CHAPTER 17

MARKET PROFILE—REMOVING THE MYSTERY

FOLLOWING IN THE FOOTSTEPS OF ELEPHANTS

Market Profile is a mystery to most traders, and I want to spend a little time talking about it and at least introduce it to traders who have never used it, since it is becoming increasingly more important to understand how to use this technique. I want to emphasize that this is an introduction—there are entire books written on Market Profile, and unfortunately, none of them is easy to read.

One of my trading partners, Alex (alleyb—his name in our trading room), uses Market Profile extensively, and he was kind enough to research the examples for this chapter. Again, this is intended to be an introduction into this methodology, so if you are already familiar with Market Profile, there shouldn't be any new information for you here. For the uninitiated, the goal of this chapter is to just introduce you to this technique and give you a basic understanding of how it works.

I must point out that I do not use a specific strategy for trading Market Profile. Rather, I use it to get a bias on the markets. If Market Profile is telling me that the sell side is more attractive than the buy side, then I will focus on short setups and generally ignore buy setups, and vice versa. By setups, I mean the setups I've already discussed in this book. Also, I personally do not do my own Market Profile analysis on the markets. It is not my area of expertise, and I would rather just look at what other experts are doing in this area and view their research. I keep an updated resource list on this at www.tradethemarkets.com. With Market Profile, people can't hide what they are doing, which is the beauty of this analysis technique, and this will become incredibly more important as the financial markets come kicking and screaming into the electronic age. Let's take a look.

Market Profile or *MP*, as I refer to it here,was originated by Pete Steidlmayer in 1982 and was licensed to the Chicago Board of Trade in 1984. In its simplest form, MP is one of the most accurate methods for analyzing market data available, and it is becoming even more important as markets make the switch from open outcry to all electronic. MP organizes data and puts them into a picture type of view that represents time, price, and volume. The picture is shown on a vertical axis in the shape of a bell curve. The price component of this picture is displayed on a vertical axis. This part is easy enough to understand. Now it gets a little more interesting.

The time portion of this visual is displayed utilizing letters of the alphabet. These letters represent the time or time brackets, and they are displayed on a horizontal axis. Finally, the third part of this picture, volume, is shown in the form of a histogram and takes different shapes depending on the provider of the data.

MP shows in real time the development of pricing patterns, which is sometimes referred to as *price discovery*. It shows the market organizing data into a unique format in which it is possible to view whether a price is being accepted or rejected over time and through volume. It is possible with constant analysis to establish whether the majority of market participants are long or short and if they are trying to add to or liquidate their positions.

It also provides an opportunity for establishing the reference points of the market. Examples of this include establishing areas of fair or unfair value. Because these data are organized as a picture, high-volume prices and low-volume prices, both of which act as support or resistance, stand out clearly. In addition, the data can establish possible price projections by knowing how the various participants are positioning themselves.

Any market exists to facilitate trade. In simplistic terms this means that the markets travel up and down to establish points of reference at which the majority of buyers and sellers are satisfied in an attempt to establish value. Value is not necessarily viewed by different timeframe participants in the same way. What may be fair to one is unfair to another. MP attempts to create balance and moves through varying degrees of imbalance or trend or vertical moves followed by renewed periods of balance or consolidation or horizontal moves. This is how the bell curve is created and takes shape, and from this the long-term MP can be used to establish short-term moves.

SPECIFIC EXAMPLES OF MARKET PROFILE IN ACTION

Let's look at a few examples of Market Profile.

- Figure 17.1 depicts a daily MP time price opportunity (TPO) together with the open, opening range, 50 percent of each day, close, and value range.
- The contract shown is the CME big S&P 500 December futures contract, covering September 16 through September 23, 2004. This contract is also referred to as the

Spoos (pronounced *spooze*), with the quantity traded often referred to as *cars* and points made or lost on a play often referred to as *handles*. September 21 was the U.S. Federal Reserve or Fed interest rate announcement day. On September 22 the Spoos opened on a gap and underneath the bottom of several of the previous days distribution giving a low risk sell opportunity. This sell opportunity was taken at the opening at 1122 and covered on the close for a profit of 8 points.

- An additional sell was generated on September 23 on the higher open and at the base of value of the previous day. If the market had wanted to go up, the stop would have been just above the top of value on September 22.

S&P Futures, December 2004 Contract, September 13, 2004

- Figure 17.2 depicts the weekly MP on the big S&Ps again with TPO and value range for the weeks shown.

FIGURE 17.1

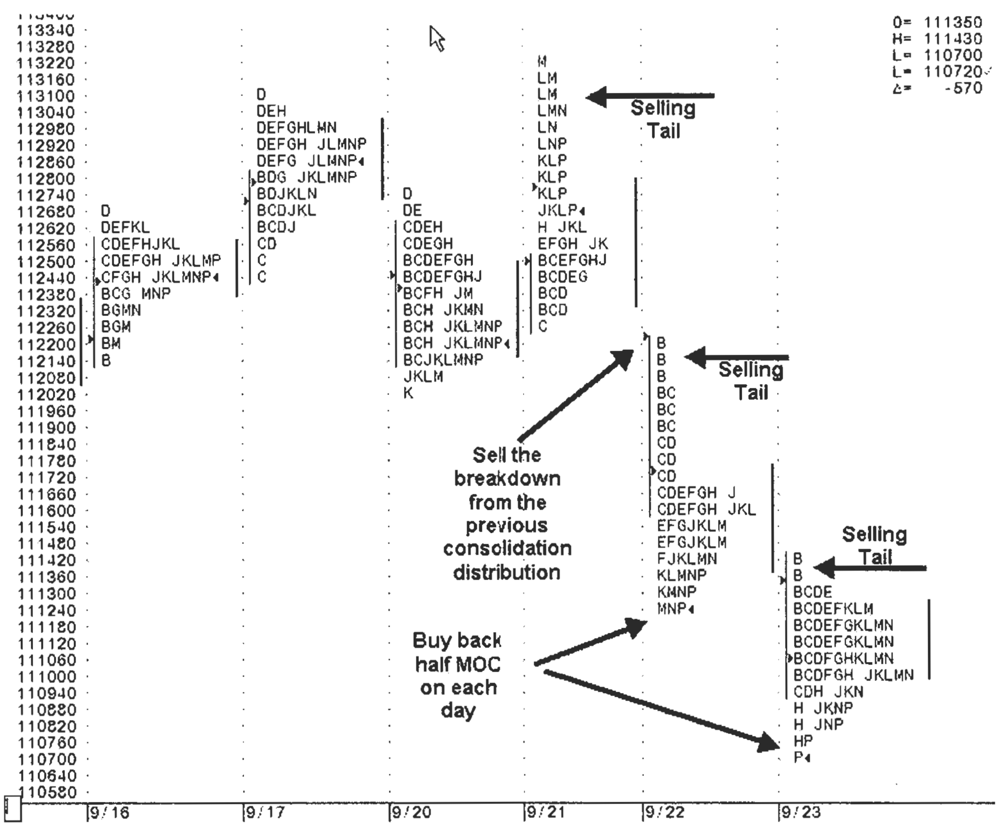
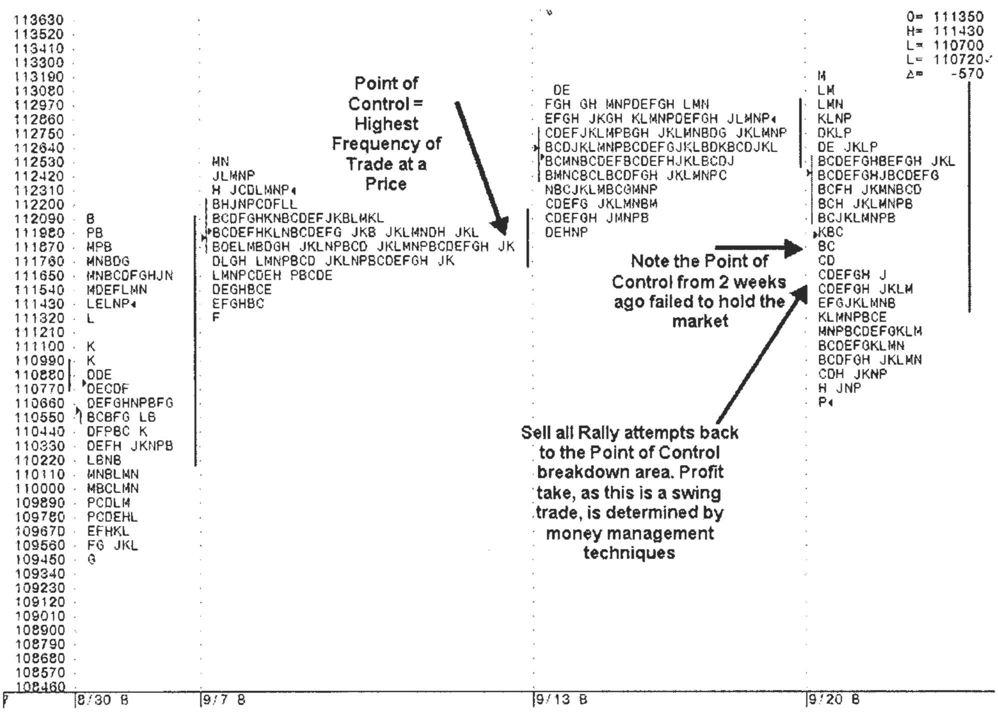


FIGURE 17.2



- The time covered is the last week of August and the first three weeks of September 2004.
- The week of September 13 clearly shows that value was being driven higher versus the previous week's value range, and as long as the close remained greater than the point of control from the week of September 7 at 1118.70, then the best trading ideas were longs or to stay flat. Short wasn't an option—unless prices broke down through 1118.70.
- The week of September 20 clearly showed the rejection of the previous week's point of control at 1127.50. The markets rolled over from here and accelerated down through 1118.70. Once this happens, the trader can set up a short. To find a target, a trader then starts to look for the bottom of value from the week of August 30, which is listed at 1102.20.

Mini-Sized Dow—September 2004 Contract, September 2, 2004

- Figure 17.3 depicts several versions of single prints where there was a single TPO.
- The contract shown is the CBOT mini-sized Dow December futures contract.

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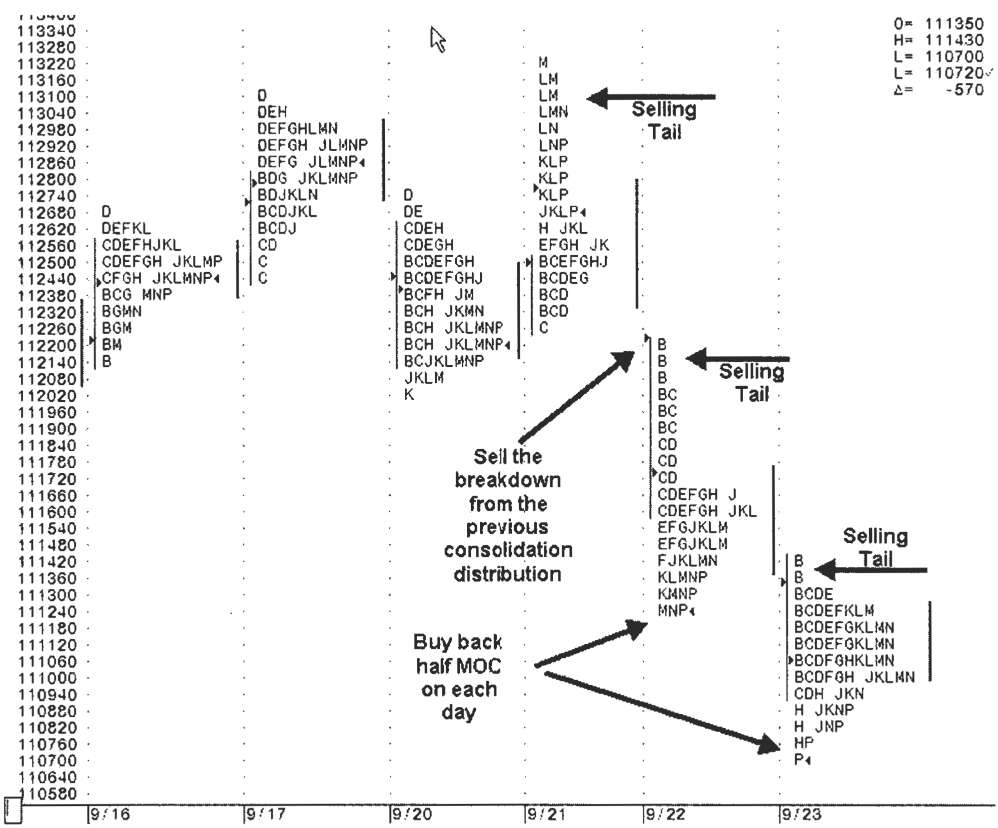
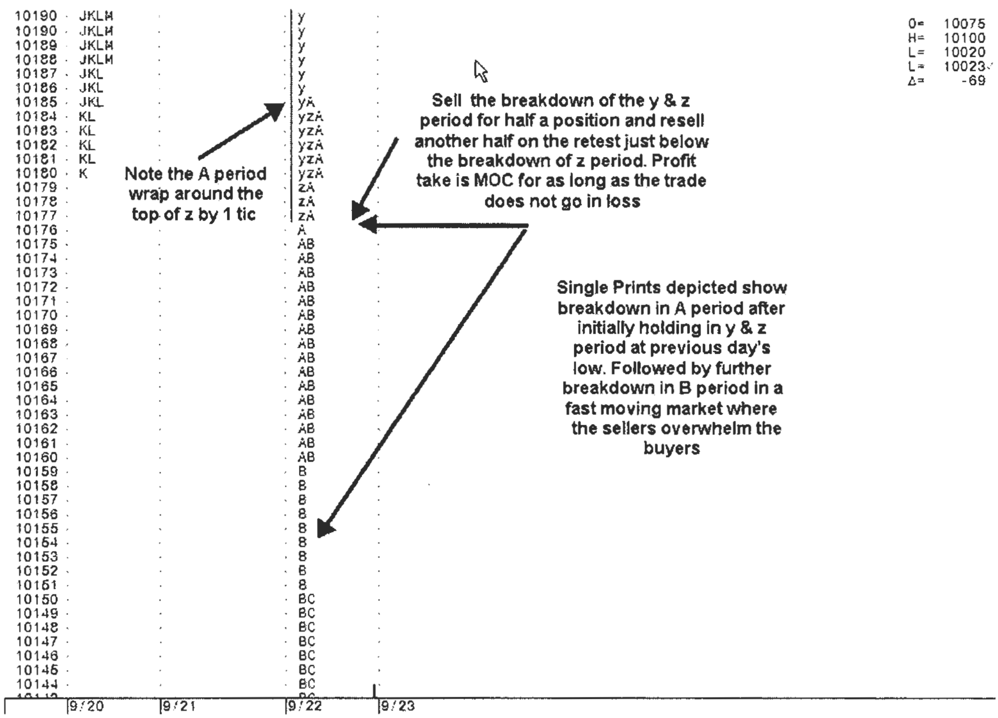


FIGURE 17.3

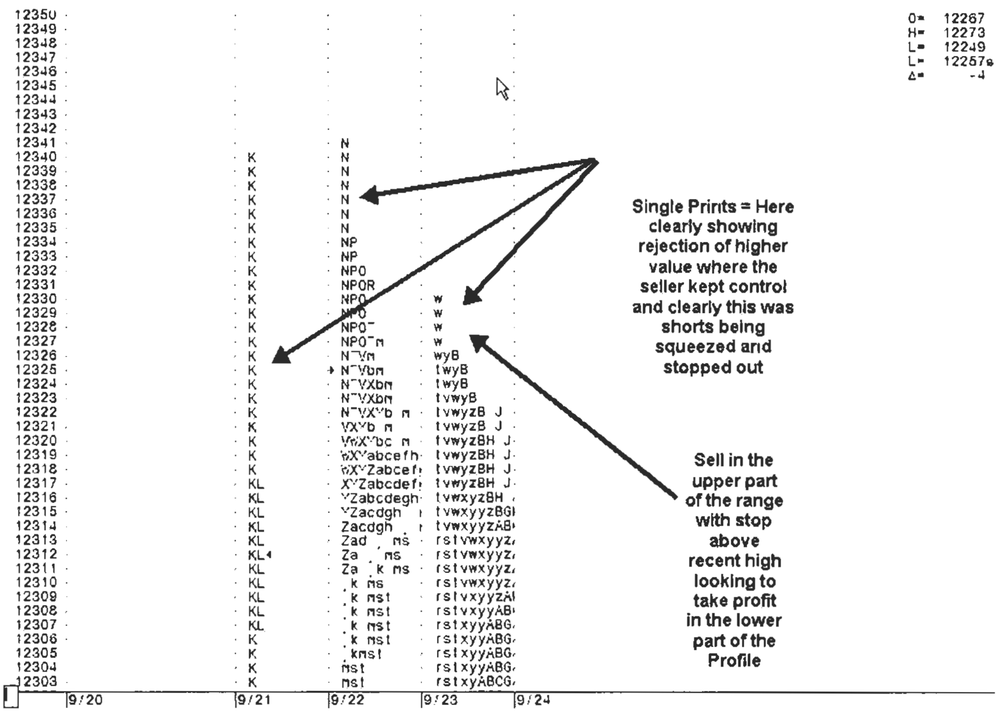


- The first example is the A wrapped around the top of z at 10185.
- The second example is the single A, which is a breakdown point at 10176.
- The third example is several again at a breakdown point from 10159 through 10151.
- The first example denotes that there is in fact a seller in control, the second example is obvious as a breakdown level, and the third example depicts a market trending, hoping to find a buyer. Instead it is being rejected by the buyers and shows that sellers are in control.

Euro FX—December 2004 Contract, September 22, 2004

- Figure 17.4 depicts the top part of an MP distribution pattern across three days.
- The contract shown is the CME Euro FX December futures contract, also referred to as the euro.
- The N period print at 1.2341 on September 22 gives a powerful sell signal where the previous day's high at 1.2340 was exceeded by one tick. This move was followed quickly by a rejection of this level.

FIGURE 17.4

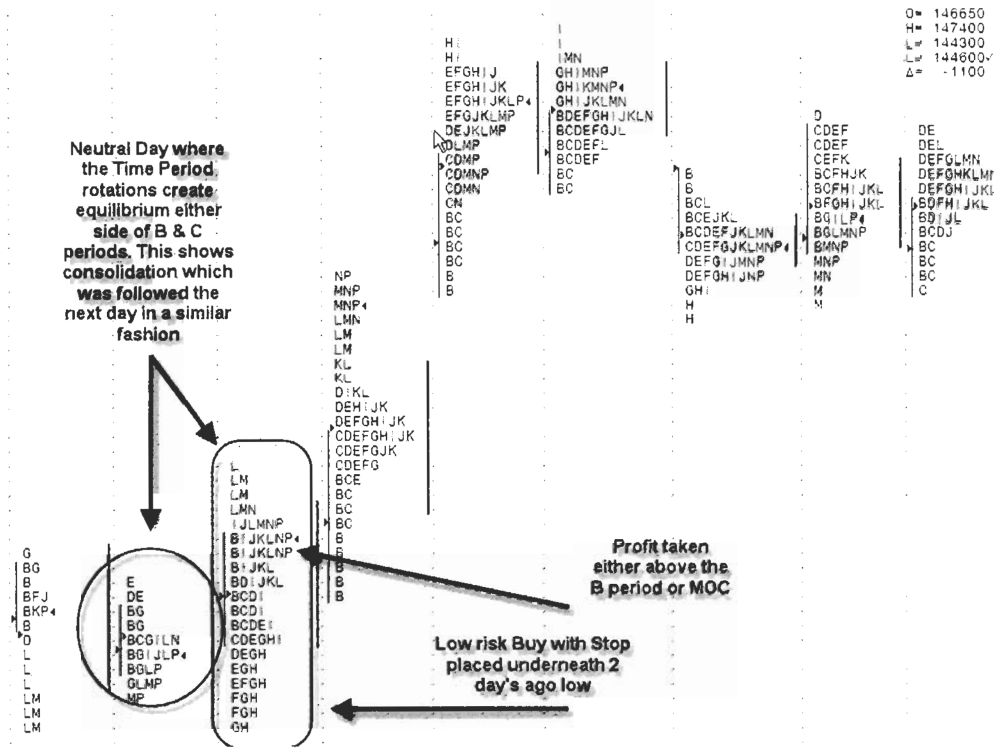


- The September 21 close to the end of day shows a late running profile in K period, which together with the N period single print and the September 23 retest and rejection at 1.2330 show a seller in control. On a daily chart this can lead to a multiday move—in this case lower and a stop close order a few ticks above the high can be used initially for risk management.

E-mini Nasdaq—December 2004 Contract, September 8, 2004

- Figure 17.5 depicts a daily MP TPO together with the open, opening range, 50 percent of the day, close, and value range.
- The contract shown is the CME E-mini Nasdaq December futures contract.
- A neutral day is a rotational day in which the market rotates on either side of the opening range, showing that the market is distributing with buyers at the low end and sellers at the top end of the day's range. September 8 and 9 are both neutral days.
- On September 8 we see how the D and E time periods are above the B. Additionally, note how the letters M and P are below the B. The B time period is the opening range in this instance.

FIGURE 17.5



- The second example shows C, D, E, F, G, and H all below B and J, L, M, N, and P above B. The next chart continues with this example.

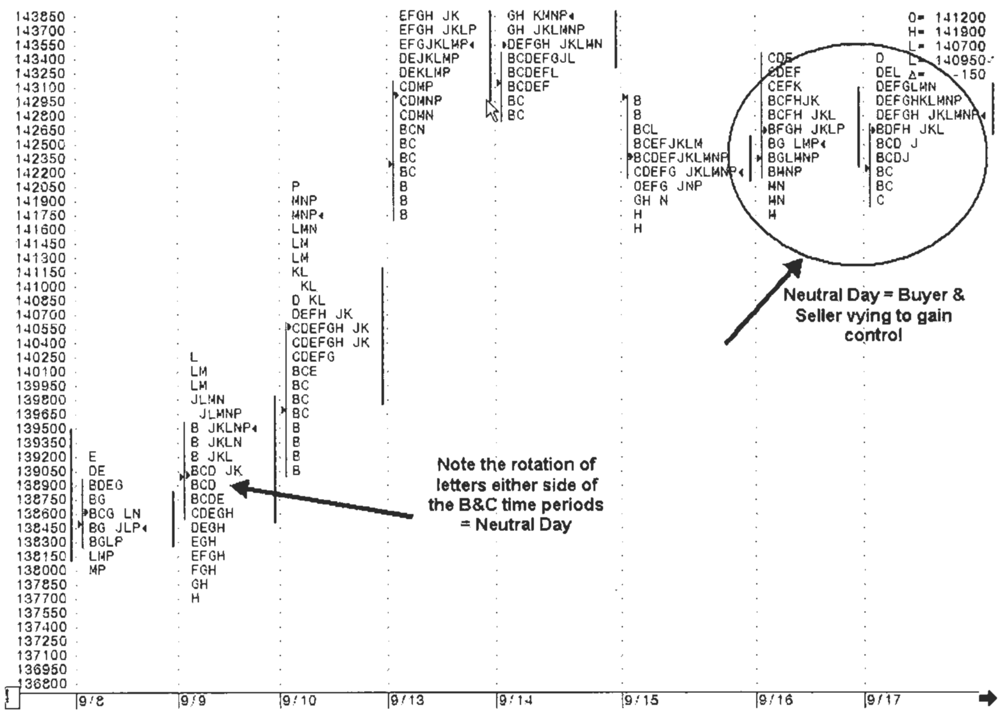
E-mini Nasdaq—December 2004 Contract, September 8, 2004

- Figure 17.6 of the NQ covers the time period of September 8 through 17 and shows the move from neutral days followed by trend and then consolidation that returns back to neutral again.
- Neutral days can be the hardest to detect if they are looked at only by themselves without relation to previous days' activity. Without these additional data as a reference, what appears to be a directional move can just as easily turn around and go the other way. These days are classic for getting people to buy high and sell low.

Emini Russell—December 2004 Contract, September 10, 2004

- Figure 17.7 depicts a daily MP TPO together with the open, opening range, 50 percent of the day, close, and value range.

FIGURE 17.6

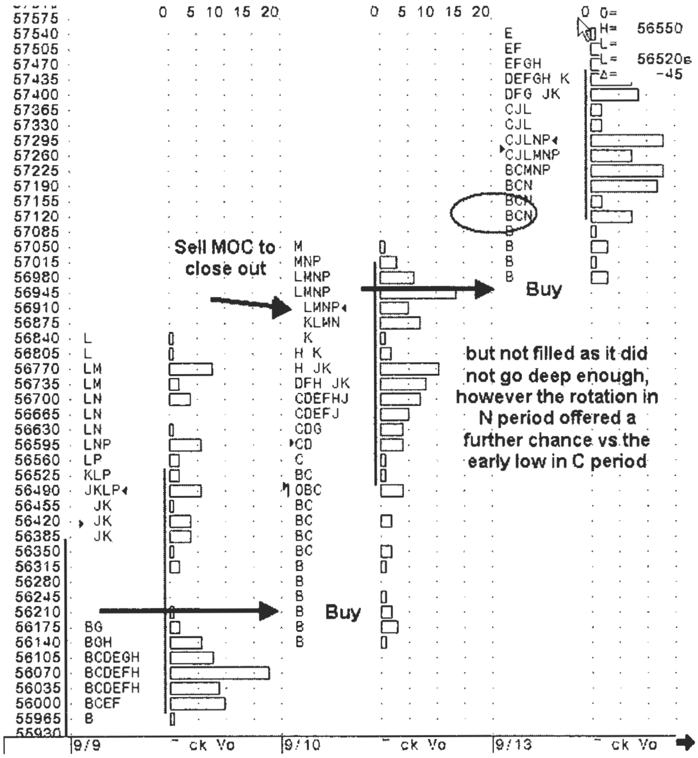


- The contract shown is the CME E-mini Russell 2000 December futures contract.
- In the first example, the Russell developed a buying tail in the B period of September 10 going right into the middle of the previous day's range. Note the lack of trade on September 9 in the middle of the MP creating a form of gap. This occurred after the initial early sell created a buying opportunity which became more evident in the C period. Profits could have been taken either at the developing point of control/high volume or MOC.
- The second example shows again on September 13 the buyer driving the market higher after having opened on a gap up and with a range extension for the first two hours through the E time period. Note that late in the day profit takers were afforded a second chance to buy this time in the N period, which traded right down to the bottom of the C period before bouncing back to midrange of the day.

SUMMING UP MARKET PROFILE

MP can be used in all markets. It is based on the statistical analysis of time, price, and volume, and, therefore, it has stood and will continue to stand the test of time. With the advent of mar-

FIGURE 17.7



kets moving to electronic platforms, MP has suddenly taken on more meaning. Why is this? Everyone is currently trying to adjust to the change of not being able to hear from the floor brokers what the various market participants are up to. What are the locals doing? What about the commercials? Funds? The general public? As more and more markets go electronic, the footprints and actions of these groups are easier to hide, and one of the biggest advantages traders have is lost. However, by using MP, these footprints and actions are picked right back up again, giving the advantage back to the trader who learns how to use this analysis technique.

I must emphasize that this chapter on market profile is just that—a chapter on market profile. People are starting to take a renewed interest in MP, and I wanted to provide a brief introduction for those who don't know anything about it. The setups I've already discussed in this book are used independently of any MP analysis. MP is just a tool and for anyone who is familiar with this analysis technique, it can be used in conjunction with the setups already discussed. For example; if MP is pointing higher, then a trader can know nothing about MP and still take the 5-minute squeeze as it fires off long. The point of this is that everything out there—whether it is Fibonacci numbers, Bollinger Bands, Eliot Waves, Market Profile, or whatever—is just a tool. It is up to the trader to find a couple of good tools that will help them with their overall trading plan, and then establish specific setups and specific money-management parameters for their plays.