A simplified Ichimoku strategy

by http://tradingtools.net
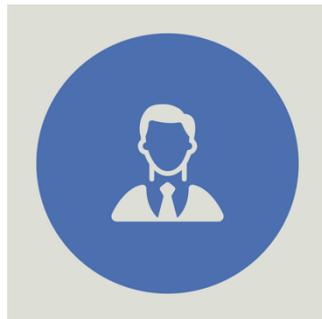
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Please do not trade with borrowed money.

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A simplified Ichimoku system

By tradingtools.net

First of all, let me say that the system I trade is a simplified Ichimoku system derived from a strategy created by Vince Vora at Tradingwins.com.

I have used the basics of his system and customized it to add a few features that make it more precise and useful to me (if you wish to see the initial system you can visit the Tradingwins.com website).

It relies quite heavily on the Ichimoku Kinko Hyo system, although it is stripped down version of it and has a few add-ons.

It is a simple system based on a few indicators that tells you in a second whether you have a trade setup or not. It can be traded with an extremely low risk level, I personally use a 1,5% risk on individual trades.

Before I go any further, please note that this document assumes that you are already familiar with Forex and Forex trading, we will not teach you to trade Forex here. If however you are a beginner and need advice on resources to help you learn the skills of Forex trading, you will find a few recommendations on the website.

Now, let me take you through the characteristics of this system, which is basically a momentum catching strategy.

Which market ? what timeframe ?

This system works on any market, any timeframe. I use it to trade forex on the H4.

Due to my day job I can't afford to watch the market more than twice a day, that is early in the morning (around 7-8 AM GMT and in the evenings around 9-10 PM GMT).

For that kind of trading, the H4 is ideal because it will give you a reasonable volume of trades and a good grip on the momentum moves of a pair without forcing you to keep a constant watch on your trades.
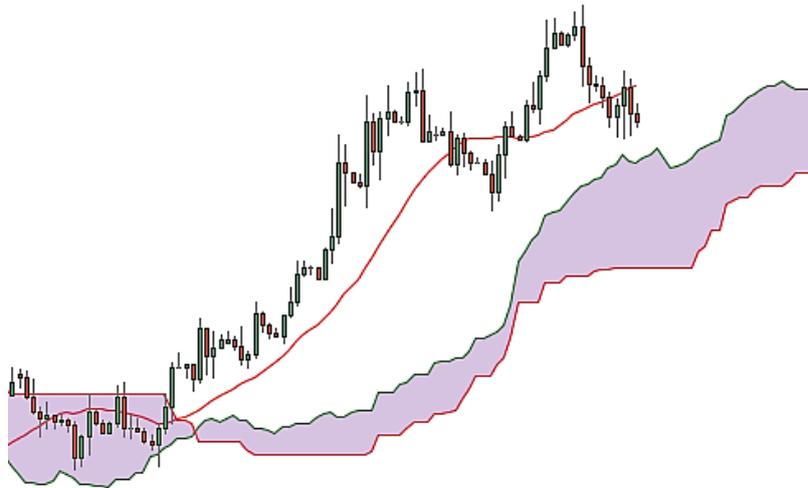
What market conditions are we looking for ?

Since this strategy aims at catching trending moves, we are looking for clean charts and want to avoid cluttered pairs where volatility is high with unclear price directions, violent swings or spikes, …

Two examples of what I mean below:

Clean chart, clear trend

Cluttered chart, high volatility, spikes, swings

What indicators ?

The system uses five indicators, that might seem a lot, but they all have a function and actually they are a tremendous visual aid for reading graphs and to me they make things much simpler.

The Ichimoku cloud and Kijun Sen

The Ichimoku Kinko Hyo system is a very elaborate but simple system devised by a Japanese journalist named Goichi Hosoda in the late 1930s and released to the general public in the late 1960s after 30 years of testing and improvement.

It is a very complete system giving an instant view of market conditions, possible entries, exits, support and resistance levels and key past and future market levels. Literally, Ichimoku Kinko Hyo translates as "one glance equilibrium chart".

The original system consists of five lines named Tenkan-Sen, Kijun-Sen, Senkou Span A, Senkou Span B and the Chikou Span. What we call the Ichimoku cloud is the area between the Senkou Span A and Senkou Span B, it is usually coloured.

Below is a representation of the system and the five lines that compose it (we only use three of them):
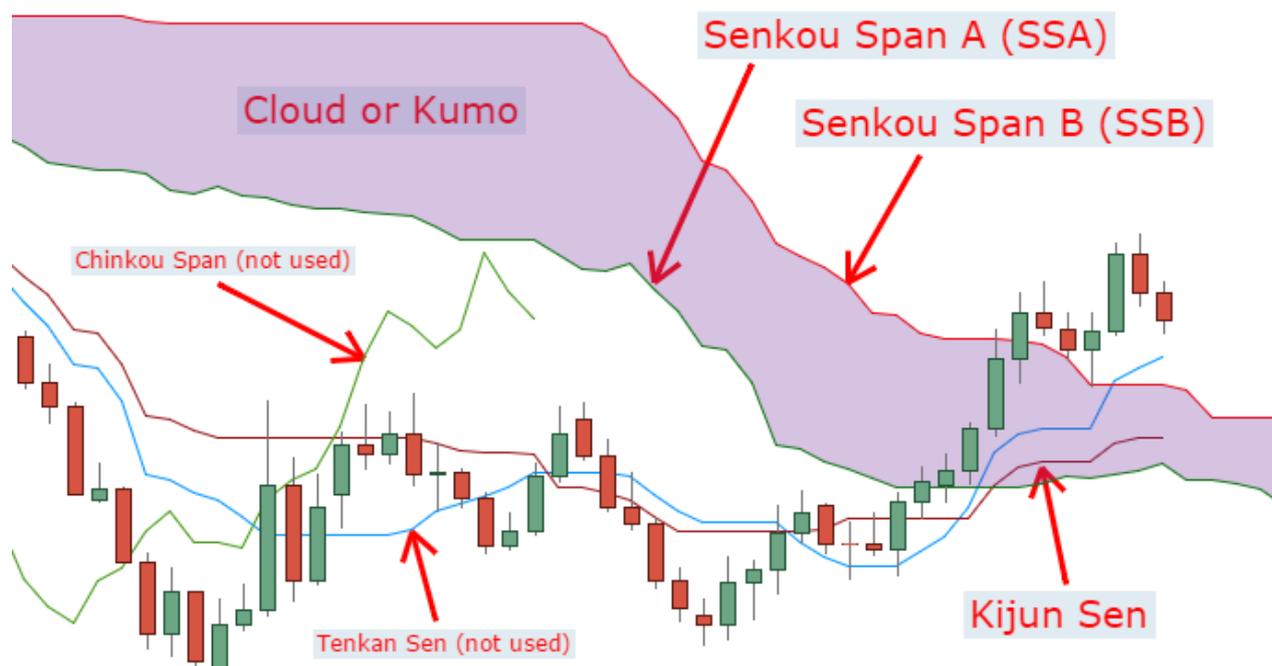
The Ichimoku system is a moving average based trade identification system. It is quite elaborate and novice traders might find it difficult to read. However, in our trading system we are only using two of the core components which are the **Kumo cloud** and the **Kijun Sen**, since the information they provide is sufficient for the kind of market conditions we want to identify.

The **cloud** (also named Kumo in Japanese) is the area between Senkou Span A (also named SSA) and Senkou Span B (SSB), whose definitions are the following:

- SSA = (Tenkan Sen + Kijun Sen) / 2 plotted 26 periods ahead

- SSB = (highest high + lowest low) / 2 calculated over the past 52 periods and plotted 26 periods ahead

The **kijun Sen** is defined as:

- Kijun Sen = (highest high + lowest low) / 2 for the past 26 periods

And for reference only (because we do not use them) the other lines are defined as:

- Tenkan Sen = (highest high + lowest low) / 2 for the last 9 periods

- Chikou Span = today's closing price projected 26 periods back on the graph

Basically, what the cloud and Kijun Sen will tell us is the following:

- **Kumo Cloud**: when price is above the cloud we have an uptrend (we only trade long), when it is below the cloud we have a downtrend (we only trade short) and when price is inside the cloud we have a neutral situation (no trade). The projected portion of the cloud can also be used as an indication of future market conditions. The height of the cloud is a representation of volatility, so a thinner cloud would indicate lower volatility, and a thicker cloud will represent stronger areas of support and resistance. The SSB is the stronger of the two lines and will generally form solid S/R levels. Markets are said to be bullish when SSA is above SSB, and bearish when SSA is below SSB. A crossing of SSA and SSB lines (usually

triggering a change in the cloud color) is called a Kumo twist and can be a sign of potential trend inversion.

- **Kijun Sen**: this line is used as a confirmation line and can be used as support or resistance. It is one the system's stronger lines and usually a good indicator of future price movement. In our system its slope is particularly important, so we use it both as a confirmation of the trend and as a potential trigger for exits being a representation of significant support or resistance lines.

A 21 period Exponential Moving Average (21 EMA)

Moving averages are the single most used indicator in trading. But let's be clear: they do not predict future price movement, they just represent the current direction of a trend. There are many different forms of moving averages (simple (SMA), exponential (EMA), weighted (WMA) …), here we use the **21 period EMA**. Exponential moving average reduce the lag by giving more weight to recent prices, therefore we prefer it to SMA. It also tends to be one of the most widely used moving averages, and as such it is kind of a self-fulfilling prophecy since a lot of traders are always going to react around it. In this system it is used to confirm a trend, we will be looking for strong slopes as indicators of strong up or down trends.

Good slope   Weak slope (no trade)

The RSI set to 7 periods

The RSI is the Relative Strength Index. It was created by Welles Wilder in 1978. It is an *oscillator* type indicator that moves up and down on a scale from 0 to 100 and identifies the speed and change of price movements.

The formula to calculate the RSI is the following: RSI=100 - [100 / (1 + RS)] where RS is the Relative Strength = average gain / average loss

In the standard setting of the RSI, the average gains (loss) are calculated by adding all the gains (losses) for the past 14 periods. **We use it with a setting of 7 periods as we want to use it to trade quite a short cycle.**

It is commonly accepted that the RSI has the following index thresholds:

- A reading of 30 or under is considered "oversold" and identifies potential price increase

- A reading of 70 or higher is "overbought" and identifies a potential price decrease

- A reading of 50 is considered neutral, and crossing that mark is usually the indication that a trend is forming. For that reason, in this system **we use the bounce on the 50 mark as confirmation that an uptrend or downtrend is resuming** (see example below)

Bill Williams Fractals

Fractals were developed by Bill Williams as part of a system that he created mixing the Chaos Theory with Human Psychology. Taken alone, fractals are indicators that actually break larger trends into smaller and simple reversal patterns. A fractal is composed of five or more bars, and there are two types of fractals:

- **Up fractals:** a bullish turning point occurs when there is a pattern with the lowest low in the middle and two higher lows on each side

- **Down fractal**: a bearish turning point occurs when there is a pattern with the highest high in the middle and two lower highs on each side

The fractals are turning points, and we will use them for our stop loss placements (initial and trailing). The idea is that in a long trade, we will place our stop at the most recent red fractal and in a short trade we will place our stop loss at the most recent green fractal (see further down stop placement).

See a representation of fractals below, swing lows are the red fractals and swing highs are green fractals.

Swing points

Entry rules

Now that we've gone over the indicators and timeframe, let's take a look at the entry rules. They are very simple and easy to remember, which makes this system very straightforward because it is nearly 100% rule-based (trader discretion is always necessary in any system):

The first thing you should do is check that no major market announcement is on the docket for the pair that you are trading (rate announcement, central bank conference, macro-economic figures release, ...), that is very important since it could bring uncontrolled volatility to the pair.

For a **long trade**, the following conditions need to be met:

- price should be above the kumo cloud, indicating an uptrend (no trade if price is in the cloud or below);

- the 21 period EMA should have an upward slope (avoid flat) as illustrated previously, and ideally the Kijun Sen shouldn't be in a flat position either because that would mean we're not really making higher highs on a medium term perspective. There will however be some cases of entry when the Kijun is not yet sloping upwards; this will be a discretionary decision, the most important is the 21 EMA;

- the idea is to catch a swing low on the uptrend and enter when the trend resumes. To time our entry, we use the RSI as a gauge of speed and momentum of price movement, and therefore we need it to dip towards the 50 mark and bounce back up again after hitting it. The signal candle will be the one where the RSI goes back up.

- enter on a break of the high of the signal candle.

For a **short trade**, things should be the exact opposite:

- price should be below the cloud, indicating a downtrend (no trade if price is in the cloud or above);

- the 21 period EMA should have on a downward slope (avoid flat) as illustrated previously, and ideally the Kijun Sen shouldn't be in a flat position either because that would mean we're not really making lower lows on a medium term perspective;

- the idea is to catch a swing high on the downtrend and enter when the trend resumes. To time our entry, we use the RSI as a gauge of speed and momentum of price movement, and therefore we need it to move towards the 50 mark and bounce down up again after hitting it. The signal candle will be the one where the RSI goes back up.

- enter on a break of the low of the signal candle

In both long and short entries, it could happen that the RSI doesn't exactly hit the 50 mark, I think that can be ok if it remains in a reasonably tight zone around the 50 level and if all other conditions are met, especially the slopes on EMA and Kijun. That is left to trader appreciation but I have found to miss significant market moves if I get too strict on an exact hit of the 50 mark.

Stops

For stop-loss placement I have already explained that I use fractals. Again, it is a simple and straightforward rule. The reason for using fractals is that they represent key short term swing highs or lows. If I'm going long and the previous up fractal (see above for definition) is broken by a downward move then my conditions for an uptrend are no longer met. And the same goes for a short trade. If a down fractal is broken by an upward move then my conditions for a downtrend are no longer met.

Trade management and exits

I usually trail my stop to the next fractal as price moves in my favor, but since I try to keep my risk extremely low I will often move my stop to break-even without waiting for a fractal if I have reached 1R (one times my risk).

Exits are very discretionary and depend heavily on your money management strategy. Several options are open:

- exit when price crosses the Kijun or EMA
- exit when price hits the cloud
- exit at a certain level of gain (this is what I use most often)
- exit before significant market announcements, weekends, …

As explained my strategy is to trail my stop with fractals but when price reaches R3 (three times my risk) I will directly move my stop-loss just beneath it, since **I never want to give back an inch of profit on an R3 trade**. That is an essential part of my money management, and the reason why this strategy is profitable for me even if I hit a 30 to 40% win rate.

Money management and risk

I use a 1,5% risk maximum on any given trade, with an overall of 5% on concurrent positions. That's very conservative, I know it sounds small but believe me with a few good trades the performance can be excellent. Anyway, I like to keep it that way because that's the amount of risk that I am comfortable with, and that is key. You cannot trade with amounts that keep you awake or have you checking prices every minute. That is simply impossible and usually creates a psychological bias that will prevent you from applying your rules. Experience has proven that keeping my losses at a

minimum is absolutely crucial. I make most of my monthly profit with my best 3 to 5 trades, the rest of them being break-even, a small loss or reasonable profit (I have around 20 to 30 trades a month).

Pairs traded

I don't think this is an essential part of the system, because basically as I said it works with any market. Anyway, here are the pairs I trade :

EUR/USD, GBP/USD, AUD/USD, USD/JPY, EUR/GBP, NZD/USD, EUR/JPY, XAG/USD (silver), XAU/USD (gold), GBP/JPY, EUR/AUD, GBP/AUD, USD/CAD, EUR/CAD, EUR/NZD, AUD/CAD, AUD/NZD, CAD/JPY => 18 pairs

Final words: a 15 minute per day system

I have a day job. I never trade at work. I can only trade from home twice a day and I have a family I like spending time with. With this simple system (nearly 100% rule-based) it takes me five minutes in the morning and five minutes in the evening to scan the 18 pairs that I trade, and a little more if I have open positions, but that's it => basically this is a **15min per day system**, no interpretations, no splitting hair, you either have a setup or you don't. The toughest part is managing trades and mainly deciding on exits.

It has been a profitable system for me so far but I believe my strict money management also has had a key role to play. I started making consistent profits when I lowered my risk, and never ever bended my rules. You have to understand that the system is only 20% of the journey, the rest is money management (low risk and never give back profits), consistency and courage (stick to the rules in drawdowns).

Well, there you have it, I hope this system works for you as well as it does for me.

If you appreciate it, leave me a quick comment below.

Safe trading to all.

John