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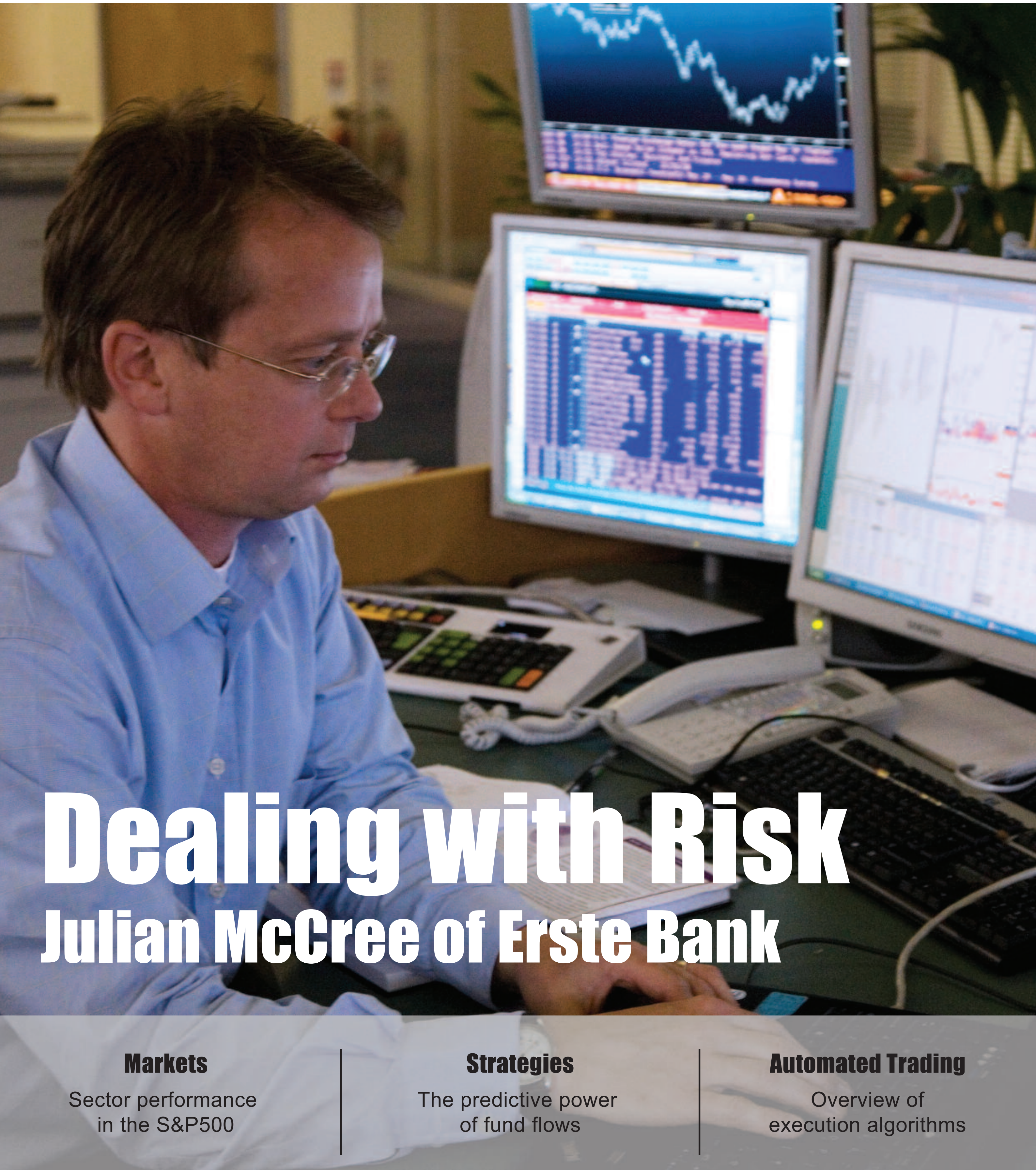

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Trading Variations in Double Tops and Double Bottoms

By Suri Duddella

Chart patterns like Double Tops and Head-and-Shoulders essentially convey the same signal – that of a trend reversal at the end of the pattern. Given the potentially important long-term Double Tops forming in the FTSE and S&P (see Figures 1 and 2), we ask Suri Duddella to discuss the many variants of Double Tops and Double Bottoms and to highlight some of their different trading rules.

Double Top and Double Bottom patterns are part of classic technical analysis. Double Top/Bottom patterns are very common and form in all timeframes and in all instruments. These patterns form when prices fail to make new highs/new lows at significant previous levels. Double Top and Bottom patterns are relatively reliable and easy to trade. When Double Bottoms/Tops fail, they may be signaling potential Triple Top or Triple Bottoms patterns. Double Top/Bottom patterns have several variants and these variations involve different trading rules and different pattern recognition methods.

Formation of Double Top/ Bottom patterns

In active markets, Double Top/Bottom patterns are found as the market works up rapidly in a peak or trough accompanied by high volume in the first stage. Without any warning signs the market reverses and retraces to a key support level/resistance and stagnates for few bars before rising/falling to the previous peak/trough with lesser volume in the second stage. These two sharp moves create the Double Top/Bottom patterns and signal a potential reversal of prior trends. In most Double Top or Double Bottom patterns the two swing peaks or troughs need not be equal and the first or second peak or trough can be higher/lower.

The preceding movement prior to the Double Top/Bottom pattern formation signals whether the pattern is a continuation or reversal pattern. If the preceding movement is a long continued up/down trend prior to the first peak/trough, the pattern may be signaling a reversal while if the preceding movement is a short trend, it may be signaling a continuation pattern. Markets making new highs/lows (at least 40-bar) in the first peak/trough may signal reversal patterns.

The "size" of the pattern or duration of the interval between the two peaks/troughs measures the success of the pattern. A long duration between the two peaks/troughs signals a high possibility of reversal. The "size" of the retracement (at least 15% from the first swing) between the two peaks/troughs also indicates the likelihood of pattern success. High volume during the first peak/trough and lighter volume in the second peak/trough followed again by higher volume during the breakout/breakdown signals greater probability of pattern success.

Figure 1.

Figure 2.

Double Top Trading Rules

Double Top patterns are recognized by the two peaks with an intermediate reaction swing low. After completion of the second peak, prices trade below the reaction low to signal a potential trade.

Trading Rules

Trade: A Double top pattern confirmation occurs at the breakdown level of the swing low at the neckline. Enter a short trade below the previous swing low at the neckline (see Figure 3).

Target: The Double Top offers a →

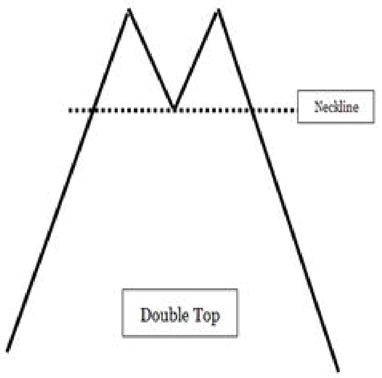

Figure 3.

good risk/reward ratio. Measure the distance between the top of the pattern to the neckline for potential target range from the trade entry (see Figure 4).

Stop: Double tops also fail and form triple or multiple top patterns. Usually the failure occurs when prices reverse and trade at the middle of the Double top pattern range. Enter a stop order at the middle of the pattern range to protect the trade.

Double Bottom Trading Rules

The Double Bottom pattern is a mirror image of the Double Top. An extended down trend results in new lows followed by a moderate rally from the first bottom. After a brief rally the prices attempt to test the first bottom again. Failure to trade below the first-bottom results in a second-bottom as prices rally and reverse the prior trend. The intermediate swing-high between the two bottoms is called the 'reaction swing-high'. When price trades above this 'reaction swing-high', it signals a potential long trade.

Trading Rules

Trade: A Double Bottom can only be traded after confirmation of the pattern breakout. Confirmation of the pattern occurs when prices close above the neckline. Enter a long trade above the high of the breakout bar from the neckline (see Figure 5).

Target: The Double Bottom pattern

Figure 4.

also has a good risk/reward ratio. The first target would be 100% of the swing range of the pattern. The second target would be 127% to 162% of the depth of the "double bottom" pattern (see Figure 6).

Stop: Double Bottom patterns do fail. This pattern failure occurs if the price closes below the middle of the pattern for multiple bars. Trading below the bottom of the pattern could signal a triple bottom. Place a stop order below the middle of the pattern to protect the trade.

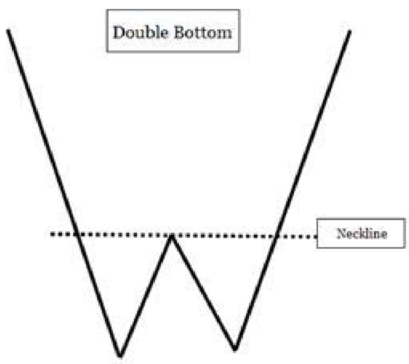

Figure 5.

Variations of Double Top/ Bottom patterns

Knowledge of the variations and their trading rules dramatically increases the chance of trading Double Tops and Bottoms successfully. Most patterns have some variation of their basic structure (simple or complex) with different trading rules to their cousins in the same group, but have the same requirements as to volume action, price movement and timing. Some examples of Double Top and Bottom variants are: Dragon Patterns, Trader Vics' 2B Top/2B Bottom, and Adam and Eve patterns, which I briefly review here.

Dragon Pattern (Figure 7)

Dragon patterns usually form at market bottoms. Dragon patterns work in all time-frames and in all market instruments. Like most Double bottom patterns, Dragon patterns present excellent trading opportunities with low risk to reward ratios. The Dragon pattern is similar to the "W" pattern and the Inverse Dragon pattern is similar to the "M" pattern, albeit with different trading rules.

The Dragon pattern starts with a "Head" formation and price declines from the head level to form two legs of the Dragon. These two legs in a Dragon pattern usually form within 5% to 10% of the price difference. The second leg gives a strong indication of imminent reversal when it posts a key

Figure 6.

reversal bar or a divergence in any oscillator indicators. The price rise in the second leg is usually followed by a spike in the volume. A trend line is drawn →

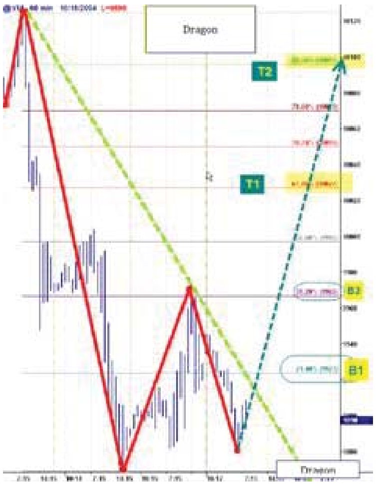

Figure 7.

connecting the head of the Dragon to the hump. When the price closes above the trend line and is also confirmed by price action or divergence in any oscillator, it signals a reversal. The second confirmation of a Dragon pattern occurs when the price closes above the hump, 38% to 50% of the range from the head to the low of the first leg.

Trade: Aggressive traders enter a long trade when the price closes above the trend line (see Figure 8). A better trade entry may be when the price closes above the hump level. Enter a long trade a few ticks above the hump level.

Target: Targets are usually at 127% of the second leg range and another target is set near the Head level.

Stop: Place a stop order below the lowest low of the two legs.

Trader Vic's 2B Top/Bottom (Figures 9 & 10)

"Principles of Professional Speculation" written by Victor Sperandeo (Trader Vic), analyzes one of the powerful top/bottom reversal techniques. Trader Vic describes this technique, *"In an uptrend, if prices penetrate the previous high, but fail to carry through and immediately drop below the previous high, the trend is apt to reverse."* The converse is true for a down trend. This pattern is also called "spring."

The 2B pattern rule is when prices make a new high or new low; they pull

Figure 8.

back for a healthy retracement. After retracement, the price tries to re-test the new high or new low. When this test of the new high or new low fails, and it does not maintain the prices above the new high or low, it signals a potential trend reversal. This setup is very powerful and signals the beginning of a correction.

Adam and Eve Patterns (Figure 11)

Adam and Eve patterns are variations of Double Top and Double Bottom patterns. The trading rules are a little more complex than for regular "Double Tops" and "Double Bottoms" but consist of pattern trading rules similar to Triangles, Pennants and Wedges. Inside the Adam and Eve pattern, the Adam part looks like a sharp spike or "V" shape whereas the Eve pattern has a round shape.

Trade: Although these patterns are easy to detect, a confirmation is needed for successful trading. Double Bottoms and Double Tops may continue to form multiple tops and multiple bottoms. Trades are entered in the direction of the breakout/breakdown of the middle spike between Adam and Eve structures.

Target: Adam and Eve pattern →

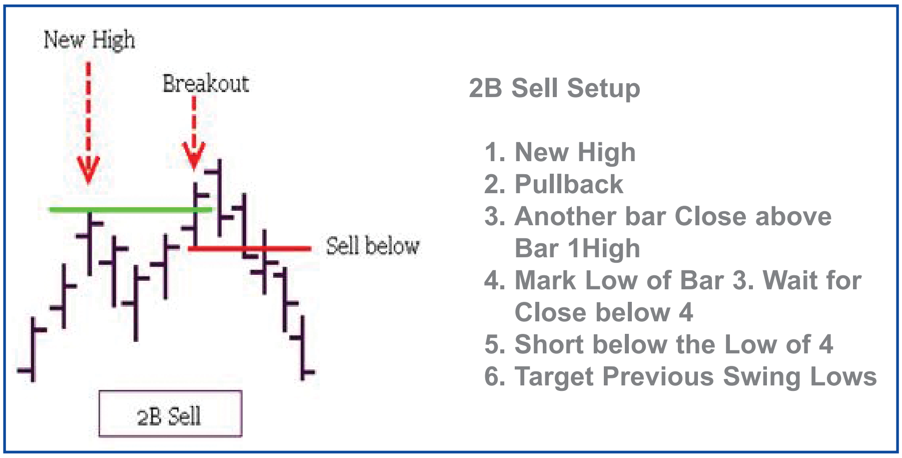

Figure 9.

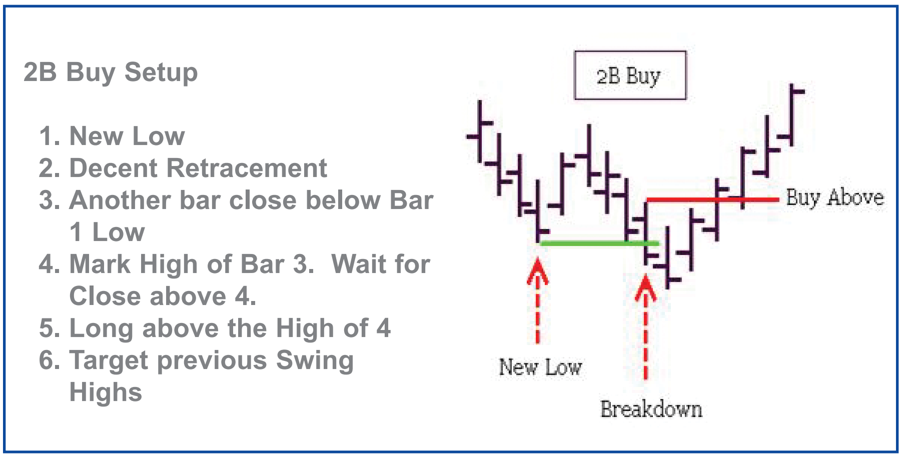

Figure 10.

formations are very profitable. The targets can be set at the previous swing high/swing low of the first swing in the Double Top or Double Bottom." Subsequent targets would be set at the next "higher swing high" or the next "lower swing low."

Stop: Adam and Eve patterns also fail. Protect trades using the pattern high for short trades and the pattern low for long trades.

Conclusion

Most chart patterns have natural variations that require slightly different pattern detection methods and different trading rules. Knowing these variations and their trading rules greatly improves any traders' success when recognizing the development of a pattern.

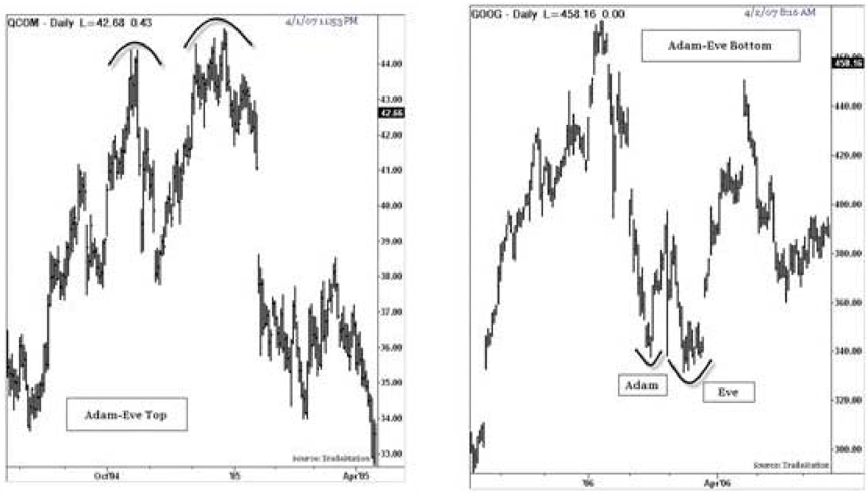

Figure 11.

Suri Duddella is the author of "Trade Chart Patterns like the Pros." Suri has been trading Futures and Equities markets full-time for over 13 years. Contact suriNotes@gmail.com / www.suriNotes.com