

## **Candlestick Chart Patterns Explained**

By Michael Sincere

In the Western world, traders and investors primarily rely on two-dimensional bar charts to get a visual snapshot of the market open, high, low, and close. But there may be a better option. Many traders have discovered they can enhance their understanding of the market by using candlestick charts in conjunction with traditional technical indicators.

“Candlestick charts are the luxury version of bar charts,” says Toni Turner, bestselling author of *A Beginner’s Guide to Short-term Trading* (Adams Media, 2<sup>nd</sup> Edition). “It’s like switching from a black-and-white television set to living color.” In fact, candlesticks not only provide more information than traditional bar charts, many traders think they are more visually appealing.

Turner says that candlesticks, when used with indicators like volume, moving averages, and support and resistance, works like a “giant symphony that tells traders a single story.”

While candlesticks have only recently become popular in the Western world, they are actually the oldest form of technical analysis, originally created by a wealthy Japanese rice trader in the 18<sup>th</sup> century. Mentioned by Charles Dow in 1900, candlesticks were pioneered in the West by Steve Nison, president of Candlecharts.com and author of the best-selling *Japanese Candlestick Charting Techniques* (Prentice-Hall, 2001).

### **The candlestick story**

“The Japanese say that every candlestick line tells a story,” confirms Nison. “The candlestick has the same information as the bar chart but it’s constructed differently. By using candlesticks, you can visually see who’s in control of the market at the time the candlestick is formed.”

Simply put, the candlestick is made of two components. There is a unique rectangular portion called the “real body.” There are lines above and below the real body called “shadows,” which designate the high and low of the day. By studying its shape, the length of the lines, and if the real body is empty or filled-in, you can quickly see during that session who is winning the battle — the bulls or the bears.

If there is a tall, white, real body, the bulls are in charge of that session. A long, black real body indicates the bears are in charge.

“Normally, in a rally you want to see tall white candles, preferably on high volume,” says Nison. “We get nervous when the real body gets smaller and smaller because it means that supply and demand is becoming more equal.” By studying the candlesticks, Nison says, you can read the psychology of the market.

In the example below, notice the small and thin real bodies (circled), which identified potential problems in this stock. Next, a series of long black real bodies proved the bears have taken control.



Source: [www.candlecharts.com](http://www.candlecharts.com)

## Using candlesticks to gain an edge

John Person, president of Nationalfutures.com and author of *Candlestick and Pivot Point Trading Triggers* (Wiley, 2006), says that “candlesticks, based on size, shape, and color, gives me a three-dimensional view that helps me to make faster decisions. In this incredibly volatile market, it gives investors and traders an edge.” He stresses it’s essential you first decipher the code of the open, high, low, and close relationships.

According to many pros, candlesticks are best for spotting potential early reversals or potentially bad trades.

“Most successful traders use candlesticks,” Nison claims, “because it gives early clues of potential market turns. If these clues are correct, you will get in or out of the market before it makes a potential big move. The best way to zero in on the psychology of the market is by looking at pure price action, and this is where candlesticks are perfect.”

Turner confirms the importance of price. “There are three things that matter on a chart: price, price, and price,” she says. “Couple that with volume and you get a much more exact picture.”

Nison explains: “Let’s say the market breaks above a resistance area of \$200 and there are small real bodies. Although it’s above the resistance level, the bulls don’t have full control, so you should be careful about adding or buying there.”

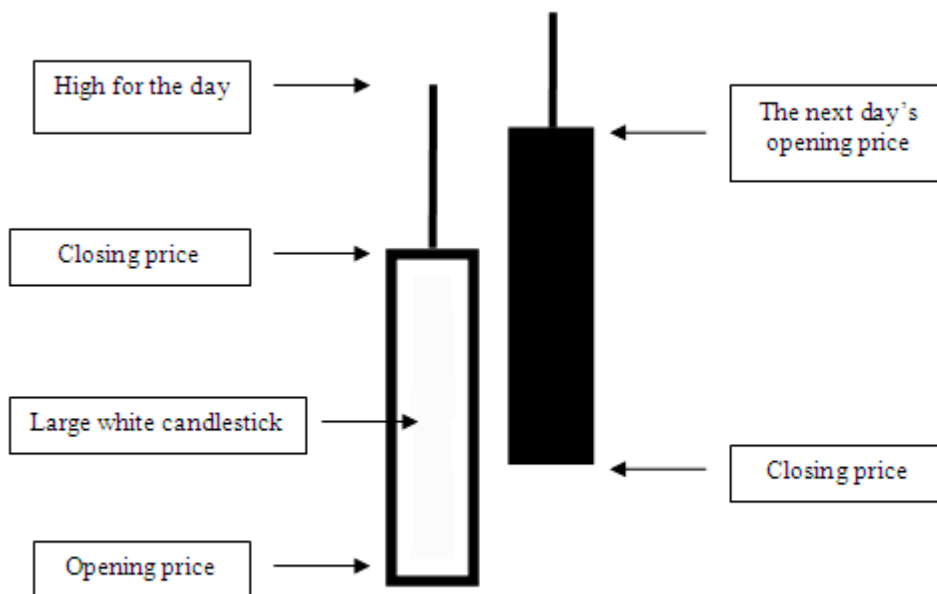
After you become familiar with candlesticks, you’ll likely recognize a handful of the most common patterns, including the popular Dark Cloud Cover and Doji.

### **Dark Cloud Cover**

One of Turner’s favorite patterns is the Dark Cloud Cover. It is considered one of the most reliable signals for identifying market tops. “As the stock moves up in an uptrend, it reaches a high,” she says. “But the next candle up will usually open up on the high of that candle and close down into the prior candle at least halfway.” Turner says this pattern shows that sellers are strengthening and buyers are giving up. “It looks like a cloudy day,” she explains.

To confirm that it’s really a Dark Cloud Cover, Turner suggests you wait for the next day’s price before taking action.

### *Dark Cloud Cover*



## The Doji

Another common candlestick pattern is the Doji, characterized by its small, thin lines and an equal opening and closing price. The cross is the Doji, which can be interpreted as indecision.

“If a stock you own makes a higher high and makes a Doji top, you’re wise to take at least partial gains,” Turner points out. “It’s a definite warning sign the market mood is shifting. At the very least, seasoned traders will raise their stops,” she says. “Once in a while, the Doji is just a resting spot for price, so you need the next day’s confirmation to see the mood of the market.”

In an orderly pullback, if the price culminates in a Doji, and sits on a rising 20-day or 50-day moving average, Turner might wait until the stock moves above the high of the Doji. “This is my signal to buy the next morning,” she explains.

## *The Doji*



Person looks for what he calls the “High-close Doji.” a reversal pattern that resembles the Doji. “After the market has been in a strong downtrend,” he says, “and a Doji is present, when the market closes above the high of the Doji, we’ll enter on that closing bar.” Just like Turner, Person will wait until the next market period to enter.

### **Conflicting signals**

There are times when the candlesticks and technical analysis might give conflicting signals. “Technical analysis, when used correctly,” Nison adds, “helps us to evaluate the probability of a trade working. But nothing is 100%.”

If there are conflicting signals, Nison says, “I would stand aside or be less aggressive,” perhaps buying fewer shares.

One of the biggest problems is that people recognize a candlestick pattern and immediately buy. “Even if you have a candlestick signal, you should confirm with Western technicals,” Nison says. “The mistake that people make is relying solely on candlesticks. You shouldn’t look at them in isolation.”

In fact, one of the limitations of candlesticks is it doesn't give price targets. For that, you need to use traditional technical analysis such as support and resistance, moving averages, Bollinger bands, and RSI. "Candlesticks are good at picking highs and lows, and helping when to exit," says Nison, "but you need technical analysis to get price targets."

### **Get a candlestick education**

Although candlestick charts are powerful and informative tools that can help you understand market psychology, Nison says one of the secrets of success in the market is to educate yourself to use a three-legged approach to the market: candlesticks, Western technical analysis, and money management.

When using candlesticks, Turner suggests that you "evaluate the major indices using candle patterns. People need to be top-down traders and keep an eye on the overall market. Candlesticks and the signals they give can help traders make wise and more successful decisions."

*Michael Sincere is a freelance writer and the author of five books on investing and trading including Understanding Stocks (McGraw-Hill, 2003) and Understanding Options (McGraw-Hill, 2006).*