Candlesticks Analysis for Forex Beginners

An edge in market reversals

About ActionForex.com

ActionForex.com was set up back in 2004 with the aim to provide insightful analysis to forex traders, serving the trading community over a decade. We started providing only a daily and a mid-day report, now known as Action Insights. Gradually, we added a lot more in-house contents to the site. Techinical Outlook section was expanded to cover more pairs. Central Bank Views, China Watch and Special Topics are added to cover fundmental developments that affect the markets. In addition to that, Top Movers, Heat Map, Pivot Point Charts and Pivot Meters, Action Bias and Volatility Charts, are tools used by traders from all over the world.

"Empowering the individual traders" was, is, and will always be our motto going forward.

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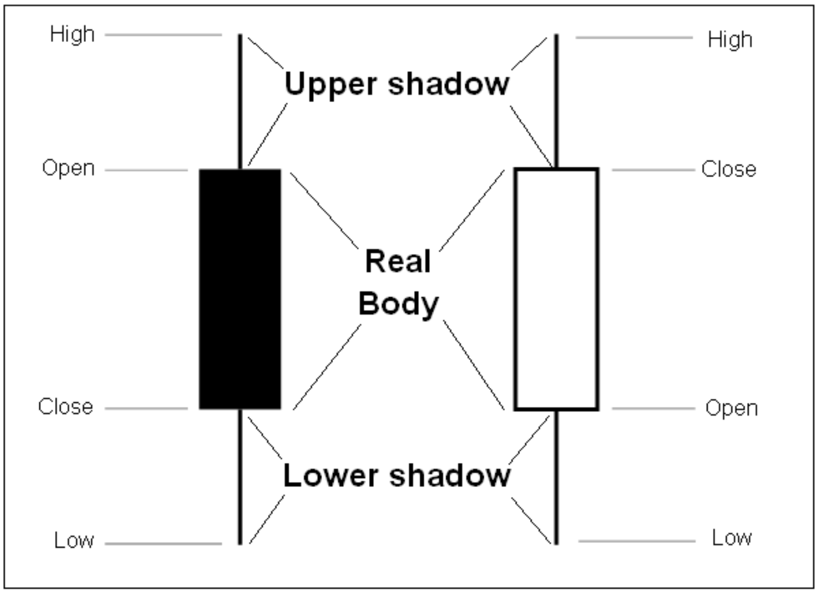
I: Introduction

Candlestick chart was developed in 1700s in Japan by a man named Munehisa Homma. Originally designed to trade rice future, he invented a method to analyze the price with an overview of the open, high, low and close prices of each trading day over a certain period of time.

A line, known as **shadow**, was drawn to show the day's price range. The broader part of the candlestick represents the area between the session's opening price and the closing price, known as **real body**.

If the opening price is lower than the closing price (i.e. a rising day), then the body is **white**; if the opening price is higher than the closing price (i.e. a falling day), then the body is **black**.



As the style of charting is relatively easier to read and understand, it became very popular. Analysts relate the chart patterns to various bullish or bearish signals, which were considered quite reliable in predicting future market directions.

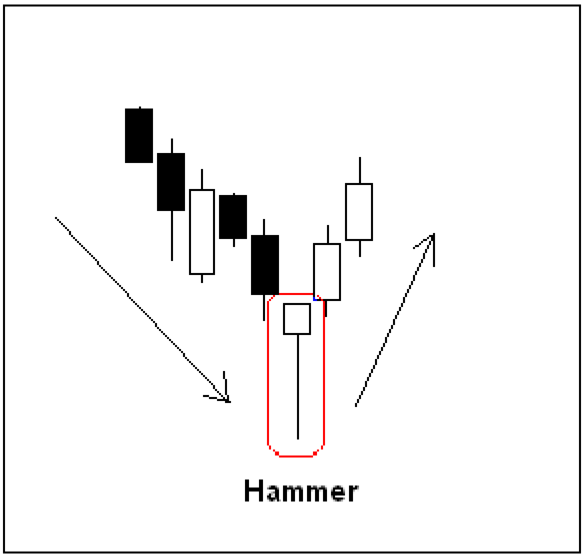
The color (white or black) and the length of the real body exhibit the market forces, whether bulls/demand or bears/supply are winning. Generally speaking, the longer body indicates the more intense in buying or selling pressure (e.g. long white candlesticks reveal strong buying interest, i.e. buyers are very aggressive) whilst shorter real body normally suggests indecisive market situation and further sideways consolidation would take place.

According to different combinations of candlesticks, various bullish and bearish patterns were found and we are going to discuss some of those major patterns here.

II: Major Bullish Patterns

Hammer

This is a single candlestick reversal pattern made up of a small real body, ideally to be white but could be black, with a long lower shadow but a very short or even non-existent upper shadow. This candlestick should be formed after a decline, the bottom of the shadow marks a new low and then followed by white candlesticks. Therefore this is grouped under bullish reversal patterns.



Doji

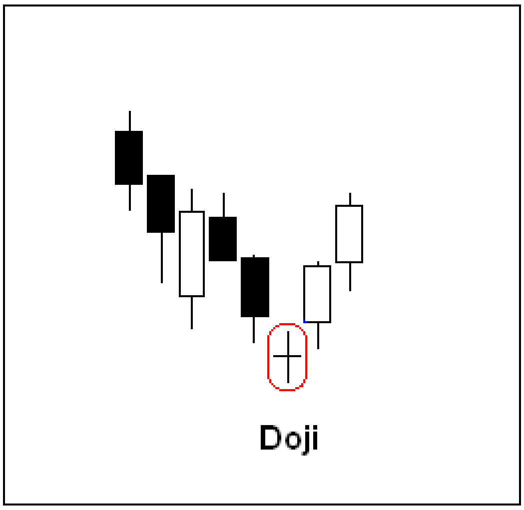
There is another single candlestick reversal pattern which could be either bullish or bearish, depending on the combinations of the preceding and the subsequent candlesticks formations.

A doji star is formed when the opening price and the closing price are virtually the same level (the word doji is actually a Japanese words '同市' which means same price level) which made no real body.

The length of the upper and lower shadows can vary and the appearance of the candlestick resembles a plus sign, a cross or an inverted cross.

One doji star alone is only a neutral pattern as it indicates a sense of indecision between the bulls and bears, whether it is going to be a bullish or bearish sign mainly depends on the prior and future price developments.

Whenever you see a 'doji' candlestick after certain trending moves, you can consider it as a warning sign or a red flag for a possible reversal and one should wait to see if there is candlestick pointing to the other direction after the doji.

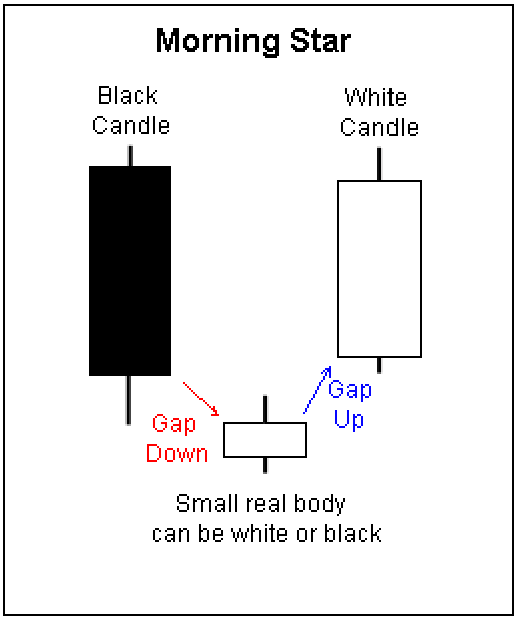


In the above example, once the white candlestick is formed after the doji, this should be treated as a confirmation and one can buy the underlying security in anticipation of a low formation.

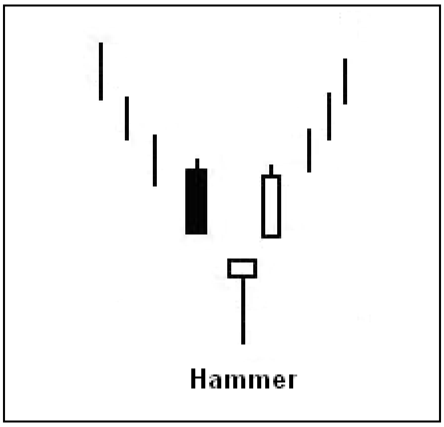
Morning star

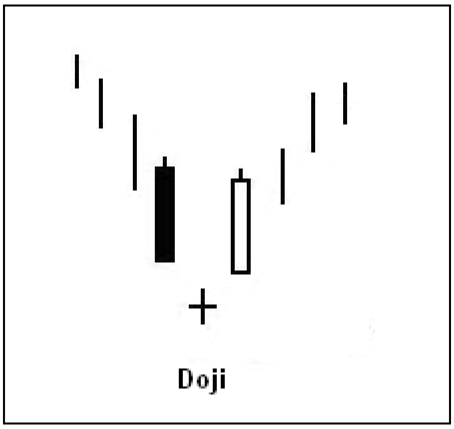
This is basically a three steps bullish reversal pattern at the bottom of a downtrend consisting of three candlesticks.

It starts with a **long real body black candlestick** after an extended downtrend. It's followed by a **small body candlestick** (could be white or black but a white body tend to have stronger indication) that gapped down on the open and closed below the low price of the previous candlestick (which make that candlestick appears isolated from prior bar). Finally, **a long real body white candle** which gapped up on the open and closed near the bar high or at least well above the mid-point of the previous black candle.



If the star itself is a hammer or doji, this normally suggests a stronger reversal signal and the subsequent impact is more likely to be bigger.



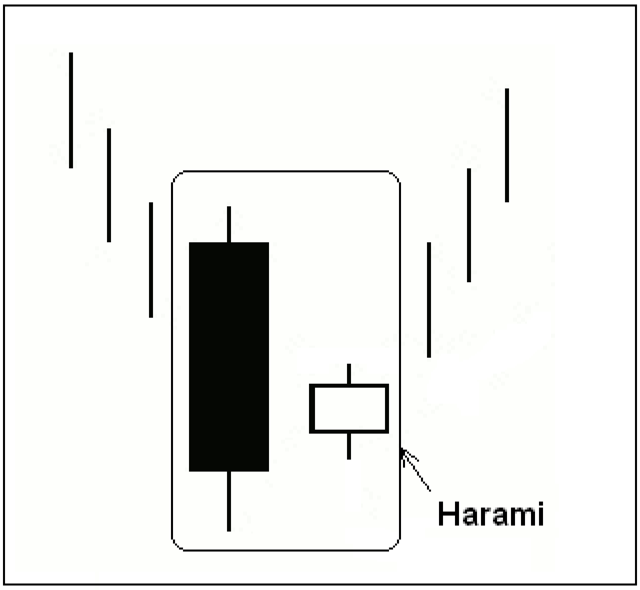


Harami

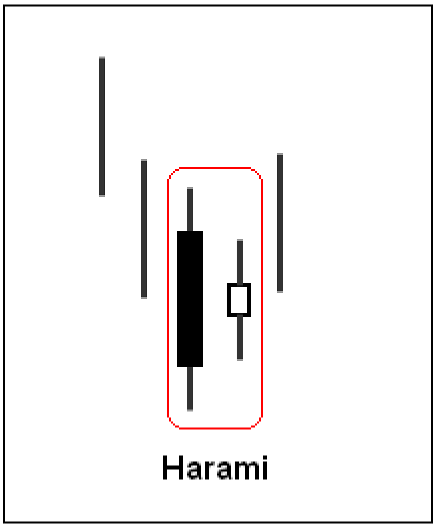
This is a two candlesticks pattern which could be either bullish or bearish depending on the combination of the prior and subsequent candlesticks development.

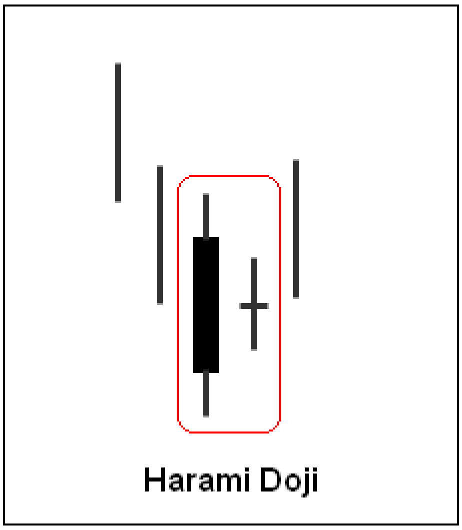
In a downtrend, after a long black-bodied candlestick hitting a new low, the second candlestick has a small white body and is completely confined within the range of the previous candle.

The Japanese word 'Harami' means pregnant, the pattern itself looks like a woman carrying a baby (needs some imaginations). The subsequent development is also important in order to provide confirmation, the candlesticks after the 'Harami' should start turning upwards, which means it should be followed by series of white candles.



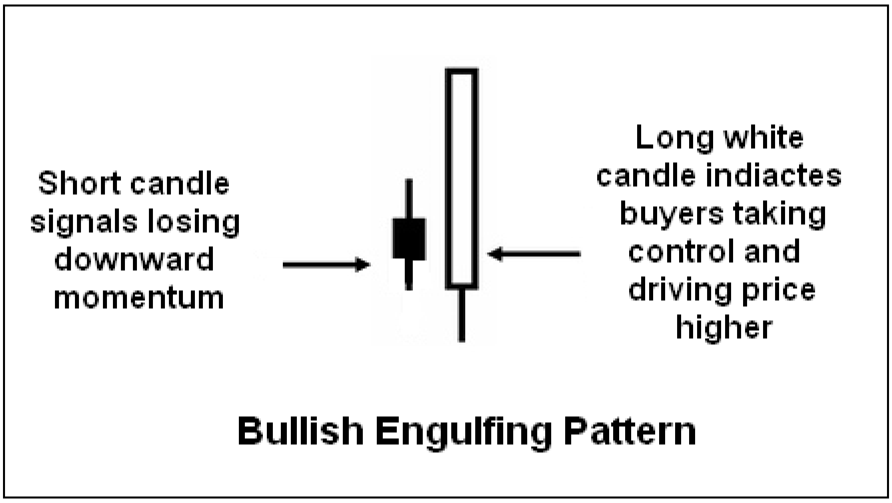
The second candlestick could appear in different forms such as doji



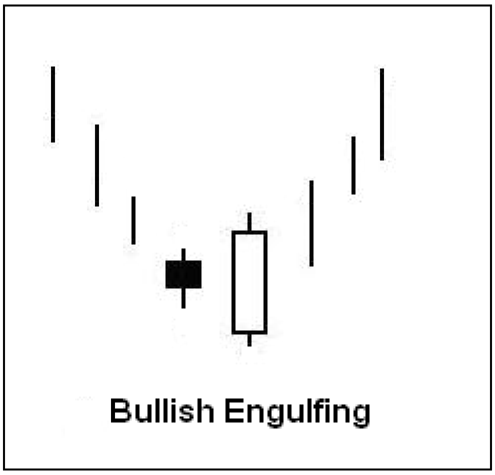


Bullish Engulfing Pattern

The Engulfing pattern is a reversal pattern which can be bearish or bullish. When it appears at the end of a downtrend, it would be a bullish engulfing pattern. The pattern starts with a small body candlestick, then followed by a candlestick whose body completely engulfs the previous candle's body as buyers outnumber the sellers, this would reflect in the chart by a long white real body candlestick.



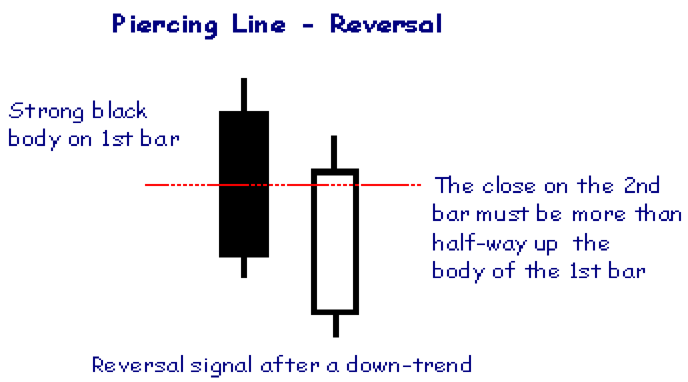
Again this pattern needs confirmation and the long white candle should be followed by series of white candlesticks to confirm a low formation.



III. More Bullish Patterns

Piercing Line

This is a bullish reversal double candlestick pattern in a falling market, it consists of a black candlestick followed by a white candlestick that opens lower than the low of preceding or below the close of the previous candlestick (i.e. gap down opening), then price closes above the middle of the previous black body candlestick.



Characteristics:

In a falling market;

1. A long black candlestick preferably closes near the low;
2. Followed by a long white candlestick which opens lower than the close of the first bar;
3. The high of second white candlestick is contained within the first black candlestick and it must close higher than the middle of the body of the first candlestick;
4. The second bar should not close above the first candlestick body.

Explanation:

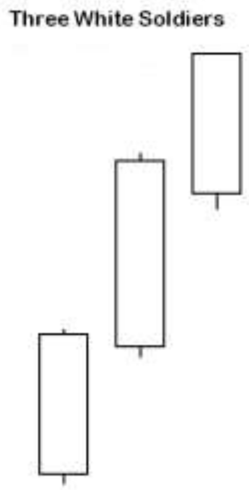
The formation basically suggests market participants are reevaluating the underlying security with potential buyer starting to consider it is undervalued and is at a good price to build long positions.

Confirmation:

In order to confirm a low formation or reversal, one needs to see another long white candlestick or a large gap up on the next trading day

Three White Soldiers

The bullish Three White Soldiers (also known as Sanpei) is one of the triple candlestick patterns which consists of three white candlesticks (preferably to be long) with consecutively higher closes. Each candlestick opening below previous close and the closing prices are near to or at their highs. When this pattern appears after market has been staying at a low price for too long, it will be considered as a bullish reversal signal which treated as an indication of the end of a downward trend.



Characteristics:

1. In a falling market;
2. Three consecutive white candlesticks, preferably long ones;
3. Each candlestick forms new high;
4. The opening price of each candlestick is within the body of the prior bar;
5. Each candlestick closes near or at its highs

Explanation:

This pattern normally appears after a prolonged period of downward trend or low price. Market is still near the low or bottom has already been formed, upward attempt by the bulls and the three consecutive white candlesticks indicate they are winning with higher highs and closing prices near the highs. This forces the bears to cover their short positions which also help pushing price further north.

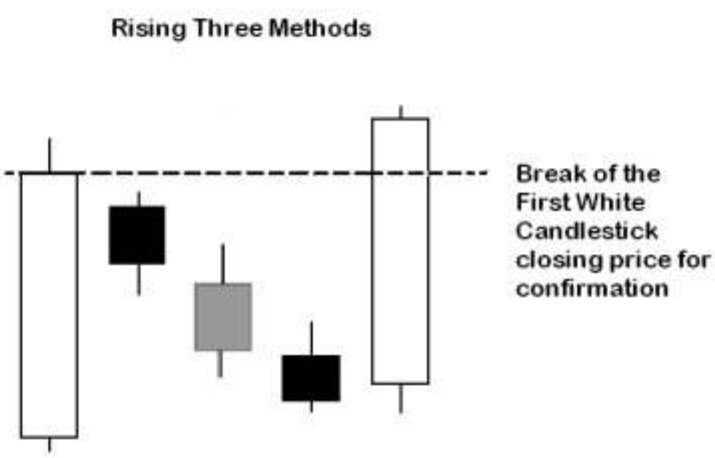
Confirmation:

Since after the completion of this patterns, price will already be quite far from the bottom and the pattern itself consists of 3 long white candlesticks, one should see oscillators e.g. RSI to rise above 50 and gap-up or addition long white candlesticks should also serve as a confirmation.

Rising Three Methods

In Candlestick charting analysis, most patterns are reversal patterns, bullish or bearish. There are only only a few continuation patterns. Heere is one which is considered quite reliable by traders.

The pattern begins with a long white body candlestick followed by three small body candlesticks (mostly black but the one in the middle could be white) and ended with another long white body candlestick. The three small body candlesticks are confined within the range of first white candlestick, indicating the market is taking a pause due to uncertainty after a strong rise (to consolidate). The fifth candlestick brings resumption of the uptrend with a closing price well above the high of the first white candlestick.



Characteristics:

1. In a rising market;
2. Start with a long white candlestick;
3. Followed by 3 small body candlesticks, could be in both colour but the pattern tend to be stronger if they are all black, all three bars should stay within the range of the first white candlestick (including the shadows;
4. Price holds above the low of the first bar and the fifth bar is another long white candlestick, opening above the close of the fourth candlestick and closing at a new high above the top of the first bar.
5. Although this pattern mostly consists of five candlesticks, some leeway can be given with the middle three small bodies could go up to four or even five.

Explanation:

A typical consolidating pattern after a sharp move, market is taking a pause. Bulls are building up new long positions with bears giving their last attempt to fight back. When price couldn't drop below the low of the first bar, bulls take over again whilst bears give up.

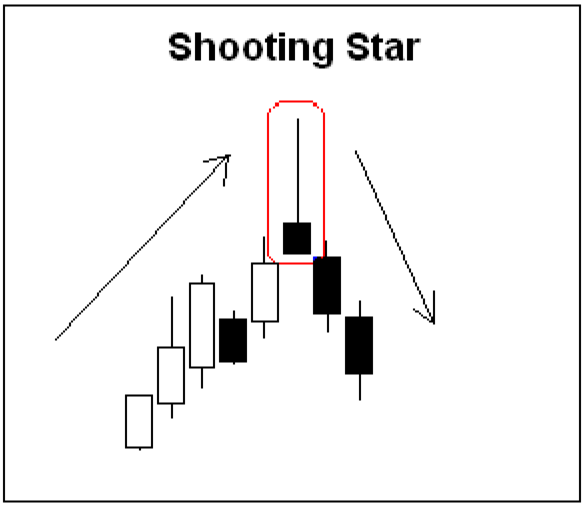
Confirmation:

1. Low of the first white candlestick must remain intact
2. The break of the closing price of the first white candlestick should be treated as the first confirmation and with the fifth bar closes well above the top of the first bar, that is final.

IV: Major Bearish Patterns

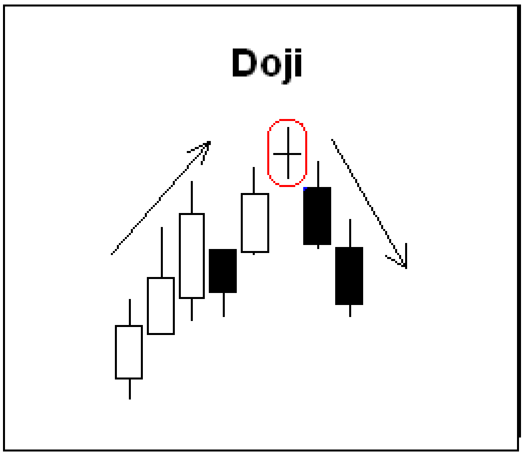
Shooting Star

This is a single candlestick reversal pattern made up of a small real body, ideally to be black but could be white, with a long upper shadow but a very short or even non-existent lower shadow. This candlestick should be formed after an uptrend, the top of the shadow marks a new high and then followed by black candlesticks. Therefore it is grouped under bearish reversal patterns



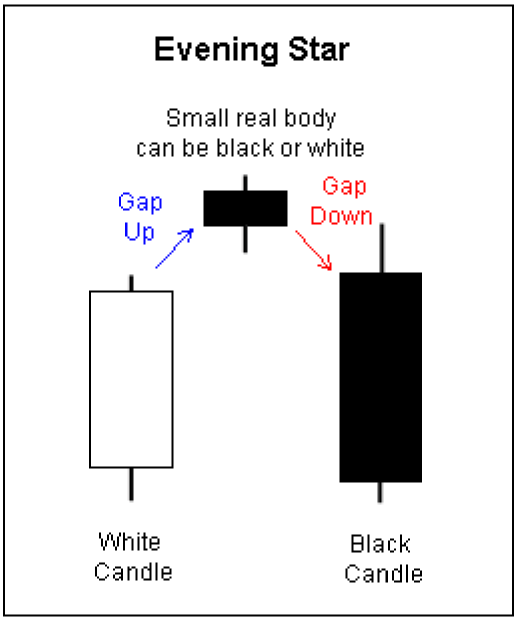
Doji

The characteristics of a doji top are similar to the doji bottom as explained earlier, only in different direction.

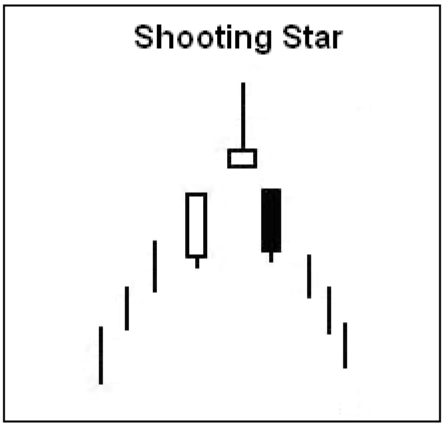


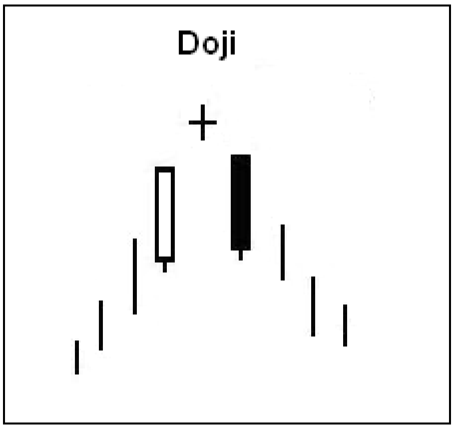
Evening star

This is a three steps bearish reversal pattern at the top of an uptrend, just like the Morning star pattern, consisting of three candlesticks, starting with a long real body white candlestick after an upmove, a small body candlestick (could be black or white but a black body tend to have stronger indication) that gapped up on the open and closed above the high price of the previous candlestick (which make that candlestick appears isolated from prior bar), finally a long real body black candle which gapped down on the open and closed near the low or at least well below the mid-point of the previous white candle.



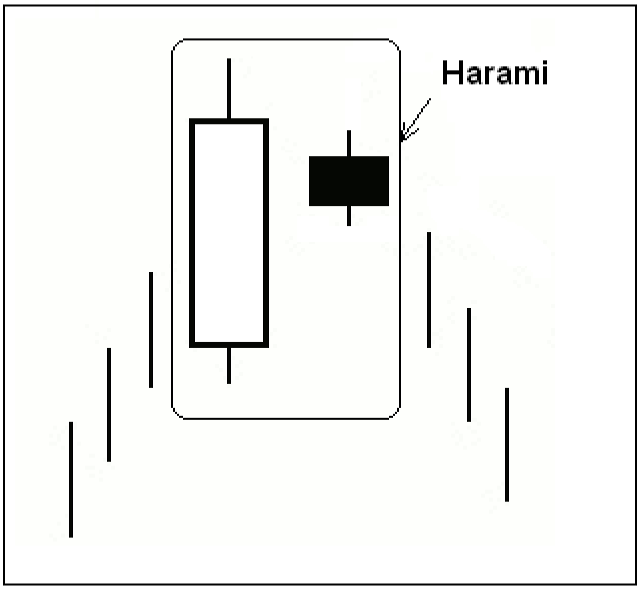
If the star itself is a shooting star or doji, this normally suggests a stronger reversal signal and the subsequent impact is more likely to be bigger.



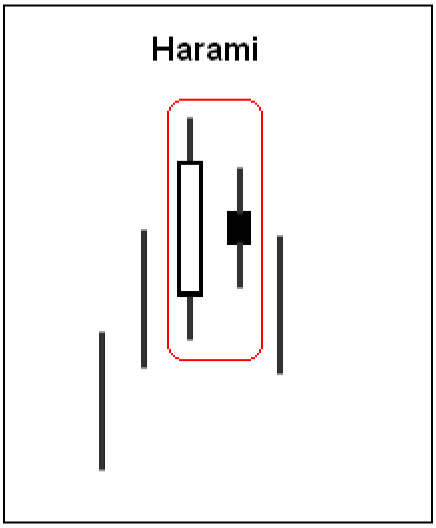


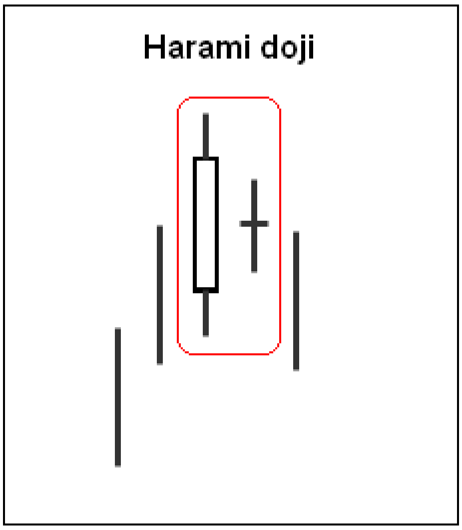
Harami

This is s two candlesticks pattern as indicated previously in the Harami bottom. In an uptrend, after a long white-bodied candlestick hitting a new high, the second candlestick has a small black body and is completely contained within the range of the previous candle. The subsequent development is also important in order to provide confirmation, the candlesticks after the 'Harami' should start turning downwards, which means it should be followed by series of black candles.



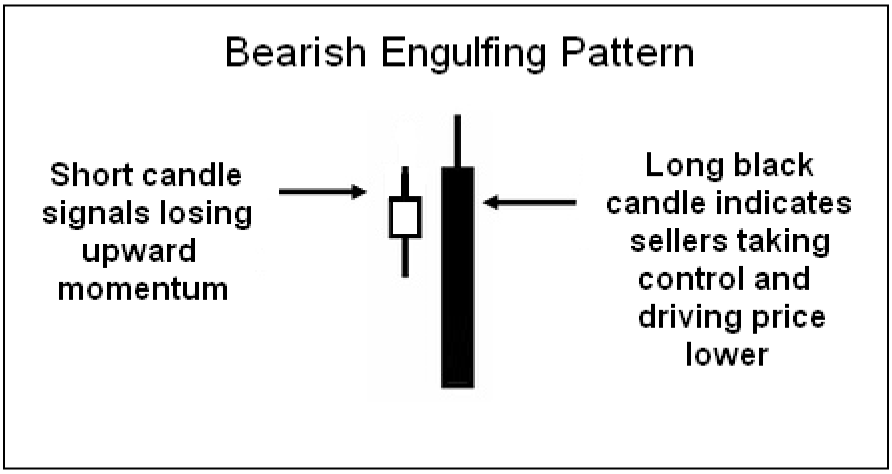
The second candlestick could appear in different forms such as doji



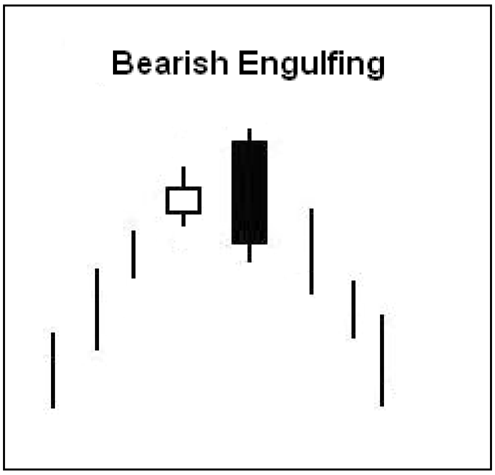


Bearish Engulfing Pattern

This is a reversal pattern that appears at the end of an uptrend, which starts with a small body candlestick, then followed by a candlestick whose body completely engulfs the previous candle's body as sellers outpace the buyers. This would reflect in the chart by a long black real body candlestick.



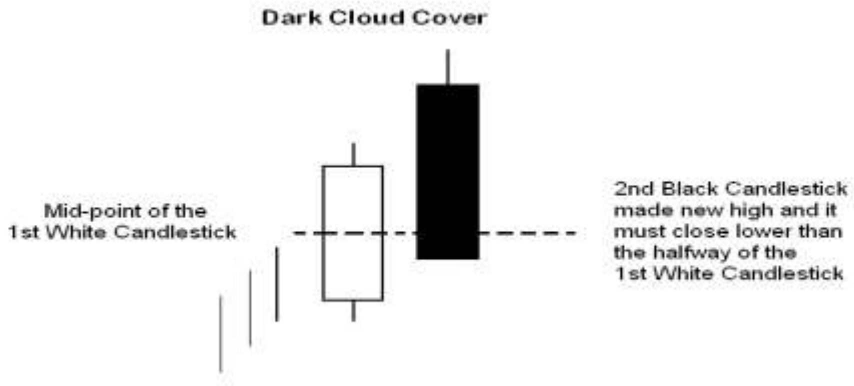
Again this pattern needs confirmation and the long black candle should be followed by series of black candlesticks to confirm a top formation.



V: More Bearish Patterns

Dark Cloud Cover

This is one of the double candlestick bearish reversal patterns, it consists of a long white candlestick followed by a black candlestick which opens above the close of the white candlestick or more ideally opens at a new high, i.e. gap-up, and then closes below the mid-point of the body of the first white candlestick. It is considered as a bearish reversal signal during an uptrend.



Characteristics:

1. In a rising market;
2. A long white candlestick preferably closes near the high;
3. Followed by a long black candlestick which opens higher than the close of the first bar, preferably opens at new high;
4. The low of the second black candlestick is contained within the first white candlestick and it must close lower than the middle of the body of the first candlestick;
5. The second bar should not close below the first candlestick body

Explanation:

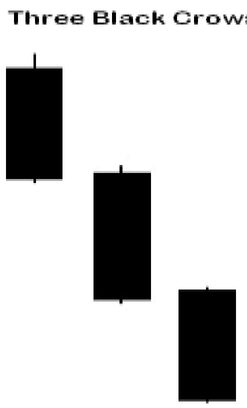
In a rising market, it seems like the bulls are taking control and after a rising day, price opens higher or gap up. However, the upmove does not continue and price quickly turn around to close near the low. In a way, the pattern suggests the market is rejecting that high but in a less dramatic way like the shooting star which finishes the whole process within 1 day.

Confirmation:

In order to confirm a top formation or reversal, one needs to see another long black candlestick or a large gap down on the next trading day

Three Black Crows

The bearish Three Black Crows is one of the triple candlestick patterns which consists of three black candlesticks (preferably to be long) with consecutively lower closes. Each candlestick opening above previous close and the closing prices are near to or at their lows. When this pattern appears after a prolonged period of high price, it will be considered as a bearish reversal signal which used as an indication of the end of an uptrend.



Characteristics:

1. In a rising market;
2. Three consecutive black candlesticks, preferably long ones;
3. Each candlestick forms new lows;
4. The opening price of each candlestick is within the body of the prior bar.
5. Each candlestick closes near or at its low.

Explanation:

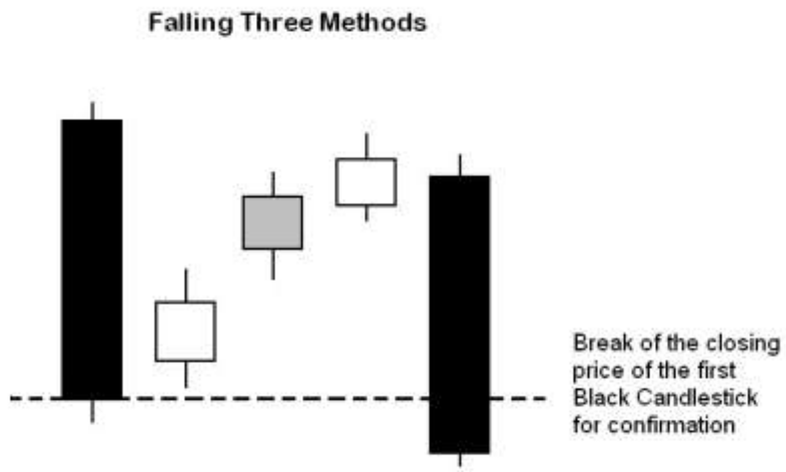
This pattern mostly happens after the market has been hanging at a high price for long time. Market is still near the high or top has already been formed. Bears are testing the supports and the three consecutive black candlesticks indicate they are having the edge with series of lower lows and closing price near the lows. Normally bulls will rush covering their longs which put extra pressure on price.

Confirmation:

Normally after the three consecutive black candlesticks, price will already be quite far from the top and the pattern itself consists of 3 long black candlesticks. One should see oscillators e.g. RSI to drop below 50 and gap-down or addition long black candlesticks should also serve as a confirmation.

Falling Three Methods

This is another continuation pattern which begins with a long black body candlestick followed by three small body candlesticks (mostly white but the one in the middle could be black) and ended with another long black body candlestick. The three small body candlesticks are confined within the range of first black candlestick, indicating the market is taking a pause due to uncertainty after a sharp fall (to consolidate). The fifth candlestick brings resumption of the decline with a closing price well below the low of the first black candlestick.



Characteristics:

1. In a falling market;
2. Start with a long black candlestick;
3. Followed by 3 small body candlesticks, could be in both colour but the pattern tend to be stronger if they are all white, all three bars should stay within the range of the first black candlestick (including the shadows);
4. Price holds below the high of the first bar and the fifth bar is another long black candlestick, opening below the close of the fourth candlestick and closing at a new low below the bottom of the first bar.
5. Although this pattern mostly consists of five candlesticks, some leeway can be given with the middle three small bodies could go up to four or even five.

Explanation:

A typical consolidating pattern after a sharp move, market is taking a pause. Bears are building up new short positions with bulls giving up their last attempt to gain ground. When price couldn't rise above the high of the first bar, bears take control again whilst bulls give up.

Confirmation:

1. High of the first black candlestick must remain intact

2. The break of the closing price of the first black candlestick should be treated as the first confirmation. With the fifth bar closes well below the bottom of the first bar, that is final.

To sum up, applying the candlestick chart patterns analysis allows the investor an added advantage especially with the reversal signals. Candlestick chart should be used in conjunction with other traditional technical analysis tools such as oscillators in order to confirm top and bottom formation.

VI: Conclusions

Candlestick chart was developed in originally for trading futures. As the style of charting is relatively easier to read and understand, it became very popular. Analysts relate the chart patterns to various bullish or bearish signals, which were considered quite reliable in predicting future market directions.

According to different combinations of candlesticks, various bullish and bearish patterns were found. The major bullish and bearish patterns were discussed in this ebook.

To sum up, applying candlestick chart patterns analysis gives the traders an added advantage especially with the reversal signals. Candlestick chart should be used in conjunction with other traditional technical analysis tools such as oscillators in order to confirm top and bottom formation.

Trading is a journey, not a destination.