



CHART PATTERNS

INTRODUCTION TO TECHNICAL ANALYSIS

LEARN HOW TO OPTIMISE YOUR TRADING POTENTIAL THROUGH THE IDENTIFICATION OF HIGHER PROBABILITY FX PAIRS TO TRADE.

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Risk Warning

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Thank you for downloading this Trading Guide. This is the second of a 4-part series to introduce you to Technical Analysis. Each part has a video and accompanying trading guide which you can view below.

Part 1: [Trends](#)

Part 2: [High Probability Support & Resistance](#)

Part 3: [Chart Patterns Trading](#)

Part 4: [TA Techniques Combined](#)

Chart Pattern Trading

By Matt Simpson

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CHART PATTERNS EXPLAINED

Introduction

Out of all the topics within this series, this is by far the hardest one to fit into one topic. If anything this should be split into two topics but then we have to remember this is an introductory guide.

It was not until I came to write this section and host the webinars that I realised how many intricacies and areas of judgement I make using these patterns. There are many textbooks and websites that will bog you down with exotic names and fancy patterns which provide little, if any, practical use for day-to-day analysis and trading. Therefore I have tried to avoid this road, and instead provide the basics along with the 'what you really need to know tips' to make any use of the most basic patterns.

I have split it into 2 main sections by their style: Long-term patterns; short-term patterns; Both styles possess their own strengths and, weaknesses, require different approaches yet at the same time, complement each other as though they were always meant to be.

If you have to take one piece of advice from this guide please take the following:

You will significantly increase the usability of each style by combining the two together.

Many try to master one style and use them in isolation (as I did) but they will create independent problems for your analysis and trading. By blending the two together you will create a more structured and comprehensive view of price.

Combine these two styles of patterns recognition with trends, support and resistance and you will never look at a price chart the same way again.

Why do chart Patterns Occur?

The concept is similar to support & resistance: At any one time market participants have one of three choices - to buy, sell or stand aside. As this ratio between the three groups change over time, so does the supply and demand for any given market. As this force changes, so does price. This is all based upon participants (and groups of) opinions of where price 'should' be.

As the battle towards the 'correct' market price unfolds we see trends and oscillations develop, which when combined form familiar patterns.

If we can identify familiar patterns, technical analysts believe that [to a certain degree] price can become predictable.

The collective individuals within any market constantly changes, along with personal opinions of where price 'should be', or why they should move in the first place.

Regardless... a Technical Analyst always takes comfort in the fact that history does repeat itself as long as prices are always governed by supply and demand.

Long-Term Patterns (LT)

I refer to long-term patterns as those which take several (and usually much more) bars of data to create and they are also commonly referred to as Western Chart Patterns.

They are not related to the trading timeframe they are seen on, as LT patterns can be seen on any timeframe. However a rule of thumb is that the higher the timeframe you see a chart pattern it is generally considered to be more reliable, and the lower the timeframe tends to generate more false signals.

You can see the same (or similar) patterns on a 1-minute chart which may only take 5 minutes to create, whilst also seeing patterns which last years or decades on the Monthly timeframes.

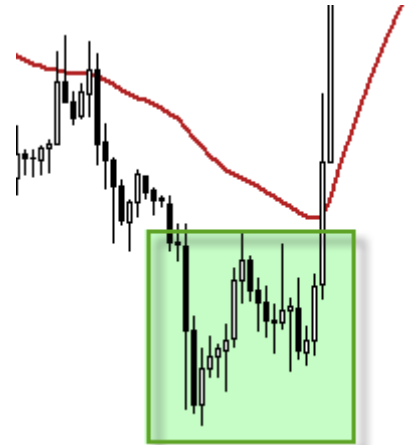
Below is an example of a Double Bottom pattern which took 18 bars to create. I have hidden the timeframes as it is irrelevant – this could be a 1 minute chart or a 1 day chart, but the concept is the same.

LT Patterns Provide

- Structure (Once combined with trends and S/R)
- Future Direction
- Price Objectives (Targets)

Examples:

- Double Bottom (pictured), Triple Bottom, Double Top, Triple Top,
- Wedge, Head & Shoulders,
- Symmetrical Triangle, Ascending Triangle, Descending Triangle,
- Pennant, Flag



Structure:

If we are familiar with these patterns and can identify the *potential* for one to appear, then it helps us gauge very roughly at what stage of the pattern we are at. In turn this either helps us to anticipate the breakout of a pattern to build our trading plan, or avoid jumping in too early.

Potential Future direction:

Once a pattern is confirmed, regardless of whether it is a continuation or reversal pattern, we then have a directional bias for price to continue trading.

Profit Objectives:

Once we have profit objectives (or targets) defined we can then see if these overlap areas of S/R to build a stronger case for price reaching or reacting at these levels.

Short-Term Patterns (ST)

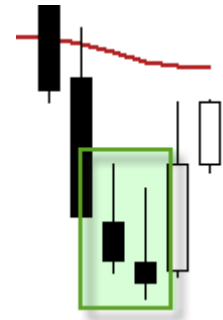
Short-term patterns can be produced from a single bar of data or more and require either Bar Charts or Candlestick charts to identify them. As with LT patterns they appear on all trading timeframes and generally considered to generate more reliable signals the higher the timeframe.

Short-Term Patterns (ST)

For example, a ST pattern can be made up from 1-3 bars of data, and may form on any tradable timeframes such as 1 minute, 1 hour, 1 day or 1 week etc.

ST Provide

- Signs of potential strength or weakness
- Entry Signals
- Exit Signals
- Trade Management



Signs of potential strength and weakness:

You may be monitoring a trend and trying to identify the end of phase 2 or the beginning of phase 1. Some candle formations would suggest a turning point. However the key with ST candles is to blend them form trends, support and resistance to make them higher probability.

Entry signals:

Some patterns are ideal for generating a buy or sell signals. However the trick here is to identify a trend and areas of support or resistance which the before

Trade Management:

When you are in a trade and price is unfolding can adjust your stoploss to suit the price action. For example if you see long candles form in favour of your trade, you can use the highs or lows of these candles to trail your stop behind.

You could also move your stop loss if a candle formation appear which may threaten the trade you are in. This would be a defensive move.

Short-Term vs Long-Term: Which is better?



Many Analysts or Traders prefer to specialise in one form of analysis. However I believe that by using the two in tandem you will achieve a much more comprehensive picture as their strengths and weaknesses complement each other very well.

For example, whilst LT patterns project future direction and price targets, they can be particularly tricky to time your entrance to a trade whilst maintaining a decent reward/risk ratio. And whilst ST patterns generate great timing for entry signals, they do not provide you with a profit objective, or much future direction beyond the candles you are currently looking at.

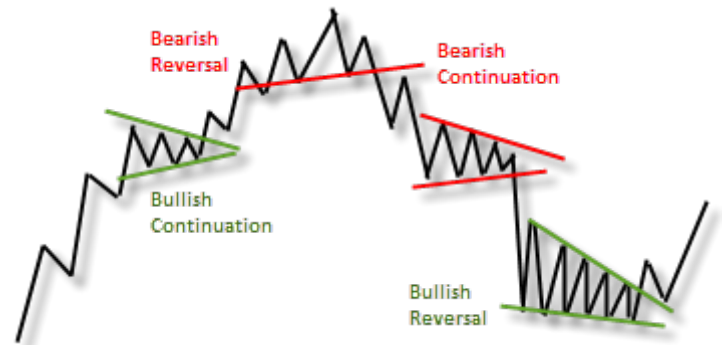
For those reasons I would strongly urge you to combine the two for a fuller picture of what price is telling you.

Continuation, Reversal, Bullish or Bearish?

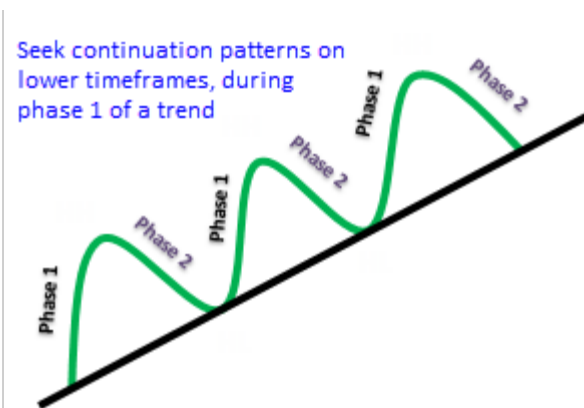
As the name implies, continuation patterns assume a breakout of the pattern in the same direction in which it entered the pattern. Reversal patterns however break out of the pattern in the opposite direction to which it entered the pattern.

Bullish patterns appear during an uptrend and bearish patterns appear during downtrends.

However a 'Bearish Reversal' will be seen during a bullish trend, as it is suggesting we are about to change from bullish to bearish. So a bullish reversal will appear during a downtrend



Seek continuation patterns on lower timeframes, during phase 1 of a trend



Trends and Patterns:

Refer to lesson one TRENDS to learn how to identify a trend.

- Once a trend has been established (or at least a suspected trend) you are statistically more likely to find a continuation pattern on a timeframe *below* the one you have identified a trend on.
- Whilst every trend will have a reversal at some point, remember that you are statistically *less likely* to identify the end of a trend.
- Seek reversal signals on lower timeframes that trade *in the direction* of the higher timeframe.

Pattern Confirmation

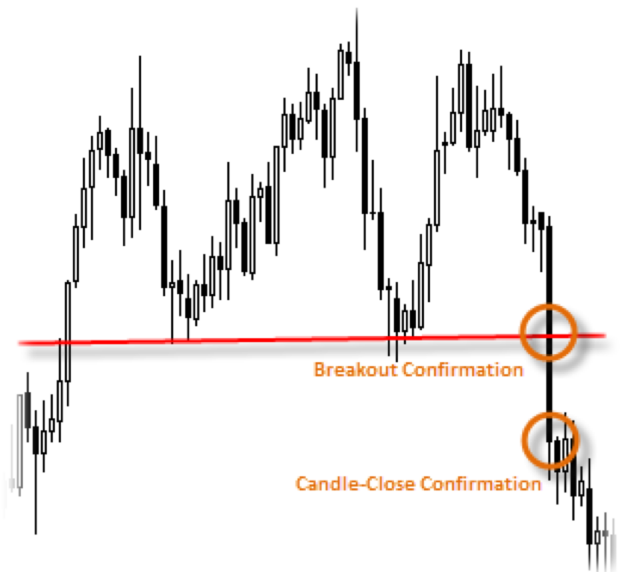
So how do we confirm a pattern? There are several methods and it is down to personal preference as to how you decide to confirm your patterns. However please be warned that the word 'confirmation' can be a little misleading as just because we confirm a pattern it does not guarantee that the pattern will be fulfilled. Confirmation simply means 'a point on the chart in which we assume, when crossed, the pattern may reach a target'.

A pattern can be confirmed, only to see price reverse and trade back into the suspected pattern to make it a 'failed pattern'. Each pattern has a breakout line which is similar to drawing a trendline or S/R level.

Breakout: We simply require price to cross the line. This is an ideal method if you want to set pending orders to catch the breakout. However price can (and does) return back over the breakout line to invalidate the pattern.

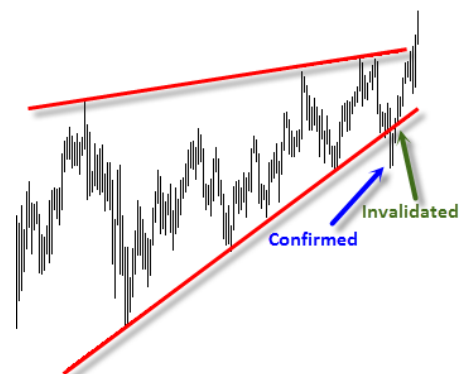
Close: We want to see price close a bar over the line to confirm the signal. This provides extra confidence and reduces the chances of it being a failed signal, however you also risk missing the move and for price to take off without you.

Multiple Closes: Some analysts use 2 or 3 closes to confirm the pattern. Whilst this provides even greater confidence you again risk the chance of missing the move for it to be profitable enough (for your reward/risk ratio)



Throwback: A throwback is my preferred style if trading the pattern. This is where price breakouts out or closes to confirm the pattern, but then returns to the breakout line. If this level then holds as either support or resistance it can provide an excellent entry with greater confidence and precision to achieve a much better reward/risk ratio. However the downside to this approach is you are much more likely to repeatedly miss moves if it doesn't quite return to the breakout line.

I would not say that one method is not particularly better than the other, but it is important to use a method which suits your trading style and personality. For example an aggressive day-trader who must be in the markets as much as possible may not have the patience to wait for a throwback (in fear of missing out) so a breakout approach may be better. Similarly and End of Day trader with more patience may be better suited to the throwback.



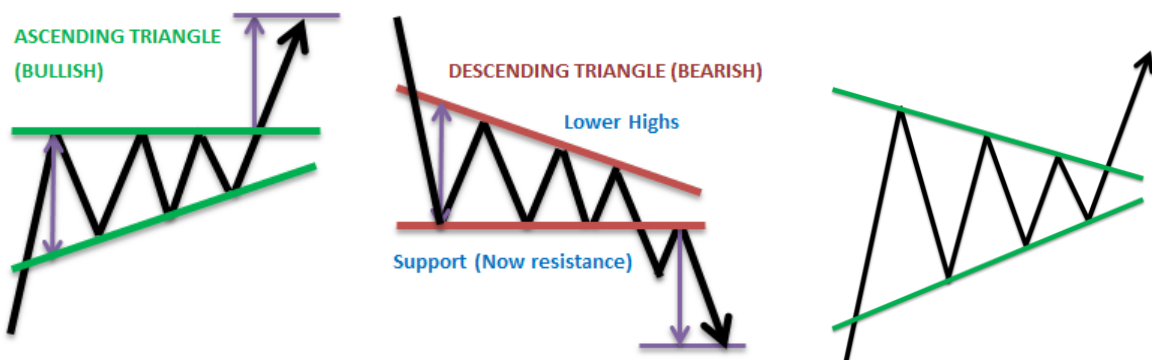
LONG-TERM PATTERNS (LT)

Continuation Patterns

Whilst LT patterns (Western Patterns) look simple in textbooks and hindsight they are by no means easy to trade. The following pictures are here merely to show you the ideal structure and methods of projecting targets. Real price charts are never this pretty – the key is to observe the relationships between the swing points on the charts.

For example in an uptrend you would observe the HH and HL (lesson 1) but in a chart pattern you would also observe that these swing points are contracting over time (getting closer together)

The key to continuation patterns is to use the higher timeframe to identify the trend (lesson 1) and seek continuation patterns on the lower timeframes.



TRIANGLES

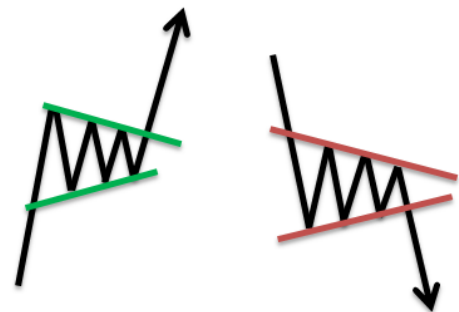
Whilst triangles have a tendency to be continuation patterns they are not always. For example an ascending triangle really only consists of higher lows forming beneath resistance. Neither of these lines need be accurate, and if the lower line breaks first it still counts as a triangle just not a continuation pattern under those circumstances... However they do provide excellent directional trade plans if and when confirmed, with price objectives.

A symmetrical triangle is simply when the two 'lines' contract (or the upper and lower swing points come closer together).

PENNANTS / FLAGS

By far the messiest and difficult of continuation patterns to trade. Personally I use them purely for observation and to judge 'phase 2' (retracements) before a supposed resumption of a trend.

Typically you measure the run into the 'flag' and project this for you target. Please take this last point with several barrels of salt – to me they just highlight retracements.



Breakouts can....

- Be clean and swift (no looking back)
- Retrace to the breakout area (throwback)
- Completely fail and trade back inside of the breakout line to invalidate the pattern

Targets:

- Usually the same distance from the depth of the pattern itself
- Price doesn't necessarily have to get there in a straight line

Reversal Patterns

I am sure you have heard of the saying 'buy low and sell high'. It sounds simple enough but attempting to do this is far harder than it sounds. I have observed how the majority of newer traders become fixated with trading reversals in an attempt to get into that 'trade of a lifetime' before everyone else. I have also observed how these same traders tend to lack the ability to stay in a trade once they have entered. This may be because they traded against a string trend, or the occasion they are in profit they move their SL too soon, so get stopped out anyway.

If you must trade reversal, always refer to the trend and trade reversal patterns that bring you back to the dominant trend. For example, if: Daily is bullish (phase one); Hourly is bullish but phase 2 (retracement); Seek bullish reversal patterns to trade on hourly chart, to trade in the direction of the daily bullish trend.

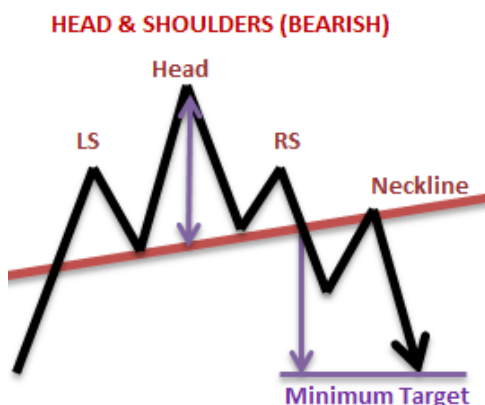
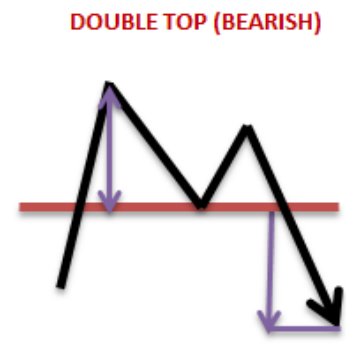
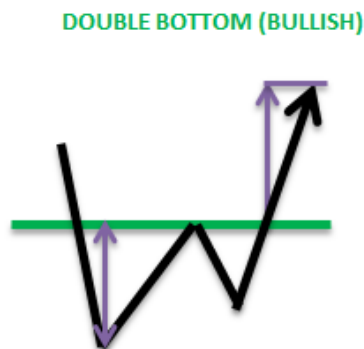


Wedges

- After a strong trend the swings begin to contract and often in defined cycles
- The catch the market out and can move very fast when the realisation kicks in the trend is over
- Similar to a broken trendline; Can provide good opportunities to enter a trade if market re-test the broken trendline
- Do not necessarily have to obey trendlines. Observe the relationship between the swings to visualise the balance between buyers, sellers and on-participants is changing.

Double/Triple Tops and Bottoms

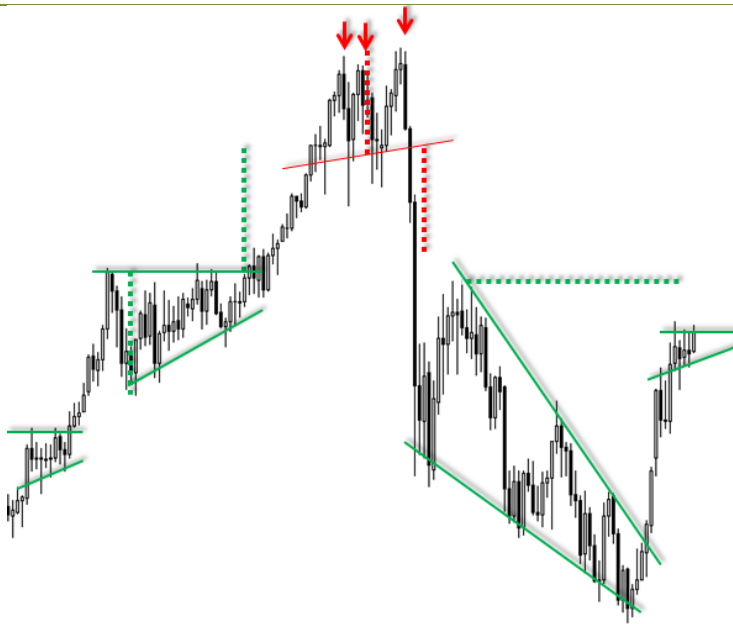
- Can be difficult to trade because (like flags/pennants) they are often very messy
- Good for observational purposes and targets
- Act as a good warning that trend is losing strength (due to the lower high/low)
- Easier to enter after a breakout



Head and Shoulders (Inverted H&S on market bottoms)

- Generally better when the RS (right Shoulder) is smaller than LS.
- Similar to wedges make excellent trading opportunities if market retests the broken trendline (neckline)
- Break outs can be very strong and fast, particularly in stock/Index markets after a bullish trend when the markets panic and offload
- This can make them difficult to enter on the breakout or get a decent entry price (due to slippage and price gaps etc.)
- I prefer to confirm patterns then look for suitable retracement before entering in direction of the breakout.

What they Really Look Like



Triple Top:

Lots of noise around the support line and the breakout was hard and fast which made it difficult to enter. However it provided a strong bearish trend to trade on lower timframes after the breakout.

Triangles:

Lots of noise around resistance lines, but noticed how their lows were being formed as new buyers came in to push prices up (eventually)

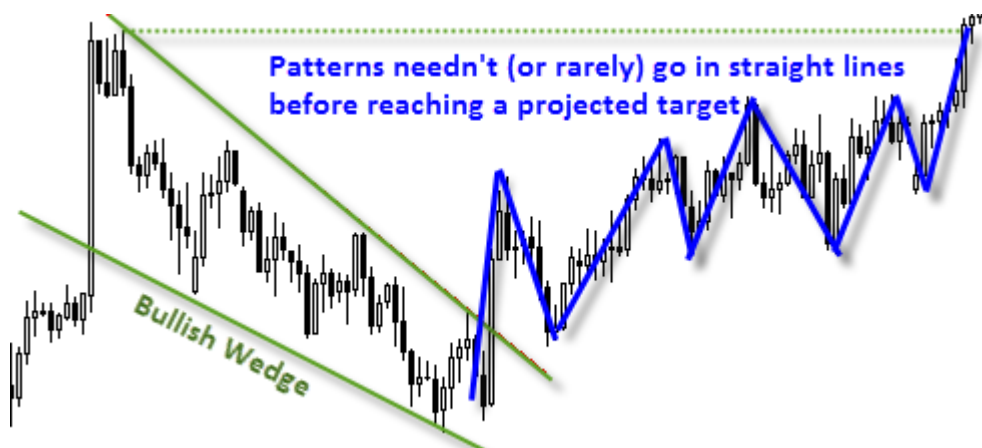
Bullish Wedge:

Notice how price oscillates as the swing points converge. They also increase in timing before the eventual breakout.

LT Patterns: Final Pointers

Patterns fail! Like any technique, nothing in this game is guaranteed. They provide a guide to *potential* future price direction and targets whilst also aiding our trading plans – that is all...

- Easier to spot after the event... but you can still build a plan around them after the breakout.
- Textbook patterns usually too good to be true
- Need not be neat and tidy
- Observe the relationship between the swings and 'join the dots'.
- Generally more reliable the higher the timeframe they appear
- Look at the bigger picture: Zooming out and using bar charts can help to identify these patterns easier
- Use multiple timeframes with trends, support and resistance to filter higher probability patterns



SHORT-TERM PATTERNS (ST)

Bar Charts vs Candlesticks

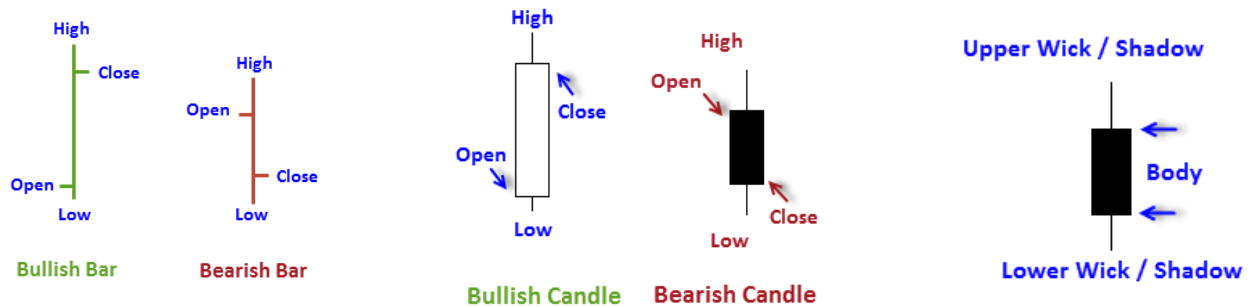
Japanese Candlesticks have been used by traders since the 1700s and very popular amongst Forex Traders. When you consider there are many patterns varying from 1 candle to several candles, by the time you start mixing combinations you literally have hundreds of patterns names to learn. My advice here is that by learning the names of all of the patterns will not necessarily make a better trader. In fact the opposite is probably true...

Bar charts are the Western equivalent and created using exactly the same information: OHLC (Open, High, Low, and Close). However their interpretation is slightly different.

Bar Charts: Focus on the relationship between the highs and lows of the current bar compared to the previous bar.

Candlesticks: Focus on the relationship between the bodies and Wicks.

Seeing as both candlesticks and bars use the same information to construct them (OHLC) you can indeed mix both forms of analysis. However seeing as Candlesticks are visually easier to interpret, many use Candlestick as the preferred method to use both forms of analysis.



***** Warning *****

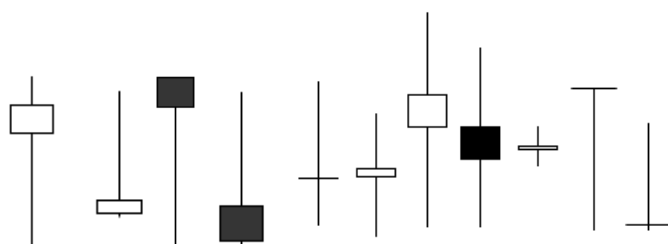
I genuinely believe using Candlesticks or Bar Chart in isolation to be a dangerous way to analyse or trade. This is because they only really pay attention to current price action, which can have the consequence of jumping in to lower probability trades, or getting very confused about the potential direction of price.

However they do help fine-tune the picture after you have identified trend, S/R and LT chart patterns. ST Patterns really are the last thing I look at as part of my analysis.

Also as this is an Introductory guide to TA I will focus on a select few patterns which incidentally are the only ones I really pay any attention to for my own trading.

Single Bar Patterns

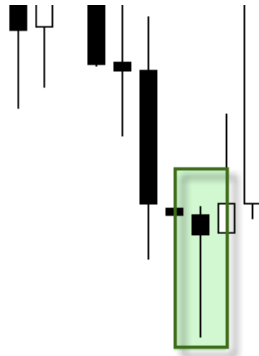
Doji's: Are simply candles which open and close at approximately the same level. Every single one of these Doji's to the right has specific name, however knowing these names will not really help you.



What you need to focus on is the relationship between the length of the wicks (or rejection areas) and the body (the open and the close).

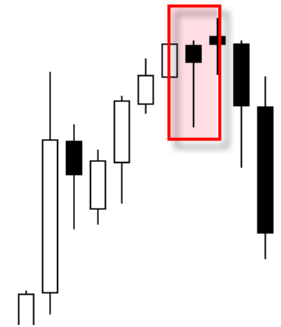
Bullish Hammer:

Some Doji's require an established trend to identify what it is. On the left we have a Bullish Hammer, as we were within a downtrend and this reversed higher. However this same pattern is called something different during an uptrend... (see Hanging Man)



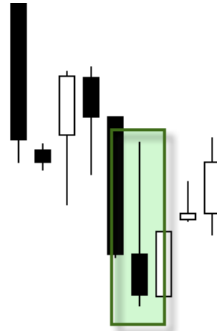
Hanging Man:

Not quite as reliable a Bullish Hammer however it does highlight a weakness in the preceding trend and indecision at the supposed top.



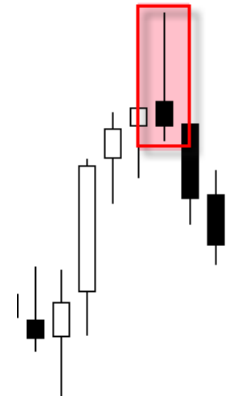
Inverted Hammer:

Not as reliable as Hammers because whilst bulls did attempt to push price higher the session still closed nearer to the lows. However it does suggest bearish sentiment is changing and losing momentum.



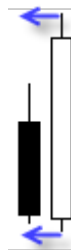
Shooting Star:

The bearish equivalent to a Bullish Hammer, the session has seen a failed attempt to keep prices higher and price has lost most (and sometimes more) than initial gains. This is a blow for the bulls...



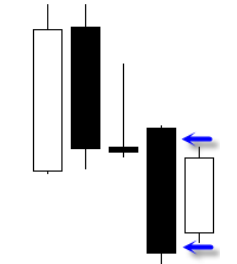
Engulfing Candles / Outside Bars:

The direction (or colour) they close on dictates if it is a bullish or bearish sign. Unfortunately they rarely provide good entry signals as they are too large but they can signify an important change in the sentiment.



Inside Bars:

Similar to Doji's they can provide doubt to the preceding trend. The closing direction (up or down) dictates their bullish or bearish bias. They are to Engulfing Bars as Inverted Hammers are to Hammers – not quite as significant, but noteworthy.



Multi-Bar Patterns

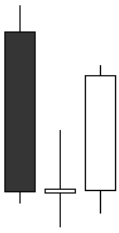
Multi-bar candles (usually 2-3 bar patterns, but can be more) are generally more reliable than single bar patterns. And as per usual, the higher the timeframe they appear on, the higher the reliability of the pattern can be assumed to be. There are a plethora of multi-bar patterns however I will only cover the ones I tend to use the most frequently as I have found them to be more reliable.

Morning Star Reversal (Bullish)

I frequently see and use this pattern

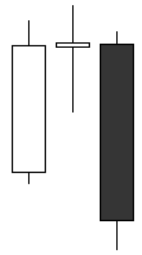
as I find it one of the more reliable

Evening Star Reversals (Bearish)



candle patterns. The 3rd bullish candle is required to close above 50% of the bearish candle's body; however I also use the height of the overall pattern as extra confirmation.

Notice how this 3-candle pattern comprises of a Doji followed by an Engulfing Candle.

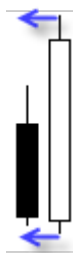
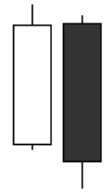


Bullish Piercing Line

Traditionally a bullish close 50% of the body of the previous bearish candle is required and it would be within a downtrend for it to be taken seriously. The height of the candles (volatility) defines if it is a trading opportunity, or merely a sign of change in sentiment.

Dark Cloud Cover

The bearish equivalent to the bullish piercing line and similar to 'train tracks' in bar charts. Traditionally the bearish candle would have to open higher than the bullish candle closed to be a genuine pattern. However as FX is less prone to gaps I personally ignore this rule.

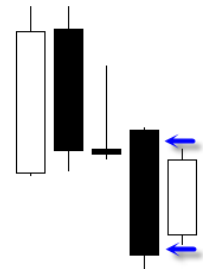


Bullish/Bearish Engulfing (Outside Bar)

These provide excellent changes in sentiment. However they are less useful for entering an actual trade due to the size of the bars. Either enter a trade on a retracement within the engulfing candle, or trade on a smaller timeframe in direction of the engulfing candle.

Inside Bar

Inside bars (in my opinion) are no reason to enter a trade but merely highlight momentum from the previous candle/s is waning. The size of the body is not important – here we are looking for the high-low to be within the range of the previous bar's high-low. The closing price/color dictates if they are bullish or bearish, but ideally a bullish inside day appears during a downtrend (and visa-versa) for any real meaning.



Again this really is a whirlwind tour of patterns, however I assure you that I only use these ST patterns alongside LT patterns. That is all I require. Forget the names – concentrate on what impact the relationship between the high-low and open-close has on preceding candles. With this information alone you will create your own patterns and meaning which is more worthy than the textbook names which you get sold to you on the street.

Rejection Spikes

When you see long wicks (or spikes) they can signify aggressive buying or selling at a specific level, and suggests a reversal away from this level.

If these spikes appear around significant levels of S/R then they are deemed as more reliable.

If you identify a trend with a rejection spike which respects a level of support or

resistance, you have a higher probability trading opportunity.



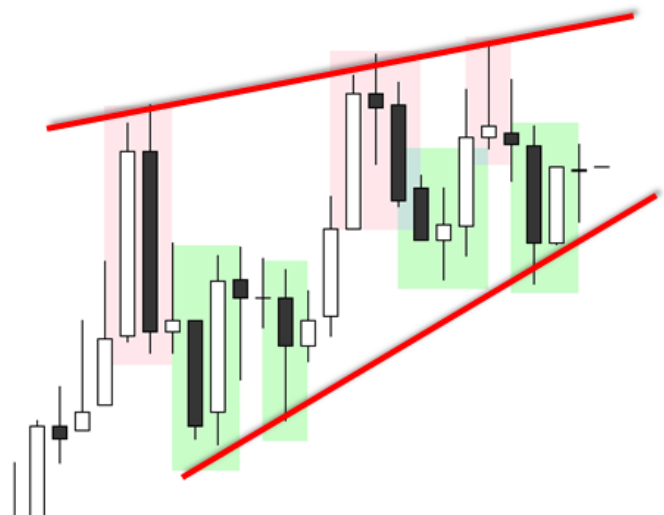
Lower timeframes = More signals false signals! (Potentially)

Candlestick patterns, like most forms of analysis, are generally more reliable the *higher* the timeframe they are seen on.

To the right is the EURJPY on the 5 minute chart and it contains 7 reversal formations, which is one for every single price swing between bullish and bearish.

If you were to enter after each reversal you would have lost money, or been lucky to break even on any single trade.

It is also a reminder not to use ST patterns in isolation as you will always be looking to enter low probability trades.



Notice you are also trading within a Bearish Wedge Pattern which may have paid to wait until price broke out of, before looking for a trading opportunity.

If you see a Bullish Hammer on the Monthly Chart, which rejects a level of support and is also in line with a trend, this is much more reliable than the 7 reversal candles seen on the 5 minute chart above!

ST Patterns: Summary

- Can be subjective, but easier to identify than Long-Term Patterns
- Many traders place too much emphasis on Short-Term patterns
- Provide more false signals on lower timeframes
- Must be combined with other forms of analysis to filter false signals
- Learning the names of exotically named patterns does NOT make you a better trader
- The LAST part of the puzzle
- Whilst they can be seen at market turns, trend traders would be wiser to trade reversal patterns that take you back in line with the dominant trend

Focus on:

- Wickes, Bodies and Candle Range
- Relationship between these
- How they integrate with preceding candles
- How they integrate with other forms of analysis

REDUCE YOUR LEARNING CURVE

I hope you have enjoyed this series and found it of benefit. Whilst I would like to think you are now expert analysts just from reading this series, like anything in life, it will take time to master which will require practice and experimentation - however a great way of speeding up the process is to watch others perform analysis.

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I would highly encourage you to subscribe to the ThinkMarkets YouTube channel and attend our weekly webinars as they included the methods used throughout the series.