5

RULES FOR TRADING

SUPPLY AND DEMAND

LIKE A PRO TRADER

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INTRODUCTION

If you're tired of losing money trading supply and demand, hold onto your hats, as this might just be the book that turns your trading around.

Supply and demand traders lose money for lots of reasons. Most of these you probably already know, or have committed yourself like drawing the zones incorrectly, entering with the wrong signal, trading the wrong zones, etc.

But there's another reason so many traders lose. A reason few traders even realize as being a mistake...

They follow the wrong rules for trading the zones.

Like most strategies, supply and demand has certain rules on how it should be traded. For example, only trade zones with a strong move away is one of the core rules almost all supply and demand guru's and experts give. The idea it's okay to trade old zones that formed a long time ago is another.

You probably follow many of these rules in your own day-to-day trading of supply and demand.

The problem with many of these rules (including the ones above) is that they aren't correct... they don't make sense with how the market works or why the zones form.

So when you follow them, naturally, you end up with lots of losing trades... not because you did anything wrong – though you'll probably find some reason to blame yourself – but due to the rules being incorrect and causing you to trade the wrong zones.

Now this is a big problem in the supply and demand world, and it's one I went through myself when I started trading S & D. I followed the wrong rules for years and suffered many losses from thinking I kept making mistakes when it was really me following the wrong rules for the zone.

I don't want you or anyone else to suffer the same fate I did, so in this book, I'm going to detail the 5 rules you need to trade trade supply and demand like a pro trader.

These 5 rules cover teach you to trade the zones THE RIGHT WAY. They cover all aspects of trading S & D, from which zones to trade, how to determine strong zones from weak ones, how to trade with the trend, plus more…

With these 5 rules, you'll be able to trade S & D just like the pros and avoid the many mistakes and losses that come with trading under the wrong rule set.

So without further ado, let's get started with rule #1…

RULE #1 A STRONG MOVE AWAY DOES NOT MEAN A ZONE IS STRONG

Have you ever wondered why seemingly strong supply and demand zones often fail to cause reversals?

When I first started trading S & D, I wondered this myself. My guru at the time said zones with strong moves away were the best to trade, but they kept falling. Again, and again, these (supposedly) strong zones failed, and I could not understand why. Sound familiar?

As I learned more about trading, specifically how order flow works, I realized the guru's and experts had got it wrong.

The strength of a zone didn't depend on the move away like they said, it was determined by the move seen before the zone formed.

To explain why this is, we need to talk about how a zone forms.

All supply and demand zones form from the banks. The banks cause the zone to form from buying and selling. Most of the time it's from taking profits, but many also form from them placing trades. Whichever it is isn't important. They both form in the same way under the same process.

To place their trades or take profits, the banks need orders.

In other words, they need other traders (people like you and me) to be buying or selling at the time they want to buy or sell. The bigger the trades they want to place or the more profit they want to take, the more people they need to be buying or selling.

Simple enough, right?

So, what this means is the strength of a supply or demand zone depends on how big the bank's trades were or the amount of profit they took off to cause a zone to form.

If the banks placed big trades, they don't want price to break through the point where they placed them (the supply or demand zone), as it could cause them to lose money. That then means the zone is strong because they don't want price to break through.

But here's where it gets deeper…

The size of the trades the banks can place or the amount of profit they can take depends on the orders coming in, right? The number of people buying or selling. The more people who are selling, let's say, the bigger the size of the buy trades the banks can place.

So really, the strength of a zone is determined by the movement seen before the zone formed.

If the movement seen prior caused lots of people to sell, for example – such as in the case of a strong downtrend – that must mean the demand zone is strong, because the banks are going to have to place bigger buy traders to overwhelm all the seller and make price reverse.

Notice that before this demand zone formed, the market was in a strong downtrend, and a very sharp decline had just taken place.

What do you think most traders are doing at this point?

Buying or selling?

Selling, right? They're selling 1. because the overall trend is down (everyone gets told to trade with the trend, remember) and 2. as they've just seen huge decline take place – sharp rises and declines always cause people to trade in the same direction.

So right now, the banks have an enormous number of sell orders to either take profits or place buy trades with.

If they decide to buy, and a demand zone forms, that zone will be extremely strong. Because they will have been able to place lots of trades or take lots of profits off, due to the vast number of orders coming in from people selling.

If I move it forward…

A demand zone forms.

What happens when price returns? It reverses, and a huge reversal gets underway, resulting in price eventually rising over 1000 pips.

Does it make sense how this works then?

It's not the move away that tells you how strong a zone is – though it is a good way to find the zones – it's the move seen before the zone formed.

If a zone forms after a long down move (demand) or long up-move (supply), it's very strong, because the banks have had a lot of orders to place their trades or take profits. Same for sharp moves. Most people buy or sell if they see a sharp rise or decline, meaning the banks have a lot of orders to use, making the zone strong.

I know this method of gauging the numbers of orders coming in isn't exactly scientific and takes a bit of understanding, but it is an effective way of gauging how strong a zone is.

I'll have a guide in the future that details this method in more detail.

RULE #2 ONLY TRADE THE FIRST TOUCH **OF A ZONE**

Supply and demand has a lot in common with support and resistance. Believe or not, I thought S + D was just a cheap S + R knockoff when it first became popular – seems silly now considering it's my main strategy. For the most part, being similar is a good thing.

But I've noticed something…

I've noticed that a bunch of traders think because supply and demand is so similar to support and resistance, the zones cause multiple reversals, as S + R levels do.

While this makes sense, it's not true.

Supply and demand zones are a one-time use. Not 2 times, not 3 times, just once. After price returns to a zone and reverses, it's done with. The probability it'll cause another reversal is extremely low.

The reason zones only work once, as opposed to the multiple times like we see with S + R, is again because they form from the banks buying and selling.

Price returns to supply and demand zones because the banks have either a. not got all their trades placed or b. not taken all their profits off.

But here's the important point to remember…

Most of the time, the banks get their trades placed/profits taken in 2 lots. For example, they'll place one set of buy trades, which is the first lot, then another set as the second lot due to not having enough orders available.

The only exception to this is when they're causing a trend reversal, in which case they'll place them in 4 possibly 5 lots, causing multiple swing highs or lows to form at similar prices – something else I've talked about before on this site.

Now, how do supply and demand zones form again?

Oh yeh: from two lots.

The banks first set of trades/profit-taking is what creates the zone – this is lot 1 – and their second batch is what causes price to reverse when it returns, which is lot 2.

So, the reason why zones don't work multiple times is that the banks have no reason to make price come back after the first touch.

They can get most of their trades placed creating the zone and causing price to return and then reverse. After that, they don't have any left, making it unlikely a second touch will cause a reversal.

RULE #3 ALWAYS TRADE WITH THE TREND… ON THE TIME FRAME YOU TRADE OFF

I know, I know, you've heard it a thousand times. But bear with me because I've added this rule for a reason…

Most traders think trade with the trend means the overall trend i.e the trend on daily or weekly timeframes. That's what all the books say, and many gurus agree. But unless you trade on those timeframes, trading with the overall trend is a big mistake. In fact, it could even be the reason you're losing money.

The problem with trading with the overall trend rather than the trend on the timeframe you trade-off is instead of trading with the trend you trade against it.

Sound confusing?

Let me explain…

Let's imagine you trade on the 1-hour chart but get your trend from the daily.

At the moment, the daily trend is down. It's been falling for quite a while now, and the market has just recently made a new lower low after a previously making a lower high.

So now you switch back to the 1 hour and begin looking for short trades from supply zones.

But here's the problem…

On the 1 hour, the trend is up.

It's just made a higher low after previously making a higher low, indicating the trend has changed and price is now likely to rise.

What this means is you're really trading counter-trend. Even though the trend on the daily is down on the 1 hour it's up. So, while you are trading with the trend, at the same time you're trading against it, because the 1-hour trend is up not down.

Now watch what happens to the supply zones…

Apart from one, they all fail.

None of the zones result in successful reversals – major ones at least. On the other hand, all the demand zones that formed after reversal did work and caused quite a few reversals you could have used to make money from.

This is the big problem with trading with the overall trend.

The trend on the timeframe you trade-off and the overall trend are two different things. The overall trend only matters for that timeframe (daily or weekly). It's too long to be relevant for the timeframe you trade-off, in this case, the 1 hour.

In the example, you were technically trading with the trend. However, at the same time, you were trading against the trend on the time frame you trade-off, which is much more relevant because of the shorter timescale.

The best way to ensure you trade with the timeframe you trade-off – or the current trend as I call it – is to always trade in the direction of the most recent higher high or lower low.

The newest lower low/higher high is the most up to date indication of what the trend on that timeframe is. So, by following it, you keep yourself on the right side of the market. It's still important to keep to the overall trend in mind, for significant points and whatnot, but the current trend is the one to always trade with.

RULE #4 STAY AWAY FROM RALLY BASE RALLY – DROP BASE DROP ZONES

Rally-base-rally/drop-base-drop zones have a good reputation with most supply and demand traders.

Back in the day, I used to trade these zones A LOT. In fact, for a time, they were all I traded. I didn't even bother with the rally-base-drop/drop-base-rally zones, I just stuck with the rally-base-rally/drop-base-drop zones I thought there were that good.

But then I went back…

I went back and looked at my losses over 7 months. What did I find? Most of my losses that hadn't come from personal mistakes (like moving the stop too early) had come from trading rally-base-rally/drop-base-drop zones.

Now you could say I was just trading them wrong… and that may be true.

However, I went back and did some backtests on RBR – DBR zones and even accounting for mistakes found they really don't work as well as people claim. Sometimes they work, but most of them fail, usually because of price blasting straight through.

I guess the question now is, why is this?

Why don't rally-base-rally/drop-base-drop zones work as well as rally-base-drop/drop-base-rally zones?

I think there are a few reasons…

The main one, however, comes back to what I said at the beginning, about how the strength of a zone is determined.

The strength of a supply and demand zone is based on the preceding movement. For example, a demand zone that forms after a sharp decline is likely to be strong because the banks had lots of sell orders available, due to the sharp decline.

But this also works the other way…

If a zone forms after a move in the same direction e.g a demand zone after a sharp rise, that zone isn't very strong because the banks haven't got enough sell orders to place big buy trades.

Now, how do all rally-base-rally/ drop-base-drop zones form?

After a move in the same direction!

They all form after price has already moved in the same direction; a rise in the case of rally-base-rally zones, and a decline for drop-base-rally zones.

This makes them much weaker than rally-base-drop/drop-base-rally zones – which form from a move in the opposite direction – as the banks don't have as many orders to buy or sell with.

Take a look at this rally-base-rally zone I found on Eur/Usd.

According to most guru's, this zone has a good chance of success. It's formed from a nice base, it has a strong move away, and is in the direction of the current trend.

But look at where it formed…

The zone formed AFTER a strong rise, which meant most traders were buying; some as a result of closing short trades placed during the decline, many because they thought it was the beginning of a reversal.

With most traders buying, the banks don't have many sell orders to use.

This means they can only place a small number of buy trades or take a limited amount of profit off. This then makes the resulting demand zone weak, because the banks will only want price to reverse from a zone if they've done something significant, like place a big bunch of trades.

And what happens when price returns?

Price stalls for a while then breaks through. Where does it reverse? Surprise, surprise… the drop-base-rally demand zone that formed at the beginning of the rise.

So, does this make sense, about why the zones don't work that well?

It's because they form after a move in the same direction rather than the opposite.

Rally-base-drop/drop-base-rally zones all form after a move in the opposite direction, which gives the banks lots of orders to buy or sell with. Rally-base-rally/drop-base-drop zones, on the other hand, all form after a move in the same direction, which gives the banks only a few orders to buy or sell with.

RULE #5 DON'T TRADE OLD ZONES

There are some big mistakes to avoid trading supply and demand.

Trading zones more than once is one of the big ones, like I said earlier. But another is something many S + D traders don't even class as a mistake…

Trading old zones.

I’ve seen lots of guru’s say or imply that old supply and demand zones have the same probability of causing a reversal as new zones. According to them, old zones function and perform the same as new zones; there’s no difference between them other than their age.

When you look at the charts, it’s obvious why they think this.

Old zones (seemingly) cause reversals all the time. Go back weeks, months, or even years, and I can guarantee you’ll find old zones that have recently caused price to reverse.

But is it really the zones causing the reversal?

The answer…

No.

It looks like it is because price has reversed from the same point, but it’s not the zone itself causing the reversal, it’s something else. What that is depends on the zone and what was happening at the time. But it’s definitely not the zone, it just seems like it is.

If you think about how zones form and why they work the way they do, it’s obvious why old zones don’t cause reversals.

The banks cause a supply or demand zone to form by either placing trades or taking profits. They then cause price to come back to a zone because they haven’t been able to get all of their trades placed or take all of their profits off, as I’ve already said.

My question is, why would they wait months or years to do this?

If they’ve placed a bunch of trades because they think price will rise, why would they wait a few months to get the rest placed? By that time, price could be 100’s of pips away from where they bought, and their reason for buying in the first place might not even exist anymore.

Therefore I don't buy that old zones cause price to reverse.

It just doesn't make sense that the banks to wait weeks, months, or years for price to come back to a zone just to get a few left-over trades placed. If they want to get their remaining trades placed/profits taken, they'll make price come back to a zone quickly. They won't wait weeks and weeks; they'll do it ASAP.

So, how do you know whether a zone is too old to be traded?

Well, really, there is no sure-fire way. However, I have come up with a few rules (or guidelines is probably the best way to put it) of how many days, weeks, or months it takes for a zone to become old, relative to the time-frame it formed on.

Here's what they are:

1 min/5 min/15 min – 1 day.

30 min/1 hour/4 hour – 20 days

Daily – 3 months

Keep in mind these are just guidelines, not cold hard rules that can never be broken.

If you see a zone form within two or three points of what I've explained e.g. a zone 23 days old instead of 20 the zone is still valid for trading even though it is technically old. It's impossible to get these things exact, so you have to allow a bit of leeway with the time.

Another point… if a zone forms within a higher time-frame zone e.g. a 1-hour zone forms inside a daily zone, the 1-hour zone falls under the daily/weekly rule. It doesn't come under the 1-hour rule because it's part of the daily zone; the banks have caused it to form from placing trades with the daily timeframe in mind, not the 1-hour.

CLOSING WORDS

Well, I hope these rules have shown you the right way to trade supply and demand and cleared up a few of the myths you've maybe been told about them. It took me a LONG time to figure these 5 rules out, with many losses to boot, so consider yourself lucky for knowing them so early.

Before putting them into practice, it's a good idea to go back over some of your old trades and see if they breached any of the rules above. The results will probably surprise you. One guy emailed me a while back to say that once he went back and looked at his losses, more the 60% were from trades that voided one or more of the rules above.

That's the kind of improvement you can expect when you put these rules into practice.

So, go back and have a look your old trades, then test these rules out for a while. They won't turn you into a successful trader overnight and you'll probably have to break a few old habits – like trading old zones – before they starting working for you, but once they do, you'll see a significant improvement in your bottom line.

That I can guarantee.

Be sure to check out some of the following posts to learn more on the ins and outs of supply and demand trading.

Why You Should Avoid Rally-Base-Rally/Drop-Base-Drop Zones

Supply And Demand Trading: Profit Taking Zones Vs Trade Placing Zones

3 Mistakes That'll Destroy Your Supply And Demand Trading