Special Report Bear Markets Part 3:

Major Reversal Patterns: When Bull Markets End and Bear Markets Start and Vice Versa

Our last Special Report on Bear Markets I explained the 6 different phases of a bear market. This Special Report will explain the first phase: Major Reversal Tops, when bull markets end and bear markets start.

Many traders and investors are interested in the ability to identify when a long-term trend is about to begin or end. Identifying major tops and bottoms (bull and bear markets) can help you make huge profits. Always keep an eye out for the major reversal patterns you'll learn in this Special Report. Major reversal topping patterns can be like ominous dark clouds in the sky. When we talk about a major reversal top we are talking about the potential of a 100% retracement of a major trend. As we know it can take months to several years to build a long-term bullish trend and normally the reversal will take much less time. The bottom reversals take time to build. You can save your capital once you identify a major reversal top and it could be very profitable in comparatively less time. Catching a bottom reversal can also be very profitable. Bottom reversals can be the beginning of a substantial long-term up trend, bull market.

The patterns that you can have at the top you can similarly see on the bottom. Tops and bottoms (head & shoulders, double top, triple top, rounding top/umbrella) have several characteristics in common. Again, pay attention to what happens on the rallies because it's just as important as paying attention to volume.

Top and bottom common features:

1. The right side is a mirror image of the left side on major topping formations. On the left side of the chart the rallies (buying) you will see strong volume and in the pullbacks (selling) you will see weaker volume. On the right side you have the opposite, rallies (buying) will have less volume and in the pullbacks (selling) will have increased volume.

2. Major topping patterns are essentially testing new highs and after several tries investors and traders tend to sell in any rallies making the potential for a new high very difficult and a reversal likely. You have a similar scenario for the bottom patterns. After several tests of a bottom investors become encouraged and an important up trend could occur.

3. A trend line is broken.

4. Bottoms take longer to build, tops have shorter durations comparatively.

5. Tops are more volatile, bottoms have smaller price ranges.
6. The longer it takes to construct a top the more significant the reversal will be. For example, a one year top will be more significant than a two month top.
7. Bottoms will look similar to a top except it is upside down. Another difference is that a significant amount of volume is needed to break out of a bottom trend.

Major Topping Patterns

There are five identifiable major top and bottom patterns:

Tops	Bottoms
1. Head & Shoulders Top	Head & Shoulders Bottom
2. Double Top	Double Bottom
3. Triple Top	Triple Bottom
4. Rounding, Umbrella Top	Bowl Shaped Bottom
5. Spike	V Shape

Head and Shoulders Top

By definition head and shoulders are characterized by a left shoulder rally, a head rally, then a right shoulder rally. Below are some of the characteristics of a Head and Shoulders Pattern.

1. The left shoulder will have the heaviest volume and then a pull back to support.
2. A rally to new highs, a head on lighter volume.
3. A correction back to the support area.
4. The last significant rally on even less volume than the head. The rally should rise to a similar level as the left shoulder. It does not have to be the exact level.
5. A close below the neckline using the filters would signal a reversal. The neckline is essentially a support (trend line). The neckline usually slopes slightly upward or it can be horizontal. On rare occasions the neckline can slope slightly down.

1. We see that the left shoulder is formed in early 1999. Notice how high the volume is which is typical for the left shoulder.

2. The head is established during the year 2000. The volume is substantially less than the left shoulder.

3. The right shoulder is built around the middle of 2001. The volume is low on the rally of the shoulder.

4. The support line of the Head and Shoulders Pattern is called the neckline. The neckline is drawn by drawing the bottoms of the Head and Shoulders Pattern. The line is slightly upward sloping which is typical. When the stock broke the neckline use the filters to confirm the pattern has been broken. If the trend is broken it can take some time before seeing those peak prices again. The Head and Shoulders Pattern took approximately 3 years to build.

Triple Tops Patterns

Triple Tops Patterns are similar to Head and Shoulders Patterns except for the head. The rallies will stall out three times in this pattern. Be careful with triple tops because they can turn into a consolidation, rectangle pattern or a rounding top. Triple Tops Patterns are the least common of the major reversal patterns. The price targets (measuring technique) would be similar to a Head and Shoulders Pattern.

Some technicians may consider the above chart a double top, or even three separate spikes. We are considering this a triple top because the tops all share the same long-term trend line and volume declines on each top. Amazon falls to the single digit level in 2001.

1. The first top is established in early 1999 on significant volume.

2. The second top is established in mid 1999 with less volume.

3. The third top is made in late 1999 with even less volume.

4. With this stock there were warnings of a major reversal, three tops with declining volume and three pullbacks with increased volume. The trend took over a year to build. Notice there was also a Head and Shoulders Pattern in the last top. It would have been better to get out on the neckline than wait for the breaking of the trend line of the triple top.

Double Tops Pattern

Double Tops Patterns are one of the easiest tops patterns to identify and are common.

By definition, the Double Tops Pattern has two tops with the first top having significant volume and the second top having lower volume. The pattern is complete when the support from the first pullback is penetrated by the second pullback. If the pattern does not penetrate then prices could continue on to a triple top or consolidation pattern. Again, the longer it takes to build a pattern the more significant the pattern. In the tech wreck of the nineties you had many double tops that occurred over several months. The time was not significant; it was the ascent of the double tops that make the stocks very vulnerable and their valuations.

1. The first top occurs in April of 1999 on significant volume.

2. The second top occurs early December 1999 on much lower volume. Notice the volume. Selling increases after the rally is over and you have other peaks in volume after rallies. This pick-up in volume on pullbacks is normal after a trend is broken. Traders and investors sell into rallies and the selling intensifies.

The double top took about 8 months to build. There are several signs for investors and traders to exit the stock:

- Double Top
- Lower volume on the second rally, increase in volume on pullbacks
- Breaking the trend line
- Fanning, third fan is established and broken
- Acceleration from the trend line
- Valuations

Rounding Top Pattern

The Rounding Top Pattern is also known as an *Umbrella* or *Inverted Bowl Pattern*. Rounding Top Patterns follow the same patterns as other tops. On the left section of the chart it has strong volume on rallies and light volume on pullbacks, on the right section of the chart it has weak volume on rallies and as investors sell into the rallies volume increases. Volume will normally look like a bowl.

Rounding Top indicators:

1. Strong volume in rallies in the beginning on the left side of the chart.
2. Strong volume on pullbacks on the right side of the chart.
3. Top took about 3 years to build.

Tops and bottoms can take time to build because it takes time for opinion and action to shift from bull to bear and vice versa.

In 2011, it looks like it established a rounding top

Spikes, One day, Two Day Reversals

All the tops we mentioned previously took time to build and were in the last phase of a long-term trend. Spikes are also known as *Key Reversals* and *One or Two Day Reversal Patterns* because they reverse very quickly. Trend lines and short-term moving averages are better tools to use instead of chart identification when trying to spot a reversal. Reversals occur frequently in short to intermediate-term patterns, they are rare for longer-term patterns except with technology stocks of the late 1990s. They are the epitome of fear and greed in the markets.

Once a stock makes a new high and spikes there is very little supply-resistance in the way to slow down the trend. The stock will make the new high lists and will attract momentum traders. The danger is the pattern accelerates from the trend line and the new trend line will be very easy to break and just as fast as it went up it can fall even faster. It is always a good idea to check valuations to understand the risk you take if you are in a long position when you are involved in a spike. If it is overvalued then the high valuation and accelerating trend line make the issue very risky.

The first chart on the left shows two spikes for eBay. The fall is just a dramatic as the rise. Both spikes have separate trend lines, the second spike has a lower trend line and falls further than the first spike. The bottom on the first spike is considered a V-shaped formation which is rare on long-term charts. We will discuss V-shaped patterns in a future Special Report.

The chart on the right zeros in on the spike that occurred in March of 2000. The spike (trend) has a tremendous move in several days but the trend is not sustainable.

Here is an example of a recent spike, major reversal pattern:

We can see that MOS had a dramatic rise during the bull market that started in 2010. It did have a spike major reversal pattern and has lost most of its bull market gain.

2011 Major Reversal Pattern?

It looks like in 2011, the market made a major market top. Did the bull market end, and did the bear market stop. Here is the Dow 30 chart for the 2009 to 2011.

Let's review the chart:

1. Stocks are up significantly in the past few years – most major markets have just about doubled off the low of 2009.

2. Major reversal tops take at least 6 months to build – this market formed a major top that started in February, about 6 months. The pattern is either a head and shoulders top, or a rounding top major reversal pattern.

3. Prices have broken the neckline (black support line).

The neckline is the support line for a major reversal top.

When prices fall all the way down to a neckline/major support and a 200-day moving average, prices are saying there is something wrong. They are red flags.

4. It is normal for prices to snap back to the neckline, although in most cases it does happen sooner after the break.

The engulfing red candle after the snap back does make the rally suspect, normal price behavior.

History of Major Market Tops

I put together a spread sheet of the major tops going back to 1917. Most bear markets have a major top. Not all bear markets are associated with a recession, most are. Here is the spread sheet:

	DOW 30 BEAR MARKET LOSSES TA				
YEAR	HIGH	LOW	LOSS	TOP	MONTHS (APPROX)
2011	12,876.00	?	?	Rounding	7
2007	14,279.96	6,440.08	54.90%	H & S	19
2000	11,908.23	7288.27	38.80%	Rounding	30
1998	9,337.97	7539.07	19.26%	Rounding	5.5
1994	3,945.43	3520.8	10.76%	NO	
1990	2,999.75	2365.1	21.20%	NO	
1987	2,722.42	1738.74	36.10%	NO	
1984	1,287.20	1086.57	15.59%	Rounding	10
1981	1,024.05	776.92	24.10%	Rounding	13
1976	1,014.79	74.12	26.90%	Rounding	9
1973	1,051.70	577.8	45.10%	Rounding	13
1968	995.21	631.16	35.90%	Rounding	12
1966	995.15	744.32	25.20%	H & S	10
1961	734.91	535.76	27.10%	H & S	12
1946 - 49	212.50	163.21	23.20%	Rounding	9
1939 TO 4	155.92	92.92	41.30%	Rounding	24
1929 TO 1	381.17	41.22	89.00%	Rounding	10
1923	105.38	85.76	18.60%	Double To	12
1919 TO 1	119.62	63.9	47.60%	Rounding	6
1917	110.15	65.95	40.10%	H & S	18
AVG. TOPPING PHASE LENGTH					15.678571
YELLOW INDICATES NO RECESSION					

For the Dow 30, most major market reversal tops are rounding tops. It is a different story for stocks that enter bear markets; the MOS chart above is a good example.

As the last row states, bear markets in yellow are not associated with recessions.

The average time to build a top is about 15.6 months. If the 2011 is truly a major top reversal, then it would be one of the shortest major top reversals, about 7 months.

Again, identifying major reversal tops and selling/selling short and buying at bottoms could be very profitable. We started the GEA2 portfolio at the beginning of the bull market in late 2008, and have been selling this bull market starting late last year.

There is a strong possibility that we will close GEA2 and start GEA3.