ATTACKING CURRENCY TRENDS

HOW TO ANTICIPATE AND TRADE BIG MOVES IN THE FOREX MARKET

GREG MICHALOWSKI

Attacking Currency Trends

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To Deb, Matt, Brian, and Bobby Michalowski

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Acknowledgments

I will always remember something Bill Kidder said to me 25 years ago, soon after I met him for the first time. He said, “Your dad was one of my first mentors. He gave me his time and taught me a lot about the markets. He is a good man.” These words are very powerful words and they stuck with me.

Bill was my first trading mentor, and the first thing he taught me, without saying, was to follow in my father’s mentoring footsteps. Over the last few years of my career I have been able to pay the favor forward—to be a mentor. Although it is less personal than the mentoring I received, I do hope it has provided a benefit to your trading. Remember, however, that ultimately you will need to “fish for yourself.”

Other life mentors I would like to acknowledge include my wife, Debbie; my mother and father; my sons, Matt, Brian, and Bobby; my six siblings; and all my extended family members (and it is a very large clan). I cannot thank you enough for all your support and unconditional love. Professionally I would like to acknowledge Tom Bonen, Guy Whittaker, Ted Muller, Kim Hamilton, Tom Bergen, Joe Botkier, Emil Assentato, Shawn Powell, my hardworking colleagues at FXDD. Each has helped form me over the years in some way or another and my appreciation is not forgotten. I would like to acknowledge my “trading apprentices” that ask for advice and support my efforts at FXDD. You provide joy to my life through your successes as traders. I would like to thank the respected traders that have crossed my path on the various social media sites. Even though an alias may be used and we may never physically meet, trading is not as lonely because of you. I would like to acknowledge my spiritual mentors, including the vibrant and positive St. Patrick’s community. I start and end my week at St. Patrick’s and it gives me the direction during all the minutes in between. Last but not least, I give thanks to the ultimate spiritual mentor, God, for giving me wisdom, the humility to accept failure, the will and desire to correct my mistakes, the opportunity to pay it forward, and all the other incredible gifts from His amazing grace.

Attacking Currency Trends

Introduction

When I was in college at Clemson University, I dreamed of a career on Wall Street. My father, Joseph Michalowski, worked on Wall Street his entire career, working his way through the ranks. There have been very few people I have met who had a professional relationship with my father who did not say, “Your father is a good man. He taught me a lot about the markets.”

One of the highlights of my father’s career was working at Chase Manhattan Bank. He was once put in charge of uncovering, unwinding, and being the expert during the Drysdale Government Securities crisis that shocked Wall Street in 1982. The crisis, built on a string of reverse repurchase agreements that went wrong, sent repercussions throughout Wall Street when the boutique firm defaulted on an interest payment totaling $250 million. The knock-on effect of the crisis resulted in the Federal Reserve’s issuing that now all-too-familiar statement, “The Fed stands ready as a lender of last resort.”

What was the catalyst for the crisis? The use of too much leverage (i.e., risk) and the lack of a plan and controls. Compare and contrast this to the 2008–2009 financial crisis where the same fundamental faults led to a near-global financial meltdown. Twenty-seven years later the lessons have not been learned.

In addition to his knowledge of interest rate products and the markets, my father was a technician, or a chartist, who would painstakingly construct by hand bar charts of bond prices on grid graph paper. At night, he would tape together the pages when the prices moved above or below the boundary of the paper, or when a new page had to be added as time progressed. He would fold his “moon charts”—as he liked to call them—as deftly as an origamist would fold a piece of paper into a swan.

During the early years of his career and without modern technology, he was able to carve a career as a technical trader by keeping analysis basic, finding good trade locations, defining risk, and trading the trend. There were no Relative Strength Indices or Stochastic Indicators. Shorter time-period moving averages could be calculated if the trader was dedicated

enough, but 100 or 200 bar simple moving averages were more difficult and time consuming (if they were even done at all). Exponential moving averages could not be done without the aid of larger computer resources.

Trading technically was simpler then than most technicians find it today. Bar charts and maybe point and figure charts were used predominantly, and to bring them to life, trend lines provided the bells and whistles, defining the trend in the process. My father and most other successful traders made money by attacking the trends. My father's career on Wall Street got me interested in trading, and that became what I wanted to do.

MY JOURNEY

I started my journey as a summer intern in 1981 for an interest rate trading pioneer named William Kidder (no relation to Kidder Peabody, a prominent Wall Street firm at the time). Bill was one of the first to use mispriced interest rate futures to arbitrage the U.S. Bill and Bond markets. In 1981 he started a software company with a goal to build a menu of programs used to exploit arbitrage opportunities in the interest rate markets. The programs would run on Apple IIs, one of the first desktop computers.

Bill's software was all about finding value and defining risk. I learned through Bill that all successful traders look to find good value and to define their risk. By doing so they are able to keep their fear to a minimum and trade more profitably.

To do the computer programming, Bill hired a team of college students—mainly from Ivy League graduate schools—and promised a lecture a day, an hourly wage, and a folding chair and computer. I did not qualify as an Ivy Leaguer—being a rising junior at Clemson University (not even an Ivy League institution of the south)—but I did qualify as being the son of Joe Michalowski. I was also "hulky" enough to carry a computer to trading rooms around New York City when needed, a task I was happy to do, being the wide-eyed undergraduate in the Big Apple.

I got the break I needed, and I was working on Wall Street, taking the morning train, reading the *Wall Street Journal*, and wearing one of my three suits in the rotation. Although hired for my hulk, I ended up holding my own with the Ivy League work colleagues, and the computer lugging was replaced by programming. I also learned a tremendous amount from Bill's morning lectures on the fundamentals of the markets, trading, value, and risk. The next year I was asked back for another summer internship opportunity. I became motivated to learn more. After graduating from college in the spring of 1983, I started full time with Bill's firm, selling the software to Wall Street's interest rate arbitrageurs.

The experience of the internship and my first job gave me a foundation for the business of trading, and more importantly, it also taught me about finding value in the market and defining risk.

In 1984, one of my clients at Citibank was looking for an entry-level trader for the interest rate arbitrage desk in the bank's funding area. Since the software they were to use was the software I helped develop and now sold, I was the obvious fit for the job. Green as I was to trading, I was offered a position, and my career as a trader began.

I worked for Citibank New York for six years, initially as a trader's assistant in the bank's funding department and later making markets in short-term forward rate agreements and interest rate swaps. In 1991, I was fortunate to move to London for four more years where I helped start up Citibank's short-term interest rate derivatives desk. It was during this time that I became more interested in technical analysis. I went to seminars, read books. Computers were becoming more mainstream. As a result, getting electronic price feeds into a spreadsheet could be done easily and allowed calculating the algebraic breakevens instantaneously. More sophisticated charting programs started to surface with the ability to add indicators and draw trend lines directly on the screen.

It was during this time I was introduced to a trading concept called Market Profile™. The Market Profile taught me to recognize different market patterns (i.e., visuals) that helped me understand "exact" risk and how to anticipate trends—two seeds that my father and Bill Kidder first planted in my brain. It became the basis for the development of thinking like a *successful* trader rather than simply being a trader. It was a foundation for moving to the next step.

THE MARKET PROFILE APPROACH

Market Profile was developed by a bond trader in the Chicago futures pits named J. Peter Steidlmayer. The concept centered on breaking down the day into time periods that each lasted a half hour. The periods were lettered A, B, C, and so on. For example, the letter A would be assigned to all prices that traded in the first half hour. The price need only trade once in the A half-hour window to get assigned a spot on the profile. In the second half hour, the letter B would be assigned to all prices that traded in that period. Prices that traded in the third half hour of the day would get assigned the letter C, and so on.

A "Market Profile" would develop with the price moving vertically from high to low. If a price traded in the A and B periods, the two letters would go side by side, A first, then B. This way, rows of letters going

horizontally would start to develop as the day's profile was built at each price.

There were four types of days that would develop using the Market Profile. Each day fell into one of the buckets. By recognizing the type of day, a trader could discover important clues about value, risk, trade location, and even what might happen tomorrow. As a group, they started to teach me about key aspects of becoming a more successful trader. The types were normal distribution, nontrend, double distribution, and trend days.

Normal Distribution Days

The most common type of day was a normal distribution day. These would occur approximately 70 percent of the time, and at the end of the day would look something like Figure I.1. Not surprisingly, the normal distribution day looked like a normal distribution of a bell curve.

The profile, as it was termed, showed the high volume price, or HVP for short. This was the price that traded the most over the course of the trading day. In Figure I.1, the HVP was at 101-22 or 101 and 22/32nds (bonds

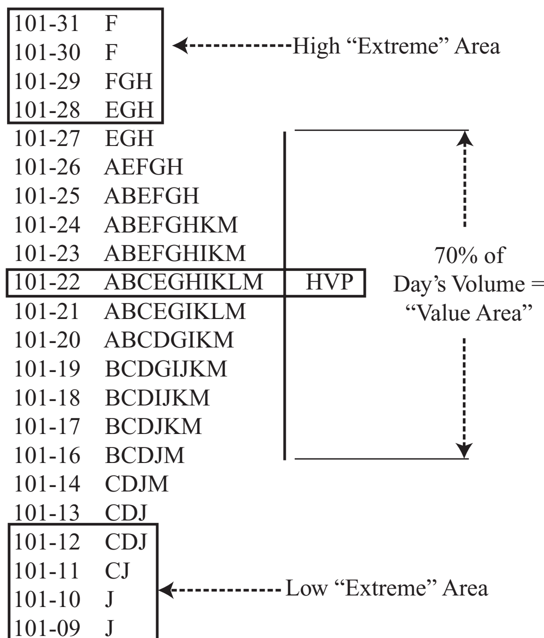

FIGURE I.1 Normal Distribution Day

and notes, which the system was developed using, trade in 32nds). The horizontal line at the end of the lettered distribution indicated that those prices were part of the value area. The value area was where 70 percent of the day's trades took place, representing roughly one standard deviation for those who might be mathematicians (I am not one, by the way). The Value Area in Figure I.1 comes in at 101-16 to 101-27.

Types of Traders During normal distribution trading days, the average trader would mainly trade around the middle of the Value Area, making a little, losing a little—basically treading water. A mentor of mine once called these traders the "Uncle owns the firm" traders. He reasoned that they could not get fired, by virtue of blood connections. However, blood only goes so far, so they would not advance in rank within the firm either.

The ends of the trade distribution bell curve were called the extremes. There were two types of traders who traded the extremes. The first type saw the market moving lower and just knew it was going even lower. They sold the lows only to have the market bounce right back where they would then cover at the upper extreme—or highs—for a nice large trading loss. These traders were termed the "Mother owns the firm" traders, since the only way they could ever keep their job was if their mother owned the firm.

The other traders who traded the extremes were doing the exact opposite. They would be buying at the low extreme and selling at the high extreme. They understood good trade location. They understood the type of market the day was developing (i.e., range bound), and what a normal trade distribution would look like at the end of the day (yes, it does help to visualize the normal bell curve developing). They were great traders, and they were termed the "Owns the firm" traders.

There was another set of traders: the ones who traded in the middle of the day's range, but were not satisfied enough at the positive extreme to take their profit. So instead they held the position and became scared enough to get out at the losing extreme—and book a loss. Needless to say, these traders were also "bad traders" and were a hybrid between the "Uncle" and "Mother owns the firm" traders. They likely got fired at some point.

Finally, there were those who traded in the middle and were content to take a quick profit near the profit extremes. They made smallish gains and were a little better than "Uncle owns the firm" traders.

So overall, there was one group (a small percentage, mind you) that made the money by buying low and selling high at the extremes. There was another that caught part of the day's ranges and made a living, but did not get rich. There was another group of traders that broke even in the middle and two groups of traders that consistently lost money (this was the bulk of the traders).

Although very simplistic, I began to think in terms of what kind of trader I was and what kind of trader I wanted to be. It was harsh to realize that I was likely an "Uncle owns the firm" trader. Needless to say, I wanted to be a Trader who "owns the firm" (or as close to it as possible), but did not fully know how. It is one thing to say you want to be good at something, and another to understand how to do it. I started to study the Market Profile further and search for clues that it told me about the markets.

Trading Clues from Normal Distribution Days It was thought that normal distribution days took place 70 percent of the time. The ranges differed from day to day, but the pictures ended up looking similar. Since seven out of ten days were "normal," I began to start to see and anticipate how the days might develop more clearly. Over time, I began to develop an idea of what a normal range was and began to think in terms of buying and selling near targeted extremes.

There were also some rules I learned that could be used to anticipate where the normal distribution day would peak or trough. For example, I learned that if you took the High to Low range for the first hour of trading and subtracted (or added) that value to a range extension down (or up), it would project the low price (high price) extreme for the day. Knowing this taught me how to be aggressive on breaks above or below the initial range, how to anticipate a move in the direction of the break, and target a level to take profit, or even to initiate a counter trend trade.

Because of things like rules, I was becoming a trader with a *reason for the trade* rather than a trader who traded because the price was moving higher or lower. I also learned that if I had a reason to do a trade, I also had a reason to get out of a trade if the market did not do what I expected it to do. I started defining risk. By defining risk I found fear from trading started to abate. With less fear I was able to stay in positions longer and to catch intraday trends. The pieces of being a real trader started coming together.

For example, in Figure I.2, the first hour (i.e., initial range) of trading during the A and B periods has a 16/32 range. When the initial range is breached on the downside during the C time period, the range extension rule says the market should target an extension level equal to the initial range of 16/32nds.

By following the rule for trade extensions, a short position at 98-10 would be initiated, with a target take profit level being at 97-27, 16/32nds lower. A stop for the trade would be if the price extends back above 98-14 (to 98-15), which was the low of the A period in the chart. With that stop in place, risk would be 5/32nds. The target gain would be 15/32nds if the target was reached. A risk/reward ratio of 1:3 was pretty good.

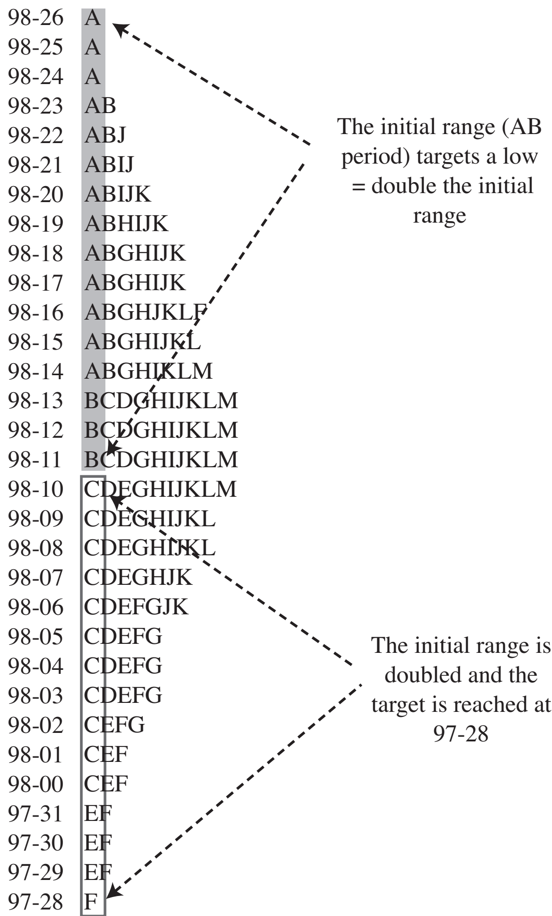

FIGURE I.2 Targeting the Range Extension

The "If . . . Should" Rule This process of trading was the foundation for what I now call the "If . . . Should" rule. The "If . . . Should" rule says: "If the market does XYZ, the market should do ABC. If it does not do what it is supposed to do (i.e., ABC), then *get out*." We will discuss the "If . . . Should" rule further in Chapter 4.

The "If . . . Should" rule in relation to this example would say something like this: "*If* the market is a normal distribution day and the price moves below the initial trading range (first hour of trading), the market *should* double the initial trading range in the direction of the extension. If it does not do what it is supposed to do, then *get out*."

In the example, the price extended the range lower and did not go to the 98-15 stop level. The market *did* what it was supposed to do.

Over time, I found that I could easily define my risk. This was very important to me as it reduced my fear. I could also define logical profit targets. They became more defined during normal distribution days. I started to find that I was selling and buying more extremes at levels that made sense. My trade location was improving, and my trading profits improved with the better trade location.

I know real estate professionals say the three most important things in real estate buying are Location, Location, Location. In trading, maybe it's not three times location, but having good location is definitely a big relief.

Nontrend Days

Of course, the market does not trade normally all the time. There were three other types of day formations I learned using the Market Profile concepts, and each gave me a further understanding about risk, the potential for reward, and even anticipating a trend.

One was a nontrend day. A nontrend day was a variation of the normal distribution day, but in this case, the day had an abnormally narrow low-to-high trading range and low volume. The profile of a nontrend day would look like Figure I.3.

Nontrend days did not provide much in the way of profit potential—in fact, they could be downright frustrating for the impatient young trader. However, I learned that the rewards of nontrend days were not from what happened that day, but for the potential for the subsequent day(s). The reason is that nontrend days tended to signify a balanced market with neither buyers nor sellers in control.

The good news for traders is that nontrend markets tend not to last long. Often, either the buyers or sellers look to take control and move the market away, either higher or lower. The reason is that trading markets

101-25	A		
101-24	ABCGM		
101-23	ABCEFGHIKM		Nontrend Day
101-22	ABCDEFGHIKLM	HVP	Low volume
101-21	ABCDEFGIKL		Narrow range
101-20	ABCDEGIKM		
101-19	BCDGIJKM		
101-18	B		

FIGURE I.3 Nontrend Day

are there to facilitate trade in a direction, up or down. If a market ceases to trade due to nontrend activity, why have a market?

Eventually, the traders in that market get antsy and look for reasons to move the market away from the current level. Often that move is exaggerated in the direction of the break (i.e., a trend-type move). The market becomes like a spring—coiling but ready to uncoil at the slightest nudge by aggressive buyers or aggressive sellers.

For me, the picture of a nontrend day and the understanding of what it signifies was an important "aha" moment for my trading success, and I use it to this day. Although I do not use the Market Profile for currency trading (it is not suited for a 24-hour currency market), the concept of nontrend days remains a very important leading indicator for catching a trend move.

Traders who can *anticipate* a trend type move are more *prepared* to trade the trend move. Nontrend days were one of the first clues that helped me increase trend trading success simply because I could better anticipate when a trend move might be forthcoming.

Later in the book I discuss in more detail the clues from nontrending markets and how they tend to be precursors for attacking currency trends.

Double Distribution Days

Another formation that was developed using the Market Profile was a double distribution day. This day formation created two separate normal distributions that trended up or down. The move was a more powerful trend type directional move with larger ranges. The two distributions often shared an extreme in the middle of a day when the market transitioned from one normal area to a higher or lower *new* normal area. Moves like this were typically initiated by some news that forced the market higher or lower to the new range.

In Figure I.4, the shared extreme occurs during the G period. The example illustrates a typical double distribution day where the price trends higher from a low normal distribution area to a higher normal distribution area.

The double distribution day gave me the visual to find exact levels to lean against that helped define risk of the trade. By defining risk clearly, I had more confidence and with it, less fear.

For example, in Figure I.4, the A to F periods were characterized by a narrow, nontrend-like trading range (low was 101-00 to 101-12). In the G period, the market broke to the new upside, the move left a string of single letters—or "single prints"—up to a new high of 101-24 in that period, with the 101-13 level being the lowest single print in that sequence.

Those single prints became levels to lean against on corrective moves back down, with the 101-14 being the lowest level the market could go

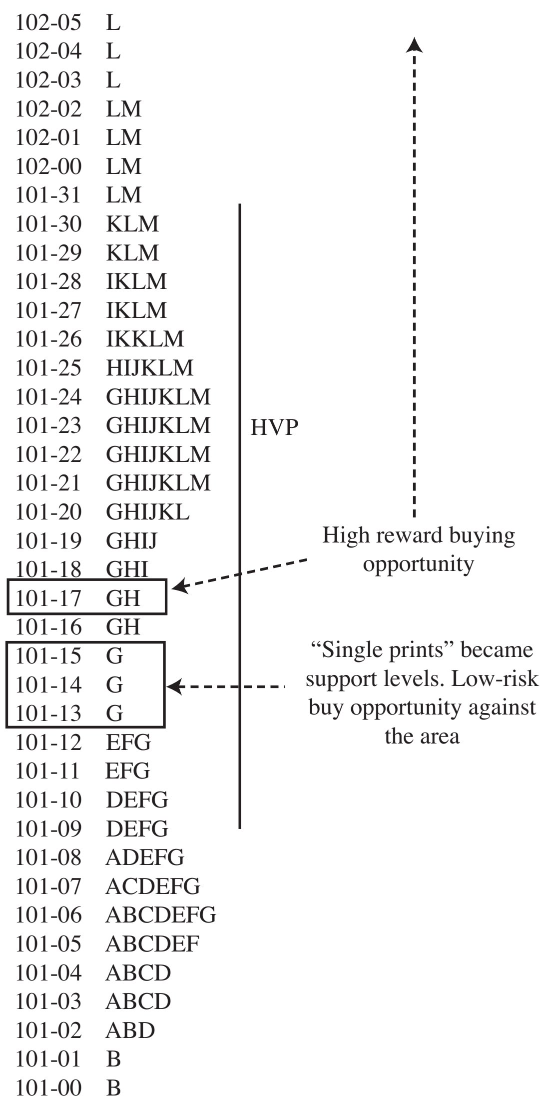

FIGURE I.4 Double Distribution Day

down to in a subsequent half-hour period that would keep the single print string intact.

The Market Profile rules believed that "*If* the market was forming a double distribution day, the market *should* have left single letter prints in its wake. If it did not, it was *not* a double distribution day and therefore

don't expect further momentum in the direction of the break." (Note the "If . . . Should" rule.)

As with normal distribution days and nontrend days, the double distribution day was another type of trading day that gave clear clues that could be used to reap good profits with little risk.

The ability to visualize trades, understand risks, and target profits are all important prerequisites for trading successfully. Understanding the characteristics of the double distribution days was another way to put the odds of trading success more firmly in my favor.

Trend Days

The final distribution that Market Profile developed that helped me lay the foundation for becoming a successful trader was the trend day distribution. This was the most powerful of market movements and provided the greatest profit potential to me as a trader. In a trend day distribution, which was estimated to occur on 10 percent of the days, the market moved directionally up or down, leaving multiple single prints in its wake. Figure I.5 is a Market Profile of a typical trend day distribution.

Characteristics that made trend days most profitable were:

- The high-to-low ranges were much larger than on normal days, providing greater profit potential.
- The market stepped higher in a consistent fashion, with each half-hour period having a higher high along the way.
- The steps had spurts where the Market Profile would leave a series of single prints (similar to the double distribution day) along the way. These single prints could be used to lean against when initiating or adding to a trading position. They also could be used to define risk by providing a stop loss if the market reversed.
- They often came after a nontrend day or after a period where the market stayed in an abnormally narrow trading range.

In Figure I.5, at C, E, and J, traders could buy against the single prints, with a stop if the price filled in the single prints. Being aware of the profit potential of a trend day and being able to anticipate the moves greatly increased the odds of success in the favor of the trader while keeping the risk to a minimum. Even though the trend day was a one-way street with little in the way of risk, the hardest thing to do was to stay on the trend. However, following the clues and the rules from the single prints at C, E, and J provided the road map for a potentially big trade.

The lessons the Market Profile gave me early in my career were the basis for my trading today. Although I do not use the method to trade

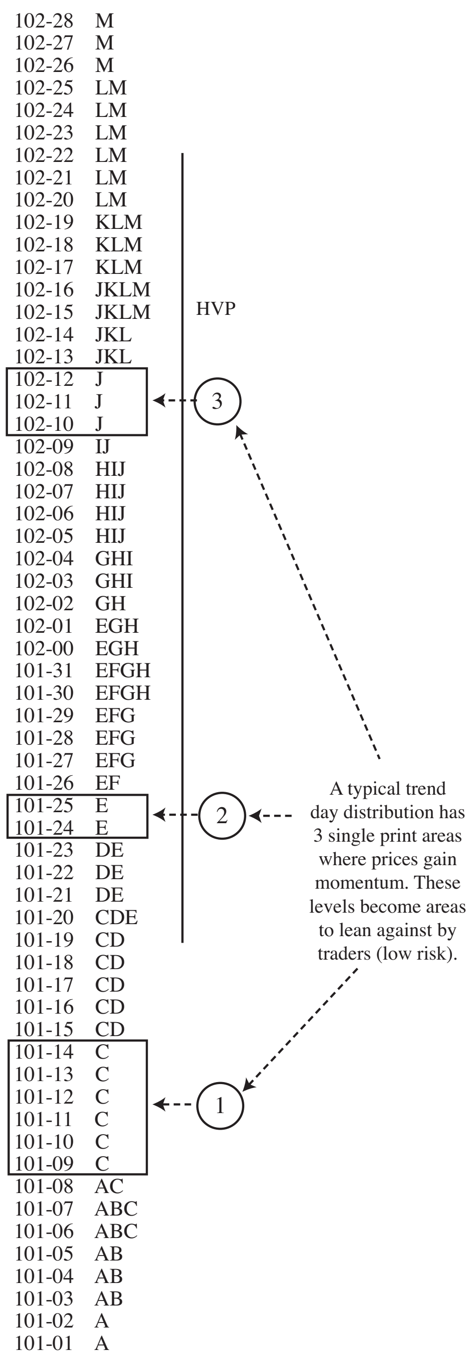

FIGURE I.5 Trend Day Distribution

currencies (it does not work well with a 24-hour market), the concepts I learned in those informative years from the Market Profile are still very relevant. The difference comes in the tools I use.

IT'S A PROCESS

In this book I will look to take progressive steps forward from forming a foundation for success to showing you how to attack trends. The basis of the steps comes from two sources. One is from my 16 years of experience trading on behalf of major global financial institutions. What you have read so far was just a small piece of some of the things that helped build my foundation as a trader, and I thank those firms and the people at those firms who allowed me to develop those skills.

The second basis for the steps outlined in this book has come over the past 10 years of my career. Over these years, I have been fortunate to work for a retail currency brokerage company, FXDD, since the day of its inception. Through those years, the hats I have worn at the various stages (and often simultaneously) have incorporated everything from customer support, risk management, sales, trading, software testing, and interface design. I prepared the firm's first customer agreements and account opening procedures. I even designed and programmed the firm's first web site. Being so involved is an advantage. I know the retail currency trading business.

The last 10 years have also taken me on the other side of the fence, as I like to tell our customers. That side is from the perspective of the *market maker*, not the *market taker*.

Market Maker versus Market Taker

For a market maker, positions are assumed and managed from the trading side. We have tens of thousands of customers logged into our trading system at any one time, and each is given a two-way bid-and-ask price in 20 different currency pairs. Those prices are live and dealable, 24 hours a day, five and a half days a week.

The benefit to the market maker is that there is a bid-to-ask spread that gives an advantage with a critical mass of traders dealing at the same time. That is, if one trader is hitting a market maker's bid in the EURUSD, another may be dealing off the ask price at nearly the exact same moment. With tens of thousands of customers, this forms the basis of a business where profits are made by virtue of facilitating trade for a large number of traders dealing off a bid-to-ask spread.

In contrast, the first 16 years of my career I spent as a *market taker*. I primarily dealt off market makers' prices when trading and had to pay away the bid-to-ask spread (i.e., sell at the bid and buy at the ask). Although there were some customer flows, the positions were self-induced and dependent on my trading acumen. If I made money, it was because I had the right position.

Most people who are reading this book are likely market takers (it is written for your benefit, not the market makers'). You decide if you want to be long or short, where your stop loss is, perhaps where you will target a profit. You initiate everything, and you also are solely responsible for your profit and loss. Although you may know others in the market and have knowledge of how they are doing, they likely represent a statistically insignificant sample of the market.

For myself, however, in the role of market maker, I have been able to see what a statistically significant sample of retail traders (again, the number reaches tens of thousands) do right and what they tend to do wrong. I also get to see what types of markets the traders trade poorly. This is valuable information to know, especially when trying to fix a problem or even write a book.

I liken myself to the golf professional at my local public golf course. Let me explain.

I love the game of golf but find the game challenging, to say the least. Priorities in life (i.e., children, family, work, writing a book) also keep me from playing with any regularity. Nevertheless, I do want to improve, so from time to time I may take a golf lesson from a trained golf professional.

What normally happens in a lesson is that the golf pro will take me out to a driving range where he will throw a dozen or so balls down on the grass. He will then ask me to take the club I am most comfortable swinging and, without giving any instruction, will have me hit the balls. Invariably, the first few will be straight down the middle, the customary 150 yards. However, fear soon enters my brain and the pulls and the slices, the fat shots and thin shots, start to rear their ugly heads.

When all the balls have been hit, I don't turn to the pro and say, "What am I doing right?" Instead, I am more likely to turn to him and say "What am I doing wrong?"

The golf pro, by virtue of the fact that he has likely hit thousands of balls more than me, has had many more hours of instruction, and has played many more holes in his life, understands the importance of a proper grip and fundamentals of a swing and is far more qualified to tell me what to do to make myself a more successful golfer.

So I listen to what he has to say. It is not my position to tell him what I am doing wrong, but for him to tell me what I am doing wrong. From there