Trading Between the Lines: Pattern Recognition and Visualization of Markets

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Insights into a pattern-based method of trading that can increase the likelihood of profitable outcomes

While most books on chart patterns, or pattern recognition, offer detailed discussion and analysis of one type of pattern, the fact is that a single pattern may not be very helpful for trading, since it often does not give a complete picture of the market.

What sets *Trading Between the Lines* apart from other books in this area is author Elaine Knuth's identification of sets of patterns that give a complete analysis of the market. In it, she identifies more complex chart patterns, often several patterns combined over multiple time frames, and skillfully examines these sets of patterns called "constellations" in relation to one another. These constellations turn sets of individual patterns into a more manageable set of patterns, where the relationship between them can lead to tactical trading opportunities.

- Shows how to apply complex patterns to specific trades and identify opportunities as well entry and exit points
- Markets covered include commodities, equities, and indexes
- Presents an effective trading approach based on real market cycles-as opposed to computer simulations-that are found in active markets

Moving beyond the simple identification of basic patterns to identifying pattern constellations, this reliable resource will give you a better view of what is really going on in the market and help you profit from the opportunities you uncover.

Q&A with Author Elaine Knuth

How can a trader improve his/her ability to recognize patterns and visualize where the market might be going?
It is the old adage, experience is the best teacher. Years of market observation has been my teacher. Every day I update data on all markets – even those I am not actively following. I first run an automated a computer scan on capturing patterns built on some of the ideas in the book. While I am doing this, I also visually scan the end of day action of each market before opening. I go through about 70 charts, spending about a minute or two on each one. This gives a daily feel for what is going on in a market. If I see something interesting, I also then spend more analysis time on that market. Then if any of the automated scans also pick up something, I also take a closer look at those markets. This may sound simple, and rather dull, but if you enjoy the markets it is as interesting as reading a good article or report in the morning.

While going through each market I ask myself:
• Is it range bound?
• Is it in a trend acceleration phase?
• Is it creeping along with very low volatility?
• Or do I even know what is going on at first glance? If not, why not?

Let's say we have a market in a strong and accelerating trend phase, breaking out to ever new highs over the past weeks. Then on the daily scans, we detect that momentum is now weakening against still rising prices. This can be important information.

So once we decide to take a trade and go short, for example, the next logical question is what do we expect from the trade? Or ask where might the market be going?

That is not quite the right question. As traders we are not in the forecasting business. We do not know where the market will go, but instead we build a trading scenario(s) around the current price action and price history.

So with this daily pattern presented and possible trade opportunity, we then take a look at the weekly price history. And ask, for example:

- What was the price range before the most recent breakout to new weekly highs?
- Did this breakout level also act as support, bringing in more buying?
- What drove the buying then?
- What is the collective market motivation for selling now?

In summary, the trigger on this example was the daily action; and the actual trade entry on the intraday price pattern. (Identifying support and resistance or pivot points on the daily session.) The visualization of possible targets -- where the market might be going -- and overall market condition is built on the weekly price history. So I work with patterns in multiple time frames to plan out the entire trade and trade management.

How do the Valley of the Kings and the Place of Truth differ from classical trend continuation patterns?

Classical trend continuation patterns such as ascending or descending triangles, pennants, bull or bear flags are generally more specific to shorter term price action. These patterns are often excellent trade set ups for swing trading strategies. Of these classical trend continuation patterns, the so-called "cup and handle," however, shares some features of the Valley of the Kings in that part of the cup and handle (bottom of the cup) is characterized by a basin or trading range. In our discussion of the Valley of the Kings, we we consider the market sentiment and logic behind the basin or extended valley.

Also,.and unlike the narrow range of the cup basin, our Valley of the Kings presents us with a wide price range, including little price volatility often over relatively long periods of time. Addittionaly, and important to remember, is that the Valley of the Kings (like other pattern constellations described in the book) is not a trade set up, but instead a state of the market where the trader can seek his or her own set up within this very large unfolding pattern.

Finaly, specific to the Valley of the Kings, is that it is a bull trend continuation pattern. Completion of this pattern is often marked by a breakaway daily pattern, such as a breakaway gap to the upside.

Can you discuss the thinking behind two other patterns you discuss in the book: the Quiet Before the Storm and the Lightning Bolt?

I was thinking about market patterns that might express themselves before a "surprise" when markets suddenly head south or take off to the upside. Would there be anything in price action alone to tip us off beforehand? And reviewing maybe hundreds of episodes where a market had big and sudden move, there was, indeed, often a series of conditions that repeated itself before market storm events or where a storm event pattern (as in the Lightning Bolt) had high predictive value. So that is what I've discussed here, putting it into weather metaphors to give it a concept and natural logic instead of simple and dry descriptions of market patterns. And I think it worked.

When thinking about what is called “Quite Before the Storm” we have low price volatility. This is obvious. But there was often something more concrete than just low or even extremely low volatility: a series of identifiable price patterns leading up to and resulting in a big and often rapid sell off. A part of this storm pattern, for example, is when the classic bull ascending wedge pattern fails and all are taken by surprise. (But if you read the book, you will see why this is neither a real failure nor a bull ascending wedge pattern as often mistaken to be.) The exact pattern and conditions behind this “failure” are described as the “Quiet before the Storm.” And like in nature, there are specific atmospheric conditions (read market conditions) that lead up to this before any sudden cloudburst.

The weather metaphor of the “Lightening Bolt” to describe the price pattern behind a market that suddenly and unexpectedly takes off to the upside worked on many levels. Often there is little or no warning, but sfter this pattern has hit, we know a massive change is underway. So unlike all other patterns we discuss in the book, the lightening bolt is the only one that is not one for anticipatory trade set up, but a reactive trade. And identifying this particular patttern has tremendously helped me trade market situations that come unnatural for me. I have weakness that I like to be early into a trade and not to jump onto a trade one a market has taken off. Of course under some conditions, such as the Lightening Bolt, that is the time to take the trade, reactive or not.

What advice would you give traders looking to incorporate price pattern analysis into their decision making process?
Keep it in perspective and understand exactly what pattern analysis is and is not.

With pattern recognition and visualization tools (that can help us detect even more discreet market behavior) we can determine – to a relatively high degree –the overall state of a market and classify a market condition. Once we have that established, we know (or think we know) the beast we are dealing with. Then, and perhaps by incorporating additional tools of TA, such as momentum or volatility indicators, a market condition and our exact trading approach can be determined. Yet my honest advice is to incorporate price derivative indicators as “diagnostics” and not for absolute trading rules.

Regardless of the level of trading experience, examine markets for patterns that you think have some predictive reliability and where a trading method that fits your style can be incorporated. This exercise to discover and define your own patterns and trading strategies around them will teach you a great deal about price analysis.

If you are a short term swing trader holding trades only a few days at the most, and concentrate on strategies around those patterns and with intra-day price data, understand what the unfolding pattern is over the longer time scales. The intra-day pattern you might be trading is the granular of a much larger price pattern. And if you do not know what is going on in the larger time scale, you see only the single trees in the forest you are venturing into. Eventhough you might only be trading the short term price action, understanding the larger price dynamic will keep you out of trades that appear to be a breakout, for example, but are nothing more than short price volatility.

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