eurotrader

Advanced Technical Analysis

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CHART PATTERNS

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Cup and Handle

The Cup and Handle is a **bullish continuation pattern**. It consists of two parts: the cup and the handle. Once the cup is completed, the handle is formed on the right side of it. If it is followed by a breakout from the resistance line, traders consider it a signal of an uptrend.

This pattern can only be recognized on **long-term charts**. The cup takes one to six months to be formed, while the handle's formation spans from one week to a month.

Ascending and Descending Triangles

The **Ascending Triangle** is a **bullish** pattern that usually forms during an uptrend while the **Descending Triangle** is its **bearish** counterpart.

For the pattern to be complete, the price needs to bounce **twice** off the **support level** and **twice** off the **resistance level**. When it subsequently breaks out of the triangle, the price is assumed to continue in that direction. It is important to note that the resistance line for an Ascending Triangle and the support line for a Descending Triangle must be horizontal and not inclined.

The strongest signals come from triangles that take three to four weeks to form, however they could appear in shorter time frames.

Rising and Falling Wedges

Wedges are **reversal patterns** that form when price waves move within a narrowing range. They are similar to Ascending and Descending Triangles with the fundamental difference being that, with the Triangles, one of the two lines has to be horizontal. In a Wedge, **both lines must be inclined**.

As with the Triangle, the **pattern completes with a breakout**, which indicates that the price is going to continue in that direction. If a Wedge is angled downward, it is called a Falling Wedge and the prices are expected to break out of its top line. The opposite is known as a Rising Wedge and the breakout is typically on the downside.

Triple Top and Bottom

A Triple Top and a Triple Bottom are **reversal patterns**. A Triple Top starts when the price subsequently **bounces off a resistance level three times** after being in an uptrend. The pattern completes when the price drops below the latest pullback low. That is considered a signal to sell, as the uptrend is over and lower prices are on the way.

A **Triple Bottom** is the **opposite** of a Triple Top. It occurs after a downtrend and indicates that the price is no longer falling and a reversal is about to begin.

Head and Shoulders

Head and Shoulders is believed to be one of the most reliable **reversal patterns**. It starts after a long bullish trend when the price rises to a peak and pulls back. Then, the price soars again to a significantly higher peak, but declines again. Finally, the price goes up for a third time, but only reaches the level of the first high. It subsequently pulls back, completing the pattern, which signals that the uptrend is ending and the price is about to decline.

The first and third peaks are **shoulders**, while the second peak is the **head**. The support level is called the **neckline**.

As with other patterns, there could also be an **inverse Head and Shoulders**, which occurs after an extended downward trend and indicates that the price will go up.

JAPANESE CANDLESTICK PATTERNS

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History of Japanese Candlestick Analysis

One of the first people known to use past prices to predict future price movements was Japanese merchant Munehisa Homma. He raised his fortune trading in the rice market in the 18th century. Homma's family had a huge rice farming estate which meant that the information about the rice market was always available to them.

In order to learn about the psychology of investors, Homma kept and analyzed records of yearly weather conditions going back more than a hundred years.

To receive the market news faster, Homma set up his own communications system. He placed men on rooftops to send signals using flags at prearranged times. These men stretched all the way from Osaka to Sakata, covering more than 600 kilometres.

Over his lifetime, Homma had written several books and the candlestick patterns he described in them became known as the Sakata Rules. They are believed to have become the basis of modern candlestick charting.

You can spot the militaristic Japanese spirit in pattern names, such as Night and Morning Attacks, Three Advancing White Soldiers, Counterattack Lines, Gravestone, and others.

Benefits of Using Candlesticks

Candlestick charts excel in visual appeal and readability. A trader can glance at a candlestick chart and will quickly understand what is going on with the price of a security and who has dominated a given period — buyers or sellers.

In addition, candlesticks form patterns that can be used to identify suitable points to enter or exit the market. Traders can use these patterns by themselves, but usually they combine the patterns with technical indicators to get more reliable predictions.

Candlestick Structure

The thick part of the candlestick is called the real body. It represents the range between that session's opening and closing prices.

When the real body is red, it means the closing price of the session was lower than the opening price.

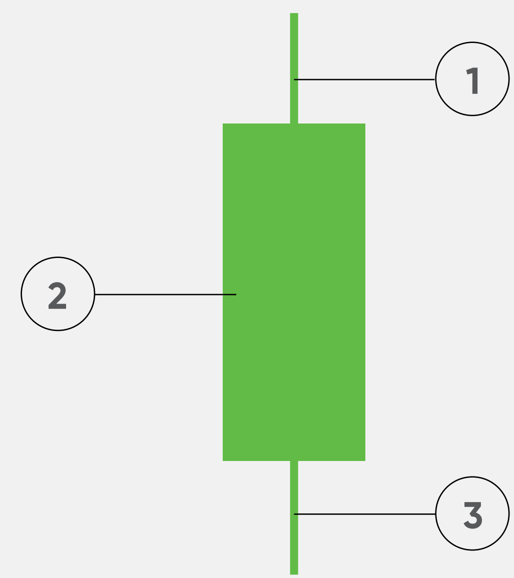
If the real body is green, it means the security price went up over that time period.

The thin lines above and below the real body are called the shadows. They represent the session's price extremes.

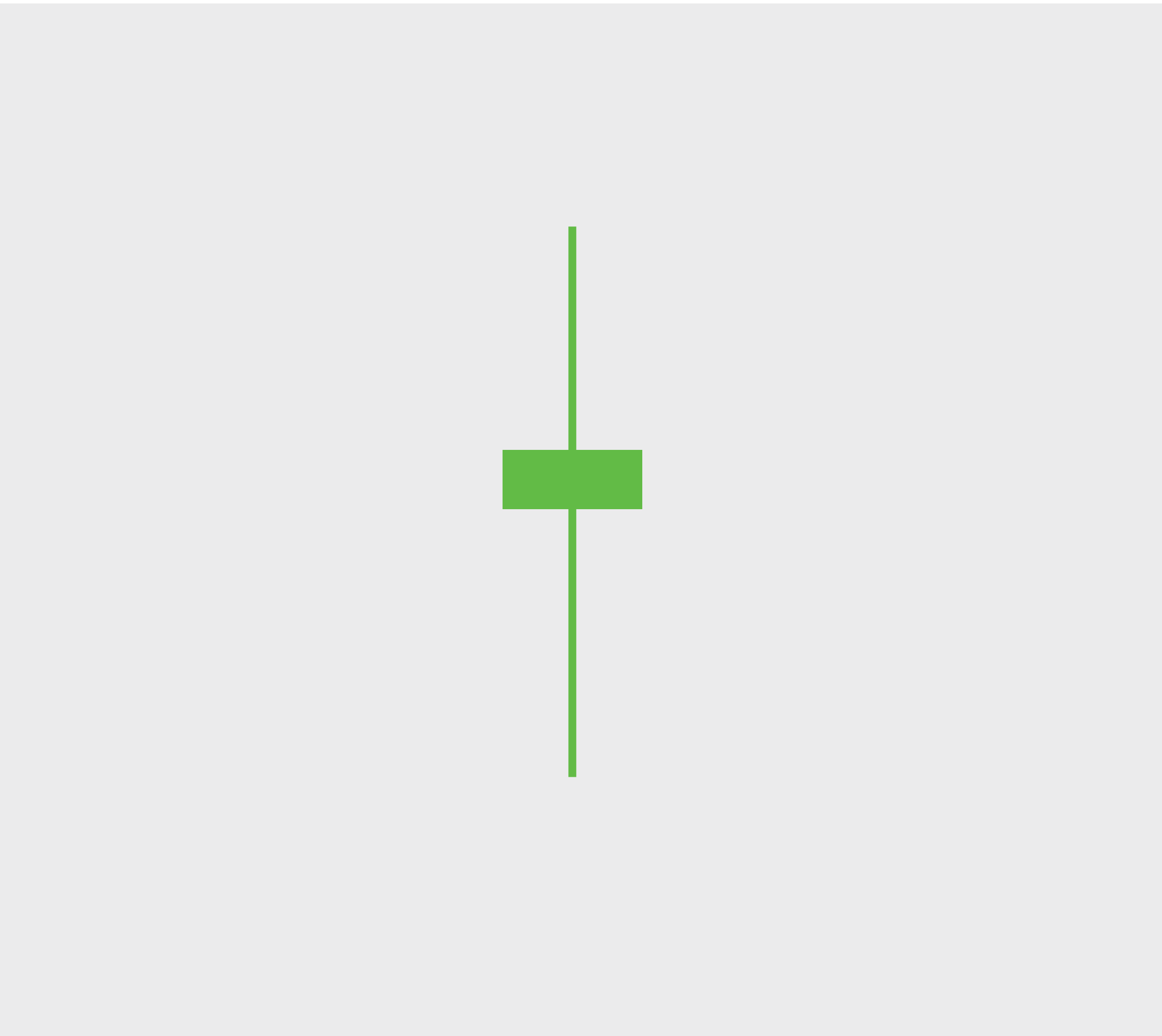
The shadow above the real body is called the upper shadow. The peak of the upper shadow is the highest level the price has reached during the session.

The shadow under the real body is known as the lower shadow. The bottom of the lower shadow is the lowest price of the session.

If a candlestick has no upper shadow, it is said to have a shaved head. A missing lower shadow on the other hand is called a shaved bottom.



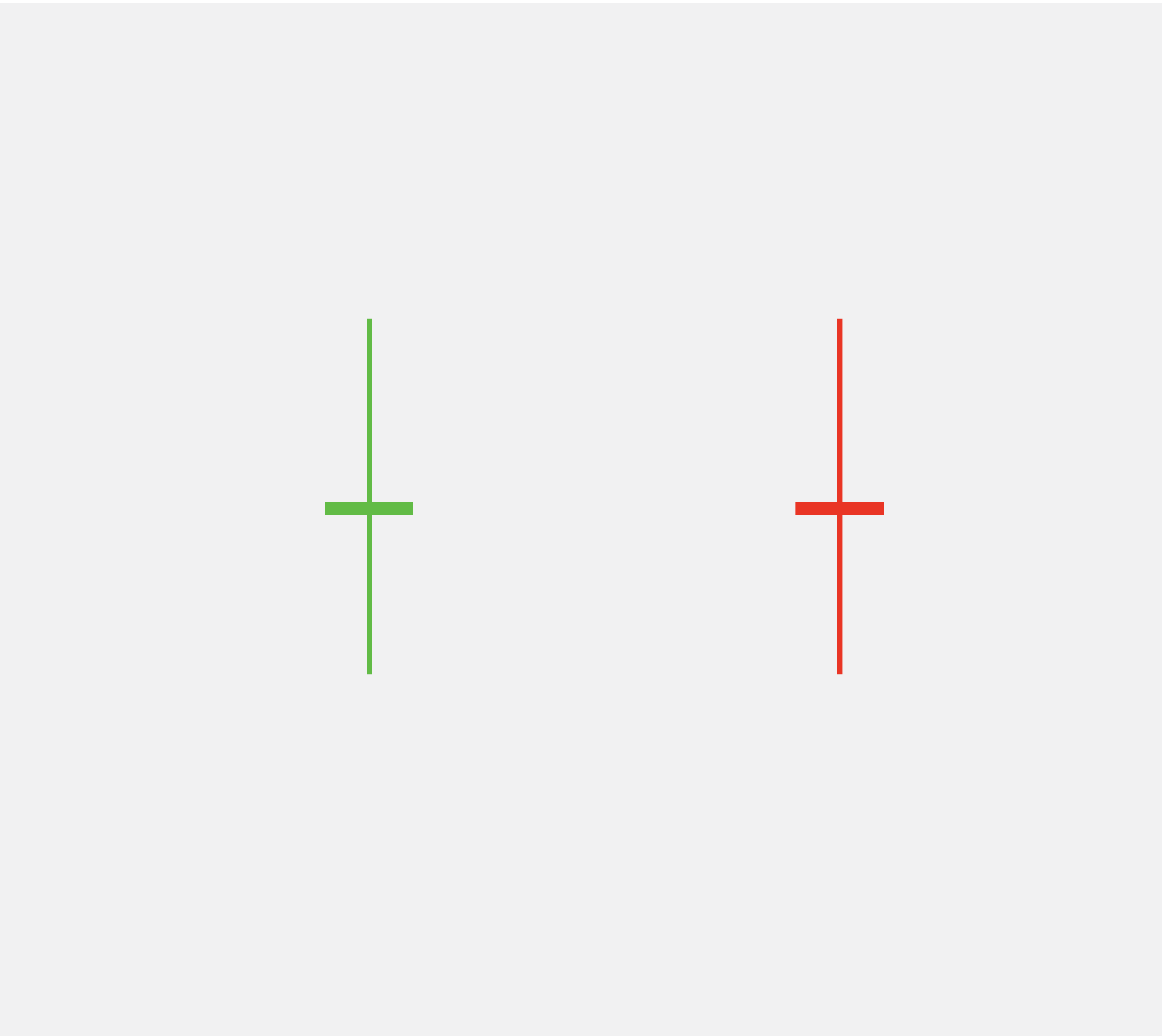
Candlestick Structure



If a candlestick has a short real body positioned in the middle, that means a struggle between the bulls and the bears. Such a pattern is known as a spinning top.

Sometimes a trader can stumble upon a candlestick where the real body is so short it is almost impossible to see. That means that the price returned to its initial level over the course of the session and such a candlestick is called a doji.

Doji



A perfect doji session has almost no difference between the opening and the closing prices. However, if recently there's been increased volatility on the market, a candlestick with a real body a few ticks long would still fall under the definition of doji.

A doji can be an important trend change indicator because it embodies traders' indecision and a possibility that they will not be able to maintain the current trend. The significance of a doji heavily depends on the context, for example, if there is a series of small real bodies preceding the doji, it would not be considered a valid signal. If, however, a doji is formed after a very long trend or there are signs that a reversal is due, it is deemed significant.

Some traders treat the doji as a warning that is better to adhere to, so they choose to take their profits in case it's a sign of a prior trend losing its strength.

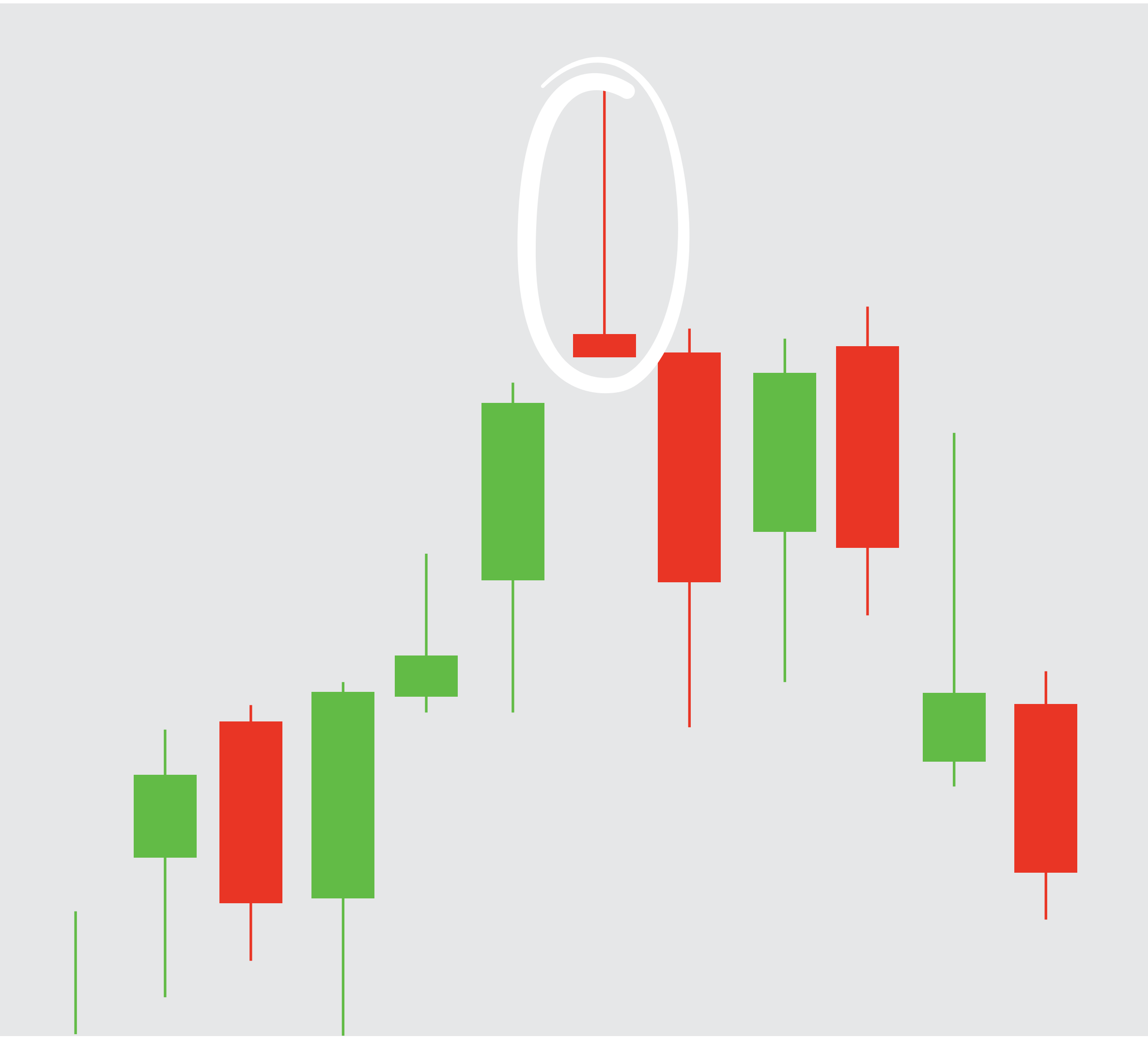
The Long-Legged Doji and the High Wave

The Long-Legged Doji pattern can be identified as having long upper and lower shadows and a nearly non-existent real body located near the middle of the candle. The pattern, also known as the Rickshaw Man, indicates a period of indecision in the market as during the trading session the price has risen, then plummeted before returning to the opening level.

The Long-Legged Doji plays a particularly important role when it appears during a strong trend as the indecision could result in a price reversal. Traders can enter the market right after the candle closes, or wait for a confirmation. The signal could be considered valid if in an uptrend the following candlestick closes below the pattern's lower shadow. During a downtrend, the next candle needs to close above the upper shadow of a Long-Legged Doji.

The Long-Legged Doji can be confused with a candlestick pattern called the High Wave. It also has long shadows from both sides, but the body of the High Wave is slightly bigger. This pattern indicates the market's confusion about where prices are heading as well, so you should wait for the next candle to confirm whether the trend will continue or reverse.

The Gravestone Doji and the Dragonfly Doji



The Gravestone Doji is formed when the opening and closing prices are at the level of the daily minimum with a long upper shadow. Most of the time the pattern appears after an uptrend, but occasionally it can be encountered after a downtrend as well. In either case, it signals a reversal.

The pattern starts with the price going up sharply after the trading session opens. Then for those who have opened long positions, trouble begins: by the end of the session, prices drop straight to the session's minimum. The higher the upper shadow, the stronger the bearish potential of the doji.

The opposite of the Gravestone Doji is the Dragonfly Doji. It's a bullish pattern that looks like a reversed Gravestone Doji and can usually be found during a downtrend, but sometimes appears during an uptrend. The Dragonfly Doji also marks a potential reversal, but both patterns require volume and the next candle for confirmation.

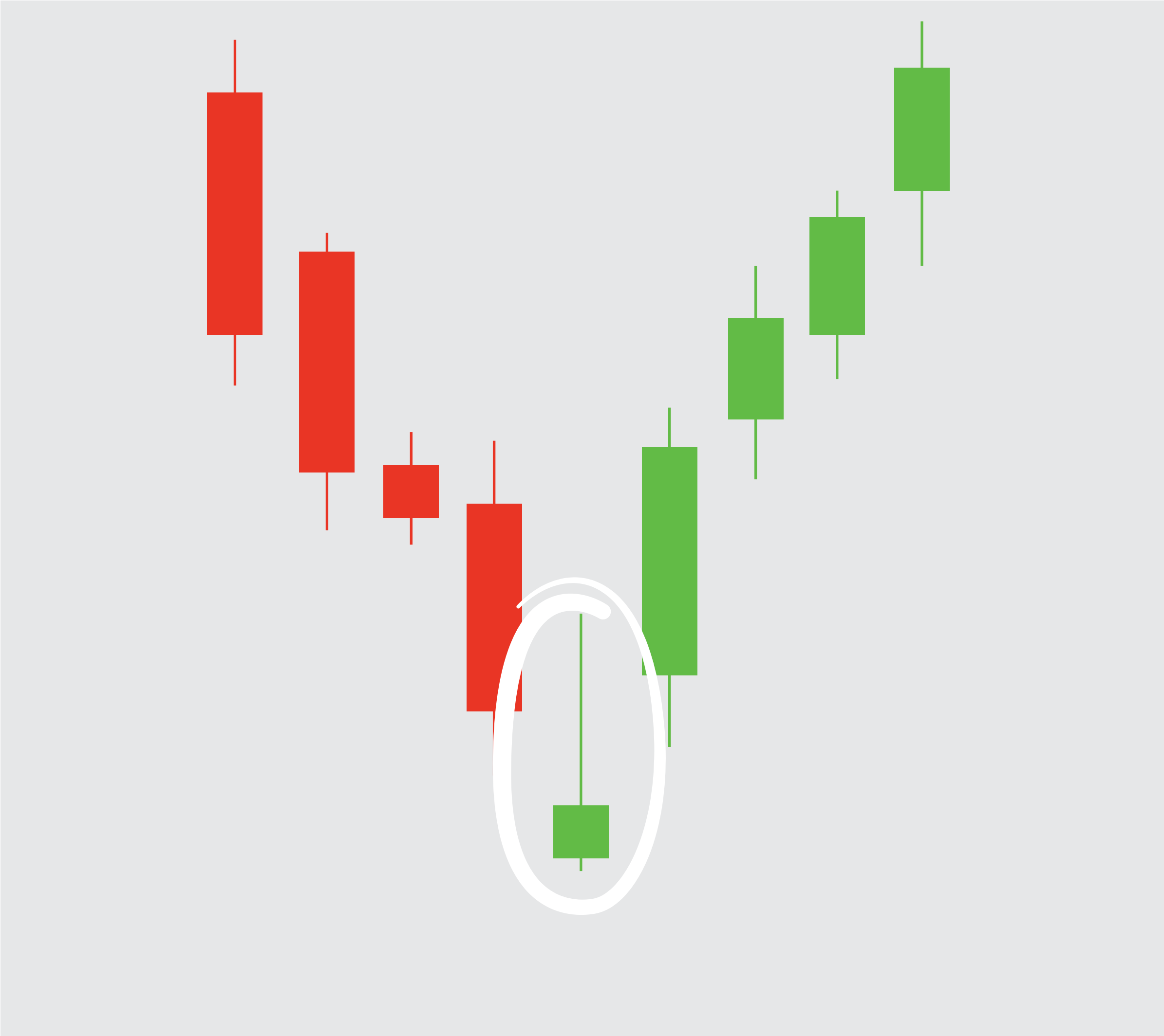
Some traders argue that the Gravestone Doji and the Dragonfly Doji should be seen simply as indicators of indecision in the market rather than strong bullish or bearish signals.

Shooting Star and Inverted Hammer

The shooting star is a one-candle pattern encountered after an uptrend that can signal a reversal. It has a long upper shadow and a small real body located at the bottom of the candle. Similar to other star patterns, the color of the body is insignificant. An ideal shooting star has a gap between its body and the body of the previous candlestick, but a gap is not necessary.

If the price drops over the next session, it could be considered a confirmation of the reversal and traders may open a sell position. But if the price rises after a shooting star, then its upper shadow could become a resistance level. If it continues to rise further, the signal should be deemed false as the uptrend is still ongoing.

A similar pattern to the shooting star is the inverted hammer. Visually, they're identical — both have long upper shadows and small real bodies near the bottom of the candle, with little or no lower shadow. The difference lies in the context. While the shooting star occurs after an uptrend, the inverted hammer is a bullish pattern that is formed after a downtrend and signals a potential bottom reversal. To validate the pattern, a confirmation is required as well. It can be a gap up while the volume is high, or a bullish candle with a higher price level.



Shooting Star and Inverted Hammer

To explain why this pattern is considered a signal of a reversal, let's look at the session of the following day. If the opening price is higher than the body of the inverted hammer, those who have taken short positions at the opening or closing prices of the previous day start to lose money. The longer the market holds above the body of the inverted hammer, the more likely it is that these short positions will be closed. This may cause a jump in price which will encourage traders who are waiting for the end of the downtrend to open long positions, which in turn will lead to further price increase.

Dark Cloud Cover

The dark cloud cover is a top reversal pattern that consists of two candles, appearing after an uptrend or at the upper border of a price range.

The first session needs to be a candlestick with a strong real body. The next day the opening price must be above the upper shadow of the first candle, but at the end of the day the candlestick must close below the midpoint of the previous bullish candle. It is preferred for the body of the second candlestick to cover more than 50% of the first one and if there is a bearish candle right after the pattern, it can be considered a confirmation.

Most traders also look to other indicators for additional confirmation. For example, if RSI is greater than seventy, it means the asset is overbought and a reversal is more likely.

Three White Soldiers and Three Black Crows

Three White Soldiers is a group of three bullish candlesticks with consistently rising closing prices. The opening price of each candlestick is within or near the real body of the preceding candle and the closing prices are equal to the maximum prices or trying to reach them. When this pattern appears after a downtrend, it's a sign of a potential bullish dominance on the market.

To be considered a reliable reversal signal, the Three White Soldiers pattern needs to be confirmed by technical indicators like the RSI. Sometimes, there is a short consolidation period following the pattern even though overall market sentiment remains bullish. Consolidation could also take place if a significant move to the upside reaches major resistance levels.

The opposite of the Three White Soldiers is the Three Black Crows pattern; it indicates that an uptrend might have just reversed into a downtrend. Volume and technical indicators should also be looked at for confirmation in this case.

It's worth noting that in both the Three White Soldiers and the Three Black Crows, all three candles must have long bodies. If the bodies get progressively shorter with each candle, that is known as either the Advance Block pattern, or the Stalled pattern.

Morning Star and Evening Star

The morning star is a bottom reversal pattern that evolves over a three-day period and signals that the bulls have seized the initiative. It starts with a candle with a long bearish body, followed by a gap and a candle with a small body. On the third day, a bullish candle appears. It needs to have a body almost as big as the first candle's to finish the pattern.

An ideal morning star pattern contains price gaps both before and after the middle candlestick, but in fact the second gap can be observed quite rarely. However, real-world experience proves that its absence does not diminish the significance of this model.

To understand the logic of the pattern, let's go over each of its stages. The first candle with a red body means that the price is falling and the bears rule the market. Then there is a candle with a small body, which shows that the sellers are running out of the forces necessary to further move the market down. Finally, the appearance of a strong green body the next day proves that bulls are starting to seize the initiative.

Morning Star and Evening Star

The counterpart of the morning star is the evening star. It you see it after an uptrend, it can be considered a signal of a reversal. It consists of a long bullish candle, followed by a small bullish or bearish candle, and finalised by a red candle that's similar in size to the first candlestick.

Like a morning star, the perfect evening star has two gaps, but an instance with a gap only between the first two candles is also considered valid.

FIBONACCI TRADING

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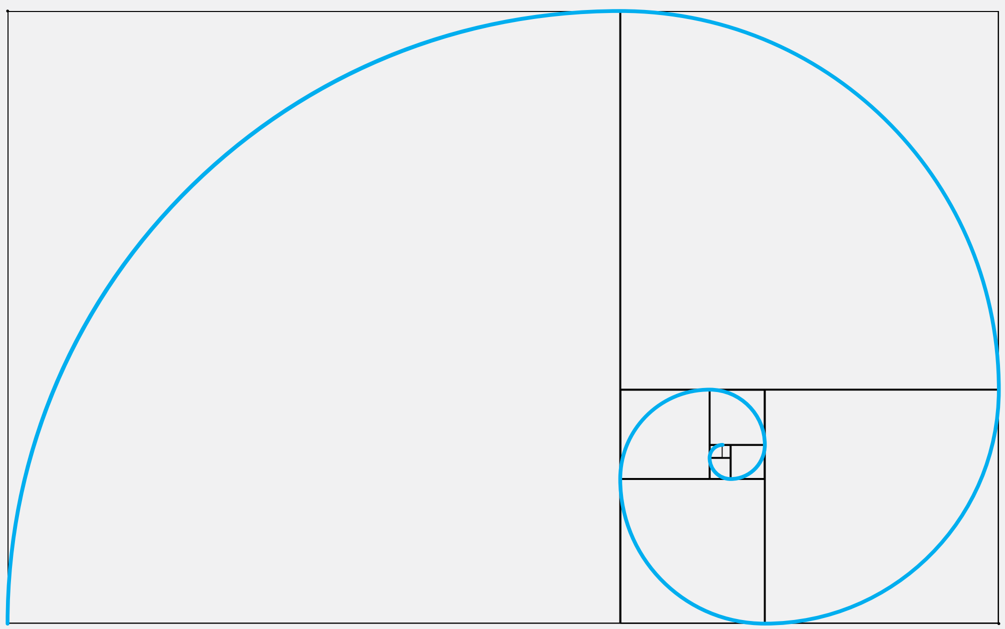
What is Fibonacci Trading?

Fibonacci tools are based on the series of numbers identified in the 13th century by mathematician Leonardo Bonacci, commonly known as Fibonacci. The sequence is infinite and each number is the sum of the two numbers before it, so 3 comes from adding up 2 and 1, and 21 is a sum of 13 and 8. The main characteristic of the sequence is that each number is approximately 61.8% of the next number, 38.2% of the following number, and 23.6% of the number after that.

Trading platforms usually offer several Fibonacci drawing tools: retracement, extension, fan, arcs, and time zone. We'll focus on retracements and extensions as they are the most popular among traders. The concept behind Fibonacci retracements is based on a theory that after a significant movement the price will pull back to a previous price level before continuing in the original direction, which means the Fibonacci levels can act as support and resistance. The opinions regarding which levels to use differ, but the three most common Fibonacci retracements are 38.2%, 50%, and 61.8%. The 50% level is not derived from a Fibonacci number, but is included because assets tend to continue moving in a certain direction after they complete a 50% retracement.

Fibonacci extensions are used to identify Take Profit levels, anticipate how far the price can reach once a retracement is finished, and establish potential reversal levels. The most common Fibonacci extensions are 61.8%, 100%, and 161.8%.

How Reliable are Fibonacci Retracements



All Fibonacci tools are based on ratios that are derived from what is essentially a mathematical irregularity without any logical foundation. While not fundamentally wrong, some traders would like to understand the logic a trading strategy is built upon.

There is also an opinion that Fibonacci levels work only because many traders use the same levels to enter and exit the market which makes them a self-fulfilling prophecy. However, this argument can be applied to all universal trading strategies, if not technical analysis in general.

Another argument against Fibonacci retracements is that they can only point to potential reversals and corrections, not providing easily identifiable signals.

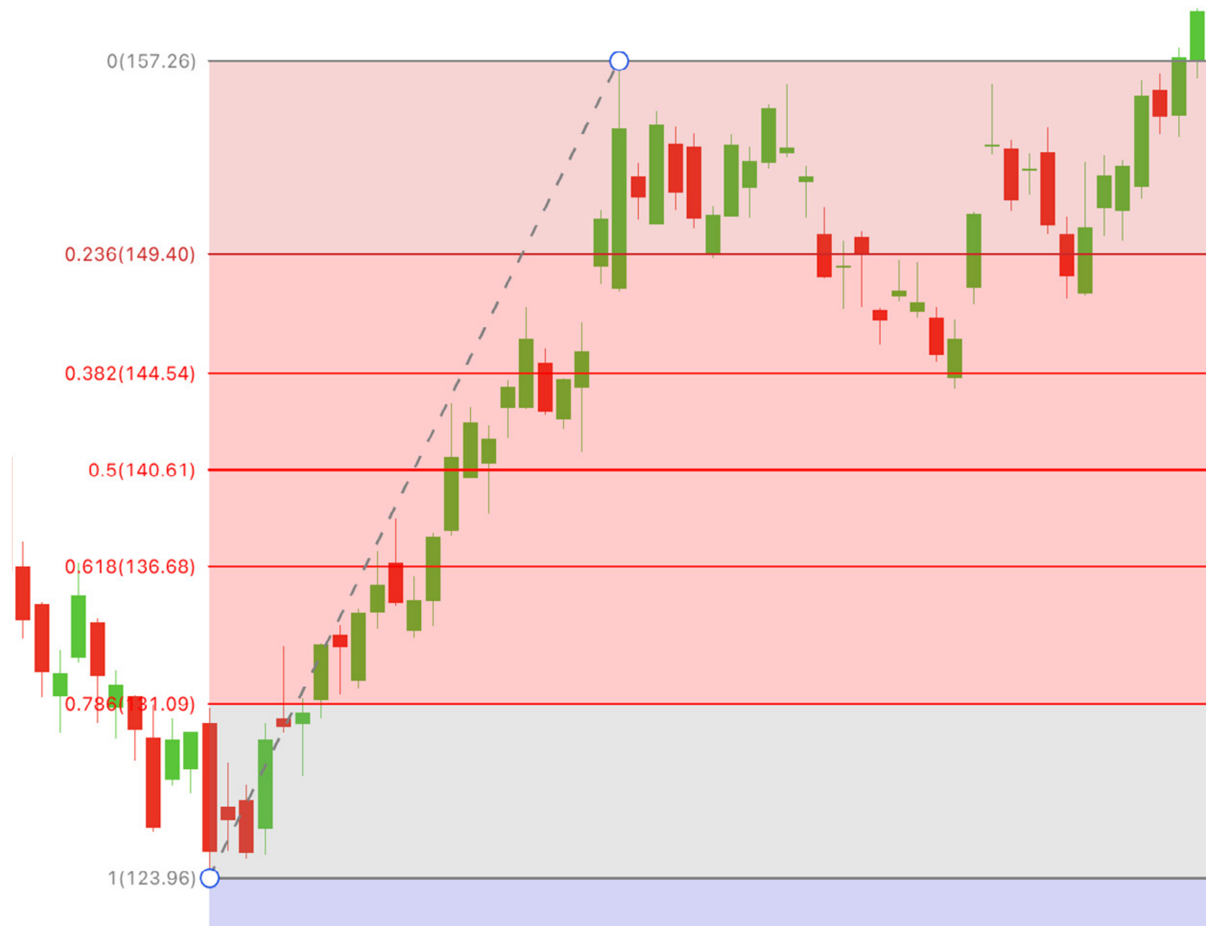
All of that said, plenty of traders have made profits from Fibonacci retracements.

How to Trade Fibonacci Retracements

Fibonacci retracements work best during long-term trends, so make sure you find the primary uptrend or downtrend. Then identify Swing High and Swing Low points. A Swing High is a peak reached by the price that forms when the high of a price is greater than a number of highs around it. A Swing Low is the opposite of a Swing High, it appears when a low is lower than surrounding prices.

When you've found the lowest Swing Low and the highest Swing High of the main trend, use the Fibonacci retracement tool to connect the starting point with the end point. Once you've applied the Fibonacci levels, simply treat them as potential support and resistance levels. The most proven retracements are 38.2%, 50%, and 61.8%.

No matter which direction the current trend is going, wait for a pullback to complete and open a position once you have a confirmation that the price has bounced off a retracement level. Don't forget to place a stop loss slightly below that retracement level for an uptrend and just above it for a downtrend, in case the price breaks through it after all.



How to Trade Fibonacci Retracements

The commonly monitored levels for a strong trend are 38.2% and 50%, while in a weak trend the price could retrace to the 61.8% level.

If you decide to use Fibonacci retracement levels, keep in mind that they are not to be treated as hard reversal points, but rather as levels to be aware of. You should always wait for a confirmation of a re-versal from technical indicators.

How to Trade Fibonacci Extensions

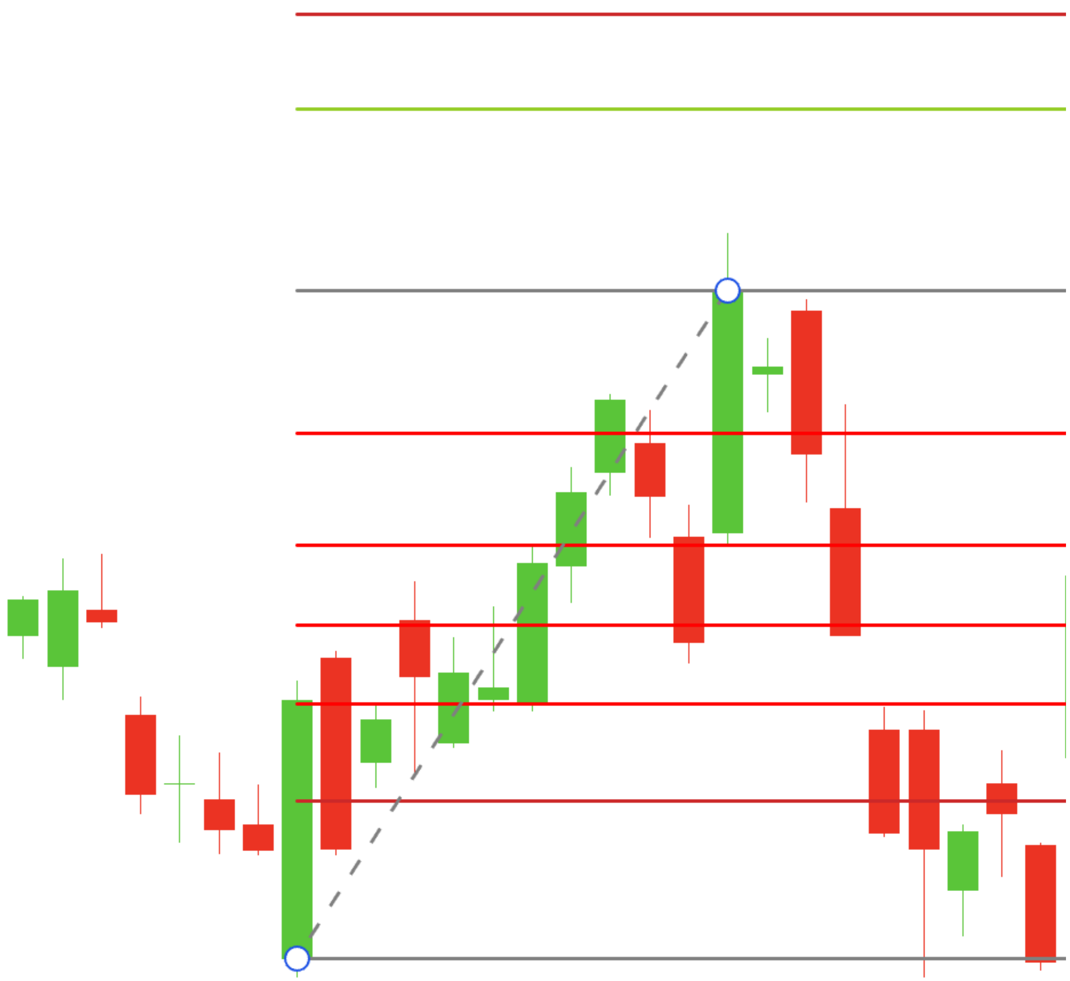
While Fibonacci retracements show where the price could stop its pullback and revert to the original trend direction, Fibonacci extensions help establish how far the price can reach before another retracement.

To add the extension tool on the chart, you need to choose three points. The first point should be placed at the start of a price move, the second point at the end of it, and the third point at the end of the retracement. Subsequently you will see extensions levels appear over the chart.

Common Fibonacci extension levels are 61.8%, 100%, and 161.8%. They act as potential resistance levels so traders can use them to place Take Profit orders or open positions in the opposite direction of the trend.

Fibonacci extensions alone are not supposed to be used for making trading decisions. It is recommended to combine them with other indicators or patterns to confirm that a reversal is indeed about to take place.

Common Mistakes with Fibonacci Tools



When applying Fibonacci tools to the chart, be consistent with choosing the reference points: connect either wick to wick, or candle body to candle body. Also make sure you correctly identify the main long-term trend as less experienced traders tend to measure pullbacks in the short term which leads to weak signals.

Another common mistake is using Fibonacci tools on short time frames. High volatility during day trading means that support and resistance levels are less reliable which makes it hard for a trader to pick retracement levels and set stop losses and take profits, although it's worth noting that some traders don't see it this way and apply Fibonacci tools even to tick charts.

Finally, do not make trading decisions based on Fibonacci tools alone. Waiting for a confirmation from technical indicators like MACD and stochastic oscillators will help you avoid false alerts, increasing the probability of a successful trade.

THANK YOU FOR CHOOSING OUR SERVICE.

WE WISH YOU SUCCESSFUL TRADING!