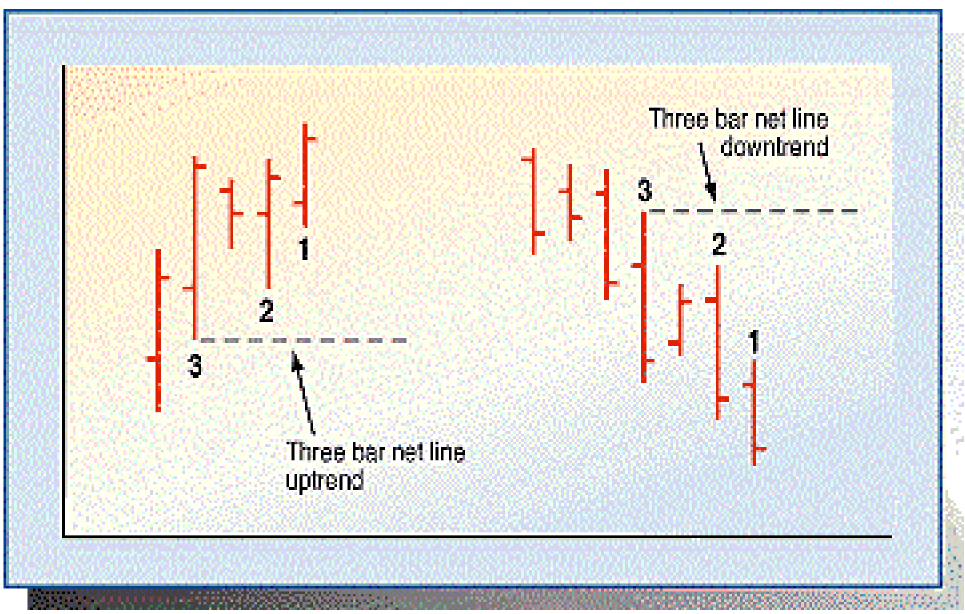
CUPS AND CAPS

Cup and cap patterns are technical formations used to signal short-term trades. The cup pattern is the basis for a sell signal when the instrument being traded is in an uptrend, while if the instrument is trading in a downtrend, then the cap pattern is the setup for a buy signal.

First, the direction of the trend is identified, and then the cup and cap patterns are used for the trading signals. The trend is determined by using a pattern called the three-bar net line. Before discussing the cup and cap formations, let's look at how the three-bar net line is identified and used to determine the trend direction.

The three-bar net line is calculated by starting with the current trading day. If the market is rising, making a series of higher highs preceded by higher lows, locate the day with the highest high. The low of this day will be day 1. Look to the left on the chart and find the previous low that is equal to or lower than day 1. That bar becomes day 2. From day 2, compare this low to the preceding low that is equal to or lower than day 2. That bar becomes day 3. Draw a horizontal line across the chart to the right using the low of day 3 as your starting point. This line is the three-bar net line. If the market matches or makes a new high, the three-bar net line needs to be recalculated. The trend is considered *up* as long as the market does not close below the three-bar net line. Joseph Stowell's work with the three-bar net line was based upon research of the Treasury bond futures market. He has commented that the technique can also be used as a trend indicator for other markets.

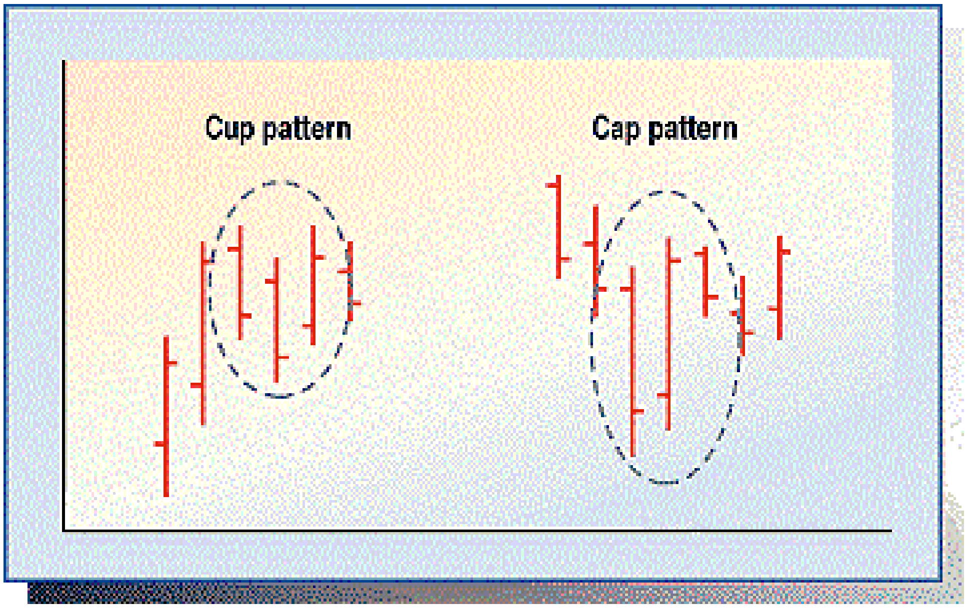
If the market pattern consists of lower lows preceded by lower highs, then the three-bar net line is used to determine a downtrend. Locate the current lowest low, and that day's high becomes day 1. Look to the left on the chart and find the previous high that is equal to or higher than the high of day 1; that day becomes day 2. From day 2, compare this high to the preceding high that is equal to, or higher than day 2. That bar becomes day 3. The three-bar net line is a horizontal line drawn from the right of the high of day 3. The trend is considered *down* as long as the market does not close above the three-bar net line (sidebar Figure 1).



SIDEBAR FIGURE 1: THREE-BAR NET LINE. *This pattern is used to identify the trend. The market is in an uptrend as long as the market does not close below the three-bar net line. Each time the market makes a new high, a new three-bar net line needs to be determined. A downtrend is identified by the market making new lows and not closing above the three-bar net line. After each new low, a new three-bar net line is calculated.*

Now that the direction of the trend is determined, the next step is finding the cup and cap patterns. These technical formations are three-day patterns. The cup pattern consists of three consecutive daily closes or daily lows. Day 2 must have the lowest low or lowest close of the three days. The closes or lows for days 1 and 3 can be the same, or one can be higher than the other. The key point is day 2, which must have the lowest low or close.

The cap pattern consists of three consecutive daily closes or daily highs. Day 2 must have the highest high or the highest close of the three days. The closes or highs of days 1 and 3 can be the same, or they can have different values. Again, day 2 must have the highest close or high for the cap pattern (sidebar Figure 2).



SIDEBAR FIGURE 2: CUPS AND CAPS, THREE-DAY FORMATION. *Each pattern is a three-day consecutive formation. The cup pattern can be based on either the lows or the closes. The second day must be the lowest; the cap pattern is based on either the highs or the closes. The second day must be the highest.*

The cup formation generates a sell signal only if the market is in an uptrend based on the three-bar net line (sidebar Figure 3). The cup formation must be located at the highest point of the current up move. The sell signal must come within three days of the cup pattern formation. There are two different sell signals:

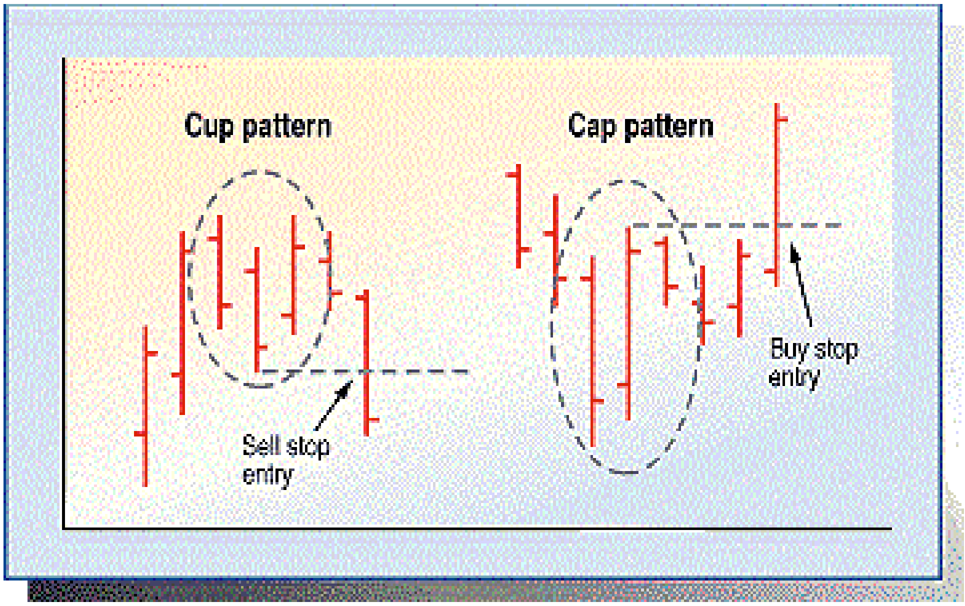
1. Use the low of the cup pattern minus three ticks to place a sell-stop entry order.

2. Enter a short position on a close below the lowest close of the cup pattern. The protective stop is placed three ticks above the highest point of the cup pattern. Exit on the second close below the low point of the cup.

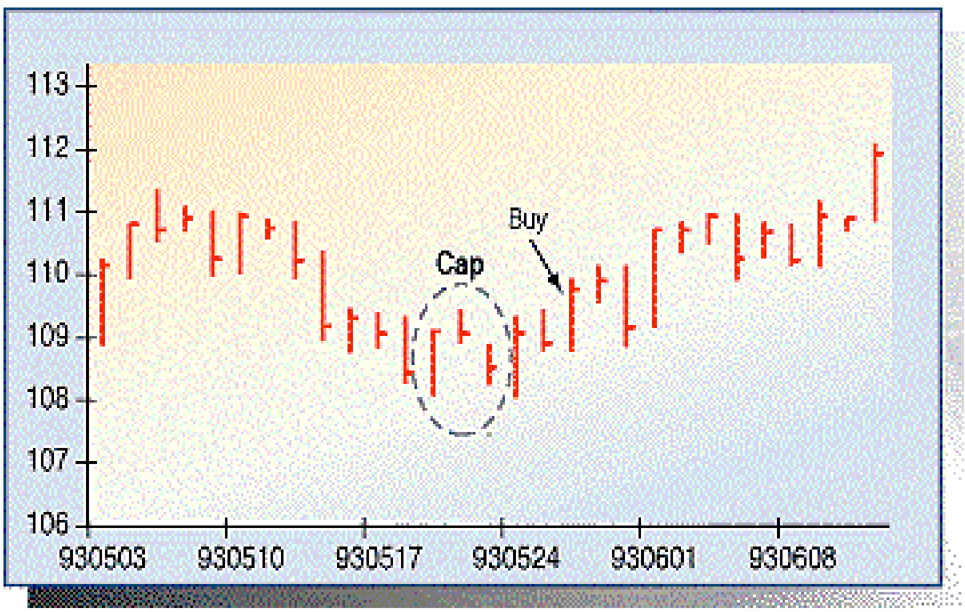
The cap formation is used as a buy signal only if the market is in a downtrend based on the three-bar net line. The low of the cap formation must be the low point for the current down move. The buy signal must come within three trading days of the cap pattern. There are two different buy signals:

1. Use the high of the cap pattern plus three ticks to place a buy-stop entry order .

2. Enter a long position on a close above the highest close of the cap pattern. The protective stop is placed three ticks below the lowest point of the cap pattern. Exit on the second close above the high point of the cap. Sidebar Figure 4 is an example of the cap pattern based on the daily highs.



SIDEBAR FIGURE 3: CUPS AND CAPS, BUYS AND SELLS. *Sell signals occur only if the market is in an uptrend and the market completes the pattern of the cup formation. You can place a sell-stop order below the lowest point of the cup or sell on the close below the lowest point of the cup. Buy signals occur if the market is in a downtrend and the rules for a cap pattern are met. You can place a buy stop over the highest point of the cap or on the close above the high point of the cup.*



SIDEBAR FIGURE 4: SEPTEMBER T-BONDS. *Here's an example of a cap pattern based on the highs. The cap pattern was the lowest point in the trend. The buy signal occurred three trading days after the completion of the cap pattern.*

-Editor