



# Using Swing Breakouts in Forex Trading



The background of the page features a blurred image of a computer keyboard in the foreground. Behind it, there are several financial charts. One chart at the top shows a bar chart with a line graph overlaid, with numerical values like '13176.79' and '14198.1'. Another chart below it shows a candlestick-style price movement. A large, semi-transparent watermark reading 'THE FOREX JOURNAL' is oriented diagonally across the center of the page.

# Doug Schaff discusses the use of intermediate swing highs and swing lows to develop a short-term approach to trading the currency markets.

**Question** – How can you use medium-term swing breakouts to catch profitable short-term trades?

**Answer** – Intermediate price high and low points shown by a swing indicator often identifies key support and resistance levels. When price trades through those swing levels, the subsequent market move is often quite powerful. The strong momentum following these breakouts can be seen by looking at a simple swing system. A short-term discretionary trader can better manage the risk and book profits from these breakout trades. These short-term trades, which I call “Pops” and “Drops,” can be quite profitable with good risk/reward characteristics. We will take a look at all of this after first reviewing swings.

## Swings Represent Key Price Levels

The legendary technical analyst, W.D. Gann, called price peaks “swing highs” and price troughs “swing lows.” He purposely chose to use the word, “swing,” because it is active. To Gann, swings personified key areas where the market’s energy paused and prices changed direction.

| Swing High   | Swing Low   |
|--|---|
| A price bar is considered a swing high when the high of that bar is higher than the high of a certain number of bars before and after it.                | A price bar is considered a swing low when the low of that bar is lower than the low of a certain number of bars before and after it. |
| The strength input specifies the required number of lower highs that need to be on either side of the swing high before it will be plotted on the chart. | The strength input specifies the required number of higher lows on either side of the swing low.                                      |

This 2-hour USD/JPY chart shows swings with an input or strength of 6. The higher the strength input, the more significant a swing high or low is. The swing indicator plots a dashed-line to the right of a price swing. The dashed-line continues until the swing is broken or a swing of the same strength occurs at a new level.

Swing highs and swing lows can represent key support and resistance levels. Therefore, swings should also be consid-

ered potential breakout points. I refer to price moves above a Swing High(6) or below Swing Low(6) as “Swing Breakouts.”

## How Powerful are Price Moves after Swing Breakouts?

A swing system on the 2-hour USD/JPY chart shows the price action that often follows a breakout. The system enters trades on breaks of swings with strength of 6. Exits occur on breaks of swings with strength 2.

Note that Swing 62 does not include a stop loss or alternate exits that could improve its results. I deliberately did this in order to focus on the power of swing breakouts.

The following 2-hour GBP/USD chart shows two Swing 62 trades.

The first trade, in the lower left of the chart, is a sell trade. It loses money because the SL(6) entry swing is below the SH(2) exit. The second trade is a buy trade that makes money. Here is the trade P/L.

The 2-hour Swing 62 system does not produce short-term trades. The second trade lasted several days (including a weekend). I call swings on the 2-hour chart “medium-term” swings.

A swing system generally performs better in more volatile or trending currency markets, such as those that have been oc-





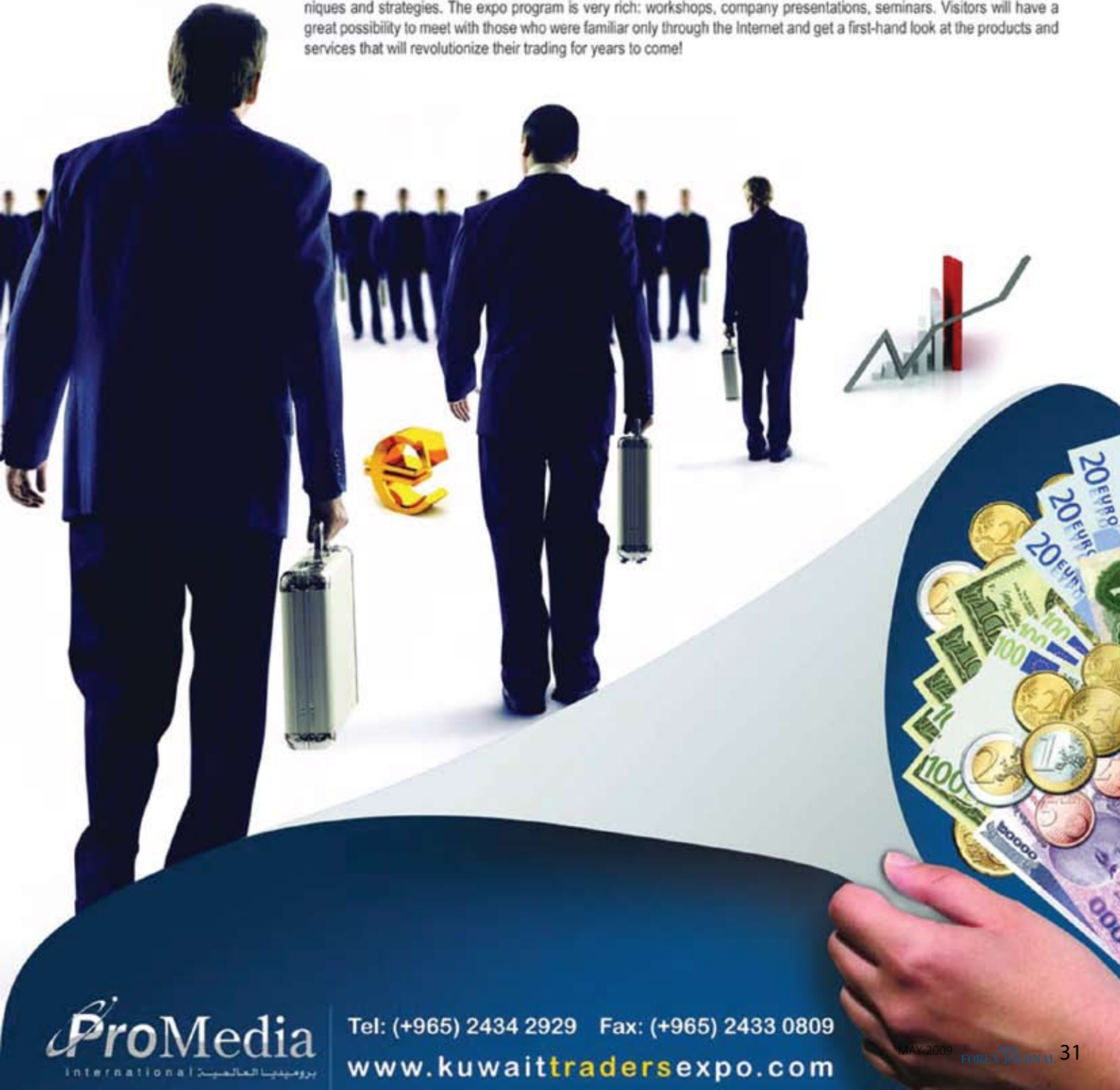
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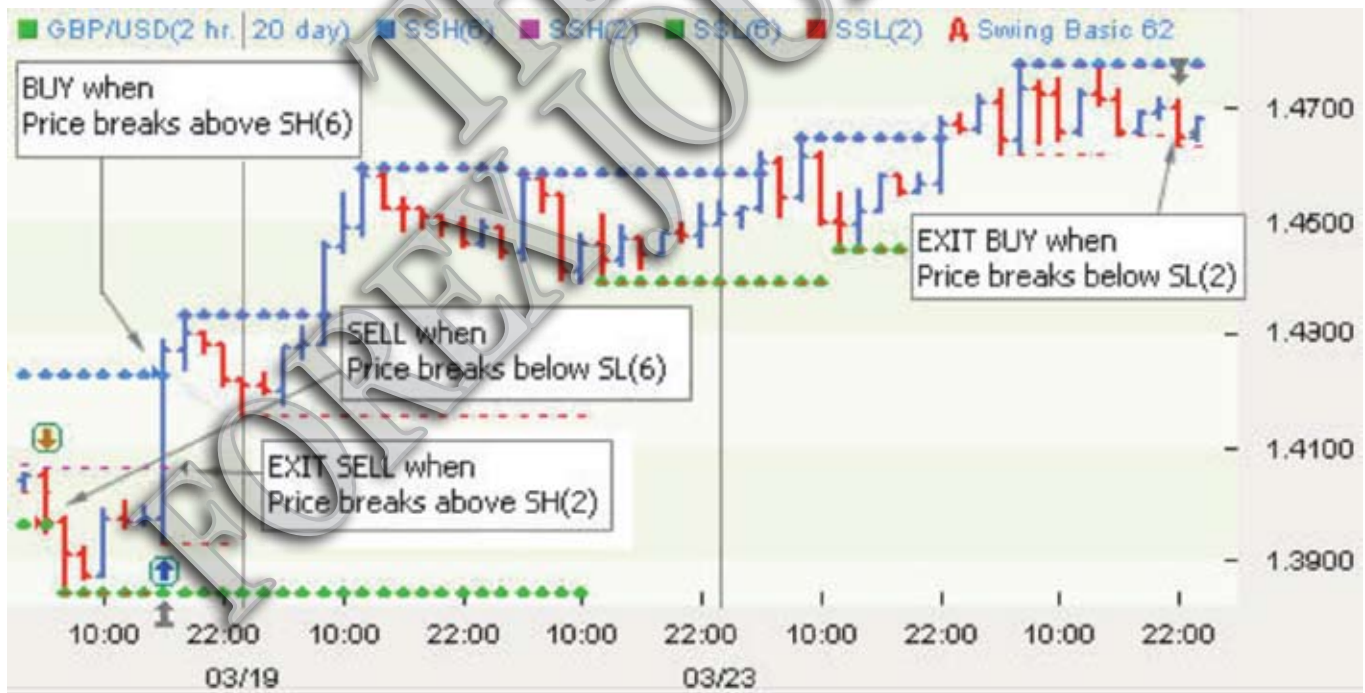
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“Swing 62”

| Trade Action | Signal Condition                           | Chart Symbol |
|--------------|--|--------------|
| BUY          | IF Price trades 1 pip above Swing High (6) | ⬆            |
| BUY EXIT     | IF Price trades 1 pip below Swing High (2) | ⬇            |
| SELL         | IF Price trades 1 pip below Swing Low (6)  | ⬇            |
| SELL EXIT    | IF Price trades 1 pip above Swing High (2) | ⬆            |

| Date       | Time  | 0Price   | Trade Type | Lot# | P/L  | Tot P/L |
|------------|-------|----------|------------|------|------|---------|
| 03/18/2009 | 04:00 | - 1.3963 | Sell       | 1    | 0    |         |
| 03/18/2009 | 16:00 | +1.4066  | Buy Exit   | 1    | -103 | -103    |
| 03/18/2009 | 16:00 | +1.4137  | Buy        | 1    | 0    |         |
| 03/24/2009 | 22:00 | - 1.4653 | Buy Exit   | 1    | 516  | 413     |



September 30, 2008 to March 31, 2009 – Swing 62 on the 2-hour chart

|              | GBP/USD   | EUR/GBP   | GBP/CHF   | GBP/JPY   |
|--------------|-----------|-----------|-----------|-----------|
| Closed P/L   | 5056 pips | 3352 pips | 5933 pips | 5750 pips |
| Open P/L     | 0         | 25 pips   | -105 pips | 0         |
| Total Trades | 49        | 39        | 53        | 47        |
| % Winners    | 55%       | 49%       | 51%       | 53%       |
| Max Drawdown | 869 pips  | 397 pips  | 1083 pips | 748 pips  |



curring and the system has backtested profitably on major currency pairs. However the British pound and its crosses have been the recent standout. Their backtest results are highlighted below.

These figures suggest that forceful price momentum follows a break beyond medium-term swings. We will show how to use the SH(6) entry signals as part of a short-term trading strategy.

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**Action**

Time: 03/18/2009 03:50:00

Rate: 1.3964

Buy/Sell: Sell

Amount(K): 100

Stop: 1.4003

Limit:

Buy/Sell

Next Bar    End    Cancel

## Short-term Trading - Capturing "Pops" and "Drops"

Breakouts beyond medium-term swings can be incorporated into profitable short-term trading. I use the buy and sell entry signals from Swing 62 along with indicators on a 10-minute chart to exit trades. This strategy goes after trades that I call "Pops" and "Drops." The name refers to the swift bull and bear moves that regularly occur after breakouts of swing highs and lows.

The 10-minute trading chart should be set up with entry swings, SH(6) and SL(6) from the 2-hour chart. Some charting services allow you to create an indicator that will automatically place the 2-hour swings on a 10-minute

chart. Or you can place a horizontal line at the SH(6) and SL(6) prices. If you place the lines yourself, you will not have to change them often. It takes at least 12-hours for a new 2-hour SH(6) or SL(6) to form.

The indicators on the trading chart show in the lower chart panels. A purple Smooth RSI ("SRSI") and a yellow Schaff Trend Cycle ("STC") are in the first indicator panel. A green MACD and black MACD signal are in the lower panel.

There is considerable flexibility in what indicators to select for the short-term trading chart. Imagine you are out fishing and suddenly your pole bends and the line rushes out after what you have caught. That is the way price can move after a swing breakout. The short-term indicators serve as the pole and line for Pop and Drop trades. You want the pole to bend and the line to run out, so to speak, until momentum slows and the main breakout price move has finished. Many different indicators can do the job. I encourage you to experiment to find the ones that work best for you.

The Pops and Drops Strategy has three trading rules for buys and sells.

Use judgment in placing stop loss orders. For example in a buy trade, if the closing price is too near the low of the bar, then consider using the low of a previous bar. Similarly, in placing a stop loss for a sell trade, use judgment to allow for reasonable price retracement within your risk tolerance.



## Simulating Live Trading

I wanted to simulate live trading of the “Pops & Drops” strategy. To accomplish this, I used FXtrek.com’s “MoneyTrek” service. It replays historical price, as it would have been seen in real time. For example, the time on the GBP/USD chart, below, is 3:40 EST on March 18th. As on a live chart, there were no further prices to see to the right of the chart. Only by clicking a “Next Bar” button, did the chart advance by one 10-minute price bar, to reveal what the market did next.

The next price bar, at 3:50, broke the swing low by 2 pips. All three indicators were bearish. So, according to the trading rules I needed to sell at the closing price, which happened to be 1.3964.

I executed the simulated trade using the order ticket shown. I selected “Sell” and placed my stop loss at 1.4003, the top of the 3:50 price bar. Once I hit the “Buy/Sell” button, a sell arrow appeared on the chart and Moneytrek began tracking the trade.

I clicked “Next Bar” several times because the indicators stayed bearish and prices generally went lower. At 7:30 the STC turned up and closed above the 25-line. That is a sign indicating that downtrend momentum was slowing. That is the reason I bought back my short GBP/USD position. One of the three indicators had turned from bearish to bullish.

I closed out the position at 1.3892 for a simulated profit

“Pops & Drops”

**Trade Action**

**Signal Condition**

|           |  |
|-----------|--|
| BUY       | IF at the indicators are bullish at the close of the 10-minute price bar that breaks the swing |
| BUY EXIT  | IF any of the indicators are bearish at the 10-minute close                                    |
| STOP LOSS | Low of the 10-minute price bar that breaks the Swing*  |
|           |  |
| SELL      | IF at the indicators are bearish at the close of the 10-minute price bar that breaks the Swing |
| SELL EXIT | IF any of the indicators are bullish at the 10-minute close                                    |
| STOP LOSS | High of the 10-minute price bar that breaks the Swing*   |





of 72 pips.

By the way, remember the 2-hour GBP/USD chart at the first of the article? The one that showed a sell trade in the lower left corner that lost 103 pips? I entered the short-term “Drop” trade on a break of exactly the same 2-hour swing low as the earlier Swing 62 sell trade used. Instead of a 103 pips loss, though, the Pops & Drops trade made 72 pips. Also, it exited 8.5 hours earlier than the Swing 62 system trade. If all else is equal, the sooner you close out a position, the sooner your risk is off the table. All else was not equal, though, because the Drop trade made money.

Exiting the 2-hour swing breakout using the 10-minute chart made all the difference. By combining the entry signals from a swing breakout system with exit rules on a short-term trading chart, you can go after the same types of trades.

I have other examples to share, but I think you get the point. If Pops & Drops makes money when Swing 62 does not, imagine what you can do with the breakouts when the 2-hour system makes money.

Doug Schaff has traded the Forex markets for close to 30 years. His website, [www.fx-strategy.com](http://www.fx-strategy.com) provides trading tools, information

and strategies to assist currency traders. The Swing 62 system is available for free download. Please visit FX-Strategy’s website for more information.

MoneyTrek is the premier simulated trading service designed for Forex traders. Test out your trading ideas with accurate historical data in Moneytrek’s realistic setting. It is available on FX-Strategy’s Pro Charts and on FXtrek’s desktop charts. Visit [www.fxtrek.com](http://www.fxtrek.com) for more information.

<sup>1</sup> There are swing systems on daily charts where the trades can last for weeks.

<sup>2</sup> Open P/L results from a position that was still open as of March 31, 2009.

<sup>3</sup> Swing 62 intentionally does not include a stop loss order, in order to focus exclusively on swings.

<sup>4</sup> This can be seen more clearly if you generate signals with the system and then browse the types of price moves that occur in the first few 2-hour price bars. Therefore, I am providing Swing 62 free from my website, FX-Strategy.com. You can download and run it on any FXtrek charting platform, including FX-Strategy Pro Charts.

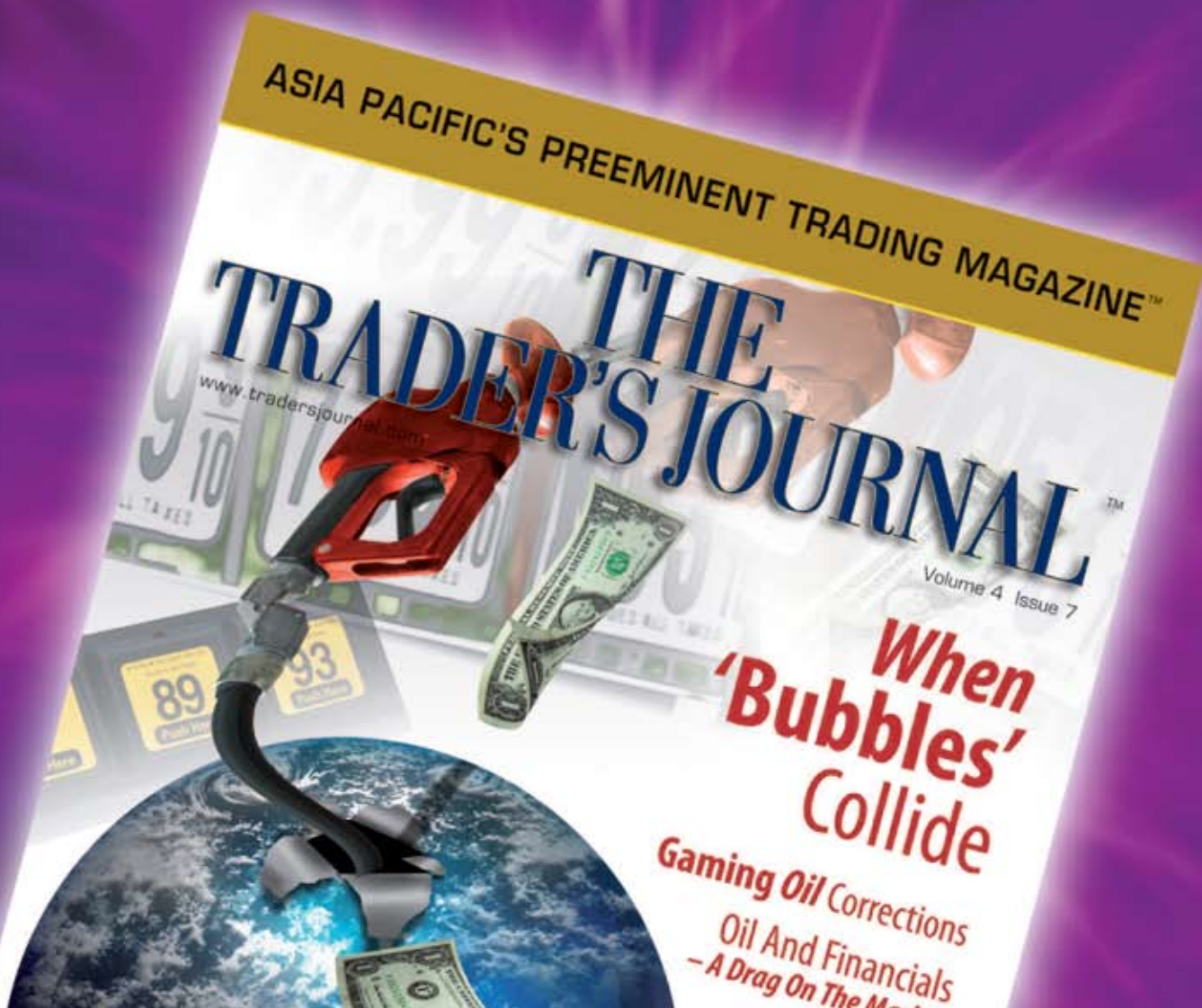
<sup>5</sup> Sometimes, a 10-minute chart may only show a swing low or swing high because the other swing is well below or above the chart.

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