

## V. Candlestick

### 1. Introduction

You may be asking yourself, "If I can already use bar charts to view prices, then why do I need another type of chart?"

The answer to this question may not seem obvious, but after going through the following candlestick chart explanations and examples, you will surely see value in the different perspective candlesticks bring to the table. In my opinion, they are much more visually appealing, and convey the price information in a quicker and easier manner.

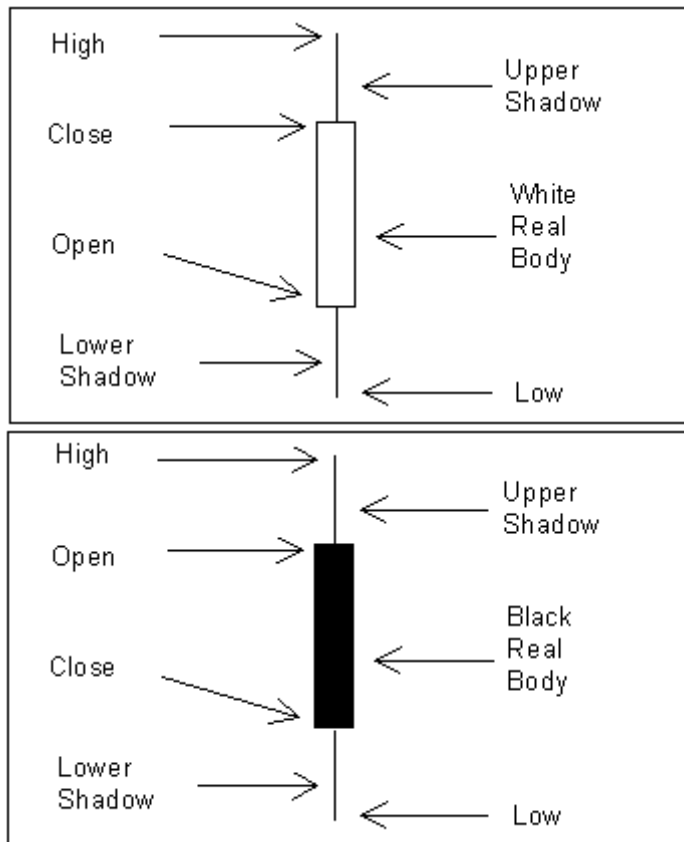
The Japanese began using technical analysis to trade rice in the 17th century. While this early version of technical analysis may have been different from the US version initiated by Charles Dow around 1900, many of the guiding principles were very similar.

The "what" (price action) is more important than the "why" (news, earnings, and so on). All known information is reflected in the price.

Buyers and sellers move markets based on expectations and emotions (fear and greed). Markets fluctuate.

The actual price may not reflect the underlying value.

According to Steve Nison, candlestick charting came later and probably began sometime after 1850. Much of the credit for candlestick development and charting goes to Homma, a legendary rice trader from Sakata. Even though it is not exactly clear "who" created candlesticks, Nison notes that they likely resulted from a collective effort developed over many years of trading.



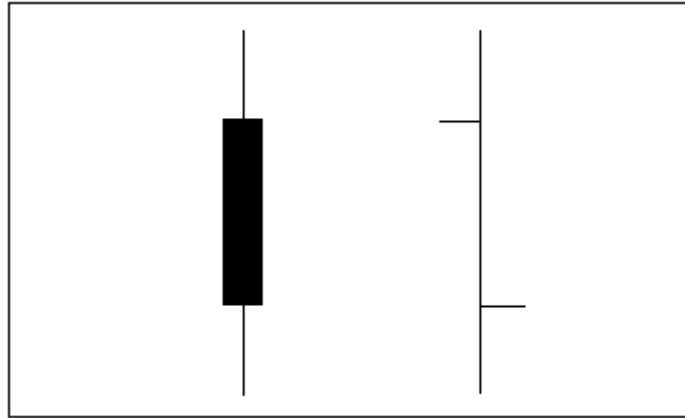
The body of the candlestick is called the *real body*, and represents the range between the open and closing prices.

A black or filled-in body represents that the close during that time period was lower than the open, (normally considered bearish) and when the body is open or white, that means the close was higher than the open (normally bullish).

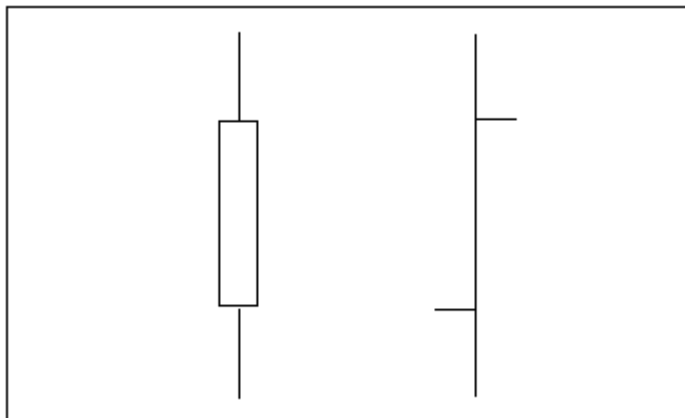
The thin vertical line above and/or below the real body is called the *upper/lower shadow*, representing the high/low price extremes for the period.

### Bar Compared to Candlestick Charts

Below is an example of the same price data conveyed in a standard bar chart and a candlestick chart. Notice how the candlestick chart appears 3-dimensional, as price data almost jumps out at you.



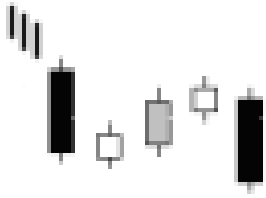
( 3a )



( 3b )

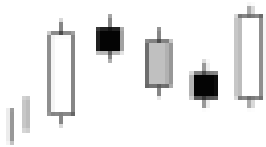
The long, dark, filled-in *real body* represents a weak (bearish) close ( 3a ), while a long open, light-colored *real body* represents a strong (bullish) close ( 3b ). It is important to note that Japanese candlestick analysts traditionally view the opening and closing prices as the most moment critical of the day. At a glance, notice how much easier it is with candlesticks to determine if the closing price was higher or lower than the opening price.

## 2. Falling Three Methods



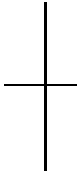
A bearish continuation pattern. A long black body is followed by three small body days, each fully contained within the range of the high and low of the first day. The fifth day closes at a new low

## 3. Rising Three Methods



A bullish continuation pattern. A long white body is followed by three small body days, each fully contained within the range of the high and low of the first day. The fifth day closes at a new high..

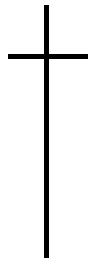
#### 4. Doji



Doji are important candlesticks that provide information on their own and also feature in a number of important patterns. Doji form when a security's open and close are virtually equal. The length of the upper and lower shadows can vary and the resulting candlestick looks like a cross, inverted cross or plus sign. Alone, doji are neutral patterns. Any bullish or bearish bias is based on preceding price action and future confirmation. The word "Doji" refers to both the singular and plural form.

##### a. Dragon fly doji (Dragongly)

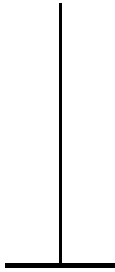
Dragon fly doji form when the open, high and close are equal and the low creates a long lower shadow. The resulting candlestick looks like a "T" with a long lower shadow and no upper shadow.



Dragon fly doji indicate that sellers dominated trading and drove prices lower during the session. By the end of the session, buyers resurfaced and pushed prices back to the opening level and the session high. The reversal implications of a dragon fly doji depend on previous price action and future confirmation. The long lower shadow provides evidence of buying pressure, but the low indicates that plenty of sellers still loom. After a long downtrend, long black candlestick or at support, a dragon fly doji could signal a potential bullish reversal or bottom. After a long uptrend, long white candlestick or at resistance, the long lower shadow could foreshadow a potential bearish reversal or top. Bearish or bullish confirmation is required for both situations.

##### b. Gravestone doji (Pagoda)

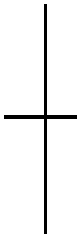
Gravestone doji form when the open, low and close are equal and the high creates a long upper shadow. The resulting candlestick looks like an upside down "T" with a long upper shadow and no lower shadow.



Gravestone doji indicate that buyers dominated trading and drove prices higher during the session. However, by the end of the session, sellers resurfaced and pushed prices back to the opening level and the session low.

As with the dragon fly doji and other candlesticks, the reversal implications of gravestone doji depend on previous price action and future confirmation. Even though the long upper shadow indicates a failed rally, the intraday high provides evidence of some buying pressure. After a long downtrend, long black candlestick or at support, focus turns to the evidence of buying pressure and a potential bullish reversal. After a long uptrend, long white candlestick or at resistance, focus turns to the failed rally and a potential bearish reversal. Bearish or bullish confirmation is required for both situations.

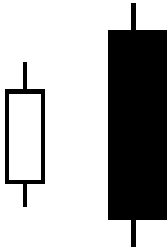
### c. Long-legged doji



This line often signifies a turning point. It occurs when the open and close are the same, and the range between the high and low is relatively large.

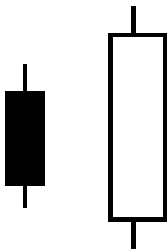
## 5. Engulfing Patterns

### a. Bearish engulfing lines



This structure appears when a black, real body totally covers, "engulfs" the prior day's real body. The market should be in a definable trend, not chopping around sideways. The shadows of the prior candlestick do not need to be engulfed.

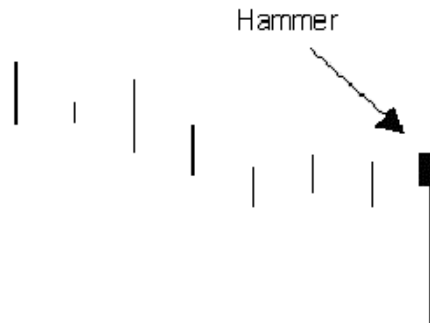
### b. Bullish engulfing lines



This structure appears when a *white, real body* totally covers, "engulfs" the prior day's *real body*. The market should be in a definable trend, not chopping around sideways. The shadows of the prior candlestick do not need to be engulfed.

## 6. Hammer

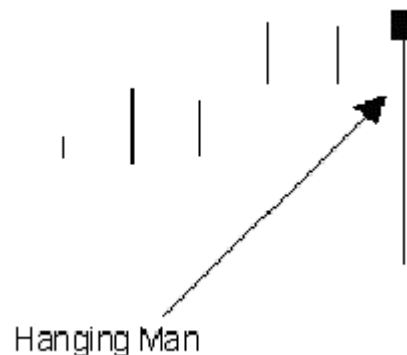
A candlestick with a long *lower shadow* and small *real body*. The *shadow* should be at least twice the length of the *real body*, and there should be no or very little *upper shadow*. The *body* may be either *black* or *white*, but the key is that this candlestick must occur within the context of a *downtrend* to be considered a *hammer*. The market may be "hammering" out a bottom.



The hammer is a bullish reversal pattern that forms after a decline. In addition to a potential trend reversal, hammers can mark bottoms or support levels. After a decline, hammers signal a bullish revival. The low of the long lower shadow implies that sellers drove prices lower during the session. However, the strong finish indicates that buyers regained their footing to end the session on a strong note. While this may seem enough to act on, hammers require further bullish confirmation. The low of the hammer shows that plenty of sellers remain. Further buying pressure, and preferably on expanding volume, is needed before acting. Such confirmation could come from a gap up or long white candlestick. Hammers are similar to selling climaxes and heavy volume can serve to reinforce the validity of the reversal.

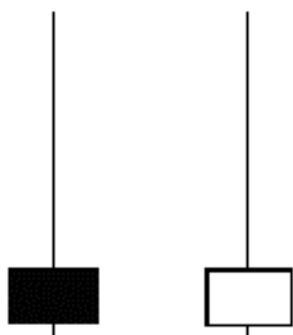
### a. Hanging man

Identical in appearance to the *hammer*, but appears within the context of an *uptrend*.



The hanging man is a bearish reversal pattern that can also mark a top or resistance level. Forming after an advance, a hanging man signals that selling pressure is starting to increase. The low of the long lower shadow confirms that sellers pushed prices lower during the session. Even though the bulls regained their footing and drove prices higher by the finish, the appearance of selling pressure raises the yellow flag. As with the hammer, a hanging man requires bearish confirmation before action. Such confirmation can come as a gap down or long black candlestick on heavy volume.

### b. Inverted hammer and shooting star



The inverted hammer and shooting star look exactly alike, but have different implications based on previous price action. Both candlesticks have small real bodies (black or white), long upper shadows and small or non-existent lower shadows. These candlesticks mark potential trend reversals, but require confirmation before action.

The shooting star is a bearish reversal pattern that forms after an advance and in the star position, hence its name. A shooting star can mark a potential trend reversal or resistance level. The candlestick forms when prices gap higher on the open, advance during the session and close well off their highs. The resulting candlestick has a long upper shadow and small black or white body. After a large advance (the upper shadow), the ability of the bears to force prices down raises the yellow flag. To indicate a substantial reversal, the upper shadow should be relatively long and at least 2 times the length of the body. Bearish confirmation is required after the shooting star and can take the form of a gap down or long black candlestick on heavy volume.

The inverted hammer looks exactly like a shooting star, but forms after a decline or downtrend. Inverted hammers represent a potential trend reversal or support levels. After a decline, the long upper shadow indicates buying pressure during the session. However, the bulls were not able to sustain this buying pressure and prices closed well off of their highs to create the long upper shadow. Because of this failure, bullish confirmation is required before action. An inverted hammer followed by a gap up or long white candlestick with heavy volume could act as bullish confirmation.

## 7. Harami

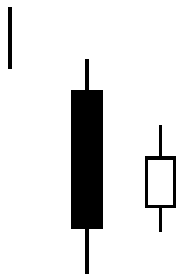
A candlestick that forms within the real body of the previous candlestick is in Harami position. Harami means pregnant in Japanese and the second candlestick is nestled inside the first. The first candlestick usually has a large real body and the second a smaller real body than the first. The shadows (high/low) of the second candlestick do not have to be contained within the first, though it's preferable if they are. Doji and spinning tops have small real bodies and can form in the harami position as well.

### a. Bearish Harami



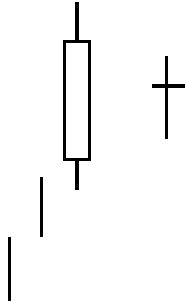
A two day pattern that has a small body day completely contained within the range of the previous body, and is the opposite color.

### b. Bullish Harami



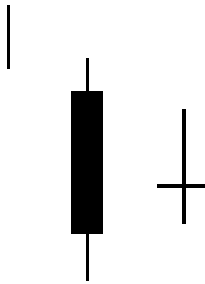
A two day pattern that has a small body day completely contained within the range of the previous body, and is the opposite color.

**c. Bearish Harami cross or Bearish Harami doji**



A two day pattern similar to the Harami. The difference is that the last day is a Doji.

**d. Bullish Harami cross or Bullish Harami doji**



A two day pattern similar to the Harami. The difference is that the last day is a Doji.

### 8. Long white (empty) line



This is a bullish line. It occurs when prices open near the low and close significantly higher near the period's high.

### 9. Long black (filled-in) line



This is a bearish line. It occurs when prices open near the high and close significantly lower near the period's low.

## 10. Doji

Doji are important candlesticks that provide information on their own and also feature in a number of important patterns. Doji form when a security's open and close are virtually equal. The length of the upper and lower shadows can vary and the resulting candlestick looks like a cross, inverted cross or plus sign. Alone, doji are neutral patterns. Any bullish or bearish bias is based on preceding price action and future confirmation. The word "Doji" refers to both the singular and plural form.

### a. Bullish doji star



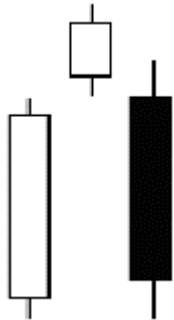
A "star" indicates a reversal and a doji indicates indecision. Thus, this pattern usually indicates a reversal following an indecisive period. You should wait for a confirmation (e.g., as in the morning star,) before trading a doji star. The first line can be empty or filled in.

### b. Bearish doji star



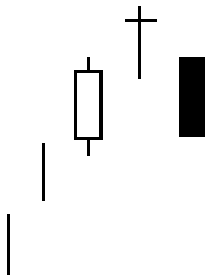
A star indicates a reversal and a doji indicates indecision. Thus, this pattern usually indicates a reversal following an indecisive period. You should wait for a confirmation (e.g., as in the evening star illustration) before trading a doji star. The first line can be empty or filled in.

**c. Evening star**



This is a bearish top reversal pattern and counterpart to the Morning Star. Three candlesticks compose the evening star, the first being long and white. The second forms a star, followed by the third, which has a black real body that moves sharply into the first white candlestick.

**d. Evening Doji star**



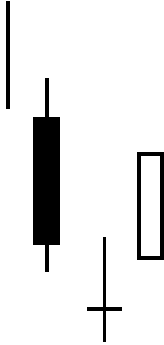
This is a doji star in an uptrend followed by a long, black real body that closed well into the prior white real body. If the candlestick after the doji star is white and gapped higher, the bearishness of the doji is invalidated.

**e. Morning Star**



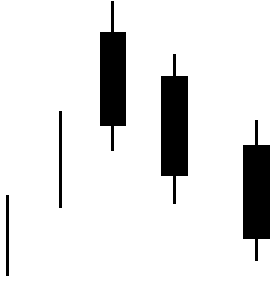
This is a bullish bottom reversal pattern. The formation is comprised of 3 candlesticks. The first candlestick is a tall black real body followed by the second, a small real body, which gaps (opens), lower (a star pattern). The third candlestick is a white real body that moves well into the first period's black real body. This is similar to an island pattern on standard bar charts.

**f. Morning Doji star**



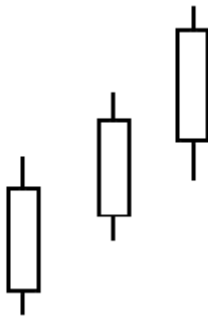
This a doji star in a downtrend followed by a long, white real body that closes well into the prior black real body. If the candlestick after the doji star is black and gapped lower, the bullishness of the doji is invalidated.

### 11. Three Black Crows



A bearish reversal pattern consisting of three consecutive black bodies where each day closes near below the previous low, and opens within the body of the previous day.

### 12. Three White Soldiers



A bullish reversal pattern consisting of three consecutive white bodies, each with a higher close. Each should open within the previous body and the close should be near the high of the day.