Forex Mentor Online

The Easy Way To Trade The Head And Shoulders Pattern

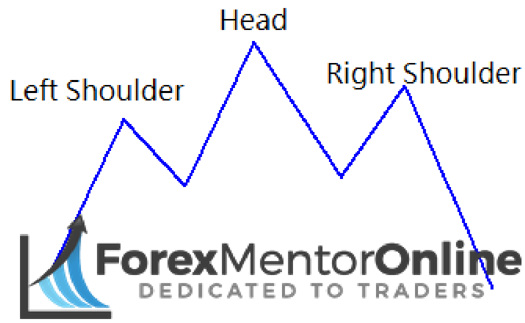
The head and shoulders pattern is one of the most common price action reversal patterns you'll see form in the forex market. It's a pattern which has been around for ages now and it's appearance is watched for by millions of forex traders all over the world. Despite it's popularity it's a pattern which many traders find causes them to lose money when they try to trade it. The reason I think it causes them to lose money is because they're trying to trade the pattern in the standard way that it has been traded since it's inception. This standard way of trading the pattern does not take account the reason why the pattern has formed or why the market should reverse after the pattern has been created.

What I'm going to do in this article is show you a new way of trading the head and shoulders pattern which is based on understanding what's caused the pattern to form in the market. This new method will not only increase your chances of having a successful trade, but will also drastically decrease the distance of your stop-loss from your entry, allowing you to risk less money on the trade whilst also giving you the opportunity to take the trade at a higher position size.

What Does The Head And Shoulders Pattern Look Like ?

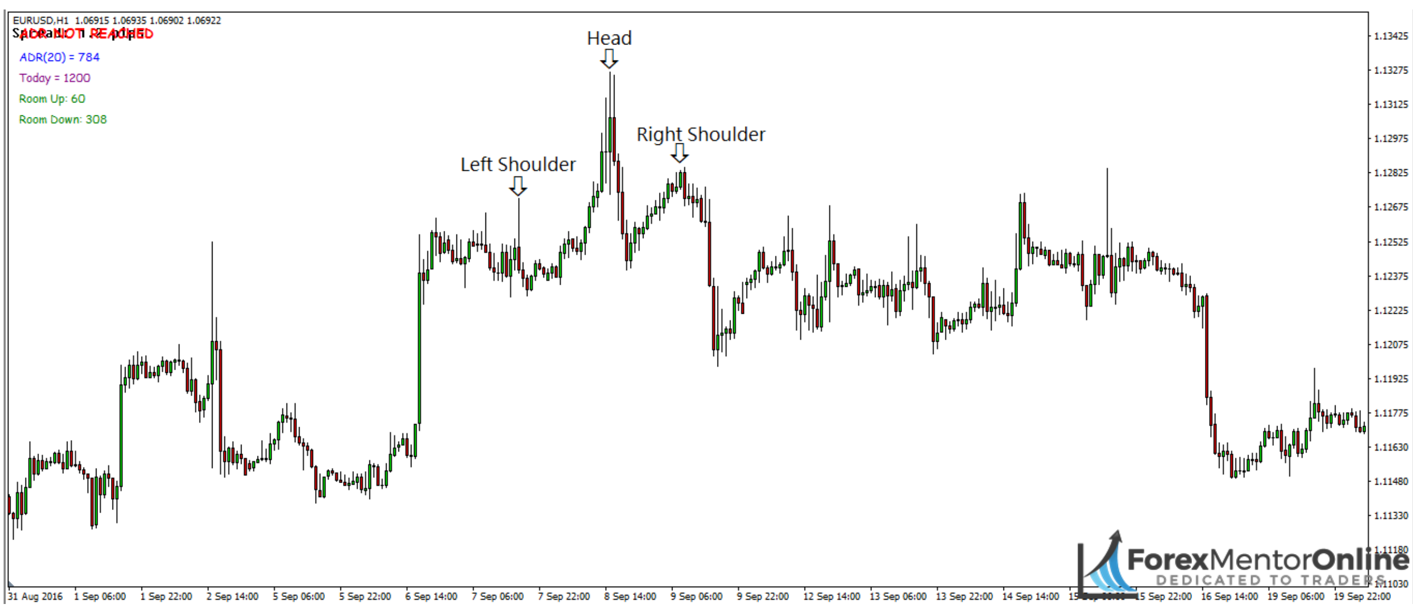
Before I show you this new method of trading the pattern, I want to give you a quick overview of what the head and shoulders pattern is and what it looks like, just in case there are some people reading this who don't have any prior knowledge of the pattern or what it looks like when it forms on the charts.

The head and shoulders pattern is a bearish reversal pattern that often but not always forms after a long move higher has taken place in the market. It's falls into the category of price action reversal patterns due to the fact it's created by the price action we see forming in the market. The reason it's called a head and shoulders pattern is because of the way the swing structure of the pattern forms in a similar way to that of a person's head and shoulders.



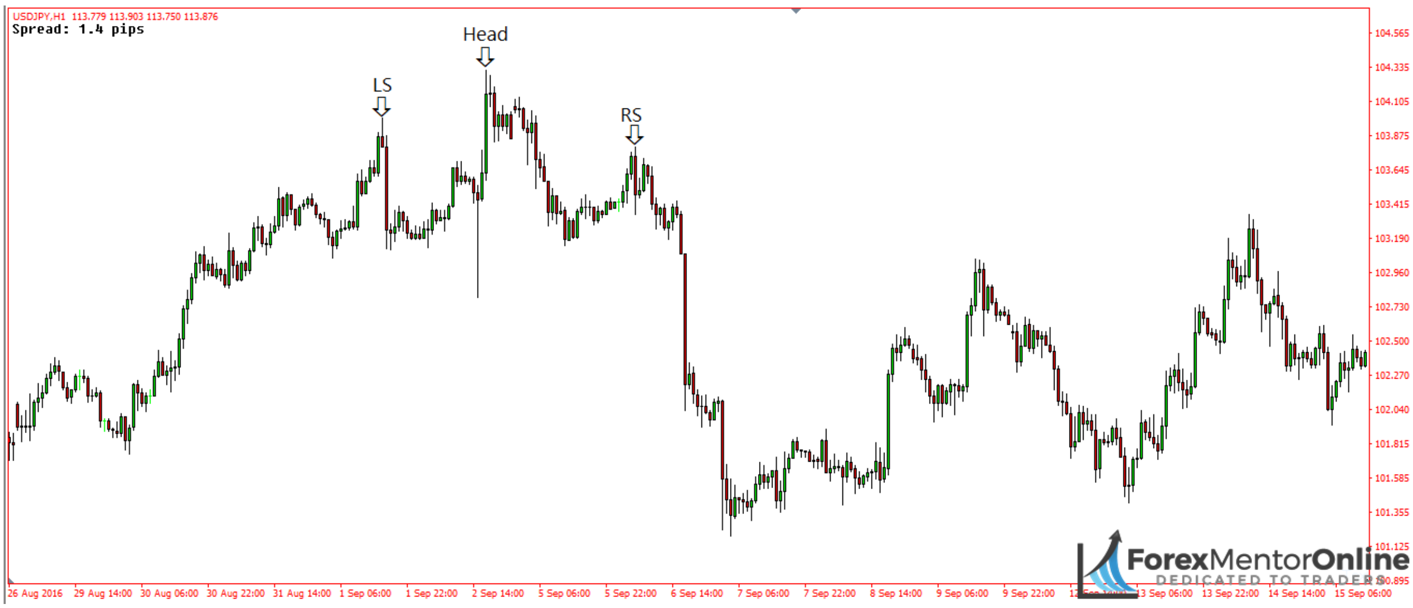
(https://dlb6879620p6s.cloudfront.net/wp-content/uploads/2017/01/Aviary-Photo_131303462660891183.png)Here's an image I drew of the basic swing structure a head and shoulders pattern creates when it forms in the market.

You can see the structure does kind of resemble a person's head and shoulders. The basic structure seen above is what all head and shoulder patterns should look like when they f0rm in the market. The head should always be found in the middle, and the two shoulders are always found to be either side. None of the shoulders are ever found be above the head, if you see that they are then the pattern is not a head and shoulders pattern and is instead something completely different. The shoulders can be found slightly above or below one another, but the right shoulder cannot be found below the low of the up-swing which preceded the formation of the head.



(https://dlb6879620p6s.cloudfront.net/wp-content/uploads/2017/01/Aviary-Photo_131302772186808463.png)This is what a common head shoulders pattern looks like on a chart.

You can clearly see the overall structure resembles that of the image I just showed you. The head of the pattern is found to b similar distance away from each of the shoulders whilst the shoulders themselves end up forming at roughly the same prices one another. In this example the right shoulder has actually formed a little higher than the left shoulder, but this is okay as it' still quite a distance below the head.

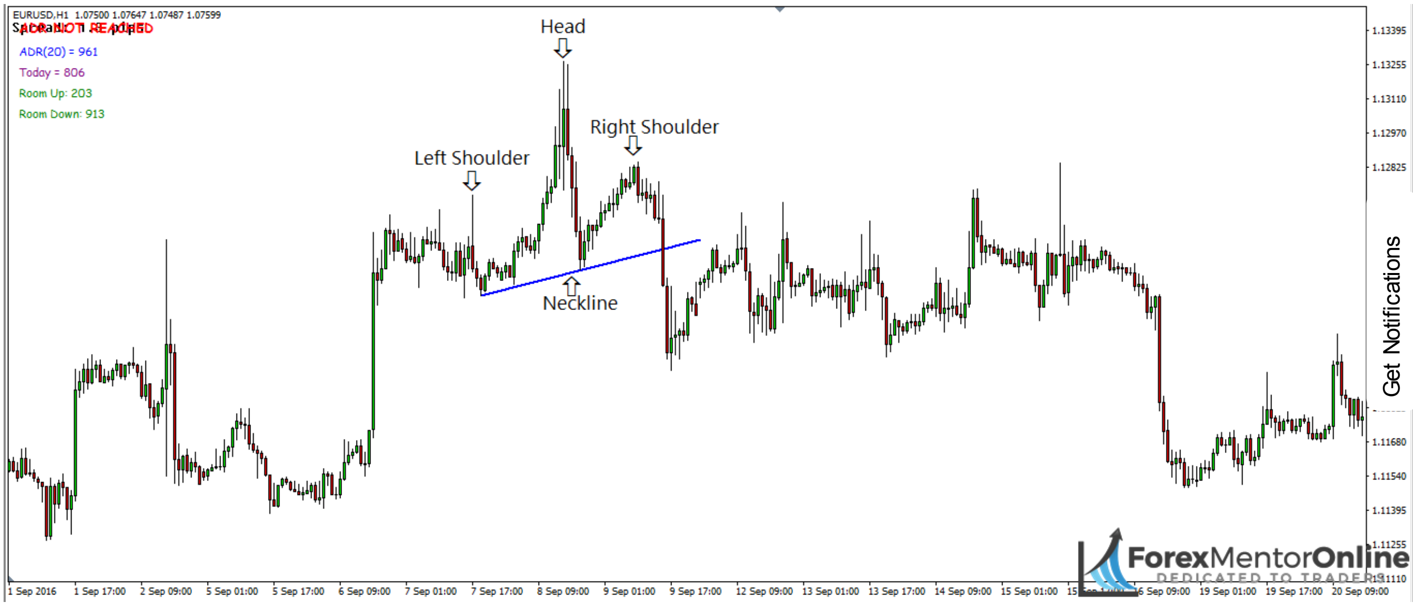


(https://dlb6879620p6s.cloudfront.net/wp-content/uploads/2017/01/Aviary-Photo_131303351749535308.png)Here's another one.....

Again you can see the same basic structure is present with this head and shoulders pattern as it is with the one I just showed you. The only difference between the two patterns, is that with this pattern the left shoulder is found to be a little bit higher than the right shoulder.

What Causes The Head And Shoulders Pattern To Form ?

The head and shoulders pattern, like all other price action reversal patterns, forms as a result of the bank traders coming into the market and placing trades to make market reverse. The sequence in which the bank traders get their sell trades placed, is what causes the pattern to form in the way similar to that of a person's head and shoulders.



(https://dlb6879620p6s.cloudfront.net/wp-content/uploads/2017/01/Aviary-Photo_131303407685466883.png)The left shoulder forms because the bank traders have either got a set of their sell trades placed, or have closed some of the buy trades they already had open before the move up creating the left shoulder began. If the left shoulder is found to only be a small distance away from the head, like you saw in the previous image, then it's probably formed because the bank traders have placed some sell trades into the market. If the head is quite far away from the left shoulder, such as it is in the first image, it means it's likely to have formed from the bank traders closing buy pre-existing trades, because we know if they were getting sell trades placed, they'd make sure to place them at similar prices to one another.

The head of the pattern always forms as a result of the bank traders placing sell trades into the market.

Similar to the head, the right shoulder also always forms because of the bank traders placing sell trades. The only difference is the sell trades they place to cause the right shoulders to form are much smaller than the sell trades they place to cause the head of the pattern to form. This is because the drop which creates the head changes the perception of the traders in the market. Before the head formed, the market looked as though it was going to continue moving in the direction of the up-trend. After it formed the drop made it looked less likely the up-trend was going to continue, so when the move up creating the left shoulder took place, not many people were interested in going long, which meant there were less buy orders available in the market for the bank traders to use to get their sell trades placed.

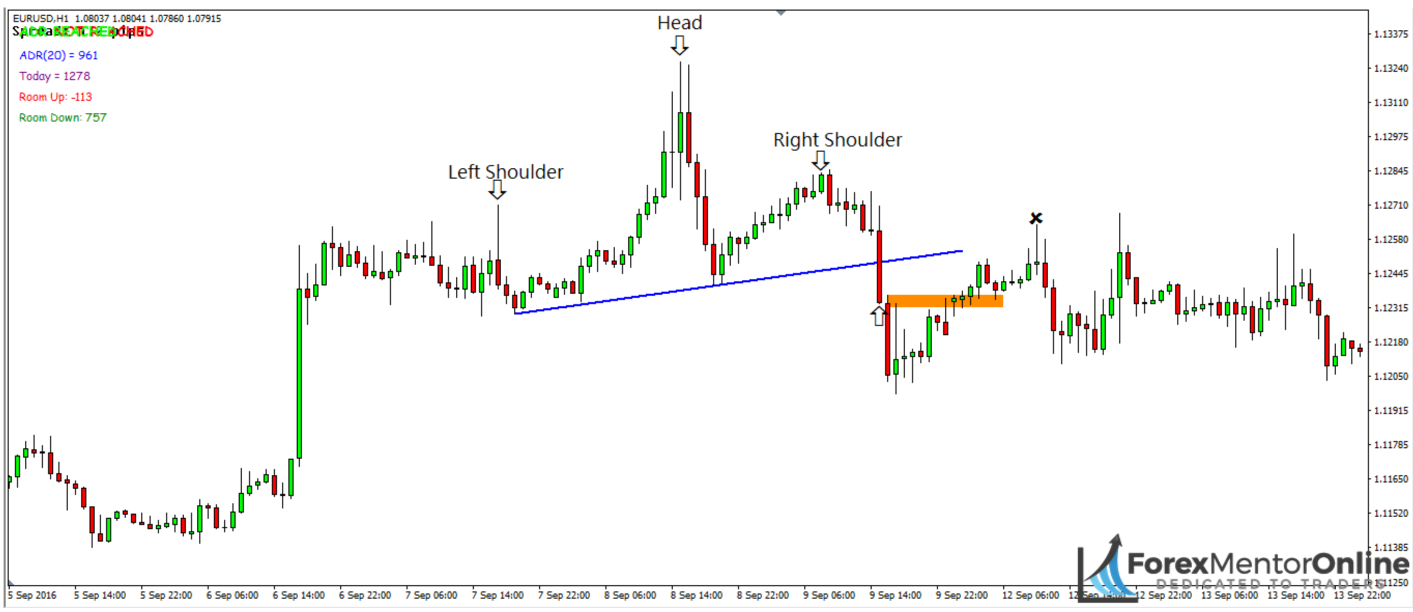
The Simple Way To Trade The Head And Shoulder Pattern

The traditional method of trading the head and shoulders pattern involves waiting for the market to break through the neckline before entering a short trade. The neckline is constructed off the swing low that forms at the bottom of the move up creating the head, and the swing low that forms at the bottom of the move up which creates the right shoulder. When the market closes below the neckline you're supposed to enter a sell trade with your stop-loss either above the high of the right shoulder or above the high of the head, because the break of the neckline is supposed to be confirmation the pattern has worked and the market is now reversing.

The problem with trading the head and shoulders pattern like this, is that because so many traders now trade the pattern in the exact same way it lessens the probability of the pattern working in the way it did before. In other words, whereas in the past the market had high a chance dropping a large distance once the neckline of the pattern had been broken, nowadays it’s likely to move up before falling, because the bank traders know that when the market closes below the neckline a large number of sell orders are going to flood into market from the traders going short trying to trade the pattern.

They can use these sell orders to take some profits off their sell trades, not necessarily because they want to secure some profit, but because they want to make the market move up again so they can get generate buy orders to use to get more sell trades placed.

We can see an example of this happening with the head and shoulders pattern we looked at earlier.



(https://dlb6879620p6s.cloudfront.net/wp-content/uploads/2017/01/Aviary-Photo_131303698755604639.png)If we look at the pattern again we can see that not long after the neckline had been broken the market moved back up to the source of the drop which caused the neckline to break.

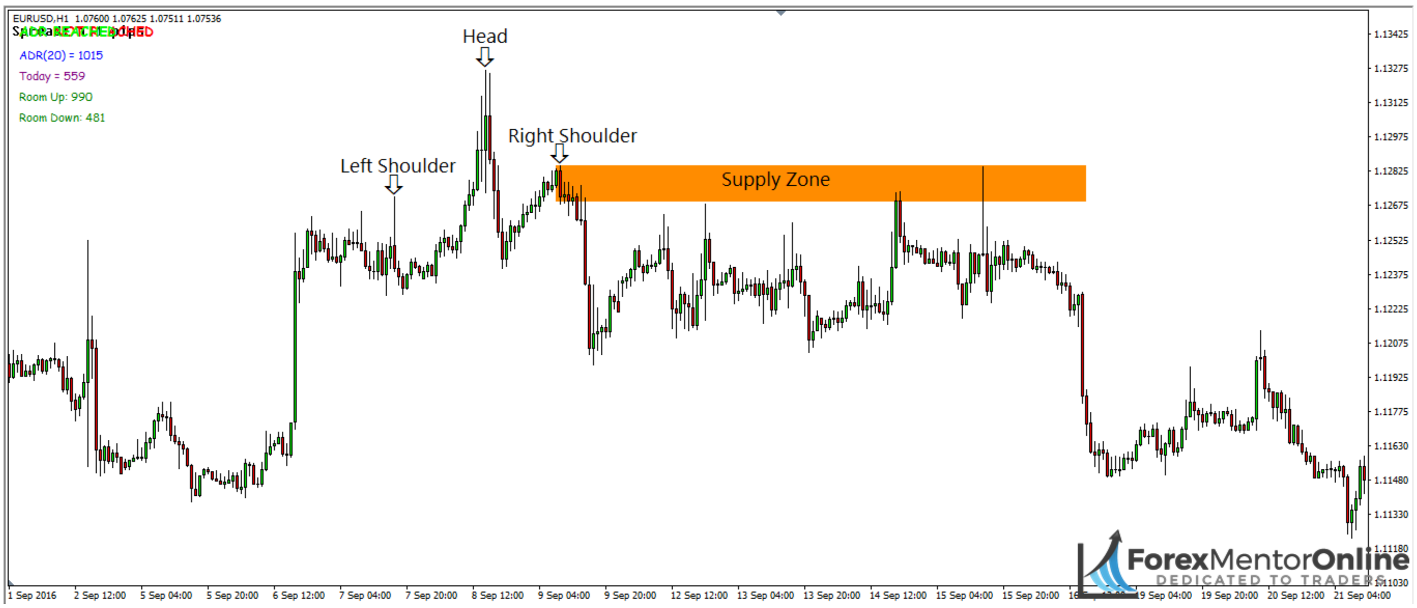
The reason it’s move back up to this point is because the bank traders decided to take some profits of the sell trades they’ve already got placed at the head and the right shoulder to get more sell trades placed into the market.

When the banks take profits all the sell orders entering the market are consumed and the price begins to rise. Now all of the people who sold on the break of the neckline are being put under pressure to close their trades, because the profit they were in from the move down after the break is getting smaller and smaller. As the market moves up to the point where their sell trades were placed (the point I’ve marked with the orange box) they begin closing their trades, because they don’t want to face the prospect of coming out of their trade with no profit at all.

This is exactly what the bank traders wanted ! They knew that by taking a little bit of profit off their sell trades they’d make the market move up, which would cause all the traders who sold upon the break of the neckline to close their sell trades, thus putting buy orders into the market which they can use to get more of their own sell trades placed.

Although the process I’ve described above doesn’t occur on all the head and shoulders patterns that form in the market, it oc on enough of them for it to be an issue, which is why I came up with a new way of trading the pattern.

The idea behind this new way of trading the head and shoulders pattern, is that rather than going short when the market bre through the neckline, you instead wait for a retracement back up to the right shoulder to take place, before looking for an entry short in the supply zone that forms from the drop which creates the right shoulder.



(https://dlb6879620p6s.cloudfront.net/wp-content/uploads/2017/02/Aviary-Photo_131304323137284449.png)Here’s the pattern we just looked at but with a supply zone drawn from the right shoulder.

You can see that had you waited for the market to return to the supply zone before going short instead of entering short right after the neckline had been broken, you would have been able to get a much better short trade placed, with a higher risk to reward ratio and a tighter stop-loss. The reason the market has a high probability of returning to the supply zone is because when the bank traders get multiple trades placed into the market, they like to get them placed around the same price as one another.

We know the right shoulder of the pattern has formed as a result of them placing sell trades, so if they decided to get any more sell trades placed, we know they are probably going to place them somewhere around here, which is what we see them do in the image.

There are basically two different ways you can enter a short trade using the method I’ve outlined above:

You can either wait for some kind of price action pattern to form once the market enters the supply zone or you can have a pending order placed at the bottom of the zone ready for any spikes that may take place.

Although I usually advocate entering supply and demand zone trades using price action, for this strategy I recommend you use a pending order, because most of the time the move into the supply zone drawn from the right shoulder will be a spike, the market won’t hang around inside the supply zone for a long time as the banks will get their trades placed as soon as the market enters the zone. Your stop location for trading the head and shoulders pattern in this way is above the high of the supply zone, and should you take some profits off your trade once the market has made a new swing low after braking through the swing low found at the bottom of the up-move into the supply zone.

Summary

I hope the method presented in this article brings you some success trading the head and shoulders pattern. As with all tradin strategies it's not perfect, I mean there will still be times when the pattern fails and the market will just come up and break through the supply zone, but at least when this does occur you'll lose less money than you would if you had traded the pattern in the standard way via placing a sell trade once the neckline has been broken.

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thank you dear for your great articles
may you write an article about PSYCHOLOGY aspects behind price chart , please ?
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