Stock Markets Guides

Head and Shoulders Pattern Guide

The head and shoulders pattern is a pattern that does not form often, but when it does, it can lead to highly accurate trades.

The head and shoulders pattern is normally used on higher time frames, and you can use it to find potential reversal trades.

In this post, we go through exactly what the head and shoulders pattern is and how you can use it in your own trading.

What is the Head and Shoulders Pattern?

The head and shoulders chart pattern is one of the most reliable and profitable charting patterns you can use.

Whilst this pattern does not form all that often, it can be traded on all time frames. The other good thing about this pattern is that you can use it on almost all of your markets.

In financial markets, when you spot a head and shoulders pattern, it is a clue that the price may be looking to make a new move lower.

The good thing about this pattern is that you can use it to find new trades and where to put your stop loss and profit target.

The opposite to the head and shoulders pattern is the inverse head and shoulders pattern. The inverse head and shoulders pattern hints that the price could be looking to make a new move higher.

How to Identify the Head and Shoulders Pattern

The head and shoulders pattern has three distinct peaks that you will use for identifying it.

The head and shoulders have the following three features;

1. First, the price is rising higher.

2. Secondly, price action forms three peaks. These consist of the left shoulder, the right shoulder, and the head in the middle.
3. The last part of the pattern is the neckline. This is where the pattern completes itself and often where you will be looking to make short trades.

In the example chart below, you can see that price first forms a left shoulder. This is the first resistance point.

Price then forms the head by moving above the left shoulder.

The right shoulder is then formed as price finds the second point of resistance at or around the same area the left shoulder found resistance.

How to Trade the Head and Shoulders Pattern

Once you have learned to identify the head and shoulders pattern correctly, you will find it an easy pattern to trade.

The most common way of trading the head and shoulders pattern is by taking a short trade as the pattern confirms itself, and the price breaks lower and through the neckline.

In the example chart below, you can see that price has formed a head and shoulders pattern. It also has a clear neckline support area.

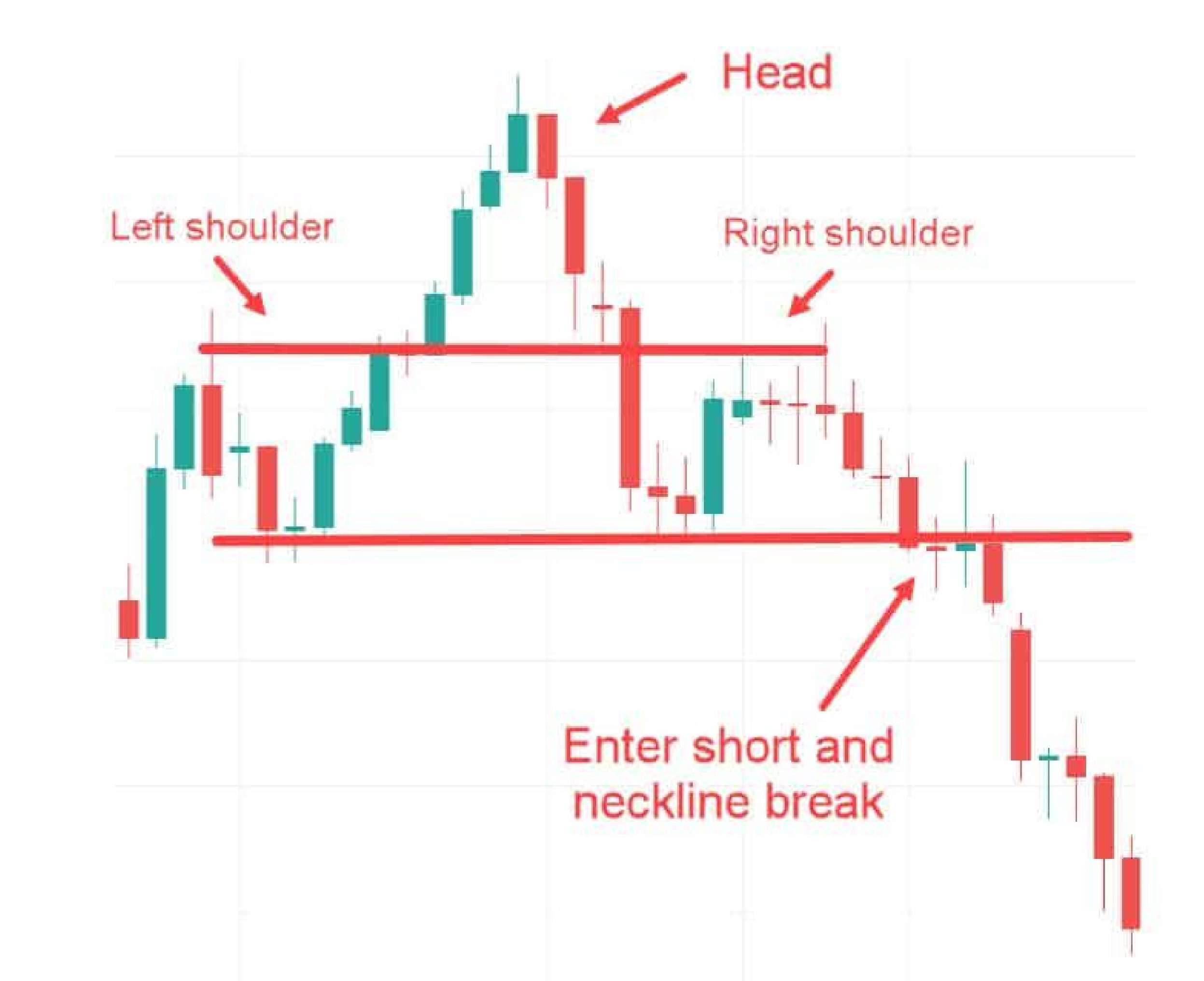
The pattern confirms itself when the price breaks lower and through this neckline support area.

The simplest way to trade the head and shoulders pattern is to wait until the neckline breaks and then look for short entries.

You can use two types of stop losses depending on how aggressive you are in your trading.

The first stop loss method is the less aggressive approach. With this stop loss, you put your stops above the 'head' of the pattern.

With the second and more aggressive stop loss, you put your stops just above the right shoulder of the pattern. This way, if the price moves higher and through the highs of the right shoulder, you are stopped out with the pattern failing.



Head and Shoulders Pattern Target

The most common way of finding the [profit target] with the head and shoulders pattern is to find the difference between the head and the low point of either shoulder.

You can find this by measuring the high of the head and the low of the shoulders in pips.

Using this method, the target would then be the same number of pips from the neckline breakout.

For example, if the high of the head and the low of the shoulders is 150 pips, then you would be looking for price to move by 150 pips lower through the neckline.

The other method to find profit targets with this pattern that is less aggressive is to find the next support level. The next support could always vary, and you will need to be strong at technical analysis to find good areas to take profit.

Inverse Head and Shoulders Pattern

The inverse head and shoulders pattern is the same pattern but inversed. The inverse head and shoulders pattern has the same key attributes as a head and shoulders pattern, but the shoulders and head form in the opposite direction.

Where the head and shoulders pattern hints at a move lower, the inverse head and shoulders pattern hints at a move back higher.

You can see price forms two shoulders and a head in the example below, just like the standard head and shoulders pattern does, but inversed.

The neckline for this pattern is now resistance, and for the pattern to confirm itself price must breakout higher and through this neckline resistance area.

Lastly

The head and shoulders pattern is a high probability pattern that you can trade on nearly all of your favorite markets.

Whilst most traders use this pattern on higher time frames, such as the daily or weekly time frame, you can use it on any time frame that suits your trading.

As with any new pattern or strategy you add to your trades, it is important that you first test it out on a demo or virtual account until you become comfortable with it.