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ORDER FLOW TRADING [PDF]

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Order Flow Trading

Every trader wants to have any kind of edge to get as much information as possible and to be able to analyze the market better than others. One way to get this edge is by using the order flow trading strategy, a unique analysis method that enables traders to define key levels and know where strong support and resistance levels are located.
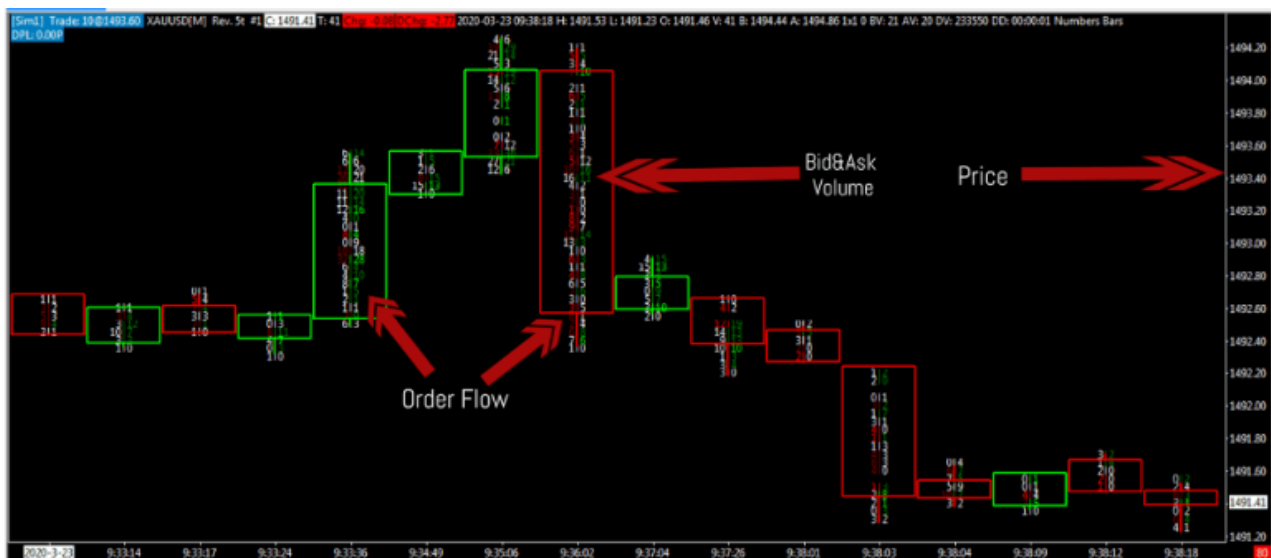
What is Order Flow Trading?

Order flow trading involves the analysis of recent executed orders as well as pending orders to predict market sentiment and the future direction of markets.

How Does the Order Flow Trading Strategy Work?

Order flow trading is about keeping an eye on market orders waiting to be executed. According to the order flow strategy, prices fluctuate due to market imbalances, and you may anticipate future price fluctuations using this approach. And it can all be seen in the price chart or the market orders box using any order flow indicator.

Before we get into the specifics of order flow trading, you first need to know what order flow analysis looks like on a trading chart.

Note that this is one way to use the order flow trading technique; however, some traders primarily use the market data box to analyze price action and use the naked trading strategy when looking at price charts.

So, let's get back to understanding the order flow concept. Let's assume there is a substantial increase in demand, and the price keeps rising. At this point, you must recognize that there are more buyers than sellers in the market.

However, as the market's nature is cyclical, the price will reverse again at some point. Once the buying pressure is over, sellers will take control. And that is the core principle of order flow trading – the market imbalance.

Using order flow analysis, you may predict where market order imbalance will occur at a future price level. The supply and demand levels represent the imbalance, so by implementing the order flow trading system, you can only anticipate the market price movements by looking at market orders. Those are displayed on the order book, which lists all pending orders and is one of the most crucial tools for order flow traders.

What is an Order Book?

When we talk about market imbalances, we have to talk about market data. This is an important concept for analyzing the markets. Technically, market imbalances typically happen when big players enter the market intending to purchase large blocks of the specified asset or place large order blocks to impact the market's price.

Now, when large banks and financial institutions place orders in the market to buy assets, they usually do that in blocks, meaning with several large orders. That is a concept known in financial jargon as Smart Money. Technically, banks and financial institutions can not place their order simultaneously because their order won't get filled due to a lack of liquidity. Also, if they place their order in one batch, other market participants can immediately notice that, and the price will instantly rise or fall. So, they break their trades into chunks and then enter and exit the market to get the number of shares or contracts they wish to buy or sell. Based on the SMC theory, this is what creates the break of structure on price charts.

Types of Market Data

As a retail trader, you can use market data to discover where large orders are placed. And there are two main types of market data: levels 1 and 2.

With level 1, you get the most basic information, that is, the current prices, recently filled trades, the last bid, and ask for the specific asset, and the trade's size. Level 2 market data, on the other hand, provides more info than level 1. Level 2 market data reveals how the market is changing, as it shows a ranked list of buyers and sellers, with the positions amounts, the market participants, and the market maker. It's where the big boys like the banks and financial institutions come into play. Level 2 data tells you pretty much everything – how much an asset is worth, who is trading it, and for how much.

Obviously, knowing when big market players have begun to buy or sell an asset in more

extensive amounts can help you become an invincible trader. Therefore, it is a necessary tool for utilizing the order flow trading strategy.

How to Use Order Flow in Trading?

Order flow trading is about looking at the orders waiting to be filled and then taking positions accordingly. These orders represent the supply and demand side of the market and may provide a strong indication of the market's direction.

When there's more supply, sellers come to the market, filling many sell orders. Conversely, buyers join the market when there's a demand, and buy orders get filled. The goal for you as a trader is to find market imbalances where you can identify buying or selling pressure.

For example, let's assume you are trading a commodity heavily affected by giant corporations' and governments' needs. Let's say wheat. Now, you look at Wheat's level 2 order book, and the market is slow, with not too many price movements and market news.

Suddenly, you see large or maybe huge blocks placed on the bid side – something unusual for the market you are trading. So, you can assume that a large corporation or a certain governmental entity is entering the market to buy huge piles of wheat. Remember, a government does not really care about a few cents here or there. When they need to buy a specific commodity, they buy the asset at any price.

For you, as a retail trader, it's a gift. Assuming you have identified a scenario where large orders are placed in the market, you will obviously enter the market in the direction of large order blocks. That is why many traders and prop trading firms follow commodity auctions. They try to find out when financial institutions or governments get involved in the markets.

It's as simple as that. That is what the order flow trading strategy is primarily based on: knowing how to read and analyze the market's order book. After all, every market is a battle between buyers and sellers, and the level 2 order book gives you the best insight into this battle. That is why many professional and prop traders rely solely on order flow trading. They believe that by trading naked and using the order flow trading method, they can easily analyze the market and develop the sixth sense of trading.

What's the Catch with Trading Order Flow?

Order flow trading certainly sounds magical, and it is in a certain way, but the only downside is that you have few options to achieve this tool. As a matter of fact, limited platforms provide level 2 market data, and you can only trade specific assets that trade on exchanges like stocks and futures. In many cases, you will not be able to get level 2 data, meaning you cannot apply the order flow trading strategy.

So, to analyze the markets using the order flow trading system, you need to work hard before you place your first trade.

- First, you need to find a brokerage firm that enables you to access level 2 market data.

- Second, decide on the instrument or market you want to focus on. Forex, for example, could be tricky for order flow trading. On the other hand, futures, stocks, and even crypto coins are much better for utilizing the order trading technique.

- Lastly, find the best trading platform to read level market data. Again, there are many factors to consider, and you might have to visit forums and trading sites to get the answer. Nevertheless, choosing a suitable trading platform is essential for you to use the order flow trading strategy.

# The Order Flow Trading Strategy – What Indicators Should You Use?

In the previous section, we mentioned that getting the order flow trading is a bit complex to achieve, but there is always a way of getting this tool. Below, we will show the best indicators to take advantage of the order flow trading method.

1. Market Depth

Market depth or Depth of Market (DoM) is an overview of all buy and sell orders for specific securities that have been placed into the market. Like stock market news, Market depth can help determine the market sentiment in one particular asset. Every live order is displayed in detail, including the volume at each price level.

Essentially, market depth is very similar to the level 2 order book. Therefore, if you examine market depth before placing an order, you can determine the likelihood that your order will be filled.

In TradingView, you can apply the Market depth feature on any asset by connecting your broker's server with the platform.
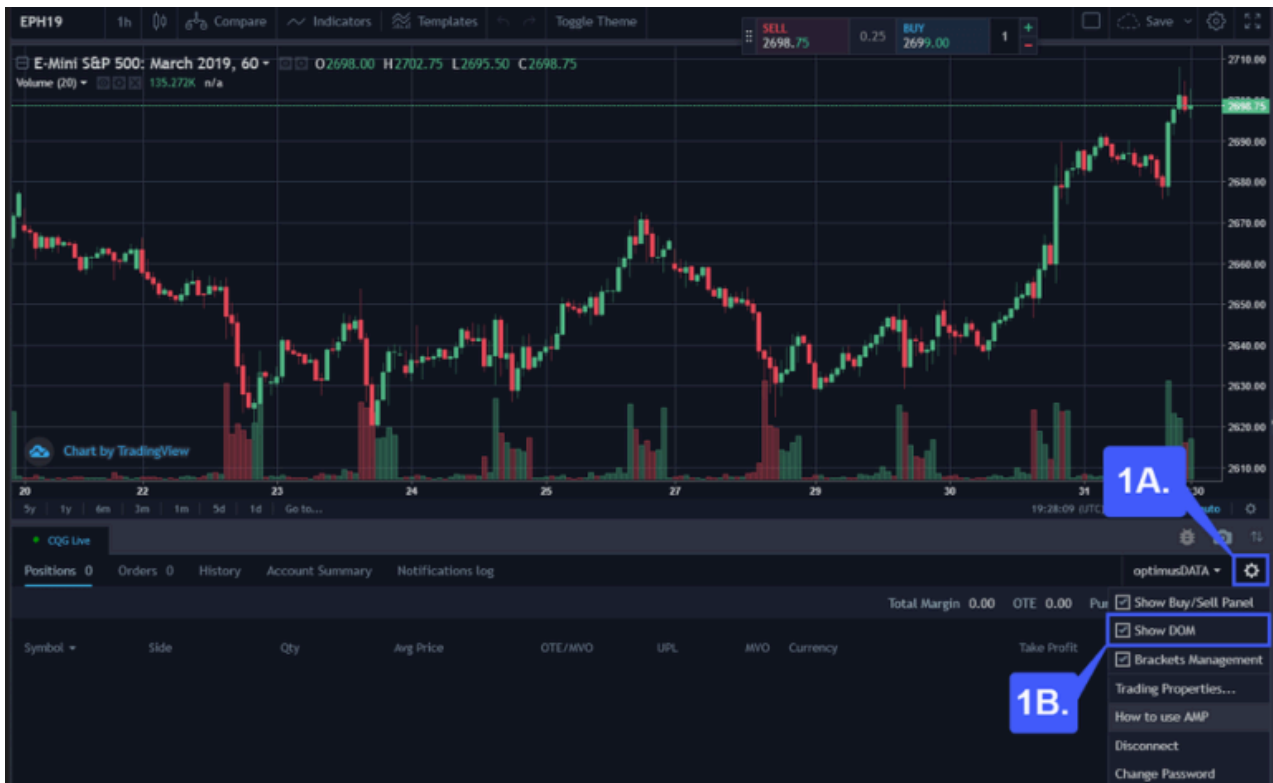
2. Level 2 Order Book

We have discussed the level 2 order book above, but let me give you a more detailed explanation of how level 2 market data works. Level 2 order book answers questions like how many buyers or sellers there are in the specific market, how large the orders are, what are the bid/ask prices of the current market, and what is the total size of orders.

Usually, a Level 2 order book shows up to 5-10 of the best bid and offer prices on a specific market (unlike Level 3, which shows a broader list of up to 20 bid and ask prices). The orders are updated in real time, providing precise info about possible price changes. Generally, the level 2 order book gives you a clear picture of all market participants entering the market – The data shows market depth by displaying the number of contracts/lots/shares placed at each bid and ask price.

Now, here is something for scalpers and day traders. Level 2 data is super beneficial for intraday traders as it enables them to capture many small price swings throughout the day. Using the level 2 market data, pro traders can use several level 2 strategies to predict how the underlying asset's price will move in the next few minutes by examining bid and ask prices and volume.
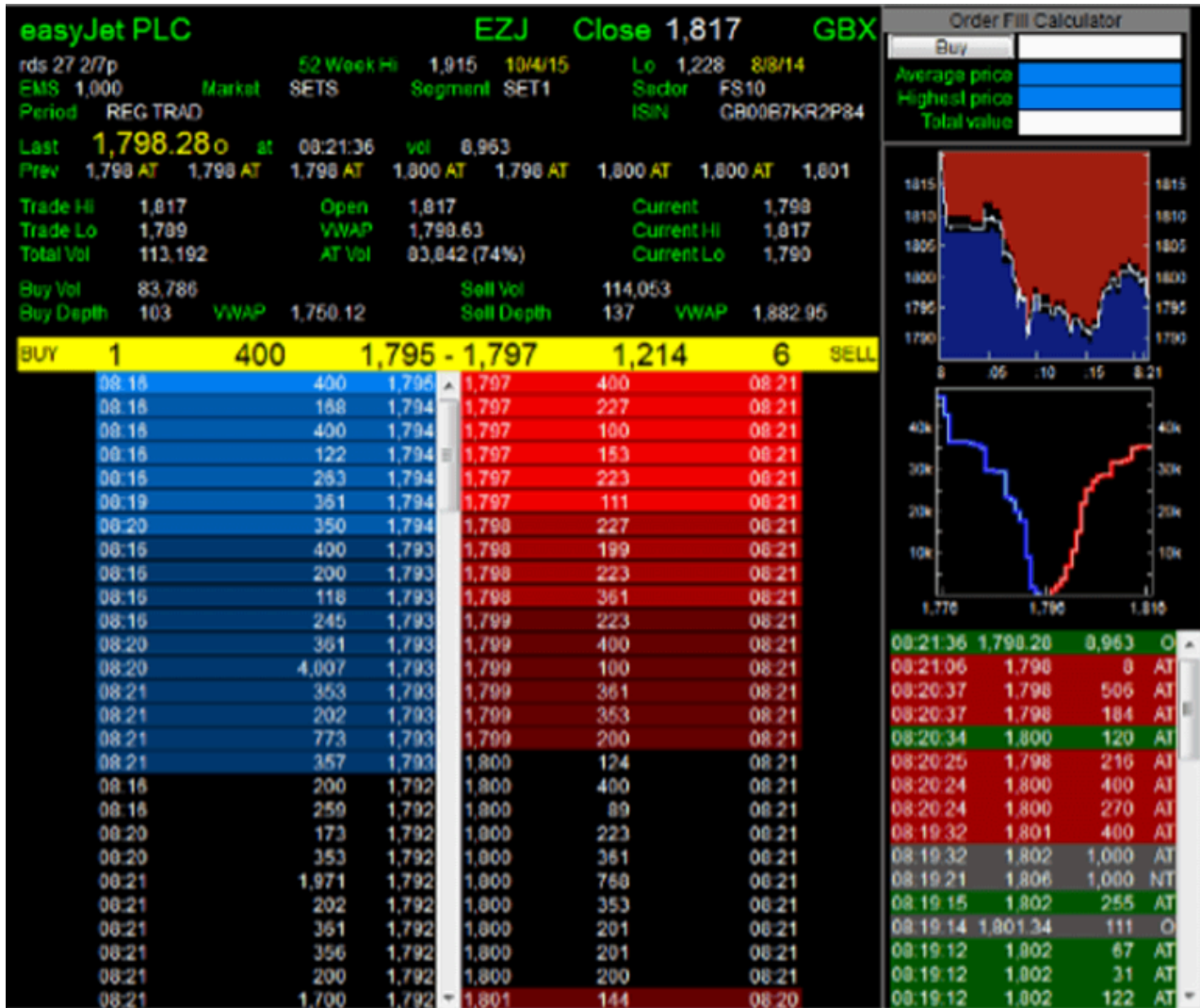
For example, if an asset's bid prices are falling, it might indicate that the price is due to fall. This is because potential buyers have begun offering less money for it at the upper end. On the other hand, rising ask prices for an asset may indicate that the price is poised to increase and gain strength in the short term.

Additionally, many day traders use various techniques when using the level 2 order book. For instance, if trading a market with low volatility, they may place limit orders on both sides and wait for execution. Otherwise, they can use the order flow trading technique to find where large institutions place big orders to utilize the breakout trading strategy.

3. Footprint Charts

A footprint chart is a visual representation of the traded volume at each price level. Much like the market depth and level 2 order book, it tells you exactly where the orders are being filled in real time.

However, compared to the Market depth, which displays a lot of info, the power of the footprint chart is based only on the fact that it only shows orders executed in the market.

As a result, you may pick up valuable information about where buyers and sellers were interested in making transactions and where the most considerable trade activity occurred.

A key point to add here is that footprint does not work in the interbank forex market. Instead, you can use it for assets listed on electronic exchanges like futures trading and the stock market. Although you can use footprint charts in forex futures trading, the volume in the interbank forex market is so massive that using footprint charts could be somehow confusing.

Nonetheless, a footprint chart is an excellent tool for order flow trading as it provides market depth information directly on a price chart, which makes the trading process much easier and more efficient.

4. Volume Weighted Average Price (VWAP) Indicator

VWAP, also known as Volume Weighted Average Price, shows the overall market volume by adding the Moving Averages trend line on a price chart. VWAP is a tool for identifying liquidity points, and, as a volume-weighted indicator, it emphasizes price levels weighted by volume. This can be useful for institutions with huge orders.

When entering huge buy or sell orders, large institutions and governments aim to avoid disrupting the market. VWAP assists these institutions in determining liquid and illiquid price points for a particular investment in a short period.

For that reason, many traders and long-term investors use the VWAP indicator to find crucial levels on a price chart and identify reasonable entry and exit levels.

How to Set Up the Order Flow Trading Indicator on MetaTrader4?

Many retail traders use MetaTrader4, the most popular trading platform in the world. But how do you add the order flow indicator to MT4? First, remember that most brokers providing MT4 usually allow access to CFDs, meaning you cannot view a level 2 order book or market depth.

Secondly, it is not a built-in indicator, so you'll have to find another provider or expert advisor plugin that gives you access to in-depth market data. Then, you must download and install a custom indicator to MT4/5.

Still, there are several ways to set up the order flow trading indicator on MT4, and you must research and find the best one on MT4 order flow plugins.

Here's one way to do that:

1. First, you have to download the order flow trader indicator here.
2. Next, install and add the indicator inside the MT4 indicators library. You can do this by clicking on the Open data folder and copy-pasting the indicator files in the indicators' library.
3. Once the indicator is installed, navigate to insert > indicators > custom and add the indicator to your charts. This is what the indicator looks like:

As you can see, the Meta Trader 4 is not among the best platforms for applying the order flow trading strategy, especially compared to other trading platforms. After all, MT4 brokers usually can not connect their clients to trading instruments listed on exchanges. As such, only a few MetaTrader4 brokers provide a level 2 order book or the order flow trading plugin as part of their service to retail traders.

Still, this indicator tells you the buy and sell flow of the current candle, meaning the order size of each side – buyers and sellers. If the buy flow is higher, there are more buying orders, and the price can go up. Conversely, if the selling flow is more dominant and you notice large amounts on the sell market order side, then there are more sell limit orders, and the price may go downwards.

Best Order Flow Charting Software

As mentioned, not every trading platform comes with an in-depth market data tool, which means that you have limited options. To get it, you must use software that provides level 2 market data and the tools that will allow you to utilize the order flow trading analysis.

So, from our research, here are some of the best order flow trading software as of 2023:

- NinjaTrader
- Stellar Trading Systems
- Sierra Charts
- MotiveWave
- Quantower