

Why Pull-Backs And Consolidations Are Essential For The Trend

Introduction

Most traders don't spend that much time studying consolidations and retracements. In my opinion, this is a mistake. Whilst consolidations and retracements may not seem like the most interesting or informative things to study, they can actually give you a lot of really useful information about the market, provided you have an understanding of how and why they form.

Because most forex traders don't currently have this understanding, I thought that it would be a good idea for me to write a book explaining their formation in more detail.

I'll start by giving you a small introduction as to how and why the market moves (some of you will already know this), and then I'll move on to showing you how retracements and consolidations form, so you can see how they affect and influence the price movement we see on our charts.

In the last section, I'll show you how you can start using this information to not only figure out which technical levels are likely to cause a consolidation or retracement to form, but also show you how to determine when a large reversal, consolidation, or retracement is likely to take place, by analyzing the size of the movements you see on two different timeframes.

Let start by taking a look at what causes the market to move.

What Really Causes The Market To Move?

The reason most of the movement is caused by traders closing losing trades is that the forex market is a zero-sum game.

A zero-sum game is a name used to describe an activity (in this case trading) where the profits of the game are determined entirely by the other players participating in the game. For example, a popular zero-sum game you may have played before is poker.

The only way to win in poker is to take all the money off the opposing players. The amount of money you can potentially make in a game is determined solely by the amount the other players have decided to play with.

The forex market works in the same way! The amount of money you can make each day trading forex is limited by the size and number of people who decide to place a trade. If every forex trader got up tomorrow and decided not to place a trade, it would be impossible for us or anyone else to make money, as no one has put any money at risk by placing a trade. This brings us to a really important point.

The only time there is an opportunity to make money in the market is after people have decided to place trades. The more people who open trades, the larger the amount of money there is to be made by making them lose.

Of course, the question now is how do you make traders lose money? The answer is you don't, or I should say, you can't. You see, us retail traders do not trade at a level where we can affect the market price, so we can't make the market move against traders to make them lose money.

The only people who do are the bank traders, as the size of their trades are much bigger than ours, thus can easily cause the price to move up and down. Because the bank traders can only make money by making other traders lose, it means studying how they manipulate the market to make others lose, can give you a better understanding of how and when reversals, retracements, and consolidations are likely to take place.

When it comes to manipulating the market, the goal of the bank traders has always been the same. They want to mislead as many traders as possible into thinking the market is going to move in one direction, and then as soon a large number have opened trades, make it move in the opposite direction by placing trades of their own.

The banks know once they place their trades, the market will move against the

traders, forcing many of them to close at a loss. The orders that enter the market as a result of this will push the price further in the direction the banks have got their trades placed, causing their profits to increase whilst simultaneously causing even more traders to close their trades.

This process of manipulating the market to purposely make traders lose is something that takes place every single day. Luckily, it's something you can easily spot occurring because when the bank traders manipulate the market, it always results in one of two different market structures forming.

What are these structures you ask?

Retracements and consolidations!

Retracements And Consolidations

Retracements and consolidations are two of the most common structures you see form in the market. They can be found forming during every up and down swing, and every swing itself is part of either a consolidation or retracement on a higher timescale.

Most people think that retracements and consolidations are simply just things which happen during a trend, but they are actually structures created by the bank traders taking profits off their trades, as a means to make traders place trades in the opposite direction to which they want the market to move in.

Even though both consolidations and retracements are created by same action (the banks taking profits off their trades), the way in which they cause people to place trades is slightly different, due to the way they're constructed. A retracement pushes the market against the current trend, causing people to place trades because they think a reversal is taking place. A consolidation causes the market to move sideways, instead of allowing it to continue moving in the direction of the trend, misleading traders into placing trades under the impression a reversal is taking place.

So despite the fact they both cause the market to do completely different things, retracements and consolidation actually have the same effect upon traders when they form. Though they have the same effect, the points where the traders get their trades placed during the time each structure is forming is different.

Knowing where these points are is important, because the only way to gauge when a consolidation or retracement is likely to take place in the market, is by having an idea of when the traders who got trades placed during the previous consolidation or retracement closed their trades at a loss.

In this next section, I'm going to give you a step by step walk-through of how retracements and consolidations form in the market, so you can see where retail traders get their trades placed during the time each respective structure is forming, and where they close their trades at a loss, to give you an idea of when and where the next consolidation or retracement is going to form.

We'll start by looking at how retracements form, because they're slightly easier to understand than consolidations.

How Do Retracements Form?

I'm going to show you an example now of how a retracement formed on the 1-hour chart of EUR/USD. Even though this retracement formed on the 1-hour chart, the process that created it is exactly the same for all other retracements that form.

The only difference between this retracement and other retracements is the way it's constructed is slightly different to the way other retracements are constructed. This will be the case with all retracements you see form.

They won't all look the same or have the same features, but the overall process that creates them will be the same, regardless of where they form or which timeframe they form on.



In the image above, you can see a retracement that formed during a downswing on EUR/USD.

This retracement, like all others, formed as a result of the bank traders taking

profits off their trades. When the banks take their profits off, it causes the market to move up against the previous move down. This move up makes most of the traders who placed sell trades during the latter portion of the move down (marked with a blue box), close their trades at a loss.

Closing a losing sell trade requires you to use a buy order. So when the traders close their losing trades, lots of buy orders enter the market, causing price to rise.

As it moves higher, an increasing number of people believe the retracement is, in fact, a reversal, and begin placing buy trades to capture what they assume is going to be a continued move higher.



Eventually, price has risen to a point where a large number of traders have opened buy trades. This is the point where the bank traders will come in and get more sell trades placed. The reason why is because they've now got a big group of traders who they know they can make money off by making the market fall.

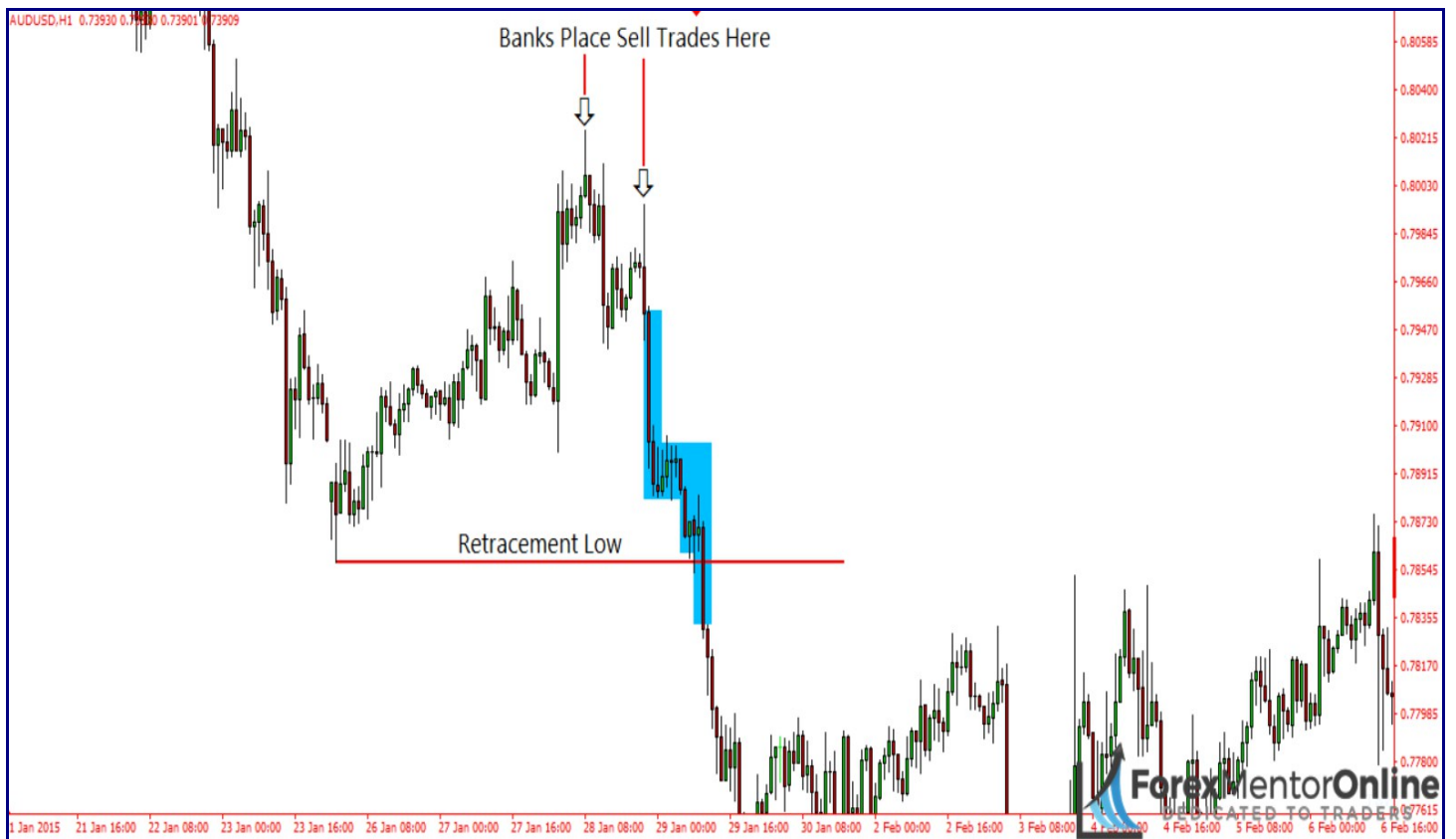
They know that when they place their sell trades, it'll make the market fall slightly, and that'll cause the traders who went long to panic and begin closing their trades at a loss, making the price fall further and causing the profits on their sell trades to rise.



If you look at this image, you can see how the down-move develops as more and more traders start closing their losing trades.

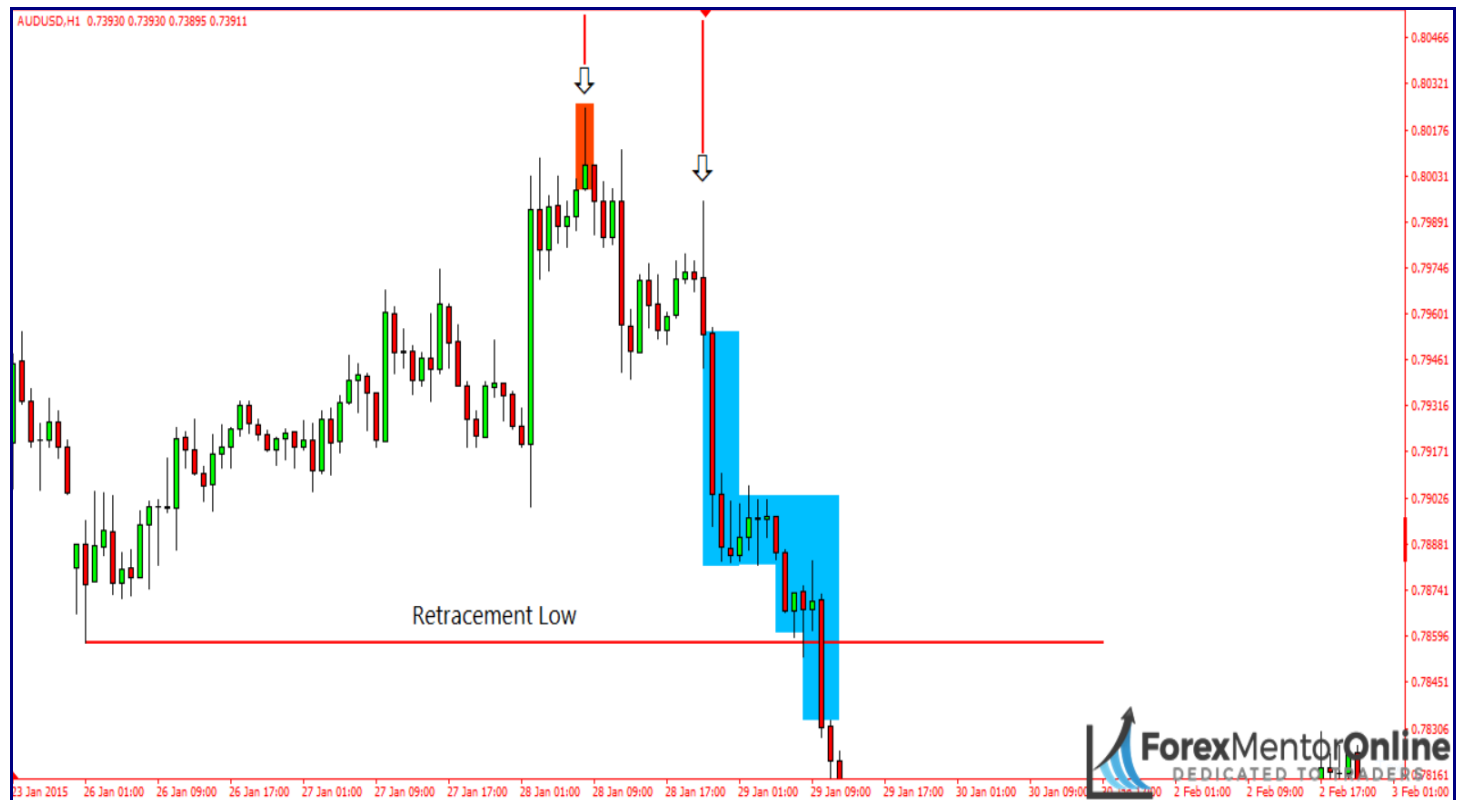
When the bank traders have got all of their sell trades placed, it only causes a small drop, but this small drop is enough to make many traders who were long close their trades at a loss. When they close, sell orders enter the market and cause price to fall further.

This causes even more traders to close their trades because it not only increases the loss on any buy trades traders are still holding open but also causes anyone who might have had a buy trade open at a profit to go into a loss.



It comes to a point where so many traders have closed at a loss that it's caused the market to drop below the low of the retracement.

By the time it's dropped this far, most traders who went long during the retracement have closed their trades at a loss. You don't know this for sure, but it's safe to assume so due to how far away the market now is from where most of them would've bought.



If you look at the image again, you can see I've marked the point where most of the traders would've placed their trades with a box.

You'll notice the box encompasses the range of the last big bullish candle which formed before the retracement terminated. The reason why most of the traders would have got their buy trades placed here is because of the fear of missing out.

The Fear Of Missing Out

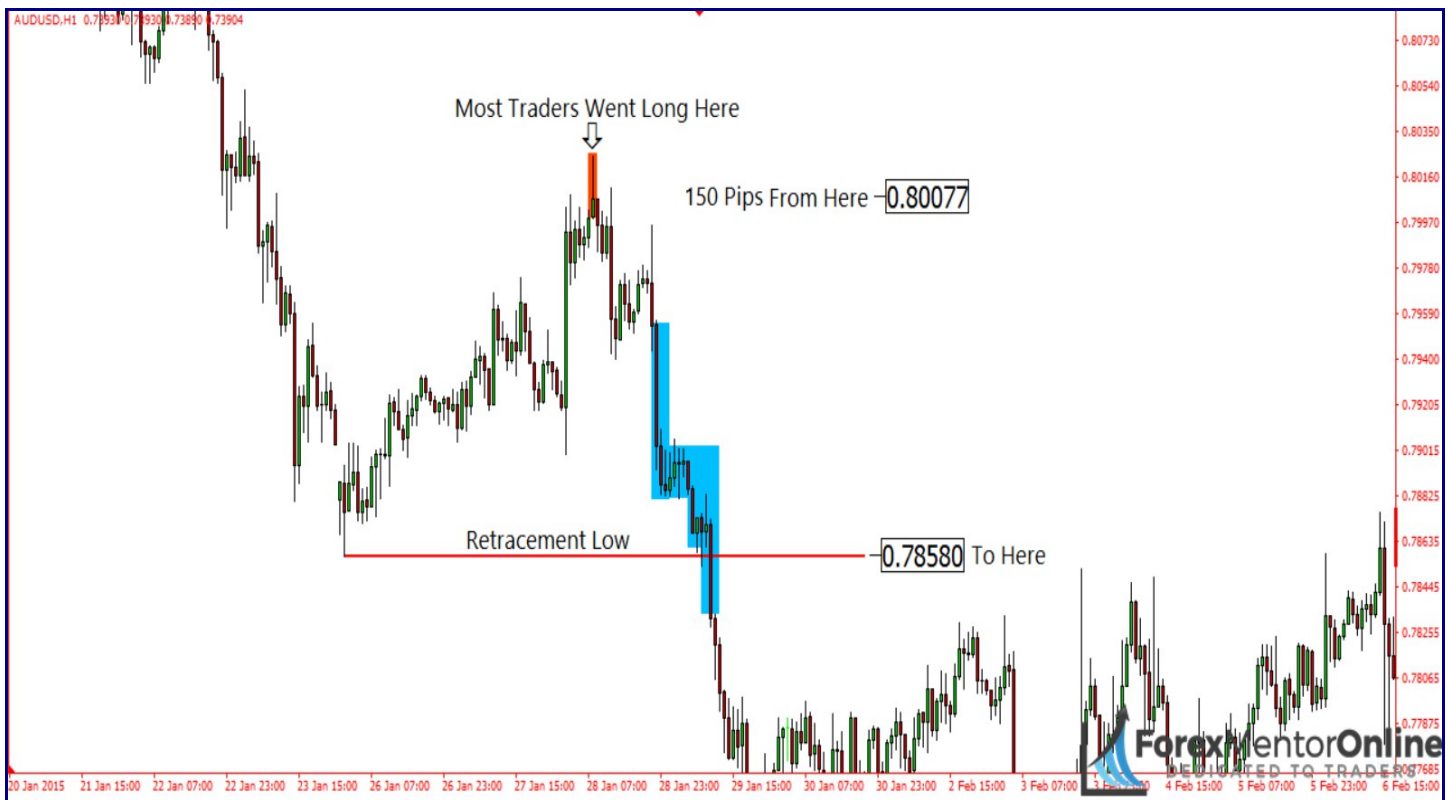
The fear of missing out is a thought process that takes place when a person (or trader in our case), believes they are missing out on something by not taking an action. In our example, the fear is missing out on potential profits by not getting buy trades placed.

When common retail traders see the market moving at a rapid pace, (which it does when large candles are forming) they feel compelled to enter trading positions, because the rapid pace makes them think the market is going to continue moving in that direction indefinitely, and that by not getting trades placed they're missing out on a large amount of profit.

So when the large bullish candle I marked in the image was forming, most common retail traders entered buy trades under the impression the market was likely to continue moving higher.

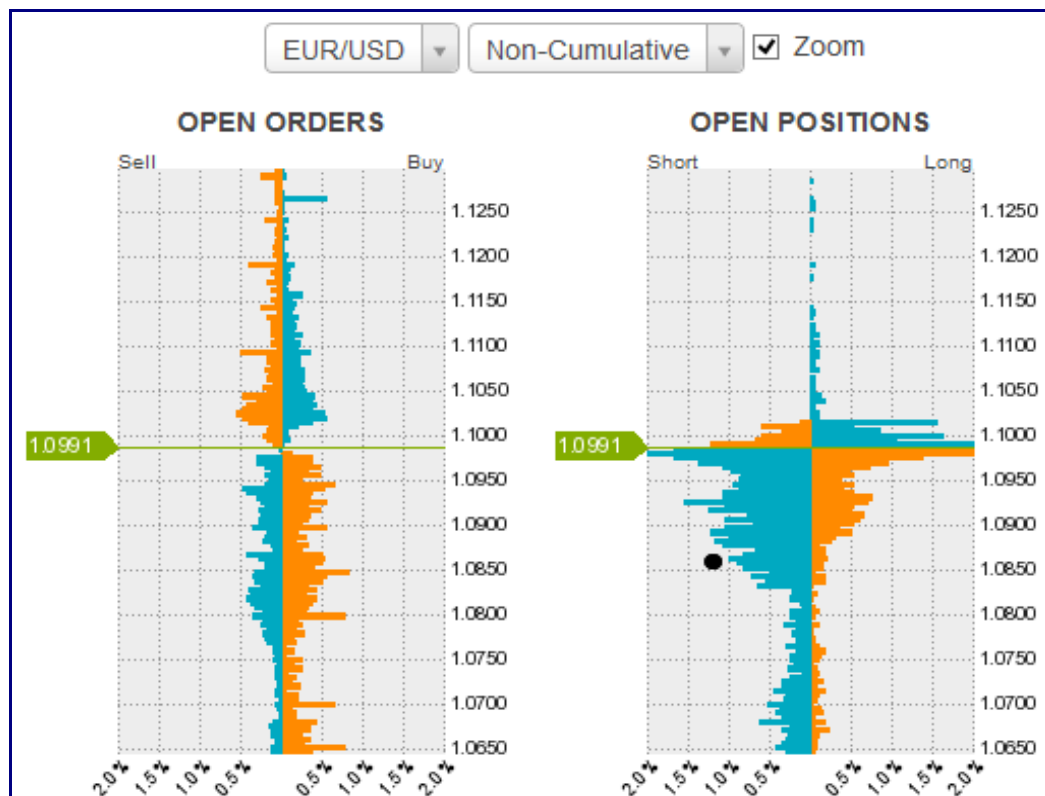
More entered during the time this candle was forming than when other large bullish candles formed during the retracement because the retracement itself had caused the market to move higher by this point, thus making more people think the market was reversing anyway.

If you want to find out where the majority of traders got their trades placed during a retracement, all you need to do is look for either the last candle with a wick on which formed before the retracement came to an end, or the last large bullish candle (or bearish candle for retracements that form during an uptrend) that formed before the retracement terminated.



By the time the market has reached the low of the retracement, it's moved 150 pips away from the point where you now know most of the traders would've got their buy trades placed.

The fact it's moved so far away means it's highly unlikely they're still holding their losing buy trades open. The reason why is because the majority of retail traders will have closed their losing trades once the market has moved 100 pips against them. It only takes one look at Oanda's order book to confirm this.



If you look at the open positions graph above, you can see I've marked a black dot on the traders who entered short around the 1.0850 - 1.0870 level.

Currently, you can see these traders only make up around 1% of the traders on Oanda.

Originally this wouldn't have been the case, and more than 2% would have opened short trades when the market first reached this price. The reason it's declined from 2% - 1%, is because the market has since moved further and further away from the point where these trades got their trades placed.

The further away the market moves, the bigger their loss becomes. So by the time it's moved 150 pips away, most of the traders have closed their trades, as they just can't handle their loss getting any bigger.

The point when the majority of the traders have closed their losing trades is the point when the bank traders will start taking profits off their own trades.

Taking profits off a sell trade requires there to be sell orders entering the market. The problem is the majority of sell orders coming into the market from traders closing losing trades aren't there anymore by the time the market has reached the low of the retracement.

So, where do the sell orders required for the bank traders to take profits come from?

The answer is from traders placing new sell trades.



When the down-move first begins, very few people are interested in getting short trades placed, as it still looks like the market has the potential to reverse and continue moving higher.

As the market falls further, more and more traders start entering short trades, because it looks increasingly unlikely the market is actually going to reverse.



By the time it's broken beyond the swing low created by the retracement, most traders are getting short trades placed, which means the bank traders will now start taking a large amount of profit off their own short trades. They would've been taking small profits off during the whole move down, but it's only after a large number of traders have opened short trades that they can take a much larger amount off.



Eventually their profit taking causes another retracement, and the same process outlined over the last few pages ends up repeating itself.

Sometimes this won't be the case, and instead of seeing another retracement you'll see a consolidation or reversal take place.

Summary

Here are the main points I want you to take away from this chapter.

- All retracements, no matter how big they are, form via the process described in this section. Retracements that form during uptrends also form in the same way, only the entire process is reversed, i.e the retracement causes people to place sell trades instead of buys, and the bank traders get buy trades placed instead of sell trades.
- To find out where the majority of traders got their trades placed during a retracement, just look for the last candlestick that had a decent-sized wick on before the retracement came to an end, or the last big bearish (or bullish if it's a retracement in an uptrend) candle that formed before the retracement terminated.

How Do Consolidations Form?

Now you have a bit of an idea as to how retracements form, I want to move on and show you how consolidations are created.



In the image above, you can see a consolidation that formed during an up-move on EUR/USD.

This consolidation was created by the bank traders taking some profits off the buy trades they managed to get placed earlier on in the move up. When they take profits, it causes the market to move against the traders who placed buy trades at the end of the previous move higher.

Just like retracements, the market moving against the traders forces some of them to close their trades at a loss, which, because they got buy trades placed, means they put sell orders into the market.

These sell orders start to push the market down, but instead of letting it drop as they do during retracements, the bank traders decide to enter the market and get more of their buy trades placed.



When they place their trades, it causes the market to rise again, which misleads many traders into placing buy trades because they think the rise is a sign the previous move higher is now going to continue. The bank traders use the buy orders which come into the market as a result of this to take more profits off their own buy trades.

This causes the market to drop again and gives them more sell orders to use to get additional buy trades placed.



This process of placing trades and taking profits repeats itself until the bank traders have been able to take the required amount of profit off their trades and get the necessary number of buy trades placed.

Now they can make the market reverse and make a profit off their newly placed buy trades.



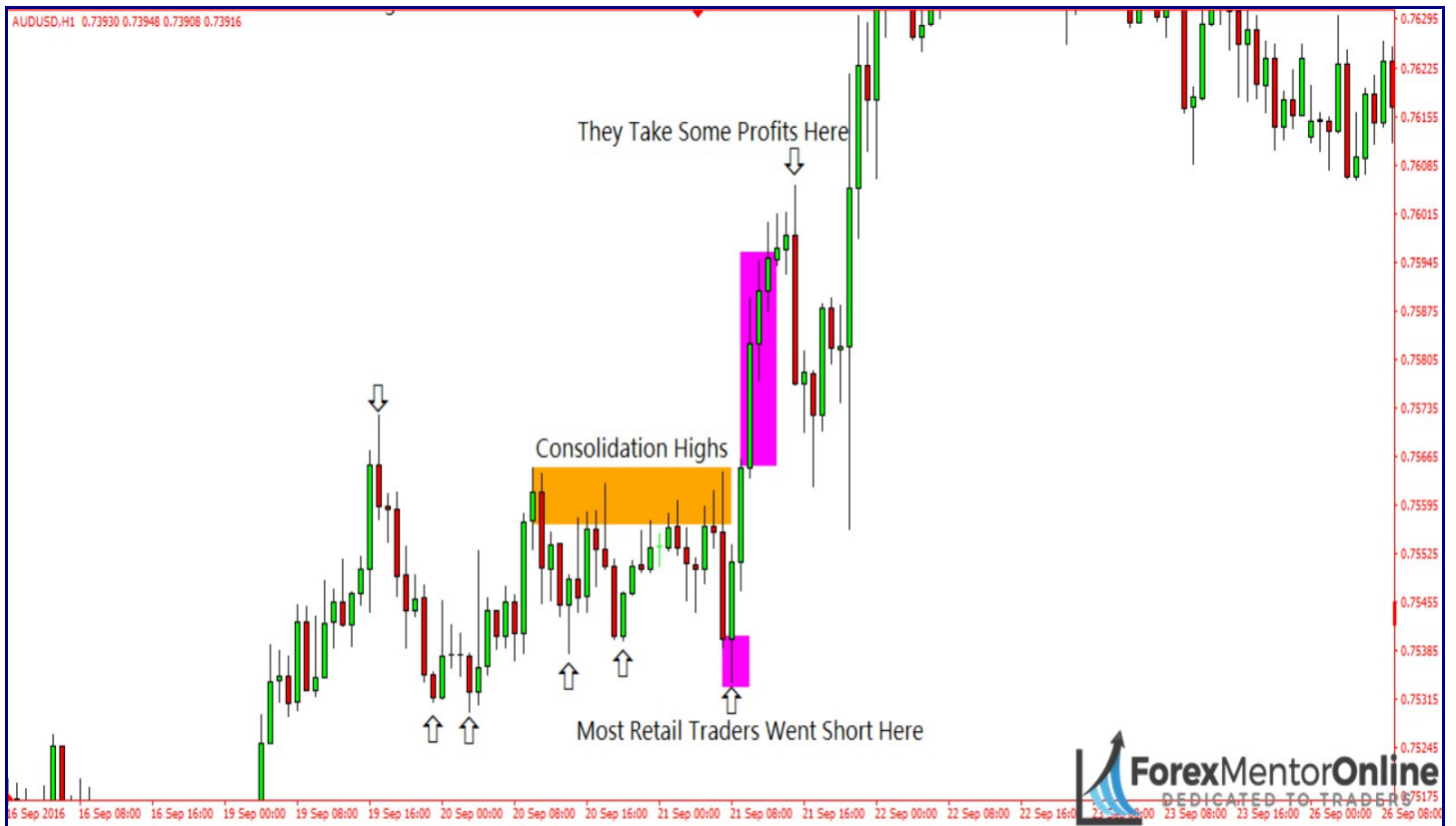
When the market reaches the high of the consolidation, most of the traders who went short have not yet closed their trades at a loss. The reason is that they still believe the market is going to continue consolidating.

Every up-move to the highs that has taken place up to this point has resulted in price falling due to the bank traders taking profits. The short traders have no reason to suspect that this final up-move is going to be any different, so they hold their trades open under the impression another move down is going to take place.

Important Note:

The points most traders get their trades placed during consolidations is around the swing highs or swing lows of the consolidation itself.

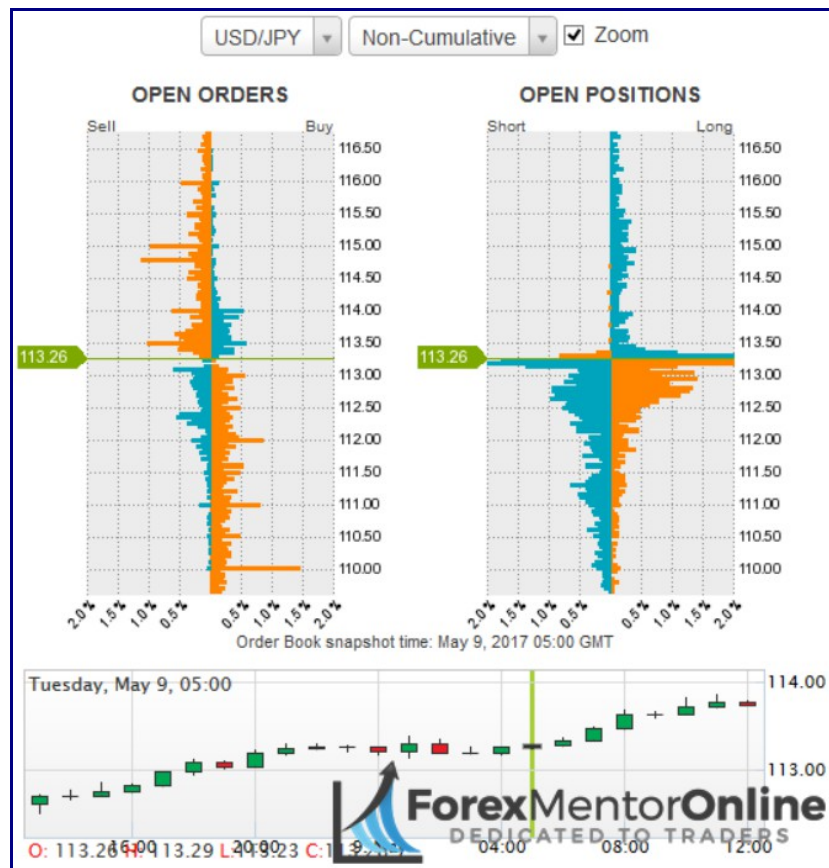
Because the consolidation in our example formed during an up-move, it means most of the traders holding short trades open got their trades placed at the swing lows. If it had formed during a down-move, most of the traders holding buy trades open would've got their trades placed around the swing highs.



When the market breaks through the highs, it causes many of the traders holding losing short trades open to close their trades, as they see the highs being broken as confirmation the consolidation is over.

When the market has moved 60 pips away from where the traders got their sell trades placed (the lows of the consolidation), it's fair to assume that most of them have closed out their trades.

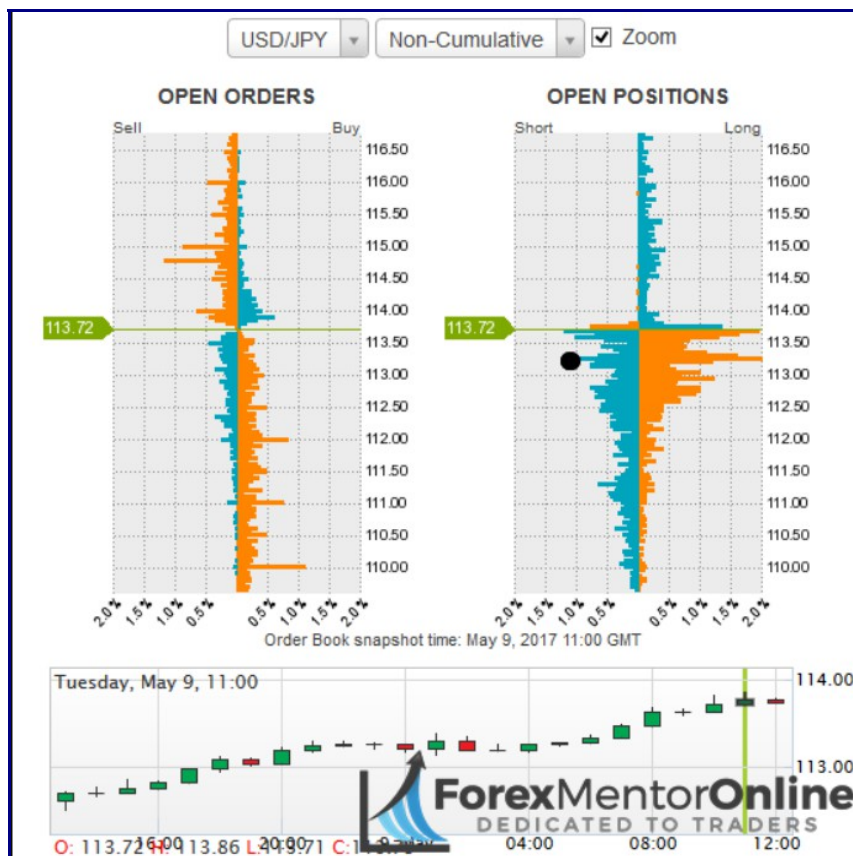
The reason why is because Oanda's Open Position's Graph shows most traders who place trades during consolidations will have closed their trades by the time the market has moved 60 pips away from the points where they entered their trades.



The image above shows what the open positions graph looked like just before a consolidation came to an end on USD/JPY.

You can see that at the time this image was taken over 2% of traders were in losing short trades from around the 113.200 level. These traders got their sell trades placed two hours before this image was taken when the market dropped slightly around 03:00 am.

They thought the drop was a signal the market was about to reverse to the downside, so entered sell trades in an attempt to make money from the fall.

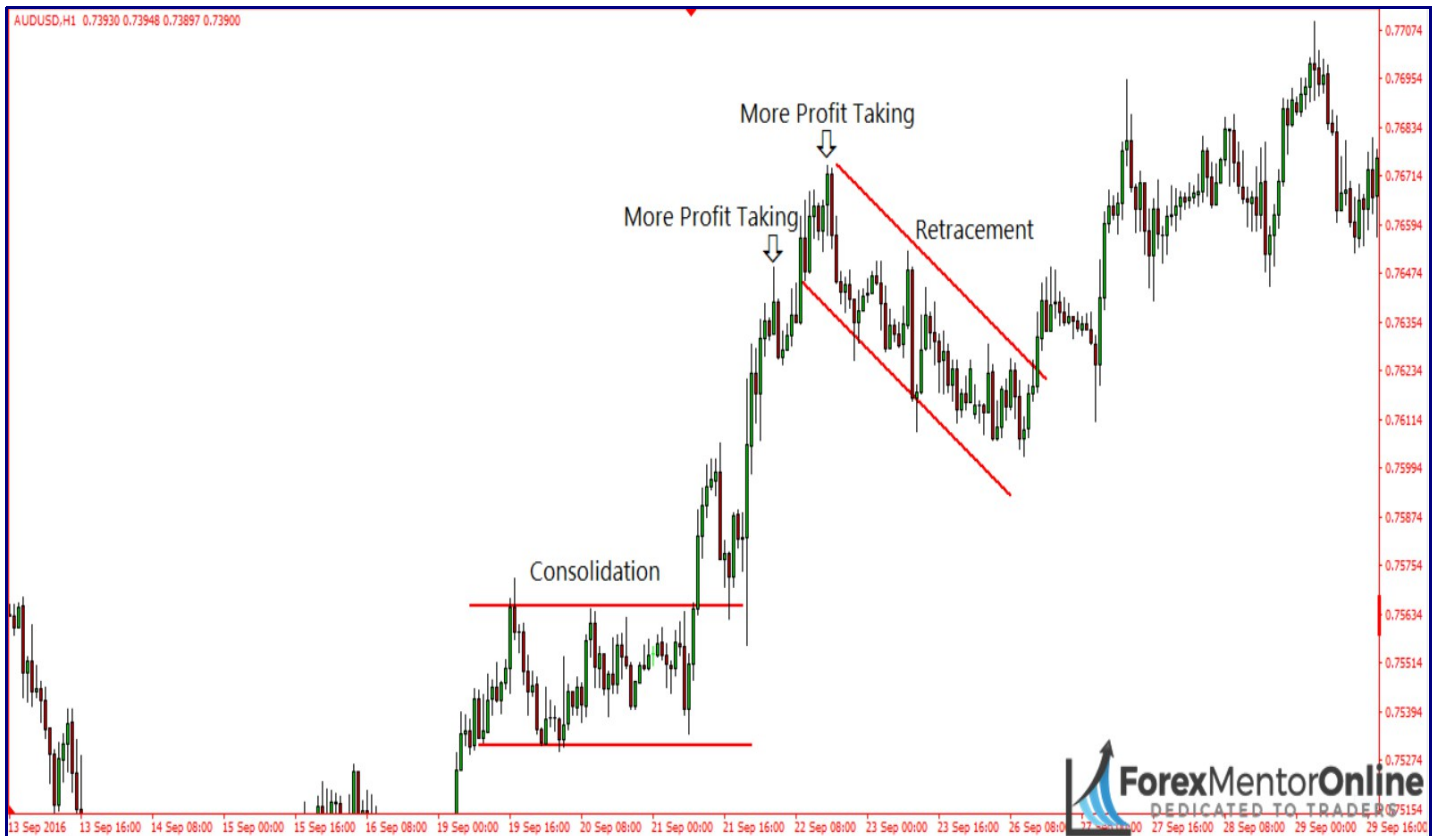


Here's an image of what the Open Positions Graph looked like 6 hours after the previous image was taken, and 8 hours after the traders had placed their sell trades due to the fall.

You can see that the number of traders who were holding losing sell trades open has declined significantly, from 2% when it was around the 113.200 level, down to 1 % after it had moved up to the 113.700 level.

The reason it declined so drastically was that the market had moved far away from the points where these traders got their sell trades placed. The further away it moved, the higher their loss became. So by the time the market had reached the 113.700 level, most of the traders had already closed their trades, as they couldn't handle holding a trade open at a 50 - 60 pip loss.

It would've been at this point when the bank traders start taking a larger amount of profit off their trades, because by the time the market has moved 50 - 60 pips away from the consolidation, most of the traders in the market will be getting buy trades placed again - thus there will lots of buy orders available for the bank traders to use to take profits off their own trades.



If we go back to our example, you can see when the bank traders start to take profits off their trades.

Once the banks have taken the necessary amount of profit off, the market falls again and causes another consolidation or retracement to take place. If a consolidation forms, it will follow the same process I've outlined over the last few pages.

Summary

Here's a summary of the main points I want you to take away from this chapter.

- The points where traders get trapped in losing trades during consolidations are the swing highs and lows of the consolidation itself. If a consolidation forms during an uptrend, traders will be holding losing trades open from the swing lows of the consolidation. If one forms during a downtrend, traders will have losing trades open from the swing highs.
- The bank traders cause a consolidation to form by taking profits off their trades and then placing more trades in the opposite direction. Instead of them letting the market move against the trend before getting their trades placed, they place them right after they have taken profits, and then proceed to get more placed at the same price.

Putting It All Together

In this last section, I want to show you how to use this information I've given you to better determine when consolidations and retracements are likely to form in the market, and when large reversals are going to take place.

At the beginning of the book, I talked about how the forex market was a zero-sum game, a game where one person cannot make a profit unless others are losing. Because this rule applies to everyone in the market, it means the only way the bank traders can make a profit on their trades is by making other traders lose money. The way they make other traders lose is by pushing the market against them once they've misled them into getting trades placed in the opposite direction.

Now there comes a time when most traders who the banks misled into placing trades have closed their trades at a loss. At this point, most of the movement in the market comes from traders placing trades in the same direction the banks have got their own trades placed.

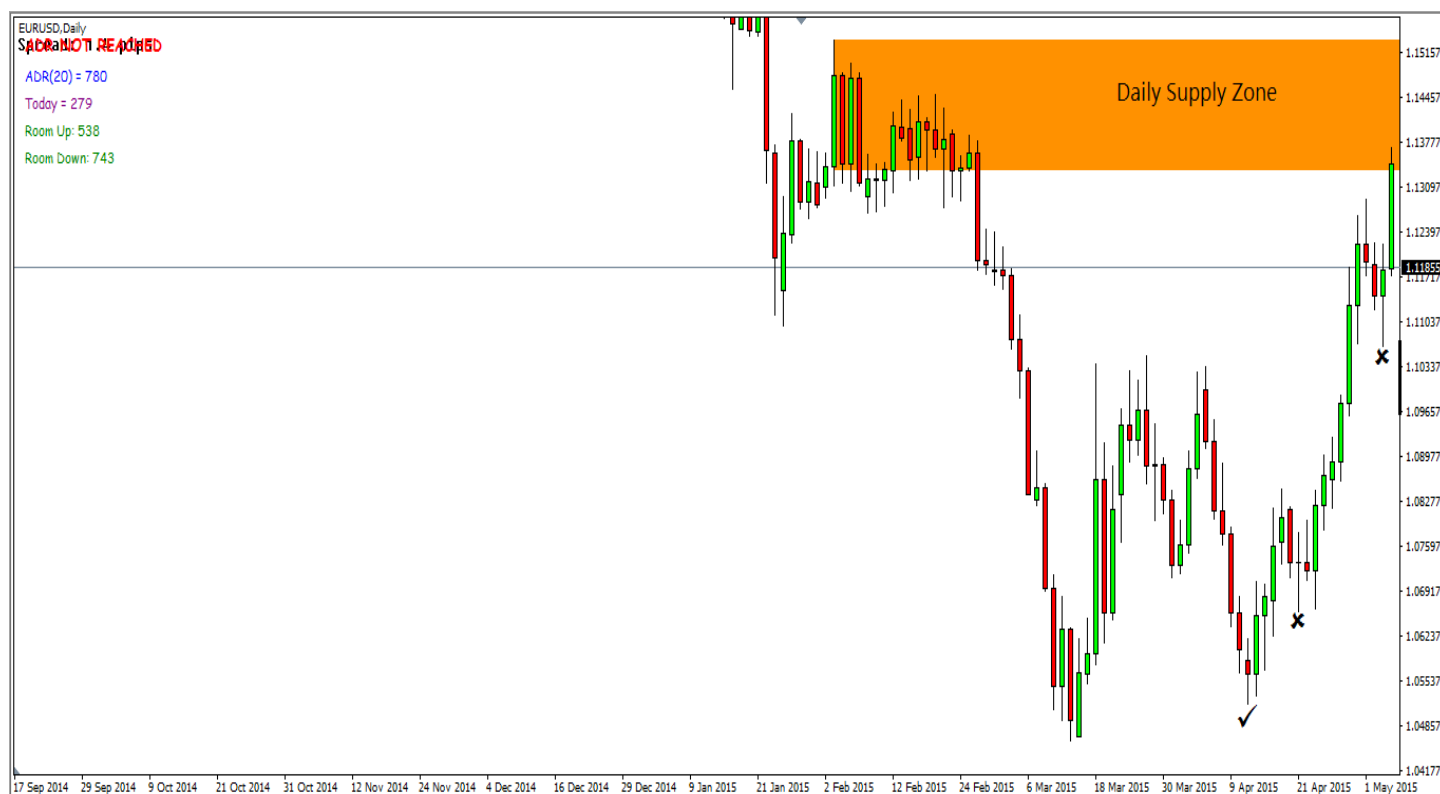
Eventually, it reaches a point where so many traders have got trades open the bank traders have to make the market move in the opposite direction, so as to actually make money off their own trades (via taking profits), and to give themselves an opportunity to make more money from the market by misleading traders into placing trades in the wrong direction again.

What this means is that the bank traders cannot let the market continue moving in one direction indefinitely, they've got to take profits off their trades to cause it to consolidate and retrace periodically, to make people place trades in the opposite direction, to create an opportunity for themselves to make more money by pushing the market against them.

In other words, the market cannot move up and down without retracements and consolidations taking place during the move.

How To Use This New Understanding In Your Trading

By understanding that it's not possible for the market to continuously move in one direction without consolidations or retracements taking place, you can not only anticipate when reversals are likely to occur but also get an early warning on which technical levels have a high probability of causing a retracement or reversal to begin.

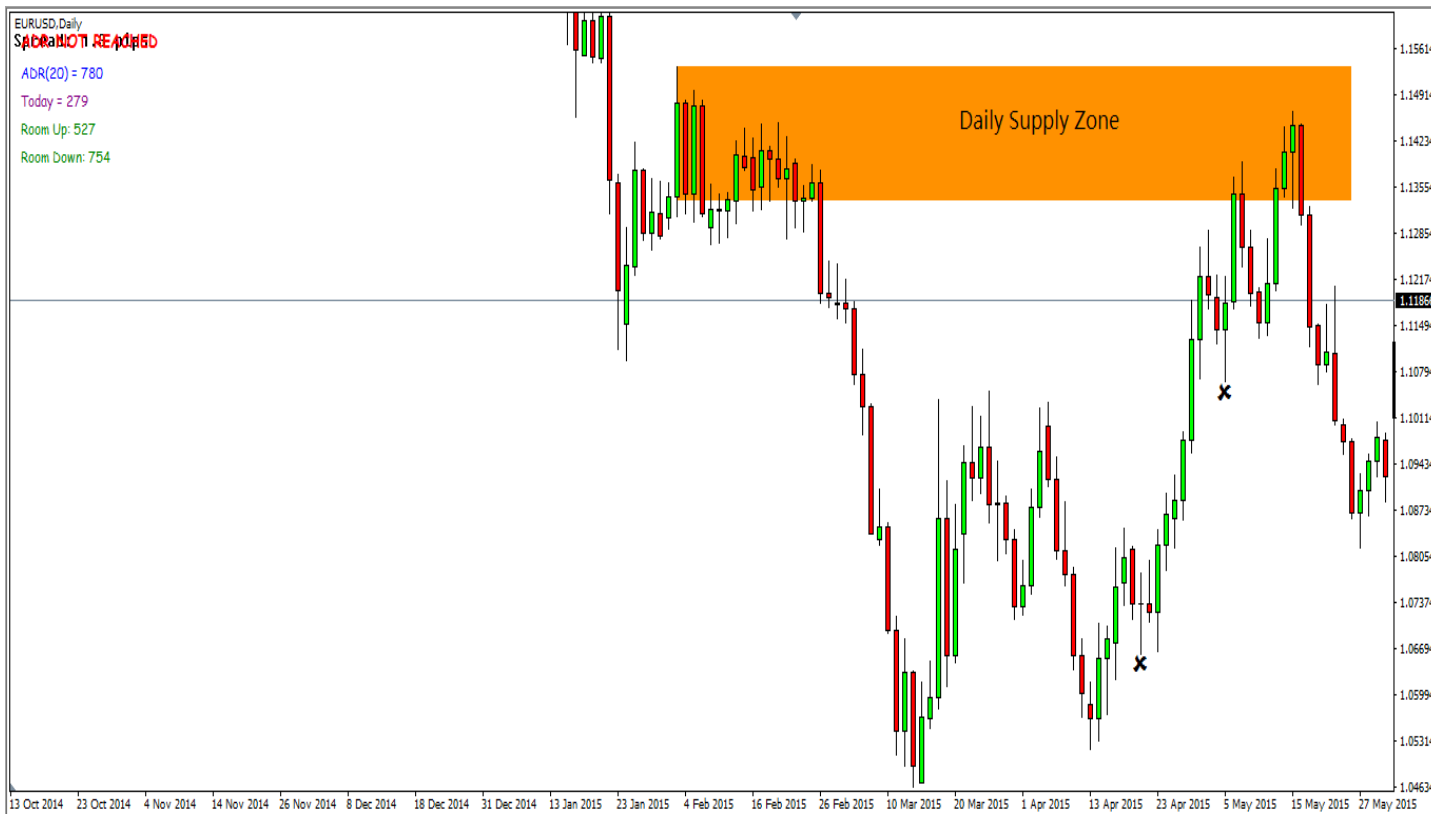


The image above shows a daily supply zone that formed on EUR/USD.

You can see by the time the market reached this supply zone, it'd moved far away from the point where the last retracement (marked with a tick) had formed. Other retracements marked with X's had taken place during the move, but these were too small to be factored into the analysis.

The fact it had moved such a large distance away, meant it was likely you were going to see either a consolidation or retracement form when the market entered the zone.

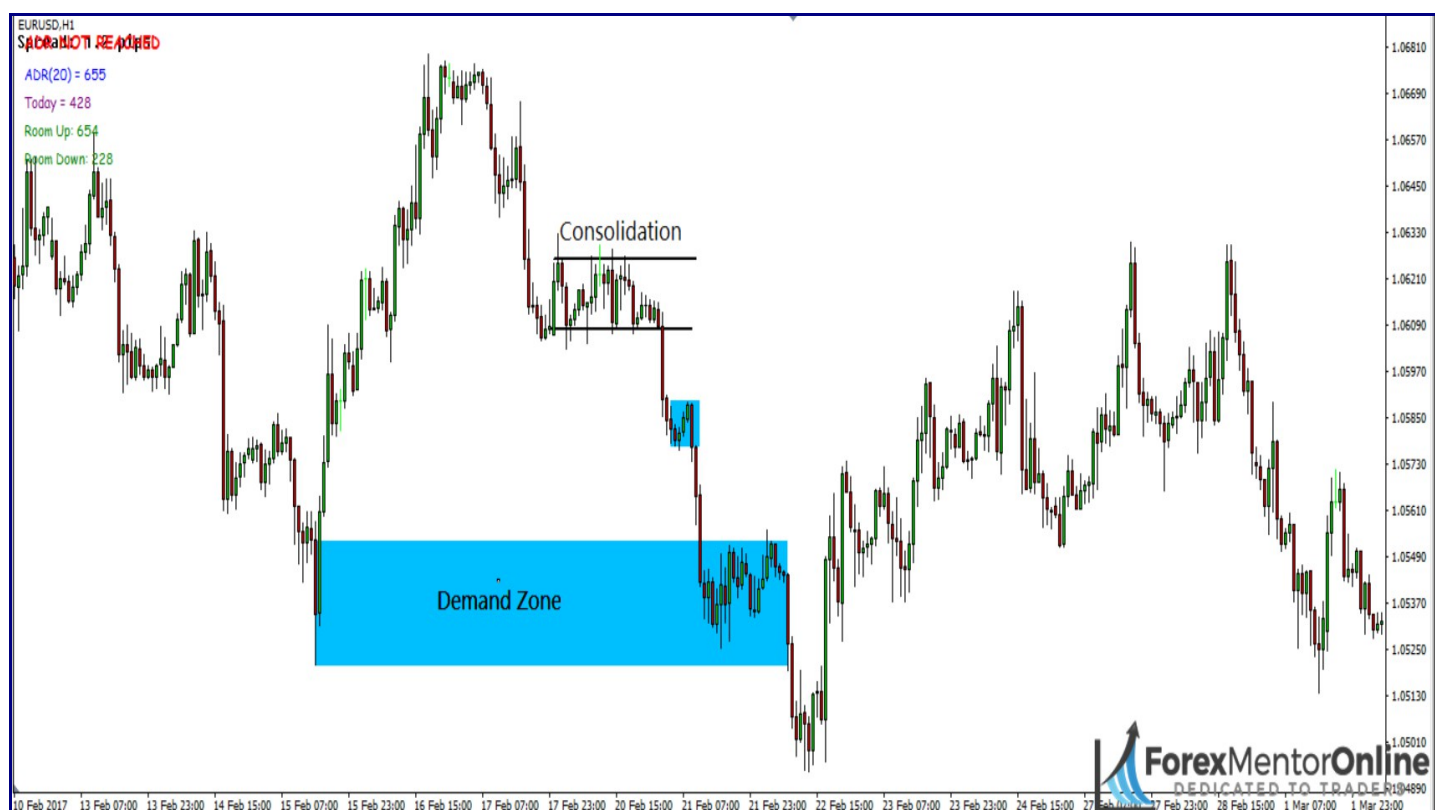
Not because the zone itself had any unique properties, but because the market can't keep moving in the same direction without consolidations or retracements taking place every so often.



If I move the chart on a little bit, you can see soon after the market entered the zone it did in fact drop out and cause a retracement to form.

Although you couldn't have predicted whether a consolidation, retracement, or reversal was going to form from this zone, by at least knowing one had a high probability of being created, you could've taken the necessary precautions on any trades you had open, or started looking for an entry into a short trade.

Lets take a look at another example.



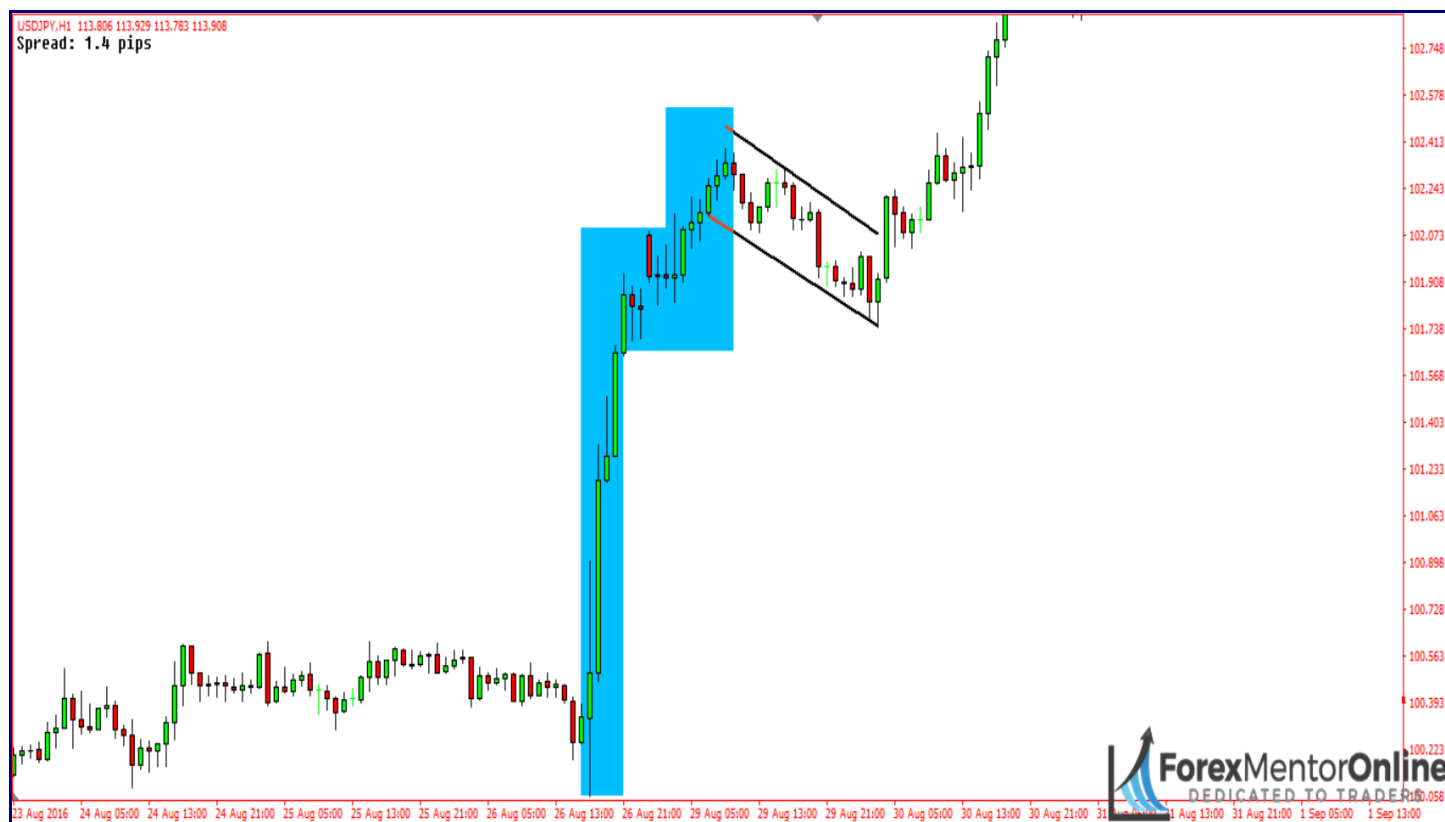
In this image, you can see a retracement took place after the market entered a demand zone that formed from a sharp move higher.

You could have anticipated that a retracement, consolidation, or reversal was likely going to take place from this zone, based on the fact you could see the market had fallen a large distance away from the point where the most recent consolidation had formed.

You know the further away the market moves from the consolidation, the higher the chance another consolidation or retracement is going to form. The demand zone was a likely place for this to occur, due to the fact the market often reverse/reacts to supply and demand zones.

Another way you can use this new understanding is to predict when large reversals and deep retracements are likely going to take place.

This concept of the market not being able to continuously move in one direction without consolidations and retracements forming applies to all timeframes. This means you can anticipate when a large reversal or retracement is likely to take place on one timeframe, by looking at the movement which has occurred on a higher timeframe.



In the image above, you can see a retracement formed after an up-move on the 1-hour chart of USD/JPY.

Before this retracement took place, you would have anticipated a retracement or consolidation was going to occur, due to the fact the market had moved a large distance away from where the previous consolidation formed.

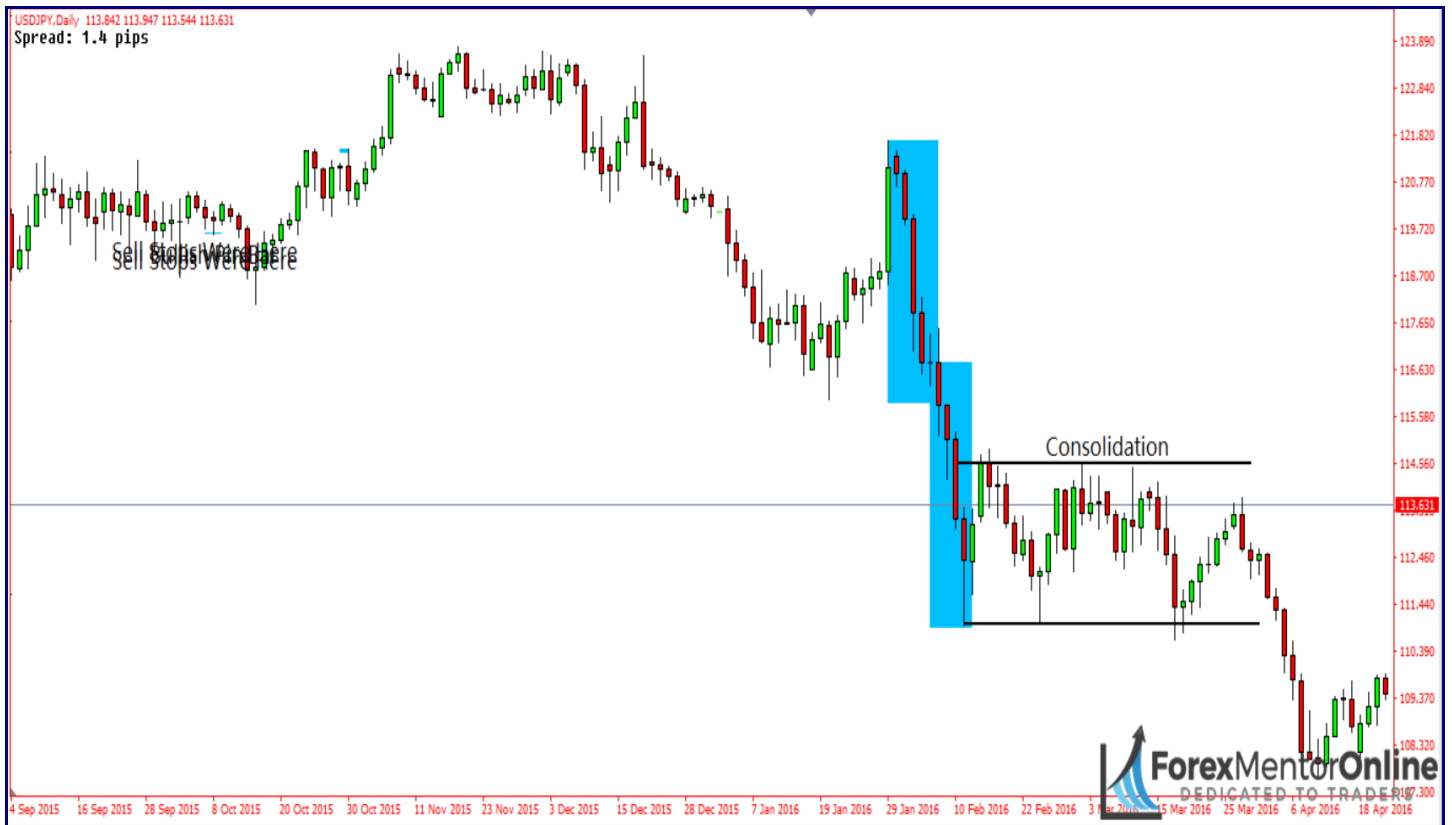
Knowing a retracement was likely going to form would've given you a hint a large reversal was probably going to occur on the 5 minute and 1 minute chart, because although the retracement is considered to be a small move down to the traders on the 1 hour, to the traders on the 5 minute, the drop is classed as being a significant reversal.



Here's what the retracement looks like on the 5-minute chart.

You can see what was just a tiny retracement on the 1 hour is a pretty significant move on the 5-minute chart. Knowing that a move like this was likely to occur would have been invaluable information to someone who trades off the 5 minute because it would've allowed them to close or take profits off any long trades they might have had open.

You can carry out the same process above to determine when big retracements - consolidations or reversals are likely to occur on the 1-hour chart too.



In the image above, you can see I've marked a consolidation that took place after a large down move on the daily chart of USD/JPY.

You could have anticipated the formation of this consolidation just from the fact that you knew the market had dropped a large distance away from the point where the previous retracement formed.

If it's moved a large distance away from where it's formed, it means another retracement or consolidation is going to form soon, as the bank traders cannot make money unless other traders are losing money, which they won't be if the market continues to drop without any more retracements or consolidations taking place.

Knowing a retracement, consolidation, or reversal was likely to occur would have been helpful to a trader who trades off the daily chart, but even more helpful to a trader who trades off the 1 hour. On the daily, the consolidation doesn't look that significant, but on the 1 hour, it's huge!



Here's what the consolidation looks like on the 1-hour chart.

You can see even though they are technically the same size on both timeframes, on here, the consolidation appears much bigger than on the daily chart. If you knew a consolidation like this had a high probability of forming, you could have started watching for signs of a reversal, or made the necessary adjustments to any short trades you may have had open.

Ultimately, you're never going to know which structure is going to form after the market has moved a large distance away from the point where it reversed, or where consolidation or retracement took place. Despite the fact you don't know, by at least knowing one is going to form, you can manage your open trades more effectively, and be more aware of what might take place soon.

Final Summary

Here's a summary of the main points I want you to take away from this last chapter.

- If you see the market has moved a large distance away from the point where the most recent consolidation or retracement has formed, before it enters a supply or demand zone (or support and resistance level), it's likely you'll see a new consolidation or retracement begin once it has entered the zone or hit the level.
- Looking to see if the market has moved a large distance away from the

point where a consolidation or retracement has formed on a higher timeframe can allow you to determine when a large reversal, retracement, or consolidation is going to form on a lower time frame. This can be helpful when it comes to taking profits and watching for opportunities etc because what initially appears to be a small movement to a trader on one time-frame, is often a much bigger move to a trader who is using a lower timeframe.

- If you trade off the 1 minute or 5-minute charts, you should watch to see how far the market has moved on the 1-hour chart to see when a large reversal or retracement is going to take place. If you trade off the 1 hour or 4-hour charts, you should watch the daily chart to see when a large reversal, retracement, or consolidation is going to take place.
- The market cannot keep moving up or down continuously without consolidations or retracements forming. The further the market moves without a consolidation or retracement forming, the higher the probability you're going to see one form.

Closing Words

I hope you can now see that despite the fact you can never know exactly when a consolidation or retracement is going to form in the market, by at least understanding how they are created, you can come up with a rough idea as to when and where one is likely to form.

Thanks for reading.