CANDLESTICK PATTERNS

One candlestick by itself shows very little other than data restricted to merely one period. We cannot do much depending on the reading from just one candlestick. As a result, we will now put together multiple candlesticks in a sequential format and then try to understand the candlestick patterns.

Multiple candlesticks together form patterns and they show the behaviour of the market over the period of time and therefore help us make decisions. These patterns reflect the psychology of the market. Most of these patterns repeat themselves over and over again and therefore give us some sense of predictability about the trading decisions to be taken.

We also saw that these patterns should not be seen as mere patterns on the graph, but the behaviour of bulls and bears that they represent is to be focused on more. The ultimate objective of candlesticks or technical analysis, in general, is to identify the one with the upper hand at the moment i.e.the bulls or the bears, and then try not to be on the wrong side. This is what we will do to understand candlesticks patterns as well.

There exists a very wide variety of candlestick patterns. We will understand the most commonly used ones. With more and more practice, one will be able to identify with many patterns. Also, it is impossible to use all the patterns to make decisions. As we move forth with it, we will be coming up with strategies based on only those patterns we are comfortable with.

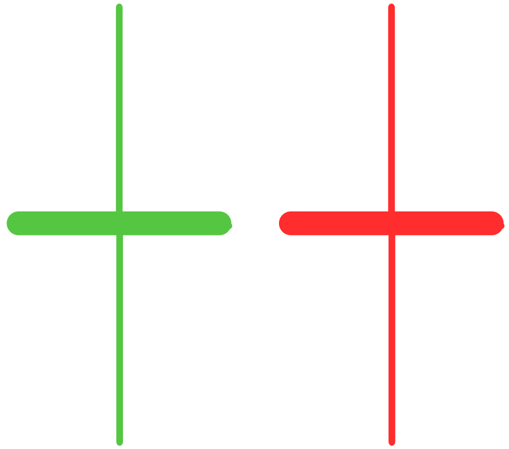
Pattern 1 DOJI

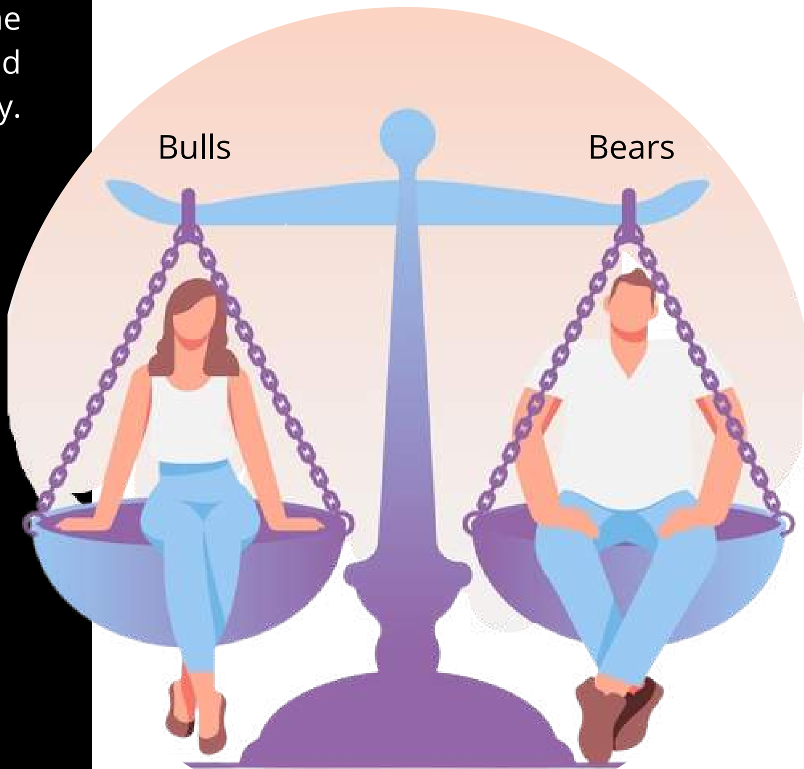
Doji is a pattern formed by a single candlestick in which the opening and closing price of the candlestick intersect resulting in a very short body. The upper shadow and lower shadow are present along with a very thin candle body.

We see in the sample image below that the Doji candlestick has a really small candle body and a relatively larger upper and lower shadow. The length of various upper shadow and lower shadow can vary.

WHAT IT INDICATES?

Doji is a signal for uncertainty in the market. The bulls and bears have similar strength at the moment as both now have conceded space. They have also recovered from the other in the market. The bulls were able to get back from the period's lows and bears were able to get back from period's high. As a result, Doji signifies a market where both bulls and bears have equal hold.





HOW TO USE?

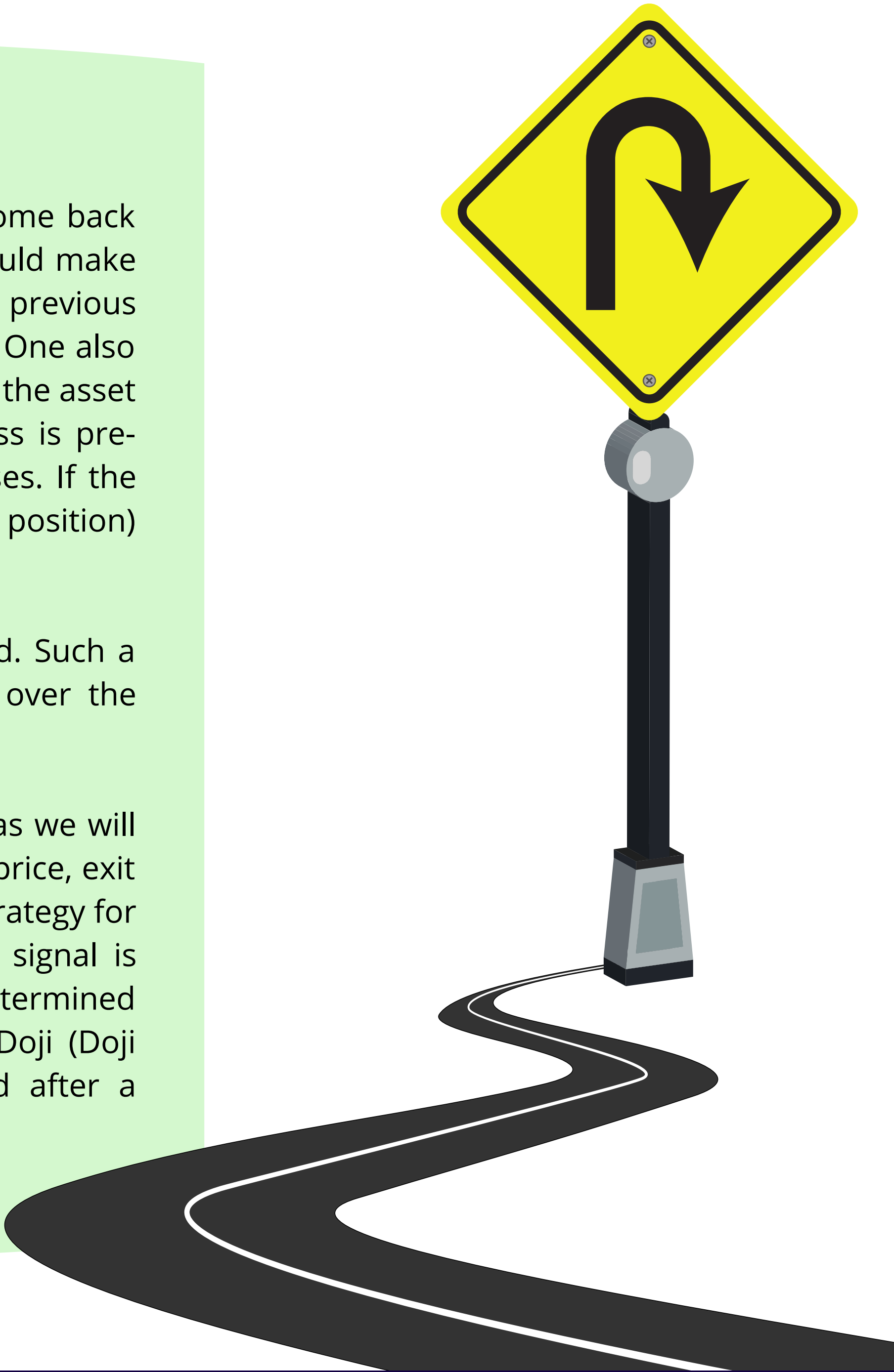
Doji is a signal for a trend reversal in the market. For example, when a market is in a strong uptrend, it means that the bulls have more power at the moment. However, when the bears form a Doji here, it means that the bears are gaining back market power. If this continues, the bears will soon have more power over the market than the bulls and a reverse movement of the price will begin.

HOW TO TRADE ?

There is a possibility that even after the formation of a Doji, the bulls may come back stronger and get the hold of the market. So, to participate in a trade, one should make an entrance if the price in the next period opens lower than the close of the previous period. The analyst can short the same i.e. benefit when the price goes down. One also needs to fix a stop loss. The stop loss can be the high of the previous day and if the asset price goes above that, we will square off the trade with a loss. The stop loss is pre-determined and it is the level beyond which we are not ready to accept losses. If the price breaches that level, we will accept the loss, square the position (exit the position) and move forward.

We can use the same when a Doji is formed in a market during a downtrend. Such a scenario shows that for the time being, bulls have regained some power over the market. If they make a comeback a reverse trend is started.

Traders can combine the same with multiple other indicators and oscillators as we will see going ahead and create a strategy for the same. They need to fix an entry price, exit price and a stop loss for each strategy. They will need to fix an entry and exit strategy for each of the candlestick patterns. Also, one cannot act simply every time a signal is generated. Selective trades have to be entered which meet all the pre-determined conditions and we have conviction. There are two kinds of Doji – Bearish Doji (Doji formed after an uptrend to signal reversal) and Bullish Doji (Doji formed after a downtrend to signal a reversal.) Let us see examples for both these.



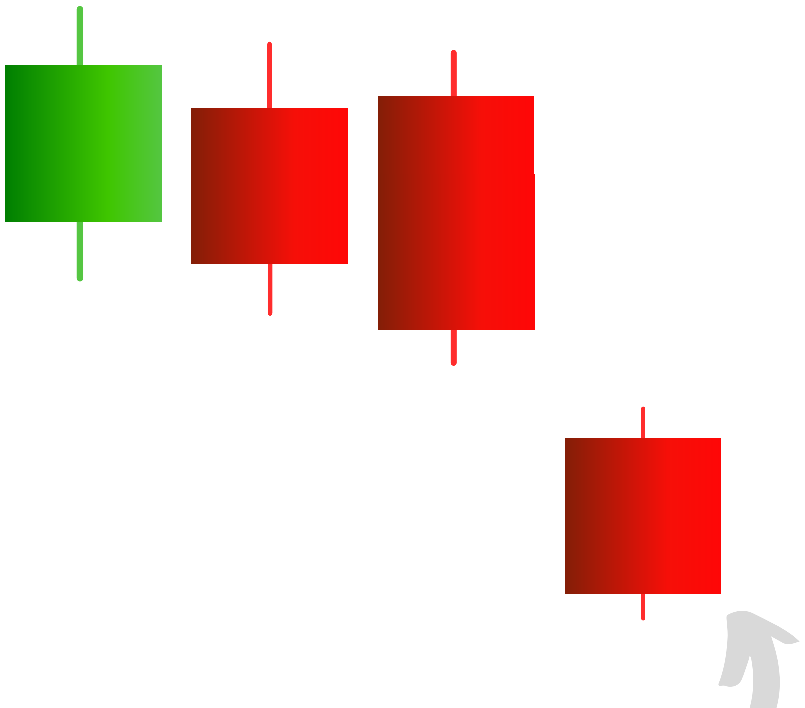
1. This is a bullish Doji. We see that it comes towards the end of a downtrend and signals a strong reversal that does take place. We would have entered the trade when the price opened higher than the close of Doji, the next day.
2. This is a bearish Doji. Again, we see that it comes at the end of an uptrend i.e. it ends bulls grip over the market.
3. This was supposed to be a bearish Doji. However, the bulls continued their power over the market and as a result, the trend continued. This is a false candlestick pattern. We would have avoided entering a trade as the open price on the next day was not lower than the close price of the Doji candlestick.

1. This is a bullish Doji. This is formed at the end of a downtrend. This might have been a false Doji in case the price pattern had not reversed.
2. This is a bearish Doji. Again, we see that it comes at the end of an uptrend i.e. it ends bulls' grip over the market.
3. This is a Bearish Doji as it follows an uptrend. It comes at a time when bulls had a grip over the market.

Here, we enter the trade as the open price on the next day is lower than the close price on Doji stick. We will fix the 'high price' on the Doji candle as the stop loss. We can change this going ahead as per our preferences.

Pattern 2 GAP UP & GAP DOWN

This is a straightforward pattern where the market opens with a gap that is significantly higher or lower than the previous day's closing and candle.

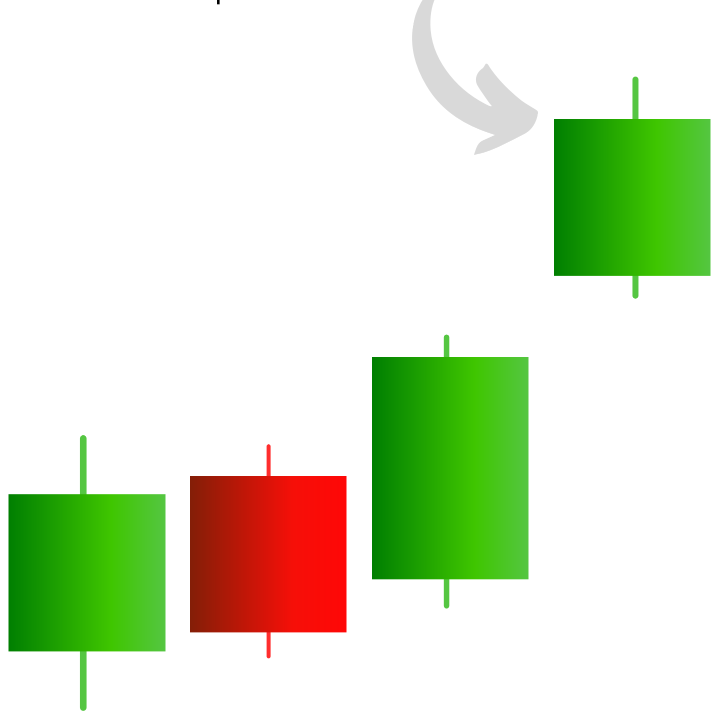


GAP DOWN

Gap downs occur when the open of the market is significantly lower than most of the previous days' candle body. This happens when bad news hits the market after the trading hours.

GAP UP

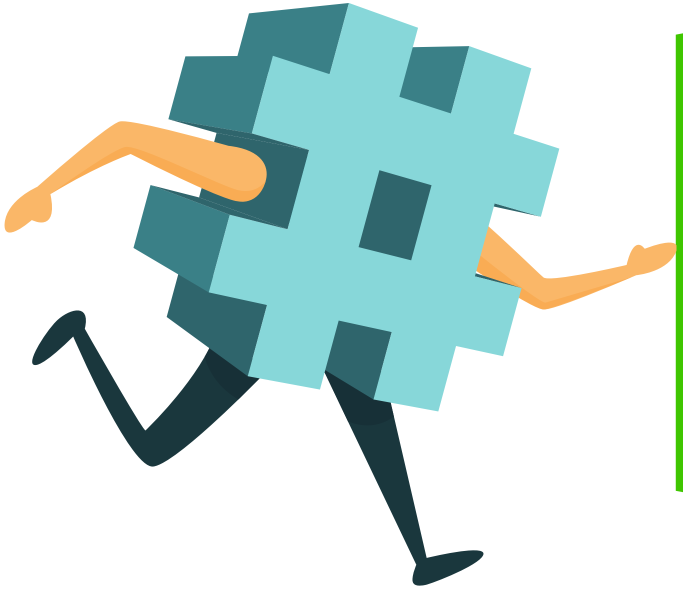
In case of gap up, the open for the next day is higher than the candle body of the previous day by a significant margin. This indicates that the bulls have solid control over the market if a gap up occurs amidst an uptrend. Gap ups are common when the good news about the asset hits the market post market hours.



HOW TO USE ?

Gap ups and gap downs have no meaning of their own in terms of trends and could take place over one-time news. Also, the market begins to exhaust itself after a few gap ups and gap downs. As a result, these should not be used to initiate any new trade assuming a high possibility of profit booking.

When we hold a particular asset, gap ups and gap downs should be helpful, as they reflect the strength in the trend and implies that we should continue holding the position. Beyond this, as discussed Gap Ups and Gap Downs should not mean anything in terms of initiating a trade.



HOW TO TRADE ?

There is a minor possibility of a profit booking if we follow a gap up. As a result, we will not initiate any new trades based on gap ups and gap downs alone. These can be combined well with other indicators to enter a trade. Let us see examples of gap ups and gap downs and their appearance when in practice.

1. This is a gap down. Bears have a strong grip over the market and the downtrend has continued after the gap down as well.
2. This is the second gap down in a period of 4 sessions. This indicates that the market is in the strong grip of the bears and we shall continue holding any short position if any. The bears have exhausted themselves after this as two-gap downs have occurred.
3. This is another gap down. This also is a gap down Doji. It shows that the bulls' grip is not completely out of place. We see how different patterns can appear together.

1. This is a bullish gap i.e. gap up. The company had announced an event that could have potentially caused the gap up. Hence, gap ups and downs are not suitable for initiating new positions.

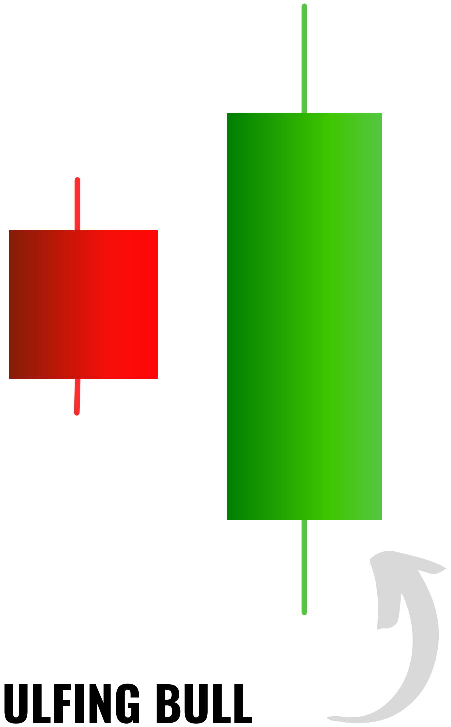
1. This is a gap down. We will not take any new trading positions based on these. However, we will continue to hold any short position that we have.
2. This is a gap up. We will continue holding any long position that we have at this moment.

With this, we end our discussion on gaps. We will make sure to practice these enough going ahead.

Pattern 3

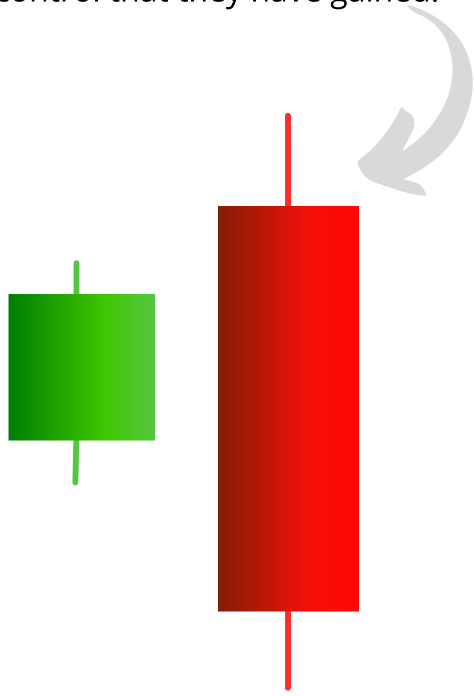
ENGULFING BULL & BEAR

The ‘Engulfing Patterns’ are two candlestick patterns. Here, the first candle is engulfed by the second candle. This means that the second candle’s body completely shadows the first candle’s body.



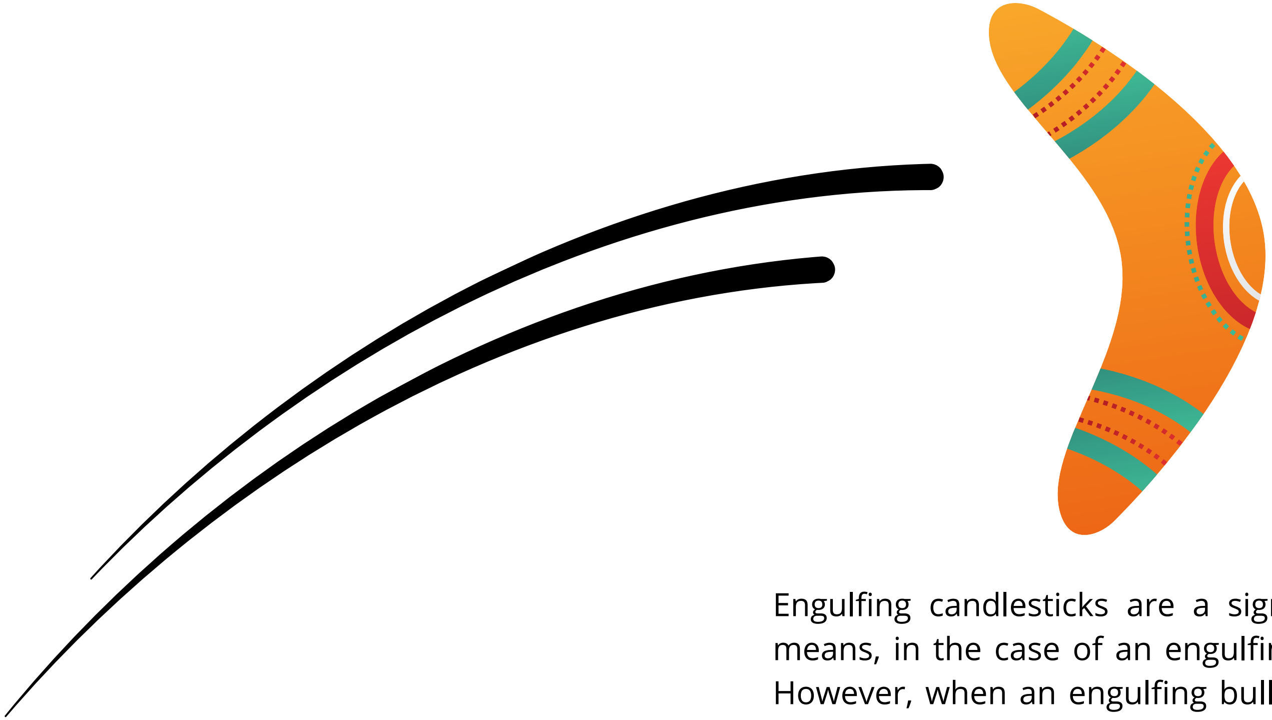
ENGULFING BEAR

Bear Engulfing Candlestick pattern is formed when the general trend is upward. A bear candle completely engulfs a bull candle and we expect the bears to build on the control that they have gained.



ENGULFING BULL

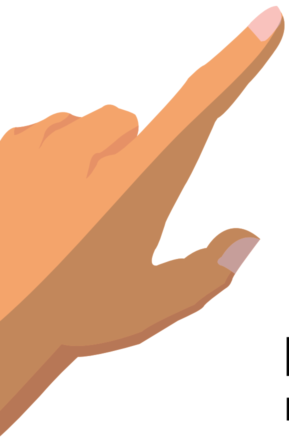
Bull Engulfing candlestick pattern is formed when the general trend is downward, and then a bull candle engulfs a bear candle completely. The bull candle’s body will completely cover the bear candle’s body.



WHAT DOES IT INDICATE?

Engulfing candlesticks are a signal for a strong reversal in trend. This means, in the case of an engulfing bull, the pre-existing trend is bearish. However, when an engulfing bull candle appears, it implies that the bulls have made a strong comeback and as a result, have not only reversed the bear candlestick but also taken control over the market. There is a good chance that the bulls will strengthen their grip on the market going ahead.

Similarly, with an engulfing bear, the bears have taken control back from the bulls and strengthened the same. As a result, we can expect them to continue their control.



HOW TO USE ?

Engulfing candlesticks can be used to initiate new trades. We go long, following a bullish engulfing candle and short, following a bearish engulfing candle. We expect the trend to reverse following these candlestick patterns and thus, we will initiate this trade. At times, the trend will not reverse and we will have to settle for losses, but otherwise, we will be able to book profits. This will be taken care of when we talk about a systematic approach to trading.

HOW TO TRADE ?

When we see an engulfing pattern, we will take long or short positions according to the type of pattern formed. We will define a fixed entry point and a stop loss to enter into the trade. This is a subjective decision and one develops this with practice. An ideal point to enter can be the open price of the very next day following the engulfing candle and the stop loss could be the high of engulfing bear candle or low of engulfing bull candle depending on the pattern and the trade.

One can also combine this with other candlesticks patterns, oscillators, and indicators to come up with custom strategies. However, we will never enter a trade where the conditions for exit and stop losses are not pre-determined.

1.1. We see that this is an engulfing bull candlestick pattern. The candle has a low that the candle body of the engulfing bull completely covers the previous day's candle body.

A reversal has followed the same.

1. This is an engulfing bear pattern. Here, we see that the trend is reversing itself following the candle. We can say that the bears have taken control over the market and we can initiate a new trade.
2. This is an example of 'Engulfing Bull'.

1. This is an engulfing bear. The bears did take control and this was followed by a gap down as well. However, the bulls quickly got the control back and most likely, in this case, we would have taken a small loss.
2. This is an engulfing bear. We see that the bears did gain control and the prices fell lower. We can combine this with other patterns to create our strategy.

1. This is an engulfing bull. We see a mild trend reversal following the same. However, the bears got the control back soon and the downward journey continued.

This way, we will have to read the charts in a very custom manner. We will always see this as a battle between bulls and bears and part with those who are winning at the moment.

With this, let us move on to the next candlestick pattern.