Traders Camp

This month's Traders Camp features a look at some well-known price patterns and explores volume, open interest, and short interest.

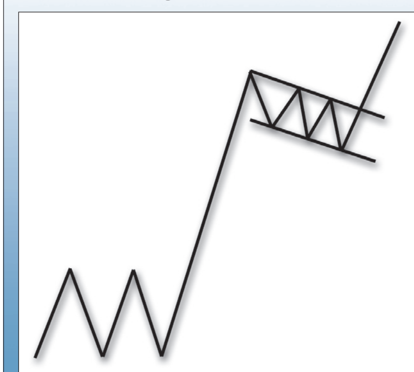
Flags, Pennants and Wedges

These basic price patterns can be used to provide trade entry and define risk. Flags, Pennants and Wedges are most often interpreted as continuation patterns appearing in any market or time frame. As their names imply, these formations paint a picture of their respective shapes and with practice can be spotted easily.

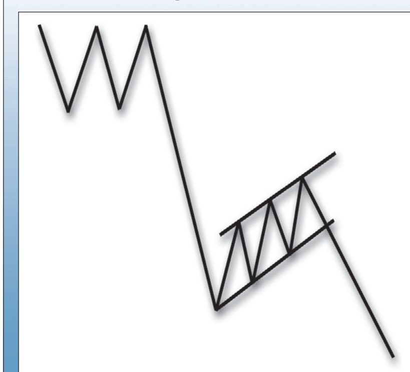
The flag is probably the most common of the three patterns. Like the pennant and the wedge, a flag basically represents a pause in an otherwise dynamic market environment; a period of controlled profit taking within a solid trend move. The formation consists of both a pole and a banner.

The pole is the price run-up or sell-off preceding the consolidation that forms the banner. To raise a good flag you need a sturdy flagpole. The price move forming the pole should be steep, but it is better if it's formed by more than one price bar. A pole consisting of just one bar painted by a single drastic price move should be approached with caution, as the market can just as easily reverse after a short consolidation.

F1) Bull Flag

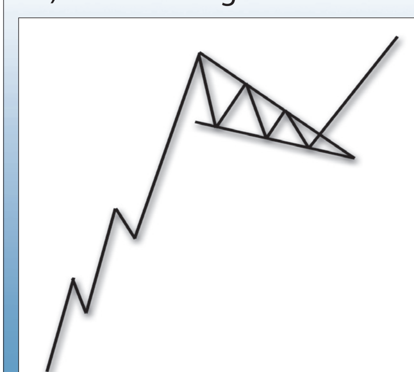


F2) Bear Flag

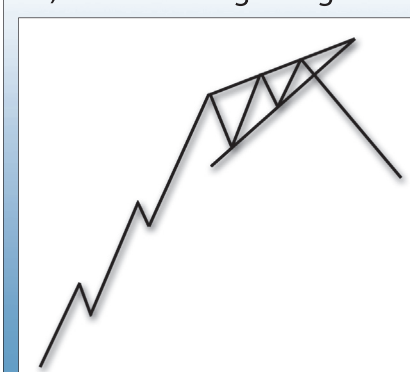


F3) Pennant

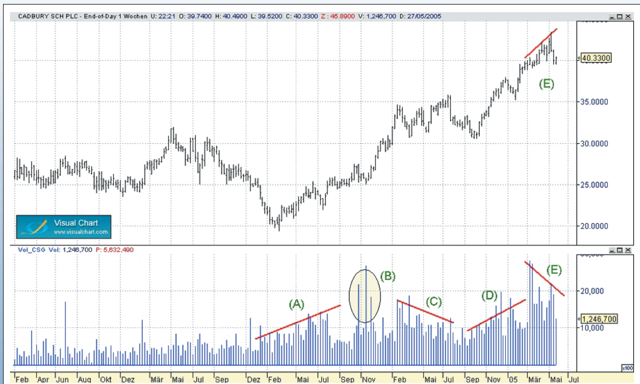
F4) Bullish Wedge



F5) Bearish Rising Wedge



F6) Price/Volume Chart of Cadbury Schweppes plc



This is a weekly price/volume chart of the stock Cadbury Schweppes plc. In Q1 of 2003 (A) prices bottomed before beginning a rally, confirmed by increasing volume. In Q4 of 2003, volume spikes (B) indicating heavy interest in the stock, which in turn preceded a strong rally. In mid-2004, the rally began losing steam as volume receded (C) and a correction ensued. Prices began a new surge in late 2004 supported by increasing volume (D). Volume and prices have recently diverged (E), indicating the possible onset of a corrective phase.

Source: www.visualchart.com

The flag itself tends to look like a parallelogram in which the price action peaks and begins a back and forth sideways consolidation within a narrow range. The consolidation tends to slope against the prevailing trend, but it can also form horizontally.

A pennant is very similar to the flag and forms for the same underlying reasons. Its shape resembles a small symmetrical triangle with two converging trend lines that are sometimes, but not always perched on top of a pole. Both the flag and the pennant are short-term patterns within the observed time frame. If a flag on a five-minute chart stretches into a two- or three-hour long sideways smear, forget it, it's time to look for a better pattern.

A wedge on the other hand takes longer to form than the flag or pennant. It's shaped like a symmetrical triangle with two converging trend lines that come together at an apex. What's unique about the wedge is that both trend lines slant either to the up- or downside. As a rule, the slant is against the prevailing trend so that a falling wedge is considered bullish, a rising wedge bearish. Wedges like flags and pennants are considered continuation patterns but they can also appear at market tops and bottoms signalling a reversal. The slant of the wedge is the clue to its nature in that case. If a rising wedge appears in an up trending market it is considered bearish, a falling wedge in a down trend, bullish.

Trading these patterns is relatively straightforward and there are a number of ways to go about it. For instance, a very simple method is to place a buy stop just above the upper trend line of a bullish formation in an upward trending market. The stop can be placed at a point just below the lower trend line. Measuring the length of the pole and extending it from the point at which prices break through the upper trend line can be used to determine price targets.

Of course money management should play the bigger role in determining the stops and price targets you choose for any trade, but that discussion goes beyond the scope of this article.

The volume characteristics of these formations can also help in singling out good patterns with a high probability of success. Trading activity should be heavy as prices run up the pole and light as the consolidation sets in. Pennants usually demonstrate an even more drastic decrease in volume during formation. If after a good price run-up a consolidation sets in without a measurable decrease in volume, then caution should be observed as this indicates more of a topping type of activity. Finally, the breakout of the respective pattern should show a solid increased in trading activity in the direction of the original trend.

Traders should realize that these patterns do nothing more than provide reference points for a trade. They allow you do pick an entry point, define a stop loss and choose a profit target. The rest, as they say, is up to the market gods.

There are no guarantees that the pattern you choose will actually unfold according to the book, in fact, these patterns fail often enough, so make sure to your money management measures are in place before putting on a trade.

Volume and Open Interest, Short Interest

Let's begin by defining these terms:

Volume: the number of shares or contracts traded in a security or market during a certain time period. Volume can be sub-divided into various types like down- and up-volume. For instance, if a stock increases in price during the day, the volume for that day is considered to be up-volume.

Open Interest is applied primarily to the futures and options markets. It is the total number of outstanding or unliquidated contracts at the

F7) Two Flags and a Wedge

The Nasdaq Composite formed a bull flag in November 2004 that preceded the strong year-end rally. That rally ended with a bearish rising wedge, which formed in December. The bearish flag in April of this year hinted at futhrer correction, but it turned out to be rather mild.

Source: www.visualchart.com