THE FIVE CHART PATTERNS
EVERY TRADER NEEDS TO KNOW

There are a number of different tradable patterns seen on futures price charts. These patterns help traders define trends, determine when to get into a trade and when to get out of one.

Chart patterns are a structural part of the futures market (and any market) because they occur based on human psychology, and they work because of human psychology.

Chart patterns occur across all time frames; for example you'll see triangles both on one-minute charts and daily charts. Which patterns you opt to trade is determined by your trading preferences.

Short-term traders focus on patterns that appear on short-term charts, such as five-minute or fifteen-minute charts.

They may also keep an eye on longer-term charts, such as the hourly or daily charts to spot major levels which may affect short-term trading.

Long-term traders focus on daily charts, as the chart pattern trades on this time frame typically don't need constant monitoring and will last several weeks or more.

Here are the five chart patterns every trader should be able to spot and trade:

1) The Triangle
2) Flags and Pennants
3) Head and Shoulders
4) Cup and Handle
5) Double/Triple Tops and Bottoms
THE TRIANGLE

There are three types of triangle patterns: descending, ascending and symmetric. For trading purposes they are all the same. Figure 1 shows a symmetric triangle. It’s symmetric because both lines are angled towards each other. With a descending triangle the lower trendline is horizontal and the upper trendline is descending (angled down). For an ascending triangle the upper trend line is horizontal and the lower trend line is ascending (angled up).

Figure 1. Symmetric Triangle in Light Sweet Crude - Daily Chart

Triangles are often considered continuation patterns because the price is expected to break out of the pattern in the same direction as the prevailing trend. In figure 1 the price was trending higher before the triangle, so an upside breakout is slightly more probable than a downside breakout. The breakout direction doesn't need to be assumed though; traders can wait for the breakout and trade it then.

Trading Triangles

The simplest way to trade a triangle involves buying or selling when the price breaks out of...
the triangle pattern—this could be in the same direction, or against, the prevailing trend. A stop loss order is placed just outside the triangle, on the opposite side of the breakout. A target is established based on the height of the triangle at the widest point, and then added or subtracted from the breakout price (upside or downside breakout respectively).

Figure 2. Trading Triangle Breakout in Japanese Yen Futures - Daily Chart

In figure 2, a short trade is initiated as soon as the price breakout below the lower triangle trendline. A stop is placed above the triangle. The height of the pattern is approximately 10.4 minus 9.90 (where trendlines start, and circled), or 0.50. This is subtracted from the breakout price of 10.03 to give a target of 9.53.

An alternative method is to assume the breakout direction, and then enter a position on the opposite side (within the triangle) of the anticipated breakout. In figure 2 the trend is down so the more likely breakout direction is to the downside. A short trade could have been taken near the upper trendline; the stop loss and target are placed and calculated using the same method discussed prior. With this method, risk is reduced because the entry price is much closer to the stop level, but the breakout direction is unknown at the time of the trade.
Triangles Perks and Disadvantages

No matter what method you use, with a triangle your potentially profit is going to be larger than your risk. This is because the widest part of the triangle is used to establish a target, yet the stop is placed using a narrower part of the triangle.

A disadvantage of triangles is that multiple price swings may not align exactly with the trend-lines. This can make trading them subjective because the exact breakout point is unknown. A triangle could be drawn a number of different ways, in which case it is up to the trader to do decide which version provides the best entry, stop and target.
FLAGS AND PENNANTS

Flags and pennants are also a continuation pattern, although we don't need to assume the breakout direction for these patterns.

Flags and pennants are created by a very sharp price move either up or down--this is the flag pole. The price then consolidates in a tight flag or pennant-like appearance. A flag consolidation is when the price moves between parallel lines. A pennant, which is less common, appears as a very small triangle.

Trading Flags and Pennants

Figure 4 shows a pennant pattern in coffee futures.

Figure 4. Trading a Pennant in Coffee Futures - Daily Chart

The surge higher (or lower) is labeled as the flag pole. This length of the flag pole is used to establish the profit target. In case of upside breakout the flag pole length is added to the bottom of the pennant/flag formation. For a downside breakout the length of the pole is subtracted from the top of the pennant/flag formation.

Source: Thinkorswim
A long trade is taken when the price breaks above the pattern, and a stop loss is placed just below pattern at the time of the breakout. If price breaks below the flag/pennant portion of the pattern, a short trade is initiated, and a stop loss placed just above the pattern at the time of the breakout. A flag is traded and same way. It looks almost the same, except the consolidation, or flag portion, is moving between parallel lines and can be slanted up, down or moving sideways.

Figure 5. Trading a Flag in Emini Euro FX Futures - Daily Chart

Flags and Pennants Perks and Disadvantages

Because the profit target is based on the flag pole is which is typically much larger than the flag/pennant upon which the stop is based, the reward to risk ratio on these patterns is quite favorable. Since the flags/pennants are so small though, false breakouts are common. This is when the price just edges past the pattern trendlines only to move right back into the pattern. These small patterns can also, sometimes, be drawn in different ways, based on different interpretations. This can make choosing which breakout point to use subjective.

Also, traders will need to differentiate a strong move from a normal move. Strong trending moves are common, but a flag or pennant should be based on a move that is larger than what is typically seen. This increases the subjectivity to trading these patterns.
HEAD AND SHOULDERS

A head and shoulders (H&S) pattern is typically a reversal pattern. A H&S at the top of a long trend higher usually indicates the uptrend has lost momentum and is transitioning into a downtrend. A H&S at the bottom of a long downtrend usually indicates the downtrend is over and a transition into an uptrend has begun.

A topping pattern is created by the price making a swing high, then pulling back, then making a higher high, pulling back and then making a lower high. The two pullback lows are connected with a trendline, called the neckline. When the price breaks below the neckline, or the low of the right shoulder pullback, the pattern is considered complete and downtrend is likely underway.

A bottom pattern is created by the price making a swing low, then pulling up, then making a lower low, pulling up, and then making a higher low. The two pullback highs are connected. When the price breaks above the neckline, or the right shoulder pullback high, the pattern is considered complete and an uptrend is likely underway.

Trading Head and Shoulders Reversals

The H&S reversal is the most recognized by traders, yet because it is occurs at major market turning points, it isn't seem frequently or daily or weekly charts. It is seem more frequently on hourly charts, or smaller time frames.

Figure 6 shows a H&S topping pattern in oat futures. Figure 6. Trading a Head and Shoulders Topping Pattern in Oat Futures - 4 Hour Chart
Once the right shoulder has formed there is potential for the pattern to complete. In order to complete, and initiate a trade, the price should break below the neckline. Occasionally the neckline will be at a steep angle, either up or down, making it ineffective as an entry point. When this occurs, the pattern is considered complete the price breaks below the low of the pullback on the right side of the pattern.

Enter short when the price breaks below the neckline. If already in a long position, this is also sign that the uptrend is over and the price is likely to trend lower.

The profit target is based on the height of the pattern. The head is near 500 and the low of the right shoulder is near 420, making the height of the pattern approximately 80. This is subtracted from the breakout price of 420 to give a target near 340.

The process for spotting and trading a H&S bottoming pattern is the same, except the head and shoulders will be upside down—commonly called an inverse head and shoulders pattern. In the case of an upside breakout from a bottom H&S, the height of the pattern is added to the breakout price to give the target.

**Head and Shoulders Reversals Perks and Disadvantages**

Since the profit target is based on the whole height of the pattern, and the stop is based on the right shoulder, the potential reward for the trade is larger than the risk. This is favorable.

If the right shoulder is almost as high as the head though, the reward to risk ratio approaches 1:1, which isn't ideal. Focus on patterns where the right shoulder shows a lot of weakness, and peaks well below the head.

Head and shoulders usually don't appear perfectly, with only a left shoulder, head and right shoulder. In the real world the patterns can be more complex. For example there may be two left shoulders, a head and two right shoulders. The pattern is traded in the same way, but it can take time to see the overall structure of the H&S when it doesn't appear exactly like a text book example.
CUP AND HANDLE

The Cup and Handle is traditionally a reversal pattern, and is usually associated with market bottoms, but can also be seen at market tops. It can also be a continuation pattern, when seen in the context of the trend--these are often the best patterns to trade since the trade direction aligns with the current trend.

A bottoming Cup and Handle occurs when the price trends lower. It then levels off and rallies up to the start of a prior downtrend wave. This creates a cup-like appearance. The price then consolidates near the top of the cup (lip), creating the handle.

A Cup and Handle that marks a potential top has the same characteristics but is flipped upside down. The price trends higher, levels off and then declines to the start of a prior up wave. This creates the cup, and the price consolidates near the lip of the cup to create the handle.

Trading the Cup and Handle

For the bottoming pattern, let the cup and handle form. The handle should be relatively small in size compared to the cup, approximately 50% of less. For example if the Cup is 10 points high, the handle should ideally be 5 points or less in height. The small handle shows buyers are willing to step in and support the price. Buy on a breakout above the handle. This will require drawing trendlines on the handle to define its edges. Figure 7 shows this in action.

Figure 7. Trading Cup and Handle Continuation in British Pound Futures - 4 Hour Chart
Place a stop loss just below the handle to control risk on the trade. The cup and handle does not have a specific price target since it attempts capture the ensuing trending waves in the breakout direction—this can result in long-term or short-trades.

One way to estimate a profit target is to add the height of the cup to the bottom of handle. In figure 7 the high point of the cup is 1.6793 and the low point is 1.6462, for a height of 0.0331. This is added to the low point of the handle at 1.6689, for a target of 1.702. Sometimes the price won't make it to the target, and other times it will surpass it. Therefore, this profit target calculation should only be used as an estimate.

Trading a topping Cup and Handle is similar. Let the upside down cup form, and the handle which develops shouldn't retrace more than 50% of the cup. Short when the price breaks below the trendline of the handle, and place a stop just above the handle. There is no specific target since the trade attempts to participate in the downside trend which develops following the handle. A target estimate can be created by taking the height of the cup and subtracting it from the top of the handle.

**Cup and Handle Perks and Disadvantages**

Cup and Handles can mark significant trend changes, and the new trend can last a long time resulting in big profits for a small amount of risk. Even when seen as a continuation pattern, the trending wave(s) following the handle breakout will typically more than compensate the trader for the risk.
The downside is that breakouts from handles can be hard to pinpoint. Not every handle will be easily defined by trendlines, in which case the trader may need to estimate the breakout price. Spotting cup and handles can also be subjective; they are a fairly common pattern. In figure 7 a large Cup and Handle bottoming pattern is shown. Within that pattern though there is smaller cup and handle, shown in figure 8.

Both these patterns (figure 7 and 8) highlight another potential drawback--breakouts may occur on price gaps, which means the price paid to enter the position is different than the anticipated breakout price. This can dramatically increase the risk as the entry point is further from the stop price than expected. Usually the ensuing trend will still compensate the trader for his or her risk though.

**DOUBLE/TRIPLE TOPS AND BOTTOM**

Double and triple bottoms are reversal patterns that signal a downtrend has run out of steam and is now reversing to the upside. A double bottom is created when the price makes a new low, rallies, declines back to same area as the prior low and then rallies gain. This second low may be slightly lower or higher than the prior low but should be in the same area.

A triple bottom is similar, except the same point is tested three times. The price declines to a new low, rallies, declines to that point again, rallies, declines there again and then rallies.

Since the price isn't able to drop much below the former low shows sellers are losing strength and buyers are stepping in.

Double and triple tops are reversal patterns that signal an uptrend is reversing. Double tops are created when the price makes a new high, declines, rallies back to the same point and then declines again. For a triple top the price makes one more run to the former high points and then declines again.

Since the price is unable to make progress higher, on multiple attempts, shows that the next most likely direction is lower.

**Trading Double/Triple Tops and Bottoms**

For a double or triple bottoming pattern, buy when the price breaks above the high point(s) of the rallies which separate the low points.

Traditionally the stop loss is placed below the double or triple low point, but once the break higher has occurred, any swing low can low be used. Using a stop that is higher than the lows reduces risk, since the stop is closer to the entry price. Figure 9 shows the "traditional" stop level and "alternative" stop loss levels.

A profit target can be established based on the height of the pattern. Measure the distance from the low points to the high points (rallies) between them, then add this distance to the breakout point. In figure 9 the low of the pattern is approximately 16, the high is very close to 17.50, so the height is 1.50. Add this to the 17.50 breakout point for a target of 19.
This is one potential exit. Since double and triple bottoms can mark major trend reversals, it is possible that greater profits can be achieved if a strong trend does indeed develop. Sometimes the price may not even reach this target though; there are no sure things in trading.

Figure 9. Triple Bottom on Sugar Daily Chart

Source: Thinkorswim

A double or triple topping pattern is pattern is traded in the same way, except everything is flipped upside down. Figure 10 shows this action. Notice the highs are not at the exact same level; this is quite common. Yet the pattern is still relevant, because it shows that on the second attempt the price was unable to climb above the former high before falling again.
The price makes a high, then pulls back, makes another high and the declines below the pullback low. This signals a short entry. A stop can be placed above the major highs, or above a slightly lower high to reduce risk. Subtract the height of the pattern (high point to pullback(s) low) from the breakout point (pullback low).

Double/Triple Perks and Disadvantages

These patterns indicate major trend reversals, and can therefore aid in overall analysis or be used for trading purposes. The downside of trading these patterns is that the reward to risk ratio isn't favorable; usually it is 1:1 if using a traditional stop loss. This is because the target and the stop both accommodate for the whole pattern. Ideally traders will want to make more on their winners than they lose on their losers. Finding an alternative stop, or using a trailing stop (a stop that reduces risk as the price moves in your favor) can aid in this regard. Also, the profit target based on the height of the pattern isn't mandatory. If a major trend reversal does unfold a larger profit can attained by allowing the price to run in your favor, instead of using a fixed target. This approach requires a lot of disciple though, and you'll need to put work into determining your own personal exit strategy.
THE FINAL WORD

Chart patterns are seen across all time frames and across all markets, making them highly tradable for all types of strategies, whether short-term or long-term. These patterns occur because traders and investors need time to process information and collect themselves, before entering the market in mass again. Chart patterns capitalize on this by waiting for a pattern to develop that shows there is conviction behind a new move—a breakout.

Focus on chart patterns that provide a bigger potential reward than what you are risking on the trade. If a profit target estimate is the same as what you are risking, skip the trade. Always use stop losses to help control risk. A profit target doesn't always need to be used, but you should always know exactly how and why you will exit a profitable trade, before you even place the trade.

Risk a small amount of your capital on each position, that way even several losing trades in a row won't significantly draw down your account.

This special report was produced by: Cory Mitchell, CMT