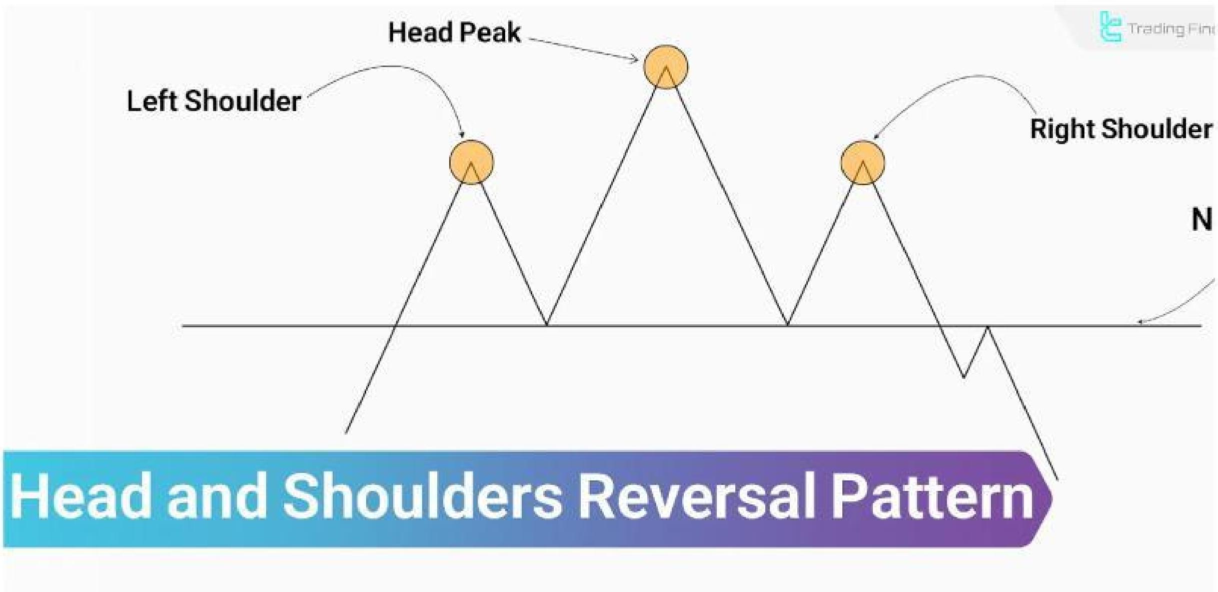
Head and Shoulders Pattern – A Combined Trading Strategy Using RSI Indicator

The **head and shoulders pattern** is among the **classic reversal** patterns that reflects shifts in supply and demand sentiment. This pattern consists of three consecutive peaks. As these peaks form, changes in **volume** and **price momentum** start to appear.

Combining the **head and shoulders pattern** with other **technical analysis tools** such as the **RSI indicator** leads to an improved **trade success rate (Win Rate)**.



The head and shoulders pattern issues a signal of trend reversal

What Is the Head and Shoulders Pattern?

The **head and shoulders pattern** usually forms at the end of a trend. Price creates one peak (left shoulder), a higher peak (head), and a lower peak (right shoulder), which signals trend **weakness**.

This pattern at the end of a trend shows the price's inability to form higher highs or break resistance zones. In this case, a **possible trend reversal** is expected.

The head and shoulders pattern is valid across all financial markets, including **Forex**, **cryptocurrencies**, and **stocks**, and it can form on different timeframes.

Advantages and Disadvantages of the Head and Shoulders Pattern

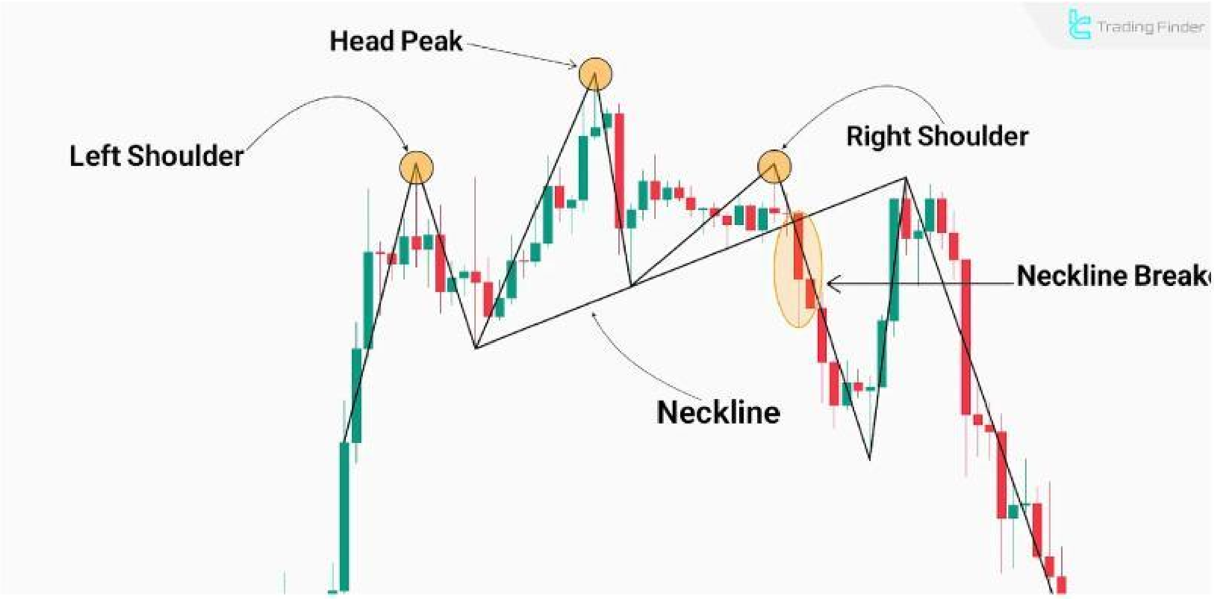
The **head and shoulders pattern** is highly useful in identifying trend reversals due to its clearly defined **breakout level**.

However, the pattern's reliability depends on several factors such as the precise shape of the components, market conditions, and more.

Disadvantages	Advantages
Possibility of false signals in volatile markets	Ability to detect structural weakness in trend continuation
High dependency on valid neckline breakout	Applicable in all timeframes
Requires confirmation from volume or indicators	Clear invalidation level
Sensitive to how the neckline is drawn	Enables accurate stop loss and take profit levels

Components of the Head and Shoulders Pattern

The **head and shoulders pattern** consists of four main parts, each with a specific role in shaping the reversal structure.



Analyzing the different components of the head and shoulders pattern individually

The sequence and behavioral characteristics of these components are the foundation of analyzing this pattern:

- **Left Shoulder**: The first peak formed after a **strong bullish move**, usually accompanied by high liquidity;
- **Head**: **The second peak**, which is higher than the first, representing the last effort of buyers to **break** **resistance level**;
- **Right Shoulder**: **The third and final peak** of the pattern, which is lower than the head and usually has **lower liquidity** than the other peaks;
- **Neckline**: The **support line** of the pattern that connects the end of the corrective moves within the **structure**; This line can form **diagonally or horizontally** depending on market conditions.

How to Trade the Head and Shoulders Pattern?

Trading based on this pattern requires accurate detection of the **neckline breakout** and monitoring **liquidity behavior** during its formation.

Entering a trade is only logical when the neckline breakout is validly confirmed and price holds below this line.

Trade Entry

There are two methods for entering trades using the **head and shoulders pattern**, each with different risk levels:

- **Aggressive Entry**: Entering the trade immediately after the neckline is broken, placing the **stop loss slightly above the right shoulder**, without additional confirmation;
- **Conservative Entry**: Entering the trade after a **pullback to the neckline** and receiving complementary confirmation such as candlestick patterns.

Determining Take Profit and Stop Loss

To determine the take profit **(TP)**, the **distance between the head and the neckline** must be measured. Then, the TP order is placed at an equivalent distance below the

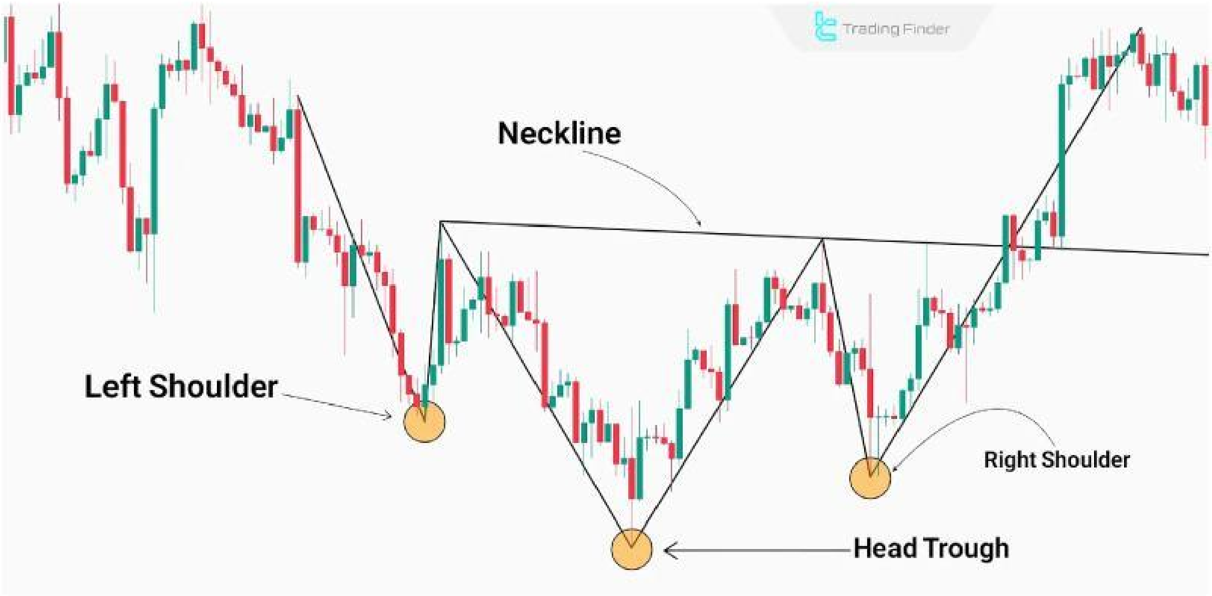
neckline.

Additionally, there are two stop loss zones with different levels of risk:

- **Above the Right Shoulder**: This area lowers the chance of **stop-hunting**, but offers a **lower risk-reward ratio**;
- **Above the Neckline Breakout Candle**: This level provides a **better risk-reward ratio** but increases the probability of **stop-hunting**.

Inverse Head and Shoulders Pattern

The **inverse head and shoulders pattern** is structurally similar to the classic one, except that the trend direction and neckline breakout are **reversed**.



The inverse head and shoulders pattern forms at the end of a downtrend, opposite to the regular pattern

This pattern forms at the **end of a downtrend**. After a strong bearish move, three consecutive **troughs** form at different levels: the first trough is the **left shoulder**, the second is the **head**, and the third is the **right shoulder**.

In this pattern, the **neckline breakout occurs to the upside**. A sudden increase in volume during the neckline break increases the **credibility** of the pattern.

Key Points About the Head and Shoulders Pattern

To evaluate the validity of the head and shoulders pattern, aspects such as **volume**, **neckline slope**, and **shoulder symmetry** should be considered.

Analyzing these factors helps identify changes in **supply and demand**, improving the trade **successrate**.

Neckline Slope

The **neckline** can form as **horizontal**, **downward**, or **upward**. In the head and shoulders pattern, a **downward-sloping neckline** indicates stronger **bearish pressure**. An upward slope generally **reduces** the pattern's reliability.

Trading Volume

At the beginning of the pattern formation, **volume is at its highest**. As the pattern develops, volume **gradually decreases**.

During the formation of the **right shoulder**, trading volume typically drops to its **lowest level**. However, once the **neckline breaks**, a **sudden spike in volume** confirms the pattern's strength.

Surge in selling volume after the neckline breakout

Shoulder Symmetry

Minor deviations in the **height of the shoulders** are natural, but the **less deviation there is**, the more **valid** the pattern becomes.

Also, the **time duration** between the formation of the two shoulders is important. The **shorter the time gap**, the higher the **reliability** of the pattern.

Price Behavior Before the Breakout

The **weaker the upward moves** before the neckline breakout, the more valid the breakout becomes.

Additionally, **compressed price ranges** and **short-term consolidations** are signs of **buyer weakness** and **increasing seller dominance**.

Breakout Confirmation

By analyzing **price action** after the neckline breakout, one can assess the **validity** of the breakout based on how price stabilizes below the neckline. The use of the **RSI indicator** is also helpful in verifying the **breakout's strength**.

The appearance of **long wicks** without price stabilizing below the neckline, often signals a **weak breakout** and the possibility of a **return to the previous trend**.

Liquidity Behavior in the Head and Shoulders Pattern

Before a confirmed breakout in the head and shoulders pattern, **intentional liquidity movements** occur in the market order flow.

In many cases, significant **liquidity** accumulates above the **right shoulder** or near the **neckline**, where **market makers** (the dominant players) attempt to **absorb liquidity** through **fake moves** or **stop-hunting** before the actual price reversal.

This behavior is often seen as **false breakouts** or **temporary penetrations** of the neckline area, prior to the main move.

Additionally, the formation of **tight liquidity zones** near the pattern's key points reflects **imbalance** in supply and demand and shows the market is **ready for a directional move**.

Validity Assessment of the Head and Shoulders Pattern

To determine the **validity** of the head and shoulders pattern, in addition to its **visual characteristics**, one must also examine its **structural position** and the **logic of its formation**.

In many cases, patterns that visually resemble the head and shoulders pattern are observed, but they do not form in the **right context** or **ideal locations** for a trend reversal.

For example, a **rapidly formed and unbalanced right shoulder**, or a pattern that forms **mid-range in a sideways trend**, are signs of **low pattern credibility**.

Price returns above the neckline after the breakout, grabbing liquidity to initiate the main move

Sometimes, **partial head and shoulders patterns** with **misleading price combinations** may lead to **misinterpretation** and **losses**.

Trading Strategy: Combining the Head and Shoulders Pattern with the RSI Indicator

In this **trading strategy**, in addition to analyzing market structure, elements such as **momentum changes** using the **RSI indicator** are considered, which increase the **trade success rate**.

#1 Identifying the Complete Structure

In the first step, the full formation of the **head and shoulders pattern** must be confirmed. The shoulders should be **relatively symmetrical** in height.

The formation of a **downward-sloping neckline** increases the credibility of this trading strategy.

#2 RSI Divergence on the Right Shoulder

After confirming the pattern structure, a **bearish divergence** must be checked on the **RSI indicator** between the **right shoulder** and the **head**.

The formation of a lower peak on RSI compared to the head, indicates the development of a **price bubble**, which increases the probability of a **price drop**.

#3 Overlap of Neckline Breakout and RSI Crossing Below 50

The next step in this **trading strategy** is the **RSI dropping below the 50 levelsimultaneously** with the **neckline breakout**. This overlap signals the beginning of **divergence release** and **price bubble burst**.

#4 Final Confirmation of Entry Signal

After a **valid breakout** and **momentum confirmation** via RSI, entry occurs once price **stabilizes below the neckline**.

If **any part** of the strategy does not confirm buyer weakness, the **entry signal** is considered **invalid**.

Entering a short trade using the head and shoulders pattern and RSI divergence strategy

Conclusion

The **head and shoulders pattern** is one of the classic **reversal** patterns. It forms at the **end of a trend** and reflects **weakness in the current trend's strength**.

This pattern is most effective when combined with a **detailed analysis** of **price behavior** and **liquidity conditions**.

Accurate identification of the pattern's components, proper **structure evaluation**, and confirmation of the **neckline breakout** are the **key factors** that determine the success rate of trades using the head and shoulders pattern.

Combining this pattern with the **RSI indicator** helps **filter false signals** and **enhance entry points**.

Sources:

Our Website Link :

https://tradingfinder.com/education/forex/head-shoulders/

All Education :

https://tradingfinder.com/education/forex/

TradingFinder Support Team (Telgram):

https://t.me/TFLABS