

BASIC TECHNIQUES

Some Patterns Are Common To All Technicians

Price Patterns, Part II

This veteran market analyst takes a look at the patterns of price formation.

by **Martin J. Pring**



Last time, I covered the basics of chart patterns using rectangles as an example. This time, I will expand on the subject by taking a look at several different patterns. To recap some of the major points:

- 1 Price patterns are clearly definable trading ranges that form on a chart. There are two types — reversal and consolidation.
- 2 The significance of a pattern is relative to its size; the longer it takes to complete, the more significant the formation is.
- 3 The *minimum* ultimate measuring objective for a price pattern is obtained by calculating its maximum depth at the breakout point and projecting it in the direction of the breakout.

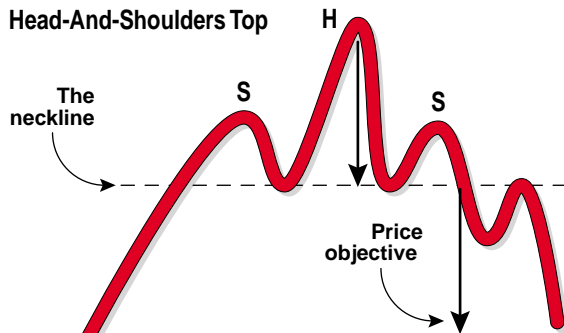


FIGURE 1: HEAD-AND-SHOULDERS TOP. Breaking below the neckline is the traditional signal to short a top.

HEAD AND SHOULDERS

Perhaps the most notorious price formation of all is the head-and-shoulders formation, a pattern that appears at both bottoms and tops. At market peaks, it consists of a final rally (the head) separated by two smaller ones (the left and right shoulders), as shown in Figure 1. The line connecting the lows is referred to as the *neckline* and the measuring objective is obtained by calculating the distance from the head to the neckline, then projecting that down. The principle is, there-

fore, identical with the measuring objective for rectangles. Volume considerations are important, since volume should be exceptionally heavy during the formation of the left shoulder and/or the head; buying volume should be noticeably less during the right-shoulder rally.

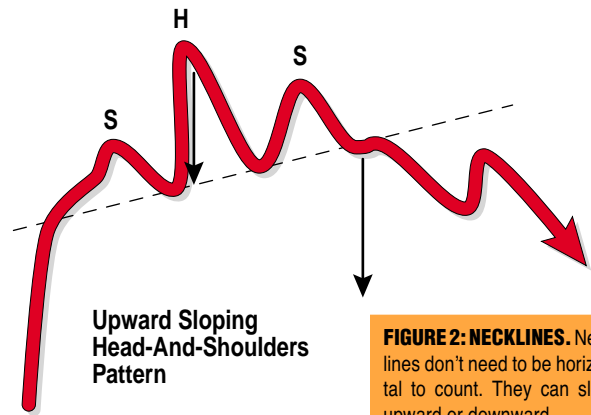


FIGURE 2: NECKLINES. Necklines don't need to be horizontal to count. They can slope upward or downward.

Head-and-shoulder formations come in several varieties. For instance, the example in Figure 1 contains a horizontal neckline. In this instance, when the price violates the neckline, it also breaks below the previous low. In effect, the completion of the head and shoulders signals that a series of declining peaks and troughs is now in force. Alternatively, the line can slope up, at which point the formation is known as an *upward sloping head and shoulders* (Figure 2), or down, when it is referred to as a *downward sloping head and shoulders*.

Reverse head-and-shoulders formation, or head-and-shoulders bottoms, form after a decline. They, too, have the usual measuring implications and can be found in the upward and downward sloping varieties (Figure 3). The key in the comple-

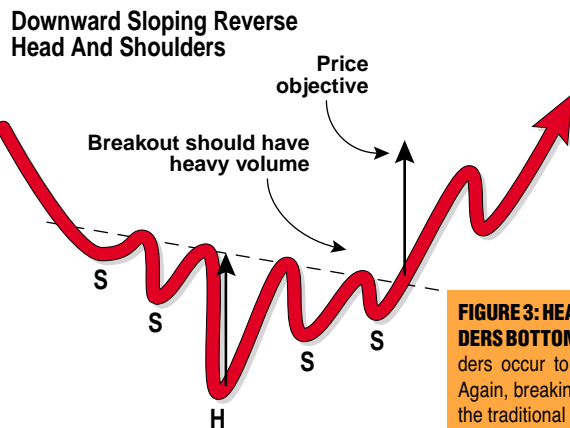
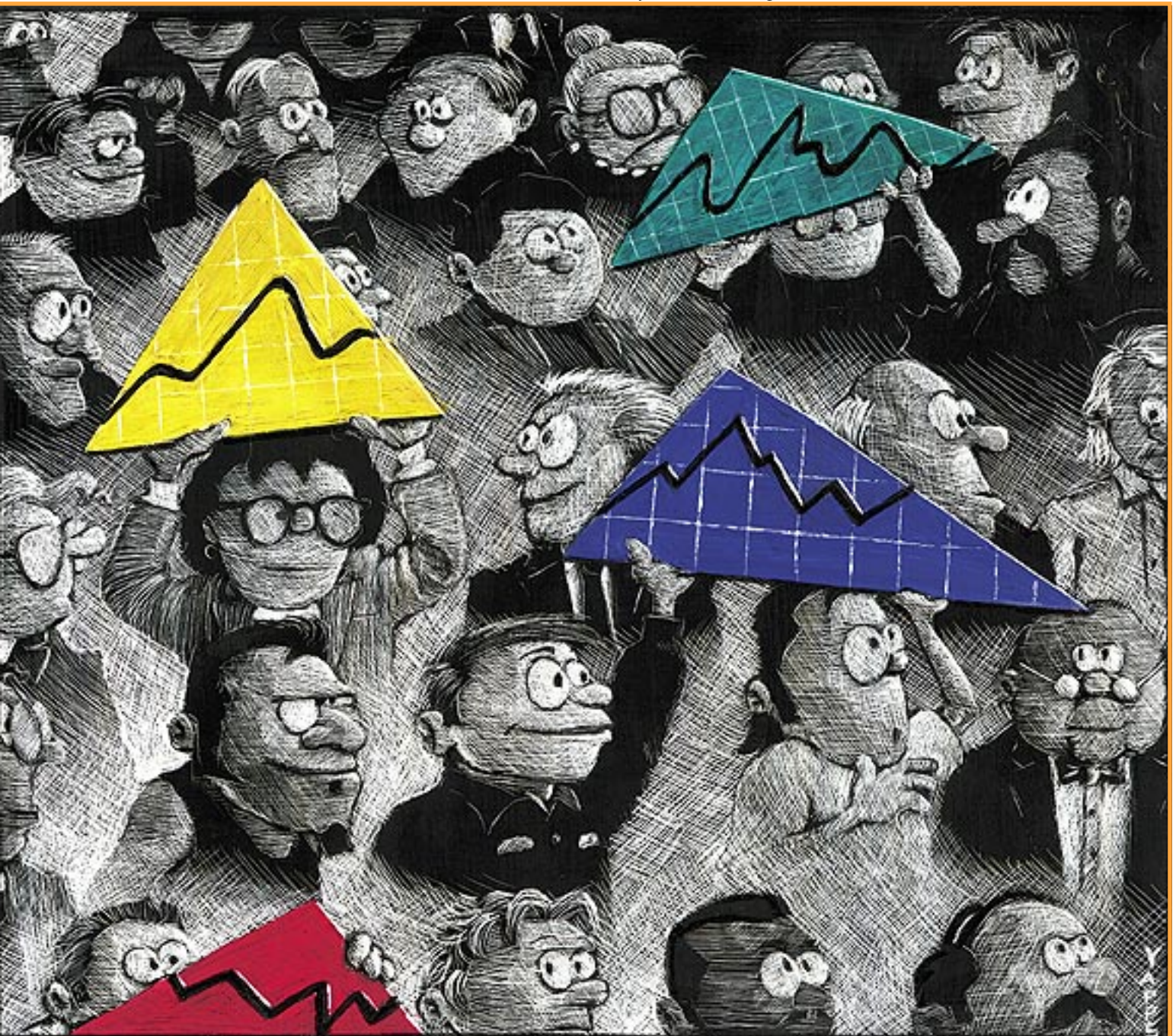


FIGURE 3: HEAD-AND-SHOULDERS BOTTOM. Multiple shoulders occur to form a bottom. Again, breaking the neckline is the traditional signal to go long from the bottom.



MIKE YAPPS

tion of any reversal pattern at market bottoms is for volume to expand during the breakout. If expanding volume is not present, neither is the enthusiasm of buyers, and that makes the breakout suspect. The appearance of several shoulders legitimizes the pattern, however, since the more shoulders that are required to form the pattern, the greater the battle is between buyers and sellers. Normally, the breakouts from multiple shoulder patterns are more significant than those of the single variety.

HEAD-AND-SHOULDER FAILURES

Sometimes, a head-and-shoulders topping pattern appears to be forming, but either falsely breaks down or avoids a break by rallying a third time from the neckline. Such situations are known as *head-and-shoulders failures*, and are usually quite bullish.

Head-And-Shoulders Top

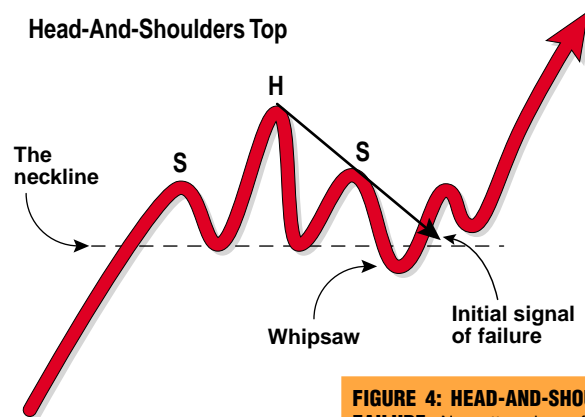


FIGURE 4: HEAD-AND-SHOULDERS FAILURE. No pattern is perfect, and your first clue to a head-and-shoulders failure is a break above the descending trendline from the head.

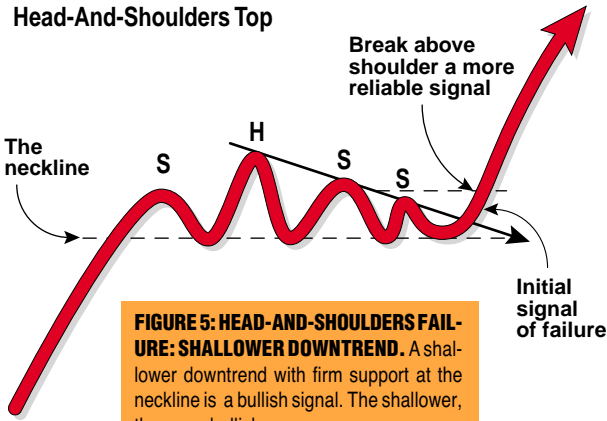


FIGURE 5: HEAD-AND-SHOULDERS FAILURE: SHALLOWER DOWNTREND. A shallower downtrend with firm support at the neckline is a bullish signal. The shallower, the more bullish.

The big question is: How do you *know* when it has broken down? There is no black and white answer. The first indication of a possible failure comes when the price rallies above the down trendline joining the head and the right shoulder (Figure 4). In this instance, the shallower the line is, the greater the significance of the break. In Figure 4, the line is quite steep, so I would not place as much significance on the break as in Figure 5, which contains a much shallower line.

The second and perhaps balance-tipping point comes when the price rallies above the right shoulder. At this juncture, we now have a series of rising peaks. If the neckline has not been violated on a horizontal head and shoulders, this means the series of rising bottoms that presumably preceded the formation of the head and shoulders is still intact. Therefore, the trend, as defined by peak and trough analysis, is still bullish. The final signal, which is more of a confirmation, develops when the price rallies above the head.

In terms of market action, the rally above the right shoulder is usually the best place to enter a buy signal because you can place a good, reasonably low-risk stop below the neckline. The same principle holds for an inverse head and shoulders, but in reverse.

Head-and-shoulders patterns also develop as continuation formations (Figure 6) in much the same way that rectangles do, as discussed last month.

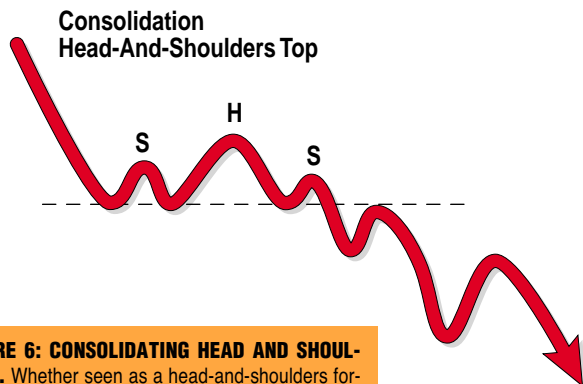


FIGURE 6: CONSOLIDATING HEAD AND SHOULDERS. Whether seen as a head-and-shoulders formation or a rectangle, breaking the support at the neckline and resuming the trend is a strong confirmation of the original direction.

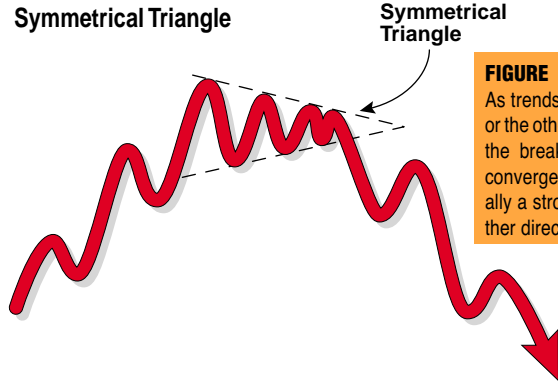


FIGURE 7: TRIANGLE. As trends converge, one or the other must win and the breakout from their convergence is traditionally a strong signal in either direction.

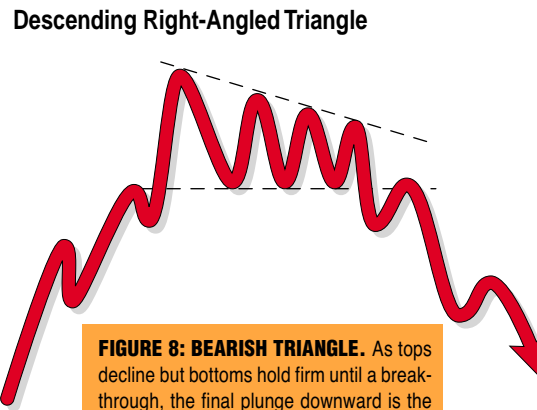


FIGURE 8: BEARISH TRIANGLE. As tops decline but bottoms hold firm until a breakthrough, the final plunge downward is the signal to go short.

TRIANGLES

Another common formation is the *triangle*, which is constructed from two converging trendlines, one joining a series of peaks and another a series of troughs. Breakouts develop when the price violates either of these lines (Figure 7). The pattern is referred to as a *symmetrical* triangle when one line is declining and the other rising. However, when one of the lines is horizontal, it is known as a *right-angled* triangle.

When a right-angled triangle contains a declining trendline, it is generally a bearish pattern (Figure 8) and is known as a *descending* right-angled triangle. The opposite, an *ascending*

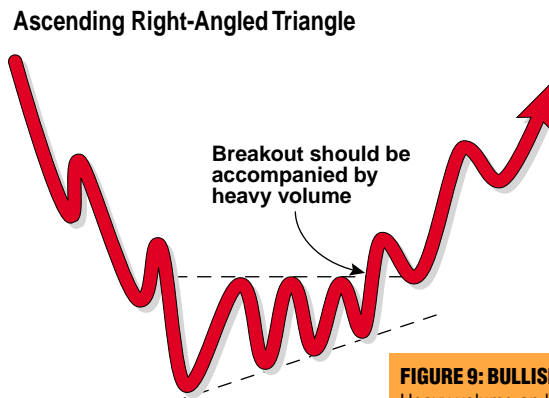


FIGURE 9: BULLISH TRIANGLE. Heavy volume on breakout from the triangle confirms the direction of the breakout.

Triangle Turns Out To Be A Rectangle

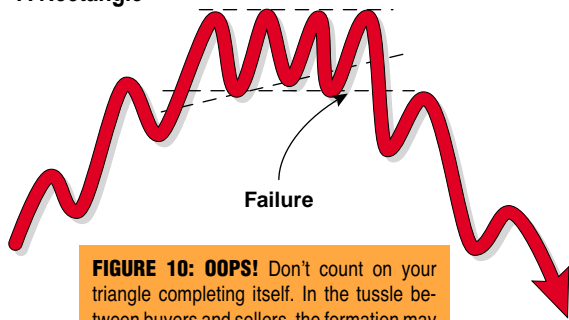


FIGURE 10: OOPS! Don't count on your triangle completing itself. In the tussle between buyers and sellers, the formation may change to a normal rectangle or trading range.

Descending Right-Hand Triangle Failure

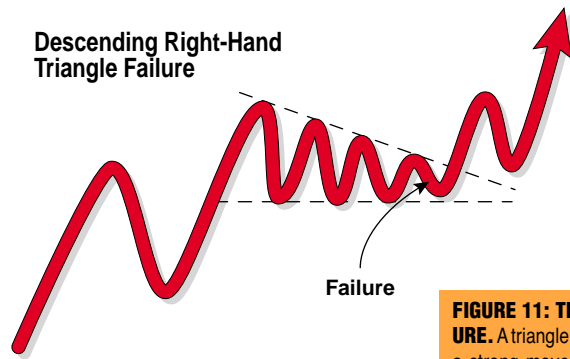


FIGURE 11: TRIANGLE FAILURE. A triangle failing presages a strong move away from the expected direction.

right-angled triangle, is generally bullish (Figure 9). The horizontal lines in these formations provide clearly definable support and resistance areas. Breakouts from right-angled triangles are usually more powerful than those from symmetrical ones. Triangles, like other patterns, can be of the

a bit below and sometimes at the same level. However, if the second peak tops out well above its predecessor, the double-top formation is not a valid call.

What we are really seeing in this formation is a reversal in the rising peaks and troughs if we allow for the fact that the second peak is not significantly above the first. For a strong indication of a double top, make sure that volume on the

Perhaps the most dynamic moves emanating from triangles arise when a right-angled variety breaks in the *opposite* direction to that expected.

reversal or continuation variety. Breakouts can sometimes be less reliable than other patterns because what starts out as a right-angled triangle can sometimes turn into a rectangle, as can be seen in Figure 10.

Perhaps the most dynamic moves emanating from triangles arise when a right-angled variety breaks in the *opposite* direction to that expected. In Figure 11, for instance, the price does not break below the horizontal line of support, but instead rallies above the declining line. Of course, the same thing can happen in the other direction. Nasty declines often follow from such breakouts, probably because the failure to rally above the horizontal level of resistance leads to exhaustion.

The traditional method of determining price objectives from triangle breakouts is to construct a line parallel with the line farthest from the breakout (Figure 12). The line itself becomes the objective. In my experience, the usual method of measuring the depth of the pattern and using that as the projected distance at the time of the breakout is a better method (Figure 13). This is because the parallel line method is usually far too modest an objective, the price usually moving a lot farther.

Descending Right-Angled Triangle

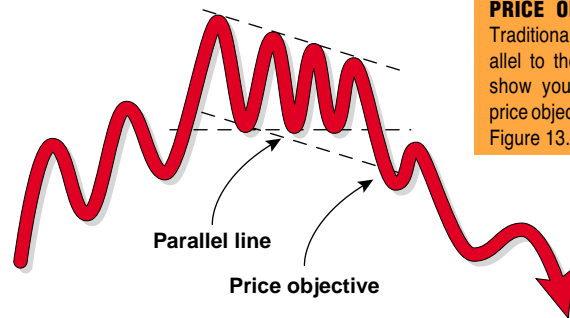


FIGURE 12: TRIANGLE PRICE OBJECTIVES. Traditionally, a line parallel to the tops would show you a triangle's price objectives, but see Figure 13.

Descending Right-Angled Triangle

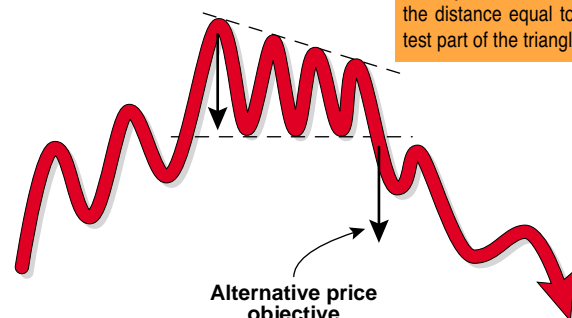


FIGURE 13: PRING'S PRICE OBJECTIVE. As an alternative, the objective is estimated as the distance equal to the fattest part of the triangle.

DOUBLE BOTTOMS AND TOPS

A double top develops in an uptrend and is a reversal pattern (Figure 14). After a rally and reaction, the subsequent advance fails to take the price meaningfully above the previous rally high. It then retreats below the previous low, signaling a trend reversal. It does not really matter where the second top develops; sometimes it is a little above the first, occasionally

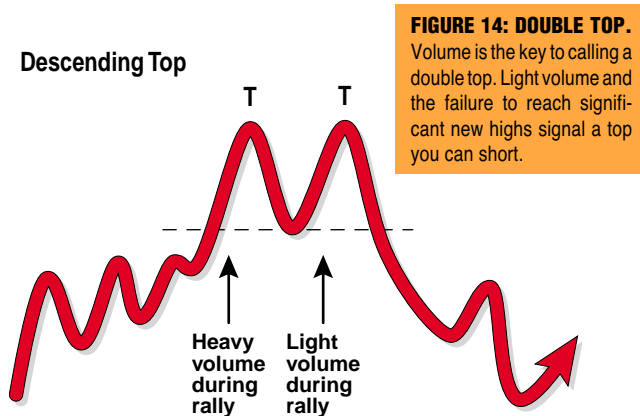


FIGURE 14: DOUBLE TOP. Volume is the key to calling a double top. Light volume and the failure to reach significant new highs signal a top you can short.

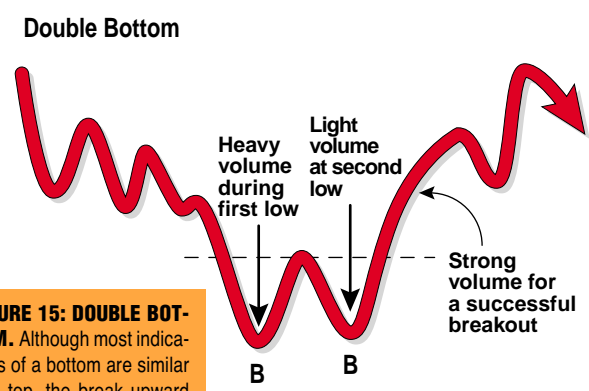


FIGURE 15: DOUBLE BOTTOM. Although most indications of a bottom are similar to a top, the break upward should be on strong volume, indicating aggressive buyers.

second peak's rally is significantly lower than that of the first. This indicates a lack of interest by buyers and makes the price more susceptible if sellers become more persistent.

A double bottom (Figure 15) is the opposite of a double top in that two reactions develop at around the same level, but the rally that forms after the formation of the second bottom takes the price above the previous peak. The first top and the first bottom in such formations are usually heavy-volume, high-excitement affairs. The second bottom is typically associated with far less volume and far less excitement. In this situation, the mood is usually more bearish than at the first bottom, due to the disappointment that the initial rally off the low is all but retraced. However, for a valid breakout, we need to see expanding volume where the complacency at the second bottom is replaced by enthusiastic buying. These patterns only appear on the charts as reversals, not continuation.

These are the most common patterns used by all technicians. One- and two-day patterns, the subject of my next article, are most commonly used by swing traders.

Martin J. Pring founded the International Institute for Economic Research in 1981. He pioneered the introduction of videos as an educational tool for technical analysis in 1987, and was the first to introduce educational interactive CDs in this field.

SUGGESTED READING

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