A Better Understanding of Breakouts

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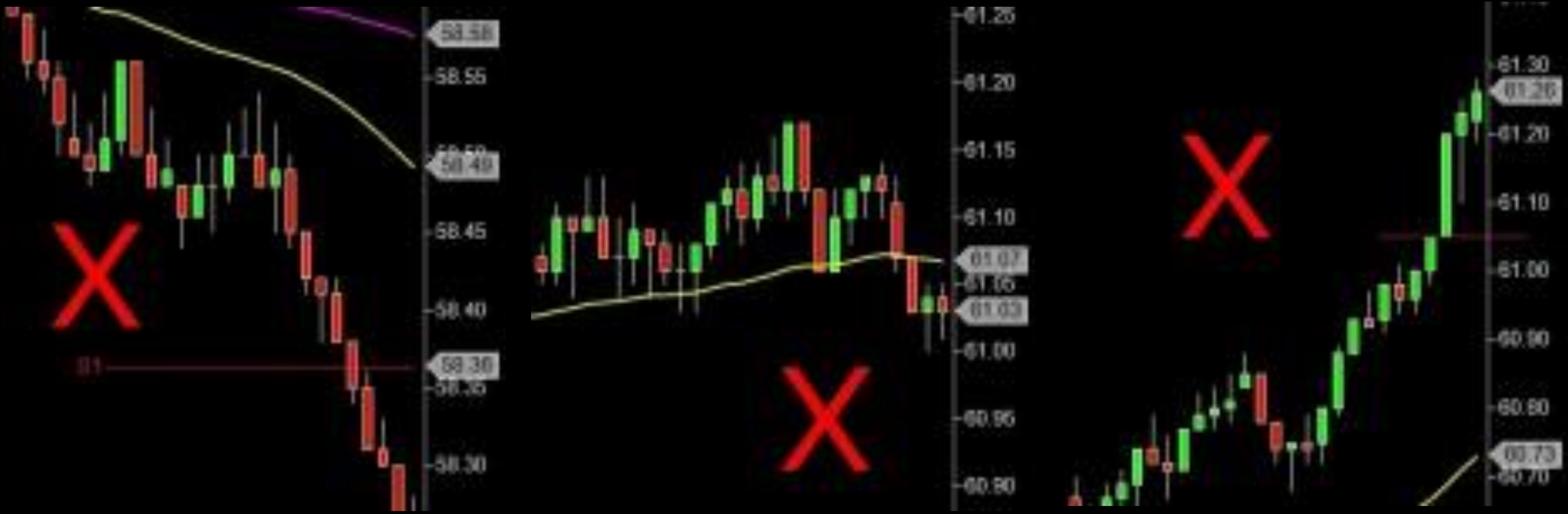
A conversation I recently had with a trader highlighted the need to clarify precisely what a breakout is although I have written a little on breakouts before.

The problem is that there's some degree of confusion about this and probably a reasonable amount of poor information out there that relates to it. Once you have a better understanding of what breakouts really are, you'll see just how useful they can be.

The first point to make is to specify what a breakout isn't. **They're NOT** a move higher or lower beyond a swing that's currently in progress. **They're NOT** a move beyond a pivot point. **They're NOT** a move beyond a moving average. **It's NOT** a move beyond any artificially generated number.


58.58
58.55
58.49
58.45
58.40
58.36
58.35
58.30
61.25
61.20
61.15
61.10
61.07
61.05
61.03
61.00
60.95
60.90
61.30
61.26
61.20
61.10
61.00
60.90
60.80
60.73
60.70

That's not to say that you won't ever see any moves through these types of technical features exhibit breakout behavior - but often it'll be that they coincide with structural features when they do.

Breaks from a structural aspect are where price moves through an area which has already been tested and previously moved away from.

They're generally more significant when the move away from the tested area is clean and fast. The reason for this is that it indicates a greater level of change when the break does happen - and really this is what breakouts are all about.

In reality, it's probably better to redefine the terminology we're using as it may be this that causes the greatest level of confusion.

A level can be taken out and a market can undergo a behavioral change. It's really the latter that I see as what is typically defined as a "breakout". A level being taken out might only mean a continuation of the same behavior.

Of course this is still relevant to a trader, but it hardly constitutes a "breakout" if the market is simply continuing to do what it's been doing already.

However, if you think about a change in behavior then you can see that the market is breaking away. Typically this is when a market goes from some type of balanced movement to imbalance or a range to a trend.

It can happen at a specific price level or it can happen at a structural reference point such as a trendline for example.

The point I made earlier about a breakout not being a move beyond the high or low of the current swing in progress, isn't strictly true.

If you were to reduce the timeframe, i.e. look at the bars under a microscope, you may well see swings within those bars which then are broken on a new high/low.

But the goal isn't to try to capitalize on what the smaller timeframes are doing - **it's to ride the wave of the higher timeframe.**

The reason for this should be clear. It's because directional trading in a timeframe that's higher than the one you execute in will carry the market in your timeframe.

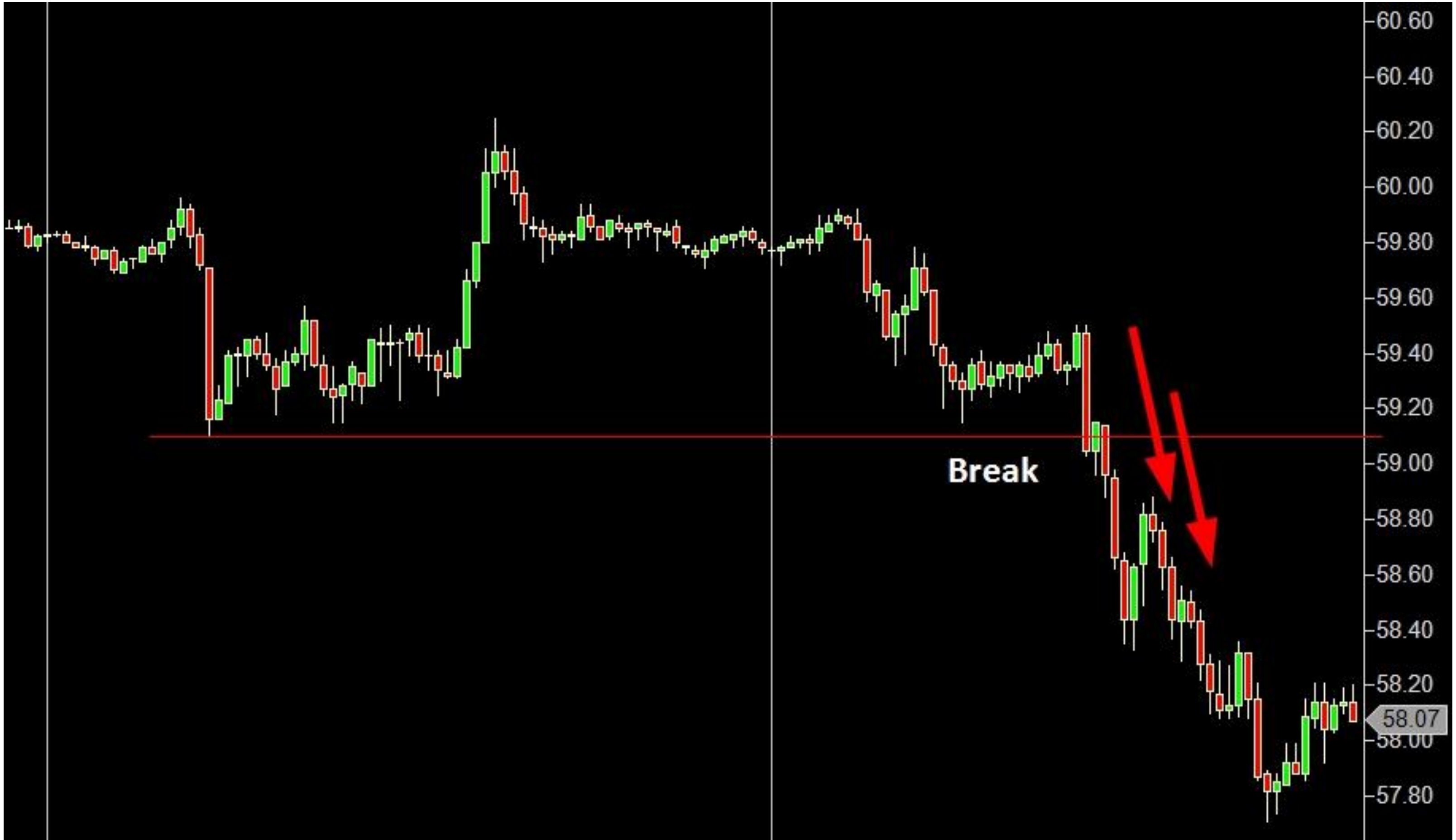
The higher the timeframe, the bigger the moves. Think about it for a moment. The biggest players such as banks and funds, have to look at a higher timeframe. If they didn't, how would they be able to execute the sorts of volume that they do?

They are looking to execute 1000's and 10000's of contracts so to get in and out in the same area would be very difficult in such a short space of time. Recognizing where changes might occur in a higher timeframe is therefor likely to be able to carry your trades if you manage them well.

You have to consider what constitutes an actual change in behavior as markets are elastic to a greater or lesser extent. In terms of a break at a specific price level, a market moving through the level does NOT automatically confirm this. This can signify a break or an extension or simply a breach.

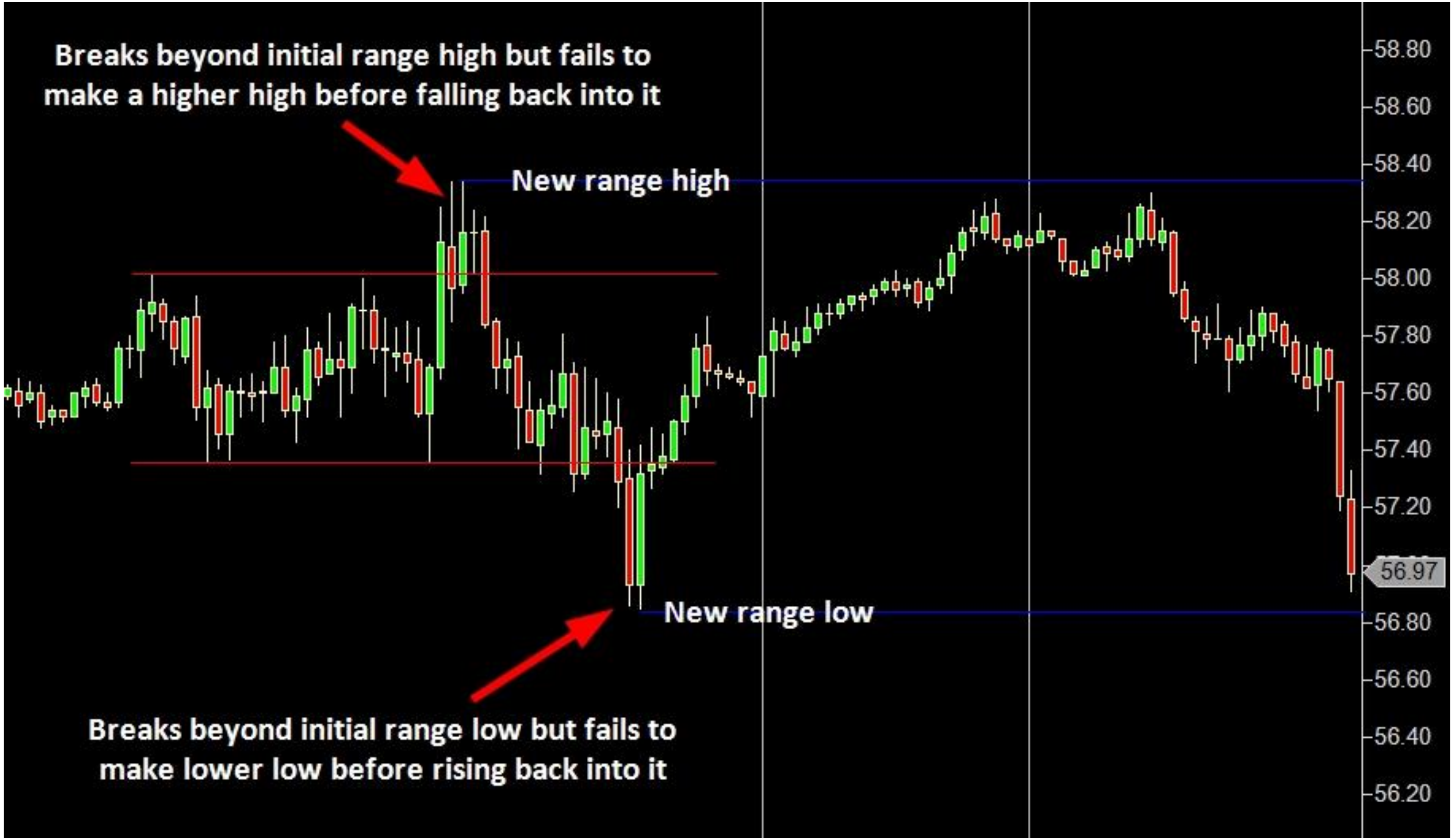
A break is the obvious one. Price moves beyond an area and continues in that direction. Often but not always, a break is accompanied by an immediate retest of the close to or at the break price. When this retest hold, this is where losing positions are covered and new positions are initiated, propelling the market further in the direction of the break.

BREAK


60.60
60.40
60.20
60.00
59.80
59.60
59.40
59.20
59.00
58.80
58.60
58.40
58.20
58.07
58.00
57.80
Break

An extension is where price clears the level by what would be considered a reasonable amount for the product and timeframe you're tracking, only to reverse back and continue with the action that was defining it before the attempted break. The amount it needs to break can be estimated by doing some simple statistical work on the size of rotations for the instrument and timeframe you're looking at.

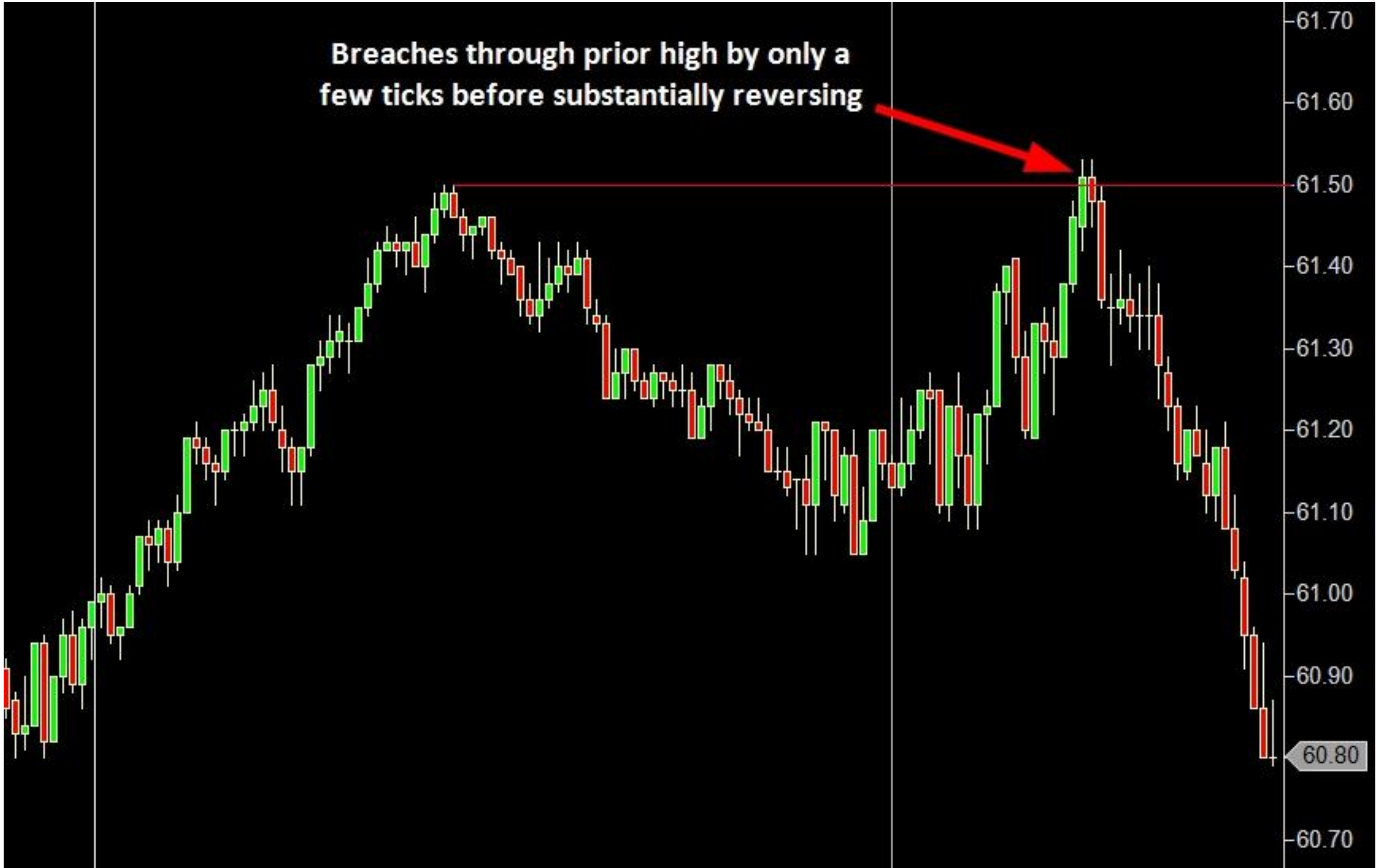
EXTENSION



Breaks beyond initial range high but fails to make a higher high before falling back into it
New range high
New range low
Breaks beyond initial range low but fails to make lower low before rising back into it
58.80
58.60
58.40
58.20
58.00
57.80
57.60
57.40
57.20
56.97
56.80
56.60
56.40
56.20

A breach is similar to an extension in that the range does extend. However, price doesn't extend far enough to warrant the sort of behavior seen on a retest of the break price. There's far less likely to be "pullback" type activity whereby traders are coving or initiating. There's just not enough "room" between the extreme and the initial break price for this to happen

BREACH


Breaches through prior high by only a few ticks before substantially reversing
61.70
61.60
61.50
61.40
61.30
61.20
61.10
61.00
60.90
60.80
60.70

Understanding that it's really a shift in energy and type of movement that causes a real behavioral change, recognizing when and where these shifts are most likely to happen and knowing the types of action that are likely to be seen when these shifts are taking place can really help you to capitalize on potentially excellent opportunities.

So take the time to consider these underlying principles and gain a better understanding of breakouts.

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