Chart Patterns for Forex Beginners

Reversal and Continuation Patterns

About ActionForex.com

ActionForex.com was set up back in 2004 with the aim to provide insightful analysis to forex traders, serving the trading community over a decade. We started providing only a daily and a mid-day report, now known as Action Insights. Gradually, we added a lot more in-house contents to the site. Techinical Outlook section was expanded to cover more pairs. Central Bank Views, China Watch and Special Topics are added to cover fundmental developments that affect the markets. In addition to that, Top Movers, Heat Map, Pivot Point Charts and Pivot Meters, Action Bias and Volatility Charts, are tools used by traders from all over the world.

"Empowering the individual traders" was, is, and will always be our motto going forward.

Contents

I: Introduction

This ebook introduces some common known reversal and continuation patterns, and discuss the ways to identify them. Reversal patterns include: Head and Shoulders, Double Tops and Bottoms, Triple Tops and Bottoms and Saucers. Continuation patterns include Triangles (Ascending, Descending, Symmetrical and Broadening), Flags and Pennants, Wedges and Rectangles.

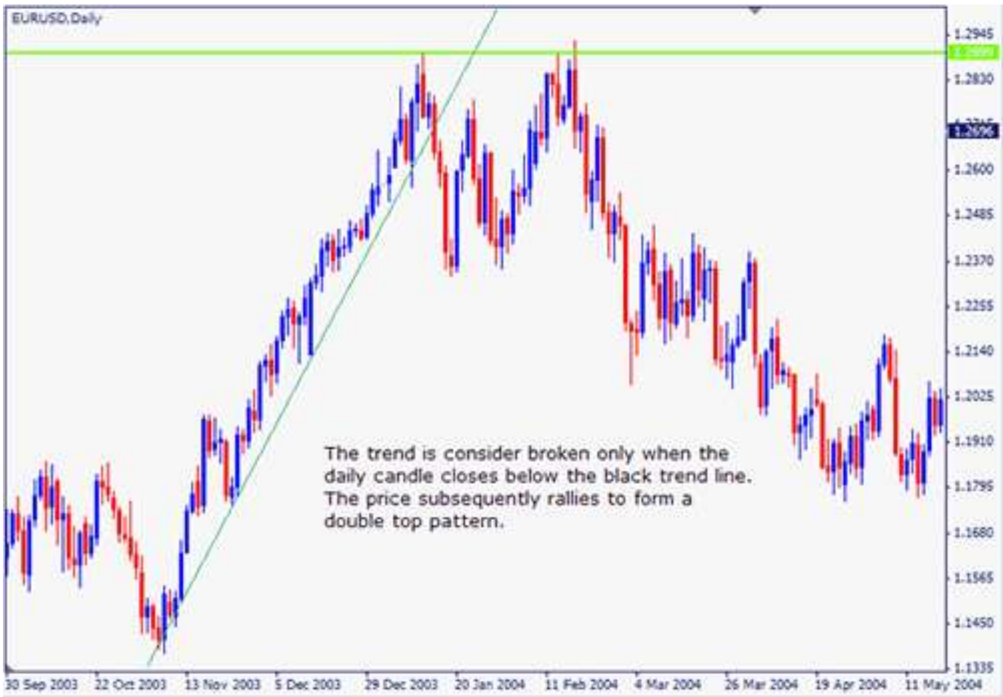
The patterns exhibit the psychology and momentum of the market. No matter which type of traders you are, it is always helpful to be aware of the patterns. Using the patterns is not a stand-alone method of trading the market, in fact, it is better to be used in conjunction with other tools like trend lines and technical indicators. Beginners might first find it difficult to identify the patterns. They can familiarize themselves with the patterns through studying historical charts and examples.

II: Reversal Patterns

The following are the three basic tenets about identifying reversal patterns. While they may seem obvious and even simplistic, they are nonetheless essential and should be remembered by traders.

A Trend Must Exist - A trend must exist before a reversal of the trend. There can be no reversal if a trend does not exist in the first place. A reversal pattern that follows a large trend will have much more movement to retrace, and so the strength of the move after the reversal pattern will likely be stronger.

Trend Lines - The first precise signal that the trend is ending is often the violation of a trend line. That might also come along with oscillators that show overbought or oversold before a reversal pattern occurs. Note that the intraday break of the trend line is not significant until a daily candle closes through the line. The chart below shows a trend line that is broken on an intraday basis before the price recovers. The first strong signal that a reversal may be coming appears when the price closes below the green trend line support. The price subsequently rallies to form a double top, but it does not hold these gains.



Time Frame - Like relative highs/lows and trend lines, reversal patterns gain greater significance if they occur over a longer time frame. A head and shoulders pattern that takes months to develop will of course signal a reversal of a much larger trend than a head and shoulders that takes place intraday.

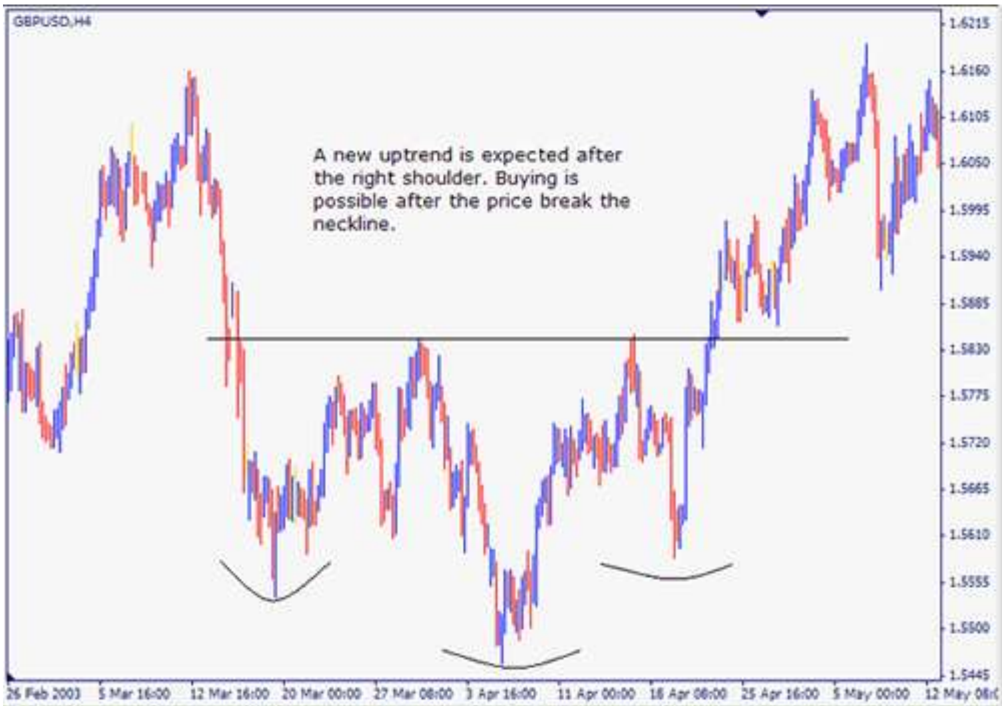
III: Head and Shoulders

Head and Shoulders Pattern

The Head and Shoulders pattern is one of the most famous reversal patterns and one that gives a clear signal and entry point. The head and shoulders in an uptrend consists of three relative highs: the first and last peaks are of nearly equal size and are the shoulders of the formation. The middle peak is greater than the other two and forms the head of the pattern. The relative lows in between the head and shoulders form a neckline at the base of the pattern. Once the pattern is completed, the neckline becomes a key support level; the market can bounce off it and reverse, or it can break through it and gather momentum.

Reverse Head and Shoulders

The reverse head and shoulders is the same formation in a downtrending market. The head and shoulders point lower in this case and signal a reversal of the market higher once the price crosses the neckline and closes above on a daily chart.



IV: Double Tops and Bottoms

The double top formation is a straightforward pattern that is easy to recognize on a chart. One of the features of a market in an uptrend is a series of increasing highs and relatively higher lows. If the market on one of its high points fails to break above the previous high, but instead stalls at the same price, this is an indication that the trend is weakening and may reverse. A double top is therefore a simple horizontal line that connects two relative highs at the same price.

The relative low between the two highpoints of the double top creates a miniature version of the neckline like that in the head and shoulders pattern, and provides traders with a potential entry point to sell. Traders should sell once they receive reasonable confirmation that the neckline has been broken; a good indication of this is when a candle closes below the neckline. In the case of the double top, traders can then place an entry order a few points below the low of the first candle that closes below the neckline.

The double bottom pattern is the inversion of the double top. In a down-trend, the price tested twice the low level but failed to break through, forming a double bottom pattern. Traders can look for opportunities to buy above the neckline once the pattern is confirmed.

V: Triple Tops and Bottoms

A triple top is the same charting pattern as the double top with an extra relative high that touches the same resistance level. A triple top creates a strong resistance level and a neckline connecting the two relative lows in the middle of the pattern. A trader should enter a short position when the daily candle closes below the neckline of the triple top.

The entry point should be set a few points beneath the low of the candle that first closed below the neckline.

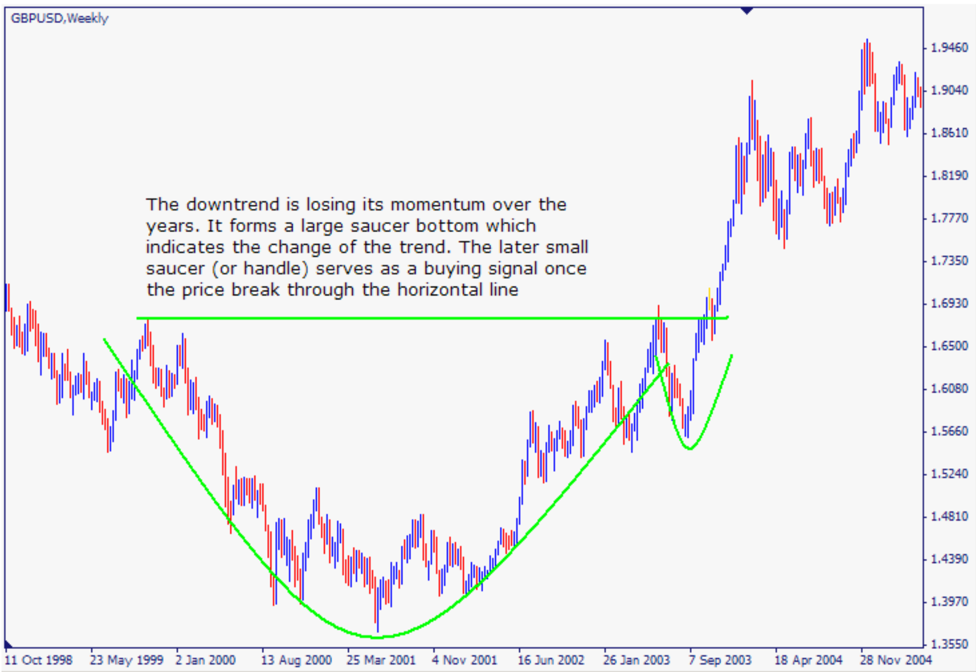
The triple bottom is similarly an extension of the double bottom. It simply contains an additional relative low on the chart that touches the same price as the two that preceded it. The triple bottom is a solid support level and can be a basis for entering a long position if it holds for a third time – particularly if there are additional indicators confirming a reversal at the triple bottom. Alternatively, a more conservative trader could also wait until the price closes above the neckline and buy when the following candle surpasses the high for the first candle. This is essentially the same logic utilized in trading the triple top, whereby traders place short orders to sell an asset at a few points beneath the low of the first candle that closes beneath neckline.

VI: Saucers

The Saucer Bottom is a very slow developing pattern that does not have a clear entry point in most cases. It becomes the foundation for a long term uptrend, but it often gives no direct signal to buy. The saucer represents a gradual loss of momentum in a downtrend, followed by consolidation in a sideways market, and an eventual return of the trend higher. A saucer may only be visible on a weekly chart, because the time it takes to develop is so long.

Because the saucer offers little in the way of a precise signal to enter a trade, and because it operates over such a long period of time, it is necessary to rely on other technical analysis to determine an entry point following a saucer formation. The saucer simply provides a foundation for a further move upwards, letting the trader know that the long-term bias will likely be to the upside.

One exception to this is the cup and handle pattern, which is demonstrated fairly closely above in the large saucer followed by a smaller saucer at the same horizontal level. In this case, once the smaller handle breaks above the high point at the end of the first saucer, a buy signal is generated. This pattern does not use any new principles, rather it is based on the relative high as a resistance level and the price breaking through resistance signaling a buy.



VII: Continuation Patterns

Continuation Patterns are patterns that exist within a trend at prices where the market consolidates before moving on in the direction of the original trend. There are several main consolidation patterns, all of which follow the same simple rules.

- The price will move decisively in one direction before running into support/resistance
- The price will consolidate for a time and create the continuation pattern
- The price will break through the support/resistance and signal a continuation of the previous trend.

There are several continuation patterns and the articles would start from the Triangles.

VIII: Triangles

Triangles can best be defined as converging trendlines. Based on this fact alone, traders can draw two immediate conclusions regarding triangles:

1. As they converge, volatility contracts; this suggests a breakout is on the horizon.
2. Once one of the triangle's trend lines is broken, traders can expect the market to breakout in that direction.

Triangles can be divided into three main types: ascending, descending and symmetrical.

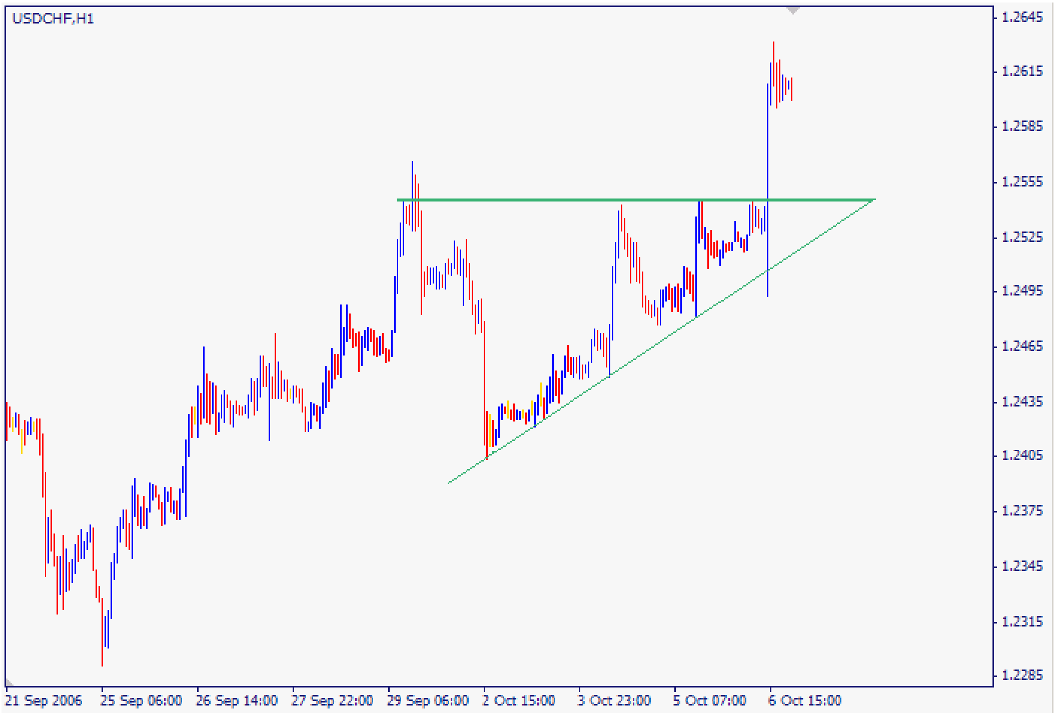
Descending Triangles

The descending triangle is a triangular consolidation zone that has a hypotenuse sloping downward at the top of the triangle. Beneath the hypotenuse is a straight trend line. Generally, when the market breaks through this trend line, it is seen as a signal that sellers have the momentum in the market, and that shorting may be a good opportunity as a result. Accordingly, it can reasonably be stated that the descending triangle usually appears in a downward trending market and signals a continuation of the downward trend.

Ascending Triangles

As you might expect, the ascending triangle usually appears in an upward trend – and signals the continuation of the upward trend. The ascending triangle is essentially an inverted descending triangle; it has a hypotenuse that moves upward with time, above which is a straight trend line that traders are eyeing carefully as a key resistance point. When this confirmation of that resistance has broken is received, it can be a signal that buyers have taken control of the market – hence making it an ideal time to buy.

In the chart below, USD/CHF formed an ascending triangle over 5 days before the release of an important economic data. The price tested the resistant level 1.2545 for three times before breakthrough. On the hypotenuse side, the buying momentum pushed the support level further up which formed the converging ascending triangle. Once the economic data was released, the price broke the resistance and shot further up.



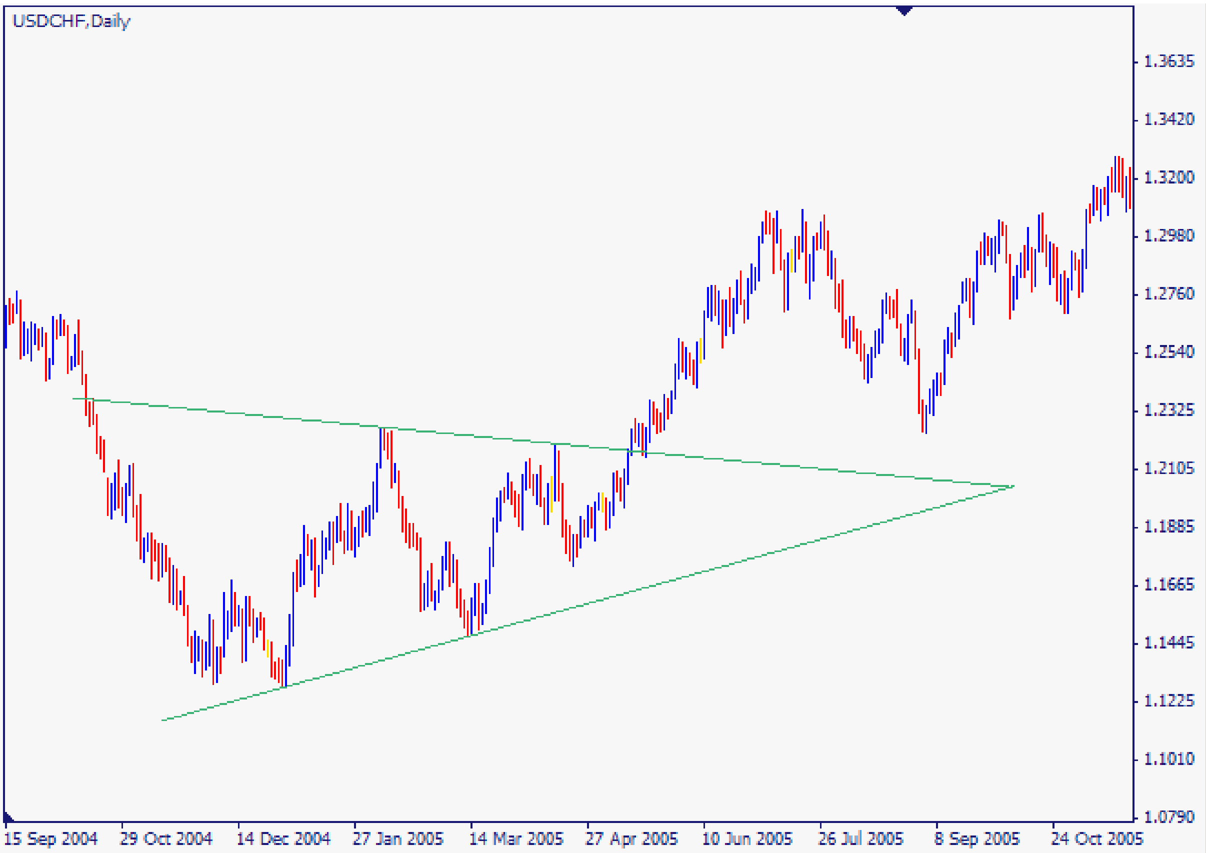
The converging triangles, no matter descending or ascending, represents the psychology of traders on the market. Before the breakout, traders are not sure which direction the price will go, they are trading with great caution, and thus, reflected by the narrow trading range before the breakout. The range will get narrower as traders are getting more cautious before the final breakout. Once the direction of breakout is conformed, the followers will enter the market following the direction, which forms the strong momentum after the breakout.

Ultimately, the important signal provided by the triangle is not the shape, though. The signal is provided by the direction of the breakout from the triangle, which signals a continuation or sometimes a reversal of the trend.

Symmetrical Triangles

The symmetrical triangle has two equal sides sloping towards each other at the same angle. It favors neither a downside nor an upside breakout. As a result, traders should look for it to signal a continuation of the move in the original direction; or, in other words, the move of the overall trend.

In the chart below, USD/CHF formed a large symmetrical triangle over a six-month period before breaking above resistance to the upside. It was difficult to know which direction the price would breakout. Traders can pay attention to the original trend and trade along the direction of the overall trend.



The trade signal provided by a symmetrical triangle should come as no surprise, since it is a rising support line and a descending resistance line converging as the chart moves to the right. Eventually one of these technical levels must be broken, at which point the trader operates just as if the line were a simple trend line. Breakouts from a triangle that has become narrow can be decisive, because buying or selling interest has accumulated while the price has consolidated.

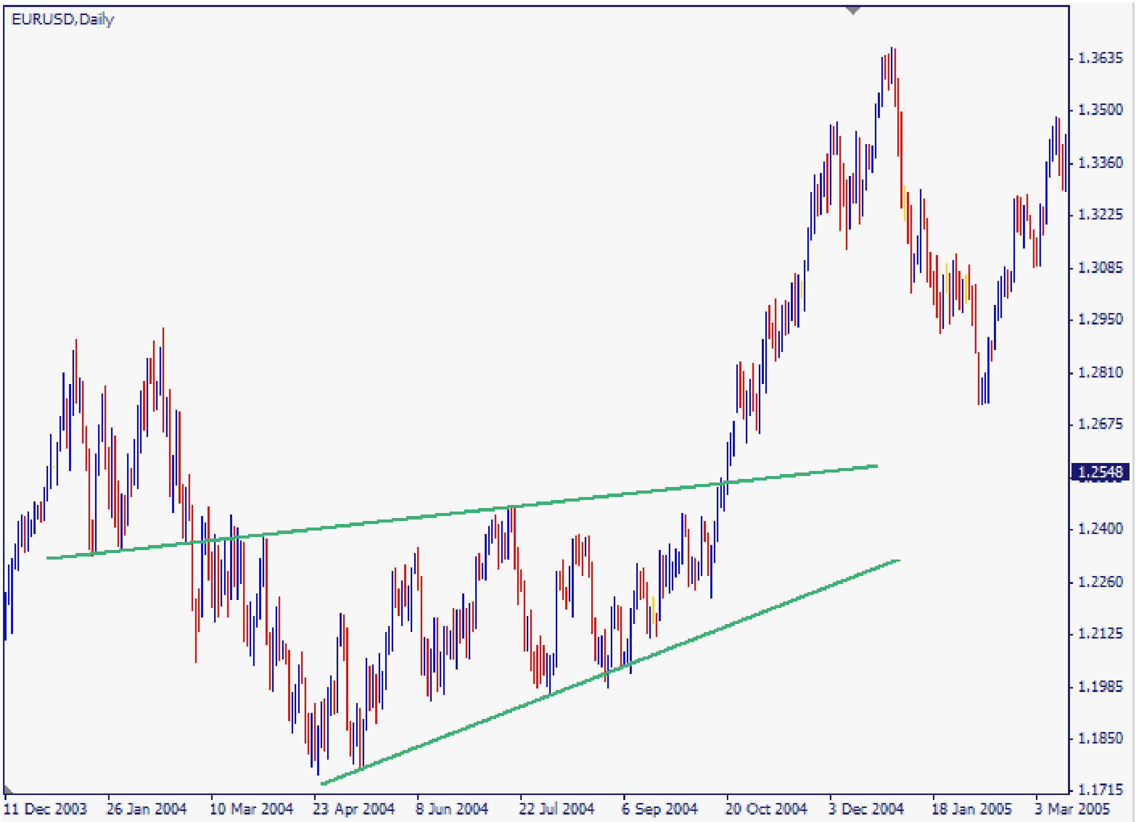
IX: Wedges

The formation of wedges can signal breakouts in upward or downward trending markets. They are similar to triangles in terms of their application.

The Wedge formation is a variation on the ascending or descending triangle in which both the angled sides of the triangle are sloping against the dominant trend in the market. The wedge formation is used in the same manner as the triangle formations discussed in the previous articles. It shows consolidation of the market in either an up or down trend, and once the support or resistance provided by the wedge is broken, it most often signals a continuation of the trend in its original direction.

The chart below showed a downward-sloping bullish wedge of USD/JPY at the end of year 2003. Notice that there was a plummet before the wedge formation, confirming the strong downtrend. The price then fell further down with narrower range, which formed the wedge. At the beginning of February 2004, the price broke above the wedge edge and surged to a peak around 112.00.

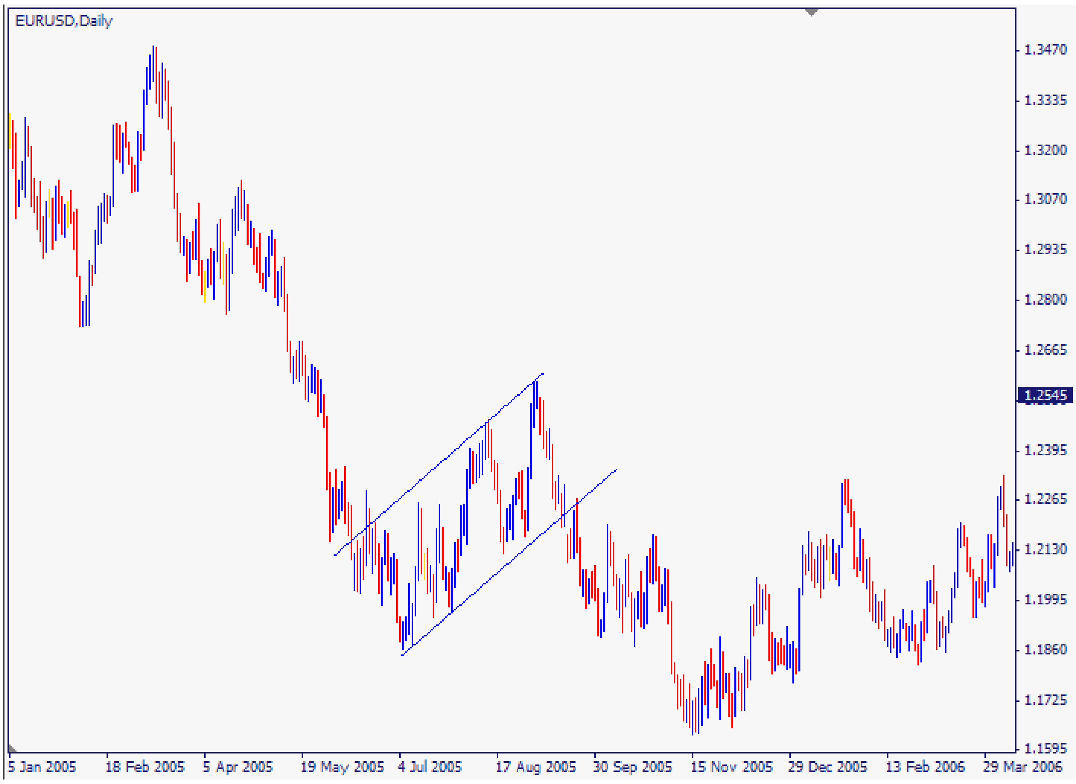
Below is a chart of a rising wedge. The price of EUR/USD consolidated from March 2004 to October 2004. It finally surged above 1.2550 in October 2004, where it broke through the upper wedge edge and continued to rise further. Generally speaking, traders can notice the dominant trend and the break out usually favors the dominant trend direction. Nonetheless, wedges are signs of price consolidation, they do not exactly indicate which direction the price is going to break through.



X: Flags and Pennants

Flags and pennants are very short consolidation periods that appear within a fast moving trend. Both are preceded by a sharp move that is nearly a vertical line, and both show consolidation against the direction of the trend. The flag is a pattern formed by two parallel lines sloping against the trend, while the pennant is a pattern of two converging lines that appear very similar to the triangle or the wedge formation.

The downtrend of EUR/USD started since Mar2005. There was a plunge at the end of May, and then it started the consolidating period, which was represented by the flag pattern. Notice the flag sloped against the dominant trend on the chart. At the beginning of September, the trend resumed after the price fell below the flag.



As with the previous patterns we have discussed, the breakout signal on a flag or a pennant almost always occurs in the direction of the original move, and when the market breaks out it usually moves decisively to continue the trend. Of course, since the pennant formation is in the shape of a triangle, it does fall into the category of triangles that has been previously discussed. What distinguishes the pennant, though, is the speed with which the market moves both before and after the pattern is created.

XI: Rectangles

The rectangle formation is often very easy to recognize. It is essentially a market that is trading in a range between two horizontal lines. The rectangle formation represents consolidation of the move that preceded it, creating a foundation for a continuation of a further move in the same direction.

The chart below showed the consolidation period of EUR/USD from May 2004 to October 2004. EUR/USD had been going on an up-trend since the beginning of 2002. In February 2004, EUR/USD started a retracement and followed by the consolidation period in the chart, forming a rectangle. EUR/USD traded between 1.1970 and 1.2460 for five months. The price eventually broke above 1.2460 in mid-October and continued the up-trend, reaching EUR/USD historical high at 1.3660 at the end of year 2004. The rectangular consolidation period created a foundation for the continuation of a further move in the up-trend.

The rectangle formation can be used in either an up trend or a down trend, and although it normally signals continuation of a market move in the direction of the original trend, the important signal is upon the breakout from the rectangle. Reversals are possible in a rectangle pattern if the breakout occurs back towards the origin of the trend that preceded the pattern.

XII: Conclusions

After reading this ebook, we hope that readers will have an idea on the common reversal and continuation patterns. It may be hard for beginners to identify these patterns and trade them profitably. But through patience, studies and practices, these patterns will become very useful members of your trading arsenal.

When you're ready, let's move on to other ebooks of the series for building your skill as a successful trader.

Trading is a journey, not a destination.