How To Trade Supply And Demand With Price Action

Supply and demand trading is one of the main trading methods I use to trade the forex market, if you've read my other article on supply and demand you'll know that I trade it a little bit differently to how most people trade it online.

When I first began trading supply and demand my entry method was to use pending orders placed at the zones to get into the trade, I think most supply and demand trading methods also use this same technique, I've noticed that a lot of traders seem to be drawn to trading zones this way, the main reason why I think people are drawn to this method of entry is down to it being much easier than learning how to watch the market for price action signals when the market actually reaches the zone.

If you were to have placed a trade at this demand zone using a pending order you would've lost money, the market only begins to encounter some sort of resistance after it drops below the zone.

Many times when I first began trading the supply and demand method I found zones which met all the criteria of the standard S+D rule set i.e. strong move away and long time away from zone, but when it came to trading these zones with pending orders most of the time the market would just blow past the zone and I would almost instantly lose money, similar to what happens in the example above.

Needless to say after suffering many unnecessary losses due to this entry method, I began thinking about to trade the zones more successfully.

I came across some good threads on Forex Factory which taught me how to use engulfing candles as an entry trigger into trades at supply and demand zones, this meant waiting for the market to return to the zones, then watching to see if an engulfing candle formed within it, when it did you would enter into the trade using a market order.

This method of using candlestick patterns to enter trades proved to be far more successful than using pending orders.

By nature if you're using pending orders to enter into trades no matter what kind of strategy you trade with, then you are in essence attempting to predict the market, however, if you use market orders your reacting to what you're seeing happen in the market, this has and always will be the better method of entering trades.

Nobody can predict exactly what the market is going to do but at least by using market orders your reacting to the most recent developments in the market.

Price Action At Supply And Demand Zones

Trading price action at supply and demand zones requires an understanding of two things.

First, you must have decent knowledge of my method of trading supply and demand which can be found in this article.
And second, you must be adept at trading pin bars and engulfing candles.

The general idea of what we are going to do is use our current understanding of how to trade pin bars and engulfing candles as our trigger for entering trades at supply and demand zones.

As I've just mentioned trading zones with pending orders has many drawbacks, by using candlestick patterns we can eliminate many of these drawbacks and begin making more successful trades.

Engulfing Candles At Zones

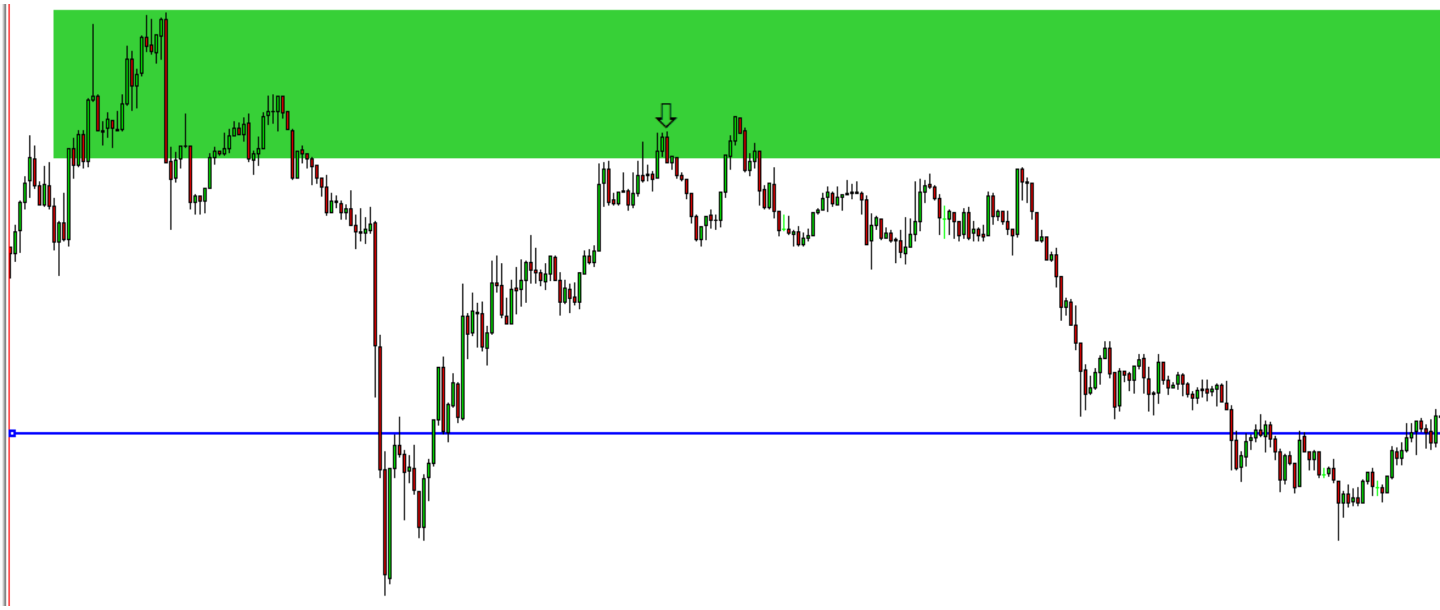
The strongest price action setup you can use in conjunction with supply and demand zones is our good friend the engulfing candle.

Engulfing candles, when found in supply or demand zones show us that bank traders have an interest in making the market move away from a zone, the candle itself is the result of bank traders entering into the market.

The image above shows a supply zone seen on the 1 hour chart of AUD/USD with an engulfing candle.

The way we would have traded this is by first locating the supply or demand zone on our charts, then, when the market returns to the zone we will switch to a lower time frame to see if an engulfing candle appears which we can use as an entry trigger into our trades.

Note:
When switching to lower time frames to look for trades I suggest you go no lower than the 5 minute chart.
If you use things like the 1 minute chart you will encounter a lot of false signals which will end up with you losing money if you decide to trade them.



Now we are looking at the supply zone on the 5 minute chart, we can see an engulfing candle appears shortly after entering the zone , this is our trigger for entering the trade, when we see this candle form we use a market order to place our trade.

We always use a lower time frame for entering supply and demand zone trades using price action.

You can if you like use the time frame you've marked the zone off when entering trades but its better to switch to a lower time frame because you can decrease your risk and increase your potential reward.

If you entered the market based on the engulfing candle seen on the image of the 1 hour chart the distance of your stop from entry would be 19 pips, however if you went on to the 5 minute chart like on the second image and entered using the engulfing candle seen on here you would have only risked 12 pips, therefore we have decreased the risk on the trade by almost half, this can work out to be a lot of money over 10 – 20 trades.

In addition to us decreasing risk we've also increased our potential gain from the trade since our entry into the market was right at the beginning of the movement lower, had we traded the engulfing candle on the 1 hour chart, we would have been entering after the market has already managed to move down slightly, therefore the potential profit we can make from the trade has decreased.

If you look at the image on the 5 minute chart you'll see that when the market enters the zone more than one engulfing candle is present.

This presents the one of the big problems a lot of people have when trading engulfing candles at zones, which engulfing candle do you trade?

We'll come back to this problem later and I'll show you how to identify 'structures' which give a clear indication of weather a zone is going to hold or not.

Flip Zones Don't Make Sense

One more technique many supply and demand traders use is the concept of flip zones.

This is where a supply or demand zone gets broken by the market then gets used as an opposite zone.

In other words, if there was a supply zone which got broken by an up-move, it would then become a demand zone, the same as when support and resistance levels get broken, I personally don't think this makes any sense.

If the assumption is zones contain pending orders placed at them, then when the market breaks the zones it means all of the orders that were assumed to be there must have been consumed, if they weren't then the market would not of broke the zone.

So if the market breaks a supply zone like in the example above, why would traders suddenly place orders there if it's no longer a supply zone?

I think sometimes people apply concepts from other trading strategies and apply them to new trading strategies thinking they will work the same way, the concept of flip zones comes from support and resistance, the difference between flip zones in support and resistance to flip zones in supply and demand, is support and resistance flip zones actually have a valid psychological reason for working based on how breakout traders enter into the market.

On the other hand, supply and demand flip zones have no underlying basis for why they work, there's no reason linked to how and why people would trade for them to work, it's as if someones just took the idea of S+R flip zones and applied them to supply and demand trading with the assumption they will work in the same way without understanding the basis for what supply and demand trading is based on to begin with.

Pin Bars At Zones

The other price action signal you're able to use when looking for entries into supply and demand zones is the pin bar.

Pin bars, as you should already know, show a rejection is taking place in the market, usually this is from a support and resistance level but can be from trend lines and recent swing highs and lows.

Although pin bars are not as reliable as engulfing candles when found at zones they are still a better method of entry than using pending orders.

Lets look at some examples:

Here's a supply zone on the 1 hour chart of EUR/USD

If this was you looking to place a trade at this supply zone the first thing you would do is have the level already marked on your chart, then you would be awaiting the market to return to the level.

When it does return to the zone you will then need to switch to a lower time frame to look for a pin bar that you can use as an entry trigger into your trade.

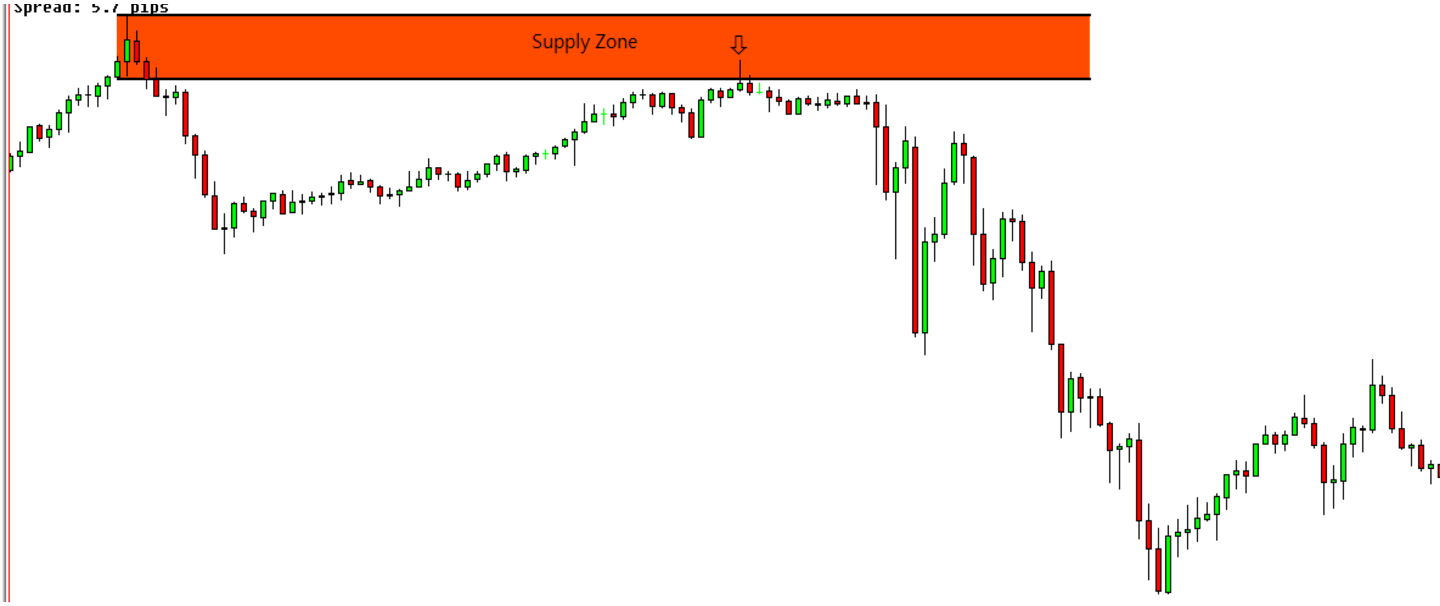
As you can see when the market enters the zone it produces a bearish pin bar.

The way you would have traded this would be to first wait for the pin bar to close, then you place a trade sell trade using a market order with the stop-loss placed above the high of the pin.

Here's another example, this is on the 1 hour chart of USD/JPY

You'll notice a pin bar actually forms on this time frame without us going onto the lower time frames to try to find a pin, you could have traded this setup from the 1 hour time frame, but in the essence of always decreasing risk and increasing reward, it would be far more productive profitable if you scan the lower time frames to see if a pin bar has formed anywhere.

This is what the supply zone looks like on 15 minute chart.



We can see another pin, its funny how this pin bar is actually a part of the pin bar seen on the 1 hour chart, really we're seeing a pin bar within a pin bar.

The way we would have traded this pin bar is exactly the same as what we just discussed.

We place a sell trade when the pin bar has closed with our stop-loss placed above the high.

Some people would tell you to put it at the far edge of the supply zone this is incorrect.

Your trade idea is based on the market moving lower after the pin has appeared, if the market moves higher and breaks past the high of the pin it means the signal was incorrect and you should wait for another signal to form, there's no point having a stop placed at the edge of the zone if we know we're wrong when the high of the pin gets broken, it's just giving the market the chance to make us lose more money than we need to.

Strong Engulfing Candles VS Weak One's

The people who trade supply and demand with price action usually tell you to look for an engulfing candle on a lower time frame when the market enters the zone, this is great advice, but do they ever talk about what types of engulfing candles work better than others?

Maybe it never occurred to them that the two candles which make up an engulfing pattern are directly linked to whether the zone is likely to work out or not.

I want you to look at the engulfing candle with the lines around it.

There's two candles which make up this engulfing structure.

The first is a small bullish candle and the second is the bearish engulfing candle.

Whenever you see a small candlestick be engulfed by a large candlestick in a supply or demand zone its a good indication that the zone market is going to move out of the zone.

The reason for this is down to my understanding of how traders think and make decisions.

If you look you can see two candles before the bearish engulfing candle there was a bullish large range candle.

This candle makes retail traders think the market is going up, so they begin to buy which creates the small bullish candle seen immediately after.

Now when the engulfing candle shows up and pushes the market down really quickly, it has the effect of putting the traders who brought under intense pressure to close their positions, this is the important bit, the aspect of how time affects the actions of the traders.

If the bearish engulfing candle was tiny and only just managed to engulf the small bullish candle, the traders who brought would feel less compelled to close their trades, the loss they are in is small, therefore they would be more willing to continue holding their trades.

When the engulfing candle is big, like in the example above, the traders are faced with a loss much greater and much more sudden than a situation where both candles that form the engulfing pattern are small.

This is the reason these types of engulfing structures tend to work so well.

The bigger the loss the traders who brought are faced with, the quicker they will close their positions, which will create the movement out of the supply or demand zone.

Examples:

The images below are all examples of what size engulfing candle you're looking to see when the market enters a supply or demand zone.

Stop Loss Position

Now I've given you some ideas as to what engulfing structure you should trade I now need to show you where you should put you stop-loss when trading these setups.

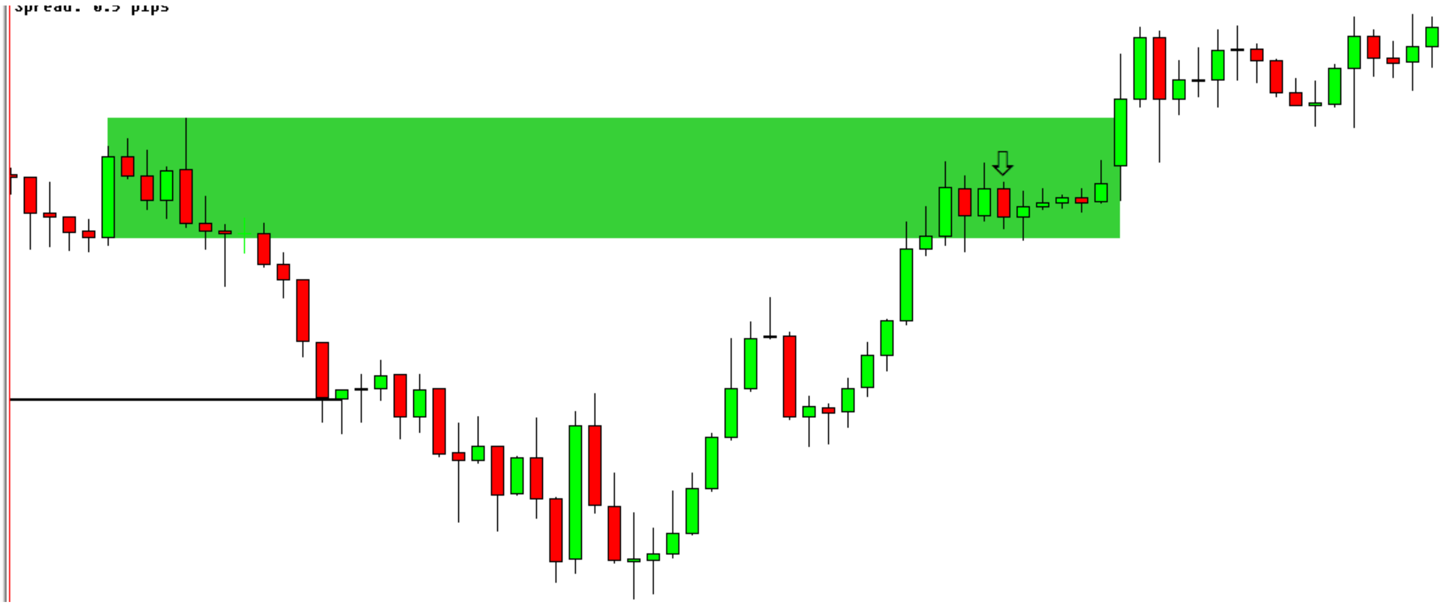
The stop-loss location for engulfing setups is a little different to the pin bars setups I showed you earlier.

Instead of putting the stop at the high or low of the pin we are instead going to put it at the high or the low of the candle that's being engulfed.

If the market breaks past the high or low of the candle being engulfed it means the setup has been invalidated, you do not move the stop or close the trade before this has happened.

Which Engulfing Candles Don't Tend To Work

Now we have looked at what kind of engulfing candles do work, I'm now going to show you some examples of setups that don't tend to result in successful trades.



The image above is an example of a supply zone with a bearish engulfing candle within it, this is a setup that would have very likely lost you money had you traded it.

The bearish engulfing candle with an arrow above it, while meeting all the criteria of standard engulfing candle teachings, is not a good setup to trade, look at how small the engulfing candle is, it only just manages to engulf the previous candle, when you see engulfing candles like the one above where both candles that make up the structure are small I would advise you to not take the trade.

The reason why these types of engulfing candles do not work well is mainly due to the level of urgency affecting the traders who have sold or brought on the previous candle.

If the engulfing candle is small it does not put the traders who have brought or sold on the previous candle at a loss big enough for them to get scared of what the market may do next, if the engulfing candle was much bigger than the candle being engulfed, all the traders on the previous candle will be feeling an intense level of fear due to being at a large loss on their trade.

These traders don't want their loss to get any bigger so their main priority is to close the trade as soon as possible, small engulfing candles do not achieve this effect, they only make a few traders close their trades which means the movement away from the zone is not significant.

A Small Secret

Another really important factor in whether a supply or demand zone is likely to hold or not is time.

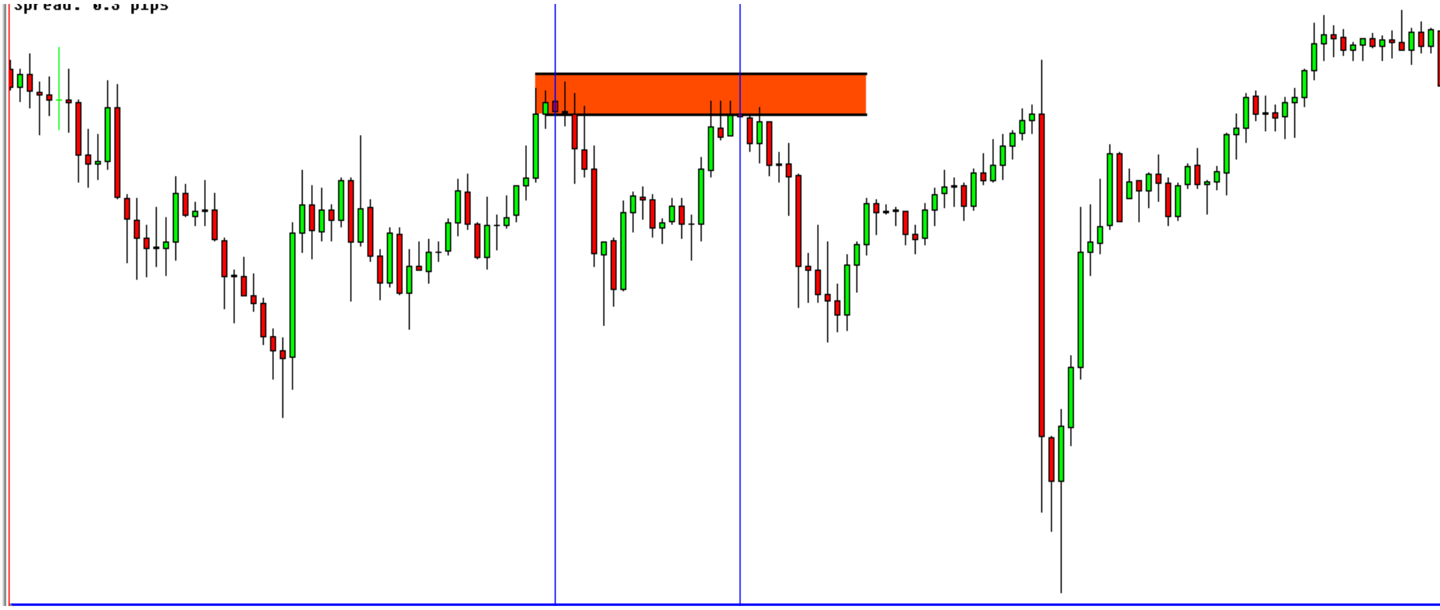
Time is a concept traders in general never seem to talk about in regards to their respective method or strategy, yet it remains one of the most important components of the market.

The traders operating in the forex market are all working off different timescales, different traders will come into the market at different times for example.

At 6.00am European traders will be coming into the market, 12 0 clock will see US traders beginning to place trades.

The reason why this is important is down to WHEN a supply and demand zone gets created.

If we work from the current theory that the reason the market returns to supply and demand zones is down to the banks not being able to place all their orders into the market then it makes sense that if the traders who were present in the market when the zone was created are not in the market when it returns, the zone must have a lower chance of working out because the traders who created it are not around to place their trades.



The supply zone above was formed on the 30th October at 1:00 o clock in the afternoon which is when the crossover between the London session and the US session happens, so for the market to move down when it returns to this zone, either the US or European Traders will have to be active in the market.

As you can see the market returns to the supply zone the next day just after the London session has started, and proceeds to move lower over the course of the day, this tells us that the London traders still had orders left over to place at this zone from the previous day.

The main take away from this is to keep track of when the zones you see on your charts were created, if your thinking about trading a zone and you find that the traders who were active in the market when the zone was formed are not in the market right now it makes sense to be a bit more cautious of how strong a chance you feel the zone has of working out, it may be still okay to trade, but if you do make sure it’s with a reduced position size, that way if you do happen to lose on the trade at least it wont be much money.

One more thing to understand about time and its relation to supply and demand zones is when you should actually trade them.

This kind of ties in to what I was just talking about.

You see, because certain currencies will only get traded during their respective time zones if you plan on trading a zone after the trading hours for that currency are over do not expect to see any kind of significant movement away from the zone until the next day when the new trading session begins.

The professional traders in the market who are working for the big banks and institutions are people whose job it is to trade, and like all other jobs there’s a specific time frame of when their working, this means that when they finish work for the day the movement in the markets their active in dies down, if you try to trade EUR/USD at 12:00 at night you’re not going to see any big movements until at least 6:00 the next morning as this is when the European session begins.

Always keep this in mind when thinking about placing any trades during non active hours.

Summary

To some extent I can see how the engulfing structure I’ve presented in this article can only be traded with a lot of discretion, its hard for me to give you definite criteria to identify which engulfing candles are considered too big or too small, it will take some time and research on your behalf to figure these things out just always remember this:

As long as the candle that’s being engulfed is small and the engulfing candle itself is much bigger you should have no problem making more successful supply and demand zone trades.