THE HEAD AND SHOULDERS PATTERN [PDF]

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The Head and Shoulders Pattern

The head and shoulders is a bearish candlestick pattern that occurs at the end of an uptrend and indicates a trend reversal. It is considered a reliable and accurate chart pattern and is often used by traders and investors to predict future price movements.

What is the Head and Shoulders Pattern?

The bearish head and shoulder pattern is a famous classical charting formation in technical analysis that appears at the end of an uptrend and signals that the previous trend may come to an end. Forex traders often use it as an indicator to enter a short-selling position or exit a long-position trade.

Much like the inverse head and shoulders pattern, the head and shoulders pattern is characterized by three tops that form the shape of the head in the middle and two shoulders – the left shoulder and the right shoulder. Also, it has a neckline that serves as a support level.

In its appearance, it has a similar formation and meaning to the double top pattern and the triple top pattern.

How to Identify the Head and Shoulders Pattern in Trading?

There are key features you need to look out for when searching for a head and shoulders pattern on trading charts. First, the pattern normally comes after a bullish uptrend at a period when the buying pressure is losing momentum.

Then, a left shoulder is formed followed by a middle peak higher than the first top. Then another right shoulder is formed at the same level as the first left shoulder (more or less). Finally, the pattern should consist of a clear neckline that is used as a support level. Taking the above into account, let's see how the head and shoulders pattern looks on a trading chart.

As seen in the CAD/JPY 1H chart above, the head and shoulders candle pattern occurs at the end of an uptrend and has all the elements that help us identify the pattern.
Based on the logic of this pattern – as soon as the price falls below the neckline, a trader will enter a short-selling position with a stop-loss order at the highest level of the right shoulder.

In summary, to identify and trade the head and shoulders pattern, we suggest you follow the steps below:

1. Identify three top levels after an uptrend that include left shoulder, head, and right shoulder
2. Find the neckline support level
3. Wait for the breakout to occur and place a selling order once a candle closes below the neckline. It's best to use Fibonacci retracement levels as a confirmation tool.
4. Set a stop-loss order above the neckline (preferably at the highest level of the right shoulder) and use a risk-reward ratio.

How to Trade the Head and Shoulders Pattern?

The head and shoulders candle pattern is essentially the same as the inverse head and shoulders pattern (also called the head and shoulders bottom) but in the other direction. This means that the target of a trader is to find the perfect entry-level to enter a short-selling position (or closing an existing long position).

To do so, we are going to show you how to trade the breakout once you identify the head and shoulders pattern and how to use Fibonacci retracement levels as another confirmation tool.

1. Trading the Breakout

Breakout trading is a trading technique that involves the buying and selling of assets when the price breaks above or below a certain level. It can be used in many different charting patterns and with the help of various technical indicators.

The good thing about the head and shoulders formation is that it's easy to identify the neckline, which helps you find the ideal breakout entry level. Therefore, some traders will be looking to enter a position immediately after the price falls below the neckline.
In the example below, we can see how the CAD/JPY pair's exchange rate dropped when the breakout occurred and a new bearish trend started.

The reason why many traders prefer to trade the breakout (without any additional tools) is that they do not want to miss the drop that usually occurs following the breakout. In other words, FOMO.

This is especially the case for active day traders or scalpers who are looking for minor price movements and get in and out of positions several times a day.

2. Confirm the Inverse Head and Shoulders Pattern with Fibonacci Levels

While breakout trading is a great method to capture small price movements, there's a certain risk in using this trading strategy and it is not necessarily suited for all types of traders. For that reason, you should use other tools that will help you to confirm that the breakout is not a false breakout.

Obviously, there are no guarantees in trading, however, using other indicators like Fibonacci levels can significantly increase your chances of success.

In the CAD/JPY chart below, we used the same scenario with Fibonacci retracement levels from the lowest to the highest level of the previous uptrend.

As you can see, the breakout occurs somewhere around the 38.2% Fibonacci level and then once the breakout is confirmed, the trend continues until the 78.6% level (not available in the chart but the trend continues).

Moreover, using Fibonacci levels not only helps you to invalidate the breakout but also assists you in placing stop-loss orders and finding the right profit target.

The Head and Shoulders Pattern – Pros and Cons

These are the most common advantages and disadvantages of trading head and shoulders pattern:

Pros

- Very accurate chart pattern
- Due to its structure, the head and shoulders pattern offers a defined entry-level, stop loss, and take profit targets.
- Effective when used in combination with Fibonacci levels and other trend reversal indicators

Cons

- Can be mistaken for a continuation of the previous trend rather than starting a new bearish trend
- Not a frequently occurring chart pattern