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THE POWER OF JAPANESE CANDLESTICK CHARTS

ADVANCED FILTERING TECHNIQUES FOR TRADING STOCKS, FUTURES AND FOREX

FRED K.H. TAM

The Power of Japanese Candlestick Charts

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Advanced Filtering Techniques for Trading Stocks, Futures, and Forex

REVISED EDITION

Fred K. H. Tam

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PREFACE

This book is about applying the popular time-tested Japanese candlestick technique to spot market turning points. After all, making money from the markets is all about predicting correctly when the market is about to turn, and the Japanese candlestick technique does this job superbly.

I find the candlestick technique very applicable for trading actively traded financial instruments such as stock indices, foreign exchange (forex), commodities futures, and stocks. This is because most, if not all, financial instruments tend to exhibit short-term rallies only to be followed by short-term corrections regardless of their time frames. Their trading cycle ranges from 5 to 15 candles (see Figure P.1 and Figure P.2).

It is fun to be on the right side of the market, buying at or near market bottoms and selling at or near market tops. But the question is, "How do I know if today's market action constitutes a market bottom?" Conversely, after a sharp rally of a few sessions, what signals are there to tell you that your stocks have topped out and are due for a correction?

Questions like "Is this the right time to buy?" or "Is this the right time to sell?" have always been a talking point amongst traders and investors. The objective of this book is to provide an answer to these questions.

There are many techniques out there, mainly from the West, like the moving average, relative strength index, moving average convergence divergence (MACD), stochastic, momentum, Bollinger bands, Elliott waves, and so on, that can help you time your entry and exit. I strongly believe that these Western techniques should be part of a trader's arsenal.

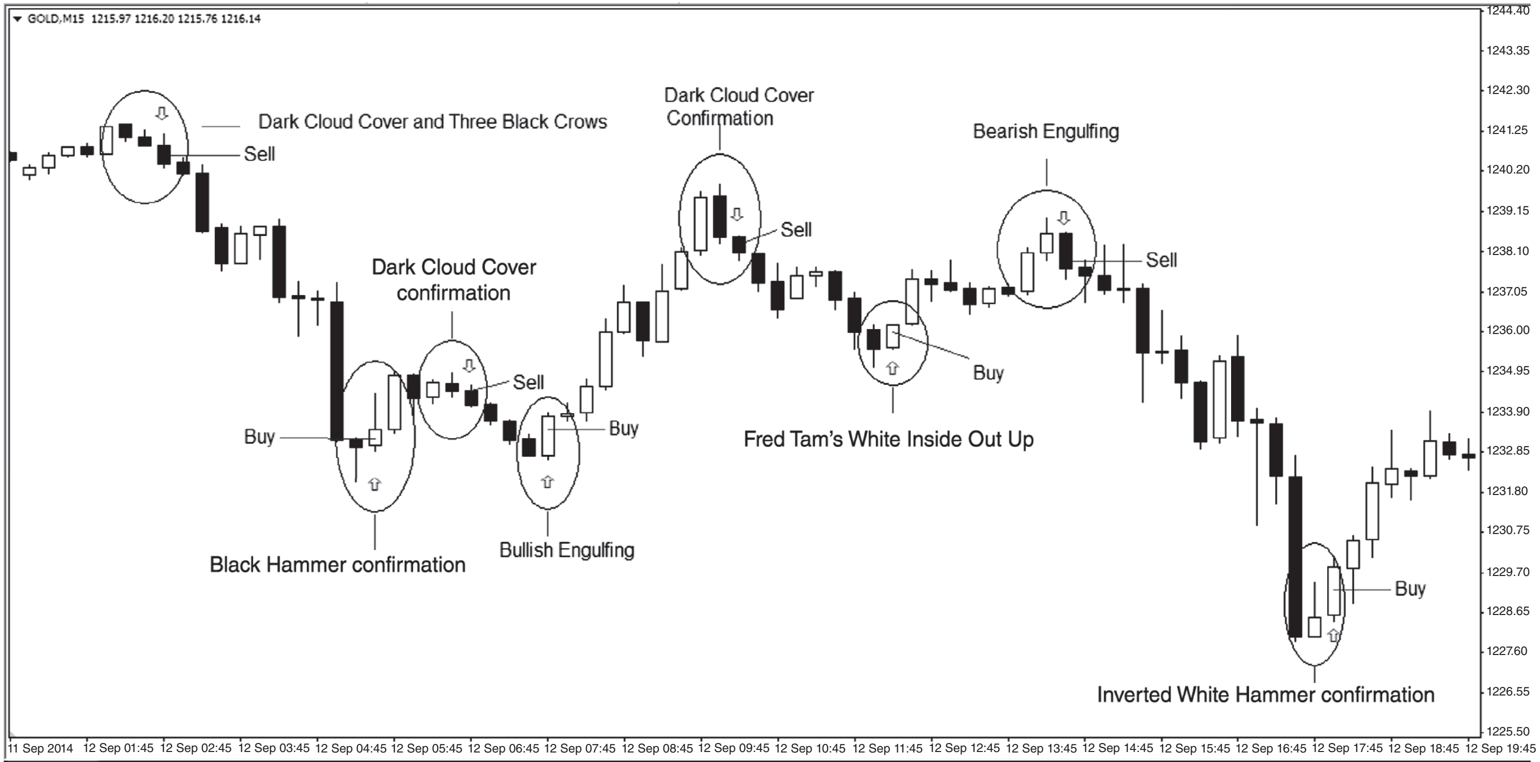


FIGURE P.1 Gold 15-Minute (2014)—Trading cycles range from 5 to 15 candles

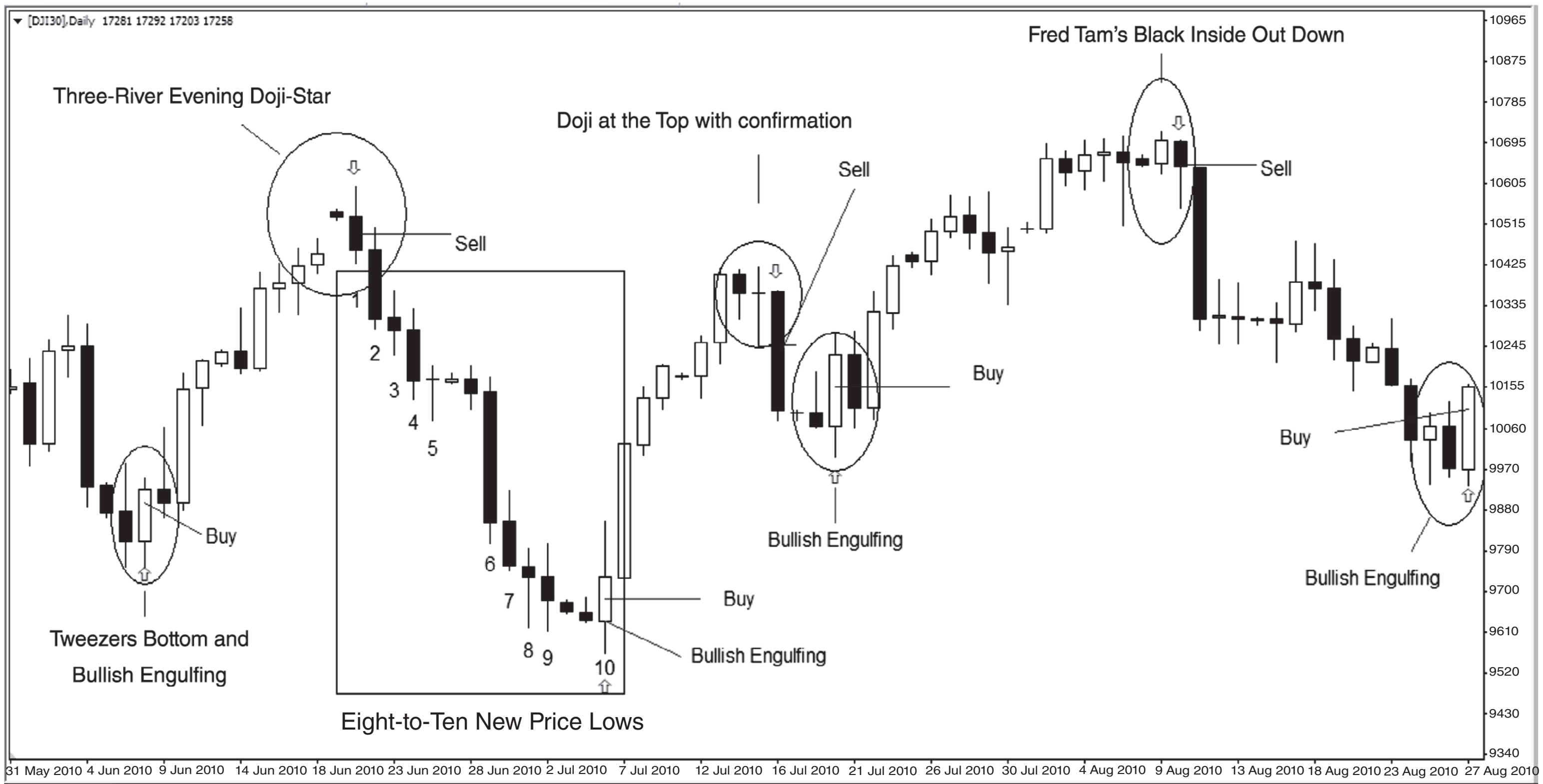


FIGURE P.2 Dow Jones Industrial Average Daily (2010)—Trading cycles range from 5 to 15 candles regardless of the periodicity of the chart

But complementing Western techniques with that of Japanese candlesticks will give you that extra edge in getting a much better price—a lower price if you are buying and a higher price if you are selling. You will be convinced from the hundreds of charts illustrated in this book that Japanese candlestick signals lead the Western technical indicators in timing market entry and exit.

The candlestick technique is the most leading of all technical indicators that I have come across. The reason why the Japanese candlestick technique triggers buy or sell signals at least 2 periods and sometimes up to 10 periods earlier than Western indicators is that candlestick signals are based on an analysis of price itself.

When you are analysing the candle chart, you are in effect analysing the psychology of the market participants that is reflected in its price. No indicators can beat a technique that analyses price in itself.

This passage taken from the Sakata Goho sums up the candlesticks' raison d'être:

> The psychology of the market participant, the supply and demand equation and the relative strength of the buyers and sellers are all reflected in the one candlestick or in a combination of candlesticks.

Western indicators, on the other hand, use formulas that take into account prices of several periods. The MACD, for example, uses a 12-day, 26-day, and 9-day exponential moving average as its parameter. Once parameters are used more than two periods, the resultant signal, when it is triggered, tends to lag behind price (see Figure P.3). This is the reason Western indicators tend to call a buy or sell between 3 and 10 periods (and sometimes more) from the market's bottom or top. The longer the parameters used, the more distant is the signal.

This book is written for the beginner as well as for the advanced trader. Part I takes you through, from the technique's historical background, to the construction of the candle chart to defining and interpreting single to multiple candles. It not only explains the psychology behind each pattern, but also offers suggestions on the proper action to take as well as a stop-loss point to exit if the signal fails.

As the candlestick technique prides itself on spotting market U-turns, I have devoted many pages in this book to describe popular reversal patterns and how to apply them to enter and exit the markets. Continuation patterns are also covered to alert the trader when a trend is only pausing momentarily but will continue with its run after a rest.

Part II of this book covers the more advanced aspects of trading with candlesticks. It emphasizes the importance of using candlesticks together with Western technical indicators to improve the accuracy of candle signals. Several popular Western technical indicators are covered in this book with examples drawn from widely traded financial instruments like forex; U.S., European, Japanese, Singapore, and Malaysian stocks; and stock indices, as well as from the futures markets to illustrate that this technique works for all markets. This technique, however, will not work if the instrument traded is controlled by a small group of players in a thinly traded environment.

The Japanese candlestick technique is a very powerful short-term trading technique if it is used on 1-minute, 5-minute, 15-minute, or 1-hour charts, as markets exhibit rallies and declines between 5 and 15 cycles on every time frame. It is therefore very suitable for use by remisiers, stockists, scalpers, day traders, and short-term position traders.

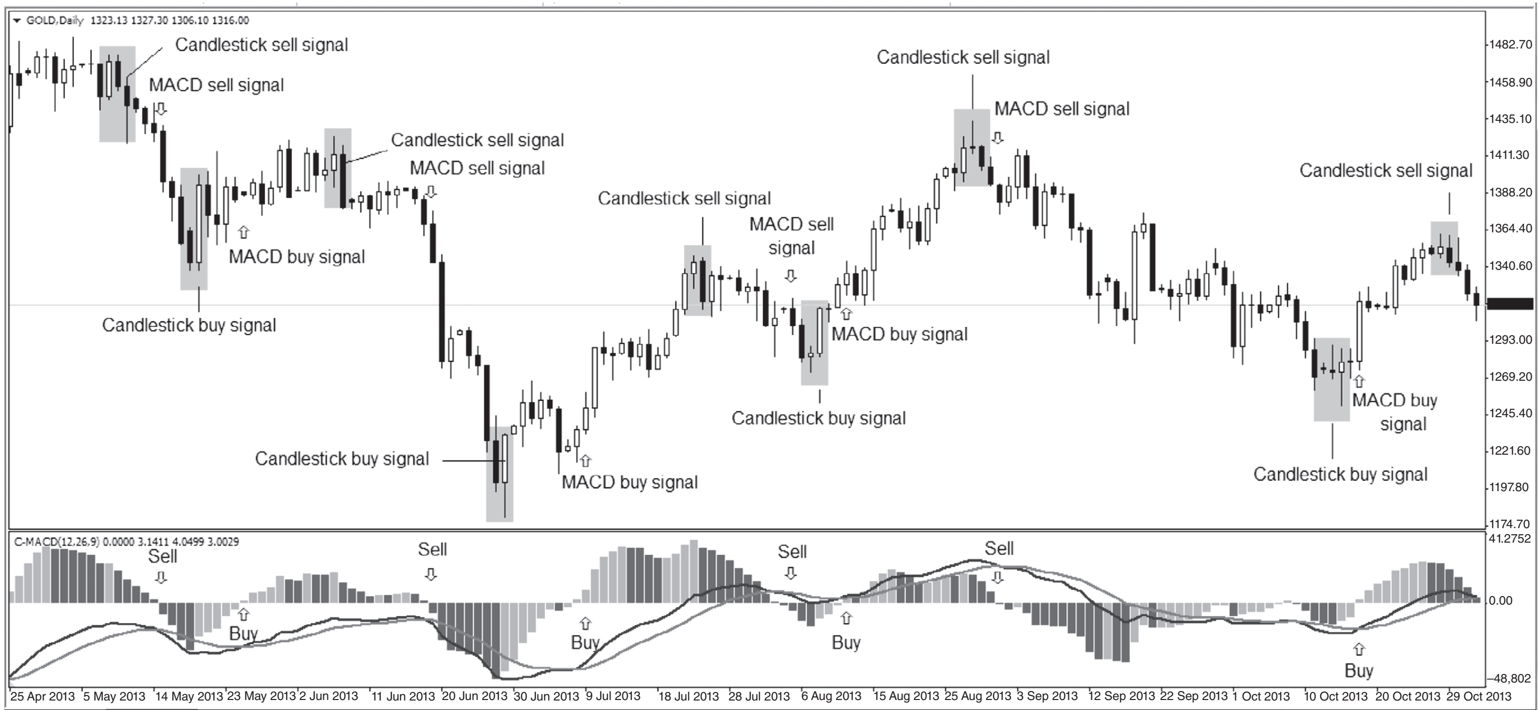


FIGURE P.3 Gold Daily (2013)—Western indicators (e.g., MACD) tend to lag behind candlesticks

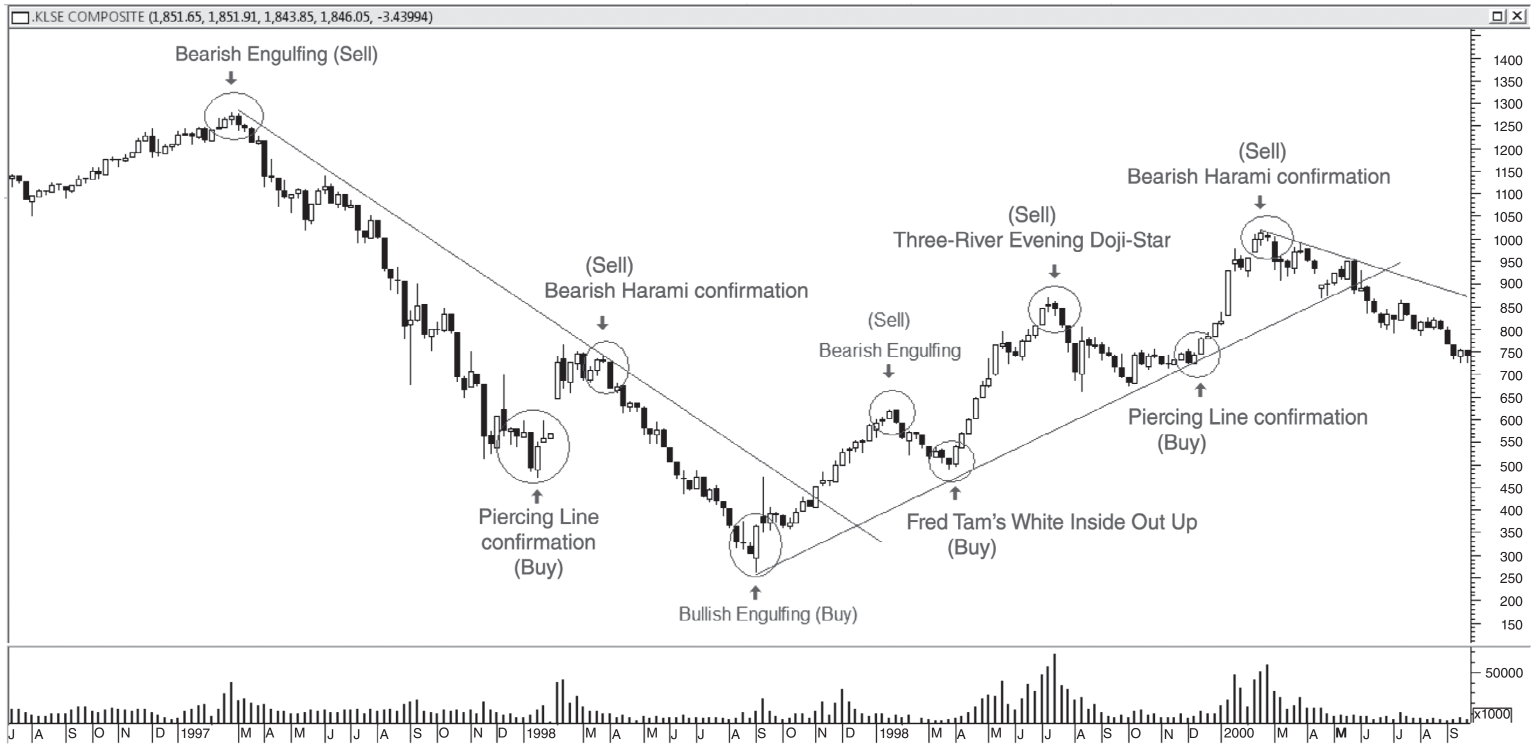


FIGURE P.4 Kuala Lumpur Composite Index Weekly (1999)—Weekly candle charts are best for long-term investors

This technique is equally useful for medium-term and long-term forecasting through the use of 4-hour, daily, weekly, and monthly candlestick charts in combination with longer-term Western technical indicators (see Figure P.4).

Herein lies the adaptability of technical analysis in that it works irrespective of the time frame used. You can apply this technique for intra-day trading through the use of a 1-minute chart, a 5-minute chart, a 15-minute chart, a 30-minute chart, or an hourly chart.

For longer-term investors like fund managers who tend to hold stocks for a period of more than a month, I have found that the weekly candle charts provide the most consistent buy and sell signals.

Winning from the market requires two ingredients. The first is that you must have a proven trading technique. The second is that you must practice sound money management. This book will provide you with the first ingredient.

Knowing when to exit the market when you are wrong is part of money management. To that extent, this book will also cover the second ingredient.

Good luck and happy trading.

ACKNOWLEDGMENTS

A book on Japanese candlesticks is not easy to write, mainly because of the lack of literature on the subject until 1991 when an American analyst by the name of Steve Nison revealed this ancient technique to the Western world through his classic book, *Japanese Candlestick Charting Techniques: A Contemporary Guide to the Ancient Investment Techniques of the Far East*.

This book was my first contact with candlesticks. Nison's second, *Beyond Candles*, is another masterpiece. After putting his research into practice, I am convinced of the candlesticks' usefulness in forecasting market U-turns as well as trend continuations and am now a faithful disciple of this age-old technique. Nison has my utmost respect for introducing candlesticks to the Western world and to me. He is, to me, the "granddaddy" of candlesticks.

I would also like to thank Gary S. Wagner and Brad L. Matheny for furthering my knowledge on candles. We met when I attended a U.S. International Trading and Markets Conference called "Futures West '94" in Los Angeles. Wagner and Matheny's book, *Trading Applications of Japanese Candlestick Charting,* taught me, besides additional candlestick techniques, the importance of computerization of candle patterns.

Though I have never had a chance to meet Greg Morris, I give him credit for his well-formatted book, *Candlepower*. He had obviously done extensive research to produce this book, including painstakingly giving each pattern a Japanese name. His interview with renowned Japanese technician Takehiro Hikita is recommended reading.

Last but not least, I want to acknowledge the guidance, support, and patience of the editors and management team at John Wiley & Sons Singapore Pte. Ltd., namely, Nick Wallwork, Chris Gage, Emilie Herman, Jeremy Chia, and Gladys Ganaden, who patiently helped me bring this book to fruition.

PART I

Basic Candlestick Techniques

Introduction

The Japanese candlestick charting technique dates back to the 1700s when bar charting and point-and-figure charting were not even discovered. Japanese traders, on the other hand, were already using this technique to trade their rice markets. Yet this technique of charting was confined strictly to Japan until the Americans discovered this technique from Japanese traders who traded the U.S. financial markets in the 1980s.

What fascinated the U.S. traders in the late 1980s was its uncanny trading accuracy in the purchase and sale of stocks, stock index and commodity futures, currency and treasury bonds on the New York and Chicago exchanges. Yet, the Americans were unaware of the techniques used by the Japanese. Strong interest emerged amongst the U.S. traders as to how the Japanese arrived at their buy and sell decisions.

They reasoned that if they were going to beat the Japanese at their game, the American traders would have to fully understand how the Japanese traders' minds worked. That entails knowing their charting technique. Understanding how

Japanese traders use their charts would help the American traders answer the question "What are the Japanese going to do next?" This accounts for the resurgence of interest in the West into this previously obscure technique of technical analysis.

More information is now available on candlestick charting after extensive research by an American analyst, Steve Nison. His two books, *Japanese Candlestick Charting Techniques* and *Beyond Candles*, offered the outside world a first glimpse into this ancient methodology of the Japanese traders.

As Nison's research into this mystically obscure charting technique became available through his two books, traders in the United States and the rest of the world began to realise its forecasting value. When combined with Western technical concepts, forecasting and trading the markets can be—in the words of Steve Nison—exciting, powerful, fun, and much more rewarding.

Even as recently as the late 1980s, real-time quote and chart services offered to investors in the United States, Europe, and the rest of the world did not feature candlestick charts—only bar charts. Yet within two years after Nison's first book, published in 1991, almost every real-time technical service and end-of-day technical analysis software package offered candlestick charts to their clients. In Malaysia, every major real-time technical chart service provider such as Thomson-Reuters, Bloomberg, Updata, Meta-Trader, and Bursa Station supports real-time candlestick charts. The inclusion candlestick charts into these companies' services underscores their popularity and usefulness.

Historical Background

After the unification of Japan under the Tokugawa Shogunate (Eighth Shogunate) from 1615 to 1867, its agrarian economy grew. By the seventeenth century, Osaka was regarded as Japan's capital and commercial centre. Osaka's easy access to the sea made it a national port for the shipping of supplies, including rice. Strategically located, Osaka soon became the centre for the rice trade, and rice brokerage became the foundation of Osaka's prosperity. The Dojima Rice Exchange became the centre of rice trade for physical delivery.

Into this background, Munehisa Homma (1716–1803) was born in the city of Sakata, Yamagata Prefecture, Japan. His real name was Kosaku Kato, but he took up the name Munehisa Homma later in his life after his adoption by the wealthy Homma family. At that time, the port of Sakata was a distribution centre for *shonai* (rice). Homma concentrated his attention on the rice market and later on the popular fixed rice market. By 1750 he was trading at his local rice exchange in Sakata. After the death of his father, he was placed in charge of managing his family's assets. With this money he went to the Dojima Rice Exchange in Osaka and began to trade rice futures.

His detailed attention to the markets and his understanding of candlesticks propelled him to become a very wealthy man. He was considered an elusive and feared trader because of his effective understanding of candlesticks and the psychology of the rice markets. He would keep records of yearly weather conditions. To analyse the psychology of investors, Homma analysed rice prices going back to the time when the rice exchange started. Using his own network of communication links he made a killing in the Osaka Rice Exchange and later in the Edo (now Tokyo) exchange.

It was believed that Homma even achieved the feat of 100 consecutive winning trades. Munehisa Homma was perhaps the first person in recorded Japanese history to have used past prices to predict futures price movements—and he did it successfully.

His charismatic personality and highly effective trading methods gained him the nickname "Dewa's long-nosed goblin" and an honour as the "god of the markets." He was such a legend that a folk song from Edo was composed to honour his feats. "When it is sunny in Sakata [Homma's hometown], it is cloudy in Dojima [the Dojima Rice Exchange in Osaka] and rainy in Kuramae [the Kuramae Exchange in Edo]." Interpreted, it means: When there is a good rice harvest in Sakata, rice prices fall on the Dojima Rice Exchange and collapse in Edo. This song underscores Homma's control over the rice markets during his time.

In later years, Homma became the financial consultant to the Japanese government and was given the title of "Samurai." He died in 1803, but his books about the markets (*Sakata Senho* and *Soba Sani No Den*), which revealed his trading principles, evolved into the candlestick charting technique that we know today.

Reasons Candlestick Charts Are So Popular Today

Here are six reasons that candlestick charts are so popular amongst professional traders today:

1. **Leading indicator:** Candlestick charts have the ability to show reversal signals earlier than Western charting techniques. As such, candlestick charts are a true leading indicator of market action. They regularly identify potential moves before they become apparent with Western technical tools. Many Japanese candlestick patterns are not found in Western chart techniques. Figure 1.1 shows an example of how candlesticks lead moving average convergence divergence (MACD) in timing entry and exit.
2. **Pictorial:** Candlestick charts are very pictorial and describe the state of players' psychology at a particular moment, which can be utilised to make meaningful trading decisions. Terminology like the "hangman," "shooting star," "dark cloud cover," "hammer," and "abandoned baby" paints indelible word pictures that can assist the trader to remember the pattern through recalling its name. The candlestick technique consists of hundreds of different pattern groups that accurately identify specific traits and tendencies.
3. **Versatile:** Candlestick charts are versatile in that they can be used alone or in combination with Western technical tools. They are unlike point-and-figure charts, which cannot be used alongside other Western technical indicators. Candlesticks use the same price data as bar charts, yet the candlestick technique better promotes the ability to recognise complex pattern groups and predict the next possible outcome based on them.
4. **Can be applied to any time dimension:** Candlestick charting techniques can be adapted for either short- or long-term trading. Candlestick charts are excellent for short-term

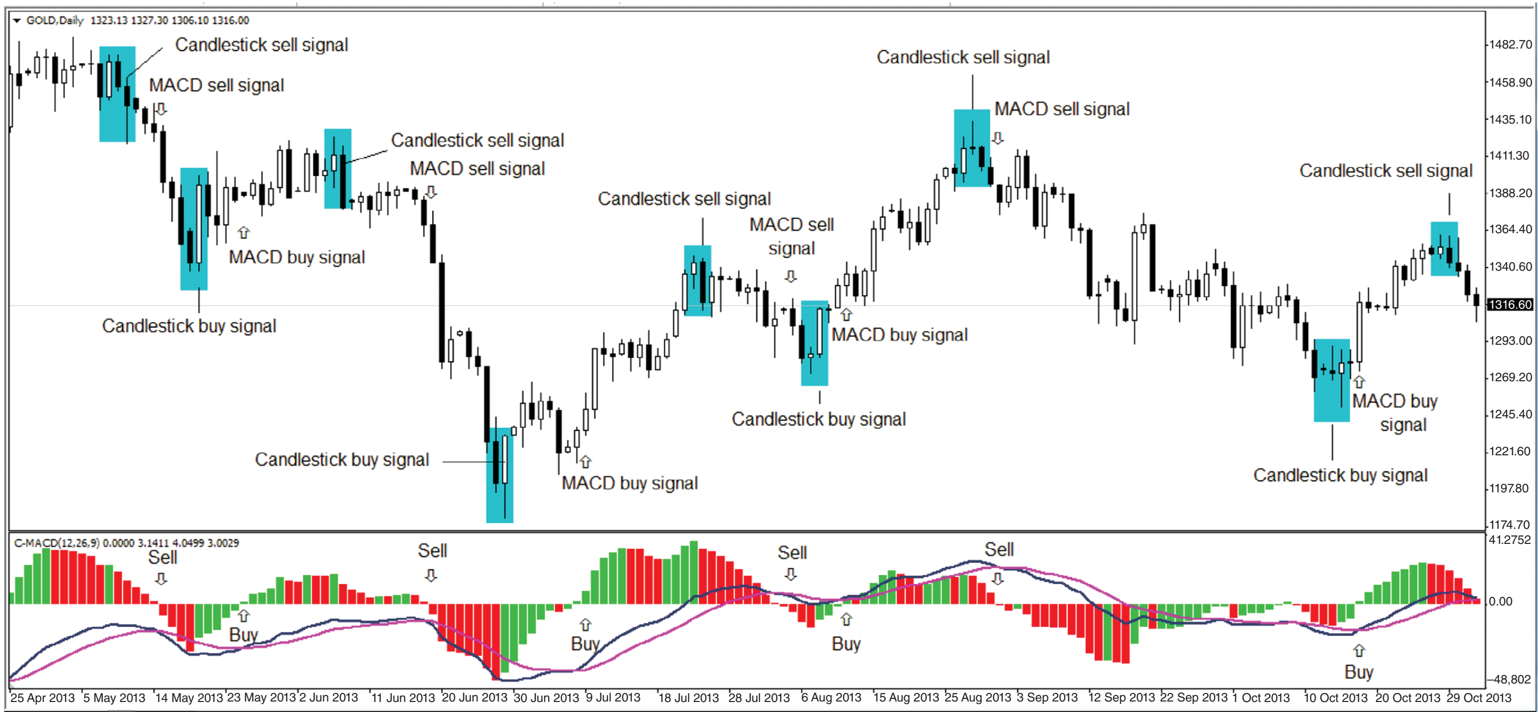


FIGURE 1.1 Gold Daily (2013)—An example of how candlesticks lead MACD in timing entry and exit

trading through the use of intra-day charts like the 1-minute, 5-minute, 15-minute, 30-minute, and 1-hour charts. They can also be applied for longer-term forecasting through the use of daily, weekly, and monthly charts.

5. **Flexibility and adaptability:** Candlestick charts can be applied to follow as many markets as desired—be they stocks, futures, currency, or commodities. In other words, a trader can apply candlestick principles to analyse or trade Malaysian stocks, index futures, or crude palm oil futures. If traders wish to diversify their portfolio, they can trade, for example, U.S. stocks, U.S. futures, foreign currency, Japanese or U.S. Treasury bonds, and for that matter any commodity in any market around the world.
6. **Time-tested, dependable, and useful:** The candlestick charting technique is time-tested and had been refined by generations of use in Japan. The fact that it is still very much in use today after more than 300 years since its discovery is testimony to its usefulness.

Construction of the Candlestick Chart

The word *candlestick* is a Western term coined by Steve Nison. In Japan it is called *Ashi*, which means "leg" or "foot." A daily chart is called *Hi Ashi*, a weekly chart *shu ashi*, and a monthly chart *tsuki ashi*. The word for *foot* is used by the Japanese to describe a chart probably because, while the foot reveals a person's past records, a chart reveals the activities of market players. *Ashi* can also mean "footprint," and the Japanese could have used it to describe the candle chart, because footprints left behind in the sand will offer clues as to where a person is heading.

Drawing a candlestick chart requires four elements of price data:

1. The open
2. The high
3. The low
4. The close

Here are the four simple steps to draw a candlestick chart.

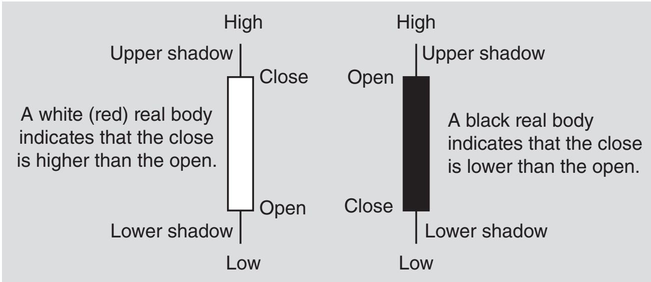
Step 1: Mark the open and the close.

Step 2: Box up the open and the close. This boxed up rectangle is called the "real body." The real body represents the range between the open and close of the session. If the close is higher than the open, the real body is coloured red (or white in some software). If the close is lower than the open, the real body is coloured black.

Step 3: Mark the high and join this to the top of the box (real body). This thin line above the box is called the "upper shadow." Shadows represent the session's price extreme. The peak of the shadow is thus the high of the session.

Step 4: Mark the low and join this to the bottom of the box (real body). This thin line below the box is called the lower shadow. The trough of the shadow is thus the low of the session.

If a candlestick line has no upper shadow, it is said to have a shaven head. A candlestick with no lower shadow has a shaven bottom. A candlestick line where the open and close are at the same or nearly the same price level is called a doji (pronounced *do-gee*). A doji implies indecision and reflects a market where the bulls and bears are in equilibrium. A doji has no box (real body).



The Real Body

The box that is joined by the open and the close is called the real body of the candlestick. If the close is higher than the open, the real body is coloured white (or red in some software). Conversely, if the close is lower than the open, the real body is coloured black. A white real body depicts an up-day or a strong day, that is, a day where the bulls are victorious over the bears, while a black real body depicts a down-day or weak day, a day where the bears are victorious. The length of the real body measures the strength of the move.

The Shadow

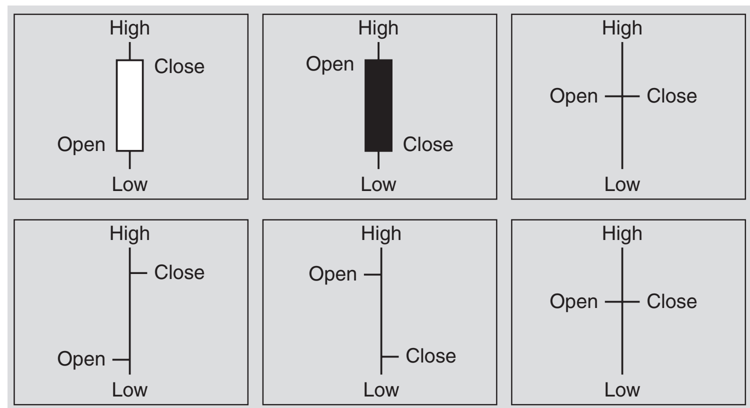
The lines above and below the real body are called shadows. The line above the real body is called the upper shadow, and the line below the real body is called the lower shadow. The upper and lower shadows reflect price fluctuations during the session. The high of the upper shadow represents the high price reached during the session while the low of the lower shadow represents the low price reached during the session.

Construction of a Bar Chart

Drawing a Western bar chart requires only three elements of price data.

1. The high
2. The low
3. The close

Sometimes the open is also drawn into the chart, in which case the open will be represented by a slash to the left of the high-low range.



Comparison between a Candlestick and a Bar Chart

Figure 1.2 and Figure 1.3 show examples of a candle chart and a bar chart for S&P 500 Hourly (2013).

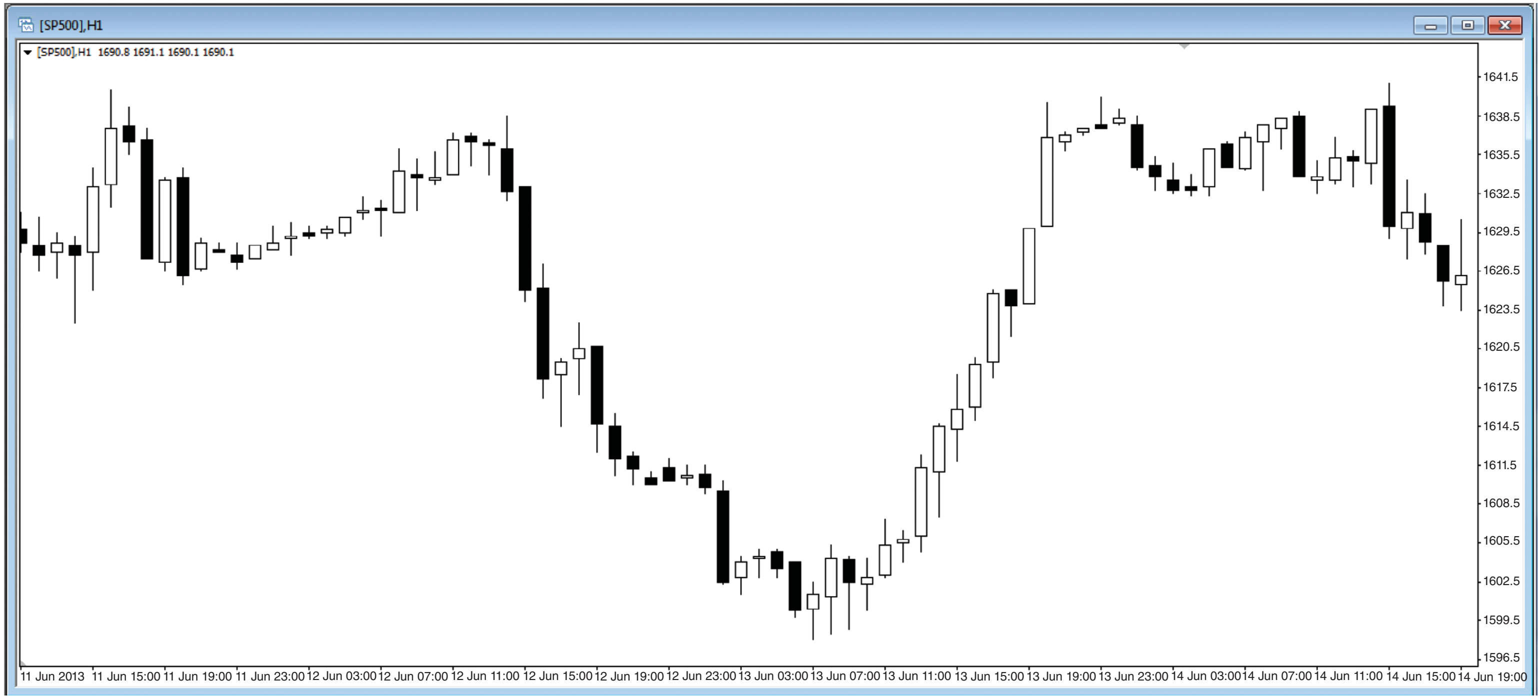


FIGURE 1.2 S&P 500 Hourly (2013)—A candle chart describes the state of players' psychology much better than a bar chart

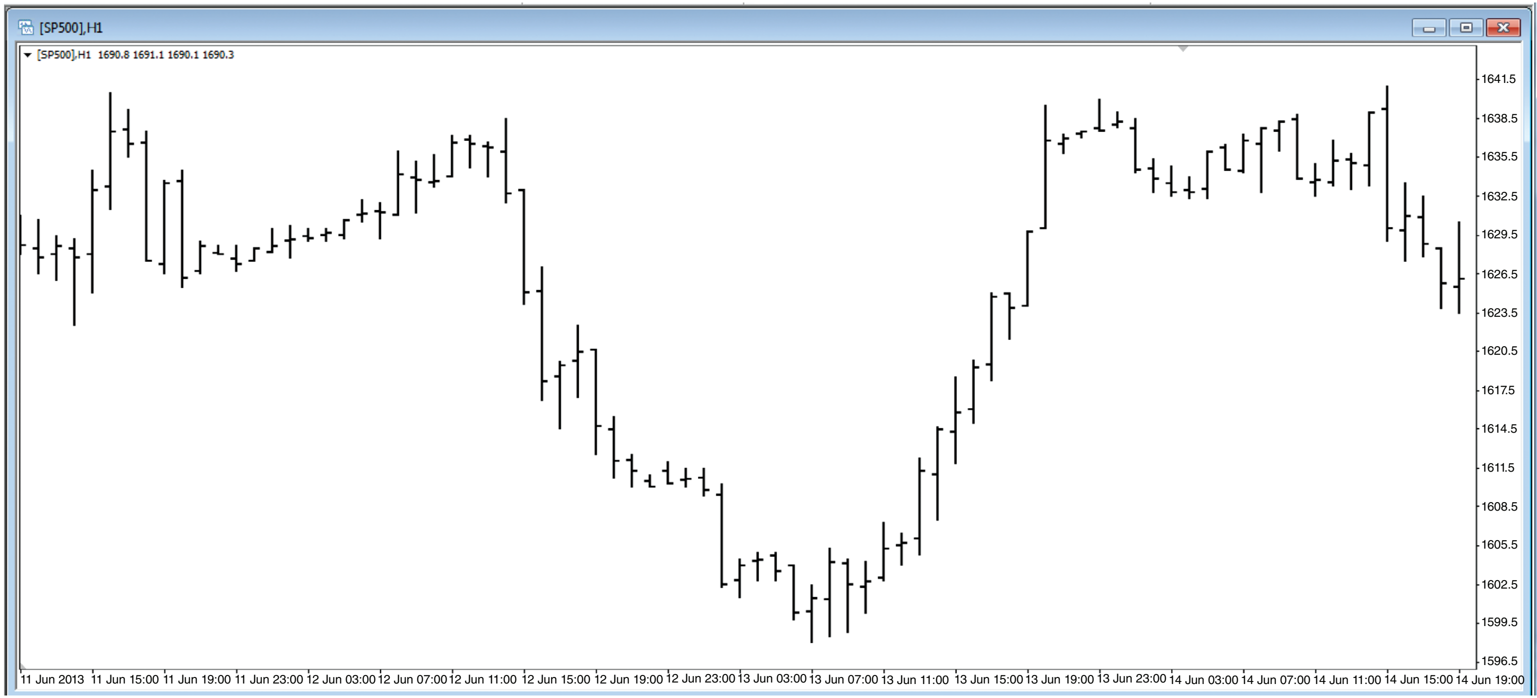


FIGURE 1.3 S&P 500 Hourly (2013)—A bar chart is flat and makes it difficult to spot changes in players' psychology

Single Candle Types

Single Candles

Reading the single candle marks the beginning of Japanese candlestick analysis. A single candle can represent any trading period, but in my examples that follow, each candle represents a trading day.

The three purposes of identifying the single candle are:

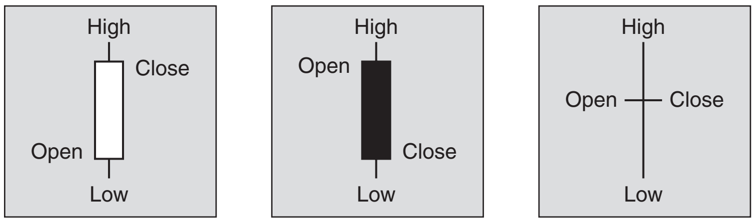
1. To understand the players' psychology behind the formation of the candle.
2. To investigate the relationship between one candle and the candles that preceded it and from this investigation, interpret any changes to the players' psychology that arise from the patterns that emerge.
3. To act by making a decision on whether to buy, hold, or sell through the patterns that emerge.

Basic Candlestick Formation

There are three basic candle types:

1. A white, or empty, candle indicates that the closing price is higher than the opening price for the trading session.
2. A black, or full, candle indicates that the closing price is lower than the opening price for the trading session.
3. A doji occurs when the opening and the closing price are equal, or very close to each other.

The following diagram shows these three basic candle types.



White Candle | Black Candle | Doji Candle

Size, Location, and Colour

To interpret the psychology behind the single candle, there are three elements to look for:

1. Size
2. Location
3. Colour

A large *size* candle, for example, suggests tremendous strength and power behind the move. A large candle is also indicative of more volatile market conditions.

Though its large size makes it a very powerful candle, the *location* of the long candle is important in analysing whether it will be a continuation or reversal pattern. Its interpretation depends on whether it is found at a low price or high price area.

The *colour* of the candle is also important in determining whether the bulls or bears are in control on a particular trading day. A white candle denotes that the bulls are in control (also called an up-day) and a black candle denotes that the bears are in control (also called a down-day). The only category of candles where colour is unimportant is the Umbrella Candles. As I go into the various candle types, you will understand how their location, size, and colour play important roles in interpreting the psychology behind a candle or a collection of candles.

The Long Candle

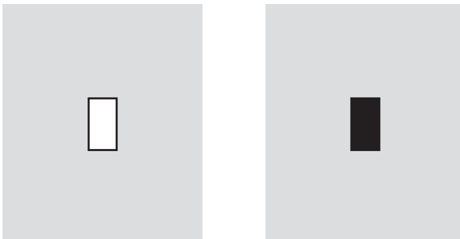
Long White Candle | Long Black Candle

A long candle is defined as one where the open and close (real body) are far apart. It has a greater than average price range. Long candles can be white (bullish) or black (bearish) as shown in the previous diagrams.

A long candle reflects a day with a larger price movement. A long white candle is generally interpreted as a very bullish day and a long black candle is interpreted as a very bearish day.

Though its large size makes it a significant candle, it is important to note the location of this large candle and the candle that follows, as their combinations may signal a reversal pattern (see Figure 2.1).

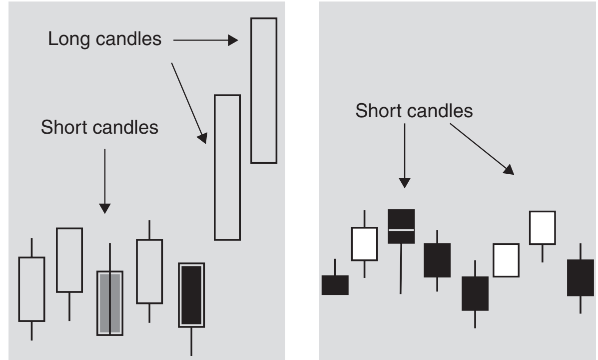
The Short Candle



Short White Candle   Short Black Candle

A short candle is defined as one where the difference between the open and close (real body) is small. It may or may not have shadows. When there are shadows, their short upper and/or lower shadows have a less than average price range. A short candle reflects a day of narrow price movement. It is generally viewed as an insignificant candle and is indicative of a consolidation or indecisive market. Relatively small volumes accompany their occurrence. Short candles can be either white or black as shown in the preceding diagrams.

Though its small size makes it an insignificant candle, it is important to note the location of this small candle along with the candles preceding it, as their combination may signal a reversal pattern.



Long Candles Reflect a Trending Move   Short Candles Signify Consolidation

Exception to the rule: A short candle is normally viewed as an insignificant candle because of its small real body, short shadows, small volume, and a less than average price range. But the exception to this rule is when short candles are a part of an umbrella group (i.e., the Hammer, Hangman, Inverted Hammer, and Shooting Star) or when they have very long upper and lower shadows (called high wave Spinning Tops or doji). If these candles of the umbrella group or high wave Spinning Tops or doji are spotted at the top or bottom of a market trend, they are signals of a market top or bottom. In such a situation the *location* of these candles will be a more significant factor than their small size.

Ten White Candle Types and Their Interpretations

Following are the definitions and interpretations of the 10 white candle types.

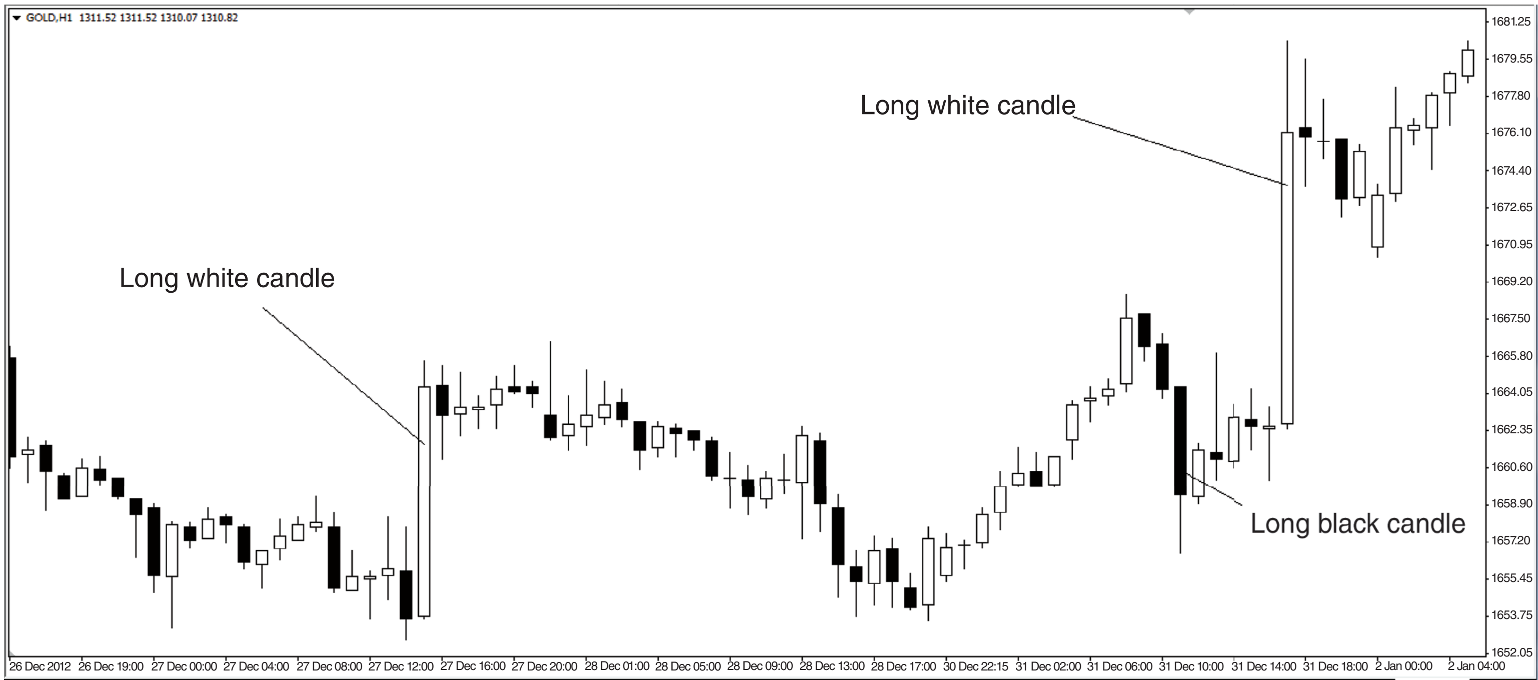
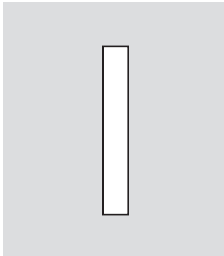


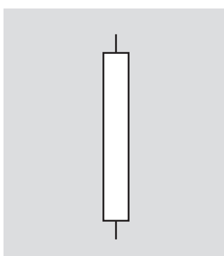
FIGURE 2.1 Gold Hourly (2012)—Locations of long candles may signal a reversal

1. Long Marubozu White Candle



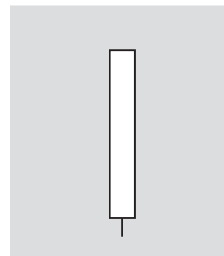
- **Definition:** This candle's close is greater than the open during a greater than average daily range. The close must be equal to the high, and the open must be equal to the low. It has no upper or lower shadows.
- **Interpretation:** *Marubozu* has several meanings in Japanese, one of which is "bald" or "shaven." In describing a candle it means there is no upper or lower shadow. A Long Marubozu White Candle is considered extremely bullish because it has no shadows. It is the most bullish of all long white candles as it opens at the low and closes at the high. The bulls are in total control of the market on this day.

2. Long White Candle



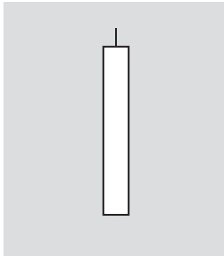
- **Definition:** This candle's close is greater than the open during a greater than average daily range. The close must be near but not at the high, and the open must be near but not at the low. It has a short upper and lower shadow.
- **Interpretation:** The long white candle is a bullish candle. It is a strong candle, but not as strong as the Long Marubozu White Candle because there is some selling close to the open and to the close, giving rise to a small lower and upper shadow. Still, the bulls are in control on this day.

3. Long Closing Bozu White Candle



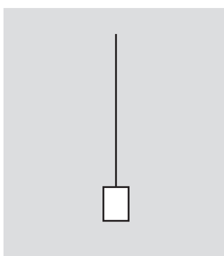
- **Definition:** This candle's close is greater than the open during a greater than average daily range. The close must be at the high, and the open must be near but not at the low. It has a short lower shadow.
- **Interpretation:** The Long Closing Bozu White Candle is a bullish candle. It is as strong as the Marubozu White Candle because it closed at the high. It is viewed as a strong day, and the interpretation of this Long Closing Bozu Candle is similar to that in analysing the Long Marubozu White Candle.

4. Long Opening Bozu White Candle



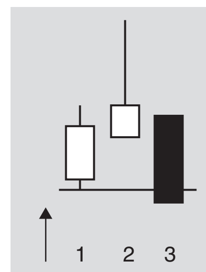
- **Definition:** This candle's close is greater than the open during a greater than average daily range. The close must be near but not at the high, and the open must be at the low. It has a short upper shadow.
- **Interpretation:** The Long Opening Bozu White Candle is a bullish candle. Though it did not close at the high, it is a strong candle but not as strong as the Long Marubozu White Candle or the Long Closing Bozu White Candle because there is some selling near the close giving rise to a short upper shadow. Still, the bulls are in control on this day.

5. Inverted White Umbrella Candle



- **Definition:** This candle's close is greater than the open during an average or large range day. The upper shadow must be at least twice the length of the real body. It has a small real body and a long upper shadow. This formation is called a shooting star if it is found at the top of the market or an Inverted Hammer if it is found at the bottom. It can be recognised by its tight opening and closing real body.
- **Interpretation:** The Inverted Umbrella Candle has strong reversal implications. In interpreting an Inverted Umbrella Candle, the colour of the real body is not important. Rather it is its *location* that is of the essence. This inverted Umbrella Candle becomes a shooting star and has bearish implications if found after a market advance. It becomes an Inverted Hammer and has bullish implications if found after a market decline.

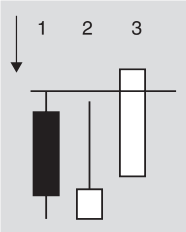
5A. Shooting Star (Inverted Umbrella Candle at the Top)



- **Definition:** This Inverted Umbrella Candle becomes a Shooting Star and has bearish implications if found after a market advance.

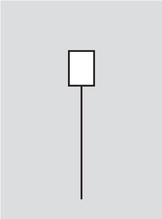
- **Interpretation:** The sighting of a Shooting Star signals a possible market top, but a bearish confirmation is required before selling. Candle 3 must close lower than the low of candles 2 and 1 to generate a sell signal (see Figure 2.2).

5B. Inverted Hammer (Inverted Umbrella Candle at the Bottom)



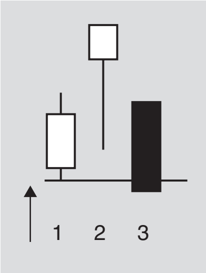
- **Definition:** This Inverted Umbrella Candle becomes an Inverted Hammer and has bullish implications if found after a market decline.
- **Interpretation:** The Inverted Hammer is an indication of a possible end of a decline, but a bullish confirmation is required before buying. Candle 3 must close higher than the high of candles 2 and 1 to generate a buy signal.

6. White Umbrella Candle



- **Definition:** This candle's close is greater than the open during an average or large range day. The lower shadow must be at least twice the length of the real body. This formation is called a Hammer if it is found at the bottom of the market or a Hanging Man if it is found at the top. It can be recognised by its tight opening and closing real body.
- **Interpretation:** The Umbrella Candle has strong reversal implications. In interpreting an Umbrella Candle, the colour of the real body is not important. Rather it is its *location* that is of the essence. This Umbrella Candle becomes a Hanging Man and has bearish implications if found after a market advance. It becomes a Hammer and has bullish implications if found after a market decline.

6A. Hanging Man (Umbrella Candle at the Top)



- **Definition:** This Umbrella Candle becomes a Hanging Man and has bearish implications if found after a market advance.
- **Interpretation:** The sighting of a Hanging Man signals a possible market top, but bearish confirmation is required before selling. Candle 3 must close lower than candles 2 and 1 to generate a sell signal.

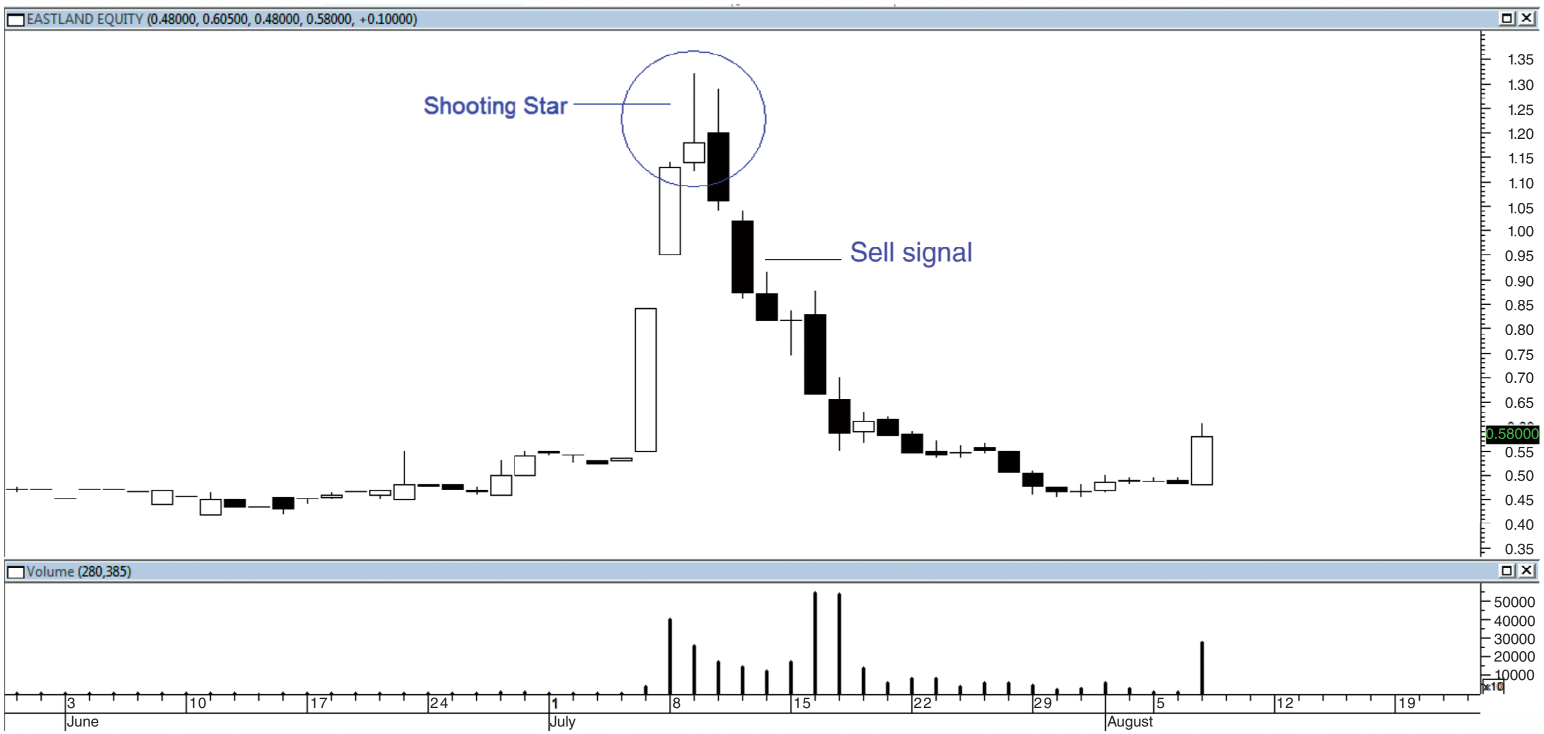
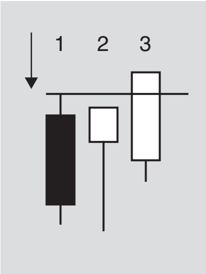


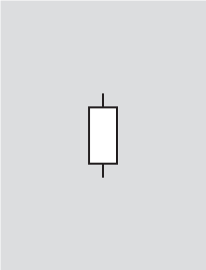
FIGURE 2.2 Eastland Equity Malaysia Daily (2013)—An Inverted Umbrella Candle at the top becomes a Shooting Star

6B. Hammer (Umbrella Candle at the Bottom)



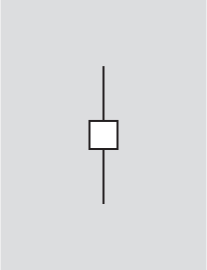
- **Definition:** This Umbrella Candle becomes a Hammer and has bullish implications if found after a market decline.
- **Interpretation:** The Hammer is an indication of a possible end of a decline, but a bullish confirmation is required before buying. Candle 3 must close higher than the high of candles 2 and 1 to generate a buy signal.

7. Short White Candle



- **Definition:** This candle's close is greater than the open with a less than average daily range. The close should be near but not at the high, and the open should be near but not at the low. It has an upper and a lower shadow. The total length of the real body must be larger than the sum of its upper and lower shadow. If there are no upper or lower shadows, it will be called a Short White Marubozu Candle.
- **Interpretation:** It is a bullish candle as its close is above its open, but due to its smaller than average range, it is not as significant as a long white candle. The short white candle is generally viewed as a trend continuation pattern.

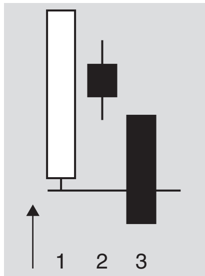
8. White Spinning Top



- **Definition:** This candle's close is greater than the open with a less than average daily range. The total length of the real body must be smaller than the sum of its upper and lower shadow.
- **Interpretation:** A Spinning Top (white or black does not matter as colour is unimportant in this type of candle) is a sign of market indecision and is considered neutral in a sideways trend. In a trending market, it can be part of a continuation pattern. Found after a strong rally, it could signal a possible reversal to the downside, but found after a decline, it could signal a reversal to the upside. In analysing a Spinning Top its colour is unimportant but its *location* is.

Analysed in conjunction with another candle before it, they help to form Stars or harami patterns and transform into a reversal pattern.

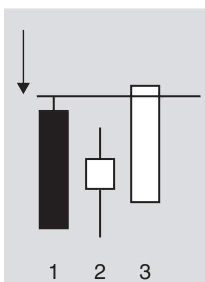
When a Spinning Top Becomes a Top Reversal Pattern



Seen after a rally, a Spinning Top (black) and another long white candle before it take the form of a Bearish Harami, a top reversal pattern. Bearish confirmation is required before selling.

Candle 3 must close below candle 2 (Spinning Top) and candle 1 to generate a sell signal. If the colour of the Spinning Top is white (very rare), this two-candle pattern is called a bearish Homing Pigeon.

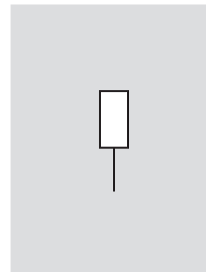
When a Spinning Top Becomes a Bottom Reversal Pattern



Seen after a decline, a Spinning Top (white) with another long black candle before it takes the form of a Bullish Harami pattern, a bottom reversal pattern. Bullish confirmation is required before buying.

Candle 3 must close above candle 2 (Spinning Top) and candle 1 to generate a buy signal. If the colour of the Spinning Top is black, this two-candle pattern is called a Homing Pigeon.

9. White Lower Shadow



- **Definition:** This candle's close is greater than the open during an average or small daily range. The close must be equal to the high. The length of its real body must be larger than the length of its lower shadow.

- **Interpretation:** It is a bullish candle as the close is greater than the open, and the close is at the high. It is likely to be a continuation pattern as the bulls are still in control. This candle's bullishness will only be threatened if there is a close below its low on the next day (see Figure 2.3).

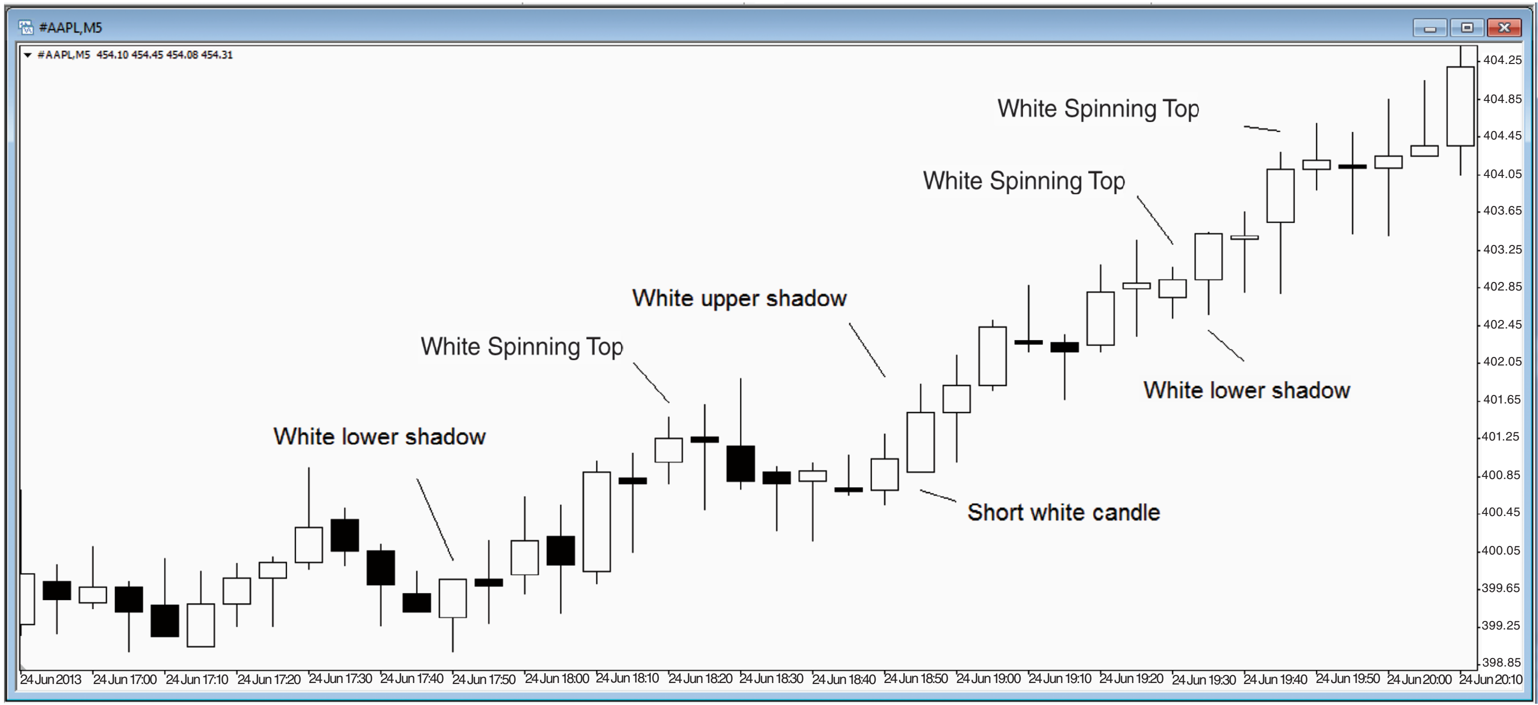
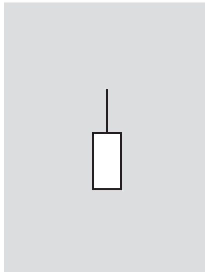


FIGURE 2.3 Apple 5-Minute (2013)—Short candles as continuation patterns

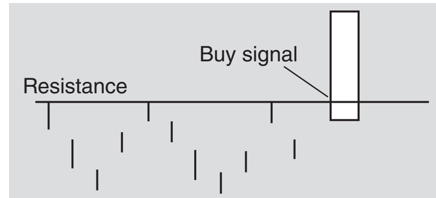
10. White Upper Shadow



- **Definition:** This candle's close is greater than the open during an average or small daily range. The open must be equal to the low. The length of its real body must be larger than the length of its upper shadow.
- **Interpretation:** It is a bullish candle as the close is greater than the open although the close is off the high. Though the bulls are still in control, there is some profit taking at the close. As such, this candle is less bullish than the White Lower Shadow Candle. Despite its close off the high, it is still considered a bullish day and is a likely continuation pattern unless confirmed by a close below its low (which is also the open).

When a Long White Candle Breaks Resistance A long white candle reflects extreme power and strength behind the move. Found after a series of small candles at a low price area, it is a strong signal of a breakout on the upside. Relatively higher volume accompanying this long white candle will confirm that the breakout is genuine and implies that bigger players are ready to buy this stock further up (see Figure 2.4).

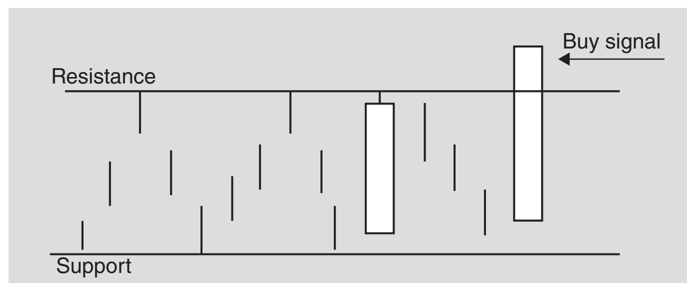
Proper action: It is appropriate to take up a long position.



Long White Candle Breaks Resistance

Long White Candle Seen at a Low Price Area Long white candles seen at a low price area represent bulls attempting to take control. But it may take some time for bulls to garner enough strength to absorb stale bull liquidations before lifting themselves out of the sideways trend. Ideally, oscillators like the relative strength index (RSI) should be at oversold levels, and volume registered on white candles should exceed volume on black candles (see Figure 2.5).

Proper action: Look for a breakout on the upside for a buy signal. Stronger volume registered on the breakout day is proof of bull intentions to drive prices higher.



Long White Candle at a Low Price Area

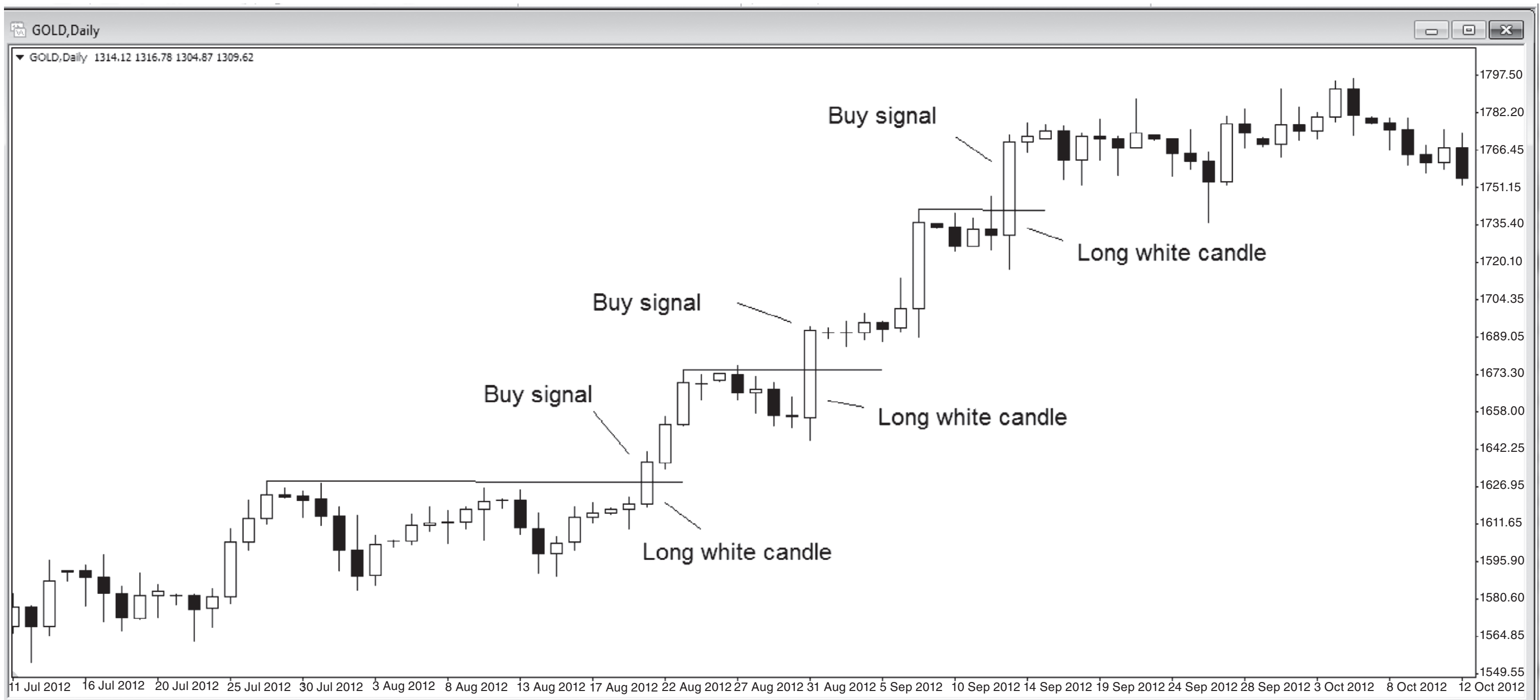


FIGURE 2.4 Gold Daily (2012)—Long white candle breaks resistance; buy signal

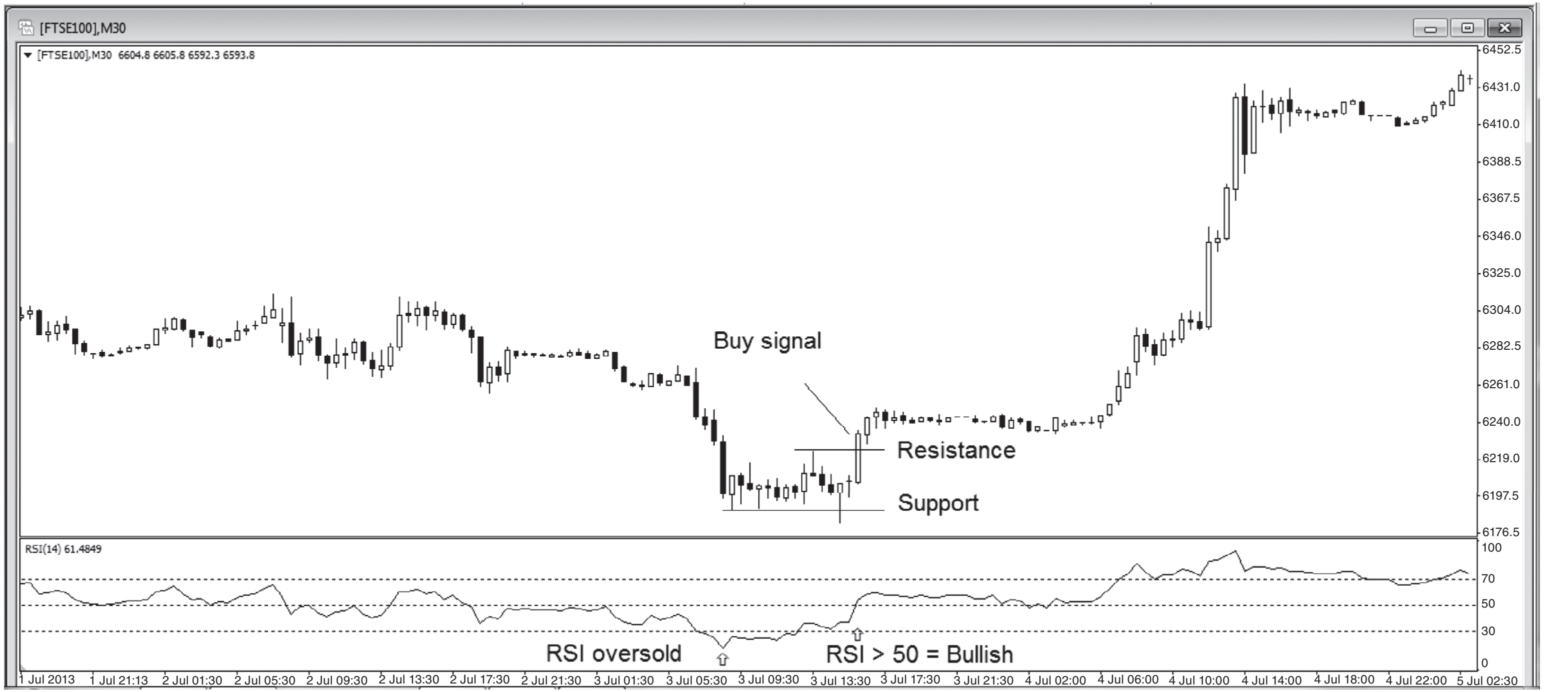
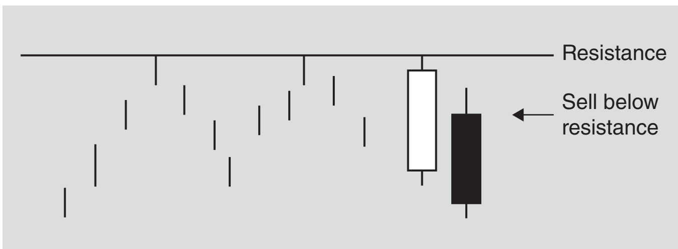


FIGURE 2.5 FTSE 30-Minute (2013)—White candles at a low price area; buy on breakout of resistance

Long White Candle Seen at a High Price Area A long white candle seen at a high price area, especially when oscillators like the RSI display overbought signals, should be approached with caution. It could well signify a market top or buying climax. It may or may not result in a trend reversal, but it is not wise to buy into it as it signifies resistance (see Figure 2.6).

Proper action: If its high is not exceeded and a black candle follows this, it is an indication of a market top. It would be wise to take some profits on long positions if a bearish candle results the next day. Bearish confirmation is required before selling.



Long White Candle Seen at a High Price Area Acts as Resistance

Long White Candle in an Inverted V Shape or Spike Formation

1. Occasionally prices rally 5 to 10 days in a row making new highs every day in a dynamic move. In this scenario, there are no previous highs to gauge resistance. Here, an exceptionally long white candle's high or close provides the resistance. Check the volume for a hint of a buying climax; also check oscillators like the RSI for overbought levels. An RSI above 70 warns of an overbought market.
2. A sell signal comes only if there is one or a series of bearish candles appearing over the next few days closing lower than the long white candle's low.
3. In the event of an uptrend resumption, the highs of either of the two candles will be your buy-stop (see Figure 2.7).

Ten Black Candle Types and Their Interpretations

Following are the definitions and interpretations of the 10 black candle types.

1. Long Marubozu Black Candle

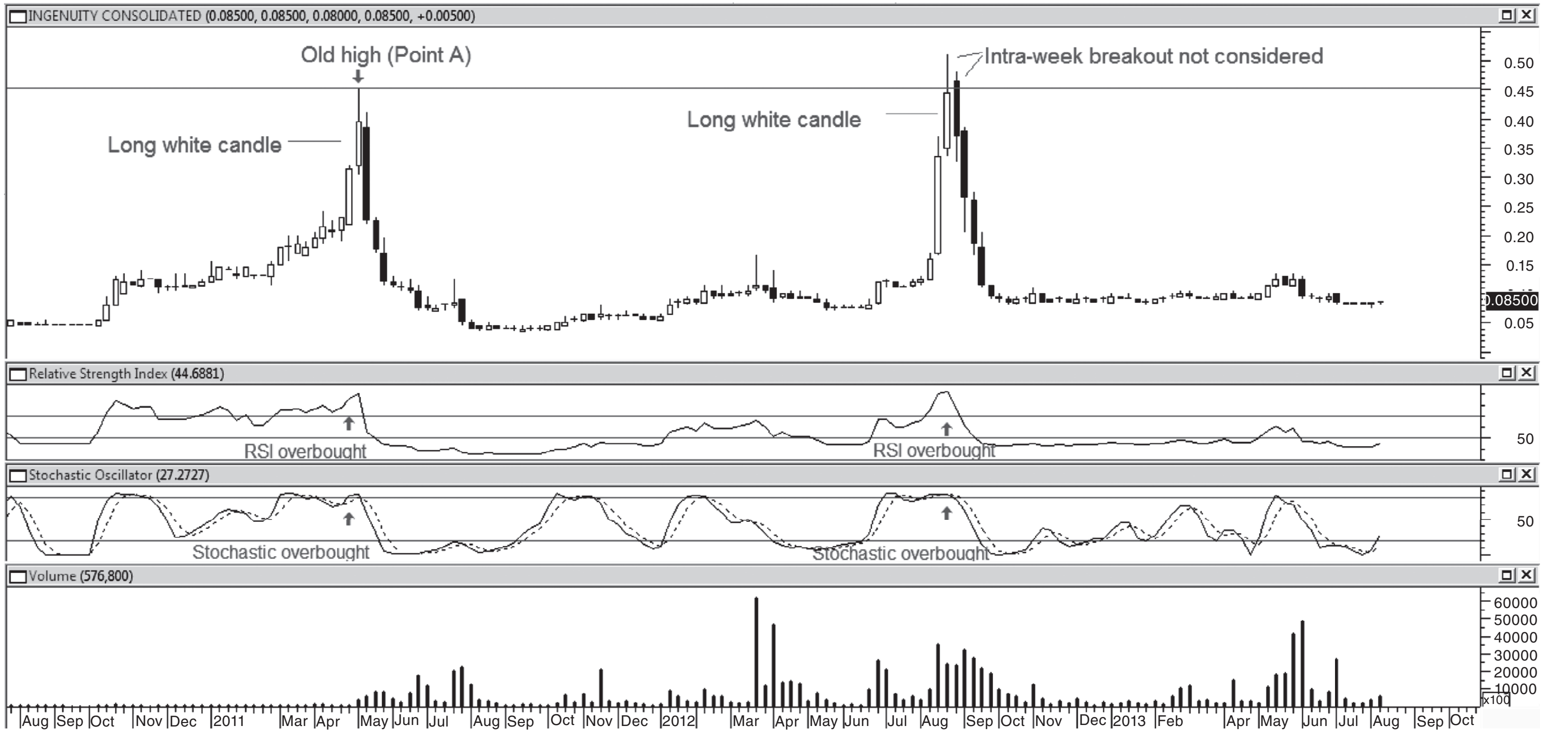


FIGURE 2.6 Ingenuity Consolidated Malaysia Weekly (2011)—Long white candles at high price area warn of an overbought market

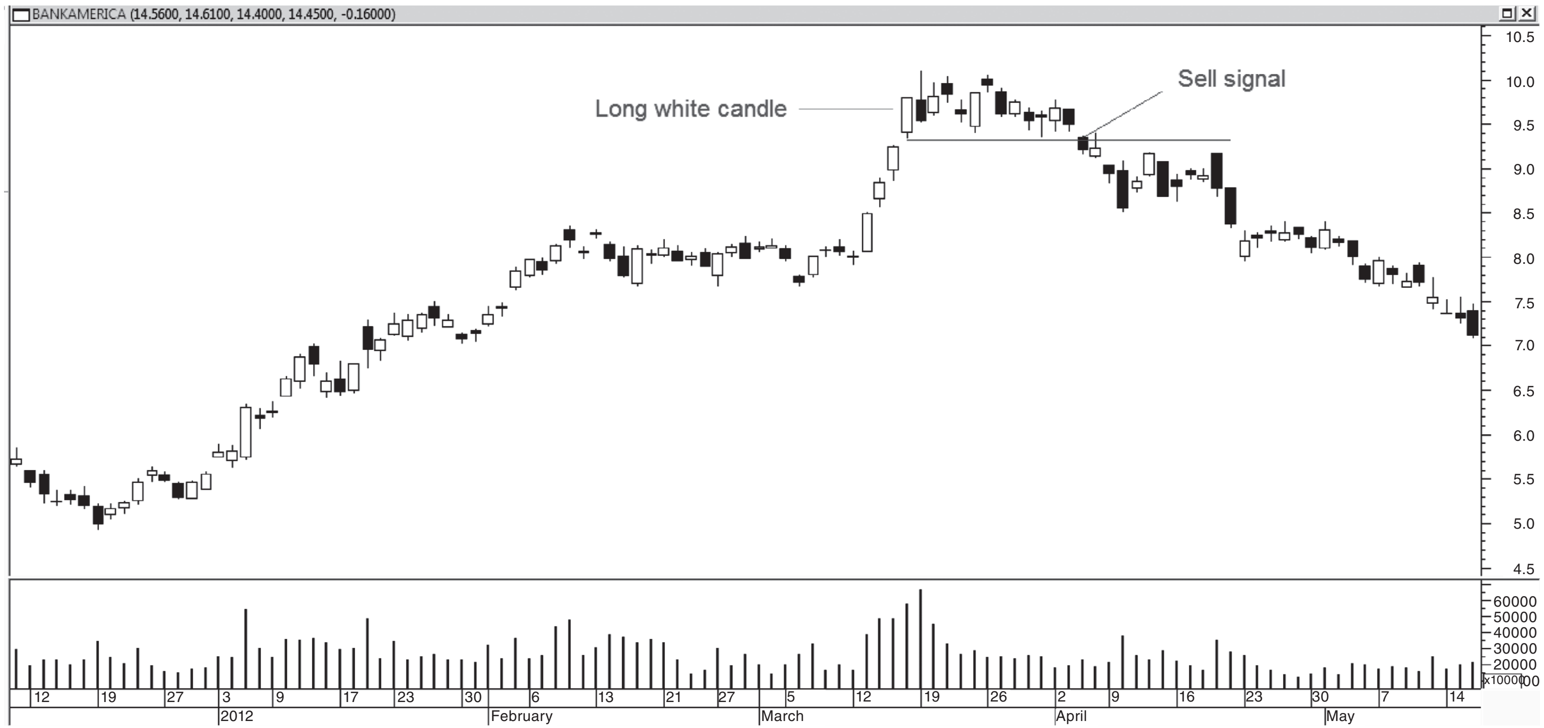


FIGURE 2.7 Bank of America Daily (2012)—Long white candle's low acts as support; sell below support

- **Definition:** This candle's close is less than the open during a greater than average daily range. The close must be equal to the low, and the open must be equal to the high. It has no upper or lower shadows.
- **Interpretation:** *Marubozu* has several meanings in Japanese, one of which is "bald" or "shaven." When applied to describe a candle, it means there is no upper or lower shadow. A Long Marubozu Black Candle is considered extremely bearish because it has no shadows. It is the most bearish of all long black candles as it opens at the high and closes at the low. The bears are in total control of the market on this day.

2. Long Black Candle

- **Definition:** This candle's close is less than the open during a greater than average daily range. The close must be near but not at the low, and the open must be near but not at the high. It has a short upper and lower shadow.
- **Interpretation:** The long black candle is a bearish candle. It is a weak candle but not as weak as the Marubozu Black Candle because there is some buying near the open and the close, creating an upper and lower shadow. Still, it is viewed as a weak day, and the interpretation of this long black candle is similar to that of the Long Marubozu Black Candle. The bears are in total control.

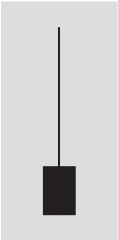
3. Long Opening Bozu Black Candle

- **Definition:** This candle's close is less than the open during a greater than average daily range. The close must be near but not at the low, and the open must be at the high. It has a short lower shadow.
- **Interpretation:** The Long Opening Bozu Black Candle is a bearish candle. It is weak, but not as weak as the Marubozu Black Candle because it closes near but not at the low. Some buying support is seen near the close. Still, it is viewed as a weak day, and the interpretation of this Long Opening Bozu Black Candle is similar to that of the Long Marubozu Black Candle.

4. Long Closing Bozu Black Candle

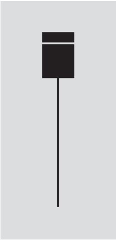
- **Definition:** This candle's close is less than the open during a greater than average daily range. The close must be at the low, and the open must be near but not at the high, indicating some buying near the open. It has a short upper shadow.
- **Interpretation:** The Long Closing Bozu Black Candle is a bearish candle. Though it opened and made a slightly higher high, it closed at the low. It is as weak as the Long Marubozu Black Candle and is a day where bears are in total control.

5. Inverted Black Umbrella Candle



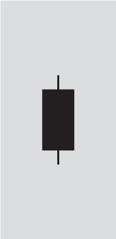
- **Definition:** This candle's close is less than the open during an average or large range day. The upper shadow must be at least twice the length of the real body. It has a small real body and a long upper shadow. This formation is called a Shooting Star if it is found at the top of the market or an Inverted Hammer if it is found at the bottom. It can be recognised by its tight opening and closing real body.
- **Interpretation:** This Black Inverted Umbrella Candle (white or black does not matter as colour is unimportant in this candle type) has strong reversal implications. In interpreting an Inverted Umbrella Candle, the colour of the real body is not important. Rather, it is its *location* that is of the essence.

6. Black Umbrella Candle



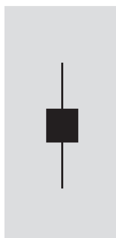
- **Definition:** This candle's close is less than the open during an average or large range day. The lower shadow must be at least twice the length of the real body. This formation is called a Hammer if it is found at the bottom of the market, or a Hanging Man if it is found at the top. It can be recognised by its tight opening and closing real body.
- **Interpretation:** This Black Umbrella Candle (white or black does not matter as colour is unimportant in this candle type) has strong reversal implications. In interpreting an Umbrella Candle, the colour of the real body is not important. Rather, it is its *location* that is of the essence.

7. Short Black Candle



- **Definition:** This candle's close is less than the open with a less than average daily range. The close should be near but not at the low, and the open should be near but not at the high. It has an upper and a lower shadow. The total length of the real body must be larger than the sum of its upper and lower shadow. If there is no upper or lower shadow, it is called a Short Marubozu Black Candle.
- **Interpretation:** The short black candle is considered a weak candle as the close is below the open. But due to its smaller than average real body, it is not as weak as a long black candle. Still, the short black candle is interpreted as weak. It can appear in a consolidation pattern or as part of a trend continuation pattern.

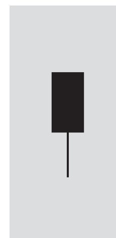
8. Black Spinning Top



- **Definition:** This candle's close is less than the open with a less than average daily range. The total length of the real body must be smaller than the sum of its upper and lower shadows.
- **Interpretation:** The Spinning Top (white or black does not matter as colour is unimportant in this candle type) is considered a neutral candle as the open and the close are near one another while its upper and lower shadows are longer than the length of its real body. This candle reflects a tug-of-war between the bulls and the bears with no party emerging victorious at the end of battle. The market is said to be indecisive or uncertain. In a trending market, it is part of a continuation pattern. Found after a strong rally, it may indicate a possible reversal to the downside. Found after a decline, it may point to a possible reversal to the upside. In analysing a Spinning Top, its colour is unimportant but its *location* is.

Analysed in relation with another candle before it, they help to form Stars or harami patterns and transform into a reversal pattern.

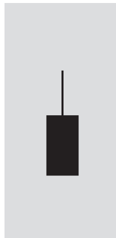
9. Black Lower Shadow



- **Definition:** This candle's close is less than the open during an average or small range, but the length of its real body must be larger than the length of its lower shadow.
- **Interpretation:** The Black Lower Shadow Candle is considered a weak candle, as the close is less than the open. The lower shadow implies some buying support towards the close. But

the lower close meant the bears were still in control. It can appear in a consolidation pattern or as part of a trend continuation pattern.

10. Black Upper Shadow



- **Definition:** This candle's close is less than the open during an average or small range, but the length of its real body must be larger than the length of its upper shadow.
- **Interpretation:** The Black Upper Shadow Candle is considered a weak candle, as the close is less than the open. Though there is an attempt by the bulls to control price at some point during the day, the weak close at the end of the day implies weakness. This candle is more bearish than the Black Lower Shadow Candle because it closed at the low. It can appear in a consolidation pattern or as part of a trend continuation pattern.

Short Black Candles as Continuation Patterns Figure 2.8 shows an example of short black candles as continuation patterns.

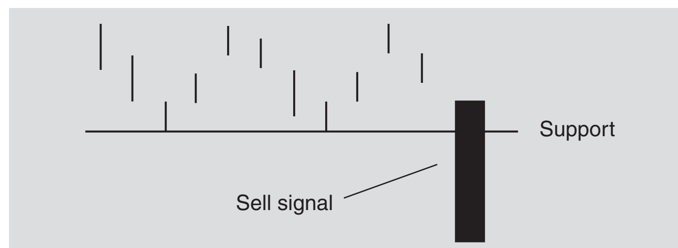
Short Black Candles as Consolidation Patterns Figure 2.9 shows an example of short black candles as consolidation patterns.

Note: When a market is in a consolidation mode, one can gauge its tone by observing the frequency of occurrence of white candles over black candles. In the previous example on Apple, Quadrant A consists of seven white candles compared to only three black candles and two doji. With more white candles than black, the predominance of white candles tells us that the bulls are in control. Note that Apple's price continues to rise.

Similarly, in Quadrant B, the number of white candles over black comes to five against three. On March 13, 2012, Apple's price broke out of this quadrant to rise further.

When a Long Black Candle Breaks Support A long black candle reflects extreme power and strength behind the move. Found breaking a support after a series of small candles (consolidation), it is a strong signal of a breakout on the downside. Relatively higher volume accompanying this long black candle will confirm this breakout and is a signal that bigger players are ready to depress this stock further (see Figure 2.10).

Proper action: It is appropriate to take up a short position.



Long Black Candle Breaks Support

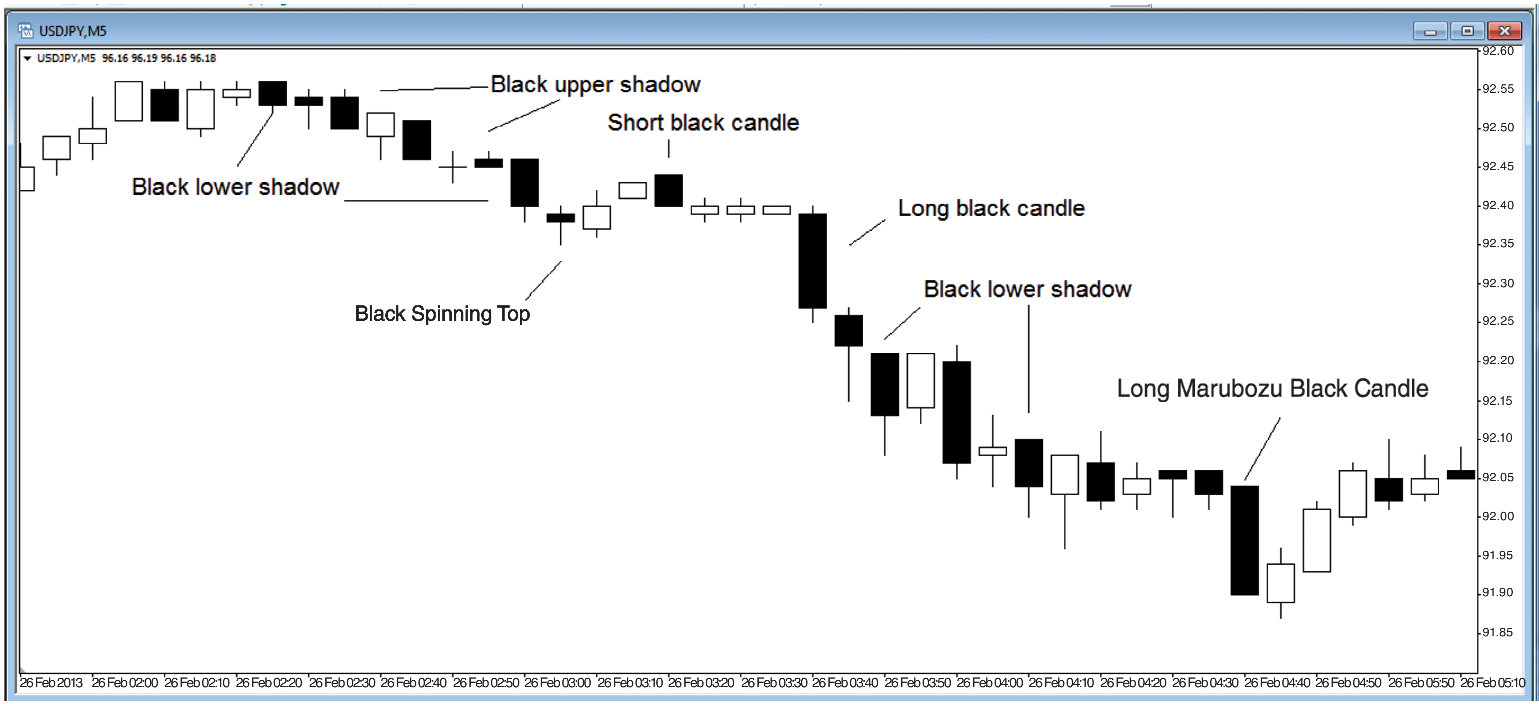


FIGURE 2.8 UsdJpy 5-Minute (2013)—Short black candles as continuation patterns

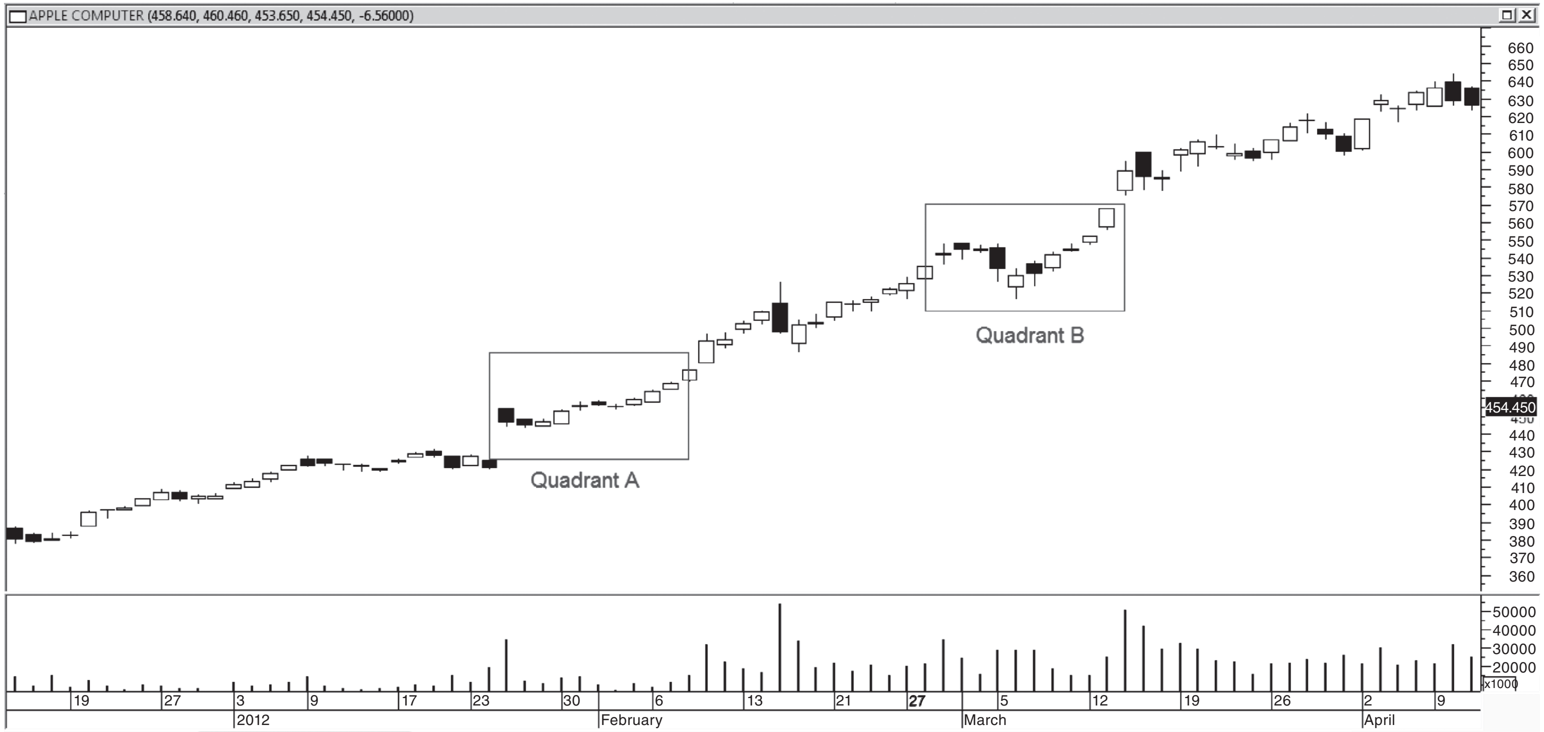


FIGURE 2.9 Apple Daily (2012)—Predominance of white candles over black candles has bullish implications

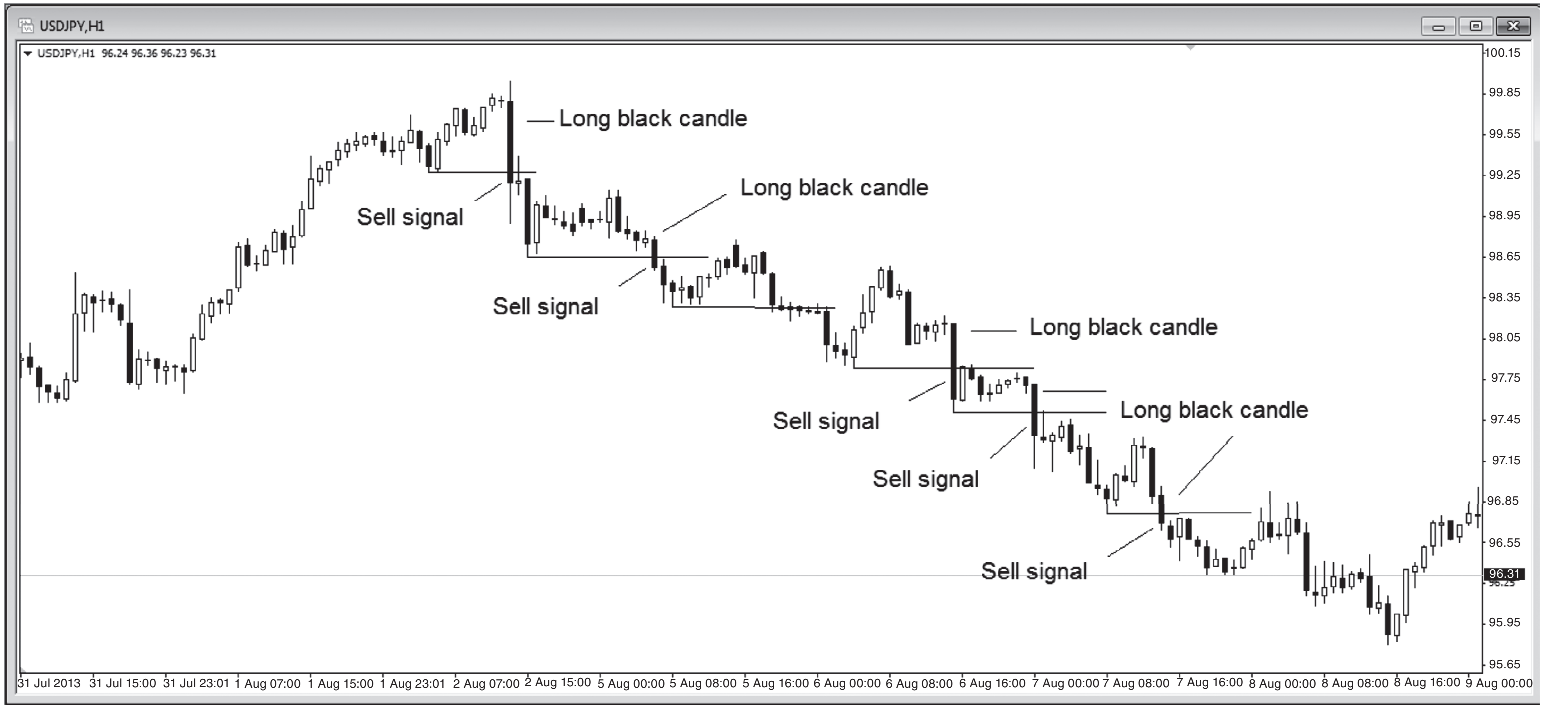
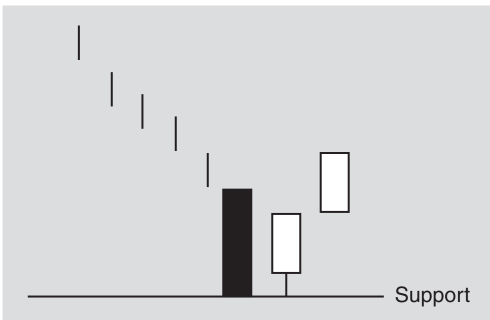


FIGURE 2.10 UsdJpy Hourly (2013)—Long black candle breaks support: sell signal

Long Black Candle Seen at a Low Price Area A long black candle seen at a low price area should be approached with caution. It could well signify a market bottom or selling climax. It may not be wise to sell into this candle as it may signify support (see Figure 2.11).

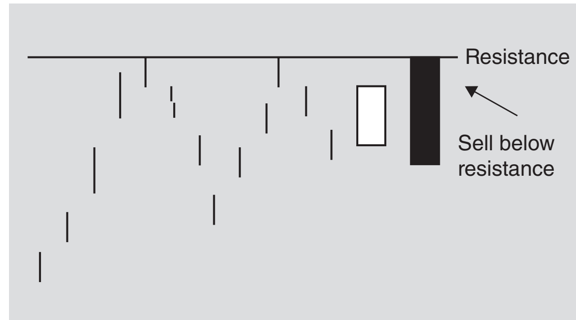
Proper action: If its low is not exceeded and is followed by a white candle, it is an indication of a market bottom. Take profits on short positions. In the event of a resumption of the downtrend, place a sell-stop below the low of the support. A long black candle seen after a protracted decline is indicative of a selling climax.



Long Black Candle at a Low Price Area Acts as Support

Long Black Candle Seen at a High Price Area A long black candle seen at a high price area should be approached with caution. It could warn of a market top or buying climax if it could not exceed previous highs. It may be a good selling area (see Figure 2.12).

Proper action: If its high is not exceeded and is preceded by a white candle forming a bearish reversal pattern group (like a bearish engulfing pattern in this example), it is wise to take profits or take up a short position. In the event of an uptrend resumption, place a buy-stop above the resistance.



Long Black Candle at High Price Area Acts as Resistance

The Doji

The doji is one of the more important single candles. It is created when its opening price and its closing price are the same. A doji does not have a real body. The upper and lower shadows can be long or short. More weight is given in analysing a doji with longer shadows. Doji with longer shadows reflect a volatile day while doji with shorter shadows reflect a dull and quiet day.

Interpretation: A doji is classified as a neutral candle if it is found within a sideways market. It takes on significance when it is spotted at a high price area, for example after an uptrend, or at a low price area after a downtrend. In such a situation, the doji is likely to warn of a market reversal. A doji seen after a long white

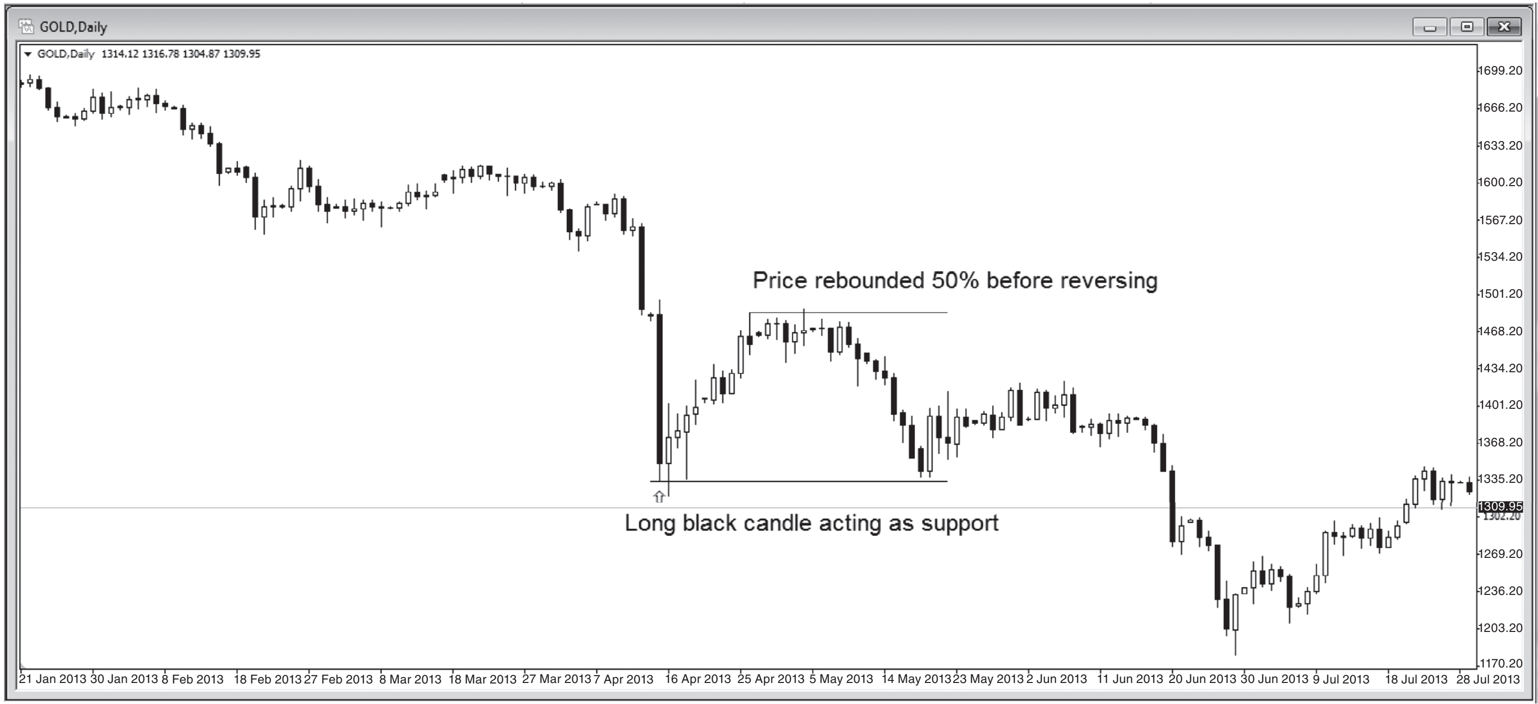


FIGURE 2.11 Gold Daily (2013)—Long black candle at low price area acts as support

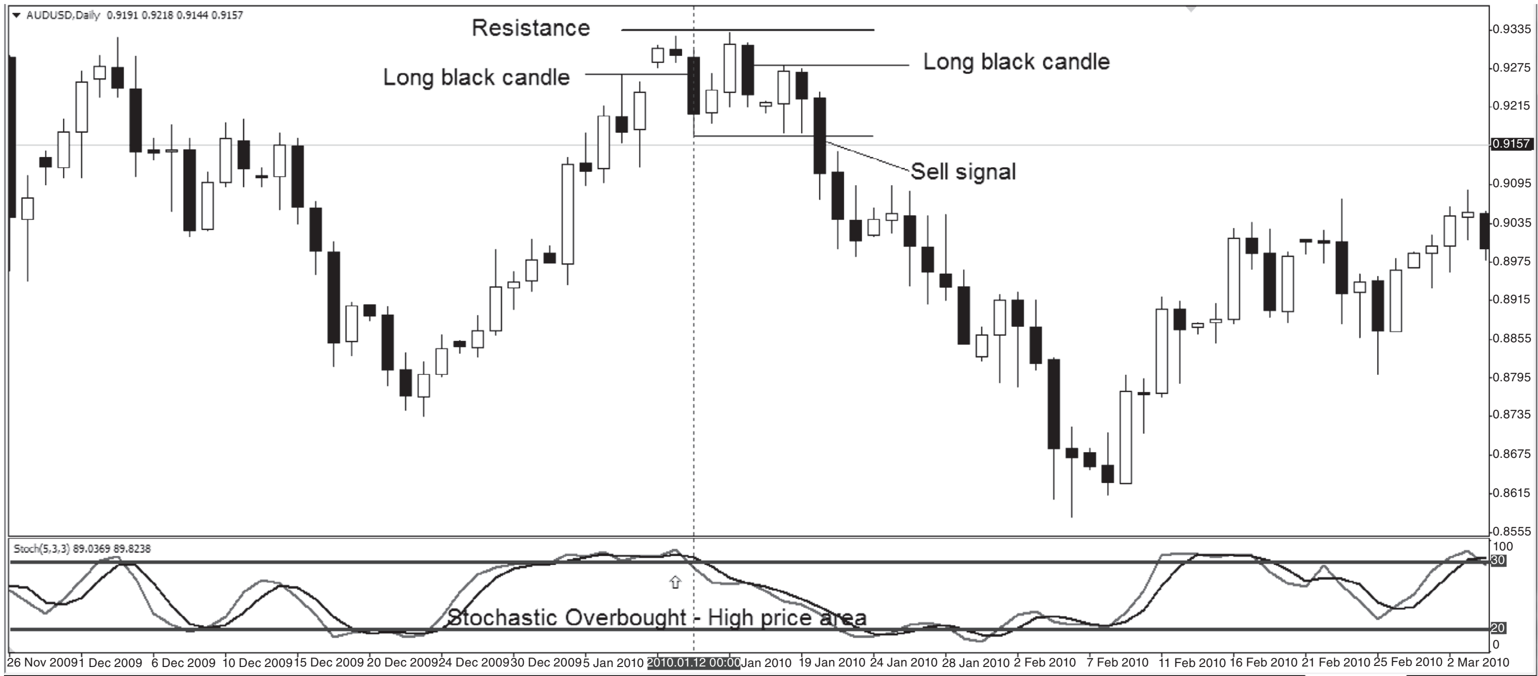


FIGURE 2.12 AudUsd Daily (2010)—Long black candle at high price area acts as resistance

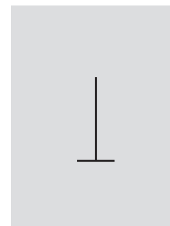
or black candle will also hint of a possible reversal. The location of the doji is of significance.

A doji should be read in conjunction with other patterns before it. The advance pattern group that is created gives a clearer picture on its next direction. For example, a small doji that gaps below or above the previous candle could form a Star. Following are five variations of the doji candle.

1. Four Price Doji

- **Definition:** The Four Price Doji is formed when the open, high, low, and close are all at the same price.
- **General interpretation:** Like all doji, the Four Price Doji can be interpreted both as a reversal or a continuation pattern. The important criterion is to identify where the doji is found. If the doji is found after a rally or at a high price area, it is generally viewed as a potential bearish reversal pattern. If it is found after a downtrend or at a low price area, it has potential bullish reversal implications. But if found in a sideways market, it is viewed as a neutral candle.
- **Proper action:** Possible reversal candle but wait for a confirmation candle before buying or selling.
- **Specific interpretation:** The Four Price Doji is a rare occurrence. It can be interpreted both as a reversal or a continuation pattern. It can be formed when a market makes a limit move (see the Seal Inc. Malaysia [2005] chart, Figure 2.13), or it can reflect an illiquid market (see the Tai Kwong Yokohama Malaysia [2014] chart, Figure 2.14).

2. Gravestone Doji



- **Definition:** The Gravestone Doji is formed when the open, close, and low are at the same price. It has a long upper shadow.
- **General interpretation:** Like all doji, the Gravestone Doji can be interpreted both as a reversal or a continuation pattern. The important criterion is to identify where the doji is found. If the doji is found after a rally or in a high price area, it is generally viewed as a potential bearish reversal pattern. If it is found after a downtrend or at a low price area, it has potential bullish reversal implications. But if found in a sideways market, it is viewed as neutral.

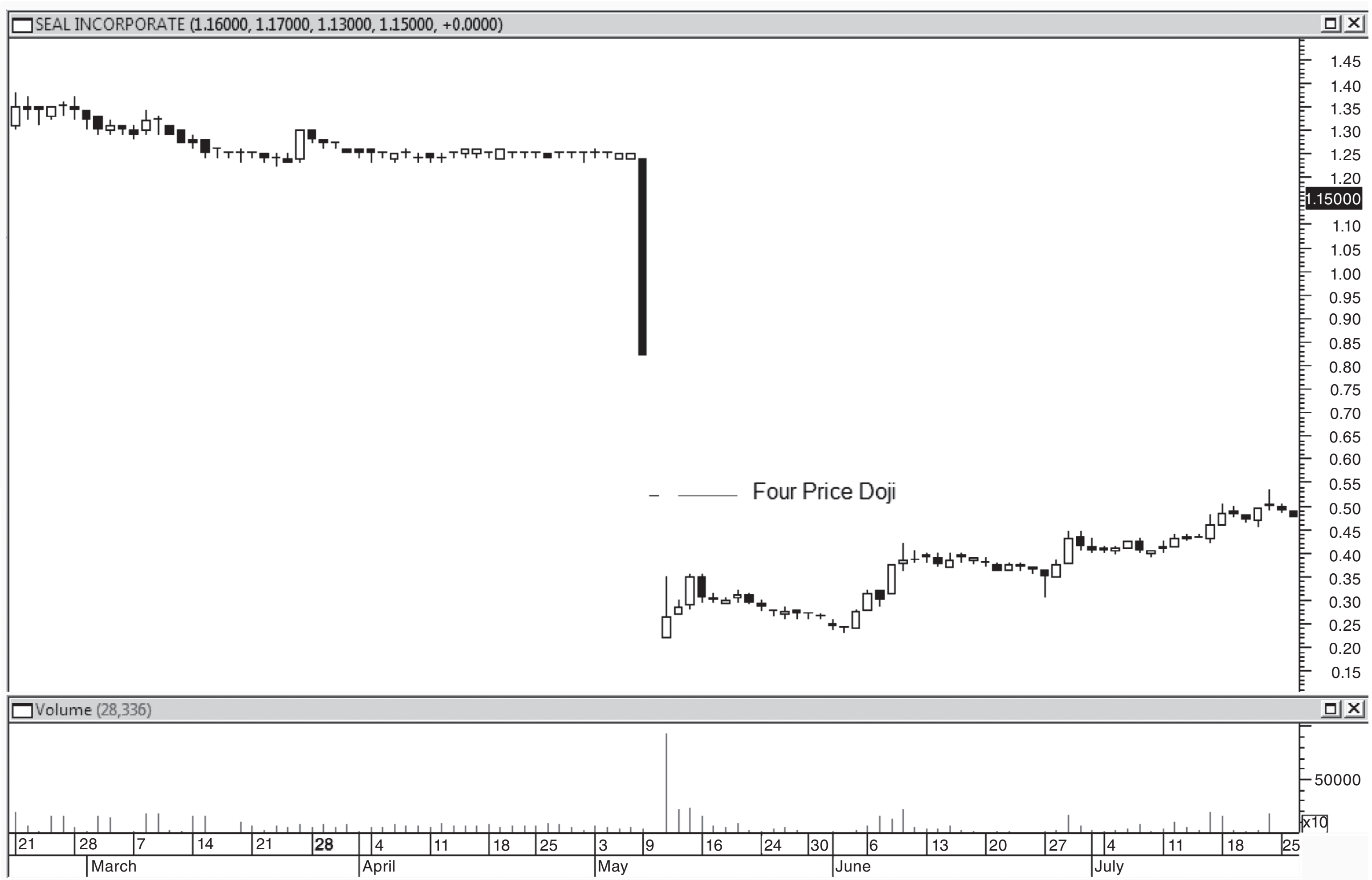


FIGURE 2.13 Seal Inc. Malaysia Daily (2005)—Four Price Doji making a limit move in an extremely bearish market

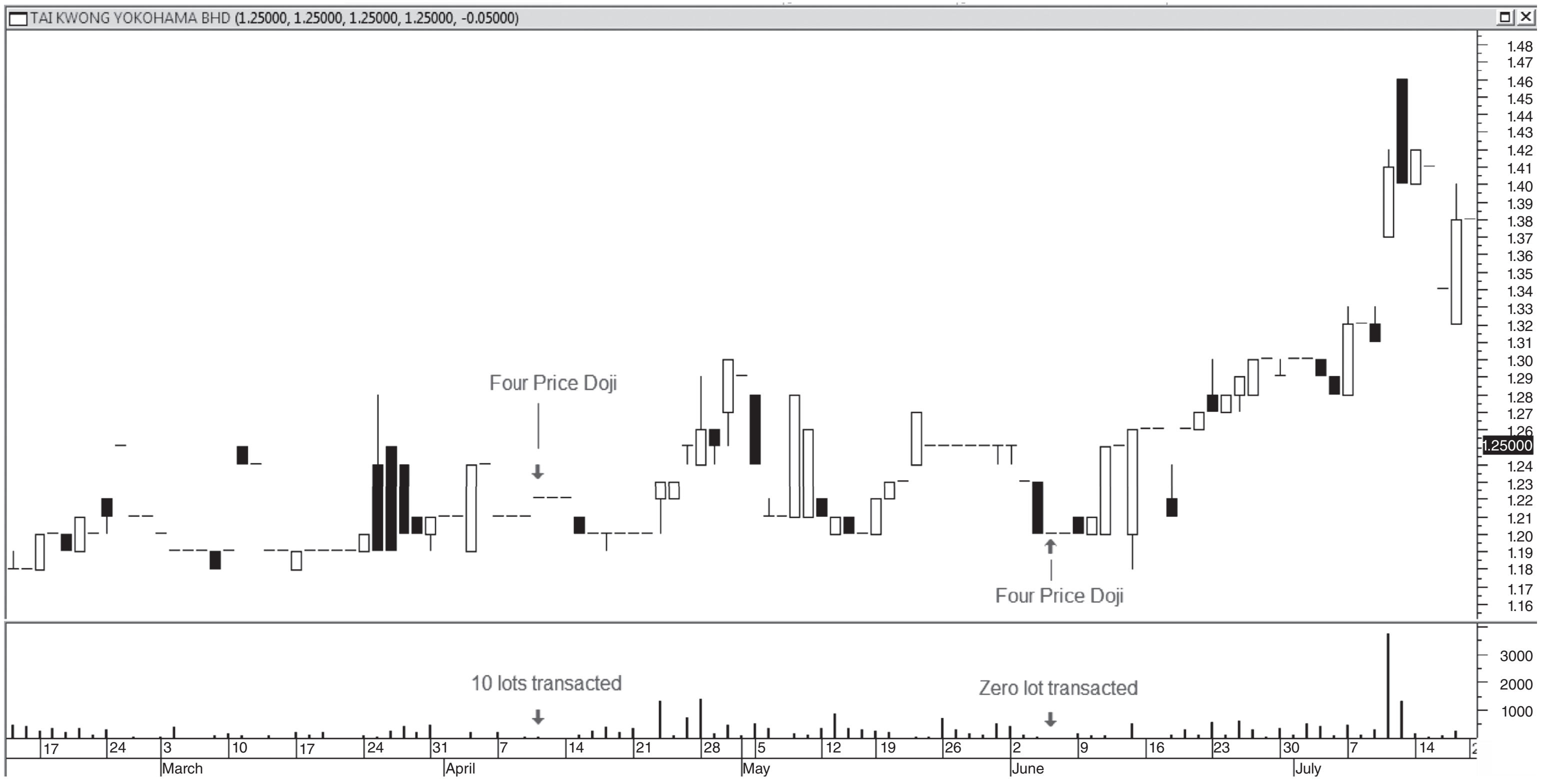
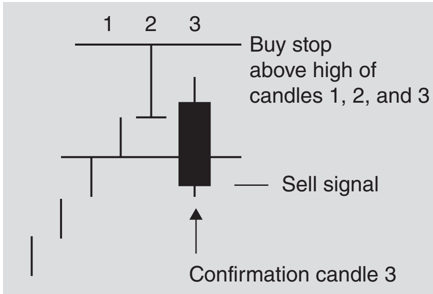


FIGURE 2.14 Tai Kwong Yokohama Malaysia (2014)—Four Price Doji in an illiquid market

Gravestone Doji at the Top



Rules

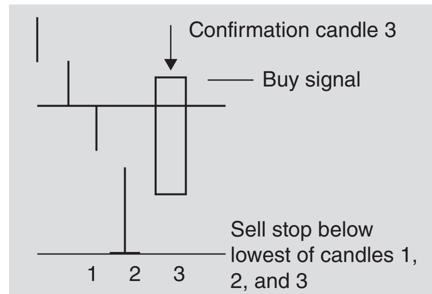
1. Sell if confirmation candle 3 closes below lowest of candles 1 and 2.
2. In case of a resumption of uptrend, place buy-stop above the highest of candles 1, 2, and 3.

Specific interpretation: The Gravestone Doji is bearish if seen after a strong uptrend or at a high price area. It is a bearish candle because of its long upper shadow and a close at its low. A low close implies that the bears dominate prices even though they were traded higher all day. If the open and close are near each other but not at the same price, it is called a Shooting Star, also a bearish candle.

Proper action: Possible major reversal candle but wait for a confirmation candle before selling. A close below the lowest low of the Gravestone Doji (candle 2) and the candle before it (candle 1) is your sell confirmation. The Gravestone Doji candle is, however, a rare pattern in Malaysian stocks and futures as well as in most financial instruments. I managed to find one perfect example in the forex pair UsdJpy 15-Minute chart (Figure 2.15). Its variation, the Shooting Star, is a much more common occurrence as a bearish reversal signal, as shown in the Gold Hourly chart (Figure 2.16).

Example of Gravestone Doji and Shooting Star Figure 2.15 and Figure 2.16 show an example of a Gravestone Doji and its variation, the Shooting Star.

Gravestone Doji at the Bottom



Rules

1. Buy if confirmation candle 3 closes above high of candles 1 and 2.
2. In case of a resumption of downtrend, place sell-stop below the lowest of candles 1, 2, and 3.
   - **Specific interpretation:** The Gravestone Doji formed in a low price area or after a downtrend is seen as a bullish candle. If the open and close are near each other but not at the same price, it is called an Inverted Hammer, a bullish candle (see Figure 2.17).

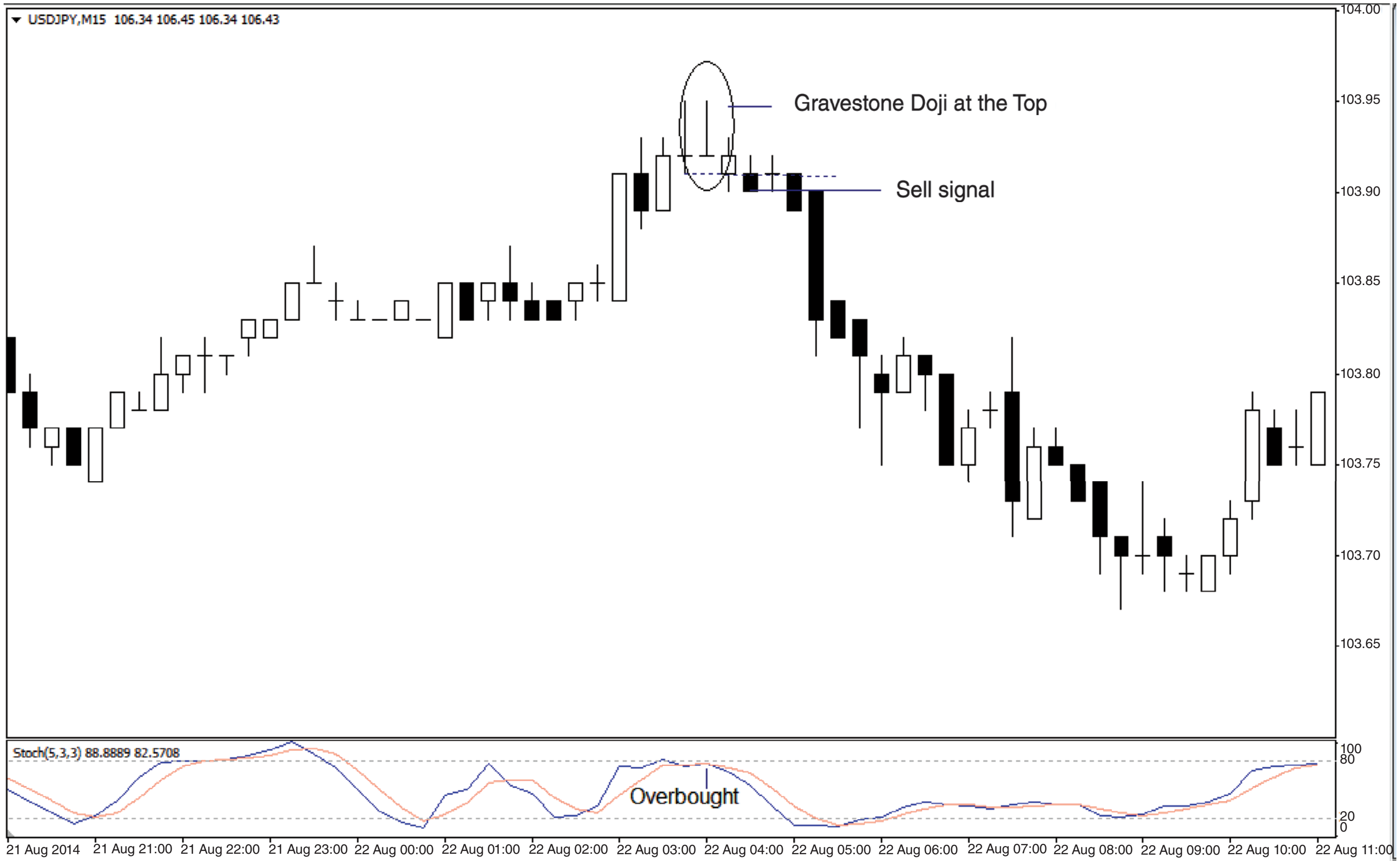


FIGURE 2.15 UsdJpy 15-Minute (2014)—Example of a Gravestone Doji

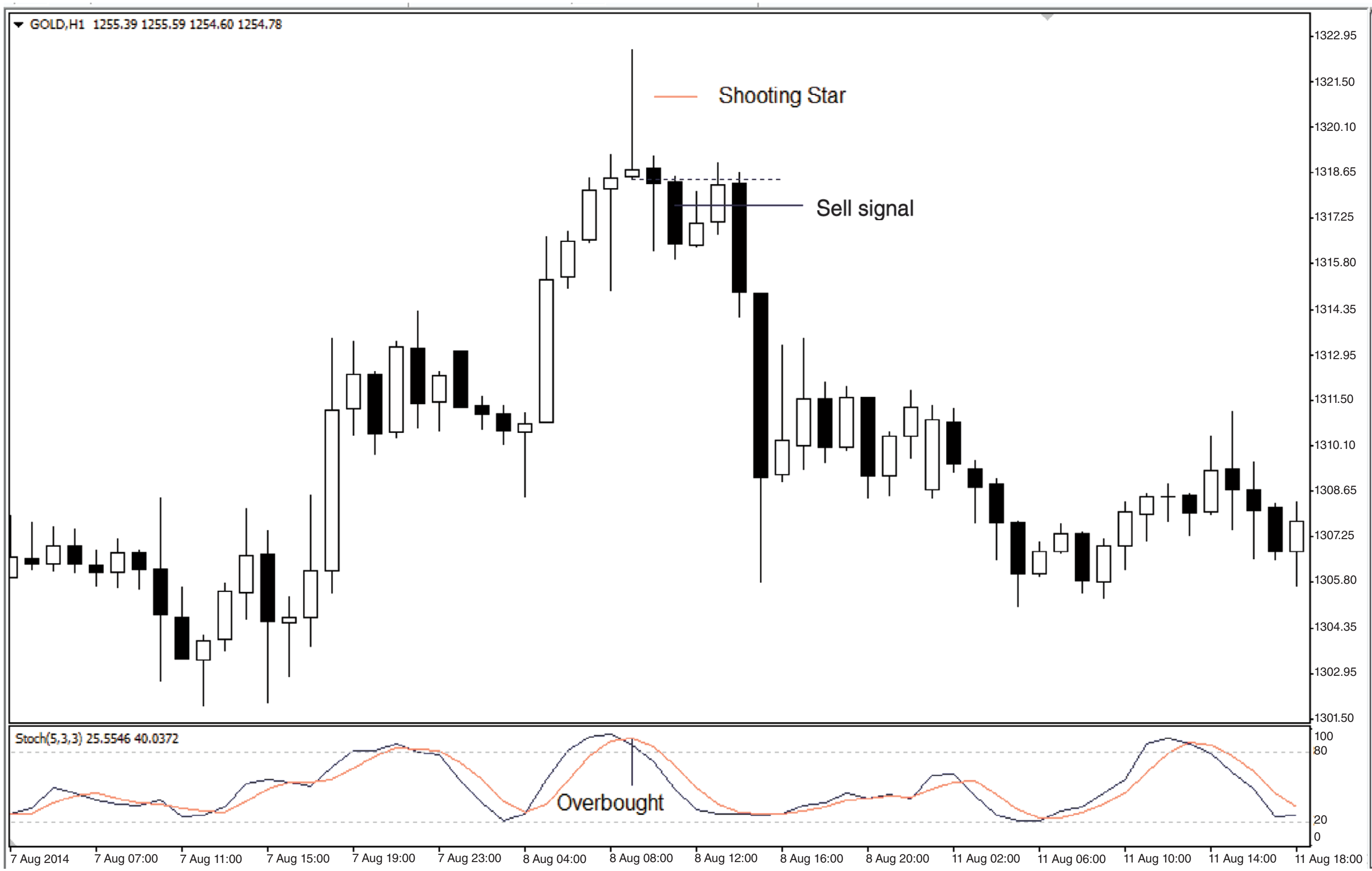


FIGURE 2.16 Gold Hourly (2014)—Shooting Star: A variation of the Gravestone Doji

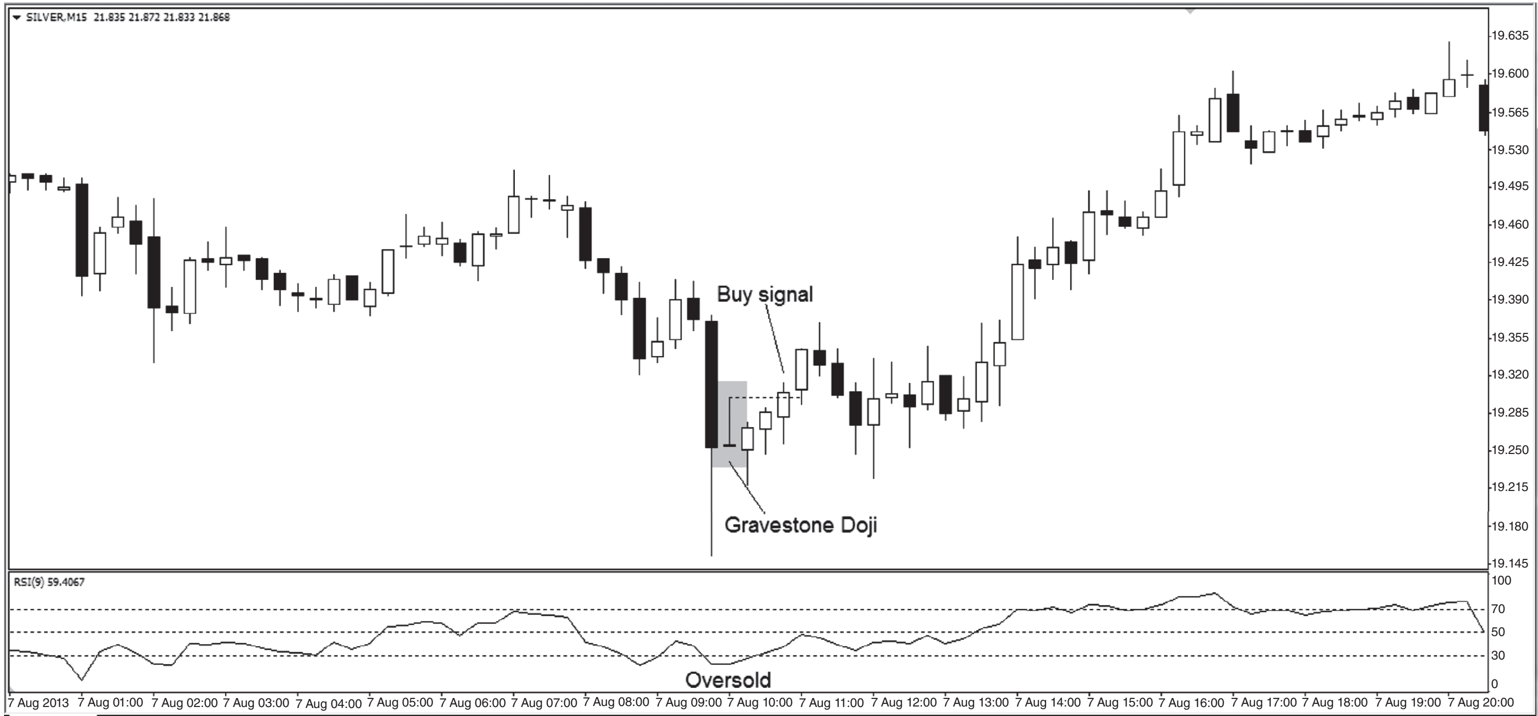
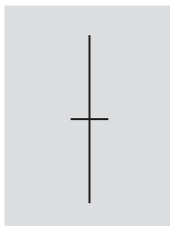


FIGURE 2.17 Silver 15-Minute (2013)—Example of a Gravestone Doji at the Bottom

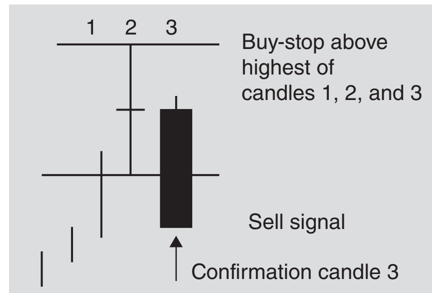
- **Proper action:** Possible major reversal candle but wait for a confirmation candle before buying. A close above the highest high of the Gravestone Doji (candle 2) and the candle before it (candle 1) is your buy confirmation. The Gravestone Doji candle is, however, a rare pattern in Malaysian stocks and futures as well as in most financial instruments. In more active issues, its variation, the Inverted Hammer, is a much more common occurrence as a bullish reversal signal.

3. Long-Legged Doji (Also Called High-Wave Doji)



- **Definition:** The Long-Legged or High-Wave Doji is formed when the open and close are at the same price during a larger than average daily range. The open and the close must be at the midpoint of its range. It has a long upper and lower shadow. It is the long upper and lower shadow that gives it the alternative name of a High-Wave Doji. When it emerges after an uptrend or downtrend, the Japanese say that the market has lost its sense of direction. This lack of orientation puts the prior trend into doubt (see Figure 2.18).
- **General interpretation:** Like all doji, the Long-Legged Doji can be interpreted both as a reversal or a continuation pattern. The important criterion is to identify where the doji is found. If the doji is found after a rally or at a high price area, it is generally viewed as a potential bearish reversal pattern. If it is found after a downtrend or at a low price area, it has potential bullish reversal implications. But if found in a lateral market, it is viewed as neutral.

Long-Legged Doji at the Top



Rules

1. Sell if confirmation candle 3 closes below the low of candle 2.
2. In case of a resumption of uptrend, place buy-stop above the highest of candles 1, 2, and 3.
3. For conservative traders, sell only below candles 1 and 2.
   - **Specific interpretation:** The Long-Legged Doji is bearish if seen after a strong uptrend or at a high price area. It is a bearish candle because of its long upper and lower shadow, which reflects extreme market volatility. The inability of either the buyers or sellers to control price, resulting in a doji, implies indecision. Found after a rally, it marks the

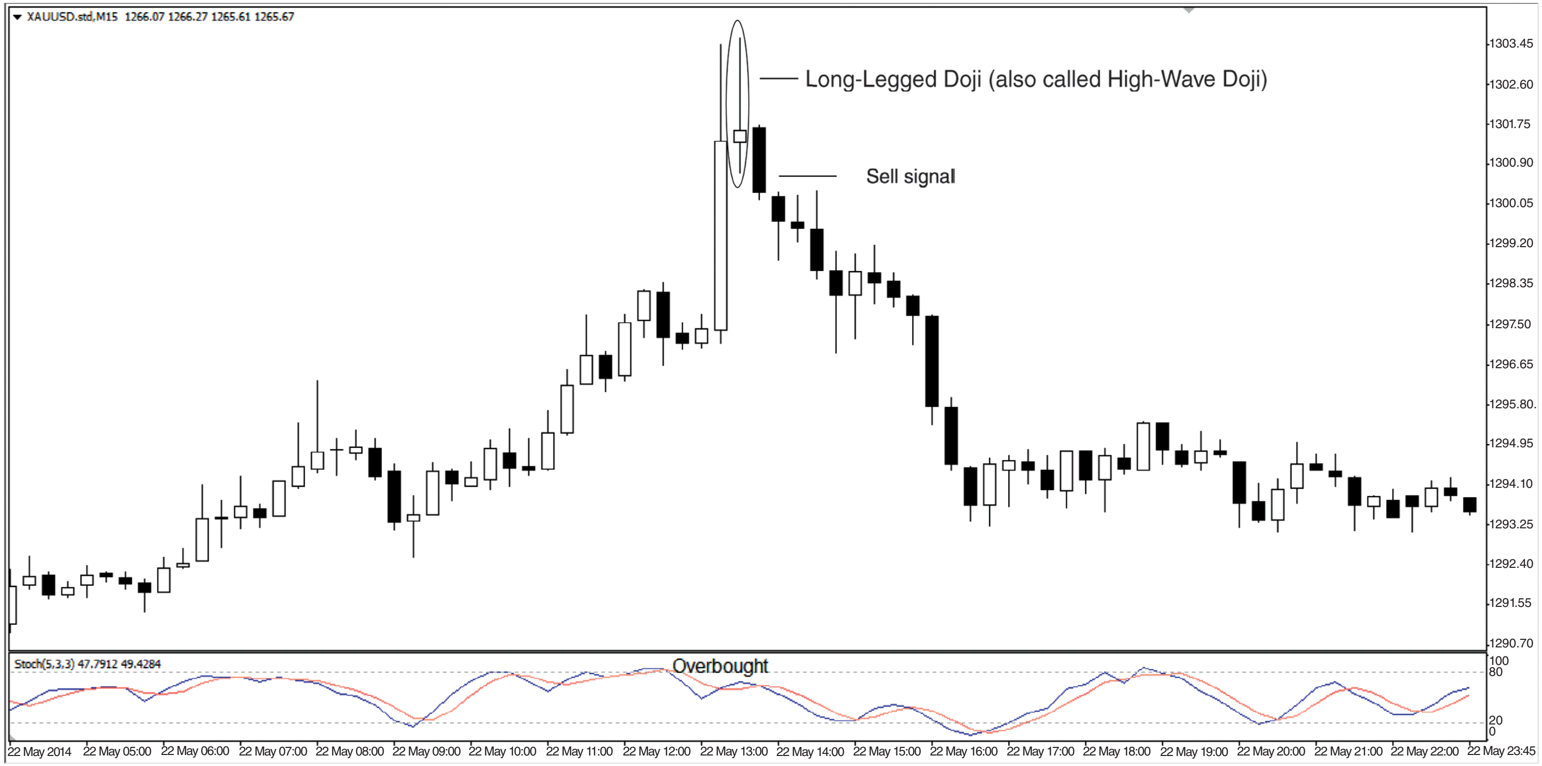
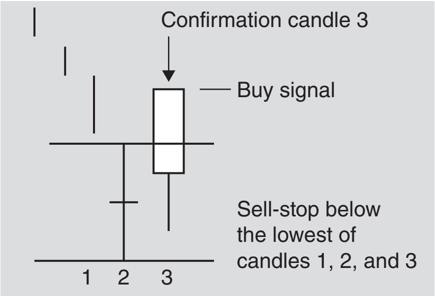


FIGURE 2.18 Gold 15-Minute (2014)—A Long-Legged Doji found after a rally is viewed as bearish

exhaustion of the uptrend. If the open and close are near each other but not at the same price, it can still be called a Long-Legged Doji or High-Wave Doji (see Figure 2.19).

- **Proper action:** Possible major reversal candle but wait for a confirmation candle before selling. For conservative traders, wait for break below candles 1 and 2 before selling.

Long-Legged Doji at the Bottom



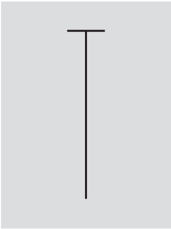
Rules

1. Buy if confirmation candle 3 closes above high of candle 2.
2. In case of a resumption of downtrend, place sell-stop below the lowest of candles 1, 2, and 3.
3. For conservative traders, buy only above candles 1 and 2.

- **Specific interpretation:** If the Long-Legged Doji is located at a low price area or after a downtrend, it is seen as a bullish reversal candle. If the open and close are near each other but not at the same price, it is still labelled a Long-Legged Doji or a High-Wave Doji (see Figure 2.20).

- **Proper action:** Possible major reversal candle but wait for a confirmation candle before buying. A close above the high of the Long-Legged Doji (candle 2) is your buy confirmation. For conservative traders, wait for break above candles 1 and 2 before buying.

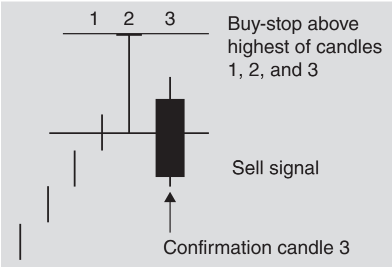
4. Dragonfly Doji



Definition: The Dragonfly Doji is formed when the open, close, and high are at the same price during an average or larger daily range. It has a long lower shadow.

General interpretation: Like all doji, the Dragonfly Doji can be interpreted both as a reversal or a continuation pattern. The important criterion is to identify where the doji is found. If the doji is found after a rally or at a high price area, it is generally viewed as a potential bearish reversal pattern. If it is found after a downtrend or at a low price area, it has potential bullish reversal implications. But if found in a sideways market, it is viewed as neutral.

The Dragonfly Doji at the Top



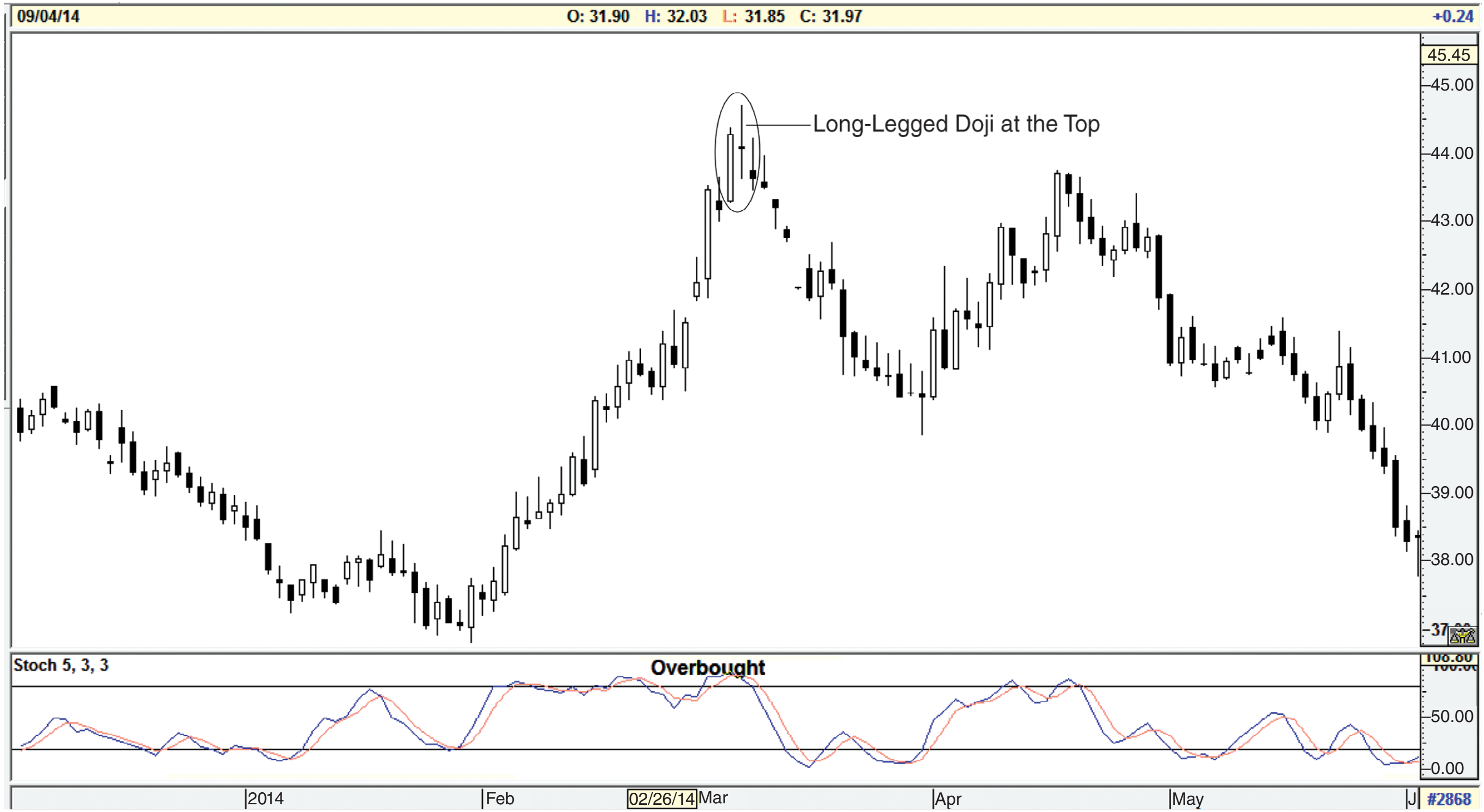


FIGURE 2.19 Soyoil Daily (2014)—A Long-Legged Doji at a high price area warns of a market top

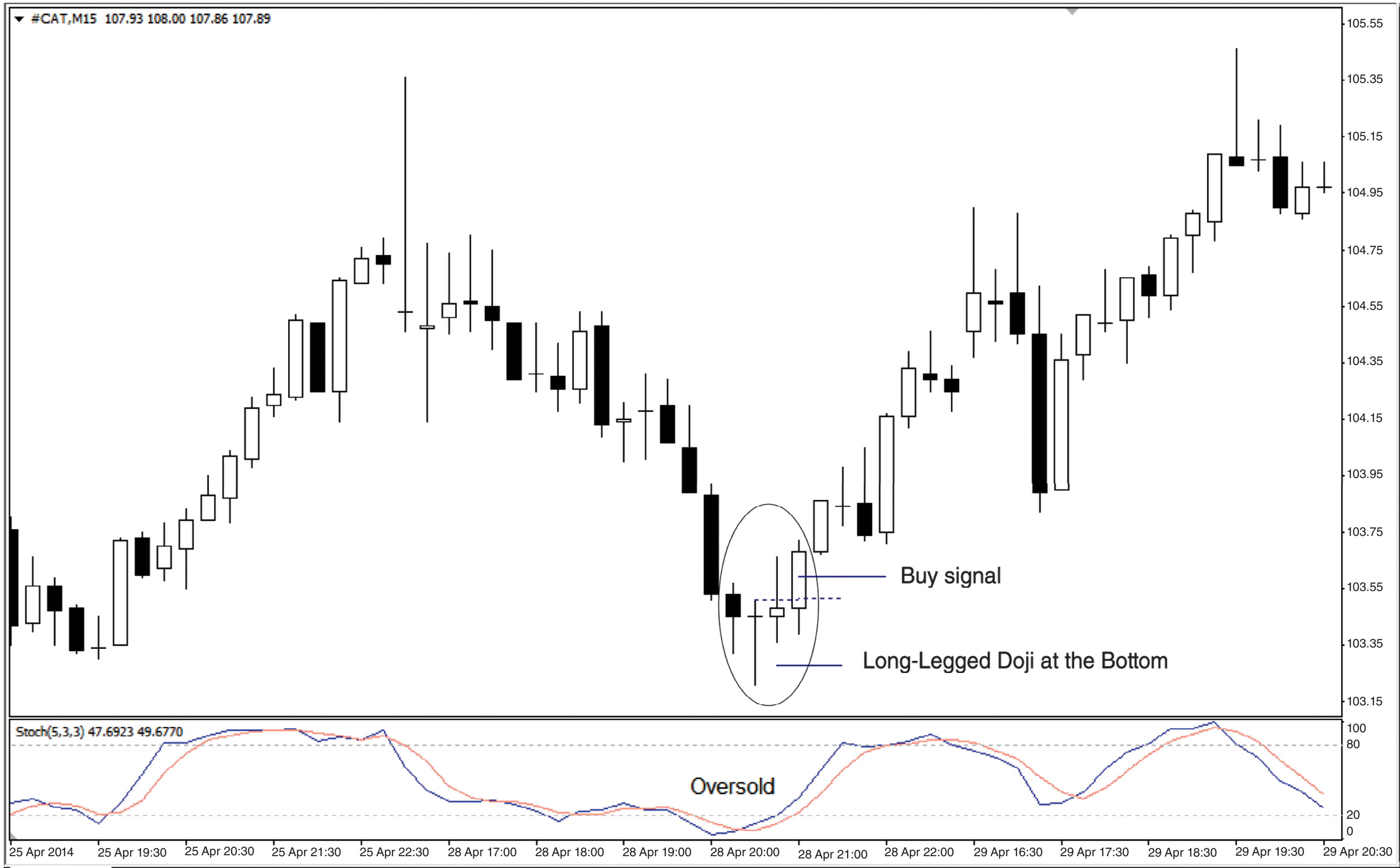


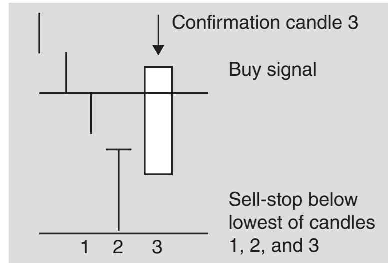
FIGURE 2.20 Caterpillar 15-Minute (2014)—A Long-Legged Doji found after a decline is a bullish reversal pattern

Rules

1. Sell if confirmation candle 3 closes below the low of candles 1 and 2.
2. In case of a resumption of uptrend, place buy-stop above the highest of candles 1, 2, and 3.
   - **Specific interpretation:** The Dragonfly Doji is potentially bearish if seen after a strong uptrend or at a high price area. It is a potentially bearish candle because, although prices recovered after trading lower during the day, buyers who had bought along the lower shadow will be pressured to sell if the confirmation candle closes below the Dragonfly Doji's low. A bearish confirmation candle is required before acting on this candle. If the open and close are near each other but not at the same price, it would be called a Hanging Man, a bearish candle (see Figure 2.21).
   - **Proper action:** Possible major reversal candle but wait for a confirmation candle before selling. A close below the lowest low of the Dragonfly Doji (candle 2) and the candle before it (candle 1) is your sell confirmation. Occasionally, a few bearish candles may appear after the Dragonfly Doji before you can see a sell confirmation candle. The Dragonfly Doji candle is, however, a rare pattern in Malaysian stocks and futures. An example is found in the EurAud 5-Minute chart (see Figure 2.21). Its variation, the Long-Legged Doji, with an upper shadow, occurs more frequently as signs of a market top (Gold 5-Minute; see Figure 2.22). The other variation, appearing with a small real body, called the Hanging Man, is a much more common occurrence (Silver 15-Minute; see Figure 2.23).

Examples of Variations of the Dragonfly Doji at the Top Figure 2.22 and Figure 2.23 show some examples of variations of the dragonfly doji at the top.

Dragonfly Doji at the Bottom



Rules

1. Buy if confirmation candle 3 closes above highest high of candles 1 and 2.
2. In case of a resumption of downtrend, place sell-stop below the lowest of candles 1, 2, and 3.
   - **Specific interpretation:** If the Dragonfly Doji is located at a low price area or after a downtrend, it is viewed as a bullish candle. If the open and close are near each other but not at the same price, it is called a Hammer, a bullish candle (see Figure 2.24).
   - **Proper action:** Possible major reversal candle but wait for a confirmation candle before buying. A close above the highest high of the Dragonfly Doji (candle 2) and the candle before it (candle 1) is your buy confirmation. The Dragonfly Doji candle is, however, a rare pattern in Malaysian stocks and futures. Its variations, the Hammer and Long-Legged Doji, are much more common occurrences as bullish reversal signals.

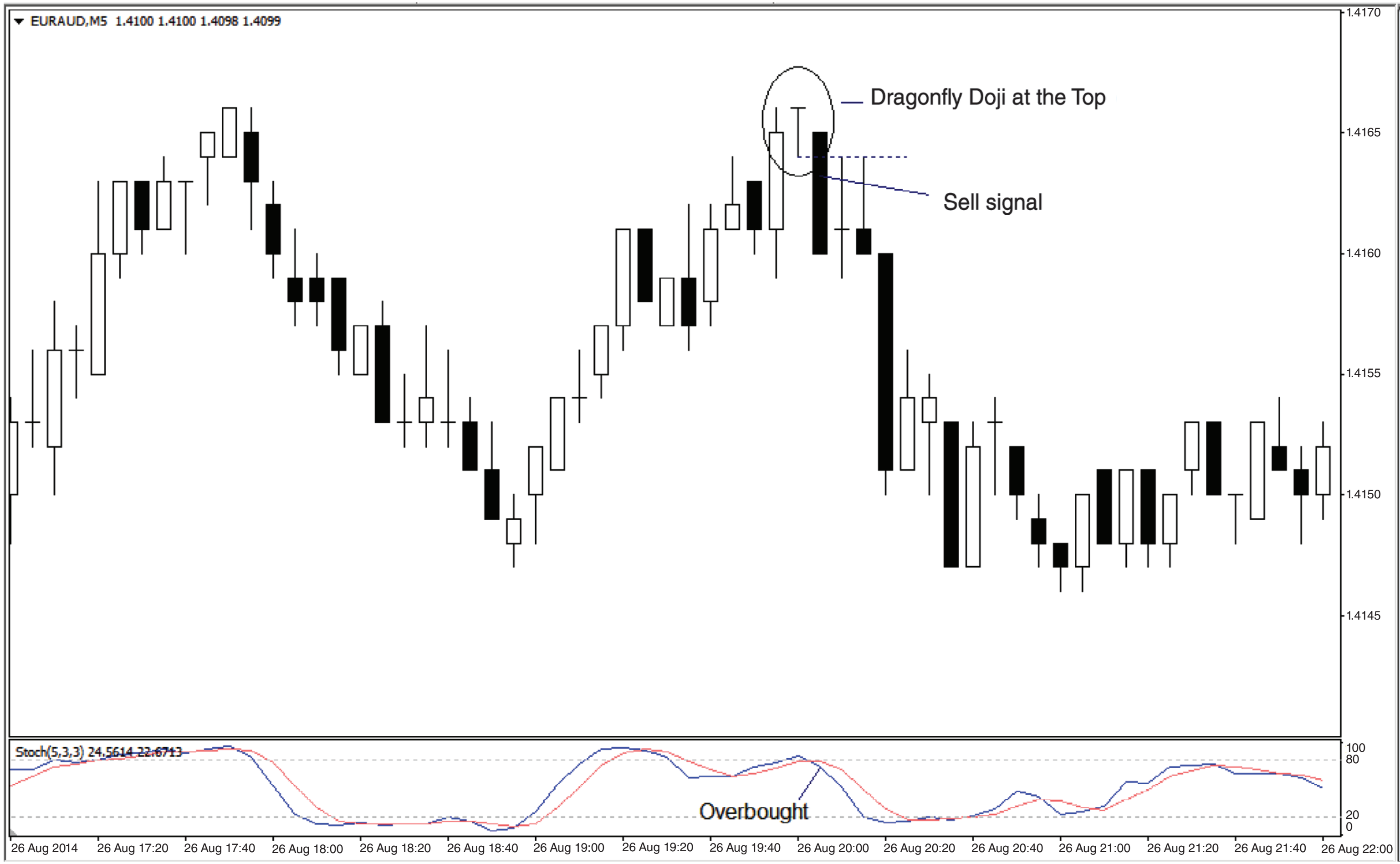


FIGURE 2.21 EurAud 5-Minute (2014)—Dragonfly Doji at the Top

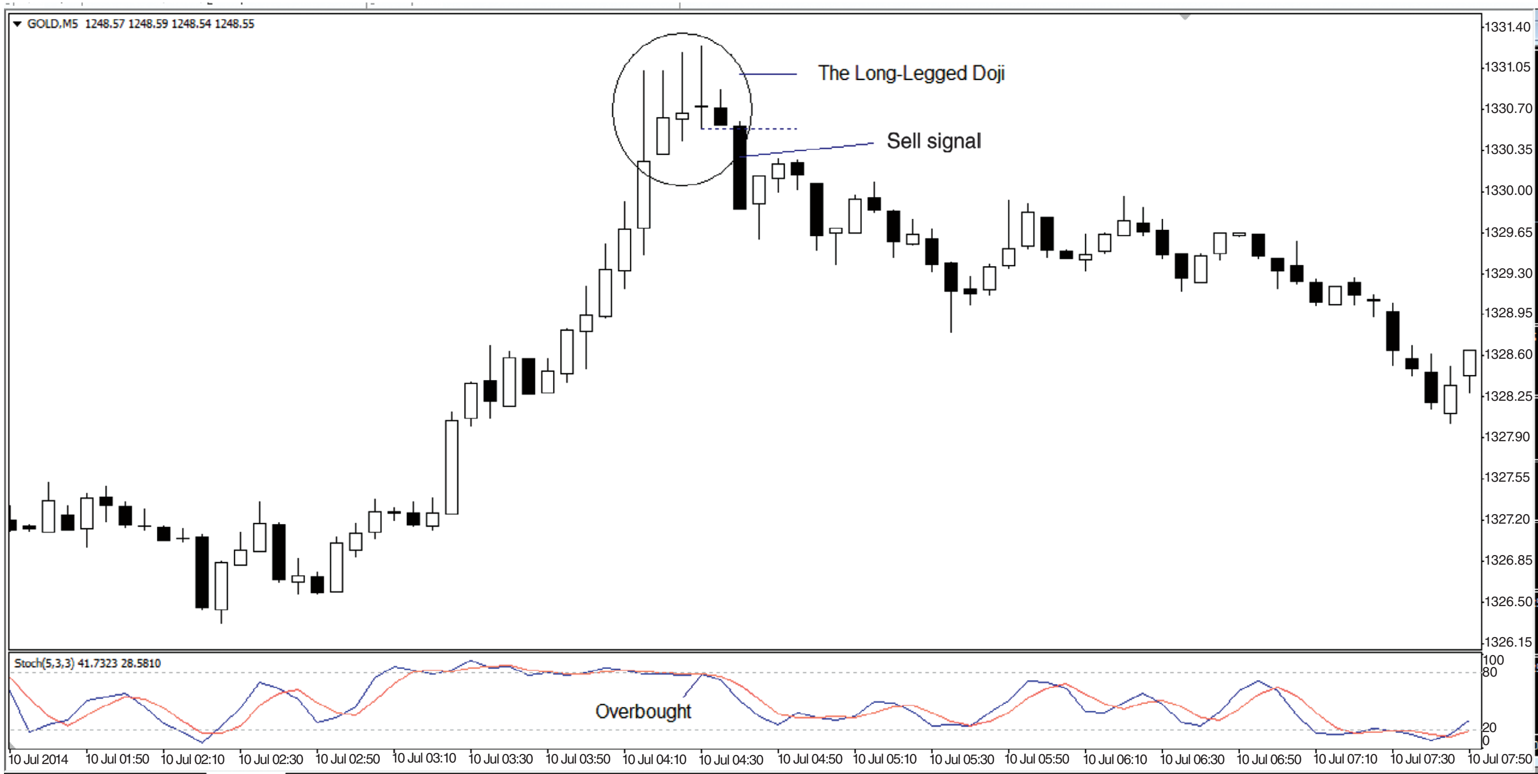


FIGURE 2.22 Gold 5-Minute (2014)—The Long-Legged Doji: A variation of the Dragonfly Doji

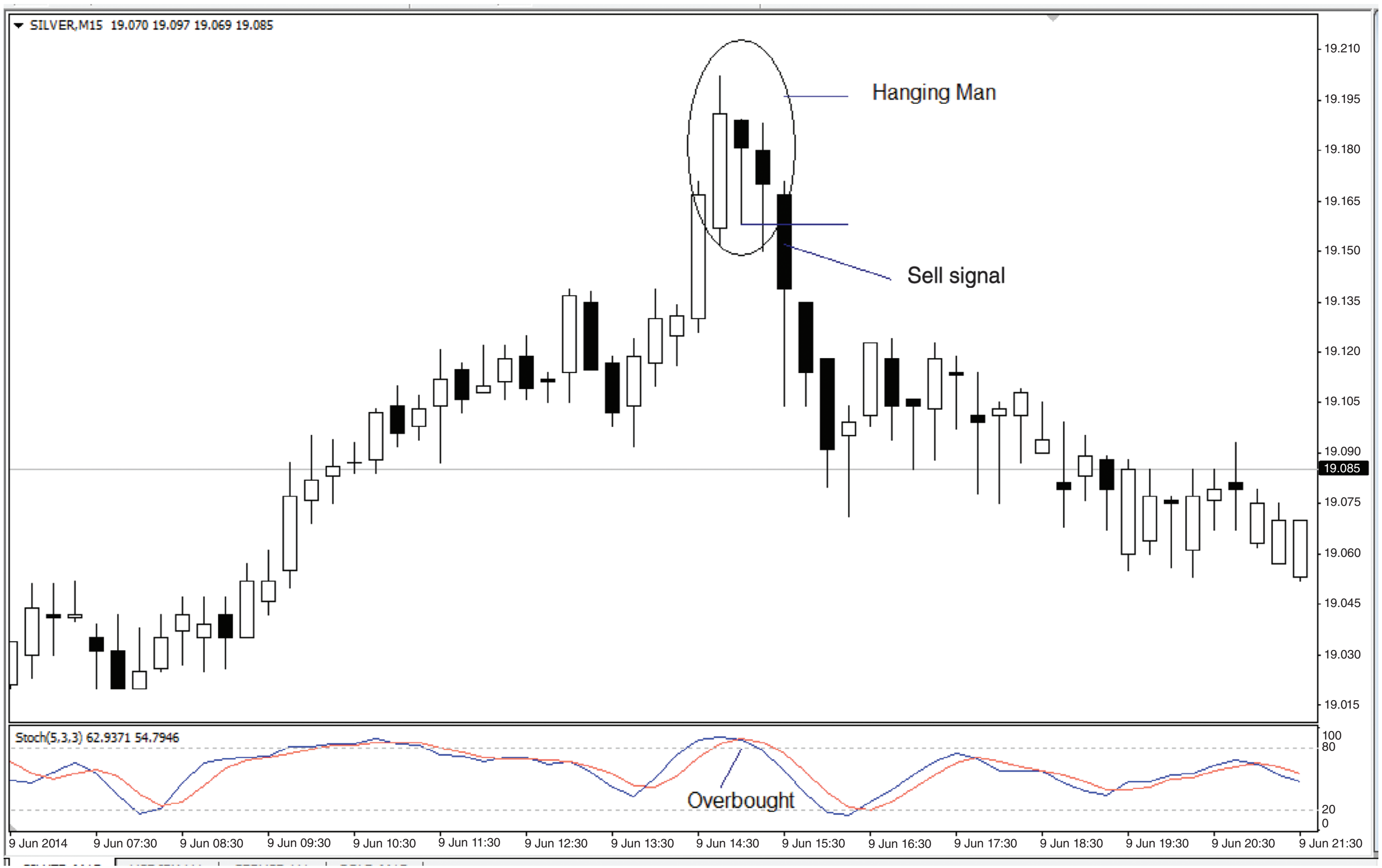


FIGURE 2.23 Silver 15-Minute (2014)—The Hanging Man: Another variation of the Dragonfly Doji

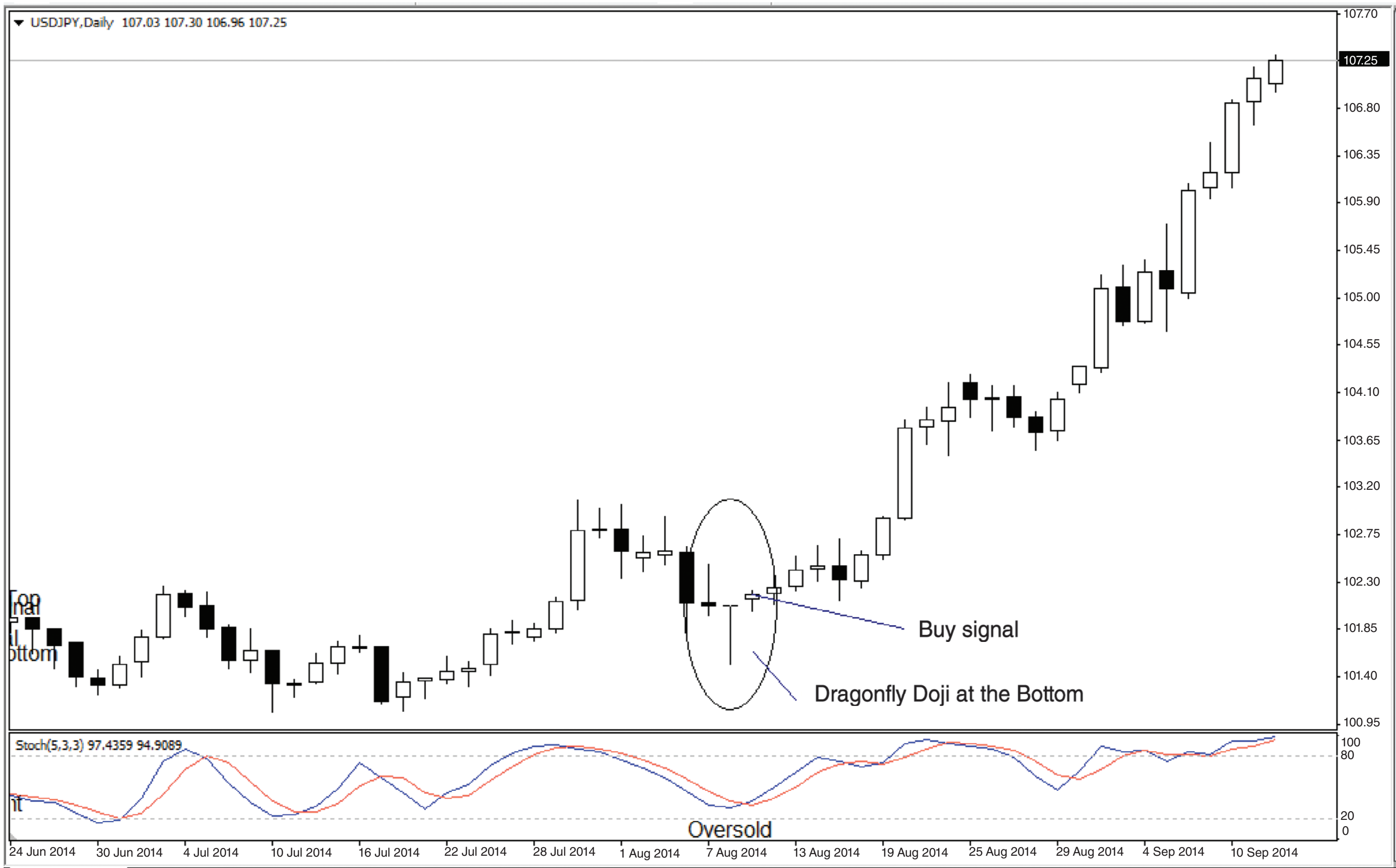
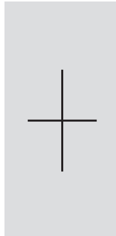


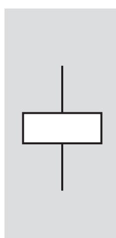
FIGURE 2.24 UsdJpy Daily (2014)—Dragonfly Doji at the Bottom

5. Small Doji



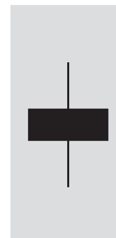
- **Definition:** This candle is formed when the open and close are equal during a smaller than average daily range. The bodyline (open and close) should be at the mid-range of the high and low (see Figure 2.25).
- **Interpretation:** This type of doji is interpreted as a consolidation pattern with a decrease in market activity because of its small range. But seen after a rally or decline, it could signal a major market top or bottom.
- **Proper action:** This doji signals a possible major market reversal if found after an advance or decline. But wait for confirmation. It is an excellent candle if it has gapped above or below to form a Star. The Doji Star indicates possible termination of a trend.

6. Small White Doji



- **Definition:** The Small White Doji is formed when the open and close are almost equal during a smaller than average daily range. The close must be greater than the open. The real body should be at the mid-range of the high and low.
- **Interpretation and proper action:** The interpretation and proper action for this Small White Doji is similar to that of the Small Doji. Colour is not important.

7. Small Black Doji



- **Definition:** The Small Black Doji is formed when the open and close are almost equal during a smaller than average daily range. The close must be less than the open. The real body should be at the mid-range of the high and low (see Figure 2.26).
- **Interpretation and proper action:** The interpretation and proper action for this Small Black Doji is similar to that of the Small Doji. Colour is not important.

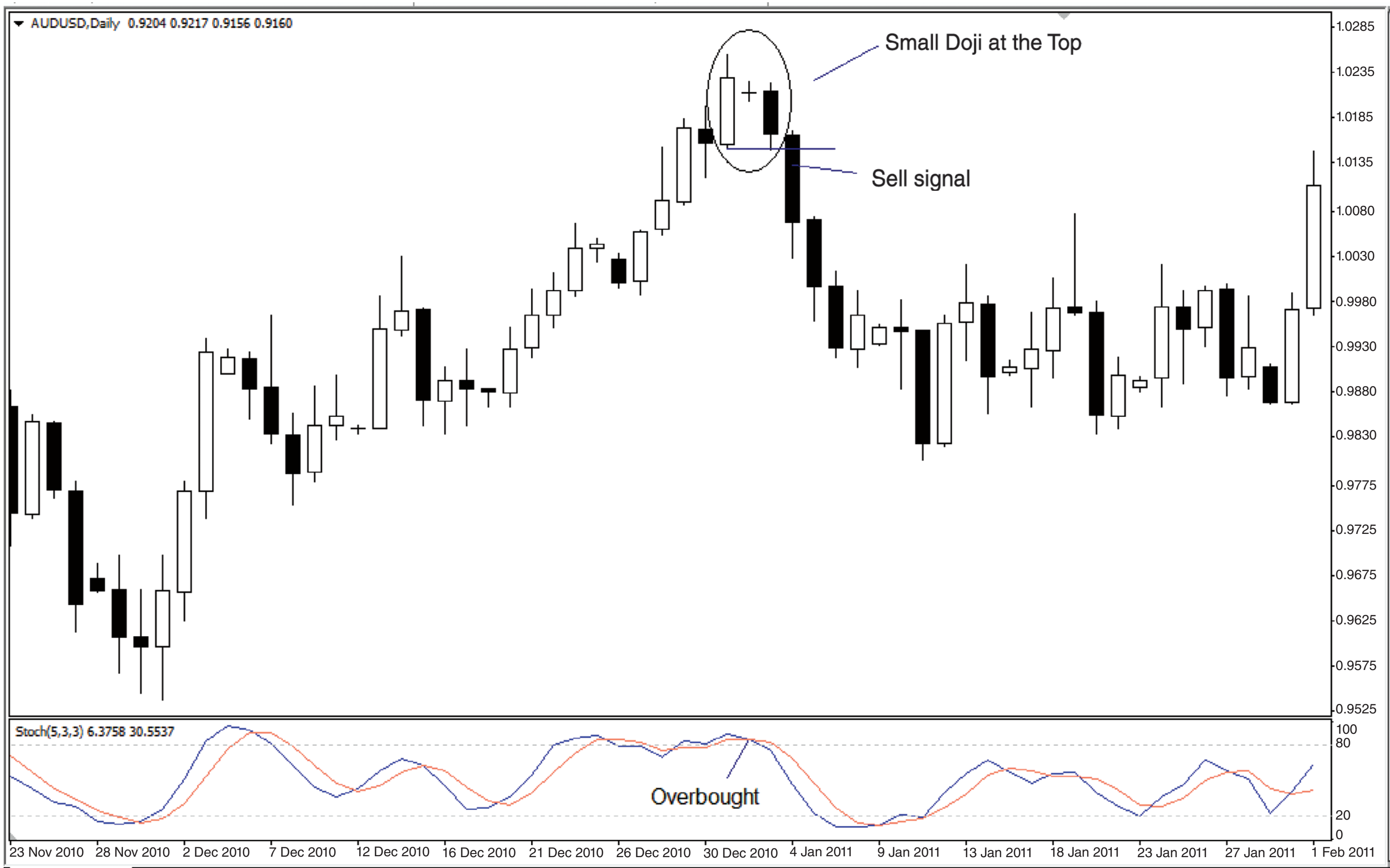


FIGURE 2.25 AudUsd Daily (2010)—A doji seen after a rally warns of a market top

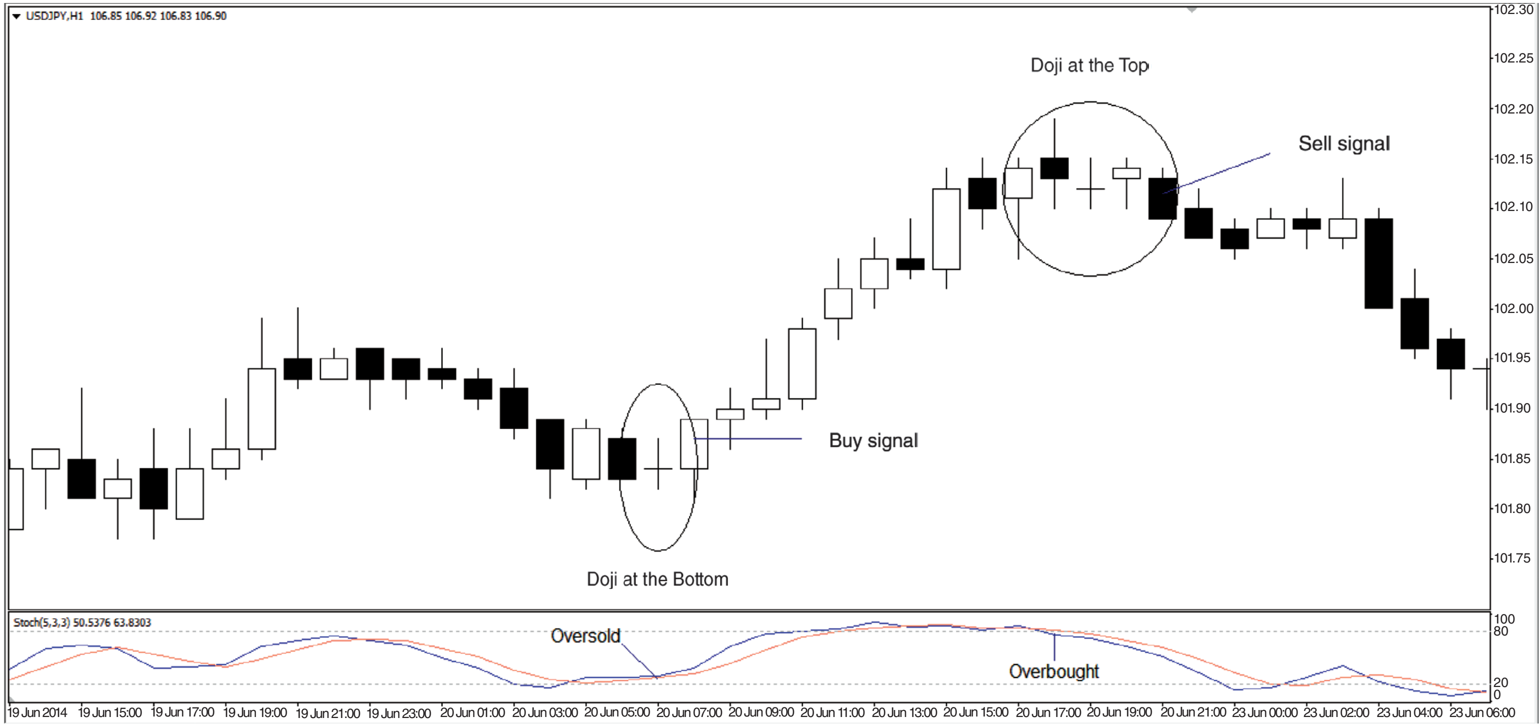
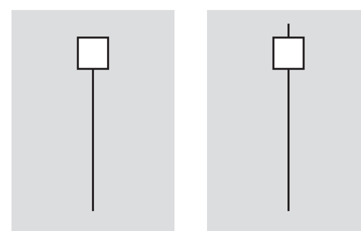


FIGURE 2.26 UsdJpy Hourly (2014)—A doji seen after a sharp decline or rally warns of market reversal

The Umbrella Group

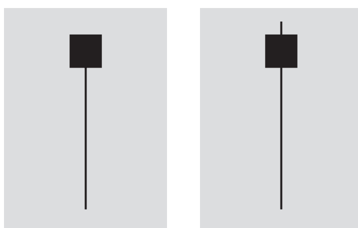
This group of candles is known in Japanese as *karakasa*, or paper umbrellas, because of their similarity in shape to the umbrella. In naming and interpreting umbrella group candles *location* and *shape* are the important determinants. Colour is unimportant in interpreting the umbrella group pattern because the opening and closing range (real body) is small. Being of small range, it is not a significant day as neither the bulls nor the bears are in absolute control. But its significance stems from the appearance of the long upper or lower shadow. The long shadow makes it a larger than average candle. Read in conjunction with its small real body, it has reversal implications.

White Hammer or Hanging Man (Also Called White Umbrella Candle)



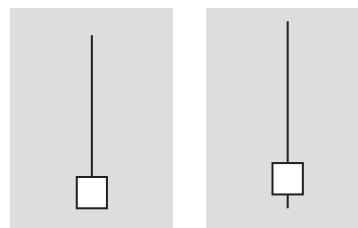
- **Definition:** The open and close are near each other (small real body). The lower shadow must be at least twice the length of the real body (three times or more is better). The close must be equal to the high or should have only a short upper shadow (see the right column in the previous diagram in this section). Although the close is greater than the open (and therefore coloured white), colour is insignificant as its real body is small.
- **Location:** If located after a downtrend or at a low price area, it is called a White Hammer. If it is found after an uptrend or at a high price area, it is called a White Hanging Man.
- **Interpretation:** A Hammer (regardless of colour) is a potentially bullish signal. A Hanging Man is a potentially bearish signal.
- **Proper action:** For conservative traders, confirmation is required before acting on this candle.

Black Hammer or Hanging Man (Also Called Black Umbrella Candle)



- **Definition:** The open and close are near each other (small real body). The lower shadow must be at least twice the length of the real body. (Three times or more is better.) The open may have a slight upper shadow, but it should be very short (see the right column in the previous diagram in this section). Although the close is less than the open (and therefore coloured black), colour is insignificant. Its significance stems from its long shadow.
- **Location:** If located after a downtrend or at a low price area, it is called a Black Hammer. If it is found after a rally or at a high price area, it is called a Black Hanging Man.
- **Interpretation:** A Hammer (regardless of colour) is a potentially bullish signal. A Hanging Man (regardless of colour) is a potentially bearish signal. For conservative traders, confirmation is required before acting on this candle.

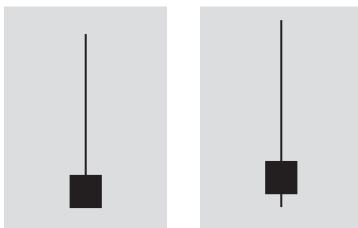
White Inverted Hammer or Shooting Star (Also Called Inverted White Umbrella Candle)



- **Definition:** The open and close are near each other (small real body). There is a long upper shadow that must be at least twice the length of the real body. (Three times or more is better). The open must be at the low or should have only a short lower shadow (see the right column in the previous diagram in this section). Although the close is greater than the open (and therefore coloured white), colour is insignificant. Its significance stems from its long shadow.

- **Location:** If located after a downtrend or at a low price area, it is called an Inverted White Hammer. If it is found after a rally or at a high price area, it is called a White Shooting Star.
- **Interpretation:** An Inverted Hammer (regardless of colour) is a potentially bullish signal. A Shooting Star (regardless of colour) is a potentially bearish signal. For conservative traders, confirmation is required before acting on this candle.

Black Inverted Hammer or Shooting Star (Also Called Inverted Black Umbrella Candle)



- **Definition:** The open and close are near each other (small real body). There is a long upper shadow that must be at least twice the length of the real body. (Three times or more is better.) The open must be at the low or should have only a short lower shadow (see the right column in the previous diagram in this section). Although the close is less than the open (and therefore coloured black), colour is insignificant. Its significance stems from its long shadow.
- **Location:** If located after a downtrend or at a low price area, it is called an Inverted Black Hammer. If it is found after a rally or at a high price area, it is called a Black Shooting Star.
- **Interpretation:** An Inverted Hammer (regardless of colour) is a potentially bullish signal. A Shooting Star (regardless of colour) is a potentially bearish signal. For conservative traders, confirmation is required before acting on this candle.

Figure 3.1 to Figure 3.4 show some examples of the umbrella candle group.

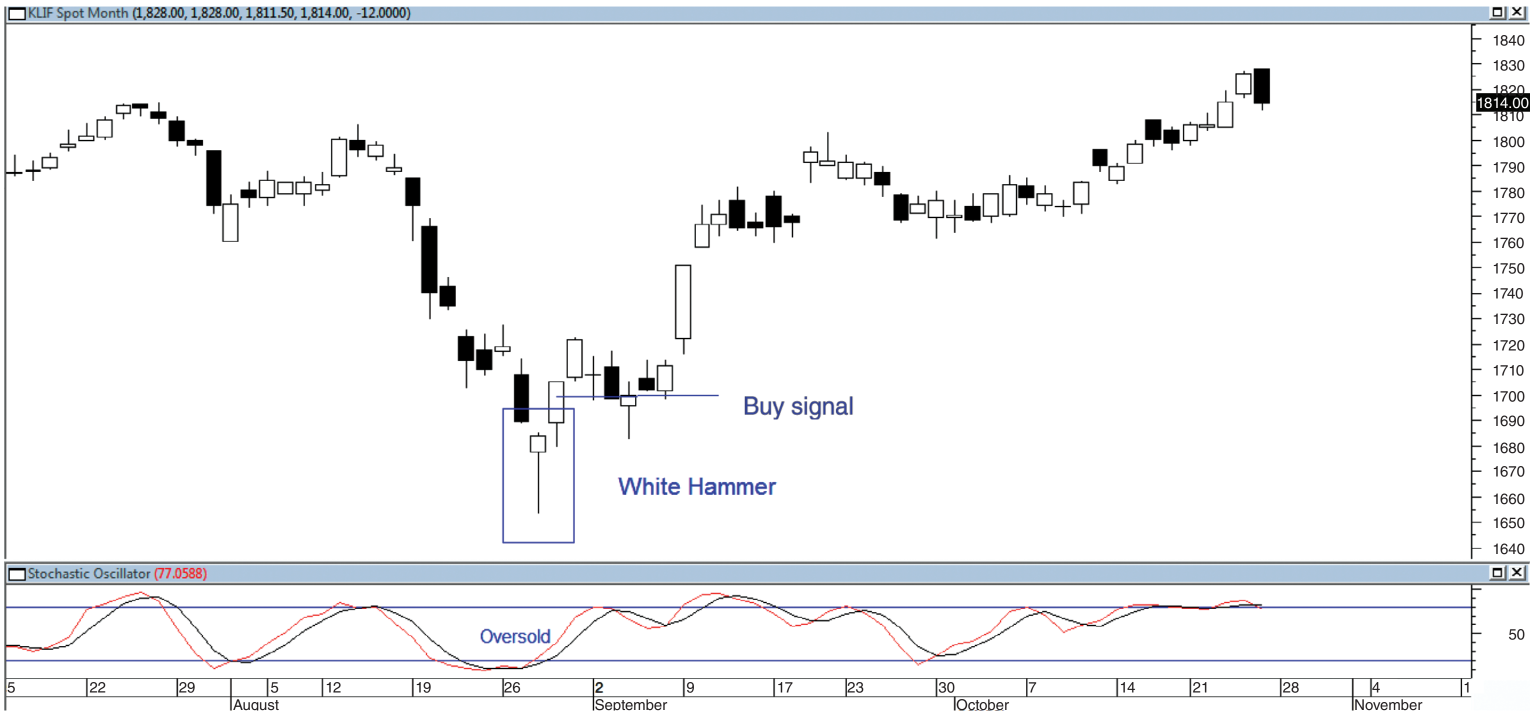


FIGURE 3.1 Kuala Lumpur Composite Index Futures Malaysia Daily (2013)—Seen after a decline this umbrella candle is called a Hammer

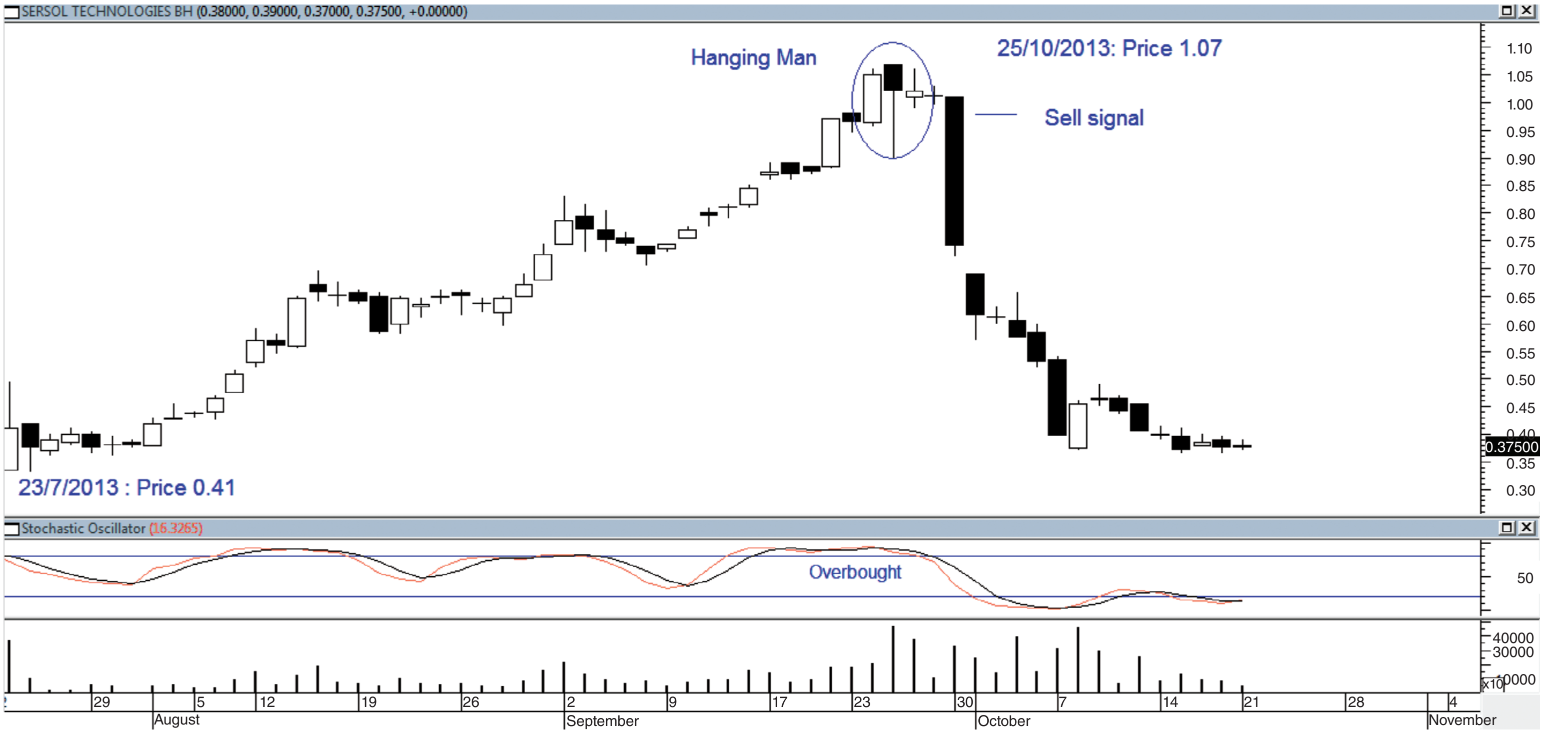


FIGURE 3.2 Sersol Industries Daily (2013)—Seen after an advance this umbrella candle is called a Hanging Man

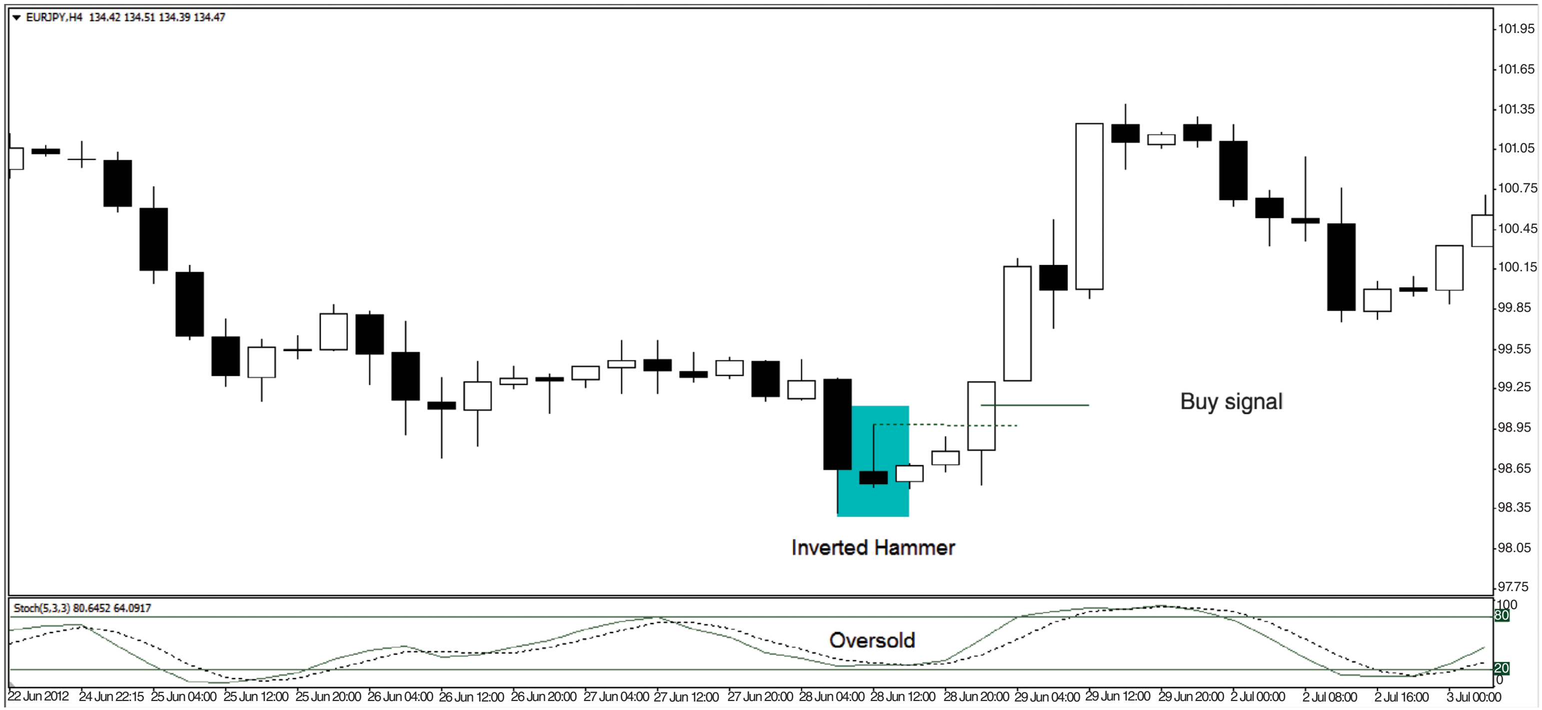


FIGURE 3.3 EurJpy Hourly (2013)—Seen after a decline this inverted umbrella candle is called an Inverted Hammer

FIGURE 3.4 Ingenuity Malaysia Daily (2013)—Seen after an advance this inverted umbrella candle is called a Shooting Star

Reversal Patterns

Introduction

In charting, pattern groups are divided into two major categories: reversal and continuation patterns.

Reversal patterns tell us that a trend reversal is taking place, be it short or long term. Continuation patterns, on the other hand, tell us that the market is only resting momentarily due to an overbought or oversold situation, after which the prior trend will resume.

The job of an analyst or trader is therefore to distinguish between the two types of patterns as early as possible during their formation and to trade in the direction of the breakout. In Western charting theory, the Head-and-Shoulders Top and Bottom, Double Tops and Bottoms, Triple Tops and Bottoms, Saucers, Spike or V Tops and Bottoms, Wedges, Broadening, and Diamond Formations are examples of the eight most common types of reversal patterns.

Japanese charting theory also recognizes the existence of reversal and continuation patterns, although they are called by different names. In Chapter 9 on Sakata's Five Methods, you will see that the Japanese have also identified some of these Western reversal patterns.

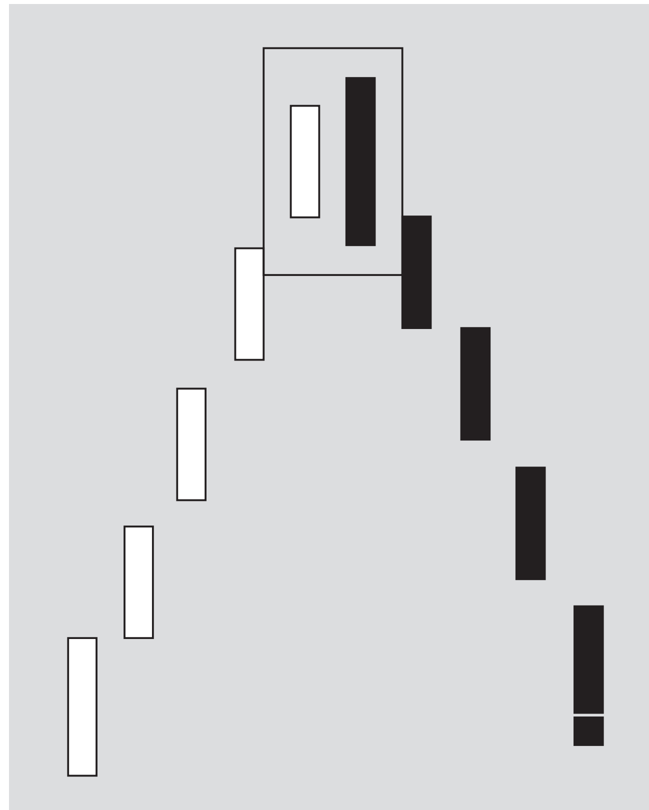
But where the Japanese and Western theories differ is in the number of patterns and names given to them. Further, Japanese theory has more short-term patterns in identifying market reversals when compared to Western theory.

For example, Western charting theory has basically three short-term reversal patterns—the key reversal day, two-day key reversal, and inside day. But Japanese charting theory has more than 50 reversal pattern types, with at least 8 of them found frequently in all financial markets.

Western Reversal Patterns Candlestick (Only Three Common Patterns)	**Equivalent in Japanese (Eight Common Reversal Patterns)**
1. Key reversal day	Bullish or Bearish Engulfing
2. Inside day	Bullish or Bearish Harami
3. Two-day key reversal	None
4. None	Piercing Line and Dark Cloud Cover
5. None	Hammer, Hangman, Inverted Hammer, Shooting Star
6. None	Fred Tam's White Inside Out Up/Black Inside Out Down
7. None	Doji
8. None	Tweezers Bottom and Top

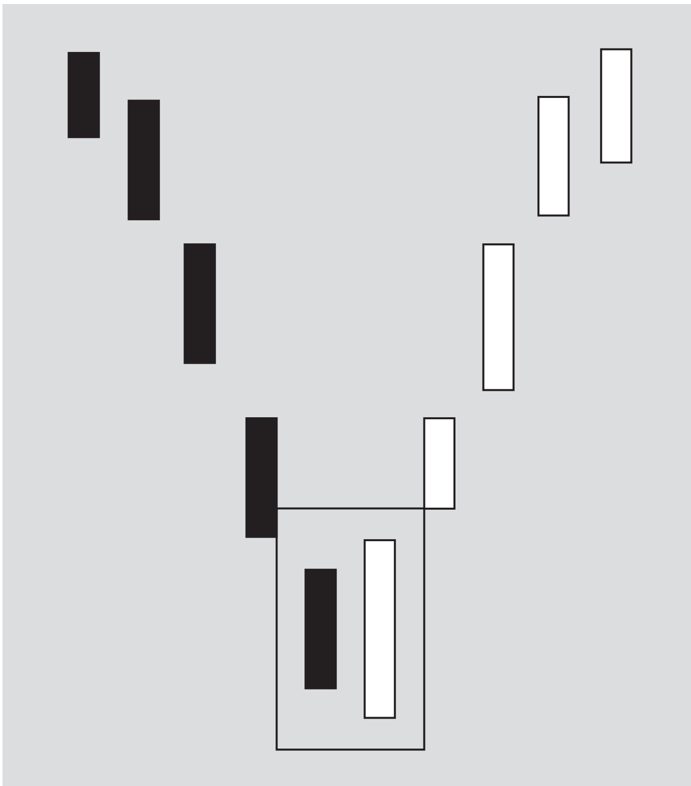
Best Time to Rely on Reversal Patterns

Reversal patterns show extreme accuracy when they are spotted after a sharp rally or decline (of between 5 and 15 cycles). In other words, candlestick reversal patterns are best applied for spotting V or Spike Tops or Bottoms (see following diagram).



Example of a V or Spike Top

This pattern usually occurs after a runaway bull trend. The turnaround is usually accompanied a reversal pattern—in this example, a Bearish Engulfing pattern. Volume is heavy on the reversal day or the day prior to the reversal day.



Example of a V or Spike Bottom

The downtrend quickly reverses into an uptrend without warning. But the Bullish Engulfing pattern signals the market's bottom. Volume is heavy on the reversal day or the day prior to the reversal day.

Reversal Patterns Are Reliable If Seen at a Low Price or High Price Area

A low price area can be defined as an area where the Western oscillators like Relative Strength Index, stochastic, momentum, or Williams' Percent R (these will be explained in later chapters) are oversold or where a previous support existed. A high price area can be defined as an area where the Western oscillators are overbought or where a previous resistance existed. Reversal patterns found at low or high price areas are reliable indications of trend reversal.

Index of Reversal Patterns

Candlestick reversal patterns can be a single candle or a group of candles. When one, two, three, or more candles combine in various formations, patterns evolve that will reveal to the trader the change in players' psychology. These candlestick reversal patterns will be the trader's guide as to whether one should enter or exit the market.

For every bullish reversal pattern, there is almost always a bearish equivalent. In this chapter I have grouped these reversal patterns into single, double, triple, and multiple candlestick patterns (see Table 4.1 to Table 4.4):

TABLE 4.1 Single Candlestick Patterns

Bullish Reversal Patterns	Bearish Reversal Patterns	Pages
Spinning Top	Spinning Top	70–72
Hammer	Hanging Man	72–73
Inverted Hammer	Shooting Star	75–78
Doji at the Bottom	Doji at the Top	78–81
Bullish Meeting Line	Bearish Meeting Line	81–84
Bullish Belt-Hold Line	Bearish Belt-Hold Line	84–87

TABLE 4.2 Double Candlestick Patterns

Bullish Reversal Patterns	Bearish Reversal Patterns	Pages
Bullish Engulfing	Bearish Engulfing	90–91
Fred Tam's White Inside Out Up	Fred Tam's Black Inside Out Down	95–96
Piercing Line	Dark Cloud Cover	99–100
Thrusting Line	Incomplete Dark Cloud Cover	100–104
Bullish Harami Line	Bearish Harami Line	104–107
Bullish Harami Cross	Bearish Harami Cross	110–111
Homing Pigeon	Bearish Homing Pigeon	114–115
Tweezers Bottom	Tweezers Top	115–119

TABLE 4.3 Triple Candlestick Patterns

Bullish Reversal Patterns	Bearish Reversal Patterns	Pages
Doji-Star at the Bottom	Doji-Star at the Top	119–123
Three-River Morning Doji-Star	Three-River Evening Doji-Star	123–126
Abandoned Baby Bottom	Abandoned Baby Top	126–131
Three-River Morning Star	Three-River Evening Star	131–134
Tri-Star Bottom	Tri-Star Top	134–137
Breakaway Three-New-Price Bottom	Breakaway Three-New-Price Top	137–140
Bullish Black Three Gaps	Bearish White Three Gaps	143–144
Three White Soldiers	Three Black Crows	147–148
—	Advance Block	151–153
—	Deliberation	153–154
—	Upside Gap Two Crows	154–156

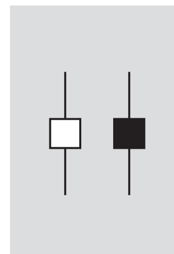
TABLE 4.4 Multiple Candlestick Patterns

Bullish Reversal Patterns	Bearish Reversal Patterns	Pages
Concealing Baby Swallow	—	156–158
Ladder Bottom	—	158–160
Tower Bottom	Tower Top	160–163
Eight-to-Ten New Record Lows	Eight-to-Ten New Record Highs	163–167

Single Candlestick Patterns

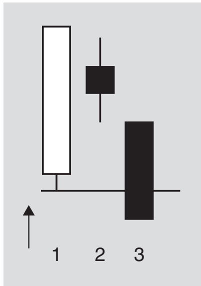
Single candlestick patterns such as the Spinning Top, Hammer, Hanging Man, Inverted Hammer, Shooting Star, Doji at the Bottom, Doji at the Top, Bullish Meeting and Bearish Meeting Lines, and Bullish Belt-Hold and Bearish Belt-Hold Lines are discussed next.

Spinning Top



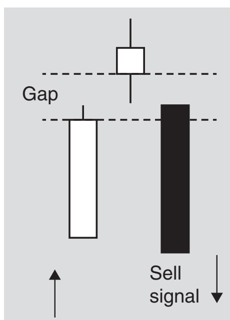
In Chapter 2, I described the Spinning Top as a short candlestick with a small real body (black or white) but with an upper and lower shadow that is longer than the length of its real body. The location of this Spinning Top is important. It is neutral if found within a consolidation market. But seen after a rally, the Spinning Top has the potential of signalling a market top; seen after a decline, it could signal a market bottom.

When a Spinning Top Becomes a Top Reversal Pattern



After a rally, a Black Spinning Top analysed in conjunction with the long white candle before it takes the form of a Bearish Harami, a possible top reversal pattern. Confirmation is required via a black candle closing below the lowest low of the two candles before it. Candle 3 must close below candle 2 (Spinning Top) and candle 1 to generate a sell signal. If the colour of the Spinning Top is white in colour, this two-candle pattern is called a Bearish Homing Pigeon.

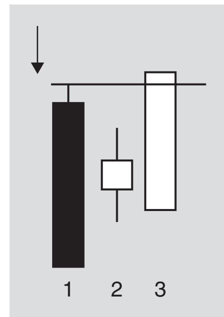
When a Spinning Top Becomes an Evening Star



The Spinning Top will take the form of a Star if it gaps above the previous white candle. Followed by a black candle closing below the low of the white candle, this Spinning Top transforms itself into an Evening Star. An Evening Star is a top reversal pattern.

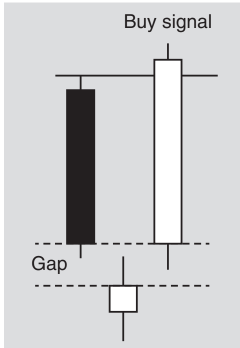
To generate a sell signal, the long black candle must close below the low of the long white candle.

When a Spinning Top Becomes a Bottom Reversal Pattern



After a decline, a White Spinning Top analysed in conjunction with a long black candle (candle 1) takes the form of a Bullish Harami pattern, a possible bottom reversal pattern. Confirmation is required via a white candle closing above the highest high of the two candles before it. Candle 3 must close above candle 2 (Spinning Top) and candle 1 to generate a buy signal. If the Spinning Top is black in colour, this two-candle pattern is called a Homing Pigeon.

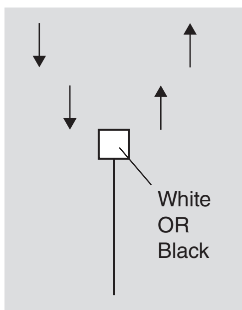
When a Spinning Top Becomes a Morning Star



The Spinning Top will take the form of a Star if it gaps below the previous black candle. If the next white candle closes above the high of the black candle, this Spinning Top will transform itself into a Morning Star, a bottom reversal pattern.

To generate a buy signal, the long white candle must close above the high of the long black candle.

Hammer



Hammer

Pattern description: The Hammer is a single candle with a long lower shadow and a small real body. The longer the shadow, the more significant is the pattern. A Hammer is an Umbrella Candle found after a decline or at a low price area.

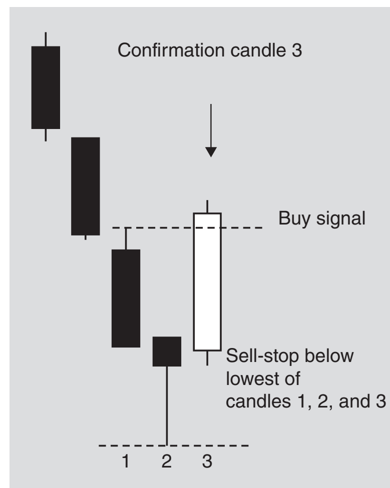
Rules of Recognition

1. A downtrend must be in progress.
2. The open and close have a very tight range (small real body).
3. The lower shadow must be at least twice the length of the real body (three times or more is better).
4. It should have no, or a very short, upper shadow.
5. Colour of the real body is unimportant.
6. The sharper the prior decline, the higher will be the probability of a market bottom.

Interpretation: Bullish signal.

Proper action: Buy signal if followed by a bullish confirmation candle.

Buying on the Hammer Pattern

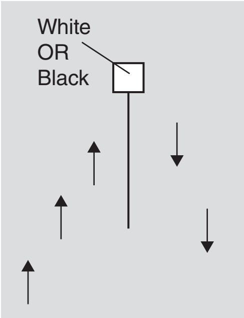


Rules

1. Buy if confirmation candle 3 closes above the highest high of candles 1 and 2.
2. In case of a resumption of a downtrend, place sell-stop below the lowest low of candles 1, 2, and 3.

Figure 4.1 shows an example of a Hammer bottoming out pattern after a sharp fall.

Hanging Man



Pattern description: The Hanging Man is a single candle with a long lower shadow and a small real body. The longer the shadow the more significant is the pattern. A Hanging Man is an Umbrella Candle found after an advance or at a high price area.

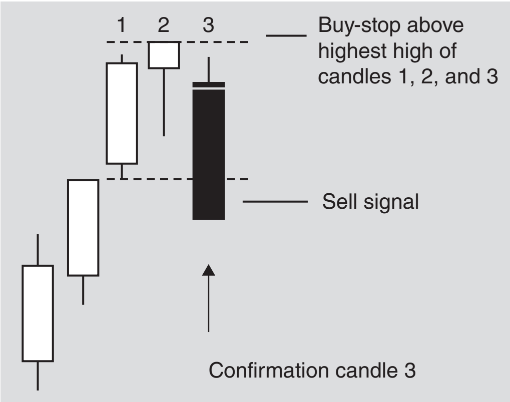
Rules of Recognition

1. An uptrend must be in progress.
2. The open and close have a very tight range (small real body).
3. The lower shadow must be at least twice the length of the real body (three times or more is better).
4. It should have no, or a very short, upper shadow.
5. Colour of the real body is unimportant.
6. The sharper the prior rally, the higher will be the probability of a market top.

Interpretation: Bearish signal.

Proper action: Sell signal if followed by a bearish confirmation candle.

Selling on the Hanging Man Pattern



Rules

1. Sell if confirmation candle 3 closes below the lowest low of candles 1 and 2.
2. In case of a resumption of an uptrend, place buy-stop above the highest high of candles 1, 2, and 3.

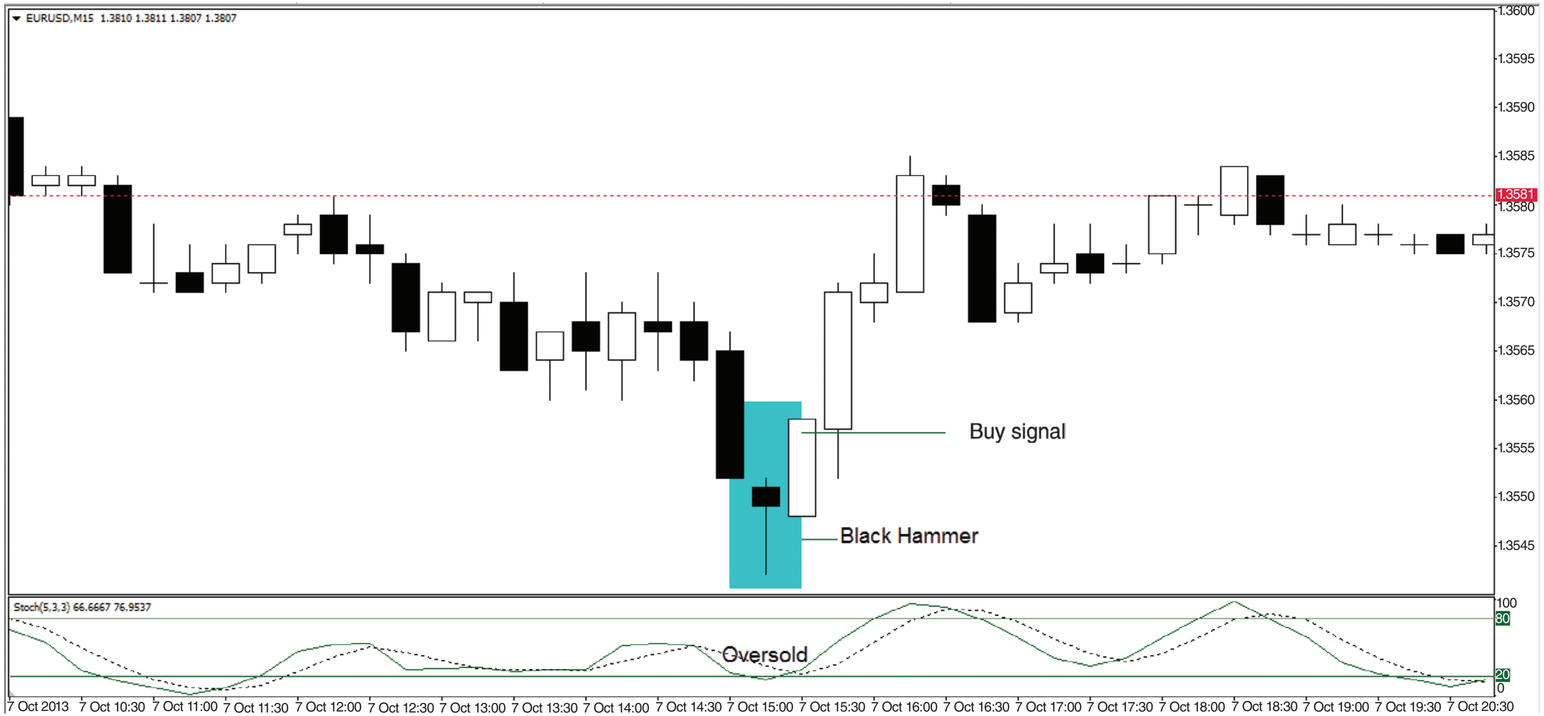
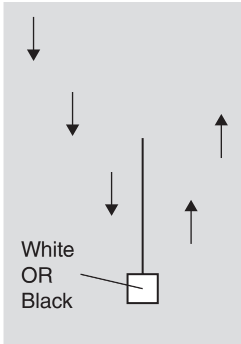


FIGURE 4.1 EurUsd 15-Minute (2013)—A Hammer is a great bottoming out pattern after a sharp fall

Inverted Hammer



Pattern description: The Inverted Hammer is a single candle with a long upper shadow and a small real body. The longer the shadow, the more significant is the pattern. An Inverted Hammer is an Inverted Umbrella Candle found after a decline or at a low price area.

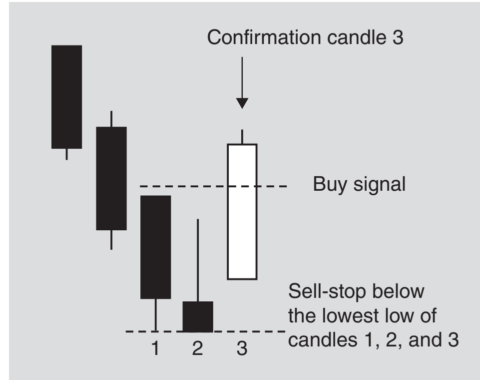
Rules of Recognition

1. A downtrend must be in progress.
2. The open and close have a very tight range (small real body).
3. The upper shadow must be at least twice the length of the real body (three times or more is better).
4. It should have no, or a very short, lower shadow.
5. Colour is unimportant.
6. The sharper the prior decline, the more significant is the subsequent rebound.

Interpretation: Bullish signal.

Proper action: Buy signal if followed by a bullish confirmation candle.

Buying on the Inverted Hammer Pattern

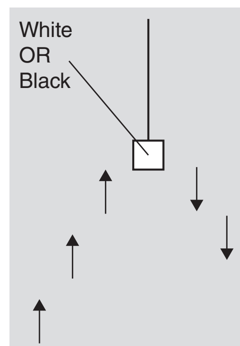


Rules

1. Buy if confirmation candle 3 closes above the highest high of candles 1 and 2.
2. In case of a resumption of a downtrend, place sell-stop below the lowest low of candles 1, 2, and 3.

Figure 4.2 and Figure 4.3 show some examples of Hanging Man and Inverted Hammer patterns.

Shooting Star



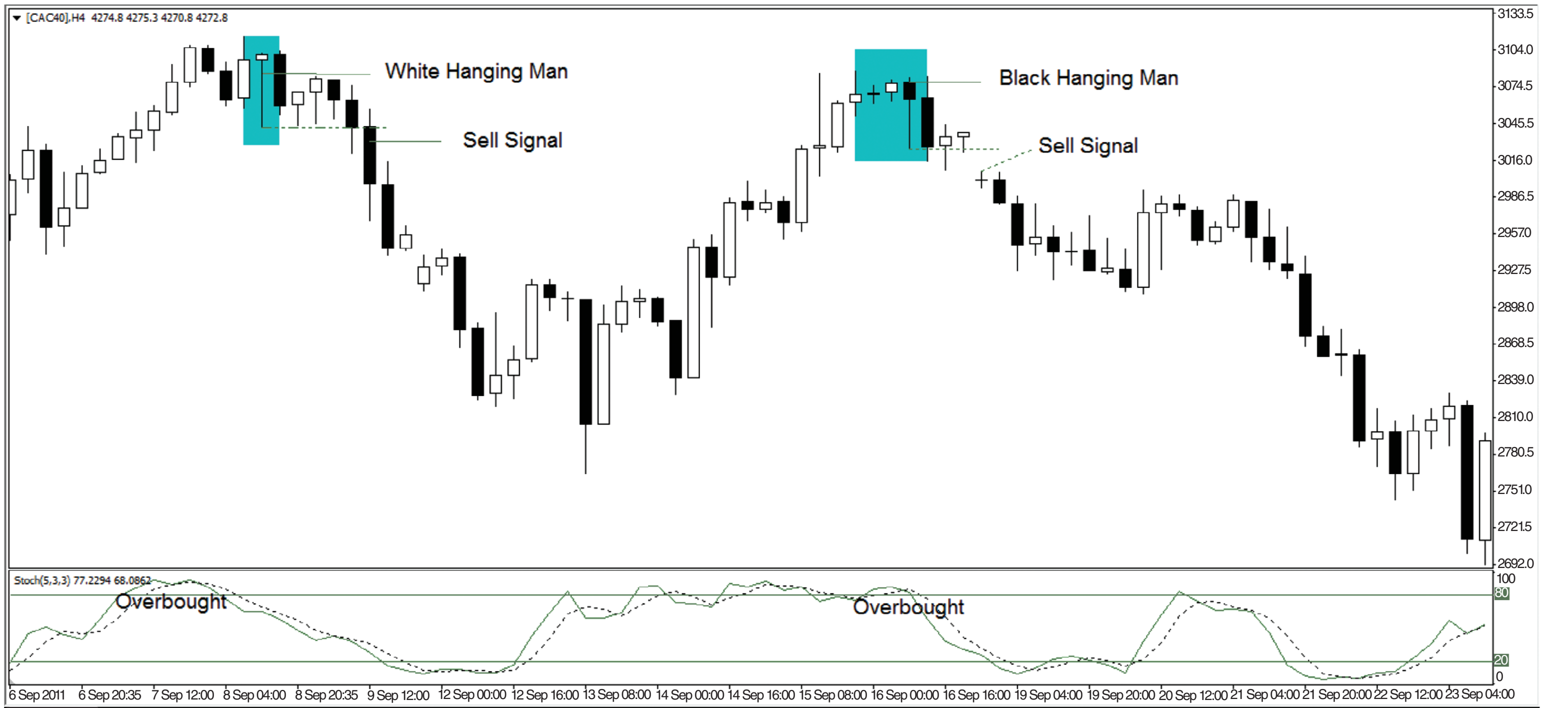


FIGURE 4.2 CAC 40 4-Hour (2013)—Hanging Man seen after a rally is bearish