Spotting Market Tops and Bottoms with Chart Patterns

Price Reversals

Common Reversal Patterns

What defines a top and bottom?
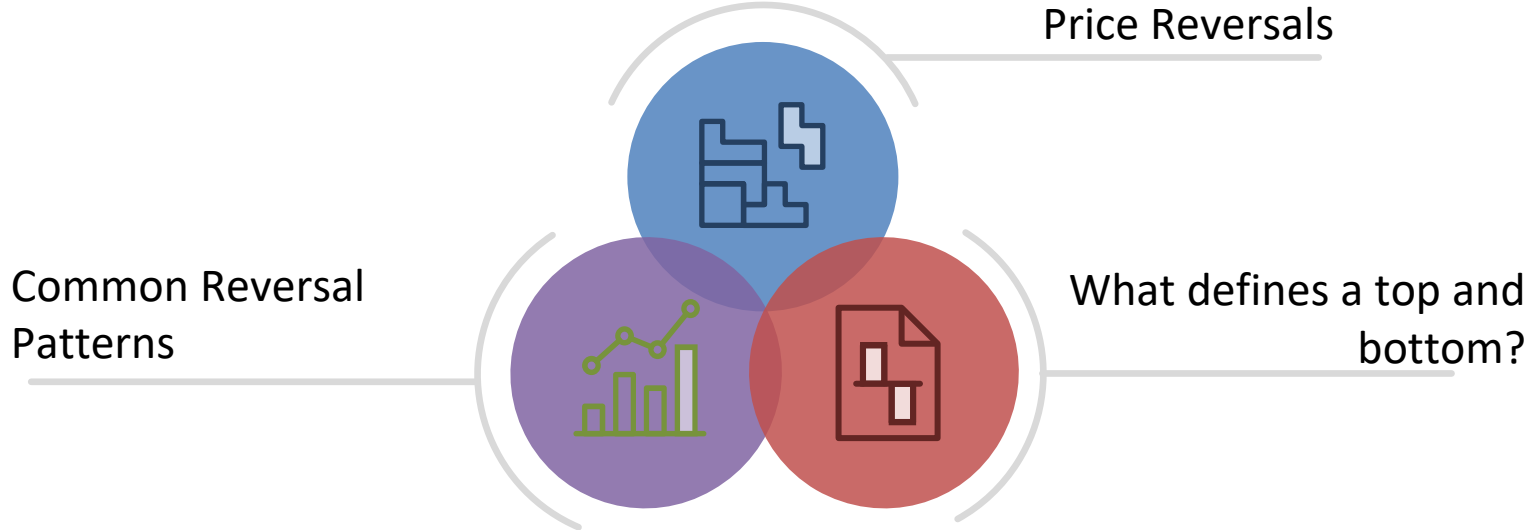
Agenda

Reversals

When a price is rising, stops, and then declines, the price at which the rise halted is a "reversal point."

- In this situation, the reversal point is called a **"peak"** and is important because it is where buyers were overcome by sellers.

- When a price is declining, stops, and then rises, the price at which the decline halted is a reversal point called a **"trough."** It is the price at which sellers were overcome by buyers.

- Reversal points are the foundations of trends, trend lines, channels, patterns, and support and resistance.

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Reversal Points

The longer the trend, the more important the reversal point

- Reversal point importance is determined by the length of the trend before and after the peak or trough.
- We can't determine if a reversal is a top or bottom until trend is broken.
- It is important to define your timeframe.
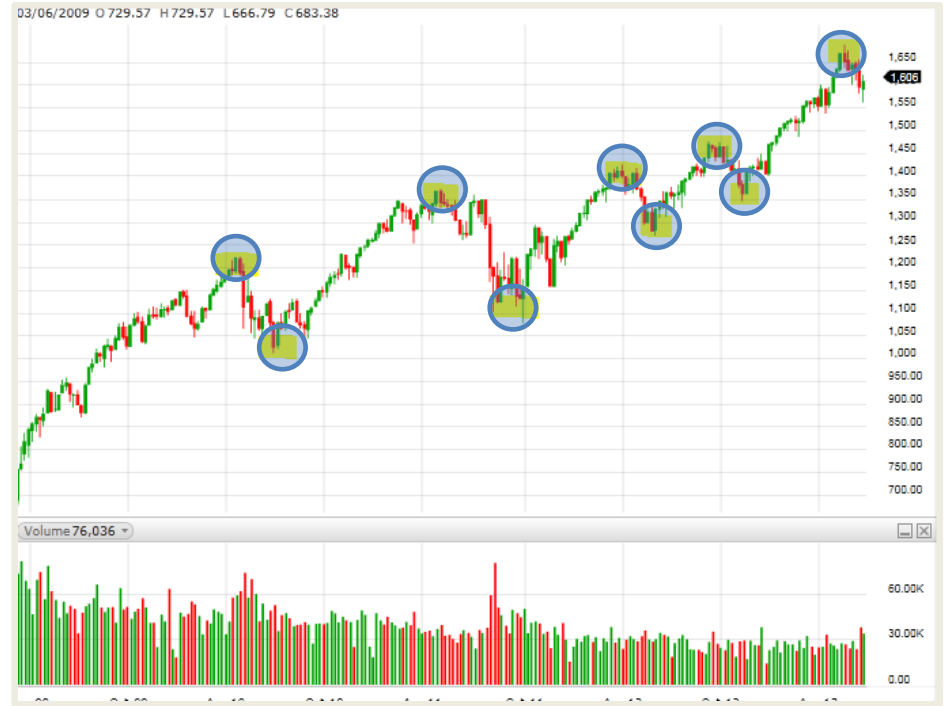
Uptrends/Tops

- Trend lines help show support for an upward trending security.
- A top is not confirmed until trend is broken.
- We can measure trend through trend lines, moving averages, and other indicators.
- Tops can take many forms. Sharp V-shaped reversals, rounding patterns, and congestion patterns for instance.

Downtrends/Bottoms

- Trend lines can also help show resistance for a downward trending security
- A bottom is not confirmed until trend is broken
- We can measure trend through trend lines, moving averages, and other indicators.
- Bottoms can take many forms. V-shaped patterns, rounding patterns, and congestion patterns for instance.

Support and Resistance

Changes in trend may also occur after a period of consolidation or basing.

Support

Horizontal line drawn through troughs at the same price level

Resistance

Horizontal line drawn through peaks at the same price level

Common Reversal Patterns

Head and Shoulders: Top

Characteristics:

- Three peaks with center peak higher than the other two

- Shoulders should be at approximately the same level and the head higher

- Line connecting the two throughs between the peaks is called the "neckline"

- Pattern is only complete on breaking the neckline

- Target is the distance from the head to the neckline projected from the neckline

- This is a standard pattern for tops and has one of the lowest failure rates

*Source: *Technical Analysis: the Complete Resource for Financial Market Technicians, 2nd ed.*

Head and Shoulders: Bottom (Inverse)

Characteristics:

- Inverted but otherwise identical to a top pattern except not as profitable*
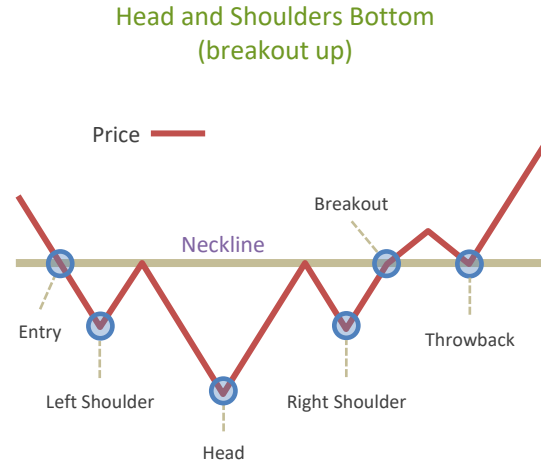
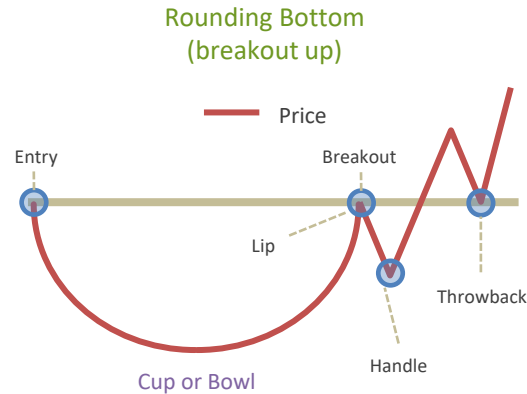Head and Shoulders Bottom (breakout up)

*Source: *Technical Analysis: the Complete Resource for Financial Market Technicians, 2nd ed.*

Cup and Handle (also "Saucer")

Characteristics:

- Pattern consists of a rounded bottom (not a "V" bottom), two "lips" at each end, and a "handle" (similar to a flag pattern) from the handle

- Pattern is complete with breakout above both lips

- Often have a throwback

- The pattern's performance ranks about average for bottom patterns*

Rounding Bottom
(breakout up)

Price

Entry

Breakout

Lip

Throwback

Handle

Cup or Bowl

Calculate target price:

Take the height of the right cup lip to the bottom of the cup, then add that amount to the breakout price.

*Source: *Technical Analysis: the Complete Resource for Financial Market Technicians, 2nd ed.*

Horizontal Congestion: Double Top

Characteristics:

- Two successive peaks separated by an opposite reversal point

- Either rounded or pointed peaks that are usually at roughly the same price (resistance level)

- Price must break out of middle reversal point

Double Top (breakout down)

Resistance Line

Entry

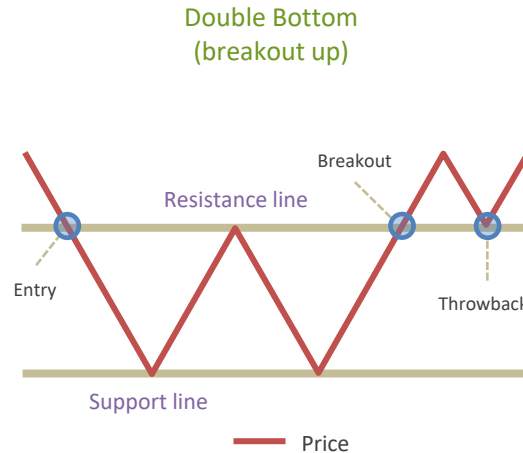Support Line

Pullback
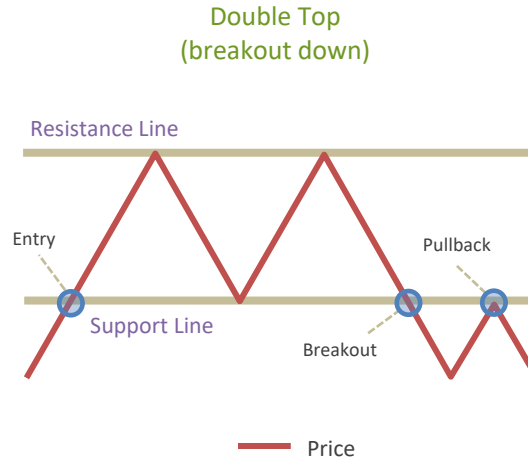
Breakout

— Price

Calculate target price:

Taking the height from the highest peak to the trough and then subtracting the amount from the breakout price to the downside.

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Horizontal Congestion: Double Bottom

Characteristics:

- Two successive troughs separated by a peak

- Either rounded or pointed troughs that are usually at roughly the same price (support level)

- Price must break out of middle peak

Double Bottom (breakout up)

Breakout

Resistance line

Entry

Support line

Throwback

Price

Breakout

Double Bottom

Calculate target price:

Taking the distance from the troughs to the peak and then adding that amount from the breakout price to the upside.

*Source: *Technical Analysis: the Complete Resource for Financial Market Technicians, 2nd ed.*

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Horizontal Congestion: Triple Top

Characteristics:

- Three distinct peaks at roughly the same price level separated by two intermittent troughs

- Breakout occurs when price exceeds the extreme of the intermittent trough or a trend line connecting those points
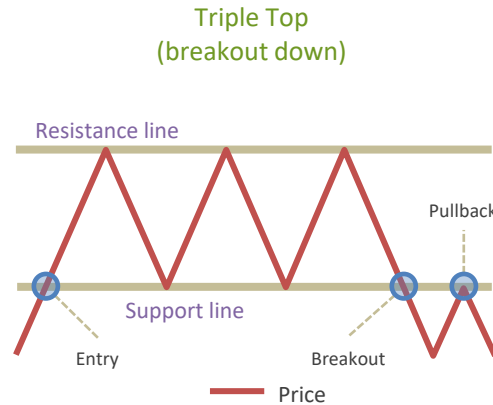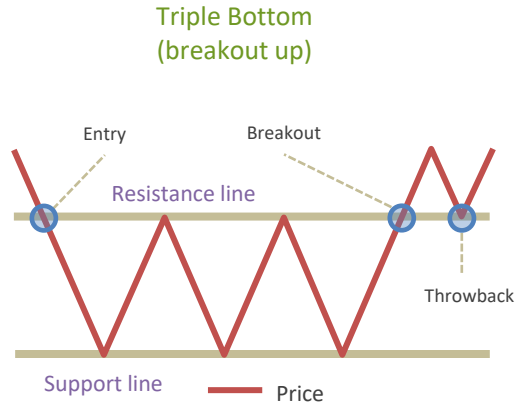

Triple Top
(breakout down)

Calculate target price:

Take the height from the highest peak to the lowest trough in the pattern. Then subtract that amount from the lowest trough in the pattern to generate a price target.

*Source: *Technical Analysis: the Complete Resource for Financial Market Technicians, 2nd ed.*

Horizontal Congestion: Triple Bottom

Characteristics:

- Three distinct troughs at roughly the same price level separated by two intermittent peaks at any level

- Breakout occurs when price exceeds the extreme of the intermittent peaks or a trend line connecting those points

- Best performance may be after a sustained decline*

- An average performance, but watch for failures*

Triple Bottom
(breakout up)

Entry   Breakout

Resistance line

Throwback

Support line   Price

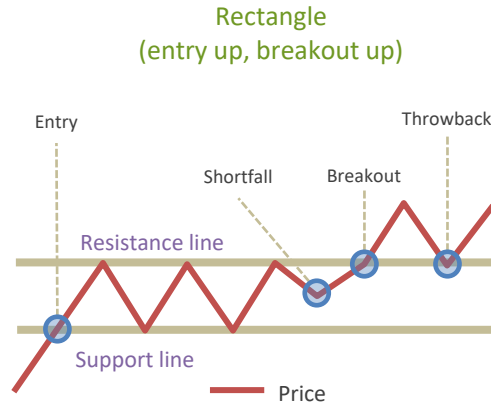Breakout

Triple Bottom

Calculate target price:

Take the height from the highest peak to the lowest trough in the pattern. Then add that amount to the highest peak in the pattern to generate a price target.

*Source: *Technical Analysis: the Complete Resource for Financial Market Technicians, 2nd ed.*

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Horizontal Congestion: Rectangles

Characteristics:

- Trading range with support and resistance levels bounding price action

- Slight tilt, similar to horizontal channel

- Often has many false breakouts*

- Things to consider:

    Confirm a breakout

    "Shortfall" often indicator of eventual breakout direction

- Best occurrence may be bottom breaking upward*

Rectangle
(entry up, breakout up)

Entry, Shortfall, Breakout, Throwback, Resistance line, Support line, Price

Resistance Zone, Support Zone, Breakout

Calculate target price:

Take the height from the resistance line to the support line. Then either add that amount to the resistance line to generate a price target for an upside breakout, OR subtract that amount from the support line to generate a price target for a downside breakout.

*Source: *Technical Analysis: the Complete Resource for Financial Market Technicians, 2nd ed.*

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