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Technical analysis explained – part III

In the previous two articles we learnt how to identify breakout patterns which indicate the formative stages of a bull market. The next logical sequence would be to learn continuation and reversal patterns. These patterns will upgrade your skills on how to identify continuation of bullish patterns and project the price targets. Forecasting will give a tremendous satisfaction cum profit as you can plan your trades accordingly. Continuation patterns are for example are an excellent phase in the markets, you can actually go out and watch movies and play golf as long as the long positions are trending within identified chart patterns. No need to sit in front of a TV screen throughout the session. Last but not the least, reversal patterns which will warn you of the bull markets exhausting their uptrend.

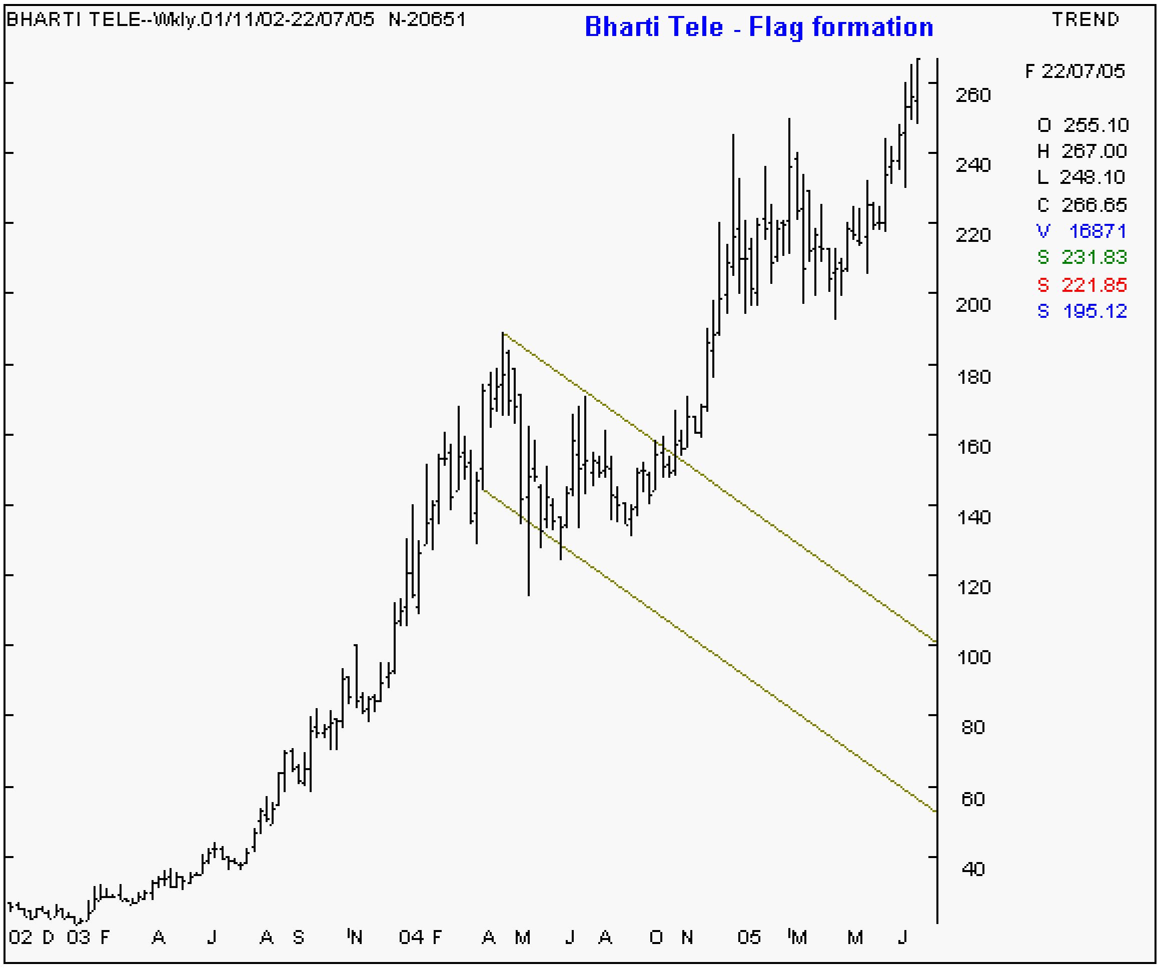
Continuation patterns – channels

Scrips can sometimes move within upward sloping channels for months. This is a bullish continuation pattern, for as long as the channel bottom is not violated, the uptrend is intact. All a savvy trader needs to do is to sit on a long position and wait till the channel is fractured. This pattern helps you to let your profits run and take a laid back approach to investing / trading. Channels were depicted in the previous article.

Flags and pennants

For those who want the power to forecast prices in the future, flags and pennants are excellent tools. Also known for their accurate price measuring capabilities, these formations are a traders best friend. A flag formation consists of a pole, a flag (parallelogram) and a breakout formation. The pole is an initial rally after which the scrip corrects downwards. The downward move is in a channel and forms the flag. The traded volumes during the flag will shrink as traders await a breakout / breakdown before taking a directional call. A flag formation is confirmed only **after** a breakout upwards. As with all price patterns, pre-emptying a pattern can be a perilous affair. The flag formation occurs typically at “half time” of an upmove. So the next time you see a flag on a scrip at 200 levels which started the upmove from 100, you know a similar rally of 100 points is yet to unfold ! A word of caution on flags – they should be of short duration as longer term flags show heavy distribution / profit taking and weakens the rally.

Pennants on the other hand are two converging lines on short term charts which show a narrowing price pattern after a good run upwards. The pattern must see lower traded volumes as traders wait and watch for a breakout / breakdown. A breakout on atleast 50 % higher volumes is needed to make a valid pennant.



Trendlines

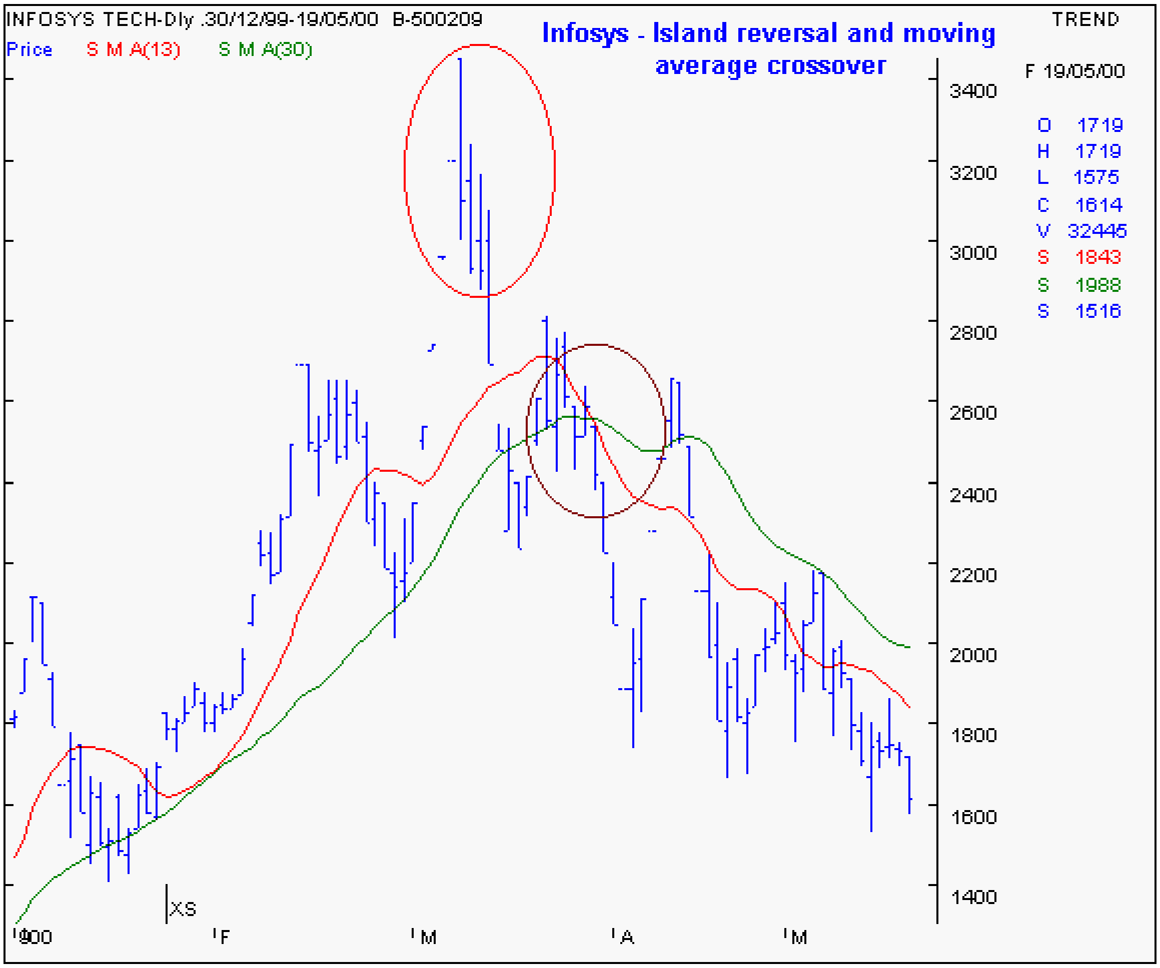
Trendlines are the simplest form of trend continuation. Savvy and experienced traders have waited for months as their long positions moved along a rising trendline and their capital multiplied. A stop loss is placed a few percentage points below the trend line violation levels and the trade is allowed to "run" it's course.

Reversal patterns – Island reversal

This pattern is the first ominous sign of a trend reversal especially if the reversal comes after a major uptrend. The bar will show a gap up opening, a new top and a sharply lower closing as the higher levels are unsustainable. Traded volumes maybe higher but prices refuse to move higher after a bar reversal. That should warn bulls to pare exposure on long positions.

Moving average crossover

A trend reversal will show up on the weekly charts as a price graph violating the short / medium term moving averages. As long as the bull run is on, prices will rise faster than the averages. A reversal will first show up on average crossover is no other pattern has been observed. Traders would do well to cut their long positions and covert to cash atleast 50 % if not 100 %. A further confirmation is when a short term moving average violates a medium / long term moving average in a downward direction. Traded volumes need not be high on the downsides as hope prevents bulls from selling scrips.



Head and shoulder formation

As discussed in the previous article, a head and shoulder formation seen at the fag end of rally will mark a trend reversal. Prices will refuse to move higher and this time the head is above the neckline. This formation is a measuring move as the distance between the neckline and the head will be seen once the neckline is violated lower. It is important that the head and shoulder pattern be confirmed by way of a neckline violation. Pre empting a head & shoulder formation is the most expensive mistake a trader can make.

Now that you are well versed about the forecasting powers using technical analysis, here's hoping you have a safer, profitable and immensely satisfying experience.

Have a profitable day !

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