Momentum trading: Using pre-market trading and range breakouts

Focusing on days the market breaks out of the prior day's range and moves in the same direction as the pre-market trend helps set up favorable trades.

BY KEN CALHOUN

One of the primary challenges traders deal with is knowing when the markets are volatile enough to enter intraday and swing trades vs. when to avoid trading. Obvious breakouts often occur too late in the trading day to generate useful buy and sell signals; what traders need are early indications of the likely intraday trend and a way to identify the most favorable conditions for follow-through.

Fortunately, pre-market trading activity and breakouts of the previous day's high or low that occur in the broader market can give an early indication of when, and in which direction, to trade during a trading session. The best trading opportunities occur on days the market is moving outside the prior day's range and in the direction of the pre-market trend.

Daily trading prep: Gauging the pre-market

To prepare for each trading day, check whether the S&P 500 ETF (SPY) has gapped up or down at 8:00 a.m. EST. The direction SPY trades between 8 a.m. and 9:30 a.m. ET (when the regular trading session begins) can indicate the day's potential bearishness or bullishness. For example, Figure 1 shows SPY had gapped down before the market opened.

Similarly, check the Nasdaq and S&P pre-market futures. Figure 2 shows the Nasdaq 100 futures (NQ) had moved down dramatically before the opening bell, indicating the market was likely to sell off during the regular session, which it later did (Figure 3).

Preparing a trading plan that takes into account the pre-market gap in SPY helps you establish a directional bias (long or short) and adjust your entry prices before the market opens each day.

FIGURE 1: PRE-MARKET SPY

SPY traded lower before the market regular market opened, an indication of potential weakness.

Breaking out of the previous day's range

A key approach used by professional traders is to give more emphasis to trading actively in the direction of the trend on days the Nasdaq Composite (COMP), S&P 500 (SPX), and Dow Jones Industrial Average (DJIA), as well as individual stocks, are outside the prior day's range (above the previous high or below the previous low).

In the preceding example, the market was trading below the previous day's low. The correct trading strategy in this situation is to short stocks making lower daily lows (or buy "inverse ETFs" making higher daily highs). A five-minute chart showing the prior day's and current day's trading allows you to identify the prior day's range, as well as the open, high, low, and closing prices used to determine entry signals for the current session.

As mentioned, the best trading opportunities occur on days the market is moving outside the prior day's range and in the direction of the pre-market trend. The period to determine the pre-market trend is from 8-9:30 a.m. ET. Institutional trading programs, which move significant amounts of capital in and out of the equity markets, use trading algorithms that factor in the prior day's high vs. low data (for indices as well as individual stocks). Higher-volume trading occurs on outside days because of the more-volatile price moves driven by institutional buy and sell orders. Because of this, the most significant breakouts tend to occur in the direction of the pre-market trend when the price action is outside the prior day's range.

Entering trades

To help avoid false breakouts and breakdowns, wait until the stock has moved approximately 1 percent above the prior day's high or below the prior day's low before initiating an entry — for example, 0.30 for a $30 stock, or .50 for a $50 stock. Similarly, place an initial stop-loss no more than 3 percent away from the entry price for swing trades — e.g., 0.8 for a $30 stock or $2 for a $60 stock. (For intraday trades, a half-point maximum for

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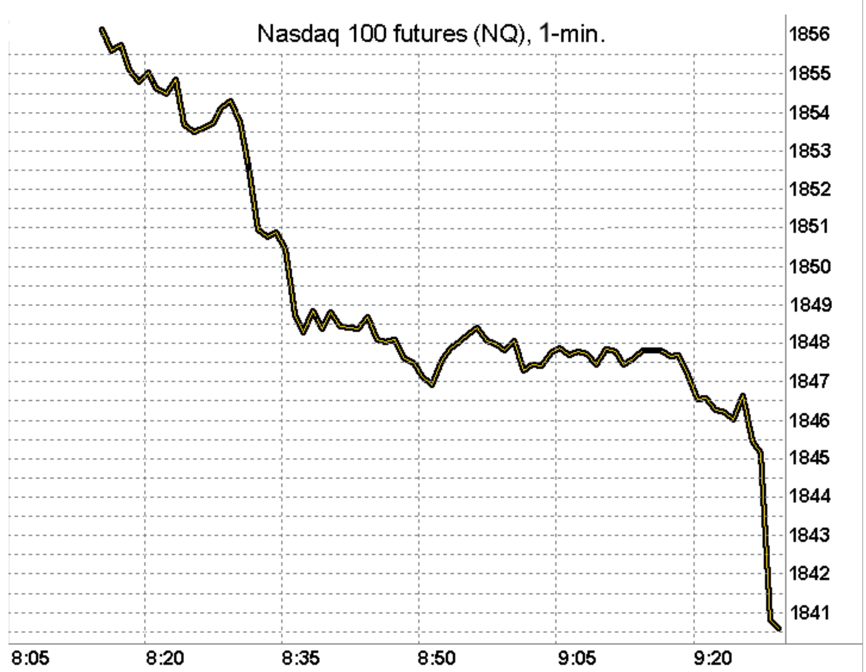
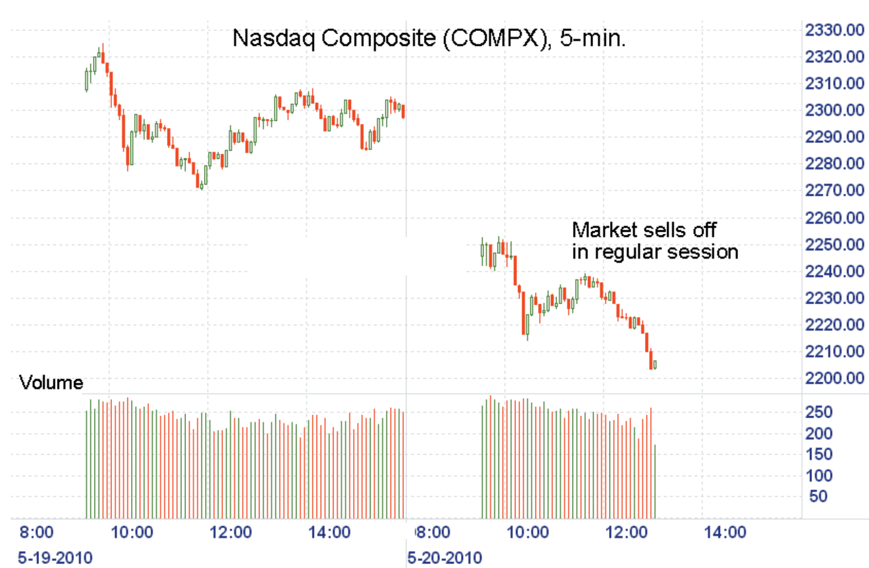
FIGURE 2: PRE-MARKET NASDAQ FUTURES



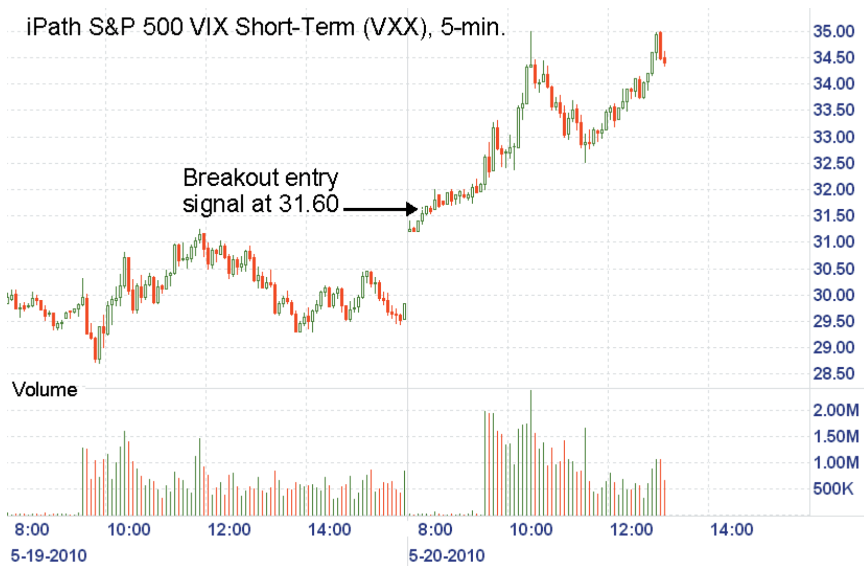
The Nasdaq and S&P pre-market futures can also be consulted for an insight into the upcoming trading day.

FIGURE 3: REGULAR SESSION



After the Nasdaq 100 futures moved down dramatically before the opening bell (Figure 2) , the market sold off during the regular session, which it later did.

FIGURE 4: LONG ENTRY ABOVE PREVIOUS HIGH



A long entry signal was triggered at $31.60, above the previous day's high. A stop-loss would be placed no more than 3 percent away from the entry price for a swing, or a maximum of a half point for an intraday trade.

FIGURE 5: SHORT ENTRY BELOW PRE-MARKET OPEN

In this case, the entry point was .30 below the pre-market opening price rather than the .30 below the previous day's below because the stock gapped lower.

initial stops is advisable regardless of share price.) For example, in Figure 4, a long entry signal was generated at $31.60 (0.30 above the May 19 high of $31.30).

The same strategy is used for short entries on penetrations of the prior day's low. In Figure 5 a short entry signal was generated below the previous low of $63.00 (63.30 - 0.30) in Research In Motion (RIMM), which dropped more than $1.50 before consolidating. In this case, however, the entry point was actually .30 below the pre-market opening price rather than the .30 below the previous day's below because the stock gapped down below the May 19 low. In the event of a similar up gap, the entry would be placed above the pre-market opening price. The breakdown short signal for the QQQQ (Figure 6) was triggered at $45.10 (45.40 - 0.30).

Gaps: Why trading with the trend is more effective than fading

Popular trading literature often incorrectly advises traders to "fade" (trade in the opposite direction of) opening gaps. However, because institutional money flow has determined the gap direction before the bell, it's often more effective to start by defining the pre-market gap consolidation or support/resistance levels by looking at pre-market high/low prices between 8 a.m. to 9:30 a.m. and giving preference to trading in the direction of the gap. That means buying up gaps that continue up, and shorting down gaps that continue down.

In Figure 7, Advanced Auto Parts (AAP) gapped up pre-market from the prior day's close of $46.20 to the current day's open of $47. It then rallied an additional $3 before pivoting lower. Figure 8 (p. 50) shows a short down-gap in the same trading session. After an initial $2 gap down from the $56.50 close to the day's open of $54.20, ROK sold off an additional $2 before consolidating.

Being on the right side of gaps by treating them as a special-case breakouts to trade in the direction of the trend can provide some of the day's best trading opportunities. The only exception to this is to prepare to trade in the opposite direction of a gap if the stock has gapped at least 30 percent or more from its previous closing price — for example a $20 stock that has gapped down to $14 in the pre-market (on an earnings miss, for example). Such situations can be traded either long or short, depending on the initial breakout direction, starting at the opening bell.

Position sizing: Making the most of your trades

Dynamic position-sizing is an approach that allows you to "scale up" and add to winning positions. It is often helpful to initiate every trade entry with small size — e.g., less than 1 percent of capital. If the stock moves in your direction, you can add to the position. Immediately after doing this, it's important to set a trailing stop just above the breakeven price (for a long trade) to protect against any pullbacks or reversals, so the increased leverage (and the increased risk) is controlled.

If the trade continues to move in the right direction, you can add to the position until a pullback or reversal signal occurs. If the initial position moves against you, having a very small initial size protects against significant drops because of gaps or intraday volatility.

Fine-tuning entries: Cup patterns

Another useful approach is to scan for simple cup-pattern breakouts above the

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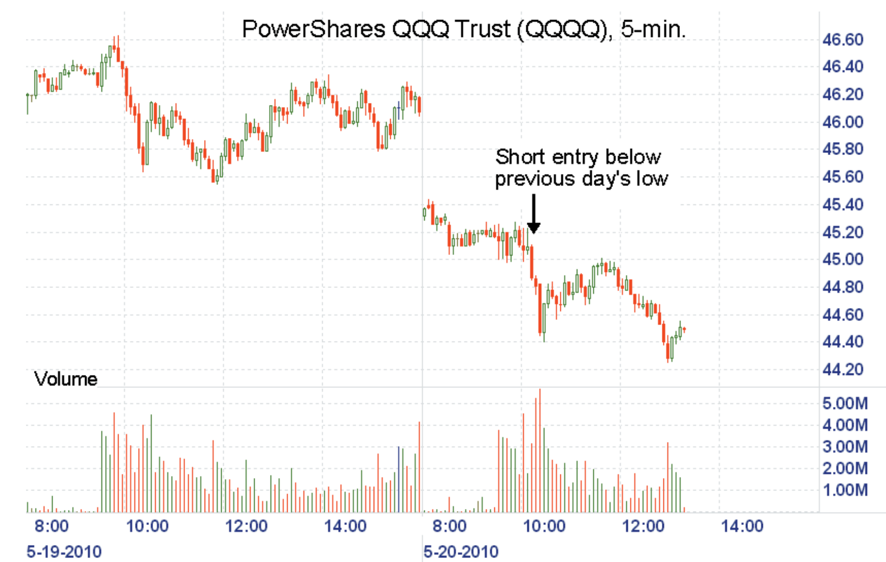
FIGURE 6: QQQQ SHORT

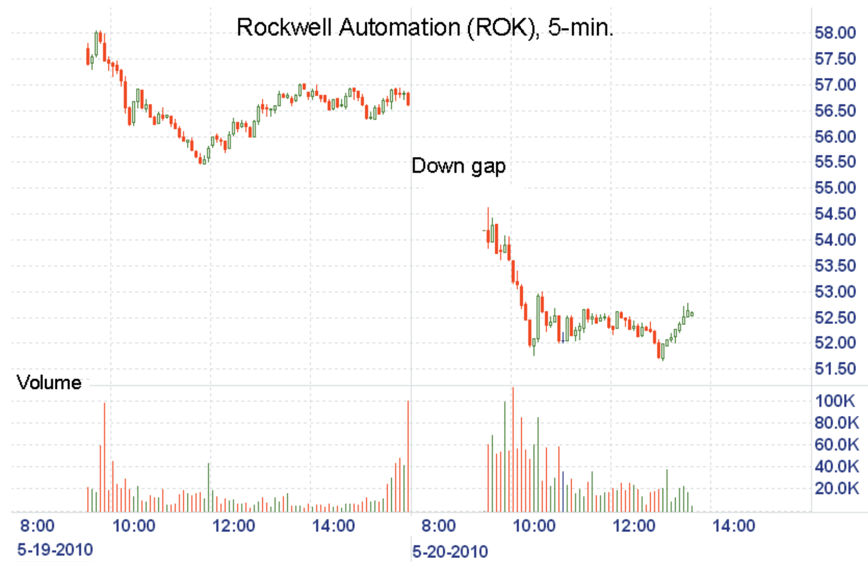


A short trade was triggered at $45.10 in QQQQ.

FIGURE 7: TRADING WITH THE GAP

After gapping higher pre-market from the prior day's close of $46.20 to the current day's open of $47, the stock rallied an additional $3 before turning down.

FIGURE 8: GAP MOMENTUM



After an initial gap down from the $56.50 close to the day's gap down open of $54.20, the stock dropped an additional $2.

FIGURE 9: PRE-MARKET CUP

Pre-market cup-pattern breakouts to new highs can make good entry signals.

previous day's high. A cup pattern looks like the letter "U," as shown in Figure 9. When the cup originates above the prior day's high and the subsequent entry is at least 0.30 above the prior day's high at the time the right side of the cup breaks out (especially when accompanied by increasing volume, as in this example), price will often continue strongly.

In Figure 9, the prior day's high was $28.80; adding 0.30 yields $29.10. The pre-market left side of the cup is at $29.25, so the entry trigger is at that price after the regular market opens. The stock subsequently rallied significantly.

In the short example in Figure 10 (p. 87), the small cup pattern formed, with initial support at $103.80. Price rallied to $104.50, then moved back down again, with the short entry signal occurring at $103.50 (103.80 - 0.30), after which price moved down sharply on the open.

A breakout entry day and swing trading plan

Developing a step-by-step trading plan that integrates these strategies in a disciplined intraday and swing trading approach is relatively simple. It begins with focusing on the pre-market SPY behavior and pre-market gap stocks.

If SPY is not outside the prior day's range before the 9:30 a.m. opening bell, it's best to avoid trading, or trade a small number of shares until (and if) the market moves outside the prior day's range. It's also helpful to scan a list of favorite stocks for cup patterns that form between 8 a.m. through 9:30 a.m. ET, and which are at or

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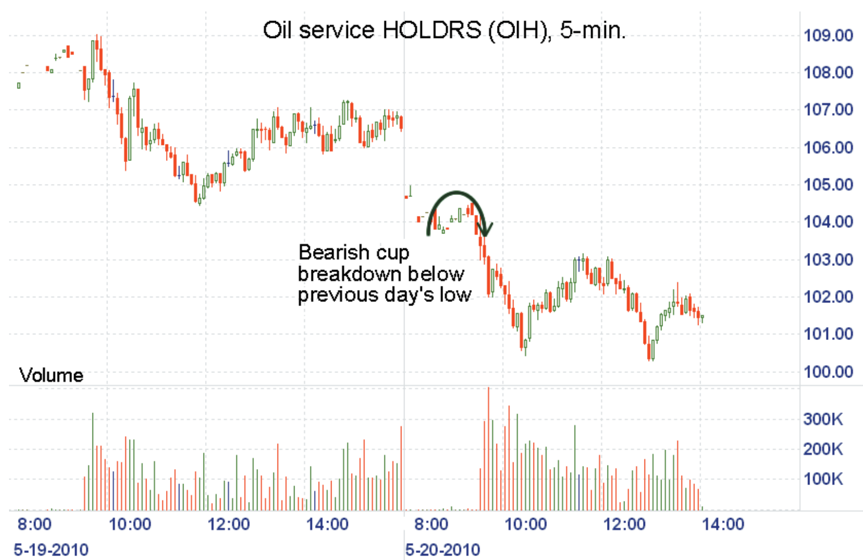
near prior days' highs or lows. Appropriate stop-entry orders should be set roughly 1 percent outside the cup support or resistance, depending on the direction of the trade. Once the trade is initiated, set an initial stop, then watch the position and scale into trades that are becoming profitable.

Trading the way institutional traders do, giving preference to "outside" days, and trading high-volume cup breakouts can be an effective strategy for individual retail traders.

For information on the author, see p. 6.

FIGURE 10: SHORT CUP SIGNAL



A small cup pattern formed with initial support at $103.80. A short-entry signal occurred at $103.50 (103.80 - 0.30).

Pre-market trading and intraday bias

Although the direction of pre-market trading is not a particularly reliable guide to whether the market will close higher or lower on the day, a study related to the setup described in the main story showed a connection between a day's pre-market move in the S&P 500 ETF (SPY) and its tendency to make a higher high or lower low from Dec. 10, 2009 and June 1, 2010 (119 trading days).

During this analysis window — a volatile period during which the market spent most of its time in an uptrend, but also suffered a major setback in May — SPY demonstrated a positive relationship between the direction of the pre-market move and the likelihood of making a higher high or lower low on the day, as well as the size of the move from high to high or low to low.

TABLE A: PRE-MARKET RELATIONSHIPS, SPY

	H2H if Pre+	All HH	L2L if Pre-	All LL
Avg.	0.34%	0.00%	-0.60%	0.00%
Med.	0.34%	0.15%	-0.33%	0.14%
	HH if Pre+	**LH if Pre+**	**LL if Pre-**	**HL if Pre-**
No.	48	13	37	17

The top portion of Table A shows that on days the pre-market move was positive ("Pre+", measured from the previous day's close to the close of the 9:30 a.m. one-minute bar), the average/median move from yesterday's high to today's high was 0.34 percent, compared to an average zero-percent (0.15-percent median) high-to-high move for all days in the analysis period.

Similarly, the average low-to-low move on days the pre-market SPY move was negative ("Pre-") was -0.60 percent (-0.33-percent median) vs. a zero-percent average (0.14-percent median) low-to-low move for all days.

The bottom portion of the table lists the number of higher highs and lower lows that corresponded to positive and negative SPY pre-market moves. For example, when the SPY pre-market move was positive, SPY made a higher high 48 times vs. making a lower high only 13 times. When the pre-market was negative, SPY made a lower low 37 times vs. making a higher only low 17 times.

— By Active Trader Staff