4 HOUR BREAKOUT TRADING SYSTEM

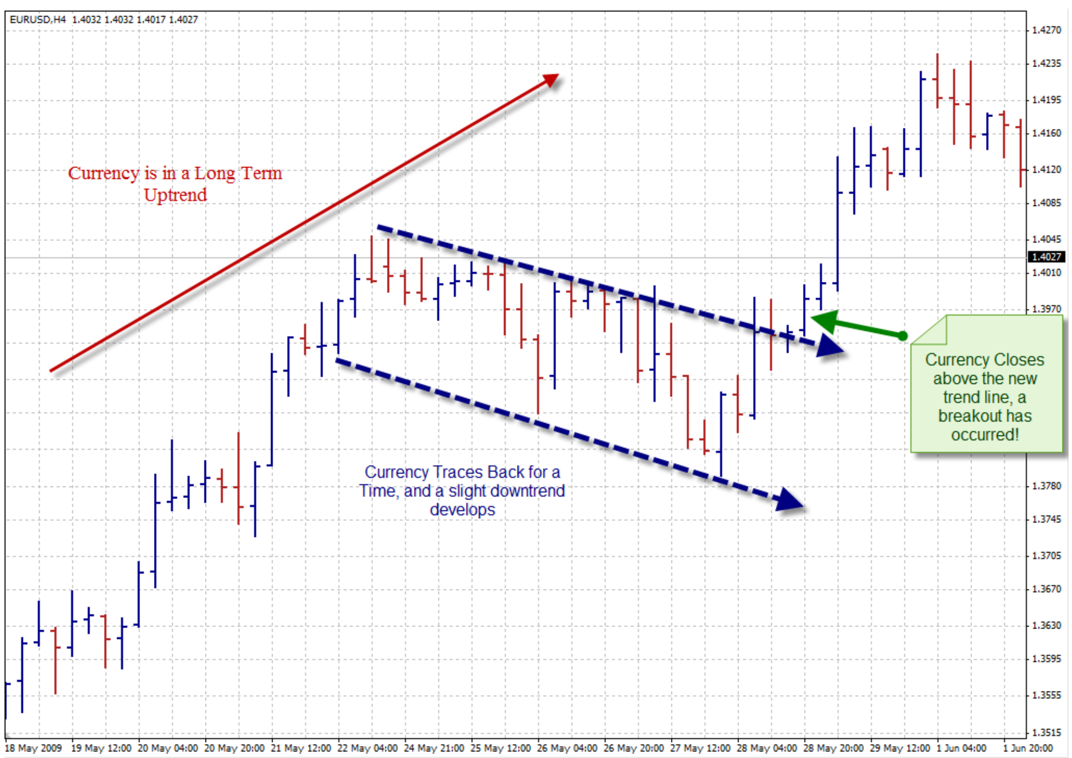
This is one of my main trading methods, and I trade it across multiple currency pairs and usually on the 4 hour charts (it works with longer terms if you can handle the bigger stops).

With this particular system I do suggest you back-test it manually on the charts. I can personally speak for the profitability of this system, but the first thing you need to do is learn it well. Back-testing will allow you to gain experience identifying breakouts and getting to know the right formations for entry signals.

Once you learn this one well, it really can build your profits to an unbelievable level. This system can be used with any currency pair, and is best when traded off of the four hour charts.

System Overview and Chart Setup

We will get to the specifics of this system in a moment. To begin with let's just talk about what a breakout is. Looking at the chart below:



On the four hour chart of the EUR/USD, the currency is in a long term uptrend. This trend has been going on for months (not shown on the chart), and it is a strong trend.

As with any currency though, the pair tends to move in waves. That is, it moves up, retraces slightly, and then moves up again. When we trade breakouts we take advantage of this by entering a trade when the currency breaks out of its current smaller trend.

Using the chart as an example:

1. The currency is in an uptrend. This is a long term trend and it is a strong upwards trend.

2. The currency retraces down for a period of about a week.

3. The currency moves back up, and a bar closes on the upwards side of the new trend line, a breakout has occurred.

4. This is our indication to enter a trade (we'll use more specifics, but you get the point).

There are actually a few ways to determine a breakout, and we will cover two of them as we get into entry signals. For now we just need an idea of what we are going to do and then you need to setup your charts.

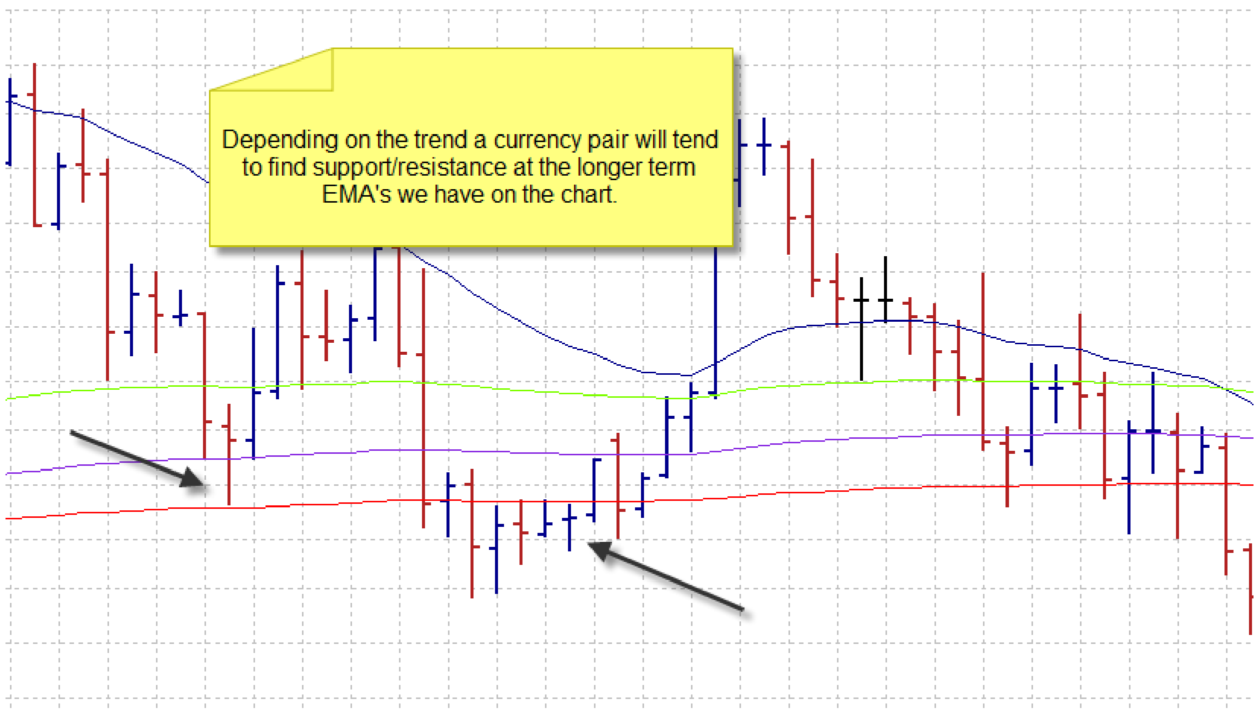
For this system we will use four indicators.

- Exponential Moving Average 30 Period
- Exponential Moving Average 150 Period
- Exponential Moving Average 200 Period
- Exponential Moving Average 365 Period

Be sure to add each indicator with a different color so that you can clear see which EMA you are looking at. Putting these indicators on a chart, your new chart should look something like this:

A quick rundown of which each indicator will be used for:

- EMA 30 – This is our current trend indicator. In a strong trend a currency pair will have a tendency to retrace to the EMA 30 and then bounce off of it.
- EMA 150, EMA 200, EMA 365 – These EMA's help us to find support and resistance levels. Most of the time these are your strong support and resistance levels, and if you look at them on a 4H chart you will see that more times than not a currency pair will bounce when it hits one of these.



Using a breakout system to trade with greatly increases your probability of winning on a trade, and that is the reason why this type of system tends to work so well. There are a couple of reasons why breakouts work.

First, you are trading with the trend. You are always better trading with a long term trend than you are against it. Simply by trading with a strong trend you are likely to win.

Even when we trade the trends though, where we enter the market determines our profit level. It won't do to risk your whole account by using massive stops and hoping that a trend continues (which it quite possibly will). A better way to enter a trade is to find a point at which we can enter, risk less, and still profit.

A breakout point gives us that entry point. Based on prior market behavior we know that when a breakout occurs, the currency pair is very likely to continue on with its trend. This makes breakouts one of the best entry systems you will ever use.

With an idea of what we will be doing, and your charts setup, let's move on to talk about entry signals.

Entry Signals and Stops

With this trading system we will be using two different styles of breakouts to identify our entry points. One is called a trend line breakout and the other is called double tops. Being able to identify both types of breakouts is important to trading with this system.

To give an example of each, let's look at some line charts. It should be noted here, that I do not suggest you trade line charts, ever. They just make it simple to show the example of what the breakout looks like.

Below is an example of a trend line breakout:

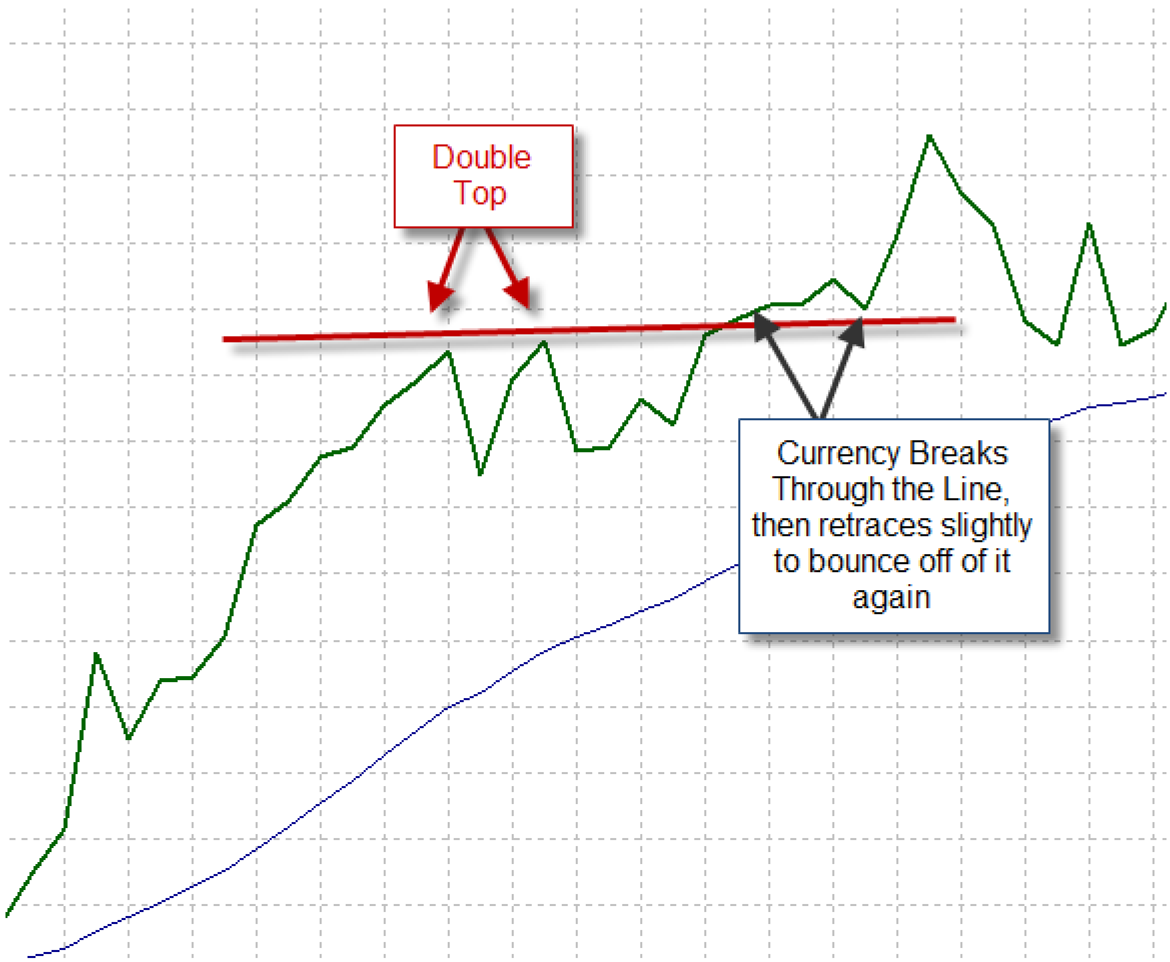
In this example the currency is currently in an uptrend. For a short time, it retraces to create a new downward trend line. After moving down for a time, the currency reverses to follow the trend, and then two important things happen that make this a trend line breakout:

1. The currency crosses back up through the trend line.

2. The currency retraces slightly to touch the trend line again (or almost touches it) and then shoots back up to follow the trend.

This is a good example of a trend line breakout. Being able to identify these is important. If it isn't clear, then fire up a line chart and find some examples like I showed above. Then compare those to identical candle and bar charts until you get good at identifying what a breakout looks like on a chart.

The next type of breakout we will use for entry signals is called a double top. To start with a visual:



With a double top, the new trend line is formed when the currency immediately retraces after hitting a resistance level, not once, but twice. The currency then breaks through the new trend line that develops, retraces a bit and bounces off of it and then continues on its way up.

This type of breakout actually tends to be the strong and more reliable signal. There is one main reason for this.

When we drew the simple trend line on the retracement on the chart above, we are basically charting the current resistance level. When a currency has bounce off a resistance level more than one, that resistance has more validity than if it just bounced off of it once. The line then becomes a strong support line when the currency does break through.

Rules and Entry Signals for Trend Line Breakouts

When we find a trend line breakout, we follow some simple rules to enter the trade. The complete list of steps you need to take before entering a trade using this system and this entry signal include:

1. Open a 4H chart with the currency pair you want to trade.

2. Determine the current trend. Is it in a long term up trend or a down trend?

3. Determine the relation of the currency pair to the 30EMA. You will find that when breakouts occur, the currency pair will tend to be close to the 30 EMA and possibly bouncing off of it.

4. Look for consolidations in the currency. That is support in a downtrend, or resistance in an uptrend.

5. Draw the slight downward trend line on your chart.

6. If the currency has broken through the trend line then we wait for it to retrace before entering the trade.

7. Once the currency retraces and bounces off of your newly drawn trend line that is our entry signal.

8. We enter the trade at the opening of the bar after the currency pair bounces.

9. We set our stop a good distance back of the trend line that we drew (Usually 25 – 50 pips, depending on how fast the market is moving).

10. When the trade moves in our favor the same level as our initial stop we set our stop to the breakeven point.

To add clarity to our rules let's look at an entry signal on a chart.

Using our entry rules and the chart above we get:

- We have determined the currency is in a uptrend.
- The currency hits a resistance level, retraces and we draw a trend line to follow it back down.
- Indicated by #1 – the currency breaks through our newly drawn resistance level and closes above it (the whole bar is above the line).

- The currency then retraces, and bounces off of the trend line (shown by number 2).
- On the next bar after the bounce we enter the trade.
- We set our stop 25 – 30 pips back of the trend line.

Rules and Entry Signals for Double Top Breakouts

Now let's look at an example using double top breakouts for an entry signal. The rules are largely the same, but let's go through them again for clarity.

1. We have determined that the currency is in a current uptrend/downtrend

2. The currency is hovering around the 30 EMA – this tells us that a breakout could occur.

3. The currency has found a support/resistance level and bounce off of it twice – forming a double top.

4. We draw a line across the tops to give ourselves a visual representation of the support/resistance level.

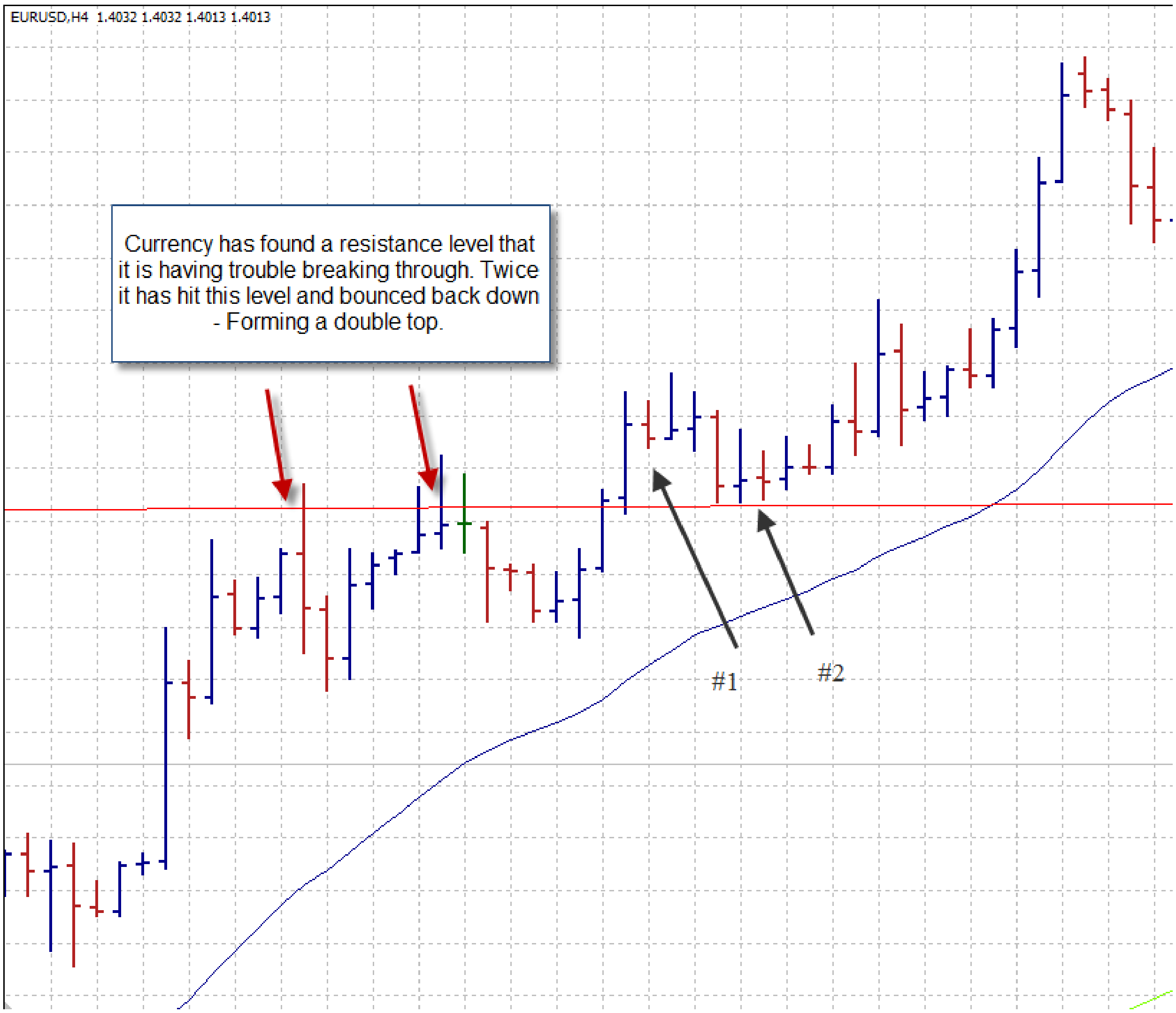
5. The currency breaks through the support / resistance and closes with a bar completely on the other side of the line.

6. The currency retraces again to bounce off of the line, before continuing on with the trend.

7. We enter the trade on the next bar after the bounce.

8. We set our stop 25-50 pips back of the support/resistance to give ourselves some breathing room.

9. When the trade moves in our favor the same amount as our original stop, we set the stop to the breakeven point.



Exit Rules

There are two separate exit systems that you can use with this trading system. There's the easy way, and the take-more-profits method. Let's briefly cover them both.

Exiting the Easy Way

With this system I like to set my take profit levels to twice what the original stop was set to. This ensures two things; first I consistently earn twice my risk level on my winning trades. More importantly though setting a take profit level protects my profits.

Take More Profits by Moving Your Take Profits (and your stop)

As an alternative, when you are monitoring your trades throughout the day, you could move your stop/take profit up each time the trade moved your original risk level (or a predefined level you determine by market volatility). I do not suggest trailing your stop as you won't allow enough room to breathe with the trade, but moving your stop up as you do along isn't a bad idea.

If you use this method and your original stop was set to 50 pips. Your trade would look something like this:

- Entered the trade with a 50 pip stop. Set your initial take profit to 100 pips, this ensures you protect your profits if you can't monitor the trade (or you lose your Internet connection, etc).
- Trade moves in your favor 50 pips
- Move your stop to the breakeven point.
- Move your take profit ahead by 50 pips
- Trade moves in your favor by another 50 pips
- Move your stop by 50 pips to ensure you protect your profits
- Move your take profit ahead by 50 pips again.
- The trade moves in your favor another 50 pips – again you move both levels.
- Repeat this process until you stop out

Using this method of setting your stops can earn you more pips sometimes. It's important that you monitor your trades if you use this method though. If can't actively monitor things at intervals throughout the day, you will be much better off using the simple method to take profits.

More on Stops – Longer Term Trades

The way I have laid out the breakout system for you thus far is basically a shorter term trading system. You always trade off the four hour charts, and with the conservative stops/take profits we are setting the trade will generally close out within a few days. This same system can also be used for much longer term trades.

This is where our other indicators on the charts come into play. Remember we added the EMA 150, the EMA 200, and the EMA 365. These do indicate long term support/resistance levels, but they can also be used to set stops for much longer term trades.

Take a moment to look back at the chart I showed as an example for double tops entry points. If I had taken this trade, using the rules I set out for you in that section I would have used a 50 pip stop, and I would have squeezed 100 pips out of the market in about 3 days.

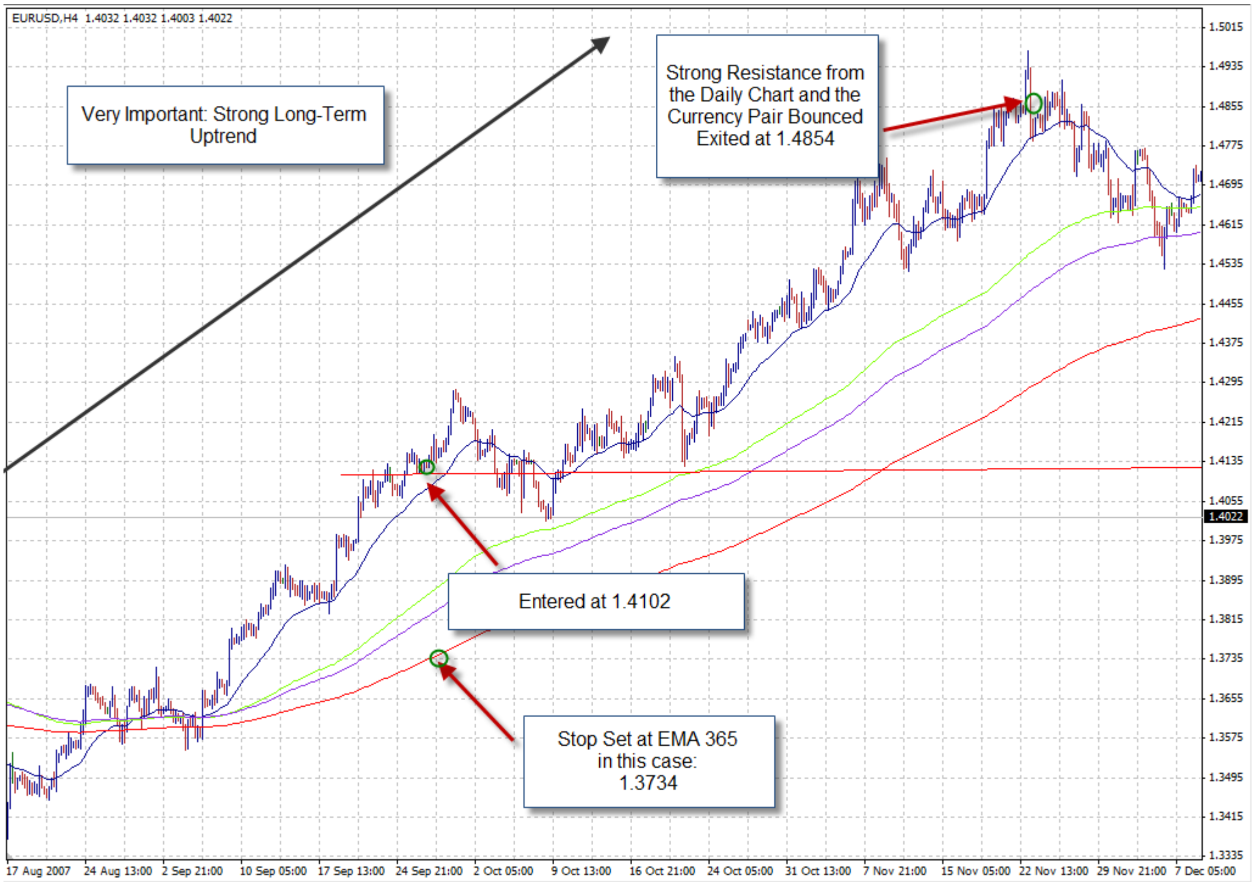
There is another way to make this trade though, and we use the same entry rules. We just set our stops/take profits differently.

Using the same example that I showed you in the previous section, let's look at a different way to set our stops and to run our trades longer.

Looking at the chart on the next page, the trade is laid out for you. This is an actual trade that I made, and that I held onto for close to 2 months. It was traded off the 4-hour chart, and the result was a 752 pip profit on a 4 lot trade.

The steps I took to make the trade are basically the same as in our double top example:

- Looked at the chart to determine the current trend – an uptrend in this case.
- Found a double top entry point where the currency pair had broken through the new trend line and had begun to retrace.
- Waited until the pair retraced to my trend line and then bounced.
- Enter the trade with four lots on the bar after the bounce.



Basically my entry signals were the same; using this method though we need a couple of more steps. I also took the time to:

1. Look back on the chart to ensure that this uptrend is a long term trend and that I'm not planning a 1-3 month trade on a trend that has only been developed for a few days. In this case the uptrend had been strong for close to a month.
2. Checked the daily charts to ensure no major resistance levels were about to be hit over the longer term.

I also need some different exit rules. Since I am using a huge stop and risking a lot on a trade like this. Instead of setting a take profit I usually trail my stop. I also watch the daily charts to ensure that I'm not about to hit a major resistance/support level. If that does occur, and the currency bounces, which it did in this case – I close the trade and take my profits.

Some Important Notes about Using the Breakout System This Way

Before we move on to trade examples, there are a few important notes I want to make about taking longer term trades like this.

First, I do not suggest this for newer traders. The rewards are sometimes greater with this type of trade, but then so are the risks. On that trade I used a 368 pip stop, and had it gone against me it could have incurred a large loss. Since most new traders don't have a float to feasibly manage this amount of risk and still follow a money management system, it should be avoided.

You can profit just as much by making multiple smaller trades over multiple currency pairs (which I do as well as the longer term trades).

The next important thing to note is that when your account is to the level where you can manage this type of risk, you shouldn't limit yourself to just the longer term trades.

While I held my longer term trade, I also found 4 more entry points with the same currency pair and made those trades over the shorter term. 3 of those trades ended up winning and one lost, but they helped me to pull extra 250 pips from the market while I was holding my longer term trade.

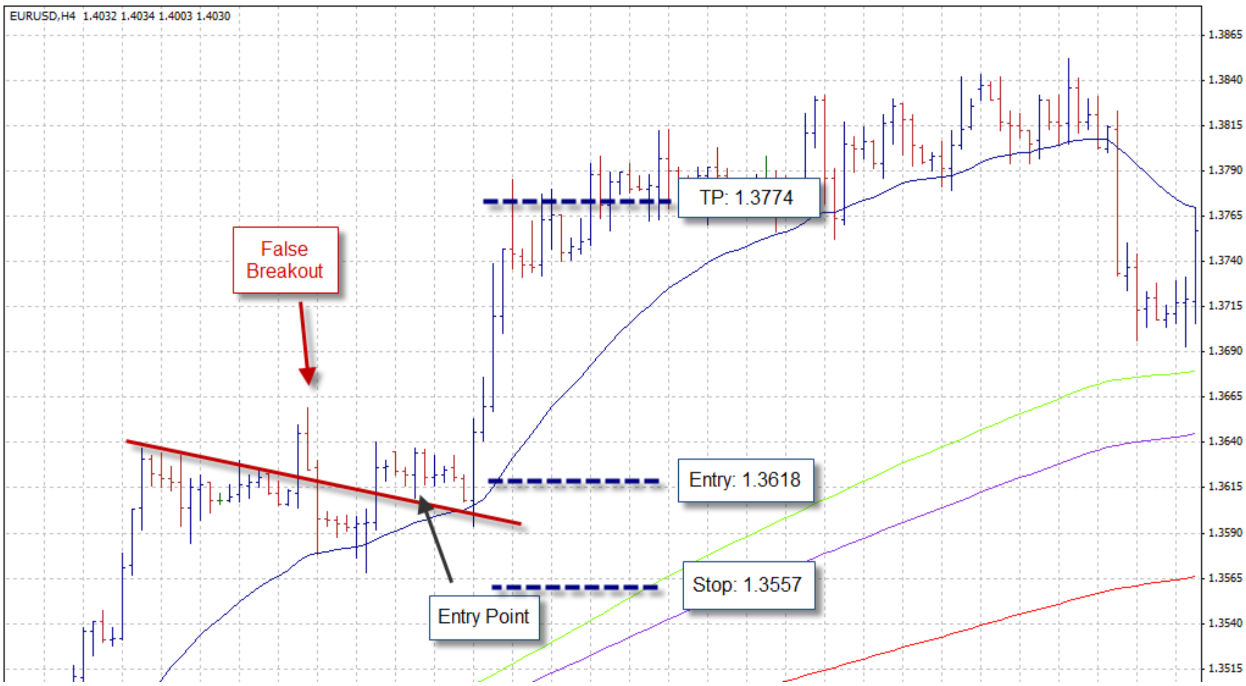
With that out of the way let's cover some trade examples. I won't be covering the longer term trades in the examples as I don't suggest it for anyone but experienced traders.

Trade Examples

With the system all laid out for you, let's cover some trade examples to help add clarity to what you've learned so far. Since most of the examples I have used in this chapter so far are for uptrend's, we will cover one example trade for an uptrend, and then cover a couple to show how to make a trade in a down trend.

Long Trade Example

Let's start out with a long trade example. This trade is a trade I made with the EUR/USD currency pair at the beginning of July.



The currency pair was in an up trend, and it is near the EMA 30. Actually in this case it was bouncing off of it.

The currency pair had retraced for a time, so I drew my trend line. The pair then broke through the line. The first time though it was a false breakout. Instead of retracing and bouncing off the trend line, it retraced right through it and bounced off the EMA 30.

A couple of days later though, I did get an entry signal with this same setup. The currency pair had broken through and close above the line, and this time it did retrace and bounce of the trend line.

I entered this trade at 1.3618. My initial stop was set 50 pips back of the trend line. In this case my stop was 1.3557. My risk level for this trade is then 1.3618 – 1.3557 = 61 pips.

My goal with these types of trades is always to make double what I risk, so I set my take profit at 122 pips ahead, or 1.3774.

Near the end of the day following my entry into this trade, I hit my take profit level and I exited the trade with a health 122 pip profit!

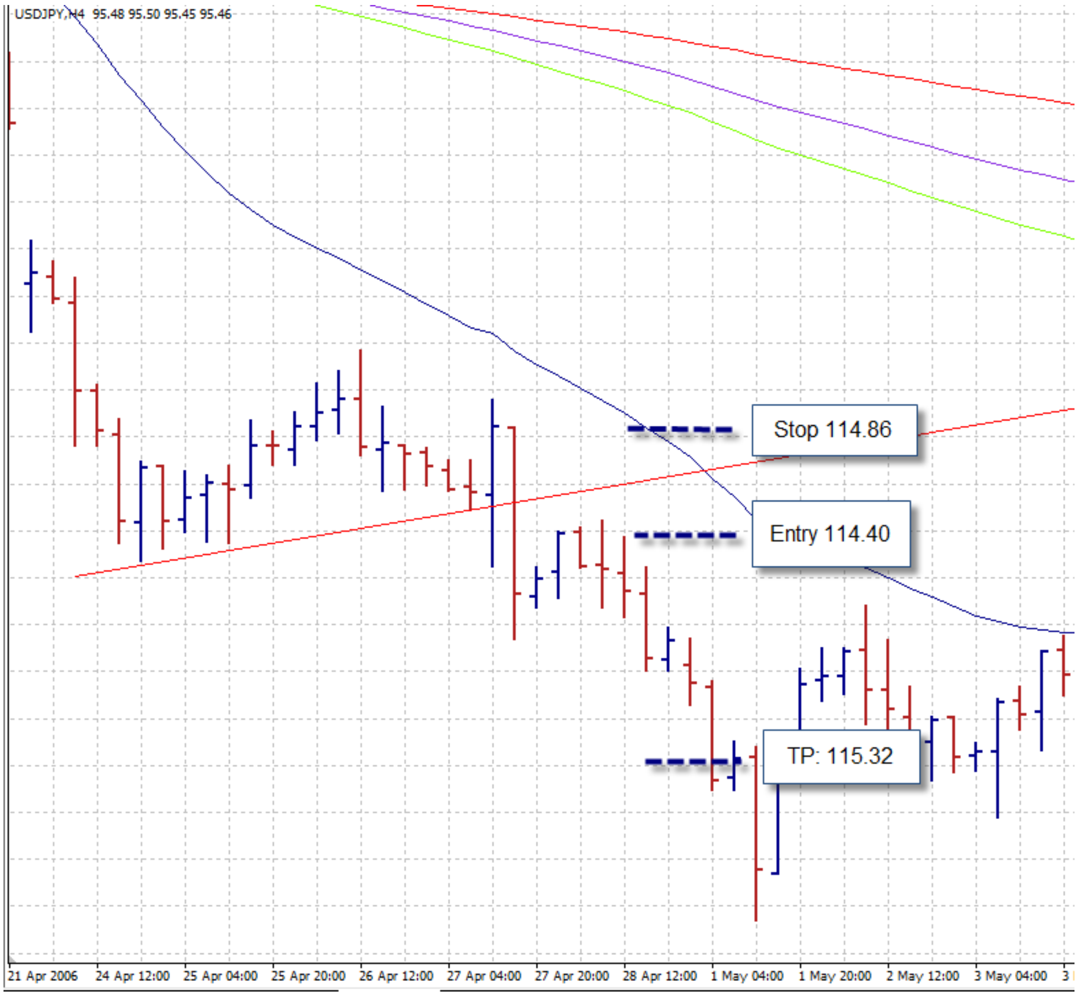
Short Trade Examples

When making short trades, all of the rules we have laid out for you thus far are the same, everything's just upside down. Looking at the example trade on the next page, this is a USD/JPY trade that I made back in April.

Looking at the chart, we have:

- The currency pair is currently in a down trend.
- The price point is near the EMA 50, and has actually been hovering below it for a few days now.
- The price has traced back up for a time so I draw my new trend line.
- The currency pair broke through my trend line and close with a full bar on the other side of it.
- The currency then retraced a bit, almost hitting the trend line, and then bounced to follow the downward trend again.

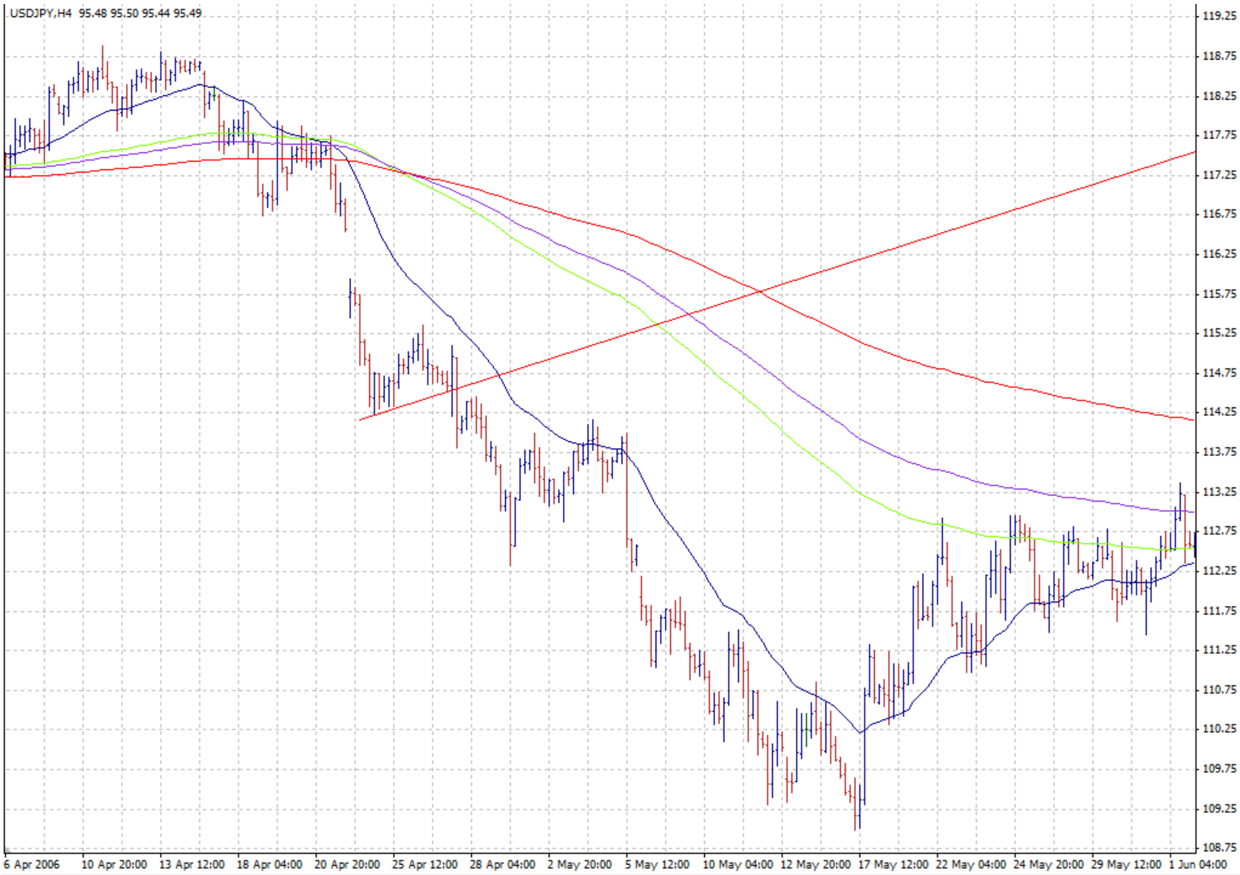
The results of this trade are laid our below.



- Entered trade on the bar after the bounce at 114.40.
- Initial stop set 25 pips behind the trend line at 114.86
- Initial risk is 46 pips, so I set my take profit at 2 x that level, or 115.32
- I hit my take profit level about 28 hours later for a profit of 92 pips.

One quick note on this one: For this trade the main reason I used a 25 pip stop instead of setting back 50 points from the trend line for a couple of reasons. First, the downtrend was really only a few days old. Secondly, it almost looked like the currency was about to start trading sideways. This was a judgment call, the trade signal was valid so I took the trade, but because of those two factors I used a smaller stop and a smaller take profit.

Zooming out a bit and looking at the whole chart, I could have used a 50 pip stop and ended up with a larger profit if I had held the trade for a about a week:

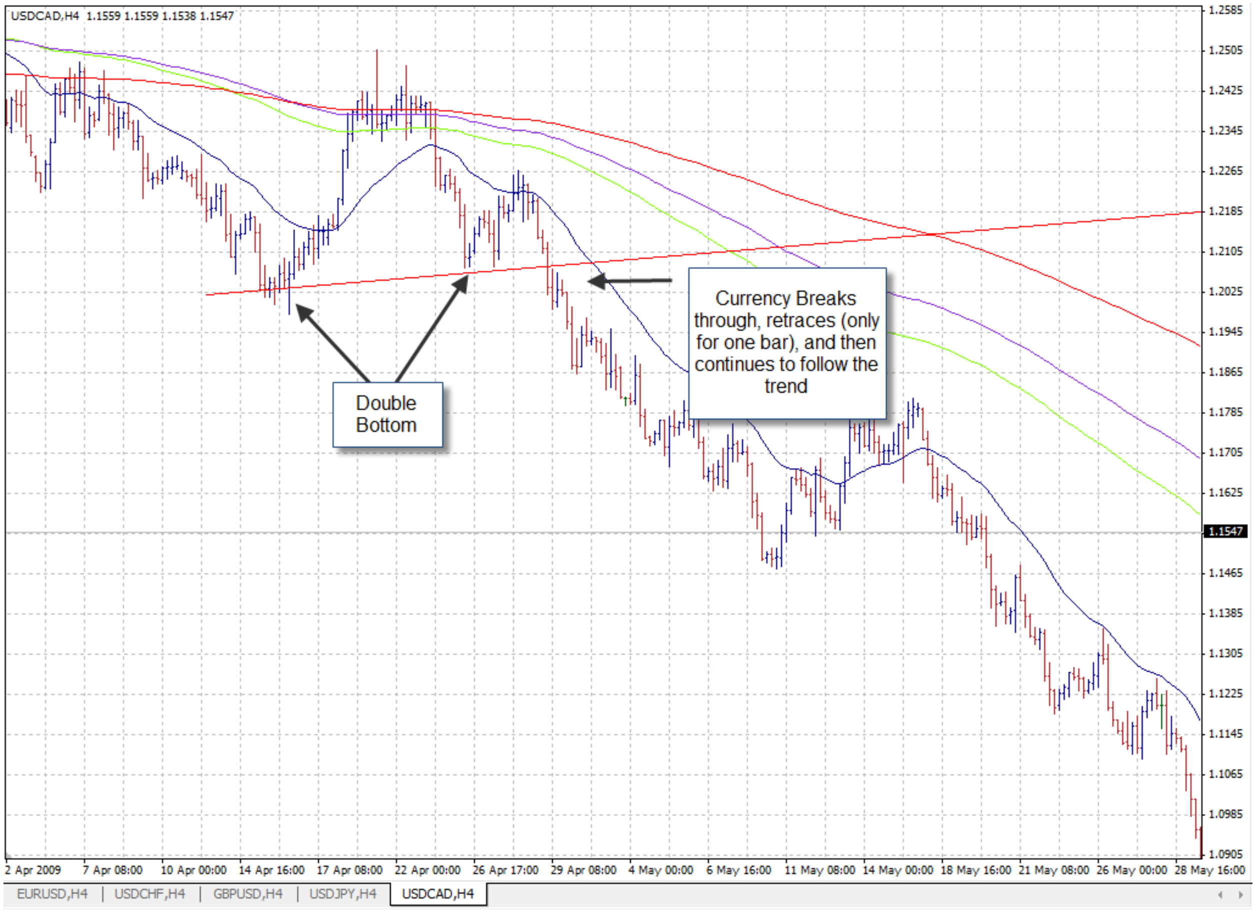


These types of judgment calls are really ones that you will have to make for yourself. My smaller stop with this trade fit well with the market conditions, and even though I could have squeezed another 40 – 50 pips with a larger stop, I was happy with the result.

Let's look at another example. This time let's use a double bottom (opposite of a double top). As shown on the chart on the next page a double bottom looks like the double top, only upside down.

The currency pair has hit a support level and bounced, not once, but twice – forming a solid double bottom.

The following is an example of an actual trade that I made with the USD/CAD pair in April. This was a hugely profitable trade, but I choose this example for another reason. I want to point out a few things.

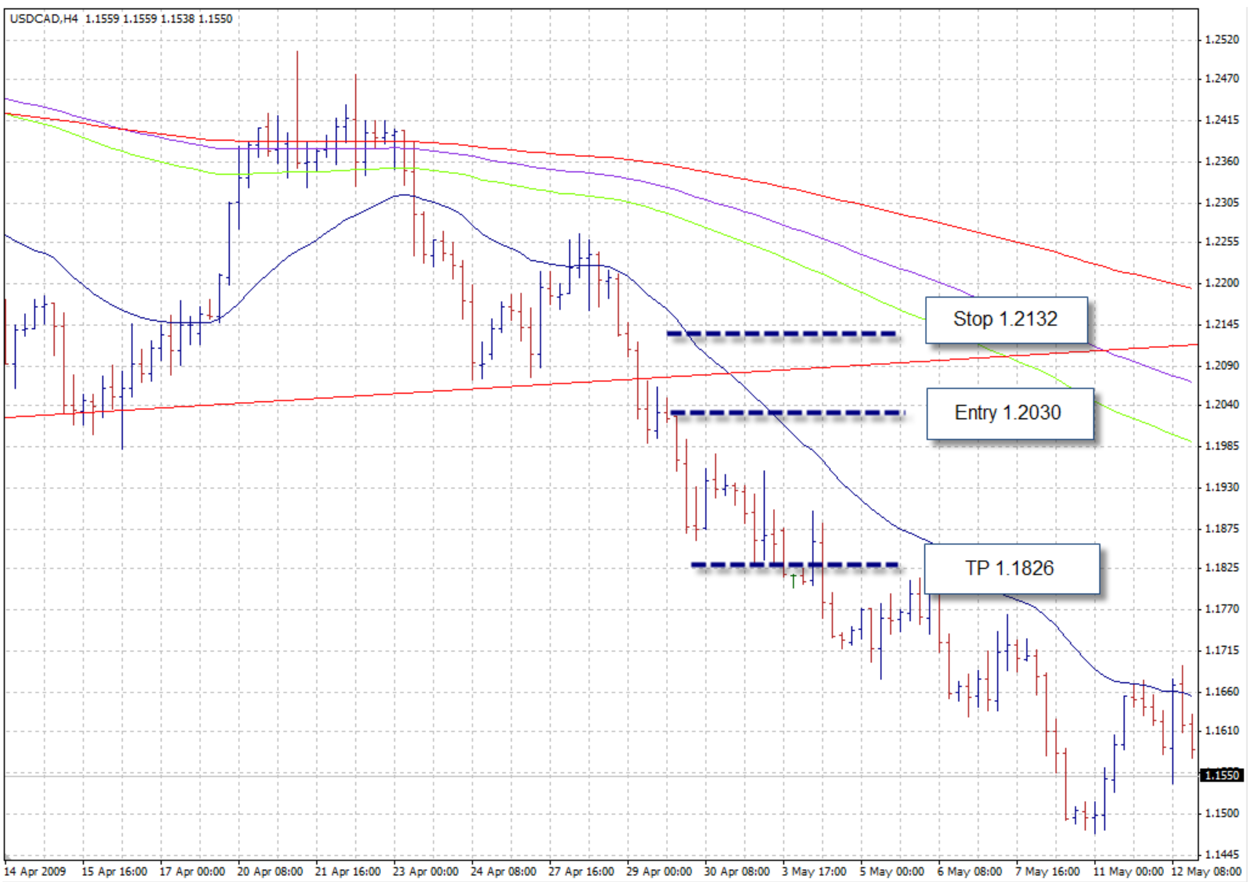


If you look at the chart above, after the currency pair broke through the currency did retrace to touch almost touch the trend line, but it only shows as one bar. Sometimes zooming into a short time frame gives us a clearer view:

Looking at the 30 minute chart at the moment the currency broke through the trend line, we get a clearer picture that it actually did retrace to touch the trend line, and then continue on its downward trend.

It can sometimes be difficult to see the retracement on the four hour charts. Looking at a 1 hour or 30 min chart will give you a closer view.

Lets' take a closer look at how this trade turned out:



The currency pair is currently in a downtrend, and a double bottom has formed. I draw my support line across the double bottom, and then the currency breaks through. It retraces for a short time, and then continues on its downward trend. I enter on the bar after the retracement, so in this case I enter short at 1.2030.

With this trade, I know that this particular currency pair is given to strong trends. I set my stop 50 pips back of the support line, which has now become the resistance, for an initial stop of 1.2132.

This means my risk when I enter the trade is 1.2132 - 1.2030 = 102 pips. I set a take profit at twice that level for an initial TP of 1.1826.

With this trade I could have let it run until it hit my take profit and earned 204 pips.

As I already said though, I know that this currency pair is given to strong trends. That is when it's in a downtrend it will stay trending down for months. It will then reverses and trend up for months. So for this trade I monitored it over a period of time and moved my stops and take profits as it moved forward.

I managed to move my stop twice before I hit my twice moved take profit at 408 pips ahead. It moved quickly once and I missed the move, or I could have squeezed even more out of this trade.