The Fish Hook Pattern

GOAL

The Fish Hook Pattern is a trade entry method that is mentioned from time to time in Jim’s Chartbook and on the Premium Alert Service. The idea behind the Fish Hook is that it gives us a way to enter a trending market on a pullback. When trying to enter an advancing market going long, we use the Fish Hook to enter if and when prices retrace to support levels. When trying to enter a declining market going short, we use the Fish Hook if and when prices retrace to resistance levels. The Fish Hook entry works whether we’re trading with futures contracts or options.

CHAPTER ONE

STEP-BY-STEP INSTRUCTIONS

Look at the diagram below to see an example of how this method works. Each line on the diagram represents one day’s trading activity. In this example, we are looking at a market that is declining, and we’re hoping to short the market. But we are waiting to get in until the market is trading at a better (i.e., higher) price. We will sell futures contracts or buy put options if and when prices retrace to a level of support of the previous consolidation (which becomes a line of resistance as we now approach it from the downside).
The support level is the horizontal line drawn across the chart. As you can see starting at the beginning of the chart, as prices traded lower, they stopped at the level where the line is drawn, consolidated for several days, and then broke below the line. Now, what we want to do is wait to see if prices retrace back up to the line. If they do, it will be our signal to buy put options or sell futures contracts. By waiting for the pullback, we will be getting in at a better price.

Look at the next diagram to see how this formation develops. Prices turn, move higher to retrace part of the previous move down, and then they reach and cross our support level (which has now become resistance).

Now if we want to, we can try to enter the market at this time, which would be a regular entry on a pullback. If trading futures contracts, we can place a limit sell order before the market ever reaches our trigger level (the line). Once our order is in place, even if we’re busy during the day, our order can still be working for us to get us into the market when our trigger is hit. If prices retrace up to that level, our order will be filled and we’ll be in the market. Of course we can always give our broker a contingent stop order to protect us in case the market takes off from that point and keeps moving higher, instead of turning around and moving back down as we want it to do.

But maybe we don’t feel comfortable entering while prices are still moving against us and we want to wait until we have confirmation that prices have started to move back down. So we wait to see if a Fish Hook develops. If it does, it will look like this: After touching the line, prices cross the line, retracing further up. The Fish Hook pattern forms if prices then hook over and head back toward the line.
Remember, the market first crossed the trigger line at what we’ll now call Point A, but instead of getting in then, we wait for prices to continue rising a bit and then turn around and move back through the line at Point B.

Using the Fish Hook Pattern, we get our assurance that prices have indeed turned back in our favor by waiting for the temporarily rising prices to stall, hook over, and then move back down again — forming, in this case, an upside-down fish hook. After prices hook over and start trading back toward the line, we would place our sell-stop order, and as soon as prices recrossed the line going down, we would be filled in the area just below Point B.

With the Fish Hook, we’re getting in by going short as the market has turned around and is moving back down, whereas with the first method (entering at Point A) we’re getting in going short while the market is still pulling back and moving higher. Either way, we get in at roughly the same price, but the difference is that with the first method we are certain of getting in the market, while with the Fish Hook we don’t get in at the first opportunity, but wait for prices to continue rising a bit, and then hook over and retrace through the line.

The Fish Hook Pattern is a more conservative approach, making us wait for assurance that prices are indeed moving back in our favor before we enter. As a result, we may miss some opportunities because there’s no guarantee the market will undergo that hook-like price action. If prices just start declining from Point A, we’ll miss the opportunity to enter on this pullback altogether if we try to enter on a Fish Hook. On the other hand, if we had placed our sell stop earlier at resistance, we would enter the market as soon as that price was hit at Point A.

That was an example of the Fish Hook in a declining market. Let’s look at how we use the same pattern in an advancing market. Here’s a sample diagram of a Fish Hook in a market that is advancing.
Starting at the beginning of the chart, we see that the market moves up, consolidates for a few days, and then moves higher, crossing the resistance line. We want to enter this market going long, but we want to wait for a brief pull back so that we can enter at a better price. Our support level is going to be the top of the consolidation, where we’ve drawn our horizontal line. The idea with the Fish Hook Pattern is to wait for the market to retrace back down to the support level (it was considered the resistance level while the market was rising, but now that prices are coming back down, it serves as support). We watch as prices break through and continue down for a few days, and then start to move back up, completing the Fish Hook Pattern. In an advancing market like this, the fish hook is right-side up.

Once the market has broken down through support at Point A, turned around, and started to move back up, we try to get in right around the trigger level (Point B). If we’re trading futures contracts, we would place our limit buy order just before our trigger price is hit. If we’re trading options, as soon as we see prices come back up and cross through the line, we would place our order to purchase a call option.

The whole idea here is that we’re buying on dips in an advancing market. We wait for the signal that the dip is over and that prices are about to resume their upward climb. The signal comes when prices move back up through the trigger line. That’s when we enter the market, and if everything goes according to plan, we expect the market to resume the trend and shoot up.

It’s just the opposite in a declining market, as in the first example we looked at. Our goal here is to sell on rallies. We wait for the signal that the rally is over and that prices are about to resume their fall.

With the Fish Hook, it feels as though we’re buying against the market trend. This seems hard for some people who feel more comfortable buying while markets are rising, and selling while markets are falling. But the idea with the Fish Hook pattern is that you want to get in at a “better price” by buying on a pull back in a trend that we expect will resume.

To summarize, basically we have been talking about two ways to get in a market on a pull back. You can try to enter on the initial pull back, at what we’ve been calling Point A, or you can wait for the market to hook over and try to get in on the re-crossing, at Point B.

The downside of getting in at Point A is that the market may pull back and cross the trigger line,
giving us the signal to enter the market; but then, instead of turning around as we hoped, prices could just keep going and we could find ourselves in a losing trade.

By waiting for the Fish Hook, we might have a better chance of getting into a winning trade, because at the point we get in, momentum has once again begun to move in the direction we want to go. Of course there’s no guarantee prices won’t roll over yet again and start moving against us, but that’s why we use stops in either case, whether we get in at Point A or Point B.

Another possible downside is that prices may not form the Fish Hook after Point A. They may hit the line of support or resistance and just turn around. By failing to enter at Point A we could end up missing the move completely.

Entering the market in this way is not rocket science. It’s just trading pullbacks. In an advancing market we’re looking to go long or buy call options on a pullback to support levels. In a declining market we’re looking to go short or buy put options on a pull back to resistance levels. The Fish Hook pattern helps us get in at a better price, while giving us some assurance that the market is likely to continue in our favor.