

Key Reversal Bars

Here's how to filter one day reversal patterns

Key reversal bars are a very simple one bar pattern to recognize, but are they effective?

Key reversal bars are used to note a large one bar reversal following a trending move. The idea is that they will cause the trend to stop and a correction or total reversal in trend to occur.

Let's first consider the definition of a key reversal bar.

Bearish: $High = Highest(High, 40)$ and $High > High[1]$ and $Close < Low[1] + Range[1] * 0.382$

Bullish: $Low = Lowest(Low, 40)$ and $Low < Low[1]$ and $Close > High[1] - Range[1] * 0.382$

Breaking this down into plain English:

Bearish reversal:

$High = Highest(H, 40)$:

The current bar's high price is the highest high over the past 40 bars

$High > High[1]$:

The current bar's high is higher than the previous bar's high

$Close < Low[1] + Range[1] * 0.382$:

The current bar's closing price is below the previous bar's low plus 0.382 of the previous bar's range

Bullish reversal:

$Low = Lowest(Low, 40)$:

The current bar's low price is the lowest low over the past 40 bars

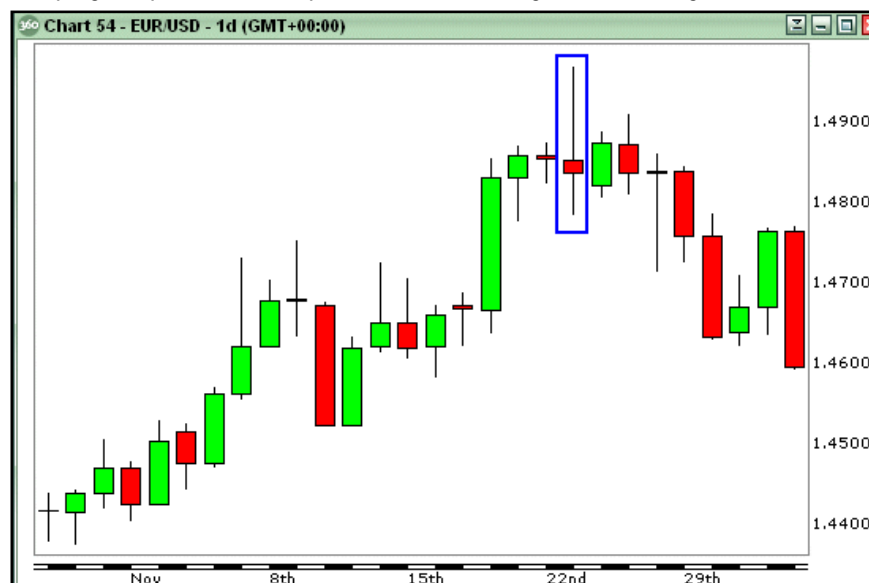
$Low < Low[1]$:

The current bar's low is below the previous bar's low

$Close > High[1] - Range[1] * 0.382$:

The current bar's close is above the previous bar's high minus 0.382 of the previous bar's range

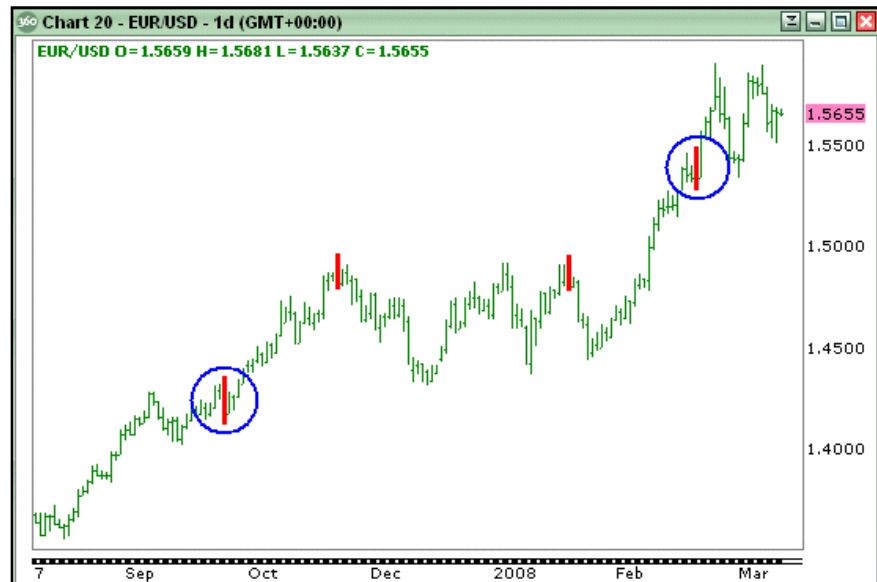
The chart below displays a perfect example of a bearish key reversal day.



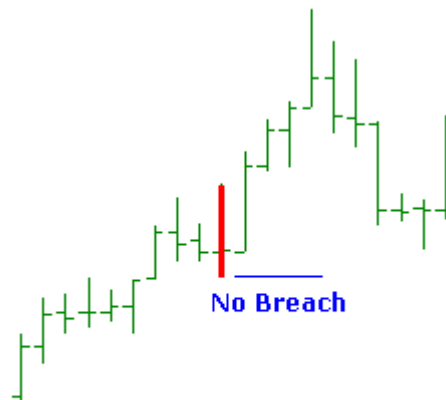
Indeed this example of a reversal following a strong uptrend in the Euro provided a sustained pullback in price which could have provided strong profit potential. Does this mean we can follow such one-bar reversals all the time?

Unfortunately not. Take a look at the following chart:

Very clearly the two examples in the center of the chart were excellent. However, the other two examples failed miserably. Is there any filter we can add to make this type of trade safer?



Of course the answer is yes. Let us take a closer look at one of these examples:



The bearish key reversal bar conforms to the definition we have given. However, instead of causing a reversal lower price actually resumes the uptrend.

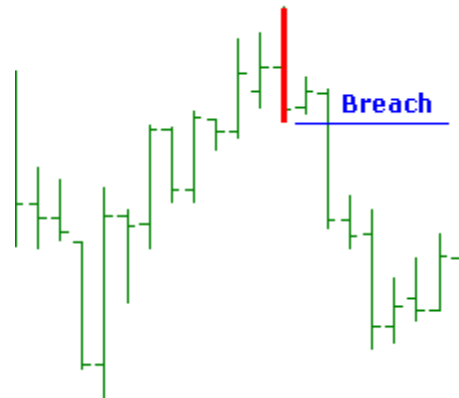
There are actually two factors to look at here:

The low of the key reversal bar has not broken below any significant swing low and therefore does not technically confirm a break in the trend. Basically until the sequence of higher lows is broken the trend can be said to be still in place. However, few bearish key reversal bars will actually break such a sequence. It doesn't mean that you only consider the potential reversal bars that do, but it does mean that you still need to be cautious in your approach.

One way to add an additional filter is to look to trade on the next bar when it breaks below the low of the key reversal bar. You can see from the example that this did not happen so this filter would have avoided a loss making trade.

I must warn that sometimes the following bar does break the low of the key reversal bar and then price resumes its rally, but these occasions are few. No single reversal pattern will work 100% of the time. What we need so is reduce our loss making trades and improve on the profitable ones. You may also add in stricter rules like needing a bearish divergence or price having hit a price target. These you can add to your list.

And finally let's look at one of those two that did work:



Here, although it didn't occur on the next bar, two bars later we did see break of the low of the reversal bar. This is also valid. You could stretch this to 3 bars but I would become a little more concerned if this failed on the 3rd day also as it really begins to break down the pattern overall.

Good luck.
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