrase, what I am referring to when I talk about Failure Confirmation. If I am looking to trade a particular stock, I have found that my best trade entries have always been when I am able to identify candle action that "proves" to me that price refuses to go in the opposite direction of my intended trade. I put quotation marks around the word "proves" because in trading there are no guarantees.

If for example, I am looking for a bullish long swing trade in a particular stock that is trading bearishly intra-day, I will generally look to enter the trade using my 15-minute chart when I see a confirmed reversal candle set-up i.e. when price proved to me that it could no longer go lower.

If the stock was actually acting more bullishly intra-day, I will look for a bullish rejection of the bottom of the intra-day trading range as my trigger to get long.

Before I go into illustrative examples of Failure Confirmations, I want to talk a bit more about the process of price discovery, as well as some general trading truisms that will help readers better understand why I am often looking for a Failure Confirmation at a certain level.

Price Discovery

Veteran traders understand that no matter what the time frame being analyzed, prices for stocks and ETFs continually search out a level that is considered fair by the majority of both buyers and sellers. In other words, supply and demand will determine at which price a security will trade. This is what is meant when you hear someone mention the concept of Price Discovery in the stock market.

What is fair value, and how is it determined? Well, you could write a number of investment tombs on this topic alone, but suffice to say that fair value is in the eye of the beholder. That is another way of saying that each buyer and seller will have differing motivations and time horizons with respect to their investments in a particular stock/ETF. For example, when I look to intra-day trade IBM's common stock long off of the prior day's low, I would hazard to guess that Warren Buffet will not be thinking the same thing – his idea of a good buying range may be 10% below yesterday's low in part because his horizon for an exit on this trade is likely to be a minimum of 5 – 10 years.

So when you combine all of the varying investor time frames with all of the differing ideas of fair market value, you arrive at a process of price constantly going back and forth.

Technically Driven Fair Market Values

My idea of fair value is probably more technically driven than fundamentally derived at. I'm not really going to explain all of the technical levels I watch or trade against with this PDF, but I do want to talk a bit about a couple of what I think are market truisms when talking about the price action / discovery process around technical levels of resistance and support.

1. Always Look to Your Left.

Traders often fail to take advantage of one of the simplest directional filters when trading … by this, I am referring to the fact that traders should expect the direction and strength of any recent stronger than normal price action to reassert itself if it has started to pause or begun to pull-back.

For example, if price made a strong bounce off of the morning low and trended higher for the past 60-minutes, traders should be looking at any short-term weakness off of that last pivot high to be just a pull-back consolidation and not a new trend lower.

When you look to the left of the current price action, what you see is price acting strongly. If you suspect or are anticipating a move lower from current levels for other reasons, at a minimum you need to wait for price to fail to bounce and take out the pivot high of that earlier strength. If it did fail to take out the pivot high, your most recent evidence would be one of weakening price action and therefore, an acceptable backdrop to try a short trade.

The biggest and most common mistake that retail traders make is that they think a stock is too strong or too weak and that the recent price action can't continue … that is wrong almost 100% of the time. Wait for price to show you that **it cannot make new highs or lows** before trying a trade in the opposite direction.

2. The Stronger and Quicker the Move, the Greater the Likelihood of a Break-Out Failure or Consolidation.

When you have an obvious technical level of price support or resistance, I always remind myself to pay attention to how quickly and how far price has traveled into that resistance/support level. This applies to all time frames.

For example, if a stock makes a strong quick intra-day move from a lower area of range trading up into the level of the prior day's high, I would always trade this stock assuming that this initial test was not going to see price make a sustainable break-out without first pulling back or consolidating sideways.

There are times when prices will run or gap through smaller time frame resistance or support levels without much of a pause, but that type of price action is generally news driven and not what I am referring to. Most normal trading conditions will see price respect this truism.

3. The First Test of an Obvious Level will Typically Fail.

Now, this may sound exactly like what I was saying in truism #2 above … it is but it refers to all types of first moves into an obvious level of support/resistance – not just ones where price makes stronger / larger-type moves.

Experienced traders understand the idea of obvious levels of support/resistance and how traders from around the world will be watching these levels. For example, a retail trader trying to momentum trade AAPL may use the high of yesterday's trading as their level to go long AAPL. Better capitalized, and often computerized algorithm trading programs know many retail traders will be getting long at the prior day's high playing and praying for a break-out … they also know that these traders will have a tight stop on their long trades as they do not want to get whipsawed like they have in the past when a breakout fails.

So, in essence, you have one group of traders trying to play a break-out move of a stock (with a tight stop-loss) and another group of traders willing to fade that break-out attempt. If the amount of traders playing the break-out is limited to generally just retail traders, this break-out will almost always fail on the first attempt as the better-capitalized fader sells more stock than retail traders and small institutions can absorb. The fader's goal is to overwhelm the break-out buyers in the short-term thereby causing the tight stop loss orders to get triggered and for price to then move back below the obvious break-out level. Once in a profitable position, these faders will cover their shorts and price will often but not always, retest that obvious break-out level.

If price attracts more and more buyers as it pulls back and trades around the obvious level of resistance, the stock will eventually be able to break that resistance level. That first test though is generally "known" by experienced traders as likely to fail.

4. Wait for a Candle in the Direction of Your Intended Trade

Again, one of the easiest trade filters for traders to take advantage of is to wait for at least one closed candle that is in the direction of your intended trade. Some traders will aggressively trade based purely on a level being hit … I think waiting for the partial confirmation of a directional candle will increase the winning percentage of your trades and increase your overall profitability.

5. Higher Time Frame Buyers and Sellers

Traders have to understand who is in command of the buying and selling of a stock on any given day. For example, corporate or industry news may cause a fundamental change in the attractiveness of a given stocks' current price. Good (or bad) news may cause a shift in bigger institutional demand for a stock, and once a decision to buy or sell is made, there may be a large difference in the amount of stock to buy versus the amount for sale.

That imbalance will often cause the stock to be constantly bid for (or sold) in the marketplace … this level of new additional demand (supply) does not care about price levels that intra-day traders normally trade against – they want to build (or sell) large positions and they understand that this may take several days to accumulate/distribute.

If shorter-time frame traders do not recognize when price is being affected by bigger institutional accounts, they are likely to get caught trying to fade normal range day support and resistance levels during an actual trend day of trading. That can be painful!

Ok … let's look at two examples of a Failure to Confirm.

Alibaba Group (BABA) – April 2, 2015

BABA Daily Chart – as of April 1, 2015

(**double click on any chart to bring up a separate copy**)

BABA has been a disappointing stock for bulls since the mid-November 2014 highs were put in ($120.00). Price has been trading in a range for the past 4 weeks, but if you look at the last three daily candles coming into April 2, 2015, you will see that they were all bearish red candles that not only ended lower than the prior day's low, but actually closed near the lows of the day.

So the bias for traders coming into the day would be to trade BABA to the downside …

BABA 3-Minute Chart – April 2, 2015

So coming into the day, your bias for BABA was to the downside … that meant any sign of weakness at the open would require traders to wait for Failure Confirmation of a consolidation range of that first move lower.

If price were to gap higher or move higher at the open, traders need to wait for Failure Confirmation of a second attempt to move higher after the first pull-back in price.

Point #1 shows that price pushed higher at the open … therefore, our bias would require us to wait for a Failure Confirmation of this opening bullishness before trying to short BABA. Price pulled back from the opening gap higher and then bounced higher into Point #2 after the opening 15-minute range was closed.

The bounce from the Opening Range low found resistance at the typical level I like to utilize when fading a stock near the open (the 50% Opening Range level). Now you needed a trigger … The first filter when looking for a trigger is a reversal candle or in this case, since I will often use the actual 50% level to fade, a bearish red candle at or near that level that points in the direction of a short trade lower.

Inside candles are viewed by some traders as a form of reversal candle … I generally only view hammers and shooting stars as possible reversal candles. If you take inside candles as reversal candles you can use the break of this candle's low as your trigger short. To me, the more conservative trade that gives you higher odds of not getting whipsawed is to wait for another candle to close below the first red candle's low and then use as a trigger **the low of that second candle**. In BABA's case here today that would only make a difference of $0.09/share … not a big amount for some extra confirmation of what price may end up doing.

The next level to watch price action at would be Point #3 … the purple dash line tells me that was the low of the day from the prior day April 1st. If price wants to keep going lower, we should not see any signs of price rejecting this level. There was an inside candle here but price did not break the high of that bullish inside candle. Remember one of the truisms that I mentioned earlier … if you look to your left as price pushed into Point #3's low, what you saw was weakness for the whole day so far – that tells you to assume that price is still heading lower until proven that it can't head lower. A small bounce in price is just that, a bounce … until price bounces and starts to give signs of more strength over a longer period of time, you still have good odds that price is going to continue lower.

Price did go lower to a new low and actually made a possible bullish reversal hammer candle at Point #4 … again, traders need to look to their left – traders have seen nothing so far today that tells them to expect a bottom near this level yet.

Price pushed down to another new low at Point #5 … again, look to your left and traders can see only weakness so far today. The one difference here though was that you were beginning to see some signs from the chart indicators that the push lower was running out of steam – the VZO had made a higher low, the red DI- line (Direction Indicators) had made a lower high, the trend strength histogram was near the extreme warning zone and the relative strength momentum indicator was showing divergences as well. Time wise, it was about 11am so in theory there was still time for another push lower during the Morning Trading Session.

In reality, a conservative approach would have been to take a partial profit on this trade and to move your stop lower to a level that you were comfortable with … an obvious level would have been just above the pivot high after Point #4's bounce. That would have stopped you out on the bounce into Area #6.

If you were aggressive and played for another attempt at a push into a new minor low (and you weren't stopped out), you would have noted the strength in the price action during the bounce into area #6 and how different that was relative to the earlier bounces. That price action and the chart indicators should have had you looking to cover your short on any possible reversal signal at any potential double bottom move or on any push down to a new minor low.

Point #7 was that push down to a new minor low – this was also right at 12pm and made sense as the conclusion to the Morning Trading Session. The bullish quasi-outside candle at Point #7 was a good signal for traders to cover their short.

Many aggressive traders may look at Point #7 as a possible long entry, but to me, all you have here is the start to a possible counter trend bounce that may only last over the lunch hour. I could see a trader arguing that the bounce up to Point #6 was evidence that a lunch hour bounce could be large enough for a scalp trade and in fact may mark the end of the move lower today.

If you took that aggressive trade at Point #7, you would be watching with interest at Point #8 … this level was right at the prior level of overlapping candles at Point #6 earlier and a logical spot for resistance. A conservative trader would take profits here and look for a Failure Confirmation of price rolling lower to re-enter a long trade. That is what happened … the 12:51pm candle was a large bullish candle that took out both of the consolidation candles, and your new entry would be the high of this large range candle or on the break of the high of the first candle to break the large range candle's high.

Point #9 came at a point where the chart indicators were pointing to a possible top to this expansion off of the low of the day … time for all traders to take profits (1:15pm).

BABA 5-Minute Chart – April 2, 2015

The last push higher into Point #10 was not the area for starting new trades, and it was at best, the last area where traders may have been hanging on for a more definitive sign of a possible reversal lower.

Macy's Inc. (M) – April 2, 2015

M Daily Chart – as of April 1, 2015

M's daily chart was starting to show signs of bullishness that the whole retail sector had been showing as of late. I highlighted an area of previous resistance with the blue rectangular box and that level would be important for traders to respect because price had faded that area in the past … however, M had made a higher low off of the last bullish looking push higher/retest.

To me, this daily chart looked like it was going to try and break higher … the question was when would it do it and how would the break occur? Would price make a clean break or would it be a smallish candle consolidation around the prior resistance level?

The indicators were not all screaming the start to a possible expansion phase so traders needed to be aware of a breakout trade. Be looking long, but look for a Failure Confirmation of price not be able to go lower.

M 15-Minute Chart – April 2, 2015

I wanted to show a bigger time frame chart here with the M example to better show how a bigger time frame intra-day chart also could be used to give you a Failure Confirmation.

M broke above the 15-min ATR resistance right out of the box first thing … any break of an ATR resistance/support level needs to be respected as a possible expansion signal. In this example, the 60-min ATR was in a position of support so, traders should have been willing to go long on either a bullish sideways consolidation near the break level or on a smallish controlled pull-back from the break level. When price pushes strongly higher through the break level like it did here with M, then you need to wait for the first bullish consolidation move after the initial push/break.

Having to wait for the first bullish consolidation after a strong push/break is sometimes frustrating, but it actually shouldn't be. After the strong break and bullish consolidation, you actually have more proof of a bullish acting stock, and the odds of follow-through and a winning trade set-up are greater than if price had pulled back or moved sideways.

So price pushed into Point #2 … that was the first 15-min candle that showed signs of an exhaustion/pause Again, look to your left … nothing to see but strength, so traders need to expect a continuation move after a period of rest/consolidation.

If possible, I like to see some sort of two-legged pull-back and if you look at M's consolidation here, you had that – the second push's low was seen with candle #1 which actually was a bullish hammer candle. My preference is to have a candle break that hammer high and then I would trigger on the break of that second candle's high.

Candle #2 was actually an inside candle so it did not trigger the hammer candle high yet … candle #3 actually broke the hammer high and closed above it as well. So an aggressive entry would have been on the break higher while a more conservative entry would have been on the break of candle #3's high.

Candle #4 was an inside candle and then candle #5 finally broke out of the consolidation and closed above all of the other candles being analyzed.

The next area of consolidation was at Point #3 … the chart indicators were beginning to warn traders of an extended push higher so it would make sense to monitor the candles to see when/if we could see a Failure Confirmation for price pushing higher. Candles 6 and 7 were both inside candles and then candle 8 pushed higher – some traders would have liked to now put their stop just below the low of this break candle (#8) but I like to place it just below the low of the two combined inside candles (candles 6 and 7).

Candle #9 broke either of these stop candles' lows so most traders would have been stopped out here – the chart indicators were warning of an extended move so taking profits here around 2:30pm is perfectly fine.

Summary

One of the trickiest parts to entering good trade set-ups is the actual timing of that buy or short … many good set-ups end up leaving traders frustrated and sitting on the sidelines when they enter the trade at an inopportune time (i.e., price is not quite ready to start its expansion phase). By entering at a time when price is not quite ready to start expanding, traders can find themselves doubting the set-up as price continues to chop, or even worse, they could get stopped out with a small loss by having too tight of a stop.

On average, I have found that the best time to enter a directional trade is when price proves to me that it cannot go in the opposite direction. When price tries but cannot sustain an attempted move in the direction opposite of my intended trade, price has made what I refer to as a “Failure Confirmation”. If price can’t go one way, it is going to try and go in the opposite direction …

Cheers … Leaf_West