How to use charts to get ahead of market shifts

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The market has a love-hate relationship with chartists. Do they have a useful role to play in current markets? What do all these geometric patterns, like head and shoulders, triangles, rectangles, and so on, actually mean?
We will be studying in particular patterns that depict long-term market shifts which give us a better idea of the market's upward and downward cycles.

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The purpose of this study is to understand what exactly these patterns tell us. Each chart, in fact, depicts a market behaviour that is governed by the law of supply and demand. As supply and demand are what drive the markets, it is important to understand them fully. Your trading idea (based on solid fundamental research) may be well-founded, but the market still must realise that it is well-founded. If you're right at the wrong time, you are wrong. Timing is key and to master timing, it is important to understand the dynamics of supply and demand.

Head and Shoulder Top

"I've learned from experience that it is not reasonable to go against what I will call the herd mentality." Jesse L. Livermore

Head and Shoulder Top

This pattern looks like a head and shoulders.
This is a confrontation between strong sellers and weak buyers. The likely outcome is a market decline.

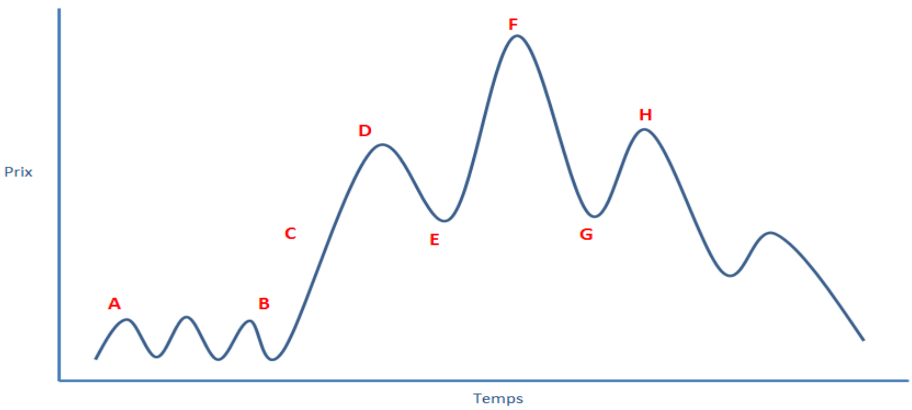


Figure 1

Source: Seven Capital

First, some aggressive buyers know that a certain stock is currently inexpensive and offers considerable upside potential. They begin to buy up shares. (**A**)

Rumours spread that something is happening on the stock and other buyers begin to pile in. But supply of the share begins to dry up and buyers end up steadily raising its price. Sellers vanish as they have the feeling that the longer they wait, the higher the price they will get. The stock begins to rise. (**B**)

The stock's gain draw in new, trend-following traders. In many cases, the trend is also driven by the stock's solid fundamentals). (**C**)

The share price now approaches the our initial investors' target and they want to sell massively to realise their gains but must do so carefully, otherwise the market could collapse in a heap. So they begin to sell and demand slackens, which lowers the share price. So our investors stop selling to keep the share price from collapsing. They may even buy a little to support the share price (**D**). This results in the Left Shoulder.

After selling dries up, some new buyers who missed out on the gains (**C**) step in and the share price turns back up. Our initial investors wait for a new high to reassure the buyers already in position. These new gains draw in new buyers (**E**). A new summit takes shape, the Head.

Our initial investors may now resume selling and unwind their positions entirely. This brings the share price towards their last support level. (**F**)

Some buyers take this opportunity to buy on this support level, which leads to a spurt, but there are not enough of them and the stock falls short of a new high. After failing to sell at the high, some buyers lose patience and begin to sell around their break-even point or at a slight loss. (**G**)

There are no longer any new buyers and the older buyers, who are beginning to lose money, want out, fast. The share price falls. Everyone is losing money, and buyers vanish. Sellers must lower their target price, and this precipitates the prices downward (**H**) and the right shoulder forms.

Head and Shoulder Top on EUR/NOK

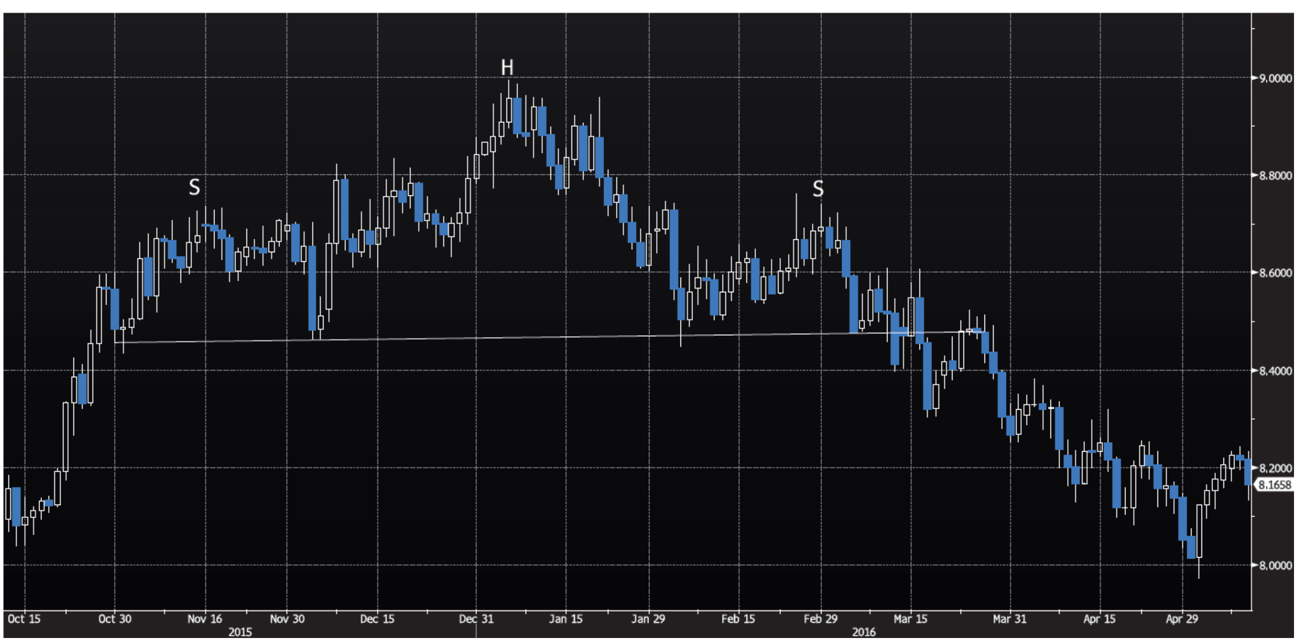
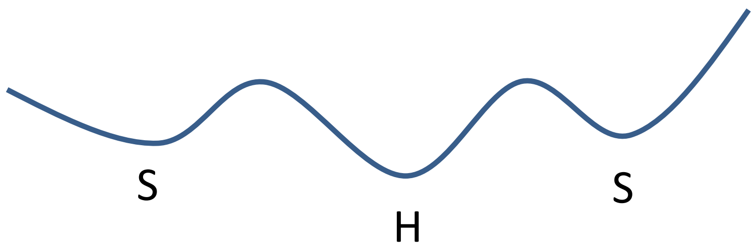


Figure 2

Source: Seven Capital

Head and Shoulders Bottom

This is the same principle as the “Head and Shoulder Top” but in reverse.
This is a confrontation between weak sellers and strong buyers. The likely outcome is a market gain.



“What drives the prices of stocks up or down is not impersonal economic forces or changing events but the human reactions to these happenings, how millions of men and women perceive the potential impact of these happenings on the future. In other words, more than anything else, the equity market is a reflection of individuals.”
Bernard Baruch

Head and Shoulder Bottom on Soybean Meal

Figure 3

Source: Seven Capital

Triangles

"It does not help one's account to feel sure one is short theoretically overvalued stocks that are currently rising or long those theoretically undervalued but actually sinking in price." Gerald M. Loeb

The symmetrical triangle: expresses doubt between buyers and sellers.

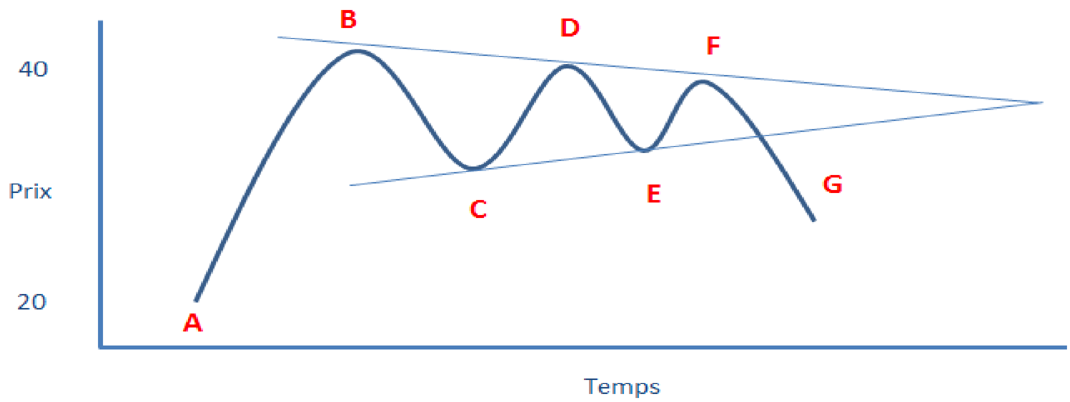


Figure 4

Source: Seven Capital

Some investors bought at around 20 (in **A**) and now have a substantial capital gain.

Some of them take their profits when the price approaches 40, and that increases supply compared to demand and sends prices down (**B**).

As the market falls, they temporarily break off their selling. Some investors who missed out on the gains and who refuse to get in at the top of the market now buy at a price slightly over 30, which swings the balance towards demand and raises the share price (**C**).

Shareholders who failed to sell at the top (at 40) decide to be less greedy and begin to sell under this price beginning at 37 and become more aggressive at 39, triggering a new market drop (**D**).

This process repeats itself over and over again with new buyers coming on the market and facing shareholders anxious to hold onto their profits (**E** then **F**).

Ultimately, sellers' paper is no longer absorbed, as buyers have vanished. They then have to sell lower and lower, and prices collapse (**G**).

However, in most cases the market will exit the triangle in the same direction that it entered (especially when a bull market is beginning). When the bull market finally runs out of steam, the triangle is very likely to be a signal of a shift.

The ascending triangle

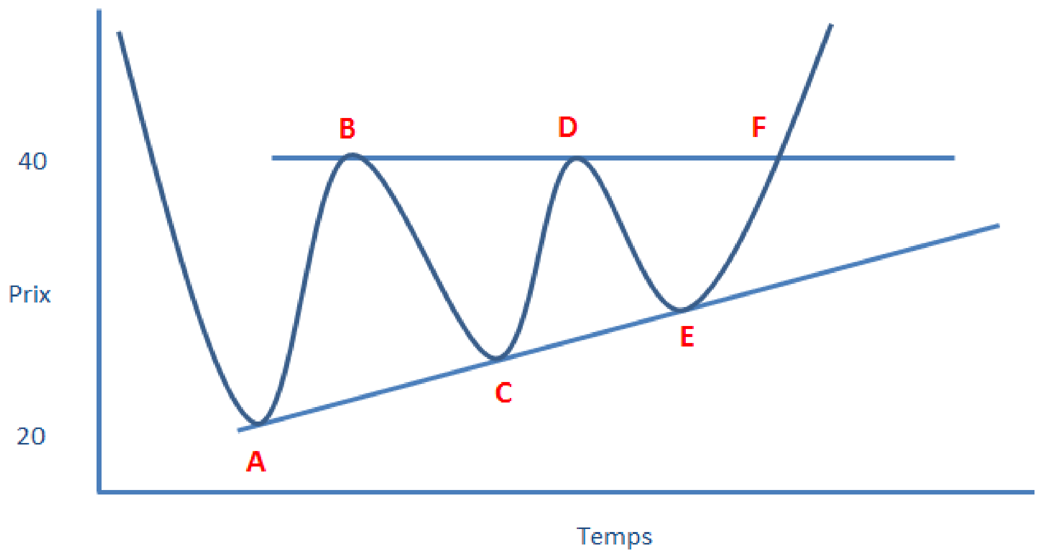


Figure 5
Source: Seven Capital

An ascending triangle develops in somewhat the same manner as a symmetrical triangle.

Some investors bought at 20 (in **A**) and are now sitting on a substantial capital gain.

Some of them take their profits when the price hits 40 euros, which boosts supply relative to demand and sends the market down (**B**).

As the market falls, they temporarily halt their selling. Some investors who missed out on the gain and who refuse to get in at the top of the market now get in at a price slightly higher than the market low (**C**), which shifts the balance towards demand and raises the share price but, this time to the former selling zone at 40. All new buyers manage to get shares at this level (**D**).

The market pulls back to 36, when new buyers arrive (**E**).

Supply then dries up and there are only buyers on the market, which forces buyers to pay more to get in. The share price explodes upward (**F**).

In this example, investors see clearly that demand is heavy and that they can sell all their shares at 40 (while believing, nonetheless that this level will be the top of the market). Once supply has been absorbed by demand at 40, the market takes off and new investors hold onto their positions to achieve a large capital gain, resulting in a run-up in the share price.

The descending triangle

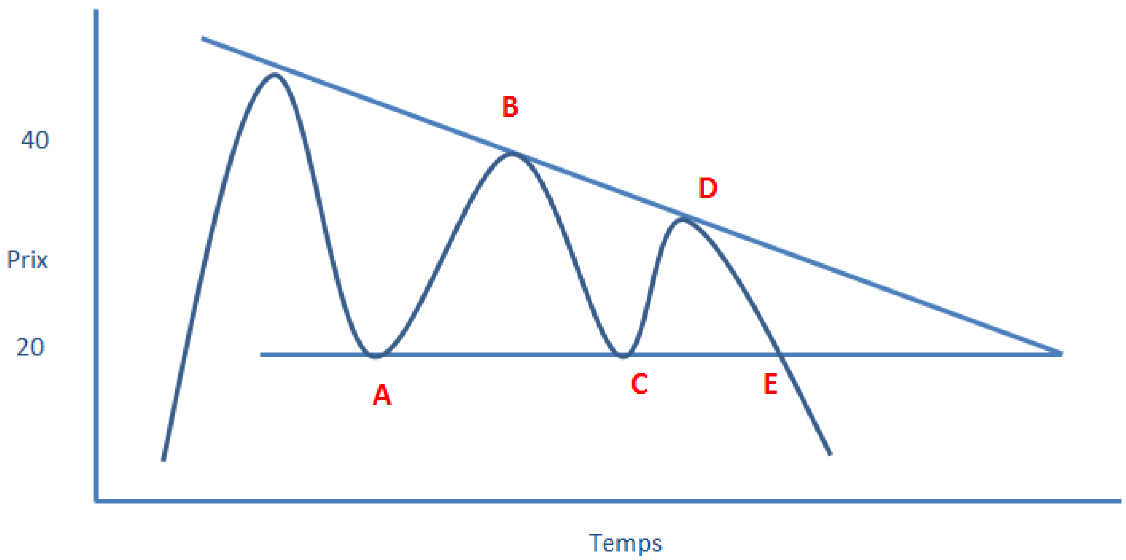


Figure 6

Source: Seven Capital

After rallying sharply, the market begins to pull back (as some investors take their profits) and some investors try to build up a large position at lows near 20 (**A**).

Purchases send the market back up to around 40 (**B**), where new sellers emerge, sending the share price back to 20. Buyers are still present at this level to build up their positions (**C**).

Driven by these purchases, the market rallies again and heavy supply re-emerges under 40 (**D**). The rally gradually runs out of steam.

The market pulls back and supply continues to expand, and buyers building up positions at 20 are served in full. Confidence of shareholders who had not planned to sell, runs out and their supply arrives on the market, triggering its decline (**E**).

Symmetrical triangle on TNOTE5Y

Figure 7

Source: Seven Capital

Ascending triangle on Heating Oil

Figure 8

Source: Seven Capital

Rectangle

"What drives the prices of stocks up or down is not impersonal economic forces or changing events but the human reactions to these happenings, how millions of men and women perceive the potential impact of these happenings on the future. In other words, more than anything else, the equity market is a reflection of individuals." Bernard Baruch

The rectangle reflects a controlled confrontation with a balance of power between buyers and sellers.

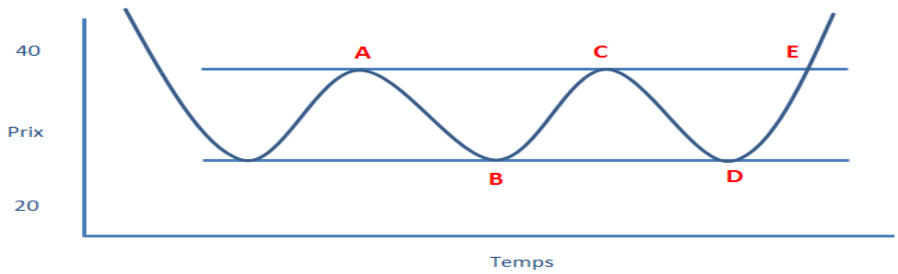


Figure 9

Source: Seven Capital

Shareholders want to sell at a certain level (**A,C**) and buyers want to build up positions at a lower level. (**B,D**)
This battle raises and lowers the market within a trading range until one of the counterparties gets exhausted or changes his view of the share. This takes the stock out of its trading range in one direction or another (**E**), but no counterparty knows in advance how this battle will turn out.

With no news on the stock some short-term traders will also take this opportunity to buy in the lower end of the trading range and sell (or sell short) in the upper end of the range, which prolongs this rectangle.

Rectangle on the S&P 500

Figure 10

Source: Seven Capital

Double Top and double Bottom

"Why are people always trying to link the economy to the market? The economy has nothing to do with timing, and timing is the most important factor." Joe Granville

These patterns are rarer and harder to interpret.

Double Top

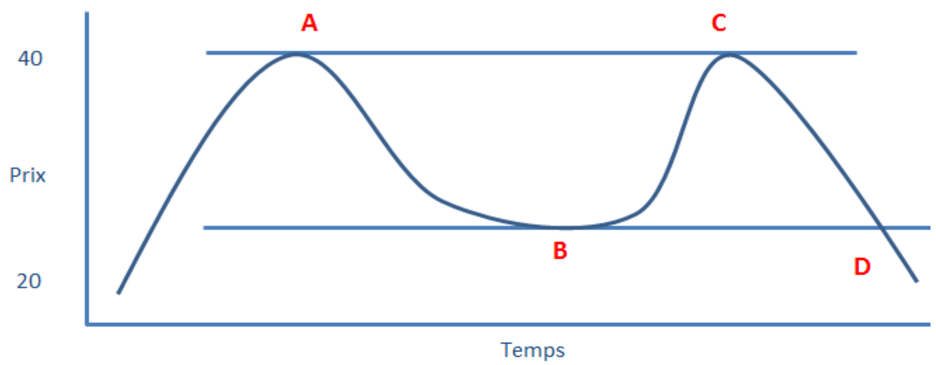


Figure 11

Source: Seven Capital

This pattern lasts between two and three months and is at least 10% high.

The first top note tells us that after a sharp run-up the initial buyers take their profits and new entrant meet with heavy supply (**A**).

Then the market gently falls by at least 10% and stays low without a meaningful rally, meaning that the decline was more than mere short-term profit-taking (**B**).

Lastly, meaning demand re-emerges while absorbing supply to push the market back up to its previous high (**C**). The price can even move back slightly above point (**A**) but demand will rapidly vanish.

At this level some short-term traders who bought in the lower end of the trading range will take their profits and those who did not take their profits at the previous high take this opportunity to sell, and this sends the price back to the most recent support level (**D**).

If buyers vanish at this level and sellers continue to gather, the market will fall and turn back downward.

The same principle applies with the triple top (three peaks instead of two).

Double Bottom

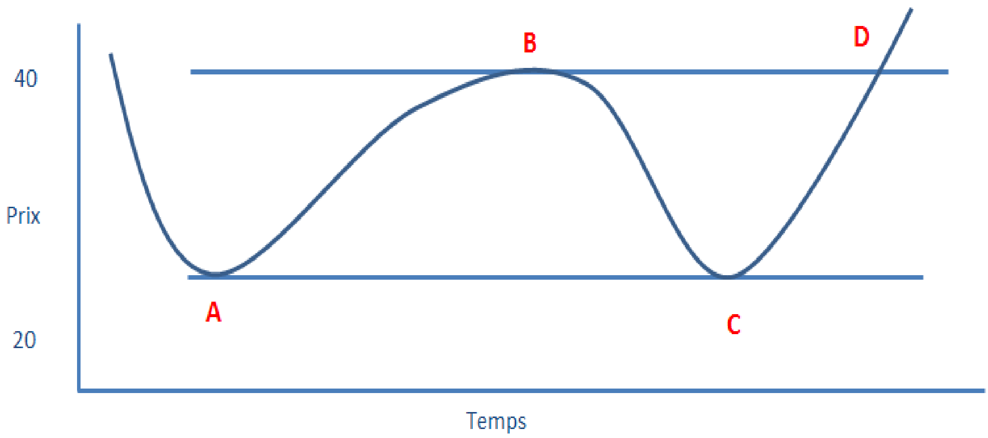


Figure 12

Source: Seven Capital

This pattern reflects the opposite phenomenon from the double top.
The same principle also exists with the triple bottom (three lows instead of two).

Double bottom on Cotton

Figure 13

Source: Seven Capital

Broadening Top and Bottom

"Better to be wrong with the market than right all alone."

Broadening Top

This pattern depicts a market with few professionals, as there are many emotions that create steep volatility.

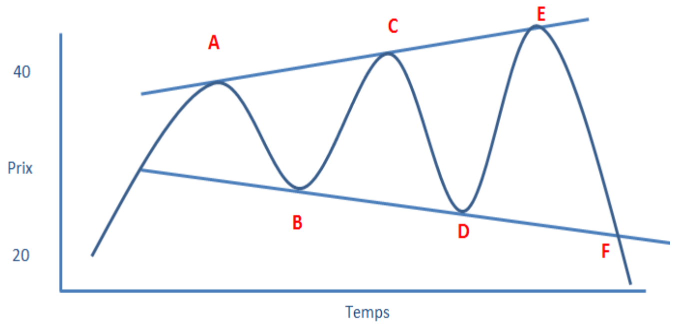


Figure 14

Source: Seven Capital

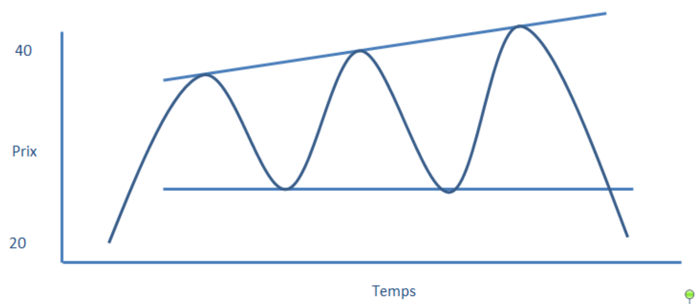


Figure 15

Source: Seven Capital

This pattern generally emerges in the last phase or the end of a bull market. If point (**F**) is crossed, that signals a coming bear market.

Broadening top on the Dow Jones Transport

Figure 16

Source: Seven Capital

Broadening Bottom

This pattern generally reflects the last phase or end of a bear market. If the resistance is broken through, that’s a signal of a coming bull market.

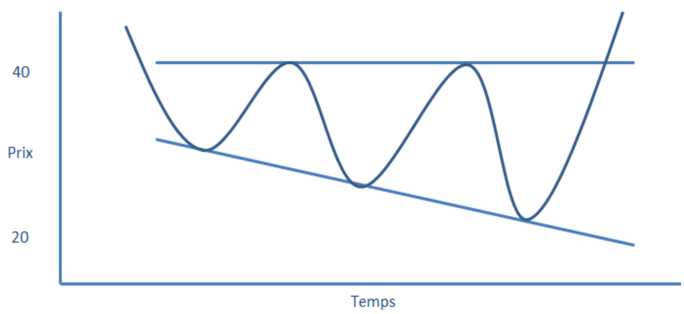


Figure 17

Source: Seven Capital

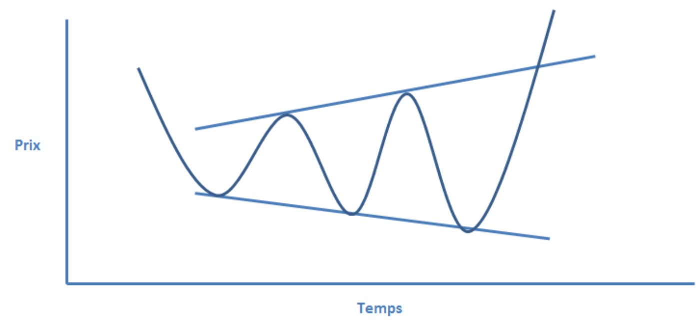


Figure 18

Source: Seven Capital

Broadening Bottom on Dow Jones Transports

Figure 19

Source: Seven Capital

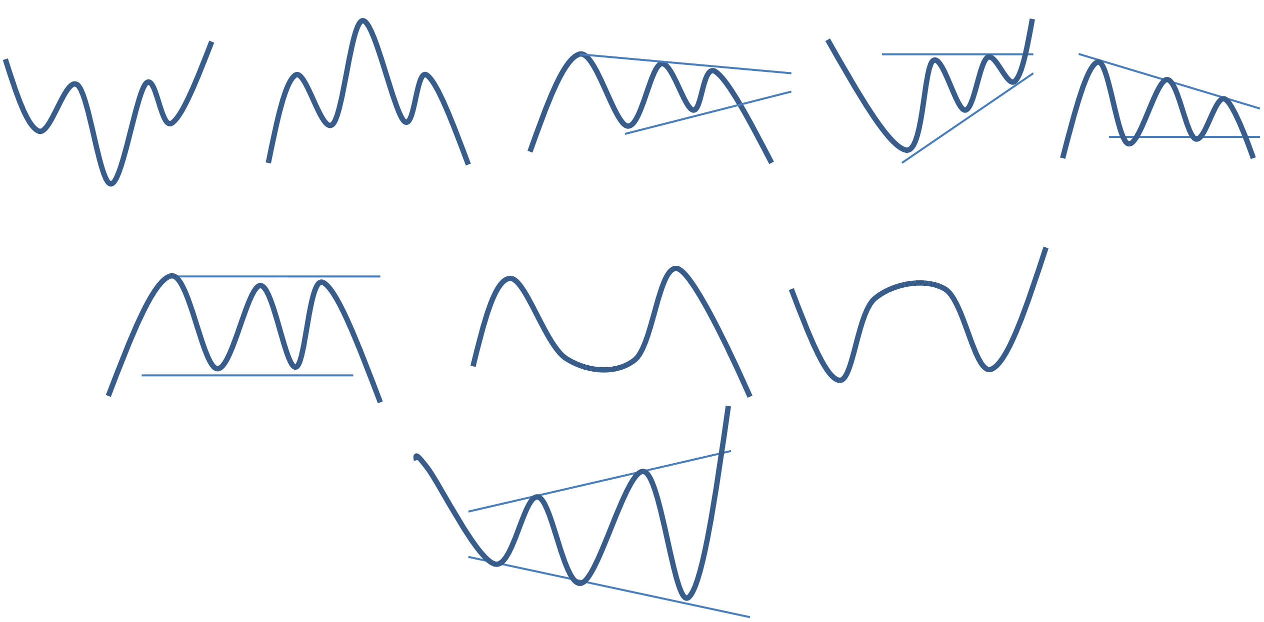
Conclusion

"Fundamentalists who say they are not going to pay any attention to the charts are like a doctor who says he's not going to take a patient's temperature." Bruce Kovner

In this study we have presented the main market shift patterns and explained the underlying psychology.
These patterns point to potential shifts in the market. We studied five groups:
The Head and Shoulder, which can point to a market high or low.
Triangles, including the symmetrical triangle, the ascending triangle and the descending triangle, which suggest a market shift when the market trend has been the same for some time. Otherwise, at the start of the trend, triangles can point to the status quo.
Rectangles, which reflect a balance of power between sellers and buyers.
The double top and double bottom, which can turn into a triple top and triple bottom. These are rarer indications of a market shift.
The broadening top and broadening bottom depict sharp, emotion-driven volatility and a lack of control by professionals.

Charts are not an end in themselves but are an excellent tool for better understanding how supply and demand work.

It would be a pity to forego this tool and miss out on the psychology that governs the markets. Charts offer an opportunity to fine-tune one's timing.



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