Stock Markets Guides

Author: Nishit Kumar

Trading Patterns In-Depth Guide

A major part of your day when trading the markets involves you trying to spot trading patterns.

As time passes, you will get better and better at identifying trading patterns. Still, in the initial stages of your trading, you will have to spend quite a lot of time and effort spotting patterns so that you can open and close positions accordingly.

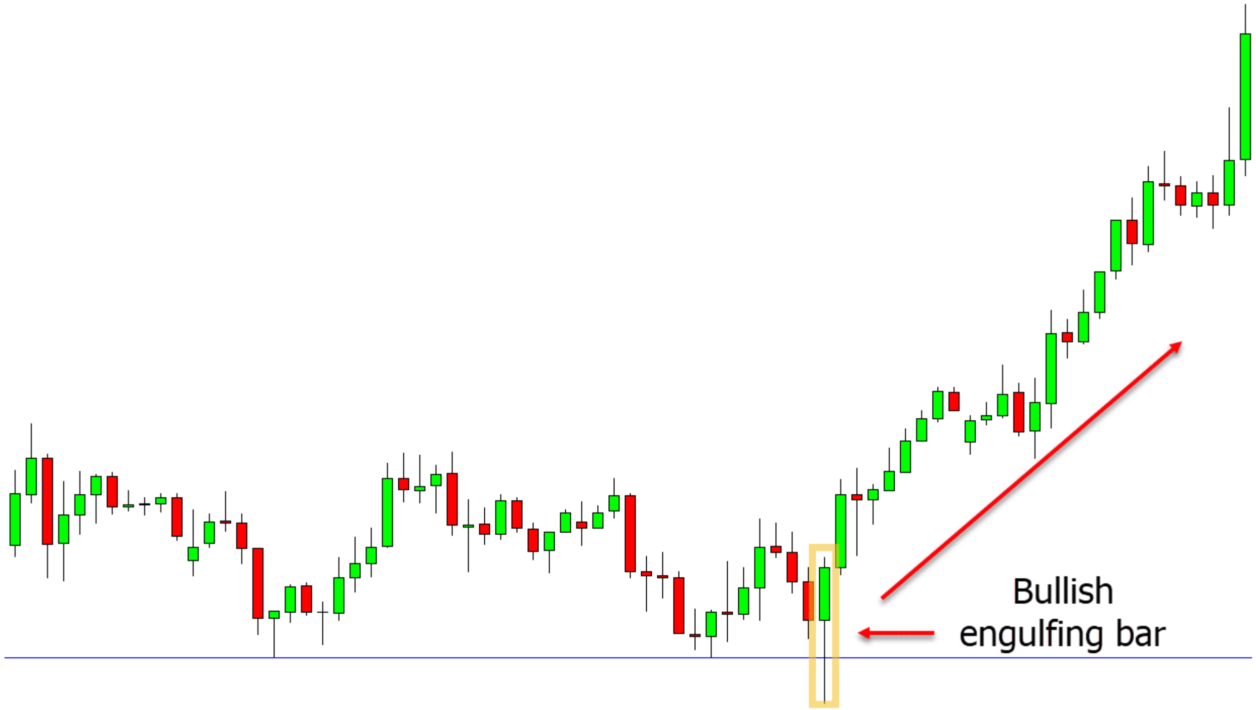
What patterns you choose to trade will depend on what type of trader you are and your preferred class of patterns. However, you need to be aware of different trading patterns.

In this post, you will learn what trading patterns are, the different types of trading patterns that you could use, and some examples of each type of pattern.

What are Trading Patterns?

Before discussing the different types of trading patterns that you can spot and choose from, you need to understand what patterns are why being able to spot them is important for you as a trader.

A pattern is a distinctive formation created by movements in the price of a particular security or stock. As a trader, you will try to identify patterns in a particular security's closing prices or highs and lows to predict the direction that the stock price will be taking in the future.



Trading patterns can easily be spotted in hindsight as you go back and look over previous price movements; however, to profitably trade, you need to be able to spot these patterns in real-time as and when they occur.

The real-time identification of trading patterns forms the basis for all [technical analysis](), and this can happen with any security at any given point in time. There are several types of patterns that traders can look out for depending on their trading style, risk profile, and choice of instruments they trade.

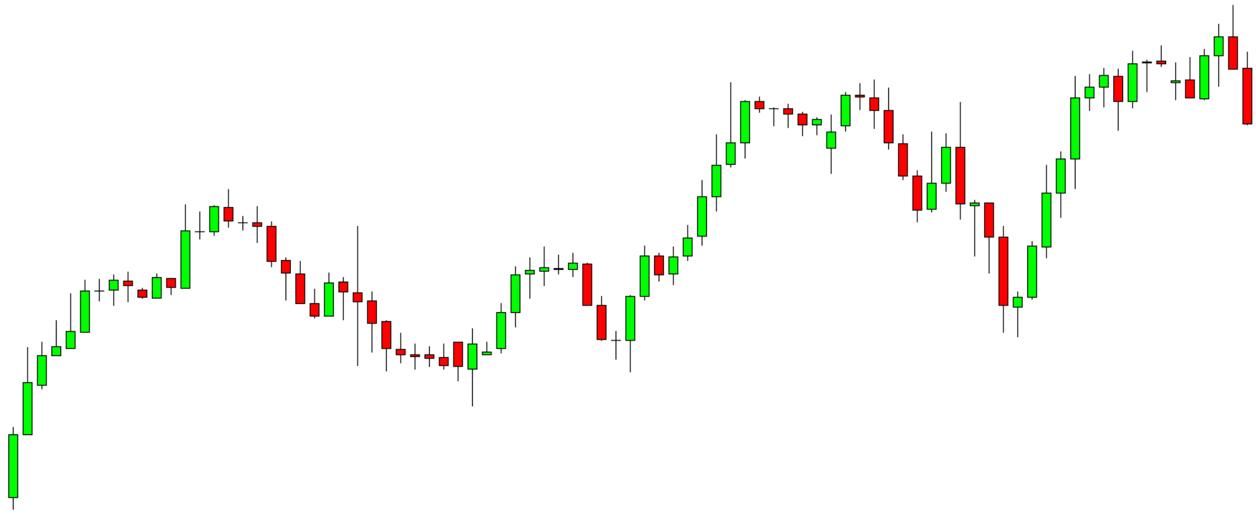
Each trading pattern has a particular predictive capacity. The higher this predictability, the higher the probability of a trader booking a profit if they choose to trade on this strategy.

Trading patterns are usually formed and identified using candlestick patterns, and the anatomy of a candlestick has been discussed below.

How to Read a Candlestick

A candlestick is basically a type of chart, and it is the most popularly used chart among traders. Its popularity stems from the fact that it is easy to read, and at the same time, it provides a lot of information that traders can use to identify patterns.

In a candlestick chart, every candle represents a unit of time, and this unit can be chosen by the trader based on their convenience and preferences. Traders use anywhere between 1 second and 1-day as their unit of time for a single candle, as different durations can be used to spot different trends in the stock price data and give rise to different strategies.



Reading a candle is quite simple and involves an understanding of the anatomy of a candle.

A candle has two parts: the body and the wicks. The body is a rectangle connecting the open and closing prices, and the wicks above and below the body indicate the highs and lows of the particular trading period respectively. By looking at a candle, you can easily see the open, closing, high, and low prices for a particular trading period.

However, a candle offers much more information than this: it also indicates whether a particular trading period was bullish, bearish, or neutral.

This is done by coloring the body of the candle. A green-colored candle is bullish, and a red-colored candle is bearish. Thus, market sentiments can easily be identified by looking at a candle.

Candlestick patterns can be formed using one candle, two candles, or a large number of candles. Each of these patterns indicates a different movement in the stock price, and they are best understood by analyzing the sentiments and the psychology behind these patterns. A variety of trading patterns grouped by categories have been discussed below.

Long Term Trading Patterns

One of the ways to group trading patterns is their timeframe. This could refer to the timeframe in which the price movements were analyzed, the timeframe in which the position is expected to pay off, or both.

Long-term trading patterns are only undertaken by traders who have a long time horizon and the highest levels of patience and discipline since these are crucial to the strategy's success. Two of the most commonly used long-term trading patterns are the cup and handle pattern and the head & shoulders pattern. Each of these has been discussed below in detail.

Cup and Handle Pattern

The cup and handle pattern is one of the longer-term trading patterns, which is usually formed over a period of time ranging from 7-65 weeks. The chart for this pattern represents a cup with a handle, and it is a bullish signal.

The wider the cup is, the more reliable the signal is said to be. In this strategy, the price first touches the resistance levels, pulls back to the support, and starts moving upwards again towards the resistance, thereby forming a cup shape.

This is followed by a slight bearish movement, which looks like the cup's handle before the stock price shoots up. There is usually a lower trading volume towards the handle, indicating that bearish pressures on the stock are now becoming weaker.

The trading strategy for this pattern is that a trade is opened at the resistance level when the handle ends and the price starts moving up. A stop order is usually placed, which means that the trade will not be executed until a specific price level.

This level is higher than the resistance, thereby protecting against a pullback. A particular limitation of this strategy is that since it can take any amount of time to play out, with the pattern not forming for a month, a year, or even several years, there is always the danger of ambiguity and missing the signal.

Head and Shoulders Pattern

The head and shoulders pattern is widely considered one of the most reliable long-term indicators for a trend reversal. Resembling the human body, the chart pattern for this pattern is three peaks in the stock price.

However, the second peak is much higher, representing the head of the body, and the outer two are approximately on the same level as the shoulders in the pattern. The timeframe for this pattern is a lot shorter than it is for the cup and handle pattern, and most often, this pattern can be observed over a period of a few weeks.

It indicates a bull-to-bear reversal, and the third peak (outer shoulder) is a good opportunity to short the stock, with the take profit levels well below the base of the pattern.

However, some risk-averse traders prefer to wait before the price touches the support levels for the pattern and only opening a short position once they are sure it is a breakout. While that restricts their potential gains, it is a more risk-averse strategy as it ensures that the downside is limited.

Intraday Chart Patterns

Intraday chart patterns are very different to long-term chart patterns in a lot of ways.

For one, their timeline is a lot shorter; [intraday trades] are usually opened and closed on the same day. The timeframe being considered is shorter, which limits the analysis that can be done on the stock. Day traders commonly use these strategies, and the successful execution of these trades requires a keen eye, fast reflexes, and good analytical skills.

Due to the shorter timeframe of these ideas, it is important to open and close trades at exactly the right time, avoid being too late or too early, and get caught on the wrong side of the trade.

Two of the most commonly used intraday chart patterns are the shooting star and the Doji candlestick. These are single candlestick charts, which makes sense considering the short timeframe in which these trades have to be identified, analyzed, and executed.

Shooting Star Pattern

The shooting star candlestick represents a reversal from a bullish to a bearish trend. It is one of the most basic trading patterns that every trader learns about and is quite simple to understand because it is based on simple market psychology.

A shooting star pattern occurs at the end of a bullish trend, usually, after around 3-4 continuously green candles have been spotted.

The candle can be characterized by a small body and an upper shadow that is at least twice the length of the body. After the shooting star pattern has been spotted, the market turns bearish, and stock prices can fall as low as support levels.

This happens because, as bulls keep pushing up prices by buying more and more of the stock, the price keeps rising.

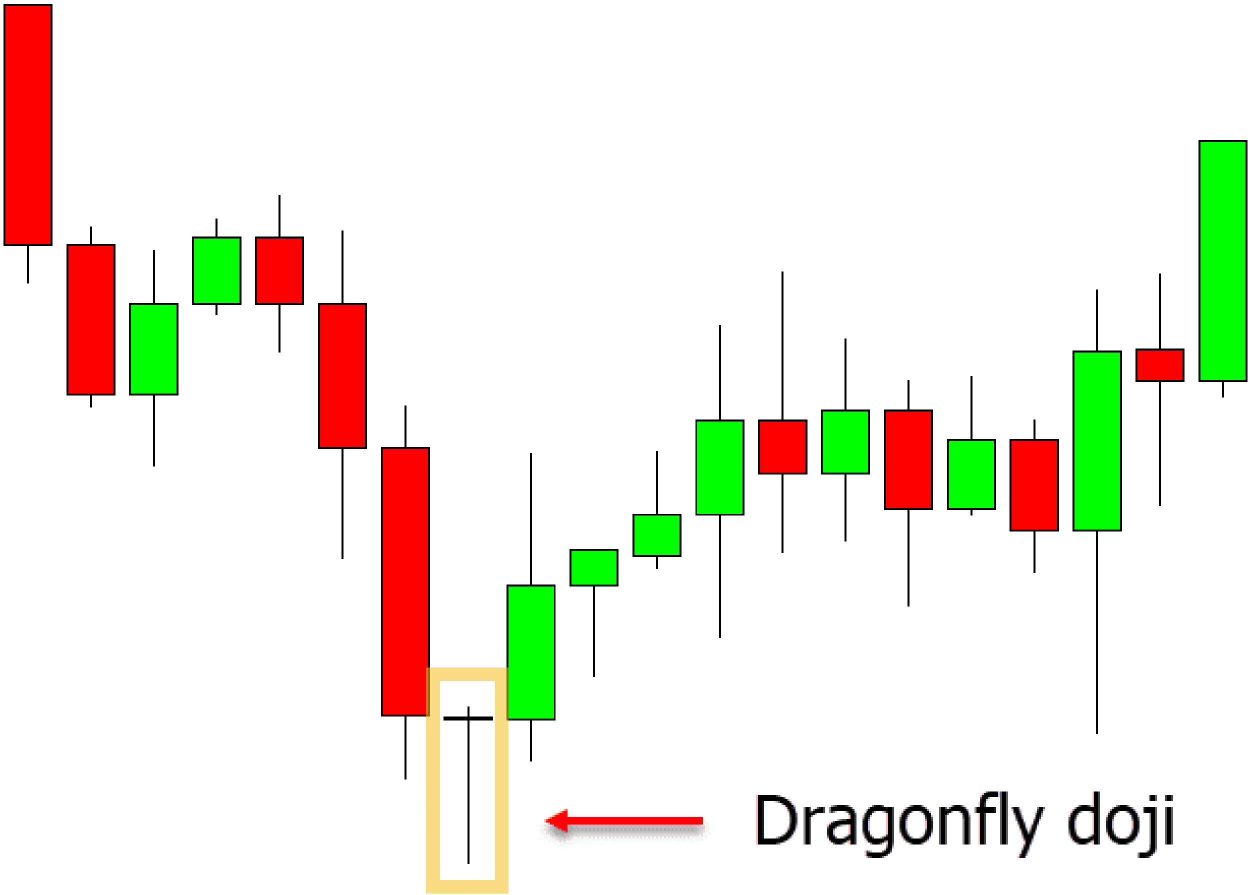
At the beginning of the shooting star candle, buyers are still buying the stock and pushing up stock prices, as indicated by the large upper shadow. However, at one point, the smart buyers book their profits and sell their stocks, resulting in a panic selling round as the bears gain more power and control over the market. As people keep pulling out and selling their shares to book profits, the prices continue to fall until the bulls come back in control of the market and begin buying again.

This is why the presence of the shooting star pattern is considered a reliable indicator to open a short position, as long as there is secondary confirmation that to do so would be advisable.

Doji Candlestick Pattern

The Doji candlestick pattern is another straightforward candlestick trading pattern that traders commonly use.

The word Doji signifies indecision, and the appearance of a Doji candlestick is usually an indicator of a reversal in the trends. The candle looks like a cross, with a tiny body and long shadows. Whether the reversal is bullish or bearish will depend on the previous candlesticks; however, the Doji candlestick is a reliable indicator of a reversal.



If a Doji candle is seen at the top of a bullish trend, it means that the prices could start falling. On the other hand, if it is seen at the bottom of a bearish trend, it indicates the beginning of an uptrend.

When the price opens in a Doji candle, it moves in the same direction as the trend indicates. However, after a point, the other side begins to gain power, and the stock price begins to move in the opposite direction. Both sides fight as they attempt to control the price by pushing it in opposite directions.

As a result, the stock price closes close to where it opened, with long shadows representing the struggle between the bears and the bulls. This indicates that one side is no longer in complete power over the market and could reverse the trend as the other side begins consolidating its power.

A Doji candlestick is a good indicator to open a position opposite the underlying trend.

Swing Trading Patterns

A swing trader is in the middle ground between a day trader and a long-term trader: they trade on a timeline that spans from a few weeks to a few months at most. Their trading patterns are longer than intraday patterns; however, they do not take as long as the long-term trading patterns do.

Swing traders are called so because they trade on swings in the prices of securities. These swings can take a bit of time to materialize; hence swing traders require both disciplines as well as analytical skills: while the latter enables them to spot potential swings, the former enables them to wait them out and ensure that they get as many profits as they can on a potential trade.

Two of the most frequently traded chart patterns by swing traders are T-30 and Bull Flag patterns.

T-30 Pattern

This is one of the easier patterns to identify and trade; hence it is very widely popular in trading circles, especially beginner traders. This pattern can be spotted using the 30-day exponential moving average if you're using the daily candlestick charts.

The pattern occurs when a particular candle cuts through the 30-day average price levels. While the candle that most commonly cuts through the average line is a hammer candle, this is not essential. Another important factor that you need to look at for this pattern is that the volume on this particular day when the slicing occurs has to be higher than in the previous few days.

To trade this pattern, all you need to do is buy the stock when this pattern has been observed. The stock will then proceed to go up. The reason this pattern is relied upon by traders is because there is a confluence of multiple trading signals: the volume indicator shows that the volume is coming back into the stock, which is a signal of a reversal; the moving average indicator shows that the stock was previously in a bearish trend and is ripe for a reversal.

In addition to this, the pattern is normally seen at the support levels of the stock prices, thereby adding to the confirmation that the trend is due to be reversed.

Bull Flag Pattern

The bull flag pattern is an indicator of a pullback in the trend of the stock price. It is named so because upon tracing the price action, the shape formed resembles a flag. A bull flag pattern has three main features:

1. The stock price begins by moving upwards with a high volume, indicating a strong bullish sentiment. This forms the pole of the flag in the strategy.
2. The stock price stabilizes on the top of the pole, and volumes also begin becoming stable.
3. The price then gradually moves downwards before stopping at a point and then reversing its direction to move upwards with an increasing volume.

Beginners commonly use this pattern; however, one of the biggest challenges to using this pattern is to spot this pattern in real-time, as you can only trace the flag once the pattern has already been formed. At that point, it is already too late.

Most traders use scanners to identify bull flag patterns and make it easier for them to trade on these patterns.

Trend Trading Patterns

Trend trading patterns can be classified into two types; reversals and continuation. Such traders try to trade the underlying trend that a stock has been following for a given period of time. Timeframes do not limit them. A trend trader could see gains in his position in a minute or a year, depending on the price action.

Both types of traders, along with the tools and patterns they most commonly use, have been discussed below.

Trend Reversal Trades

Reversal trend traders usually open trades at the top of a trend and bet against the underlying momentum. This is done when they think that the stock has been overbought or oversold, and they believe that the price movements indicate a reversal of the trend as the other side of the market gains power. They have higher profit potential as reversals in trends tend to be quite large; however, the level of risk they undertake is also quite high since reversals are difficult to predict.

Often, what looks like a reversal could very well be a false reversal, and the price could continue moving in the same direction.

Reversal traders generally use indicators to show them when a stock is overbought or oversold.

An example of such an indicator is the RSI (Relative Strength Index), which gives a value between 0-100 depending on the market's previous price action and volatility to indicate overbuying and overselling.

An RSI score above 80 indicates that a stock is overbought and could reverse into a bearish market at any point. In contrast, an RSI score below 30 indicates an oversold market ripe for a bullish reversal.

Trend Continuation Trades

On the other hand, continuation traders trade on the side of the underlying momentum of the stock price, and they aim to ride the trend and make profits. This is done when they are confident that the trend is expected to continue for quite a while.

While continuation trades are considered to be much safer since the underlying volume and momentum of the stock price favor the trader, the profit potential is quite limited since a reversal might happen at any time.

A very commonly used continuation pattern that traders tend to use is a triangle. It is characterized by a series of candles that are constantly fluctuating and changing trends. However, each time, the highs keep getting lower, and the lows keep getting higher, forming a triangle shape.

As the triangle gets closer and closer, the greater is the probability that the stock price will breakout and pass the resistance levels to continue on its bullish trend.

Stock Trading Patterns

As you have seen above, every type of trader has their own set of patterns that they choose to trade on. For each type, say swing trading or day trading, there are many patterns that the trader can choose from.

Each pattern means something different in terms of what it indicates for the stock price.

The best way to understand a stock pattern is to think about it in terms of bears and bulls and analyze the psychology behind each segment of the market. Like what was done above for the doji and shooting star candlestick, you should try and analyze every candle to see what it could indicate and what it means for the future price movements in the market.

Using Pattern Scanners and Indicators

Some patterns might be difficult to spot in real-time, which is why traders use scanners to indicate if certain patterns are being formed.

There are two types of scanners you can use: discretionary scanners and automatic scanners.

Discretionary scanners will merely alert you about certain patterns formed in the market, leaving the ultimate decision of whether or not to trade on this pattern up to you. This leaves you in control as the final decision maker and is useful because it lets you identify high probability trading strategies and trade only on them; however, it might also result in wasted time and therefore cause a minimization in the profits.

On the other hand, an automatic scanner will identify a pattern and assume it fits the criteria you have specified initially; the scanner will automatically open a position.

This is a useful tool when you are paper trading to finetune your trading strategies, as it enables you to test your hypothesis in real-time and make adjustments to maximize the profitability of your strategies.

However, this also has the disadvantage that you are no longer in control, and the scanner might end up making some sub-optimal trades just because they conform to your criteria.

High-Profit Trading Patterns

Not every trading pattern is worth trading. Certain patterns offer a higher probability of success than others do.

As a trader, there will always be several opportunities for you to trade on; however, it is up to you to identify the ones which yield the highest probability of success and use that to then trade so that your capital and time are being utilized in the best way possible.

The two ways to ensure that a particular strategy is both high-probability and highly profitable are to check the confluence and wide-open space on the trade.

Confluence

The confluence factor is the number of different indicators that agree on a particular trading opportunity. Suppose your support and resistance are consistent with a doji candlestick pattern, backed by the favorable RSI number. You know that a particular trading opportunity has a higher likelihood of being profitable because several patterns have a confluence on that particular point.

Wide-open space

The wide-open space refers to how much potential there is for a particular stock's price to move once you open a position.

The larger the wide-open space is, the higher the potential for you to be profitable. This wide-open space is often the distance to the next support or resistance level since reversals are most likely to occur at this point. Hence, the wide-open space is also a factor worth considering when deciding on what patterns to trade.

Trading Classic Chart Patterns

Identifying a chart pattern that you can trade on is not all it takes to become a profitable trader.

What you also need in conjunction with an ability to spot trading patterns is an established trading setup. A trading pattern is different from a setup in that the setup is a list of conditions that need to be satisfied for the trader to go ahead with the trade.

This could include looking for confluence factors, conditions relating to the volume of the stock, setting the stop-loss, or any number of other factors. It would be best to have a trading setup since it will make you disciplined and enable you to trade optimally and consistently. Setting a proper stop loss will also ensure that you do not risk large amounts of capital on a single trade and minimize your losses.

The ideal way to establish a trading setup is to borrow one from a more successful trader and then adapt it over time to suit your own needs and requirements.

Lastly

In this article, you have seen various trading patterns, each of them with its own degree of difficulty, timeline, level of certainty, and potential for profits.

Similar to this, several other patterns exist. As a trader you will have to read and understand them based on what kind of trader you are, try to spot them while trading, and learn to exploit these patterns to ensure your profitability in the market.

Stock Markets Guides