Aussie Day Trader
Introduction to Day Trading Chart Patterns

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INTRODUCTION

In technical analysis, the definition of a PATTERN is the distinctive formation created by the movement of security prices on a chart. It is identified by a line connecting common price points (closing prices, highs, lows) over a period of time.

The ‘chartists’ – traders analysing the historical prices and past trends on the chart trying to identify patterns -attempt to anticipate the future direction of the price also known as “trading pattern”.
The chart patterns will help you make good trading decisions in your everyday trading but it is the way our brain decides what is important and what is not that makes the difference.

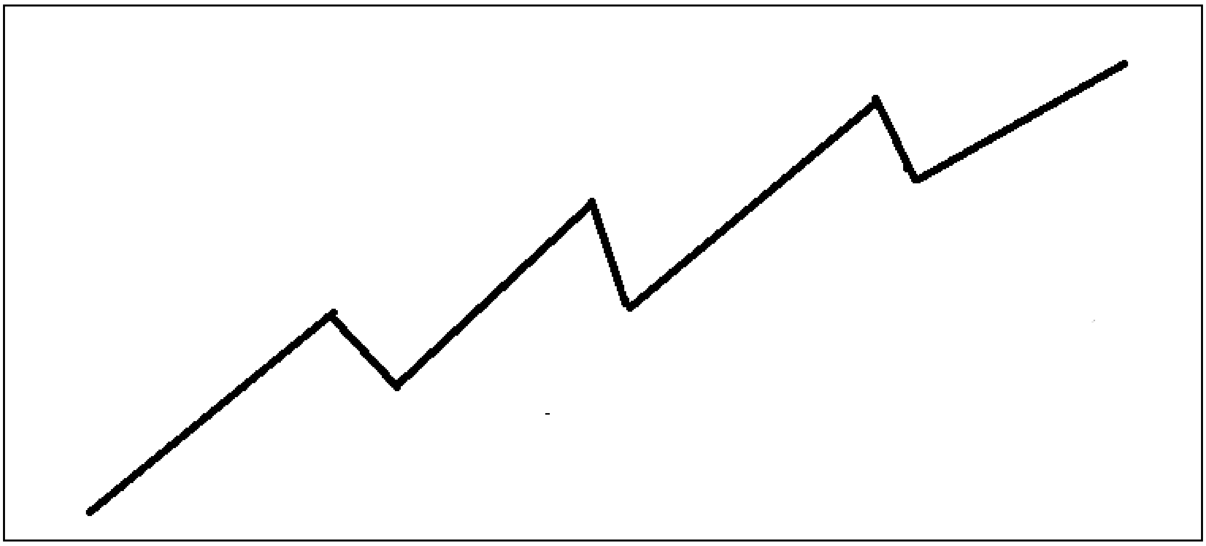
Recognizing a chart pattern relies on how our perception works and it affects everyone differently even though we are looking at the same chart. The brain naturally seeks to reorder and reshape information received to relate that information to past experiences held in memory. It is a continual process of receiving information and then comparing that input to a benchmark.

Having learnt and memorized the common chart pattern for trading any market can only help your brain do the comparison and ultimately determine the your actions: enter a trade, take your profits or take a loss, stay longer in the position.

Let’s now look and learn the best chart patterns for Day Trading. The most popular charts used for identifying the patterns are the Bar Chart, Candle Chart or Line Chart. You can use your preferred type of chart for identifying the patterns – experiment with various types and find out which one seems to be easier for you.

1. UPTREND/DOWN TREND PATTERN

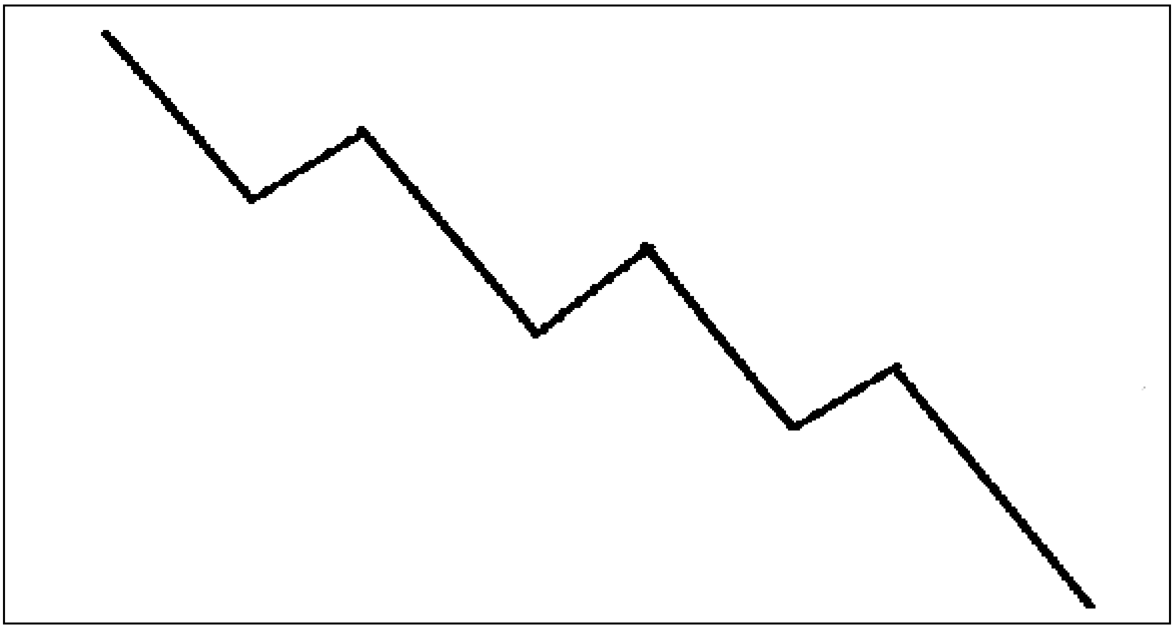
An **uptrend is** defined as a series of ascending peaks and troughs over your chosen period of time, as illustrated below. The price goes up steadily but never in a straight line. The uptrend can therefore be identified by continuously **higher highs** and **higher lows.**



HOW TO TRADE THE UPTREND PATTERN

"The trend is your friend" – look for a 'buy' opportunity when the price is a period of consolidation or retracement in then opposite direction. These retraces are when we have the highest potential for a high probability entry within the trend. Often, a market will retrace to approximately the level of its previous swing point before the trend resumes. In an uptrend these swing points are becoming a support for the price to resume the uptrend.

Conversely, a **downtrend** is defined as series of *descending* peaks and troughs as illustrated below.



HOW TO TRADE THE DOWNTREND PATTERN

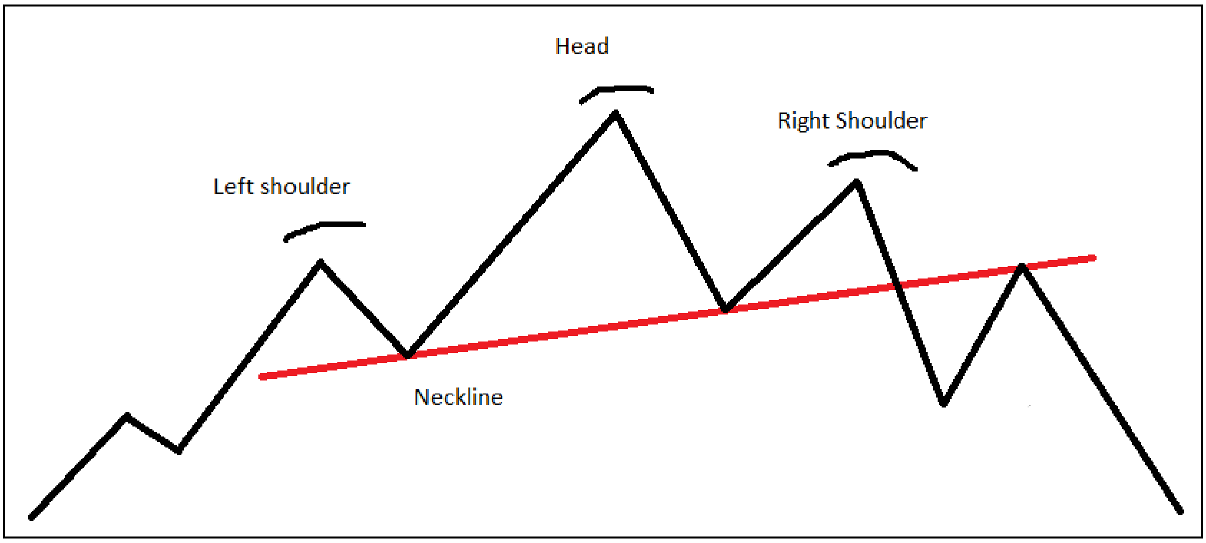
"The trend is your friend" again – but this time look for a 'sell' opportunity when the price is a period of consolidation or retracement in then opposite direction.

Same rules apply here: when the price retraces we have the highest potential for a high probability entry within the trend. Often, a market will retrace to approximately the level of its previous swing point before the trend resumes. In a downtrend these swing points are becoming a resistance for the price to resume the downtrend.

2. HEAD AND SHOULDERS PATTERN

The **Head and Shoulders Top** is undoubtedly the best known and perhaps the most reliable of all major reversal patterns. During the formation of this pattern, the forces of supply and demand are in relative balance. Once the distribution phase is completed, support along the bottom of the horizontal range (called the neckline) is broken and a new downtrend is established.

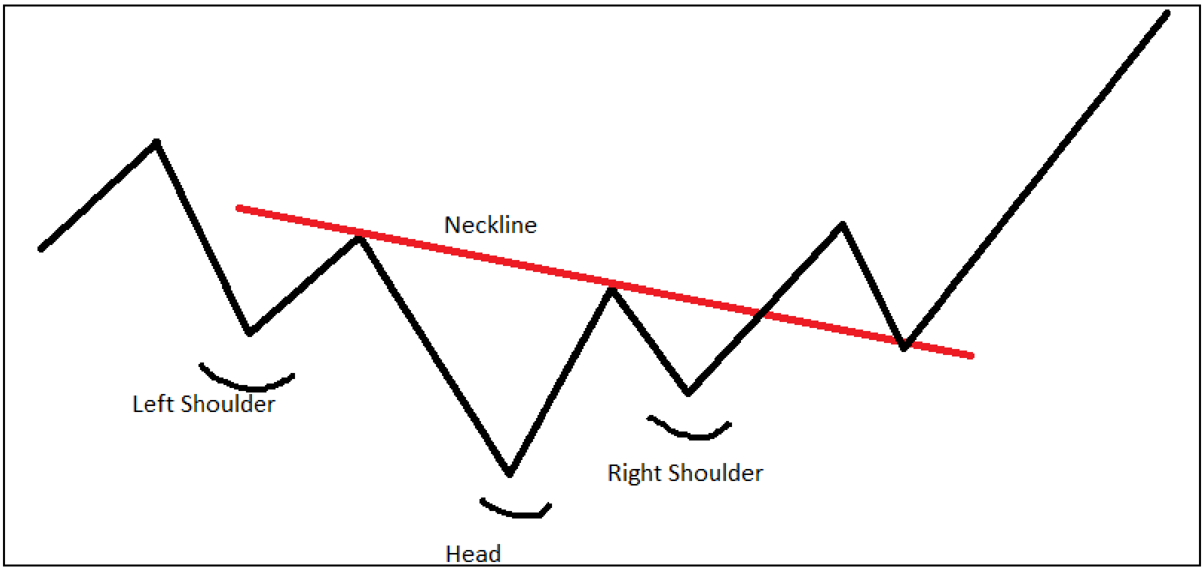
The neckline is very often slightly upward sloping to flat line.



HOW TO TRADE THE HEAD AND SHOULDER TOP

The head and shoulders pattern is a trend reversal formation. We need to wait for the pattern to complete - no trades should be made until the pattern breaks the neckline. The most common entry is a short trade (i.e. sell) when the breakout occurs and the neckline is broken.

The **Head and Shoulders Bottom** is simply an inverted image of the Head and Shoulder Top. The formation of this pattern occurs exactly the same as Head and Shoulder Top pattern except it is preceded by a downtrend. It marks the transition period at the end of a downtrend and the beginning of an uptrend.



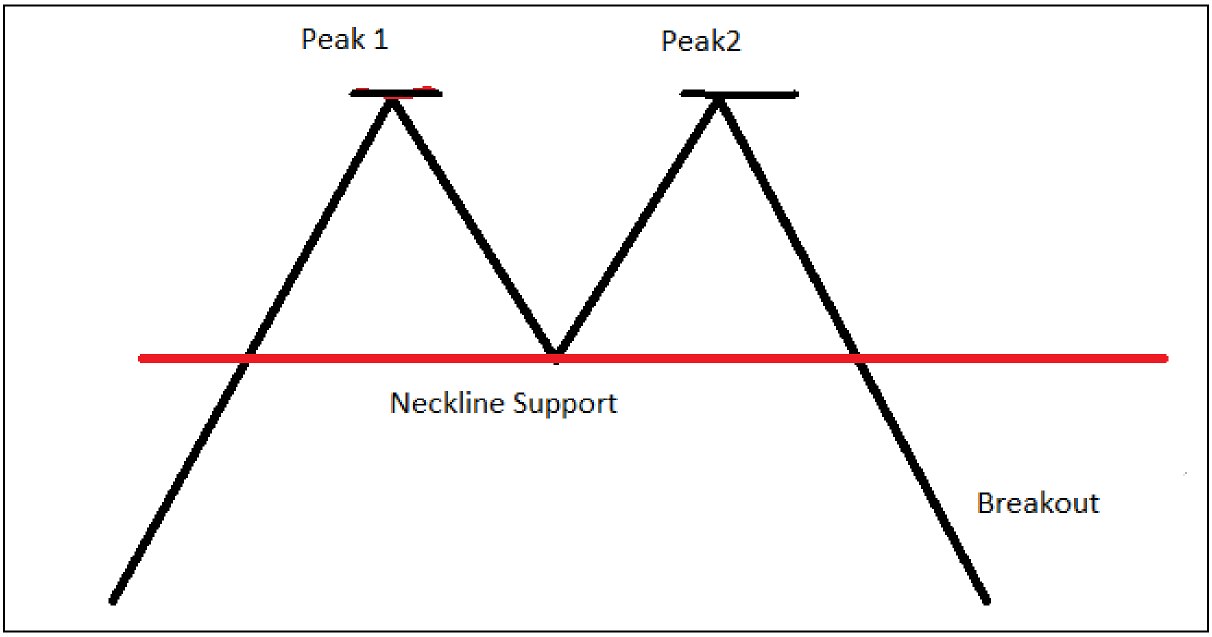
HOW TO TRADE THE HEAD AND SHOULDER BOTTOM

Same as with the head and shoulder top, we must wait and make sure the pattern is fully developed and not make any prior assumptions. Take a long entry (i.e. buy) when the price breaks through the 'neckline'.

3. DOUBLE TOPS/BOTTOMS PATTERNS

The **Double Top** pattern is perhaps the most frequent and easily spotted of all the reversal patterns. For obvious reasons, this pattern is often referred to as an "M" top.

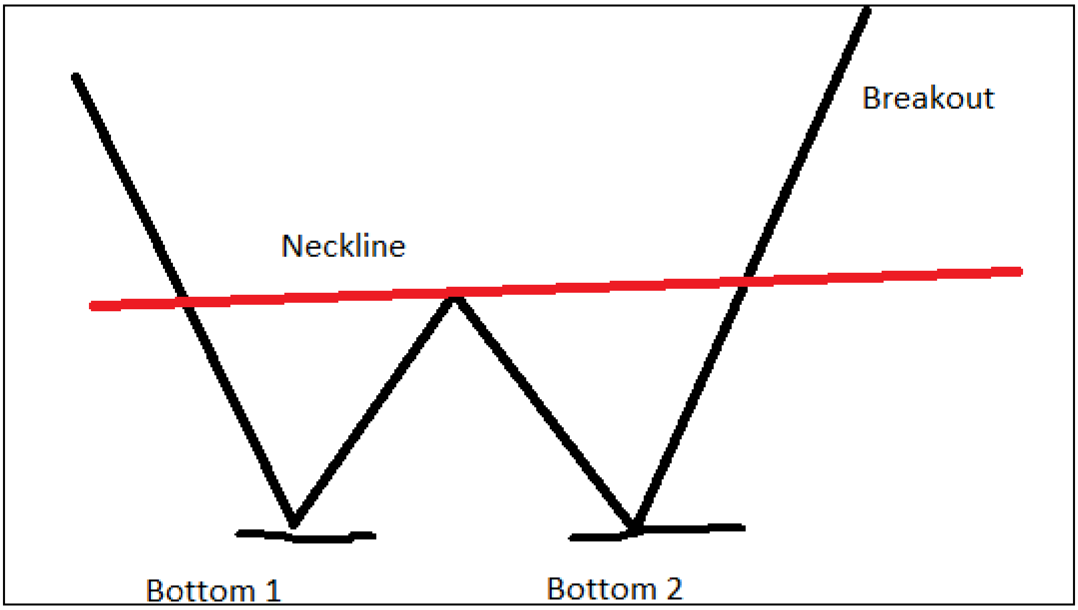
A Double Top pattern occurs after an uptrend and is comprised of two prominent peaks at approximately the same price level. As prices trend upward with successive peaks and troughs, prices encounter resistance and retreat temporarily. Prices then make a final attempt to rally, where they again encounter resistance at about the same price level as the previous peak. The conclusion of the Double Top formation occurs when prices close below the previous trough.



HOW TO TRADE THE DOUBLE TOP

The double top pattern is also a trend reversal formation. Confirmation of the pattern – meaning that the price goes through the support level at 'neckline'- is needed before placing a short/sell trade.

The **Double Bottom** is simply an inverted image of the Double Top. The formation of this pattern occurs exactly the same as the Double Top pattern except it is preceded by a downtrend. It marks the transition period at the end of a downtrend and the beginning of an uptrend.

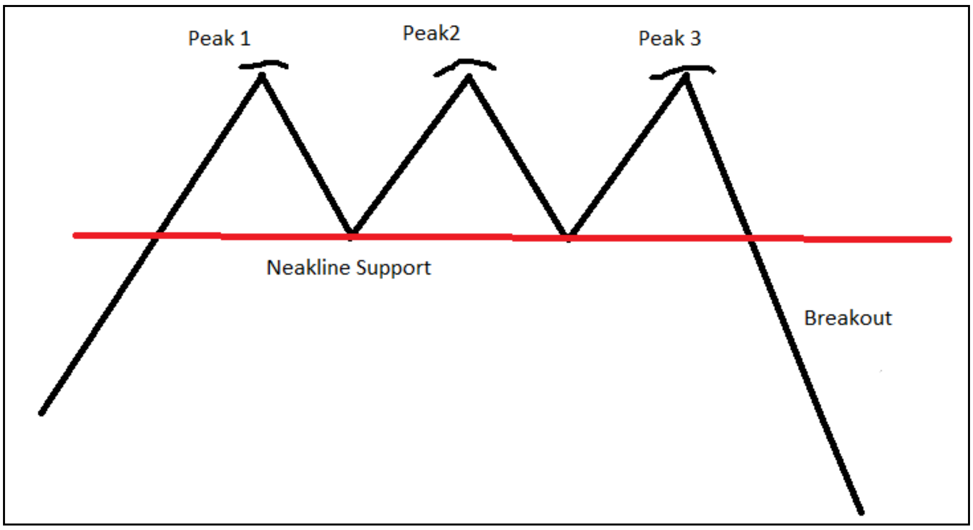


HOW TO TRADE THE DOUBLE BOTTOM

Same as the double tops, the double bottoms signals the reversal of the trend and can be used as an entry into a long position, or exit from a short trade. Wait for the price confirmation – price above the previous level of resistance – before buying.

4. TRIPLE TOPS/BOTTOMS PATTERN

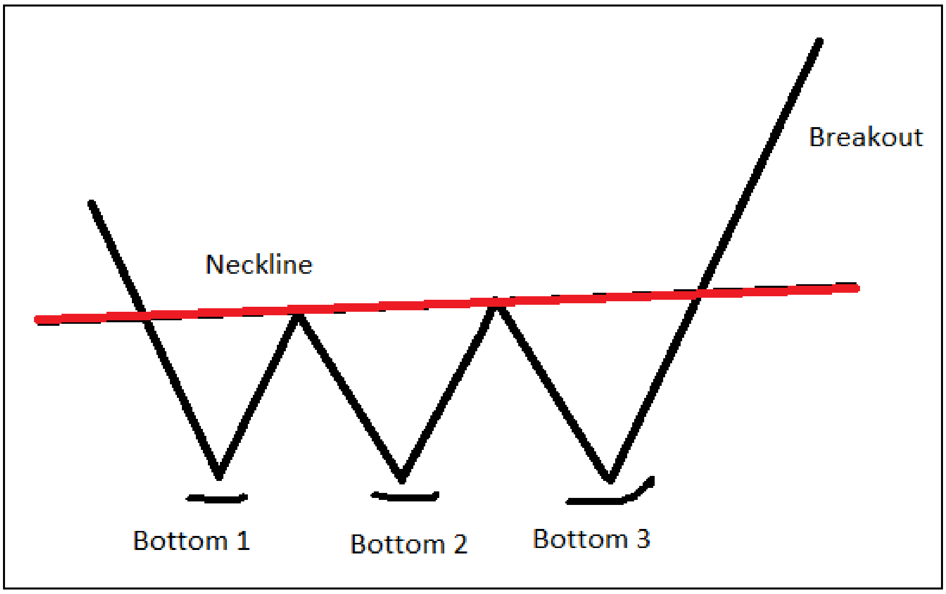
The **Triple Top** is a close cousin of the Head & Shoulders Top. It occurs after uptrend and is comprised of three peaks at approximately the same price level. Refer to the pattern of Head & Shoulders Tops and Double Tops for additional insight.



HOW TO TRADE THE TRIPLE TOP

Same as the double tops, the triple top pattern is indicating the reversal of the uptrend and can be used as an entry into a short position, or exit from a long trade. Wait for the pattern to confirm and the price to close under the neckline support level then take the short trade.

The **Triple Bottom** is simply an inverted image of the Triple Top. The formation of this pattern occurs exactly the same as the Triple Top pattern except is preceded by a downtrend.



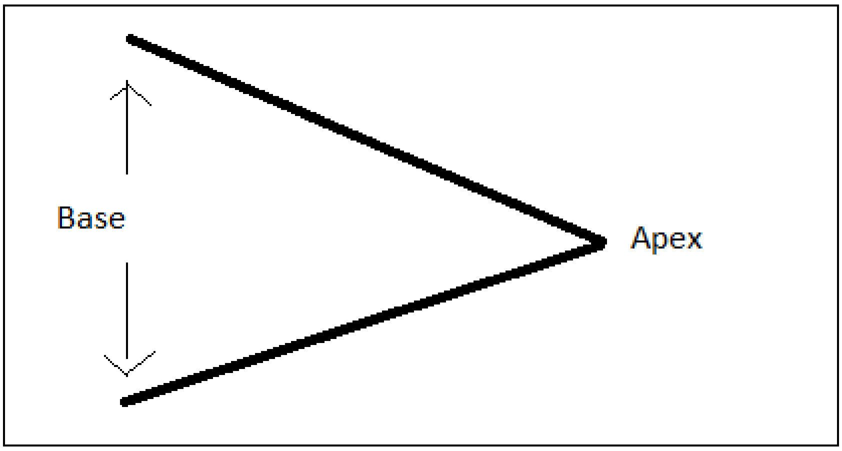
HOW TO TRADE THE TRIPLE BOTTOM

The triple bottom pattern is indicating the reversal of the downtrend and could be used as an entry into a long position, or exit from a short trade. Wait for the pattern to confirm and the price to close under the neckline support level then take the short trade.

5. TRIANGLES PATTERN

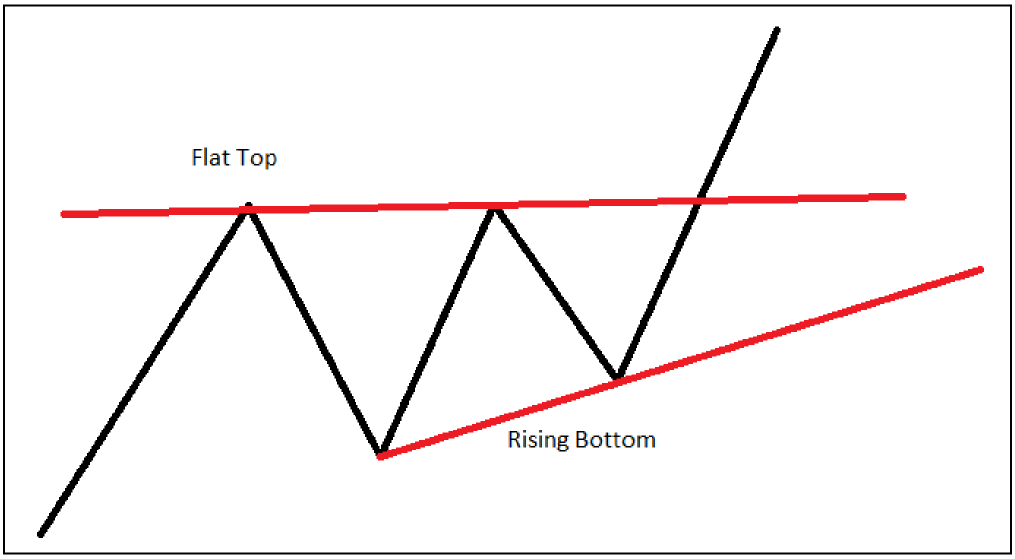
There are three categories of **triangles**: ***Ascending Triangle, Descending Triangle*** **and** ***Symmetrical Triangle*** **-** All of them are Trend Continuation Patterns.

All three triangle patterns have three common elements: *the base*, *apex*, and a minimum of four reversal points. The *base* marks the beginning of the pattern and is the widest point. The height of the pattern, which is used in determining the price move objectives, is measured at the base. The *apex* marks the intersection of the trend lines drawn along the peaks and troughs. All triangle patterns require at least two peaks and two troughs.



The **Ascending Triangle** is a bullish pattern that marks a pause in an uptrend. It has a rising lower line along the troughs with a flat upper line along the peaks. The conclusion of the Ascending Triangle occurs when the prices close above the resistance line along the peaks.

Important: A common mistake is to prematurely identify a Double Top as Ascending Triangle. The only difference is that the final pullback in the Double Top breaks below the previous trough.

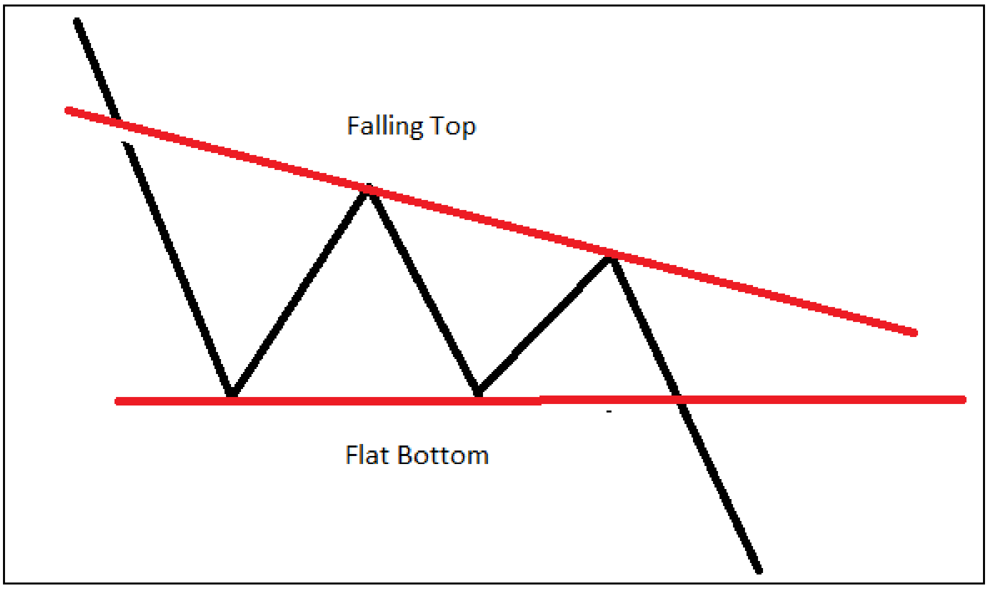


HOW TO TRADE THE ASCENDING TRIANGLE

The **Ascending Triangle** is a bullish pattern and a buy entry can be place above the resistance level at the top.

The **Descending Triangle** is a bearish pattern that makes a pause in a downtrend. It has a falling upper line along the peaks with a flat lower line along the troughs. The conclusion of the Descending Triangle pattern occurs when prices close below the support line along the troughs.

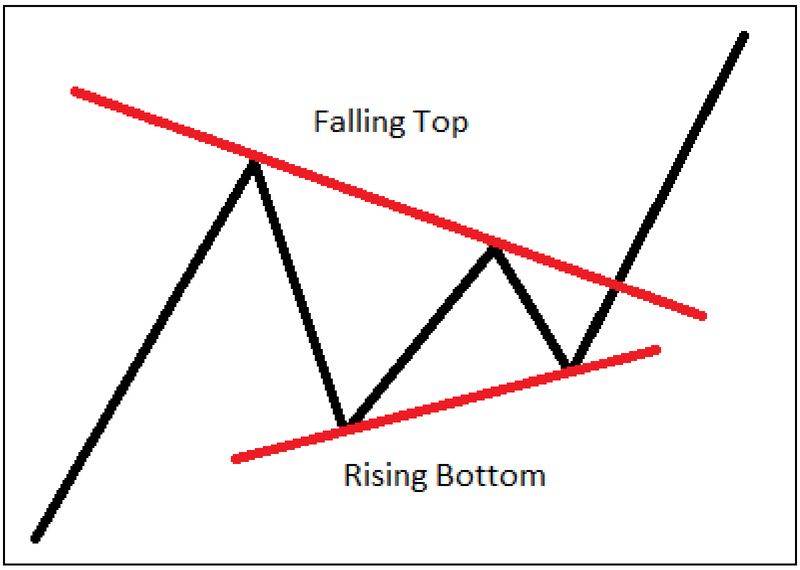
<u>Important:</u> A common mistake is to prematurely identify a Double Bottom as a Descending Triangle. The only difference is that the final rally in the Double Bottom breaks above the previous peak.

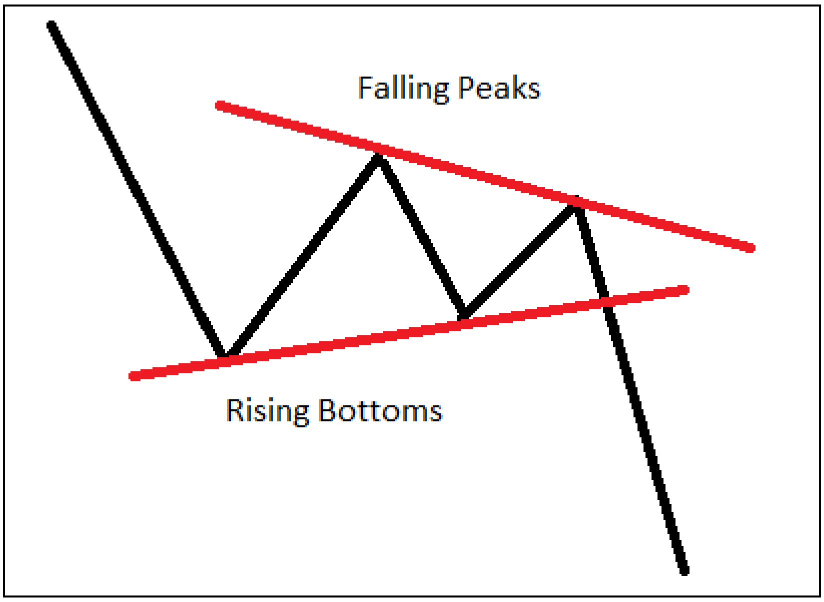


HOW TO TRADE THE DESCENDING TRIANGLE

The **descending triangle** pattern usually forms in a bearish market it should be used for short entries. The sell order can be place just under the support level at the bottom.

The **Symmetrical Triangle** is a continuation pattern that makes a pause in the trend – can be an uptrend or a downtrend. The triangle has a falling upper line along the peaks and a rising lower line along the troughs.





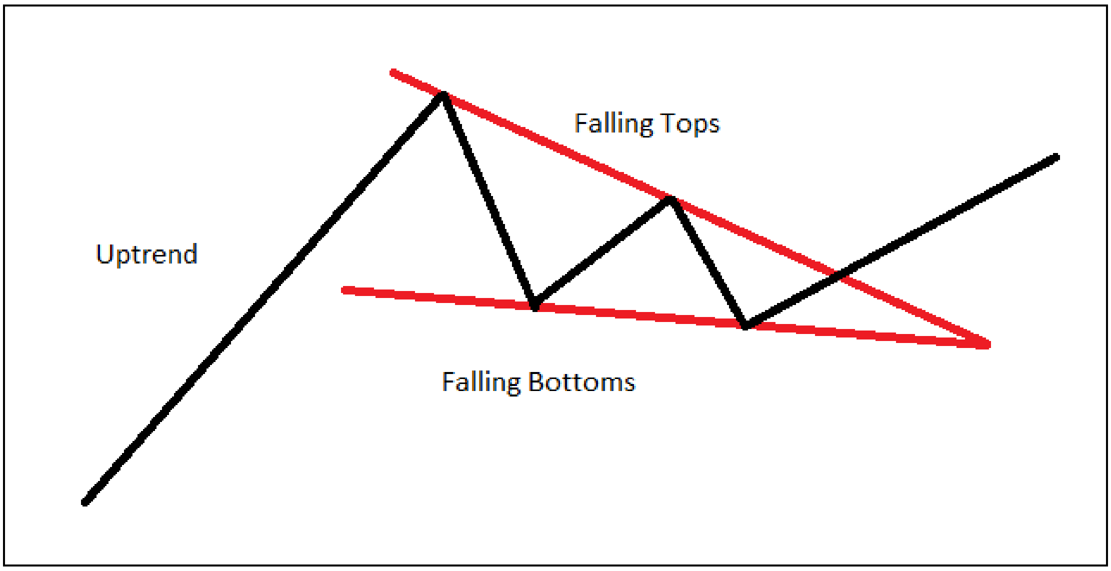
HOW TO TRADE THE SYMMETRICAL TRIANGLE

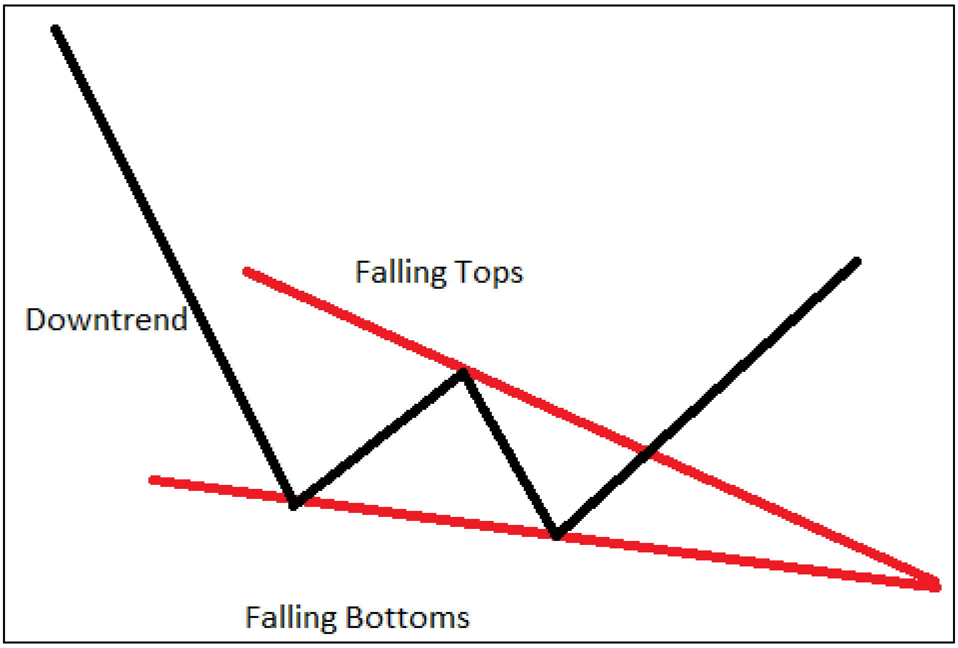
The symmetrical triangle pattern is followed most often by a continuation of the prior trend. We must wait for a valid breakout before taking a trade in the same direction.

6. WEDGES PATTERN

The **wedge formation** is also similar to a symmetrical triangle in appearance, in that they have converging trend lines that come together at an apex. However, wedges are distinguished by a noticeable slant, either to the upside or to the downside.

A **Falling Wedge** is generally considered bullish and is usually found in uptrends. But they can also be found in downtrends as well. The implication however is still generally bullish. This pattern is marked by a series of lower tops and lower bottoms.

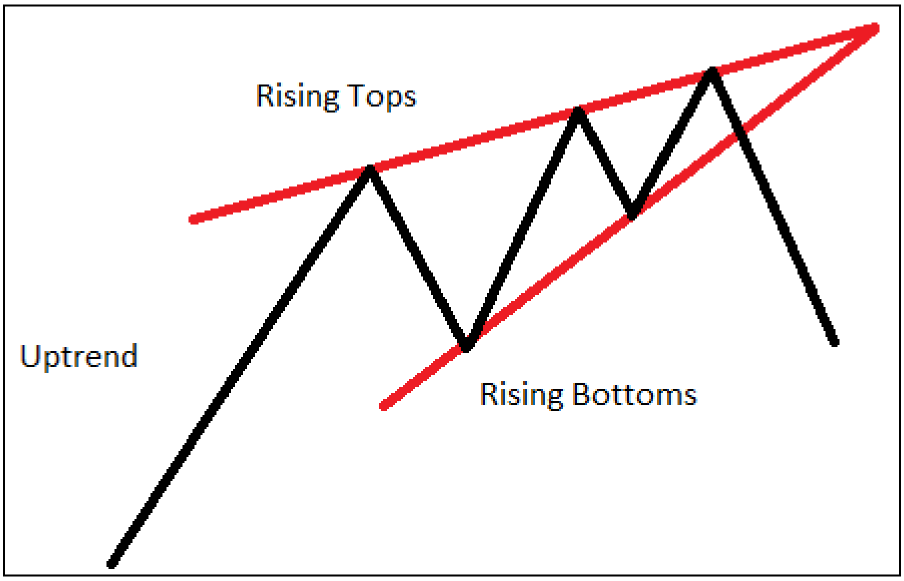


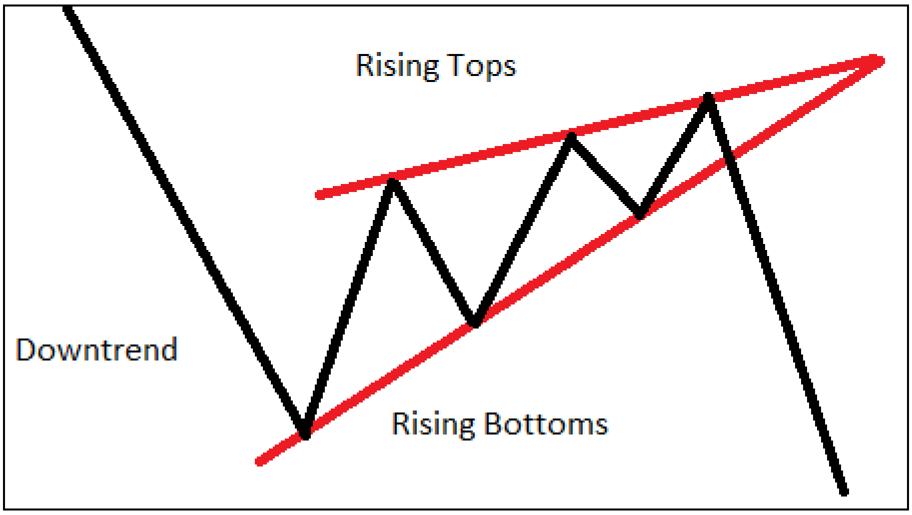


HOW TO TRADE THE FALLING WEDGE

The falling wedge pattern is a generally a bullish pattern signalling that one will likely see the price break upwards through the wedge and move into an uptrend.

A **Rising Wedge** is generally considered bearish and is usually found in downtrends. They can be found in uptrends too, but would still generally be regarded as bearish. Rising wedges put in a series of higher tops and higher bottoms.





HOW TO TRADE THE RISING WEDGE

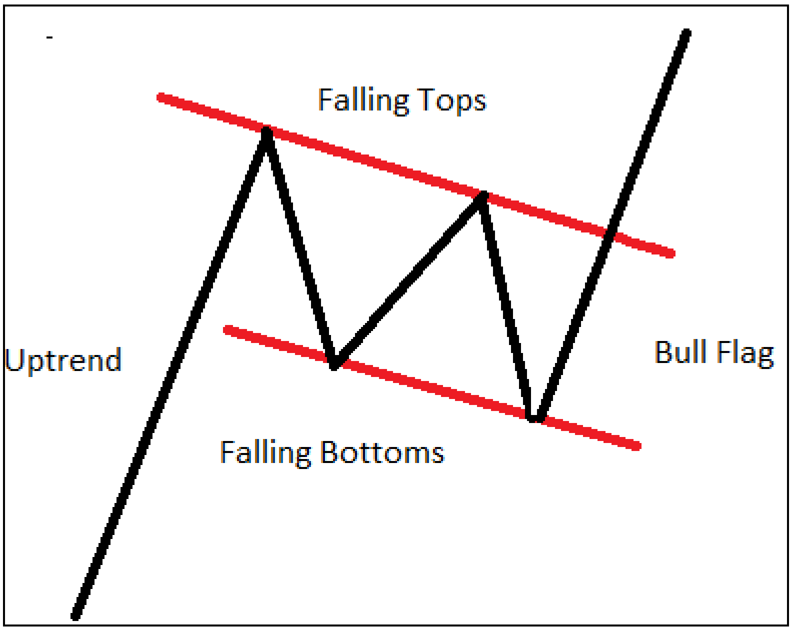
The rising wedge is a bearish pattern that signals that the price is likely to head in a downward direction.

7. FLAGS AND PENNANTS PATTERN

Flags and pennants can be categorized as continuation patterns. They usually represent only brief pauses in a dynamic market. They are typically seen right after a big, quick move.

The market then usually takes off again in the same direction. Research has shown that these patterns are some of the most reliable continuation patterns.

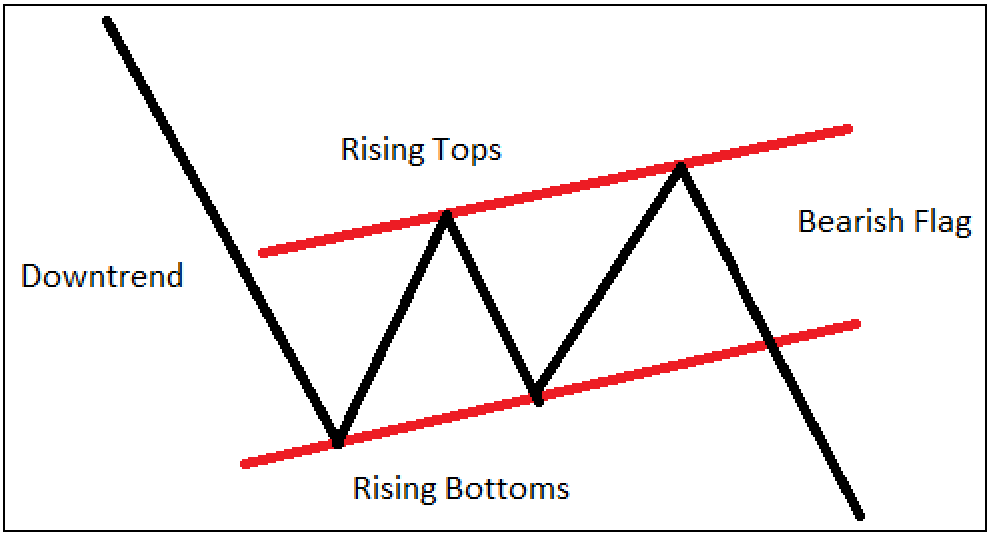
Bullish Flags are characterized by lower tops and lower bottoms, with the pattern slanting against the trend. But unlike wedges, their trend lines run parallel.



HOW TO TRADE THE BULLISH FLAGS

The bullish flag pattern signals the continuation of the uptrend. The entry point is either at the bottom of the flag or breakout of the highs.

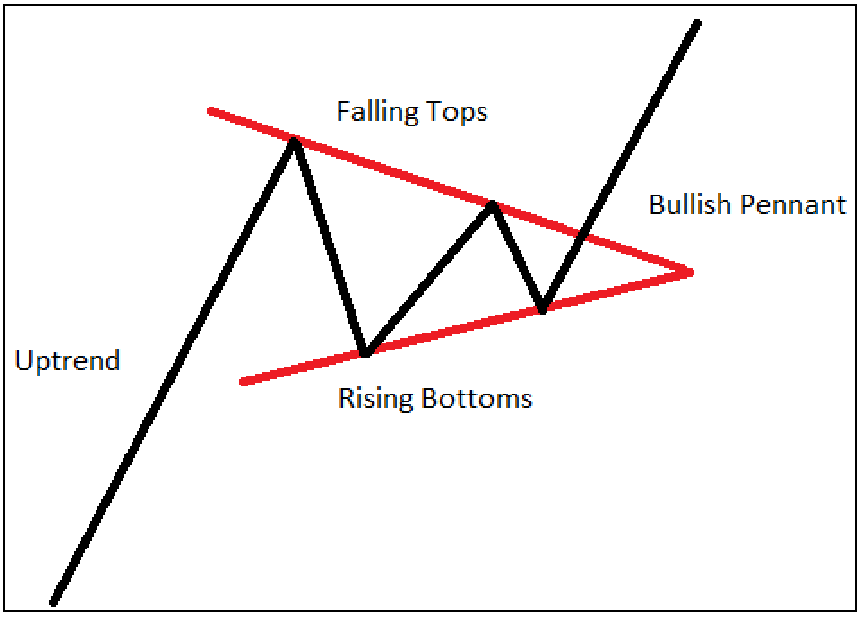
Bearish Flags are comprised of higher tops and higher bottoms. "Bear" flags also have a tendency to slope against the trend. Their trend lines run parallel as well.

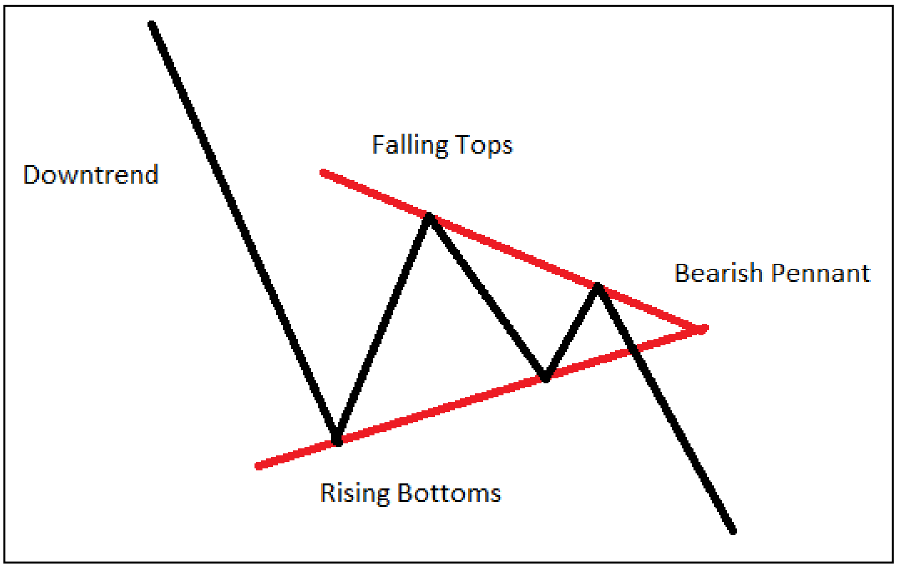


HOW TO TRADE THE BEARISH FLAGS

The bearish flag pattern signals the continuation of the downtrend. The entry/sell point is either at the top of the flag or breakout of the bottoms.

Pennants look very much like symmetrical triangles. But pennants are typically smaller in size (volatility) and duration. (Volume generally contracts during the pause with an increase on the breakout).





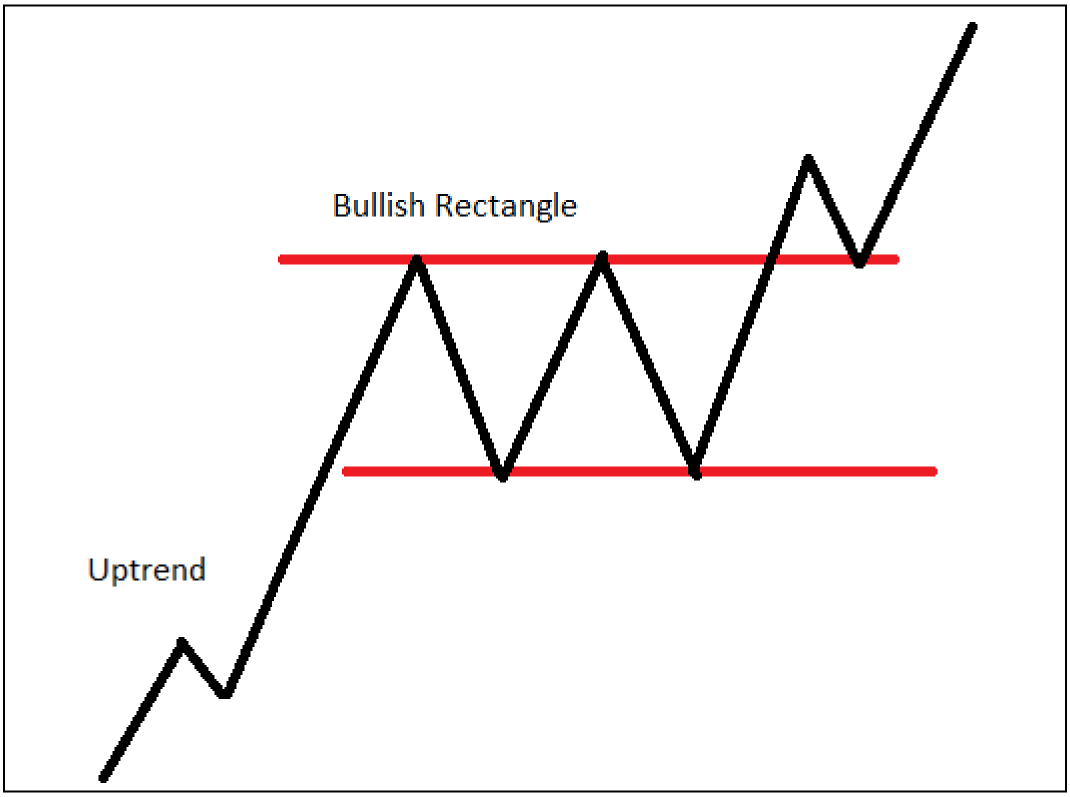
HOW TO TRADE THE PENNANTS

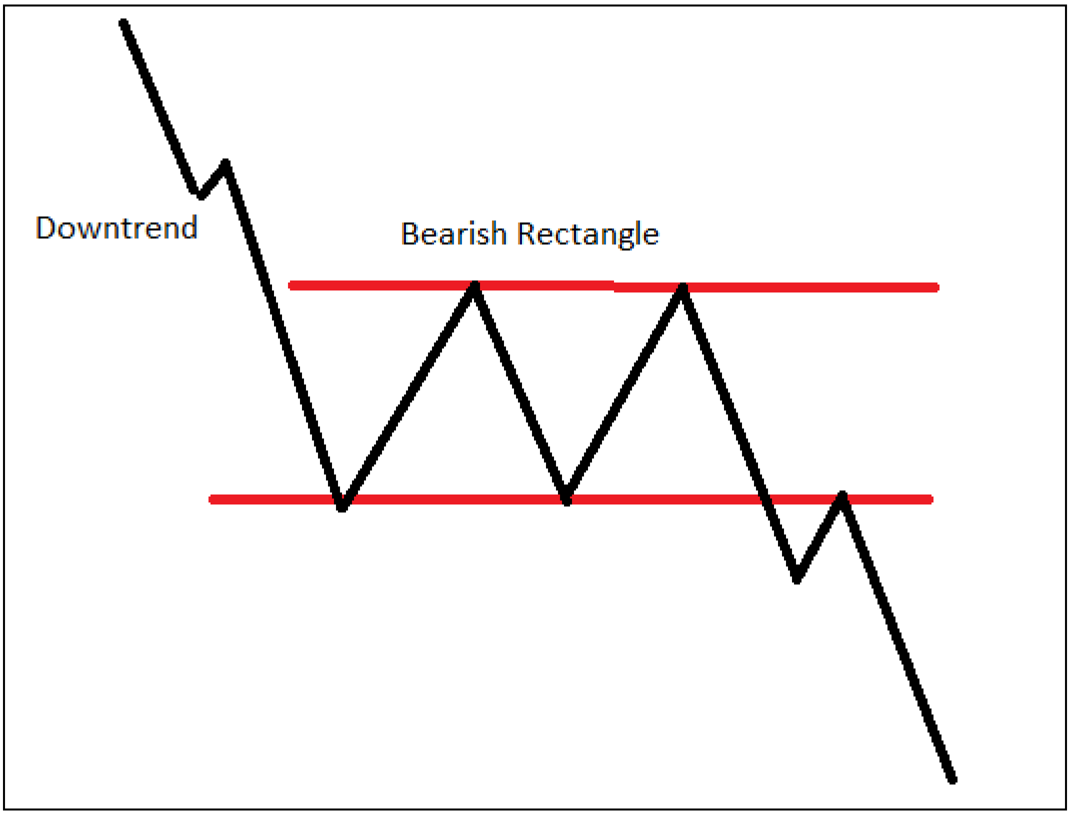
The pennant pattern is a continuation chart patterns formed after strong move. Buy or sell according with the main trend.

8. RECTANGLES PATTERNS

Rectangle pattern is actually a trading range and are also referred to as trading ranges, consolidation zones or congestion areas.

They are indecision areas that are usually resolved in the direction of the trend. Of course, the trend lines run parallel in a rectangle. Supply and demand seems evenly balanced at the moment. Buyers and sellers also seem equally matched. The same 'highs' are constantly tested as are the same 'lows'. The market vacillates between two clearly set parameters. (While volume doesn't seem to suffer like it does in other patterns, there usually is a lessening of activity within the pattern. But like the others, volume should noticeably increase on the breakout.


Bullish Rectangle
Uptrend


Downtrend
Bearish Rectangle

HOW TO TRADE THE RECTANGLE PATTERS

The rectangle pattern should generally be traded as continuation pattern so we can trade within the range buying at the bottom and selling at the top or wait for the confirmation of breakthrough the top resistance or support and enter the trade after that.

CONCLUSION

Identifying and understanding the chart patterns is one of the way you can prepare yourself for the next trade – to either go with the trend or to wait for a reversal.