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# Rounding Top Pattern: Optimism rounded off by pessimism

Stocks as an asset class are volatile, responding to multiple triggers, including earnings reports, news flows, future expectations, etc. A series of positive triggers can cause a significant upward movement fuelled by optimism, and prices appreciate sharply. Subsequently, the buying momentum slows as the triggers reduce or the news flows become well-known. This leads to a period of consolidation. However, if the built-in expectations fail to come through quickly or the results and guidance start to turn downbeat, traders tend to get impatient and start selling. Separately, investors who buy at expensive valuations may start doubting their initial thesis and may even consider exiting their investment. Initially, this happens slowly, but eventually, the selling snowballs, leading to a price correction.

An interesting paradox observed in stock price movements. When stocks fall sharply, they tend to recover quickly. However, when prices rise sharply, the selloff is slow, leading to what is known as a **rounding top formation**.

# What is a rounding top formation?

A rounding top is formed after a sharp build-up followed by slow but steady consolidation with declining confidence and then a snowball-like effect when it seems like everyone has simultaneously lost conviction.
This pattern is characterised by the following properties:

- It typically forms at the end of an extended upward trend and may indicate a reversal in the long-term price movement.
- The pattern is marked by a rounded shape where prices initially trend higher, then taper off, and subsequently trend lower. The support price level is generally identified at the base of this formation.

# What does a rounding top pattern indicate?

This pattern suggests a gradual transition from an uptrend to a downtrend, often accompanied by decreasing trading volume during the formation phase and an increase in volume as the price begins to decline. The breach of a significant support level, typically marked by the neckline of the pattern, serves as a confirmation of the bearish reversal and highlights the potential for downside risk.

Investors should exercise caution upon observing this chart formation, as it often signifies a potential trend reversal.

If results start to improve, the buyers start coming in again, and the bullish trend resumes. However, if the sentiment continues to worsen, a rounding top could quickly turn into a significant sell off.

# Where are we currently seeing the rounding top formation?

In 2024, the Nifty Auto index performed significantly well for much of the year before the rally started to lose steam. This rally was driven by a surge in demand for automobiles, including passenger cars, commercial vehicles, and two-wheelers. Government initiatives and policies further boosted manufacturing and exports, contributing to the sector's growth.

**Exhibit:** Sectoral performance as of 31st Dec 2024

| Sectoral Index | 1Y | 3Y |
|---|---|---|
| Nifty Pharma | 26.26% | 55.88% |
| Nifty Consumer Durables | 21.43% | 30.86% |
| Nifty IT | 20.47% | 13.97% |
| Nifty Auto | 19.59% | 91.53% |
| Nifty Financial Services | 5.16% | 20.36% |
| Nifty Oil And Gas | 4.33% | 32.08% |
| Nifty Realty | 2.26% | 78.84% |
| Nifty Metal | 0.67% | 35.16% |
| Nifty PSU Bank | 0.62% | 111.61% |
| Nifty FMCG | -0.12% | 48.13% |
| Nifty Pvt Bank | -3.78% | 21.69% |
| Nifty Media | -31.95% | -28.37% |

Source: Tradepoint by Definedge

At present, however, we can see a potential rounding top pattern in the Auto sector. This corresponds with shifts in the news cycle as reports are emerging of the sector facing headwinds like high inventory levels, cash flow challenges to dealers, etc. The monthly auto sales data is also indicating a declining trend, further adding to the uncertainty surrounding the auto index.

**Exhibit:** Nifty Auto Index Price Chart


When looking at signals, it is recommended to seek confirmation of emerging pattern. A good supplementary indicator can be the ratio chart. A ratio chart of the Nifty Auto index against the broader market index can help assess the relative strength of the emerging trend.

This ratio chart is also showing a rounding top pattern,– confirming the change in trend and subsequent breakdown in prices.

**Exhibit:** Nifty Auto vs Nifty 50 Price Chart Ratio


This suggests that we can expect the index to now underperform the market. As an example, a similar setup was seen on the Nifty Pharma to Nifty ratio chart in the 2016-2017 period. Following the breakdown of the rounding top pattern, the index exhibited a sideways move and underperformed the broader market for nearly 4 years.

**Exhibit:** : Nifty Pharma vs Nifty 50 Price Chart Ratio (Historical)

Here are some historical examples of rounding tops and how they played out:

**Exhibit:** Jubilant Foodworks Ltd


**Exhibit:** Reliance Industries Ltd


**Exhibit:** HDFC Bank Ltd

To conclude, a rounded top pattern is essentially a sign of market optimism fading slowly and then all at once. Investors should pay attention to this sign and remain alert to shifts in fundamentals. By combining chart patterns with ratio analysis and market indicators, one can make informed decisions to navigate potential risks.