STRATEGY 9: FIFTH ELEMENT

“I am using a wonderful strategy, but I have to constantly monitor the market in order not to miss a trade.” “Ah! I missed a trade again.” “According to my strategy, it looks like there may be a trade setup soon, but I have a movie date in the next hour. What should I do?”

Do these scenarios sound familiar to you?

Wouldn’t it be nice to have a strategy that actually prompts you when momentum of the market has switched to a new trend? In fact, the beauty of the fifth element strategy is that it tells you ahead of time when the entry price will be.

This is the third and final trend strategy in this segment. Let’s find out what’s so special about it.

Time Frame

The fifth element strategy works with the hourly (H1) or 4-hourly (H4) chart. This means that each candle on the chart represents 1 hour or 4 hours of price movement respectively.

Indicators

We use this indicator for this strategy:

Moving average convergence divergence (MACD) with default settings:

a. Fast EMA: 12
b. Slow EMA: 26
c. MACD SMA: 9
d. Apply to close.

Currency Pairs

This strategy is suitable for all currency pairs listed on the broker’s platform, especially the seven major currency pairs of:

EUR/USD
USD/JPY
GBP/USD
USD/CHF
USD/CAD
AUD/USD
NZD/USD
**Strategy Concept**

The MACD histogram indicates the direction and momentum of the market. When the MACD histogram switches from negative to positive, this indicates a possible upward shift in momentum. We wait for five positive bars on the histogram to confirm the momentum before entering a long trade on the fifth bar. No prizes for guessing why the name of this strategy is called the fifth element!

When the MACD histogram switches from positive to negative, this indicates a possible downward shift in momentum. We wait for five negative bars of the histogram to confirm the momentum before entering a short trade on the fifth bar.

**Long Trade Setup**

We use the AUD/USD on the H4 time frame to illustrate a long trade. Here are the steps to execute the fifth element strategy for long:

1. Wait for the MACD histogram to go from negative (<0) to positive (>0). (See Figure 8.18.)
2. Wait for four positive bars to form on the histogram before going long on the opening candle of the fifth histogram. (See Figure 8.19.)
3. Set the stop loss at the last low of the histogram.
4. The trade will have two profit targets with risk to reward ratios of 1:1 and 1:2 respectively. (See Figure 8.20.)

From the long example in Figure 8.21:

- Entry price = 1.0300
- Stop loss = 1.0150
- Profit target 1 = 1.0450
- Profit target 2 = 1.0600

The risk for this trade is 150 pips, and the reward is 300 pips if both targets are hit. The risk to reward ratio is 1:2, which yields a tidy 6% return if we take a 3% risk.
FIGURE 8.18  MACD Histogram Goes from Negative to Positive

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FIGURE 8.19  Four Positive Bars Form before Going Long

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Short Trade Setup

We use the EUR/USD on the H4 time frame to illustrate a short trade. Here are the steps to execute the fifth element strategy for short:

1. Wait for the MACD histogram to go from positive (\(<0\)) to negative (\(>0\)). (See Figure 8.22.)
2. Wait for four negative bars of the histogram before going short on the opening candle of the fifth histogram. (See Figure 8.23.)

3. Set the stop loss at the last high of the histogram.

4. The trade will have two profit targets with risk to reward ratios of 1:1 and 1:2 respectively. (See Figure 8.24.)
FIGURE 8.24  Set Stop Loss and Profit Targets

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From the short example in Figure 8.25:

Entry price = 1.3400
Stop loss = 1.3547
Profit target 1 = 1.3253
Profit target 2 = 1.3106

FIGURE 8.25 Trade Hits Profit Targets

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The risk for this trade is 147 pips, and the reward is 294 pips if both targets are hit. The risk to reward ratio is 1:2, which yields a tidy 6% return if we take a 3% risk.

**Strategy Roundup**

The fifth element is an excellent swing trading strategy for beginners. The beauty of this strategy is that it does not require you to monitor the market for a long time. It also signals you well in advance as to when the entry of a trade is about to take place. As you know by now, the entry takes place on the fifth bar after the MACD histogram switches from negative to positive or from positive to negative.

Five bars of the histogram is equivalent to 5 hours on the H1 time frame or 20 hours on the H4 time frame. This means you need to monitor the market only on a 5-hourly basis if you are trading the H1 time frame or a 20-hourly basis if you are trading the H4 time frame. Knowing that the entry is always on the fifth bar of the histogram means that you are in total control of your time.

As an example, let’s say that you are trading the H1 time frame. You spot the MACD histogram switching from negative to positive. You glance at your watch and see that the time is 2:15 P.M.

The current bar is the first bar, and it corresponds to the 2 P.M. candle. What would be the likely time that you will enter the trade? The answer is 6 P.M., because that would be the start of the candle that corresponds to the fifth bar of the histogram. You have ample time to catch a two-hour movie before heading home again to prepare for the trade!