Lecture №9, Part 2

Graphical Patterns Analysis

Continuation Patterns

The graphical configurations we would look into are called *continuation patterns*. Such models usually mean that the period of price stagnation reflected on the chart is not more than a pause in the trend development, and the trend direction will be the same afterwards. This is the major difference between reversal patterns, which reflect the fracture of the main trend, and continuation ones.

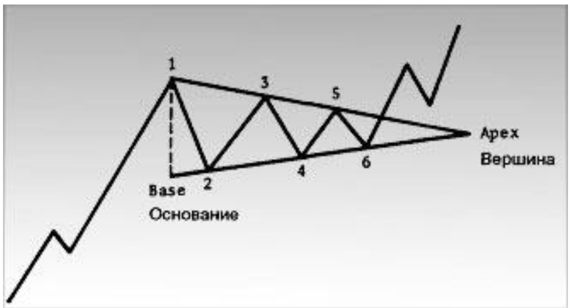
Another criterion of difference between the reversal and continuation models is the duration of its formation. More time is spent for the formation of the former which show cardinal changes in price dynamics. Continuation models are short-term patterns. They should be correctly called intermediate.

Triangles

Let us start with triangles. There are three types of triangles: symmetrical, ascending and descending. All of them are different by shape and have different forecast functions. It should be underlined that triangles often are the last correcting formation which precedes the cardinal top or bottom completing the trend. When this model is forming, you should carefully investigate the chart for the possibility of the main trend's end approaching.

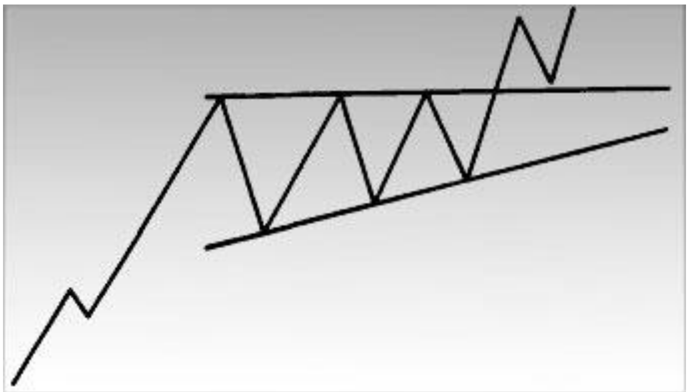
The main varieties of this pattern are shown in pictures 1 a-c. A symmetrical triangle (pic.1a) is formed from two convergent trend lines where the top line is going down and the bottom line is going up.

The vertical line from the left, which determines the height of the model, is called the *base*. The cross point of two lines from the right is the *apex*. The symmetrical triangle is also called a *spiral* for obvious reasons.



Picture 1a. Schematic image of the symmetrical triangle

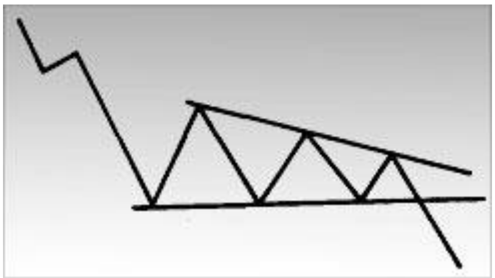
Pic.1 – 1a. Pay attention how the triangle is the last consolidating formation before the top forming



Pic. 1b. Schematic image of an ascending triangle

Pic. 1 -1b. An ascending triangle in the short timeframe formed before the completion of a short-term trend.

A descending triangle (pic. 1c), on the contrary, has a horizontal bottom and falling top lines.



Pic. 1c.

Pic. 1 – 1c. A descending triangle warning us about the forthcoming completion of the 2-weeks bearish trend

A triangle's formation signifies a pause in the present trend, after which the latter is renewing. For instance, in picture 1a the previous trend was ascending and after the price consolidation in the shape of a triangle, their development will continue. In case the descending trend symmetrical triangle would signify that after its completion, the price decrease will resume. The minimum requirement for every triangle is the presence of four point of control. For drawing the trend line as we remember, it is necessary to have 2 points. So to draw two convergent trend lines each of them should go at least through the two points. In picture 1a, a triangle starts forming in point 1 - where the uptrend consolidation forms. Prices are falling to point 2 and then go up to point 3. However, point 3 is lower than point 1. The upper trend line can be drawn only if prices fall from below point 3.

Pay attention to the fact that point 4 is higher than point 2. The lower ascending line can be drawn only when the prices go up from point 4. Only after this moment does the analyst understand that this is a symmetrical triangle. Now we have four points of control (1, 2, 3, and 4) and two convergent trend lines.

The signal for the pattern's completion is given when the closing price surpasses one of the trend lines. Sometimes the *backstroke* of the prices to the trend line is observed after the breakthrough. Depending on the trend's direction – ascending or descending - this line becomes a support or a resistance level. After the breakthrough, the top serves as an important support or resistance level. The criteria for the intersection while the break through can be different, in these cases minimal criterion of intersection is closing price fixed out the bounds of the trend line but not the simple intraday intersection.

Trading rules are the same for all the triangles. It is better not to trade upon the insignificant fluctuation inside a triangle, of course, if this triangle is small. As the triangle reflects older prices, the fluctuations become fewer. Profit decreases and shifts, but commissions keep on eating your balance as before. That is why the best option is to buy or sell respectively during the breakthrough upwards and downwards of the triangle trend line in the direction of the main trend. Stop-losses should be placed above or below the breaking trend line.

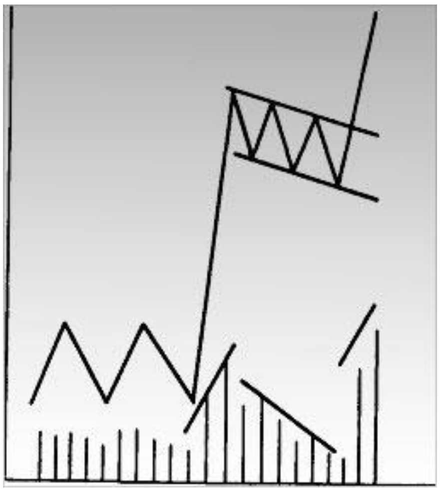
There is a method that allows us to determine the price guideposts the market would reach after the triangle completion. It is rather simple. First measure the height of the model in its widest part and project this distance upward or downward (depending on the direction of the trend). The level derived as a result of this projection will be the price guidepost.

Flag and Pennon

Flags and *pennons* are very widespread on financial market charts. We consider them together because of their similarity. These configurations form in the same area of trend development, they have the same indicators of trading volume, and their interpretation is also similar.

Flag and *pennon* signify the short pauses in dynamically developing trends. A steep line of price movement should precede the formation of these models on charts. They designate the markets which outrun themselves in their development upwards or downwards and should stop for a while before they start moving in the same direction.

Flags and pennons are the most reliable patterns of a continuation trend. Reversal trends occur seldom in these patterns. Look at the example (picture 2) and see how similar these models are. Pay attention to the quick price rising with a big volume, preceding the model formation, and also the swift activity decrease during its formation which gives a signal about a market consolidation. The activity quickly increases after the top trend line breakthrough.



Picture 2: Bullish pennon. It looks like a small symmetrical triangle. This model forms by a small volume. The price movement after its completion must repeat the distance traveled by prices before the model appearance.

The formation of these two models is almost the same. A flag looks like a parallelogram or rectangle limited by two parallel trend lines with incline to the opposite side of the dominant trend. In a downward trend, the flag should be directed upward a little. The pennon model can be determined by two convergent trend lines and a more horizontal position. The pennon is similar to a small symmetrical triangle but differs in scale: if a triangle is forming by several swings of chart movement, then for a pennon formation several candlesticks are needed, which form a little triangle. The flag forms by several candlesticks placed parallel in an oblong shape.

Both models are rather short-term. During a downtrend they need less time to form than in an uptrend. The completion of both models occurs at the crossing of the upper trend line during the uptrend. The breakthrough of the bottom trend line indicates the downtrend resumption.

Picture 3. Bullish and bearish flags and pennons. After the breakthrough of the trend, line movement resumes in the direction of the main trend.

A sharp foregoing pulse is obligatory for flags and pennons' formation; it makes up the pole which the models stand upon.

There are also ways of price guideposts determination, which will be reached when the model is completed. These are similar for both patterns. Flag and pennon models in a way "fly up from the pole to the middle of the mast." This means flags or pennons are placed in the middle of the price increase or decrease.

In aggressive trading the trader takes all the distance the price exceeded before a model formation as a guideline, while in a more careful trading 50% of the distance is taken. It is recommended to open positions when the process of pattern formation is complete, after the breakthrough of the trend line limited the body of the model in the direction of the main trend.

Test questions

1. Name the types of triangles.
2. What is the criterion for the completion of triangle formation?
3. What is the difference between the pennon and the flag?
4. Suppose that the market movement upwards before the flag forming was 80 points and the completion of the pattern formation is breakthrough of level 1.2540. Determine the price guideposts which the market will rise to.
5. Indicate on charts of trading terminals the continuation patterns considered in this lecture.
6. What are the trading rules for triangles?

What is the signal for position opening during the pennon and flag patterns' formation?