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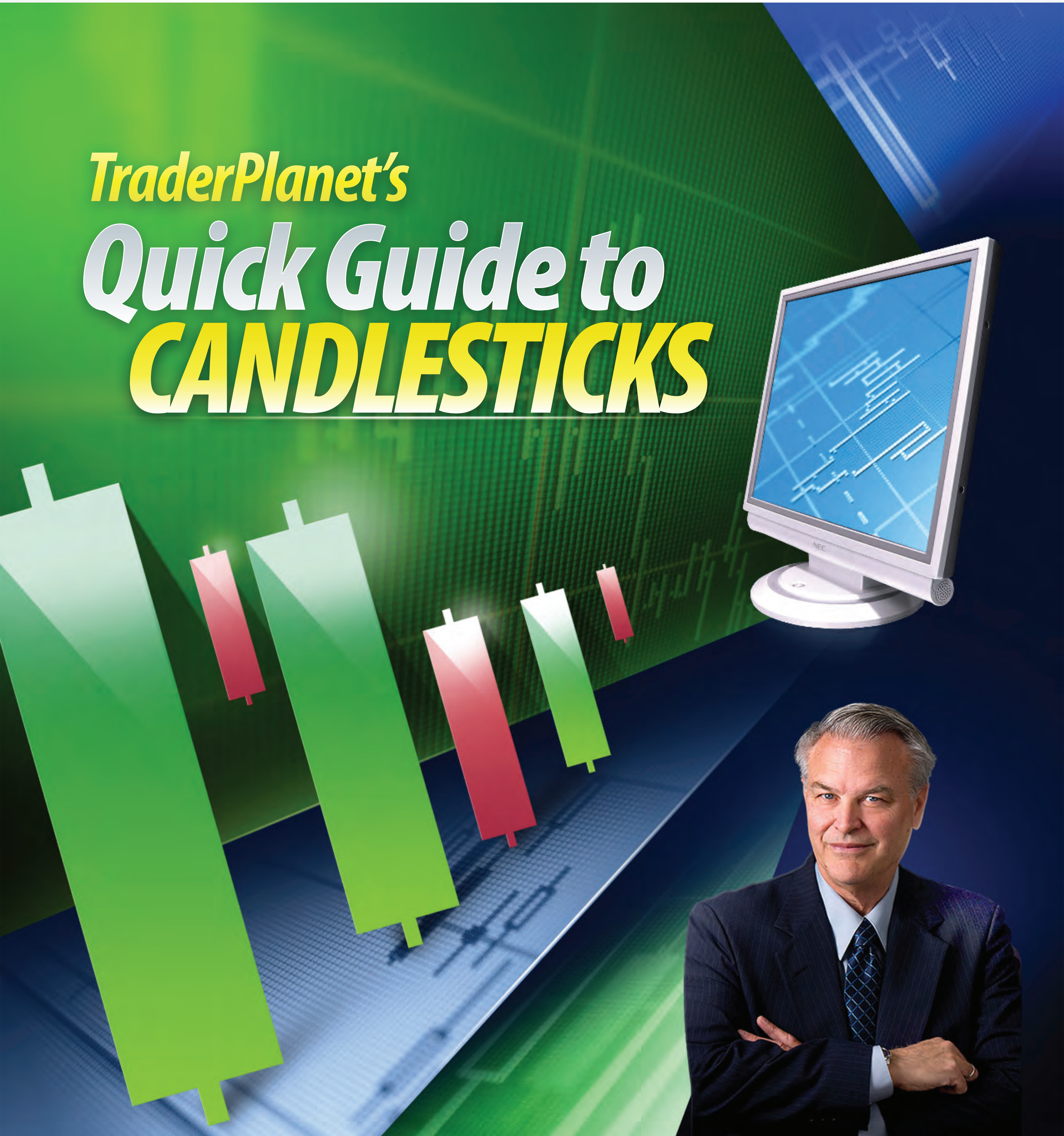
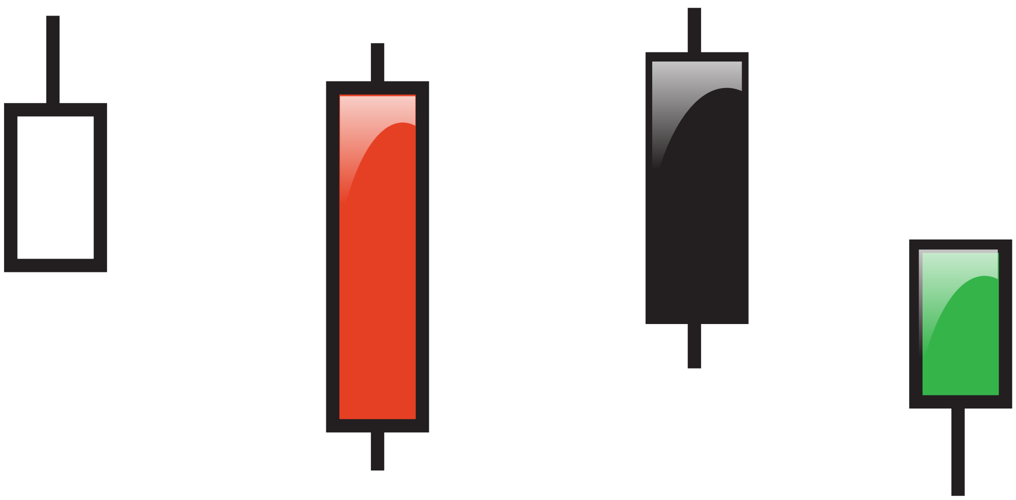
TraderPlanet's Quick Guide to CANDLESTICKS



TRADERPLANET SPECIAL REPORT

By Darrell Jobman

TraderPlanet's Quick Guide to CANDLESTICKS



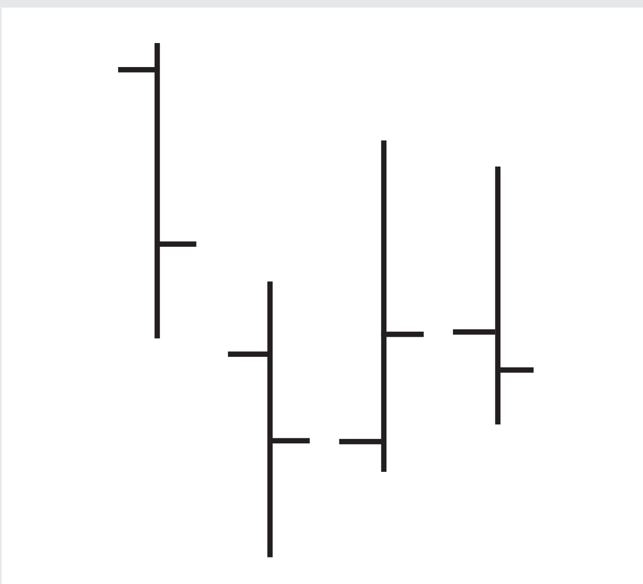
Candlestick charting traces its roots to Japanese rice traders in the 17th and 18th centuries as trading in physical rice moved to the first futures exchange, the Dojima Rice Exchange of Osaka. Munehisa Homma (1724-1803), also referred to as Sokyu Homma or Sokyu Honma, was a wealthy rice merchant and trader who is widely credited with being a pioneer in technical analysis and the father of Japanese candlestick charting. In1755, he wrote The Fountain of Gold - The Three Monkey Record of Money, a text focused on market psychology.

The person generally credited with bringing candlesticks to the attention of the Western world is Steve Nison, an analyst at Merrill Lynch who introduced candlestick techniques in an article in the December 1989 issue of Futures magazine and in his first book, Japanese Candlestick Charting Techniques: A Contemporary Guide to the Ancient Investment Techniques of the Far East, published in 1991, followed by another book a few years later, Beyond Candlesticks: More Japanese Charting Techniques Revealed. Since Nison's introduction, candlesticks have become the charting method of choice for many traders, and numerous other books and articles have been written about candlestick concepts.

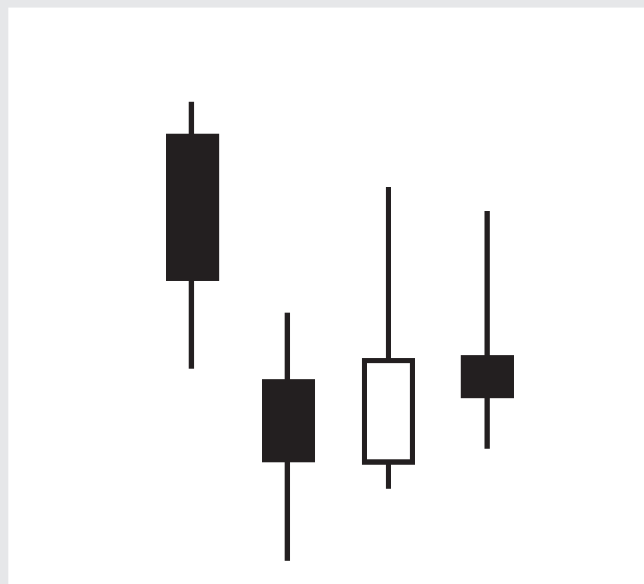
Candlesticks caught on quickly in the West for several reasons: (1) They could be analyzed and interpreted with the same techniques used for the familiar bar charts, (2) they could be produced easily by computers using analytical software, (3) they could be adapted to any time period, and (4) most important, they provided the same information as the traditional bar chart – open, high, low and close price – but in a way that is a more visual presentation of price action during a single period or a series of time periods.

The graphical differences between bar charts and candlestick charts show up clearly in the following charts.

Constructing the candles



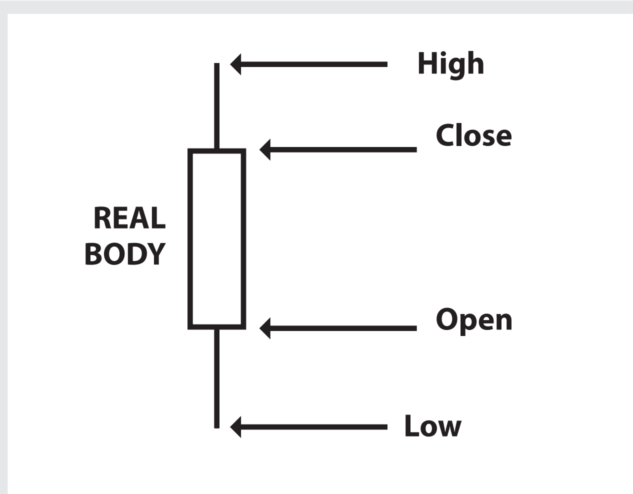
Western bar chart



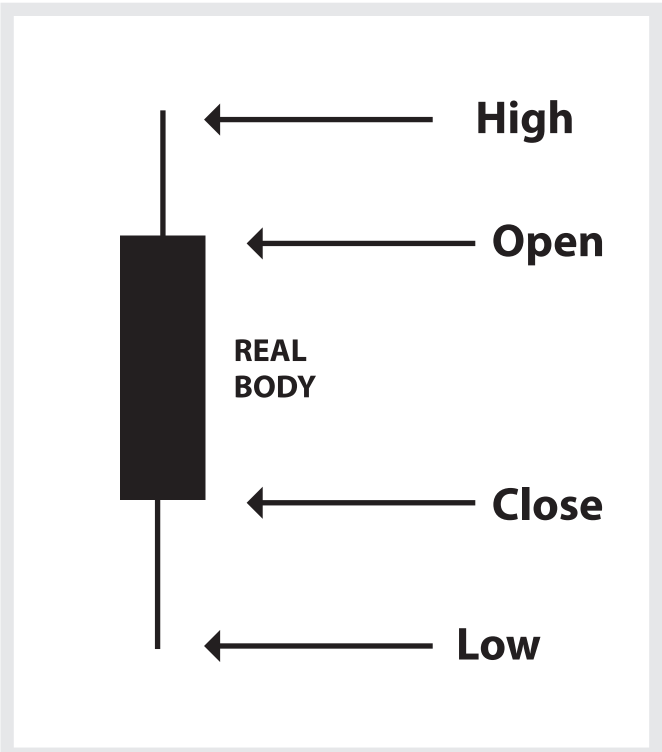
Candlestick chart using same price data

One candle by itself can provide important information about the strength or weakness of the market during a given day or other time period, visually portraying where the market closed relative to the open.

The real "body" of the candle represents the difference between the opening price and the closing price. If the body is white or clear or some other color of the user's choice, it indicates prices moved higher from the open to the close for the period and buying was the dominant force. This is a bullish sign.



If the body is black or a solid color, it indicates prices moved lower from the open to the close for the period, and selling was the larger factor. This is a bearish sign.



Although the color of the real body generally sets the bullish or bearish tone of a trading session, the "wicks" or "tails" or "shadows" – that is, the price activity beyond the open-close range – are also important, showing how far traders were willing to push prices during the period before coming back to close in the real body.

One candle alone can be significant but, depending upon its location on a chart, a candlestick pattern usually takes several candles to produce chart formations that give the best signals, sometimes in combinations of three candles. Candlesticks may look identical but may have an entirely different meaning after an uptrend than they do after a downtrend.

Candlestick analysts have added a little mystique to candlestick charts by giving various patterns clever names and providing more descriptive characteristics for these patterns than is the case in typical bar chart analysis. Both types of charts have their double tops, inside days, gaps and other formations. But the serious candlestick analyst has identified and labeled dozens of candle patterns and given them specific meanings, depending on their location on a chart and the length of their bodies and tails.

This brief guide to candlesticks covers some of the major patterns. The color combination used for the bodies of the candles here is white or clear candles to indicate the close is higher than the open and black or solid candles to indicate the close is lower than the open. Some traders prefer to use red to indicate bearish candles and green or black to indicate bullish candles. Whatever combination you use, candlesticks will provide a quick visual representation of trading activity that occurred during the period covered by the candle.

This tutorial splits the candle patterns into three major categories – indecisive, reversal and continuation.

Indecisive patterns

Individual candlesticks or candlestick patterns tend to be most useful in helping to spot market reversal tops or bottoms, but they can also provide information as a trend is unfolding. Some candlesticks suggest that bullish and bearish traders may have achieved some kind of balance, and the market can't decide which way to go next. This candlestick pattern may just be setting up to continue the trend that is already in place or may become a turning point if the market has been trending.

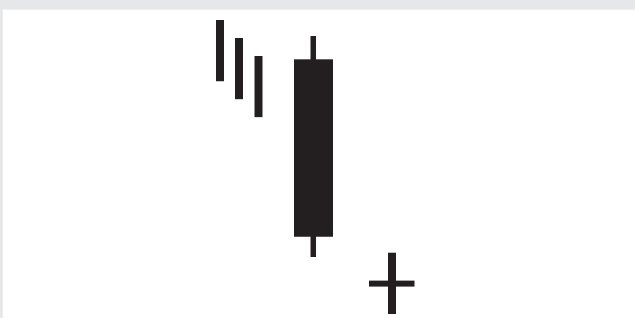
Dojis

Perhaps the best-known candlestick analysis reflecting an indecisive market condition is a group of individual candles known as doji.

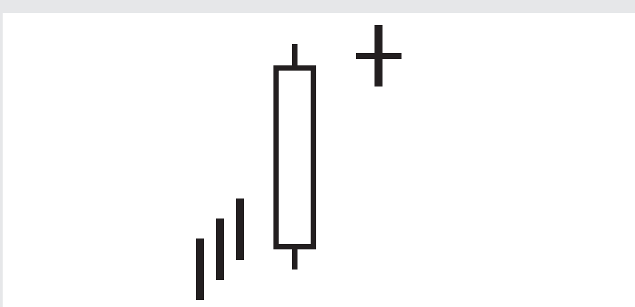
When the open and close prices are at the same price level or nearly so, there is no real body. A doji indicates neither buyers nor sellers were in charge from the open to the close during the trading session and suggests the market has reached some kind of equilibrium.

Charts may display a number of dojis during a trend, implying some uncertainty about the trend. Not all dojis are significant, but they provide a visual alert for a possible trend change. After a series of downtrending candles, a doji can suggest a bottom and a potential turn higher – a bullish situation. A doji candle that appears after a series of uptrending candles hints that buying is diminishing and is generally more reliable in signaling a price turn – a bearish situation.

For the chart analyst, the key value of a doji is providing a point to place orders to take advantage of what might happen to prices after the doji.

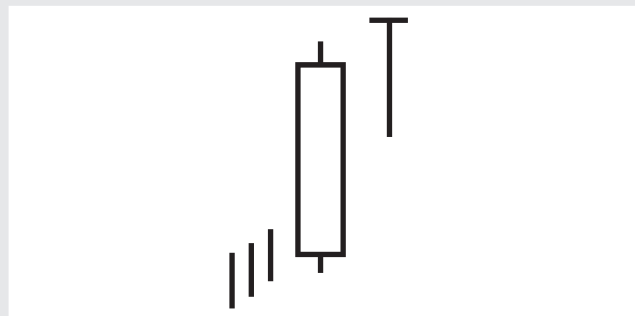


Bullish doji



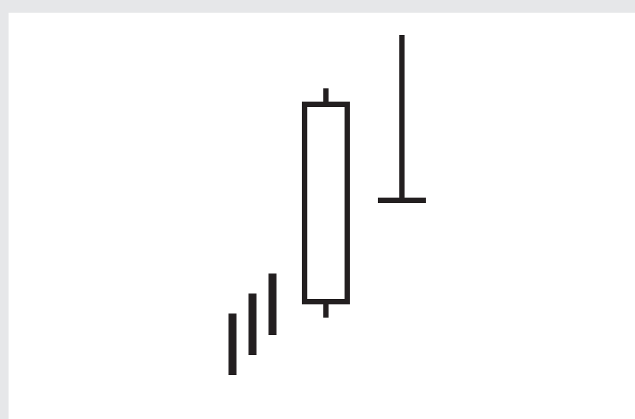
Bearish doji

Colorful names have been given to some dojis based on the images that the candle tails leave on a chart. For example, **dragonfly doji** has a long lower tail and little or no upper tail. If it appears after an uptrend, it may mean a bearish reversal. If it appears after a downtrend, it may indicate that traders have rejected lower prices and may trigger a shift to an uptrend.



Dragonfly doji

A **gravestone doji** looks like the dragonfly doji upside down – the upper tail is long and there is no lower tail. If prices have been moving up and a doji forms with the open and close at the low of the period, it suggests traders have rejected higher prices and is bearish. The longer the upper tail is, the more bearish the outlook may be.



Gravestone doji

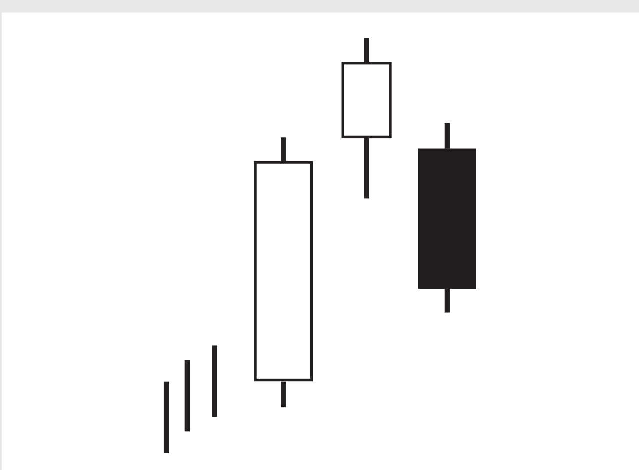
A **four price doji** is a name given to a candle when the open, high, low and close are all at the same price. This doji can occur when trading is very quiet or thin. Keep in mind that this same type of candle can appear with a limit up or limit down price move, sometimes leaving a large gap, so location must be taken into account along with appearance.

Other doji names include **long-legged doji,** which has both very long upper and lower tails, and **rickshaw man**, similar to a long-legged doji but with the open and close in the middle of the price range.

Where any of these dojis appear on a chart is an important factor in their interpretation, and they all require followup price action to confirm the validity of their signals.

Spinning top

When you have a doji but add a real body to the candle, you have a spinning top – that is, the open and close are not at the same price level and the tails are longer than the real body. Whether the real body is white (close higher than open) or black (close lower than open) is not important. Like dojis, spinning tops indicate indecision or a balance of bullish and bearish forces.



Spinning top

Reversal patterns

One of the most important clues that most traders want is when and where a market is ending one trend and starting another so they can get on the new trend early. For this reason, many traders are most interested in the reversal signals that candles can provide.

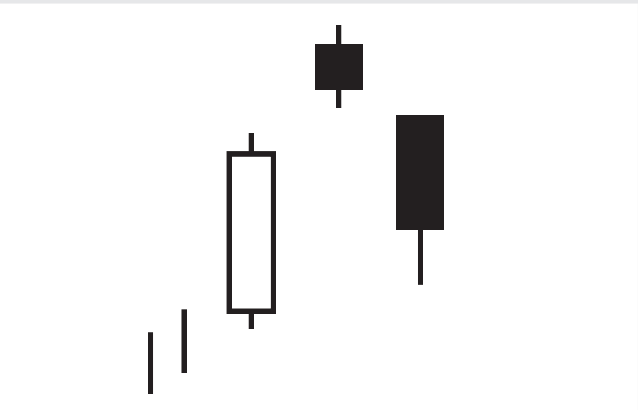
While the indecisive candles described above generally provide an alert based on the appearance of one candle, reversal patterns typically require several candles – in many cases, a series of three. Analysts have identified and named a number of candlestick reversal patterns, keeping in mind that in all cases the location of the candles on a chart and confirming followup price action are essential in assessing their value.

Stars

Stars as a reversal pattern come in several different forms. The pattern usually consists of three candles, the first a large candle at the end of an extended trend followed by a second smaller candle that leaves a gap or window and then another large body candle in the direction of the new trend. Large volume would help to confirm the reversal signal.

The **shooting star** has a long upper tail, a small real body at the lower end of the price range and little or no lower tail. In many respects, it looks like the hammer described below, but it appears at the top of a trend rather than the bottom. The candle pattern following an upward move suggests a strong rally off the open on buying enthusiasm, which fades as the market rejects the higher prices and collapses back down to close near the open. Demand has dried up. If the market has gapped up on the open before failing, the move is even more significant.

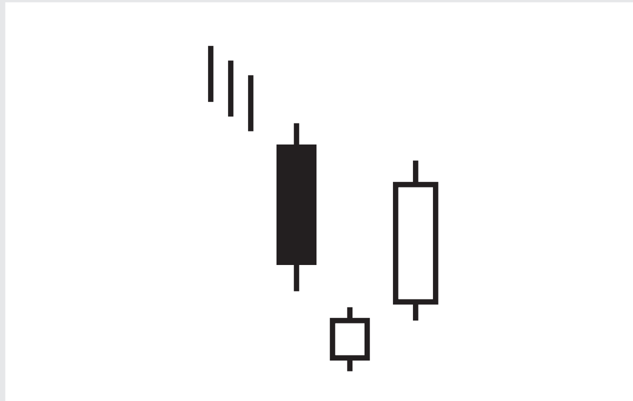
The **evening star** pattern covering three candles depicts this type of bearish scenario. The first of three candles is a long white candle. The second candle features a gap-higher open and a small real body (black or white) that is completely above the real body of the first candle. The third candle has a black real body that closes well into the range of the first candle's white body. The longer the black real body of this third candle is, the more meaningful it is in forecasting a bearish turn. High volume on this third down candle adds confirmation to the reversal signal.



Evening star

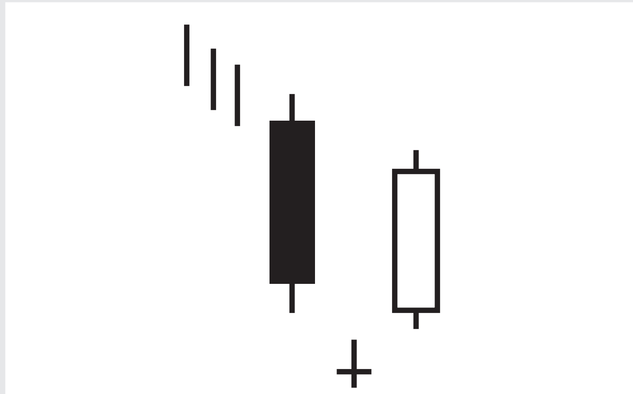
If the middle candle is a doji, the pattern is called an **evening doji star,** which adds more significance to an ordinary evening star. If the doji's lower tail is isolated completely above the tails of the first and third candle tails, the pattern is called an **abandoned baby top,** increasing the significance of the topping signal.

Turn that pattern around and you have the **morning star** bottom reversal signal after a price. This pattern also includes three candlesticks. The first is a long black candle after a decline. The second features a gap-lower open and a small real body (black or white) totally below and not touching the real body of the first candle. The third candle has a long white real body that closes well into the price range of the first candle's long black body. The longer the white real body of the third candle is, the more meaningful it is as a bullish turn signal. Again, high volume on the third candle adds confirmation to the reversal signal.



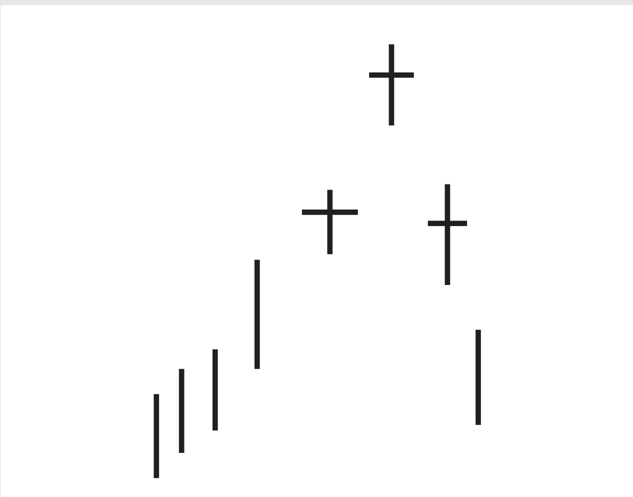
Morning star

If the middle candle is a doji, the pattern is called a **morning doji star,** which has more meaning than an ordinary morning star. If the tails of the middle doji are totally below the tails of the first and third candlesticks, the pattern is called an **abandoned baby bottom**, which adds to its significance.



Abandoned baby bottom

A **tri-star doji** does not occur that often but, when it does, a combination of three dojis together can be a significant reversal pattern, especially if the middle doji gaps away from the doji preceding it. The tri-star doji formation sometimes follows an extended trend that is losing steam as traders are uncertain about the continuing momentum and direction of the trend.

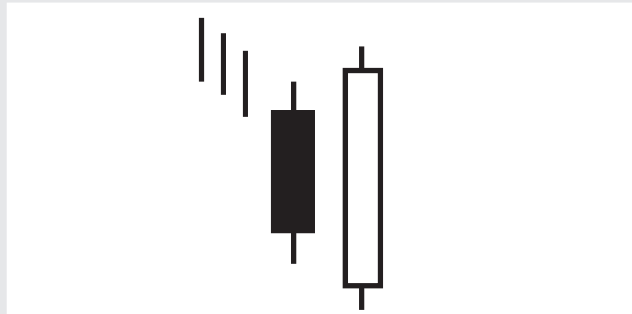

Tri-Star dojis

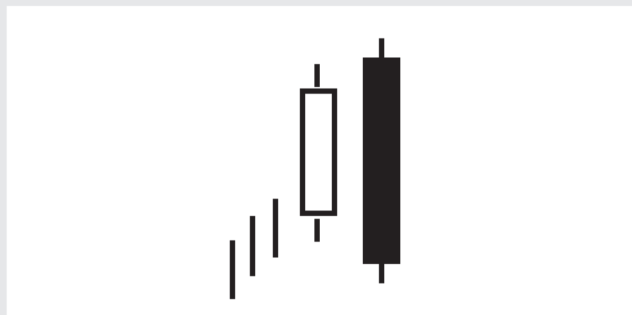
Engulfing patterns

Sometimes an event or other new information can cause an abrupt change in investor sentiment. This change shows up visibly with several candle formations on a chart, the most vivid of which is the **engulfing pattern**. As with other candle patterns, they can mark tops or bottoms.

With a **bullish engulfing pattern**, prices open below the previous close and then surge higher, resulting in a white candle body that completely engulfs the body of the previous candle. With a **bearish engulfing pattern**, prices open above the previous close and then collapse lower during the trading session, producing a black body that completely engulfs the previous candle.

These candles suggest a reversal in trend direction as buyers take over in the bullish version and sellers dominating the market in a bearish version.


Bullish engulfing pattern

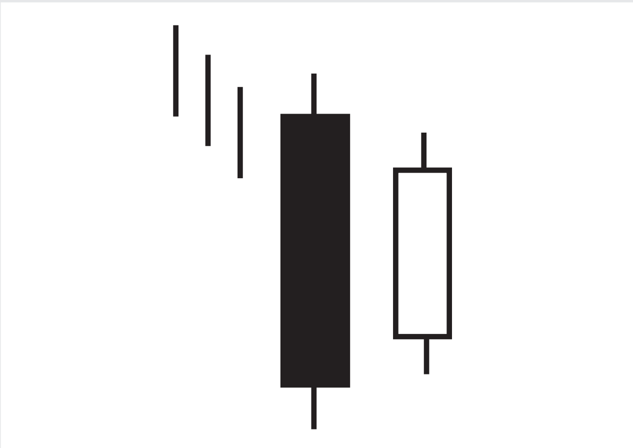

Bearish engulfing pattern

Harami

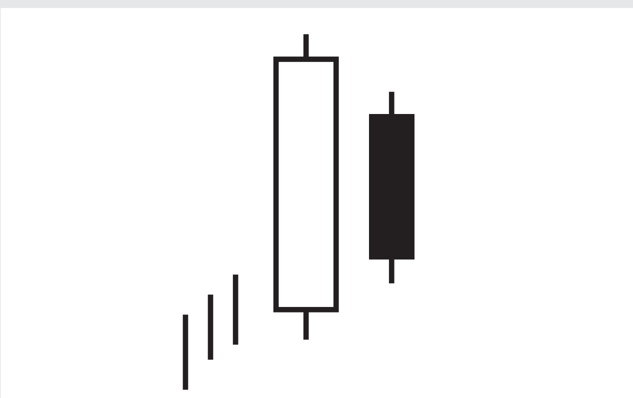
The **harami** is a reversal pattern that looks somewhat like the engulfing pattern except that this candle is smaller than the previous candle, lying completely within the price range of the previous candle. It looks like a child within the body of the mother candle and can give birth to a new trend.

After an uptrend and especially after a long white real body candle, a **bearish harami** is formed by a shorter black body candle where all prices are within the price range of the white body of the previous candle. A **bullish harami** occurs after a downtrend when prices of the current candle all fall within the price boundaries of the previous big black body candle.

This pattern does not assure a price reversal but requires immediate upside price action after a bullish harami or immediate downside price action after a bearish harami to confirm the candle pattern signal.



Bullish harami



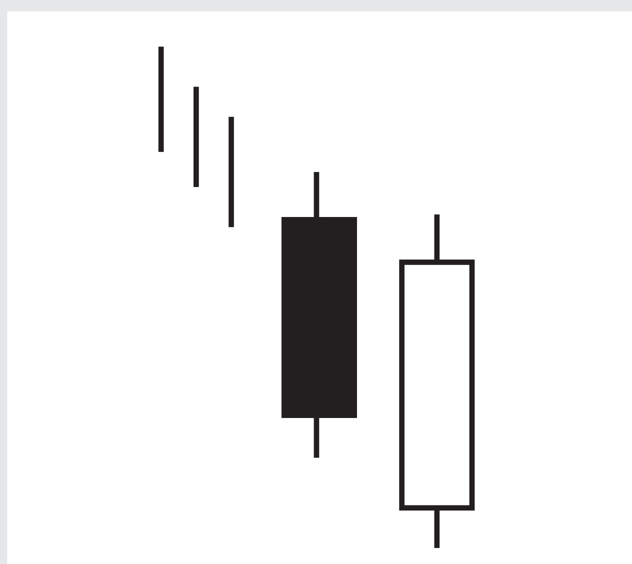
Bearish harami

When the harami candle is a doji with the open and close at the same price level, the signal is even more effective. A bearish harami cross is a doji within the confines of the previous long white body candle after an uptrend. A bullish harami cross is formed by a doji candle within the price range of the previous large black body candle after a downtrend. They also require confirmation by followup price action.

Piercing line, dark cloud cover

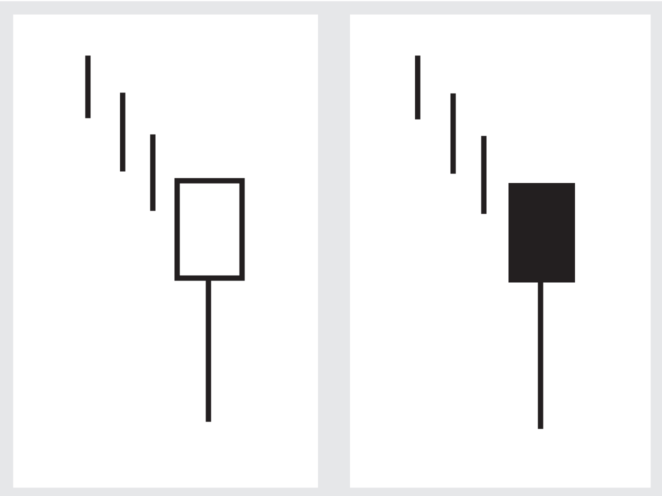
Another reversal candle pattern that is similar to the engulfing pattern and harami occurs when the current candle does not entirely cover or stay within the previous candle in a trend. These candle patterns feature a gap opening followed by a sharp move in the opposite direction of the trend with the close at least halfway through the previous candle body's price range.

The **piercing line** appears after a downtrend and a large black body candle when the market gaps lower on the open, then rallies sharply and closes in the upper half of the previous black candle. The **dark cloud cover** is a mirror image that occurs at a top after a long white candle body – the market gaps higher, indicating bulls are still willing to push prices up, but then tumbles and closes below the midpoint of the previous white candle's body. The extent of the drive into the previous candle's body can reveal how strong or weak these candle signals are, again assuming price action follows through with the signal.



Piercing line

Dark cloud cover



Hammer

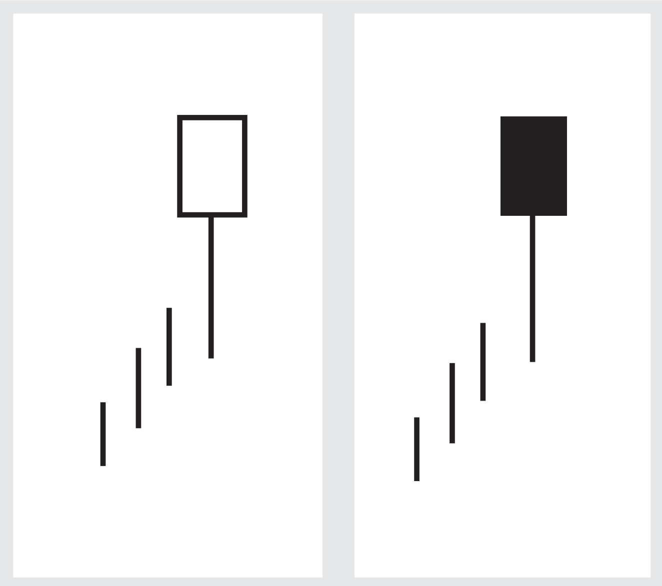
Hammer, hanging man

These two reversal patterns look very much alike, but their name and impact on prices depend on whether they occur at the end of a downtrend or an uptrend. In either case, the signal candle has a small real body that forms at or near the high, little or no upper tail and a long lower tail, suggesting the previous trend is losing momentum.

The **hammer** occurs within an extended downtrend and has the look of a hammer (body) with a long handle (tail). The body may be white or black, but white would be more bullish than black. If prices gap higher or form a long white candle during the next period, it would enhance the prospects of a bullish move as traders appear to be rejecting a move to lower prices and the downward momentum is declining.

If this candle has no upper tail or shadow, it is also known as a **shaven head** pattern (white or black body).

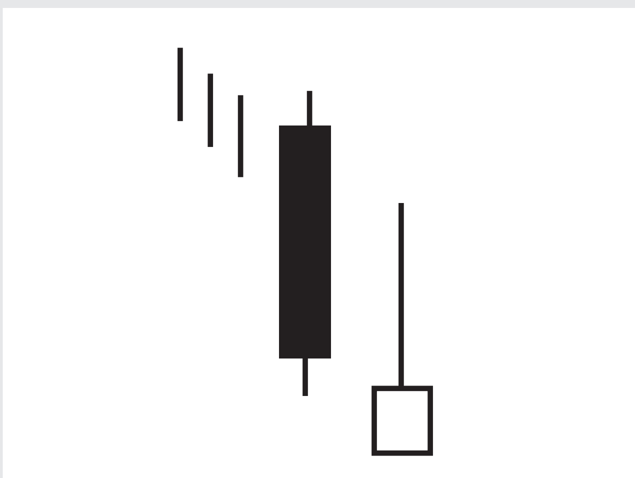
The **hanging man** is a bearish reversal pattern that occurs within an extended uptrend. It has the appearance of man (body) with a leg dangling down (tail). The small real body may be white or black, but black is more bearish than white. If prices gap lower or form a long black candle during the next period, it would increase the odds of a bearish price move.



Hanging man

Turning the tails on the candle patterns around can give the pattern a different meaning. For example, the **inverted hammer** can be a bullish reversal pattern if it appears during a downtrend. The small real body (white or black) is the same, but the long tail on this pattern is the upper tail and there is little or no lower tail. This pattern requires confirmation with a strong followup price move to the upside producing a large white real body during the next trading period.

Another name for this candle (white or black) when there is no lower tail is a **shaven bottom** pattern.

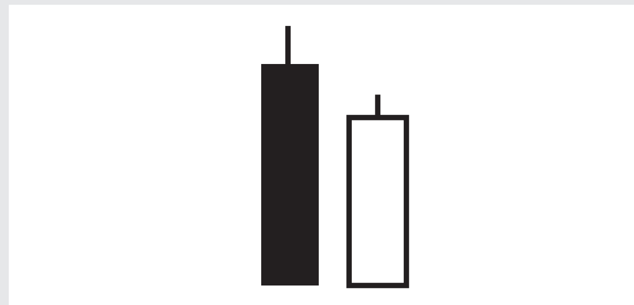


Inverted hammer

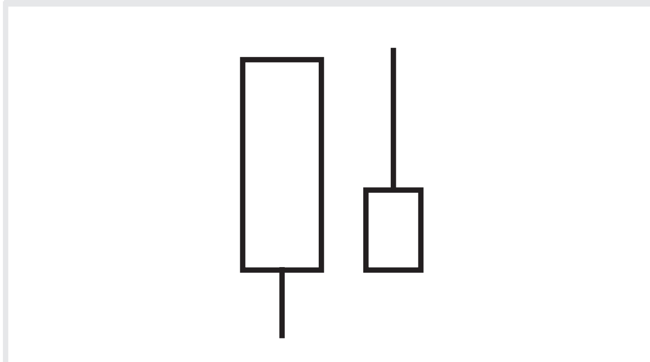
Combinations

When the various types of candles are put together in different combinations, they provide a large group of other reversal candle patterns. Spotting these patterns may be a little more difficult than the basic patterns described above, but their colorful names add to the mystique of candle analysis.

Tweezers are minor reversal signals that have two or more candles with matching bottoms or matching tops – not necessarily consecutive or requiring followup for confirmation. Traditional bar chart analysis might consider these double tops or double bottoms.

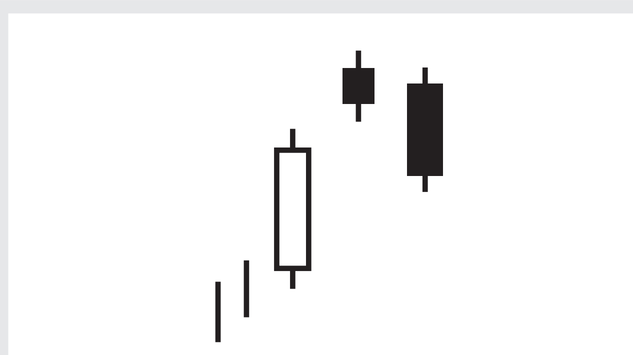


Tweezer bottom



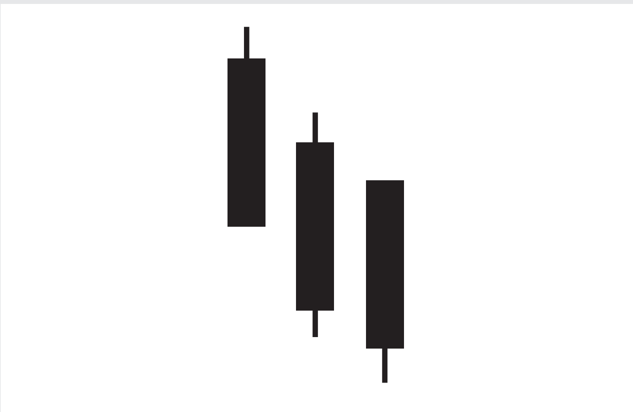
Tweezer top

After an uptrend, the **two crow pattern** indicates a reversal. A relatively small black candle suggests a loss of upside momentum. Then a much larger black candle confirms a bearish change in momentum that could lead to a downtrend.



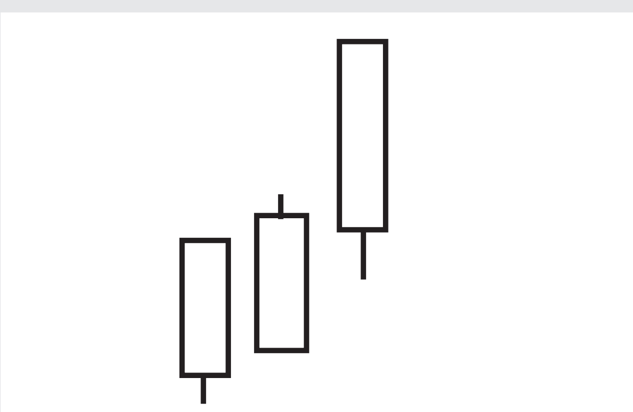
Two crows

Three black crows just adds another black candle to provide a more decisive clue that the existing uptrend is turning. The three large black candles should close near or at their lows, perhaps even forming an identical three black crows pattern.



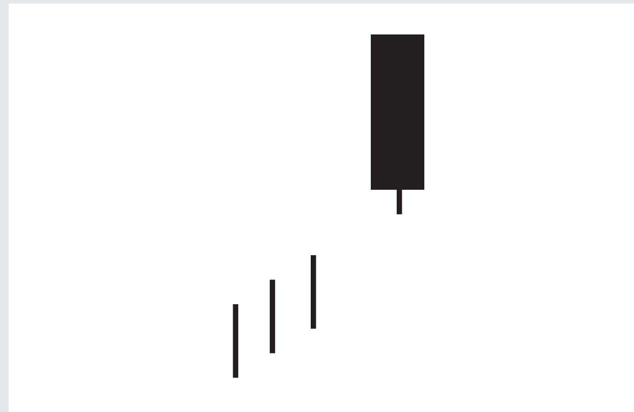
Three black crows

If three black crows suggest the reversal of an uptrend, **three white soldiers** reverse an existing downtrend. Again, there are three relatively large consecutive candles – in this case, white bodies that close near or at their highs of the period.

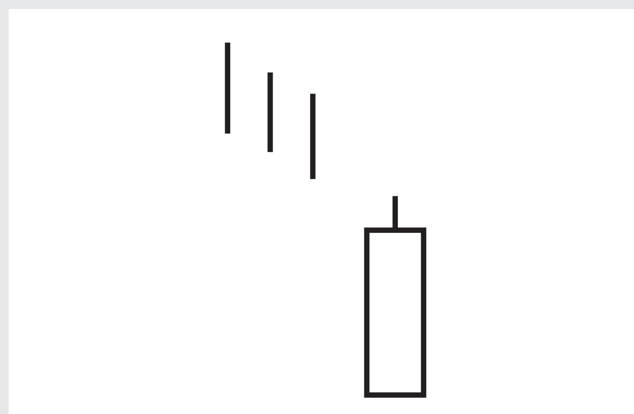


Three white soldiers

The **belt hold** candle pattern forms when prices gap open much higher or much lower but then give up much of their gain, closing significantly higher (bullish) or much lower (bearish) for the trading session.

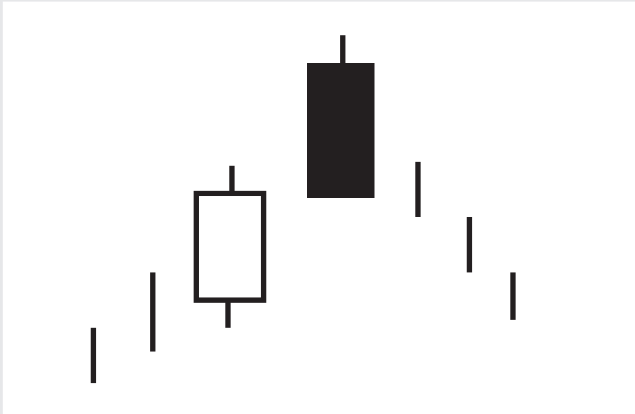


Belt hold



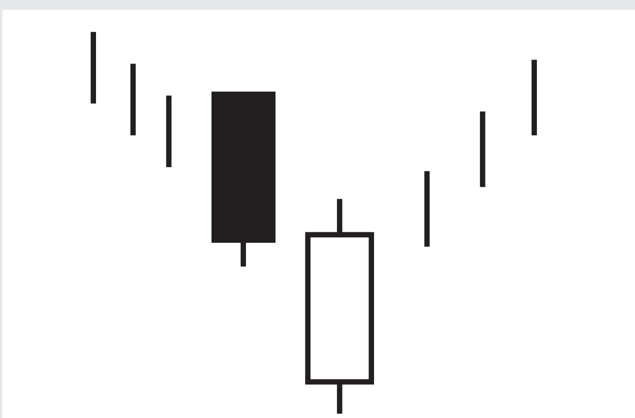
Belt hold

A bearish counterattack line forms in uptrending market conditions when a large white candle is followed by a large black candle that has had a gap higher open but then falls back during the trading session and closes at the same price as the previous close. Confirmation to the downside is required to complete the pattern.



Bearish counterattack line

A **bullish counterattack line** has similar price action but on the downside. In a falling market, a large black candle is followed by a large white candle that has opened with a gap down, then rallied during the trading session to close at the same price level as the previous black candle close. Again, confirmation to the upside is needed.



Bullish counterattack line

Three inside down is a three-candle pattern that builds on the harami candle described above and indicates a downward reversal. After an uptrend, a large white candle is followed by a short black candle whose prices are entirely within the real body of the big white candle – the harami. The third candle is a large black candle closing below the lows of the two previous candles, indicating loss of momentum and a shift to a bearish trend.

Three outside down is also a three-candle pattern that builds on the engulfing candle pattern. After an uptrend, a white candle is followed by a larger black candle that entirely covers the white candle's price range – an engulfing candle. That already bearish pattern then gains additional confirmation for a shift to a bearish downtrend when the third candle is a large black candle that closes below the lows of the two previous candles.

Kicking might be regarded as a two-day bull trap. After a period when prices open on their lows but then close on their highs – a white candle with no tails – the next candle is just the opposite, making a large downside gap on the open and then falling during the period to their lows – a black candle with no tails. That type of formation can be a back-breaker for bulls, leading to further price weakness in the next few sessions.

Deliberation suggests a bit of uncertainty causing a congestion area on a chart. The first two white candles of this pattern during an uptrend are relatively large but the third is small, suggesting a loss of upward momentum while waiting for resolution of the trend direction.

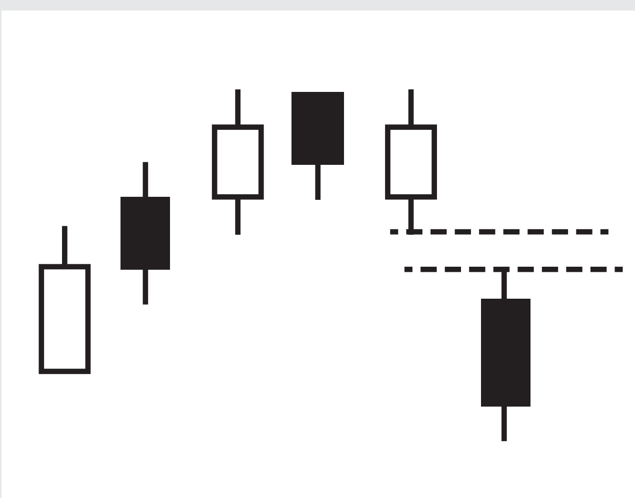
Advance block takes deliberation a step further in an uptrend when a larger white candle is followed by a second and a third white candle with smaller price ranges and smaller bodies than those in the candle before, suggesting upward price momentum is diminishing.

A **ladder top** follows three consecutive large bullish white candles and reverses an uptrend when the fourth candle displays a definite slowdown in upward momentum. The trend change from up to down is solidly confirmed by the fifth candle if it is a relatively large back candle that closes on its low and below the lows of the three previous periods.

In the Western world, three Buddha top looks a lot like the longer-term head-and-shoulders top. As with the head-and-shoulders signals, three Buddha top confirms a sell signal when the price falls below the two interim minor lows – the neckline in the Western version. The breakdown gains additional credence if it occurs with a large black candle or with a gap down and an increase in trading volume.

Three mountains top also looks like a longer-term Western formation – the triple top. A sell signal is confirmed when the price falls below the pullback lows, again adding credence if the breakdown occurs with a large black candle or a gap down and an increase in trading volume to affirm the selling pressure.

Another candle formation that has a Western counterpart is a dumping top, a longer-term pattern that is similar to a rounding top. A breakaway gap to the downside would give more emphasis to the selling pressure.



Rounding top

Eight new price lines is a candle chart pattern displaying eight new price highs. This might be the result of an overbought market where conditions are ripe to change as traders start to take profit.

Continuation patterns

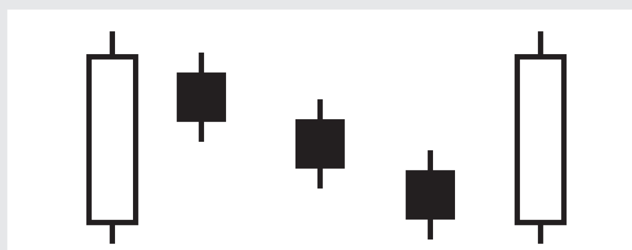
Although most traders may be analyzing candle charts to spot upward or downward price reversals intending to get onboard a trend early, continuation candle chart patterns can also be helpful in providing clues about when a trend is likely to stay in place or resume – that is, when it is wise to hold off on taking a directional position or when to use a range-trading strategy.

Flag formations and triangles in Western chart analysis are pauses or consolidation areas where the market seems to take a little breather to let prices adjust to conditions.

Candlestick charts also feature similar patterns.

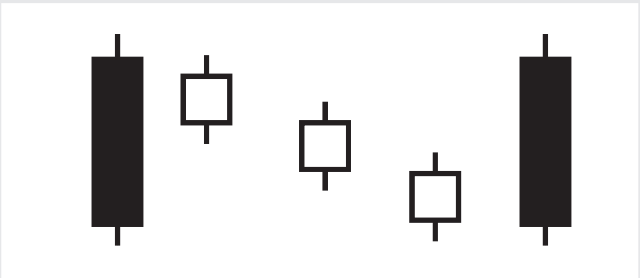
Rising and falling three methods

The **rising three methods** pattern appears in an uptrend and covers five candles. The first candle has a long white body. The next three candles have smaller real bodies, two of which are black, and prices for all three are contained within the price range of the first white body. The fifth candle has another long white body and closes at a new high, confirming that the market is ready to resume the uptrend that existed prior to the first candle in the pattern.



Rising three methods

Reverse everything in the rising three methods and you have the **falling three methods** candle pattern, which occurs in a downtrend. The first candle has a long black body. The next three candles have small real bodies, two of which are white, and all prices in those candles are within the price range of the body of the first large black candle. The fifth candle is another long black candle, which closes at a new low, confirming that the downtrend going into the pattern is ready to resume.



Falling three methods

In a variation of the rising and falling three methods shown, the number of candles in the middle is not necessarily limited to three, and these candles do not have to be totally within the price range of the first candle. Ideally, however, in the bullish rising three methods, the tails will not drop below the low of the first white candle and in the bearish falling three methods, the tails of those candles will not extend above the high of the first black candle.

The key point is that the three (more or less) candles in the middle act as a congestion area that looks like a flag on Western charts, and the breakout leads to a renewal of the trend in place.

Windows

A **window** on a candle chart is a gap on a Western chart. It is an area where no trading occurs from one period to the next as the price range of the current candle does not touch the price range of the previous candle.

Windows, like gaps, can have several different meanings. Often, they are rather minor occurrences and have little influence on price direction so they are considered continuation patterns, indicating the existing trend before the window is likely to continue after the window.

Windows can also indicate quick, sudden changes in market conditions and act as the catalyst for the new trend direction, either during a running price situation or coming out of a congestion area.

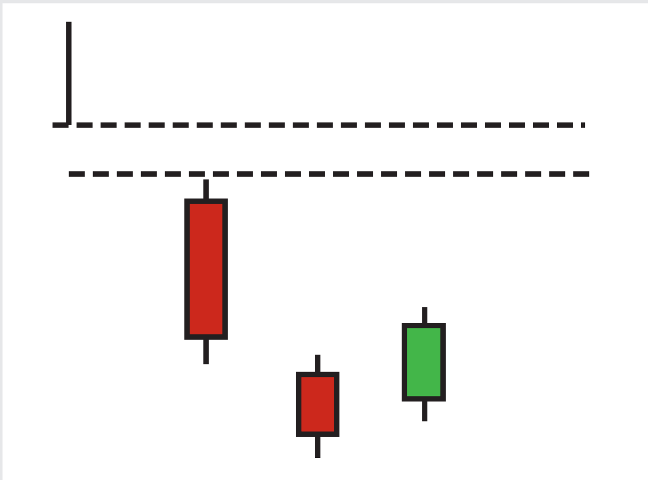
A **rising window** in candle language occurs when the current candle price low is higher than the previous period's high, leaving an upside gap on the chart. If prices make a downward correction against the potential uptrend, the window is likely to provide support against the downward reaction. If the downward price move fills or closes the gap/window, it negates the support from the gap.

In a **falling window**, the current candle price high is lower than the previous candle's low, leaving a downside gap on the chart. If prices try to react upward with a correction against the downtrend, the window will likely provide resistance at the previous period's low. If prices fill/close the gap/window, it negates the resistance effect if the gap.

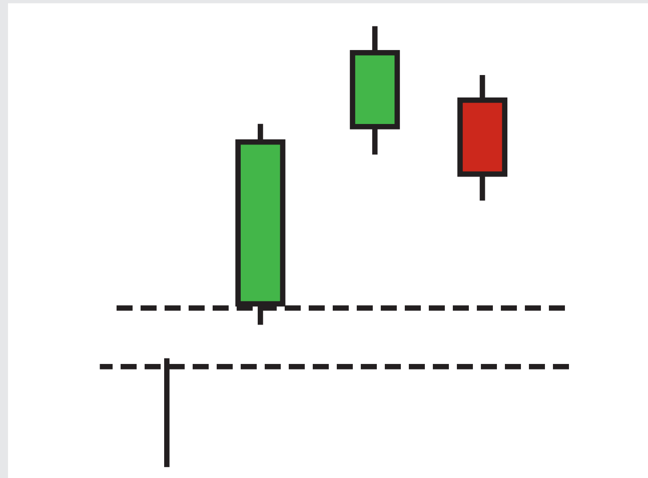
Three windows define an extended price move. The first window is the breakaway gap that launches the move. The second window is a continuation gap (also known as a measuring gap because it tends to occur halfway through the move). The third window is the exhaustion gap at the end of a move when the trend appears to have worn itself out.

Three falling windows are three downside gaps followed by a bullish white candle indicating that selling pressure is exhausted. Conversely, three rising windows are three upside gaps followed by a bearish black candle indicating buying pressure is exhausted.

The **Tasuki gap** is a brief, contratrend retracement where prices may enter the area of a recent window but do not close the window on a closing price basis.



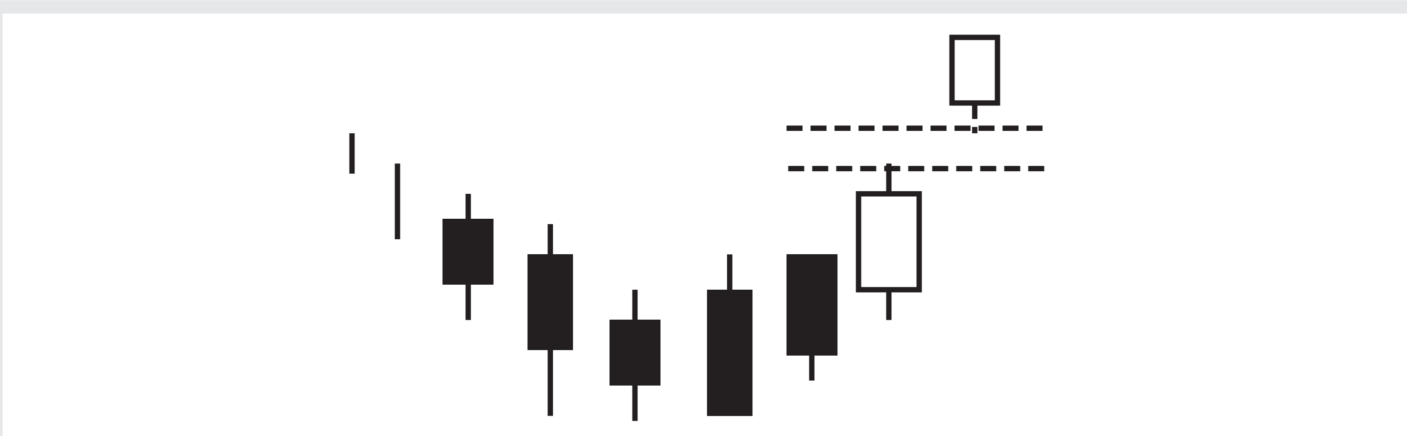
Tasuki gap bottom



Tasuki gap top

Meeting line is a candle term that defines a window in the direction of the prevailing trend on the open, but the close reverses to meet the previous period's close. If the trend is to continue, this window closing should not happen so it is likely the trend will reverse.

Fry pan bottom is candle talk for another Western pattern, the rounding bottom. After prices slope down and then move back up, a buy signal occurs on a rising window (breakaway gap) to suggest a surge in buying interest.



Fry pan bottom

Lighting the way

Like any other aspect of trading, candle charts will not guarantee profits or instant trading success. You still have to do the analytical work when you use candles, you still have to make tough trading decisions, and you still have to manage your trades and your account carefully to avoid risks or exposure beyond your capability to control it.

But, using the same open, high, low, close price data available to all traders using all kinds of charts and methods, candles provide you with a better visual picture of what is happening in a market during a specific period of time. With a clearer view of the dynamics of market movement within that period, you can interpret traders' reactions to various price levels and make decisions about how you might respond to what the charts are telling you.

Candles are a relatively new approach to Western traders, but the speed at which they have become arguably the most popular way to look at markets and charts today attests to the value traders have found in them. For many traders who have become familiar with the various candle patterns and the nuances of each of them, there will be no going back to the traditional old bar charts any time soon.