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Patterns within Patterns

Patterns inundate every aspect of reality in nature. Patterns within Patterns are like sub-patterns or embedded patterns within a larger pattern. Financial market traders use simple patterns like flags, triangles, rectangles, and trend channels comprising of simple trend lines to succeed in trading. Successful pattern trading requires the knowledge of pattern formation, its arrangement and its market impact. Traders benefit by using smaller patterns support and resistance levels as entry and stop levels to trade larger patterns. Trading smaller patterns inside larger patterns may reduce the risk and provide an early entry opportunity into a position. In this article, I will attempt to show some of these trading methods using smaller patterns within other patterns.

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The trained engineer and computer scientist began his trading career twelve years ago. In addition to technical analysis, he takes a special interest in market psychology. His trading approach is based on pattern trading in stocks and futures. Duddella regularly publishes his research and operates his own website. Contact: www.surinotes.com.

Pattern Recognition

Pattern recognition is the basic and primary ability any trader develops in Technical Analysis. It may be basic development, but the perfection of pattern recognition takes extensive practice and repetitive exposure. The expert recognition of patterns helps traders to quantify and react to the changing market environment. Chart patterns are categorized into continuous and reversal patterns and these categories are further classified as simple and complex patterns. The complex patterns consist of collections of simple patterns. The knowledge of this classification of pattern recognition and its properties give traders greater potential to react and adapt to a wider range of trading conditions.

Pattern Formation

Market prices always exhibit trend, consolidation and re-trend behavior. They rarely reverse their trends and transitional phases to turn from a previous trend on a single bar. During this transitional phase, they experience trading ranges and price fluctuations. This ranging action defines identifiable price patterns. These consolidation phases occasionally favor prevailing trends prior to their formation and continue their direction. These are called 'Continuation' patterns and a few examples of these patterns are: Symmetric Triangle, Flags and Cup and Handle. Some phases result in reversing the prior trend and continue in reversal conditions.

These are called 'reversal' patterns and few examples of reversal patterns are: Head and Shoulders, Double Bottoms and Broadening Patterns.

Patterns within Patterns

When a trader is knowledgeable about patterns, it is difficult not to see patterns within other patterns. Examples of embedded patterns include a series of bullish and bearish triangles in a symmetric triangle, or bear flag setups in rectangle channels (Figure 1). When a pattern dimension is large then risk implied by its trading range may be also large. Traders should then look for smaller congestion patterns inside the large pattern near key support and resistance levels to reduce the risk. Multiple patterns inside a large pattern cause change in its trading behavior, price targets and time-frames. Trading larger patterns but using embedded pattern's dimensions as key support may reduce traders' risk.

F1) Embedded Patterns

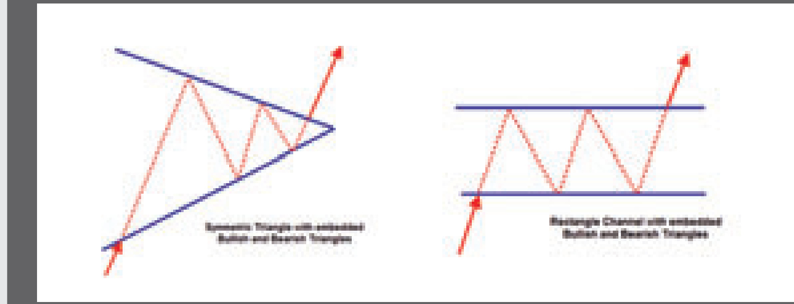
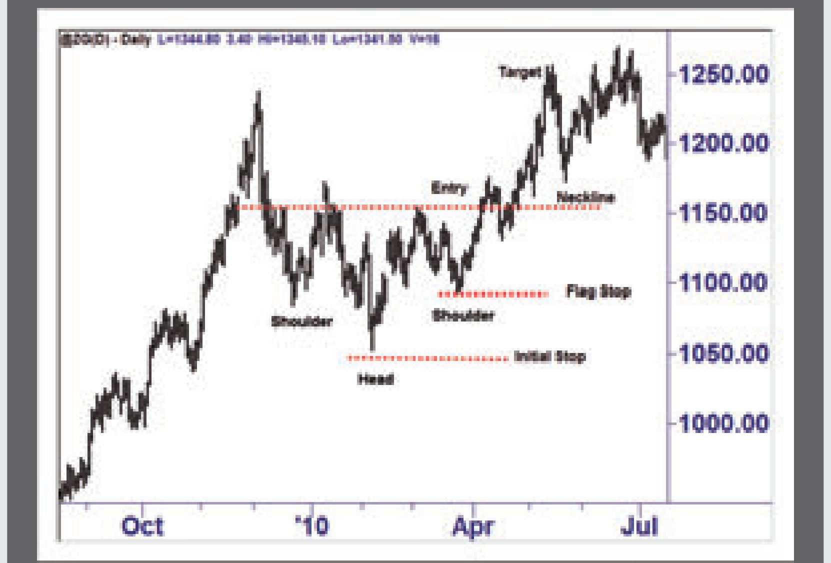


Figure 1 shows embedded bullish and bearish patterns within a larger Symmetric Triangle and Rectangle Channel.

Source: www.tradestation.com

F2) Inverse Head and Shoulders Pattern



I opened a long trade above the breakout bar's high (1160) and placed my initial a stop below the second shoulder's low. In order to reduce my risk, I moved the initial stop to the low of the flag at around 1130.

Source: www.tradestation.com

Trading Inverse Head and Shoulders Pattern with Flag Pattern Support

Figure 2 shows an Inverse Head and Shoulders pattern in gold. Inverse Head and Shoulders patterns are traded when price breaks out from the neckline for 1-2 bars after completing the second shoulder. A long trade is entered above the breakout bar’s high (1160) and a stop is placed below the second shoulder’s low. Usually this pattern is very reliable but the risk in this pattern could be high as the distance from neckline to right shoulder low could be large. In the gold chart, the risk is around 60 points with reward of over 100 points target (to 1260). Since the risk is very large, traders look for other congestion based patterns (like flags, pullbacks to key Moving Averages among others) and protect their stop levels. After the long entry, the price retraced below the neckline to 1130 as a throw-back. In most breakouts, the throw-back to the neckline is expected. The throw-back low price provides an opportunity to set a second stop. Once price crosses over (for the second time) the neckline, the initial stop should be moved to the low of the flag (or throw-back) around 1130. This will reduce the risk to 35 points with no reduction in reward. As the trade emerges from the neckline towards the target, similar trail-stops may be used to protect the profits.

Trading the Bearish Gartley Pattern

Figure 3 shows a bearish Gartley pattern (5-point XABCD) in Schlumberger (SLB) with an embedded bullish ABC Pattern. The bearish Gartley pattern suggests a short-setup once the D-point is identified. A short-trade is entered from D ($72 entry) with stop loss just above ($74.5). The bearish Gartley targets are set at 100%XA at $62 and 162%XA at $54. This pattern also presents another opportunity for a bullish ABC pattern trade.

Trading the Bullish ABC

Figure 4 is the same SLB chart as in Figure 3 and shows the bullish ABC pattern (in blue) with entry, targets and stop. The bullish ABC pattern presented itself inside the bearish Gartely pattern. In ABC pattern, the entry is set at 63.76 (marked as EL), with targets at 100%AB = $68.23, 127%AB = $70.27 and 162%AB = $72.92 and the stop is placed below C ($60). ABC pattern targets are also aligned with the bearish XABCD pattern completion at 162%AB range. At the completion of the ABC pattern, the chart shows XABCD pattern and a short trade is entered at D with Gartley pattern’s trading rules as described in Figure 3.

Conclusion

The basic purpose of chart reading is to visualize the history of a stock, determine the strength of supply and demand, mark key price levels, and predict the direction of prices. Many traders spend thousands of hours trying to visualize charts and constructing an indelible memory of a few specific price movements or sequences to form patterns and their trading rules. In its most basic form, Technical Analysis is nothing more than the forecasting of price trends based on chart pattern recognition. Chart patterns consist of simple chart techniques like trendlines, channels, flags, pennants etc. to build key trading techniques like breakouts or reversals from a pattern.

Pattern Trading provides the greatest advantage over other forms of technical trading. It provides a clearly defined risk and reward so that traders know exactly how and when to enter and exit the trades. The recognition of patterns within patterns and its body of knowledge of how to react and what to expect, is a definite factor in helping traders achieve success.

F3) Bearish Gartley Pattern with Bullish ABC

I entered a short trade from D ($72 entry) with a stop loss just above D ($74.5). My targets were set at 100%XA at $62 and 162%XA at $54. You can also recognize a bullish ABC pattern (marked in blue).

Source: www.tradestation.com

F4) Bullish ABC Pattern

The chart shows the embedded bullish ABC pattern (in blue). I placed my entry at 63.76. Targets are at 100%AB= $68.23, 127%AB = $70.27 and 162%AB = $72.92, and stop below C ($60). When the ABC pattern is completed, the chart shows a XABCD pattern so we can enter a short trade at D.

Source: www.tradestation.com