The chart pattern called "head and shoulders" is one of the oldest known and most widely used by technical traders. This bearish type of reversal is formed by prices of a stock or index rising to a peak and subsequently declining. Price then rises above the former peak making a higher high and again declines. Price then rises again, but not as high as the second peak and declines once more.

These three peaks with the middle being the highest and lower highs on either side of it, create a pattern in the image of a silhouette of a head and shoulders where the first and third peaks are the shoulders and the second peak forms the head. While this is a very accurate description of what the pattern is, its really only half the story. Price patterns do not only show us where price has been, but are also a graphical representation of the emotion and psychology of the players on either side whose actions left their marks on those charts.

The main reason why head and shoulders patterns are quite powerful in predicting further downside declines is due to the fact that each of the three parts of the H&S has its own psychological profile. Let's look at each part separately and analyze what a majority of traders may be thinking as they operate within the confines of each section's price action.

Left shoulder - This is a consolidation after a move higher. There is recent new high within the left shoulder and then some sort of mild pullback which does not disturb the uptrend. At this point, most traders are long and holding, hence the rise up in prices and the mild pullback forming the shoulder. The lows of this pullback often begin to define the nascent neckline. Given that the pattern is one of consolidation we should also assume that there is some amount of pressure here as bulls are holding their original positions and possibly adding to them in expectation of still higher prices and bears are thinking that price is too high here and are selling their longs or initiating shorts.

Head - The head is formed when price moves higher out of the left shoulder consolidation and either tops out over one or two sessions or in this case creates a second consolidation higher than the first which was the left shoulder. So, in keeping with the rule of always analyzing every chart by trying to establish who is happy and who is disappointed (also translatable as "who is greedy and who is fearful"), we can again look closely at who is participating and how during this "head" phase of our pattern. Firstly we have the bulls from the left shoulder. They are happy because they were right. Price did indeed move higher and any bears who were shorting in the left shoulder were clearly wrong and had to cover. Now we have two instances where the bulls were right. They were right into the move up into the left shoulder and again right in the move up higher out of the left shoulder. Additionally we have two levels of consolidation now, both of which have built up some pressure.

Right shoulder - At this point, prices break down out of the head area and begin to consolidate again in the same area where they consolidated earlier, which is at a lower level than the head, hence forming the right shoulder. Pressure built up from the "value area" that was the head consolidation creates a snap to the downside where bulls who bought in the head consolidation are no longer happy, *however* note that not all bulls are disappointed. This is where it gets interesting. While price stays in the right shoulder area, the only bulls that are already completely wrong are those that initiated new positions from the head area. Bulls who got active in the left shoulder are now at break-even, and older bulls who already had established positions in the ascent leading up to the left shoulder are still in a position of profitability. This right shoulder is also an area of congestion where bulls and bears are in disagreement about price. Whenever this occurs, think "pressure" which will magnify any ensuing move. Price will often find support here at the same area it did in the left shoulder, thereby further defining the neckline.

Now the theory is that the head and shoulders is a pattern which *leads* to much lower prices, meaning that once prices break down out of the left shoulder through the neckline, an extended downward slide should ensue. The reason why this is often true is because of the profile of the three areas that we just discussed. At a break below the neckline following the completion of the head and shoulders pattern we now have three distinct value areas where bulls will all be wrong en masse. What gives it power is that while price remains in the right shoulder, only *one* of the three groups of bulls (the buyers at the head) is really wrong. The left shoulder bulls are back to break-even and the right shoulder bulls who bought the support of the neckline are either slightly profitable, break-even, or are only slightly in the red and more than likely still holding and using that neckline as their stop area. Once price breaks down below the right shoulder the one wrong group all of a sudden becomes three and a lot of dumping occurs as bulls from all three areas must become sellers along with an increasing number of older bulls from the move leading up to the left shoulder who are now no longer profitable.

Although this particular head and shoulders is made up of three distinct consolidations, while most H&S patterns have more of a spiky top that defines the head, take note that the mechanics are the same regardless. In a more spiky H&S top, there is often a large surge of emotion at the top over one to two sessions which creates the head. All that volume that went in has to come out when price suddenly fails. As price comes down into support of the neckline and left shoulder area, be aware that not every bull from the top has sold. Some may have a longer term outlook and are ok with holding through one pullback especially when they know that there is a support area (left shoulder) below. As long as the right shoulder doesn't break downward, this group is still ok and we must assume that they don't hit the sell button yet. The rush of course comes when that right shoulder/neckline support is lost.

The above summarizes only the psychological inner workings of the head and shoulders. But traders should be aware that these emotional and psychological underpinnings exist behind all charts and all patterns. Every mark on every chart is an individual or institutional vote as to where they think price will go next. Remember to always "look to the left" at every turn and always analyze current price action in the context of "who is greedy and who is fearful". Doing so can help you decipher the expected future actions of traders which will of course define where price is likely to go next.

- Extract ‘The Shadow Swing Trader’