THE 123 PATTERN

By Suniel

SUBJECT SUMMARY
USING CHART PATTERNS

Patterns by themselves do not necessarily lead to consistent outcomes. The development of chart patterns alerts the trader that a range of outcomes is more likely than at other times. As price moves towards a well-established resistance level, the trader pays more attention to the stock, ready to place a buy order if prices move a few ticks above the level. He cannot buy until others have bought because he wants to follow the action, not create it. When prices retreat into the body of the support and resistance band, or other chart pattern, the trader shifts his attention elsewhere. Chart patterns signal the probability of action.

The **123 pattern** is a reversal chart pattern which occurs very frequently and has a very high success ratio.

123's occur only at the end of trends and swings. They are an indication of a change in trend. They can also be found within a trading range, and they take place when the directional momentum of a trend is diminishing.

Let us first look at the above illustrated typical 123 formation forming at the end of a downtrend. Price will make a swing low (point 1), retrace upwards to a swing high (point 2), where a downward correction begins. Price would then form another swing low (point 3), **which is higher than the previous low (point 1).**

From this higher swing low (point 3) price then resumes the upward movement, thus confirming the change in the trend. A long trade is then entered when price breaks the previous high formed at point 2.

This may sound complicated, but the concept is very simple and easy to use. Since this is all that the pattern consists of, it is very easy to spot for a confirmation of the change in trend.

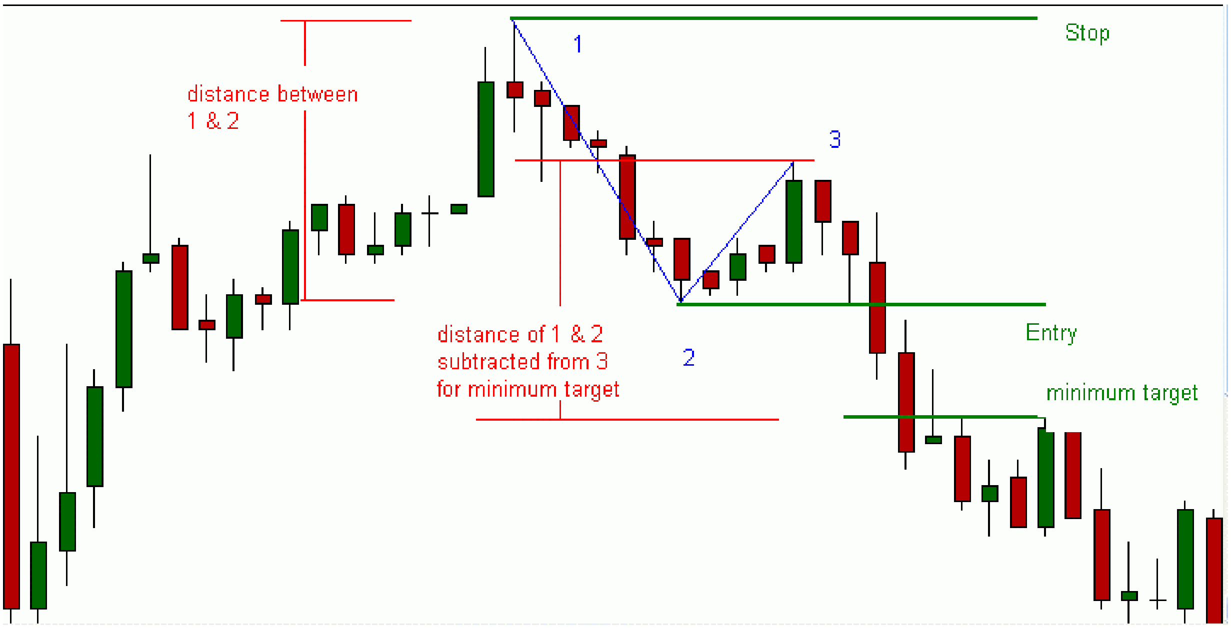
If we look at the fundamental reason for the forming of this pattern, we can see why it works so well. The unfolding of the pattern step wise, would be as follows –

- An indication of the change in trend is seen, when price retraces the original down move. This can be confirmed with a simple trend line.
- Failure to make a new low.
- Price rallying again from here, creating an anticipation of a reversal.
- Breach of the previous high, confirming the reversal. At this point, everybody is going long creating the extra momentum for the upwards trend. This is because traders, who had anticipated the downtrend to continue, would have placed their stops above point 2 of this pattern. And when these stops are hit, these breakout traders will tend to cover their positions by going long, driving the price up with thrust.

Once this pattern has been spotted, let us define some very simple rules for managing the trade.

- The entry should be taken only on the break of the point 2 – the previous high (or low as the case maybe)
- The stops to be placed beneath the low of point 1. Aggressive traders may even place the stops below the higher low at point 3, but it is always better to give price enough room to move without hitting the stops.
- While this pattern does not give any projected target, a minimum target can be estimated by a simple thumb rule. Calculate the distance from the point 1 to point 2 in the formation. Add this to the low of point 3, and this should be the minimum distance that price will travel to.
- The setup of the entire pattern from point 1 to 3 could take place in 3 bars or as long as 20 bars. But the rules of pattern remain the same. A point to keep in mind here is that the more number of bars involved in the setup, bigger should be the move. This is not a fixed rule, but more often not, this concept is followed by the price.
- Allow the pattern to prove itself before entering a trade. If point 3 forms below the point 1, the pattern is negated. Similarly price has to break the high of point 2 for confirmation. There will be times when price will consolidate within the area of points 2 & 3, without giving any indications of the direction. At such times it is better to stay out, till price action confirms a direction.

Now let us look at some examples of the setup.

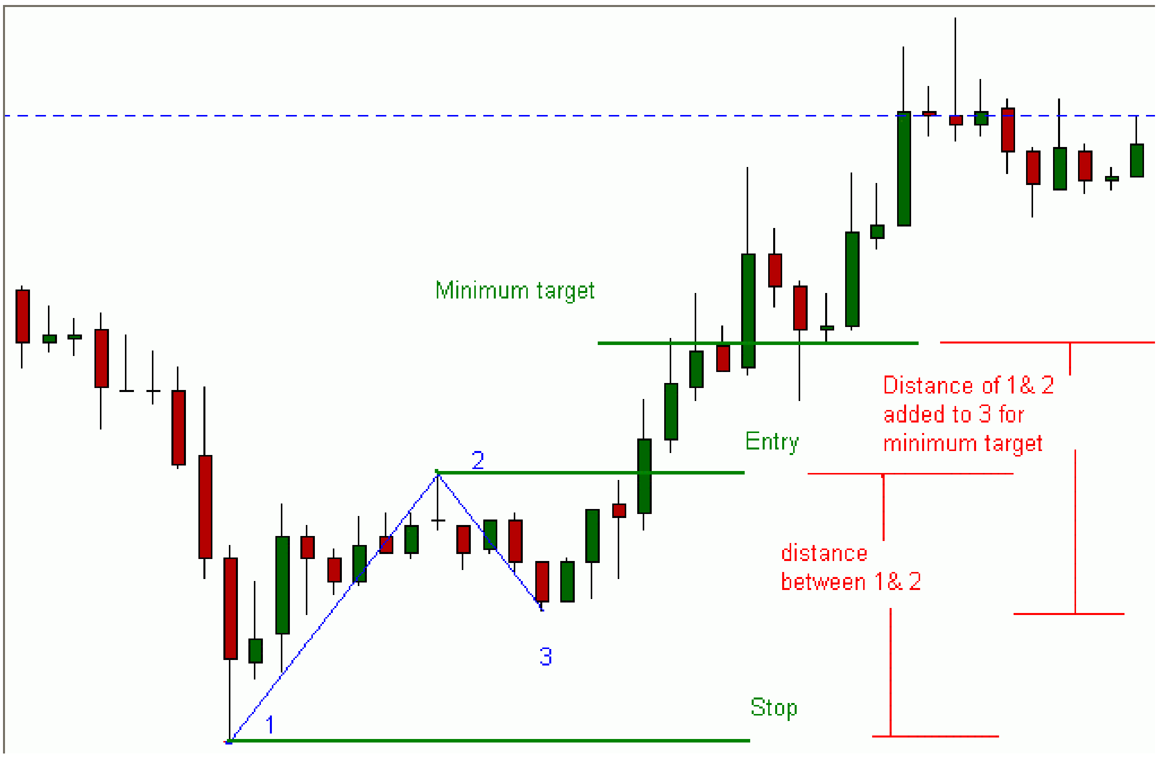


In this example we can see that price is initially in an uptrend. Price then moves down and a simple trend line break will give us the indication of a change of trend. It is here that we label the swing high as point.1 of the formation.

In this new downtrend, we then have a swing low from where price retraces up again in the direction of the previous uptrend. We label this as point.2 of the formation.

Now at this point, even though we have the two initial points of the formation, we are not sure if this is a retracement of the uptrend, or a reversal to the downtrend. The confirmation comes when price makes a swing high, which is lower than the high of point1 (the point.3). This tells us that price does not have the momentum to break the previous high, thus indicating a change of trend.

If you notice, we mentioned that it only indicates a change of trend. This could just be a consolidation where price could be pausing before resuming the uptrend again. This is where we wait for the confirmation. As soon as price breaks the low of point.2, we enter the trade.



As per our conditions, we place our stops above the point.1 of the formation, and estimate the minimum distance that price should go to. As we can see, price easily surpasses the minimum distance, giving a good short trade.

Here we have a 123 formation for an uptrend also, giving us a better understanding of the pattern. The rules remain the same as above, and we can see the effectiveness of the pattern.

CHART BRIEFS - UOB LTH (UOBH), SINGAPORE

By Petra Rak

INDICATOR REVISION

CUP AND HANDLE

This is a bullish chart pattern. Prices trend upwards slowly, then pause to consolidate over several days. The next up trend is projected by taking the distance from the bottom of the cup to the brim, or alternatively, from one edge of the cup to the other. Often these give targets within a few cents of each other and this is quite an accurate method. The cup and handle pattern provides confirmation of a safe entry as trends pause. This pattern should not be confused with sharp declines and rallies. The cup and handle pattern develops over weeks rather than days. There are some day trading applications of this pattern, but they are not as reliable.

The daily chart of UOBH shows the collapse of a bullish cup and handle pattern into a likely consolidation. Overall, the chart shows that UOBH is in an overall long-term uptrend, coming up from the lows in early 2008 around 15.25. However the chart also shows that while the general upward movement is there, it appears that the stock is more controlled by support and resistance levels than by the overall upward trendline (hence the trendline is not drawn on the chart).

The most recent development shows a reversal from a medium-term downtrend which bottomed out gradually above a support at 18.40. The reversal was also gradual, resulting in a cup and the start of a handle pattern under a lip resistance at 20.10.

However, though the handle started to develop, over the last three days the pattern broke down and prices are currently well on their way back to the 18.40 support. This has invalidated the cup and handle pattern and suggests that the consolidation between 18.40 and 20.10 is now the dominant feature in the stock, until a breakout in either direction develops. The failure of the bullish pattern is another example of the current tendency in the markets for unreliable and volatile breakouts, and considerable general uncertainty.

UP CONDITIONS

The failure of a relatively high probability bullish pattern, such as a cup and handle, increases the probability of a consolidation phase. The GMMAs confirm this as the moving average groups which had recently completed a bullish crossover and were turning upwards are now once again converged, and trending broadly sideways consistent with consolidation and uncertainty. The narrow long-term group also indicates very little support in the event of a retreat.

A rebound from 18.40 is likely to result in a return to the 20.10 resistance, with the potential for an ongoing breakout above this resistance. This is also consistent with the overall (though reasonably poorly defined) uptrend in this stock.

Hence, opportunities in this stock are most likely to come from short to medium-term uptrends which commence on rebound from a support and have a likely target at the closest overhead resistance, with the potential for a continuation to the next resistance. This is consistent with the strong support/resistance control evident in this stock. At this point, it is necessary to recognise that the separation of these support and resistance levels is not especially wide, for instance around 8% from 18.40 to 20.10, and another similar separation to the 21.70 level which capped the previous medium-term uptrend.

Any trades based on a support rebound should be accompanied with a very tight stop loss, necessary in the current uncertain environment. Trades can be managed with reference to support/resistance levels, any developing short to medium-term trendline and appropriate stop losses (initially on a close below the nearest support, shifting to the trailing CBL stop loss).