THE EXTREME REVERSAL SETUP

The *extreme reversal setup* is a fabulous signal that I've back tested over countless years of data on many instruments, different timeframes, and using various trade management methodologies. The results have always been highly favorable. Needless to say, this setup remains a key staple of my trading arsenal. The extreme reversal setup is a classic "rubber band" trade. When a rubber band is stretched to its limits and then released, it snaps back in the direction from whence it came. We are looking to trade the snapback reversal with this setup.

The basic setup occurs when an extremely large candle forms that is about twice the size of the average candlestick. While this candle may indicate that a continuation will be seen, the second bar of the pattern does not confirm a continuation and, instead, is an opposing candle that signals an upcoming reversal. VVhen this occurs, you have a fantastic opportunity to buy below value, or sell at a premium. *The extreme reversal setup looks to capitalize 011 over-extended situations* in *the market, as responsive buyers and sellers will enter the market to push price back* in *the opposite direction.*

PATTERN STRUCTURE

Let's take a closer look at the structure of the extreme reversal setup. Figure 2.8 illustrates bullish and
bearish extreme reversal examples. The first bar of the two-bar setup is the extreme bar, which is the basis for the setup. This bar can be anywhere from 50 to 100 percent larger than the average size of the candles in the lookback period. This figure will *vary,* however, depending on the volatility of the given market that you are trading. If you are trading a market with extremely low volatility, then you will likely need to see a larger extreme candlestick to properly qualify this candle. Conversely, in markets with high volatility, you may need to downward adjust the size ofthe extreme bar.

The second characteristic to consider when judging the extreme bar of the pattern is the percentage of the total bar that is the body of the candlestick. That is, what percentage of the total range of the bar does the body of the candle encompass? This is a little tricky because you would like to see a high percentage of the candle covered by the body, but not so high as to discourage a potential reversal. I will typically allow any signal to pass that has a simple majority of coverage by the body. In other words, any percentage over SO percent will usually suffice, but I will keep a close eye on any percentage that is above 8S percent. Why? Think about it for a moment, if the extreme bar has a close percentage of over 90 percent, there is a good chance that this bar could indeed lead to a continuation in the current direction. Therefore, you may be entering the market during a "resting" period ahead of a continuation. However, if the extreme bar has 60 percent coverage by the body, this is a better indication that a reversal may indeed occur, as a reversal may have already begun intrabar, especially if the wick portion of the candlestick has formed at the end of the candle where the reversal is to occur.

The second bar of the extreme reversal setup should be the opposite color of the first candle of the pattern.

That is, if the first bar of the pattern is bullish (green or white), then the second bar of the pattern should be bearish (red or black). Obviously, the colors of the bars will depend on the charting software you use, but you get the point. The second candle of the setup is just as important as the first, as this candle will either lead to a continuation or signal a reversal. Many times, this candle will be rather small compared to prior price activity, however, this is not always the case. As a matter of fact, if the bar strongly opposses the first, the odds of a reversal increase. That is, if the second bar of the pattern is a big, full-bodied candle that opposses the first, the market may be well on its way to a clear reversal opportunity.

PATTERN SUMMARY

1. The first bar of the pattern is about two times larger than the average size of the candles in the lookback period.
2. The body of the first bar of the pattern should encompass more than 50 percent of the bar's total range, but usually not more than 85 percent.
3. The second bar of the pattern opposes the first. If the first bar of the pattern is bullish ($C > 0$), then the second bar must be bearish ($C < 0$). If the first bar is bearish ($C < 0$), then the second bar must be bullish ($C > 0$).

PATTERN PSYCHOLOGY

The extreme reversal setup is a clever pattern that capitalizes on the ongoing psychological patterns of investors, traders, and institutions. Basically, the setup looks for an extreme pattern of selling pressure and then looks to fade this behavior to capture a bullish move higher (reverse for shorts). In essence, this setup is visually pointing out oversold and overbought scenarios that forces responsive buyers and sellers to come out of the dark and put their money to work-price has been over-extended and must be pushed back toward a fair area of value so two-sided trade can take place.
This setup works because many normal investors, or casual traders, head for the exits once their trade begins to move sharply against them. When this happens, price becomes extremely overbought or oversold, creating value for responsive buyers and sellers. Therefore, savvy professionals will see that price is above or below value and will seize the opportunity. When the scared money is selling, the smart money begins to buy, and Vice versa.
Look at it this way, when the market sells off sharply in one giant candlestick, traders that were short during the drop begin to cover their profitable positions by buying. Likewise, the traders that were on the sidelines during the sell-off now see value in lower prices and begin to buy, thus doubling up on the buying pressure. This helps to spark a sharp v-bottom reversal that pushes price in the opposite direction back toward fair value.