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Envelopes

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We are going to use some basic indicators in a different way to try and get a precise entry into a trade.

What we are going to show here is the use of Envelopes, which form trading bands. The particular trading bands we are going to use will be based on exponential moving averages. This will help us form a method to trade. This is basically an intraday strategy, which works well on the 10min/15min time frame.

Envelopes are used to indicate the trading range of a given market above and below an average price. Basically, moving average envelopes or trading bands are calculated by taking a moving average and calculating upper and lower trading bands as a fixed percentage above and below the moving average respectively.

These are considered to suggest extreme overbought or oversold conditions. The assumption is that, price should not deviate from the average of the underlying price element (high or low) by the percentage utilized.

They differ from Bollinger bands, since Bollinger Bands place boundary lines based on standard deviation, whereas envelopes place lines at fixed percentage points above and below a moving average line. The upper and lower limits specify entry and exit points for traders.

But, instead of using them to indicate overbought or oversold conditions, we will attempt to create a narrow trading range and base the rules for this method on this narrow band. We will keep our settings for the Trading Bands as (40, 0.30)

This means you have a band of two moving averages of 40, with a fixed percentage of 0.30 above and below. We then use another Exponential moving average with a setting of 15. The additional moving average is to help identify when the market is beginning to trend.

The first rule is - do not enter a trade when the price is within the band. A trade is signaled only when the price moves outside the band. The general policy is to go long when the price is above the band, and to go short when the price is below the band.

The second rule is for confirmation - don't trade when the 15 exponential moving average is flat. Only trade when the 15 exponential moving average starts rising or falling in the direction of the trade.

This method keeps you out of the market when there is consolidation, which means more chances of getting whipsawed.

The chart below, clearly shows that price was within the band for the first part of the chart and entering a trade here would have got you whipsawed. As a matter of fact, the EUR/USD was in a major uptrend on the daily charts at this time and this method gave us a precise point to enter the trade on a lower time frame.

Chart Points

The red line is where the market was in consolidation. The market then began to rise slightly and the 15 exponential moving average also began to rise - this is the set up.

Even though the market was set up for a trade, the safe play was to wait for 15 exponential moving average to start to trend and for the price to be well above the bands.

The market then pulled back forming resistance. This resistance area is what we are looking for. A break of the resistance is the final confirmation that we have a high probability trade.

The entry is made on a breach of the previous resistance with an initial stop just below the support area that formed.

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