

SPECIAL REPORT

The Jeff Clark Trader
Guide to Technical Analysis



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Technical analysis (TA) is much more of an art than a science. If you try to force it to conform to strict rules and formulas, it will be wrong almost every time.

Try thinking of TA the way I do... where the chart of a stock (or index) and its technical indicators is an emotional picture of the stock at a specific moment in time. If I can go back in that picture and find a time where the conditions were similar, and note how the chart behaved afterwards, it can provide strong clues about what to expect in the future.

But TA is emotional. It evolves. So, conditions that used to provide a catalyst for a big move or reversal may need to get more extreme to cause a similar movement the next time.

Think about it this way...

When I first got married, I'd often come home from work, take off my socks, and drop them on the floor next to the couch in the living room. My wife would come home, see my socks on the floor, and get all ticked off about it. This happened over and over again.

Eventually, though, my wife got a little better about dealing with her slob of a husband, and I got a little better about not leaving my socks next to the couch. Leaving my socks on the floor no longer elicited the same reaction from my wife.

She still had the same emotions. But she had adapted. She had evolved. She would need a bigger catalyst before getting upset with me – like when she found a dozen pairs of dirty socks tucked underneath the sofa.

Here's my point...

A lot of my trading strategy revolves around finding emotionally overbought/oversold conditions that are ready to reverse. TA helps me identify conditions in which investors' emotions have gotten extreme, and where I can see how stocks have reacted to similar conditions in the past.

But you can't force TA into a strict formula. You have to give it some "wobble room."

In this guide, I aim to show you the fundamentals of chart pattern analysis, and teach you everything you need to know about my approach to TA. I'll also show you that, while TA can be a valuable predictive tool, it isn't foolproof or 100% accurate every single time. It's a tool that should support the trade idea, but not be the trade idea.

With all that said, let's get started...

ANATOMY OF A CHART PATTERN

Before you can start identifying chart patterns, there are important aspects of a pattern to know and consider...

Trend

A trend is the general direction of the price of a security, asset, or index.

Upward trends form as prices make consistently higher highs and higher lows. Downward trends form as prices make lower highs and lower lows. And sideways trends form as the highs and lows of a price stay generally the same.

Trendline

A trendline is a line drawn over a series of highs or lows to show the direction of a security's price over a given timeframe. The two trendlines that make up typical chart patterns are support and resistance lines.

Plotting support and resistance lines is one of the first steps to identifying a chart pattern. See the chart of the VanEck Vectors Gold Miners ETF (GDX) below for an example of a sideways trend with consistent support and resistance levels.



Timeframe

A timeframe is a period in which a trend is identified. For our purposes, trends manifest over several different timeframes – hours, days, weeks, and months.

We often refer to the short term, intermediate term, and long term when talking about timeframes. We define the short term as one day to two weeks, the intermediate term as two weeks to three months, and the long term as anything longer than that.

Support

A trendline formed below the price of a security which the price stays above. This typically marks the spot where buyers step up and buy the stock.

These trendlines can rise, fall, or stay horizontal.

Resistance

A trendline formed above the price of the security which the price stays below. This typically marks the spot where sellers prevail.

Like support lines, resistance lines can rise, fall, or stay horizontal.



Breakout

A breakout occurs when the price of a security breaks through a support or resistance line. This can indicate either that a pattern has completed successfully or that a security has bucked a trend.

Volume

Volume is the number of shares or contracts transacted in a security in a given timeframe. A transaction is made up of both a buy and a sell from two separate parties.

Trading volume can be used as a confirmation tool when analyzing a trend breakout. For instance, if a stock price breaks out of a trend with high trading volume, the new trend will likely continue. If it breaks out with lower volume, it indicates the breakout could reverse.

Price Target

A price target is where a trader predicts the price will be in the future. Traders use chart analysis and predetermined conditions to predict where the price of a security will go.

TECHNICAL INDICATORS

While recognizing chart patterns can help traders predict future price movements, it's not a foolproof method. It's also very important to know various technical indicators and overlays that we use to identify chart patterns, and any short-term strength or weakness in a security...

Moving Average (MA)

A trend-following indicator used in technical analysis to smooth out price action by filtering out large spikes and drops in a security's price. For our purposes, we'll most often be using the simple 50-day MA.

Exponential Moving Average (EMA)

A type of moving average that is weighted more towards recent data. Because of this, the EMA reacts to price changes in a security more quickly than a simple MA. For our purposes, we'll most often be using the 9-day EMA.

Moving Average Convergence Divergence (MACD)

A momentum indicator that shows the relationship between two distinct moving averages of a security's price. Traditionally, the MACD is calculated by subtracting the 26-day exponential moving average (EMA) from the 12-day EMA.

Relative Strength Index (RSI)

A momentum indicator designed by J. Welles Wilder to measure the speed and change of price movements. The RSI ranges from 0 to 100. Traditionally, traders consider a security overbought if the RSI is over 70 and oversold if it's below 30. The data is generally measured over a period of 14 trading days.

Bollinger Bands

Points on a chart plotted two standard deviations above and below an asset's moving average line. It is used in technical analysis to determine overbought and oversold market conditions.

The bands are also subject to market volatility – during periods of low volatility the bands contract, while during periods of high volatility the bands widen.

McClellan Oscillator

An indicator used in technical analysis to determine the balance between stocks that are advancing and declining. It is calculated by subtracting the 39-day exponential moving average (EMA) of stock advances, less declines, from the 19-day EMA of stock advances, less declines. The result is a momentum indicator that works similarly to the MACD.

Commodity Channel Index (CCI)

A momentum-based indicator that is often used to determine when an investment is reaching oversold or overbought conditions. In general, it measures the current price level relative to an average price level over a given period of time.

If the CCI is high, prices are far above their average. If the CCI is low, prices are far below their average. This versatile indicator can be applied to indices, ETFs, stocks, and other securities.

Now, here are some of the most common chart patterns and how to play them...

CHART PATTERNS

Double Top/Bottom Pattern

A double top or double bottom chart pattern indicates a future move beyond two repeated support or resistance levels.

For instance, if a chart has a big run up to a resistance level, falls, and then returns to the resistance level (forming two "tops" on the chart), it is likely to head much lower.

See the chart of United Airlines (UAL) on the following page. The chart found two similar peaks (marked by the blue arrows) near a strong resistance level (the blue line) and then broke down.

The reverse is true, too... If a chart makes two bottoms at a support level but doesn't breach them, it is likely that the next high will be higher than the previous peak.

Note the double bottom that UAL formed below (the red arrows). After bottoming a second time at the same support level, the stock overcame its previous peak.



HOW TO TRADE THE DOUBLE TOP/BOTTOM PATTERN:

Traders using a double top pattern should **look to enter short trades after a security's price has started to decline from its previous resistance level.**

For the double bottom pattern, **look to enter long trades once the price reverses from a similar support level a second time.**

Head and Shoulders Pattern

The head and shoulders pattern is used to predict a trend reversal from bullish to bearish. It's considered one of the most reliable reversal patterns.

This pattern is formed when the price of a security in a bullish trend forms a peak and then dips down to form a trough below it. This forms the first “shoulder.”

After finding the bottom of the trough, the price rises again to form a second high, higher than the first. Again, the price declines to a similar level as the previous trough. This larger peak is what’s called the “head” of the pattern. And connecting the two troughs forms the “neckline” of the pattern.

Finally, the price of the security will make another high from the bottom formed by the second trough – the second shoulder. This high will be lower than the previous high set by the “head” and closer to the initial shoulder. (See the chart of the U.S. dollar below for an example.)

It is at this point – if the pattern plays out successfully – that the price will break down from any bullish uptrend and decline to lows last seen before the initial shoulder.

HOW TO TRADE THE HEAD AND SHOULDERS PATTERN:

Aggressive traders following this pattern should **look to enter short trades once the level set by the first “shoulder” is reached and reverses.**

Conservative traders following this pattern should **look to enter short trades after the price breaches the neckline.**

If the price can’t break the neckline, it’s called a failed head and shoulders reversal... If that happens, the stock typically rises.



Inverse Head and Shoulders Pattern

Charts can also form an inverse head and shoulders pattern. This pattern is used to predict a downtrend reversal. The pattern is, as the name implies, the inverse of the typical head and shoulders pattern.

The pattern starts when the price of a security falls to form a trough (the first shoulder) and recovers. Then, it falls again to form a lower trough and recovers to the previous high set after the first trough, forming the head.

Finally, after the price falls again to form a third trough – but not as low as the previous one (the second shoulder) – the pattern resolves in a breakout to the upside.

See the chart of Seattle Genetics (SGEN) below for an example.



HOW TO TRADE THE INVERSE HEAD AND SHOULDERS PATTERN:

Once identified, traders should **look to enter long trades once the second shoulder clearly forms** – meaning when the price reverses from a higher low than the previous trough (the head).

Wedge Pattern

A wedge pattern is a contrary indicator, predicting a reversal move as the trading range of a security tightens as it rises or falls. The two variants, a rising wedge and a falling wedge, work similarly.

In a **rising wedge pattern**, the price of a stock or security is in an uptrend and makes a series of gradually higher highs and higher lows.

If the trading range within the uptrend begins to contract, the trend is likely to break down at the corner of the wedge, below the major support level.

See the chart of Hertz (HTZ) below for an example of a rising wedge pattern resolving to the downside.



The same is true of **falling wedge** patterns, in which the price of a security in a downtrend will break out from the pattern once the series of gradually lower lows and lower highs contracts tightly. Once the price of a downtrending security breaks above the falling resistance line, the pattern resolves to the upside.

See the chart of General Motors (GM) below for an example of a falling wedge pattern resolving to the upside.



HOW TO TRADE THE WEDGE PATTERN:

Traders following the rising wedge pattern should **look to enter short trades once the price of a security breaks below the rising support line.**

Likewise, *falling* wedge patterns should be **exploited on the long side by doing the opposite – entering a long position when the price breaks above the falling resistance line.**

Flag and Pole Pattern

A flag pattern is a continuation pattern that forms as the price of an asset or security begins to trend downward after a sharp rise upward, or vice versa.

The “flag” of the pattern is formed by two parallel lines acting as the resistance and support for the trend as it bucks the initial trend, or the “pole.”

See the chart of GameStop (GME) below for an example of how the “poles” formed by sharp spikes in price usually resolve to the downside.



Flag patterns usually resolve to the opposite direction of where the flag was trending. This occurs once the price of a security breaks through resistance or support, depending on the previously established trend.

HOW TO TRADE THE FLAG AND POLE PATTERN:

Traders following this pattern should **look to enter positions when the price breaks the flag formation in the direction the price was moving before the flag formed.**

Triangle Patterns

A triangle pattern is one of the simplest types of chart patterns to spot and follow.

This type of pattern occurs when a stock price consolidates – meaning the lows and highs in the stock price trend closer together and volatility tightens. This manifests as two trendlines that converge at an apex.

This apex marks the end of a triangle pattern. At that point, the pattern will either complete successfully and the movement predicted by the pattern will manifest, or the pattern will fail and a new trend will be established. **(Note:** Traders should not enter trades using a triangle pattern until it resolves in a breakout to either side.)

There are several variants of triangular chart patterns, all of which predict different future price action:

a) Symmetrical Triangle

A symmetrical triangle pattern marks a period of consolidation in a trend after a prior large move in either direction. As the price of a stock chops around back and forth between lower highs and higher lows, two converging trendlines – a descending resistance line and an ascending support line – form, leading to an apex point and completing the triangle.

See the chart of W.W. Grainger (GWW) below for an example of a symmetrical triangle reaching its apex and resolving to the upside.



Once the chart reaches the apex point, the price typically breaks out in the same direction as the initial large move. To determine future price action, look for a break above the descending resistance line if the pattern is playing out after a large run up. If the pattern formed in response to a large move to the downside, look for the stock price to break below the ascending support line for another downside move.

However, if the trend reverses at the apex point and breaks in the opposite direction of the previous move, it is likely that the trend has reversed.

HOW TO TRADE THE SYMMETRICAL TRIANGLE PATTERN:

Traders following this pattern should **look to enter positions in the same direction as the initial move that preceded the price consolidation.**

b) Ascending Triangle

An ascending triangle pattern marks a potential bullish breakout upon completion. It is also often preceded by an upward trend, making it a continuation pattern (like the flag pattern we discussed earlier).

The pattern is formed by two trendlines: an ascending support line formed by higher lows, and a flat resistance line formed by repeated tests of a high point in the price. At the apex of this trend, the price of a security is likely to break to the upside.

See the chart of the VanEck Vectors Semiconductor ETF (SMH) below for an example of an ascending triangle pattern reaching its apex and resolving to the upside.



The key aspect to watch in this pattern is the rising support line. It indicates declining selling interest. If the price breaks below this support line, the pattern fails and a new trend is formed.

HOW TO TRADE THE ASCENDING TRIANGLE PATTERN:

Traders following this pattern should **look to enter long trades once the price of the security breaks the sideways resistance line.**

c) Descending Triangle

A descending triangle pattern represents the opposite of the ascending triangle pattern – a successful completion of the pattern results in a break to the downside.

The pattern is formed by two trendlines: a declining resistance line of lower highs, and a steady support level of repeated lows.

See the chart of the iPath Bloomberg Coffee Subindex Total Return ETN (JO) below for an example of a descending triangle pattern reaching its apex and resolving to the downside.



The descending triangle culminates at the apex near the sideways support line (the resistance line in the ascending triangle) and typically resolves in a break to the downside. This is the opposite of the ascending triangle, in which a break from the pattern to the upside occurs when the pattern culminates at the apex formed at the sideways resistance line.

HOW TO TRADE THE DESCENDING TRIANGLE PATTERN:

Traders following this pattern should **look to enter short positions once a break to the downside of this pattern has occurred.**

Cup and Handle Pattern

A cup and handle pattern occurs when a security rebounds from a low period over an intermediate- to long-term timeframe to retest old highs. This action forms a rounded bottom in the stock’s trajectory – the “cup.”

After reaching those previous highs, traders who held the stock since then would be looking to exit their positions, as they're now profiting on the trade. This selling pressure then forms a new trend from the recent test of the previous high. This channel is the "handle" of the pattern.

If the pattern completes successfully, the price should break above the trend established by the "handle" and go on to reach new highs.

See the chart of the VanEck Vectors Coal ETF (KOL) below for an example of a sideways-trending handle forming after a cup.



HOW TO TRADE THE CUP AND HANDLE PATTERN:

Traders following this pattern should **look to enter long positions once the trend established by the "handle" breaks to the upside.**

Rectangle Pattern

A rectangle pattern is a continuation pattern which marks a pause in the trend for a security's price. The pattern is formed by a series of at least two consistent highs and lows. These highs and lows make up the connecting point for two parallel lines that form the top and bottom of the rectangle.

This pattern completes once the security price breaks below the top or bottom of these two parallel lines. Thus, the rectangle is similar to the symmetrical triangle, but not as predictive. This is because a series of higher lows and consistent highs is not established.

See the chart of Chevron (CVX) on the next page for an example.



HOW TO TRADE THE RECTANGLE PATTERN:

Traders following this pattern could look to enter trades once either the support or resistance line has been breached. But as we mentioned, the rectangle pattern isn't a very good predictive pattern. So it shouldn't be relied upon like the other patterns listed here. **Instead, the rectangle pattern can help pin down other potential patterns or trends.**

Crosses

While not technically a pattern, a cross can be an important catalyst to watch when looking to enter new trades in either direction.

A cross occurs when the various moving average lines of a security – like the moving average (MA), exponential moving average (EMA), or Bollinger Bands – cross one another.

This can result in a number of buy or sell signals, depending on the lines involved and the direction.

One example of a bullish cross is when the 9-day EMA crosses above the 50-day MA. This indicates that the most recent, ultra-short-term price action has been favorable when compared to longer-term price action. This means that momentum has shifted in the opposite direction, and typically results in a broken trend.

See the chart of the United States Oil Fund (USO) on the next page for an example of the 9-day EMA crossing above the 50-day MA, and the effect it has.



HOW TO TRADE A CROSS:

Traders watching for crosses should **look to establish long positions as the 9-day EMA crosses above the 50-day MA.**

And on the downside, **look to establish short positions when the 9-day EMA crosses below the 50-day MA.**

Sledgehammer Pattern

Another important trend to watch out for is the "sledgehammer." Like the cross, the sledgehammer isn't technically a pattern like most of the others on this list. But it is still a valuable TA tool.

The sledgehammer is a bullish reversal pattern. It plays out when a stock get crushed, bounces a little, and then gets crushed again.

See the chart of Target (TGT) on the next page for an example of where to buy in when observing a sledgehammer pattern.



HOW TO TRADE THE SLEDGEHAMMER PATTERN:

Traders following this pattern should **look to enter long positions on that second crushing** – the reason being that when sledgehammer patterns play out, the momentum indicators are usually stretched so far to the downside that a reversal move is highly likely.

IN SUMMARY

So, there you have it – a quick and easy illustration of some of the most frequently used chart patterns, and how to use them.

I suggest keeping this guide handy – maybe print it out and keep it near your desk. And refer to it whenever I issue a trade recommendation. It'll keep you in tune with how I use TA. Then, once you're more comfortable, you can start searching for these patterns in your own trading.

There are other patterns, for sure. But the patterns I've explained here are the ones I look for most. They tend to be reliable at forecasting future price movements. And they've helped to identify many successful trade setups for me over the years.

I expect they'll continue to do so.

Best regards and good trading,

Jeff Clark

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