They're Not So Rare

Diamonds Are A Trader's Best Friend

The diamond pattern is a classic chart formation yet it is often misunderstood and underestimated. Here's a deep dive into diamonds.

by Igor R. Toshchakov

Dozens or perhaps even hundreds of books have been written and published over the last several decades depicting classic technical analysis patterns and their practical application for trading in various financial markets. Despite such a large variety of reading choices and of what seems like plenty of useful information readily available for market practitioners of any kind, those books and other sources of information are often full of misconceptions and factual errors. The information provided can be inaccurate, shallow, and sometimes misleading.

Through thick and thin

Among the classic pattern formations, the diamond pattern is one of the most misunderstood and underestimated. While many resources are dedicated to such technical formations as head & shoulders formations, the double (triple) top (bottom),

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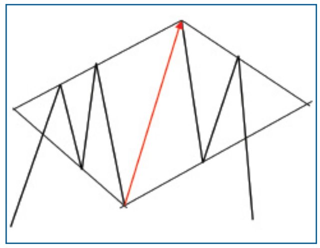
different types of triangle formations and so on, the diamond, for some reason, still stands alone in obscurity and under a dark cloud of misconception.

Ideas such as that of a flat earth standing on the backs of three elephants and whales have been replaced over time by more scientific concepts. The time has come to shed light onto the diamond technical pattern and how it can be applied for practical trading in the financial markets.

Let's start with an overview of the diamond pattern.

1. Diamonds can be a continuation or reversal pattern. The shape of the pattern is what will indicate whether it's a continuation or reversal.
2. Diamond patterns may not be as rare as perceived. Many major reversal and continuation moves in the currency market over the last several years have taken place after the market broke out of a larger-scale diamond formation.
3. I also don't think diamonds should be considered a "minor" pattern. Unlike other technical formations such as double tops/bottoms or head & shoulders, diamonds can usually be identified well in advance. This gives traders the opportunity to plan their trades before the pattern is fully formed.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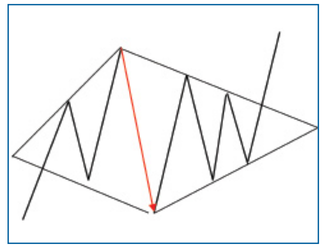
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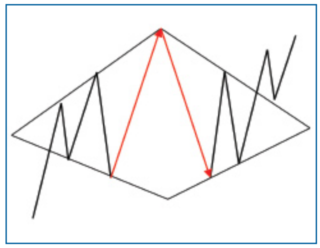
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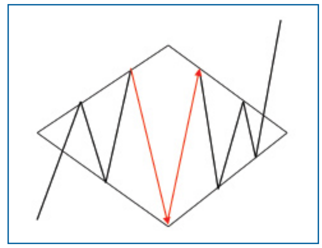
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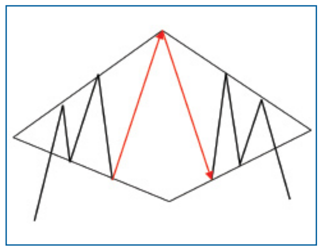
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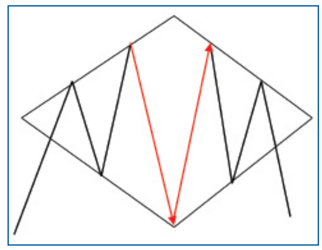
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Possible diamond shapes

From a geometrical perspective, diamond formations look like a rhombus. They are composed of two triangles bound together: a broadening triangle is formed first and is immediately followed by a regular triangle. Both triangles are often symmetrical but not necessarily so, and sometimes they can be shifted or tilted in one direction. Contrary to general assumption, there is no such thing as a "typical" diamond formation.

There are at least four major kinds of diamond shapes and each has its own meaning. These shapes differ by the sequences and lengths of the moves inside of a particular diamond pattern.

According to my own classification, diamonds can be either "single-diagonal" or "two-diagonal."

- The *single-diagonal diamond* is a rhombus in which the pattern's top and bottom are directly connected by the longest single line, while all the other price swings are substantially shorter than the main one (diagrams 1 & 2). Whether the diamond will become a continuation or reversal depends on the main price move's direction of that single diagonal. If the pattern's bottom formed before the top, then the main move's direction of the diagonal is up, and vice versa. In a single-diagonal diamond, the breakout occurs in the direction opposite to the direction of the main diagonal. Because of its distinctive shape and the extended period of time usually required to form such a pattern, it is relatively easy to project, in advance, the next move's direction, and to take a market position before the pattern gets fully formed.
- *Two-diagonal diamonds* have two subsequent main diagonals of relatively similar sizes. They can also be either "straight" or "inverted." All types of two-diagonal diamonds can work as continuations (diagrams 3 & 4)

FIGURE 1: SINGLE-DIAGONAL CONTINUATION DIAMOND ON USD/CHF WEEKLY. After price broke out of the diamond pattern, USD/CHF continued its trend.

FIGURE 2: DIAMOND IN THE DOW JONES INDUSTRIAL AVERAGE. Note how the single-diagonal diamond pattern that formed from 2014 to 2016 was an indication of the continuation of the bullish trend.

FIGURE 3: SINGLE-DIAGONAL REVERSAL DIAMOND ON EUR/USD WEEKLY. As expected, the breakout occurred in the direction opposite to the direction of the main diagonal.

FIGURE 4: STRAIGHT TWO-DIAGONAL REVERSAL DIAMOND ON GBP/JPY MONTHLY. Notice how it can easily be mistaken for a head & shoulders pattern.

or reversals (diagrams 5 & 6). The eventual breakout may occur in either direction. Because of this complication, it isn't always possible to predict in advance the breakout direction of the two-diagonal diamond. Thus, you have to use some other clues to project the next move's direction. It is also worth noting that this particular type of two-diagonal diamond is often mistakenly identified as a potential *head & shoulders* pattern by less-experienced technical traders. This may not be a big concern if a diamond eventually turns into a reversal pattern, but if the diamond is a continuation pattern, it could cause problems.

EXAMPLES OF DIAMOND FORMATIONS

Single-diagonal diamonds

Diamonds occur frequently, can be formed on any timeframe chart, and in any financial market. When diamonds form on bigger-scale charts such as weekly and monthly, they often define the direction of the following medium- and even longer-term trend. Figure 1 depicts a single-diagonal continuation diamond that formed on the weekly chart of USD/CHF. After the breakout occurred, USD/CHF continued its trend.

To see diamonds in action, take a look at the weekly chart of the Dow Jones Industrial Average in Figure 2. On September 1, 2018, the index was trading near its historic high. On its way to this level, the index formed a single-diagonal diamond in 2014–2016.

Given that such continuation diamonds are usually formed mid-trend, you can figure out that the measured objective target for the trend that started in 2009 should be at around the 27,250 level. Such a situation is a clear sign the US stock market is about to run out of steam. A minimal correction (which is a must under the circumstance) should be back toward the diamond and to at least the 19,300 area, which is the 38.3% Fibonacci level, before the index possibly enters a consolidation period. However, it is unlikely that new historic tops will form over that time period. Breaking below the lowest point of the diamond (15,370 level) is likely to lead to further losses if the index retests the 2009 lows by dropping below the 6470 level. Is it possible that a sizeable correction is in the cards?

In Figure 3, you see single-diagonal

A single-diagonal type of diamond may be easier to trade since it has a distinctive appearance and the breakout can be projected even before the pattern is fully formed.

reversal diamonds on a larger timeframe. Note that the breakout occurred in the direction opposite to that of the main diagonal.

Two-diagonal diamonds

Although two-diagonal diamonds can be a continuation or reversal pattern, more often than not they are reversal patterns that form at the top or bottom of a trend. Straight two-diagonal diamonds are similar to head & shoulders formations but the presence of an identifiable broadening triangle on the left side of the formation can usually help identify whether it is a diamond or a H&S.

Figure 4 shows an example of a straight, two-diagonal reversal diamond on a monthly chart of the GBP/JPY.

In Figure 5, you see a unique situation: Three different types of diamonds are visible on the weekly chart of the USD/JPY from 2001 to 2005. A large, straight, two-diagonal reversal diamond is immediately followed by a smaller-size inverted two-diagonal continuation diamond, which is followed by a single-diagonal continuation diamond.

Trading diamond formations

From the examples provided, you may have assumed that diamond formations are common in the currency markets. But this isn't their only advantage. Unlike most other chart patterns, diamonds:

- Can usually be identified in advance
- Often have distinctive and relatively accurate borders
- Have a low failure rate and a low rate of false breakouts. This gives traders enough time to prepare for the imminent breakout and plan each trade without rushing or added psychological pressure.

One point to keep in mind is that when you see a broadening triangle on any of your charts, there is always a chance it can eventually turn into a diamond.

If you want to be conservative, you can wait till the breakout occurs before entering a position in the direction of the breakout, and place stops above the extreme of the last minor diagonal. This is especially true for two-diagonal diamonds. With single-diagonal diamonds, it may be a different story.

A single-diagonal type of diamond may be easier to trade since it has a distinctive appearance and the breakout can be projected even before the pattern is fully formed. Since a sophisticated trader can correctly identify such a pattern while it's still in progress, it might make sense to consider entering a position in the direction of the projected breakout a bit earlier. Such a position can be taken closer to the top or bottom of the next diagonal that forms immediately after the main one with stops above or below the top or bottom of the main diagonal. This trading technique is riskier than the conservative one but can offer a much better risk/reward ratio.

The most common complications and problems when trading diamonds include:

- Incorrect pattern identification by the trader
- The pattern's exact borders can't be precisely drawn before the breakout occurs
- The profit target can't easily be set or projected in advance. That is because, contrary to general perception, the diamond formation doesn't have a measured objective target after a breakout. More often than not, it exceeds the height of a diamond measured from the breakout point by far. Trailing stops may not be as effective as you would want them to be.

Your best friend

All possible pitfalls of diamonds are relatively minor. Once you start to experience the practical application of the diamond pattern, you can overcome the pitfalls. The bottom line is that diamond patterns are common, have a distinctive

FIGURE 5: MORE THAN ONE? It's a unique situation when three different types of diamonds can be seen on the same screen on the USD/JPY weekly chart. A huge, straight two-diagonal reversal diamond is immediately followed by a much smaller-size inverted two-diagonal continuation diamond, which in turn is followed by a single-diagonal continuation diamond.

and identifiable shape, and have a relatively low failure rate. These characteristics make the diamond the king of all the known technical patterns. They can be extremely profitable and fun to trade.

When you see a broadening triangle on any of your charts, there is always a chance it can eventually turn into a diamond.

Igor R. Toshchakov (a.k.a. L.A. Igrok) is a professional trader of forex and other financial markets, analyst, and fund manager since 1993. He is also the author of Beat The Odds In Forex Trading: How To Identify And Profit From High Percentage Market Patterns *(Wiley, 2006).*

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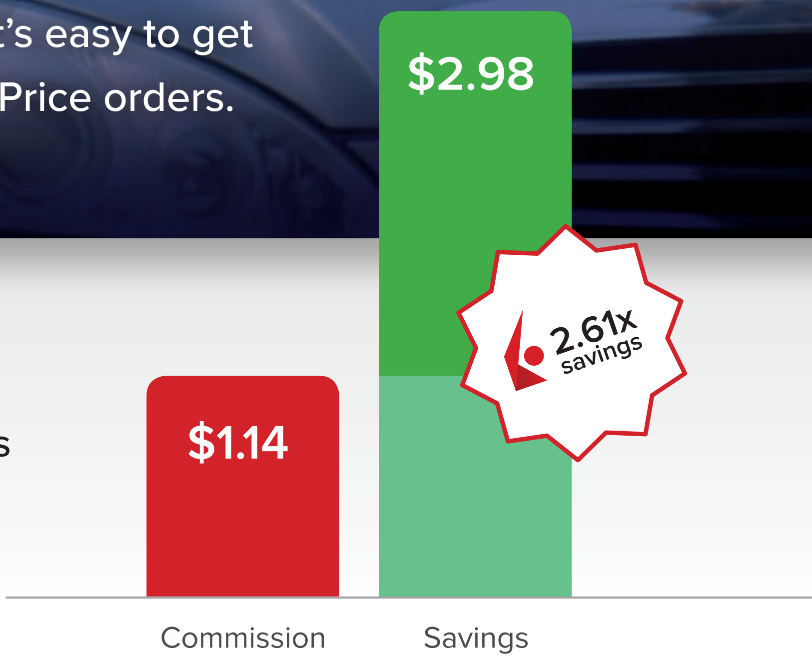

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