Pinocchio bars

Short-term momentum results when traders get caught leaning the wrong way.

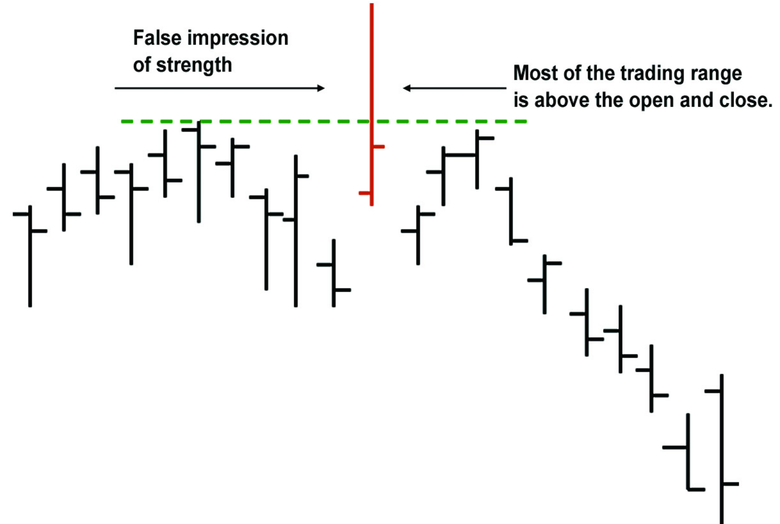
BY MARTIN PRING

Technical analysis is pretty good at identifying trend reversals at a relatively early stage and allowing you to ride that trend. That should be good enough for most of us, but many traders would also like to consistently predict the duration and magnitude of the next trend. That's not possible, of course, but there are some instances where specific setups or characteristics are often followed by above-average price moves.

Typically, these develop from "whipsaw" or false moves. Traders trapped on the wrong side of a whipsaw are forced to unwind their positions, while others position themselves in the direction of the true trend, resulting in two strong forces at least temporarily working in unison. Here, we'll examine one type of whipsaw, called "Pinocchio bars" because, like the Disney character, they lie to us about the true direction of the trend.

Pinocchio's nose gets bigger the larger the lie. In the case of the Pinocchio bar, the bigger its "nose," the more significant the whipsaw. Although the following examples are drawn from daily charts, the concept is valid for any time frame and the principles of interpretation remain the same; only the significance is different. For example, it is reasonable to expect a Pinocchio bar to have an effect on prices for five to 10 bars. A pattern of this nature that appears on a monthly chart will have a much longer influence than one on a 10-minute chart.

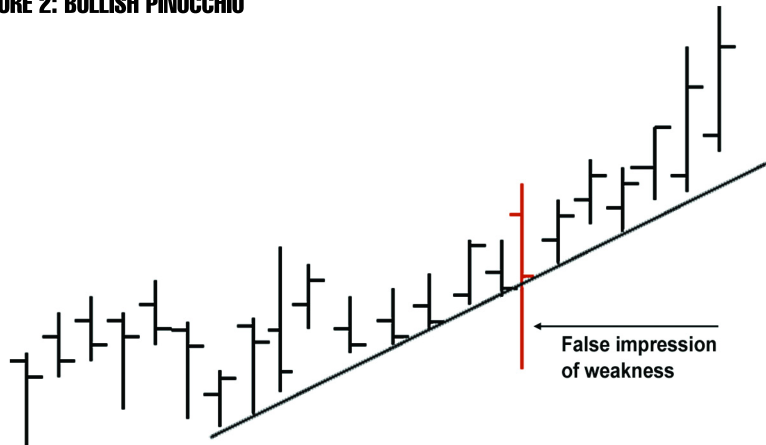
FIGURE 1: BEARISH PINOCCHIO



Price pushed decisively above the previous high on an intrabar basis but closed below it — a sign of exhaustion.

Source: www.pring.com

FIGURE 2: BULLISH PINOCCHIO



Price whipsaws through the support of an up trendline fails to hold below it at the close. The open is also above the trendline.

Source: www.pring.com

Basic characteristics

A bearish Pinocchio bar forms when the intraday price action takes price decisively above a resistance zone but the opening and closing prices do not. The most common forms of resistance in this respect would be a previous high or a trendline. In Figure 1, for example, price moves decisively above the previous high on an intrabar basis, but by the close it is

below it. In this example, price hesitates for a couple of bars prior to moving much lower. This hesitation is quite normal and gives traders an additional opportunity to enter a short position.

Such bars represent exhaustion moves where buyers run out of steam and are completely overwhelmed by the sellers at the bar's close — all those who bought on the basis of price hitting a new high are now trapped with a loss. The rationale for being long is no longer valid because the breakout did not hold, which means the position should be liquidated. Unfortunately, many traders ignore this on the hope things will turn around. They do, of course — but in the opposite direction to the one desired.

One factor that will increase the significance of a Pinocchio bar is the amount of volume associated with it. The more trading activity, the greater the battle between buyers and sellers and the greater the amount of "trapped" overhead supply.

Pinocchios also appear on charts as bullish formations: price whipsaws through support on an intraday basis, but fails to hold below it at the close. In Figure 2, the support comes in the form of an up trendline. The principle is the same: Price moves decisively through the support during the course of the bar's formation, but the open and close are above the trendline.

Stop placement

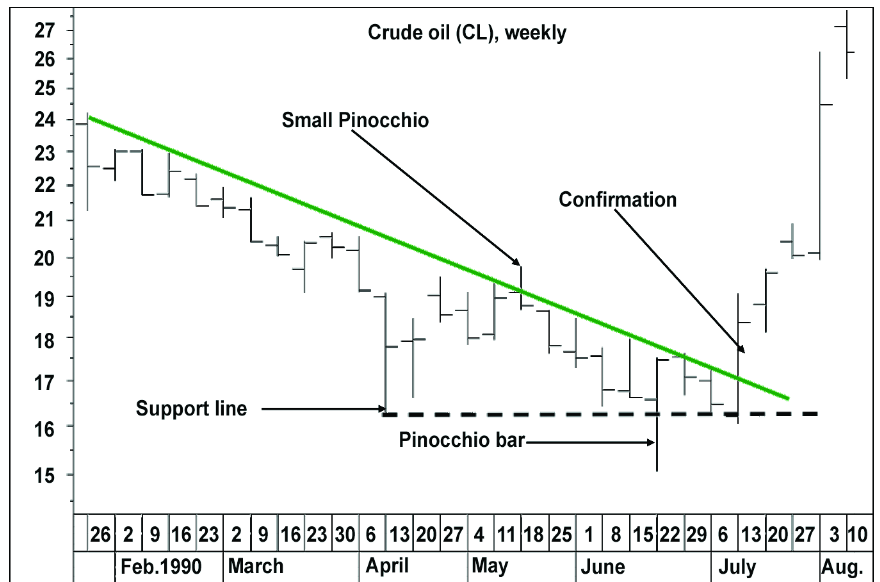
Emotional points on charts represent important potential support or resistance areas. The extreme point of a Pinocchio represents exhaustion and is therefore a potential pivotal point. Consequently, it makes sense to place stops slightly clear of the extreme point of a Pinocchio bar. A move beyond that point has two implications. First, price will have violated a support or resistance area. Second, a sustained move beyond the extreme of the pattern will negate it, and as a result, the reason for entering the trade will no longer be valid.

Market examples

Figure 3 shows a great example in crude oil (CL) from 1990. This pattern developed as price temporarily broke below a support line established by a previous low. It subsequently held above the line and then broke above the green down trendline. This is a classic setup because the violation of the trendline acts as a confirmation the Pinocchio will "work." It is a particularly significant line because it had previously turned back numerous rallies. When price finally penetrated it, a tremendous constraint had been lifted from prices.

The whipsaw break in mid-May was also a small, bearish Pinocchio bar, as the intraday action took price decisively above the trendline, but the open and close did not. Not surprisingly, this was followed by another sell-off. If anything,

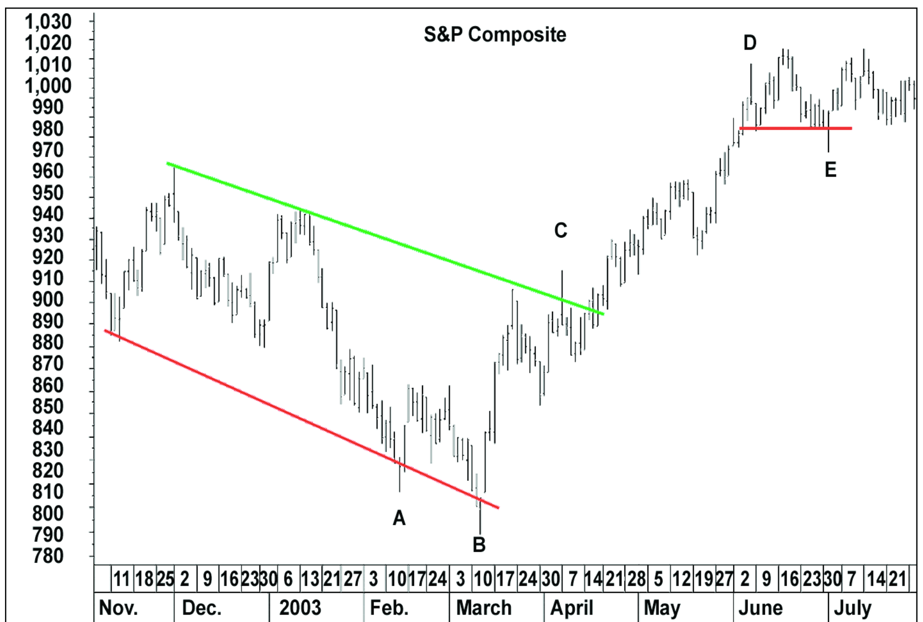
FIGURE 3: SIGNAL CONFIRMATION



The violation of the down provided confirmation of the bullish Pinocchio bar.

Source: www.pring.com

FIGURE 4: MULTIPLE SIGNALS



Although a big rally followed Pinocchio bar B, it was not signaled by the Pinocchio bar. The pattern typically indicates follow-through over the next 10 or so bars.

Source: www.pring.com

the appearance of this Pinocchio added to the significance of the green trendline as a resistance area, because even though price moved above the line, it was unable to hold above it.

Figure 4 shows several more examples. The first (A) turned out to be a Pinocchio bar but because it was not possible to construct the down trendline at the time it formed, it wasn't an actionable pattern. Example B is a valid bar, as price broke below the trendline but closed above it. Although this turned out to be a major rally, it was not signaled by the Pinocchio bar, which normally doesn't influence price more than 10 bars forward. Rather, the big move was caused by the interaction of the short and intermediate cycles where the Pinocchio happened to be positioned.

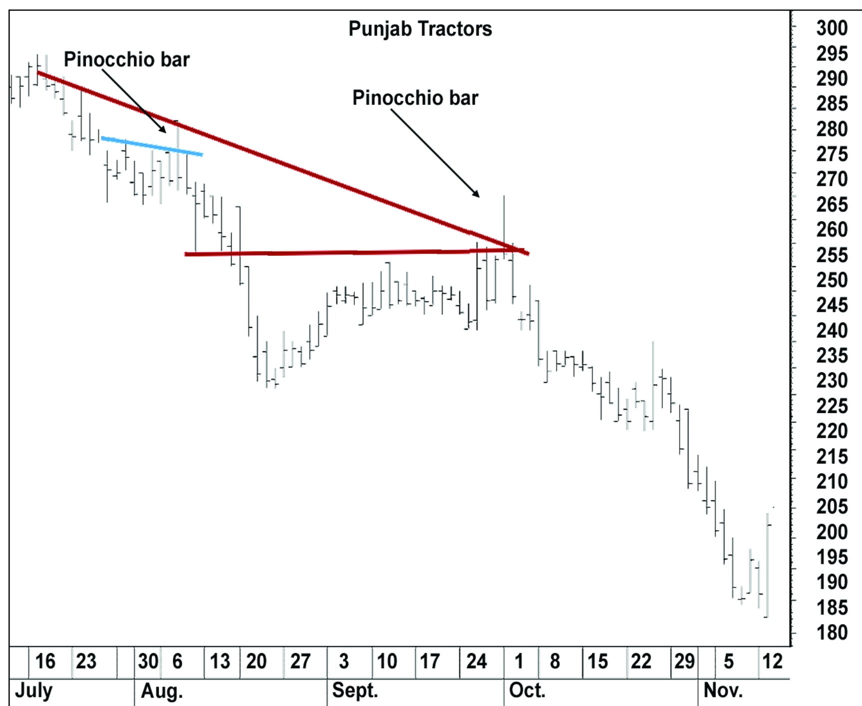
Another Pinocchio developed at C with the false breakout above the trendline. This example is included because it is a countertrend signal. At the time, the market was coming off the March 2003 low, so this was a bearish signal under the context of a primary bull market. Generally speaking, if a technical event of any kind is going to fail, it will typically arise from a signal that moves in the opposite direction to the main.

Another false signal developed at D, although this was not a true Pinocchio bar because price didn't move above any apparent resistance on an intraday basis. Finally, at bar E, price fell temporarily below the support trendline. There wasn't much of a rally, but the pattern achieved the expected objective of a five- to 10-day up move.

The final example features two bearish Pinocchios in Punjab Tractors, an Indian stock (Figure 5). The second was particularly powerful: Price temporarily pushed through tremendous resistance (in the form of two converging trendlines) on an intraday basis. In this case, there was not much hesitation following the whipsaw, but there can be no arguing it was followed by an above-average decline.

Pinocchio bars are essentially whipsaw moves that reflect the exhaustion of buyers or sellers, depending on the direction of the false signal. Like all technical concepts, they will fail from time to time. This is most likely to happen when these bars offer a signal that takes us in the opposite direction of the main trend. Like all whipsaw signals, Pinocchios have a tendency to be followed by an above-average price move.

FIGURE 5: CONVERGING RESISTANCE



In the case of the second bearish pattern, price temporarily pushed through significant resistance intraday, but closed near the low of the bar.

Source: www.pring.com

Related reading

Books by Martin Pring:

The Definitive Guide to Momentum Indicators
MarketPlace books, 2009.

Martin Pring on Price Patterns:
The Definitive Guide to Price Pattern Analysis and Interpretation
McGraw Hill, 2005.

***Articles*:**

"Martin Pring: Patterns and the big picture"
Active Trader, April 2005.
Interview with Martin Pring.

"Twice as nice: The two-bar reversal pattern"
By Martin Pring (*Active Trader,* March 2003).
Analysis of a two-bar chart pattern that signals climactic reversals.

"One- and two-bar price patterns"
By Martin Pring (*Active Trader,* June 2001).
Short-term reversal setups.

For information on the author see p. 6.

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