

FOREX TRADING

ULTIMATE **PROVEN** GUIDE
TO **PROFITABLE TRADING**

VOL III - INTRODUCTION TO TECHNICAL ANALYSIS

J O S H B R I G H T

Forex Trading

Ultimate Proven Guide to Profitable Trading
Volume III - Introduction to Technical Analysis

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Table of Contents

[Chapter 1](#)

[Hammers and Shooting Stars to Reverse a Trend](#)

[Chapter 2](#)

[Morning and Evening Stars in Technical Analysis](#)

[Chapter 3](#)

[Gaps vs. Windows](#)

[Chapter 4](#)

[Different Types of Doji Candles](#)

[Chapter 5](#)

[Moving Averages to Ride a Trend](#)

[Chapter 6](#)

[Golden and Death Crosses in Forex Trading](#)

[Chapter 7](#)

[Using the Higher Highs and Lower Lows to Build a Channel](#)

[Chapter 8](#)

[Classic and Dynamic Support and Resistance Levels](#)

[Chapter 9](#)

Confluence Areas in Forex Trading

Chapter 10

How to Trade the Head and Shoulders Pattern

Chapter 11

A Guide to Trading Wedges

Chapter 12

Bullish and Bearish Flags Explained

Chapter 13

Ascending and Descending Triangles in Forex

Chapter 14

When Triangles Reverse a Trend

Chapter 15

Bollinger Bands as a Trend Indicator

Chapter 16

Bollinger Bands as a Breakout Indicator

Chapter 17

The Key to Trading Theories – Fibonacci Ratios

CHAPTER 1

HAMMERS AND SHOOTING STARS TO REVERSE A TREND

This book deals with Technical Analysis, or the art of interpreting patterns on the left side of a chart and projecting future prices onto the right. Technical Analysis has been around a long time, from the very beginning of the U.S. stock market.

Traders noticed that stock prices have a tendency to form specific patterns before continuing or reversing a trend. They started to document those patterns, and this is how technical analysis was born.

But this was only the so-called “Western” approach to technical analysis. In the late 1990s, Steve Nison introduced Japanese “candlesticks” techniques in the United States.

To the surprise of many in the Western world, it turned out that the Japanese had used candlesticks to trade rice futures since the mid-1700’s.

In one of the previous books we covered the concept of a candlestick and specifically the concept of a hammer. However, we merely talked about what it was, not how to trade it.

As a reminder, a hammer is one of the most powerful reversal patterns in the set of Japanese candlesticks techniques. Traders love it because it is so strong and so easy to recognize: a single candle that has the power to reverse an entire trend.

A hammer appears at the end of a bearish trend, while its opposite “brother” - the shooting star -- forms at the end of a bullish trend.

Signs of a hammer:

- The market is moving in a strong bearish trend
- The candlestick has a lower shadow at least three times longer than the real body
- The candlestick has little or no upper shadow
- The real body is either green or red

Conversely, for a shooting star:

- The market is moving in a bullish trend
- The candlestick forms with a very long upper shadow
- The upper shadow is at least three times longer than the real body
- The real body can be either green or red

As it turns out, like all Japanese candlestick patterns, the hammer and the shooting star provide great opportunities for Forex trading. Because the resulting trades offer outstanding risk-reward ratios, traders strive to find them.

But once they find them, how do they trade a hammer or a shooting star?

As you are accustomed to by now, we'll use examples to illustrate how to trade a hammer properly. And, as for every trade in the currency market, we'll set up clear rules for what the entry, exit, and take profit levels should be.

Since the hammer and the shooting star are reversal patterns, the bears or bulls won't give up that easy. This is the key to trading them.

Our example involves a shooting star pattern formed on the EURUSD 4h timeframe. Here it is:



The market rises in a bullish trend, and suddenly stops and forms a shooting star. All the required conditions are in place.

However, bulls won't give up after the shooting star. They'll keep trying to push the price back above the top of it. If that happens, the shooting star becomes invalidated.

For this reason, savvy traders use the inevitable pullback to find better entries for the short trade. The steps to follow are:

- measure the entire length of the shooting star, from top to bottom
- use a Fibonacci retracement tool to calculate the 50% and 61.8% retracement points
- place a pending sell stop limit order in that 50%-61.8% range
- place a stop loss order at the top of the shooting star (its highest value)



You can also enter the sell order manually, at the market, but always keep in mind that the stop loss order is mandatory.

The next thing to do is to determine the reward. Or, the target value.

Obviously, the bigger the better, but in Forex trading reality tells us that proper risk-reward ratios are anywhere between 1:2 and 1:3. As we discussed in an earlier book, the risk-reward ratio shows the pips or dollars to be made for every pip or dollar risked.

The chart below speaks for itself, as a 1:3 ratio is easily reached. In fact, it could be more than that, because the 50%-61.8% retracement range that provided the entry point of the trade comes on top of the initial target.



CHAPTER 2

MORNING AND EVENING STARS IN TECHNICAL ANALYSIS

The morning and evening stars are two other Japanese candlestick patterns, similar to the hammer and the shooting star because they also indicate the reversal of a trend. They need three candles for the pattern to form.

As the name suggests, a morning star is a bullish reversal pattern. The Sun rises – so does a new bullish trend.

As you might expect, the evening star's name comes from the Sun setting down as the night approaches. A bearish reversal pattern, its conditions are exactly opposite those of the morning star.



For a morning star, the market must be in a bearish trend and:

- the 1st candle goes in the trend's direction, with a strong red real body
- the 2nd candle has a small body, and can be either red or green (if the 2nd candle is a hammer, the morning star is an even stronger reversal pattern)
- finally, the last candle has a strong, bullish green body that retraces at least fifty percent of the 1st candle's body

An evening star, on the other hand, is a bearish pattern and:

- the 1st candle goes in the trend's direction, with a strong green real body
- the 2nd candle has a small body, and can be either red or green (if the 2nd candle is a shooting star, the evening star is an even stronger reversal pattern)
- finally, the last candle has a strong, bearish red body that retraces at

least fifty percent of the 1st candle's body

Since we used the bearish shooting star in the previous chapter to illustrate the hammer/shooting star pattern, let's focus on the morning star this time. Here's how the pattern looks:



In this example, the third candle is a really strong one, outsizing the first candle's real body easily. How should we trade it?

The key here is to understand that the market doesn't retrace that much into the territory of the morning star. Hence, your trade entry point isn't the 50%-61.8% range, but more in the 38.2%-50% area.

To find it, just use two horizontal lines to mark the highest and the lowest point in the morning star pattern. In other words, just check the highest and lowest values of the three candles that make the pattern.

Next, use the Fibonacci retracement tool to mark the 38.2%-50% area. Finally, wait for a pullback into that range, and enter a trade on the long side either at the market or using a pending buy limit order.

Obviously, your stop loss should sit at the bottom of the pattern (at the lowest value of the three candles that make the morning star).



What about the take profit point? This time we use the effective risk (the distance between the entry point and the stop loss) and multiply it by three for a proper risk-reward ratio.



These steps presented here correspond to the morning star. For the evening star, they are similar, but in reverse: bears go short.

The hammer and the shooting star together with the morning and evening stars, are representative of all Japanese candlesticks techniques. The methods to trade other reversal patterns are the same. For this reason, of the other patterns we will only cover the Doji pattern a bit later in this book, as the rest (bullish and bearish engulfing, piercing and dark-cloud cover) follow similar

trading techniques.

CHAPTER 3

GAPS VS. WINDOWS

Perhaps the most exciting difference between the Western approach to technical analysis and the Japanese one is to consider their interpretation of gaps.

To begin with, a gap appears when the opening price of the next period (or candlestick) is much higher or lower when compared with the previous period (or candlestick)'s closing price.

In the Forex market, gaps rarely form when the market is open. That is, from early Monday when trading starts in New Zealand until late Friday in North America, gaps don't appear for a single reason: the market is so deep and liquid that no event causes significant gaps (some examples existed in the past, but those were unprecedented – e.g., Swiss National Bank dropping the 1.20 EURCHF peg).

Gaps do form, though, at the Monday's opening. Over the weekend important events can take place, such as general elections, referendums, economic summits, and so on.

Or, central banks can take important decisions over the weekend, taking advantage of the fact that financial markets are closed. In any case, if there's ever a chance to see a gap in the Forex market, it would be on Monday's opening.

The Western approach to interpret gaps is that eventually all of them must be filled. Some theories say that gaps must be filled by the end of the day, some others claim that the end of the week is a more appropriate target.

Reality begs to differ. In Forex trading, some gaps take quite some time to fill. If ever.



See the grey circle in the chart above? That's the so-called "French election" gap.

It formed on the EURUSD pair (and is visible on some other Euro pairs too) around 1.06-1.08 levels in April 2017 and is still open fourteen months later. It may close someday, to fulfill the expectation of the Western approach, but staying short waiting for the gap to close is an expensive way to find out if the Western approach works in all cases or not.

In the meantime, the EURUSD traded as high as 1.2555 in February 2018.



The Japanese have a different approach to trading. Why aren't we surprised?

According to the Japanese approach to gaps, they are continuation patterns. Hence, if there's a bullish trend in place, and the market gaps higher, the gap only confirms the previous trend.

Moreover, the Japanese have a different name for gaps. They call them windows, and, in Forex trading, a window is an empty space between the closing price on Friday and the opening price on Monday.

Even more interesting is the idea that the window's edges are supposed to act as strong future support and resistance levels.

If that's the case, look for 1.07-1.08 area to be a tough nut to crack in the period ahead.



CHAPTER 4

DIFFERENT TYPES OF DOJI CANDLES

We can't leave the Japanese approach to Technical Analysis without discussing the Doji candle. For a single candle, the Doji pattern is full of mystery as it shows both continuation and reversal conditions.

But what makes a Doji candle?

Like any candlestick, a Doji has a real body and an upper and lower shadow. For the real body, things are pretty straightforward: it should be a perfectly horizontal line: the opening and closing prices exactly the same.

Notice the wording "it should be."

Trading the FX market in the 21st- century may require adapting to advances in technology. Nowadays the execution and market prices are so precise (most brokers offer five-digit quotes for currency trading) that seeing the exact same prices for the opening and closing levels is exceedingly rare.



So, this is what makes a Doji candle: the opening and the closing price must be similar. Again, due to today's market conditions, traders must have an open mind regarding what "similar" means. Try to think in terms of "close" or "within the area" rather than "exactly".

This is especially true when looking at a Doji candle on a bigger timeframe, monthly or weekly. What are the chances in 21st- century Forex trading that a currency pair will close the month at the exact level it started? Virtually zero.

The mystery of a Doji candle comes from what it signals. Pure uncertainty. There's nothing certain, so traders must wait for the market to move before they do anything.

The simple appearance of a Doji candle does indicate something, though. Hesitation.

For whatever the reason, the market hesitates. It either consolidates, taking a breath ahead of another push in the direction of the underlying trend... or it prepares for a sharp reversal.

The usual caveat applies here too: the bigger the timeframe, the stronger the implications of a Doji candle.

We've already covered the basics of the Doji candle in the first book in this educational series, but now we should go into more details. How to trade a Doji? And how many types of Doji candles exist?

The best way to illustrate the magic of the Doji candle is to look at a chart. In this case, we'll examine the AUDUSD 4h timeframe showing the recent downtrend. For the entire month of June 2018, it fell from about 0.77 to almost the 0.73 level.



The chart above may not tell you anything other than showing a downward trend. However, remember the title of this chapter? We're here to interpret the Doji candles, their types, and what they tell us regarding future price action. You might be surprised to discover how much a “naked” chart like the one above has to tell the trader that pays attention.

If we zoom in a bit, the AUDUSD four-hour timeframe reveals plenty of Doji candles. Some of them showing hesitation (the classic Doji), others reversal patterns (Northern Doji is a bearish reversal pattern) and others that just show the market has lost a sense of direction (Rickshaw man). Furthermore, some Doji candles show bullish conditions, like the Doji after a bearish candle (after a tall bearish candle, as the original Japanese nickname states).



In any case, trading a Doji is relatively simple:

- wait for the market to break higher or lower with the next candle or candles
- enter when the price breaks the lower or upper part of the Doji candle
- go for 1:3 risk-reward ratio
- place a stop loss at the high or low of the Doji candle, depending on the direction

Don't worry if the stop loss is hit! As the chart above shows, there are plenty of other opportunities to trade, as Doji candles form often. The only thing traders don't know is how to interpret them. Now, that mystery is revealed.

CHAPTER 5

MOVING AVERAGES TO RIDE A TREND



Traders have been interested in moving averages since the dawn of technical analysis. Beginning in the late 1970s, the Personal Computer (PC) made it possible for the home trader to more easily analyze existing data using sophisticated formulas.

Hence, technical analysis got a new push and the use of moving averages of different types appeared.

A Moving Average (MA) is a trend indicator. As a rule of thumb, all trend indicators appear on the actual chart, closely following the price action.

The aim, obviously, is to ride a trend. That is, to buy dips in a bullish trend and sell spikes in a bearish one.

Even the strongest trends have pullbacks and paying attention to moving averages gives traders the opportunity to scale into a position by trading such pullbacks.

Different types of moving averages exist:

- SMA – Simple Moving Average
- EMA – Exponential Moving Average
- DMA – Displaced Moving Average

The three above are only some examples. There are so many other ones that it doesn't make sense to list them all here.

What matters is how to use moving averages when trading the Forex market. If you know the principle, you can use then any MA type.

The name is self-explanatory. A moving average “averages” past prices to project a level corresponding to the current period.

Usually, MAs use the closing price of a period, but that can easily be customized. And, the most popular MA is the SMA.

The SMA does exactly what the name suggests: it simply averages the closing prices for a certain number of past periods. The bigger the number of periods that are averaged, the flatter the SMA.

A moving average divides the screen into two parts: bullish and bearish. The idea behind trading with a moving average is to note the underlying trend and then enter on the long or short side when the price hits the MA.



One thing to note: the more time the price spends near the MA, the weaker

the eventual support or resistance it'll offer.

The USDCAD daily time frame above has the SMA(200) on it. The black line averages the closing prices of the last two hundred days to plot the current value.

It is considered to be the most relevant MA in the sense that if a moving average uses more periods, the line will lose its relevance.

At this point, it is important to remember the take-aways for using a moving average:

- it divides the market into bullish and bearish territory
- traders buy in a bullish market and sell in a bearish one
- the longer the price spends near the MA, the weaker the support or resistance becomes
- beyond MA(200) the line flattens too much and it loses its relevance
- the bigger the chart timeframe, the stronger the support or resistance level

CHAPTER 6

GOLDEN AND DEATH CROSSES IN FOREX TRADING

The concept of a golden or death cross comes from the stock market. It uses two SMA's (Simple Moving Average) to signal the market entering a bullish or a bearish phase.

As the name might suggest, a golden cross is bullish, while a death cross is bearish.

The two SMAs used are the SMA(200) and SMA(50). Typically, traders use different colors for the two, so that they can identify the MA's quickly on the chart.

When the faster MA crosses above the slower one, it is said that the price enters a bullish market. When it happens on bigger timeframes, like the monthly or so, the implications are more significant than on the smaller ones.



Here's the previous USDCAD daily time frame, only this time we added the

SMA(50) to it. The blue line crossing below the black one signals a death cross, so traders will use any opportunity to sell into resistance.



Obviously, the SMA(50) offers less resistance than the SMA(200). What traders do is use the two averages for entries and exits. For instance, the most common way to trade the two is to sell SMA(200) resistance for the SMA(50) target.

Or, after a golden cross, to buy SMA(200) support for SMA(50) resistance. Quite simple, isn't it? Like in life, simple things work best when trading the Forex market.

CHAPTER 7

USING THE HIGHER HIGHS AND LOWER LOWS TO BUILD A CHANNEL

One of the reasons why traders come to the Forex market is to ride trends. What can be easier than to make money riding a trend?

An old saying in trading states that “the trend is your friend”. Ignore it, and you’re doing it at your own risk.



The beauty of trading the Forex market is that trends appear often. Not that often on long timeframes, but often enough to make the most out of them.

The problem with riding a trend is that traders don’t know when it’ll end. When profits build up, the temptation is to book them and close the position.

In most cases, the market continues the trend and traders that got out start regretting their decision to exit the trade.

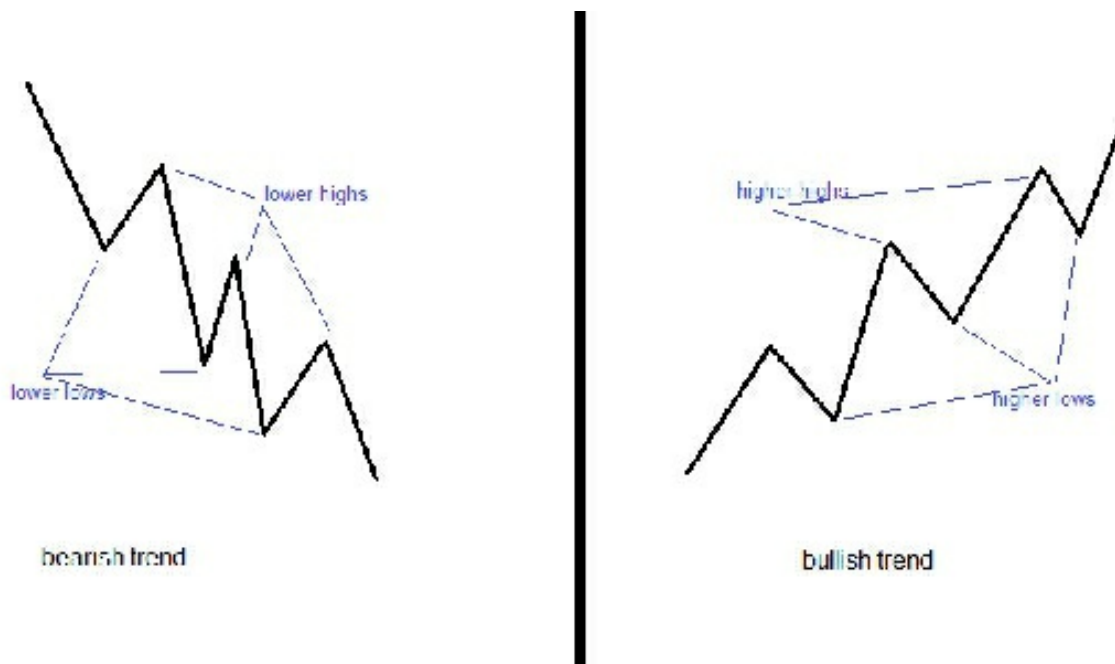
Fortunately, trends have rules. And traders can use the rules of a trend to build a channel.

In technical analysis, channels work like the roads for automobiles. They give direction and a roadmap for future price action.

A bullish market advances by making a series of higher highs and higher lows. This is what traders focus on because as long as this series remains in place, the trend will keep on going.

The opposite happens in a bearish trend: the market declines and makes a series of lower lows and lower highs.

No matter how strong a reversal pattern might appear, until that series of higher highs and higher lows is broken, fighting a bullish trend is risky. Of course, the same is true in the case of a series of lower lows and lower highs: a bearish trend won't reverse until the series breaks.



Above is an illustration of the two series that make a bullish and a bearish trend. Here's how a trend on the currency market looks like:



This EURUSD daily chart shows the rising trend that dominated 2017 price action. The market started slowly to rise, and it broke the previous lower lows and lower highs series that belonged to the prior bearish trend.

It signaled that the bulls were prepared to take back control. However, even the strongest trend has its pullbacks.

The key is to check if the market manages to build the series for the new trend. If it does, a new trend starts.

The two series described help building a rising or falling channel. Here are the rules:

- start from the top (in a bearish trend) or bottom (in a bullish one)
- connect the top or bottom with the first higher low or lower high
- project the resulting trendline to the right side of the chart
- copy the trendline and project it from the previous lower highs or higher lows series

If we apply these rules on the EURUSD daily chart, the result is a nice bullish channel that gives the resistance against its upper edge.



CHAPTER 8

CLASSIC AND DYNAMIC SUPPORT AND RESISTANCE LEVELS

One of the earliest technical analysis concepts, support and resistance, originated from price action. Price action or trading with an empty chart refers to projecting areas where price hesitated in the past.

When the market moves, it moves in steps. For various reasons, it consolidates for a while before the main trend resumes.

Projecting these consolidation areas to the right side of the chart can give the trader an idea about what the price is likely to do next. More precisely, where the price will hesitate or have a difficult time breaking through to continue the trend.

The most important thing to understand about support and resistance is their transformation from one to the other. Once support breaks, it becomes resistance. Once the price breaks through resistance, it becomes support.

Support and resistance levels are of two types:

- classic
- dynamic

Classic support and resistance levels form on the horizontal. Simply put, traders highlight the area where the price consolidated in a bearish or bullish trend, and project it to the right side of the chart.



The chart above shows the recent price action on the EURJPY daily timeframe. One thing to mention about support and resistance levels is that the bigger the timeframe, the stronger the levels become.

The EURJPY cross fell to the 110 level in June 2016, marking the bottom of a bearish trend. However, in the move lower the price left some “traces” we could use.

Marking the support level and dragging the areas to the right side of the chart shows where the price may meet resistance. Once broken, resistance becomes support.

As mentioned earlier, support and resistance levels come in a dynamic form too. It means that the levels follow the price action. Or, other support and resistance levels that aren’t horizontal can fit into this category.

Rising and falling trendlines are great technical analysis tools to find dynamic support and resistance.



Here's the same EURJPY daily chart showing a rising channel. The lower part of the channel represents the main trendline built following the principles explained earlier with the series of higher highs and higher lows.

The trendlines offer dynamic support and resistance levels for future price action. A principle of market geometry, dynamic support and resistance levels are stronger than classic (horizontal) ones.

CHAPTER 9

CONFLUENCE AREAS IN FOREX TRADING

Confluence areas are another aspect of price action and market geometry, and can give more weight to support and resistance levels. What exactly is a confluence area?

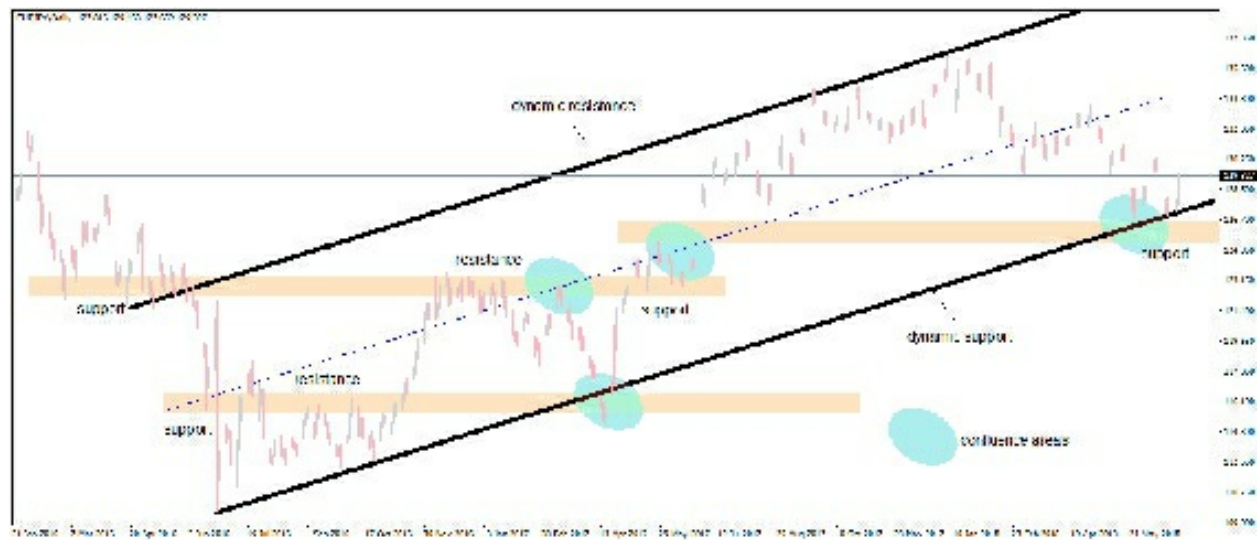
Generally speaking, when two or more factors meet in the same place, that's a confluence area. The principle is valid in technical analysis too, especially when using classic and dynamic support and resistance. When the price meets both dynamic *and* classic support and resistance in the same place, it'll have a more difficult time breaking it.



Here's how to spot confluence areas. Using the same EURJPY chart, simply look for places where the price meets both types of support and resistance.

Moreover, traders use different variations of the main trendline to extend the concept further. Here are two more confluence areas found by projecting the

main trendline.



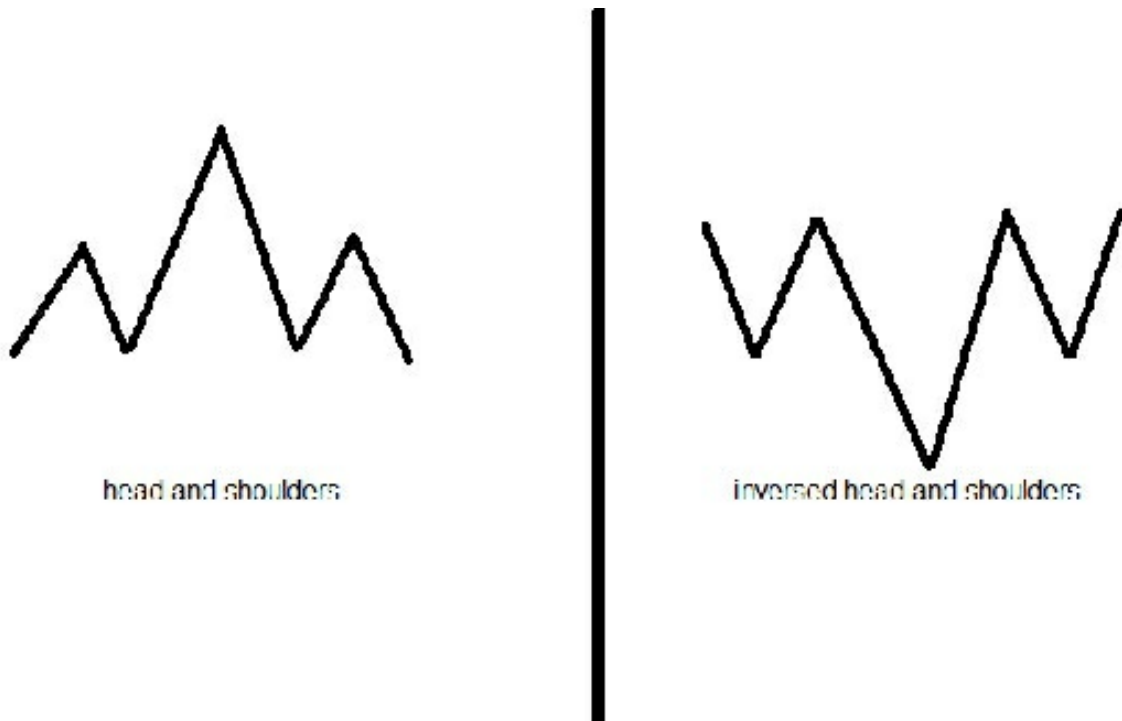
CHAPTER 10

HOW TO TRADE THE HEAD AND SHOULDERS PATTERN

The head and shoulders is a reversal pattern. It forms at the end of a bullish or bearish trend, and it belongs to classic technical analysis patterns.

First documented on the stock market when technical analysis was born, the head and shoulders pattern has stood the test of time to become one of the favorite reversal patterns for all kind of traders. In Forex trading it has a special interpretation due to the high volatility in the currency market.

The textbook head and shoulders pattern looks like below:



Keep in mind that the pattern was first documented on the stock market, and not the Forex market, where volatility distorts its elements. In other words,

expect the head and shoulders patterns on the currency market to look slightly different than the original ones.

The start of the pattern is impossible to predict. The market advances in a strong bullish trend or declines in a selloff, and there is no possible reversal in sight.

Suddenly, the price stops advancing or declining. It forms a consolidation area that may take quite some time if the head and shoulders pattern appears on a significant timeframe.

But when the consolidation ends, the price breaks in the same direction of the underlying trend. Furthermore, it'll make a new high or low, dragging bulls or bears to the party.

The break higher or lower comes in an aggressive fashion. The consolidation area we're referring to is called the left shoulder, and at this stage, no one knows that the price will form a head and shoulders pattern.

Almost always the left shoulder is a continuation pattern such as:

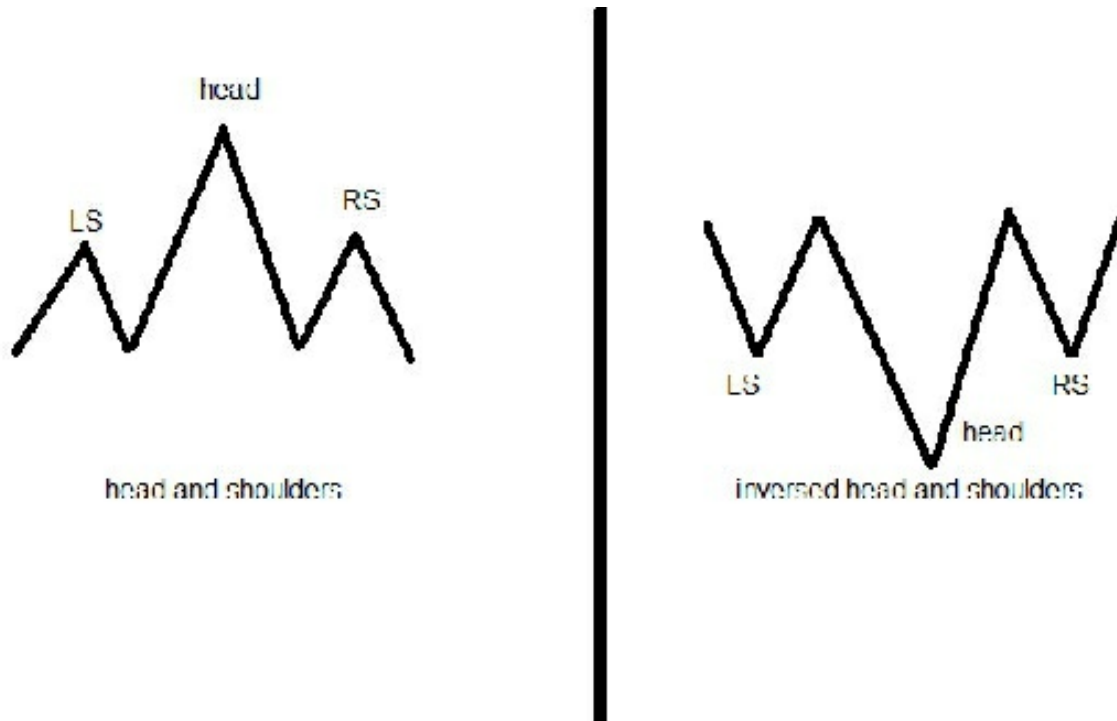
- ascending or descending triangle
- pennant
- bullish or bearish flag
- symmetrical triangle

When the price breaks out of the left shoulder, it does so with a vengeance. The move is so aggressive that nothing signals a reversal.

However, the stronger the break, the stronger the reversal. For whatever reason, the price reverses sharply to the original breaking point.

This is the moment traders get a clue that the market may form a head and shoulders. They start suspecting there might be a consolidation area on the right side of the chart, which will be known as the right shoulder. The formation in between is called the head. The violent break out from the left shoulder, followed by a pullback to the original breaking point is the head of the pattern and is almost impossible to trade.

Since the pattern's name comes from the human body, it should come as no surprise that methods of trading it use terms from the human body as well (e.g., neckline).



The neckline is a line that defines the head and shoulders pattern. The entire price action sits above the neckline (in a head and shoulders) or below it (in an inverted head and shoulders).

Obviously, the focus sits on the neckline. When broken, the pattern is ended, and the reversal of the trend is now in place. Besides the visual clue of the neckline, there is a specific measured move you can compute to confirm a head and shoulders pattern.

To calculate the move, traders measure the empty space (the void) between the neckline and the lowest or highest point in the head of the pattern. Then they project that distance up (or down) at a 90-degree angle from the neckline. This is the minimum distance the price needs to travel to confirm the head and shoulders pattern.

The beauty of the head and shoulders pattern is that it forms on all timeframes and all currency pairs. However, as mentioned earlier, in the

Forex market the actual pattern can appear slightly different than the theoretical concept.

Below you have the GBPUSD four-hour timeframe. It shows a steady bearish trend, and nothing signals the inversed head and shoulders pattern that followed.



The market paused for a while, forming a bearish flag. Eventually, the flag broke lower, but that move was quickly reversed.

Now the left shoulder and the head are in place. From this moment, traders can draw the neckline as the consolidation on the right shoulder begins.

An important thing to note here is that the neckline should connect the real bodies of the candles that make the left and right shoulders, not their highs. And, most of the time, the neckline is not horizontal, due to the volatile aspect of the currency market.

The blue and the brown lines show the neckline and the measured move, as explained earlier. Most of the time, the price retests the neckline, but that is not a mandatory condition for the head and shoulders pattern. In this case, for instance, the GBPUSD pair didn't revisit the neckline after it broke higher.

Now that we know what the head and shoulders pattern looks like in the currency market, how to trade it? Here's a step-by-step guide:



- copy the neckline and project it from the lower part of the left shoulder
- enter on the long side when the price reaches the projection on the right shoulder
- place a stop loss at the lowest point in the head of the pattern
- set the take profit level at the measured move
- book half of the profits by the time the price reaches the measured move and trail the stop for the rest of the position



Now you understand why traders love head and shoulders patterns. They give a disciplined approach to trading and, on top of that, great risk-reward ratios.

CHAPTER 11

A GUIDE TO TRADING WEDGES

Another pattern that belongs to the classic technical analysis reversal concepts, a wedge reverses even the strongest trends. The difference between a wedge and a head and shoulders pattern is the time taken for the two patterns to form.

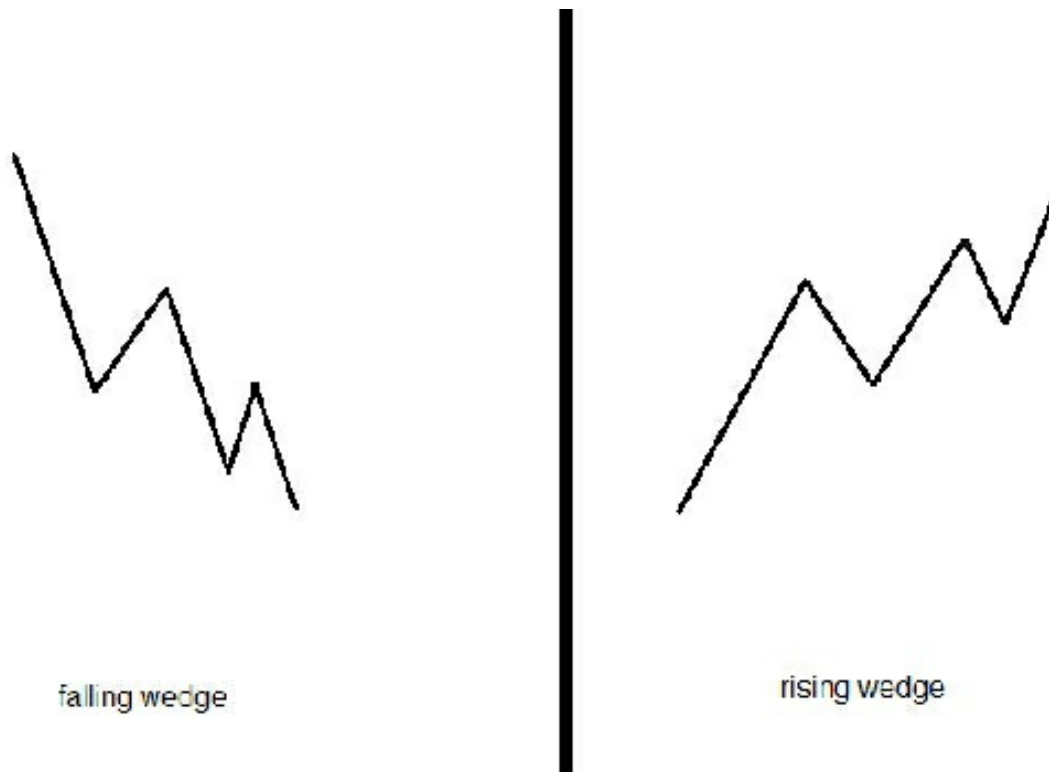
The wedge is, by far, less time-consuming and is an indicator of price exhaustion.

At this point in this book, please go back and check the higher highs and lower lows concepts discussed a few chapters back. They form the basis for a wedge's formation as the price finds it difficult to advance or decline further.

Wedges are of two types:

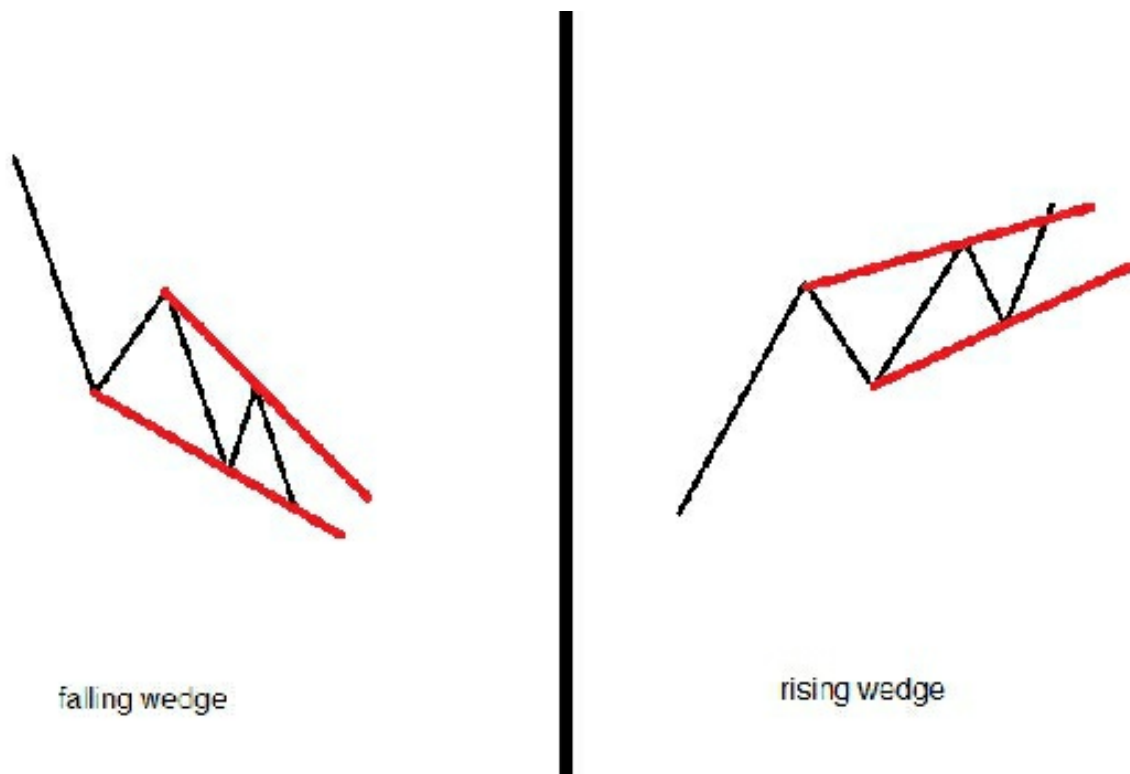
- falling
- rising

The saying goes that rising wedges are falling and falling wedges are rising, suggesting their bearish or bullish natures, respectively. Hence, a rising wedge forms at the end of a bullish trend, while a falling wedge appears at the end of a bearish one.



This is how the price action looks like during the wedge formation. While the market keeps forming lower lows or higher highs, it only makes marginal advances.

Technical traders document wedges using two trendlines. The trendlines, as you can see, connect a series of lower lows and lower highs into a falling wedge, and, respectively, a series of higher highs and higher lows into the rising wedge.

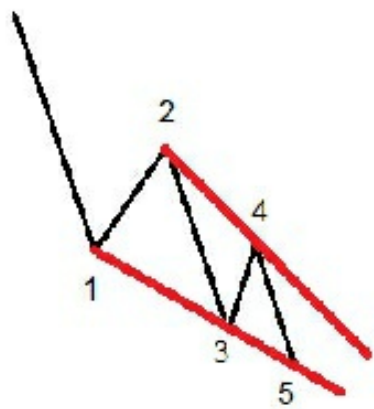


Now that the trendlines are in place, the pattern becomes more evident. Keep in mind that wedges are reversal patterns, so our focus sits with the trendline that shows the pattern's break.

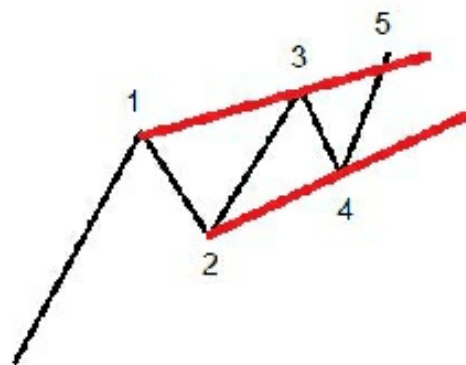
In reality, wedges are nothing but contracting triangles. However, there are many types of contracting triangles, and this is just one triangle that doesn't form on the horizontal.

One of the pioneers in documenting triangular formations, Ralph N. Elliott (the one that developed the Elliott Waves Theory), used letters to indicate the triangle's nature. We'll cover more about the Elliott Waves Theory in the following book part of our educational series.

In the case of a wedge, traders use numbers, not letters, to count the lower lows and lower highs, higher highs and higher lows respectively.



falling wedge



rising wedge

The wedge now is easier to identify and interpret as the price is contained between the two trendlines: the 1-3 and 2-4.

By far, the most important trendline is the 2-4. When the price breaks it, it means the reversal pattern is in place.



This is the USDCAD four-hour timeframe showing nothing but some price

swings. Can you spot a wedge? Anywhere?

Here it is:



The price falls, making a series of lower lows, but only marginal ones. By counting the lower lows and lower highs, the two trendlines become evident.

But how to trade it? Here's a quick guide:

- look for the price to pierce the 1-3 trendline
- enter on the long side when the 2-4 trendline breaks
- place a stop loss at the lowest point in the 5th segment
- measure the time taken for the falling wedge to form
- project it to the right side of the chart from the end of the 5th segment
- find the 50% retracement of the entire pattern
- book half of the profits and trail the stop for the rest of the position when the market reaches the target

For the first time in our educational series, we introduce the concept of price and time. It is one thing to know where the price is going, but another to know when it is likely to reach the target. More about price and time in future books in the series.

Following the rules listed above, the falling wedge trading setup looks like this:



Now, compare this chart with the “naked” one. Isn’t technical analysis beautiful?

CHAPTER 12

BULLISH AND BEARISH FLAGS EXPLAINED

Great continuation patterns, bullish and bearish flags mark time before the trend resumes. Depending on the timeframe they appear on, traders have different trading strategies to use for flags.

Above all, flags indicate consolidation. Hence, they provide a great opportunity to trade the range while preparing for the breakout.

The nature of the flag gives the direction of the trade. Naturally, traders look to go long during and after a bullish flag's formation, or short during and after a bearish flag.

In the Forex market, consolidations form for various reasons. Sometimes the market just waits for an important economic event or piece of data to move.

For instance, the NFP (Non-Farm Payrolls) shows the state of the United States labor market. Released monthly, it is a cause of great volatility in the Forex universe because the Federal Reserve of the United States considers the jobs data before changing the interest rate on the U.S. Dollar.

Therefore, ahead of an NFP announcement, the market typically consolidates. Statistically, ranges form more often than trends, especially on timeframes bigger than the hourly chart.

Because the NFP comes out on the first Friday of every month, the entire week until the NFP release shows ranging conditions.

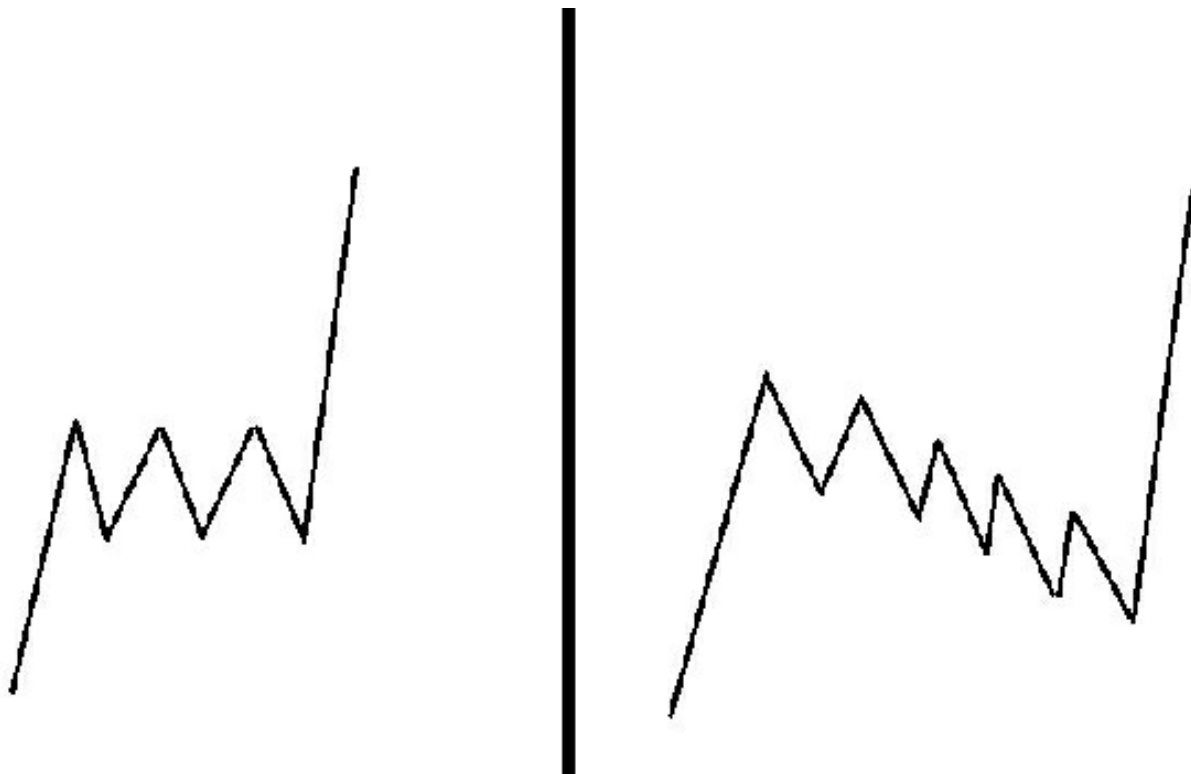
Flags, triangles, etc. form during such periods as the market participants simply wait for the release before taking any chances on the long or short side.

But ranges aren't as bad as many lament. In fact, because the market spends more time in consolidation than in trends, ranges provide great opportunities to trade, as long as traders know how to do it.

The image below shows what a bullish flag looks like. Both the price action on the left and right show a slightly different shaped flag.

The reason for illustrating two bullish flags is to make you understand that flags are tricky patterns. The market may remain in a consolidation long enough for many traders to lose patience.

And, more importantly, not all flags work. A bullish flag that keeps a descending angle can be invalidated by the market. This is why a trading strategy is needed.



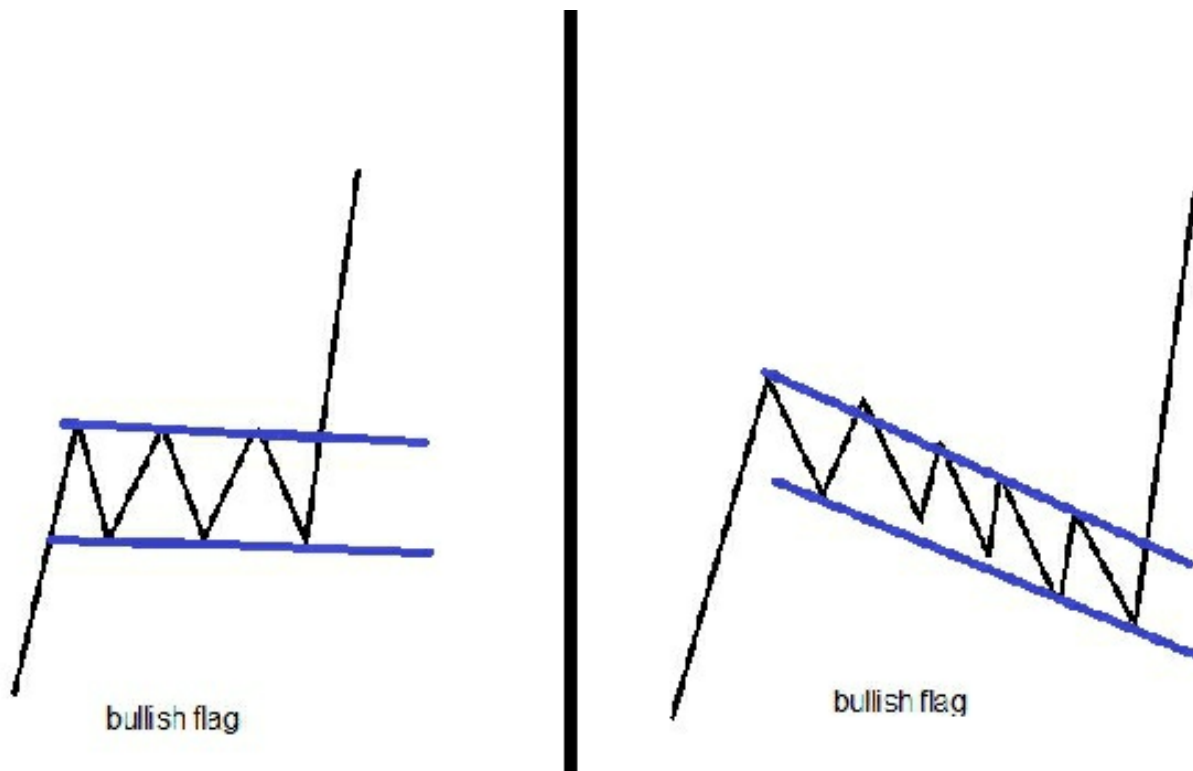
The bullish flag on the left forms on the horizontal, but the one on the right has a descending angle. Nevertheless, they both belong to the same bullish flag category.

The problem is that when the flags form on big timeframes, like the weekly

or monthly, traders lose patience waiting for the break to come.

But again, trading a range is still a perfect situation to profit from the range, even if the market may eventually invalidate the pattern.

The easiest way to visualize a flag is to use two parallel lines to delineate the consolidation area. This way, it becomes easier to spot the range and to trade accordingly.



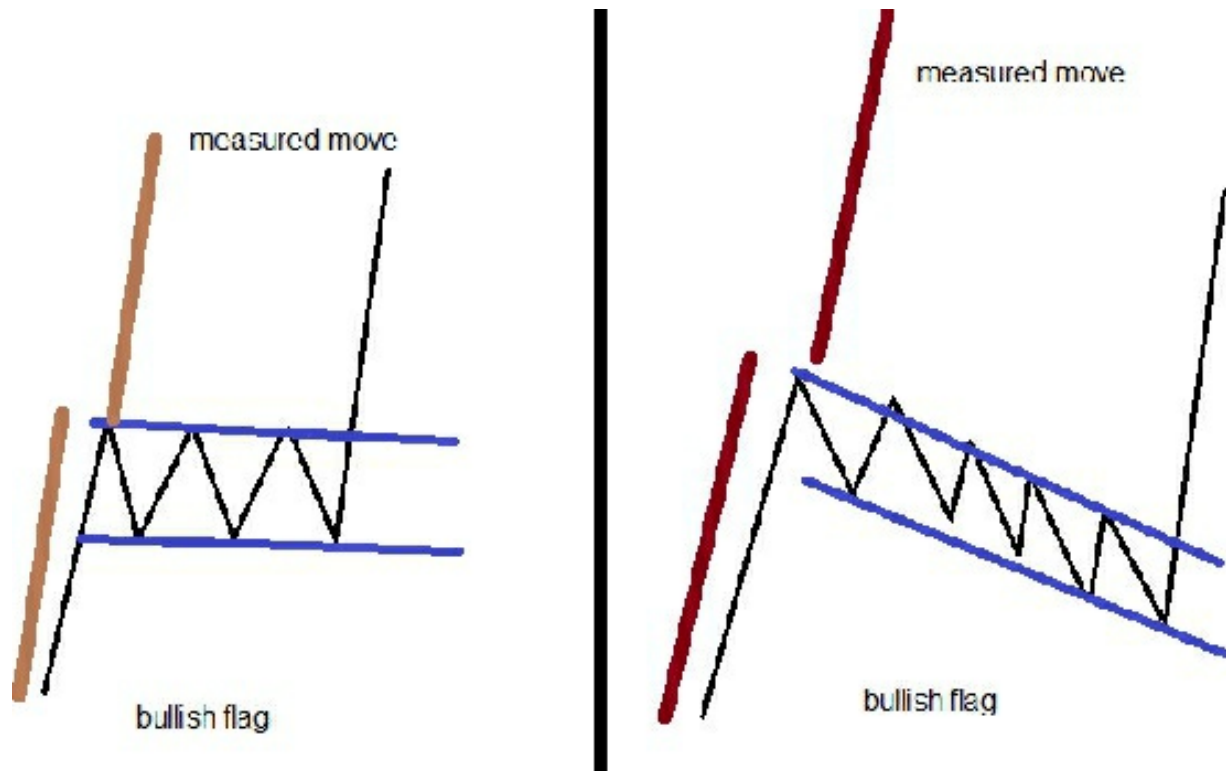
Before continuing, there's one crucial thing to mention: Trading flags in the opposite direction of the trend should be avoided at all costs.

In other words, during a bullish flag's formation, traders should only look for opportunities to go long. Naturally, during a bearish flag's formation, traders only go short.

But how to trade a flag?

Flags do have a measured move. You measure the flag's pole and then project it from the moment the consolidation breaks.

However, due to the highly volatile currency trading environment, a safer bet is to project the measured move from the highest point of a bullish flag or the lowest of a bearish one.



But again, trading a flag provides more opportunities to profit from the range it describes than from its measured move after the breakout. Instead of waiting for the break, why not trade the range? After all, we don't know when the flag will break, or, in fact, if it will.



This is the EURGBP recent daily price action. For almost a year, the pair has consolidated in a tight range.

For whatever the reason (e.g. Brexit uncertainties), the price just can't break the range. Nevertheless, using the rules of a bearish flag this time, we can define the range.

The range appears clearly visible from just the first few months of consolidation. The next thing is to divide the resulting channel into four equal parts.

Remember, trading takes place only in the direction of the flag. In this case, the suspected pattern is a bearish flag, so traders look for opportunities to go short.

The measured move or the length of the pole of the flag plays no role here. The idea is to trade the range for as long as possible by selling the upper quarters for the lower ones.



In plain English, going short at the fifty percent mark targeting the first quarter, selling the 75% retracement for the 50% target, and so on.

Following this simple rule gives plenty of opportunities to trade the consolidation, considering that this is the daily chart. Hence, trading the range of a flag may be more profitable than trading its measured move.

As a side note, scalpers love range trading. We will cover more about this topic in the next book of our series where we'll focus on oscillators used to define and profit from a range.

CHAPTER 13

ASCENDING AND DESCENDING TRIANGLES IN FOREX

Every trader has heard of triangles as consolidation patterns. When the market waits for a reason to break higher, it usually forms a triangle.

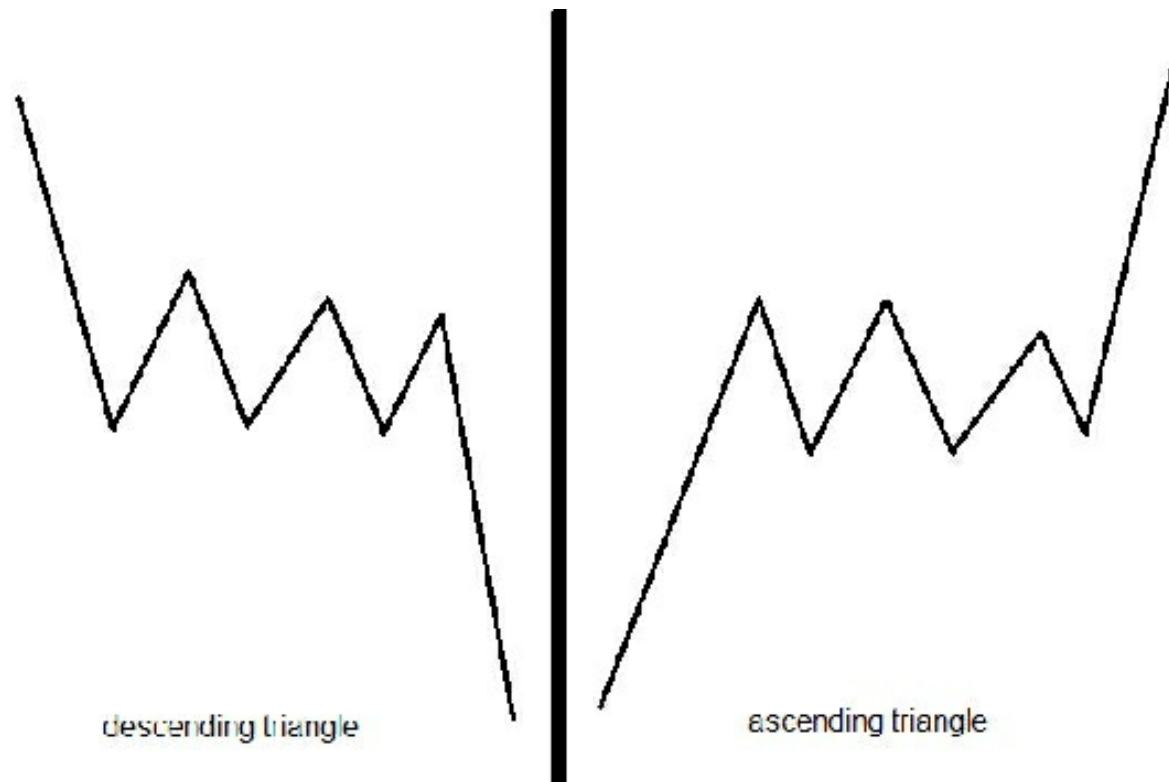
In fact, triangles are the most common consolidation patterns. They form all the time, on all timeframes, so understanding the concept behind a triangular formation is key to successful trading.

Few traders know that triangles aren't only continuation patterns. They can also reverse a trend, as we'll show in the next chapter.

For now, ascending and descending triangles do resolve in the direction of the underlying trend. As the name suggests, the first is a bullish pattern, while the second shows bearish market conditions.

To spot an ascending or descending triangle, think of a triple top or bottom formation. It forms against a horizontal line, and typically it reverses a trend.

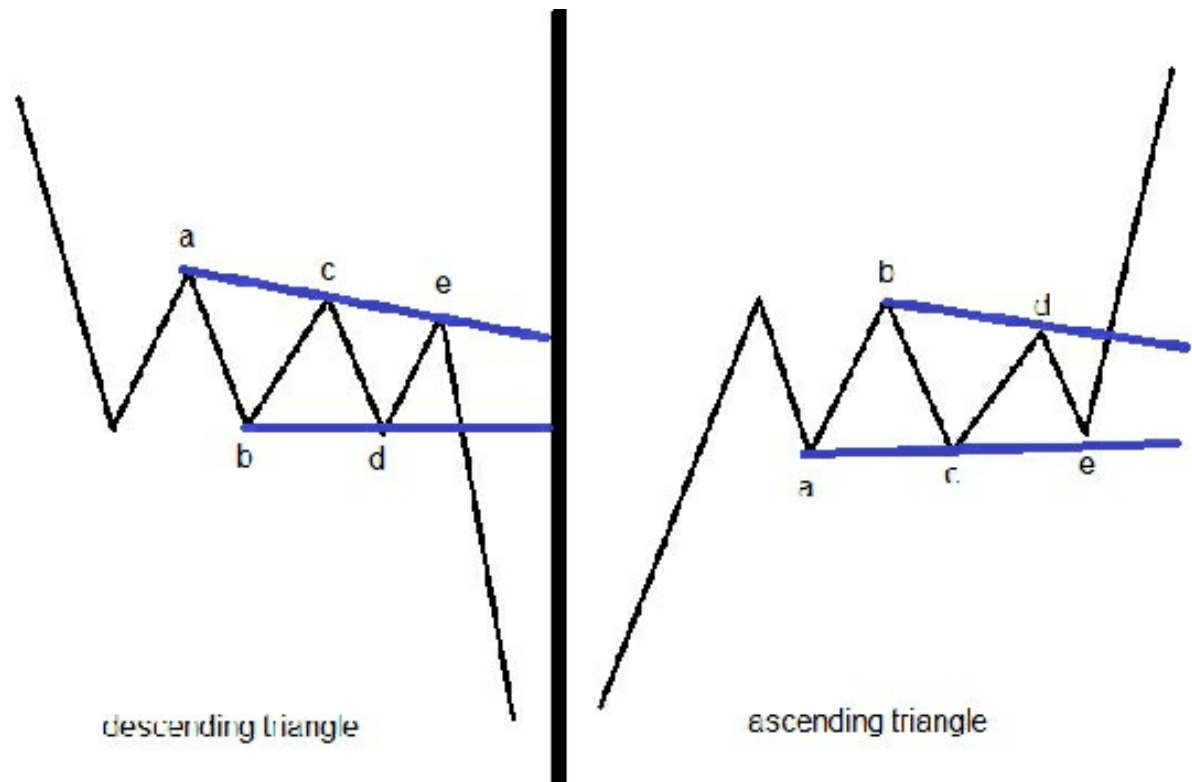
However, there is a saying especially valid in the Forex market: triple tops or bottoms rarely hold. The reason for that comes from the ascending or descending nature seen in the price action.



Check it above! Instead of thinking of it as a triple bottom on the left side or a triple top on the right, look at it as the market forming a descending or an ascending triangle, respectively.

Effectively, the price needs more time to break lower or higher. It builds energy to do that, with market participants looking for an excuse to keep selling or buying.

Ralph N. Elliott documented triangles and said that labeling them with letters makes it easier to understand these important consolidation areas. Moreover, a triangle depicts corrective price action, a concept we will cover in the next book of this educational series.



Labeling triangles with letters makes it easier to understand and interpret them. By far, the most important trendline is the b-d one, as it shows the end of the triangular formation.

The theory behind an ascending or descending triangle says that they form against a horizontal line. Again, this is OK for other markets, but in Forex trading finding such a perfect flat line is difficult. The currency market's volatility won't allow many patterns to follow that rule.

Instead, Forex traders must be flexible enough to understand the overall concept and look for an area of market consolidation, not just a line.

Think of an ascending or descending triangle like a bump in the road. Or, a challenge for the underlying trend. Bulls are challenged by bears, for a while, until an ascending triangle breaks higher. Or, bears have a hard time fighting bullish momentum during a descending triangle's formation.



The price tries to clear an area that proves to be challenging to get through. For that, it needs multiple tests, but eventually, it prevails.

In both ascending and descending triangles, the price makes one series of lower highs and one of higher lows. Just consider the a-c-e labeling, as it indicates the price activity normal in such series.

The chart below shows a descending triangle on the USDJPY pair. Note the horizontal area, not perfectly level, defining the descending characteristic of the triangle.



The bounces are shallow, the price fails to break the previous lower highs, and eventually, the price manages to break the horizontal support.

Ascending and descending triangles have a measured move too, given by the longest segment in the triangular formation. The thing to do is to find it and project it lower (in a descending triangle) or higher (in an ascending triangle) from the support or resistance area.



How to trade a triangle like the one above? Here's a guide:

- go short when the price breaks lower after the a-c-e lower highs series becomes evident
- place a stop loss at the previous lower high
- target the measured move
- book half profits and trail the stop for the remaining of the position



CHAPTER 14

WHEN TRIANGLES REVERSE A TREND

Triangles are complex patterns. Despite the general belief that their interpretation is simple, traders don't really know if a triangle will act as a continuation or reversal pattern.

As we approach the end of this book, we introduce more concepts close to the Elliott Waves Theory that we will treat in detail in an upcoming book. Triangles as reversal patterns are one of the concepts discovered by Elliott, and he noted that these triangles, also called non-limiting, are extremely powerful.

Like the name suggests, triangles that fit into this category cause a sharp reversal. There is virtually no limitation to the extent of the price movement to follow.

And they can reverse powerful trends as well. Here's the EURUSD forming a triangle at the 1.25 area.



The market tried to break higher, but every time the bulls tried to make a new high, they failed. Instead, the price action shows a series of lower highs very common in triangular formations.

You might say that this triangle is not important in reversing a trend, but take a look at the price action before the triangle's formation:



Even clearer:



The sharp move higher belongs to the most important trend in the currency market for 2017. The EURUSD broke higher despite the interest rate differential between the two currencies clearly favoring the USD.

From the 1.06 all the way up to 1.25, the pair didn't look back for a second. It merely consolidated before making a new high.

However, a triangular pattern started at the 1.25 area. Savvy traders know what it means when the price starts making lower highs and higher lows...a triangle forms.

This triangle, in particular, was special. It kept the bullish bias, but bears kept the pressure too.



Using the Elliott Waves Theory rules that we'll explain in the next book, the correct labeling looks like above. As a hint, Elliott said that a triangle has no more and no fewer than five legs, or segments.

Labeling with letters is useful in identifying the b-d trendline. In this case, by the time the price broke lower, the triangle as a reversal pattern was already in place.

The key to spotting such a triangle lies with the series of lower highs and higher lows. At any moment one of the two will break.

When it happens, that's the direction of the new trend.

There is a strong tendency for the price to retest the b-d trendline after the break. In this case, bears have a hard time letting the fight go.

So, there is almost always a retest. And that's the perfect entry point for trading a triangle as a reversal pattern.

Here's how to trade a bearish triangle as a reversal pattern:

- wait for the lower highs and higher lows series to break
- keep your eyes on the b-d trendline
- the perfect entry point is at the b-d trendline's retest, though such a retest is not inevitable

- place a stop loss at the highest point of the e-wave; that's the risk a trader is willing to take
- target three times the risk; 1:3 risk-reward ratios work well in these situations



If we are to follow Elliott's rules for a non-limiting triangle, it means that the trading move to follow a triangle as a reversal pattern doesn't have a pattern-indicated target. Instead, traders set a 1:3 risk-reward ratio, and then trail the stop for the rest of the position.

CHAPTER 15

BOLLINGER BANDS AS A TREND INDICATOR

Slowly but surely, we come closer to the end of this volume dedicated to technical analysis. More precisely, dedicated to basic technical analysis principles.

John Bollinger developed the Bollinger Bands indicator, and it turned out to be one of the widely used indicators in the retail trading sphere. The thing is that most traders use Bollinger Bands just as a trend indicator, but the principle has much more use in technical analysis.

This is the reason why we dedicate two full chapters to Bollinger Bands, as it is one indicator that retail traders love. In this chapter, we'll use the standard interpretation, and that is to trade in the direction of the underlying trend.

The Bollinger Bands indicator is formed out of three bands:

- UBB – Upper Bollinger Band
- MBB – Middle Bollinger Band
- LBB – Lower Bollinger Band

Depending on the trading strategy, all bands play a different role. However, when using it as a trend indicator, the MBB plays the most important role.

The MBB is usually a moving average. The default setting on most of the trading platforms uses an SMA (Simple Moving Average) as the MBB.

But this can easily be changed in the settings, and retail traders these days find the EMA (Exponential Moving Average) to be more useful for the simple reason that it follows the price closely.

The MT4 platform offers the Bollinger Bands indicator in the trending indicators category, but this is not the only way to use it.

In any event, when a trend is in place, paying attention to the Bollinger Bands does help the trader ride it. The idea is to use the MBB to sell the spikes into a bearish trend or buy the dips into a bullish one.

Because the bands split the price action into two channels, traders use the MBB to join the underlying trend. The AUDUSD chart below shows the price breaking lower and the MBB proving to be a nice place to enter on the short side of the market.



When traders use it as a trend indicator and enter the market like this, they use the UBB as the stop loss. And, for money management purposes, they measure the distance between the MBB and UBB and project it three times to the downside.

You should use at least 1:2.5 or 1:3 risk-reward ratio, as the market may turn on nothing at all.



CHAPTER 16

BOLLINGER BANDS AS A BREAKOUT INDICATOR

The standard interpretation of the Bollinger Bands indicator says that it is a trend indicator. Hence, traders use the MBB to add to their position or simply to ride the underlying trend.

However, the Bollinger Bands' true value lies not with the trending characteristic. Instead, traders value it for its ability to forecast breakouts.

To spot a breakout, traders focus on volatility. Because there is no standard, reliable volatility indicator, Bollinger Bands can serve as a true volatility indicator for the traders that know what they're looking for.

The key here is to focus on the upper and lower bands. Or, the UBB and the LBB.

When the distance between the two narrows, the price is about to break higher or lower. The narrower the distance between the two bands becomes, the more powerful the breakout will be.

Therefore, Bollinger Bands act as a strong indicator that the market will break after the two bands narrow.

Enough with the theory, here's an example!



This is the AUDUSD four-hour timeframe. The pair slides lower, but bulls keep pushing, trying to overcome bears.

However, the distance between the UBB and LBB tells much about what the next move will be. More precisely, traders take the most recent narrower distance between the UBB and LBB and use it as a measured move for future price action interpretation.

When the bands narrow more than the measured move, a breakout is coming. The funny thing is that traders won't know the direction in advance!

The key is to look for the price to close beyond the UBB or LBB, and that will be the right side of the market to be on. Most traders go long or short at a close beyond the UBB or LBB and strive for a 1:2.5 or 1:3 risk-reward ratio.

Here's a challenge: open any chart on any currency pair you like. Next, apply the Bollinger Bands indicator. Finally, click the Home tab on your keyboard to look for historical prices and identify a narrowed distance between the UBB and LBB.



Use a shape to measure it and copy the shape to check if the future price action holds true or not. If you follow the rules above, the chances are that the trading will grow, as probabilities are in favor of logic, not chance.

CHAPTER 17

THE KEY TO TRADING THEORIES – FIBONACCI RATIOS

To close this wonderful technical analysis book, we have to introduce the next one.

The thing is that most retail traders reading this book will be satisfied with the knowledge found in it. After all, the book covers most of the important technical analysis aspects.

However, it doesn't cover all of them. There are other trading theories we haven't covered yet, and which can be applied to the currency market too.

The next part of our series deals with the Elliott Waves Theory. Not all of the book, but most of it.

If there is one trading theory that makes use of both price and time, it's the Elliott Waves Theory. Moreover, the theory follows a logical process that leaves no room for error for the trader that follows every rule as Elliott intended.

Despite the fact the theory was built on the stock market, it is valid on the current FX market too. Because it deals with human nature (emotions like greed, fear, optimism, pessimism), it is useful in all markets.

But that won't be all! Besides the Elliott Waves Theory, we'll cover things like:

- Volatility trading with Bollinger Bands (hint – beyond that what you just learned here!)
- How to trade overbought and oversold levels with various oscillators
- How to trade based on pure market geometry concepts

- The RSI (Relative Strength Index) as the most powerful oscillator of them all
- How to trade with the MACD (Moving Average Convergence Divergence)
- How to use Andrews Pitchfork in Forex trading
- Volume – tips and tricks to use volume indicators when trading the currency market
- Harmonics trading – all you need to know about Gartley and the origin of harmonic trading
- How to use the Stochastics oscillator
- Trading the perfect order setup with moving averages

If that's not enough to tempt the technical trader, here's what will come on the Elliott Theory:

- What are impulsive waves, how many types exist and how to interpret them
- Corrective waves – simple and complex
- How to find the extended wave and how to trade it
- Ten types of flat patterns
- Three types of zigzag patterns
- Triangles in the Elliott Waves Theory

Above all, the next book in our educational series will focus on Fibonacci ratios. If there is one enigma in technical analysis, Fibonacci ratios have the solution for it.

Everything in technical analysis has to do with Fibonacci ratios. The entire Elliott Waves Theory is built upon the main Fibonacci ratios.

Harmonic patterns and the Gartley patterns depend on Fibonacci as well. Support and resistance levels have more significance if a Fibonacci level comes in to reinforce a trade.

This book was a technical part of our series. The next one will be a technical one too.

However, it'll cover additional concepts, meant to complement all the info in

this one. After all, if you've read everything up to this point, the next book is just around the corner.

Right?

