The 3-2-1 Trading Methodology

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A Simplified Method for Trading Any Market

You're starved for knowledge about trading. You buy all the books. You're searching like mad through the Internet. Maybe you lay out some big bucks for a can't-miss system that works great when the market is consolidating but falls apart when it begins to trend.

After you add every technical indicator, and combinations of indicators, into your trading arsenal, and put them on tick, time, volume, and range charts, you realize that all you're getting is confused.

Been there and done that, and there is a better way.

With the right tools and information feed you will find there are really only two or three important factors actually driving the markets and that you can make good, timely decisions, if you don't have too sort through so many variables before you take a trade.

The **Key** is **Volume**.

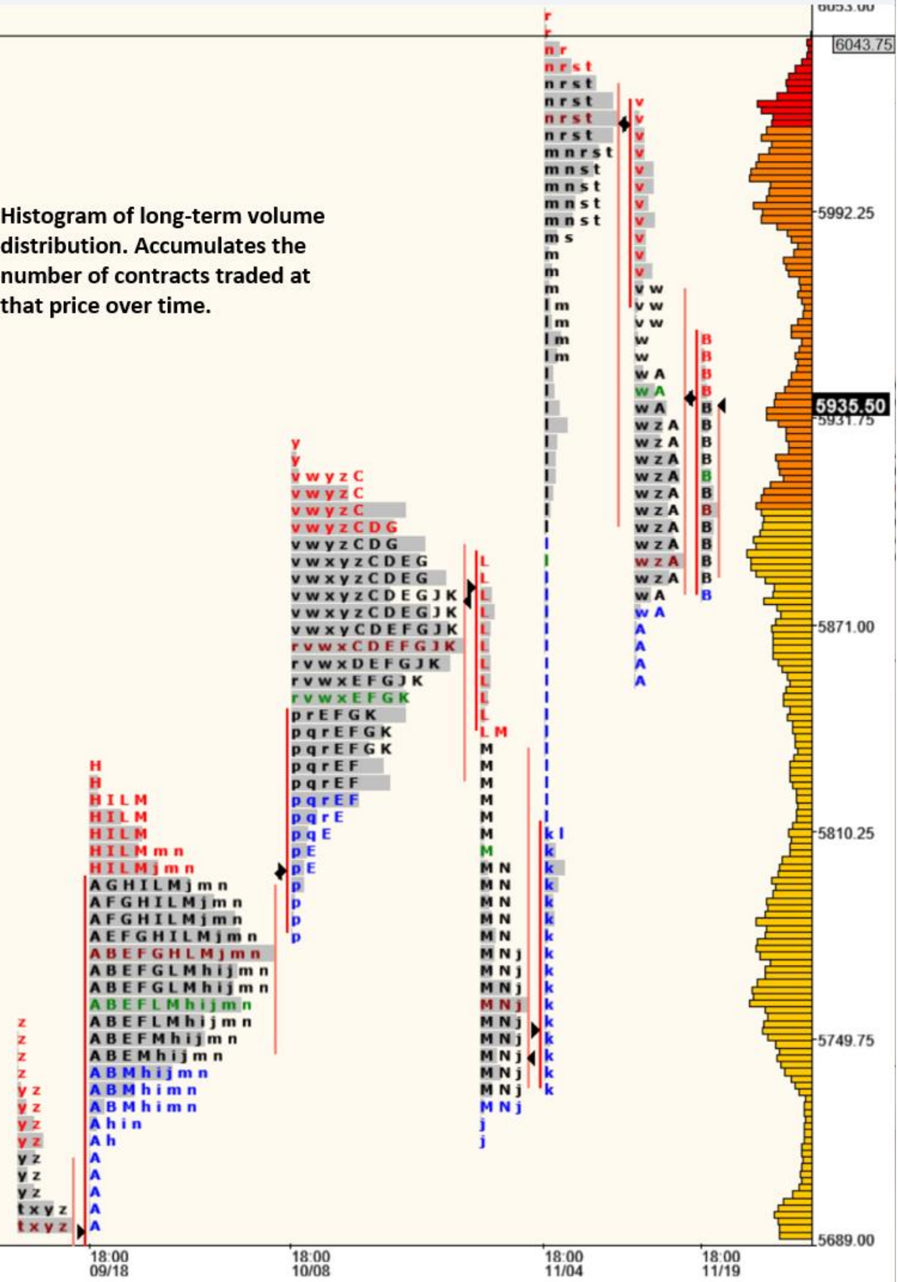
When the Market Profile methodology was introduced in 1985/86, we could track price changes and the number of trades at a price. The Market Profile combined time and price in one display. It showed what the market was doing, not what a study said it was doing. The Bluewater version also overlays volume in a unique way to visualize TPO and volume skew and it is all based on raw data.

Reality, what is actually happening is what it is all about, or what it should be about in our quest for market-based information.

By using the Market Profile you will discover that the one thing consistently driving the markets is the directional movement of volume, which had nothing to do with the open/high/low/close data points. After learning this we can discard all the analysis, tracking and manipulation on those four data points and begin to focus only on volume.

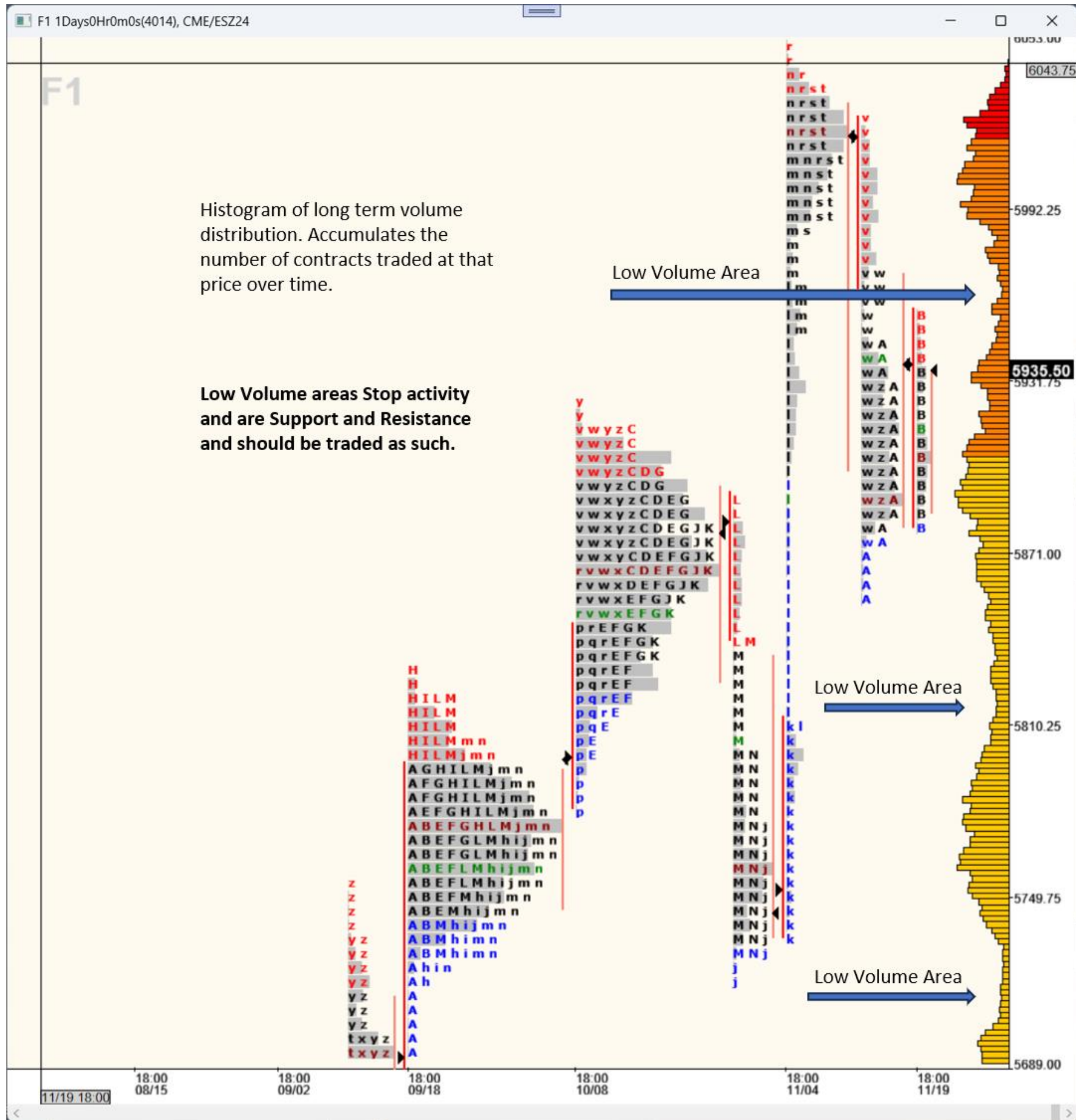
We added volume histograms to the right of the profile and began observing the price points that had the highest and lowest amount of volume traded. Over time, we could see how the high volume and low volume numbers stopped or attracted activity, and how the days' or preceding days' numbers in the regular Market Profile could be used to predict the upcoming days' rotational highs or lows.

What really drives the market directionally is volume. Period.


F1 1Days0Hr0m0s(4014), CME/ESZ24
Histogram of long-term volume distribution. Accumulates the number of contracts traded at that price over time.
6043.75
5992.25
5935.50
5931.75
5871.00
5810.25
5749.75
5689.00
18:00 08/15
18:00 09/02
18:00 09/18
18:00 10/08
18:00 11/04
18:00 11/19
11/19 18:00

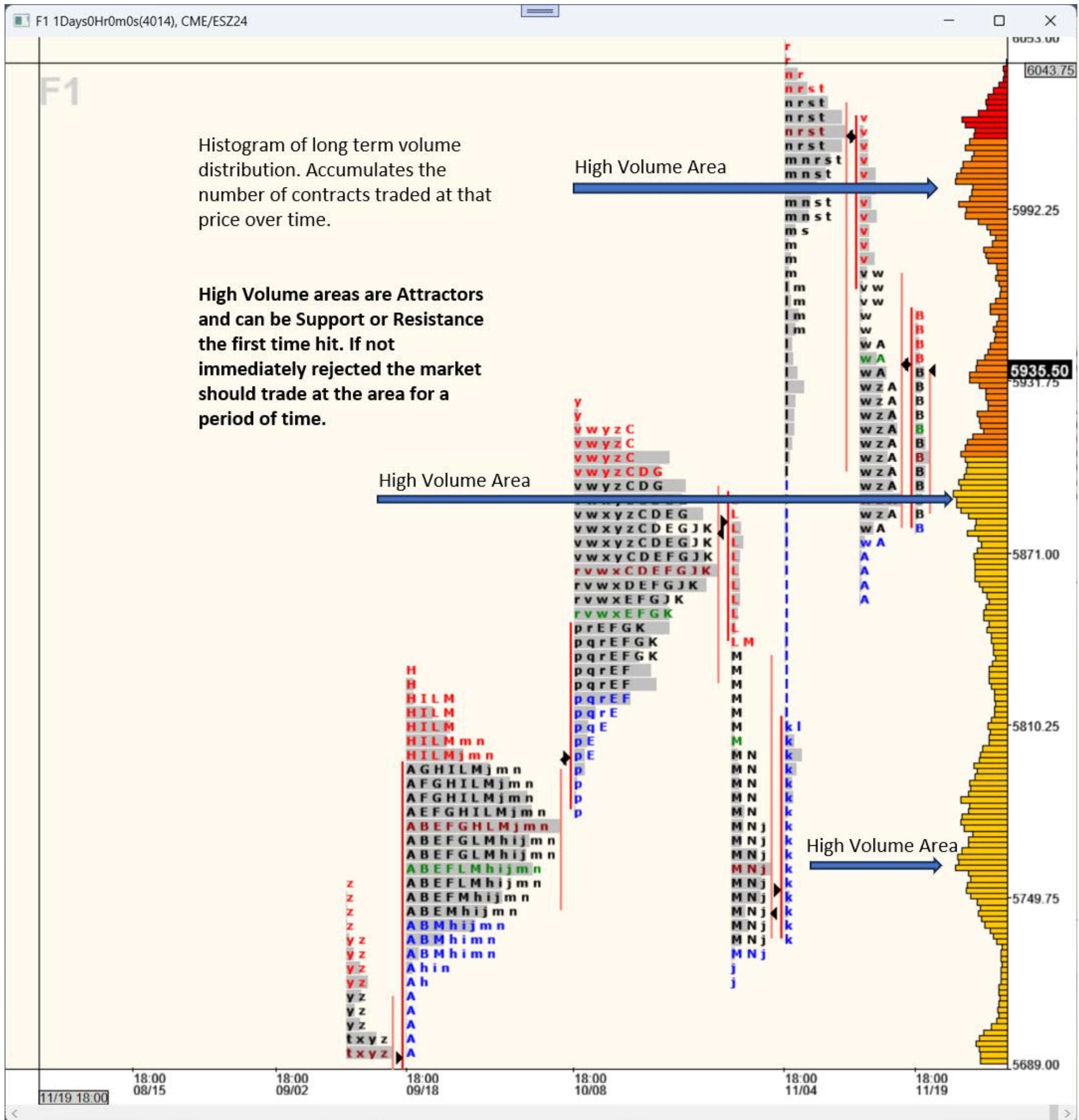
Rule #1

In commercial or hedge markets, low volume numbers are support and resistance, they stop activity and should be traded as such.



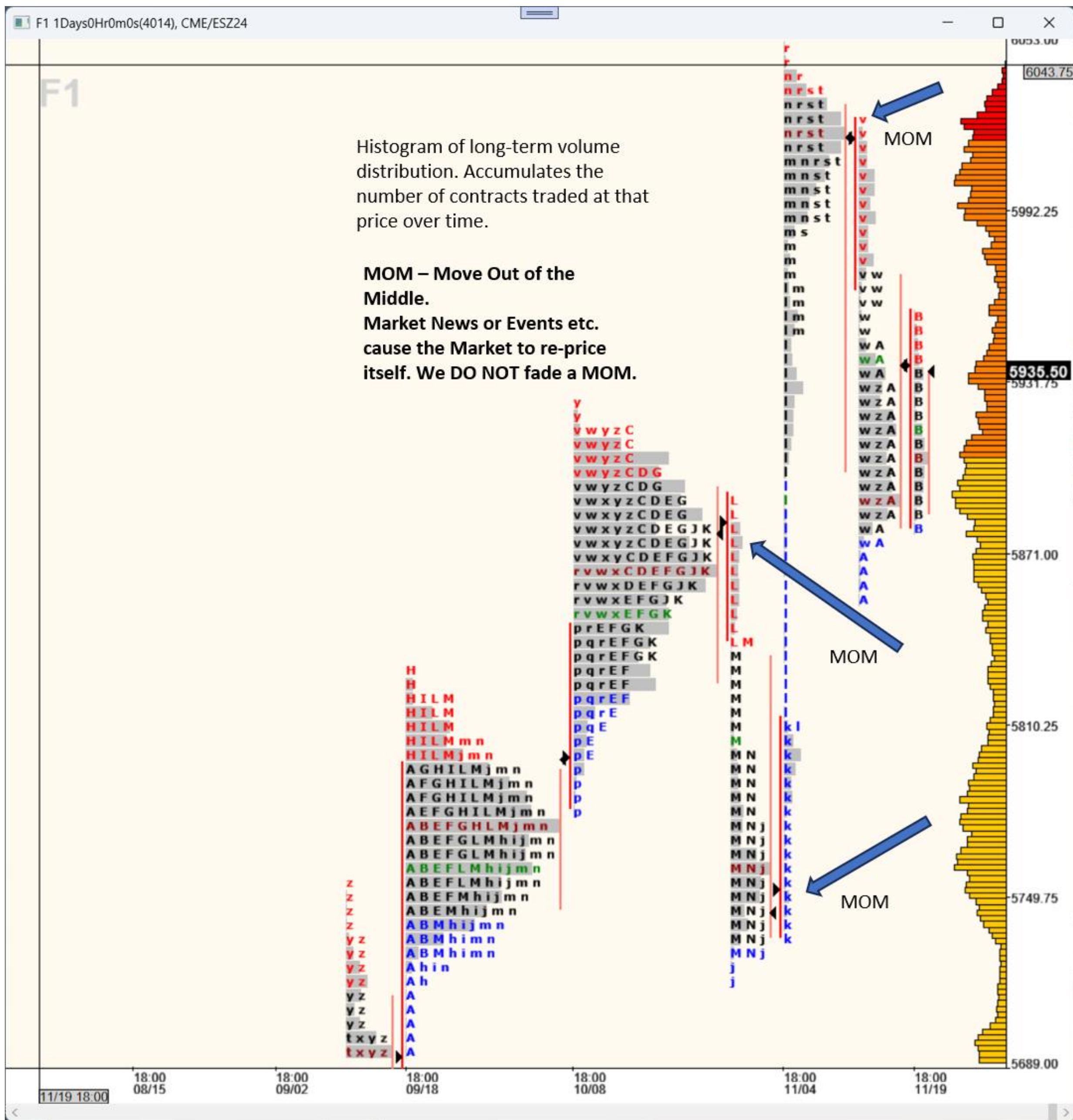
Rule #2

High Volume areas represent value and are attractors. They serve as support and resistance the first time touched only. If not immediately rejected, you can expect the market to trade around the high-volume numbers for a period of time.
Here's why: It's where new moves start. New moves come out of the middle and the way the market confirms this is through the re-test. It will re-test a breakout and if it holds, more people will come in and trade.



Rule #3

Don't fade Moves out of the Middle (MOMs). New moves start when the market has come into balance, off the Balance Point, Point of Control, or Mode. The reason is a piece of news or external event of some kind that forces the market to re-price itself. This is what a MOM looks like:



Caveat: there are MOMs and there are MOMs. MOMs can develop over 2-3 hours, days or months. The longer time spent building a Balance Point/Point of Control/Mode the greater the impending move. You don't have to be in a hurry to fade a MOM. In fact, the better trade is to jump on board and go with a MOM.

Two Patterns

When it comes to trading, there are 2 distinct primary patterns that offer the most potential to trade, the “P” and “b” patterns.

Once a pattern has completed the 3 stages of development, we have a market that will start building value and keep testing the edges of the new distribution, reverting back to the mean each time such a test fails, until we get a new move based on a piece of news or external event that forces the market to re-price itself.

In the Bluewater implementation the overlaid volume also gives you a clear view of any volume skew that may be present within the distribution. Prices action tends to gravitate towards the volume skew.

P-pattern

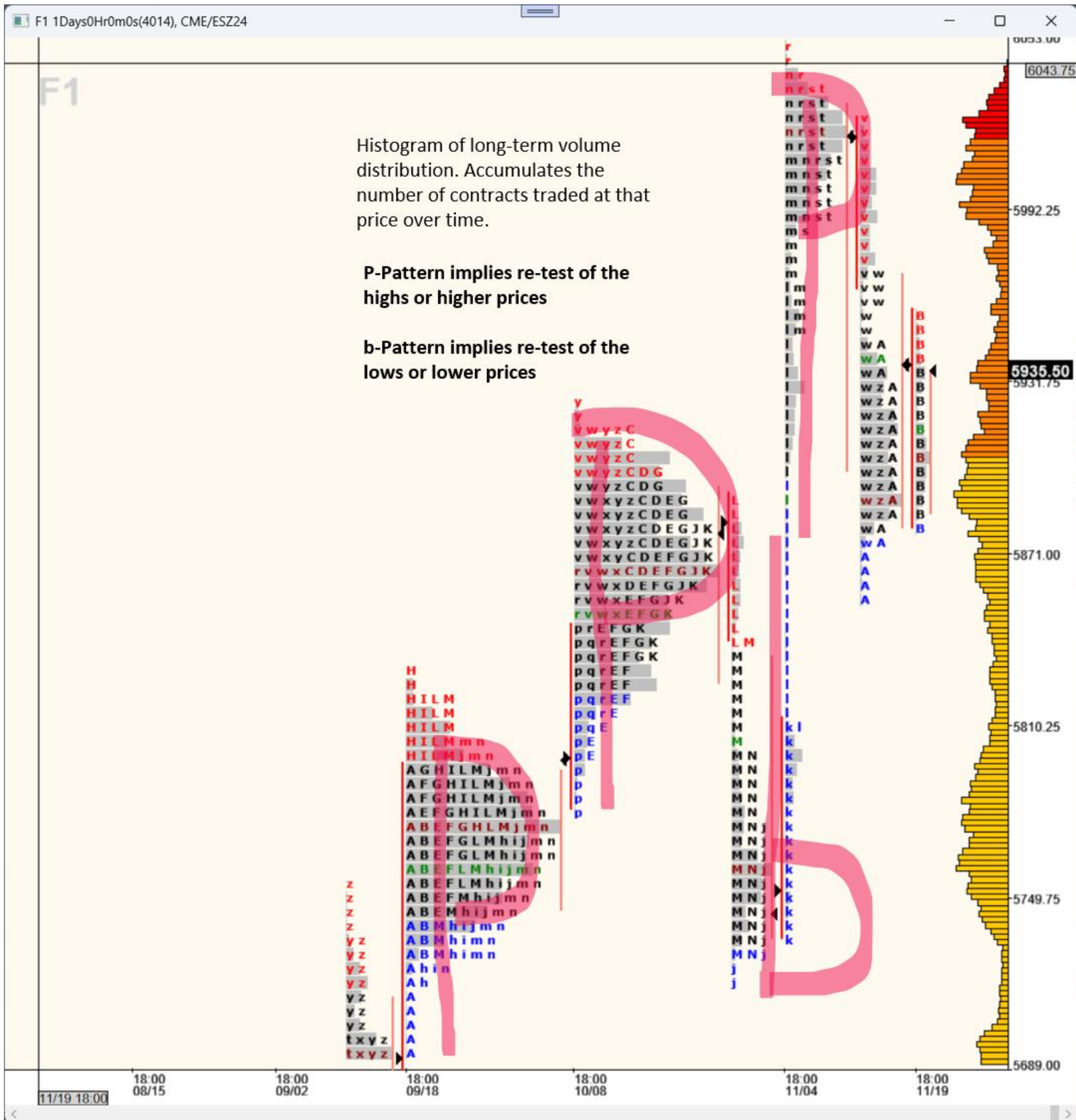
A capital “P” pattern indicates a re-test of resistance and/or higher prices. The 3 stages of a P-pattern begin as a Move out of the Middle (MOM) to the upside:

1. As the market keeps moving higher taking out resistance, we wait for the price level that cuts off the buying.
2. Then we wait for the market to retrace and for the price level that cuts off the selling.
3. Finally, we get an inside bar/TPO where the market doesn’t extend either of the edges set in stage 1 or 2.

b-pattern

A lower case “b” pattern shows a re-test of support and/or lower prices. The 3 stages of a b-pattern begin as a Move out of the Middle (MOM) to the downside:

1. As the market keeps moving lower taking out support, we wait for the price level that cuts off the selling.
2. Then we wait for the market to retrace and for the price level that cuts off the buying.
3. Finally, we get an inside bar/TPO where the market doesn’t extend either of the edges set in stage 1 or 2.



Once you discover the skewing in a distribution and understand what causes this skewing, you will then understand that all you really need to know is which way the distribution is skewed. This shows the markets' next likely directional move without news. Combine this directional knowledge with the markets' structure from the long-term distribution and you know where the market is going before the fact. This combination yields the most powerful trading tools available in the public, or private domain.

One Indicator

Volume deceleration is the final indicator on the 3-2-1 list for establishing good trade location which is critical for successful trading. Poor trade location increases chances of getting shaken out of a trade and also lowers your ability to manage the trade should it not develop in your favor.

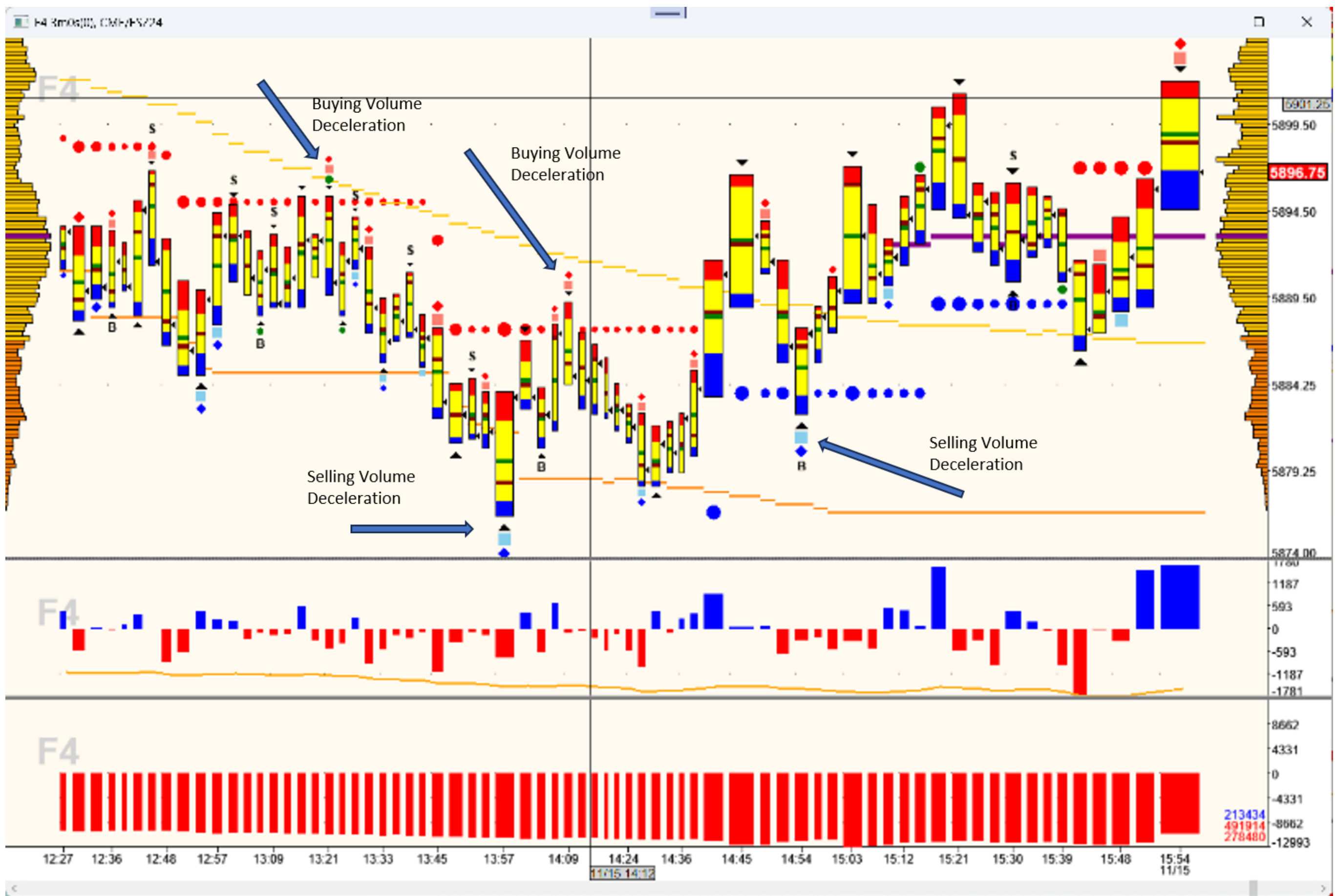
Everyone who has been trading for any amount of time has been steamrolled once or twice and if you have ever visited the trading floor at the Chicago Board of Trade, you can see how it happens. It is incredibly powerful: Brokers, hands in the air, indicating big buying and big selling as it is happening and then suddenly the brokers' hands go down and things get quiet.

Seeing this for the first time, you realize the immediacy of it and the type of trading that could be done with visual access to the actual order flow. The locals pay a tremendous amount of money to have access to this information and with good reason: They can't be blindsided, while entering a trade. If all the brokers' hands are down at their sides, they know nothing is going on and it is safe to trade for a bit.

The next challenge is getting this same volume deceleration information from the electronic markets that the locals get standing on the floor. How can this be done?

The answer to the question is the auction process: As the markets move higher or lower, eventually the buying and selling interest disappears. Markets go up until the last buyer has bought and down until the last seller has sold. Deceleration in market activity and volume when in proximity to the current or historical high or low volume numbers signals it is time to take the trade.

In the image below the pink squares indicates buying volume deceleration and the blue squares indicate selling volume deceleration.



The pink or blue square is the equivalent of seeing brokers put their hands down at their sides. It tells you that interest in buying or selling has dried up at this level and it means the market will do one of two things: It will pause and then continue moving in its current direction or after pausing, retrace its recent move by trading in the opposite direction. This helps you avoid those situations where you could get steamrolled.

The F4 chart above is the execution and trade management chart and is usually set to 3 or 5 minute bars, it is key in identifying prescribed trade setups with the best possible trade location.
The top pane displays intraday volume information to better find trade location once you are in an area of interest. The middle pane displays volume delta per bar and also a green/orange line representing unfiltered cumulative delta volume. The lower pane displays filtered cumulative delta volume. Default trades that are included are 20 lot and above which can be adjusted as necessary.

Conclusion

Three rules. Two patterns. One indicator. All based on the Market Profile and keenly focused on volume movement in conjunction with the long-term distribution. The 3-2-1 approach eliminates much of the noise and most of the variables currently used in your approach to trading. You can make better trading decisions, and more quickly too. With the right tools and information, you can trash most of your trading checklist and focus on the two or three important factors that actually drive the markets. This can only improve your decision making and your trading performance.