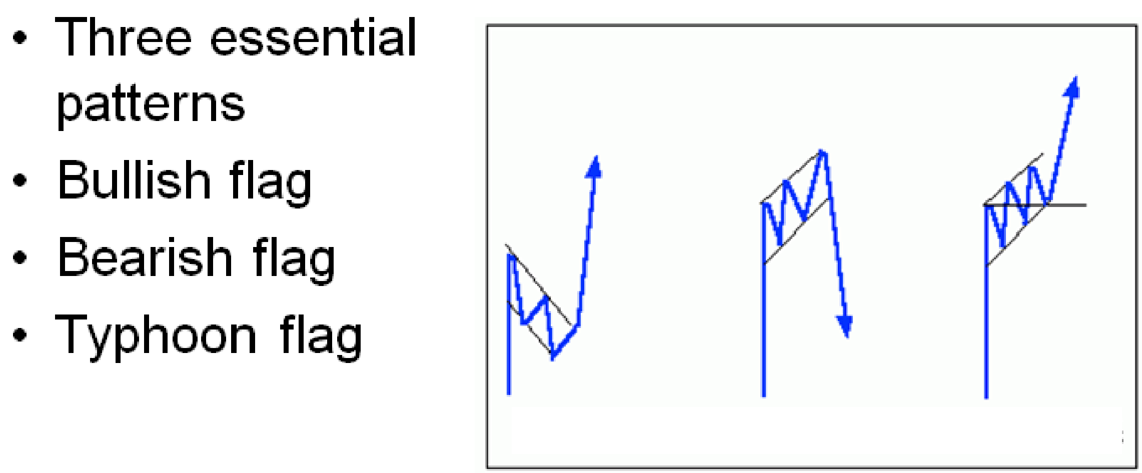
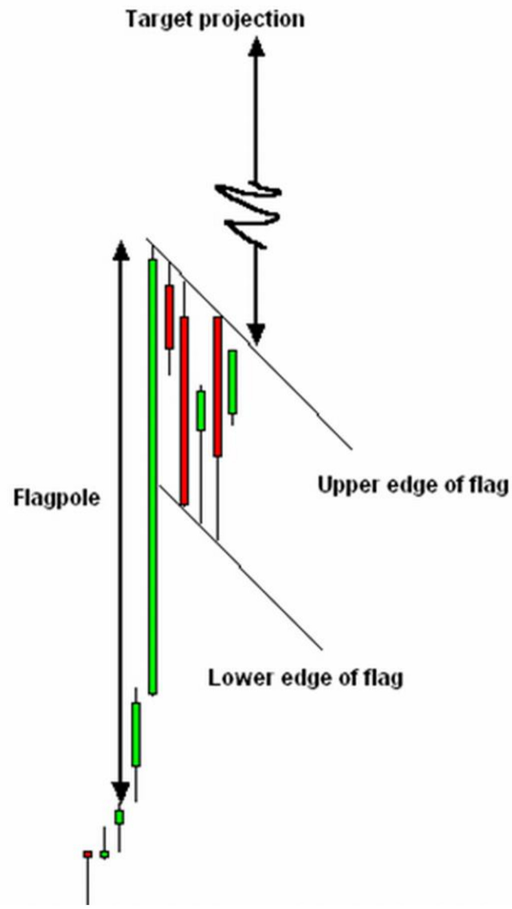
# <u>**TYPHOON FLAG TRADING**</u>

*By Daryl Guppy*

Traders use chart patterns because they point the way to high probability trading situations. The most useful of these allow the trader to set exact reward targets. Armed with this information the trader not only has a high probability trade, but is also able to make an accurate calculation of the risk/reward ratio. Over recent months a distinctive rebound pattern has developed in many Asian markets. It is based on a flag pattern, but traders cannot use it in the same way. To illustrate the differences and to apply the appropriate trading techniques, we need to start with a brief revision of the classic and highly profitable bullish flag pattern.

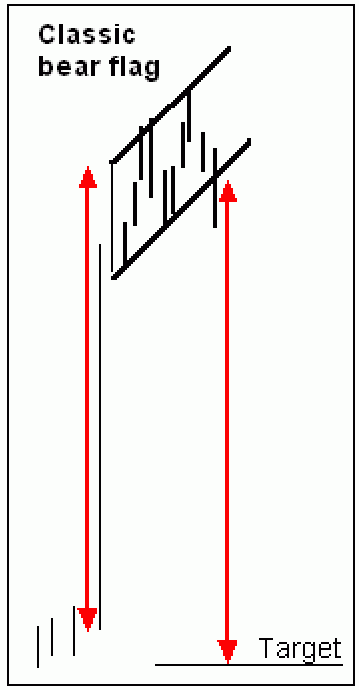



This is a high probability pattern. It starts with a flagpole created by 1 to 5 days of very fast price movements with large price ranges. A flagpole is a clear outstanding price pattern. The pullback, or retreat, from the top of the flagpole defines the flag pattern. The bullish flag drops away as shown. The upper and lower edges of the pattern are defined by parallel straight edge trend lines. The breakout above the top edge of the flag sets up a high probability trading target. This is calculated by taking the height of the flagpole, shown by the red double headed arrow, and projecting it upwards from the point at which prices break above the top edge of the flag.




This is a classic bullish flag and it is a continuation pattern. It signals a continuation of the momentum move that created the original flagpole.

The bearish flag starts off like a bullish flag but the subsequent development signals an end to the momentum driven continuation. This is an exhaustion pattern. The market does not pause for breath, it simply keeps running until it runs out of puff, and then it falls in a heap. This pattern is usually associated with a drop in prices and a collapse of the previous fast rise. The probability of the price collapse is around 70% vs the 85% success rate for the breakout above the bullish flag. This is an unexpected development. The continued rise in prices looks as if it should support a continuation of the initial bullish rise.



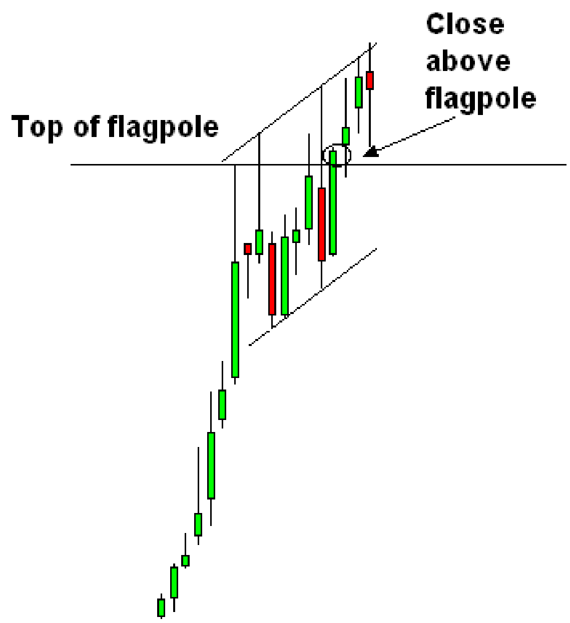

Some traders who short the market use these bearish flags to set downside targets for the short trade. They use the height of the flagpole as the calculation point and they measure the potential downside target from the point at which prices break below the lower edge of the bearish flag. The diagram shows the way this is applied. We do not use bearish flags in this way. Instead we prefer to use them, as a general guide to a collapse of the initial uptrend. These are not trades we want to be involved in.

The typhoon flag is a specialised development of the bearish flag. In Hong Kong in the days of the China Traders weather forecasts were posted as flag signals. The typhoon flag signalled very strong winds and we can imagine the strength of the gathering storm trying to lift the flag upwards from the peak of the flagpole. We use the term typhoon flag to describe a similar satiation in the market where strong trends push the flag pattern to new highs and it is even more appropriate as these patterns are frequently found in Asian markets.

Initially the typhoon flag develops in the same way as the classic bearish flag. The difference comes in three ways.

- The way the top of the flagpole acts as a support level.
- The way the fall in prices, consistent with a bearish flag collapse, is arrested by the support level and is followed by a rebound in a trend continuation.
- This is also sometimes associated with a break above the top edge of the up sloping flag.

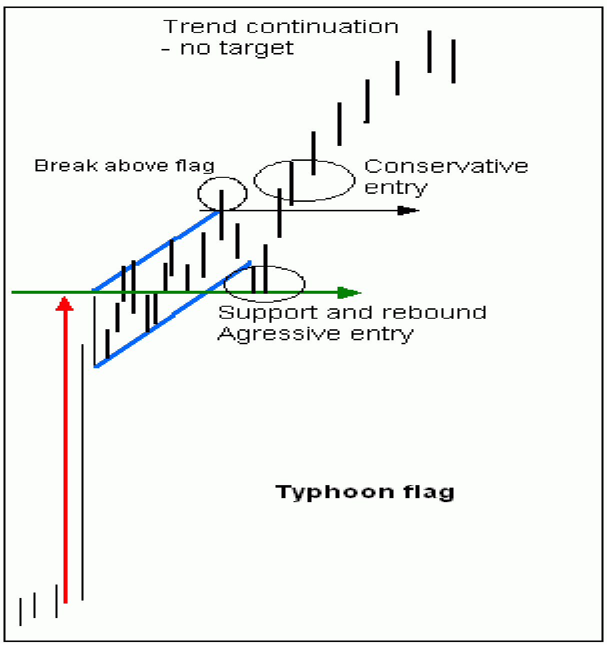
The typhoon flag captures the exhaustion that follows a fast run up, but the collapse is temporary. The support level provides a rebound point and the trend gains new momentum and continues to move at a steady pace. Think of it in the same way as breaking through the joggers pain barrier and getting a second wind.




The typhoon flag signals a rebound opportunity that allows the trader to join a resumption of the trend. Traders have a choice of aggressive or conservative entry points, but no matter which they select, this pattern signals the continuation of an up trend. The pattern does not have any price projection, or target setting advantages. Unlike the classic flag patterns, there is no value in measuring the hight of the flag pole and projecting this upwards. The new trend often met and exceed these types of target projections. The typhoon flag is most useful in identifying a change in market conditions. Many fast moving price rises are temporary, which is what makes them suitable for short term trading. The typhoon flag signals the trend change has come to stay.

The first indication of a potential typhoon flag comes when prices collapse below the bottom of the bearish flag pattern.

Confirmation comes when prices rebound from a support level based on the height of the flagpole. This is shown as the green line on the chart. This support level may be hit several times over several days. There is not always a sudden single rebound from this area. This support activity provides an entry opportunity for aggressive traders who wish to join this new trend early. An aggressive stop is activated on any close below this support level.




The top edge of the bearish flag cannot be projected indefinitely into the future. At some stage prices move above this level and this signals the end of the flag pattern. We have shown the upper blue line of the flag ending on the day prices moved above the flag pattern. We plot a line to the right, shown as the thin black line. The objective is to wait for a new close above this level before making a conservative entry. It is conservative because we wait for confirmation that the new up trend is in place.

In the diagram extract, prices collapsed after this initial breakout, then rebounded from the support level. Conservative traders wait until prices close above this upper line. This provides conformation that the rebound is sound and that the new slower uptrend is likely to develop. This pattern signals a higher probability trade situation, but it does not provide a trading target.

The typhoon flag pattern identifies a change in circumstances and highlights the opportunity to join an emerging trend. It is no longer a target based pattern, but it remains a high probability pattern.