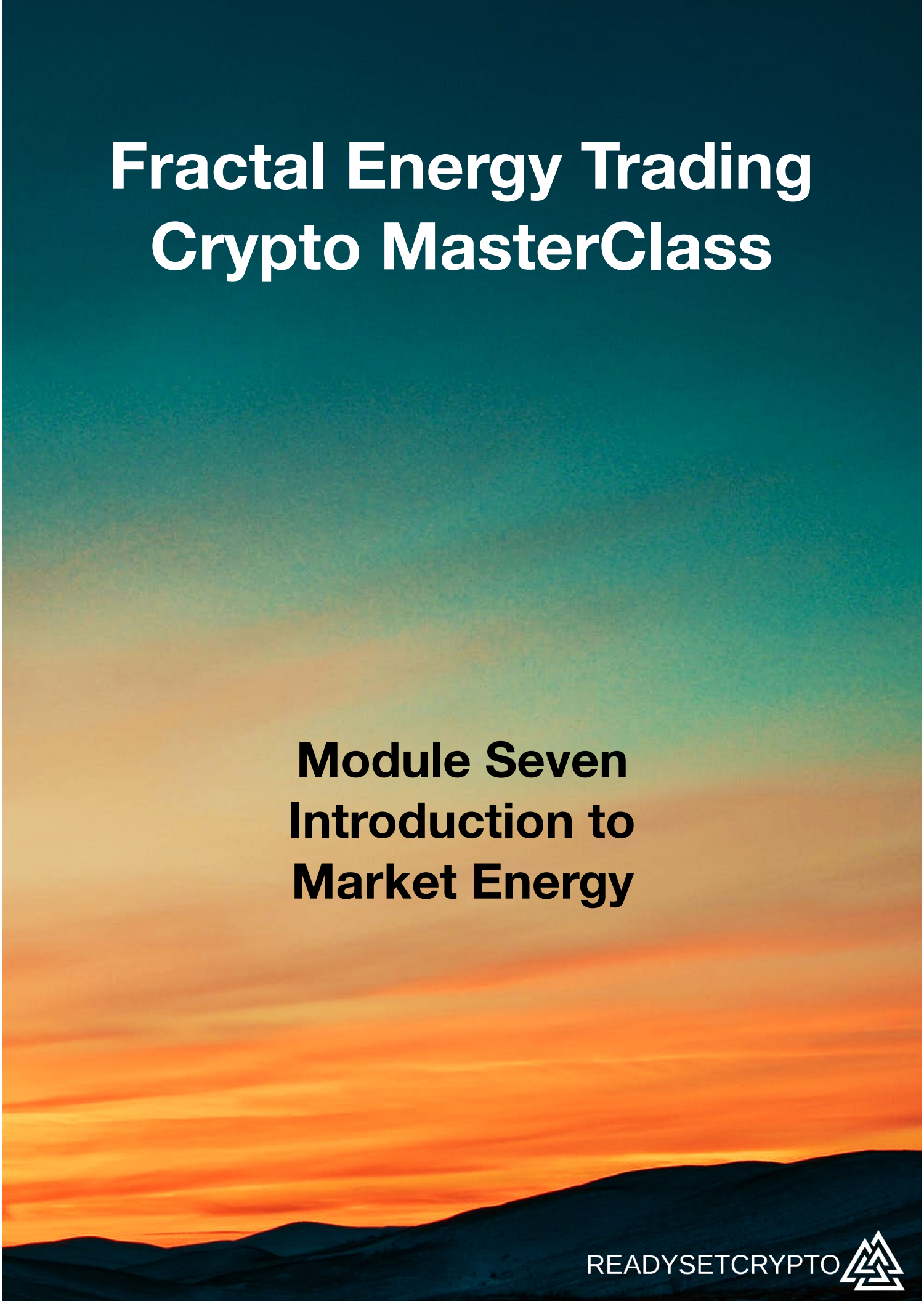
Fractal Energy Trading Crypto MasterClass

Module Seven Introduction to Market Energy



Module Seven
Introduction to Market Energy

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Table of Contents

Introduction to Market Energy

We're used to thinking of the term "energy" as being associated with something physical, such as the amount of energy that it takes to move an automobile a certain distance… or the amount of energy that we need to produce to convert one form of energy to another, such as burning coal to produce electricity or the windspeed needed to drive a certain number of megawatts from a wind farm.

We see energy around us in all forms and states, such as the awesome amount of energy that a storm can bring to bear on the land, either through rain, snow, wind, or temperature changes. And there is a huge and booming business for the past few centuries to process raw materials that can be easily converted for recreational and industrial purposes, such as transportation, lighting, entertainment, etc.

Yep. I know that you understand how important the concept of "energy" is, and how we generate and use it every day. And it absolutely makes sense to us in the "tangible" realm that we see every day.

But what about the concept of "virtual" energy? With the advent of instantaneous, world-wide communications this has taken on a new context. Think about this for a second….if the President of the United States speaks into a microphone, how much "energy" is he expending? Not much…but what if that voice is being broadcast to millions of people around the globe, who then react to his statements? In that case, an enormous amount of energy could be transferred. And what happens when a business leader sends out a Tweet from their mobile phone? Perhaps Tim Cook from Apple inadvertently sending something that he didn't mean to, leaking plans for the next mobile device…how much energy would be transferred in that scenario? (or any tweet from Elon Musk, for that matter)

The point here is that “energy” is not just in the physical sense any more; the concept of “energy transfer” is also part of the virtual world.

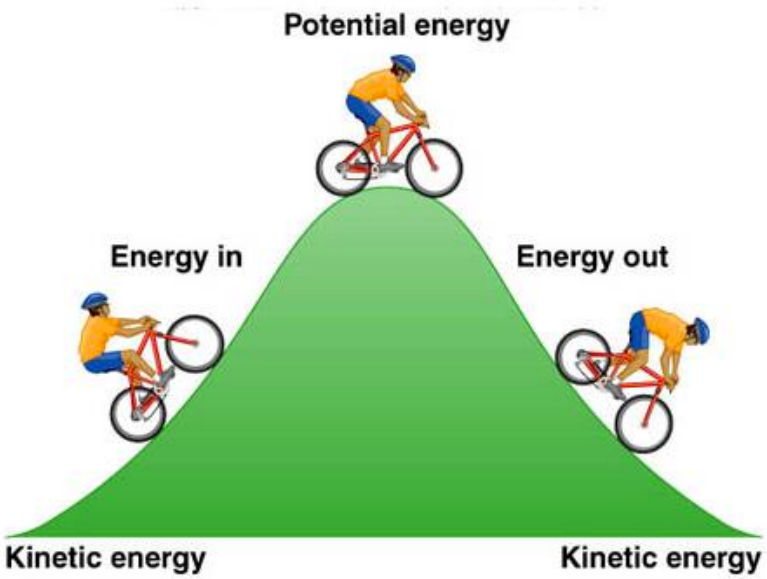
So how does this relate to Markets? Do financial Markets also contain and transfer “energy?” Well, not in the classic sense that we can measure in units like Joules, but the information on a price chart, and especially changes to that price chart contain the potential of massive amounts of energy.

So this “tie” into how energy is defined in the classical world of physics is what we’re going to explore in this module so that we can show how financial markets contain energy, and how we can use this concept to profit from it.

But first, we need to go back to grade school and remember some concepts about energy….

Physics 101

No, we’re not going to get weird on you with Quantum mechanics or particle energies; all we need to do is remember what the terms “Potential Energy” and “Kinetic Energy” mean. Think about the following diagram showing a biker riding up and down a hill:



Think of Kinetic Energy as energy that is “expended,” such as a bowling ball rolling down the alley and hitting the pins. Potential Energy is similar to the winding of a spring, where energy is being “stored” for later conversion to Kinetic energy.

As the biker approaches the hill, he starts to build up Potential Energy by ascending the grade. The further up the hill that he goes, the more Potential Energy that he stores up. Once he gets to the top of the hill, how much effort does he need to expend to get to the bottom of the hill? None! All of that Potential Energy gets converted to Kinetic Energy as he coasts down the hill at speed.

A Constant Cycle

And it's a constant cycle, isn't it? Unless you're being dropped off at the top of Mount Haleakala to coast the rest of the way down, a typical bike ride includes hills where you have to convert a lot of effort via legs and lungs into that Potential Energy which gets maximized at the top of a hill. And the rest of the ride will be a constant cycle back and forth between storing Potential Energy as you ride up a hill, vs. releasing that into Kinetic Energy as you coast down the hill. The cycle will not stop until you park the bike.

And isn't this example seen everywhere in your daily life? During the day you expend energy Kinetically until you're exhausted by the end of the day and you sleep to build up your energy again for the next day.

Your car will not run forever unless you fill up the gas tank; Potential Energy in the form of gasoline (petrol) is slowly converted to Kinetic Energy when you start the engine and put the car in gear.

And you can point to just about any system that we see around us during the day, and we'll find out that Energy is "finite" or has a limited supply. Once this supply is exhausted, then we'll see some form of "pause" or "rest" or "re-fueling."

Energy in Financial Markets?

So is there "energy" in financial markets? YES. Markets "rest" and build up Potential Energy which then gets expended via Kinetic Energy. We can't really measure this "energy" in any manner which is part of our study set, however as you'll see we can approximate how much energy is expended kinetically as the market "coasts" in the form of a trend.

Markets and Physics

Do financial markets move with the same laws as bike riders and cars and humans? You could make the correlation that financial markets are really human themselves, since all decisions are being made in the markets (directly or indirectly) by humans anyway.

What we then need to agree on is how we define areas of “rest” where potential energy is stored, vs. periods of activity in markets where kinetic energy is expended. And a quick look at a price chart will give us a simple answer to this question.

In the monthly chart below, you can see areas where the chart is range-bound (marked in yellow).

And it’s an easy assumption to make that these range-bound areas of price “chop” are periods of “rest” for a market. During the other points on the chart where the price is in a trend, think about how much energy needs to be “added” (or subtracted during a Bear market) to this market to keep the price going in that same direction. In the case of a strong uptrend as in the right side of the chart, new buyers have to continually come into the market and keep buying the highs. It’s not hard to see that trends require a massive amount of Potential Energy to start the trend, and a continual infusion of energy (or in this case, money!) to keep them moving along the same trend.

Moving down to a smaller timeframe chart, we can see the periods of price movement where the kinetic energy is being released, in the blue lines in the form of a trend…and we can see periods of price movement where potential energy is being stored, in the form of a consolidation:

If you're like me, this was a revelation to me to note that the world of "physics" also applied to financial markets. I already intuitively know how the world of physics works in my everyday life, so it's just a matter of finding and applying these similarities. And probably the biggest one that we need to apply is….

Expansion Leads to Contraction, and Vice Versa

We're not talking about the nebulous concepts of "overbought" and "oversold" that we've all been taught but find difficult to apply with accuracy. This goes right back to what we already know…that things run as far as they possibly can until they run out of energy, and then they rest until they're ready to go again, and the cycle repeats.

And what we'll find is that there's a quantifiable amount of "energy" that a market will store up before it's ready to release that energy and trend again, as well as a quantifiable level of a *lack* of energy where the chart is highly probable to "rest", as shown in the chart above.

We just need to figure out how to measure this "market energy."

Measuring Market Energy

As we pointed out before, there is no “pressure gauge” that we can plug into a financial market to understand how much energy a chart contains, and whether it’s more likely to trend or consolidate.

What we can do, however, is make a correlation that will be valuable to us. And that relates to the *linearity* of the current trend.

The Linearity of the Trend

First of all, let’s define what “linear” means….it can mean many things in a figurative sense, as the dictionary definition is “*arranged in or extending along a straight or nearly straight line.*” People that think in a linear fashion tend to follow along a connected series of logical thoughts based upon the visible information, while people that think in a non-linear fashion tend to jump around from one thought to another.

In our case regarding financial markets, however, the “straight line” definition makes sense for us.

Notice how linear that the trends marked with the red lines are; think of yourself sprinting as fast as you can. Even when you were younger, there was a limit to how far you could run before you’d have to stop and walk, usually bent over at the waist gasping for breath. And notice how the price behaves at the end of each of these

strong rallies; it becomes *non-linear*! It chops around or outright reverses the previous "red" trend. Look at that chart for a minute and it doesn't take much of a stretch to see how the red trends are the chart "sprinting" and the rest of the time it's catching its breath!

The longer and straighter the trend, the more linear it is….and the more energy it's exerting to continue moving in that direction.

And there's a limit to everything; charts cannot go forever in one direction. They must stop and rest at some point.

So back to "measuring" this energy; how are we going to do it?

Well, one of the chart study candidates that I evaluated years ago was the **Average Directional Index**, or ADX, written by J. Welles Wilder. This is actually a pretty good indicator to show "strength of trend" and it shows some solid results to get us closer to what we need to measure, which is "energy." Another study that I've evaluated over the years is the "**Squeeze**" indicator which is fabricated from the Bollinger Bands and Keltner Channels and identifies quiet markets. That indicator works well to identify quiet, resting markets that are about to trend again, but doesn't show anything relating to "exhaustion."

The answer to the tool that we were looking for was a little-known study called the Choppiness Index, authored by Australian Forex trader E.W. Dreiss. [1] In the next module we'll show you how we apply this study to show the amount of "energy" in the chart, or the lack thereof.

So far we've discussed the "linear" trend and it's obvious to see one in person; you can almost put a ruler on the chart and see how straight the price trends in one direction, when a trend is really strong.

But what about the opposite situation? How do we know what's going on when a chart is recharging? Let's cover the three different ways that a chart can "recharge" by exhibiting non-linear behavior.

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[1] http://www.motivewave.com/studies/choppiness_index.htm

Three Forms of Recharging

I think we're going to see a complete paradigm shift in how we "recharge" our vehicles over the coming decades. We're used to the nearly-immediate recharge of our vehicles by filling up the tank with gasoline. Five minutes later, we're on our way with a full tank and ready to drive another 400 miles.

Electric vehicles, however, are still a challenge to recharge with today's technology. To fully charge up a battery-based vehicle like a Tesla, an overnight charge is required, or at least an hour-long charge on a dedicated, high-capacity 220V outlet that can supply a lot of current. Doing this "long" charge will net you 56 miles of range for every hour that you charge the battery.

While out driving around, 220V high-capacity outlets are not readily available in today's world, apart from an odd charging station here and there. So Tesla drivers have to compromise as they can, by going to a lower-current charge from a lower-capacity 220V outlet, which will net them 32 miles of range for every hour that they charge the vehicle.

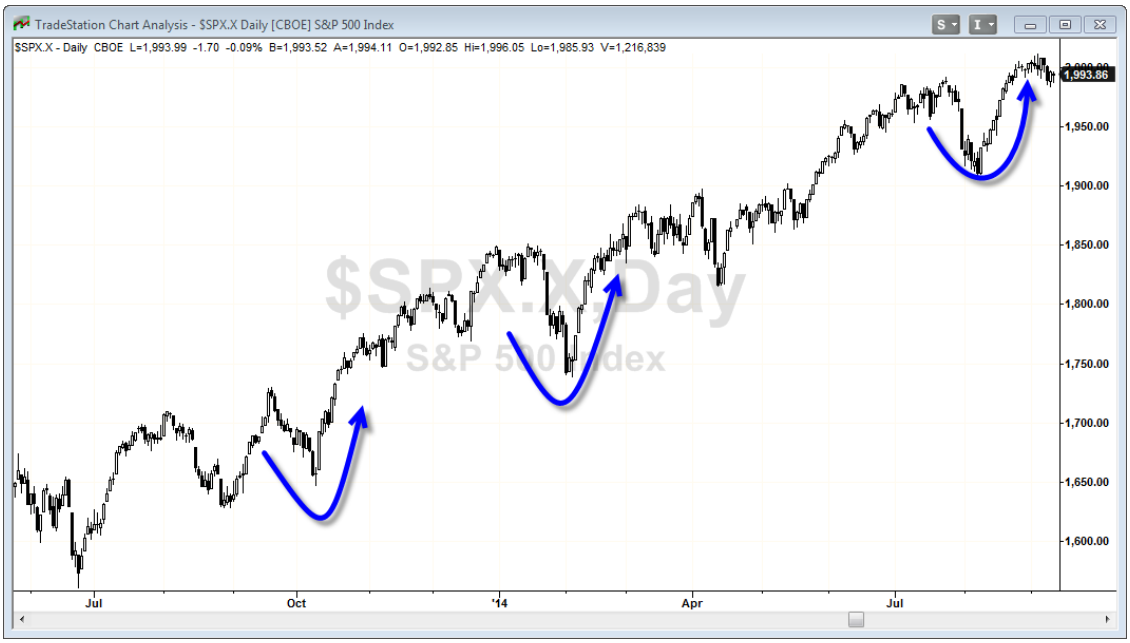
But even 220V low-capacity outlets are still rare to find on the side of the road, so a third option for Tesla drivers is to plug into a standard low-capacity 110V outlet, which will net them 5 miles of range for every hour that they charge the vehicle.

The point here is that the laws of physics dictate the amount of potential energy that you can cram into a Tesla within a specific period of time. And the same thing happens to financial markets; markets can choose to "recharge" at three different speeds. Let's see how this is accomplished:

Fast Market Recharge via Pullback/Slingshot

The fastest market recharge is also what's commonly called a "slingshot" move, where the price pulls back very quickly against the main trend, akin to pulling back a slingshot or a rubber band….and then it very quickly shoots higher into the main trend again. This type of recharge typically is the fastest way to re-energize a chart that has "tired."

You can see this in the chart below, designated by the blue arrows, where we'll see very quick pullbacks in the price which cause immediate rallies back in the original direction of the main trend.



The faster that the price pulls back against a main trend like this, the quicker the recharge, and the stronger the eventual "slingshot" move higher.

Slower Sideways Recharge or "Railroad Tracks"

Another very common way for a price chart to recharge is to see it walk sideways:

This type of “recharge” will definitely take longer than the slingshot move, and is very common to see. This is typically very frustrating price action for most traders to encounter, specifically because it is so “non-linear” and choppy. You’ll hear other traders complaining bitterly that the market cannot “make up its mind” although you’ll know better….the market just needs a rest, and you’ll see it coming.

Slowest Recharge via “Upside Grind”

There are some trends that are just relentless.

There is so much of a supply/demand imbalance that every little micro-dip in price is bought, although it’s not able to explode higher due to the amount of “exhaustion” that the chart is showing. By far, this is the slowest manner in which a chart can recharge for the next potential trend.

Hybrid Recharging

No, this is not about a Toyota Prius….what you’ll typically find is that when trends have been on a very extreme, linear trend…they will recharge themselves via non-linear price behavior with a “hybrid” method of consolidation, or a combination of these three methods.

Summary - Understanding Market Energy

We showed how physical things “breathe” by going through constant cycles of advancing and resting; just about everything that we come in contact with on a daily basis goes through this “expansion” and “contraction” cycle.

And we showed that financial markets go through the same cycles as well, partly because they are just extensions of normal human behavior, albeit “crowd” behavior.

We also tackled the concept of “energy” as it relates to financial markets; admittedly we cannot directly measure it but we can measure the linearity of the current trend, and will apply that concept in the next module.

Lastly, with respect to the “recharging” aspect of financial markets, we showed that there are three different, distinct ways in which financial markets will offer non-linear price behavior that creates a rise in the amount of potential energy on that chart….and in this case, the potential to trend again.

In the next module, we’ll move beyond the concept of market energy to show how we measure and use it to increase the probabilities on our trade setups.

Homework and Next Steps

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

- [ ] Watch the associated video for this module.
- [ ] Look around you; note all of the “things” in your life that require a rest after exertion. These could be mechanical systems or things in nature. How do they recharge? What exerts them?
- [ ] Try to draw parallels from these systems/things to the financial markets. Are they similar?