5 KEY CHART PATTERNS

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"Kingdom comes, kingdom goes but human nature remained the same."

That famous Chinese saying is on the dot when referring to history repetition. Humans are the creatures of tendencies and habits.

With stocks, support and resistance levels are the evidences that humans remember their experiences. The basis that history repeats is the essential foundation of technical analysis, which is the analysis of historical price data to forecast future price movements.

The "dejavu" experience is a very common one for any technical analyst. Many a time I have looked at the chart of various securities and thought,

"I've seen a pattern just like that before."

As technical analysts, we believe that almost all of the relevant information is already reflected in the prices. The market represents the summation of all market participants' view of the future in regards to fundamental expectations, hope, fear, greed, economic forecasts, political outlooks, news updates and other factors. This is an important point to remember. Many times beginning traders and investors go long on a stock after the release of a good earnings report only to find the stock price drifts downward. Other times, beginners find themselves shorting the market on bad news only to find the market rally up after a short dip. This is the discounting mechanism at work.

Believe it or not, markets do have structures. Just like people, the market has its own life, heartbeat and structure. It is as though an invisible hand is guiding it through the motion of time. Although not all technical analysts are agreeing to this, those that are looking at it in depth will be surprised to see patterns of this occurring so often to be ignored. Market moves within the scope of the structure in place and the understanding of such structures will enable us to have a better trading edge.

Later in this report, we will discuss more on these structures in the form of 5 common chart patterns that appear on the charts of stocks.

"One way to end up with $1 million is to start with $2 million and use technical analysis." - *Ralph Seger*

I find that quote amusing. A lot of people feel very strongly that technical analysis is about as useful as voodoo for helping you figure out the best investments for your money, and would rather advise the study of the fundamentals of the underlying security. I obviously tend to disagree, but let's take a look at some of the differences between fundamental and technical analysis of investments

Technical analysis is based on the idea that to know where stock prices are going, you must know where they have been. Therefore, charts are a fundamental element of technical analysis. Technical market analysis is based on the technical action of the market itself. According to technical analysis, the market is - at its most basic - groups of buyers pitted against groups of sellers. Put buyers and sellers together and the law of supply and demand is not far behind. According to that law, when demand exceeds supply, prices rise. When supply outruns demand, prices fall.

While technical analysis focuses on the action of the market itself, the other major form of market analysis - **fundamental analysis** - concentrates on studying the potential of a stock by focusing on the fundamentals of the company and the economic environment in which it is operating.

A fundamental analyst will look at the business of the company, its earnings and dividends - all the relevant factors that determine the success or failure of the business. Like technical analysis, the goal of fundamental analysis is the determination of where stock prices are headed. The difference is the fundamentalist studies the cause of market movement, while the technician studies the effect. So, simply put, as technical analysts we are not that concerned with the fundamentals.

Price charts - by detailing the history of price movements of a stock - are the key tools of a technical analyst. Charts tell the story of whether the market is moving up or down, helping investors to find the stocks they wish to buy and determine which stocks they want to sell. Experts will tell you that charts do not predict. However, according to technical analysts, charts are invaluable in determining the probabilities of success for the decision to buy, sell or hold. The keys to successful technical analysis is figuring out how to analyze the information the charts provide and, in turn, forecast future price movements.

At the core, stock trends and patterns are what technical analysts are looking for in their charts. **Chart analysis** is based on the theory that prices tend to move in trends and that past price behavior can give clues to the future direction of the trend. In addition, stock prices can form patterns that frequently forecast a stock's potential future path.

The main goal of chart analysis is to identify and evaluate price trends and patterns, with the objective of profiting from the future movement of prices. A chartist's skill lies not so much in his being able to forecast how high or how low a market will go, or when it will get there, as in being able to identify the direction of a trend and to call the turn of a trend when it comes.

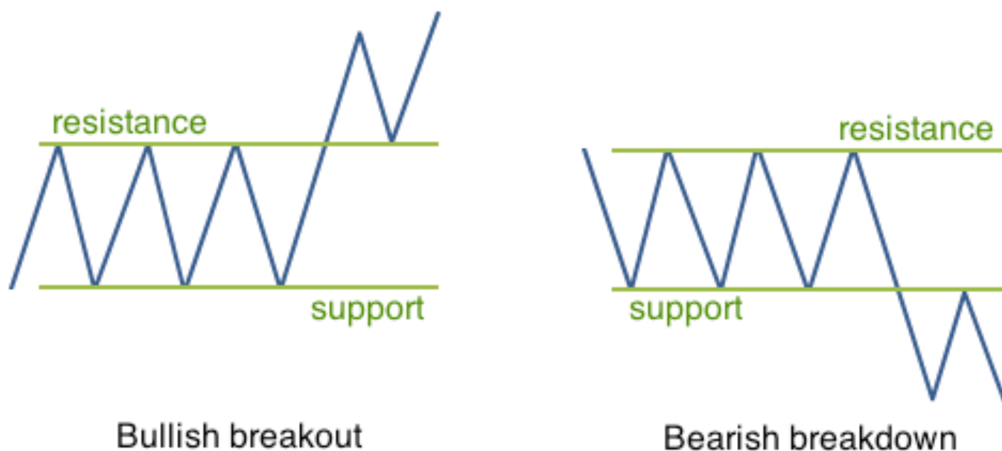
The purpose of this report is not only to highlight several common chart patterns that frequently occur on charts, but also it is to identify 5 securities where these patterns are currently forming.

The Rectangle

A Rectangle is a pattern that forms as a trading range during a pause in the trend.

The pattern is easily identifiable by two comparable highs and two comparable lows. The highs and lows can be connected to form two parallel lines that make up the top and bottom of a rectangle. The pattern is not complete until a breakout has occurred and although sometimes clues can be found, the direction of the breakout is usually not determinable beforehand. Things to remember with rectangles:

At least two equivalent highs are required to form the upper resistance line and two equivalent lows to form the lower support line. They do not have to be exactly equal, but should be within a reasonable proximity. Although not a prerequisite, it is preferable that the highs and lows alternate.



Rectangles can extend for a few weeks or many months. If the pattern is less than 3 weeks, it is usually not considered a rectangle. Ideally, rectangles will

develop over a multi-month period. Generally, the longer the pattern, the more significant the breakout. For example, a 3-month pattern might be expected to fulfill its breakout projection. However, a 6-month pattern might be expected to exceed its breakout target.

The direction of the next significant move can only be determined after the breakout has occurred. In other words, rectangles are neutral patterns that are dependent on the direction of the future breakout. Volume patterns can sometimes offer clues, but there is no confirmation until an actual break above resistance or break below support.

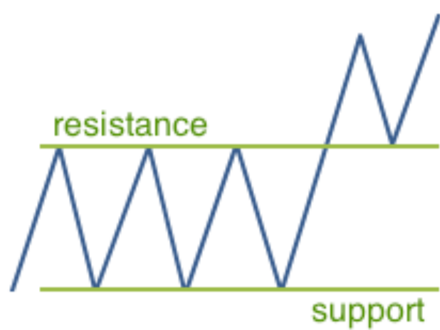
- For a breakout to be considered valid, it should be on a closing basis. One basic tenet of technical analysis is that broken support turns into potential resistance and visa versa. After a break above resistance (or below support), there is sometimes a return to test this newfound support level (or resistance level). A return to or near the original breakout level can offer a second chance to enter a trade.

Rectangles represent a trading range that pits the bulls against the bears. As the price nears support, buyers step in and push the price higher. As the price nears resistance, bears take over and force the price lower. More active traders will sometimes play these bounces by buying near support and selling near resistance. Eventually either the bulls or bears will exhaust themselves and a winner will emerge when there is a breakout.

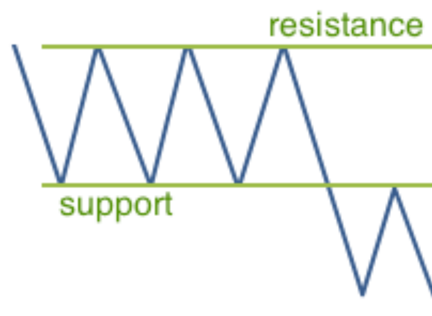
Again, it is important to remember that rectangles have a neutral bias. Even though there can be a tendency to try to predict the breakout, the actual price action depicts a market in conflict. Only until the price breaks above resistance or below support will it be clear which group has won the battle and a trade can be entered.

Again here's the idealized view of a rectangle pattern:

Basic rectangle pattern

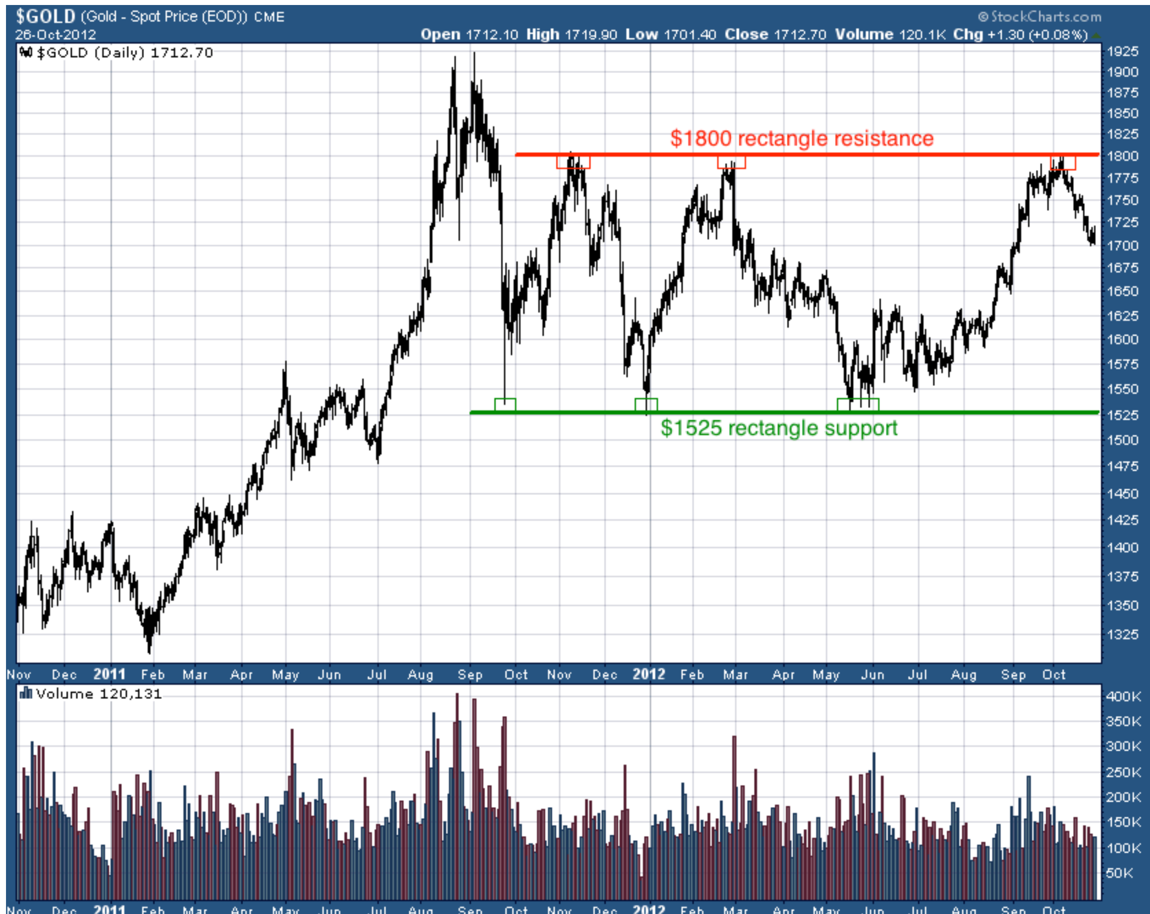


Bullish breakout



Bearish breakdown

Now, take a look at this chart of gold:

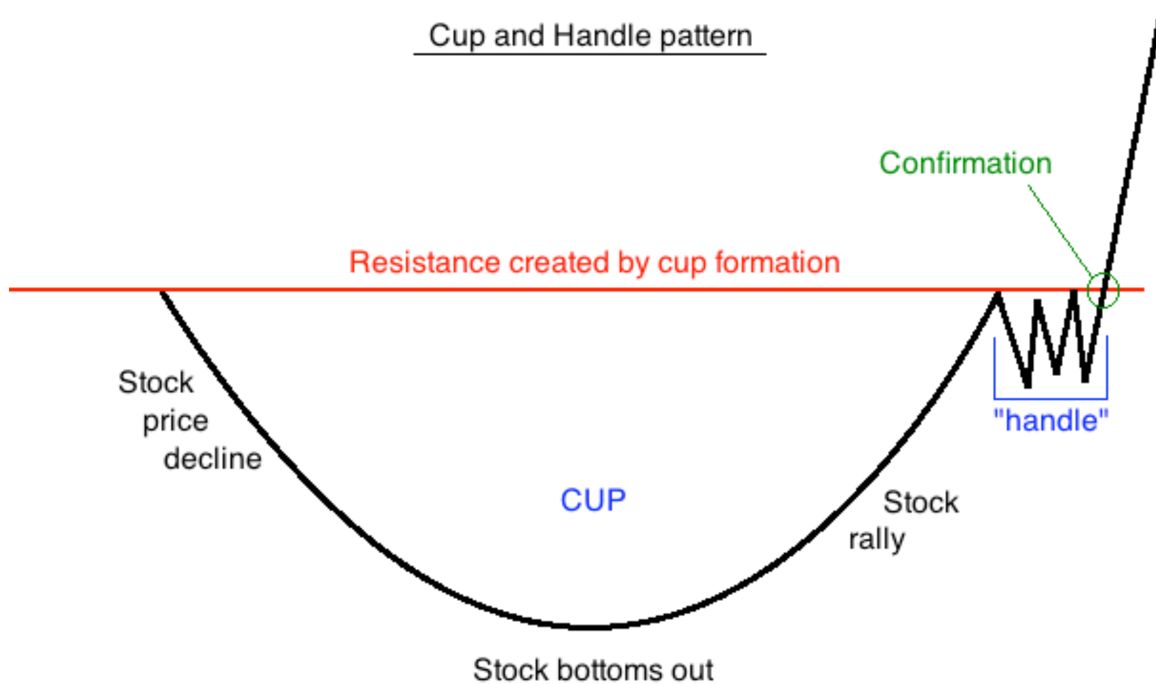


As you can see by the chart of gold above, the metal has been trading within a very large rectangle pattern. The resistance of the pattern is at $1800 (red) and the support for the rectangle is near $1525 (green). Not only could traders buy at support and short at resistance, but at some point gold will have to break out of this pattern. That eventual breakout or breakdown out of the pattern should signal the next big move for gold.

The Cup and Handle

The cup and handle is a **bullish continuation pattern** that marks a consolidation period followed by a breakout. As its name implies, there are two parts to the pattern: the cup and the handle.

The cup forms after an advance and looks like a bowl or “rounding bottom”. As the cup is completed, a trading range develops on the right hand side and the handle is formed. A subsequent breakout from the handle's trading range, and through the resistance created by the cup, usually signals a continuation of the prior advance.



Here are few things to remember with cup and handle patterns:

- To qualify as a continuation pattern, a prior trend higher should exist. Ideally, the trend should be a few months old, but not too mature. Ideally, the depth of the cup should retrace 1/3 or less of the previous advance. However, with volatile markets and over-reactions, the retracement could range from 1/3 to 1/2. In some rare situations, the maximum retracement could be as much as 2/3 of the previous trend.

- The **cup** should be "U" shaped or resemble a bowl or rounding bottom. A "V" shaped bottom would be considered too sharp of a reversal, thus would not meet the definition of a cup. The ideal pattern would have equal highs on both sides of the cup, but this is not always the case.

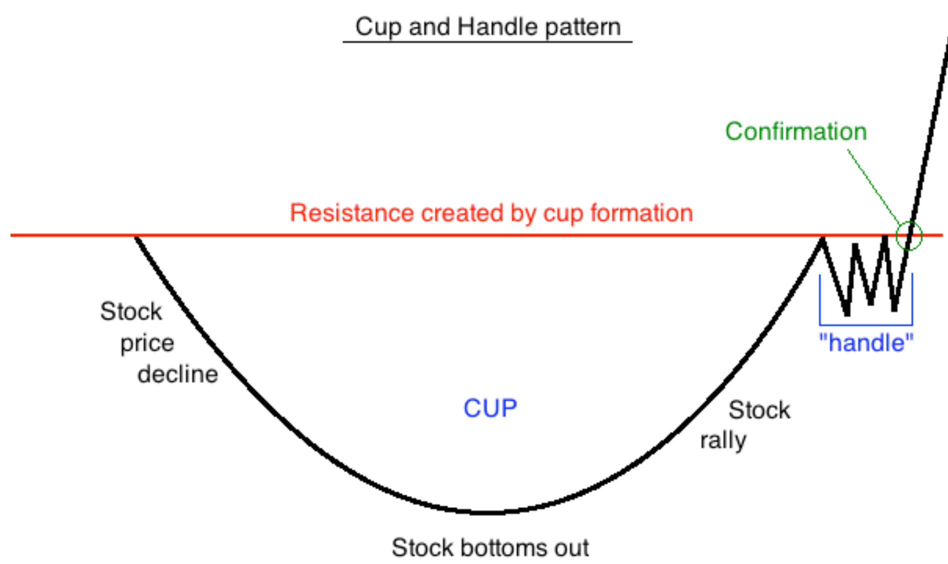
- After the high forms on the right side of the cup, there is a pullback that forms the **handle**. Sometimes this handle resembles a flag that slopes downward, but other times it is just a short pullback. The handle represents the final consolidation before the big breakout and can retrace up to 1/3 of the cup's advance, but usually not more. The smaller the retracement, the more bullish the formation and significant the breakout. Sometimes it is prudent to wait for a break above the resistance line established by the highs of the cup.

- The cup can extend from 1 to 6 months, sometimes longer on weekly charts. The handle can be from 1 week to many weeks and ideally completes within 1-4 weeks.

As with most chart patterns, it is more important to capture the essence of the pattern than the particulars. **The cup is a bowl-shaped consolidation and the handle is a short pullback followed by a breakout.**

The breakout should occur on a large increase in volume, at least 150% of the average is preferred. A cup retracement of 62% may not fit the pattern requirements, but a particular stock's pattern may still capture the essence of the cup and handle.

Here again is an idealized view of a cup and handle pattern



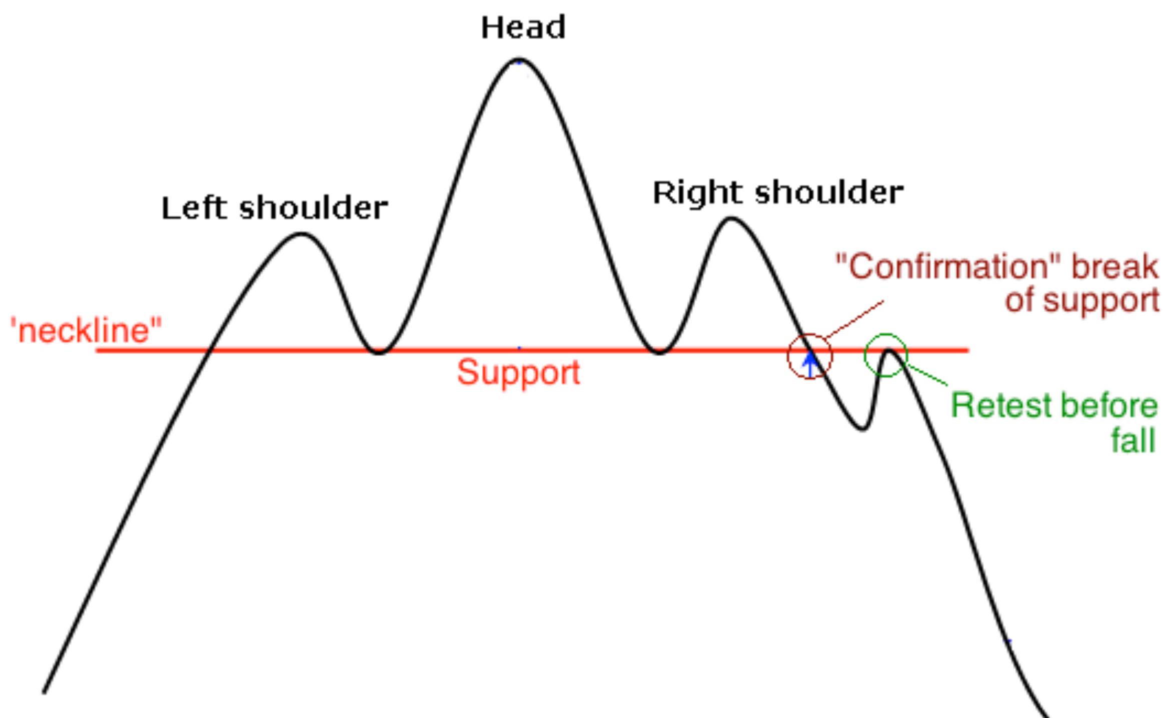
Now, take a look at this chart of the stock VRX:

As you can see by the chart of VRX, the stock has formed a very well defined cup and handle pattern. The stock has the necessary uptrend leading into the formation of the cup. The cup is clearly visible (blue). The handle is in the process of forming (green). The resistance created by the cup appears to be around $60 (red).

So, traders would want to wait to see the stock break up and out of the handle, and preferably through the $60 resistance. In addition, a high increase in volume on the breakout would be ideal.

Head and Shoulders

A **head and shoulders reversal pattern** forms after an uptrend, and its completion marks the reversal of the preceding trend. The pattern contains three successive peaks with the middle peak (head) being the highest and the two outside peaks (shoulders) being low and roughly equal. The support lows of each peak are called the "neckline". A few things about head and shoulders:



- It is important to establish the existence of a prior uptrend for this to be a reversal pattern. Without a prior uptrend to reverse, there cannot be a head and shoulders reversal pattern.

- While in an uptrend, the left shoulder forms a peak that marks the high point of the current trend. After making this peak, a decline ensues to complete the formation of the left shoulder.

- From the low of the left shoulder, a rally begins that exceeds the left shoulder high and eventually marks the top of the head. After the head formation peaks, the low of the following decline marks the second point for the formation of the neckline.

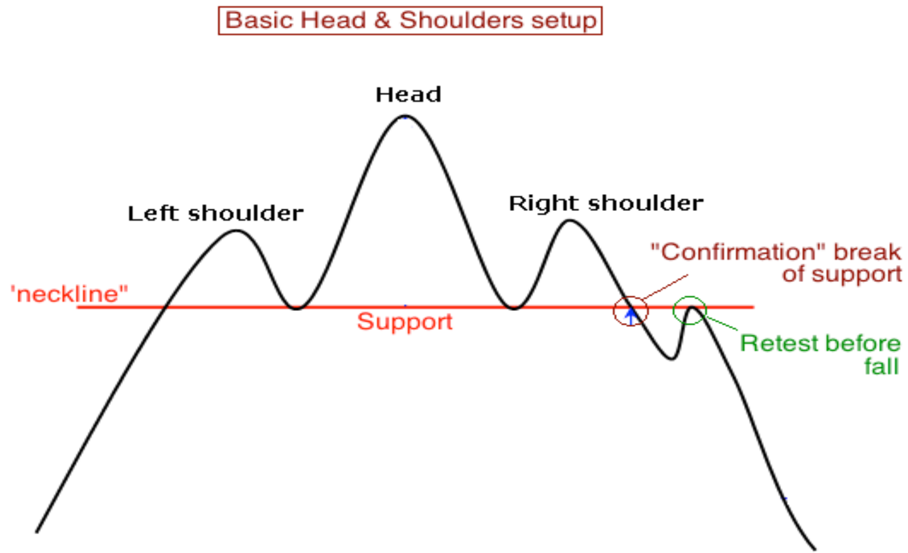
- The advance from the low of the head forms the right shoulder. This peak is lower than the head (a lower high) and usually in line with the high of the left shoulder. While symmetry is preferred, sometimes the shoulders can be out of whack. The decline from the peak of the right shoulder should break the neckline.

- The neckline forms by connecting the low point of the left shoulder decline with the low point of the head decline. Depending on the relationship between the two low points, the neckline can slope up, slope down or be horizontal. Sometimes more than one low point can be used to form the neckline.

- The head and shoulders pattern is not complete and the uptrend is not reversed until neckline support is broken. Ideally, this should also occur in a convincing manner, with a large increase in volume. The volume increase adds validity to the breakdown.

- Once support (neckline) is broken, it is common for this same support level to then turn into resistance on any rallies. Sometimes, but certainly not always, this return to the support break area will offer a second chance to sell or enter a short trade.

Here is an idealized view of a head and shoulders pattern:



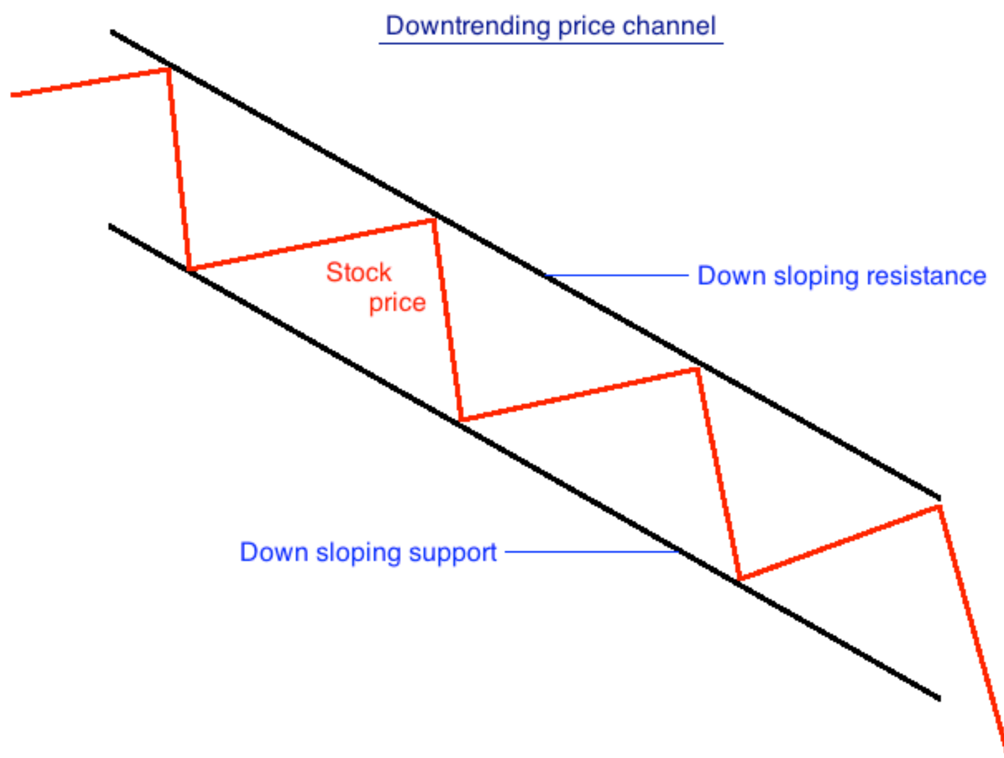
Now, take a look at this chart of the stock RL:

As you can see from the chart of RL, the stock has formed a very well defined head and shoulders pattern. The stock has the necessary uptrend leading into the formation of the pattern and the pattern itself is clear (blue), with the right shoulder still forming. The “neckline” that’s been created by the head and shoulders pattern appears to be at $135 (red).

Traders would want to wait to see the stock break down though the “neckline, and preferably, on a high increase in volume on the actual breakdown.

Price Channels

A **price channel** is a continuation pattern that trends up or down and is bound by an upper and lower trend line. The upper trend line marks resistance and the lower trend line marks support. Price channels with negative slopes (downward) are considered bearish and those with positive slopes (upward) bullish. For explanatory purposes, an **uptrending price channel** will refer to a channel with positive slope and a **downtrending price channel** will refer to one with a negative slope. Here are several things to consider with price channels:



- It takes at least two points to draw the main trend line. This line sets the tone for the trend and the slope. For an uptrending price channel, the main trend line extends up and at least two reaction lows are required to draw it (support). For a downtrending price channel, the main trend line extends down and at least two reaction highs are required to draw it (resistance).

- The line drawn parallel to the main trend line will be the resistance for

uptrending price channel and the support for the downtrending price channel. Ideally, the channel line will be based off of two opposite highs or lows. However, after the main trend line has been established, some analysts draw the parallel channel line using only one reaction high or low.

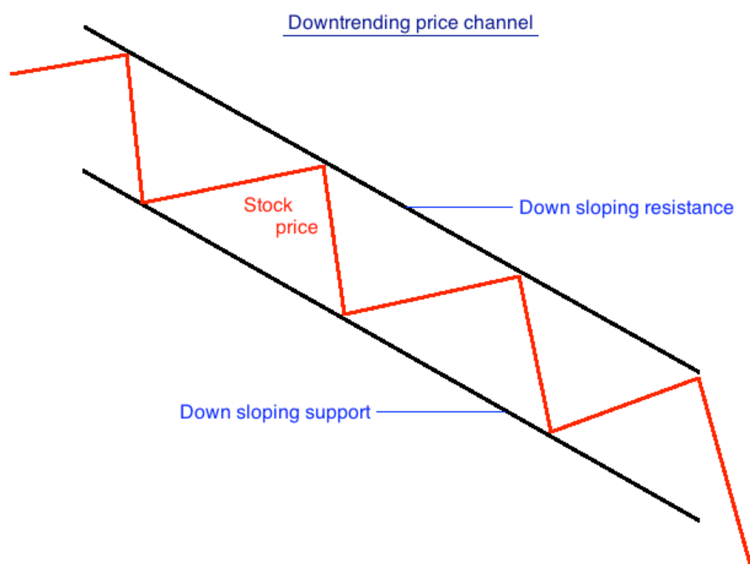
- For uptrending channels, ass long as prices advance and trade within the channel, the trend is considered bullish. The first warning of a trend change occurs when prices fall short of channel line resistance. A subsequent break below main trend line support would provide further indication of a trend change. A break above channel line resistance would be bullish and indicate an acceleration of the advance.

- For downtrending channels, as long as prices decline and trade within the channel, the trend is considered bearish. The first warning of a trend change occurs when prices fail to reach channel line support. A subsequent break above main trend line resistance would provide further indication of a trend change. A break below channel line support would be bearish and indicate an acceleration of the decline.

In a bullish price channel, some traders look to buy when prices reach main trend line support. Conversely, some traders look to sell (or short) when prices reach main trend line resistance in a bearish price channel.

Because technical analysis is just as much art as it is science, there is room for flexibility. Even though exact trend line touches are ideal, it is up to each individual to judge the relevance and placement of both the main trend line and the channel line.

Here again is an idealized view of a downtrending price channel:



Now, take a look at this chart of the ETF FXE (euro):

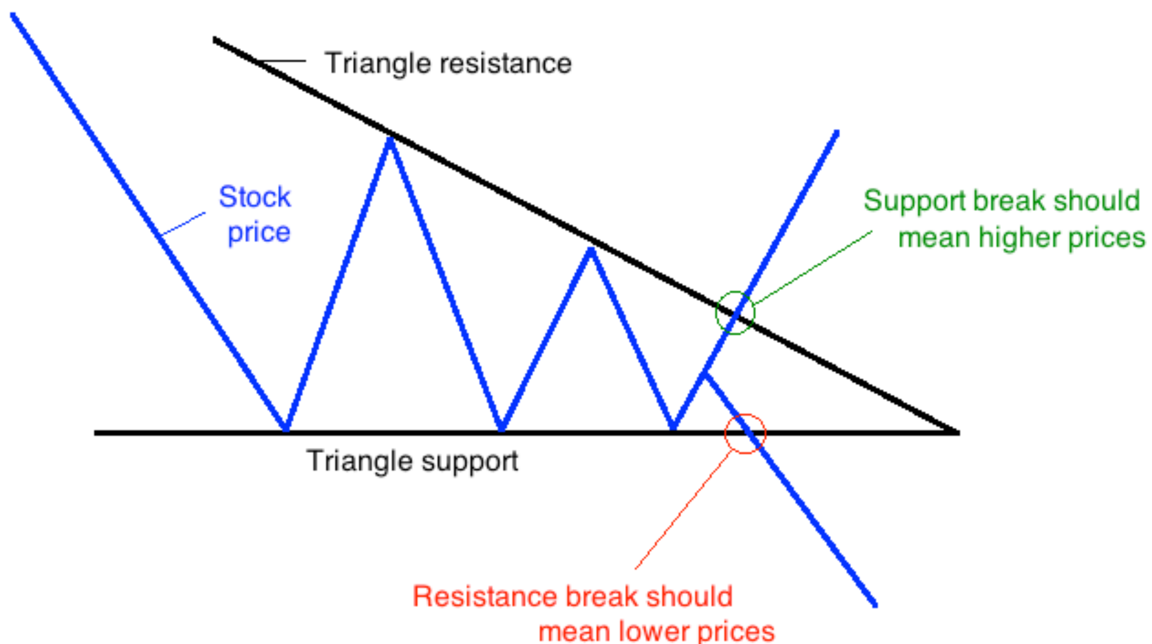
The chart of FXE (euro) shows the ETF stuck within the downtrending price channel. The channel resistance (red) currently sits near $130 and the channel support (green) probably sits somewhere near $117-118. The FXE currently sits at resistance.

Traders could look to enter a short position on a test of the channel resistance or if the ETF would happen to break below the channel support. By the same token, a trader could enter a long trade on a pullback to the channel support or on a breakout through the channel resistance.

The Triangle

The **descending triangle is a bearish formation** that usually forms during a downtrend as a continuation pattern. There are instances when descending triangles form as reversal patterns at the end of an uptrend, but they are typically continuation patterns.

Because of its shape, the pattern can also be referred to as a right-angle triangle. Two or more comparable lows form a horizontal support at the bottom. Two or more declining peaks form a descending trend line resistance above that converges with the support as it descends.



Here are some key factors to consider with descending triangles:

- At least 2 lows are required to form the lower horizontal support level. The lows do not have to be exact, but should be within reasonable proximity of each other. There should be some distance separating the lows and rally highs in between them.

- At least 2 rally peaks are required to form the upper descending trend

line. These peaks should be successively lower and there should be some distance between them. If a more recent high is equal to or greater than the previous high, then the descending triangle is not valid.

- The length of the pattern can range from a few weeks to many months, with the average pattern lasting from 1-3 months. The bigger the pattern, the bigger the subsequent move on the breakout or breakdown.

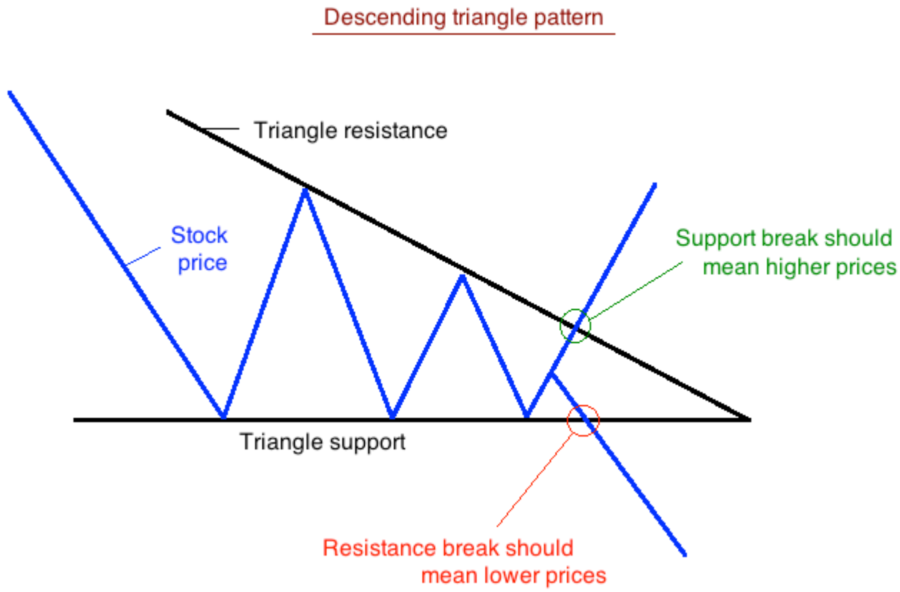
- As stated earlier, a basic tenet of technical analysis is that broken support commonly turns into resistance and visa versa. So, if the horizontal support level of the descending triangle is broken, it turns into resistance. Sometimes there will be a return to this newfound resistance level before the down move begins in earnest.

A descending triangle definitely has a **bearish** bias before the actual break, but the pattern must be given the latitude to break higher as well. This is why it is important to let the pattern develop if one is waiting for a break.

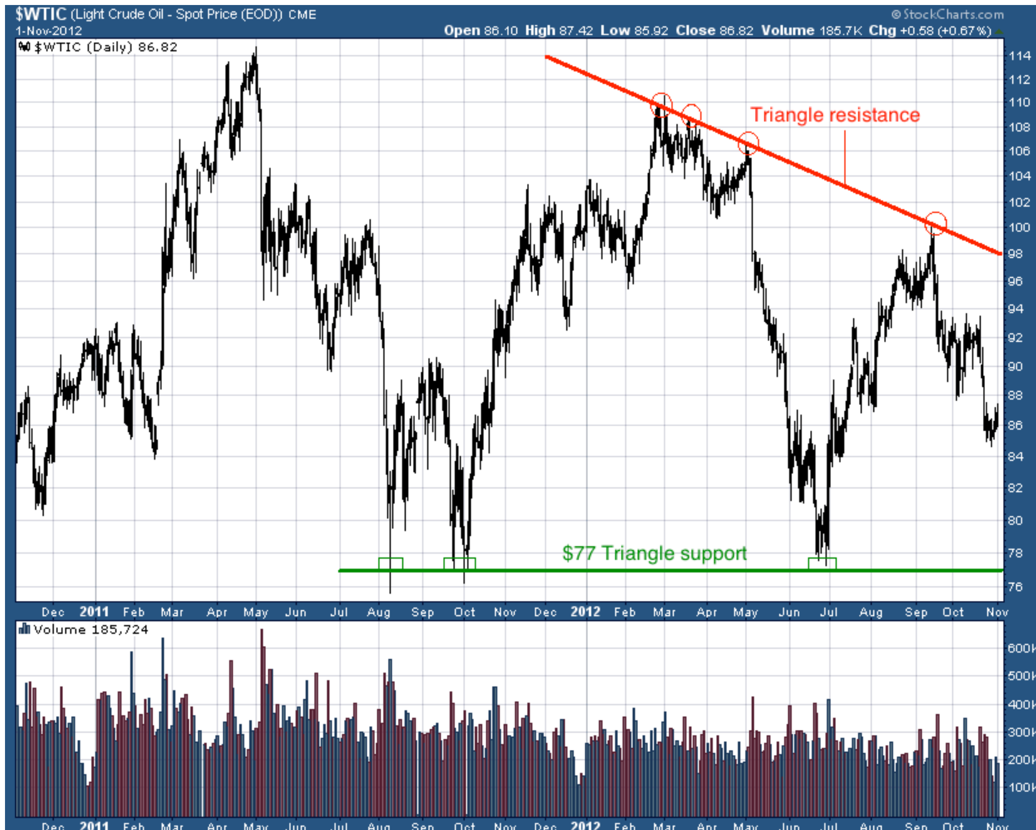
The reason why the bearish biased is assumed is because the horizontal support level represents demand that prevents the security from declining past a certain level. It is as if a large buy order has been placed at this level and it is taking a number of weeks or months to execute, thus preventing the price from declining further. Even though the price does not decline past this level, the rally peaks continue to decline.

It is these lower highs that indicate increased selling pressure and give the descending triangle its bearish bias.

Here again is an idealized view of a descending triangle:



Now, take a look at this chart of the Oil:



The chart of oil highlights the descending triangle that the commodity has been forming. The triangle resistance (red) currently is at approximately $98 and the triangle support (green) sits near $77. This is a very large pattern, thus the eventual break should lead to a significant move in the direction of the break.

Traders could look to enter a short position on a test of the triangle resistance or if oil does end up breaking below the $77 support. By the same token, a trader could enter a long trade on a pullback to that support or on a breakout through the triangle resistance.

So, there you have it. Not only have I highlighted 5 chart patterns that you can keep an eye out for in all of your future trading, but 5 corresponding securities that are in the process of forming these patterns. Now that you are aware of these potential stock market profit generators, what should you do next?

If you do not already have one, build yourself a watch list of stocks that include the ones I've mentioned in this report. This list can be built on any financial site, such as Yahoo Finance, Google Finance or Marketwatch. Most however keep their watch list in their own trading account. This way, if a trade presents itself on one of your stocks, you can immediately click "buy" or "sell".

The biggest piece of advice I give everyone I coach or consult is: Set your stop loss. Although it can take time to figure out the appropriate stop loss management approach, protecting yourself is always paramount. Remember,

" Markets can remain irrational longer than you can remain solvent" - *John Maynard Keynes.*

A few other great stock market quotes to leave you with:

" Nobody works as hard for his money as the man who marries it."

-Kin Hubbard, 1868-1930, American Journalist.

"I know from experience that nobody can give me a tip or a series of tips that will make more money for me than my own judgment."

-Jesse Livermore

" Emotions are your worst enemy in the stock market." *-Don Hays.*

Thank you for reading and please let me know if you have any questions or comments.

P.S. If you liked this report and would like to get more great ideas and information on technical analysis and access to my weekly calls where I break down the hot topics of the market each week, **start your risk-free trial of my 5 Star Trading Academy today!**