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THE CMC MARKETS TRADING SMART SERIES

Tell-tale Trading Patterns

'Swing trading requires a serious commitment to skill, knowledge, and emotional control. Prepare a personal trading plan, carefully evaluate risk capital, and set attainable goals for the future.'

Alan S. Farley, from *The Master Swing Trader: Tools and Techniques to Profit from Outstanding Short-Term Trading Opportunities*

Pattern recognition is one of the most versatile skills you can learn when it comes to trading. This is the branch of technical analysis that focuses on finding price (and often volume) patterns that can be isolated using nothing more than a pencil and a ruler. The key thing for you to do is spend time learning the basic rules so you can use these methods most effectively with your trading.

While the idea of pattern recognition may seem strange, it is based on carefully tested methods that have been subjected to many tests which underline their usefulness to traders. Importantly, patterns are factors to consider when working on methods to work out where to enter, where to set stop loss orders, and where to set your profit targets. These factors are, of course, some of the key things that all traders will wish to consider when managing their overall portfolio.

Types of patterns

This topic will help you:

- to recognise how price movements can develop into price patterns
- to isolate sensible entry points
- to manage risk and set profit targets

Although seemingly basic in some ways, the foundation of pattern recognition comes from looking for patterns that appear in the prices of traded instruments. You should be looking for shapes such as *triangles*, *rectangles* and *diamonds*. While this may not inspire confidence at the outset, these are formations that arise and track the changes in support and resistance in these instruments. What is most interesting is that once you have learnt these skills, you will be able to apply them in any financial market that you choose, from shares to indices and even foreign exchange.

Pattern recognition can form the basis of trading strategies for day traders, swing traders and longer-term position traders alike. They can be applied to anything from five-minute to weekly charts.

The patterns focused on here are the rectangles and, in particular, the triangles, which have a wide number of varieties that can be used. In essence, all price patterns are looking at the interaction of supply and demand over time and establish sensible ways in which to react when these patterns form. When we say 'sensible', we simply mean that you know how you will react in terms of risk management and taking of profits.

Triangles

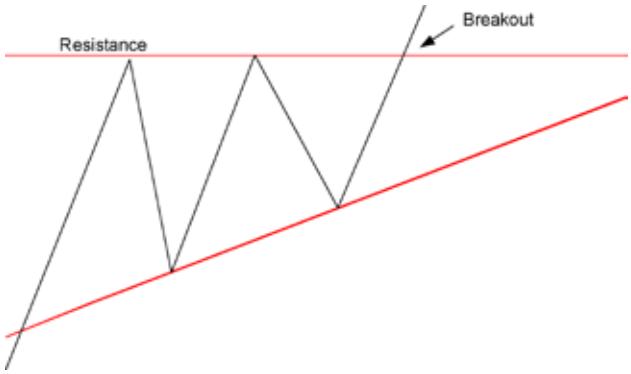
There are several different types of triangle which can all be very effective for your trading. The great thing that you have in the majority of cases with triangles is the fact that there is no bias to either the long side or the short side, and this makes them very useful from the perspective of a CFD trader. Keep in mind that if you are always biasing yourself to the long side of the market then you are missing out on some of the most attractive features of this pattern.

Triangles are patterns inside which the price consolidates. However, because there is no long or short side bias, you must keep an eye on triangles for when an eventual breakout occurs. There are two broad categories of triangle that form:

- the ascending and descending triangle (the opposite of one another), and
- the symmetrical triangle.

Ascending triangle

The ascending triangle is possibly the best recognised pattern in this category, as it incorporates the use of a resistance line (which traders are frequently on the lookout for) and a rising support line. The pattern itself takes the form below:



Example of an ascending triangle

The important parts of this formation are the two lines marked in red: the *resistance* line and the *uptrend* line. A breakout is marked here, but we will examine how breakouts should be treated in a later section. As a trader, you should be mindful of what the volume is doing during the formation of the pattern and then what it does when the breakout occurs.

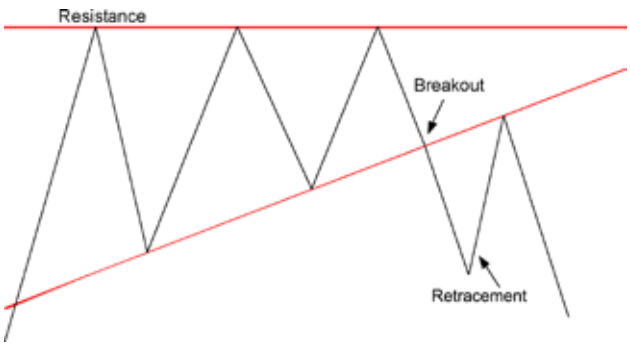
Typically, you would look for volume levels in general to decline over the time that the pattern itself forms. Here is one way to think about this decline: buyers and sellers gradually get pushed into a narrower and narrower balance of support and resistance which effectively drives out the interest until the price can break out and begin to trend once more. If volume isn't declining, this doesn't necessarily mean that there is a problem with the pattern; however, something you should be on the lookout for is a volume spike when the breakout occurs. This tends to have a beneficial effect on the overall strength of the pattern from then on.

Another effect that can be greatly beneficial to look out for when breakouts occur is a *gap* in the price. This shows a surge in demand for the instrument (surge in supply if it is a short trade) which adds a great deal of price confirmation for the trader. Traders may sometimes be put off by this because they feel that the trade may have gotten away from them, but in reality this is likely to be reinforcement that you have correctly determined that a breakout is occurring.

Something that traders all fear when it comes to breakout pattern trades is what is known as the *false breakout*, or *whipsaw*. This occurs when the price breaches the pattern, which may lead the more aggressive traders to move straight into the trade. Unfortunately, what happens in the case of the false breakout is that you get what seems to be a genuine signal only to find out later that the price retreats back within the confines of the pattern, and you are left holding a trade that is not doing what you hoped it would.

The only way you can try to combat this is by applying a filter of some sort, and the most obvious method is to wait until there have been X closes outside of the pattern. If you are looking at daily charts, then you may decide to wait until the price has closed outside of the pattern for two days before entry. There are other means of avoiding this type of false breakout. Some traders choose to wait until the price has moved twice the average true range (2ATR) outside of the pattern. None of these methods will guarantee you that you won't suffer from false breakouts, but they will at least reduce the chances.

In the previous diagram, we demonstrated an example of an ascending triangle with an upward breakout. As there is no directional bias as to which way patterns are going to break out, we need to also look at an example of what a downward break on an ascending triangle looks like.

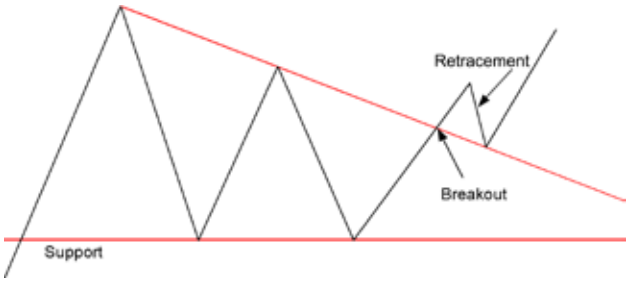


Example of a downward break on an ascending triangle

You can see that the basic setup is exactly the same, except the breakout occurs in the opposite direction which then necessitates a short trade. You should note that in the case of both these examples we have shown a retracement back to the line from which they broke out. This is something that can happen without the signal being considered a failure – however, you should not assume that this will always happen. In fact, you would assume that the instances where this does not occur are when you are receiving the strongest signals.

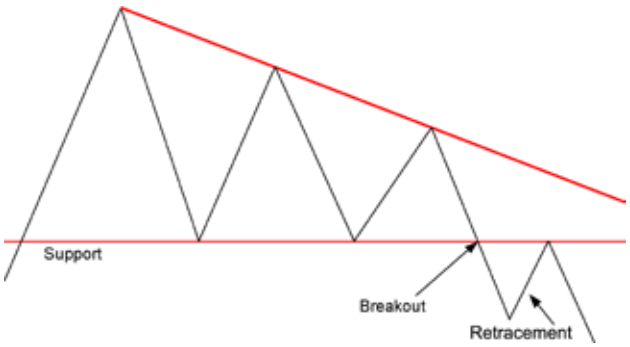
Descending triangle

The flipside of the previously described ascending triangle is the *descending triangle*, which has very similar characteristics but sets itself up in the opposite direction. As with its ascending counterpart, the breakout can occur in either direction, so you need to watch for which direction the breakout occurs in.



Example of a descending triangle

As with all patterns you examine, you will find that they seldom look exactly like they do in diagrams such as these. These illustrations provide something of a best case scenario, but most of the time you will want to see the price movements resemble the diagram as closely as possible. Some traders would suggest that you want to see the price drive quite clearly from the support and resistance points and not spend too much time drifting sideways. In addition, when it comes to triangle patterns you would preferably see the price break out of the pattern before it reaches 75% of the way to the apex of the pattern. The reason for this is that if the pattern continues sideways it is starting to lose its momentum and may continue to drift sideways which is far from what the breakout trader wants.



Example of a descending triangle that applies the same set of rules you would see in any of the other cases we have examined

Symmetrical triangle

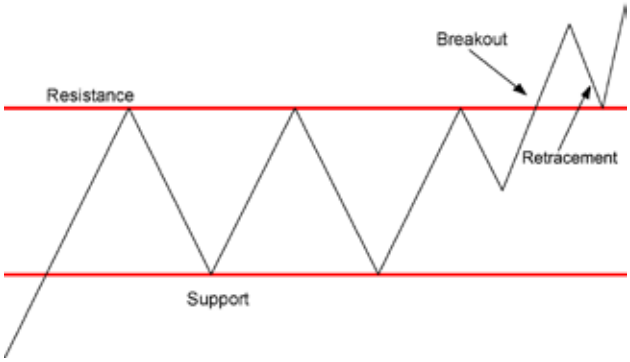
The *symmetrical triangle* has some characteristics in common with the ascending/descending triangle in that the price is being driven into a narrower band of price movement and the trader is looking to see a break out of the price. In addition to this, you will likely see the level of volume occurring in the instrument decline as it moves throughout the formation, and then subsequently rise significantly above the average when the breakout occurs.

As with other triangles, there is the possibility of false breakouts occurring, so you need to be mindful enough of this to place some sort of filter on the breakout to reduce your chances of being exposed to a whipsaw entry into the trade. Again, this may be a set number of closes above the breakout level or, alternatively, using a filter like the average true range already mentioned.

In these trades, as with any of the triangles, traders have two main choices as to where they place their stop loss orders. Which method you choose will likely be dependent on how aggressive you are. If you are a more aggressive trader, you would place a stop just on the other side of the breakout line where you believe that you have been whipsawed. This is as close as a stop loss can realistically be placed, because otherwise you aren't really giving the trade a decent chance of success. The alternative and more conservative method is to put the stop on the far side of the pattern completely, which would show a total failure of the setup if that level is reached.

Rectangles

So far we have looked at setups where the support and resistance levels are moving closer together, but now we will look at a *rectangle* setup, where the two levels run parallel to one another. Although the pattern looks very different to any of the triangle family, the behaviours in terms of the setups are quite similar in what you are looking for regarding the breakout and how you handle your risk management.



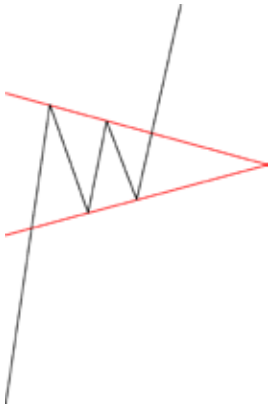
Example of a rectangle

In this case, again, we are illustrating the breakout having a subsequent throwback to what was the resistance line, but this will not always be the case. In the same way as occurs with the triangle, the best outcome is a strong continuation from this level on high volume from the point of the breakout.

In *Technical Analysis*, Kirkpatrick and Dahlquist suggest that if you see a price movement that doesn't reach the other side of the formation it may in fact be giving an indication as to the likely direction in which the breakout may occur.[1]

Pennants

In the previous examples we looked at patterns where the direction of the breakout did not matter. In the final two examples we are looking at two patterns that are specifically continuation formations that will only be confirmed if the breakout occurs in the same direction as price was moving leading into the formation.



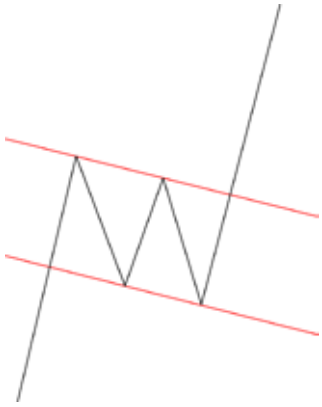
Example of a pennant formation

As you can see from the diagram, a successful *pennant* will see price leaving the pattern in the same direction that it arrived. Although this pattern has visual similarities to a symmetrical triangle it is much shorter term in nature with 10–15 periods being the general rule between formation and completion.

[1] Charles D. Kirkpatrick and Julie R. Dahlquist, Technical Analysis: The Complete Resource for Financial Market Technicians, FT Prentice Hall 2006.

Flags

Flags require many of the same characteristics of the pennant in order to be confirmed as genuine.



Example of a flag formation

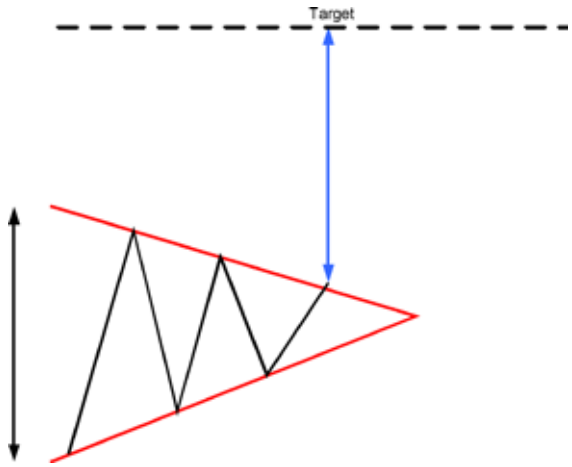
Like the pennant, the flag is a shorter-term version of a similar pattern – in this case a *channel*. This pattern is also only genuine if the breakout occurs in the same direction in which price entered it. In addition, you will tend to see the direction of the flag move in the opposite direction of the prevailing price movement.

Both the flag and the pennant occur after a sharp movement in price – this near-vertical price move forms the 'flag pole' on which the pennant or the flag occurs. It is important to see this in the lead-up because the pattern is not genuine without it. Lastly, you will likely see a spike in volume in both cases on the breakout which will add to the confirmation of the pattern.

The placement of stops obeys the same basic rules that we have looked at all along, with the aggressive trader closing trades at the first sign of failure, while the more conservative trader will look for price to cross the pattern entirely before regarding it a failure.

Price targets

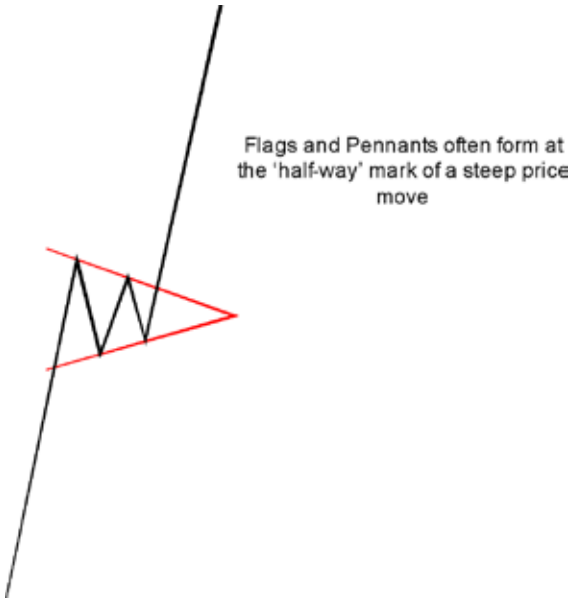
It is possible to use all the patterns discussed to target an eventual profit-taking point. In the case of the triangles and the rectangle, this is done easily by measuring the height of the pattern and then extrapolating the target out from the breakout point. If that sounds a little confusing, then the diagram should help.



Extrapolating target out from breakout point

The same basic premise is applied to the rectangle.

In the case of flags and pennants the target is determined by measuring the height of the flagpole leading into the formation and then added on the way out. These formations are sometimes referred to as measuring formations because the often occur halfway through the price swing.



Review

- You should recognise basic price conditions required for a pattern to be genuine.
- You should know how to tell when a pattern has failed.
- You should be able to generate a sensible risk-management plan in line with your pattern-recognition skills.

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