SHORT TERM PATTERNS

TradeSmart Education Center
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Short Term Patterns

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Short-Term Patterns

*Short-term patterns* are based on the shape and relationship of the candlestick(s) or price bar(s) representing one or multiple consecutive trading days. This includes patterns such as the Hanging Man and the Gap Up. The technical event is the confirmation that the pattern has formed in the price bar(s). These Technical Event® opportunities are useful for suggesting possible short-term price movement. They are also useful for supporting or refuting the possible price movement suggested by classic patterns. Short-term patterns are often considered as supplementary information.

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Other patterns

- Gap Down
- Gap Up
BULLISH PATTERNS
1. Engulfing Line (Bullish)

Implication

An Engulfing Line (Bullish) indicates a possible reversal of the current downtrend to a new uptrend. This pattern is an indication of a financial instrument's SHORT-TERM outlook.

Description

The Engulfing Line (Bullish) occurs when the Real Body for a price bar is larger than the Real body for the previous price bar. In addition, for an Engulfing Line (Bullish), the Real Body of the previous session must be Black (close lower than open) and the Real Body of the second session must be White (close higher than open).

![Figure 1: Engulfing Line (Bullish)](image)

Criteria that Support

The difference in the sizes of the two Real Bodies can be an important indicator of the significance of the Engulfing Line. If the Real Body of the previous session is substantially smaller than the Real Body of the following session then this pattern should be considered more significant. The greater the size difference the more significant the formation.

The longer and higher the inbound trend that leads into the Engulfing Line, the more significant the pattern.

Look for heavy volume in the following session. A noticeable increase in volume from the previous few sessions is a strong indication that this pattern is more significant.

If the following session "engulfs" more than one session's Real Body this pattern is very significant.
2. Exhaustion Bar (Bullish)

Implication

An Exhaustion Bar (Bullish) indicates a possible reversal of the current downtrend to a new uptrend. This pattern is an indication of a financial instrument's SHORT-TERM outlook. One and two-bar patterns reflect changes in investor psychology that have a very short-term influence on future prices - typically less than 10 bars. Often the immediate effect is trend exhaustion followed by reversal. For traders looking for clear entry and exit points, these patterns serve well. They are normally not suitable as signals for long-term investors unless viewed as monthly bars.

Description

Exhaustion Bars can develop after a rapid up or down move. They are a form of key reversal, but differ sufficiently enough to warrant their own category.

![Figure 2: Exhaustion Bar (Bullish)](image)

Trading Considerations

Exhaustion Bars can be either Bullish or Bearish depending on the direction of the inbound trend. If the inbound price trend is up, then upon identification of an Exhaustion Bar, taking a short position or selling a long position is recommended. Conversely, if the inbound price trend is down as in this case, then upon identification of an Exhaustion Bar, taking a long position or closing a short position is recommended.

Failure of this pattern is denoted by a price move in the wrong direction beyond the extreme point of the Exhaustion Bar.
The degree that the price bars and volume characteristics match this description will likely have a bearing on the strength of the post pattern price movement. Good trading practice dictates that these signals should not be used in isolation: fundamental data, sector and market indications and other technicals such as support/resistance and momentum studies should be used to support your trading decisions.

Criteria that Support

- The price opens with a large gap in the direction of the then-prevailing trend.
- The bar is extremely wide relative to the previous bars.
- The opening price develops in the lower half of the bar in a downtrend and in the upper half in an uptrend.
- The closing price should be both above the opening price and in the top half of the bar in a downtrend and in the lower half and below the opening in an uptrend.
- The bar is completed with a gap to the left still in place.
- Look for heavy volume to indicate temporary inbound trend climax.

Underlying Behavior

The presence of an Exhaustion Bar usually warns of a reversal of psychology. With a large opening gap, we are seeing the results of extreme sentiment, but as the wide trading range eats up a large part of the opening gap, and the bar ends with the gap almost closed, we have a strong indication of a sentiment reversal from bearish to bullish.
3. Gravestone (Bullish)

Implication

The Gravestone (Bullish) candlestick indicates a possible reversal of the current downtrend to a new uptrend. The Gravestone (Bullish) is mostly seen as a bottom pattern indicating the end of a downtrend. This pattern is an indication of a financial instrument's SHORT-TERM outlook.

Description

The Gravestone consists of a long Upper Shadow and no Real Body (that is the open is equal to the close for the session). There should be no Lower Shadow for a Gravestone.

Trading Considerations

- A small Lower Shadow is acceptable.
- A small Real Body is acceptable.
- A next session bar confirming bullish direction is recommended.

Criteria that Support

The longer the Upper Shadow the more significant the pattern.

Criteria that Refute

- If a Lower Shadow exists and is too long then it will reduce the significance of this pattern.
- If a Real Body exists and is too large then it will reduce the significance of this pattern.
4. Hammer

Implication

The Hammer indicates that the prior downtrend is about to end and may reverse to an uptrend or move sideways. This pattern is an indication of a financial instrument's SHORT-TERM outlook.

Description

The Hammer is characterized by a small Real Body near the top of the price range. The Real Body can be black or white, although a white candlestick is preferable. A white candlestick is slightly more bullish since it shows that the market sold off sharply during the session and then rebounded to close slightly above the opening price level. The Hammer has a long Lower Shadow and an Upper Shadow that is very small or non-existent.

Trading Considerations

In cases where a major downtrend followed by a Hammer exists, the investor should consider vacating short positions.
**Criteria that Support**

- A Hammer can be confirmed by a bullish gap between the Real Body of the Hammer and the open on the next session. In other words, the investor should look for the next session opening higher than the Real Body of the Hammer. The greater the gap, the stronger the signal.
- The Hammer may be stronger if the subsequent session shows a white Real Body with a close higher than the close of the Hammer.
- A Hammer is more significant if it is followed in the next session by another Hammer with superior characteristics.
- Patterns with longer Lower Shadows have greater significance.
- The smaller the Real Body and the Upper Shadow the greater the significance of the pattern.

**Criteria that Refute**

It is important to view signals in the context of prior price action. If the downtrend is strong and there are major bearish indicators before the Hammer, then the Hammer may not work. In this instance, it may be better to wait for bullish confirmation before acting.

The downtrend may still be in force if the next session opens lower than the Real Body of the Hammer.

A Hammer with a black Real Body (where the open is higher than the close) may indicate weakness in the pattern.

**Underlying Behavior**

A long Lower Shadow and the positioning of the Real Body near the top of the range are both indications that the bears could not maintain new lows. This creates the bullish situation.
5. Inside Bar (Bullish)

Implication
An Inside Bar (Bullish) indicates a possible reversal of the current downtrend to a new uptrend. This pattern is an indication of a financial instrument's SHORT-TERM outlook. Two-bar patterns reflect changes in investor psychology that have a very short-term influence on future prices - typically less than 10 bars. Often the immediate effect is trend exhaustion and potentially, a reversal. For traders looking for clear entry and exit points, these patterns serve well. They are normally not suitable as signals for long-term investors unless viewed as monthly bars.

Description
An Inside Bar is a reversal formation characterized by a bar that forms totally within the trading range of the preceding bar. Inside Bars reflect a balance between buyers and sellers following a sharp up or down move, which is sometimes later resolved by a change in trend.

Trading Considerations
Inside Bars can be either Bullish or Bearish depending on the direction of the inbound trend. If the inbound price trend is up, then upon identification of an Inside Bar, taking a short position or selling a long position is recommended. Conversely, if the inbound price trend is down, then upon identification of an Inside Bar, taking a long position or closing a short position is recommended. Look for confirmation in a trend-line break.
The degree that the price bars and volume characteristics match this description will likely have a bearing on the strength of the post pattern price movement. Good trading practice dictates that these signals should not be used in isolation: fundamental data, sector and market indications and other technicals such as support/resistance and momentum studies should be used to support your trading decisions.

Criteria that Support

- The sharper the trend preceding the pattern, the better.
- The wider the first bar and its immediate predecessors in relation to previous bars, the better. This is evidence that the strong underlying momentum of the prevailing trend has climaxed and will dissipate.
- The smaller the second bar relative to the broader range of the first bar, the more dramatic the change in the buyer/seller balance and therefore the stronger the signal.
- Volume on the inside bar should be noticeably smaller than that of the preceding bar since it indicates a more balanced situation.

Underlying Behavior

An Inside Bar indicates a balancing of sentiment between buyers and sellers after a sustained up or down move. On the Inside Bar’s second day, especially with a drop in volume, we are seeing a drop off of interest in this instrument. This balancing usually leads to a period of sideways price movement, but a reversal is possible.
6. Inverted Hammer

Implication

An Inverted Hammer indicates that the prior downtrend is about to end and may reverse to an uptrend or move sideways. This pattern is an indication of a financial instrument's SHORT-TERM outlook.

Description

An Inverted Hammer forms when the Upper Shadow is longer than the Real Body and the Lower Shadow is small or non-existent. The Inverted Hammer is the same candlestick shape as a Shooting Star, although the Inverted Hammer marks the end/reversal of a downtrend, whereas the Shooting Star marks the end/reversal of an uptrend.

Criteria that Support

The Real Body of the Inverted Hammer should "gap" away from the Real Body of the previous session. The greater the size of that gap the more important the Inverted Hammer. Measure the gap between the Real Bodies by taking the higher of the open or the close for the Inverted Hammer and comparing it to the lower of the open or close for the previous session. If the Inverted Hammer's higher value is less than the previous session's lower value then a gap is present.

The Lower Shadow of the Inverted Hammer should be almost non-existent.

The Upper Shadow of the Inverted Hammer should be as large as possible. The larger the Upper Shadow, the more important the Inverted Hammer.

It is recommended to wait for an additional bullish confirmation bar to develop before trading on an Inverted Hammer. This can come in the form of a gap up above the Inverted Hammer's real body or a white candlestick forming on higher prices.
7. Island Bottom

Implication

An Island Bottom is a bullish signal indicating a possible reversal of the current downtrend to a new uptrend. This pattern is an indication of a financial instrument's SHORT-TERM outlook.

Description

The Island Bottom occurs when the price "gaps" below a specific price range for a number of days and then is confirmed when the price "gaps" above the original range.

Figure 7: Island Bottom
8. Key Reversal Bar (Bullish)

Implication

A Key Reversal Bar (Bullish) indicates a possible reversal of the current downtrend to a new uptrend. This pattern is an indication of a financial instrument's SHORT-TERM outlook. One and two-bar patterns reflect changes in investor psychology that have a very short-term influence on future prices - typically less than 10 bars. Often the immediate effect is trend exhaustion, followed by a reversal. For traders looking for clear entry and exit points, these patterns serve well. They are normally not suitable as signals for long-term investors unless viewed as monthly bars.

Description

A Key Reversal Bar is one that develops after a prolonged rally or reaction. Often the trend will be accelerating by the time the price experiences the Key Reversal Bar.

![Figure 8: Key Reversal Bar (Bullish)](image)

Trading Considerations

Key Reversal Bars can be either Bullish or Bearish depending on the direction of the inbound trend. If the inbound price trend is up, then upon identification of a Key Reversal Bar, taking a short position or selling a long position is recommended. Conversely, if the inbound price trend is down, then upon identification of a Key Reversal Bar, taking a long position or closing a short position is recommended.

Failure of this pattern is denoted by a price move in the wrong direction beyond the extreme point of the Key Reversal Bar.
The degree that the price bars and volume characteristics match this description will likely have a bearing on the strength of the post pattern price movement. Good trading practice dictates that these signals should not be used in isolation: fundamental data, sector and market indications and other technicals such as support/resistance and momentum studies should be used to support your trading decisions.

Criteria that Support

- The price opens strongly in the direction of the prevailing trend.
- The trading range is very wide relative to the preceding bars.
- The price closes near or below the previous close (or near or above the previous close in a downtrend reversal).
- Volume if available, should be climactic on the Key Reversal Bar, and should expand during the inbound trend.

Underlying Behavior

The presence of a Key Reversal Bar usually signals a reversal of psychology and a subsequent retracement of recent gains. With a large opening gap on continued volume expansion, we are seeing the results of climactic sentiment growth, but as the bar's wide trading range eats up a large part, or the entire opening gap, we have a very strong indication of sentiment reversal.
9. Outside Bar (Bullish)

Implication

An Outside Bar (Bullish) indicates a possible reversal of the current downtrend to a new uptrend. This pattern is an indication of a financial instrument's SHORT-TERM outlook. Two-bar patterns reflect changes in investor psychology that have a very short-term influence on future prices - typically less than 10 bars. Often the immediate effect is trend exhaustion, then reversal. For traders looking for clear entry and exit points, these patterns serve well. They are normally not suitable as signals for long-term investors unless viewed as monthly bars.

Description

Outside Bars exhibit a trading range that fully encompasses that of the previous bar. They can appear after both downtrends and uptrends, and are a strong signal of trend exhaustion leading to reversal.

Figure 9: Outside Bar (Bullish)
Trading Considerations

Outside Bars can be either Bullish or Bearish depending on the direction of the inbound trend. If the inbound price trend is down, then upon identification of an Outside Bar, taking a long position or closing a short position is recommended. Conversely, if the inbound price trend is up, then upon identification of an Outside Bar, taking a short position or closing a long position is recommended.

The degree that the price bars and volume characteristics match the description above will likely have a bearing on the strength of the post pattern price movement. Look for price influence over the next 5 to 10 bars. Good trading practice dictates that these signals should not be used in isolation: fundamental data, sector and market indications and other technicals such as support/resistance and momentum studies should be used to support your trading decisions.

Criteria that Support

- The wider the second bar relative to the narrower trading range of the preceding bar, the stronger the signal.
- The sharper the downtrend preceding the Outside Bar, the more significant the bar.
- The more bars encompassed, the better the signal.
- The greater the volume accompanying the Outside Bar relative to previous bars, the stronger the signal.
- The nearer the price closes to the extreme point of the bar that is away from the direction of the previous trend, the better. For example, if the previous trend is down and the price closes very near to the high of the Outside Bar, this is more favorable than if it closes near the low and vice versa.

Underlying Behavior

Outside Bars are classic indicators of trend exhaustion and likely reversal of sentiment. The presence of a pair of high volume bars following a sharp rally - with the second bar exhibiting a wide trading range that encompasses all or more of the first bar - is a powerful warning of a change of investor/trader psychology.
10. Two Bar Reversal (Bullish)

Implication

A Two Bar Reversal (Bullish) indicates a possible reversal of the current downtrend to a new uptrend. This pattern is an indication of a financial instrument's SHORT-TERM outlook. One and two-bar patterns reflect changes in investor psychology that have a very short-term influence on future prices - typically less than 10 bars. Often the immediate effect is trend reversal. For traders looking for clear entry and exit points, these patterns serve well. They are normally not suitable as signals for long-term investors unless viewed as monthly bars.

Description

A Two Bar Reversal is a classic signal of trend exhaustion. When these patterns occur after a pronounced advance or decline, the first bar should exhibit a dramatic continuation of the inbound trend, closing close to the bar's extreme end. The second bar completely negates the first bar, with the open price on the second bar being close to the close of the first bar and the close of the second bar being close to the open of the first bar. Wider trading ranges on both bars denote a more climactic reversal in psychology.

Figure 10: Two Bar Reversal
Trading Considerations

Two Bar Reversals can be either Bullish or Bearish depending on the direction of the inbound price trend. If the inbound trend is up, then upon identification of a Two Bar Reversal, taking a short position or selling a long position is recommended. Conversely, if the inbound price trend is down, then upon identification of a Two Bar Reversal, taking a long position or closing a short position is recommended.

The degree that the price bars and volume characteristics match this description will likely have a bearing on the strength of the post pattern price movement. Good trading practice dictates that these signals should not be used in isolation: fundamental data, sector and market indications and other technicals such as support/resistance and momentum studies should be used to support your trading decisions.

Criteria that Support

- A persistent downward inbound trend is required; the longer and sharper, the better.
- Both bars should have exceptionally wide trading ranges relative to the previous bars formed during the inbound trend.
- For both bars, the opening and closing prices should be as close to the extreme points of the bars as possible.
- Volume, if available, should be higher on both bars to accentuate the sentiment reversal. The greater the expansion of volume, the better the signal.

Underlying Behavior

Two Bar Reversals signal the dashing of hopes for those traders and investors that had been riding the trend or had jumped on board the especially wide trading of the pattern's first bar. The second bar, by completely reversing the ground made on the first bar, turns the tide of inbound sentiment and replaces it with an equal and opposite sentiment view. Look for an outbound trend period that reverses any gains made in the lead up to the Two Bar Reversal.
BEARISH PATTERNS
1. Engulfing Line (Bearish)

Implication

An Engulfing Line (Bearish) indicates a possible reversal of the current uptrend to a new downtrend. This pattern is an indication of a financial instrument's SHORT-TERM outlook.

Description

The Engulfing Line (Bearish) occurs when the Real Body for a price bar is larger than the Real Body for the previous price bar. In addition, for an Engulfing Line (Bearish), the Real Body of the previous session must be White (close higher than open) and the Real Body of the second session must be Black (close lower than open).

![Engulfing Line (Bearish)](image)

Criteria that Support

The difference in the sizes of the two Real Bodies can be an important indicator of the significance of the Engulfing Line. If the Real Body of the previous session is substantially smaller than the Real Body of the following session then this pattern should be considered more significant. The greater the size difference the more significant the formation.

The longer and higher the inbound trend that leads into the Engulfing Line, the more significant the pattern.

Look for heavy volume on the following session. A noticeable increase in volume from the previous few sessions is a strong indication that this pattern is more significant.

If the following session "engulfs" more than one session's Real Body this pattern is very significant.
2. Exhaustion Bar (Bearish)

Implication

An Exhaustion Bar (Bearish) indicates a possible reversal of the current uptrend to a new downtrend. This pattern is an indication of a financial instrument's SHORT-TERM outlook. One and two-bar patterns reflect changes in investor psychology that have a very short-term influence on future prices - typically less than 10 bars. Often the immediate effect is trend exhaustion followed by reversal. For traders looking for clear entry and exit points, these patterns serve well. They are normally not suitable as signals for long-term investors unless viewed as monthly bars.

Description

Exhaustion Bars can develop after a rapid up or down move. They are a form of key reversal, but differ sufficiently enough to warrant their own category.

Figure 12: Exhaustion Bar (Bearish)
**Trading Considerations**

Exhaustion Bars can be either Bullish or Bearish depending on the direction of the inbound trend. If the inbound price trend is up as in this case, then upon identification of an Exhaustion Bar, taking a short position or selling a long position is recommended. Conversely, if the inbound price trend is down, then upon identification of an Exhaustion Bar, taking a long position or closing a short position is recommended.

Failure of this pattern is denoted by a price move in the wrong direction beyond the extreme point of the Exhaustion Bar.

The degree that the price bars and volume characteristics match this description will likely have a bearing on the strength of the post pattern price movement. Good trading practice dictates that these signals should not be used in isolation: fundamental data, sector and market indications and other technicals such as support/resistance and momentum studies should be used to support your trading decisions.

**Criteria that Support**

- The price opens with a large gap in the direction of the then-prevailing trend.
- The bar is extremely wide relative to the previous bars.
- The opening price develops in the lower half of the bar in a downtrend and in the upper half in an uptrend.
- The closing price should be both above the opening price and in the top half of the bar in a downtrend and in the lower half and below the opening in an uptrend.
- The bar is completed with a gap to the left still in place.
- Look for heavy volume to indicate temporary inbound trend climax.

**Underlying Behavior**

The presence of an Exhaustion Bar usually warns of a reversal of psychology. With a large opening gap, we are seeing the results of extreme sentiment, but as the wide trading range eats up a large part of the opening gap, and the bar ends with the gap almost closed, we have a strong indication of a sentiment reversal from bullish to bearish.
3. Gravestone (Bearish)

Implication

The Gravestone (Bearish) candlestick indicates a possible reversal of the current uptrend to a new downtrend. This pattern is an indication of a financial instrument's SHORT-TERM outlook.

Description

The Gravestone (Bearish) consists of a long Upper Shadow and no Real Body (i.e. the open is equal to the close for the session). There should be no Lower Shadow for a Gravestone.

Trading Considerations

- A small Lower Shadow is acceptable.
- A small Real Body is acceptable.

Criteria that Support

- The longer the Upper Shadow the more significant the pattern.

Criteria that Refute

- If a Lower Shadow exists and is too long then it will reduce the significance of this pattern.
- If a Real Body exists and is too large then it will reduce the significance of this pattern.
4. Hanging Man

Implication

The Hanging Man is a bearish signal indicating that the prior uptrend is about to end and may reverse to a downtrend or move sideways. This pattern is an indication of a financial instrument's SHORT-TERM outlook.

Description

The name "Hanging Man" is used because it has a gloomy connotation, and also because the candlestick that defines this pattern looks like a hanging man with dangling legs. The Hanging Man pattern is characterized by a small Real Body near the top of the price range. The Real Body can be black or white, although a black candlestick is preferable. A black candlestick is slightly more bearish since it shows that the close could not get back up to the opening price level. The Hanging Man has a long lower shadow that should be at least twice the length of the Real Body. The upper shadow should be very small or non-existent.

Trading Considerations

In cases where a major uptrend exists followed by a Hanging Man, the investor should consider vacating long positions.
Criteria that Support

- A Hanging Man can be confirmed by a bearish gap between the Real Body of the Hanging Man and the open on the next session. In other words, the investor should look for the next session opening lower than the Real Body of the Hanging Man. The greater the gap, the stronger the signal.
- A Hanging Man may be a stronger signal if the subsequent session shows a black Real Body with a close lower than the close of the Hanging Man.
- A Hanging Man may be a stronger signal if it is followed by another, well-formed Hanging Man in the next session.
- The longer the Lower Shadow of the Hanging Man the greater the significance of the pattern.
- The smaller the Real Body and the Upper Shadow the more significant the pattern.

Criteria that Refute

It is important to view signals in the context of prior price action. If the uptrend is strong and there are major bullish indicators before the Hanging Man, then perhaps the bullish momentum is overwhelming and the Hanging Man won't work. In such cases it is wise to wait for bearish confirmation before acting.

The uptrend may still be in force if the next session opens higher than the Real Body of the Hanging Man.

A Hanging Man with a white Real Body (where the close is higher than the open) may indicate weakness in the pattern.
5. Inside Bar (Bearish)

Implication

An Inside Bar (Bearish) indicates a possible reversal of the current uptrend to a new downtrend. This pattern is an indication of a financial instrument's SHORT-TERM outlook. Two-bar patterns reflect changes in investor psychology that have a very short-term influence on future prices - typically less than 10 bars. Often the immediate effect is trend exhaustion and potentially, a reversal. For traders looking for clear entry and exit points, these patterns serve well. They are normally not suitable as signals for long-term investors unless viewed as monthly bars.

Description

An Inside Bar is a reversal formation characterized by a bar that forms totally within the trading range of the preceding bar. Inside bars reflect a balance between buyers and sellers following a sharp up or down move, which is sometimes later resolved by a change in trend.

Figure 15: Inside Bar (Bearish)
Trading Considerations

Inside Bars can be either Bullish or Bearish depending on the direction of the inbound trend. If the inbound price trend is up, then upon identification of an Inside Bar, taking a short position or selling a long position is recommended. Conversely, if the inbound price trend is down, then upon identification of an Inside Bar, taking a long position or closing a short position is recommended. Look for confirmation in a trend-line break.

The degree that the price bars and volume characteristics match this description will likely have a bearing on the strength of the post pattern price movement. Good trading practice dictates that these signals should not be used in isolation: fundamental data, sector and market indications and other technicals such as support/resistance and momentum studies should be used to support your trading decisions.

Criteria that Support

- The sharper the trend preceding the pattern, the better.
- The wider the first bar and its immediate predecessors in relation to previous bars, the better.
  
  This is evidence that the strong underlying momentum of the prevailing trend has climaxed and will dissipate.
- The smaller the second bar relative to the broader range of the first bar, the more dramatic the change in the buyer/seller balance and therefore the stronger the signal.
- Volume on the inside bar should be noticeably smaller than that of the preceding bar since it indicates a more balanced situation.

Underlying Behavior

An Inside Bar indicates a balancing of sentiment between buyers and sellers after a sustained up or down move. On the Inside Bar’s second day, especially with a drop in volume, we are seeing a drop off of interest in this instrument. This balancing usually leads to a period of sideways price movement, but a reversal is possible.
6. Island Top

Implication

An Island Top is a bearish signal indicating a possible reversal of the current uptrend to a new downtrend. This pattern is an indication of a financial instrument's SHORT-TERM outlook.

Description

The Island Top occurs when the price "gaps" above a specific price range for a number of days and then is confirmed when the price "gaps" down below to the original range.

Figure 16: Island Top
7. Key Reversal Bar (Bearish)

Implication

A Key Reversal Bar (Bearish) indicates a possible reversal of the current uptrend to a new downtrend. This pattern is an indication of a financial instrument's SHORT-TERM outlook. One and two-bar patterns reflect changes in investor psychology that have a very short-term influence on future prices - typically less than 10 bars. Often the immediate effect is trend exhaustion, followed by a reversal. For traders looking for clear entry and exit points, these patterns serve well. They are normally not suitable as signals for long-term investors unless viewed as monthly bars.

Description

A Key Reversal Bar is one that develops after a prolonged rally or reaction. Often the trend will be accelerating by the time the price experiences the Key Reversal Bar.

Figure 17: Key Reversal Bar (Bearish)
Trading Considerations

Key Reversal Bars can be either Bullish or Bearish depending on the direction of the inbound trend. If the inbound price trend is up, then upon identification of a Key Reversal Bar, taking a short position or selling a long position is recommended. Conversely, if the inbound price trend is down, then upon identification of a Key Reversal Bar, taking a long position or closing a short position is recommended.

Failure of this pattern is denoted by a price move in the wrong direction beyond the extreme point of the Key Reversal Bar.

The degree that the price bars and volume characteristics match this description will likely have a bearing on the strength of the post pattern price movement. Good trading practice dictates that these signals should not be used in isolation: fundamental data, sector and market indications and other technicals such as support/resistance and momentum studies should be used to support your trading decisions.

Criteria that Support

- The price opens strongly in the direction of the prevailing trend.
- The trading range is very wide relative to the preceding bars.
- The price closes near or below the previous close (or near or above the previous close in a downtrend reversal).
- Volume if available, should be climactic on the Key Reversal Bar, and should expand during the inbound trend.

Underlying Behavior

The presence of a Key Reversal Bar usually signals a reversal of psychology and a subsequent retracement of recent gains. With a large opening gap on continued volume expansion, we are seeing the results of climactic sentiment growth, but as the bar's wide trading range eats up a large part, or the entire opening gap, we have a very strong indication of sentiment reversal.
8. Outside Bar (Bearish)

Implication

An Outside Bar (Bearish) indicates a possible reversal of the current uptrend to a new downtrend. This pattern is an indication of a financial instrument's SHORT-TERM outlook. Two-bar patterns reflect changes in investor psychology that have a very short-term influence on future prices - typically less than 10 bars. Often the immediate effect is trend exhaustion, then reversal. For traders looking for clear entry and exit points, these patterns serve well. They are normally not suitable as signals for long-term investors unless viewed as monthly bars.

Description

Outside Bars exhibit a trading range that fully encompasses that of the previous bar. They can appear after both downtrends and uptrends, and are a strong signal of trend exhaustion leading to reversal.

Trading Considerations

Outside Bars can be either Bullish or Bearish depending on the direction of the inbound trend. If the inbound price trend is down, then upon identification of an Outside Bar, taking a long position or closing a short position is recommended. Conversely, if the inbound price trend is up, then upon identification of an Outside Bar, taking a short position or closing a long position is recommended.

The degree that the price bars and volume characteristics match the description above will likely have a bearing on the strength of the post pattern price movement. Look for price influence over the next 5 to 10 bars. Good trading practice dictates that these signals should not be used in isolation: fundamental data, sector and market indications and other technicals such as support/resistance and momentum studies should be used to support your trading decisions.
Criteria that Support

- The wider the second bar relative to the narrower trading range of the preceding bar, the stronger the signal.
- The sharper the rally preceding the Outside Bar, the more significant the bar.
- The more bars encompassed, the better the signal.
- The greater the volume accompanying the Outside Bar relative to previous bars, the stronger the signal.
- The nearer the price closes to the extreme point of the bar that is away from the direction of the previous trend, the better. For example, if the previous trend is up and the price closes very near to the low of the Outside Bar, this is more favorable than if it closes near the high and vice versa.

Underlying Behavior

Outside Bars are classic indicators of trend exhaustion and likely reversal of sentiment. The presence of a pair of high volume bars following a sharp rally - with the second bar exhibiting a wide trading range that encompasses all or more of the first bar - is a powerful warning of a change of investor/trader psychology.
9. Shooting Star

Implication

A Shooting Star indicates that the prior uptrend is about to end and may reverse to a downtrend or move sideways. This pattern is an indication of a financial instrument's SHORT-TERM outlook.

Description

A Shooting Star forms when the Upper Shadow is longer than the Real Body and the Lower Shadow is small or non-existent. The Shooting Star is the same as an Inverted Hammer, only the Shooting Star appears at the end of an uptrend, whereas the Inverted Hammer appears at the end of a downtrend.

Figure 19: Shooting Star

Criteria that Support

The Real Body of the Shooting Star should "gap" away from the Real Body of the previous period. The greater the size of that gap the more important the Shooting Star. Measure the gap between the Real Bodies by taking the lower of the open or the close for the Shooting Star and comparing it to the higher of the open or close for the previous period. If the Shooting Star's lower value is greater than the previous period's higher value then a gap is present.

The Lower Shadow of the Shooting Star should be close to zero.

The Upper Shadow of the Shooting Star should be as large as possible. The larger the Upper Shadow, the more important the Shooting Star.
10. Two Bar Reversal (Bearish)

Implication

A Two Bar Reversal (Bearish) indicates a possible reversal of the current uptrend to a new downtrend. This pattern is an indication of a financial instrument's SHORT-TERM outlook. One and two-bar patterns reflect changes in investor psychology that have a very short-term influence on future prices - typically less than 10 bars. Often the immediate effect is trend reversal. For traders looking for clear entry and exit points, these patterns serve well. They are normally not suitable as signals for long-term investors unless viewed as monthly bars.

Description

A Two Bar Reversal is a classic signal of trend exhaustion. When these patterns occur after a pronounced advance or decline, the first bar should exhibit a dramatic continuation of the inbound trend, closing close to the bar's extreme end. The second bar completely negates the first bar, with the open price on the second bar being close to the close of the first bar and the close of the second bar being close to the open of the first bar. Wider trading ranges on both bars denote a more climactic reversal in psychology.

Trading Considerations

Two Bar Reversals can be either Bullish or Bearish depending on the direction of the inbound price trend. If the inbound trend is up, then upon identification of a Two Bar Reversal, taking a short position or selling a long position is recommended. Conversely, if the inbound price trend is down, then upon identification of a Two Bar Reversal, taking a long position or closing a short position is recommended.

The degree that the price bars and volume characteristics match this description will likely have a bearing on the strength of the post pattern price movement. Good trading practice dictates that these signals should not be used in isolation: fundamental data, sector and market indications and other technicals such as support/resistance and momentum studies should be used to support your trading decisions.
Criteria that Support

- A persistent upward inbound trend is required; the longer and sharper, the better.
- Both bars should have exceptionally wide trading ranges relative to the previous bars formed during the inbound trend.
- For both bars, the opening and closing prices should be as close to the extreme points of the bars as possible.
- Volume, if available, should be higher on both bars to accentuate the sentiment reversal. The greater the expansion of volume, the better the signal.

Underlying Behavior

Two Bar Reversals signal the dashing of hopes for those traders and investors that had been riding the trend or had jumped on board the especially wide trading of the pattern's first bar. The second bar, by completely reversing the ground made on the first bar, turns the tide of inbound sentiment and replaces it with an equal and opposite sentiment view. Look for an outbound trend period that reverses any gains made in the lead up to the Two Bar Reversal.
OTHER PATTERNS
1. Gap Down

Implication

Gaps usually represent important areas of support or resistance. A Gap Down will indicate different situations based on the context in which it was formed. A Gap Down in a downtrend may indicate a previous level of support has been broken and now forms a resistance level. A Gap Down in an uptrend may indicate an end to, or a reversal of, the prior uptrend. Gaps provide an indication of a financial instrument's SHORT-TERM outlook.

Description

A Gap Down forms when the high for a period (usually a day) is lower than the previous period's low.

Trading Considerations

Since Gaps represent important areas of support or resistance they can be used to measure the strength of moves. If a price breaks through a Gap it is usually a signal of a significant price move.

Criteria that Support

Three Gap Downs within a trend indicate a possible end to, or reversal of, that trend. The three Gaps do not have to occur on sequential days, but may form many days apart.
2. Gap Up

Implication

Gaps usually represent important areas of support or resistance. A Gap Up will indicate different situations based on the context in which it was formed. A Gap Up in an uptrend may indicate a previous level of resistance has been broken and now forms a support level. A Gap Up in a downtrend may indicate an end to, or a reversal of, the prior downtrend. Gaps provide an indication of a financial instrument's SHORT-TERM outlook.

Description

A Gap Up forms when the low for a period (usually day) is higher than the previous period's high.

Trading Considerations

Since Gaps represent important areas of support or resistance they can be used to measure the strength of moves. If a price breaks through a Gap it is usually a signal of a significant price move.

Criteria that Support

Three Gap Ups within a trend indicate a possible end to, or reversal of, that trend. The three Gaps do not have to occur on sequential days, but may form many days apart.