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Derivatives Analysis with the E-mini and Russell Futures Contracts

M. WILLIAM SCHEIER

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Pivots, Patterns, and Intraday Swing Trades

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M. William Scheier
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Dedicated to the memory of Randolph Newman,
and to his wonderful granddaughter Glenny,
who saw in me something of merit
when I was a young man.

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PREFACE

My initial efforts in trading were focused almost exclusively on what is known as *position trading*, using equities and the physical commodity futures. Stretched out over the days and weeks a position could last, a trend in that time frame would eventually begin to make sense in technical terms, unfolding gradually as it proceeded on. There was a pace to the decision process. As a trader, one could mull over the conflicting elements of the technical picture. Some aspects would recede into the background and render themselves less relevant; some would grow in their importance and become glaring.

Initial forays into day trading stock index futures reveal a starkly different decision environment. There is no time to dwell on technical conditions. A day trade opportunity does not take shape over days and weeks. Opposing technical signals don't recede in time enough to sweep away the cross current of doubts before a decision is required. By the time a trend finally makes sense, it is often about to end. Intraday volatility in the stock indices is far more exaggerated than the daily bar charts of other markets, partly due to the extreme leverage, partly due to the intense participation. And positioning techniques that survive in the action of the long-term trends in other instruments get slaughtered in the countertrend reactions of the highly leveraged S&P 500 futures contract within the short term.

When starting out, understanding the day as it unfolded on a day trading scale was akin to trying to read a foreign language or decipher a secret code. Somehow the tremendous opportunities in these intraday trend swings were surely being captured successfully, but by whom?

The less-experienced student will often assume that floor traders in the pit capture the intraday swings. After all, those guys must be in the know. Their access is so immediate. They literally create price. That being out there—hanging 10 on the leading edge to the rhythm of history—must provide a better view, and information not otherwise available to the rest of us must be streaming across the pit at critical moments, providing the insight to decipher the head fakes from the real trend swings. One could easily come to the conclusion that because these guys are the professionals, they must surely make up that slim minority who are consistently taking the profits from those less skilled working off-floor on their video screens.

But nothing could be further from the truth. Floor traders are, for the most part, scalpers. They tend to front-run or fade the order flow. To them, swing trading intraday trends *would* be position trading. I was also surprised to learn that the majority of floor traders see the world from the point of view of Efficient Market Theorists, admittedly or not. For floor traders, if paper flow into the pit is the current of energy driving the markets, then it is the news and news events that provide the power supply for that energy. Why should they believe otherwise, given their worldview!

Nor is the S&P pit in Chicago the bastion of capitalism and free trade one might think it to be. The number of Efficient Market Practitioners on the floor of the futures exchange is only surpassed by the number of pit traders whose politics reveal an inclination toward unionism, trade regulation, intervention, and controls. Remarks from otherwise very talented traders actually reveal the belief that it was one U.S. President's tenure or another that caused a difficult period of market activity or a particularly beneficial one. With thinking like that underlying the operations of the S&P pit, how much insight is to be garnered there for a conceptual understanding of market trend structure? The theory of Random Walk never had more adamant proponents.

A useful propensity toward trend analysis was already working for me when I approached day trading—that of pattern recognition. What was needed to crack the code of intraday trend disguise was to see the process of pattern recognition in broader terms than just visual price formation. What was needed was an expanded understanding of pattern recognition to include other concepts in market behavior, concepts of technical event minutia, including time of day and relative price position, especially those happening in tandem. From such concepts, models were derived, and with models, the activity of an otherwise indecipherable and random-looking day

could be matched to one or more of a limited number of codified categories, each replete with its own setups.

The application of this broader definition of pattern recognition is particularly well adapted to the shorter time frames, where the decision environment requires quick response. When Adrian De Groot, a psychologist working in the 1960s, studied the differences between chess players, he discovered that the grandmasters recognized familiar configurations and visual patterns to assess game progress and decipher board strategy; they did not rely on mathematics, statistics, or remarkable memory skills. How else could a single player manage to play dozens of games simultaneously, going from board to board with near immediate response!

The focus of this book is day trading in the shorter time frames of the stock index futures contracts, with techniques that are anything but mechanical scalping. With conceptual event models and their accompanying rules, the intent is to convey a set of tools by which the major intraday swing trends can be identified quickly, and often at the very turning points where they begin.

The voice of the text is directed at the trading community in general, with an intentional clarity for each explanation aimed at the beginner stock index futures trader in particular. The term *Trader* has been capitalized in many places as a reference to the profile of a specific role model intended for emulation by any man or woman who understands that the process of development is ever one of student to market, and not one of retail to professional.

Pivots, Patterns, and Intraday Swing Trades

PART ONE

Time Frame Concepts

"Everybody" is always wrong. If everyone was right and no one was wrong, "everybody" would be rich and nobody would be poor. "Everybody" is always wrong.

—Randolph Newman[1]

Even the scholar most in repute knows only what is reputed and holds fast to just that.

—Heraclitus

CHAPTER 1

A Three-Frame Day

For the longest time as a commodities position trader, I was confused by day trading, especially day trading the S&P 500 futures contract. The lengthy trading period of nearly seven hours was itself an impediment to understanding the price action. The day's trading behavior patterns and events often seemed strung together at random, encouraging the deceptive practice of attributing trend direction to unfolding news events. There was no making any technical sense of it from one hour to the next. But it cleared up almost immediately when I began to view the day as divided into three separate and distinct trading sessions: the *1st Frame*, the *Midday Frame*, and the 3rd or *Last Hour Time Frame*.

These are just names. In truth, the periods don't last for exactly the same time each day. The 1st Frame of the day can last about 1 hour and 45 minutes, give or take about 20 minutes. The Midday Frame can last anywhere from about three to about three-and-a-half hours. And the Last Hour Time Frame gets whatever is left over, occasionally not distinguishing itself at all. Although traders often refer to this third period as the "last hour," I have found it to begin earlier and extend longer than the last hour of the trading day.

To be of any practical use, however, these time periods should be treated as fixed. In that way, a rule-based approach can serve to compare daily action in the transition windows from one period to the next. Each of these three main periods of the trading day does, in fact, have a flavor and unique character all its own. Because price action actually changes in character from one

period to the next, and does so fairly consistently, different methods to trade these different behavior periods serve better than a one-size-fits-all plan. Rules can be devised based on the differences between these time sessions, and thus can help reduce one's temptation to introduce into trade entry decisions the intuition that rules of a trade plan are designed to eliminate. So for purposes of establishing a time reminder, and a trigger to implement a different phase of a trading plan, the 1st Frame of the day for the equity indices starts from the cash opening of the New York Stock Exchange at 9:30 A.M. and lasts until 11:15 A.M. ET. The Midday Frame picks up at that point and extends to 2:30 P.M. And, thereafter, the Last Hour Time Frame of the day starts at 2:30 P.M. and extends until the futures close at 4:15 P.M. ET, 15 minutes past the NYSE cash equity close.

An important thing not to confuse about these three time periods is the association with trend. Going from one time period to another does not necessarily mean a change of trend, although it can. Instead, it is better to understand the transition from frame to frame in terms of *resolution*, *momentum*, *price action*, and *complexity of pattern*.

Often, one time period can be said to be a resolution to the one preceding it. The 1st Frame of the day is usually the more volatile, and thus the Midday Frame tends to consolidate what was accomplished in the earlier going. If, instead, the 1st Frame is corrective and overlapping in pattern, more like a consolidation pattern, it usually resolves itself early in the Midday Frame by a sharp breakout into trend. However, when analyzing the relationship between the first two frames, the latter pattern occurs less often. The 1st Frame is usually the more volatile and trending, and the Midday Frame tends more to consolidate or even just chop around. If the Midday Frame builds a consolidation pattern, it will usually resolve itself in transition to the Last Hour Time Frame, beginning around 2:30 P.M. ET. If the trend in one period is destined to continue into the next, it will often accelerate in transition. If a trend had already accelerated within one time period, the next period may see a slowdown and even become choppy. Reversals can come in the middle of any period, but the momentum and the direction of such a reversal is more likely to change around 11:15 A.M. or 2:30 P.M. Short-term reversals are especially common at 10:30 A.M. and 12 P.M., and are thus also worthy to be included as designated *Time Markers*, but the transition of momentum and price action is better represented at the specific Time Markers of 11:15 P.M. and 2:30 P.M. ET.

Marking at least these two *Transition Times* on your own charts every day is a great exercise. Watch how often the market action seems to call for either a trade exit or entry as they approach. (See Figures 1.1 and 1.2.)

FIGURE 1.1 Transition Times

FIGURE 1.2 Transition Times

(For colorized versions of these charts, go to the Wiley companion website for this book, with instructions in Appendix A).

To be an effective trader, plotting such lines of time frame demarcation must become more than an exercise of mere curiosity. It must become habitual. And speaking from a lot of experience, traders can become lazy and complacent. Besides, in the heat of a trade entry or exit decision, many other emotional factors can take precedence over something a trader may or may not remember to check. Therefore, an indicator that automatically plots vertical lines on the screen at these critical junctures should be a standard tool in a trader's software package.[2]

The 1st Frame

While stock investors and position traders often consider the closing price of each day to be the most important for assessing performance, day traders consider the opening price as the most critical, as Grant Noble has noted in his book, *The Trader's Edge*.[3] Everything that happens for the entire day in the futures market—and especially price reaction throughout the first hour—is influenced by that opening. Volume and volatility are usually strongest in this first time period.

Pent-up orders from traders and institutions alike arrive at the floor most heavily at the opening bell, 9:30 A.M. ET. Attendance in the S&P and Nasdaq trading pits on the floor of the Chicago Mercantile Exchange is always greatest during this period. So important is the 1st Frame time period that many of these same floor traders consider the day over when the first hour and a half or so comes to an end.

For beginning traders, the opening hour presents some special challenges. Price volatility can be extreme, sometimes in a whipsaw manner. This volatility can frustrate the placement of stop-loss orders, as the market seems almost determined to take them out. Then again, on many a morning, price action seems truncated, sometimes on the very days when so much direction would have otherwise been expected.

That is why many novice traders get chopped up in the early going, and are warned to avoid trading in the first hour. Without a specific trading methodology that takes into account where the day's pivots and reversals are most likely to take place, a trader hoping to initiate a position for the early trend is not likely to survive his first stop-loss order.

Think about what was said earlier in this section regarding the S&P trading pit attendance. Some floor traders are done for the day after the 1st Frame is