

Trading Multiple Time Frames In FX

by John Kicklighter

Most technical traders in the foreign exchange market, whether they are novices or seasoned pros, have come across the concept of multiple time frame analysis in their market educations. However, this well-founded means of reading charts and developing strategies is often the first level of analysis to be forgotten when a trader pursues an edge over the market.

In specializing as a day trader, momentum trader, breakout trader or event risk trader, among other styles, many market participants lose sight of the larger trend, miss clear levels of support and resistance and overlook high probability entry and stop levels. In this article, we will describe what multiple time frame analysis is and how to choose the various periods and how to put it all together. (For related reading, see [Multiple Time Frames Can Multiply Returns](#).)

What Is Multiple Time Frame Analysis?

Multiple time frame analysis involves monitoring the same currency pair across different frequencies (or time compressions). While there is no real limit as to how many frequencies can be monitored or which specific ones to choose, there are general guidelines that most practitioners will follow.

Typically, using three different periods gives a broad enough reading on the market - using fewer than this can result in a considerable loss of data, while using more typically provides redundant analysis. When choosing the three time frequencies, a simple strategy can be to follow a "rule of four". This means that a medium-term period should first be determined and it should represent a standard as to how long the average trade is held. From there, a shorter term time frame should be chosen and it should be at least one-fourth the intermediate period (for example, a 15-minute chart for the short-term time frame and 60-minute chart for the medium or intermediate time frame). Through the same calculation, the long-term time frame should be at least four times greater than the intermediate one (so, keeping with the previous example, the 240-minute, or four-hour, chart would round out the three time frequencies).

It is imperative to select the correct time frame when choosing the range of the three periods. Clearly, a long-term trader who holds positions for months will find little use for a 15-minute, 60-minute and 240-minute combination. At the same time, a day trader who holds positions for hours and rarely longer than a day would find little advantage in daily, weekly and monthly arrangements. This is not to say that the long-term trader would not benefit from keeping an eye on the 240-minute chart or the short-term trader from keeping a daily chart in the repertoire, but these should come at the extremes rather than anchoring the entire range.

Long-Term Time Frame

Equipped with the groundwork for describing multiple time frame analysis, it is now time to apply it to the forex market. With this method of studying charts, it is generally the best policy to start with the long-term time frame and work down to the more granular frequencies. By looking at the long-term time frame, the dominant trend is established. It is best to remember the most overused adage in trading for this frequency - "The trend is your friend." (For more on this topic, read [Trading Trend Or Range?](#))

Positions should not be executed on this wide angled chart, but the trades that are taken should be in the same direction as this frequency's trend is heading. This doesn't mean that trades can't be taken against the larger trend, but that those that are will likely have a lower probability of success and the profit target should be smaller than if it was heading in the direction of the overall trend.

In the currency markets, when the long-term time frame has a daily, weekly or monthly periodicity, fundamentals tend to have a significant impact on direction. Therefore, a trader should monitor the major economic trends when following the general trend on this time frame. Whether the primary economic concern is current account deficits, consumer spending, business investment or any other number of influences, these developments should be monitored to better understand the direction in price action. At the same time, such dynamics tend to change infrequently, just as the trend in price on this time frame, so they need only be checked occasionally. (For related reading, see [Fundamental Analysis For Traders.](#))

Another consideration for a higher time frame in this range is the interest rate. Partially a reflection of an economy's health, the interest rate is a basic component in pricing exchange rates. Under most circumstances, capital will flow toward the currency with the higher rate in a pair as this equates to greater returns on investments.

Medium-Term Time Frame

Increasing the granularity of the same chart to the intermediate time frame, smaller moves within the broader trend become visible. This is the most versatile of the three frequencies because a sense of both the short-term and longer term time frames can be obtained from this level. As we said above, the expected holding period for an average trade should define this anchor for the time frame range. In fact, this level should be the most frequently followed chart when planning a trade while the trade is on and as the position nears either its profit target or stop loss. (To learn more, check out [Devising A Medium-Term Forex Trading System.](#))

Short-Term Time Frame

Finally, trades should be executed on the short-term time frame. As the smaller fluctuations in price action become clearer, a trader is better able to pick an attractive entry for a position whose direction has already been defined by the higher frequency charts.

Another consideration for this period is that fundamentals once again hold a heavy influence over price action in these charts, although in a very different way than they do for the higher time frame. Fundamental trends are no longer discernible when charts are below a four-hour frequency. Instead, the short-term time frame will respond with increased volatility to those indicators dubbed market moving. The more granular this lower time frame is, the bigger the reaction to economic indicators will seem. Often, these sharp moves last for a very short time and, as such, are sometimes described as noise. However, a trader will often avoid taking poor trades on these temporary imbalances as they monitor the progression of the other time frames.

Putting It All Together

When all three time frames are combined to evaluate a currency pair, a trader will easily improve the odds of success for a trade, regardless of the other rules applied for a strategy. Performing the top-down analysis encourages trading with the larger trend. This alone lowers risk as there is a higher probability that price action will eventually continue on the longer trend. Applying this theory, the confidence level in a trade should be measured by how the time frames line up. For example, if the larger trend is to the upside but the medium- and short-term trends are heading lower, cautious shorts should be taken with reasonable profit targets and stops. Alternatively, a trader may wait until a bearish wave runs its course on the lower frequency charts and look to go long at a good level when the three time frames line up once again. (To learn more, read [A Top-Down Approach To Investing](#).)

Another clear benefit from incorporating multiple time frames into analyzing trades is the ability to identify support and resistance readings as well as strong entry and exit levels. A trade's chance of success improves when it is followed on a short-term chart because of the ability for a trader to avoid poor entry prices, ill-placed stops, and/or unreasonable targets.

Example

To put this theory into action, we will analyze the EUR/USD.

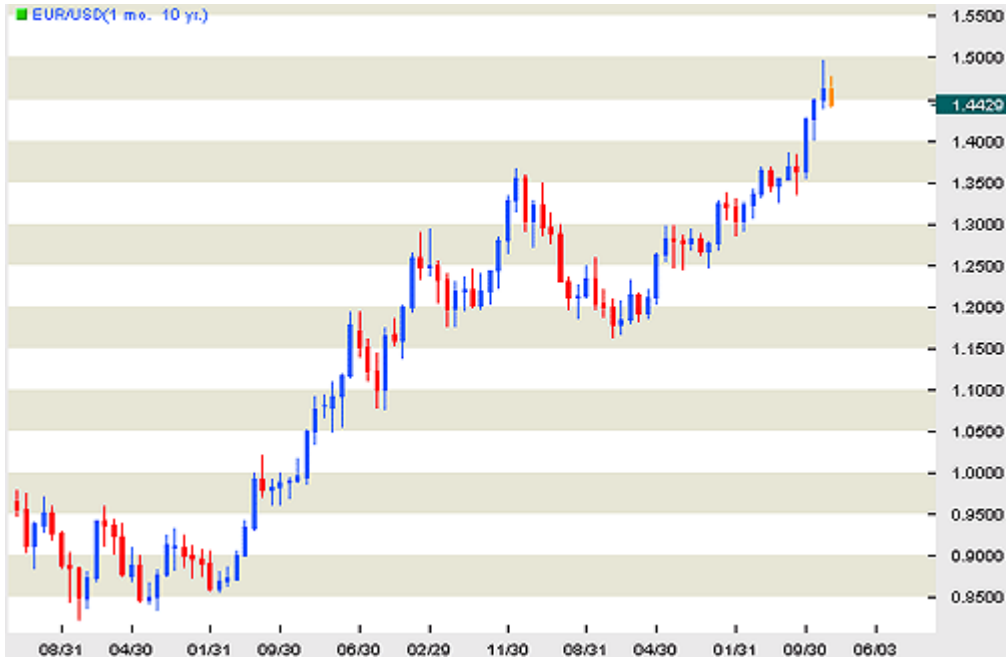


Figure 1: Monthly frequency over a long-term (10-year) time frame.

In Figure 1 a monthly frequency was chosen for the long-term time frame. It is clear from this chart that EUR/USD has been in an uptrend for a number of years. More precisely, the pair has formed a rather consistent rising trendline from a swing low in late 2005. Over a few months, the spot pulled away from this trendline.



Figure 2: A daily frequency over a medium-term time frame (one year).

Moving down to the medium-term time frame, the general uptrend seen in the monthly chart is still identifiable. However, it is now evident that the spot price has broken a different, yet notable, rising trendline on this period and a correction back to the bigger trend may be underway. Taking this into consideration, a trade can be fleshed out. For the best chance at profit, a long position should only be considered when the price pulls back to the trendline on the long-term time frame. Another possible trade is to short the break of this medium-term trendline and set the profit target above the monthly chart's technical level.



Figure 3: A short-term frequency (four hours) over a shorter time frame (40 days).

Depending on what direction we take from the higher period charts, the lower time frame can better frame entry for a short or monitor the decline toward the major trendline. On the four-hour chart shown in Figure 3, a support level at 1.4525 has just recently fallen. Often, former support turns into new resistance (and vice versa) so a short limit entry order can be set just below this technical level and a stop can be placed above 1.4750 to ensure the trade's integrity should spot move up to test the new, short-term falling trend.

Conclusion

Using multiple time frame analysis can drastically improve the odds of making a successful trade. Unfortunately, many traders ignore the usefulness of this technique once they start to find a specialized niche. As we've shown in this article, it may be time for many novice traders to revisit this method because it is a simple way to ensure that a position benefits from the direction of the underlying trend.

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