Fractal Energy Trading Crypto MasterClass

Module Eight
Market Energy & Trends

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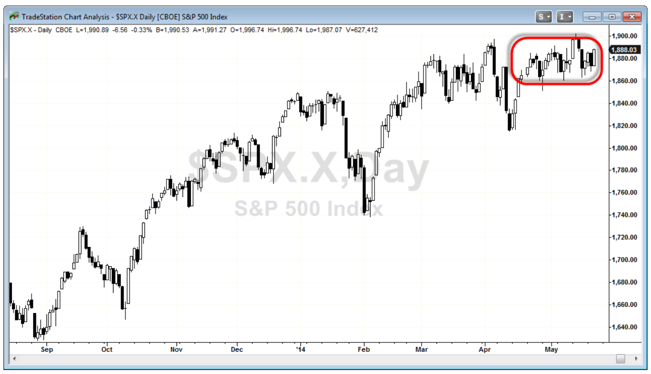
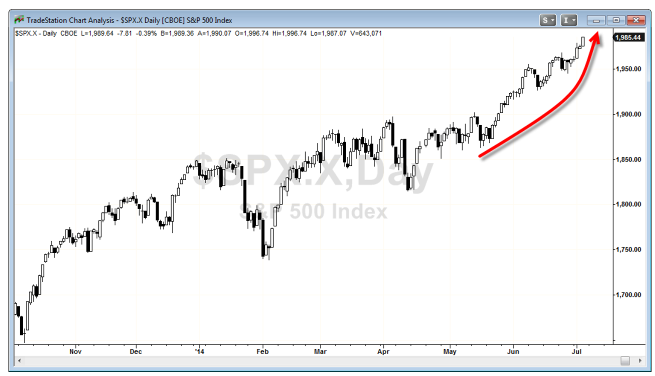
Introduction to Market Energy & Trends

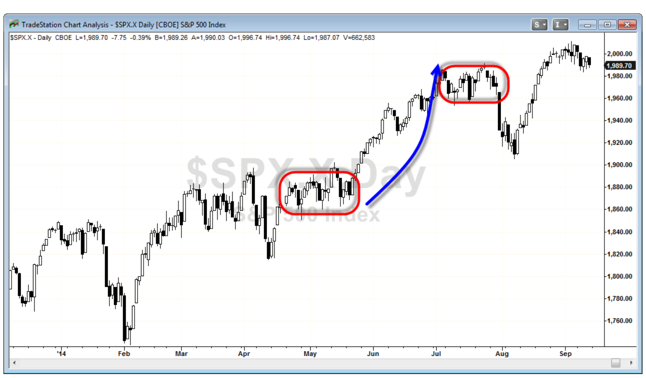
In Module Seven we saw that markets are forever oscillating between the states of Range Expansion (trends) and Range Contraction (consolidation). We also saw that this wasn't the exclusive domain of financial markets, EVERYTHING around us runs in these cycles, so this should get us in the mode of feeling more comfortable with how markets work.



If we identify a market that's currently sitting in an extended consolidation pattern, then we should identify that as an opportunity for the price to possibly break out and trend. The key, as we'll find out, is to *anticipate* when it might do so. If we know that we're about to see movement in an asset, then there are different ways that we can take advantage of that extended movement, as well see in the later modules of this course.



Conversely, when we see a market that's currently in the midst of an extended, linear trend, we'd expect to see the rest of the investing public "chasing" after that trend in a panic to buy. We have a different approach; we'll measure the amount of energy left in that trend to better be able to anticipate when that trend is likely to run out of momentum and fall into the next consolidation pattern. There are also different ways that we can take advantage of that type of price action.



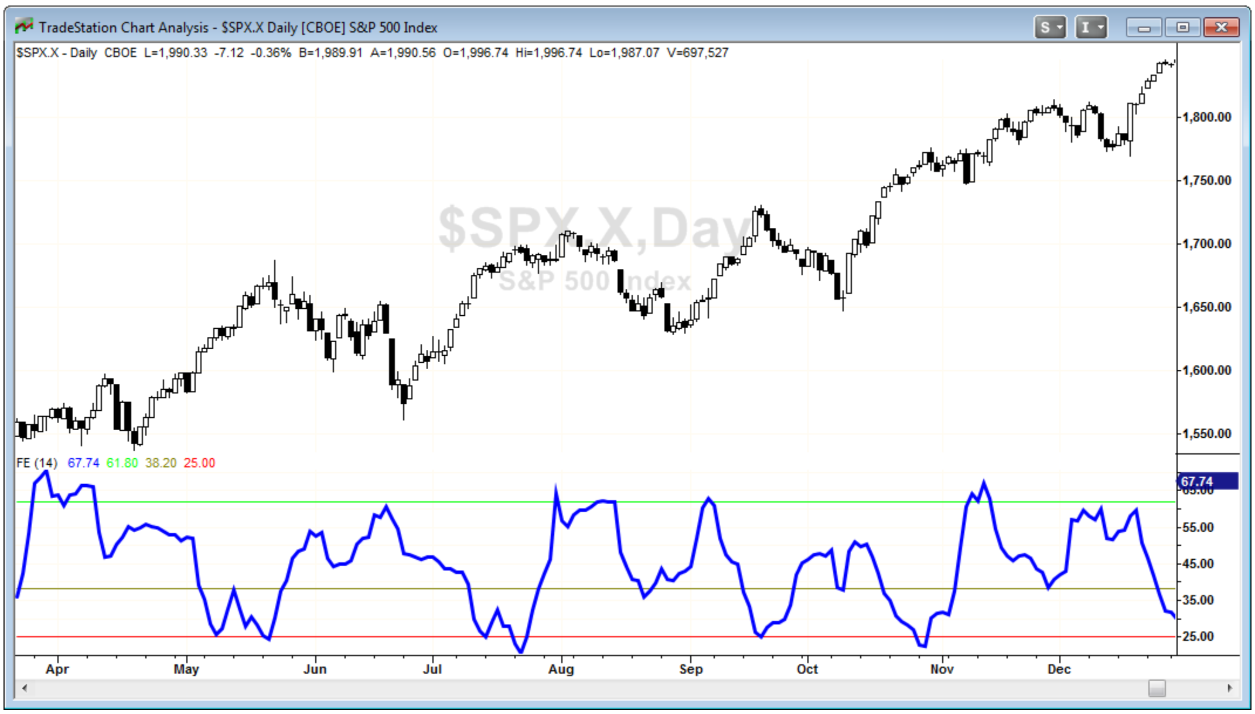
Markets just go back and forth between states of Range Expansion (blue) and Range Contraction. (red) What we're going to do in this module is measure that available "energy" to determine when the trend is likely to move to the next "state" in that cycle.

Measuring Energy - The Choppiness Index

In the last module we made reference to Dreiss' "Choppiness Index" as the tool that we were going to use to measure the linearity of the current trend. In this manner we use it as a "fuel gauge" to see whether a chart is currently either "charged up," "exhausted," or some level in between. When you go to drive your car somewhere, most people take at least a cursory glance at the fuel gauge to determine how much fuel they have and whether they'll need to recharge their energy supply to get to their destination.

Figure 1 shows a typical daily price chart with the 14-period Choppiness Index applied to it:

Figure 1

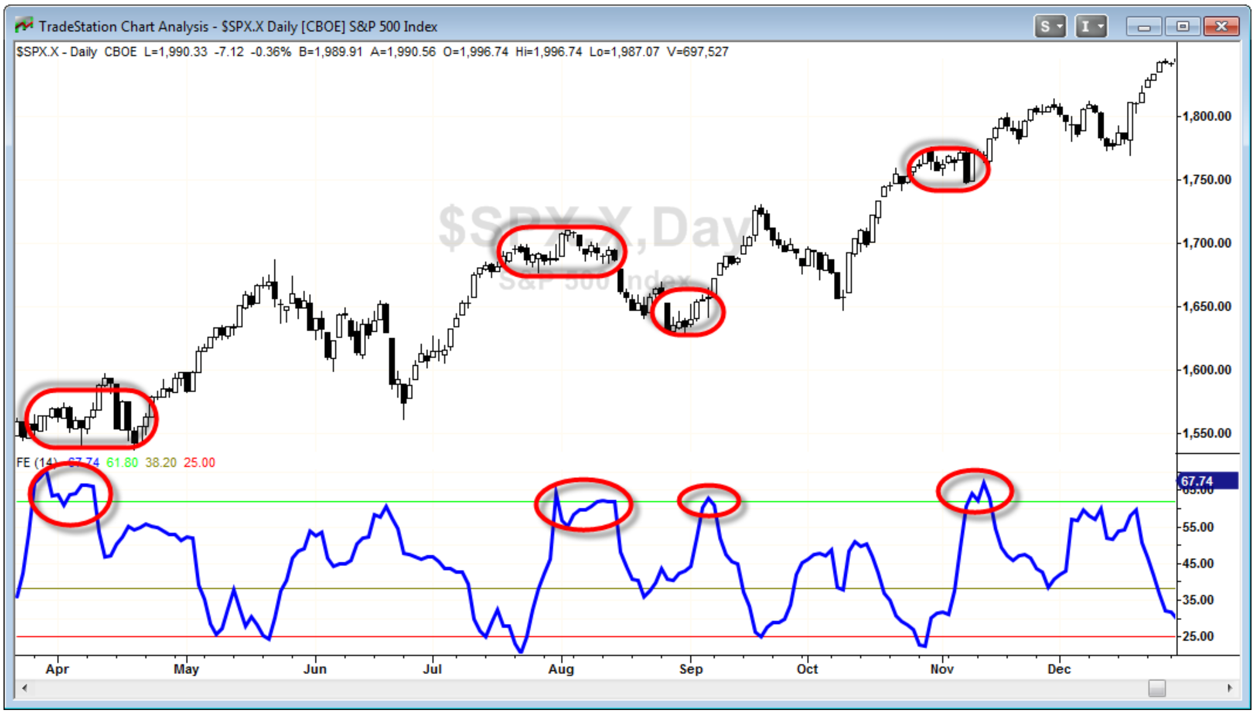


Notice how the blue signal line travels up and down, similar to an oscillator. Remember, this study tracks the ***linearity*** of the most recent 14 bars on a scale from zero to 100. We also notice three horizontal lines that I've added to the study; those signify levels at 61.8, 38.2, and 25. Before we get into too much detail, notice how the indicator rises when the price is stuck in a consolidation zone, such as the July/August timeframe….and how the indicator drops to low levels near the end of a strong trend, such as in mid-May or late October.

Think about how we defined linearity when it came to market trends; highly linear moves corresponded to strong, straight trends, and removed “energy” from a market… while non-linear price behavior “charged up” the chart again with potential energy.

Now look at Figure 2 where the red circles show periods of non-linear price behavior, as well as very high levels on the Choppiness Indicator:

Figure 2



In a way, you can see how the Choppiness Index indicator is a form of “fuel gauge” to show the amount of available energy for the potential of a trend. Notice how the price tends to trend not long after….every time we see the formation of non-linear price behavior, which also corresponds to a high level on the Choppiness Index. A high level in early April led to a strong rally higher in early May, for example.

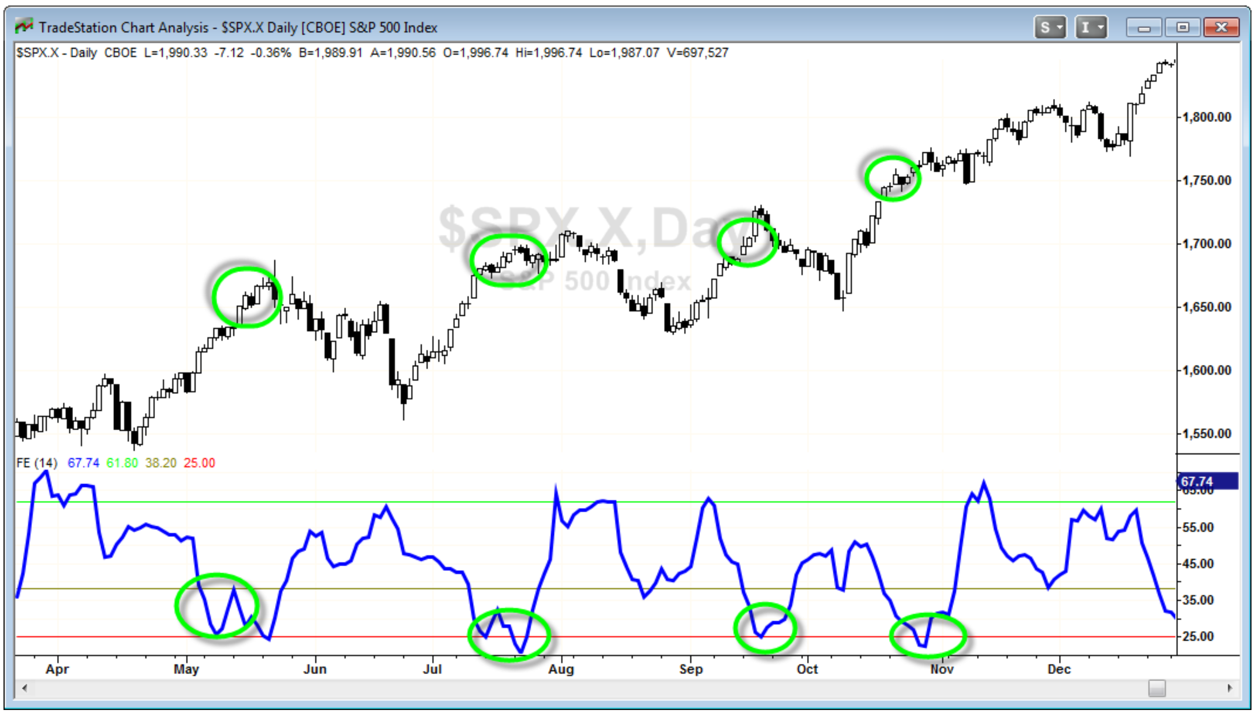
Those with sharp eyes are already noticing a seeming conflict with this concept; what happened in mid-August? The chart was coiling sideways and showing non-linear price behavior, and the corresponding energy level was very high on the indicator….yet the price broke to the downside?

The Choppiness Index shows non-linear price behavior which translates to potential energy being “loaded” into a chart, however *it does not predict the direction that the next trend will go!*

And THIS is why we still need to do our due diligence with Price Action, because price will always show us an early indication “from the inside-out” which way the trend is starting to assemble itself. Another concept that we'll just mention at this point is that a higher timeframe (like the Weekly or Monthly chart) might have very low energies at that point, so the trend might have difficulty continuing to the upside, and the path of least resistance would be to the downside for the daily chart energy. Much more on that concept in the next module.

The next application of our "fuel gauge" is shown in Figure 3 as the indicator shows that the chart is LOW on energy after a strong, linear trend:

Figure 3



Notice how the chart "slows down" the trend once we see a low level of energy associated with the Choppiness Index. This usually prefaces one of the three forms of "recharging" that we talked about in the last module…either sideways, a pullback, or a slow upside grind.

Again, in these scenarios every other trader is "chasing" the market while you're either taking profits on directional positions, or you're anticipating a sideways consolidation that you can take profits into, or simply hold through. We'll get to those applications later on in this program.

What Levels Do We Look For?

I've already mentioned the 61.8, 38.2, and 25 levels, so let's add one more and put some framework around how we'll interpret the results of this indicator.

- **61.8 or Greater** - This is a highly-consolidated chart that is showing a great deal of energy. The price has been in a very choppy, tight coil for several periods now, and is exhibiting extremely non-linear price behavior. A trend will "spring" from this level at any point now.
- **55 or Greater** - This is still a highly-charged chart and will provide enough energy to support the formation of a trend. *This is usually about the minimum required consolidation/coiling to begin a trend.* Any value above 55 should put you on notice that a trend will form soon, which is a little less "urgent" than the 61.8 or greater value.
- **38.2 or Less** - This signifies that a linear price trend has been in play and a significant amount of energy has been expended. This is also the very first point in the trend where you might expect to see some type of non-linear behavior, such as a one-day pullback or a very quick 2-3 day consolidation to briefly "recharge" the chart and maintain the trend. Think of this level from the perspective of a Marathon runner slowing down to grab a cup of water at a water station. Few trends come to an abrupt stop at this level, but the probabilities have increased for a reversal and/or consolidation when this energy level is reached.
- **25 or Less** - Very few trends continue when this energy level is reached, as it signifies that an extremely line trend has been taking place. It is a very high probability that the price will exhibit a shift into a "recharge" mode at this point using one of the three methods discussed previously.

Those are really the keys to the kingdom that we'll be using from this point forward. We will 1) understand the price action/trend at each timeframe, 2) understand the available "energy" at each timeframe, 3) correlate those data points to understand what our forecast is at each timeframe, and 4) apply the appropriate option strategy to use that probability advantage and harvest our fair share.

Let's show how we apply these concepts to anticipate the next Trend or next Consolidation on one timeframe only….

Application - Anticipating the Next Trend

The Cicada[1] is an insect that has an unusual life cycle; it begins life being hatched from an egg deposited on a tree, at which point it drops and burrows into the ground; in some cases it spends seventeen years underground before finally emerging with the rest of its friends and creating an awful racket. What's interesting is that Entomologists study this bug and know exactly when a new swarm of 17-year-cycle bugs is about to emerge….so in some ways, these scientists are doing the same thing that we're doing, just studying insects and their cyclic behavior instead of that of financial markets.

So why am I bringing up this repulsive creature? To make the point that we are always anticipating the next "sign of life" whether it's a bug…or whether it's a financial instrument that we're tracking. The first snowflake in the Fall? Here comes Winter. The first daffodil pushing up in March? Here comes Spring. Think about it….we're always looking for that "sign" that the "sleeper has awakened."

So what and how are we going to do to understand when a sleeping market is about to emerge on its next trend?

[Start With Price Action]

Let's not abandon all of those hard-fought skills that we acquired in the last section of the program! One of the most accurate ways of seeing an actual break into a trend from a consolidation pattern….is by watching the Price Action. Remember…reversals start from the inside-out, or in this case, the change from a sideways pattern to a full trend will start from the lead of the smallest timeframes. Don't just blindly assume that the trend will be in the same direction as it was before the consolidation; watch the smallest timeframes as the new trend will spawn from the inside-out.

[Anticipate This Condition with Fractal Energy]

When we see a chart like this just "chop" around in a range, most investors either get chewed up by the price taking out their "stops," or they just tune out and get bored with a market that's not going up every day. As you can see by this point, this is a HUGE opportunity and you can be the first one on the trend when it starts.

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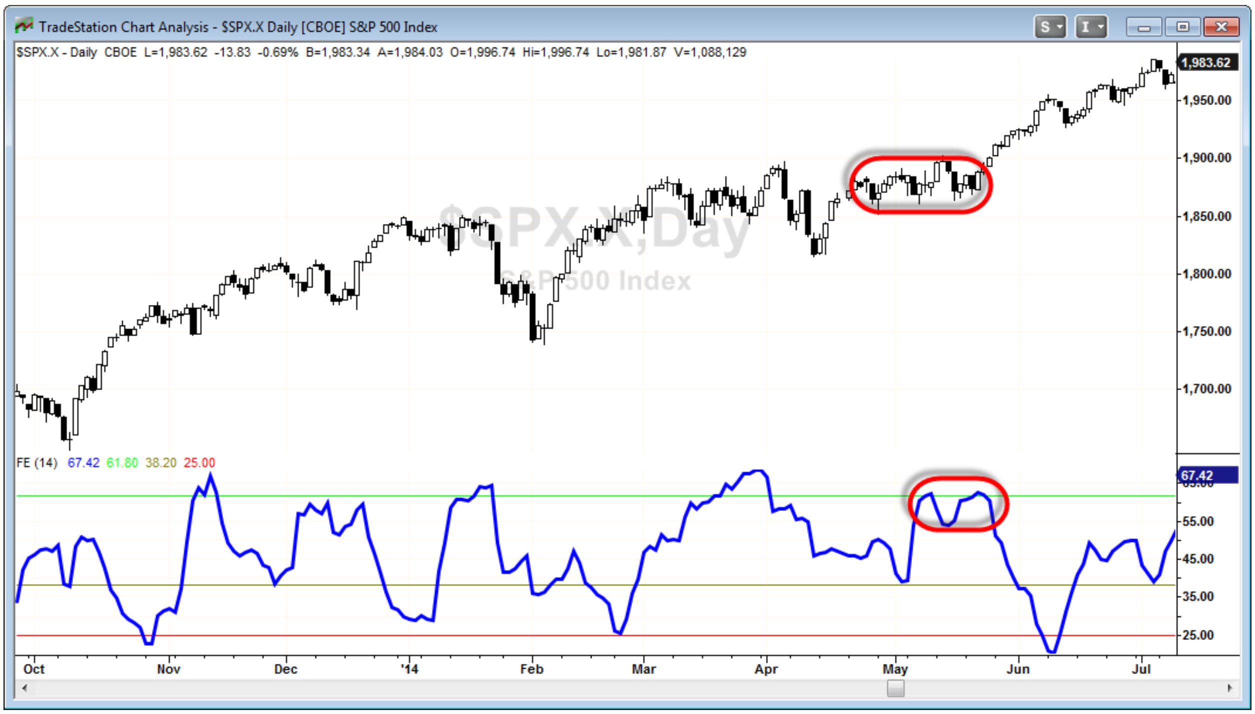
[1] http://en.wikipedia.org/wiki/Cicada

I will typically see “energy” values on the Choppiness Index of at least 55 when this type of price action is seen, and sometimes as high as the upper 60’s which indicates that a HUGE trend will likely pop out of that pattern. No one will be on that trend when it finally leaves, having “shaken off” all of the investors that bought every dip and were stopped out on the drop back into the consolidation pattern.

Note in Figure 4 how the requisite amount of “energy” was coiled up and this chart was ready to bust a move:

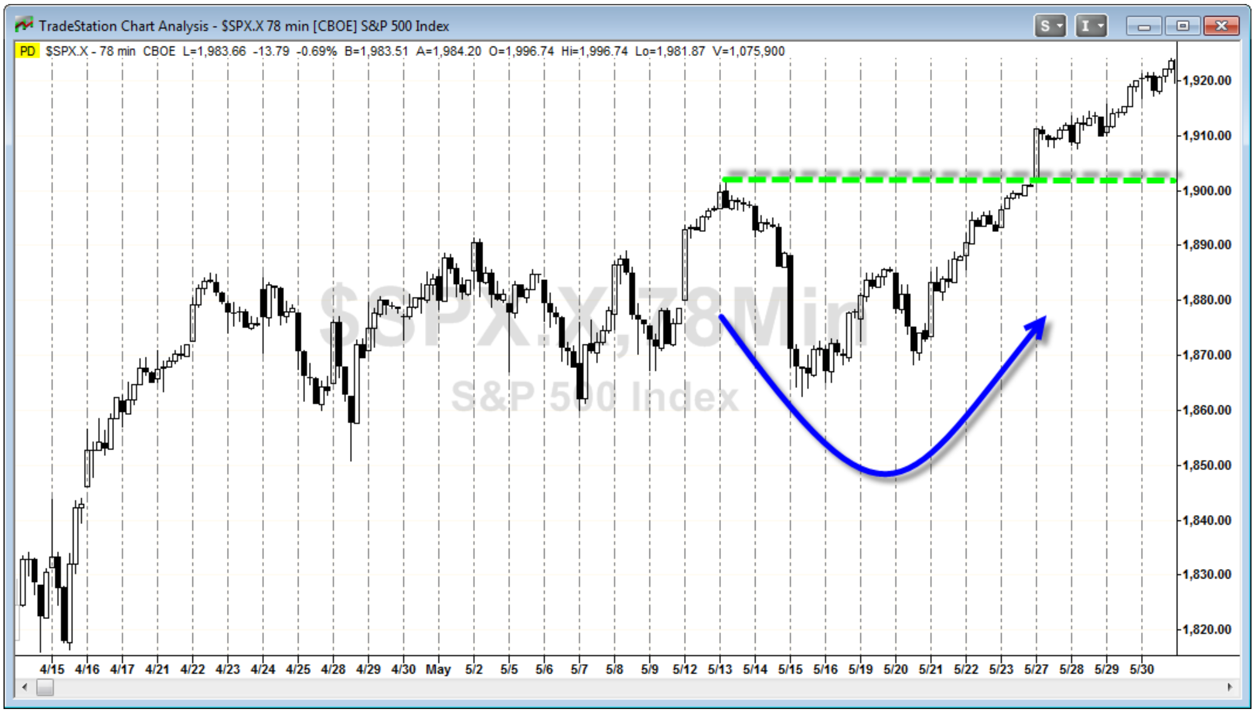
Figure 4



[Verify With Price Action]

Watching the fractal series of timeframes would have given you the first clue that this chart would be breaking out to the upside again, by monitoring for a change in polarity to an uptrend on the intraday chart. Figure 5 shows this change in polarity in late May, which is confirmed at the green line when it breaks to new highs:

Figure 5



No one will be taking that ride as they tried to go long on the earlier breakouts before the chart had built up enough energy to achieve escape velocity. There are quite often some nasty little twists and turns which accompany breakouts, as the price whips and dips around, but those with a fundamental understanding of trend and energy will be able to hold fast through those and stay on board for the ride.

Application - Anticipating the Next Consolidation

You know the feeling; every evening around the same time you start to drag and get sleepy. It's predictable….this is your Circadian Rhythm[2] trying to tell you that it's time to go to sleep. And unless you're like some people I know, this rhythm will also wake you the next morning after about the same number of hours of sleep every night. In fact, these rhythms include different stages of sleep (REM cycle, etc) that you cycle through, so to some degree your sleep is "Fractal." There are always patterns buried inside larger patterns.

And this brings us to our application to financial markets; if we're presently seeing a trend in the markets that we follow, ***when is that trend likely to move from the "linear" state to a "non-linear" or consolidation state?***

Start with Price Action

In this case, looking at the actual fractal price action will give us the most accurate signal that a rally is topping out, however it won't give us the fastest one. What I'll typically see is a rally coming strong off the bottom until exhaustion, a short consolidation, and then a "parabolic tail" as the slope becomes almost infinite, as in Figure 6:

Figure 6

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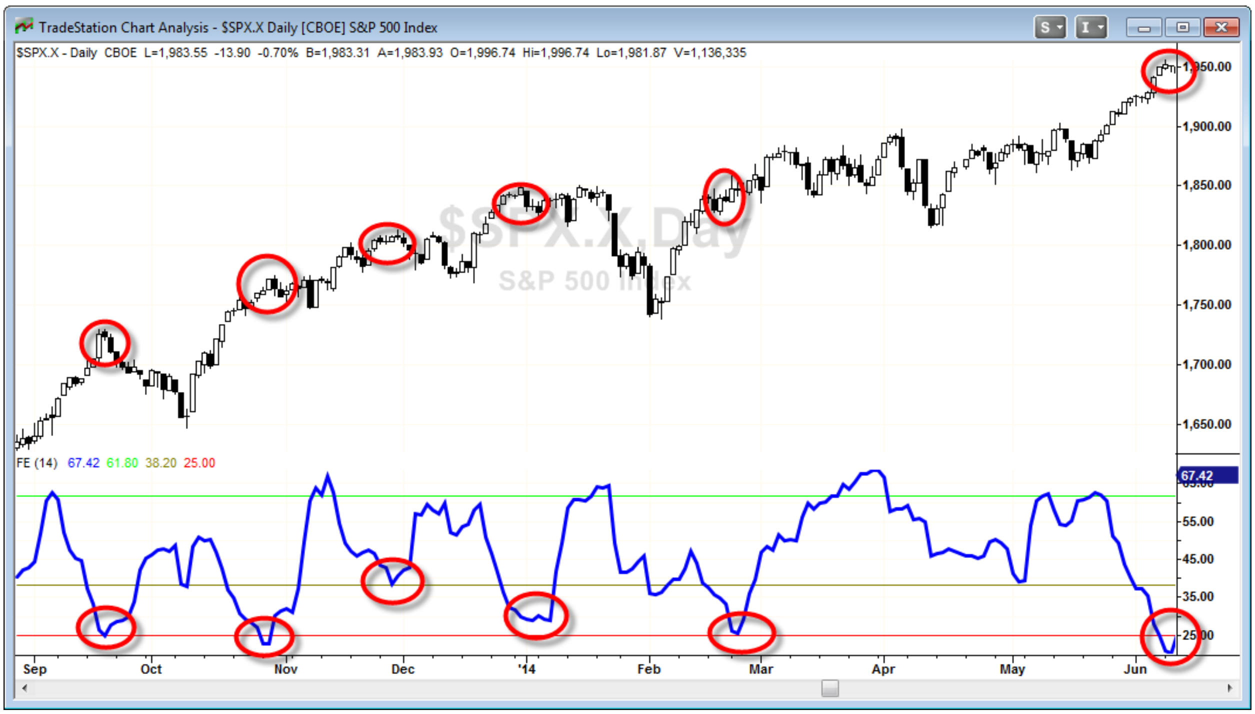
[2] http://en.wikipedia.org/wiki/Circadian_rhythm

Again, this is the place where most retail investors are “chasing” the market higher and will soon be bitterly disappointed when the price starts to coil sideways.

Anticipate This Condition with Fractal Energy

And it’s no surprise that these “tails” usually correspond to very low-energy conditions as seen in Figure 7:

Figure 7



Verify with Price Action

Price action will eventually roll into a sideways consolidation or a pullback, using one of the three “recharging” methods brought up in the last module…but it will take a while to do so. As we’ll see in the latter part of this program, an aggressive but highly successful tactic is to set up non-directional spread trades right as that “tail” sets up.

Summary - Market Energy & Trends

In this module we put a little more detail on the chart to show how understanding the linearity of the current trend can also give us a reading on the amount of "energy" available on that chart.

We also showed how reading this "fuel gauge" could help us anticipate what was likely to happen next on the chart….whether a trend was likely to tire, or whether a trend was likely to spring to life from a messy, choppy consolidation.

Hold on to your hats because we're about to crank up the heat dramatically in the next couple of modules of this program. Not only are we going to bring together Price Action and Market Energy together in one chart, but we're going to bring our "Family of Timeframes" together, each having their own energy reading.

I want to stress that you should really master the previous material before you immediately jump forward from here. Evaluating multiple timeframes of price action AND energy will twist you into a knot unless you take a very slow, methodical approach to your forecast.

Homework and Next Steps

Please complete the following tasks before moving to the next module:

- [ ] Watch the associated video for this module.
- [ ] Look at your price charts and if you hadn't done so before, start to notice the various levels of trend and consolidation on the daily chart. Sometimes they'll be an indecipherable mess - that's OK, it might be caught in a higher-timeframe consolidation. But try to visually sort out the trends from the periods of "rest" and note how they go back and forth between those two states.