What Causes Consolidations And Retracements To Form?
Introduction

I think it's fair to say that most forex traders don't really spend that much time studying consolidations and retracements, mainly due to the belief that they're simply just things which happen during a trend. In my opinion this is a mistake, because whilst consolidations and retracements may not seem like the most interesting or informative things to study, they can actually give you a lot of really useful information about the market, provided you have an understanding of how and why they form.

Because most forex traders don't currently have this understanding, I thought that it would be a good idea for me to write a book explaining their formation in more detail, so you can have access to the information they provide about the market.

I'll start off by giving you a small introduction as to how and why the market moves (some of you will already know this,) and then I'll move on to showing you how retracements and consolidations form, so you can see how they affect and influence the price movement we see on our charts.

In the last section, I'll show you how you can start using this information to not only figure out which technical levels are likely to cause a consolidation or retracement to form, but also show you how to determine when a large reversal - consolidation or retracement is likely to take place, by analyzing the size of the movements you see on two different timeframes.

Let start off by taking a look at what really causes the market to move.
What Really Causes The Market To Move ?

It may surprise you to know that most of the movement which takes place in the market occurs as a result of traders closing losing trades, not from placing trades in an attempt to make money, as is commonly assumed by most forex traders.

The reason most of the movement is caused by traders closing losing trades, is because the forex market is a zero sum game. A zero sum game is a name used to described an activity (in this case trading) where the profits of the game are determined entirely by the other players participating in the game. For example, a popular zero sum game you may have played before is poker.

The only way to win in a game of poker is to take all the money off the opposing players. The amount of money you can potentially make in a game, is determined solely by the amount the other players have decided to play with.

The forex market works in exactly same way ! The amount of money you can make each day trading forex, is limited by the size and number of people who decide to place a trade. If every forex trader in the world got up tomorrow and decided not to place a trade, it would be impossible for us or anyone else to make money, as no one has put any money at risk by getting a trade placed - this brings us onto a really important point.

The only time there is an opportunity to make money in the market is after people have decided to get trades placed. The more people who open trades, the larger the amount of money there is to be made by making them lose.

Of course, the question now is how do you actually make traders lose money on their trades ? The answer is you don't, or I should say you can't. You see us retail traders do not trade at a level where we can affect the market price, so it's not possible for us to make the market move against traders who have got trades placed to make them lose money.

The only people who do are the bank traders, as the size of the trades they can place into the market are much bigger than ours, and thus can easily cause the price move up and down. Because the bank traders can only make money by making other traders lose money, it means studying how they manipulate the market to make others lose, can give you a better understanding of how and when reversals - retracements and consolidations are likely to take place.

When it comes to actually manipulating the market, the goal of the bank traders has always been the same. They want to mislead as many traders as possible into thinking the market is going to move in one direction, and then as soon a large number have started to get trades open, make the market move in the opposite direction by getting trades of their own placed.
The banks know that once they place their own trades, the market will move against the traders, forcing many of them to close their trades at a loss. The orders that enter the market as result of this, will push the price further in the direction the banks have got their trades placed, causing their profits to increase, whilst simultaneously causing even more traders to close their trades at a loss.

This process of manipulating the market to purposely make traders lose money is something which takes place every single day. Luckily, it's something which you can easily spot occurring, because when the bank traders manipulate the market it always results in one of two different market structures forming.

What are these structures you ask? Retracements and consolidations!

**Retracements And Consolidations**

Retracements and consolidations are two of the most common structures you see form in the market. They can be found forming during every up and down swing, and every swing itself is part of either a consolidation or retracement on a higher timescale.

Most people think that retracements and consolidations are simply just things which happen during a trend, but they are actually structures created by the bank traders taking profits off their trades, as a means to make traders place trades in the opposite direction to which they want the market to move in.

Even though both consolidations and retracements are created by same action (the banks taking profits off their trades), the way in which they cause people to place trades is slightly different, due to the way they're constructed. A retracement pushes the market against the current trend, causing people to place trades because they think a reversal is taking place. A consolidation causes the market to move sideways, instead of allowing it to continue moving in the direction of the trend, misleading traders into placing trades under the impression a reversal is taking place.

So despite the fact they both cause the market to do completely different things, you can see that retracements and consolidation actually have the same effect upon traders when they form. Though they have the same effect, the points where the traders get their trades placed during the time each structure is forming is different.

Knowing where these points are is important, because the only way to gauge when a consolidation or retracement is likely to take place in the market, is by having an idea of when the traders who got trades placed during the previous consolidation or retracement closed their trades at a loss.
In this next section, I'm going give you a step by step walk-through of how retracements and consolidations form in the market, so you can see where retail traders get their trades placed during the time each respective structure is forming, and where they close their trades at a loss, to give you an idea of when and where the next consolidation or retracement is going to form.

We'll start by looking at how retracements form, because they're slightly easier to understand than consolidations.

**How Do Retracements Form?**

I'm going to show you an example now of how a retracement formed on the 1 hour chart of EUR/USD. Even though this retracement formed on the 1 hour chart, the process which created it is exactly the same as the process which causes all other retracements to form.

The only difference between the retracement you see here and other retracements in the market, is the way this retracement is constructed is slightly different to the way other retracements are constructed. This will be the case with all retracements you see forming.

They won't all look the same or have the same features, but the overall process which causes them to they form will be the same, regardless of where they form in the market or which timeframe they form on.

In the image above you can see a retracement that formed during a downswing on EUR/USD.
This retracement, like all other retracements, formed in the market as a result of the bank traders taking profits off their trades. When the banks take their profits off, it causes the market to move up against the previous move down. This move up makes most of the traders who had placed sell trades during the latter portion of the move down (marked with a blue box), close their trades at a loss.

Closing a losing sell trade requires you to use to use a buy order, so when the traders close their losing trades, lots of buy orders enter the market and the price rises.

As the price moves higher, an increasing number of people start to believe the retracement is in fact a reversal, and begin getting buy trades placed to try to capture what they assume is going to be a continued move higher.

Eventually the price has risen to a point where a large number of traders have got buy trades open. This is the point where the bank traders will come into the market and get more sell trades placed. The reason why, is because they've now got a big group of traders who they know they can make money off by making the market fall.

They know that when they place their sell trades it'll make the market fall slightly, and that'll cause the traders who went long to panic and begin closing their trades at a loss, making the price fall further and causing the profits on the sell trades they've got placed to rise.
If you look at this image, you can see how the down-move develops as more and more traders start closing their losing buy trades.

When the bank traders have got all of their sell trades placed, it only causes a small drop to occur, but this small drop is enough to make a number of traders who were long close their trades at a loss. When they close their trades, sell orders enter the market and make the price fall further.

This causes even more long traders to close their trades, because it not only increases the size of the loss on any buy trades traders are still holding open, but also causes anyone who might have had a buy trade open at a profit to go into a loss on their trade.
It comes to a point where so many traders have closed their long trades at a loss, that it's caused the market to drop below the low of the retracement. By the time it's dropped this far, most of the traders who went long during the retracement have closed their trades at a loss. You don't know this for sure, but it's safe to assume so, due to how far away the market now is from the points where most of them would've got their buy trades placed.
If you look at the image again, you can see I've marked the point where most of the traders would've got their trades buy placed with a box.

You'll notice that the box encompasses the range of the last big bullish candle which formed before the retracement terminated. The reason why most of the traders would have got their buy trades placed here, is because of something called the fear of missing out.

**The Fear Of Missing Out**

The fear of missing out is a thought process which takes place when a person (or trader in our case), believes they are missing out on something by not taking an action. In our example, the fear is missing out on potential profits by not getting buy trades placed.

When common retail traders see the market moving at a rapid pace, (which it does when large candles are forming) they feel compelled to enter trading positions, because the rapid pace of the move makes them think the market is going to continue moving in that direction indefinitely, and that by not getting trades placed they're missing out on a large amount of profit.

So when the large bullish candle I marked in the image was forming, most common retail traders entered buy trades under the impression the market was likely to continue moving higher. More entered during the time this candle was forming, than when other large bullish candles formed during the retracement, because the retracement itself had caused the market to move higher by this point, thus making more people think the market was reversing anyway.

If you want to find out where the majority of traders got their trades placed during a retracement, all you need to do is look for either the last candle with a wick on which formed before the retracement came to an end, or the last large bullish candle (or bearish candle for retracements that form during an uptrend) that formed before the retracement terminated.
By the time the market has reached the low of the retracement, it's moved 150 pips away from the point where you now know most of the traders would've got their buy trades placed.

The fact that it's moved so far away, means it's highly unlikely most of them are still holding their losing buy trades open. The reason why is because the majority of retail traders will have closed their losing trades once the market has moved 100 pips against them. It only takes one look at Oanda's order book to confirm this to be true.
If you look at the open positions graph above, you can see I've marked a black dot on the traders who entered short trades around the 1.0850 - 1.0870 level.

Currently you can see these short traders only make up around 1% of the traders on Oanda. Originally this wouldn't have been the case, and more than 2% would have opened short trades when the market first reached this price. The reason it's declined from 2% - 1%, is because the market has since moved further and further away from the point where these trades got their short trades placed.

The further away the market moves, the bigger their loss becomes, so by the time it's moved 150 pips away from them, most of the traders have closed their trades, as they just can't handle their loss getting any bigger than what it already is.

The point when the majority of the traders have closed their losing trades, is the point when the bank traders will start taking profits off their own trades.

Taking profits off a sell trade requires there to be sell orders entering the market. The problem is, the majority of the sell orders which were coming into the market from traders closing losing trades aren't there anymore by the time the market has reached the low of the retracement. So where do the sell orders required for the bank traders to take profits come from?

The answer is from traders placing new sell trades.

When the downmove first begins, very few people are interested in getting short trades placed, as it still looks like the market has the potential to reverse and continue moving higher.
As the market falls further, more and more traders start entering short trades, because it looks increasingly unlikely the market is actually going to end up reversing.

By the time it's broken beyond the swing low created by the retracement, most of the traders in the market are getting short trades placed, which means the bank traders will now start taking a large amount of profit off their own short trades. They would've been taking small profits off their trades during the whole move down, but it's only after a large number of traders have opened short trades that they are able to take a much larger amount off.

Eventually their profit taking causes another retracement to occur, and the same process outlined over the last few pages ends up repeating itself all over again.
Sometimes this won't be the case, and instead of seeing another retracement form you'll see a consolidation or reversal take place. You're not going to know for sure which of these structures is going to form, but what you will know is that if a reversal is going to occur, a pattern like the one I talk about in my reversals book is likely to form before the market reverses.

Summary

Here are the main points I want you to take away from this chapter.

- All retracements in the market, no matter how big they are, form via the process described in this section taking place. Retracements that form during uptrends also form in the same way, only the entire process is reversed, i.e the retracement causes people to place sell trades instead of buys, and the bank traders get buy trades placed instead of sell trades.

- To find out where the majority of traders got their trades placed during a retracement, just look for the last candlestick which had a decent sized wick on it before the retracement came to an end, or the last big bearish (or bullish if it's a retracement in an uptrend) candle that formed before the retracement terminated.

- If the market has moved 150 pips away from the point where the majority of traders got their trades placed during a retracement, it's likely that very few of them are still holding trades open, and you should expect to see a retracement occur sometime soon, as the bank traders will begin taking profits off their trades once more people have re-entered the market.
How Do Consolidations Form?

Now that you have a bit of an idea as to how retracements form in the market, I want to move on and show you how consolidations are created, so you can see where the bank traders get their trades placed to cause them to form, and where the retail traders start closing their trades at a loss.

In the image above you can see a consolidation which formed during an up-move on EUR/USD.

This consolidation was created by the bank traders taking some profits off the buy trades they managed to get placed earlier on in the move up. When they take profits, it causes the market to move against the traders who had got buy trades placed at the end of the previous move higher.

Just like retracements, the market moving against the traders forces some of them to close their trades at a loss, which because they got buy trades placed means they unwillingly put sell orders into the market.

These sell orders start to push the market down, but instead of letting it drop like they do during retracements, the bank traders decide to enter the market and get more of their buy trades placed.
When they place their trades, it causes the market to rise again, which misleads many traders into placing buy trades because they think the rise is a sign the previous move higher is now going to continue. The bank traders use the buy orders which come into the market as a result of this, to take more profits off their own buy trades. This causes the market to drop again, and gives them more sell orders to use to get additional buy trades placed.
This process of placing trades and taking profits repeats itself, until it reaches a point where the bank traders have been able to take the required amount of profit off their trades, and get the necessary number of buy trades placed. Now they can make the market reverse and make a profit off their newly placed buy trades.

When the market reaches the point where the of the high consolidation have formed, most of the traders who have gone short have not yet closed their trades at a loss. The reason they haven't closed them, is because they still believe the market is going to continue consolidating.

Every up-move to the highs which has taken place up to this point, has resulted in the price falling due to the bank traders taking profits. The short traders have no reason to suspect that this final up-move is going to be any different, so they willingly hold their trades open under the impression another move down is going to take place.

**Important Note:**

The points where most traders get their trades placed during consolidations, is around the swing highs or swing lows of the consolidation itself.

Because the consolidation in our example formed during an up-move, it means most of the traders holding short trades open got their trades placed at the swing lows. If it had formed during a down-move, most of the traders holding buy trades open would've got their trades placed around the swing highs.
When the market breaks though the highs, it causes a large number of the traders holding losing short trades open to close their trades, as they see the highs being broken as confirmation the consolidation is now over.

When the market has moved 60 pips away from the point where the traders got their sell trades placed (the lows of the consolidation), it's fair to assume that most of them have closed out their trades.

The reason why, is because Oanda's Open Position's Graph shows that most of the traders who place trades during consolidations, will have closed their trades by the time the market has moved 60 pips away from the points where they entered their trades.
The image above shows what the open positions graph looked like just before a consolidation came to an end on USD/JPY.

If you look, you can see that at the time this image was taken over 2% of traders were in losing short trades from around the 113.200 level. These traders got their sell trades placed two hours before this image was taken, when the market dropped slightly around 03:00 am.

They thought the drop was a signal the market was about to reverse to the downside, so entered sell trades in an attempt to make money from the fall.
Here's an image of what the Open Positions Graph looked like 6 hours after the previous image was taken, and 8 hours after the traders had placed their sell trades due to the fall.

You can see that the number of traders who were holding losing sell trades open had declined significantly, from 2% when it was around the 113.200 level, down to 1% after it had moved up to the 113.700 level.

The reason it declined so drastically, was because the market had moved far away from the points where these traders got their sell trades placed. The further away it moved, the higher their loss became, so by the time the market had reached the 113.700 level, most of the traders had already closed their trades, as they couldn't handle holding a trade open at a 50 - 60 pip loss.

It would've been at this point where the bank traders start taking a larger amount of profit off their own trades, because by the time the market has moved 50 - 60 pips away from the consolidation, most of the traders in the market will be getting buy trades placed again - thus there will lots of buy orders available for the bank traders to use to take profits off their own trades.
If we go back to our example you can see when the bank traders start to take profits off their trades.

Once the banks have taken the necessary amount of profit off their trades, the market falls again and causes another consolidation or retracement to take place. If a consolidation forms, it will follow the same process I've outlined over the past few pages.

**Summary**

Here's a summary of the main points I want you to take away from this chapter.

- The points where traders will get trapped in losing trades during consolidations are the swing highs and lows of the consolidation itself. If a consolidation forms during an uptrend, traders will be holding losing trades open from the swing lows of the consolidation. If one forms during a downtrend, traders will have losing trades open from the swing highs.

- The bank traders cause a consolidation to form by taking profits off their trades, and then placing more trades in the direction the difference is, instead of them letting the market move against the trend before getting their trades placed, they place them right after they have taken profits, and then process to get more placed at the same price.
• If the market has moved 60 pips away from the point where the majority of traders got their trades placed during a consolidation, (either the swing lows or swing highs), it's likely that most of them have closed their trades at a loss, and that it won't be long before you see another retracement or consolidation take place.
Putting It All Together

In this last section, I want to show you how you can use the information I've given you up to this point, to better determine when consolidations and retracements are likely to form in the market, and when large reversals are going to take place.

At the beginning of the book, I talked about how the forex market was a zero sum game, a game where one person cannot make a profit unless there are others losing. Because this is a rule which applies to everyone in the market, it means the only way the bank traders can make a profit on their trades is by making other traders lose money. The way they make other traders lose, is by pushing the market against them once they've misled them into getting trades placed in the opposite direction to which they want the market to move in.

Now there comes a time when the vast majority of traders who the banks misled into placing trades have closed their trades at a loss. At this point, most of the movement being generated in the market comes as a result of traders placing trades in the same direction to which the bank traders have got their own trades placed.

Eventually it reaches a point where so many traders have got trades open, that the bank traders have to make the market move in the opposite direction, so as to actually make money off their own trades (via taking profits), and to give themselves an opportunity to make more money from the market by misleading traders into placing trades in the wrong direction again.

What this basically means, is that the bank traders cannot let the market continue moving in one direction indefinitely, they've got to take profits off their trades to cause it to consolidate and retrace periodically, to make people place trades in the opposite direction, so as to create an opportunity for themselves to make more money by pushing the market against them.

In other words, the market cannot move up and down without retracements and consolidations taking place during the move.

How To Use This New Understanding In Your Trading

By understanding that it's not possible for the market to continuously move in one direction without consolidations or retracements taking place, you can not only anticipate when reversals are likely to occur, but also get an early warning signal on which technical levels have a high probability of causing a retracement or reversal to take place.
The image above shows a daily supply zone that formed on EUR/USD.

You can see that by the time the market had reached this supply zone, it'd moved far away from the point where the last retracement (marked with a tick) had formed. Other retracements marked with X's had taken place during the move, but these were too small to be factored into the analysis.

The fact that it had moved such a large distance away, meant that it was likely you were going to see either a consolidation or retracement form when the market entered the zone, not because the zone itself had any unique properties, but because it's not possible for the market to keep on moving in the same direction without consolidations or retracements taking place every so often.
If I move the chart on a little bit, you can see that soon after the market entered the daily supply zone it did in fact drop out and cause a retracement to form.

Although you couldn't have predicted whether a consolidation - retracement or reversal was going to form from this zone, by at least knowing one had a high probability of being created, you could've taken the necessary precautions on any trades you had open, or started looking for an entry into a short trade via the reversal pattern talk about in my reversal book.

Let's take a look at another example.
In this image, you can see how a retracement took place after the market had entered a demand zone that formed from a sharp move higher.

You could have been anticipating that a retracement - consolidation or reversal was likely going to take place from this zone, based on the fact you could see the market had fallen a large distance away from the point where the most recent consolidation had formed.

You know the further away the market moves from the consolidation, the higher the chance there is that another consolidation or retracement is going to form. The demand zone was just a likely place for this to occur, due to the fact the market often reverse/reacts to supply and demand zones.

Another way in which you can use this new understanding of how the market moves, is to predict when large reversals and deep retracements are likely going to take place.

Because this concept of the market not being able to continuously move in one direction without consolidations and retracements forming, applies to the movements you see on all timeframes in the market, it means you can anticipate when a large reversal or retracement is likely to take place on one timeframe, by looking at the movement which has occurred on a higher timeframe.

In the image above, you can see a retracement that formed after an up-move had occurred on the 1 hour chart of USD/JPY.
Before this retracement took place, you would have been anticipating that a retracement or consolidation was going to occur soon, due to the fact the market had moved a large distance away from the point where the previous consolidation had formed.

Knowing a retracement was likely going to form, would've given you a hint a large reversal was probably going to occur on the 5 minute chart and 1 minute chart, because although the retracement is considered to be a small move down to a trader operating on the 1 hour chart, to a trader on the 5 minute chart, the drop is classed as being a rather significant reversal.

Here's an image of what the retracement looks like on the 5 minute chart.

You can see that what was just a tiny retracement on the 1 hour chart, is actually a fairly significant move down on the 5 minute chart. Knowing that a move like this was likely to occur soon, would have been invaluable information to someone who trades off the 5 minute chart, because it would've given them an opportunity to close or take profits off any long trades they might have already had open.

You can carry out the same process above to determine when big retracements - consolidations or reversals are likely to occur on the 1 hour chart too.
In the image above, you can see I've marked a consolidation which took place after a large downmove had occurred on the daily chart of USD/JPY.

You could have been anticipating the formation of this consolidation, just from the fact that you knew the market had dropped a large distance away from the point where the previous retracement formed.

If it's moved a large distance away from where it's formed, it means another retracement or consolidation is going to form soon, as the bank traders cannot make money off their trades unless other traders are losing money on theirs, which they won't be if the market just continues to drop without any more retracements or consolidations taking place.

Knowing a retracement - consolidation or reversal was likely to occur, would have been helpful to a trader who trades off the daily chart, but even more helpful to a trader who trades off the 1 hour chart, because whilst on the daily chart the consolidation doesn't look that significant, on the 1 hour chart it's huge! with multiple 300 pip swings taking place causing the consolidation to form.
Here's what the consolidation actually looks like on the 1 hour chart.

You can see that even though they are technically the same size on both timeframes, on here the consolidation appears to be much much bigger on than what it is on the daily chart. If you had been aware a consolidation like this had a high probability of forming, you could have begun watching for signs of a reversal taking place, or made the necessary adjustments to any short trades you may have already been holding open.

Ultimately, you’re never going to know which structure is going to form after the market has moved a large distance away from the point where it reversed, or where a consolidation or retracement took place. Despite the fact you don't know which is going to be created, by at least knowing one is going to form, you have the ability to manage your open trades more effectively, and be more aware of what might take place soon.

Final Summary
Here's a summary of the main points I want you to take away from this last chapter.

- If you see that the market has moved a large distance away from the point where the most recent consolidation or retracement has formed, before it enters a supply or demand zone (or support and resistance level), it’s likely that you'll see a new consolidation or retracement begin once it has entered the zone or hit the level.
• Looking to see if the market has moved a large distance away from the point where a consolidation or retracement has formed on a higher timeframe, can allow you to determine when a large reversal - retracement or consolidation is likely going to form on a lower time frame. This can be really helpful when it comes to taking profits and watching for opportunities etc, because what initially appears to be a small movement to a trader on one time-frame, is often a much bigger move to a trader who is using a lower timeframe.

• If you trade off the 1 minute or 5 minute charts, you should watch to see how far the market has moved on the 1 hour chart to see when a large reversal or retracement is going to take place. If you trade off the 1 hour or 4 hour charts, you should watch the daily chart to see when a large reversal retracement or consolidation is going to take place.

• The market cannot keep moving up or down continuously without consolidations or retracements taking place. The further the market moves without a consolidation or retracement forming, the higher the probability there is that you're going to see one form.

Closing Words

I hope you can now see, that despite the fact you can never know exactly when a consolidation or retracement is going to form in the market, by at least understanding how they are created, you can come up with a rough idea as to when and where one is likely to form.

My apologies if some of the things discussed in this book have been difficult to follow. I really wish there was an easy way to explain these concepts to people but there isn't most of the time, so please, if you have any questions on the things discussed in this book, feel free to email me at forexmentoronline.com and I'll get back to you as soon as I can.

Thanks for reading