

SOME THOUGHTS ABOUT "TRADING CHAOS" AS PER BILL WILLIAMS AND AS APPLIED TO THE EUR/USD CURRENCY PAIR

When I first begin to gain knowledge in a field of endeavor that is new to me or even if it is an expansion of knowledge pertaining to a subject in which I am interested, I like to sometimes expound my thoughts on "paper" as the learning adventure progresses. Those who have read the work of Bill Williams (and I will assume that you have) will know whereof I speak when I say that these musings are my equivalent of "the morning papers" as applied to the subject at hand. Here, they pertain to understanding and using practical knowledge about Chaos theory to successfully navigate the financial markets from what may be considered a fairly aggressive traders point of view.

CHAOS

Chaotic structure and organization , I know that sounds like an oxymoron :) but I am referring to market flow or price movement. Market flow in the Eur/Usd has been attempted to be described and revealed in numerous ways, witness the great variety of trading strategies of which traders can avail themselves.

One of the approaches, within the context of chaos theory, that I think warrants merit is Elliot Wave Theory. My understanding is that it defines the structure of the market by acknowledging it's inherent chaotic principals and revealing the recurrent patterns within patterns within patterns that Chaos theory is so adept at describing. Although I find the theory of Elliot Waves to ring true, I find the practical application of it to be a bit too esoteric and tedious for my liking. I am such a darn lazy trader that I insist that there must be an easier way. My preference would be "the path of least resistance". Is there such a way?

Well, all is not lost. As far as I can tell "Trading Chaos" is Bill Williams' way of saying "Elliot Wave" (if I remember correctly, that is what he says in his books). Better yet, it is his way of saying "Elliot Wave Simplified" and I'm all about simplicity when it comes to trading..... so is Trading Chaos simple?

In studying it, perhaps not, in taking on anything new there is a learning curve that one has to be willing to endure. In practice, yes the methodologies are pretty straight forward and rather easy to implement. In nuances, again perhaps not, but therein lies all the fun. Trading is above all a business and as a professional in that business you are always gaining nuances simply through the act of gaining experience. According to Williams, being "in the zone" can eventually become the normal state of trading and I suppose that it is the experience that gets you there.

TRADING CHAOS

Trading Chaos is an aggressive trend trading approach with aggressive countertrend tactics included. Make no mistake about that! With it's multiple entry methodologies it is meant to put you into a developing trend (impulse move) and carry you through the length of it in an aggressive manner. It is also not shy when it comes to countertrend trading as it tries to follow market

rhythm.

When talking about other markets, Williams states that the goal is to bank 3 to 5 times the actual value of an impulse move. To our delight (and profitability) in Forex this can often be considerably more. This aggressive approach may at times require a rather strong stomach. Having said that, in my humble opinion, pretty well every trader could benefit from have a solid trend trading strategy that they feel suits them. I personally like Williams methodologies and have adapted them and continue to adapt them to suit myself. However, I do not feel the need to be a purist simply for the sake of being a purist. I feel quite comfortable applying any other knowledge that I have gained and adapting Williams methodology accordingly. Just like the markets, being a trader is a fluid processes consisting of periods of gaining knowledge and periods of practical application.. In trading there is only one ultimate goal—to efficiently use the path of least resistance to make the most profit possible. To this Williams would probably add, “all the while staying in your own personal zone and enjoying the fruits of your intellect”, that should be implicit in the goal.

Most often when traders think of trend trading strategies they think long term time frames and the difficulty of adapting to non trending markets. Although they are not wrong in doing so that is only part of the story. My preferred time frame to look for trades, especially impulse waves in the Eur/Usd pair is the Daily timeframe. However, trends can develop in all time frames and that is the other part of the story.

I find that up trends and down trends that develop in the Daily timeframe are often a real pleasure to trade using Trading Chaos methodologies. We all know though, that trends don't last forever and that there can be some considerable time between them. When a ranging or sideways trading market develops in the Daily timeframe then that timeframe is temporarily no longer suited to trend trading. But, a good trend trading approach should be able hold its own in varying market conditions.

I find that if I identify a trading range in the Daily timeframe then that very same trading range will often manifest itself as a series of smaller trends in a lower time frame. This is the beauty of those patterns within patterns that Chaos Theory defines so well. Although it requires a bit more nimble trading, ranging markets can submit themselves to giving up a substantial number of pips on what are lesser degree impulse waves and countertrend trades. So in theory at least, it should be possible to follow the ebb and flow of the market by using an appropriate timeframe for the particular prevailing market condition.

If I decide to trade a lower timeframe, then my own preference is to use anywhere from a 4 hour to a 30 minute timeframe. I find timeframes lower than that to have too much "noise" to my liking (too many Fractals) and being the basically lazy trader that I am, require too much screen time. Like I said, I really love those Daily's - a couple of minutes a day and presto... your done! It doesn't get more easy peasey than that. If possible, I am all for living a life away from the trading screen—its not my favourite way of getting a tan :). Being the lazy sot that I am I will also often just wait out a ranging market and forget about the lower time frame trading. I am quite happy to let someone else have those pips and then be prepared for the next impulse wave in the Daily timeframe. How can you guess that Zone trading is probably my most favourite

Williams method?

CHAOS ENTRY METHODOLOGIES

These methodologies are comprised of a handful of different strategies each with its own set of specific criteria. All are reliant on their relationship to the Alligator.

I feel that Zone trading is the most important (and profitable) part of Williams' approach as opposed to the Divergence bar countertrend method. This, to me is trend trading at its best. When a trend does establish itself, at certain points the trading action can become very aggressive. The different trading criteria (AO and AC, Balance line, and Fractal criteria) can begin to fall into place one after another and often simultaneously as well. With the potential of numerous add on trades, money management needs to be sound and disciplined.

Of all the entry methods I particularly like the ZONE setups. The majority of the price movement happens here and this is where some pretty active trading can happen. Every bar now becomes a setup bar and money management now becomes absolutely crucial. Here is where we learn the difference between beautiful and ugly. The profit numbers can be tremendously beautiful. Stop losses must be tended to and careful money management applied to prevent the numbers turning ugly. A gorging Alligator is a beautiful thing indeed. When he is done and well stuffed so should be your account.

ALLIGATOR

This is the core creature that the other methodologies are woven around.

I am a sucker for corny analogies so the Alligator doing the sleeping and awakening and then gorging on Bull/Bear meat just puts a double :) :) on my sneerk :).

I like the idea of adding a 5 SMA of the close offset by 3 as a stop loss guide. Although using a moving average as a stop loss guide is acceptable practice by many traders (I think?), offsetting it into the future is nicely in keeping with the construction of the Alligator, whose moving averages are also offset into the future by varying degrees. They are all nice Fibonacci numbers too (5,8,13). I don't know how relevant that is although, Fibonacci does qualify as a chaos concept.

DIVERGENT BAR

The first thing that I must remember is that not every change in market rhythm is preceded by a Divergent bar. As Japanese Candle traders will tell you, there are many ways to read the landscape and many candle formations to do so. Chaos trading should steer us to the pertinent ones and not bother us with the undesirable ones. It does this quite admirably by following "the path of least resistance" - or so the theory goes.

In price action terminology, one of the best Divergent bars would be called a pin bar. It is probably the best type of Divergent bar that we will ever see. Traders, who are also candlestick followers, will know the importance of being able to recognize where in the overall landscape that the bar prints. I am going to speculate, that Divergent bars that appear at the end of an impulse

wave 5 should be more interesting than say a Divergent bar that appears at the end of a wave 1. Why? Well, the ends of wave 5's within both impulse and corrective waves are supposedly (if I understand my Elliot Wave Theory correctly) where we can expect to see new trends being given birth. The Alligator is switching from Bull meat to Bear meat or vice versa. The general rhythm is one of impulse wave then corrective wave and repeated again, so on and so on.

Divergent bars at the ends of long trend legs seem to have more trading potential than ones that appear at the ends of shorter trend legs. The Shorter trend may likely be a wave 1 within a perhaps larger wave count and/or corrective move. In this case they may appear near a recent Fractal break and are just a part of a retest of the recent breakout. I may not want to consider them as tradeable at this point because the countertrend may well be rather shallow. I would perhaps rather watch for Balance line trades for a resumption of the trend.

Having said all that, there is the wave 3 scenario that should be considered as well. Wave 3 can be and hopefully will be a Long (impulse) leg or so Elliot wave theory tells us. This is often the wave wherein good AO saucer trades appear as the market breaths in a minor corrective fashion. I guess that even Alligators needs to swallow and digest a bit before continuing feeding. A Divergence bar at the end of a wave 3 will lead to a corrective wave 4 which may be a pullback of some depth but not a trend changing wave as the end of a wave 5 should be.

A Divergence bar may become a Fractal point, but of course, not every Fractal is going to be a Divergence bar.

THE AO AND THREE BAR AO CRITERIA

This one seems pretty straight forward. I think that the AO three bar criteria can sometimes be a bit conservative and under certain conditions (if I can identify a wave 3) I may look for an earlier entry.

My interest lies more in using the AO in conjunction with the AC, along with compliant Alligator conditions. The alignment of the three indicators defines the parameters for Zone trading conditions. I believe that herein lies the strength of Chaos trading and Bill Williams' approach. Zone trading is where the money is to be made. Williams puts some emphasis on this in his writing and I whole heartedly agree.

RACTALS

Fractals are great, basic simple and often straight forward. Fractals are a particularly good subset of Chaos Theory. I see them as sticky spots. I suppose you could say they gather up chaos. New information comes into the market and it sticks at this point. That point may then act as an initiating point for later action - such as a breakout.

Because Fractals define support/resistance so well, they work best for me as simple trend continuation indicators - the scenario goes something like this - price goes past this point (the Fractal) and I want in because the Alligator is compliant and is showing us in which direction it is feeding - a simple straight forward way to step in front of the market and often move into profits quickly.

I like Williams' idea of using Fractals as stop and reverse points too - that makes a lot of sense and helps you to define what your overall risk in the market might initially be for a particular trade setup. Every trend has to begin and end with a Fractal. They can serve as both ending and new initiation points. As initiating points they act as a "Butterfly Effect" at work, that's my guess.

When I view Fractals I see support and resistance levels and I see these support/resistance levels as breakout levels. It is nice to know their location in the charting landscape in relation to the Alligator. Williams states that they need to trigger outside of the Alligator's mouth. This will determine how I view them, either as the beginning of a trend or as a continuation of a current trend or as the end of a trend. Once again, as Williams says, they also act as stop and reverse points, should the market so dictate.

ZONES

This, to my way of thinking, is the very meat of William's approach. When the market enters a Zone we get to see the Alligator begin feeding, for this is the impulse wave being formed. As Zone bars print they become entry setup bars. Often we will see several bars in a row become setup bars and consequently the trading can become aggressive within the Zone. In keeping with William's philosophy, just as an athlete performs best when they are in their personal zone, this is the ideal time for the trader to also be in their personal zone. When both price and trader are in the Zone, that's as close as we will ever come to that much overused phrase "The Holy Grail" of trading.

The EUR/USD trading Zones are the ones I prefer. I have simply quit trading multiple currency pairs. Why only one currency pair? Well, I am kind of a lazy trader, I guess. My day is full of life being lived and trading is only a portion of that. That does not at all diminish its importance or the attention to detail required, on the contrary. I have chosen to trade only one currency pair so that I can treat it with the importance that it deserves and do so in a relaxed and pleasant manner. I find that the major currency pairs are for the most part either positively or negatively correlated anyway, so in a way, trading one of them is akin to trading all of them. From a pure business perspective, it is known as concentrating your resources to the greatest effect, always a smart business move. Chaos trading, to be at its most effective, should be "the path of least resistance". For me that entails the EUR/USD pair, the Daily timeframe for setups (particularly the Zones) and market identification (up, down, sideways). Even though I prefer the Daily charts to identify setups, I will certainly not hesitate to use lower timeframes for entries and position management.

BALANCE LINE

Nice technique when used at the right time. In other trading circles I believe it is known as pivot trading the best of which often occur near support/resistance. I surmise that it would be most effective in timing trades around Bull/Bear flag like formations. I would think that the most effective Balance line trades occur on the first pullback after a breakout.

I wonder if Balance line trades might also be effective around a Divergence bar print - moving back a Hi/Low or two might be enough to keep one out of the wrong side of a shallow retrace or allow for an evaluation of the pertinent Fractals in relation to the Divergence bar. In any case, I see a profitable Balance line method as akin to an early Fractal breakout entry.

When price hesitates during Zone trading conditions, but one expects a trend continuation (Alligator still wanting to feed), then watching for a Balance line trade would be most appropriate. Sometimes if the market consolidates a wee bit and manifests as an A B C wave type of correction, there can be more than one Balance line trade signal given. A clean classic A B C would give two signals, one during the A leg and one during the C leg. The trader then has the choice of taking the first one knowing that it could require a larger stop loss and/or a quick take profit or take a chance and wait for the second one. The second one is, I think, the more desirable one since it should lead directly into the next impulse leg trend continuation.

EXITS

There comes a time to take the money home or conversely cut the losses, that is what Exits are for. Trading Chaos suggests the use of a few different Exit techniques. All of them have their use. I find Exits to be some what discretionary. I agree with Williams that the best approach should be to let the market tell you when it wants you to get out. That applies to both successful trades and the not successful ones. How one lets the market determine that may require a bit of ones own discretion.

For placing stop losses, I find an additional 5 SMA of the close offset by 3 to be useful as well as the other Alligator lines. Then there is the so many bars back exit rule and lets not forget the humble Fractal as well. They are all good approaches. I am also not adverse to dropping in some Fibonacci lines on a lower timeframe. The old Fib trader's rule of thumb, "if it breaks the .618, I am out", still has some merit. My endeavor is to used the methodology that I think best suits the trade at the time.

A lot of Exiting is about stop loss management and money management, that is, specific and overall risk control. One has to take into consideration the number of current open positions, whether or not they are in the money and profit protected and the wisdom of adding further trades. I think that it is imperative to stay within very conservative risk percentages not only for each individual trade but for all the trades combined. Ideally I prefer a trade to be nicely profit protected in the money before taking on another trade and carrying on in that same manner as the trend develops. That of course is the ideal scenario. Once again, it is the idea of letting the market tell you how many positions you should be holding according to your disciplined risk/reward criteria and whether or not you are in a position to add on. That way, the trade account is also allowed to follow "the path of least resistance" in both growth and position sizing. I personally think that is a purer approach to "wanting what the market wants" than the "pyramid entry approach" although I believe Williams use of the pyramid is such that he scales it to suit market action. Either way requires personal discretion.

Exits are also about profit protection and profit collection. In this regard the ideal scenario would be letting the market do its thing and letting the trade time its way out much in the same manner that an entry is timed in. I prefer to be very aggressive with my stop losses during the

early part of a trade. That old cliché “don’t let a winner turn into a loser” comes to mind. The idea is to have the best risk/reward possible (profit being protected) so that one can take full advantage of any subsequent add on trades at minimal risk. Perhaps its all a bit easier said than done. This is, I suppose, where that right brain intuition that Williams talks about comes in handy.

CONCLUSION

Trading Chaos is perhaps as much a philosophy as a trading methodology, at least if we want to believe Bill Williams. That may well be its strength. I am quite willing to embrace those aspects of it that give me vision and clarity when observing EUR/USD price action. I am finding that it meshes well with my other perspectives on market action and is readily enhanced by my other technical knowledge. I think that Trading Chaos is a very good approach for traders who want to develop the skills of aggressive trend trading and countertrend trading. What I find particularly appealing is the flexibility with which this style of trading can be applied to varying market conditions. Because it deals with wave structure it can be adapted to a number of time frames allowing the trader to fashion an approach to trading that will be his “path of least resistance”. With some of the wonderfully sophisticated charting platforms now available and with well studied and practiced methodologies, trading can be both a profitable and pleasurable experience.

ADDITIONAL THOUGHTS

Is “Chaos Everything” becoming the latest rage? It certainly seems to be making some inroads into the public consciousness. Both the popular scientific literature and spiritual literature have embraced its concepts. The movie "What The BLEEP Do We Know?" is considered ground breaking in presenting the esoterica of Quantum Theory and Chaos to a large following.

Chaos theory is not foreign to other times and cultures. It has been expressed in mystical forms in Eastern philosophy for millennia. It has only recently been couched in Western terms where it has been able to reach a new audience.

Bill Williams has made a great and admirable presentation about why and how to employ Chaos theory in life and trading. Apparently he has found it to be of use in a long and respectable trading career. I think his concepts are well thought out and should be applicable with a great degree of success. Solid trading knowledge should be worth its weight in gold and then some, how it is used, well that's pretty much all up to the individual.