

Introduction Into Order Flow Trading

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In today's article, I would like to spend a small bit of time talking about something called order flow trading. Order flow trading is a relatively new type of trading method which has become quite popular with forex traders over the last few years. It's a method which differs from other types of trading as it focuses less on understanding when something has taken place in the market, and more on why something has taken place in the market.

Today's article is just going to be a little introduction into what order flow trading is. I'll start by explaining what the core beliefs behind order flow trading are, and then I'll move on to showing you the differences between order flow trading and other types of trading like price action trading.

I've left some links at the end to other order flow articles on my site, so be sure to check them out if you already have a decent understanding of order flow trading.

What Is Order Flow Trading ?

In simple terms, order flow trading is a type of trading which focus on understanding how orders enter the market via traders making decisions.

Order flow trading itself is not a new method of trading the forex markets, it's been around since the beginning of modern financial markets, just not in the format we would recognize today.

The name order flow comes from the way buy and sell orders will 'flow' into the market from different market participants making trading related decisions like, placing trades - closing trades and taking profits. In all other financial markets order flow trading would be conducted using an indicator called the order book. (Not to be confused with the similar, but different order book provided by Oanda) The order book is a trading indicator which gives the trader using it a huge amount of information about the buy and sell orders that are entering the market from the different financial institutions.

It shows the prices at which the buy and sell orders are being placed at, which type of orders are actually being placed (i.e pending orders or market orders) and also how big the size of the orders are.

For the people who have access to it, the order book provides a sizable advantage over other types of market analysis, although as with anything in trading it does require a significant amount of training in order to learn how to use it effectively.

Unfortunately for us, the order book is unavailable to use in the forex market, due to the fact there's no centralized exchange where trading takes place. The closest thing we have to a similar order flow indicator would be the order book provided by the trading broker Oanda.

This is a very basic order book which is vastly inferior to the ones you would be able to use trading other markets, but it is still a very useful tool for learning how retail traders trade and understanding where they have got their orders placed in the market.

The Difference Between Order Flow Trading And Other Types Of Trading

I think it's important to just have a quick run through of the differences order flow trading has with other types of trading, so as to make it clear what order flow trading is and isn't when compared to things like price action trading.

Order flow trading is a type of trading which is similar to price action trading in the sense that they both propose analyzing the market in a certain way. Price action traders believe in analyzing the market price to determine which direction the market is going to move in, whilst order flow traders believe they can predict where the market is going to move by simply understanding the actions made by the traders in the market.

If you were to ask me which type of trader I think I am, I'd say that I consider myself to be a combination of the two, because I use the common things all price action traders use in their trading, like pin bars - support and resistance levels - Fibonacci retracements etc, but I use them in conjunction with my understanding of order flow trading. For example, using my understanding of order flow trading I know when a pin bar is likely to have formed as a result of the bank traders taking profits off their trades.

Having this information allows me to take more successful pin bar trades, because I have a idea of which pins are probably going to cause the market to reverse and which are going to fail.

How Does Order Flow Trading Work ?

The idea behind order flow trading, is that if you understand when and where traders are likely to make their trading decisions, you can determine with a large degree of accuracy which direction the market is going to move in. The reason why is because whenever a trader makes a decision, like place a trade - close a trade etc, they put an order into the market which has the potential to cause the

price to change. One order on its own is not enough to cause a price change, but thousands of orders all coming into the market at the same time can cause the price to change. So the basic goal of an order flow trader is to understand how other traders in the market trade, as that is what will allow him to figure out when a large set of orders are likely going to come into the market and cause the price to move up or down.

Now figuring out other traders trade is quite difficult, due mainly to the fact there are so many different trading strategies out there which people use to trade the markets with. Luckily we don't need to know the specifics of the trading strategies people use. All we need to know is what the basic goal of their trading method is, and from that we can work out when and where they are going to make a decision which will put orders into the market.

There are basically two types of trading strategy in use by traders in the forex market:

Trend trading strategies and reversal trading strategies.

Trend trading strategies are strategies in which the goal is to get the trader using them into a trading position AFTER a movement has occurred in the market. A moving average system is a great example of this, as the averages only cross one another once the market has already spent some time moving up or down.

Now the goal of a reversal trading strategy is to get the trader into a trade BEFORE a movement in the market has taken place. Examples of reversal trading strategies are things like looking for candlestick patterns at support and resistance levels or taking trades at supply and demand zones. Although both strategies are quite different to one another, they are essentially the same, because they aim to get the trader using them into a trade before a movement has occurred in the market.

So even though there are lots of different trend trading and reversal trading strategies out there, they are all basically different spins on the same formula. They're either trying to get a trader into a trade BEFORE a movement has taken place or AFTER a movement has taken place. By simply understanding these two facts you negate the need to learn about the intricacies of all the different trading strategies out there because you already know when the traders using these strategies are likely to enter the market and get their trades placed. i.e either before or a after a movement has taken place in the market.

Basics Of Order Flow Trading

We're just going to take a quick look now at some of the basic order flow concepts you need to understand if you are going to trade the forex market using order flow analysis.

Understanding How Different Orders Impact The Market Price

Although at the end of the day the price moves as a result of different traders making trading decisions, it is the orders that are put into the market from these decisions being made that actually causes the market price to move up and down. Knowing what these orders are and the different effects they have upon the market price, is an important part of being an order flow trader and will help you better understand the reason why the market moves in the way it does.

There are two different types of orders traders can execute in the market. Each of these two orders are executed by traders for different reasons and have different effects on the market price upon being executed.

Lets take a look at what these orders are.

Market Orders

A market order is a type of order used by a trader who wishes to get a trade placed into the market as soon as possible. When a trader spots something happening on his charts which he defines as an opportunity to make money right there and then, he will use a market order to enter a trade to guarantee he doesn't miss out on that opportunity. The trading strategies which have the trader use a market order to enter a trade are considered to be reactive strategies, because the trader is reacting to what he sees taking place in the market right now.

Limit Orders / Pending Order

Pending orders and limit orders are the orders used by traders who want to have a trade placed at a price which has yet to be reached in the market. These traders do not want their trades to be placed right now like the traders using market orders do, they want them to be placed at a later date. Stop losses are also limit orders because when they are placed they guarantee you will buy or sell currency at a price which the market hasn't reached yet.

This means when you place a trade using a market order that has a stop loss, you are essentially placing two orders into the market, because the stop loss itself a limit order to sell or buy at a price that has yet to be reached.

Strategies in which the trader uses a limit order to enter a trade are referred to as being predictive, because the limit order has been placed at a price in the market where the trader expects something to happen in the future.

The main difference between market orders and pending / limit orders is the effect they have on the market price. When a market order is placed it consumes some of the available liquidity in the market and when a pending / limit order is placed it adds liquidity to the market.

Example:

Imagine you were trading USD/JPY and the bid price (the price you can sell at) is 112.100 and the offer price (the price you can buy at) is 112.098.

Now lets say the best bid at 112.100 is 7 million buy orders and the best offer at 112.098 is 13 million sell orders. This means there are 7 million limit orders to buy at 112.100 and 10 million limit orders to sell at 112.098. In order for the market to move up, the 13 million limit orders to sell have to be consumed by 13 million or more market orders to buy. Once that happens the market will move up to the price at which the next best offer has been made. If, for example the next best offer was 15 million limit orders to sell at 112.120, the price would move up from 112.098 to 112.120.

During the time it was moving from 112.098 to 112.120 there would be a lack of sell side liquidity in the market because there's no sell limit orders available for people to buy into until the market reaches 112.120. So the 10 million limit orders to sell provided buy side liquidity because they enabled traders using market orders to buy at 112.098 until the 10 million limit orders to sell had been consumed.

The reverse also has to happen if the market was to move down from 112.100.

If there were 7 million limit orders to buy at 112.100, the only way the market can drop from this price is if 7 million or more market orders to sell come into the market. If those orders come in, the price will drop down to the price where the next best bid has been made. So if the next best bid was to buy 20 million at 112.090, that's the price the market would drop down to before stopping.

When it's dropping to this price there's a lack of buy side liquidity, because there isn't any limit orders to buy until the price reaches the 112.090 level. In this

instance the 7 million limit orders to buy provided sell side liquidity, as they gave the traders using market orders to sell the chance to sell at 112.100 until the 7 million limit orders to buy had been consumed.

What I've described above is what you see happening on your charts every single day.

When you see the market move from one price to another, it's because all the limit orders that were at that price were consumed by the market orders entering the market from traders who want to get trades placed. Of course things happen much quicker in the real markets and the size of the orders would probably be much bigger than what I've listed above, but the core process still remains the same, the price will not move until all the limit orders at that price have been consumed by market orders.

Liquidity

A key term you'll frequently hear when learning about order flow trading is liquidity.

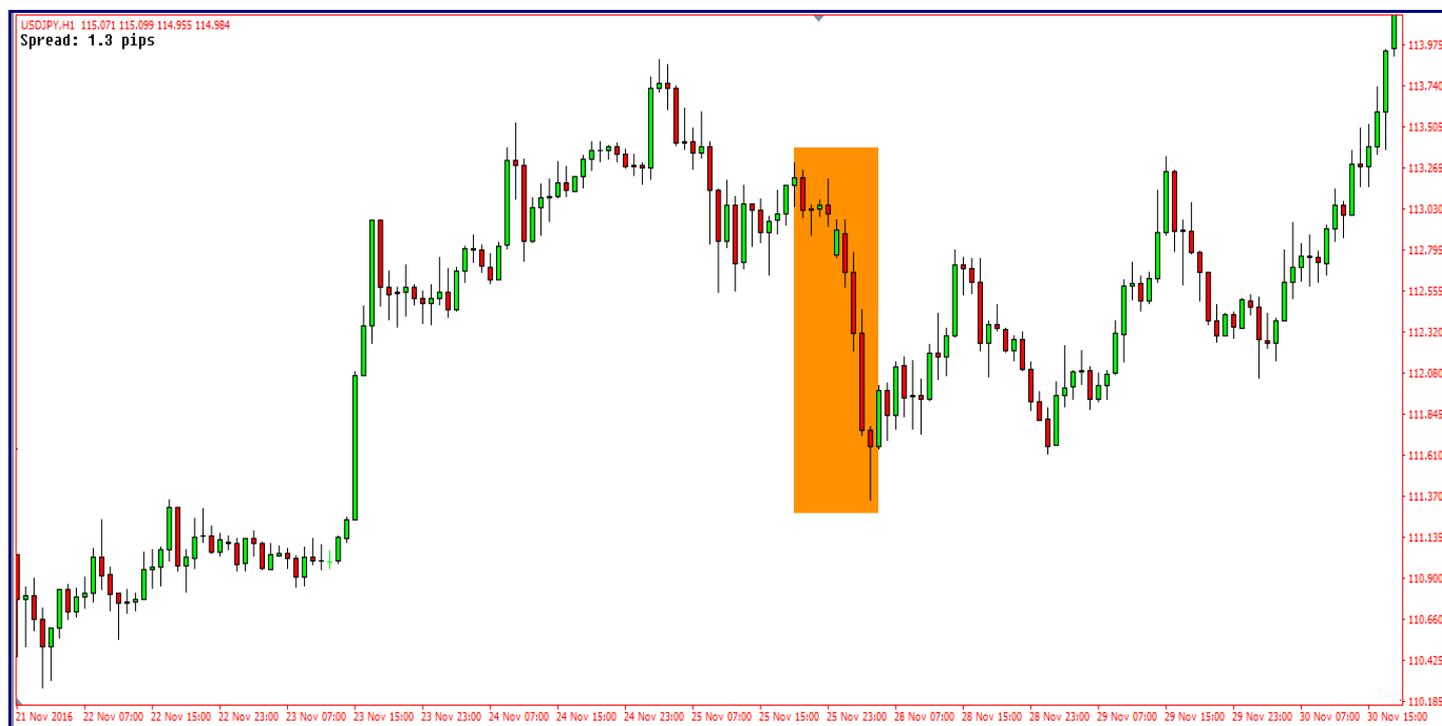
Liquidity is a term used to describe how easy is it to buy or sell something in the market. If a market was described as being very liquid, it would mean that it's quite easy for you to buy and sell in. If it was referred to as being illiquid it would mean that it's pretty difficult to buy and sell. The forex market is considered to be one of the most liquid financial markets in the world, due to how easy it is to find people willing to buy from you and sell to you. Even though it's one of the most liquid markets, it still fluctuates between periods of high liquidity and periods of low liquidity (illiquidity)



Take a look at the move up I've marked in orange.

Movements like this are considered to be low liquidity up-moves because of the fact it's almost impossible for the bank traders to get sell trades placed during the time this up-move was taking place. Most of the orders entering the market during this move up were buy orders, which means the banks can't get any of their own buy trades placed because there's not enough people in the market selling.

What they are able to do is complete an action which requires there to be a large number of buy orders coming into the market. Actions like place sell trades or take profits off existing buy trades is possible for the banks during up-moves like these, as they can only be completed when there is a huge number of buy orders entering the market.



Here's an image of a low liquidity downmove that took place on USD/JPY

During the time this down move was taking place it would have been really difficult for the banks to get sell trades placed, because all of the orders entering the market were sell orders from traders selling. It would have been easy for them to place buy trades or take profits off any sell trades they've already got placed, as both of these actions require there to be a large number of sell orders entering the market.

What I want you to understand from all this, is that whenever you see a low liquidity movement come to an end, it means the bank traders have made some kind of decision in the market. Knowing which decision they've made depends on

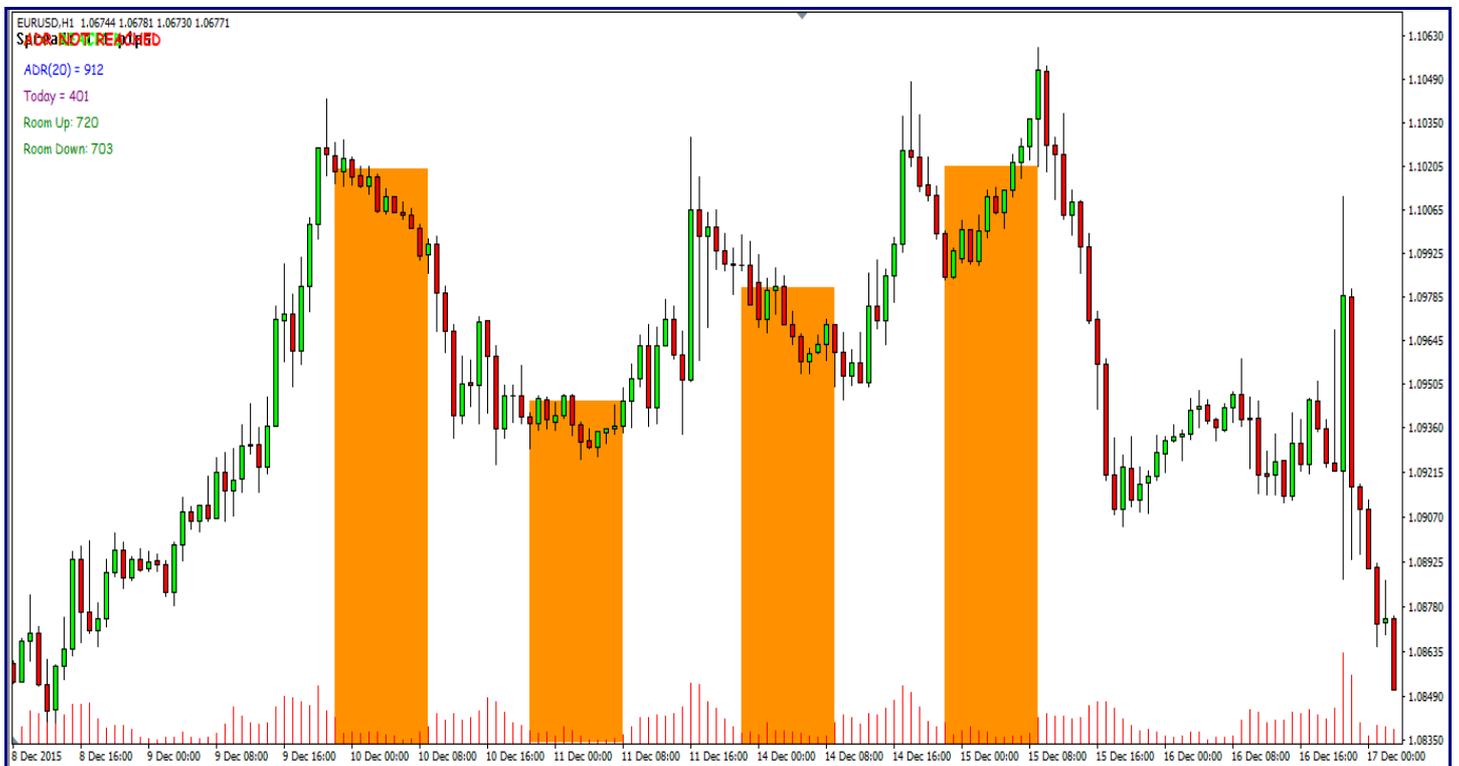
which direction the low liquidity movement occurred in. If it was a down-move like you see in the image above, then you'd know the banks traders have either placed buy trades into the market or took some profits off sell trades which have already been placed.

If it was an up-move you would know they've either placed sell trades or took profits off buy trades, as these decisions can only be made when there is a large number of buy orders available.

Another thing which has a big effect on the amount of liquidity in the market is time.

When markets are active the ability to buy or sell currency is easy, as lots of traders are in the market making trading decisions. Not only that but lots of bank traders are also in the market making decisions, which means bank traders are able to transact with one another to get trades placed or to take profits off trades. The markets are at their most active when the traders who trade each respective currency are available

When these sessions come to an end the level of liquidity in the market drops because there aren't many traders in the market placing trades.



If you go onto MT4 and select the volume tool, you can see how the activity in the market drops off significantly when the main trading sessions for the currency you're viewing come to an end.

In the image above I've marked some of the times when there was very little activity taking place on EUR/USD.

If you look closely you'll see that the time when the activity really drops off and starts to base out is the same time when the US trading session comes to an end. (10:00pm GMT for those who don't know) It always picks back up again around 8:00 - 9:00am in the morning, the time when the London trading session is just beginning to get underway. You'll see this same pattern occur on every single currency in the market. When the main trading sessions for the currency you're viewing begin the volume (activity) will pick up and when they come to an end it will die down and base out.

How Do The Banks Trade ?

Understanding how large groups of retail traders trade is one of the primary components of order flow trading, but you not only need to understand how the retail traders in the market trade, but also how the bank traders trade, as ultimately they will be the ones who cause the market price to move up and down. As you'd probably expect, the banks trade in a very different way to how us retail traders trade. Not necessarily in terms of which trading strategies they actually use, but in the conditions that must be present in order for them to place trades or take profits.

When we decide to place a trade we never think about whether or not there are enough orders coming into the market for our trade to be placed. This is because we know we can place our trades whenever we want. The reason this is possible is because we're placing very small trades into the market.

There only needs to be a tiny number of buy or sell orders entering the market at the time we want to place our trade for our trade to be placed. Now unfortunately the banks don't have this luxury because the size of the trades they're placing are much much bigger than ours.

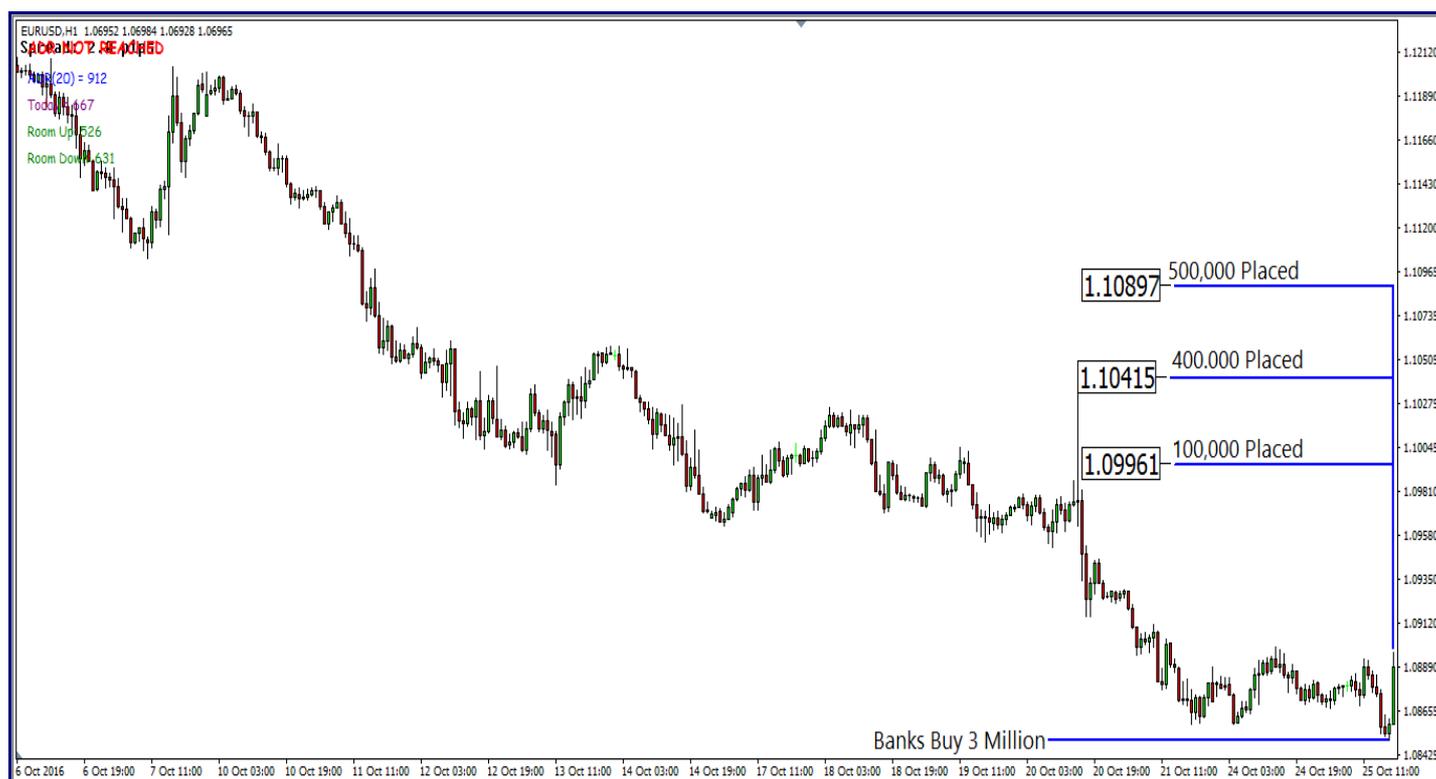
They can only get their trades placed when there are a vast number of sell orders (or buy orders if they were placing a sell trades) coming into the market. This means when you see an up-move take place, the banks are unable to get buy trades placed or take profits off any sell trades because most of the orders entering the market are buy orders from traders placing buy trades of their own. What they can do is get sell trades placed or take profits off existing buy trades, as both of these actions require there to be a large number of buy orders coming into the market.

For down-moves it's the opposite way around. When the market is falling the banks can't get sell trades placed or decide to take profits off any buy trades they've got placed as the majority of the orders entering the market are sell orders from people selling and liquidating losing buy trades. They can decide to place some buy trades into the market or take some profits off the sell trades they've already got placed, as these are two actions which can only be completed if there is a large number of sell orders entering the market.

Slippage

Slippage is a term used to describe what happens when your trade gets placed at a price different to the one you wanted it to be placed at.

Slippage for the bank traders occurs when they place a trade which is bigger than the number of orders coming into the market. In other words, if I was to come into the market and buy 4 million AUD when there was only 3 million orders to sell AUD available, what would happen is the 3 million of my buy orders would be placed, but the remaining million would only be placed once another 1 million orders to sell have come into the market.



Here's an example of what happens when the bank traders encounter slippage on their trades.

You can see the banks get their 3 million buy orders placed at the low. The market then moves up to find more sell orders to match with the 1 million buy orders the banks have still got left to place into the market. It ends up finding 100,000 sell orders at 1.09961, so now the banks have 900,000 buy orders left to get placed.

The price continues moving higher and a short time later another 400,000 sell orders are found at 1.1041. At this point the banks still have 500,000 buy orders which haven't been executed, so the price keep on rising. Eventually 500,000 sell orders come into the market and the remainder of the bank traders buy trades get placed at 1.10897.

The reason slippage is such a big issue for the bank traders is because it causes them to make less from money from their trading positions. In our example because there weren't enough sell orders coming into the market at the time the banks decided to place their buy trade, it meant that only part of their buy position was placed at the price they actually wanted it to be placed at. The rest of their trades were placed at much higher prices, so these trades would not make the bank traders as much money as they would have had all the trades been placed at the same price.

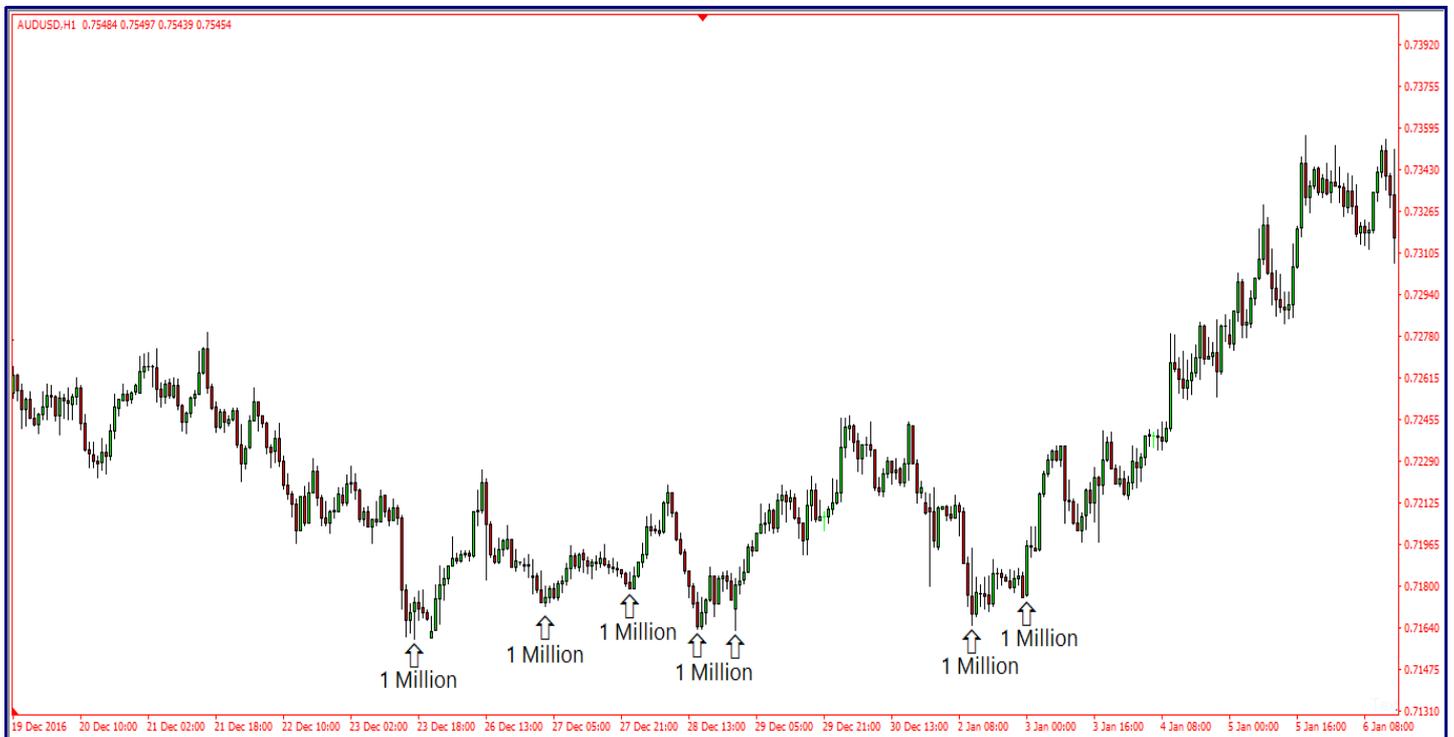
Order Spitting

To avoid having slippage on their trades what the bank traders do is get their trades placed at similar prices to one another. This is done via a process called order splitting. Order splitting is where the bank traders will split one really big trade up into lots of smaller trades to make it easier for them to get their entire trade executed in the market at the prices they want.

For example:

Lets say the banks wanted to place a buy trade on AUD/USD which totaled 7 million. In order for them to get the entirety of this buy trade placed, they'd need to have 7 million sell orders coming into the market. The problem is there are only 1 million sell orders available in the market at the time they want their trade to be placed.

Now the banks could just go and place their entire 7 million buy position into the market, but that would cause them to have slippage, so what they do instead is split the 7 million buy position up into lots of smaller trades, to make it easier to get their whole position placed into the market without encountering any slippage.



Take a look at this reversal which occurred on AUD/USD.

Notice how the swing lows of this reversal are all found at similar prices to one another? This is a perfect example of the banks splitting a really big trade up into smaller more manageable sizes to make sure the whole trade gets placed at favorable prices.

If we apply the example I just gave to this chart, you can see each swing low would have formed as a result of the bank traders placing 1 million of their total 7 million buy position into the market. If they had just placed their entire 7 million buy position without there being enough sell orders available, they would have had slippage, and a large number of their buy trades would've ended up being placed at increasingly worse prices.

By splitting their position up, the bank traders are able to have much more control over when and where their buy trades are placed. This allows them to get their trades placed at similar prices to one another, so as to make sure they all generate a similar amount of profit when the market begins moving up.

Summary

In my opinion having a good understanding of order flow trading is essential if you want to become a really good forex trader. Price action trading and other types of trading can only get you so far, order flow trading just gives you that extra level of understanding which allows you to have a much better grasp of what's actually going on in the market and why different events are taking place.

Resources

Here are the links to some of the other order flow articles I have available on the site.

[Using Order Flow To Understand Where The Banks Have Got Their Trades Placed](#)

[Understanding How Large Groups Of Retail Traders Trade](#)

[What Does Oanda's Order Book Teach Us About The Way Retail Traders Trade](#)

[How To Determine When The Trend Has Changed](#)

[The Top 3 Order Flow Trading Books](#)

Links To Order Flow Trading PDF

Here are a few links to some scientific papers which have been written on several order flow concepts which exists in the market.

[The Predictive Power Of Candlesticks](#)

[Round Number Effects On Stocks](#)

[Round Number Effect On Stocks 2](#)

[Technical Analysis And Market Efficiency](#)

[The Effect Of Limit Orders In Financial Markets](#)

[How And Why Traders Mask Their Orders](#)

[Mean Reversion And Momentum Strategies](#)

[Pricing Liquidity In Electronic Markets](#)

[Do Futures Lead Price Discovery in Foreign Exchange Markets](#)

[Is Technical Analysis In The Foreign Exchange Market Profitable](#)

[Price Discovery In Brazilian FX Markets](#)

[The Profitability Of Simple Technical Trading Rules Applied On Value And Growth Stocks](#)

[Technical Analysis And Random Walks](#)