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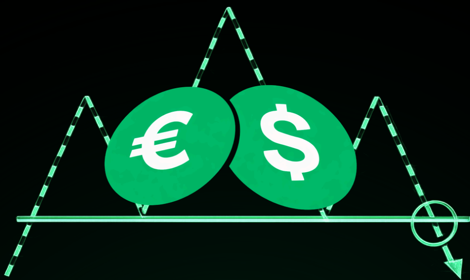

HEAD AND SHOULDER PATTERN

Spotting Market Reversals with Head and Shoulders

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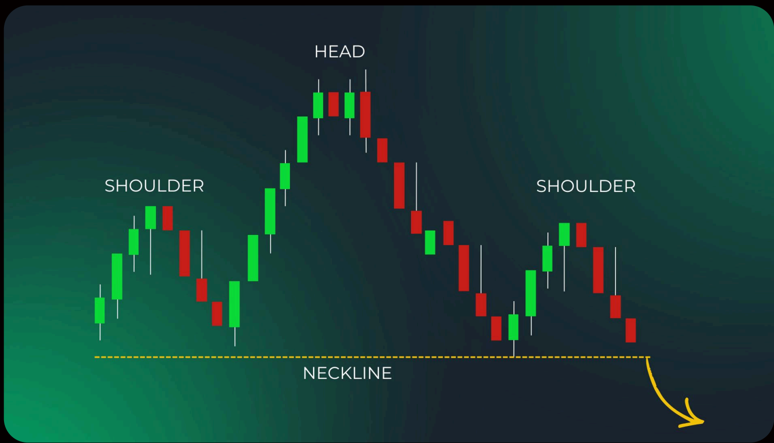
1. CONTEXT

The Head and Shoulders trading pattern is one of the oldest and most powerful formations used by day traders today. When identified at the right levels, it can provide excellent foresight into potential trend reversals. By its very nature, the pattern also offers a consistently favourable risk-to-reward ratio.

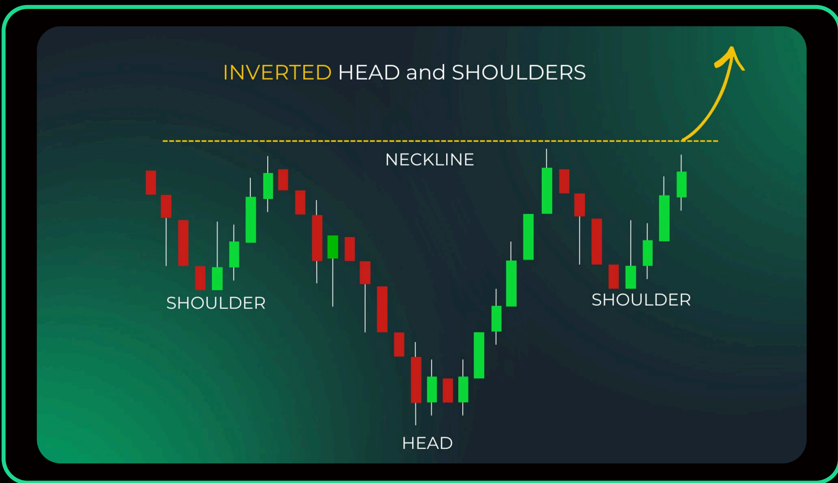
The most powerful setups are identified by using liquidity areas found on higher time frames, typically the 4-hour and daily charts. The patterns themselves are then identified on the lower time frames.
Head and shoulders patterns form on all time frames; however, daily and weekly head and shoulders patterns can be used to anticipate large swing reversal trades.

It is characterized by two shoulders on either side of a failed high, known as the head. The base of the pattern is called the neckline, which is used to define entry levels and to calculate profit targets.



A conventional head and shoulders pattern is used to identify short-selling opportunities, as it signals a potential bearish trend reversal.

An inverted head and shoulders pattern, on the other hand, is used to identify long or buy opportunities, as it signals a potential bullish trend reversal.



Trades are typically taken on the break of the neckline; however, waiting for a retest of the neckline after the break often provides higher-probability trade entries.

RISK MANAGEMENT AND PROFIT TARGETS

On the conventional head and shoulders pattern, the initial stop loss is placed above the preceding shoulder prior to the neckline break. The profit target is then set using the same distance measured from the top of the head to the neckline, projected downward from the point of entry.

On the inverted head and shoulders pattern, the initial stop loss is placed below the preceding shoulder prior to the neckline break. The profit target is set using the same distance measured from the bottom of the head to the neckline, projected upward from the point of entry.

To reiterate, the most powerful levels are found at strong liquidity areas. As always, backtest thoroughly before implementing this strategy.

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