The Art of Candlesticks

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History

It is believed the first person to use candlesticks in his trading was a Japanese man called Munehisa Homma. This man became rich trading in the rice market during the 1700s.

Some of the methods he deployed to become one of the best traders at that time were to keep records of yearly weather conditions, to learn the psychology of investors and to analyse the fluctuations of price through time.

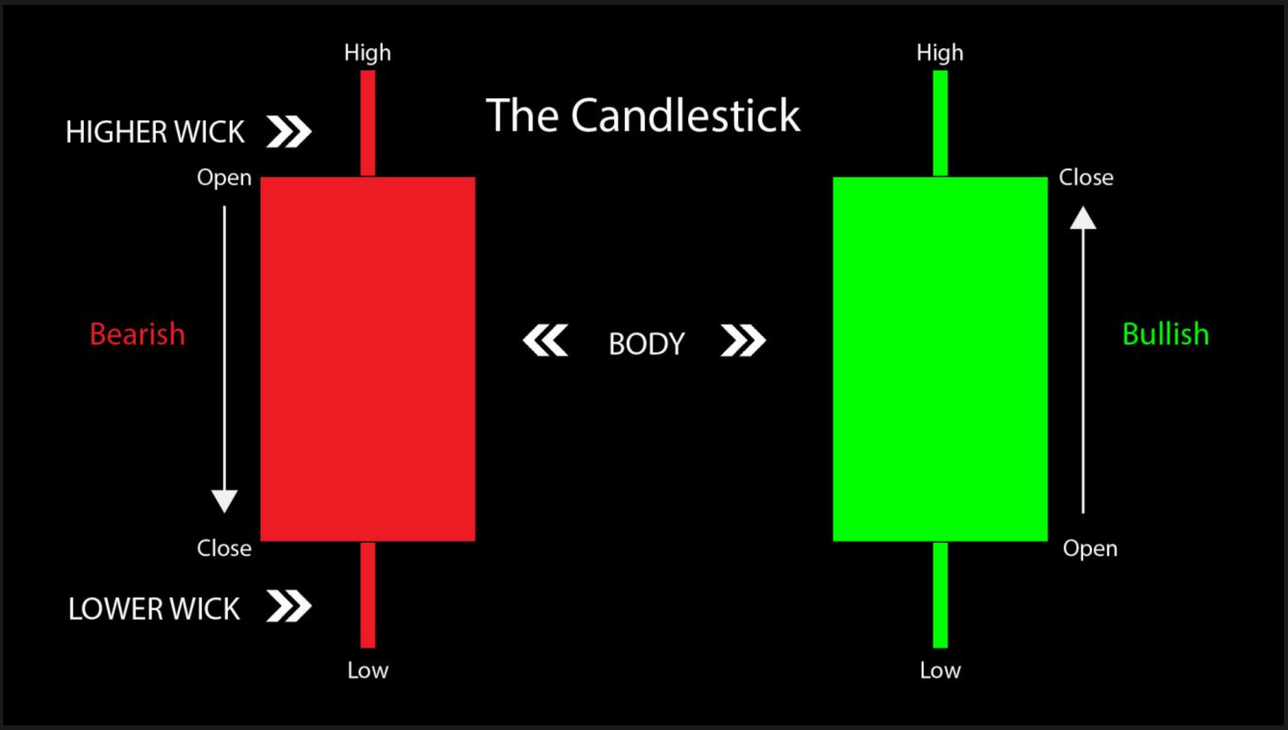
DOJIMA RICE EXCHANGE **Painting by Hiroshige (1797-1858) Property of Osaka Prefectural Nakanoshima Library**

He understood that price was not based on one single factor. It was in reality the product of many forces, which did not have necessarily any business with supply and demand. That main force is human nature.

The price is the collective reflection of human emotions. It acts as a filter through which we base our buying and selling on. He who understands it, understands the market.

In time, thanks to his insights a new methodology of trading evolved in Japan, the candlestick methodology, which we are now going to explore.

THE CANDLESTICK



A candlesticks has only 2 parts, a body which represents the solid portions of the candle, and a tail or wick, which represents the thin lines on the ends of the candle. The colour of the body is either green or red, and indicates if the stock has traded up (green) or down (red), for a given amount of time.

The body is often referred also as the **"essence of price of price movement".** Mostly because by looking at its height and colour we can get an immediate visual information whether the bulls or bears are in control of the price.

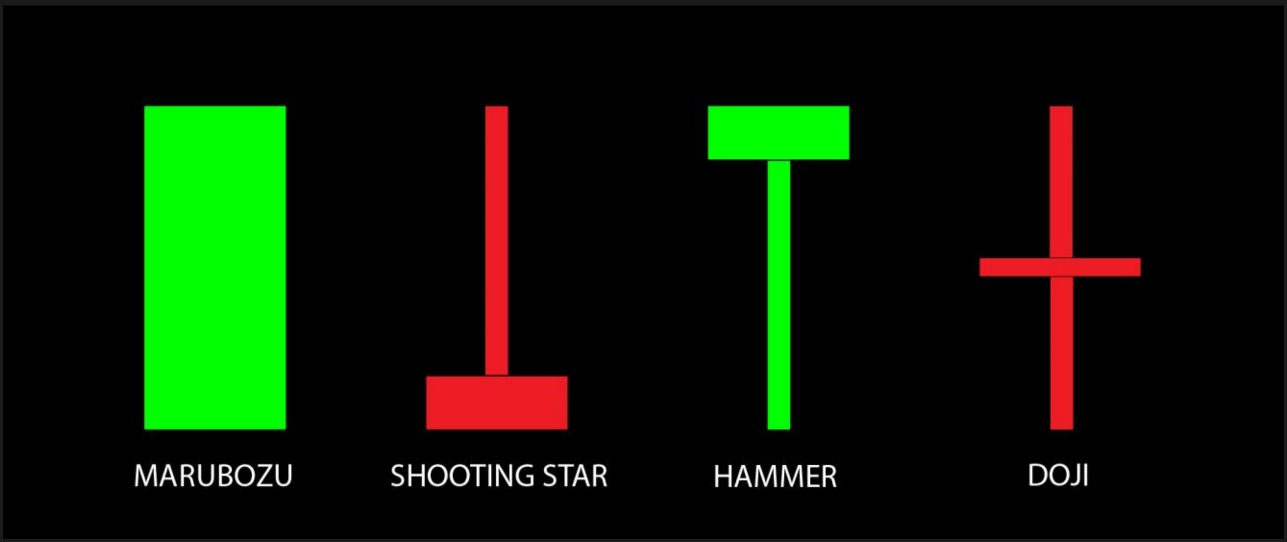
A single candlestick includes an entire trading period and to understand it, you have to pay attention to 4 key elements: **the open, high, low and close**.

- **The High is the highest price reached by the candle.** It is usually at the end of the tail but sometimes there can also be no tail and the high will be the topmost part of the body.
- **The Low is the lowest price reached by the candle.** As in the case with the high it is usually the bottom of the tail or the bottom part of the body if there is no tail.
- **The Open is the first price the candle traded at.**
- **The Close is the last price the candle traded at.**

Pro Tip: The close has much more value that the open. The majority of professional investors and traders base their decisions on the closing prices of a stock. They often wait for a close to confirm a breakout from a significant price pattern and many computer trading system, such as moving averages are calculated from closes.

The distance between the open and the close is called range and it represents the body of the candle. A green body indicates the price opened at a lower price and closed at a higher price. A red body indicates the opposite.

CANDLESTICK FORMATIONS



There are many variations, sometimes there is no body as in the case with the doji candlestick. Other times there is no wick. Each of these differences in colour, size, location, position and context reveal important information about the price action.

GUIDLINE FOR UNDERSTANDING CANDLESTICKS

1.Colour. If its green is bullish and if its red is bearish

2. Size of the body. It determines the strength. The longer the body is, the stronger the buying or selling (depending on colour) conviction will be.

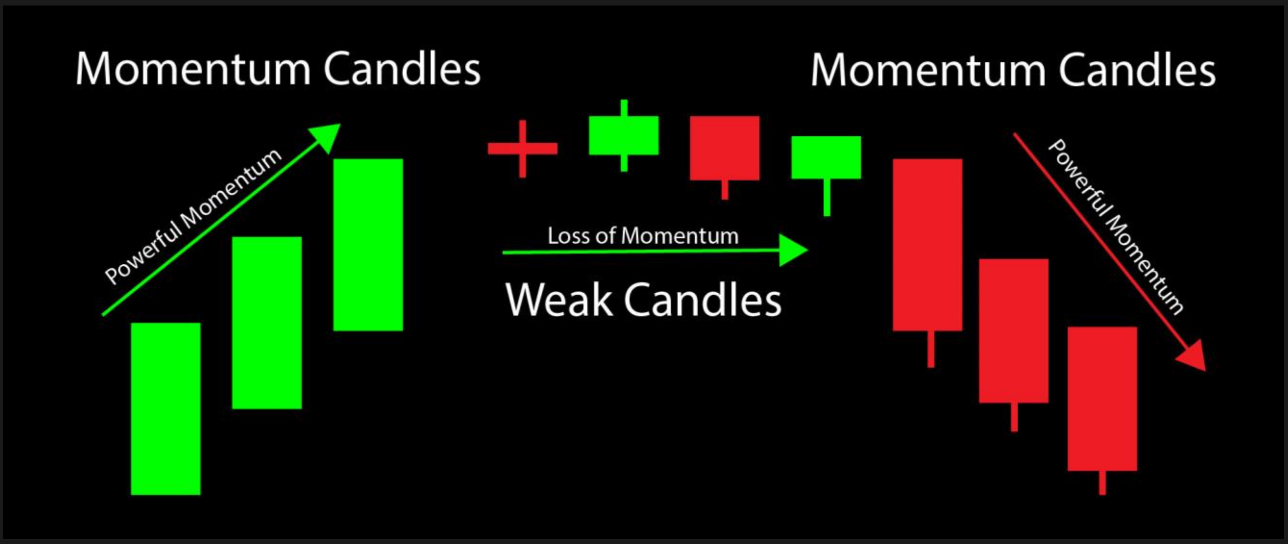
3. Location of the close. The closer the close is to the high, the more bullish it is. The closer the close is to the low, the more bearish it is.

4. Position of the candle. Similar features in different positions, uptrends or downtrends, will give different signals.

5. Relationship with other candlesticks. Context is very important and the relationship between candlesticks is very useful for a complete understanding.

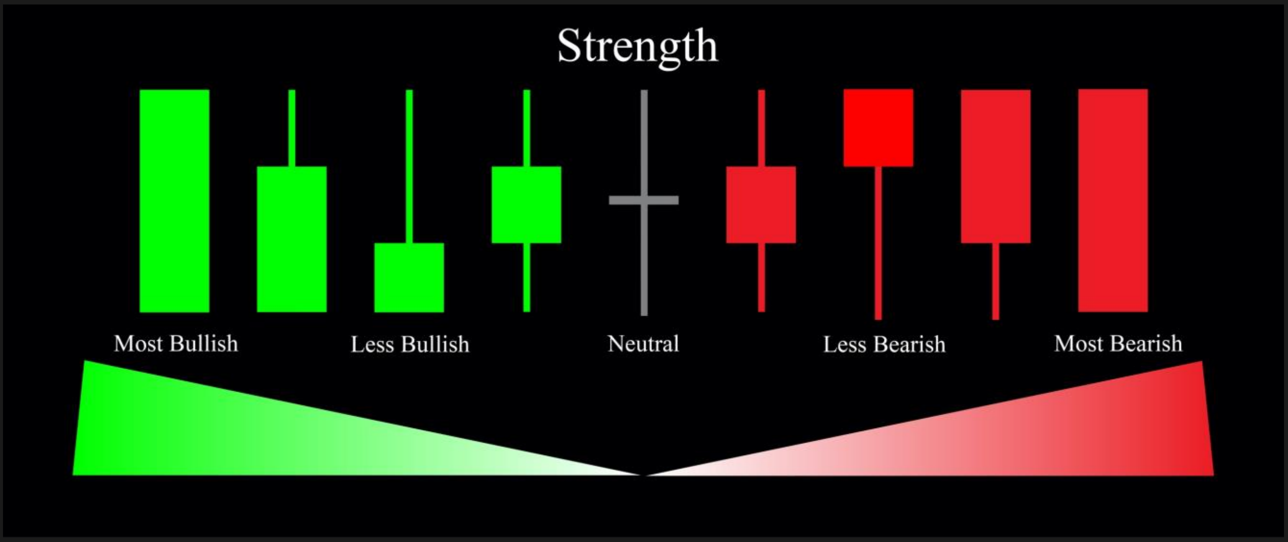
MOMENTUM AND WEAK CANDLECTICKS

To understand the candlesticks formations it's invaluable to be able to successfully asses their strength. This is done simply by noticing the dimensions of the candle. There are two main types, momentum and weak candles.



Momentum candles are the ones which move the price. Their dimensions are a reflection of where the balance of power is.

Weak candles are the ones which show signs of weakness in price. Their look is a reflection of the losses in momentum and possible changes in trends.

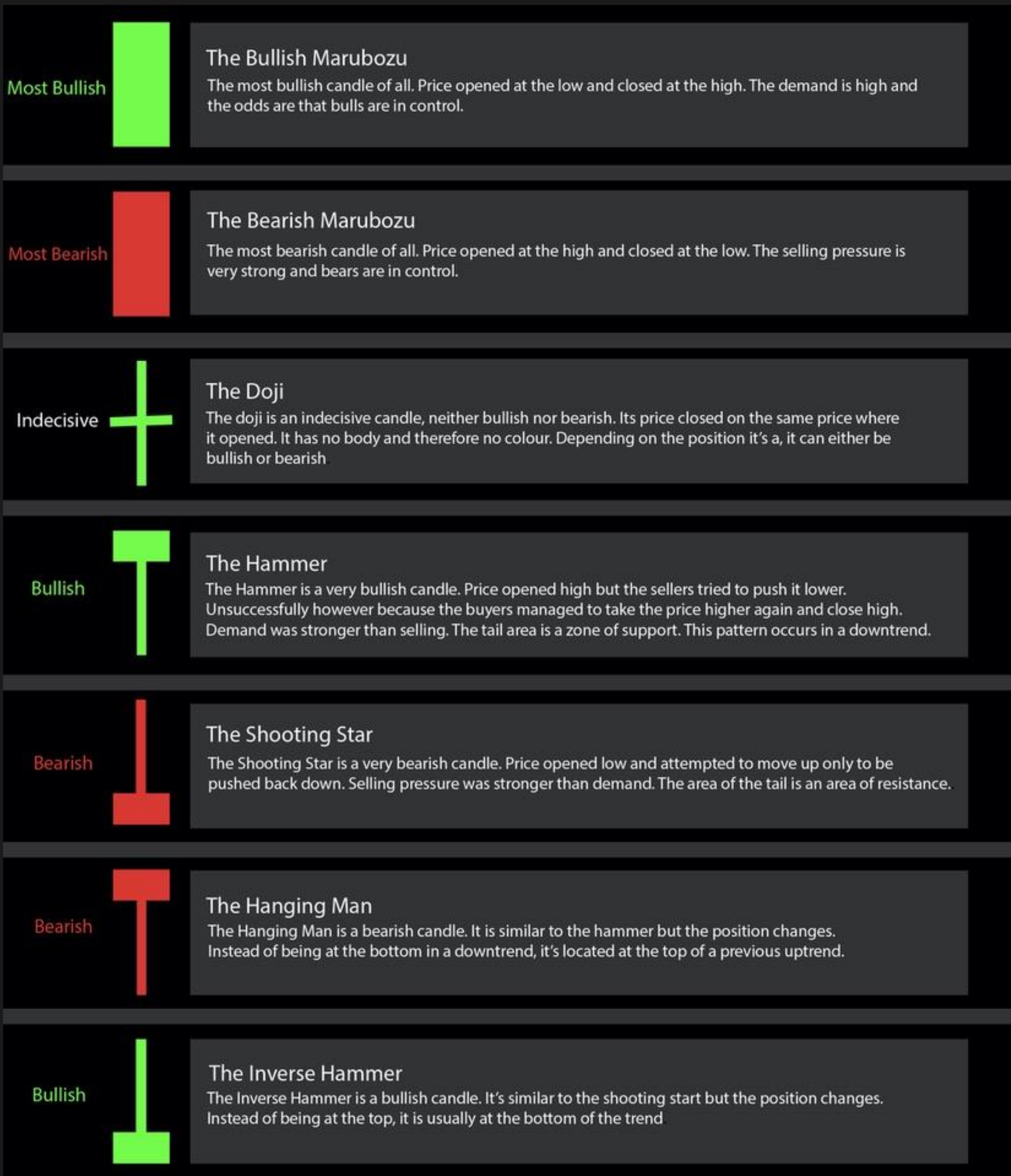


The body reflects the sentiment of the market. The shadow reflects the price extremes.

The longer the body, the stronger the buying or selling sentiment is.
The longer the shadow, the more indecisive the market is.

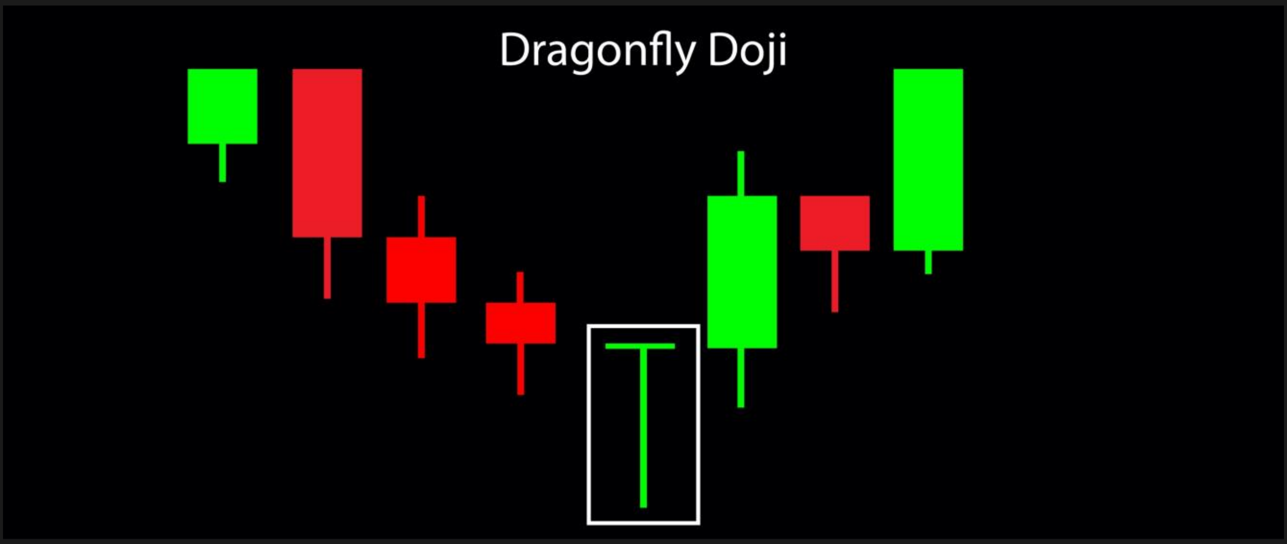
THE 7 MAIN CANDLESTICKS

These are the most frequent candlesticks one encounters in trading. The names may sound new (some are in Japanese) but they are very easy to remember once you see their features



OTHER SINGLE CANDLESTICKS

BULLISH DRAGONFLY DOJI

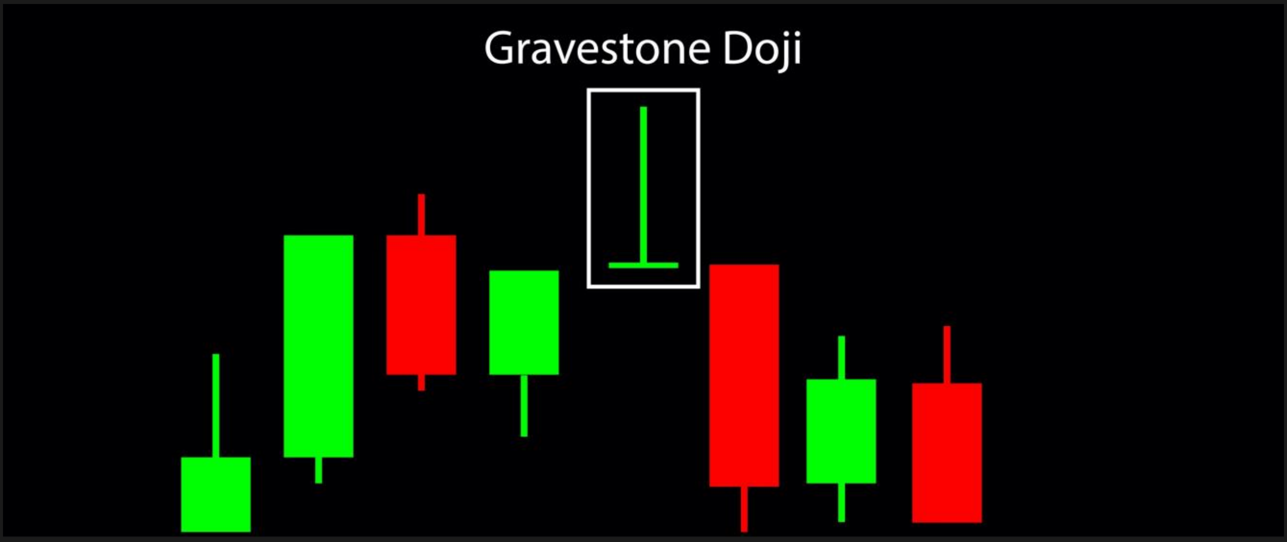


This is the bullish variation of the classical doji. This time the open, high and close are equal or very close to being equal. The price opens, goes down forming the tail, then closes back up where it opened. **Usually the longer the tail is, the more bullish the dragonfly will be.**

How to Trade It

The tail of the dragonfly doji will establish a level of support. The area around the bottom of the tail will be the support level. As long as the price does not break down below the established support area, this zone will be a great opportunity where you could open long positions. If the level is violated close your position.

BEARISH GRAVESTONE DOJI



This is the bearish variation of the classical doji. The open, low and close are equal or very close to being equal. Price opens, trades up only to return back down at the open price (which corresponds to the low) because of the selling pressure.

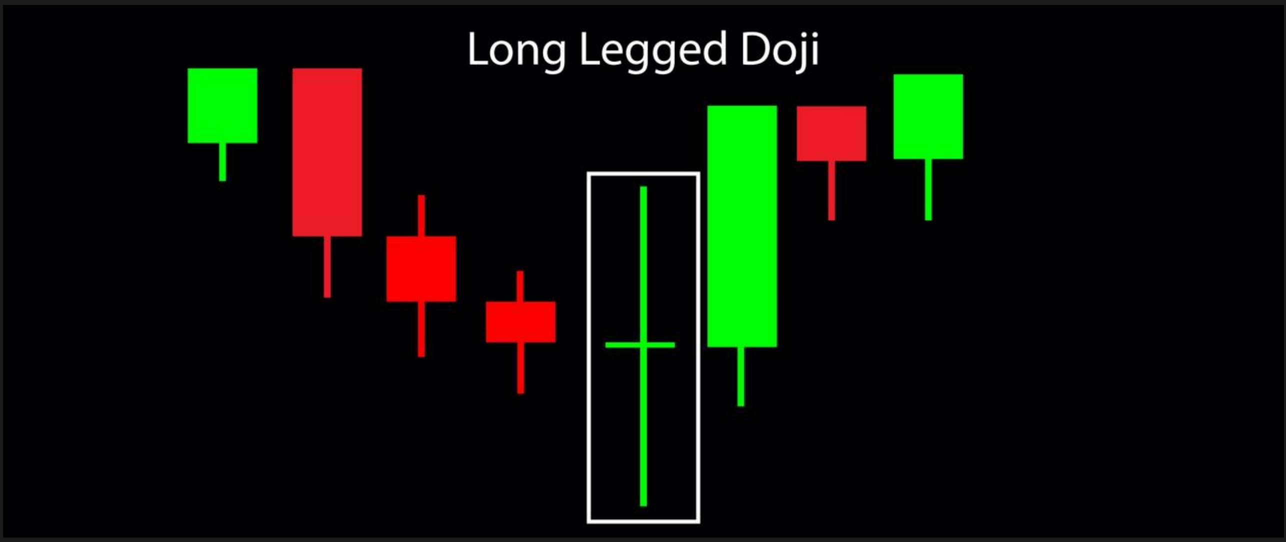
As in the case of the dragonfly, the longer the tail is, the more bearish the gravestone will be.

How to Trade It

The upper level of the tail will establish the level of resistance. When the next candles close below the gravestone, a reversal is taking place and a short position can be taken.

Word of caution: nothing guarantees the reversal will continue for long. Sometimes prices can reverse back up at any time. As always use stop loss and take profit levels.

LONG LEGGED DOJI



A reversal doji. It has a small body and very long tails on each side. The small body is located near the centre.

What it shows is indecision and uncertainty after a period when prices went in one direction. It appears when the market is not convinced of the previous trend and it usually comes before a reversal.

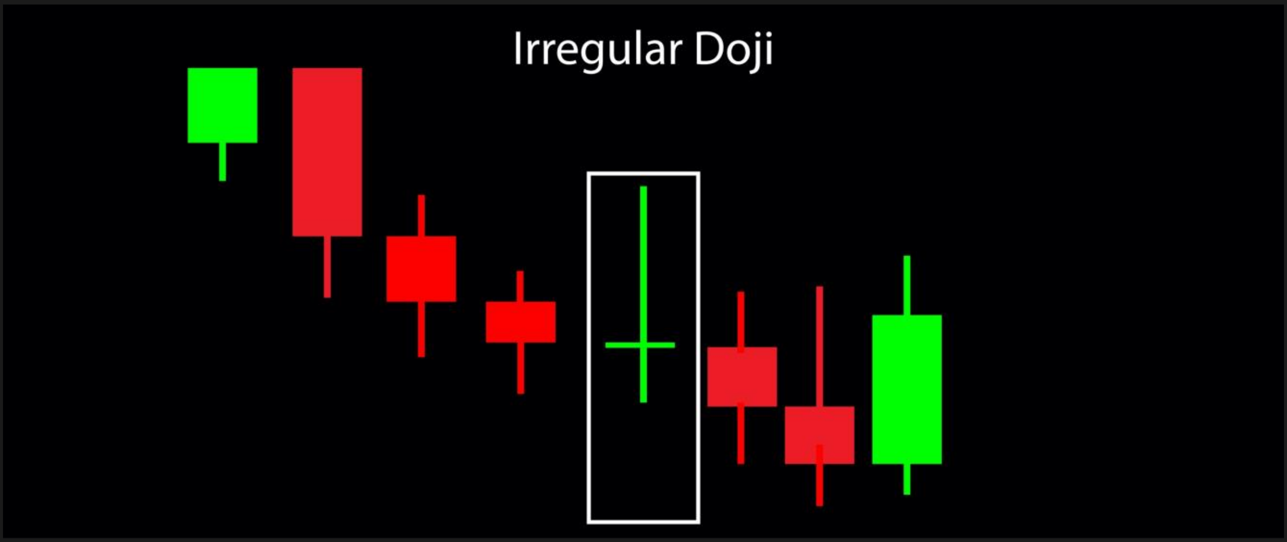
How to Trade It

Depending on where it's located, a long legged doji can signal either a buy or sell signal. If the prior trend was trending down and a long legged doji appeared, it provides a buy signal.

The faster the prices react to the upside the stronger the signal will be. If price suddenly reverses, the idea is invalidated. As always, a stop loss is essential. If the prior trend was trending up and the same doji appeared, it provides a sell signal.

Remember: Sometimes in the market there is no obvious trend. A long legged doji may appear and the best thing to do will be to do nothing. The doji is useful only when it appears in a trending market.

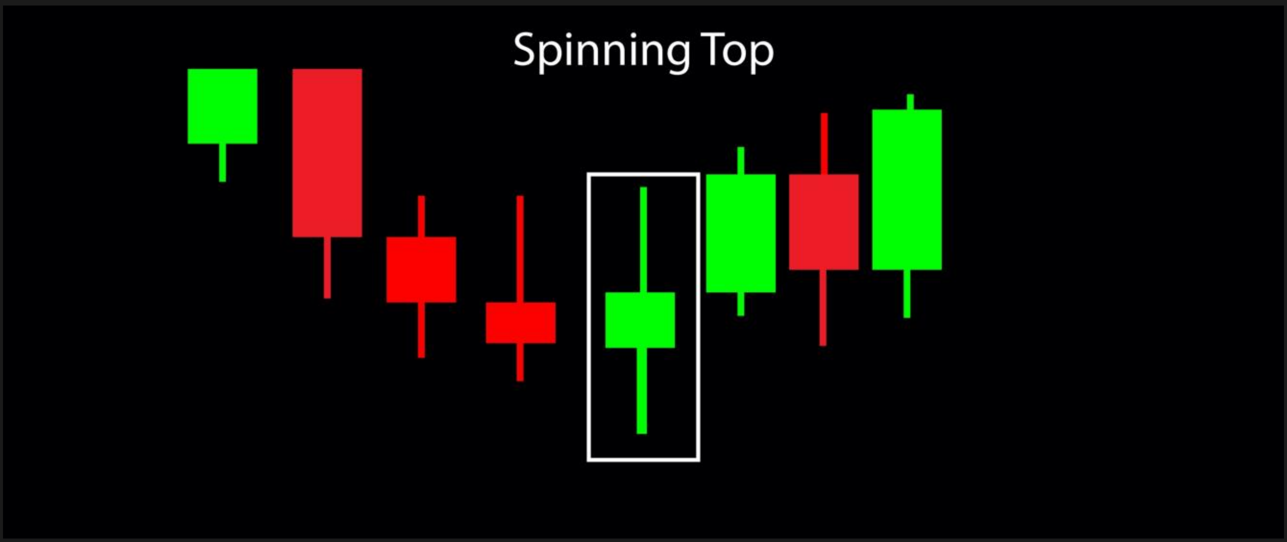
IRREGULAR DOJI



Most of the times the dojis are not perfectly symmetrical. The centre will be either moved more to the upside or the downside and the length of the tails will be different.

How can you now differentiate between buy and sell signals? The guideline on the variations should be followed. You look at the size, the position, the close and the relationship with others candlesticks. You will notice the same rules apply as for the other dojis.

SPINNING TOP



A spinning top is a candlestick with a small body and wicks which extend on both ends. The body is close to the centre of the range and the wicks are at least as long as the body.

<u>Like dojis, this formation usually appears during changes in trends</u>

How to Trade It

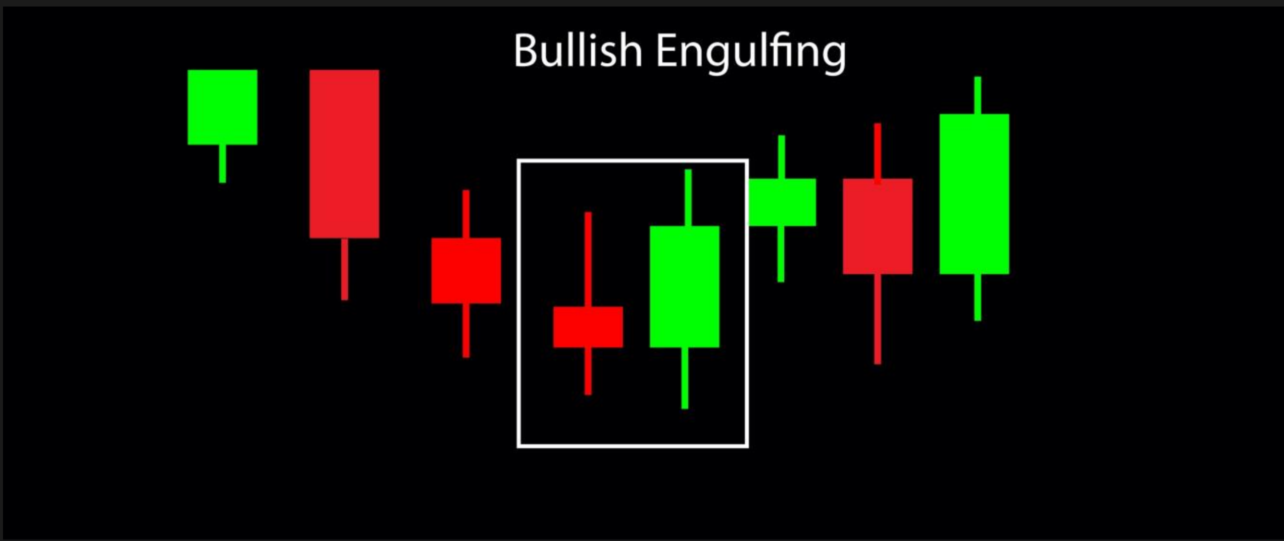
When spinning tops appear near important zones, such as resistance or support, you can enter open long or short positions. As always look at the context. If you see a spinning top on the hourly but a shooting star on the daily, you might have to reconsider your trade.

DOUBLE CANDLESTICKS

Double candlesticks are more advanced compared to single candlesticks but they can be very powerful for identifying potential reversals or continuations in trends.

When trading this pattern is useful to think of the first candle as **"the setup candlestick"** and of the second as **"the signal candlestick"**. The first you will give you the initial idea about the pattern forming and the second will give you the signal to enter the trade.

BULLISH ENGULFING

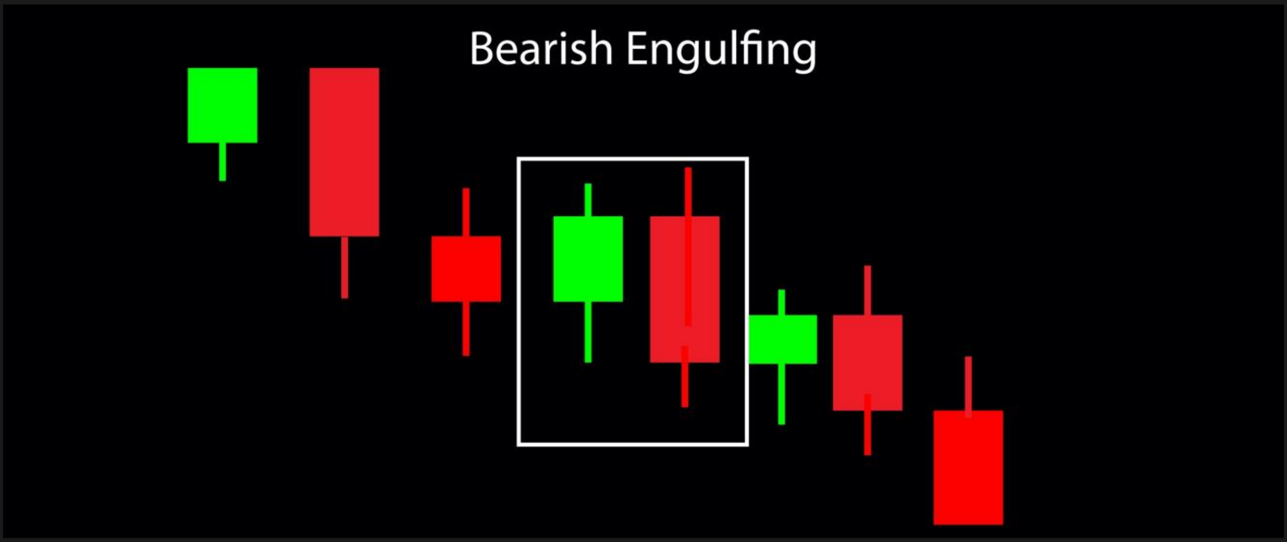


This is a bullish reversal pattern. The first candle is a bearish candle. The second candle is a bullish one which completely engulfs the first one. The body and the tails of the second covers much more ground and both the highs and lows will be higher and lower compared to the first one.

How to Trade It

When engulfing patterns appear bulls are in control of the price. The price will often be pushed higher and the profitable position will be a long one. The pattern is no longer valid when the low of the setup day is violated. Therefore, a stop loss at that level is essential.

BEARISH ENGULFING



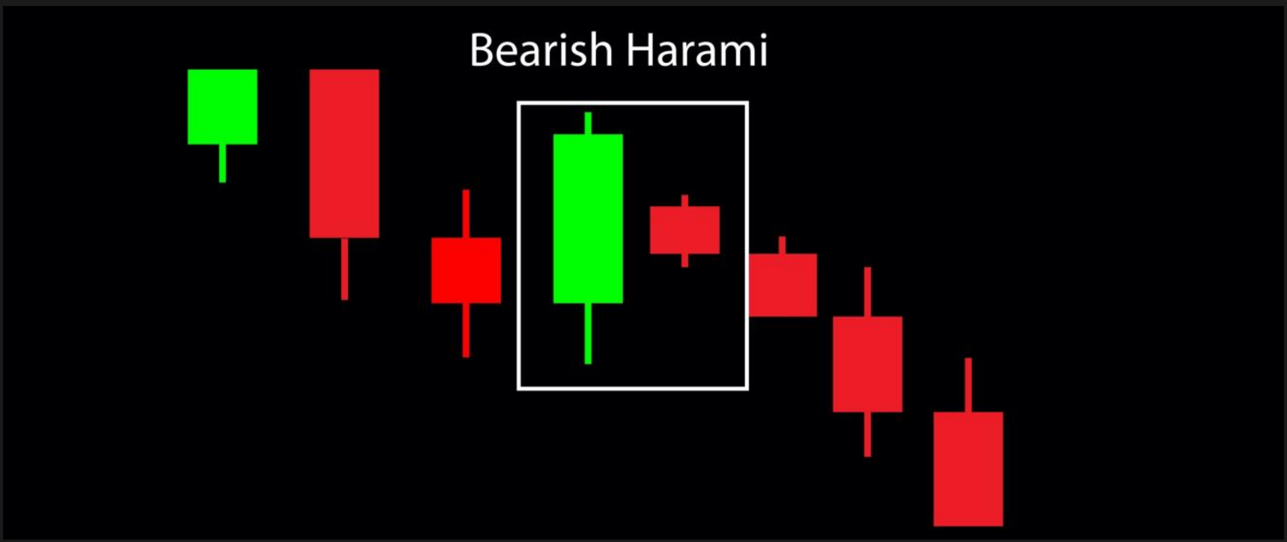
This is a bearish reversal pattern. The first candle is a bullish candle. The second candle is a bearish one which completely engulfs the first one. The bears are now in control and the trend will often reverse.

<u>How to Trade It</u>

Short position are good to catch, but **<u>keep in mind when you are shorting stocks or cryptocurrencies you are working against a general long-term uptrend</u>**. Therefore, it is my personal belief shorting should be used only at key moments and not be part as your primary way of making money trading.

Enter on the signal candlestick. Once it closes below the previous low of the first candle the selling pressure will usually be higher than demand. Place your stop loss at the open of the second candlestick.

BEARISH HARAMI



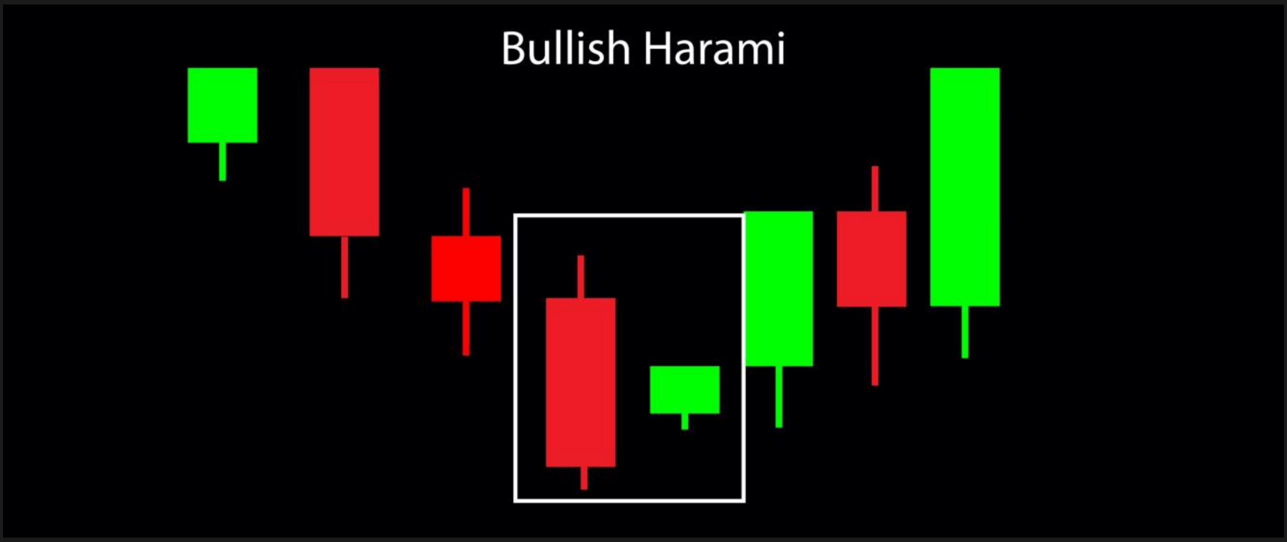
The bearish harami is a pattern where a first bullish candle is followed by a bearish spinning top. This occurs after a previous trend has been established, in this case up and the market displays uncertainty.

The small real body of the spinning top is a strong signal the bulls upward buying pressure has weakened. Therefore, a trend reversal is likely to happen.

How to Trade It

Look for a previous uptrend. When you see a bearish harami appear look out for the immediate reaction. **Fear is much stronger than greed and when prices fall, they usually do it faster and stronger than rises.**

BULLISH HARAMI



The bullish harami is a pattern where a first bearish candle is followed by a bullish spinning top. This occurs after a previous trend has been established, in this case down and the market displays uncertainty.

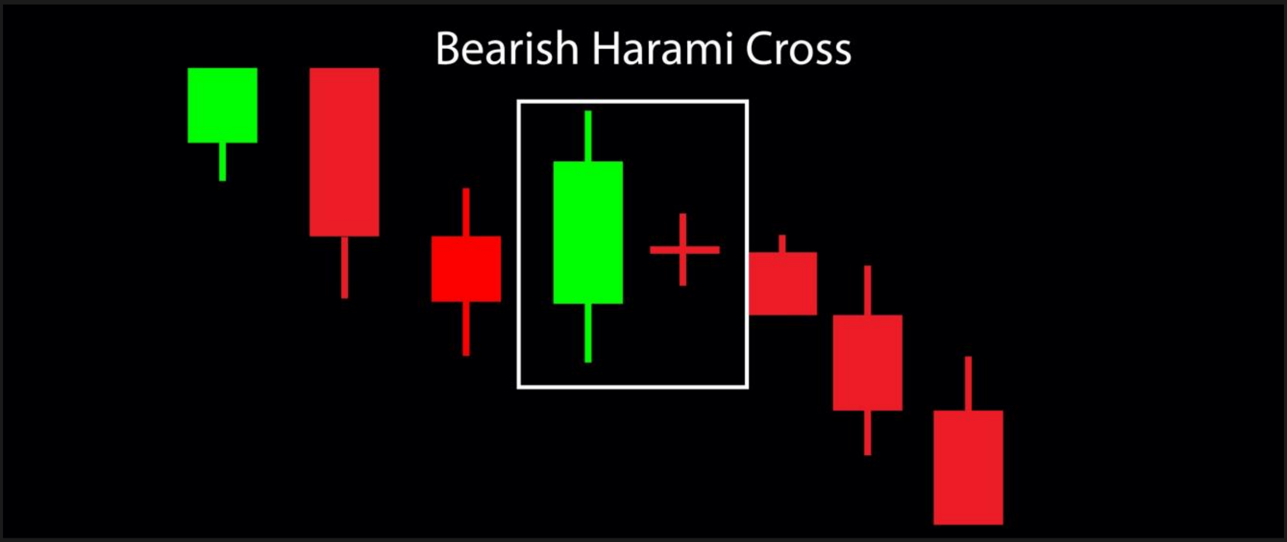
The small real body of the spinning top is a strong signal the bulls upward buying pressure has weakened. Therefore, a trend reversal is likely to happen.

How to Trade It

Look for a previous downtrend. When you see a bullish harami appear look out how the price reacts.

A thing to watch out for with the harami is that only the open and close matter. The spinning top can wick above or below the previous candle, yet this has no major relevance. What matters is how it opens and closes.

BEARISH HARAMI CROSS



Like the doji candlesticks, the harami has more than one variation. The regular harami has a tall body followed by a small body. The smaller the small body is**, the more uncertainty it signals and the more powerful the pattern will be.**

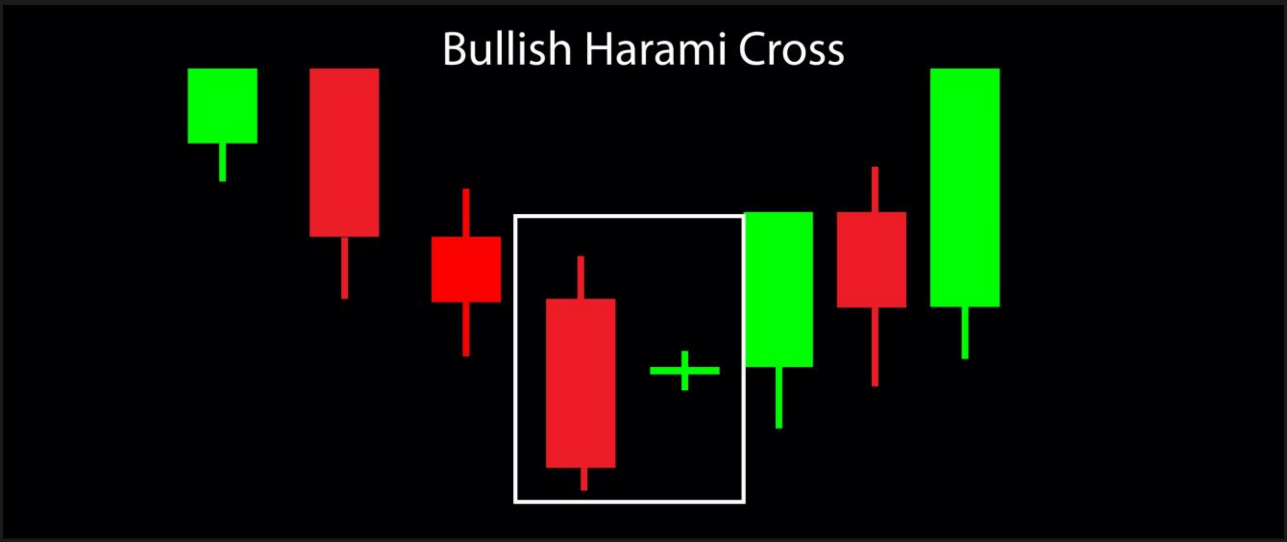
As the smaller body reduces in size it can become a doji. At this point the type of harami is referred to as a harami cross.

How to Trade It

The bearish harami is an alarm. It occurs at moments where ambivalence is present and investors don't know if the market will continue the trend. A decision will be made.

A reaction to the downside is your signal a reversal is taking place.

BULLISH HARAMI CROSS

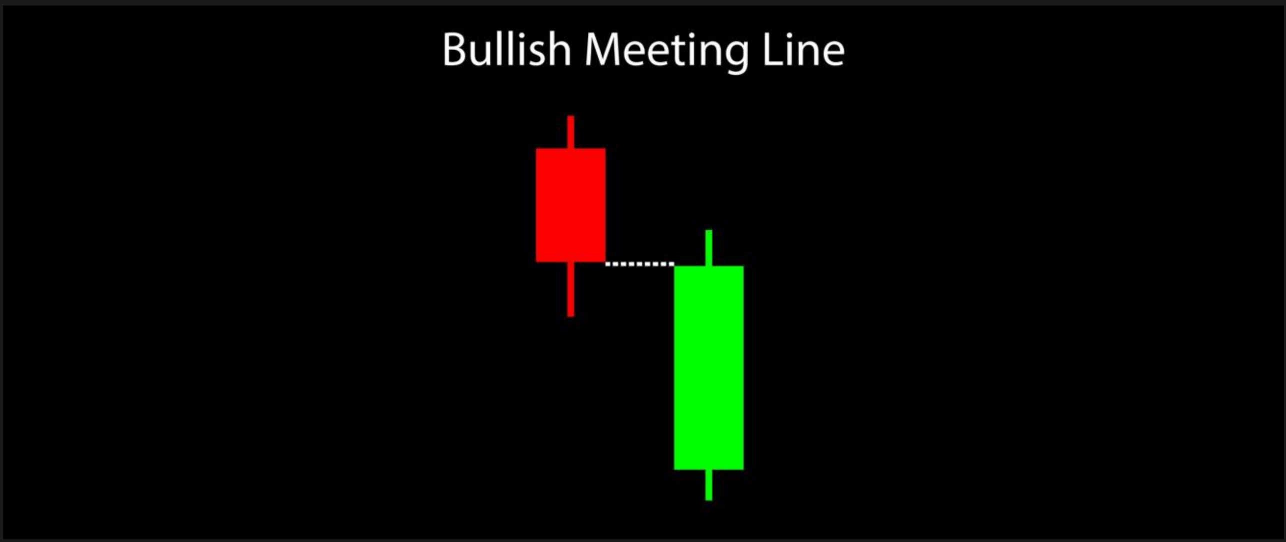


The bullish harami is the opposite of the bearish harami. It appears during a downtrend, the setup candle is a long bearish candle and the signal candle is a doji.

How to Trade It

The market will not stay ambivalent for long. Based on the strength of the next candle, it will be clear if the reversal is successful. Once there is strong buying pressure, a long position can be taken.

BULLISH MEETING LINE



This is a reversal and quite rare pattern. The setup candle is long and bearish, while the signal candle is also long but bullish.

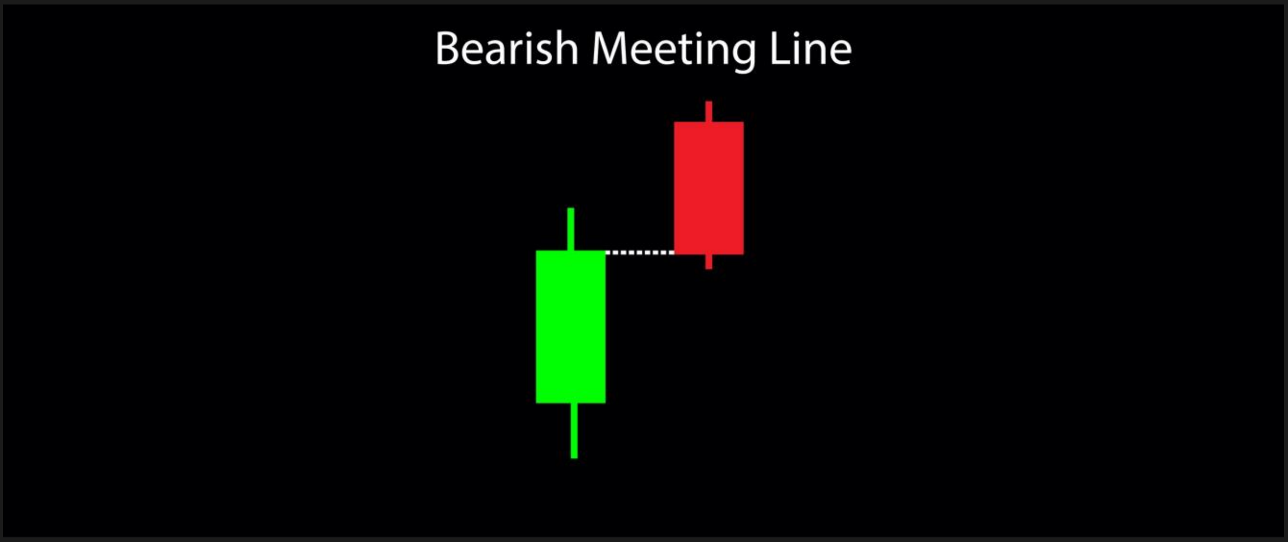
What's interesting here is that the closing prices of the two candles are equal or nearly equal. This indicates a shift in trend.

How to Trade It

Look for the next candles. In particular at how they close. If they manage to close reasonably above, a long position can be taken.

The stop loss should be placed either at the low or open of the signal day

BEARISH MEETING LINE

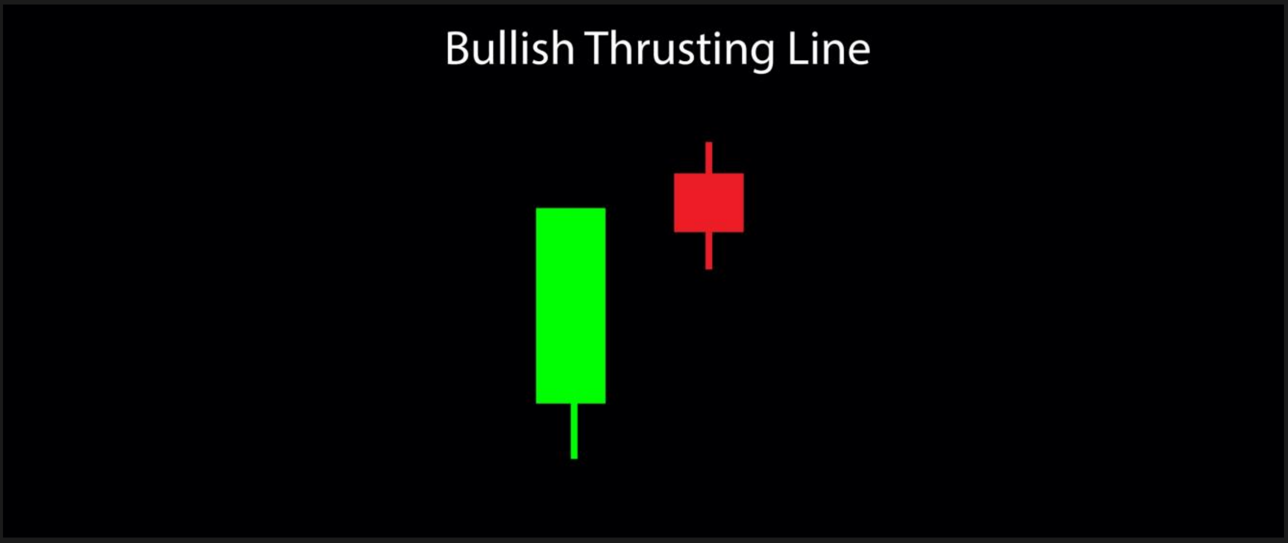


The inverse of the bullish meeting line. The setup candle is long and bullish, while the signal candle is also long but bearish.

How to Trade It

An established prior uptrend exists. You will notice than when this pattern appears the bears will push the price lower than the previous candle close and it closes near the close. The trend reversal will begin and the immediate reaction of the next candles will give you the overall market situation.

BULLISH THRUSTING LINE



Not every double candlestick pattern indicates a reversal. Some of them will reveal if the market is going to continue its trend in the same direction. The bullish thrusting line is a trend continuation pattern. It appears during an uptrend. The setup candle is tall and bullish, while the signal candle is much smaller and it will open higher, leaving a gap upside and closing it near the lows. When the close is above the midpoint, the demand is stronger than selling and the market will continue to be bullish.

How to Trade It

This pattern gives you an opportunity. Market pause. These moment of pausing are good moments to get enter long, especially when a long-term trend has been established. The stop loss should be placed on the low of the setup candle.

BEARISH THRUSTING LINE

The bearish thrusting line appears during a downtrend. The setup candle is tall and bearish, while the signal candle is much smaller and it will often open lower, leaving a gap to the downside and closing it near the lows. When the close is below the midpoint, the selling is stronger than the demand and the market will continue to be bearish.

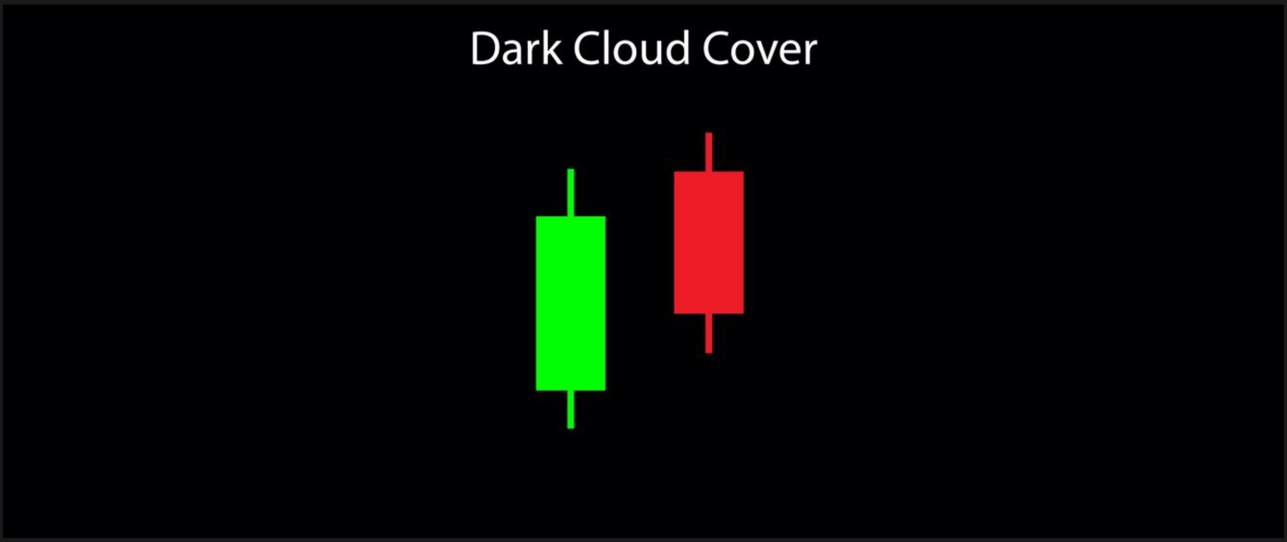
How to Trade It

The established trend should be down. The bulls may seem to succeed with the second candlestick, but if they don' t get the price close above the upper half of the previous candle, the selling is still there.

This shows that even if momentarily bears are not in control, they will come out in the coming moments.

When entering profits should be taken when a trend line has been broken and the signs of reversal start to emerge. If the next candles go above the high of the signal candle the pattern is invalidated.

DARK CLOUD COVER



The dark cloud cover is a bearish pattern. The setup candle is bullish, while the second one is bearish. Even if the second one opens higher, it quickly goes back down reaching the midpoint of the first candle and even closing below it.

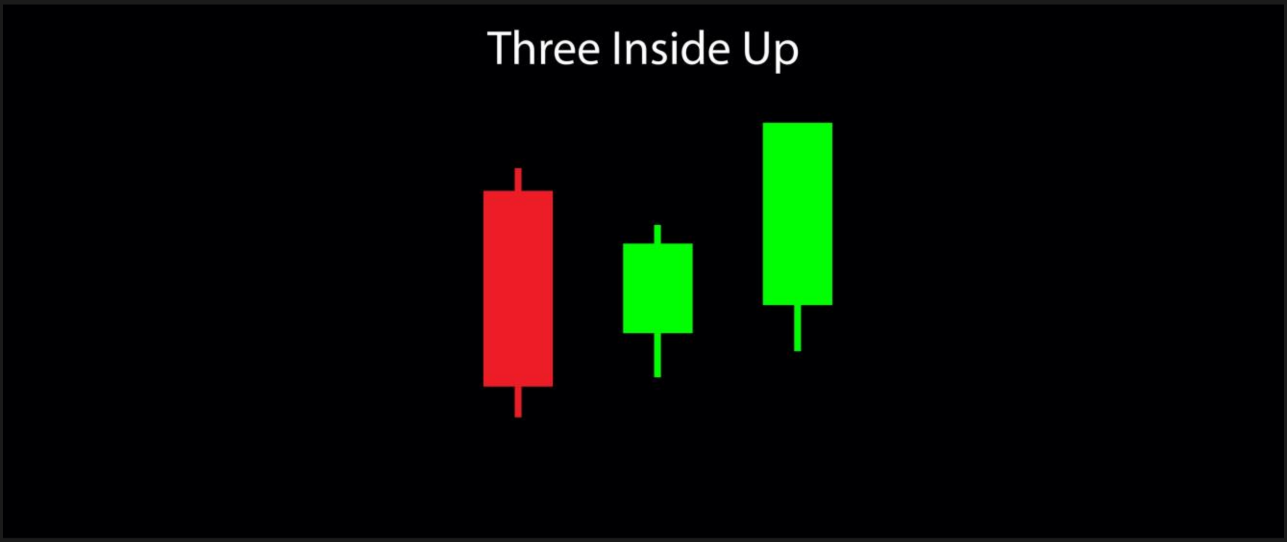
How to Trade It

The pattern is useful for entering long positions. When the signal candle closes near or above the midpoint it shows a shift in momentum is happening. Place your stop loss at the low of the signal day

TRIPLE CANDLESTICKS

Three candlesticks patterns are some of the most advanced trading pattern there are in trading. It can be a very valuable tool in your arsenal. The complexity of these patterns is higher. Often you will see a trading pattern develop with the first two candles only to be by the third candlestick.

THREE INSIDE UP

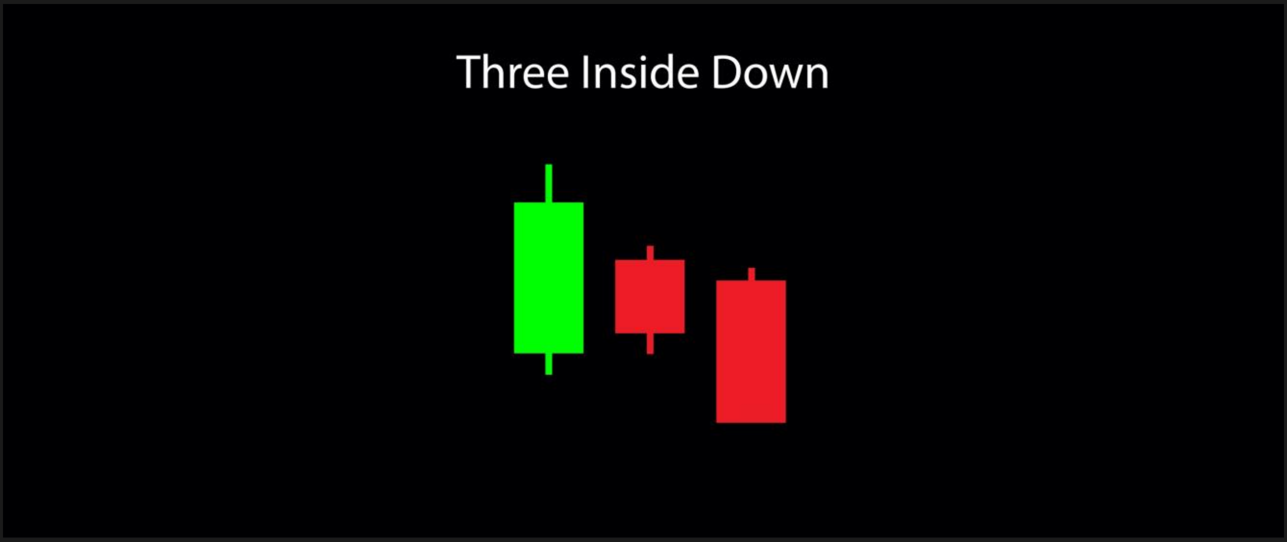


The three inside up is a bullish reversal pattern. As the name implies there are three candlesticks. The second one is an inside one relative to the first one, meaning it trades inside the range of the first one. The final candle trends up and closes above the first candle open.

How to Trade It

A very useful setup is when you spot this pattern in a market which has slowly shifted its trend. To place your stop loss either choose the open or low of the second candle. If these levels are violated the pattern is invalid.

THREE INSIDE DOWN

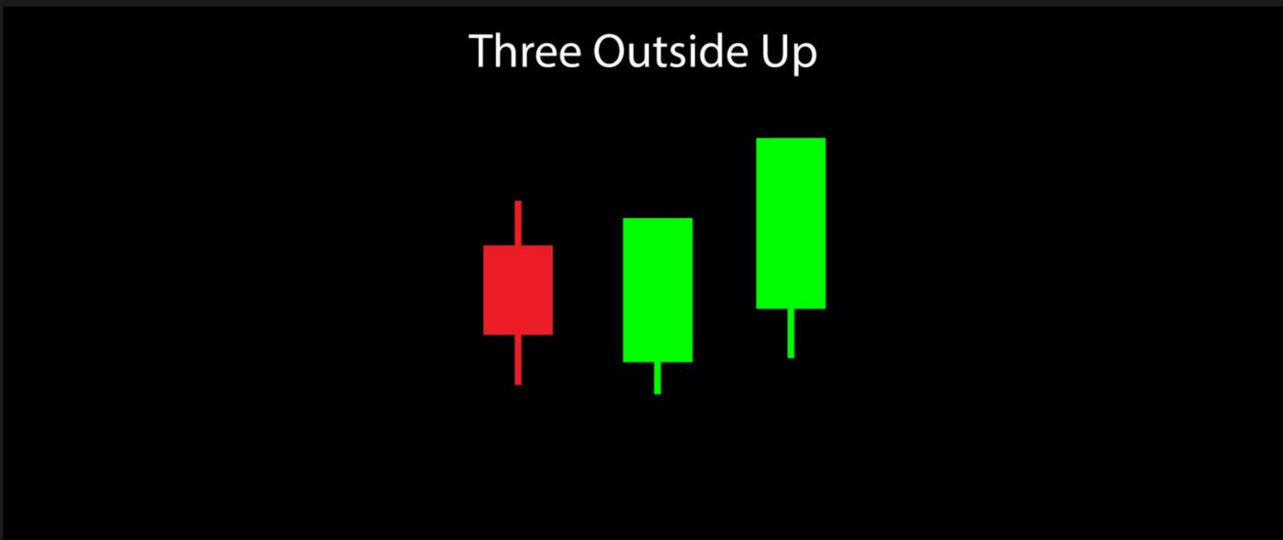


The opposite formation of three inside up. This time the second inside candle is bearish, which is bullish. The pattern is confirmed when the final candle closes below the first candle open.

How to Trade It

Enter when the previous established by the first candle are broken down by the final candlestick. Place your stop loss at the high or low of the inside candle.

THREE OUTSIDE UP



The three outside up is a bullish reversal pattern. The pattern's first candle is a bearish candle, but not by much.

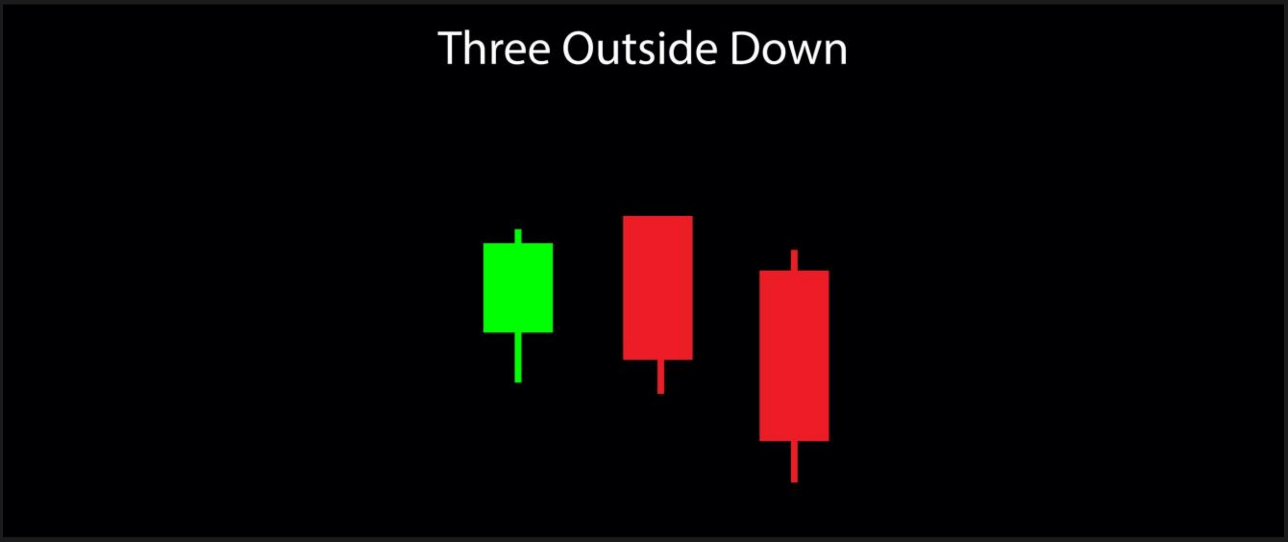
The balance has now shifted bullish.

The pattern is then completed with a final up move by the third candlestick, which closes higher than the previous close.

How to Trade It

This pattern is very useful for identifying shift in trends. Depending on the body dimensions of the bullish candles the signal of going long will vary. Watch out for price gaps. If the price suddenly moves up leaving price gaps. This can quickly reverse the momentum accumulated and turn it bearish.

THREE OUTSIDE DOWN



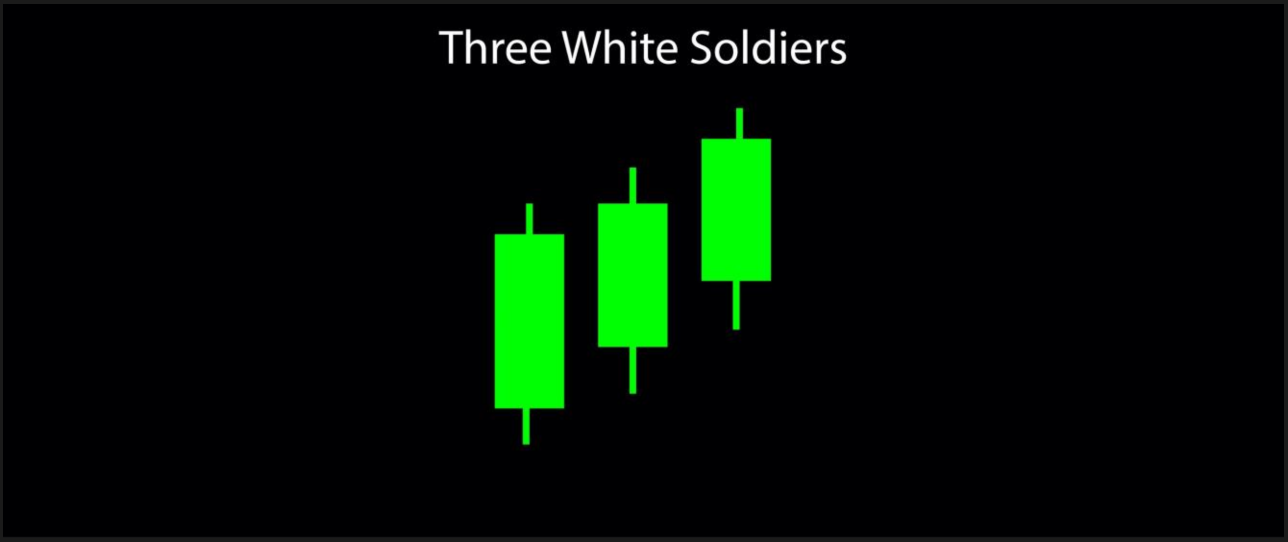
The three outside up is a bearish reversal pattern. The pattern's first candle is a bullish candle, but not by much. The second candle is an outside candle, meaning its high will be higher and its low lower. The balance has now shifted bearish. The pattern is then completed with a final down move by the third candlestick, which closes

How to Trade It

This is the opposite of the outside up. A good opportunity to enter short is near the close of the first day.

As for the stop loss choose the pattern's high or the last day high.

THREE WHITE SOLDIERS



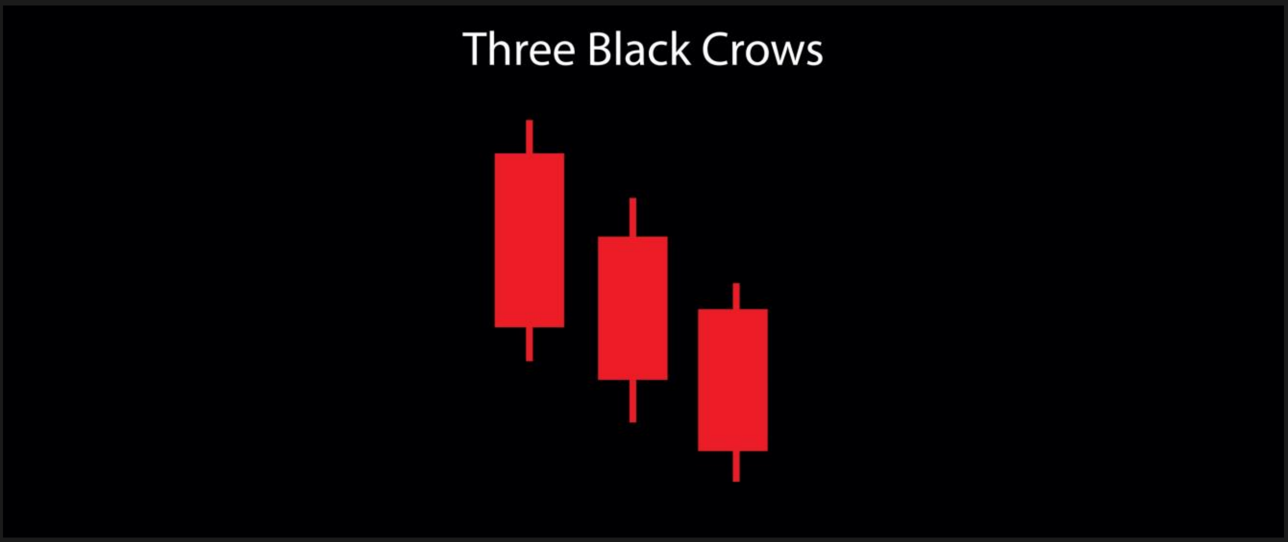
The three white soldiers are a bullish group of three consecutive candles, each one closing above the other. When this pattern appears after a period of stability in the prices, it's strong sign of a bullish trend its starting.

How to Trade It

The dimensions of the candles is very important. They should not be too overextended, otherwise the buying pressure could quickly reverse into selling pressure. Ideally the dimensions should be similar. Place your stop loss at the low of the second candle.

Be very cautious when observing this pattern after prolonged uptrends. It is usually a sign of exhaustion and it is shortly followed by a deep correction.

THREE BLACK CROWS



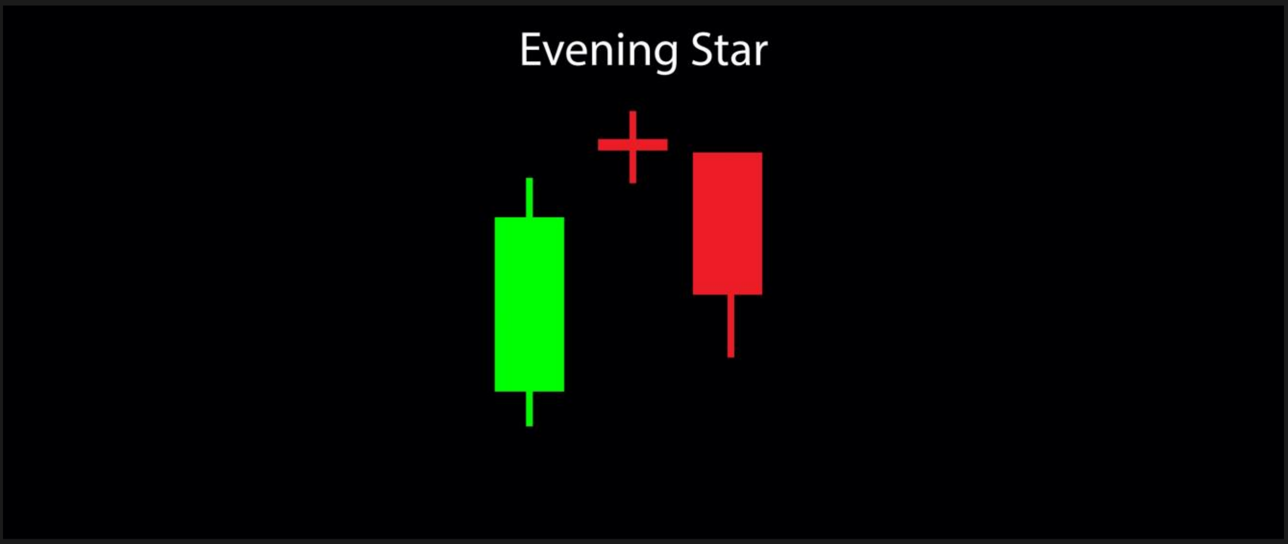
The three black crows are three bearish candles. All of them should close in proximity of their lows. Substantial downside moves occur when this pattern appears.

How to Trade It

The pattern occurs fairly quick. Down movements always happen faster than up movements. It usually leaves gaps and the price rebounds, but the momentum is not enough and it closes back down near the lows.

When you enter short place your stop loss near the highs or the midpoint of the previous candle.

EVENING STAR

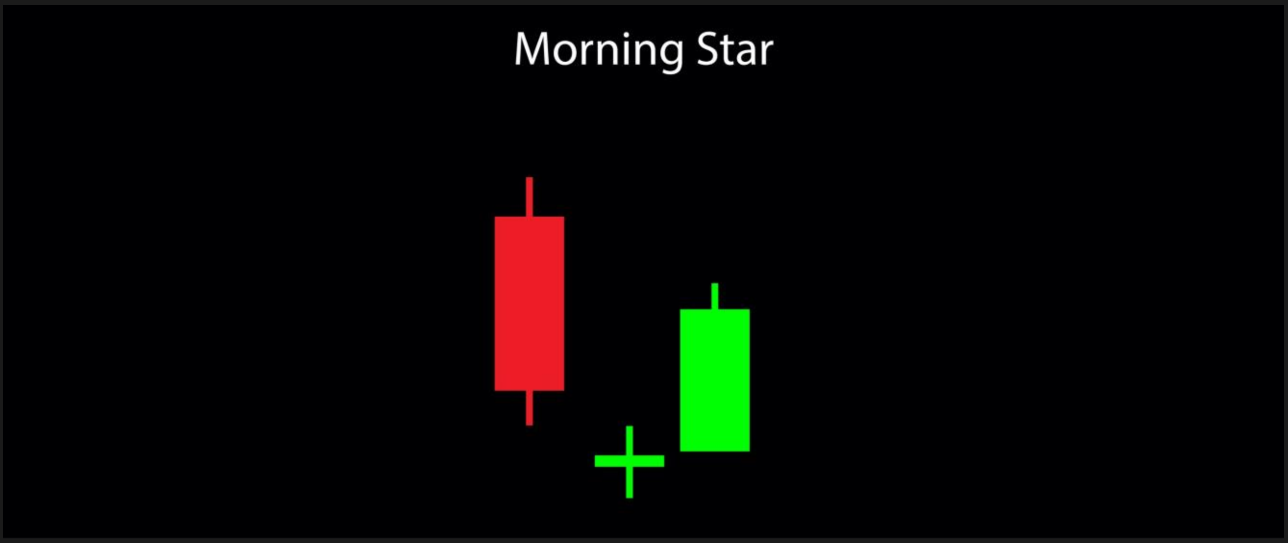


The evening star is a top reversal formation. Three candlesticks create it. The first is a long bullish body. This is followed by a gap opening and then a doji candle tight at the top. This gap attracts seller and the third candlestick which is appears is bearish and manages to close the gap pushing the prices back down

<u>How to Trade it</u>

Based on the penetration of the third candlestick, we can assess the strength of the bears. If the push down lower results in to a considerable move back down, then a short position can be opened. The stop loss should be placed near the third days high.

MORNING STAR

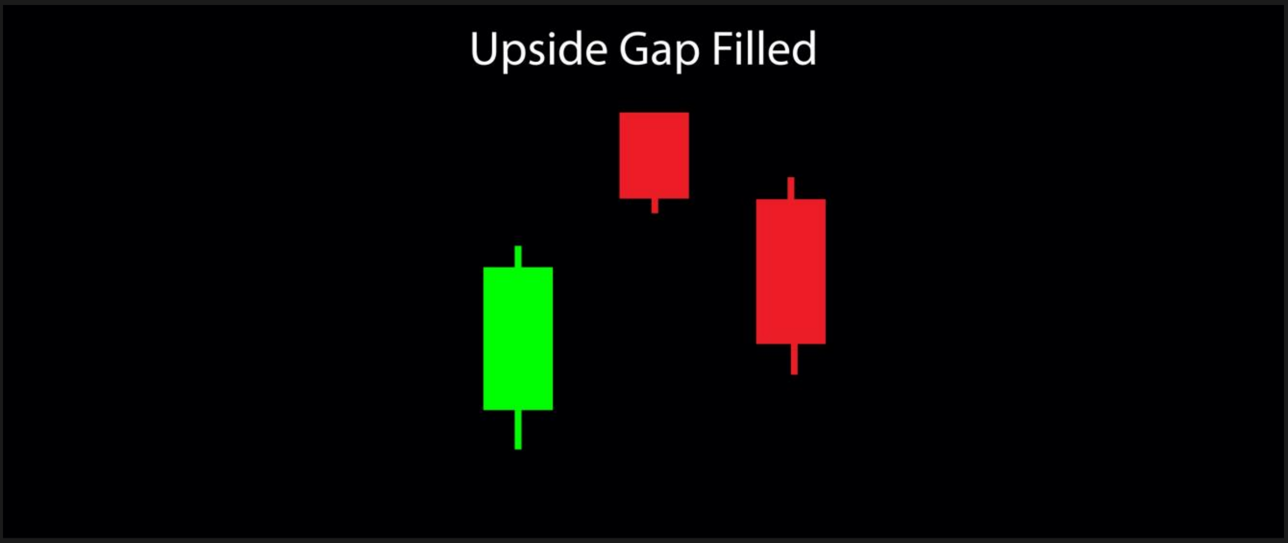


The morning star is the inverse of the evening star formation. This type of formation can establish meaningful bottoms for the price action.

<u>How to Trade It</u>

This is often a very profitable pattern. Enter near the range lows. Exit the position if the range is invalidated. The stop loss will be placed at the low of the third candlestick

UPSIDE GAP FILLED

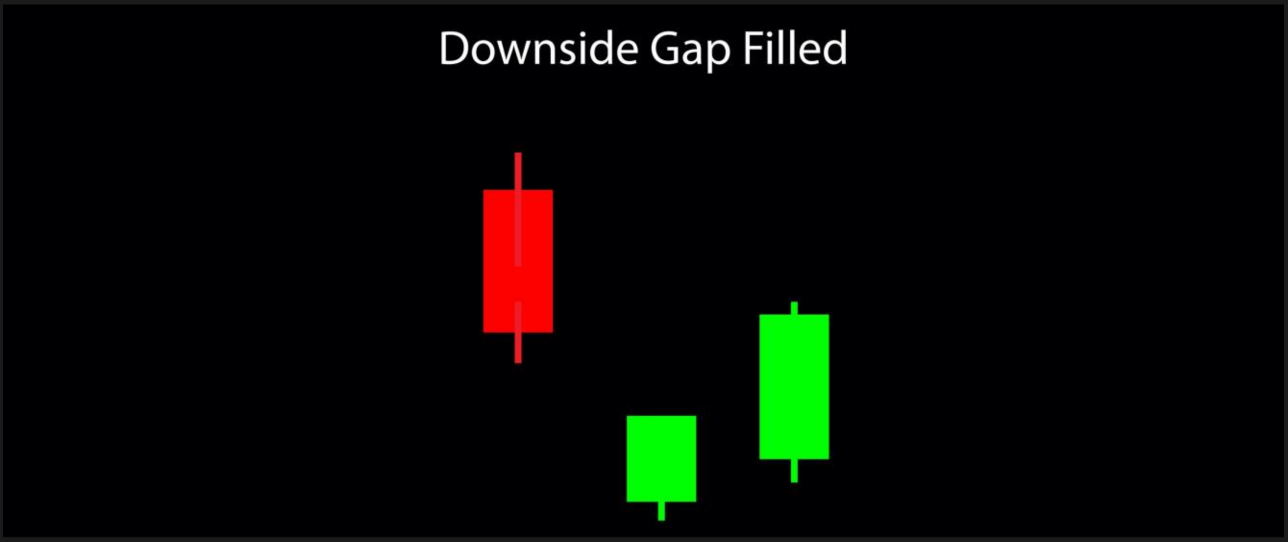


The final three bullish candlesticks formation is the upside gap filled. This pattern occurs in uptrends. Most of the times after an upside gap is filled the interest to continue back lower disappears. It's important to notice how the prices react. If there is no strong penetration of the first.

How to Trade It

Look at how the prices react, but also pay attention to the timeframe. If it quickly reverses back up you can enter a long position, but if you see the price struggle to go above this range, that's a warning signal the setup might be invalidated.

DOWNSIDE GAP FILLED



The opposite of the upside gap filled. The formation is a bearish continuation formed after a downtrend has been established. The first candle is bearish, followed by a gap in price. The gap is then filled by the third candle. However, the buying pressure of the bull is not enough to reverse and the selling continues.

How to Trade it
This is an ideal setup for shorts. Keep your position opens until the first signs of reversal start to emerge. Ideally try not to enter at strong support zones.

STOP LOSS

There should always be a price at where your idea is invalidated. The stop loss level is that price. There will always be times, no matter what system you are using, when the price will move against you. Risk management in this case is key. What's important is that you stay in the game.

FOLLOW THE TREND

Don't fight against the current. Flow with it and you will prosper in the markets. Determining where the price currently is in relation to the trend is key. Every candlestick formation should be viewed in relation to the trend. If the trend is bullish, while the formation is bearish, the probabilities of being only a small correction are very high. If you are at the end of trend, and the candlestick pattern is very bearish, then a reversal is most likely to happen.

No matter where you identify candlesticks formations, don't view them as single elements, but as connected parts of a greater whole. Look at the tress but be aware of the forest.

THE POWER OF COMBINATION

Candlesticks used in combination with volume, indicators, patterns, Fibonacci levels and cycles will take your trading to a whole other level. A complete trader integrates the best tools for each individual situation. He adapts to the market, which allows him to discover the best opportunity.

A complete trader understands nothing in the market is certain and no strategy will last forever. The best way to thrive in it is to be fluid like water. In the next chapters you will find out how the best traders are doing it.

"The consummation of forming an army is to arrive at formlessness. Victory in war is not repetitious, but adapts its form endlessly. .. A military force has no constant formation, water has no constant shape: The ability to gain victory by changing and adapting according to the opponent is called genius."

SUN TZU