INTELLIGENCE7

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HEAD AND SHOULDERS PATTERNS

Head and Shoulders

A head and shoulders pattern consists of a peak followed by a higher peak and then a lower peak with a break below the neckline. The neckline is drawn through the lowest points of the two intervening troughs and may slope upward or downward. A downward sloping neckline is more reliable as a signal

The extent of the breakout move can be estimated by measuring from the top of the middle peak down to the neckline. This target is then projected downwards from the point of breakout.

Volume confirmation

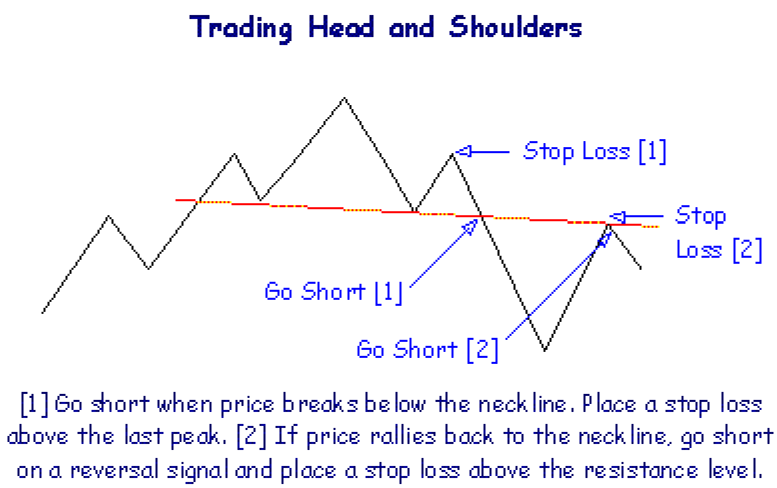
- High volume on the first peak,
- Moderate volume on the middle peak,
- Low volume on the third peak, and
- A sharp increase in volume on the break below the neckline

Trading Signals

Go short at breakout below the neckline.

Place a stop-loss just above the last peak.

After the breakout, price often rallies back to the neckline which then acts as a resistance level. Go short on a reversal signal and place a stop-loss one tick above the resistance level.



Never trust a head and shoulders pattern where the neckline is clearly ascending (the second trough being higher than the first). Also, the more level the neckline, the more reliable the pattern.