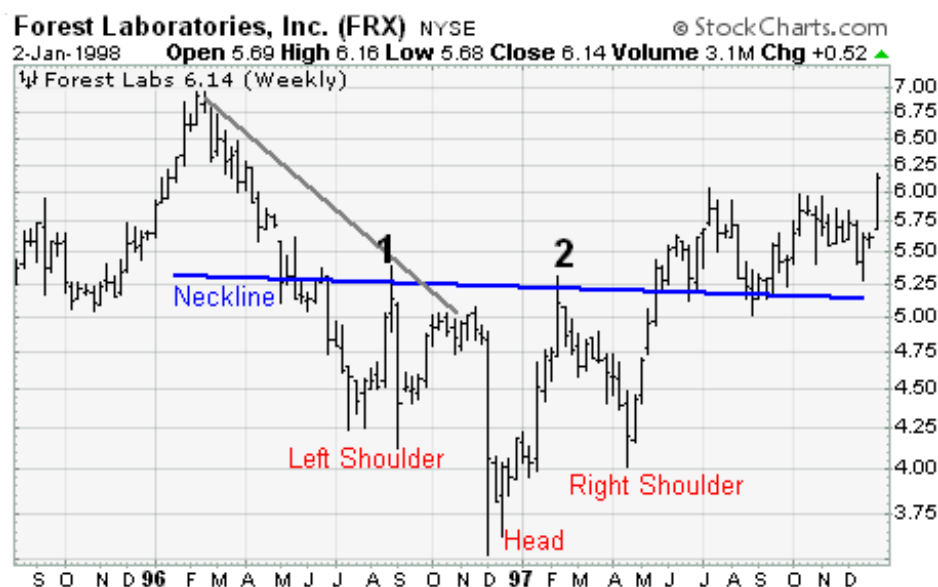


# Head and Shoulders Bottom (Reversal)

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The Head and Shoulders Bottom, sometimes referred to as an Inverse Head and Shoulders, is a pattern that shares many common characteristics with its comparable partner, but relies more heavily on volume patterns for confirmation.

As a major reversal pattern, the Head and Shoulders Bottom forms after a downtrend, and its completion marks a change in trend. The pattern contains three successive troughs with the middle trough (head) being the deepest and the two outside troughs (shoulders) being shallower. Ideally, the two shoulders would be equal in height and width. The reaction highs in the middle of the pattern can be connected to form resistance, or a neckline.



The price action forming both Head and Shoulders Top and Head and Shoulders Bottom patterns remains roughly the same, but reversed. The role of volume marks the biggest difference between the two. Generally speaking, volume plays a larger role in bottom formations than top formations. While an increase in volume on the neckline breakout for a Head and Shoulders Top is welcomed, it is absolutely required for a bottom. We will look at each part of the pattern individually, keeping volume in mind, and then put the parts together with some examples.

1. **Prior Trend:** It is important to establish the existence of a prior downtrend for this to be a reversal pattern. Without a prior downtrend to reverse, there cannot be a Head and Shoulders Bottom formation.
2. **Left Shoulder:** While in a downtrend, the left shoulder forms a trough that marks a new reaction low in the current trend. After forming this trough, an advance ensues to complete the formation of the left shoulder (1). The high of the decline usually remains below any longer trend line, thus keeping the downtrend intact.
3. **Head:** From the high of the left shoulder, a decline begins that exceeds the previous low and forms the low point of the head. After making a bottom, the high of the

subsequent advance forms the second point of the neckline (2). The high of the advance sometimes breaks a downtrend line, which calls into question the robustness of the downtrend.

4. **Right Shoulder:** The decline from the high of the head (neckline) begins to form the right shoulder. This low is always higher than the head, and it is usually in line with the low of the left shoulder. While symmetry is preferred, sometimes the shoulders can be out of whack, and the right shoulder will be higher, lower, wider, or narrower. When the advance from the low of the right shoulder breaks the neckline, the Head and Shoulders Bottom reversal is complete.
5. **Neckline:** The neckline forms by connecting reaction highs 1 and 2. Reaction High 1 marks the end of the left shoulder and the beginning of the head. Reaction High 2 marks the end of the head and the beginning of the right shoulder. Depending on the relationship between the two reaction highs, the neckline can slope up, slope down, or be horizontal. The slope of the neckline will affect the pattern's degree of bullishness: an upward slope is more bullish than a downward slope.
6. **Volume:** While volume plays an important role in the Head and Shoulders Top, it plays a crucial role in the Head and Shoulders Bottom. Without the proper expansion of volume, the validity of any breakout becomes suspect. Volume can be measured as an indicator (OBV, Chaikin Money Flow) or simply by analyzing the absolute levels associated with each peak and trough.
  - Volume levels during the first half of the pattern are less important than in the second half. Volume on the decline of the left shoulder is usually pretty heavy and selling pressure quite intense. The intensity of selling can even continue during the decline that forms the low of the head. After this low, subsequent volume patterns should be watched carefully to look for expansion during the advances.
  - The advance from the low of the head should show an increase in volume and/or better indicator readings, e.g.,  $CMF > 0$  or rise in OBV. After the reaction high forms the second neckline point, the right shoulder's decline should be accompanied with light volume. It is normal to experience profit-taking after an advance. Volume analysis helps distinguish between normal profit-taking and heavy selling pressure. With light volume on the pullback, indicators like CMF and OBV should remain strong. The most important moment for volume occurs on the advance from the low of the right shoulder. For a breakout to be considered valid, there needs to be an expansion of volume on the advance and during the breakout.
7. **Neckline Break:** The Head and Shoulders Bottom pattern is not complete, and the downtrend is not reversed until neckline resistance is broken. For a Head and Shoulders Bottom, this must occur in a convincing manner, with an expansion of volume.
8. **Resistance Turned Support:** Once resistance is broken, it is common for this same resistance level to turn into support. Often, the price will return to the resistance

break, and offer a second chance to buy.

9. **Price Target:** After breaking neckline resistance, the projected advance is found by measuring the distance from the neckline to the bottom of the head. This distance is then added to the neckline to reach a price target. Any price target should serve as a rough guide, and other factors should be considered, as well. These factors might include previous resistance levels, Fibonacci retracements or long-term moving averages.

Alaska Air Group, Inc. (ALK) formed a Head and Shoulders Bottom with a downward sloping neckline. Key points include:



1. The stock began a downtrend in early July, and declined from 60 to 26.
2. The low of the left shoulder formed with a large spike in volume on a sharp down day (red arrows).
3. The reaction rally at around 42 1/2 formed the first point of the neckline (1). Volume on the advance was respectable with many gray bars exceeding the 60-day SMA. (Note: **gray bars** denote advancing days, **black bars** declining days and the **thin red horizontal** is the 60-day SMA).
4. The decline from 42 1/2 to 26 (head) was quite dramatic, but volume did not get out of hand. Chaikin Money Flow was mostly positive when the lows around 26 were forming.

5. The advance off of the low saw a large expansion of volume (green oval) and gap up. The strength behind the move indicated that a significant low formed.
6. After the reaction high around 39, the second point of the neckline could be drawn (2).
7. The decline from 39 to 33 occurred on light volume until the final two days, when volume reached its highest point in a month. Even though there are two long black (down) volume bars, these are surrounded by above-average gray (up) volume bars. Also, notice how trend line resistance near 35 became support around 33 on the price chart.
8. The advance off of the low of the right shoulder occurred with above-average volume. Chaikin Money Flow was at its highest levels, and surpassed +20% shortly after neckline resistance was broken.
9. After breaking neckline resistance, the stock returned to this newfound support with a successful test around 35 (green arrow).



AT&T (T) formed a head and shoulders bottom with a flat neckline. The shoulders are a bit shallow, but the neckline and head are well pronounced. Key points include:

1. The stock established a 6-month downtrend with the trend line extending down from Mar-98.
2. After a head fake above the trend line in late June, the stock fell from 66 to 50 with a

sharp increase in volume to form the left shoulder.

3. The rally to 61 met resistance from the trend line, and the reaction high became the first point of the neckline.
4. The decline from 61 to 48 finished with a piercing line pattern to form the low of the head. Even though volume was heavy when the long black candlestick formed, the subsequent reversal occurred on even higher volume. This reversal was followed by a number of strong advances and up gaps. Also notice that Chaikin Money Flow was above +10% when the low of the head formed.
5. The advance from the low of the head broke above the trend line, extending down from Mar-98, and met resistance around 61. This reaction high formed the second point of the neckline.
6. The right shoulder was quite short and shallow. The low was recorded at 57 and Chaikin Money Flow remained above +10% the whole time. Support was found from the trend line that offered resistance a few weeks earlier.
7. The stock advanced sharply off of lows that formed the right shoulder, and volume increased three straight days (blue arrow). This is a bit early, but volume remained just above average for the neckline breakout a few days later. Also Chaikin Money Flow remained above +10% the whole time.
8. After the break of neckline resistance, the stock tested this newfound support twice while consolidating recent gains. The power arrived a few weeks later with a strong move off support and a huge increase in volume. The stock subsequently advanced from the low sixties to the low eighties.

Head and Shoulder Bottoms are one of the most common and reliable reversal formations. **It is important to remember that they occur after a downtrend and usually mark a major trend reversal when complete.** While it is preferable that the left and right shoulders be symmetrical, it is not an absolute requirement. Shoulders can be different widths as well as different heights. Keep in mind that technical analysis is more an art than a science. If you are looking for the perfect pattern, it may be a long time coming.

Analysis of the Head and Shoulders Bottom should focus on correct identification of neckline resistance and volume patterns. These are two of the most important aspects of a successful read, and by extension, a successful trade. The neckline resistance breakout combined with an increase in volume indicates an increase in demand at higher prices. Buyers are exerting greater force, and the price is being affected.

As seen from the examples, traders do not always have to chase a stock after the neckline breakout. Often, but certainly not always, the price will return to this new support level and offer a second chance to buy. Measuring the expected length of the advance after the breakout can be helpful, but don't count on it for your ultimate target. As the pattern unfolds over time, other aspects of the technical picture are likely to take precedence. Technical analysis is dynamic, and your analysis should incorporate aspects of the long-, medium- and short-term picture.