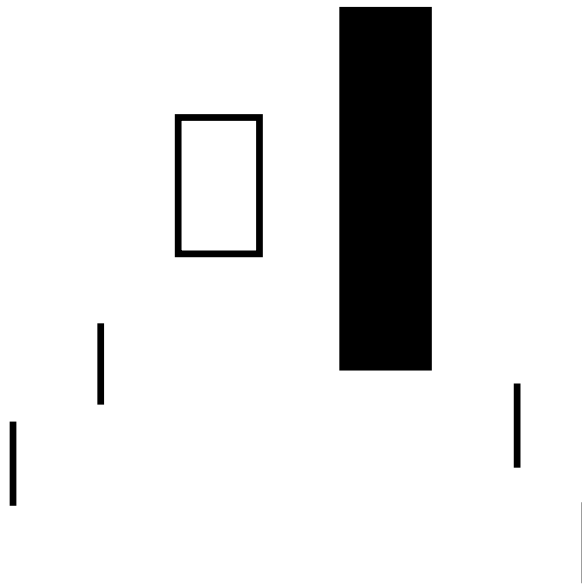


2-line & 3-line Candle Patterns

Bearish Engulfing Pattern



Candle Location

Located at the top of a trend, the bearish engulfing pattern is one of the most powerful reversals available. Gaps are not usually present before and after the trigger.

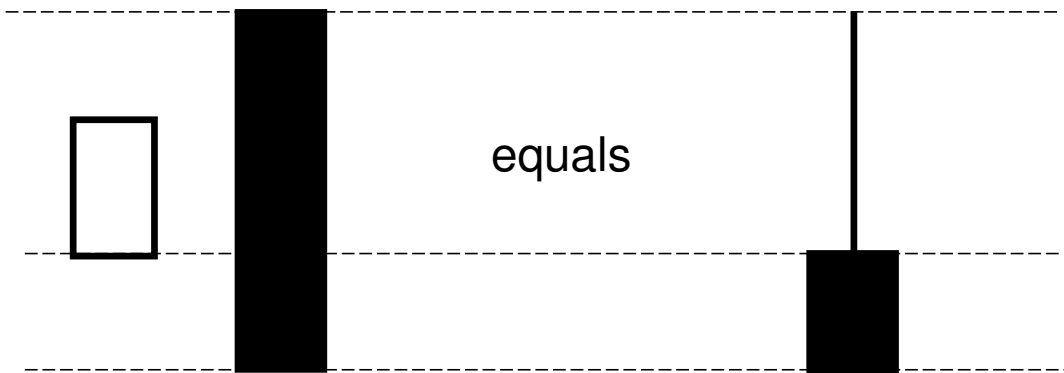
Confirmation is derived if prices ultimately trade at a lower range than the second candle.

Psychology

The first period shows that the bulls were still winning the tug of war. The second period, although it initially gaps up and away from the first body, experiences a quick sell off. The sell off is often sustained by high volume, showing that the majority of traders were of a decidedly bearish temperament for the second part of this signal.

The second candle resonates the emotion of fear, as it is usually a long or dominant candle. If volume is a key feature of the activity of the second candle, I consider the second candle to be dominant, rather than long.

Candle Addition – Bearish Engulfing



Let's have a look at the process of candle addition with the bearish engulfing pattern as a practical example.

When we take the open of candle (1) and the close of candle (2), the real body of candle (3) is formed.

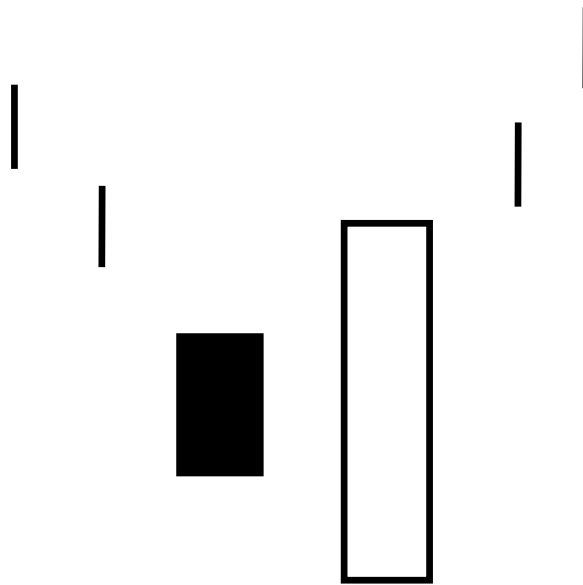
The highest high of candle (1) *or* (2) forms the high for candle (3).

The lowest low of candle (1) *or* (2) forms the low for candle (3).

(The trigger candlestick pattern in this case is, of course, both candles (1) and (2). Two-line candles are considered to be a 'formation', as well as one-line candles.)

The candle addition process _____
the effectiveness of the bearish engulfing pattern because it
reduces to a _____

Bullish Engulfing Pattern



Candle Location

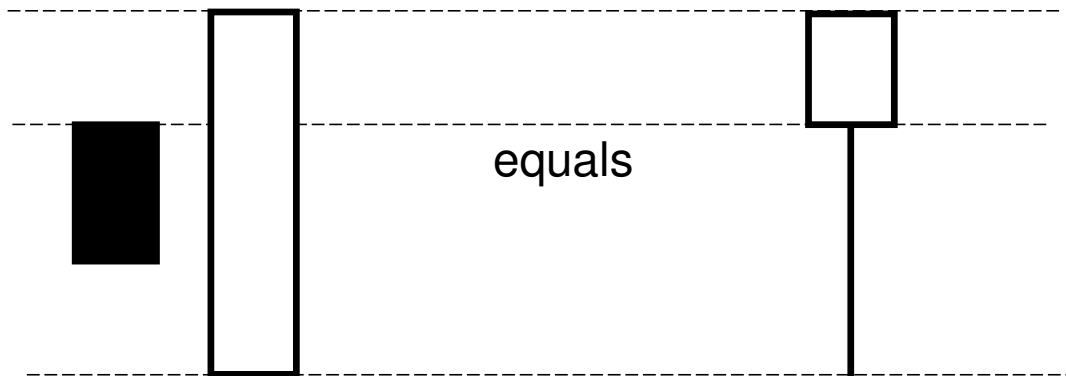
This engulfing pattern is found at the bottom of a downtrend. Confirmation is derived if subsequent trades are made at least within the range of the second candle, or preferably above the mid-point or entire range.

The two engulfing patterns often display violent changes of market sentiment. I rarely ignore a signal like this. Trend flattening is not a high probability after the trigger candle. The change in market direction is likely to be immediate and conclusive.

Psychology

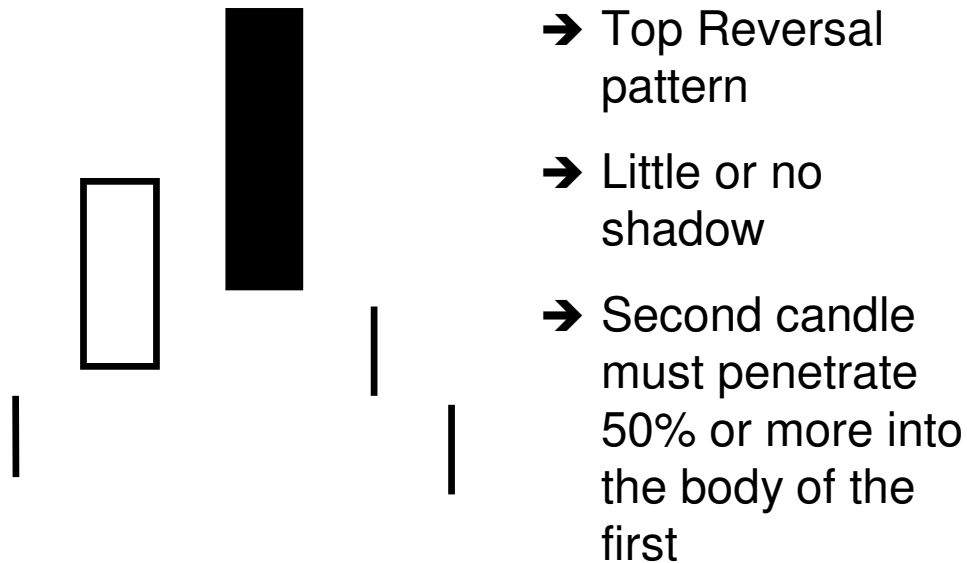
The wind has metaphorically been taken out of the bears' sails, and the bulls have arisen with increased stamina. Traders with short positions make a quick dash to cover their exposure, and their rush to exit their positions adds power to the creation of the pattern. The volume on the uptick component shows that the majority of traders have changed camp from a bearish perspective to a bullish orientation, within the duration of one period.

Candle Addition - Bullish Engulfing



The candle addition process _____
the effectiveness of the bullish engulfing pattern because it
reduces to a _____

Dark Cloud Cover



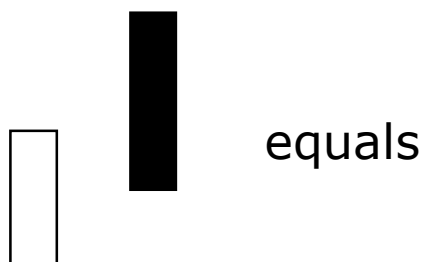
Candle Location

The first candle extends the existing uptrend, and the second candle runs contrary to the trend. Gaps from the candle prior to the trigger are not common. However, a gap after the trigger in a downward direction reinforces that the market has lost faith in the share.

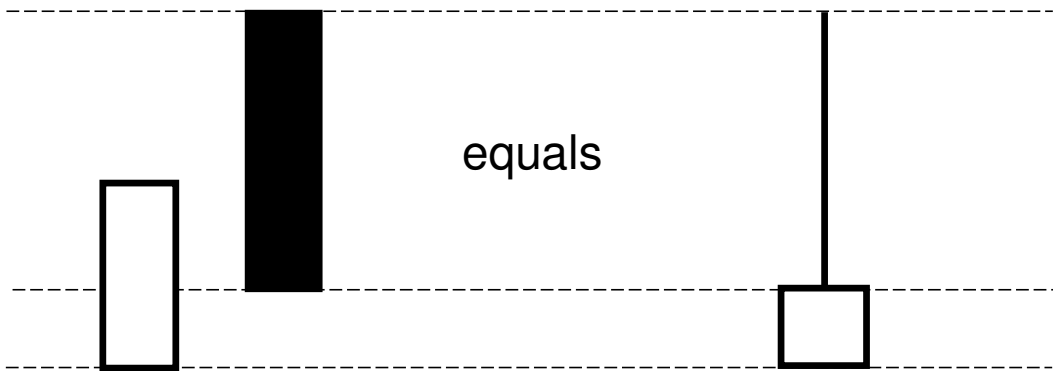
Psychology

The bears have threatened the confidence of the bulls by trading at lower values than the closing price of the first candle. This loss of confidence may lead to a future downturn in trend.

Try performing the process of candle addition on the Dark Cloud Cover:



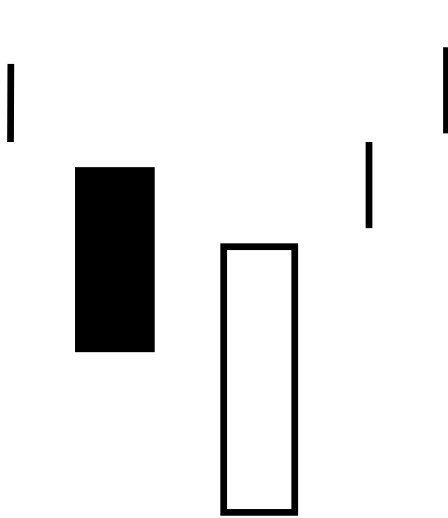
Candle Addition - Dark Cloud Cover



Does this confirm the pattern's effectiveness? Is this a stronger signal than the Bearish Engulfing Pattern reduction?

Markets often increase in value slowly, but experience bouts of fast and panicky declines, so the importance of a top reversal assumes a special significance. The bulls tediously climb the mountain, whilst the bears happily abseil down it.

Piercing Pattern



- Bottom Reversal pattern
- The greater the penetration, the more the chance of reversal. 50% is minimum.
- Especially significant along resistance levels

The 50% penetration level of the second candle into the body of the first is *imperative* to the definition. The piercing pattern is the main formation that has such a very strict definition.

Candle Location

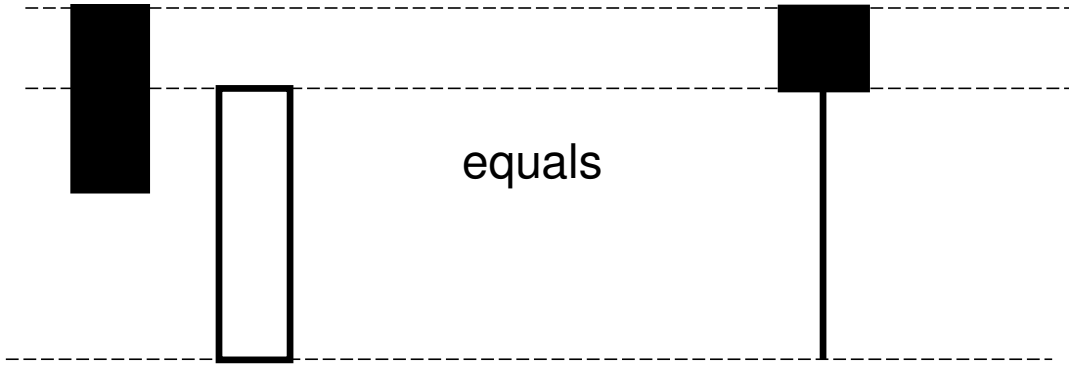
Piercing patterns are found at the bottom of downtrends. If they are confirmed by higher subsequent prices, they are very reliable. This confirmation is essential in order to trust the implied bullish tendencies.

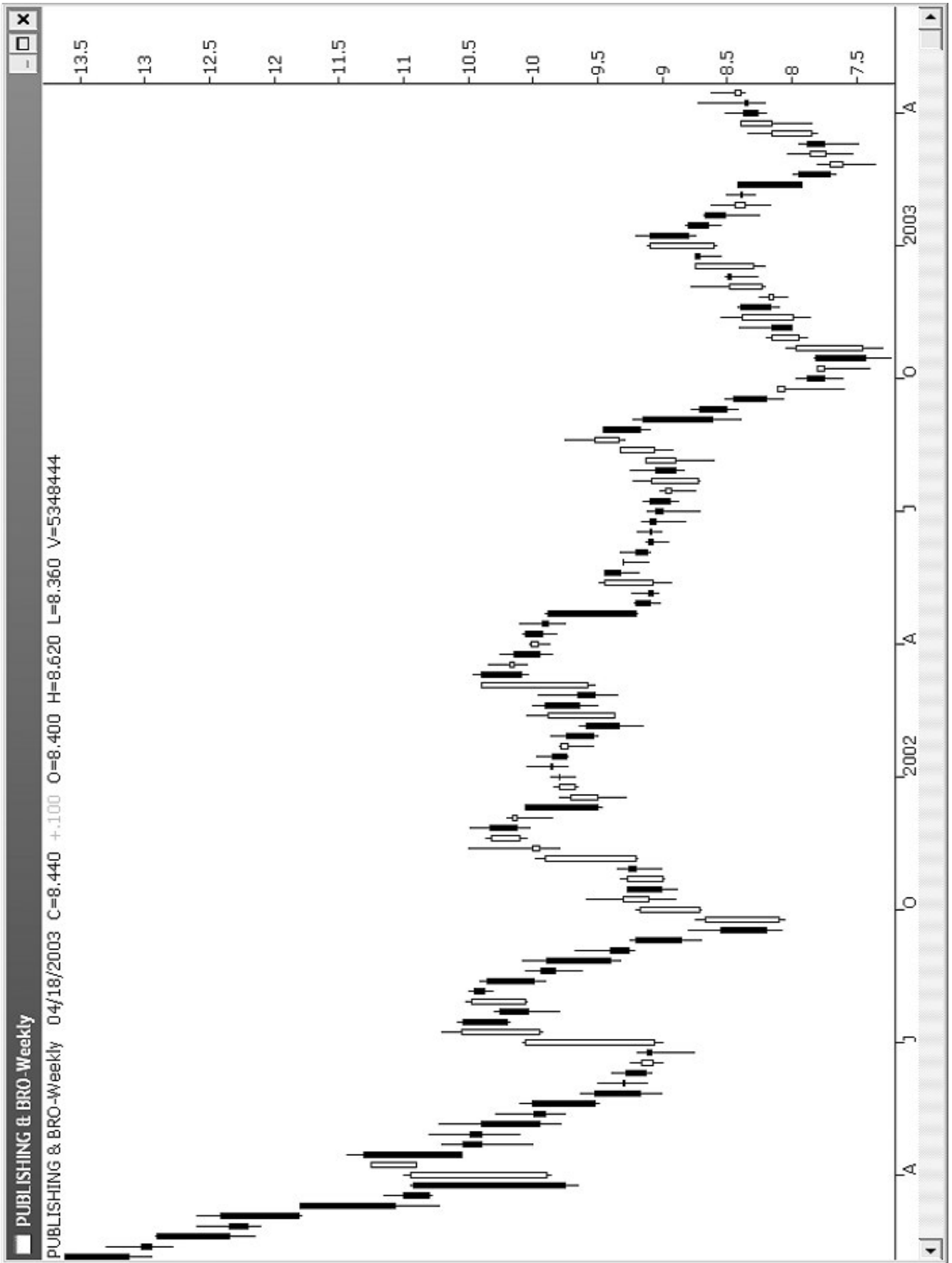
Psychology

The bears that had been winning the game to date have just been dealt a potentially losing hand. They have been threatened by the traders with bullish tendencies.

Is this a stronger signal than the Bullish Engulfing Pattern reduction?

Candle Addition - Piercing Pattern

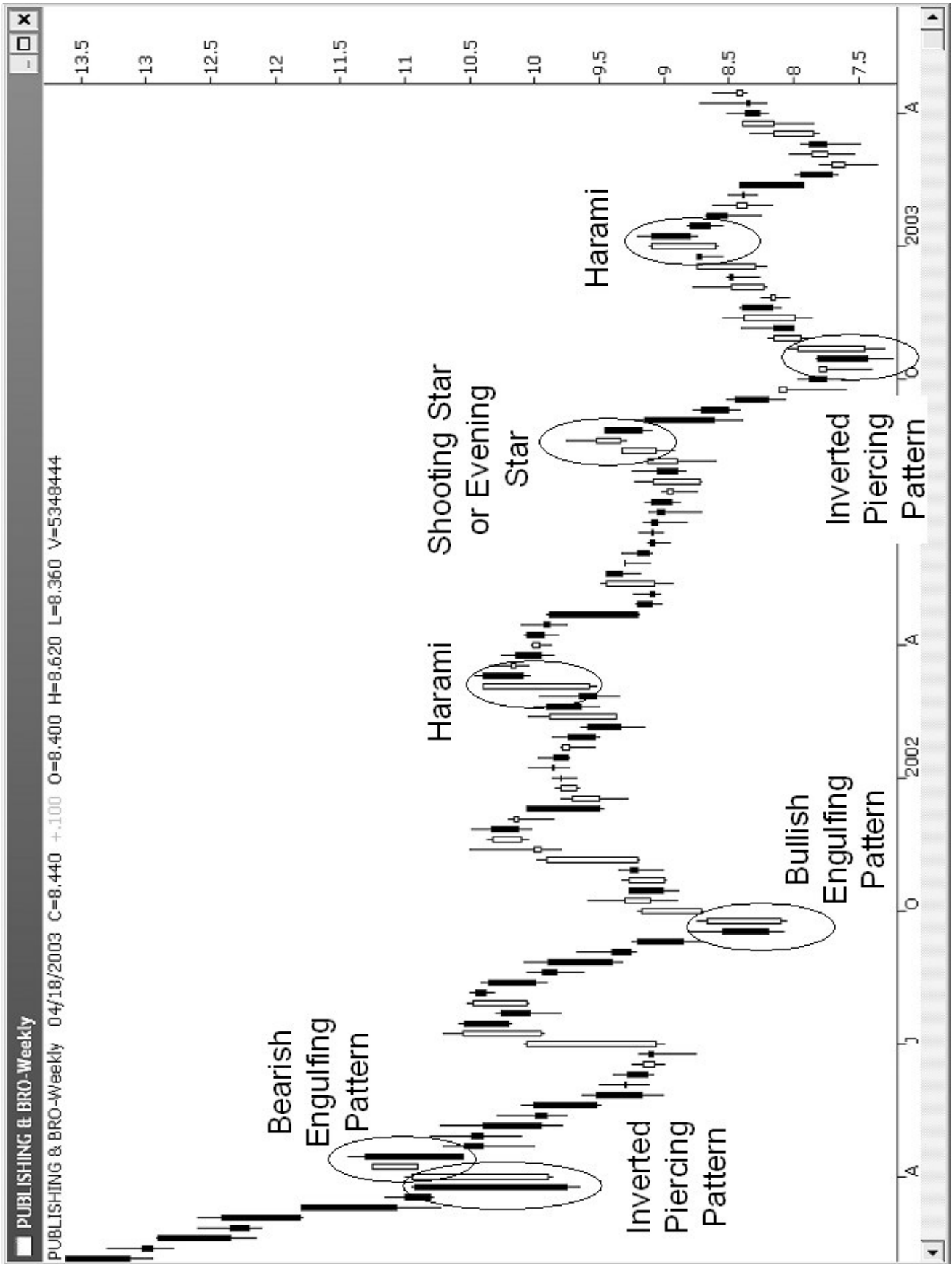




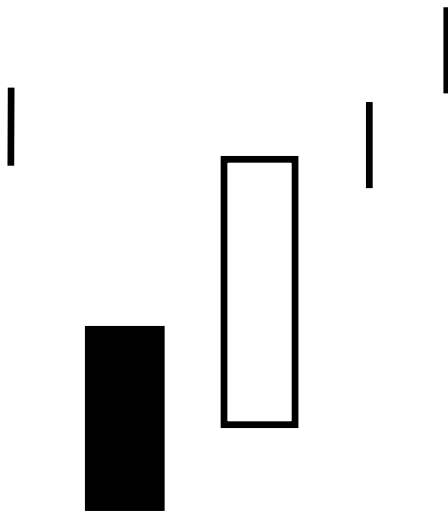
On the previous page, circle any candlestick patterns on the chart that you recognise.

Can you identify a new pattern on this chart? Draw it here. What does it look like? Is it a very strong pattern? How can you tell?

If you find a new pattern, what is the best way to determine whether it is effective?

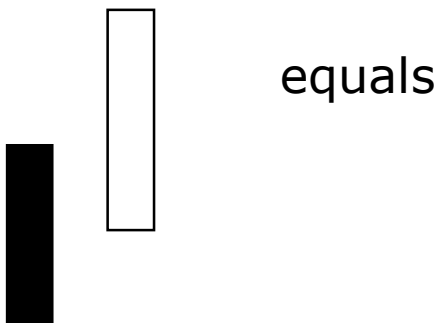


The Inverted Piercing Pattern

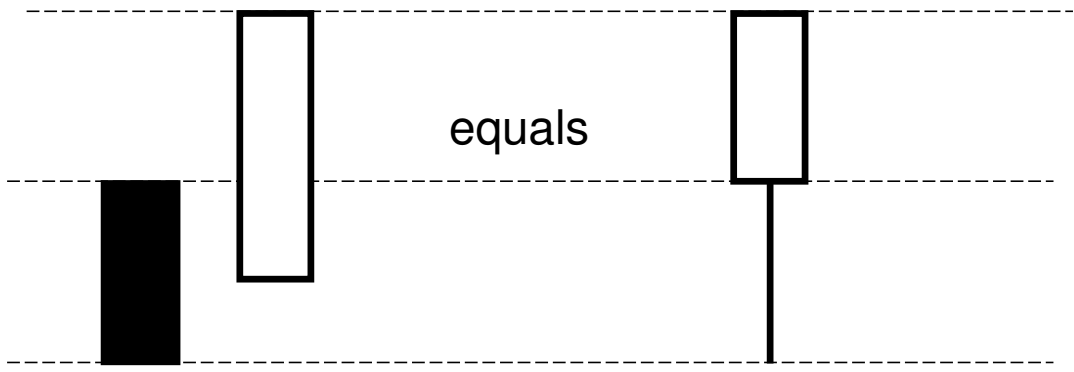


- Bottom Reversal pattern
- Bullish Candle starts at 50% or > of the bearish candle and closes above its real body
- Especially significant along support levels

Candle Addition



Candle Addition – Inverted Piercing



The Inverted Dark Cloud Cover



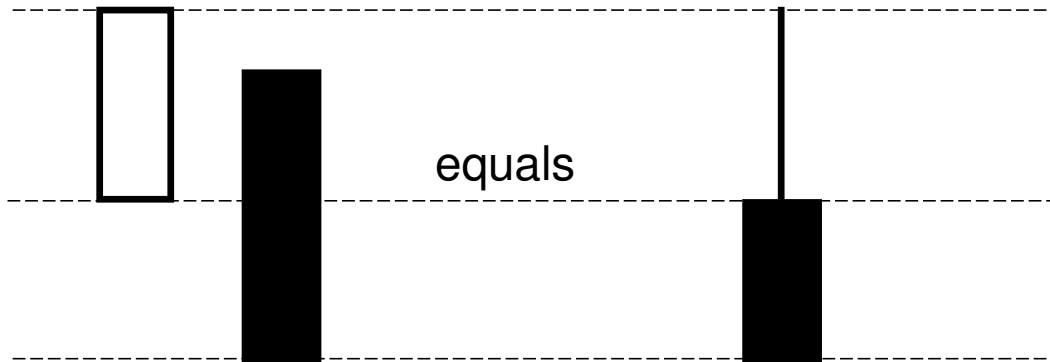
- Top Reversal pattern
- Bearish Candle starts at approximately the midpoint of the bullish candle and closes below its real body
- Especially significant along resistance levels

Try performing the process of candle addition on the Inverted Dark Cloud Cover:



Does this confirm the pattern's effectiveness? Is this a stronger signal than the Dark Cloud Cover reduction?

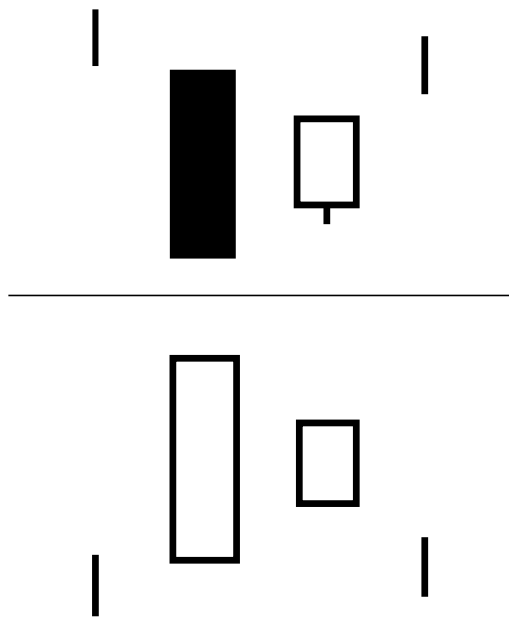
Candle Addition - Inverted Dark Cloud



Because the Inverted Dark Cloud Cover creates a red bearish candle after the process of candle addition, it is just as strong a signal as the Bearish Engulfing Pattern.



Harami



- First real body engulfs second real body
- Same or opposite colour
- Trend is starting to soften/may ease into a congestion band

In many ways, the harami looks like an engulfing pattern in reverse. The first real body must totally engulf the second real body in order to form a harami. The market is taking a break from the direction of the initial candle and pausing for a period of recovery.

Candle Location

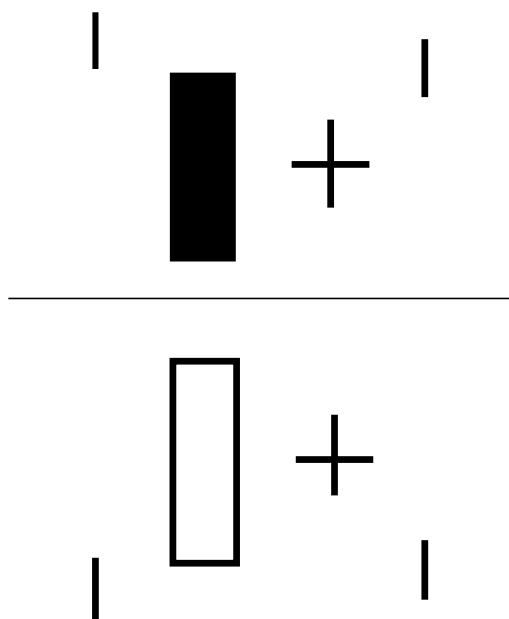
Harami are both top and bottom reversal signals. They have bullish tendencies when found at the bottom of trends, and bearish tendencies when found at the top of trends.

Confirmation consists of a subsequent candle trading within the span of the initial real body. This will indicate that a sideways movement is likely. If the following trading periods show movement of share prices outside the range of the initial body, counter to the existing trend, the signal is also considered to be confirmed.

Psychology

The first real body is long in nature and represents a decided move by the market in one direction. The second real body shows indecision, as it is small in relation to the first real body. This indecision shows vulnerability to a counter trend attack.

Harami Cross



→ Any pattern combined with a doji becomes more powerful & more likely to inspire a more dramatic change of direction

→ It is a sign of heightened indecision

Candle Location

White Harami Cross patterns are likely to be found at the top of uptrends. Black Harami Crosses are likely to be found at the bottom of downtrends.

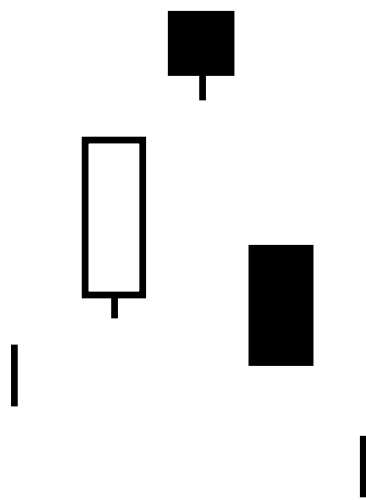
Psychology

The first real body is long in nature and represents a decided move by the market. The second real body shows the ultimate symbol of indecision - a doji.

If a strong move above a previous level of resistance or below a strong level of support has occurred, the market is likely to pause and consolidate, prior to resuming its vigorous trending behaviour. A harami or harami cross in this situation represents the ideal resting point for a tired market.

An indication that this may be the case is if the second small body incurs a significant volume surge. The market is 'churning' as new buyers buy, and sellers who have been in the sideways moving share begin selling.

Evening Star



- Decision, Indecision, Confirmation
- Especially significant with gaps between each candle
- Even more impact if a doji forms the star
- The smaller the star & the lower the third candle, the more bearish

This bearish three candle reversal shows a long white real body (1), a small star of either colour (2), then a black real body (3).

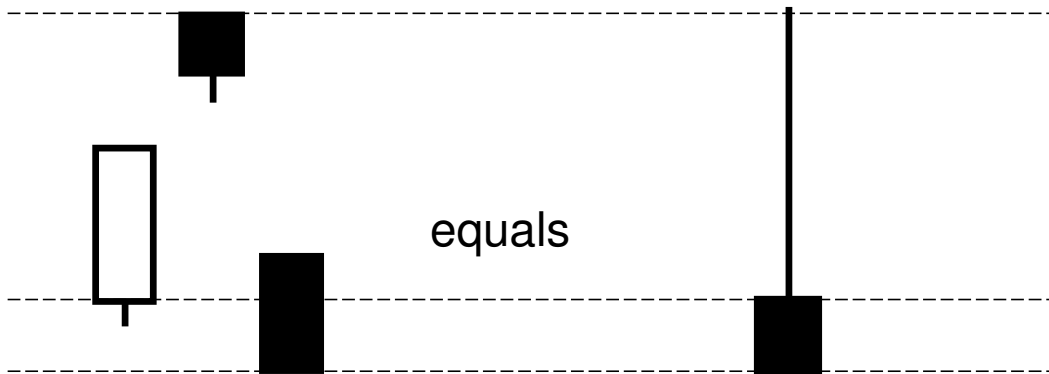
Candle Location

An evening star is located at the top of a trend, and rather than creating a softening of trading activity, a dramatic direction change will often ensue. When the gaps are distinct between each candle, this is one of the strongest signals available. Future trading activity should be at least below the mid-point of the final candle in order to provide confirmation that the trend has changed to a downward direction.

Psychology

The first candle reflects a clear bullish direction. A gap upward from this initial candle reinforces the bullish sentiment, but this session quickly turns to a period of indecision, as depicted by a small candle. The indecision shakes the confidence of the bulls, so the bears move in with strength to create the final candle.

Candle Addition - Evening Star

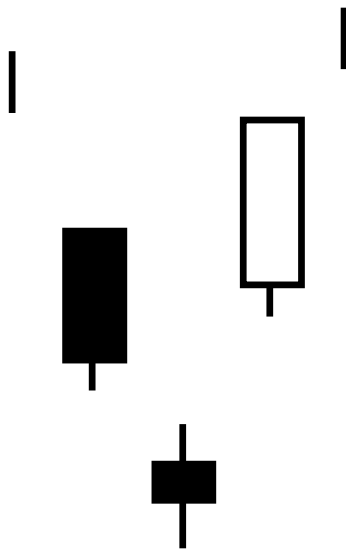


If a doji forms the star, the pattern is known as an Evening Cross and is even more powerful. This is also true for the Morning Star pattern.

Here is an example of an Evening Cross pattern



Morning Star



- Decision, Indecision, Confirmation
- The smaller the star & the higher the third candle, the more bullish
- Even more impact if a doji forms the star
- Watch for a volume increase on final candle

Candle Location

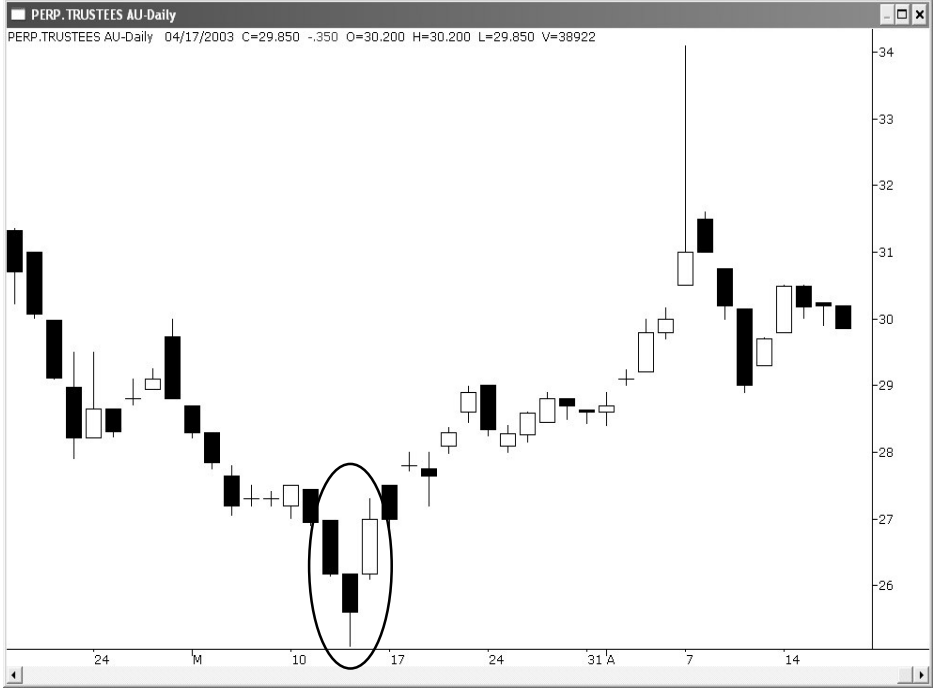
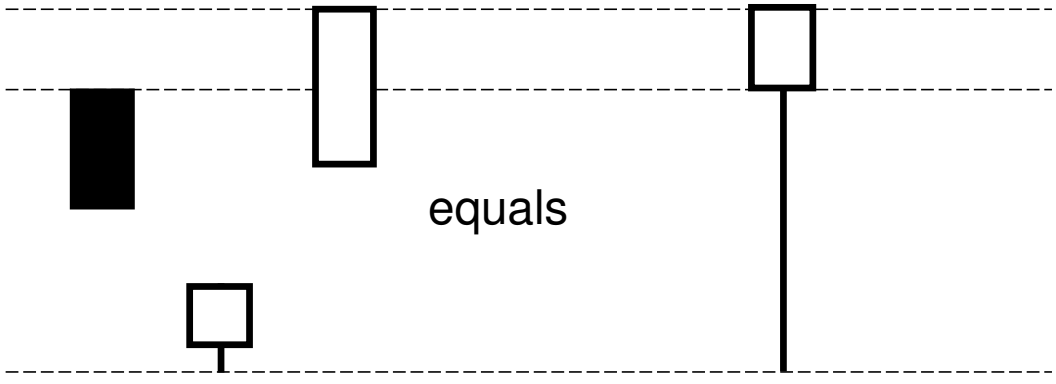
The morning star is a bottom reversal pattern. Future trading activity should at least be above the *mid-point* of the final candle in order to provide confirmation that the trend has changed to an upward direction.

The mid-point represents the shift of power from a bullish perspective to a bearish perspective, and vice versa.

Psychology

The downward direction of the initial candle is followed by a period of indecision. The final bullish candle sends ripples of greed throughout the trading community, especially when accompanied by significant volume levels.

Candle Addition - Morning Star



Review

- 1 Reversal patterns could mean that the trend is flattening or changing direction:
a) True b) False
- 2 The real body of a candlestick is represented by:
(a) The closing price and the high for that session
(b) The opening and the closing price
(c) The high and the low
- 3 Name and draw the 3 concepts central to the formation of a candlestick.
- 4 Convert these bar charts to candlesticks by drawing in your answers in the spaces provided.

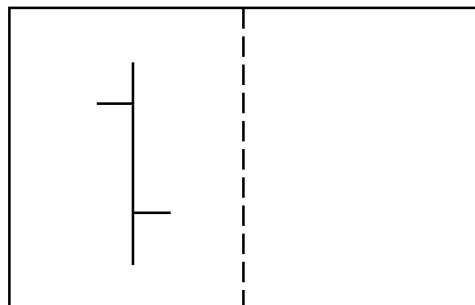
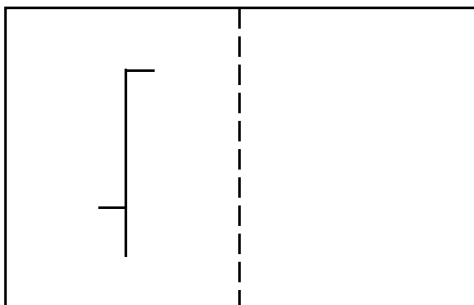
Answers

1)

2)

3)

4)



Review

- 5) A doji is a more powerful signal than a spinning top:
(a) True (b) False
- 6) A hammer and an inverted hammer have bullish implications and occur at the bottom of a trend:
(a) True (b) False
- 7) A dominant candle is a long day of either colour with high volume. They are of even more significant if they penetrate a previously established support/resistance level:
(a) True (b) False
- 8) Review the chart shown on the next page and circle and name any candlestick formations that you recognise.

Answers

5)

6)

7)

8) There are no "right" answers. You may need to review about 50 or so charts to really grasp the candlesticks concept. Be patient with yourself. Your skills will improve with time. Have a look at the chart on the page after the one that you have annotated for suggested solutions.

