

 WILEY Trading

HIGH-PROBABILITY TRADE SETUPS



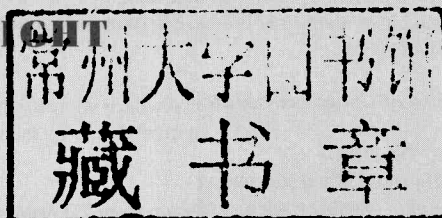
A CHARTIST'S GUIDE TO
REAL-TIME TRADING

TIMOTHY KNIGHT

High-Probability Trade Setups

A Chartist's Guide to Real-Time Trading

TIM KNIGHT



WILEY

John Wiley & Sons, Inc.

Copyright © 2011 by Tim Knight. All rights reserved.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 646-8600, or on the Web at www.copyright.com. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030, (201) 748-6011, fax (201) 748-6008, or online at <http://www.wiley.com/go/permissions>.

Limit of Liability/Disclaimer of Warranty: While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. No warranty may be created or extended by sales representatives or written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor author shall be liable for any loss of profit or any other commercial damages, including but not limited to special, incidental, consequential, or other damages.

ProphetCharts used with permission from TD Ameritrade.

For general information on our other products and services or for technical support, please contact our Customer Care Department within the United States at (800) 762-2974, outside the United States at (317) 572-3993 or fax (317) 572-4002.

Wiley also publishes its books in a variety of electronic formats. Some content that appears in print may not be available in electronic books. For more information about Wiley products, visit our web site at www.wiley.com.

Library of Congress Cataloging-in-Publication Data:

Knight, Tim, 1966–

High-probability trade setups : a chartist's guide to real-time trading / Tim Knight.

p. cm. – (Wiley trading series)

Includes index.

ISBN 978-1-118-02225-2 (hardback); ISBN 978-1-118-11296-0 (ebk); ISBN 978-1-118-11295-3 (ebk); ISBN 978-1-118-11297-7 (ebk)

1. Stocks–Prices–Charts, diagrams, etc. 2. Stocks–Charts, diagrams, etc. 3. Investment analysis.
4. Speculation. I. Title.
HG4638.K553 2011
332.63'2042–dc22

2011014260

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

High-Probability Trade Setups

Founded in 1807, John Wiley & Sons is the oldest independent publishing company in the United States. With offices in North America, Europe, Australia, and Asia, Wiley is globally committed to developing and marketing print and electronic products and services for our customers' professional and personal knowledge and understanding.

The Wiley Trading series features books by traders who have survived the market's ever-changing temperament and have prospered—some by reinventing systems, others by getting back to basics. Whether a novice trader, professional, or somewhere in-between, these books will provide the advice and strategies needed to prosper today and well into the future.

For a list of available titles, please visit our web site at www.WileyFinance.com.

*For E&S
May you always be the best of friends*

About the Author

Tim Knight is a hedge fund manager and the founder of Prophet Financial Systems (now owned by TD Ameritrade), rated by *Forbes* magazine and *Barron's* as the number-one online site for technical analysis. He also writes the popular blog Slope of Hope (www.slopeofhope.com). Prior to starting Prophet.net, he was Vice President of Products for Montgomery Securities investment bank, where he helped develop Macintosh-based traders' workstations before the development of Web trading. Knight has traded for over 20 years, primarily using technical analysis and price charts, and has written 20 other books. He lives with his family in Palo Alto, California.

Contents

	About the Author	xiii
PART I	An Overview	1
CHAPTER 1	A Primer on Chart Setups	3
	The Bulls versus the Bears	4
	Why Is a Prediction Valuable?	4
	A Word on Shorting	6
	Support and Resistance	7
	What Happens When Prices Punch Through?	8
	History Repeats Itself	11
	When Patterns Work Together	13
	How to Use This Book	14
CHAPTER 2	My Personal Trading Journey	15
	Earliest Interest in the Markets	15
	Beginning with the Crash	16
	Technical Tools	17
	Prophet's Beginning	18
	The Internet Makes Its Appearance	18
	Enter Alex and JavaCharts	19
	Project Kandinsky	21
	The Slope of Hope	22
	Lessons Learned	22
	ProphetCharts Lives	23
	The Three Steps	24
PART II	The Patterns	31
CHAPTER 3	Ascending Triangles	33
	Definition of the Pattern	33
	Psychology behind the Pattern	35

	Examples	35
	Summary	43
CHAPTER 4	Ascending Wedges	45
	Definition of the Pattern	45
	Psychology behind the Pattern	47
	Examples	47
	Summary	53
CHAPTER 5	Channels	55
	Definition of the Pattern	55
	Psychology behind the Pattern	57
	Examples	57
	Summary	68
CHAPTER 6	Cup with Handle	69
	Definition of the Pattern	69
	Psychology behind the Pattern	70
	Examples	72
	Longer-Term Examples	75
	Summary	79
CHAPTER 7	Descending Triangles	81
	Definition of the Pattern	81
	Psychology behind the Pattern	83
	Examples	83
	Summary	89
CHAPTER 8	Descending Wedges	91
	Definition of the Pattern	91
	Psychology behind the Pattern	92
	Examples	93
	Summary	102
CHAPTER 9	Diamonds	103
	Definition of the Pattern	103
	Psychology behind the Pattern	105

	Examples	105
	Summary	110
CHAPTER 10	Fibonacci Fans	111
	Definition of the Pattern	111
	Psychology behind the Pattern	113
	Examples	114
	Summary	126
CHAPTER 11	Fibonacci Retracements	129
	Definition of the Pattern	130
	Examples	132
	Summary	139
CHAPTER 12	Flags	141
	Definition of the Pattern	141
	Psychology behind the Pattern	142
	Examples	143
	Summary	153
CHAPTER 13	Gaps	155
	Definition of the Pattern	155
	Psychology behind the Pattern	157
	Examples	158
	Summary	174
CHAPTER 14	Head and Shoulders	175
	Definition of the Pattern	175
	Psychology behind the Pattern	176
	The Importance of the Neckline	177
	Examples	178
	Summary	197
CHAPTER 15	Inverted Head and Shoulders	199
	Definition of the Pattern	199
	Psychology behind the Pattern	201
	The Importance of the Neckline	202
	Examples	202
	Summary	215

CHAPTER 16	Multiple Bottoms	217
	Definition of the Pattern	217
	Psychology behind the Pattern	219
	Examples	220
	Summary	230
CHAPTER 17	Multiple Tops	231
	Definition of the Pattern	231
	Psychology behind the Pattern	233
	Examples	233
	Summary	241
CHAPTER 18	Pennants	243
	Definition of the Pattern	243
	Psychology behind the Pattern	244
	Examples	245
	Summary	253
CHAPTER 19	Rounded Bottoms	255
	Definition of the Pattern	255
	Psychology behind the Pattern	256
	Examples	257
	Summary	265
CHAPTER 20	Rounded Tops	267
	Definition of the Pattern	267
	Psychology behind the Pattern	269
	Examples	270
	Summary	278
CHAPTER 21	Support Failure	279
	Definition of the Pattern	279
	Psychology behind the Pattern	280
	Examples	281
	Summary	299
CHAPTER 22	Automatic Patterns	301
	Patterns in ProphetCharts	302
	Working with the Results	307

	Pattern Failures	314
	Putting the Patterns to Work	315
PART III	Trading and You	317
CHAPTER 23	Setting Stops	319
	General Guidelines	319
	Below Support	320
	Above Resistance	320
	Above Trendline	321
	Below Trendline	321
	Most Recent Low	322
	Most Recent High	322
	Special Cases	323
CHAPTER 24	On Being a Bear	325
	The Philosophy of Shorting	325
	Practical Guide to Short Selling	326
	Exchange-Traded Funds	328
	Puts for Leveraged Profits	330
	The Philosophy of Shorting	332
CHAPTER 25	A Guide to Real-Life Trading	337
	Trading Rules	337
	How to Open a Position	338
	How to Hold a Position	341
	How to Close a Position	343
	Time and Money	343
	There Is No Holy Grail	344
	Closing Thoughts	345
	Index	347

PART I

An Overview

A Primer on Chart Setups

This is a book about chart setups and how they can make you a more profitable trader. I have been involved in trading for a quarter-century, and during almost that entire time, I have used charts and technical analysis as the basis of my investing decisions. This book endeavors to show you meaningful, clear examples of the most powerful chart patterns so that you can commit them, and their importance, to memory.

Technical analysis is the study of past price movement for the purpose of predicting future price movement, which, if done correctly, can lead to substantial trading profits. The prices studied are typically those of financial instruments such as stocks, commodities, and foreign currencies. But no matter what market is being studied, the underlying principles are the same. Specifically:

- A price chart is the most perfect representation of the balance of buyers and sellers for any given entity.
- Prices tend to move in trends and patterns which, based on historical analysis, can lead to statistically meaningful probabilities of future price movement.
- The skilled examination of a price chart can guide a trader as to how long he should remain in a trade and when he should exit.

No matter what you trade, technical analysis can make you a better and more profitable trader. Price charts will consistently provide the most truthful picture that can be had of a tradable object, because everything that can be publicly known or speculated is already built into the graph. You will never get the same pure representation of a stock (or anything else) from a broker, a newsletter writer, or an analyst. A chart is as good as

it gets. How much good that chart can do for *you* depends on your own skill and objective analysis.

THE BULLS VERSUS THE BEARS

Before we get into price charts—and there will be hundreds of them in this book—let's examine the basics about what forms a price chart in the first place: sellers (the supply) and buyers (the demand). It should also be noted at the outset that almost all the examples in this book will be of stocks, but the same rules and methods are appropriate for any form of financial instrument.

When buyers are more powerful than sellers, prices move up. When sellers are more powerful than buyers, prices move down. This tug-of-war, in these simple terms, is behind the trillions of dollars that get traded every week of the year. Buying power represents an excess of demand which will, because of simple market dynamics, inflate price levels.

What many people tend to forget is that every time a trade is placed, each side believes that they are right and the other side of the transaction is wrong. When person A buys stock from person B, person A believes the stock is going to go up in price (meaning B is selling too cheap) and person B believes he would rather have the cash than the stock (meaning A is buying an overvalued, or at least fully valued, stock).

As a group, the individuals who believe a given instrument is going to move higher in price are the bulls, whereas the opposing camp, believing prices for the same instrument will drop, are the bears. And the war between the bulls and the bears, fought over many thousands of different stocks, options, and commodities every day, is what creates price movement. Analyzing that movement with skill is what will give you a substantial edge in the markets you trade.

This book seeks not so much to interpret what those wiggles of movement mean. Instead, it seeks to illustrate for you, with example after real-life example, how these patterns as a whole have played out in actual trading. History tends to repeat itself, and recognizing the meaning of a well-formed pattern will be a great ally in your trading career.

WHY IS A PREDICTION VALUABLE?

The astonishing thing about technical analysis is not only how far out its predictive power goes, but also how, even with a future full of unknowns, it still seems able to see its way clear to make a meaningful prediction. A staggering number of great forces can wreak havoc with financial markets—scandals, war, governmental chaos, interest rates, terrorist attacks, earnings surprises, the social climate, financial meltdowns, and so forth.

Through it all, the knowledgeable chartist can see what others cannot see and know what seems unknowable.

Let's take a real-life example with a very long timespan: the Dow Jones Industrial Average over a period of more than a century. Figure 1.1 has two Fibonacci fans drawn on it (don't worry if you are not familiar with that term; it is explained later in this book). These fans are drawn from an extreme low to an extreme high. The first is drawn from the low in 1903 (called the Rich Man's Panic) to the peak of the Roaring Twenties bull market in 1929. The second is drawn from the depths of the depression in 1932 to the peak of the Internet bubble in January 2000.



FIGURE 1.1 The Dow Jones Industrial Average from 1900 to 2005, enhanced with two Fibonacci fans.

There is a variety of astounding things to note in this chart:

- The point where the two major lines intersect in 1974 predicted the precise bottom of the massive 1973–1974 bear market.
- The steady climb from 1990 to 1995 was perfectly bounded by two of the fan lines.
- Most impressive of all, the ultimate market top in 2000 was established by the first fan (which, remember, began 97 years before).

Figure 1.2 is a close-up view of late 1999 and early 2000; as you can see, the almost century-old fan line creates impressive resistance to these prices moving higher on four