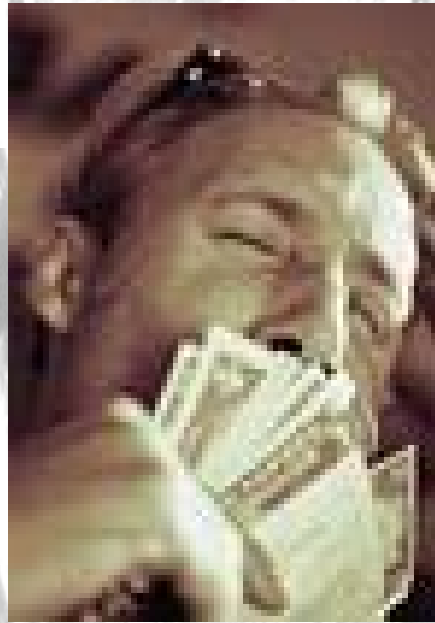


TECHNICAL ANALYSIS

Winning Techniques of Analysing Stock Trends and Price Movements



An Exhaustive
Report submitted to
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Prepared by
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INTRODUCTION

Technical Analysis is the study of market action, primarily through the use of charts, for the purpose of forecasting future price trends. The term market action includes the three principal sources of information available to the technician – price, volume, open interest. The term price action which is often used, seems to narrow because most commodity technicians include volume and open interest as an integral part of their market analysis.

Technical V/S Fundamental forecasting: While technical analysis concentrates on the study of market action, fundamental analysis focuses on the economic forces of supply and demand that cause prices to move higher, lower, or stay the same. The fundamental approach examines all of the relevant factors affecting the price of a commodity in order to determine the intrinsic value of that commodity. The intrinsic value is what the fundamentals indicate commodities actually worth based on the law of supply and demand. Both of these approaches to market forecasting attempt to solve the same problem, that is, to determine the direction prices are likely to move. They just approach the problems from different directions. The fundamentalist studies the cause of market movement, while the technician studies the effect.

Purpose of the project: The project was undertaken with the purpose of delving into the theoretical inputs of technical analysis and testing the classical technical tools in the foreign exchange markets. The project deals with Dow Theory, trends, supports, reversal and continuation patterns. The other classical tool dealt in the project is Japanese candle sticks. Finally the project takes life examples from the foreign exchange market and tries to see the application of these tools in the real world.

The foreign exchange crosses are:

- Dollar/Yen: Dollar is the base currency in this cross
- Euro/dollar: Euro is the base currency in this cross
- Euro/Yen: Euro is the base currency in this cross

THE DOW THEORY

The Basis of all Technical Market Studies

INTRODUCTION

The Dow theory is the granddaddy of all technical market studies.

Although it is frequently criticized for being “too late,” and occasionally derided (particularly in the early stages of a Bear Market) by those who rebel at accepting its verdicts, it is known by name to nearly everyone who has had any association with the stock market, and respected by most. Many who heed it in greater or lesser degree in determining their investment policies never realize that it is purely and simply “technical.” It is built upon and concerned with nothing but the action of the stock market itself (as expressed in certain “averages”), deriving nothing from the business statistics on which the fundamentalists depend.

There is much in the writings of its original propounder, Charles H. Dow, to suggest that he did not think of his “theory” as a device for forecasting the stock market, or even as a guide for investors, but rather as a barometer of general business trends. Dow founded the Dow-Jones Financial News Service and is credited with the invention of stock market averages. Unfortunately for us, Dow never wrote a book on his theory. He set down his ideas of stock market behaviour in a series of Wall Street Journal editorials around the turn of the century. It wasn’t until after his death in 1902 that his editorials were reprinted in a 1903 book by S.A. Nelson, *The ABC of Stock Speculation* (available in a 1978 reprint by Fraser Publishing Company, Burlington, Vermont). It was in that work that the term “Dow’s Theory” was first used. In the introduction, Richard Russell compares Dow’s contribution to stock market theory with Freud’s contribution to psychiatry.

Dow’s successor, as editor of the Journal, William P. Hamilton, took up Dow’s principles and, in the course of 27 years of writing on the stock market, organized them and formulated them into the Dow Theory as we know today.

THE BASIC TENETS

1. The averages discount everything: the theory states that every possible factor affecting supply and demand must be reflected in the market averages. Allowance is even made for “acts of God”— earthquakes and various other natural calamities. While these obviously cannot be anticipated by the markets, they are quickly discounted and assimilated into the price action.
2. The market has three trends: Dow’s definition of a trend was that an uptrend existed as long as each successive rally high and each successive rally low was higher than the one before. In other words, an uptrend had to have a pattern of rising peaks and troughs. A downtrend would be just the opposite with successively lower peaks and troughs. This is still the basic definition of a trend and the starting point of all trend analysis.
Dow divided the trend into three different categories—the primary, secondary and minor. His main concern was with the primary or major trend, which usually lasted for more than a year and possibly for several years in some cases. It was belief that that most stock market investors were concerned with the major direction of the market. Dow compared the three categories of trend to the tide, waves and ripples of the sea.
The primary trend was like the tide. The secondary, or intermediate, trend was compared to the waves that made up the tide. The minor trends were just like ripples on the waves. By using stakes to measure the highest point on the beach reached by each successive wave, the direction of the tide could be measured. If each successive wave moved further inland than the preceding one, the tide was still in. Only when the waves began to recede would the observer know that the tide of the ocean had turned out.

The secondary, or intermediate, trend represents corrections in the primary trend and usually lasts for three weeks to three months. These intermediate corrections usually retrace one-third to two-thirds of the previous trend. Often the retracement will be about half.

The minor, or near-term, trend usually lasts less than three weeks and represents shorter term fluctuations in the intermediate trend.

3. Major trends have three phases: the major trend usually takes place in three distinct phases. The first phase, called the accumulation phase, represents informed buying by the most astute investors as all the so-called bad economic news has finally been discounted by the market. The second phase, where most technical trend-followers begin to participate, takes place as prices begin to advance rapidly and business news improves. The third and final phase is characterized by increased public participation as newspapers begin to print increasingly bullish stories, economic news is better than ever, and speculative volume increases. It is during this last phase that the informed investors who began to “accumulate” near the bear market bottom, when no one else wanted to buy, now begin to “distribute” when no one else seems to be selling.

Elliott (Elliott Wave Theory; Refer the Section on Elliott Wave Theory) also recognized three major upward moves in the bull market. There is close similarity between Dow’s three phases of a bull market and the various wave personalities under the wave principle. One major difference between Elliott’s and Dow’s work is the principle of confirmation.

4. the averages must confirm each other: in this point, Dow was referring to the industrial and rail averages. He meant that no important bull or bear market signal could take place unless both averages gave the same signal. In other words, both averages had to exceed a previous secondary peak in order for a bull market to begin. If only one average gave the signal, then there was no bull market. The signals did not have to occur simultaneously, but the closer together the better. When the two averages diverged from one another, the prior trend was still in effect. Elliott wave theory differs from Dow theory on this point by only requiring signals in a single average.
5. volume must confirm the trend: Dow recognized the importance of volume as a secondary but important factor in confirming the signals generated on the price charts. To state this tenet simply, “volume should expand in the direction of the major trend.” If the major trend is up, volume should expand or increase as prices move higher. Conversely, volume should diminish as prices dip. In a downtrend, the opposite should take place. Volume should be heavier as prices drop and should diminish as prices rally in the downtrend. It should be stressed, however, that volume is only a secondary indicator. The actual Dow theory buy and sell signals are entirely based on closing prices. Even the more sophisticated volume indicators are used to help determine in which direction the heavier volume is flowing. This information is then compared to price action.
6. a trend is assumed to be in effect until it gives definite signals that it has reversed: this tenet forms much of the basis of the trend-following approach as it is used today. It is another way of saying that a trend in motion tends to continue in motion (can be compared with Newton’s law of nature). Of course, being able to spot reversal signals isn’t as easy as it sounds. The study of support and resistance levels, price patterns, trendlines, and moving averages are among several technical tools available that indicate when an existing trend may be in the process of changing. The use of oscillators helps to provide an even earlier warning signal of loss of momentum. The odds usually favour the trend continuing. The most difficult task for a Dow theorist, and any trend follower for that matter, is being able to distinguish between a normal secondary correction in an existing trend in the opposite direction. There is some disagreement among users of the theory as to when an actual reversal signal is given. Figures 1 and 2 show two different market scenarios. In figure 1, notice that the rally at point C is unable to clear the previous peak at A before declining below point B. In this case, two lower peaks and two lower troughs now exist, giving a clearcut sell signal at the point where the low at B is broken (point S). This reversal pattern is sometimes referred to as a “failure swing.”

In figure2, notice that the rally top at C actually exceeds the previous peak at A, before falling below point B. while a violation of support clearly takes place at S1, some dow theorists would not consider that a bona fide sell signal. The reason is that only lower lows now exist, not lower highs. They would prefer to see a rally to E, falling short of C, then another new low below point D. to them, the actual sell signal would be given at S2, at which point two lower highs and two lower lows are now present. The reversal pattern shown in figure2 is referred to as a “non-failure swing.” A failure swing (figure1) is a much weaker pattern than the non-failure swing in figure2.

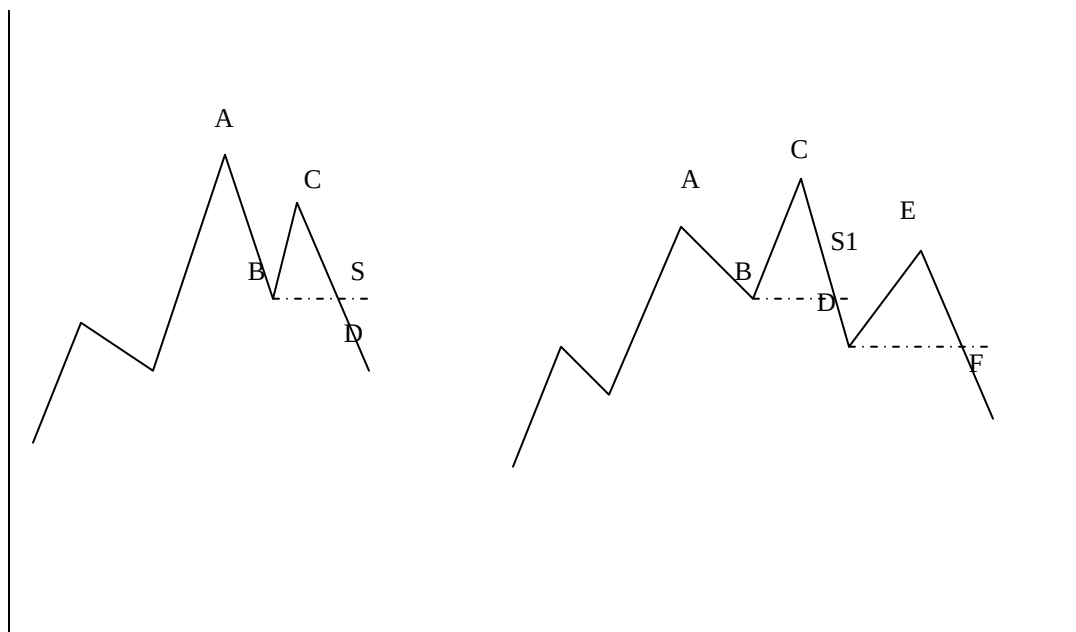


Fig. 1: Failure swing. The failure of the peak at C to overcome A, followed by the violation of the low at B, constitutes a “sell” signal at S.

Fig. 2: Non-failure swing. Notice that C exceeds A before falling below B. Some Dow theorists would see a “sell” signal at S1, while others would need to see a lower high at E before turning bearish.

DEFECTS IN THE DOW THEORY

First, let’s take up the charge of “second guessing” which is so often flung at writers on dow theory. It is a charge which will continue to crop up so long as opinions differ among dow theorists at critical periods (which, unfortunately, is often the case). Even the most experienced and careful dow analysts find it necessary occasionally to change their interpretations when a stand first ventured is rendered untenable by some subsequent action of the market. They would not attempt to deny it—but, they say, in the long run, surprisingly little is lost by such temporary misinterpretations. Many of them publish their comments regularly and can refer you to the printed files of opinions and advice expressed before and during the event, as well as after it.

The Dow theory is “too late”

This is a more valid objection. It is sometimes expressed in the rather intemperate statement that “the dow theory is a surefire system of depriving the investor of the first third and the last third of every Major Move, and sometimes there isn’t any middle third!” or, to give a specific example: a primary bull market started in 1942 with the industrial average at 92.92 and ended in 1946 at 212.50, for a total gain of 119.58 average points, but the strict dow theorists could not buy until the industrials were up to 125.88 and could not sell until prices had already declined to 191.04, thus capturing, at best, only about 65 points or not much more than half of the total move. This specific statement cannot be disputed. But the answer to the general objection is “try and find a man who first bought his stocks at 92.92 (or even within 5 points of that level) and stayed 100% long throughout the intervening years, and finally sold out at 212.50, or within 5 points thereof.” In fact, it is very difficult to locate even a dozen who did as well as the dow theory.

The dow theory is not infallible

Of course, it isn’t. it depends on interpretation and is subject to all the hazards of human interpretive ability. But, again, the record speaks of itself.

The dow theory frequently leaves the investor in doubt

This is true in one sense and not in another. There is never a time when the dow theory does not afford a *presumptive* answer to the question of the direction of the Primary Trend. That answer will be wrong for a relatively short time at the beginning of each new Major Swing. There will also be times when a good dow analyst should say, “the primary trend is still presumably up, but it has reached a dangerous stage, and I cannot conscientiously advise you to buy now. It may be too late.”

Frequently, however, the above objection simply reflects the inability of the critic mentally to accept the fundamental concept that the Averages discount all the news and statistics. He doubts the dow theory because he cannot reconcile its message with his own ideas, derived from other sources, of what stocks should do.

This criticism in other cases reflects nothing but impatience. There may be weeks or months (as, for example, during the formation of a Line) when the dow theory cannot “talk.” The active trader quite naturally rebels. But patience is a virtue in the stock market as elsewhere—in fact, essential if serious mistakes are to be avoided.

The dow theory does not help the intermediate trend investor

This is perfectly true. The theory gives little or no warning of changes in Intermediate Trend. Yet, if a fair share of these can be captured, the profit amounts to more than can be derived from the Primary Trend alone. Some traders have worked out supplementary rules based on dow principles which they apply to Intermediate Movements, but these have not proved to be altogether satisfactory.

A man cannot buy or sell the averages

Also perfectly true. The dow theory is a mechanical device, designed to tell the direction of the Primary Market Trend which is important because most stocks tend to go with the trend. The dow theory does not and cannot tell you what stocks to buy.

THE CONCEPT OF TREND

The concept of *trend* is absolutely essential to the technical approach to market analysis. All of the tools used by the chartist—support and resistance levels, price patterns, moving averages, trendlines, etc.—have the sole purpose of helping to measure the trend of the market for the purpose of participating in that trend. We often hear such familiar expressions as “always trade in the direction of the trend,” “never buck the trend,” or “the trend is your friend.”

In a general sense, the trend is simply the direction of the market, which way it’s moving. But we need a more precise definition with which to work. First of all, markets don’t generally move in a straight line in any direction. Market moves are characterized by a series of zigzags. These zigzags resemble a series of successive waves with fairly obvious peaks and troughs. *It is the direction of those peaks and troughs that constitutes market trend.* Whether those peaks and troughs are moving up, down, or sideways tells us the trend of the market. An uptrend would be defined as a series of successively

higher peaks and troughs; a downtrend is just the opposite, a series of declining peaks and troughs; horizontal peaks and troughs would identify a sideways price trend.

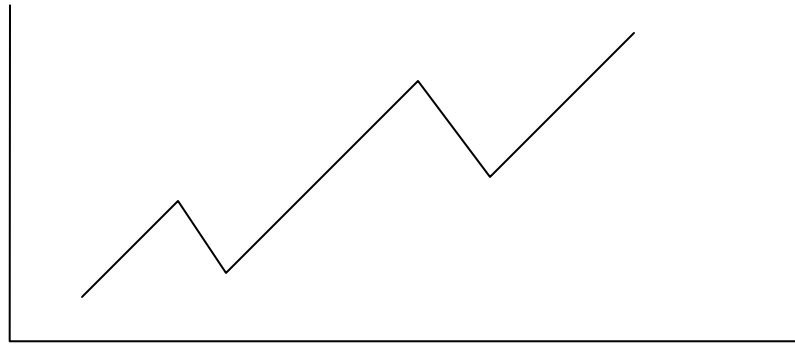


Fig: 3 Example of an uptrend with ascending peaks and troughs

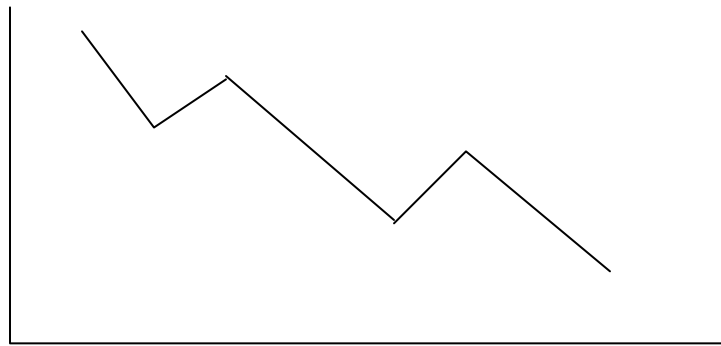


Fig: 4 A downtrend with descending peaks & troughs

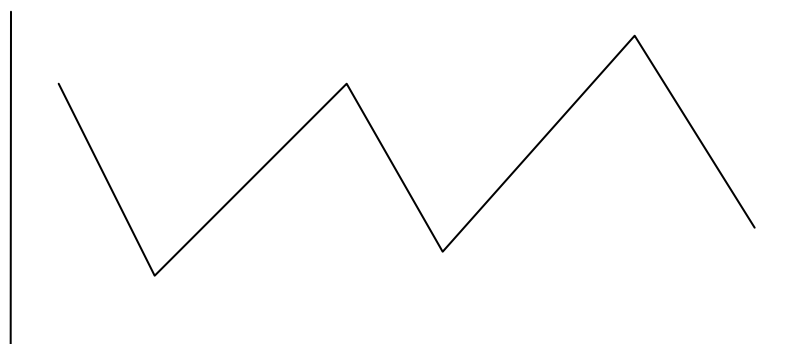


Fig: 5 A sideways trend with horizontal peaks and troughs. This type of market is often referred to as “trendless.”

A TREND HAS THREE DIRECTIONS

We have mentioned an uptrend, downtrend, and sideways trend for a very good reason. Most people tend to think of markets as being always in either an uptrend or a downtrend. The fact of the matter is that markets actually move in three directions—up, down, and sideways. It is important to be aware of this distinction because for at least a third of the time, by a conservative estimate, prices move in a flat, horizontal pattern that is referred to as a “trading range.” This type of sideways action reflects a period of equilibrium in the price level where the forces of supply and demand are in a state of relative balance. (Dow Theory refers to this type of pattern as a *line*.) Although we have defined a flat market as having a sideways trend, it is more commonly referred to as being “trendless.”

Most technical tools and systems are trend-following in nature, which means that they are primarily designed for markets that are moving up or down. They usually work very poorly, or not at all, when markets enter these lateral or “trendless” phases. It is during these periods of sideways market movement that technical traders experience their greatest frustration, and systems traders their greatest equity losses. A trend-following system, by its very definition, needs a trend to work properly. The failure here lies not with the system. Rather, the failure lies with the trader who is attempting to apply a system designed for trending markets into a nontrending market environment.

There are three decisions confronting the trader—whether to buy a market (go long), sell a market (go short), or do nothing (stand aside). When a market is rising, the buying strategy is preferable. When it is falling, the second approach would be correct. However, when the market is moving sideways, the third choice—to stay out of the market—is usually the wisest.

THREE CLASSIFICATIONS OF A TREND

In addition to having three directions, trend is usually broken down into the three categories mentioned earlier; major, intermediate, and near-term trends. In reality, there are almost an infinite number of trends interacting with one another, from the very short-term trends covering minutes and hours to super-long trends lasting around 50 years. Most technicians, however, limit trend classifications to three. There is a certain amount of ambiguity, however, as to how different analysts define each trend. Dow Theory classifies the major trend as being in effect for longer than a year. Because future traders operate in a shorter time dimension than do stock investors, the major trend is anything over 6 months in the commodity markets. A time period of about 6 weeks is appropriate for the stock as well as the futures markets. Anything less than this is defined as near-term trend.

Each trend becomes a portion of its next larger trend. For example, the intermediate trend would be a correction in the major trend. In a long-term uptrend, the market pauses to correct itself for a couple of months before resuming its upward path. That secondary correction would itself consist of shorter waves that would be identified as near-term dips and rallies. This theme recurs many times—that each trend is part of the next larger trend and is itself comprised of smaller trends. (Fig: 6)

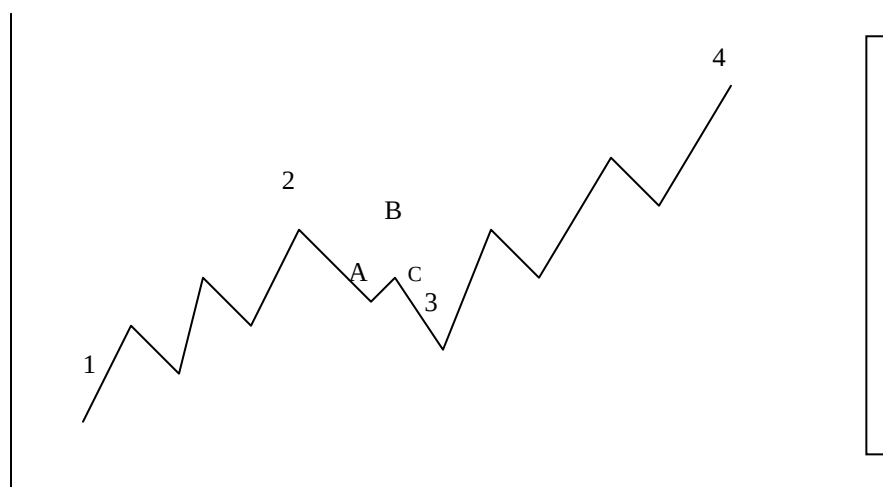


Fig: 6 Three degrees of trend: major, secondary, and near-term. Points 1, 2, 3 and 4 show the major uptrend. Wave 2-3 represents a secondary correction within the major uptrend. Secondary wave 2-3 divides into minor waves A-B-C.

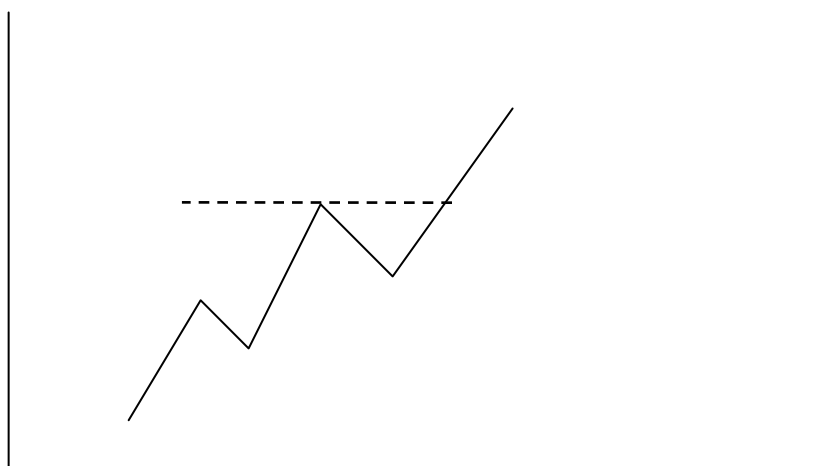


Fig: 7 Shows rising support and resistance levels in uptrend. Points 2 & 4 are support levels which are usually previous reaction lows. Points 1 & 3 are resistance levels, usually marked by previous peaks.

In fig: 6, the major trend is up as reflected by the rising peaks and troughs (points 1, 2, 3 and 4). The corrective phase (2-3) represents an intermediate correction within the major uptrend. However, the 2-3 also breaks down into three smaller waves (A, B, C). At point C, the analyst would say that the major trend was still up, but the intermediate trend and near-term trends were down. At point 4, all three trends would be up.

Quite a bit of misunderstanding arises because of different traders' perceptions as to what is meant by a trend. To long-term position traders, a few days' to a few weeks' price action might be insignificant. To a day trader, a two or three day advance might constitute a major uptrend.

Most trend following approaches focus on the intermediate trend, which may last for several months. The near-term trend is used primarily for timing purposes. In an intermediate uptrend, short-term setbacks would be used to initiate long positions. In intermediate downtrends, short-term bounces would be used for short positions.

SUPPORT AND RESISTANCE

The Peaks and Troughs of Price Movements

INTRODUCTION

Prices move in a series of peaks and troughs, and that the direction of those peaks and troughs determine the trend of the market. The troughs, or reaction lows, are called *support*. The term is self-explanatory and indicates that support is a level or area on the chart *under the market* where buying interest is sufficiently strong to overcome selling pressure. As a result, a decline is halted and prices turn back up again. Usually a support level is identified beforehand by a previous reaction low.

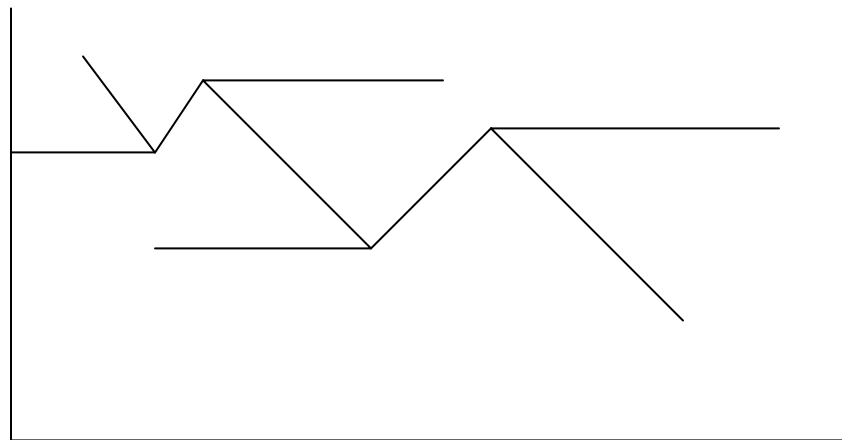


Fig: 8 Shows support and resistance in a downtrend.

Resistance is the opposite of support and represents a price level or area *over the market* where selling pressure overcomes buying pressure and a price advance is turned back. Usually a previous peak identifies a resistance level.

Support is defined as buying, in actual or potential, sufficient in volume to halt a downward trend in prices for appreciable period. Support level is the price at which sufficient demand for the stock arise to hold the downtrend in prices are halted temporarily. It represents a concentration of demand.

Resistance is the antithesis of support; it is selling, actual or potential, sufficient in volume to satisfy all bids and hence, stops prices from going higher for a time. Resistance level is the price at which sufficient selling pressures exists to temporarily hold the uptrend in prices. It represents a concentration of supply.

As a rule, support and resistance levels are supposed to hold and hence lends some amount of predictive capacity. Think of security prices as the result of a head-to-head battle between a bull (the buyer) and a bear (the seller). The bulls push prices higher and the bears push prices lower.

Support and resistances help in predicting with a certain amount of certainty the prices levels at which the uptrend or the downtrend will stop and one can expect a trend reversal.

A solid grasp of the concepts of support and resistance is necessary for a full understanding of the concept of trend. For an uptrend to continue, each successive low (support level) must be higher than the one preceding it. Each rally high (resistance level) must be higher than the one before it. If the corrective dip in an uptrend comes all the way down to the previous low, it may be an early warning that the uptrend is ending or at least moving from an uptrend to a sideways trend. If the support level is violated, then a trend reversal from up to down is likely.

Each time a previous resistance peak is being tested, the uptrend is in an especially critical phase. Failure to exceed a previous peak in an uptrend, or the inability of prices to violate the previous support low in a downtrend, is usually the first warning that the existing trend is changing.

Trendlines and channels

One of the basic tenets in this system of Technical stock chart analysis is that *prices move in trends*. The market in general, and the many stocks which compose it, do not jump up and down in an altogether random fashion; on the contrary, they show definite organization and pattern in their charted course.

Prices move in trends. These trends may be either up or down or sideways (horizontal). They may be brief or of long duration. They may be classified as Major (primary), Intermediate (secondary) or Minor, according to the rules of the Dow Theory, or as Horizontal Line Formations. But sooner or later, trends change; they may change by reversing from up to down or down to up, and they may also change direction without reversing as, for example, from up to sideways and then perhaps to up again, or from a moderate slope to a steep slope, and vice versa.

Profits are made by capitalizing on up or downtrends, by following them until they are reversed. The investor's problem is to recognize a profitable trend at the earliest possible stage of its development and then later to detect, again as quickly as possible, its end and Reversal. The Reversal of any important trend is usually characterized by the construction of some sort of joint price and volume pattern—in brief, of a Reversal Formation.

THE TRENDLINE

One of the first discoveries a novice is likely to make when he begins to inspect stock charts with a critical eye is that nearly all Minor and most Intermediate Trends follow nearly straight lines. A few will, perhaps, dismiss this as a perfectly natural, something to be taken for granted. But the majority becomes increasingly amazed and

excited as they delve deeper. Not only the smaller fluctuations, but frequently, also the great Primary Swings of several years' duration appear on the charts as though their courses had been plotted with a straightedge ruler. This phenomenon is, in truth, the most fascinating, impressive and mysterious of all that the stock charts exhibit.

On Descending Price Trend, the line most likely to be straight is the one that connects the *Tops* of the Minor Rallies within it, while the Minor Bottoms may or may not fall along a straight edge. The *Tops* of the ripples are usually less even; sometimes, they also can be defined by a straight line, but more often, they vary slightly in amplitude, and so any line connecting their upper tips would be more or less crooked.

These two lines—the one that slants up along the successive wave Bottoms within a broad up-move and the one that slants down across successive wave *Tops* within a broad down-wave—are the basic trendlines.

How Trendlines Are Drawn

A straight line is mathematically determined by any two points along it. In order to draw a trendline, therefore, we require two determining points—two established Top Reversal points to fix a down trendline and two established Bottom Reversal points to fix an up trendline.

An Illustration

Suppose we start with a Major Bottom point and describe how a series of Up Trendlines might develop therefrom. To make this simple, let us assume that the Bear Market Bottom in our stock consisted of a Rectangle area between $6\frac{1}{2}$ and 8, and that the last move in this formation arose from the $6\frac{1}{2}$ level, broke through the pattern's Top at 8, and proceeded to 9. From 9, prices reacted to 8 and then headed back up again. As soon as this last rally had gone far enough to leave the dip to 8 showing in the clear as a Minor Bottom, we could draw our first UP Trendline because we then had two Bottom points, the second (8) higher than the first ($6\frac{1}{2}$), to fix its slope. This would be a Minor Up Trendline.

To proceed, suppose prices push up to 10, then move sideways for a few days, or dip slightly, until they have approached and touched, once more, our extended Minor Trendline. Then they start to move up in a third advance, but ran into supply again without making much progress, quickly make a fourth contact with the trendline, hesitate, and then break down through it. If prices now close clearly below the line, and if, in addition, there has been some pickup in trading volume evident on the penetration, we may conclude that our first Minor Trend is completed, and that our stock either will build some sort of Consolidation Pattern before it stages another advance, or will suffer a more extensive "Correction" than any of the brief dips it registered during its first Minor Upswing.

The whole Minor Uptrend described above might last for two weeks, and the first trendline would then have been very steep—too steep to hold for any very long period of time. Now, let us assume that a series of downward fluctuations produces the more extensive correction which we have foreseen as one probability following the trendline break, and that this carries prices back to the Support Level set up at the Top of the original Rectangle, i.e., at 8 (prime "buy spot"). Assuming that subsequent developments pursue a normal course, prices should not linger long at 8, but should start promptly on a new series of advancing fluctuations. As soon as this becomes evident and the new Bottom at 8 is "in the clear," we can rule in a new trendline across the original base point at $6\frac{1}{2}$ and the new point at 8. This should be, and

probably is, an *Intermediate* Up Trendline which will not be penetrated for several weeks, and may be for several months, until the Intermediate Advance tops out.

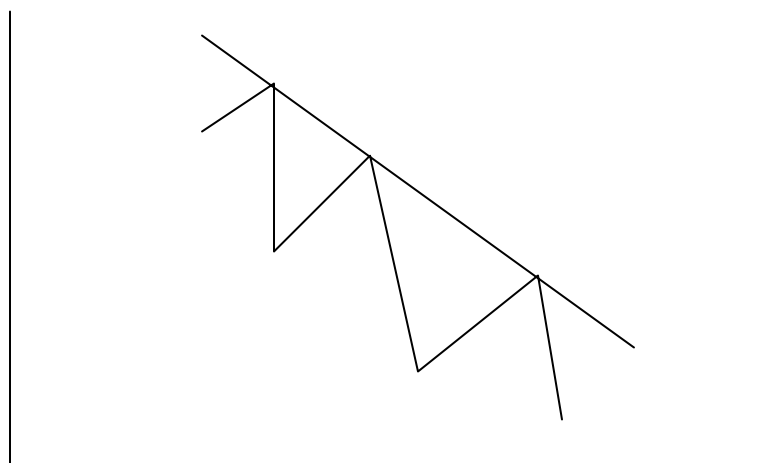
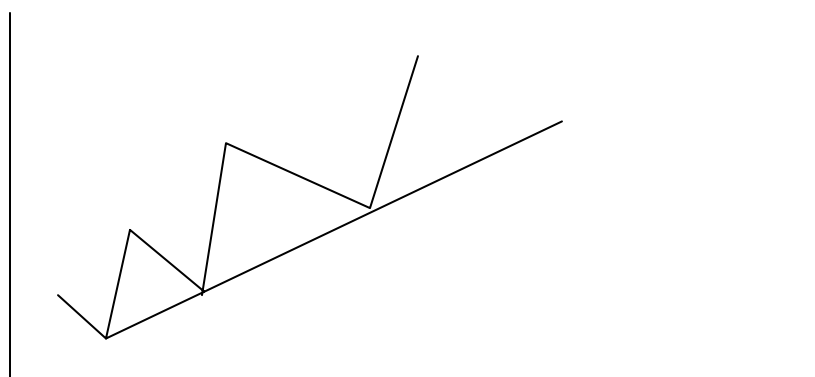


Fig: 10 A down trendline is drawn over the successively lower rally highs. The tentative down trendline needs two points (1 & 3) to be drawn and a third test (5) to confirm its validity.

Then, if that Intermediate Top takes the form of a Head-and-Shoulders Reversal Pattern, our Intermediate Up Trendline may be broken by the recession from the top of the head to the neckline. As a rule, however, the final advance in a strong

Intermediate Move accelerates far enough away from the extended trendline to leave room (to the right on the chart) for considerable pattern construction before the line is again touched and penetrated. Hence, the actual puncturing of the trendline is more apt to occur either on the decline from the right shoulder to the neckline, or at about the same time as prices break down through the neckline to complete the Head-and-Shoulders signal. It is surprising to see how often the two lines, neckline and trendline, are broken *simultaneously*. In other instances in which the trendline is the first to be punctured, perhaps shortly after prices turn down from the right shoulder, we do not have to wait for a neckline break but can take action at once. Here is one type of trendline indication which produces a working signal a little earlier, and often at a much more favourable price level, than is given by the completion of a Reversal Formation.



Tests of Authority

Here are some of the tests which may be applied to judge the technical validity, the authority, of an Up Trendline:

1. The greater the number of Bottoms that have developed at (or very near) a trendline in the course of a series of Minor Up Waves, the greater the importance of that line in the technical sense. With successive “test,” the significance of the line is increased. A first and tentative Up Trendline can be drawn as soon as two Bottoms have formed, the second higher than the first, but if prices move back to that line a third time, make a third bottom there and start a renewed advance, then the validity of that line as a true definition of the trend has been *confirmed* by the action of the market. Should a fourth Bottom later form on it, and prices move up away from it again, its value as a trend criterion is very considerably enhanced.
2. The length of the line, i.e., the longer it has held without being penetrated downside by prices, the greater technical significance. This principle, however, requires some qualification. If the trendline is drawn from two original Bottoms which are very close together in time—say, less than a week apart—it is subject to error; it may be too steep or (more often) too flat. If the latter, prices may move away from it and stay high above it for a long time; they may then turn down and have declined well along in an Intermediate Correction before the trendline thus drawn is reached. But if the trendline has been drawn from Bottoms which are far enough apart to have developed as independent wave components of the trend you are trying to define, with a good rally and “open water” between them, then it is more apt to be the true trendline. Greater weight should be given to the number of bottoms that have formed on a trendline (test 1) than to its length alone (test 2).
3. The angle of the trendline (to the horizontal) is also, to some degree, a criterion of its validity as a true delimiter of Intermediate Trend. A very steep line can easily be broken by a brief sideways Consolidation move—as, for example, by a compact Flag forming on an advance of the “mast” type—only to have prices shoot up again in another extensive advance. Such steep lines are of little forecasting value to the technician. The flatter, more nearly horizontal the trendline, the more important it is technically and, in consequence, the greater the significance of any downside break through it.

Validity of penetration

We have enumerated three criteria for appraising the authority or accuracy of an Intermediate Up Trendline. The next problem is to determine when it has been broken finally and definitely broken.

Again, we can set up three tests or criteria, two of which are practically identical with the rules laid down for determining decisive breakouts from Reversal or Consolidation Formations. The first is *extent of penetration*. To be decisive, prices must not only push through the line, but close beyond it by a margin equal to about 3% of the stock's price. This does not need to be accomplished in a single day, although it often is. The 3% penetration may come as a result of two or three days of gradual decline.

The second is *volume of trading*. Activity should always be expected to rise notably on a genuine upside breakout from an Area Pattern, but need not increase to confirm a downside break. In many cases, volume does not show much increase on the first day of down break from Descending Triangles but usually picks up rapidly as the decline proceeds. Here, we are dealing with Up Trendlines, and their penetration is, therefore, analogous to a downside breakout. We should expect the same rules to apply, and in general, they do. Given a close beyond the line by a price margin of 3%, it is not necessary for volume to have expanded much at that point to confirm the validity of the penetration.

The fact is, however, that the breaking of an Intermediate Up Trendline, much more often than not, is attended by some visible intensification of trading activity. To that extent, then, an increase in volume may be regarded as confirmation of a decisive penetration. It is a particularly useful adjunct in borderline cases. If prices start to decline from a point somewhat above the trendline, move down through it on *conspicuously expanding* turnover, and close beyond it, say, only 2% of the price but at or near the bottom of the day's range, our 3% margin rule has not been satisfied, but the lesser margin plus the volume action may be construed as decisive.

The third test is also one that applies particularly to breaks which are borderline so far as margin of penetration is concerned. Suppose a stock which is quoted in the neighborhood of 40 declines through a well-established Intermediate Up Trendline and closes 1 or 1 1/8 points below it—a margin which is only slightly less than the specified 3%—without much enlargement in trading volume. Suppose it fluctuates there for a day or two or two in a dull and narrow market, and then starts to rally. If there is no pick up in activity on this recovery move—if prices simply edge up feebly to the underside of the trendline and tend to “round over” there without being able to close clearly above it—then the situation is indeed critical, and the slightest sign of renewed selling pressure may be taken as a signal that the uptrend has been decisively broken. Such a return move is known as a Throwback or Pullback.

Amendment of Trendlines

When a trendline is broken by a margin less than decisive, and prices subsequently rally back up through it again, doubt naturally arises as to the continued authority of the original line.

Here again, judgment and experience must be called into play, but a few general principles are helpful in deciding. If the original trendlines depended on only two points, i.e., on the first two Bottoms across which it was projected, and the indecisive

penetration occurred when prices returned to it for the third time, the line had better be redrawn across the original first and the new third Bottoms.

If, on the other hand, the original trendline has been “tested” one or more times after it was drawn—if a third and perhaps a fourth Bottom have formed on it without penetrating it and have thus “confirmed” it—then the subsequent indecisive penetration may be disregarded and the original line considered to be still in effect.

An intraday break through an established trendline which, however, does not result in prices *closing* beyond the line, may be disregarded and the line left as is. In fact, as already has been suggested, the closing prices frequently make a better trendline than the extreme intraday lows of successive Bottoms, and this is most apt to be true with “thin” stocks subject to erratic swings. A bit of experimenting with different lines often pays. A thin, transparent ruler is especially useful for trendline study.

DOUBLE TRENDLINES AND TREND RANGES

In the course of “cutting and trying” in an effort to fit a good line to an Intermediate Uptrend, one may find that *two parallel lines*, perhaps a point or so apart in a stock selling will define the true trend pattern much better than any single line that can be drawn. Sharp Bottoms and shakeout thrusts in such cases will often fall along the outer or lower line, while the duller, more rounded reactions will stop at or near the upper or inner line. Or the two lines will mark off a *range* somewhere within with successive Minor Down Waves tend to halt and reverse.

Trends that are best defined by Double Trendlines (or by a very Broad Trendline) cannot be regarded as ended until the outer, lower line has been decisively penetrated. Sharp, shakeout Bottoms tend to fall on the outer line. The recoveries from such Bottoms are usually just as sharp, and prices, therefore, rally back above the upper, inner line quickly. Warning of an impending break in the trend is given when the prices come down to the outer line steadily, rather than by the quick “shake” type of reaction, and then have difficulty rallying back through the inner line. A break down may not follow; the situation may still be “saved,” but the chances are that the trend is near its end.

Trend Channels

Generally, the Minor Waves are sufficiently regular to be defined at their other extremes by another line. That is, the Tops of the rallies composing an Intermediate Advance sometimes develop along a line which is approximately parallel to the Basic Trendline projected along their Bottoms. This parallel might be called the *Return Line*, since it marks the zone where reactions originate. The area between Basic Trendline and Return Line is the *Trend Channel*.

Trend Channels appear most often in actively traded stocks of large outstanding issue—least often in the less popular and the relatively thin equities which receive only sporadic attention from investors. Its greatest utility, however, is not what usually appeals to the beginner when he first makes its acquaintance, viz., the

determination of good profit-taking levels. Experienced technicians, find it more helpful in a negative sense. Thus, once a Trend Channel appears to have become well established, any failure of rally to reach the Return Line is taken as a sign of deterioration in the trend. Further, the margin by which a rally fails to reach the Return Line frequently equals the margin by which the Basic Trendline is penetrated by the ensuing decline before a halt or Throwback in the latter occurs.

Consequences of Trendline Penetration—Throwbacks

If an Intermediate Up Trendline has been constructed, has qualified as technically significant by the tests previously discussed, and then has been decisively broken, the inference is that that uptrend is finished. And the consequences to be expected are either a full Intermediate Recession or a period of Consolidation. In either event, the Intermediate Trend trader will certainly look twice before attempting to find further profit in that particular situation at that time. A more immediate but less important probable consequence of trendline penetration is—the “Pullback.”

Support-Resistance Theory enables us to rationalize most of the Throwback moves which occur after prices have broken out of other types of Reversal or Consolidation Areas. The pullbacks which follow trendline penetrations cannot be thus rationalized; yet they occur much more frequently, and they appear to be stopped much more exactly at the old trendline level, than is the case with Area Formations.

Throwbacks do not occur, it should be noted, when prices erupt through a *Return* Line, i.e., break out of the top side of an Uptrend Channel. Or, more correctly stated, the Return Line does not function as a Support against a Throwback after prices have gone through it. An unusually strong upswing in a Rising Trend Channel may carry beyond the top of the channel as defined by its Return Line, but the next reaction may go right back down through it without evidencing any hesitation at its level.

Intermediate Downtrends

Intermediate (Bear Market) Downtrends are far less regular and uniform in their development than Bull Market Advances. Their angles of decline are characteristically steeper, and this is particularly true of the Panic Moves which are typical of the second phase of a Bear Market. The practical results of this down-curving tendency are not so important, insofar as it delays the penetration of the original trendline and, hence, the giving of a signal of a trend change. The fact is that prices tend to thrash around for some time, making a base at the Bottom of one of these precipitous declines. In so doing they work out sideways on the chart, and the trend frequently does not turn up visibly until after the trendline has finally been reached and broken through on the upside after all.

It naturally follows that Return Lines on most Bear Market have little practical utility; they are, more often than not, very quickly broken downside. Good channels are hard to find.

However the very last Intermediate Downswing in a Major Bear Market, i.e., the last Primary Move which leads to the final, long-term Bottom, is usually cleaner, more regular, less precipitous—a more nearly normal trend of the sort we expect to find in

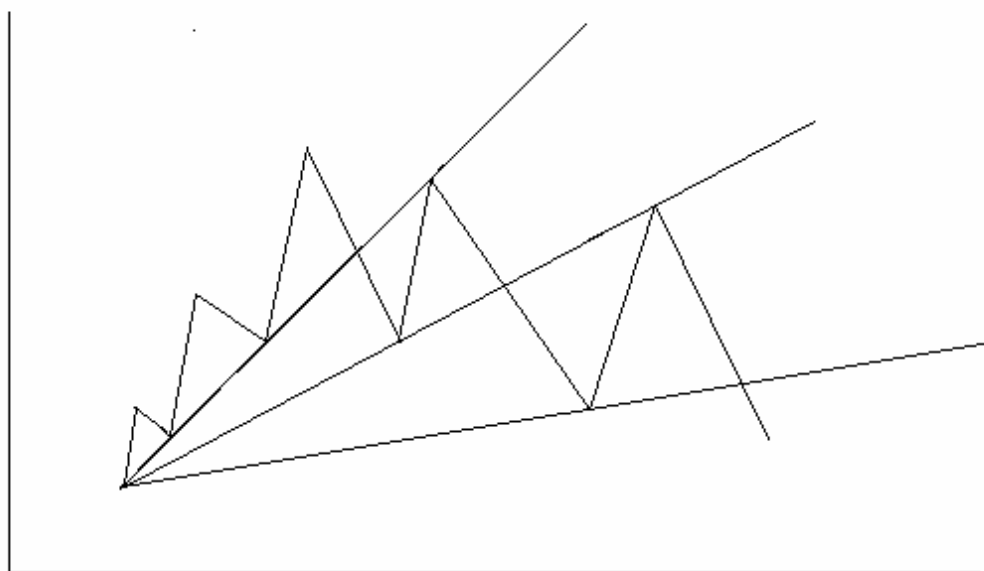
most Intermediate Advances in a Bull Market. This interesting habit is of practical importance. Knowing it, we have an additional and very useful clue to the end of a Bear Market.

When, after a Major Bear Trend has proceeded for some time and distance, and has experienced at least one Panic Sell-Off, it then goes off in another but less active and more orderly decline, and this decline develops and follows a good trendline. If this Intermediate holds to its steady and not-too-steep downward course—if its trendline is contacted several times by Minor Rallies—if it produces a fairly consistent channel, and prices do not “fall out of bed” down through its parallel Return Line, then the eventual upside penetration of its trendline may well signal a *Major Turn*, the inception of a new Bull Market.

Corrective Trends—The Fan Principle

Intermediate Reactions against the Major Direction of the market take a variety of forms. Sometimes they run out into Consolidation Formations—Triangles, Rectangles, etc.—in which the net price reaction is of minor consequence but time is consumed in backing and filling before the Primary Trend can be resumed.

At the other extreme we find Corrective Swings which develop as a more or less orderly straight-line return of moderate slope to the nearest good Intermediate Support or Resistance Level, retracing perhaps a third to a half of the preceding Primary Swing. These reactions produce good trendlines, as a rule, and the eventual penetration of their trendlines is a good technical signal of Reversal. Intermediate



Corrections clearly of this type are relatively rare.

A third form taken by Intermediate Corrections is nearly as common as the first named above (Consolidation Pattern) and much more common on the charts than the second. In a Bull Market, it starts with a sharp reaction which proceeds for several

days—perhaps for as much as two weeks—producing a steep Minor Trendline. This line is broken upside by a quick Minor Rally, after which prices slide off again in a duller and less precipitate trend. This second trendline is broken by another partial recovery thrust, and a third and still duller and flatter sell-off ensues. A third trendline can now be drawn from the original high across the Top of the second upthrust. The whole move, by this time, has taken roughly and irregularly a “Saucering-out” form. The three trendlines drawn from the original Reversal point from which the Corrective Decline started, each at a flatter angle than its predecessor, are known as *Fan Lines*. And the rule is that when the *third* Fan Line is broken upside, the low of the Intermediate Correction has been seen.

There are exceptions to this rule. Rarely, a correction of this type will go on to make another dip to a new low for the whole corrective move before prices really start to round up again. But the Three-Fan Principle works in the great majority of cases. Moreover, it offers the trader an opportunity to take a position at a point where he can logically employ a very close stop order and, thus, limit his loss to a trivial amount if the rule does not work out.

It is interesting to note that prices consistently Throwback in these movements to the preceding Fan Line after each upthrust. The new Primary Swing, once the low has been passed, usually starts slowly and carries out for a time the Saucer picture.

Fig: 11 Example of the Fan principle. The breaking of the third trendline signals the reversal of a trend. Notice also that the broken trendlines 1 & 2 often become resistance lines.

The Three-Fan Rule works just as well in calling the turn on Intermediate Recoveries in a Bear Market, the majority of which take the rounding form which is adapted to its use. The Fan Principle is normally applied only to corrective moves, i.e., to determine the end of Intermediate Reactions in a Bull Market and of Intermediate Recoveries in a Bear Market.

Major Trendlines

If we examine a large collection of arithmetically scaled monthly charts covering ten years or more of market history, the Bull Trends, in the great majority of activity traded, more or less speculative common stocks, tend to *accelerate*. They start slowly and push up at a steeper and steeper angle as they approach a Major Top. This up-curving path takes them farther away from any straight trendline drawn from two Bottom points in the first, slow-moving stage of advance. As a consequence, they top out and have gone down a long way in a recession which may be of Major consequence before their straight trendline is again touched.

Many of the stocks which show such typical *accelerating* curves in their advance (Major) Trends on arithmetic paper produce *straight* trends on a logarithmic scale. As a consequence, their logarithmic Major Trendlines are broken more quickly, and usually at a higher price level, when at last their trends do top out and turn down. In the case of such stocks, then, the logarithmic scale gives a better trend signal.

But there are other stocks—mostly of the more substantial investment or semi-investment type—which tend to advance in straight arithmetic trends. Still a third class, made up largely of high-grade preferred stocks, produces a rounding over or decelerating Bull Trendline even on the arithmetic scale. And, finally, there are a number of issues whose normal Bull Market Trendlines fall somewhere between the first two types; that is, they curve up away from a straight path on the arithmetic scale, but curve over to the right (breaking through a straight line) on the logarithmic scale.

As a matter of interest, stocks do sometimes change over a long period of years. Companies which were regarded as extremely speculative when their shares were first listed may attain a more and more important and stable position in the general economy, with the result that, eventually, their stock acquires a solid investment rating. Their Bull Market Trends will then gradually change from an up-curve to a straight-line and, finally, to a decelerating curve. Other old, established corporations may lose position and rating, shift from the investment type of trendline to the speculative. But, it is true in general, nevertheless, that Major Patterns do repeat.

The tests for the technical significance of a Major Trendline are substantially the same as those specified for Intermediate Lines. A little more leeway must be allowed on penetrations—again, a matter of judgment—but you are dealing with coarse data and long swings here, and what you want from your monthly charts, primarily, is perspective on the broad picture.

One more point regarding the construction of Major Bull Trendlines: The best lines—the most useful—are drawn, as a rule, not from the absolute low of the preceding Bear Market, but starting, rather, from the next Intermediate Bottom. The accumulation area at the beginning of a Bull Market is usually long and drawn out in time, and relatively flat. The first trendline that can be drawn from the extreme low point may, therefore, be too nearly horizontal to express the genuine Bull Trend which starts with the markup phase.

Major Downtrends

From the technical analyst's point of view, it is to be regretted that few Bear Markets have produced Major Trendlines of any practical significance on the charts of individual stocks. A notable exception was the long Bear Market of 1929-32 which produced magnificently straight trendlines on the arithmetic plotting of a host of issues (as well as in the Averages). But it is almost impossible to find other instances where a Bear Trendline having any forecasting value can be drawn on either arithmetic or semi logarithmic scale.

The *normal* Major Bear Market Trend is not only steeper than the normal Bull Trend (because Bear Markets last, in general, less than Bull Markets), but it is also accelerating or down-curving in its course. This feature is accentuated and, hence, particularly difficult to project effectively on the semi logarithmic scale.

The net of it is that the technician cannot expect to obtain much help from *Major* Trendlines in determining the change from a *Primary Down* to a *Primary Upswing*. However, this should not be taken as advice to draw no trendlines on a *Major Down Move*, or to disregard entirely any trendlines which may develop with some appearance of authority. They afford some useful clue as to the way in which conditions are tending to change. At times, they produce curious reactions (or, at least, appear to produce what would be otherwise inexplicable market action) when the real price trend catches up with them months or years later.

Major Trend Channels

One runs into another difficulty when trying to draw Return Lines and construct channels for Major Trends on an arithmetic chart. Owing to the marked tendency for prices to fluctuate in ever wider swings (both Intermediate and Minor) as they work upward in a *Primary Bull Market*, their channel grows progressively broader. The Return Line does not run parallel to the Basic Trendline (assuming there is a good Basic Trendline to begin with) but diverges from it. Occasionally, a stock produces a clear-cut Major Channel Pattern, but the majority does not.

Semi logarithmic scaling will, in many cases, correct for the Widening Channel effect in Bull Trends, but then it can run into the opposite tendency in *Primary Bear Markets*, and for that, neither type of scaling will compensate.

Trendlines in the Averages

Practically everything stated regarding Intermediate Trendline development in individual stocks applies, as well, to the various Averages. The broad Averages or Indexes, in fact, produce more regular trends and, in consequence, more exactly applicable trendlines. This may be due, in part, to the fact that most Averages are composed of active, well-publicized, and widely owned issues whose market action individually is "normal" in the technical sense. Another reason is that the process of averaging sobers down vagaries of component stocks, and the result, thus, more truly reflects the deep and relatively steady economic trends and tides.

In any event, it is a fact that such averages do propagate excellent trendlines on their charts. The very accuracy of their trends, particularly their Intermediate Moves, permits us to construe their trendlines more tightly. Less leeway need be allowed for doubtful penetrations. Thus, while we ask for a 3% penetration in the case of an individual stock of medium range, 2% is ample in the Averages to give a dependable break signal.

REVERSAL PATTERNS

The Signal of Impending Trend Reversal

INTRODUCTION

There are two major types of price patterns: Reversal Patterns & Continuation Patterns.

Reversal patterns, as the name indicates, that there is a reversal in the trend taking place. The preliminary points common to all Reversal patterns are:

- The existence of a prior trend
- The first signal of an impending trend reversal is often the breaking of an important trendline.
- The larger the pattern, greater is the subsequent move
- Topping patterns are usually shorter duration and more volatile than bottoms
- Bottoms usually have smaller price ranges and take longer to build
- Volume is more important on the upside

The need for a **prior trend** is important, as the market must have something to reverse.

In case a formation appears without the prior trend, there is nothing to reverse and the pattern is suspect.

The first sign of a trend reversal is the **breaking of a trend line**. It is to be noted that the violation of a major trend line does not necessarily mean a trend reversal as they could only be false breaks.

The **larger the pattern, greater is the potential of a price reversal**. Size here refers here to the height and the width of the price pattern. The height measures the volatility of the pattern and the width measures the time required to build and complete the pattern. The greater the price pattern in terms of width and height, greater is the potential of the ensuing price move.

DIFFERENCE BETWEEN TOPS & BOTTOMS

Topping patterns are shorter in duration and more volatile than bottoms. They take less time to form, compared to bottoms and are more violent.

Volume should generally increase in the direction of the market trend and is an important confirming factor in the completion of all price patterns. At the tops the volumes are not that important as the market reverses and falls of their own weight. Hence when markets fall, volumes are not of much importance. At the bottoms, however, the volume pick up is important. A downward trend reversal accompanied by rising volumes is absolutely essential for the breakout to be significant.

The major Reversal Patterns are

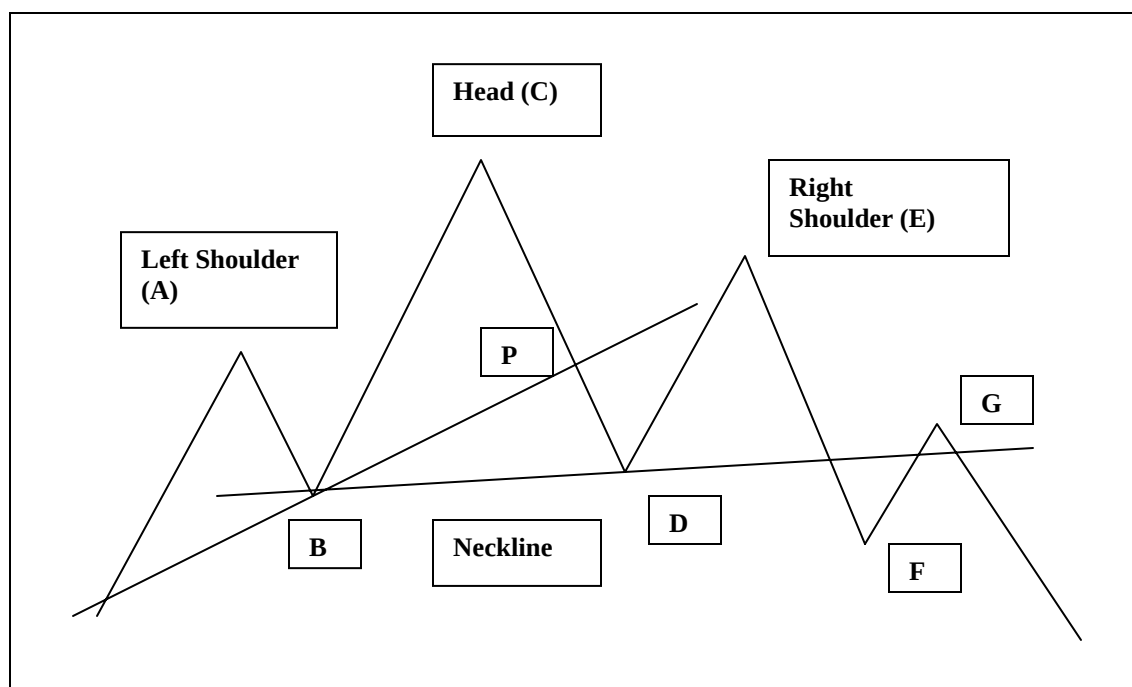
- Head and Shoulders
- Inverse Head and Shoulders
- Double tops and Double Bottoms
- Saucers
- V formations or Spikes

HEAD & SHOULDERS

The head and shoulders is one of the best known and most reliable reversal pattern.

Pattern Formation: The head and shoulder pattern formation consists of a left shoulder, a head and a right shoulder. The head lies in between the two shoulders and the height is more than the two shoulders.

Left Shoulder: The point upto point A, there is already an upward trend, with no signs of a top. Volume expands on the price move. Then there is a corrective dip to the point of B to complete the first shoulder. The volumes on the corrective dip is of lower volumes, indicating a few players are booking profits and in all probability the trend will reverse with the volumes picking up.



Head: The upward trend begins again from B, where there exists a support of the trend line, and the upward movement moves beyond the levels of A and into new territories. A point C, the Chartist will observe that, the volumes have fallen after the movement passed beyond the levels of A, the high of the left shoulder. There is again a corrective dip to the levels of D, which is almost near the levels of the previous corrective move B. The dip this time actually moves below the trend support of P which would be disturbing to the analyst.

Right Shoulder: The market again rallies this time to levels of E on lighter volumes, but is unable to reach the previous heights of C. This upward movement from D to E is usually half to two thirds of the movement from C to D. To continue an uptrend, each new high trend must exceed the high point of the rally preceding it. The failure of the rally at point E to reach beyond C levels fulfils half of the requirement of a downward trend, namely descending peaks. This completes the right shoulder and the head and shoulders pattern.

Neckline: The previous trend has been broken at point P, but a new trendline has emerged, joining the points B and D. This line is known as the neckline. In the downward move from E to F, the volumes have picked up and the downward pull moves beyond the neckline. The slope of the neckline has significance, a downward sloping neckline is more bearish than an upward neckline.

Neckline break: The head and shoulders pattern is complete only after the neckline support is broken. This happens in the movement from E to F. This movement is accompanied by increasing volumes. The neckline support now has turned into a resistance. This offers a market to wait and sell when the prices move back in the return move to the neckline levels. The downward trend from the neckline, after the return move fails completes fulfils the requirement of a downward trend.

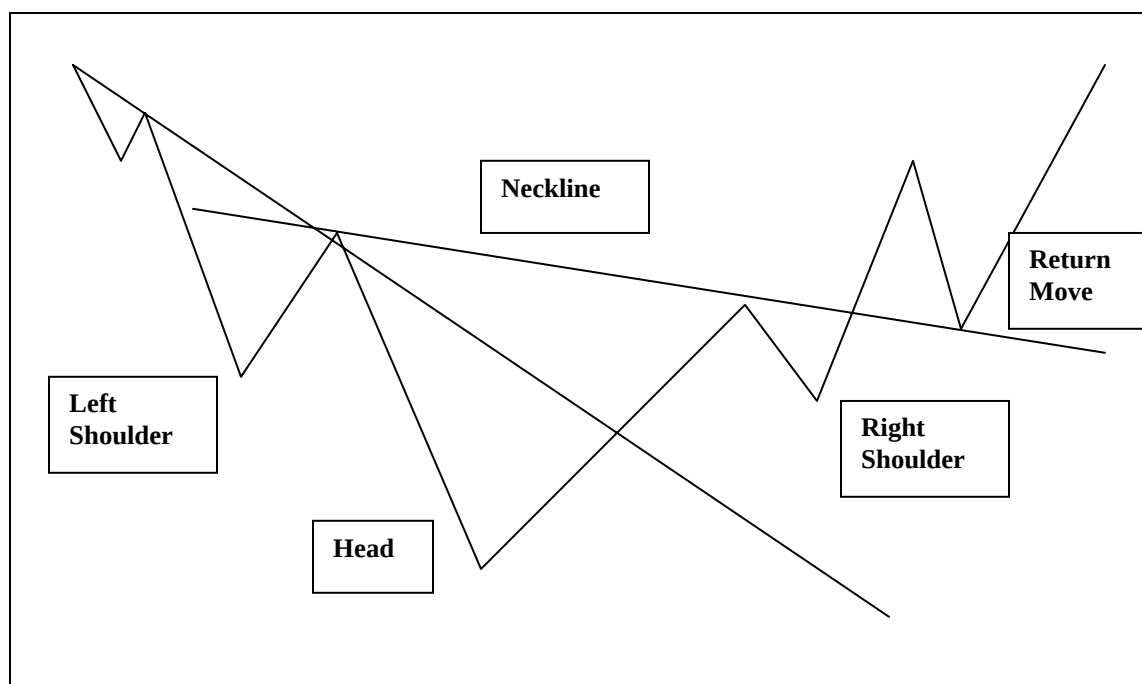
Volume: The accompanying volume pattern plays an important role in the development of the head and shoulders. As a general rule, the second peak should be formed on lower volumes than the first shoulder. The most important volume indication takes place during the third peak. Volumes on the upward move should be noticeably lower than the upward move of the previous two moves. The

volume should expand slowly on the falling part of the right shoulder and the volumes should pick up heavily on the breaking of the neckline.

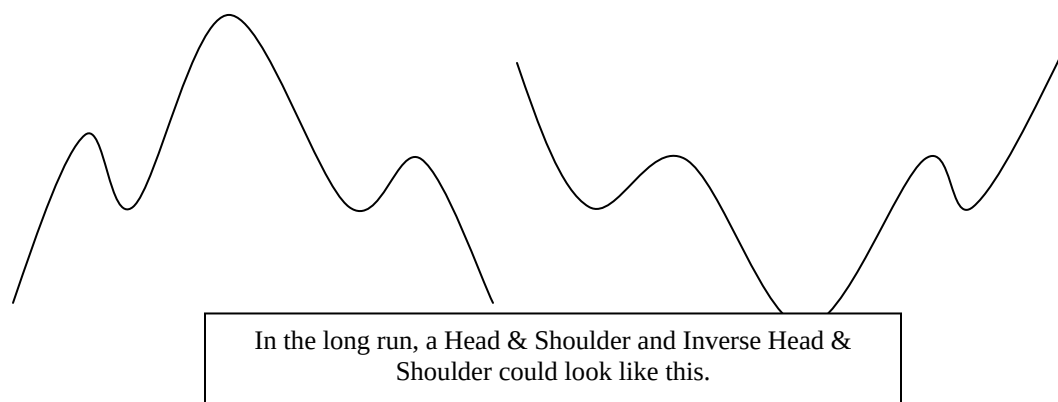
Price Objective: The height of the pattern offers a method of arriving at the price objective of the downward move. The height of the head and shoulder pattern is measured by the distance of the point between the points C (head) and the neckline. The price objective is at least the same distance from the point of breaking of the neckline.

INVERSE HEAD & SHOULDERS

The inverse head and shoulders is a mirror image of the Head and shoulder pattern. There are three distinct bottoms, with the middle one a bit lower than the two inverted shoulders. The most important difference between the head and shoulders pattern and the inverted pattern is the **volume sequence**. Volume plays a very critical role in the identification and completion of the pattern. Markets have a tendency to “**fall of their weights**”. At the bottoms, however, markets require a significant increase in buying pressure, reflected in greater volumes, to launch a new bull market. A market can fall just from inertia. Lack of demand on the part of the traders is often enough to push a market to lower, but market does not move up on inertia.

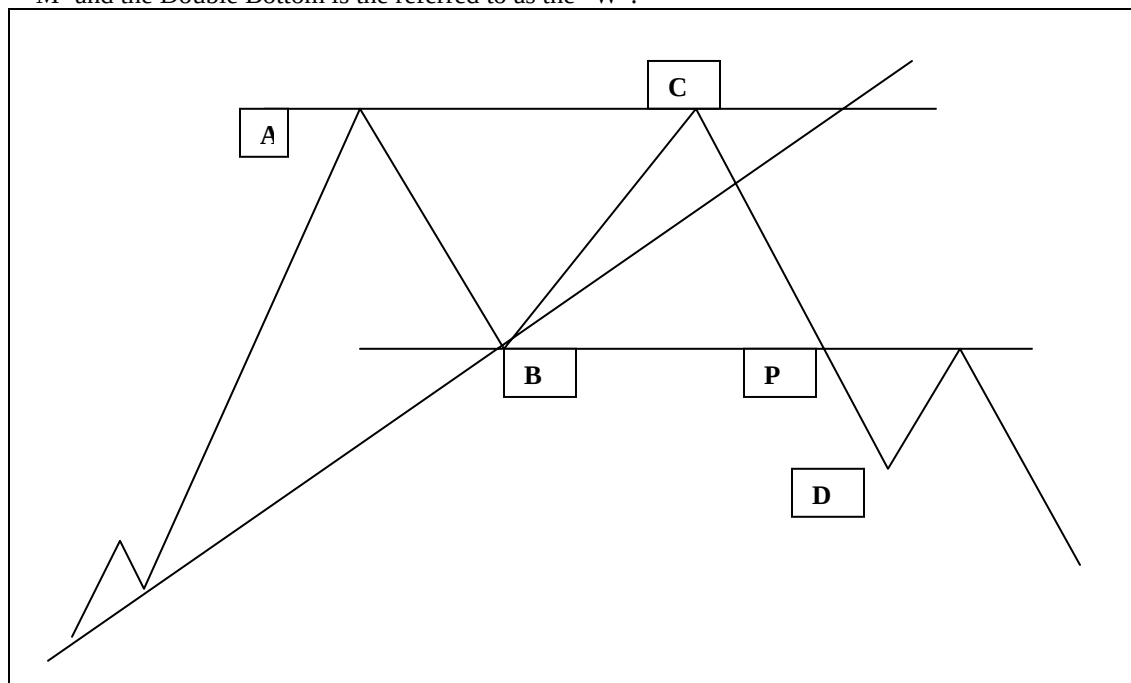


That is, the volume at the head is a bit lighter than that at the left shoulder. The rally of from the inverted head, however, begins to show not only an increase in the trading activity, volume exceeds that registered on the rally from the left shoulder. The dip to the right shoulder is on very low volumes. The critical point occurs at the rally through the neckline. The signal must be accompanied by a sharp burst of trading volume if the breakout is real



DOUBLE TOPS AND BOTTOMS

Another reversal pattern is the Double top and bottom. The Double top formation is referred to as the “M’ and the Double Bottom is the referred to as the “W”.



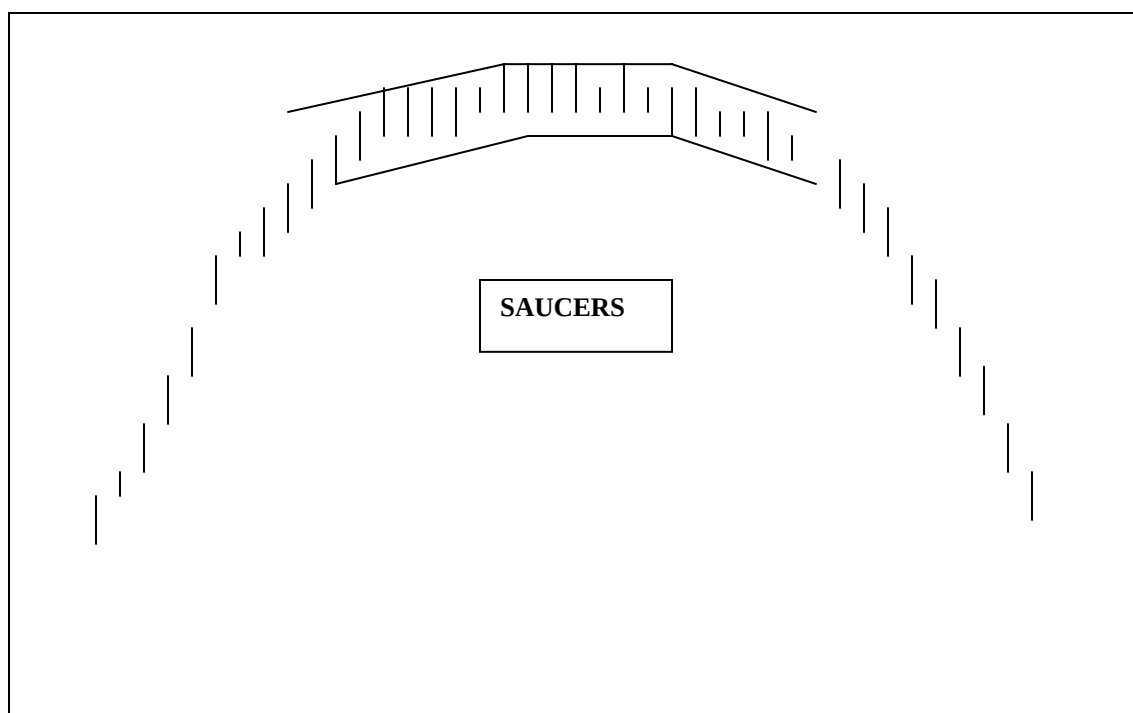
In the uptrend, the market sets a new high, upto point A. This is in continuation of the previous uptrend. The volumes in this segment also move up. From point A the market declines to point to B, which is the trendline support. The prices again move up after taking the support at B, and continue to move upward, but this time the volumes fall compared to the previous top. The upward movement does not extend beyond the previous top and the trend reverses. This sets up a potential Double Top, and it is confirmed when the downtrend moves beyond the point of P.

The measuring technique of a double top is the height of the pattern projected from the breakdown point P. The projected downward movement is the length of the the top.

The size of the pattern is also important. The longer the time period between the two peaks and greater the height of the pattern, greater the potential of the impending reversal.

SAUCERS OR ROUNDING TOPS AND BOTTOMS

Saucers or the rounding top or bottom or the bowl is much less frequent. This pattern represents a very slow and gradual change in trend. The volume pattern also forms a saucer formation. The volumes are high as the price moves up (in rounding top) or prices moving down (in rounding down) but as the peak is reached or the bottom is reached, the volumes start thinning. As the trend changes gradually, the volumes again start picking up.

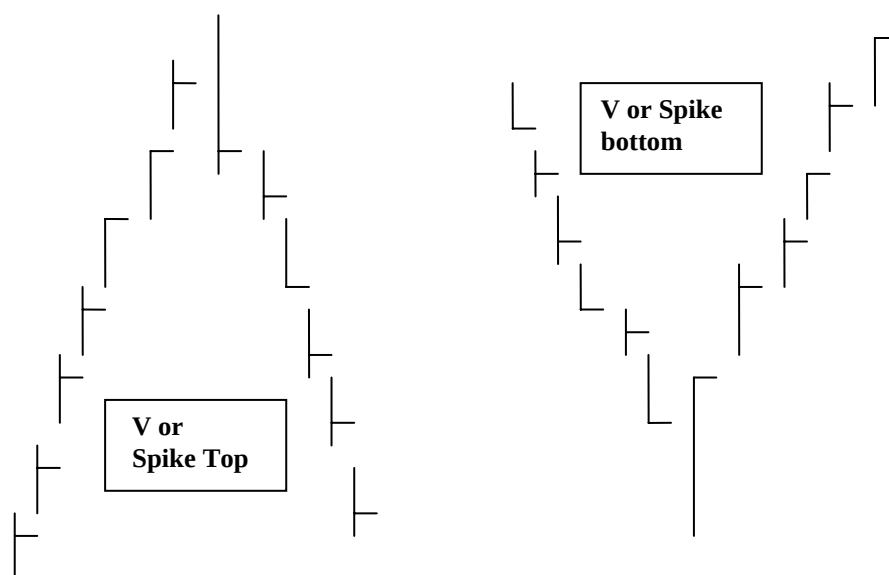


It is hard to say exactly when the saucer has been completed. There are no precise measuring rules for the bottom, in case of a rounding top, a top. The amount of time that the saucer pattern has been forming is significant. The longer it takes to form, the greater is the potential.

V FORMATIONS OR SPIKES

The final reversal pattern, the V-formation or the spikes is difficult to identify but isn't an uncommon pattern. The V- pattern unlike all other reversal patterns represents a radical departure from the tendency of markets to gradually change direction. What happens is an abrupt reversal of trend with little or no warning, followed by a swift and sudden move in the opposite direction.

The main precondition to the formation of a V or spike is a **previous runaway trend**. The trend preceding the V reversal is a runaway situation with few and generally minor corrections on the way. It



is a situation where things appear to have gotten out of control, and the market seems to have run well beyond most normal expectations. The actual turn is characterised by a **key reversal day** on **very heavy volumes** or an **island reversal pattern**. The only valid trend reversal signal which accompanies such a reversal is the breaking of a very steep trendline.

The subsequent decline usually retraces a significant portion of the prior trend. The subsequent move usually retraces a significant portion of the prior uptrend, as much as 50% of the previous move in a very short time. The decline is further fuelled by those who have been trapped near the top of the previous move and are scrambling to liquidate their move.

CONTINUATION PATTERNS

The Short Term Trend Indicators

INTRODUCTION

The Continuation patterns indicate that the sideways price action on the chart is nothing more than a pause in the prevailing trend and the next move will be in the same direction as the trend that preceded the formation.

The continuation of the previous pattern is one distinguishing factor from the previous patterns, which resulted in trend reversals. The other distinguishing factor is the time factor. Reversal patterns usually take much longer to build and represent major trend changes. Continuation patterns, on the other hand, are usually shorter term in duration and are more accurately classified as near term or intermediate patterns.

The major Continuation patterns are:

- Triangles
- Flags and Pennants
- Wedge
- Gaps

TRIANGLES

There are three types of Triangle formations which form a part of the continuation pattern. The minimum requirement for the formation of triangles is four reversal points. It takes two points to draw a trendline. Therefore in order to draw two converging trendlines, each line must be touched twice. The three forms of triangles are:

- Symmetrical Triangles
- Ascending Triangles
- Descending Triangles

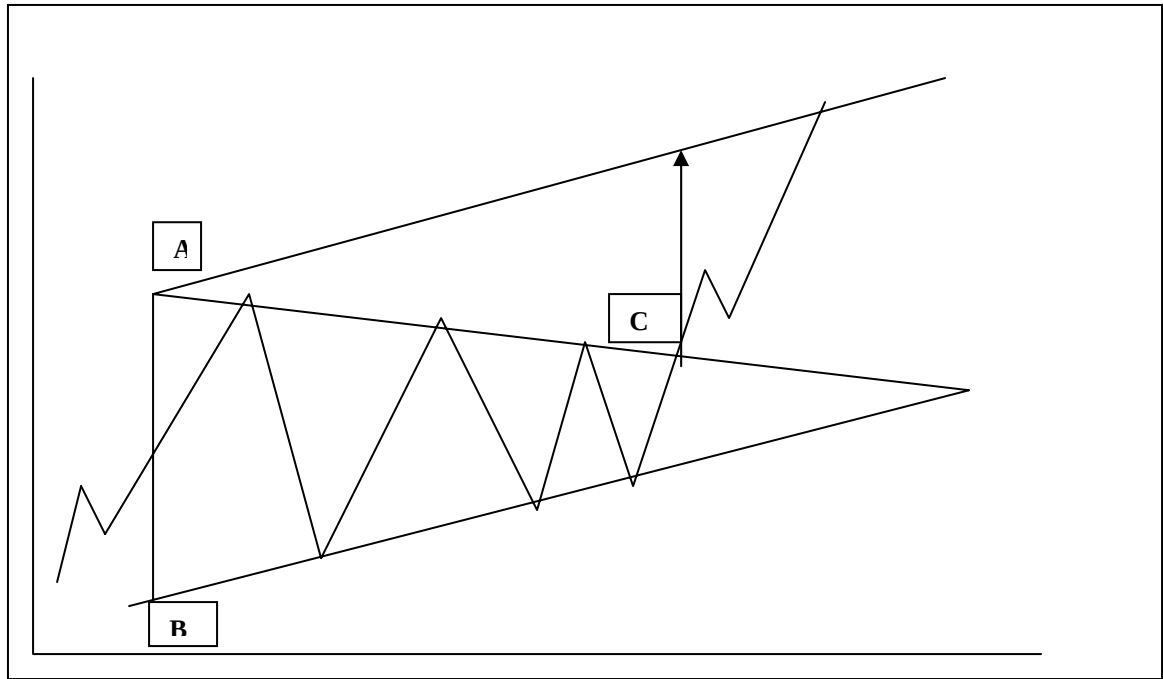
Symmetrical triangle

The symmetrical pattern is usually a continuation pattern. It represents a pause in the existing trend after which the original trend is resumed. If the original trend was upwards, the triangle will have bullish implications and visa versa.

In a symmetrical triangle, the slope of the trend lines is almost similar. The initial price trend in the above figure is upwards. There are atleast four reversal points , but in reality it is usually six reversal points, before it breaks out at point C. The breakout should be between one half to three quarters point of the horizontal width of the triangle, that is the distance from the vertical base on the left to the pattern to the apex at the far right. The upward breakout is signaled by a penetration of the upper trendline. If the prices remain within the triangle beyond the three quarter point, the triangle begins to lose potency.

Volume: As the symmetrical triangle extends and the trading range contracts, the volumes start diminishing. This is referred to as the consolidation phase, when prices move within a range sideways. The breakout is supported with expansion in the volumes. After the breakout, the trendline becomes a support (in case of an upward break) or a resistance (in case of downward break).

Price target: There are two methods to measure the price target. One is to measure the height of the vertical distance at the widest part of the triangle (distance between A and B) and measure the same distance from the breakout point or the apex. The second method is to draw a trendline from the top of the base parallel to the lower trendline (in case of an upward break), and visa versa. Then this parallel becomes the price target for the move beyond the breakout point.



Edwards and Magee suggests that roughly three fourth of the symmetrical triangles are continuation patterns. Hence one should not anticipate the direction of the breakout, but rather wait for it to happen. Prices sometimes return to the breakout point of the apex on a reaction move before resumption of the trend. This return offers a chance to participate with a better risk reward ratio.

Ascending Triangle:

The ascending triangle is a bullish formation . Regardless of where they form, ascending triangles are bullish patterns that indicate accumulation.

Because of the shape they can be referred to as right angle triangle, with the right angle forming on the top of the triangle formation. Two or more equal highs form the upper trendline, while two rising bottoms form the lower trendline. The lower trendline actually forms the hypotenuse of the triangle

Trend: In order to qualify as a continuation pattern, an established trend should exist. The robustness of the formation is more important than the length and duration of the current trend.

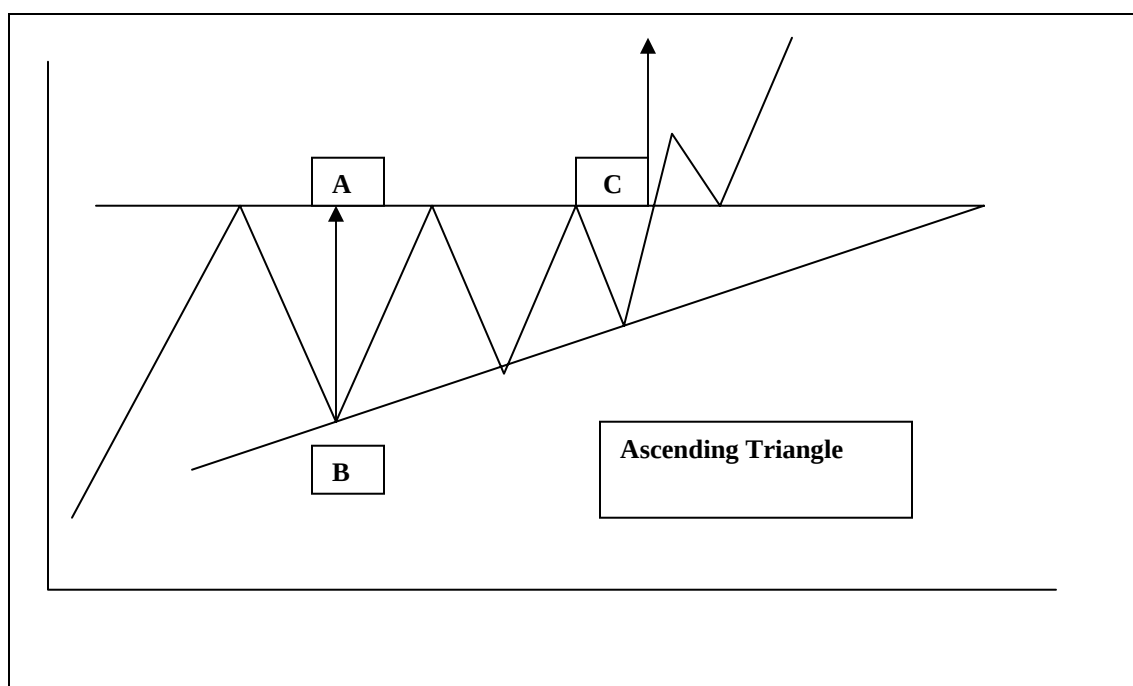
Top Horizontal Line: At least two reaction highs are required to form the top horizontal line. The two highs have to be about the same heights. Hence the upper trendline is parallel to the X axis.

Lower ascending trendline: Atleast two reaction lows, the latter higher than the first is necessary to form the lower trendline. The slope of the trendline must be positive.

Volume: As the pattern develops, volume usually contract. When the upside breakout occurs, there should be an expansion of volume to confirm to the breakout.

The upward trendline which was a resistance becomes a support after the breakout. The calculation of the target is similar to the symmetrical triangle.

In contrast to the symmetrical triangle, the ascending triangle has a definite bullish bias. The symmetrical triangle is a neutral triangle and usually continues with the previous pattern.



Descending Triangle

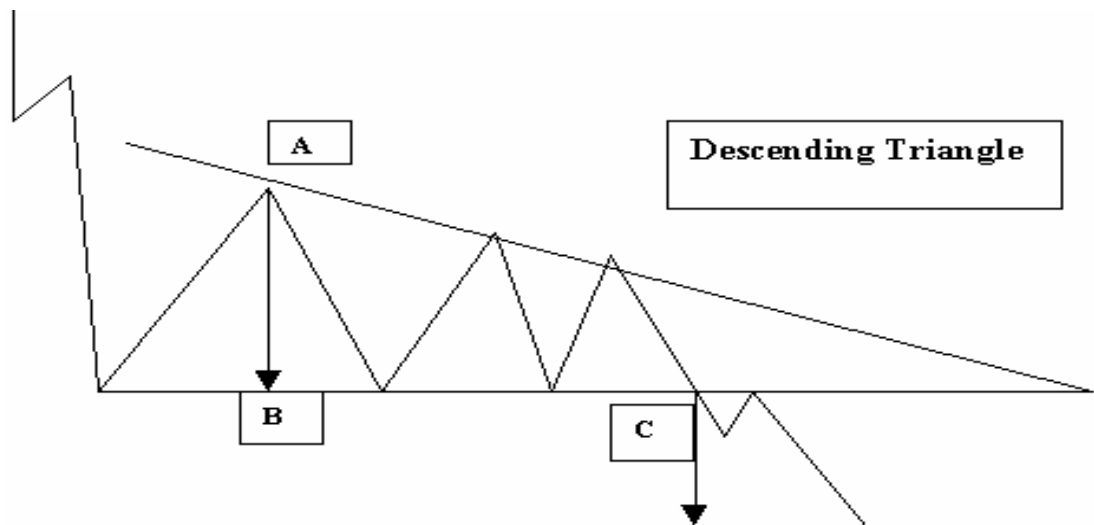
The descending triangle is a bearish formation that usually forms during a downtrend as a continuation pattern. These patterns indicate distributions. The descending triangle indicates that the sellers are more aggressive than the buyers and is usually resolved on the downside. The formation is similar to a right angle triangle, this time the upper trendline which has a negative slope, forms the hypotenuse. Like the ascending triangle, there must be a previous trend.

Lower horizontal line: there must be atleast two reaction lows to form the lower horizontal line. They need not be exactly, but should be within reasonable proximity.

Upper Descending line: Atleast two reaction highs are needed to form the upper trendline. The high must be descending in nature, so that the upper trendline has a negative slope

Volume: As the volume develops the volume contracts. When the downside break occurs, there would ideally be an expansion in the volumes, which confirm the breakout.

There lower trendline which was a support line, becomes a resistance and offers palyers a chance to sell off when prices retrace to those levels. The price target is calculated in a similar fashion to symmetrical triangles.



FLAGS & PENNANTS:

Flags and Pennants are continuation patterns and the price usually breaks out in the direction of the trend. The flags and pennants represent brief pauses in the dynamic market move. They are usually treated together because they are very similar in appearance. They represent situations where a steep advance or decline has occurred and the market pauses briefly to “catch its breath”. Flags and Pennants are among the most reliable continuation patterns and only rarely produce a trend reversal.

The points to be noted in their formation are:

- They are both preceded by an almost straight line move (called a flagpole) on heavy volume.
- Prices then pause for some time on lighter volume.
- The trend resumes on a burst of trading activity.
- Both patterns occur at about the midpoint of the market move.
- The pennant resembles a small horizontal symmetrical triangle.
- The flag represents a small parallelogram that slopes against the prevailing trend.
- Both patterns take less time to form to develop in downtrends.

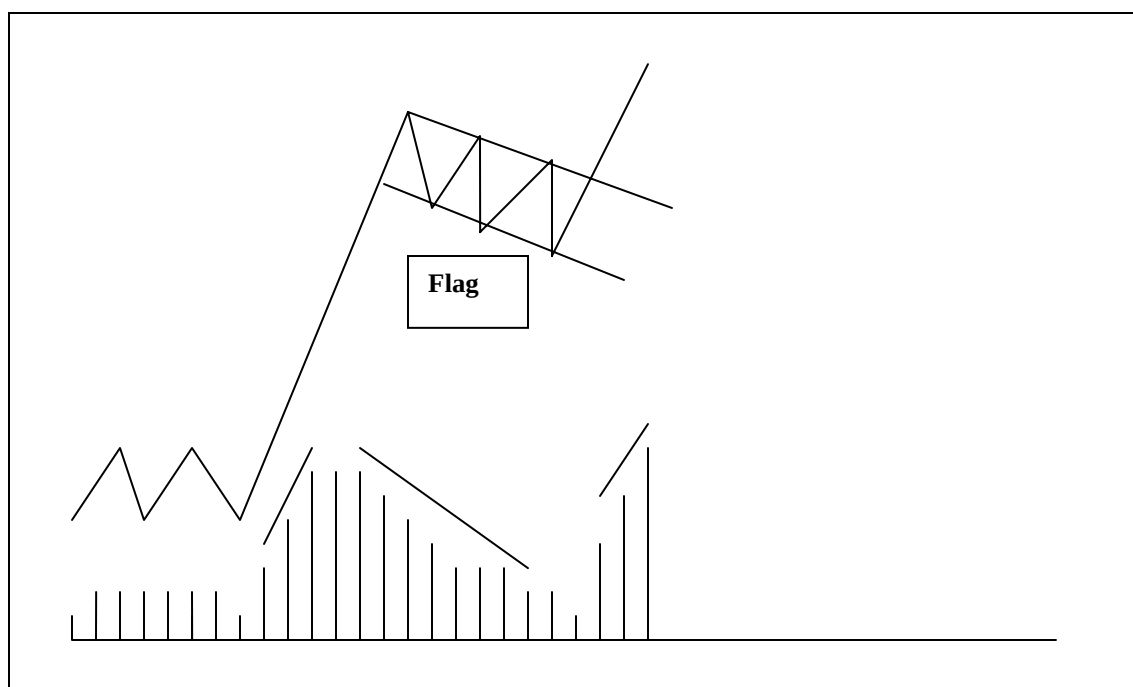
The construction of flags and pennants differ slightly. The flag resembles a parallelogram, marked by two parallel trendlines that tend to slope against the prevailing trend.

The pennant is identified by two converging trendlines and is more horizontal. It closely resembles a symmetrical triangle. Both the flags and are short term formations. Pennants and flags take even shorter time to form in downtrends.

Flags:

The Uptrend flag usually forms after a rapid and extensive advance which produces a steep price track on the charts. On such moves, volumes normally show a progressive increase until it reaches a high rate. After the price rise, players start booking profits and profit taking halts the rise. A new rally occurs, but fails to meet the previous highs or the volumes. The volumes dry up as a series of minor fluctuating moves take place in a small trading range. Hence the steep rise is followed by compact, sideways and slightly down sloping price congestion area. The price then suddenly spurts accompanied by sudden increase in volumes. The spurt in price moves beyond the congestion area and prices move straight up again in another advance which practically duplicates the original ‘flagpole’.

Flags formed in a downtrend are similar to the formation of flags in an uptrend and have similar implications. The volume pattern is also similar.

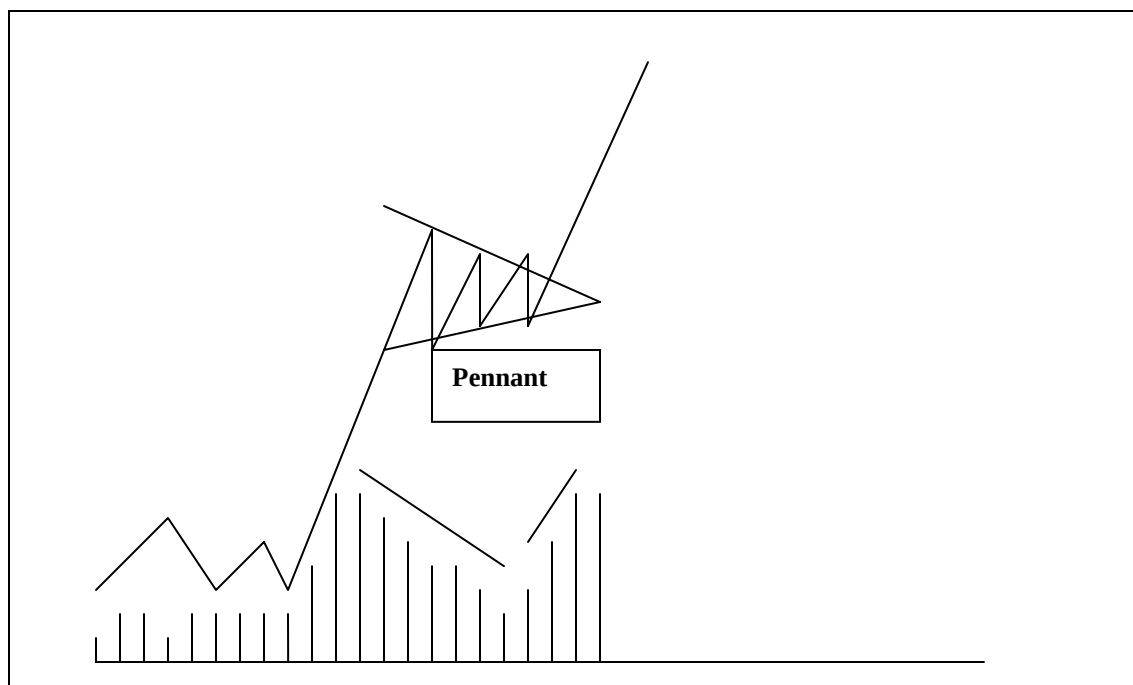


Pennants:

The only important difference between a flag and a pennant is that the latter is bound by converging lines, rather than parallel lines. The pennant slopes downward in an uptrend and up in downtrend. Activities diminish even more in pennant formations compared to flags.

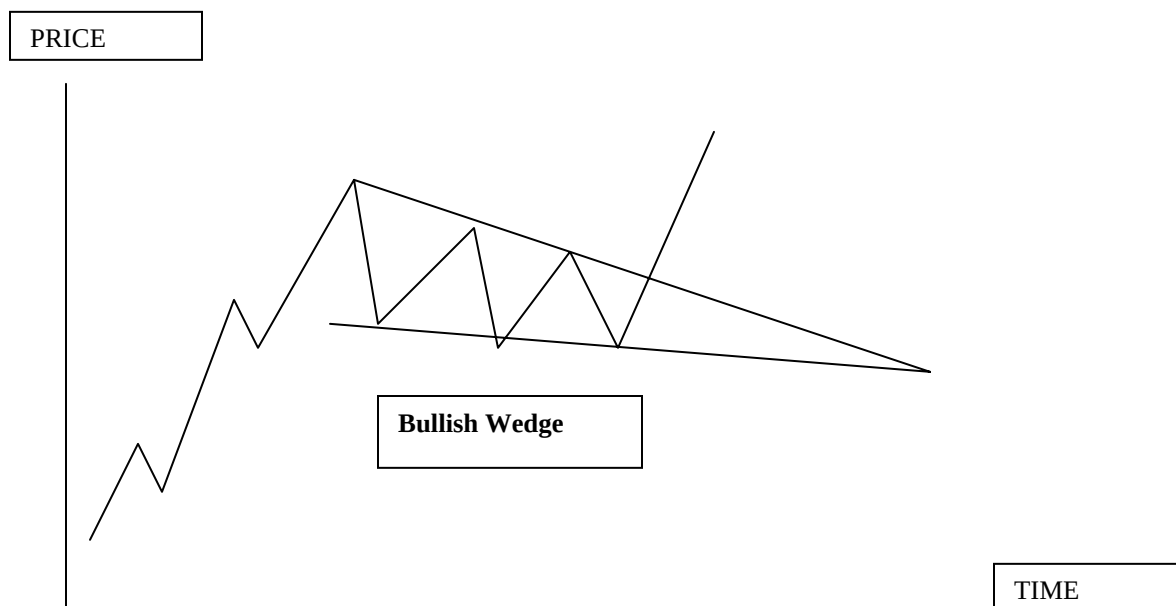
The measuring implications are similar for both the patterns. Flags and pennants are said to “fly at half-mast” from a flagpole. The term “half-mast” suggests that these minor continuation patterns tend to appear at about the halfway point of the move. The move after the trend has resumed will duplicate the flagpole or the move just prior to the formation of the pattern.

The measuring technique is done by measuring the distance of the preceding move from the original breakout point. That is to say, the point at which the original trend signal was given, either by the penetration of a support or resistance level or an important trendline. The vertical distance of the preceding move is then measured from the breakout point of the flag or pennant.



WEDGE FORMATION:

The wedge formation is similar to a triangle both in terms of its shape and the amount of time it takes to form. Like the symmetrical triangle, it is identified by two converging trendlines that come together at an apex. The distinguishing factor with a symmetrical triangle is its noticeable slant of both the trendlines upward or downward. The wedge slants against the prevailing trend. Hence a falling wedge is bullish, while a rising wedge is bearish.



Wedge is usually a continuation pattern, but in some instances they form at the top or the bottom and become trend reversal patterns. The prices fluctuate within the wedge's confines for at least two thirds of the distance from the base (beginning of the convergence) to the apex. Trading volumes follow the

same pattern as in a pennant or a triangle. The volumes drop considerably within the wedge but once it breaks out from the wedge, it is accompanied by high volumes.

GAPS

A Gap occurs when the lowest price of a specific trading period is above the highest price of the previous trading period (in a bullish trend), or when the highest price for a specific trading period is below the lowest price of the previous trading period (in a bearish trend). A Gap is represented by a vertical space between one trading period and another. A Gap is filled or closed when the prices comes back and retraces the whole range of the gap.

The three types of gaps that are worthy of consideration are:

- Breakaway Gaps
- Continuation or Runaway Gaps
- Exhaustion Gaps

Breakaway Gaps: A Breakaway gap is created when a price breaks out of a price pattern. Generally speaking, the presence of the gap emphasizes the bullishness or the bearishness of the breakout, depending on which direction it takes even so, it is still important for an upside breakout to be accompanied by a relatively high level of volume. It should not be concluded that every gap breakout will be valid, because the “sure thing” does not exist in technical analysis. However a gap associated with a breakout is more likely to be valid than not. Gap breakouts which happen on the downside need not be accompanied by high volumes.

Continuation or Runaway Gaps: Runaway gaps occurs during a straight line advance or decline when price quotations are moving rapidly and emotions are high. Either they are closed very quickly, or they tend to remain open for much longer periods and are not generally closed until the market makes a major or intermediate swing in the opposite direction to the price movement that was responsible for the gap. This type of gap often occurs halfway between a previous breakout and the ultimate duration of the move.

Exhaustion Gaps: A price move sometimes contains more than one runaway gap. This indicates that a very powerful trend is in force, but the presence of a second or third gap should also alert the technician the move might run out of steam soon. Hence there is a chance that the second or the third runaway gap will be the final one. An exhaustion gap is therefore associated with the terminal phase of a rapid advance or decline and is the last in a series of runaway gaps. One clue that an exhaustion gap may be forming is a level of volume that is unusually heavy in relation to the price change of that day. In such a case, volume usually works up to a crescendo well before previous levels. Sometimes the price will close near the vacuum (or gaps) and well away from its extremes. It the next day's trading creates an island on which the gap day is completely isolated by a vacuum from the previous day's trading. This is usually an excellent sign that the gap day was in fact that turning point.

GENERAL TRADING TACTICS

Rules for buying and Selling

GENERAL TRADING TACTICS/RULES

Upon completion of the market analysis, the trader should know whether he or she wants to buy or sell the market. The final step is the actual purchase or sale of the instrument. This can be the most difficult part of the process because the timing of entry and exit points must be precise to maximize gain or minimize loss.

Here we provide a broad framework of tactics to be employed. The major ones are:

1. Tactics on breakouts
2. The breaking of trendlines
3. The use of support and resistance
4. The use of percentage retracements
5. The use of gaps

Tactics on Breakouts: Anticipation or Reaction?

The trader is always faced with the dilemma of taking a position in anticipation of a breakout, taking a position on the breakout itself, or waiting for the pullback or reaction after the breakout occurs. If the position is taken in anticipation of an upside breakout, the payoff is a better (lower) price if the anticipated breakout takes place. The odds of making a bad trade, however, are increased. Waiting for the actual breakout increases the odds of success, but the penalty is a later (higher) entry price. Waiting for the pullback after the breakout is a compromise.

This situation shows how trading multiple positions simplifies the dilemma. The trader could take a small position in anticipation of the breakout, and add a little more on the corrective dip following the breakout. The most conservative approach would be buy the pullback after the breakout.

The Breaking of Trendlines

This is one of the most useful early entry or exit signals. Other technical factors must always be considered. Trendlines can also be used for entry points when they act as support or resistance. Buying against a major up trendline or selling against a down trendline can be an effective timing strategy.

Using Support and Resistance

Support and resistance are the most effective chart tools to use for entry and exit points. The breaking of resistance can be a signal for a new long position. Protective stops can then be placed under the nearest support point. A closer protective stop could be placed just below the actual breakout point, which should now function as support. Rallies to resistance in a downtrend or declines to support in an uptrend can be used to initiate new positions or add to old profitable ones. For purposes of placing protective stops, support and resistance levels are most valuable.

Using Percentage Retracements

In an uptrend, pullbacks that retrace 40% to 60% of the prior advance can be utilized for new or additional long positions. For timing, percentage retracements can be applied to very short-term action. A 40% pullback after a bullish breakout, for example, might provide an excellent buying point. Bounces of 40% to 60% usually provide excellent shorting opportunities in down trends. Percentage retracements can be used on intra-day charts also.

Using Price Gaps

Price gaps on bar charts can be used effectively in the timing of purchases or sales. After an up-move, underlying gaps usually function as support levels. Buy a dip to the upper end of the gap or a dip into the gap itself. A protective stop can be placed below the gap. In a bear move, sell a rally to the lower end of the gap or into the gap itself. A protective stop can be kept over the gap.

Combining Technical Concepts

The most effective way to use technical concepts is to combine them. It's important to fine-tune the entry or exit point. If a buy signal has been given, the trader wants to get the best price possible. Suppose prices dip into the 40% to 60% buying zone, show a prominent support level in that zone, and/or have a potential support gap. All of these factors used together would improve the timing of the trade. The idea is to buy near support, but to exit quickly if that support is broken. In a downtrend, sell as close to resistance as possible, exiting quickly if that resistance is broken. Violation of a tight down trendline drawn above the highs of a downside reaction could also be used as a buying signal. During a bounce in a downtrend, the breaking of a tight up trendline could be a shorting opportunity.

JAPANESE CANDLESTICKS

The Investors Interpretation of Value

INTRODUCTION

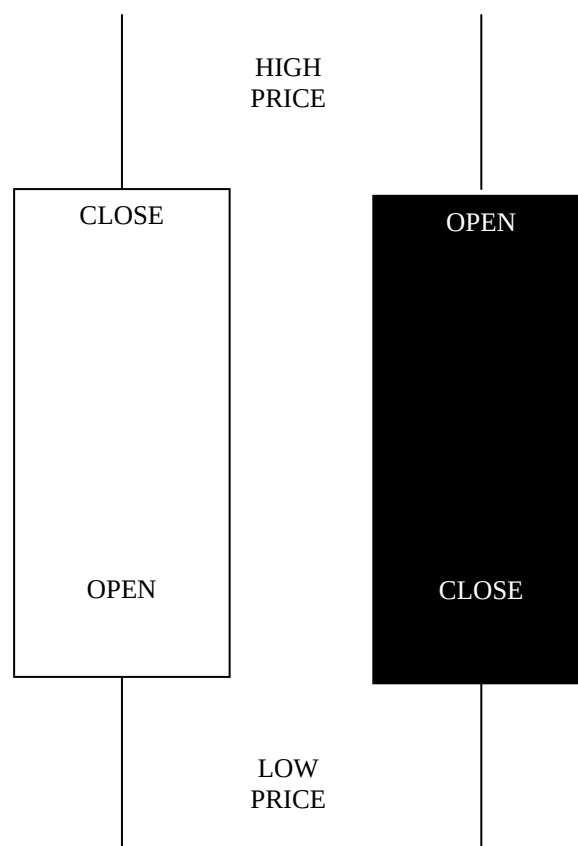
Japanese candlestick read the changes in the makeup of investor's interpretation of value. This is then reflected in price movement. In the 1600s, the Japanese developed a method of technical analysis to analyze the price of rice contracts. This technique is called Candlestick charting. Steven Nison is credited with popularizing candlestick charting and has become recognized as the leading expert on their interpretation.

Candlesticks

The candlestick is white in colour in case the closing price is higher than the opening price (bullish candle) and the candle is a black candle in case the closing price is lower than the opening price (bearish candle).

The candlestick is made of two components:

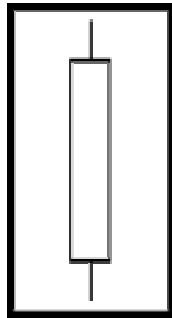
1. **The Body (Jittai):** The box that makes up the difference between the opening price and the closing price is called the body of the candle. The height of the candle represents the difference between the Opening and the Closing prices.
2. **The Shadow (Kage):** The candlestick may have thin lines above and below the body representing the range between the highest and lowest prices. These lines are called the shadows. The Upper shadow (Uwakage) represents the high price and the lower shadow (shitakage) represents the low price.



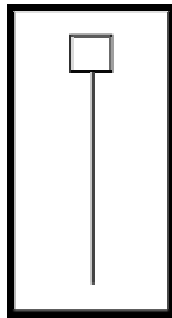
CANDLESTICKS PATTERNS

The interpretation of candlestick charts is based primarily on patterns. The most popular patterns are:

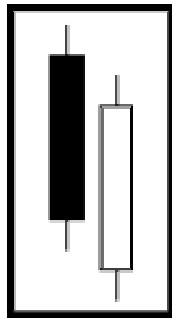
BULLISH PATTERNS



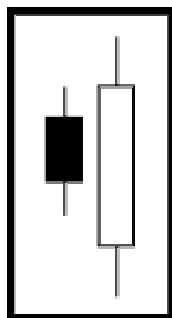
Long white (empty) line. This is a bullish line. It occurs when prices open near the low and close significantly higher near the period's high.



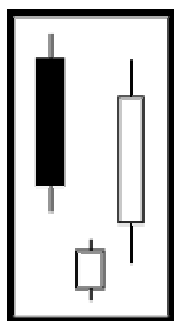
Hammer. This is a bullish line if it occurs after a significant downtrend. If the line occurs after a significant up-trend, it is called a Hanging Man. A Hammer is identified by a small real body (i.e., a small range between the open and closing prices) and a long lower shadow (i.e., the low is significantly lower than the open, high, and close). The body can be empty or filled-in.



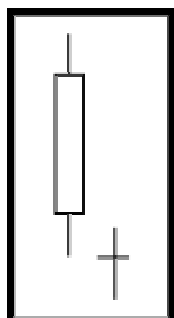
Piercing line. This is a bullish pattern and the opposite of a dark cloud cover. The first line is a long black line and the second line is a long white line. The second line opens lower than the first line's low, but it closes more than halfway above the first line's real body.



Bullish engulfing lines. This pattern is strongly bullish if it occurs after a significant downtrend (i.e., it acts as a reversal pattern). It occurs when a small bearish (filled-in) line is engulfed by a large bullish (empty) line.

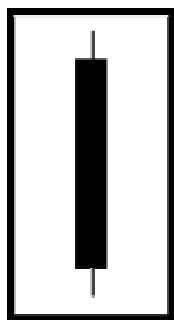


Morning star. This is a bullish pattern signifying a potential bottom. The "star" indicates a possible reversal and the bullish (empty) line confirms this. The star can be empty or filled-in.

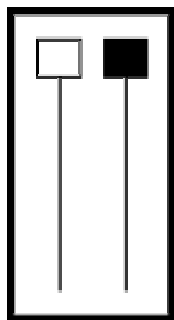


Bullish doji star. A "star" indicates a reversal and a doji indicates indecision. Thus, this pattern usually indicates a reversal following an indecisive period. You should wait for a confirmation (e.g., as in the morning star, above) before trading a doji star. The first line can be empty or filled in.

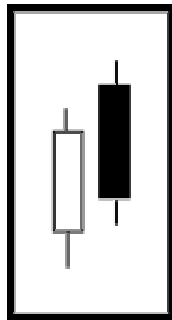
BEARISH PATTERNS



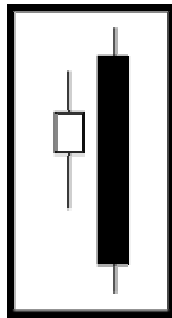
Long black (filled-in) line. This is a bearish line. It occurs when prices open near the high and close significantly lower near the period's low.



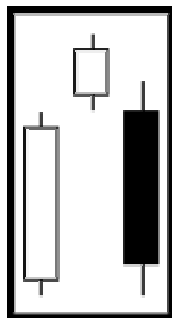
Hanging Man. These lines are bearish if they occur after a significant uptrend. If this pattern occurs after a significant downtrend, it is called a Hammer. They are identified by small real bodies (i.e., a small range between the open and closing prices) and a long lower shadow (i.e., the low was significantly lower than the open, high, and close). The bodies can be empty or filled-in.



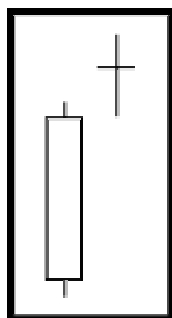
Dark cloud cover. This is a bearish pattern. The pattern is more significant if the second line's body is below the center of the previous line's body (as illustrated).



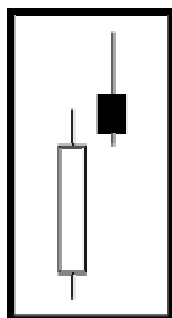
Bearish engulfing lines. This pattern is strongly bearish if it occurs after a significant up-trend (i.e., it acts as a reversal pattern). It occurs when a small bullish (empty) line is engulfed by a large bearish (filled-in) line.



Evening star. This is a bearish pattern signifying a potential top. The "star" indicates a possible reversal and the bearish (filled-in) line confirms this. The star can be empty or filled-in.

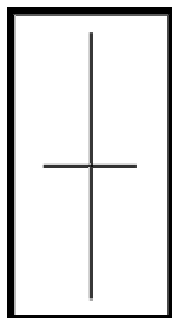


Doji star. A star indicates a reversal and a doji indicates indecision. Thus, this pattern usually indicates a reversal following an indecisive period. You should wait for a confirmation (e.g., as in the evening star illustration) before trading a doji star.

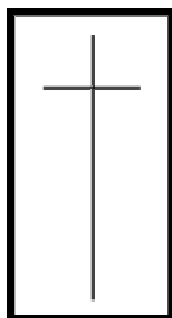


Shooting star. This pattern suggests a minor reversal when it appears after a rally. The star's body must appear near the low price and the line should have a long upper shadow.

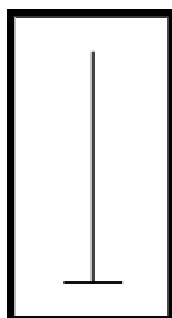
REVERSAL PATTERNS



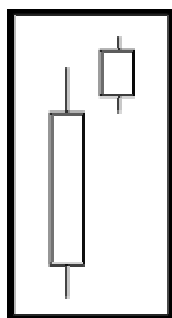
Long-legged doji. This line often signifies a turning point. It occurs when the open and close are the same, and the range between the high and low is relatively large.



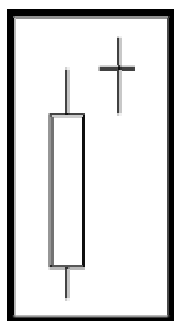
Dragon-fly doji. This line also signifies a turning point. It occurs when the open and close are the same, and the low is significantly lower than the open, high, and closing prices.



Gravestone doji. This line also signifies a turning point. It occurs when the open, close, and low are the same, and the high is significantly higher than the open, low, and closing prices.

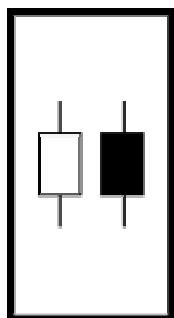


Star. Stars indicate reversals. A star is a line with a small real body that occurs after a line with a much larger real body, where the real bodies do not overlap. The shadows may overlap.

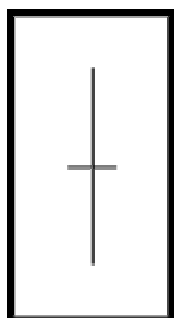


Doji star. A star indicates a reversal and a doji indicates indecision. Thus, this pattern usually indicates a reversal following an indecisive period. You should wait for a confirmation (e.g., as in the evening star illustration) before trading a doji star.

NEUTRAL PATTERNS

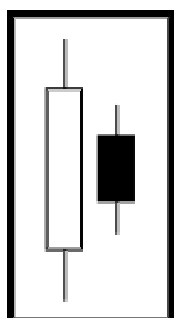


Spinning tops. These are neutral lines. They occur when the distance between the high and low, and the distance between the open and close, are relatively small.



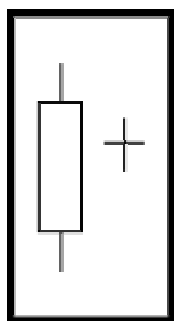
Doji. This line implies indecision. The security opened and closed at the same price. These lines can appear in several different patterns.

Double doji lines (two adjacent doji lines) imply that a forceful move will follow a breakout from the current indecision.



Harami ("pregnant" in English). This pattern indicates a decrease in momentum. It occurs when a line with a small body falls within the area of a larger body.

In this example, a bullish (empty) line with a long body is followed by a weak bearish (filled-in) line. This implies a decrease in the bullish momentum.



Harami cross. This pattern also indicates a decrease in momentum. The pattern is similar to a harami, except the second line is a doji (signifying indecision).

REVERSAL PATTERNS: A DETAILED ANALYSIS

Patterns can also be segmented into Reversal Patterns and Continuation Patterns. The major Reversal Patterns are given below along with the scenario and psychology behind the pattern formation. The major reversal patterns are:

- Hammer and Hanging Man
- Engulfing Pattern
- Harami Cross Pattern
- Inverted Hammer and Shooting Star
- Doji Star
- Morning Star and Evening Star

Hammer and Hanging Man

The Hammer happens in a downtrend and is so named because it is hammering out a bottom.

The Hanging Man occurs at the top of a trend during an uptrend. The name comes from the fact that the candlestick looks like a man hanging.

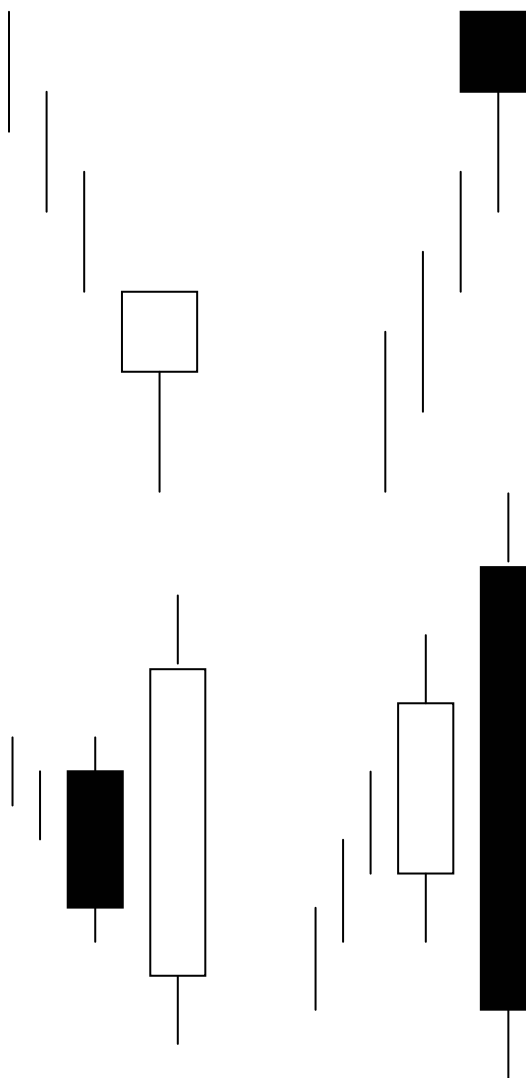
Scenario and Psychology:

Hammer: The market is in a downtrend and after the opening there is a sell off. The sell off is abated and the market returns to, or near the high of the day. The failure of the market to continue the selling reduces the bearish sentiment, and people will be uneasy with short positions. If the close is above the opening levels, causing a white body, the situation is even better.

Hanging Man: In this case the market is bullish and the price action must be lower than the opening levels. It indicates that the market had dipped and recovered a little. Players in the market will look to sell off long positions at the earliest and square off.

Engulfing Pattern (tsutsumi)

The engulfing pattern consists of two real bodies of opposite colours. The second day's body completely engulfs the prior day's body. The second day's body is longer than the first day and it being of the opposite colour, it is dramatic and reflects a possible end to the previous trend.

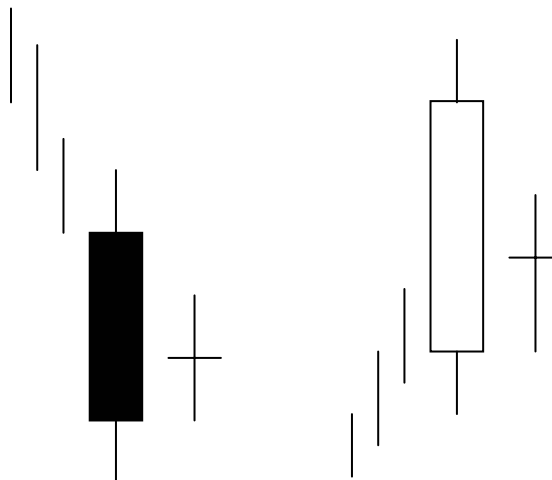


Scenario and Psychology:

The initial day the price movement is small but with the trend. The second day the candle is of a different colour and engulfs the previous candle. Emotionally the trend has been damaged by the second candle.

Harami Cross (harami yose sen)

In a Harami Cross formation, a long day occurs with the trend. The second day is a doji formation with the opening and closing levels being the same. The range of the Doji is within the range of the previous long day.



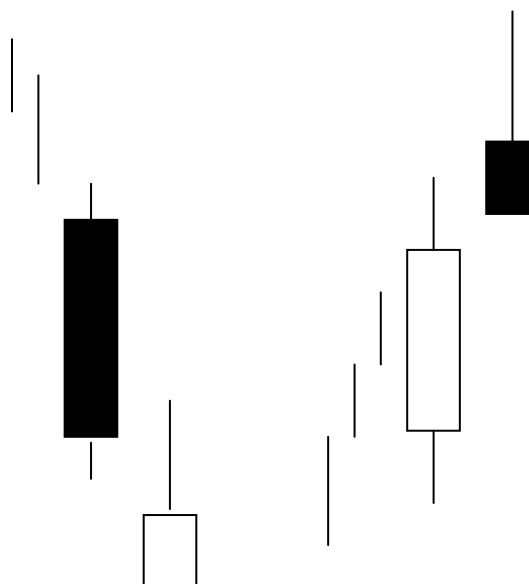
Scenario and Psychology

A Trend is in place when, all of a sudden, the market gyrates in a range within the previous days range and closes at the opening levels. This indicates a lack of direction of the players and their unwillingness to continue with the trend.

Inverted Hammer & Shooting Star (Tohba & nagare boshi)

Inverted Hammer: The inverted hammer is a bottom reversal pattern. It occurs in a down trend and represents a possible reversal of trend. It is a small real body near the lower part of the price range. The lower shadow is virtually non-existent.

Shooting Star: The shooting star occurs in a up trend and indicates an end to the upward move. It looks exactly like an Inverted Hammer except that it occurs at the top. A rally attempt is completely aborted as the close price is near the lowest price of the day. The upper shadow is usually three times the body length. The lower shadow is virtually non-existent.



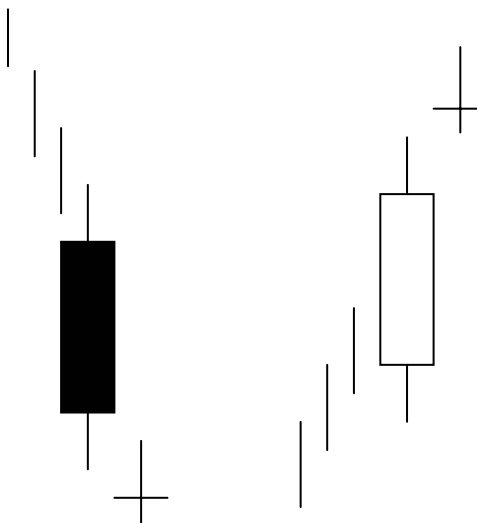
Scenario and Psychology

In case of an Inverted Hammer, a downtrend is in place. The rally throughout the day fails to sustain and the closing of the market is near the low levels. In case the next day the opening is above the inverted hammer, players are not sure about the downtrend and square off short positions ending the downtrend.

In case of a shooting star, during the up trend, the market usually opens with a gap, rallies to a new high before closing near the day's low prices. As the rally does not sustain, players would look to square off their positions at the earliest.

Doji Star

A Doji Star is a warning that the pattern will change. It is a long real body indicating the previous trend. A downward trend should produce a black body and an upward trend a white body. The second day gaps in the direction of the trend and is a Doji.



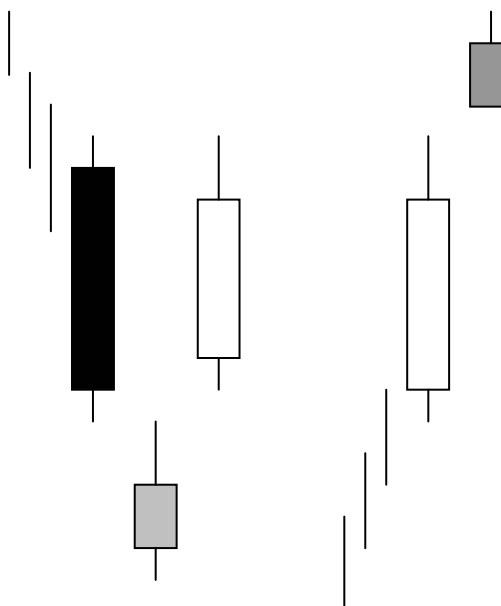
Scenario and Psychology

The first candle continues the previous trend. The second candle gaps in the same direction and rallies before players start squaring their positions. The closing price is equal to the opening price and the rally could not be sustained. The market players will be apprehensive of the trend and will erode the confidence of the previous trend.

Morning Star & Evening Star (Sankawa ake no myojyo & sankawa yoi no myojyo)

Morning Star: The morning Star is a bullish reversal pattern. It is made up of a long black body followed by a small body which gaps lower. The Third body is a white body that moves into the first black body. An ideal morning star would have a gap before and after the middle candle's body.

Evening Star: the bearish counterpart for the Morning Star is the Evening Star. It appears in an uptrend. The first body is a white body followed by a star body. The third body gaps down and is a black candle. There must be gaps between the first and second body and the second and third body.



Scenario and Psychology

In case of the morning star, a downtrend is in place which is assisted by a long black candlestick. The next day prices gap lower on the open, trade within a small range and close near the open, indicating an indecision in the market about continuing the trend. The next day the prices gap upward on the open and close much higher, concluding a significant reversal pattern.

In the case of an evening star, the scenario is exactly the opposite.

Other major Reversal Patterns are:

- Harami
- Piercing Line and Dark Cloud Cover
- Morning Doji Star and Evening Doji Star
- Abandoned Baby
- Tri star
- Three White Soldiers
- Three Black Crows
- Kicking
- Homing Pigeon
- Breakaway
- Identical Three Crows

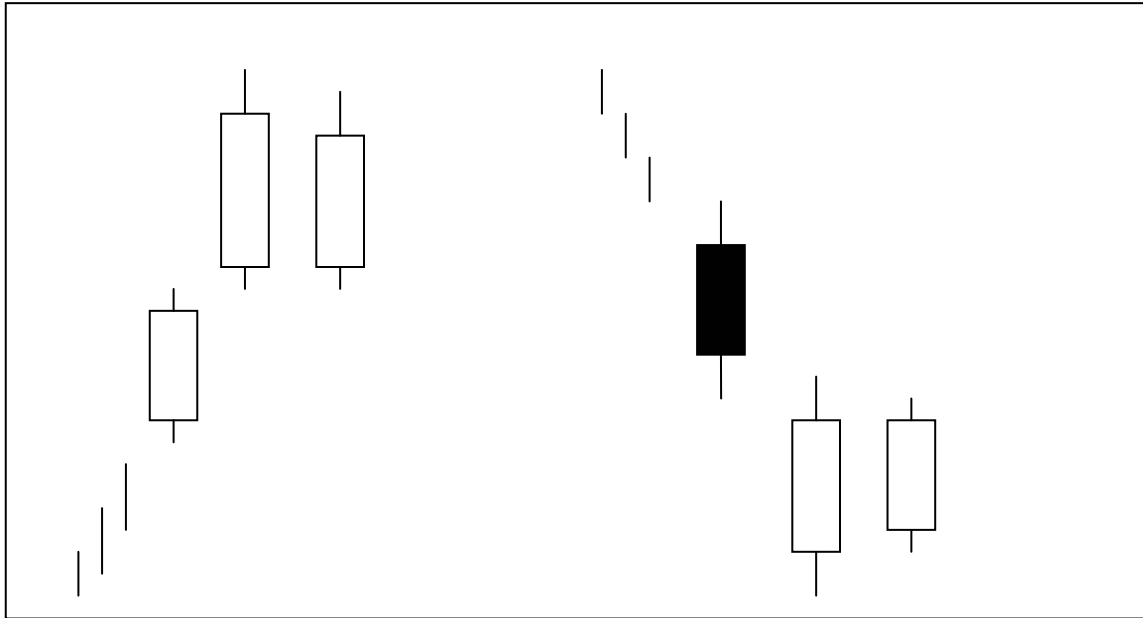
CONTINUATION PATTERNS: A DETAILED ANALYSIS

The major Continuation patterns are:

- Side-by-Side White Candles
- Rising Three methods and Falling Three Methods

Side-by-Side White Candles (Narabi Aka)

Narabi means "in a row" and Narabiaka means "Whites in a row". In a bullish Side by Side candle formation, two white candlesticks of similar size are side by side after gapping above another white candle. The opening prices are very close and they are similar in size. In the bearish formation, the side by side white candles form after gapping from the previous candle. This is a rare formation.



Scenario and Psychology:

In a Bullish Side by Side white candlestick, a long white candlestick perpetuates the bullishness. The next candlestick gaps from the previous candle and closes still higher.

Rising Three methods and Falling Three Methods

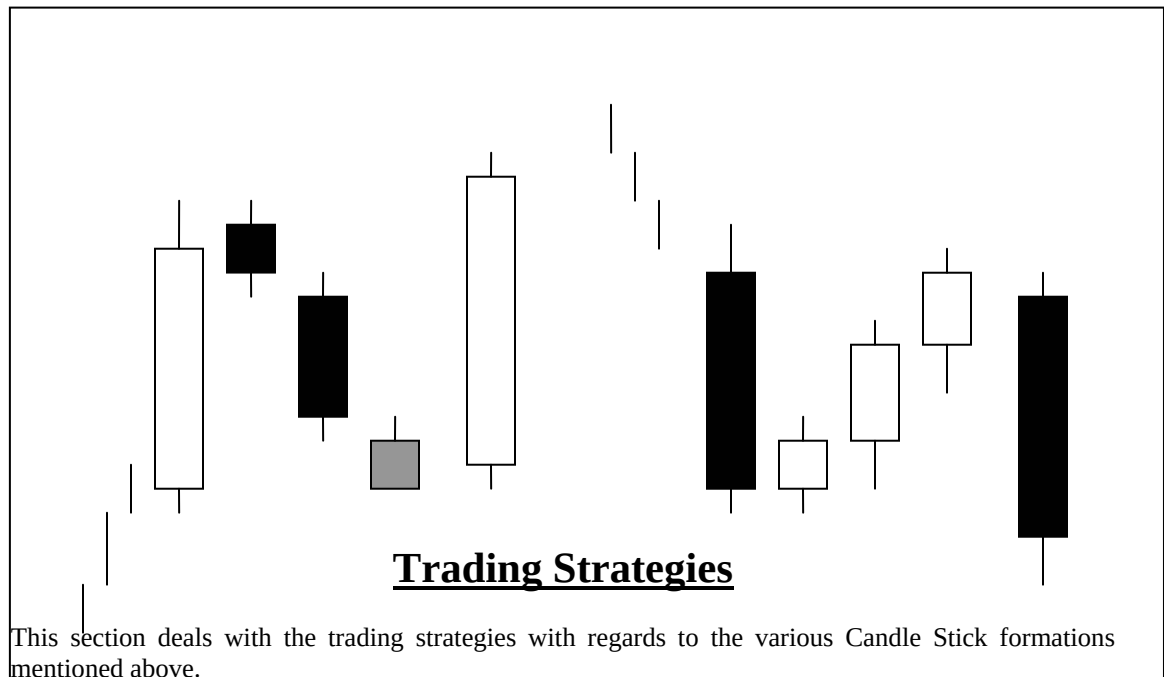
The Bullish and Bearish Three Methods are continuation patterns. Both the patterns that represent breaks in the trend of the prices without causing a reversal. In the Bullish Rising methods, the bullish long white candle is followed by two or three small candles representing indecision periods. These candles representing indecision fall within the range of the first long white candle. The final candle is again a long white body candle, opening at a level above the close of the previous period and closes at a new high. In the Bearish Falling Methods, the reverse pattern occurs.

Scenario and Psychology:

The psychology behind the formations is that the market is taking a rest and hence there is indecision among the players. Once the indecision is over the players continue with the previous trend.

The other major Continuation patterns are:

- Mat Hold
- Three line strike
- On neck line
- In neck line
- Thrusting Line



Reversal Patterns

Hammer and Hanging Pattern: As with most single candlestick patterns, it is important to wait for a confirmation before taking a position after a hammer or hanging man formation. The confirmation can be merely the next day opening price and action. It is though best to wait for a confirming close on the following day. Hence, in case a hammer is formed, the following day should close even higher, before bullish positions are taken.

Bullish or bearish Engulfing pattern: The engulfing pattern of the second day has emotionally dampened the previous trend. Confirmation is suggested before taking a position opposite of the existing trend. The confirmation of trend reversal occurs at either the starting prices of the next day or preferably after the close of the next day.

Harami: In the Harami formation, the second day's candle lies within the body of the previous day's candle and is of the opposite colour. The formation is not as powerful as the engulfing pattern and hence confirmation is definitely required. One is supposed to take a position only after the trend reversal is confirmed by the next day's candle.

Harami Cross: The second candle is a cross, depicting the conflict going on between the bulls and the bears specially when the previous day was a bullish or bearish day in continuation of an existing trend. Confirmation is not required in a Harami Cross formation, though it is recommended. The volumes usually dry up, reflecting complete lack of decision by traders.

Inverted Hammer and Shooting Star: In both these cases, confirmation is definitely required. The confirmation could be in the form of the next day prices opening above the inverted hammer or below the shooting star. As the closing price of an inverted hammer is near the day's close, while trades have actually taken place at higher levels, confirmation is even more required in case of an inverted hammer than a shooting star.

Doji Star: In this formation, confirmation is suggested, though not always required. The formation of the Doji Star after a previous trend, indicates the deterioration of the previous trend. It erodes almost

all confidence of the previous rally. In case the next day prices are against the previous trend, the reversal is confirmed.

Morning Star and Evening Star: This formation requires no confirmation at all. Since the third candle of the formation is against the initial trend, the trend has reversed and traders can take positions against the trend without waiting for the confirmation.

Continuation Pattern:

Side by side white lines: No confirmation is required for this formation, though confirmation is suggested for the bearish formation. The initial sell of the third day has been countered by the buyers and pushed the prices up. The resting period of the bullish traders is over. Traders need not wait for a confirmation and can initiate positions on the next day.

In case of the bearish formation, though the bulls could not close the gap on the previous two days, a confirmation in the form of the next day's opening prices is required, before a trader initiates a sell position.

Rising and Falling Three Method: In the case of rising and falling three method, a confirmation is not required in both the case and traders can initiate positions without waiting for a confirmation.

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ANNEXURES