

1-2-3/TrendChange Pattern

It is the hallmark of any good approach that it should work on ANY market, in ANY timeframe. This pattern is frequently observed in different markets and can be traded intra-day as well as on longer timeframes.

This pattern is out there in the public domain, but we've added a couple of filters and twists to improve its reliability and reduce the risk associated with trading it. This pattern is frequently referred to as a 1-2-3 pattern or a Trend Change pattern.

The premise of the pattern is that markets rarely turn on a dime making an A top or a V bottom, i.e. moving in a straight-line from new highs to new lows or conversely from new lows to new highs as depicted below.



Most of the time they will make a high, followed by a test of that high before reversing direction, resulting in a chart pattern that looks like an 'M' top. In the case of market bottoms they will usually make a low, followed by a test of that low before reversing direction, resulting in a pattern that looks like a 'W' bottom.



The 1-2-3 pattern is frequently seen at market turning points and is easy to identify. In the case of a 1-2-3 High, it is characterized by a market making a high (the #1 point) followed by a pullback and retracement of the last upswing (down to the #2 point) with a subsequent rally to test the previous high. This rally stops short of the #1 point high and the market subsequently reverses direction (creating the #3 point).

The traditional way to trade the 1-2-3: For a 1-2-3 High, the traditional way is to wait for price to break below the #2 point after the #3 point is completed and enter a short trade at that point. Once the trade is entered the protective stop will be placed either above the #1 point, or for those desiring to use a tighter stop, above the #3 point. Clearly, there will frequently be a significant distance from the #3 point to the #2 point requiring a sizable stop and the market in question will often take several bars to complete this distance.

Our Way of trading the 1-2-3: In researching this pattern we wondered if there wasn't a way to get in closer to the #3 point extreme. If such a way could be found it would allow us to capture more of the profit potential in the trade, while reducing our risk. In other words we figured there had to be a better way to trade this pattern.

After examining hundreds of charts we developed the following criteria for identifying the #3 point **as it formed**. It doesn't capture all 1-2-3's as some #3 points don't meet the criteria outlined below. In those instances you will have to stick to the traditional method of entry, i.e. waiting for the #2 point to be taken out. In the instances, however, where the #3 point meets the criteria you will be able to enter at significantly better prices, use a tighter stop and enjoy the satisfaction that comes from knowing you are among the first to identify and get on-board an impending move. This experience is made even sweeter by the fact that as other market participants identify the potential market extreme, anything they do to "play it" will work in favour of your position!

Triggers and Requirements

First we get a Trendline break followed by a countertrend swing of at least 5 bars or more (the swing labelled 1-2)

Next we get the test of the top. The test leg (the swing labelled 2-3) should retrace at least 50% (can even be a double-top) of the previous swing (the difference between Point# 1 and Point# 2). This leg needs to be 3 bars at a minimum

Finally we require the Signal bar for a Sell to be the Highest High of the last 3 bars and to close weak, i.e. Below the Open AND in the lower-half. We will then look to enter below the Low of the Signal Bar with stop beyond #3 point - Opposite applies for Buys

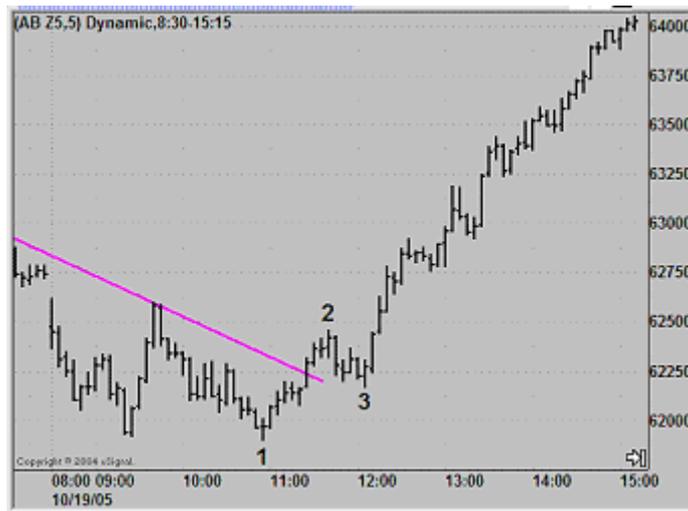


Let's take a look at a couple of recent chart examples from different markets

A number of day traders have switched to the E-mini Russell 2000 from the E-mini S&P in the past year due to its higher intra-day volatility and greater daily ranges. Following are a couple of 'Before' and 'After' charts demonstrating the 1-2-3/TrendChange pattern as it set up on a 5 minute chart on **Wednesday of last week, i.e. 10/19/05** (time scale at bottom of chart is U.S. CST):



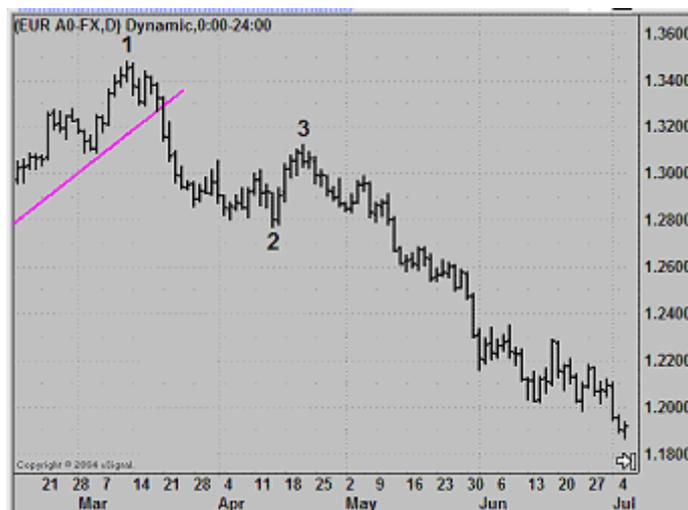
Note how the criteria outlined above are met. First we got the trendline break shortly after 11:30am CST alerting us to the potential for a trend change. This was followed by the counter-trend swing which was 5 bars or more in duration and a subsequent test of the low that re-traced only slightly more than 50% of the 1-2 swing. The 2-3 swing is more than 3 bars in duration, and the #3 point is signalled by a bar that is the lowest low of the last 3 bars, yet closes strongly, in the upper half of the bar and above the open. At this point the pattern is complete signalling entry above the high of the bar completing the pattern. If/when filled the protective stop is placed below the low of the signal bar. **The pattern preceded a rally of 17.00pts (worth \$1,700) in 3 hrs. as the market proceeded to move higher for the balance of the day as seen below!:**



As previously mentioned this pattern works in any market in any timeframe. Now let's turn our attention to the biggest market in the world, the interbank foreign exchange market (FOREX), specifically the daily chart of the EUR/USD crossrate.

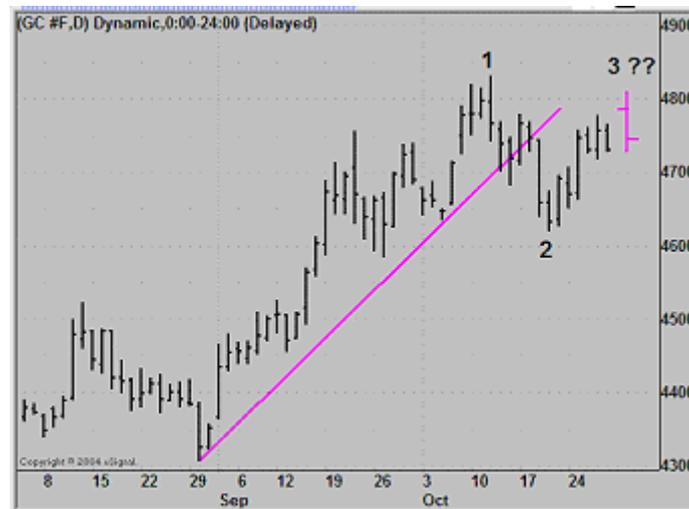


Again, all of the criteria for a 1-2-3 High outlined above are met, **after which the EUR/USD dropped 1100pips (-8.5%) in the next 10 weeks** as demonstrated by the following chart.



TRADE IDEA: Potential 1-2-3 High presently forming on the Gold Daily Chart ??

The Gold market is currently in an interesting position as it rallied approx. 17% from the May lows into the fall. Recently Gold has backed off, breaking the uptrend line going back to the late August low, giving us the first ingredient required for the 1-2-3 High pattern. The 1-2 swing as noted below exceeds 5 bars in duration and Gold has been climbing again in the last few days as this is written on **Friday morning, 10/28/05**, rallying in excess of \$15.



The swing low labelled '2' above counts as the first bar in the 2-3 swing that has started to form, the rally has already exceeded the minimum number of bars for the 2-3 swing as well as the min. 50% retracement requirement, as a result **the only criteria missing** to complete the 1-2-3 High/Trend Change pattern is a daily bar that is the highest high of the last 3 bars and closes weakly (i.e. in the lower half and below the Open of the bar as demonstrated by the magenta bar hand drawn in at the hard right edge of the chart) to have a completed 1-2-3 High pattern in place.

If this happens you'll know what to do: Place SELL STOP order to go short below the low of the bar that completed the #3 of the pattern. If filled, the protective stop should be placed above the high of the signal bar, i.e. the #3 point. Should the high of the signal bar be exceeded, however, without filling your short entry order you should cancel the order, as that would invalidate the pattern.