3 TECHNICAL ANALYSIS AND PATTERNS

Technical analysis is the most common way of trading in the forex market. It is mostly used by individuals like us who are also called retail traders and investors. The rise and fall of the price are indicated by patterns. These patterns are made by the movement of the price using trend lines or curves. (Adam Hayes, 2021).

Reversal patterns are the technical analysis patterns signalling a change in direction of the trend while the continuous pattern is the trend continuing pattern signalling to continue in the direction of the existing trend. These patterns are mostly used by retail traders to analyse the current price moments and predict the future market. (Adam Hayes, 2021). Below are some of the most common technical analysis and chart patterns traded by retail traders.

3.1 Support and resistance

Support and Resistance are the most common technical analysis used by traders to enter a position in the forex market. Traders use support and resistance to identify the level in the chart where price could reverse or consolidates from. Support is formed where a bearish trend pauses due to the demand of the orders while resistance is formed when a bullish trend pauses because of the selling interest. (Casey Murphy, 2021).

Support acts as a floor that does not let the price fall further down and resistance act as a ceiling that does not let the price rise further up. When the price reaches the zone of support or resistance, the price either breaches the level or bounces back from the level till the next support or resistance zones. (Casey Murphy, 2021). Also, if a price breaks support, then that area of support is treated as resistance and if a price breaks a resistance, then that area of resistance is treated as support.

FIGURE 2. Support and Resistance Zone on EURUSD chart.

In Figure 2, we can see support and resistance levels. The support zone can be seen as the level where price could not breach further, hence acting as a floor, and the resistance zone can be seen as the level where the price is not being able to breach further upwards hence acting as a ceiling.

3.2 Trend line

Trend lines are the diagonal lines connecting the lows of the candlesticks in an uptrend and the high of the candlesticks in a downtrend. It is one diagonal form of support and resistance levels. It is drawn when the price moves in a zigzag direction but is continuing in one direction of the trend. When the market is in bullish momentum, levels of resistance form, and the trendline is drawn by connecting a series of low peaks moving in an upward direction, while in a downtrend, a trendline can be drawn by connecting a series of high peaks moving in a downward direction. Trend lines are believed to be stronger when the price fails to breach the level multiple times. (Casey Murphy, 2021).

FIGURE 3. Trendline in a downtrend.

In Figure 3, we can see the trend line in the down trend holding the price. The price is moving in the downward direction and the trend line is drawn connecting the series of high peaks moving in a downward direction. The price moves down after touching the trendline, which in the figure is acting as the resistance level.

3.3 Head and Shoulder

Head and Shoulder is a reversal technical pattern. The pattern is made of three peaks, a smaller peak on both sides with a large peak in the middle and the final peak which is similar to the first. The middle peaks of candles are known as the head, while the side ones are called the shoulder. Traders view the head and shoulder pattern as a trend reversal from a bullish trend to a bearish trend. When the third peak breaks down the neckline, the trend is likely to break down to a bearish trend to the downside. This pattern can be drawn by connecting the base of the peaks as shown in the figure below. Head and shoulder is one of the most consistent and reliable technical pattern, which signals upward trend is nearing the end. (Adam Hayes, 2021).

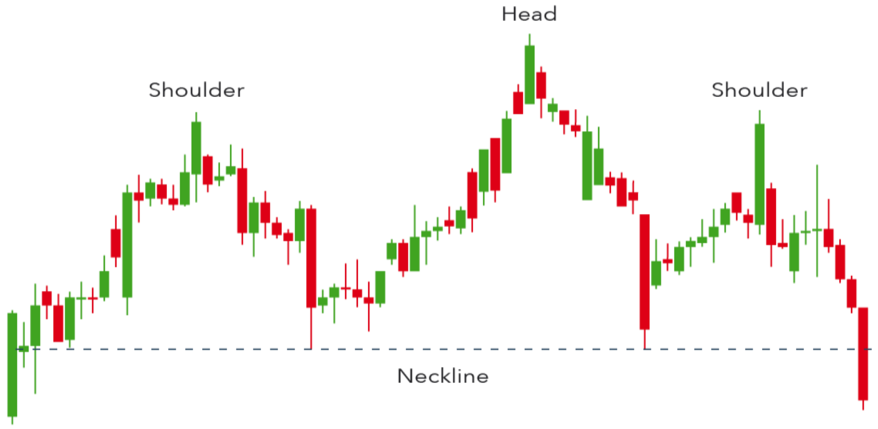

FIGURE 4. Head and Shoulder pattern

In Figure 4, we can see head and should pattern forming with the small two peaks or shoulder on the two sides and a large peak in the middle. The trend reverses when the neckline is broken by the third shoulder reversing the trend to a downward direction.

3.4 Pennants

Pennants are the price continuing trend chart pattern which is mainly formed when there is a large movement in price and then the consolidation. Pennants are drawn by two trendlines that in the end meet at a point. These trendlines must be moving in two opposite directions: one upwards and one downwards. When a pennant is formed, there will be a decrease in the volume of the price and then a sudden increase after the break of the pennant. (Adam Hayes, 2021).

FIGURE 5. Breakdown of the Bearish Pennant and downward continuation of price.

In Figure 5, we can see that in the price trend price consolidates and forms pennant. This is the price continuing pattern and once, the price breakout of the pennant it continued to move in its existing direction of the trend.

3.5 Flags

Flags are the trend continuing patterns that are usually made from the two parallel trendlines that can either be sloping up or down or moving sideways. The up-sloping flags can be considered as consolidation of price in a downtrend while down sloping flags can be considered as a consolidation of price in an uptrend. (Adam Hayes, 2021).

When a flag is formed after a huge moment of price, then there can be seen a decrease in the volume of the price. Once the price breaks down of the flag the decreased volume will recover. (Adam Hayes, 2021).

FIGURE 6. Bearish flag pattern showing downward falling of price after a breakout.

In Figure 6, we can see an upward sloping flag pattern. Once, the price breaks down of the flag pattern the price continued to its bearish momentum of the trend.

3.6 Wedges

Wedges are the technical price pattern that is made by the convergence of two trend lines. It is a consolidation that refers to the pause in the trend and then the continuation in trend after the breakout. Wedges are like pennants. The only difference between them is that both trendlines in the wedge are moving in the same direction. There are two types of wedges: Rising Wedge and Falling Wedge.
A rising wedge is a wedge that is pointing towards an upward direction, representing consolidation in a downtrend while a falling wedge is a wedge that is pointing towards a downward direction representing consolidation in an uptrend. (Adam Hayes, 2021).

Like in the pennants and flags pattern, the wedge is also the consolidation in price and the volume decreases with the formation of the wedge pattern.

FIGURE 7. Breakout of the falling wedge in downtrend and continuation of price.

In Figure 7, we can see the falling wedge, which is similar to flag patterns, but with both trend lines moving towards the downward direction. When the falling wedge is formed, the price consolidates and there can be seen a decrease in the volume of the price. After the breakout of the wedge, the price continues its bullish trend.

3.7 Triangles

Triangles are the continuous and the most occurring price pattern in the candlesticks chart. These are also the most popular technical patterns. This chart patterns often signal trend continuation. Symmetrical, Ascending, and Descending triangles are the triangle patterns widely popular among retail traders. These triangular patterns usually occur in the middle of the trend and last up to several weeks or months. (Adam Hayes, 2021).

The symmetrical triangle is the convergence of two opposite trendlines connecting in two opposite directions, which signals the breakout about to occur. While an ascending triangle is a trend continuing triangle occurring mostly in bullish trend having flat upper trend line and rising lower trend line suggesting the higher breakout of the price. And the descending triangle is the opposite of the ascending triangle, having a horizontal lower trendline and rising upper trendline suggesting a breakout of the trend. (Adam Hayes, 2021). The size of the break of the patterns is usually similar to the height of the triangle as shown in the figure below.

FIGURE 8. Break down of the ascending triangle

In Figure 8, we can see the descending triangle breaking down and continuing its existing bearish trend. When the triangle forms and consolidates we can see the decrease in the volume of the price. The size of the breakdown of the triangle can be seen likely to be the size of the triangle which we can use as a profit taking area.

3.8 Double Top and Double Bottom

Double top and Double Bottom are the most common reversal pattern used by retail traders. Double top indicates the reversal of price from bullish to bearish trend, while double bottom indicates the reversal of price from the bearish to a bullish trend. Double tops often look like the letter M where the price first pushes to the resistance and then tries to push again to the resistance but fails in the second attempt which outcomes in the trend reversal. (Adam Hayes, 2021).

A double bottom looks like the letter W and is the opposite of a double top and occurs after the second failed attempt to breach the support level on the second time outcoming with the trend reversal. Triple tops and triple bottoms are also the reversal pattern similar to double tops and bottoms where the prices try to breach resistance or support zone three times and fail, causing the price to reverse. (Adam Hayes, 2021).

FIGURE 9. Double Bottom causing the reversal of the trend.

FIGURE 10. Double top causing a reversal of the trend to the downside

Figures 9 and 10 show us the double bottom and top respectively. In Figure 9, we can see a double bottom pattern which looks like the letter W, where price tries to push to the support zone two times but could not breach it causing the reversal of the trend. Similarly in Figure 10, we can see the double top pattern. This pattern looks like the letter M, and the price comes to push the resistance zone two times but could not breach the level causing the reversal of the price towards the downward direction of the trend.