

Candlestick Charting Explained

An Introduction To Candlesticks

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An Introduction To Candlesticks

There are two types of ways to analysis the price of a stock, fundamental analysis, and technical analysis. Fundamental analysis is used to gauge the price of a stock based on the fundamental attributes of the stock, such as price/earnings ratio, Return on invest, and associated economic statistics.

Technical analysis deals more with the psychological component of trading a stock, and is influenced for the most part on emotionalism.

The technical analyst is seeking to answer the question "how are other traders viewing this stock, and how will that effect the price in the immediate future".

As you will see, the candlestick chart is the most effective way to gauge the sentiments of other traders.

The History of Candlestick Charts

The Japanese were the first to use technical analysis to trade one of the world's first rice futures markets in the 1600s. A Japanese man by the name of Homma who traded the futures markets in the 1700s discovered that although there was link between supply and demand of the rice, the markets were also strongly influenced by the emotions of the traders.

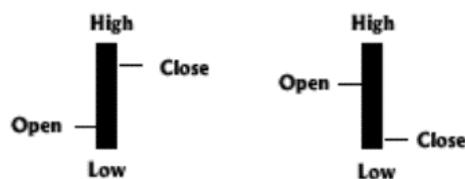
Homma realized that he could benefit from understanding the emotions to help predict the future prices. He understood that there could be a vast difference between value and price of rice.

This difference between value and price is as valid today with stocks, as it was with rice in Japan centuries ago.

The principles established by Homma in measuring market emotions in a stock are the basis for the Candlestick Chart analysis, which we will present in this seminar.

Candlestick vs. Western Charts

The Western bar chart is made up of four parts components, open, high, low, and close. The vertical bar depicts the high and low of the session, while the left horizontal line represents the open and the right horizontal line represents the close.



Western Line (OHLC)

Figure 1

The Japanese Candlestick Line (Figure 2) uses the same data (open, high, low, and close) to create a much more visual graphic to depict what is going on with the stock. The thick part of the candlestick line is called the real body. It represents the range between the session's opening and closing prices. If the real body is red, it means that the close of the session was lower than the open. If the real body is green, it means that the close was higher than the open. The lines above and below the body are the shadows. The shadows represent the

session's price extremes. The shadow above the real body is called the upper shadow and the shadow below the real body is called the lower shadow. The top of the upper shadow is the high of the day, and the bottom of the lower shadow is the low of the day.

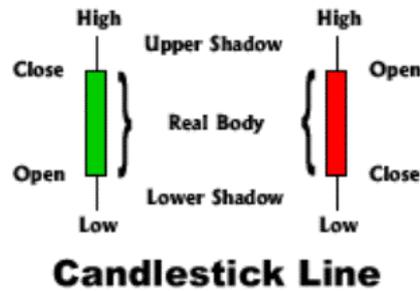


Figure 2

One of the main differences between the Western Line and the Japanese Candlestick line is the relationship between open and closing prices. The Westerner places the greatest importance on the closing price of a stock in relation to the prior periods close. The Japanese place the highest importance on the close as it relates to the open of the same day. You can see why the Candlestick Line and its highly graphical representation of the open to close relationship is such an indispensable tool for the Japanese trader. To illustrate the difference, compare the daily chart plotted with Western Lines (Figure 3) with the exact same chart plotted with Japanese Candlestick lines (Figure 4). In the Western bar chart as with the Japanese Candlestick chart, it is easy to interpret the overall trend of the stock, but note how much easier it is to interpret change in sentiment on a day to day basis by viewing the change in real body color in the Japanese Candlestick chart.

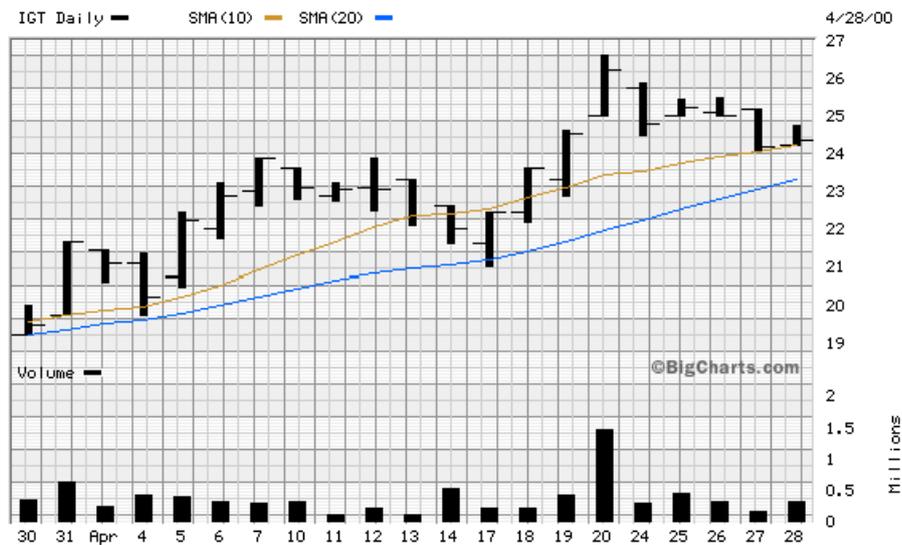


Figure 3

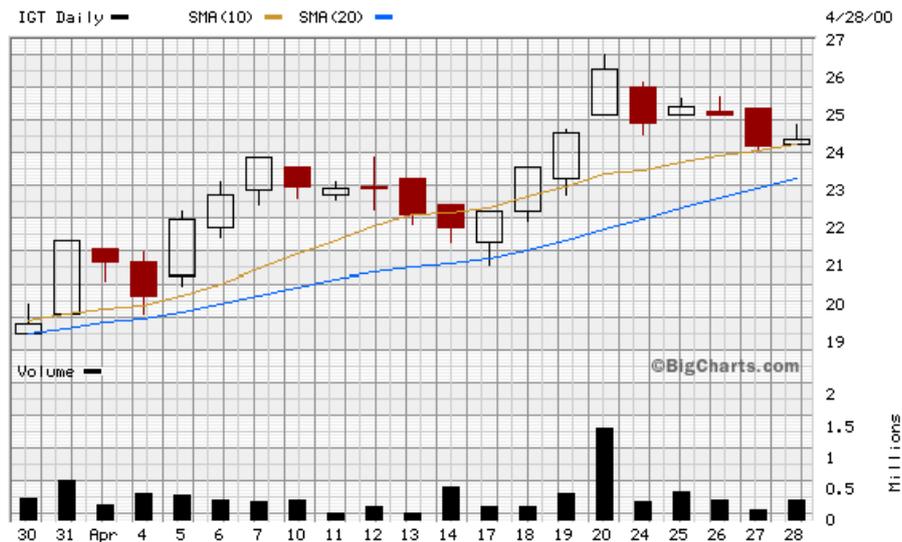


Figure 4

Trader's Sentiment

One of the greatest values of the candlestick chart is the ability to read market sentiment regarding a stock. To illustrate consider the following example of a stock traded from the eyes of a Western chart trader and then from the eyes of a candlestick chart trader.

Western Chart Trader

At the close of the day's session you observe that the stock closed well above your entry price (2), which leaves you very content with your trade.

After the close of day 2, you open the financial section of the paper and check the closing price of the stock and observe that not only is your stock well above your entry price, but also has gained slightly (it is worth mentioning that most western papers only publish closing prices while Japanese papers publish both opening and closing prices).

On day 3 you open and the newspaper to check the close and notice a slight dip in your stocks price but you do not panic, because you are still well in the money.

You convince yourself that the stock has only dipped slightly relative to the entry day close (day 1), and should resume its up trend on the next day.

On day 4, you check the close and notice that the stock has fallen significantly relative to the prior days close.

You are now concerned about protecting the profits that you had previously bragged about just days before.

On the beginning of day 6, you call your broker (or logon to your online trading account) and place a market order to sell at the first opportunity.

At the day 5 markets open, the stock opens sharply lower and continues to fall.

Your order is executed at a price several points below where you entered.

You then shrug off the trade as an unpredictable misfortune, and move on to the next trade.

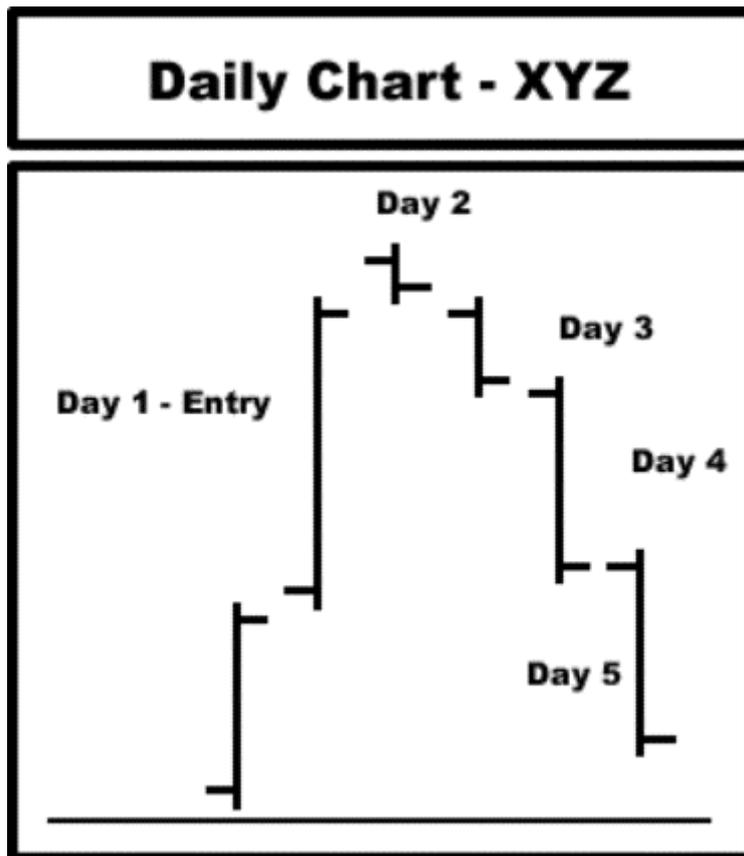


Figure 5

Candlestick Chart Trader

Now suppose you are a candlestick chart trader trading the same stock using a candlestick chart (Figure 6).

At the beginning of Day 1 you enter the stock based on a candlestick pattern entry signal (we will discuss proper entries in detail later in this unit).

At the close of the day's session you observe that the stock closed well above your entry price (2) which leaves you very content with your trade, but also moves you into a state of caution for signs of a change in trend or reversal.

After the close of day 2, you observe the candlestick formed for the day and notice that the real body is small indicating that there was a tug of war between the bears and the bulls.

You also observe that the real body is read in color indicating that the stock closed lower than the open indicating that the bulls actually lost the tug of war to the bears.

Based on these observations you conclude that the bullish rally in the stock has ceased, and the bullish sentiment of the market regarding the stock is changing.

You decided to sell your position at the days close, or at the market open on the next day to lock in your profit.

If this were a stock in the midst of an overall downtrend, you may decide to short the stock under the low of the day 2 bearish candlestick.

As you can see the candlestick chart trader has the advantage over the western chart trader in that he can use the signals generated in each candlestick to help foretell the changing sentiments of the market regarding a stock.

The open to close relationship revealed in the candlestick is more effective than the close-to-close relationship commonly used by western traders.

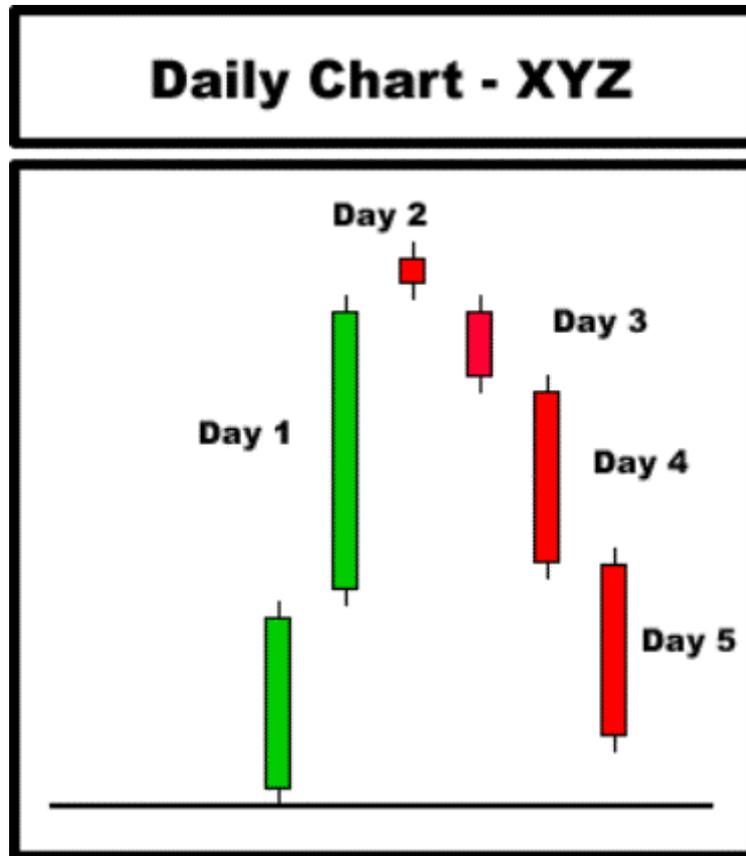


Figure 6

Supply and Demand

A stock's price will adjust to higher or lower prices based strictly on supply and demand principles.

In Figure 7 is shown a diagram of a green candlestick. The green color of the candlestick indicates that the closing price of the stock at the end of the day is higher than the opening price at the beginning of the day.

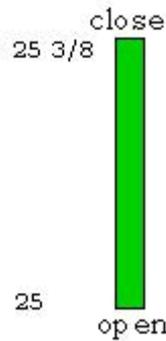


Figure 7

As you will see, the candlestick's color and size provide very important clues regarding the TRADER'S SENTIMENT toward a given stock's future price.

Notice that 'trader's sentiment' is the key phrase here. In short term trading, it is critical for the trader to have a clear understanding of what other traders are thinking. As you will see, the most direct way to get that understanding is through proper interpretation of the candlestick.

Let's look at an example. In Figure 8 is shown a candlestick of XYZ Company, which opened at 25 and closed at 25 3/8.



Figure 8

The candlestick is green in color, which gives us a quick visual signal that the stock price has rallied higher during this period.

How can we use this information to help us understand what other traders are thinking? To answer this question, we will follow the candlestick's changes step by step to understand the mechanism which is driving the stock price to move higher.

In Figure 8, we see the stock opens at 25, and then quickly rallies to 25 1/8. The reason the price moves to 25 1/8 is because there is a high demand to buy the stock at 25 1/8, and a short supply of sellers offering stock at 25 1/8.

Once all of the stock available at 25 1/8 is snatched up, the next group of sellers steps up to offer their stock at 25 1/4. All of the 25 1/4 stock is quickly snatched up because there are still a larger number of traders willing to buy at 25 1/4 than sellers willing to sell stock at 25 1/4.

Once the 25 1/4 stock is gone, the next group of sellers steps up to offer their stock at 25 3/8. The 25 3/8 stock is quickly snatched up too.

This process will repeat itself until the buyers lose interest in buying the stock resulting in a reduction of demand.

The result of combining these steps is a green candlestick with an opening price of 25, rallying to a closing price of 25 3/8.

During the rally period; however, the astute candlestick reader will be able to observe the long green color of the candlestick, and deduce that buyer demand is high.

Now there is only one reason why traders would increase demand by stepping up to buy the stock, and that is because they think that the stock will go up in the near future. So by observing the candlestick color and size, the astute candlestick reader is able to deduce exactly what other traders are thinking, and that is that they think the stock price will go higher in the future.

In Figures 9 & 10 we show an example of how the same principle in reverse applies to the analyses of a red candlestick.

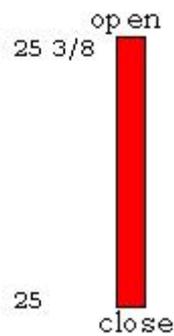


Figure 9

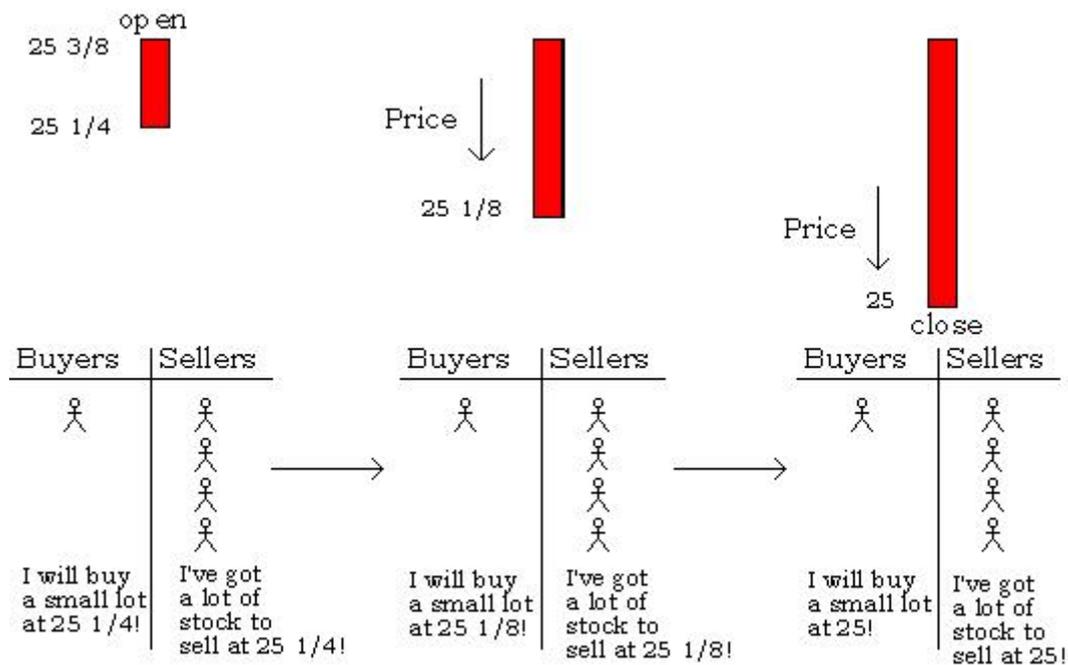


Figure 10

The reason the price moves to $25 \frac{1}{4}$ is because there are many sellers looking to unload their stock at $25 \frac{1}{4}$, and a low number of buyers willing to buy at $25 \frac{1}{4}$.

Once all of the buyers have bought the stock at $25 \frac{1}{4}$, the next group of buyers steps up to bid for stock at the lower price of $25 \frac{1}{8}$.

The desperate sellers quickly sell all of the stock at $25 \frac{1}{8}$, and then the next set of buyers step up at the price of 25.

This process will repeat itself until all of the sellers have unloaded all of the stock that they want to sell, resulting in a reduction of supply.

The result is a red candlestick with an opening price of $25 \frac{3}{8}$, falling to a closing price of 25. During the stock's price fall; however, the astute candlestick reader will be able to observe the long red color of the candlestick, and deduce that demand for the stock is low.

Now there is only one reason why traders would increase the supply of stock to sell, and that is because they think that the stock will go down in the near future.

So by observing the candlestick color and size, the astute candlestick reader is able to deduce exactly what other traders are thinking, and that is that they think the stock price will go lower in the future.

Buy on Greed, Sell on Fear

There are only two forces behind the supply and demand forces that drive a stock's price higher or lower.

Those forces are the emotional forces of fear and greed. To illustrate this point we refer to Figure 11.

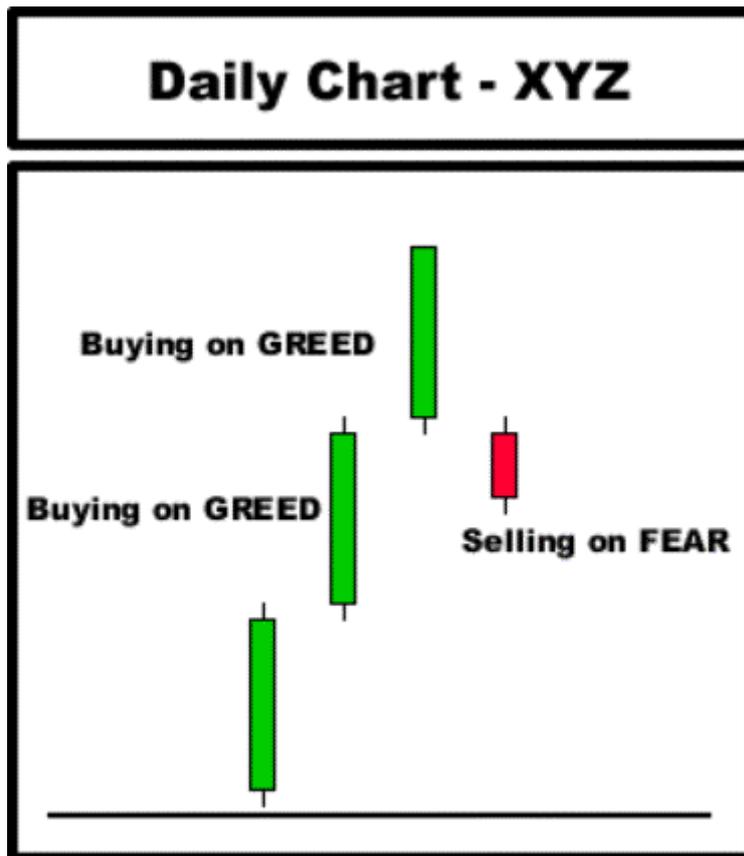


Figure 11

Suppose you are a trader observing the bullish rally of Stock XYZ at the beginning of the 3rd bullish green candlestick, and considering an entry.

You have witnessed the stock rally huge for two days and know that each trader who entered on the first two days is now a big winner.

Based on the emotion of greed you decide to enter at that beginning of the 3 day, and mentally count your profits as the price rallies to a new high.

After the stock closes, you brag to your friends at the golf course regarding the great trade that you made that day.

You go home from the golf course and celebrate the victory with your spouse and maybe even discuss how you will use the extra money that you have earned through the trade.

Now keep in mind that the profit is only on paper and not one penny has been earned yet.

The next morning you check the price of your position, with expectations that your bullish stock will rocket to the moon! Now imagine the emotion that goes through your mind when your position not only fails to go higher, but also opens below your entry price.

What is the emotion that flows through your body as you not only see your profits erode before your eyes, but now rob your account of precious capital?

The emotion that you will experience is undoubtedly fear and will prompt you to scramble to liquidate your position as soon as possible to minimize your losses.

Now consider that there were also 2 or 3 thousand additional traders who entered the same stock at around the same price with the hopes of the gaining the same profit.

All of these traders will be tripping over themselves trying to get out of the stock.

As was illustrated in the previous section, this increase in fear results in an increase in supply of the stock relative to the increase in demand, and triggers the sharp decline in the price.

The deeper the red candlestick cuts into the bullish green candlesticks, the more traders are thrown into losing positions, and thus the further the price decline.

Perhaps you are beginning to realize the power of emotions in price movements of a stock.

The technical analyst through candlestick reading is trained to read this greed and fear emotions in the market and capitalize on them.

Capitalizing on Fear and Greed

From the previous section, we determined that price movements result from massive emotions of fear and greed regarding trader's position in the market with a given stock.

Recognizing the footprints of greed and fear is not difficult. Recognizing the signs that the rally or decline before it happens is the difficult part of trading. How many times has this situation happened to you: You enter a trade based on a bullish reversal signal, but then exit on a slight pull back only to see the stock rally to a new high after you exit.

Or how often have you held on to a stock that experiences a bearish pull back in hopes that it will turn around, only to see the stock plummet to new lows before you finally concede to defeat and exit.

Unfortunately, there is no system that can predict with 100% accuracy exactly where a greed rally or fear sell off begins. There are; however, techniques based on candlestick patterns that help us locate probable areas for these turning points. The rest of this section will explore the techniques in identifying those probable areas that properly managed will result in profits for the trader in the long run.

Recognizing Reversal Signals

Throw a baseball straight up into air. As the ball approaches the top of its projectile path it will decelerate to a speed of zero, and then reverse downward picking up speed as it approaches the ground.

Now imagine yourself drilling into a piece of wood. You suddenly hit a hard spot in the wood at which time bear down with all of your might to overcome the temporary resistance created by the knot in the wood.

When you penetrate the knot you surge forward and quickly poke through to the other side. These are two analogies to help explain the patterns of stocks as they transition between one move and the next move.

When a stock is completing a move, it experiences a period of deceleration, which is referred to by chartist as price consolidation.

Consolidation is one of the most important signals that a stock is about to begin a new move.

The move can be a continuation in the same direction, or it can be a reversal in the opposite direction.

The area of consolidation represents a battle zone where the bears are at war with the bulls.

The outcome of the battle often defines the direction of the next move.

As short-term traders, it is important to identify these areas of consolidation and enter a trade just as the new move is beginning.

During the consolidation period or 'battle zone', traders, both long and short are patiently waiting on the sidelines watching to learn the outcome of the battle.

As these winners emerge, there is often a scramble of traders jumping in with the winning team.

The candlestick patterns gives the trader excellent clues on when this move is about to take place, and helps the trader time his entry so that he can get in at the very beginning.

There are four different consolidation patterns experienced by stocks.

They are 1) Bearish Continuation, 2) Bullish Continuation, 3) Bearish Reversal, 4) Bullish Reversal.

The Bearish Continuation Consolidation Pattern

Several strong bearish candlesticks precede the Bearish Continuation pattern where the bears are clearly in control (Figure 12).

The bears and bulls then begin to battle by pushing the stock up and down in price in a tightly formed consolidation zone.

The narrowing size of the candlesticks toward a line of support indicates that the bears are winning the battle.

The bulls finally weaken and allow the bears to penetrate the line of support, at which time the bears quickly conquer new territory by taking the stock to lower prices.

By recognizing the consolidation pattern the trader is able to short the stock just after the stock breaks the line of support, and profit from the sharp move downward.

The cause of the sharp sell off is fueled by the emotions of the traders watching for the outcome of the battle. Traders who bought the stock in the area of consolidation in hope of a rally off of support, are now scrambling to exit their losing positions.

Traders who are short from the period before the area of consolidation are realizing that their original entries were correct and are adding to their winning positions.

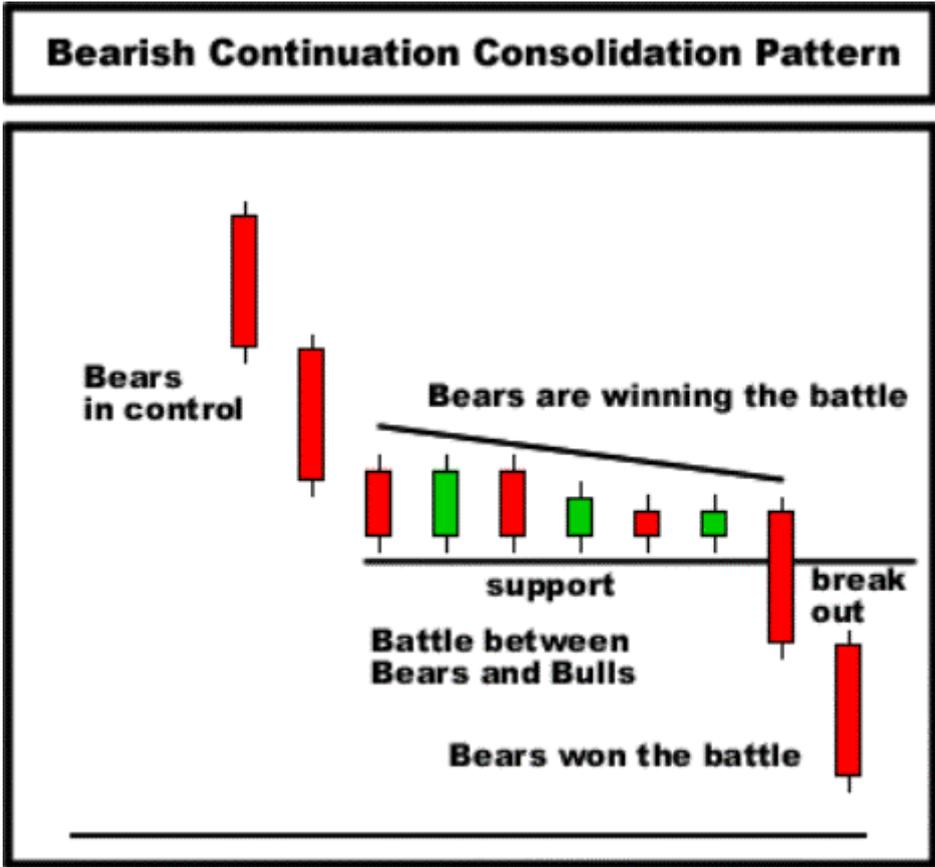


Figure 12

The Bullish Reversal Consolidation Pattern

Several strong bearish candlesticks precede the Bullish Reversal Continuation pattern where the bears are clearly in control (Figure 13).

The bears and bulls then begin to battle by pushing the stock up and down in price in a tightly formed consolidation zone.

The narrowing size of the candlesticks toward a line against upward resistance indicating that the bulls are winning territory from the bears.

The bears finally weaken and allow the bulls to penetrate the line of resistance, at which time the bulls quickly conquer new territory by taking the stock to higher prices.

By recognizing the consolidation pattern the trader is able to buy the stock just after the stock breaks the line of resistance, and profit from the sharp move upward.

The cause of the rally is fueled by the emotions of the traders watching for the outcome of the battle.

Additional traders who jump in to buy the stock now that its strength has been confirmed fuel the sharp upward move.

Traders who are currently short the stock in the area of consolidation waiting in hope of a breakdown, are now scrambling to cover their short positions.

This buying action also fuels the fire pushing the stock to higher prices.

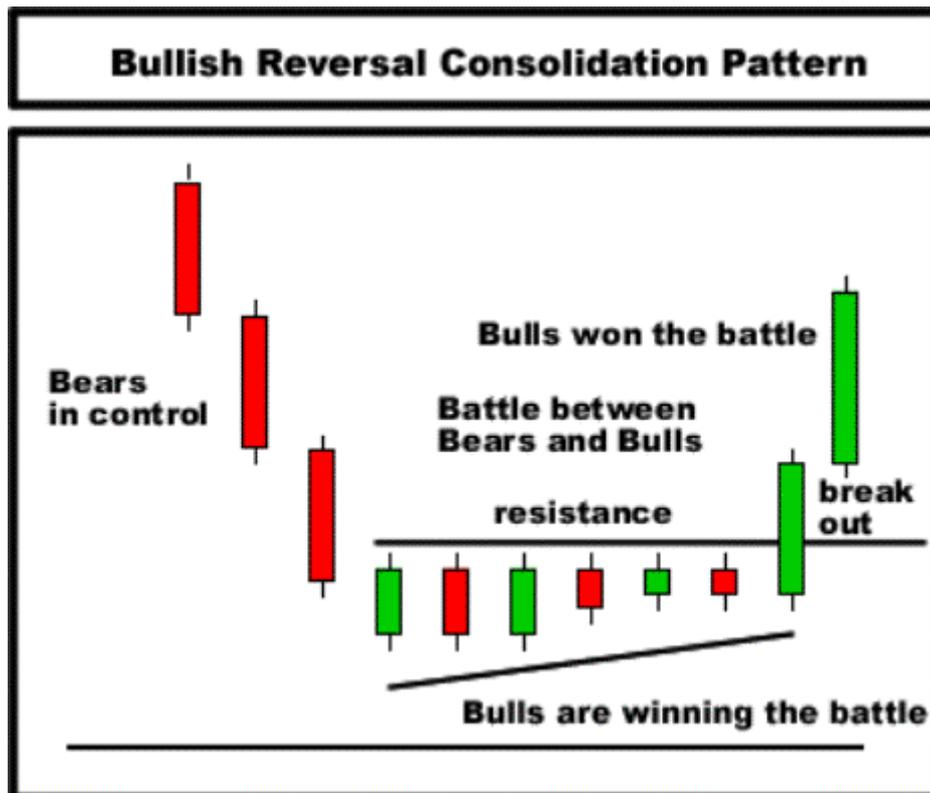


Figure 13

The Bearish Reversal Consolidation Pattern

Several strong bullish candlesticks precede the Bearish Reversal Continuation pattern where the bulls are clearly in control (Figure 14).

The bears and bulls then begin to battle by pushing the stock up and down in price in a tightly formed consolidation zone.

The narrowing size of the candlesticks toward a line of support indicates that the bears are winning the battle.

The bulls finally weaken and allow the bears to penetrate through the line of support, at which time the bears quickly conquer new territory by taking the stock to lower prices.

By recognizing the consolidation pattern the trader is able to sell short the stock just after the stock breaks the line of support, and profit from the sharp spike downward.

Additional traders who jump in to short the stock now that its weakness has been confirmed fuel the sharp sell off.

Traders, who are currently long the stock in the area of consolidation waiting in hope of a breakdown, are now scrambling to sell their long positions.

This selling action also fuels the fire pushing the stock to lower prices.

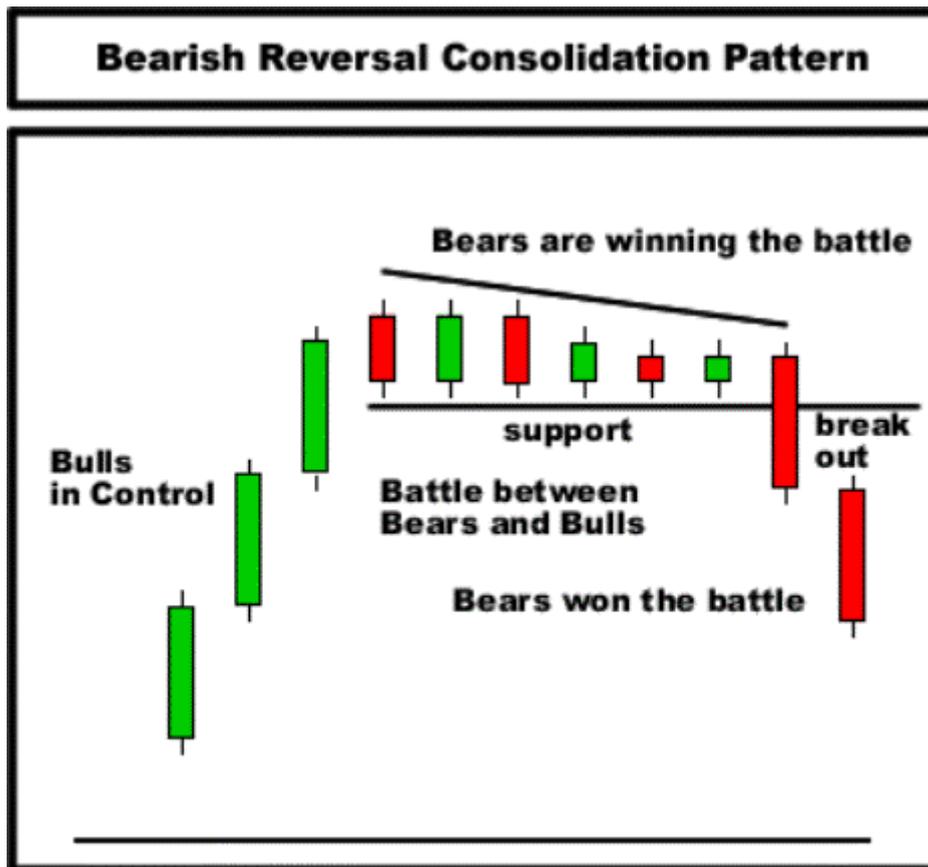


Figure 14

The Bullish Continuation Consolidation Pattern

Several strong bullish candlesticks precede the Bullish Continuation Consolidation Pattern where the bulls are clearly in control (Figure 15).

The bears and bulls then begin to battle by pushing the stock up and down in price in a tightly formed consolidation zone.

The narrowing size of the candlesticks toward a line of resistance indicates that the bulls are winning the battle.

The bears finally weaken and allow the bulls to penetrate the line of resistance, at which time the bulls quickly conquer new territory by taking the stock to higher prices.

By recognizing the consolidation pattern the trader is able to buy the stock just after the stock breaks the line of resistance, and profit from the sharp move upward.

The cause of the sharp sell off is fueled by the emotions of the traders watching for the outcome of the battle.

Traders, who shorted the stock in the area of consolidation in hope of a sell off in the area of consolidation, are now scrambling to exit their losing positions.

Traders who are long from the period before the area of consolidation are realizing that their original entries were correct and are adding to their winning positions.

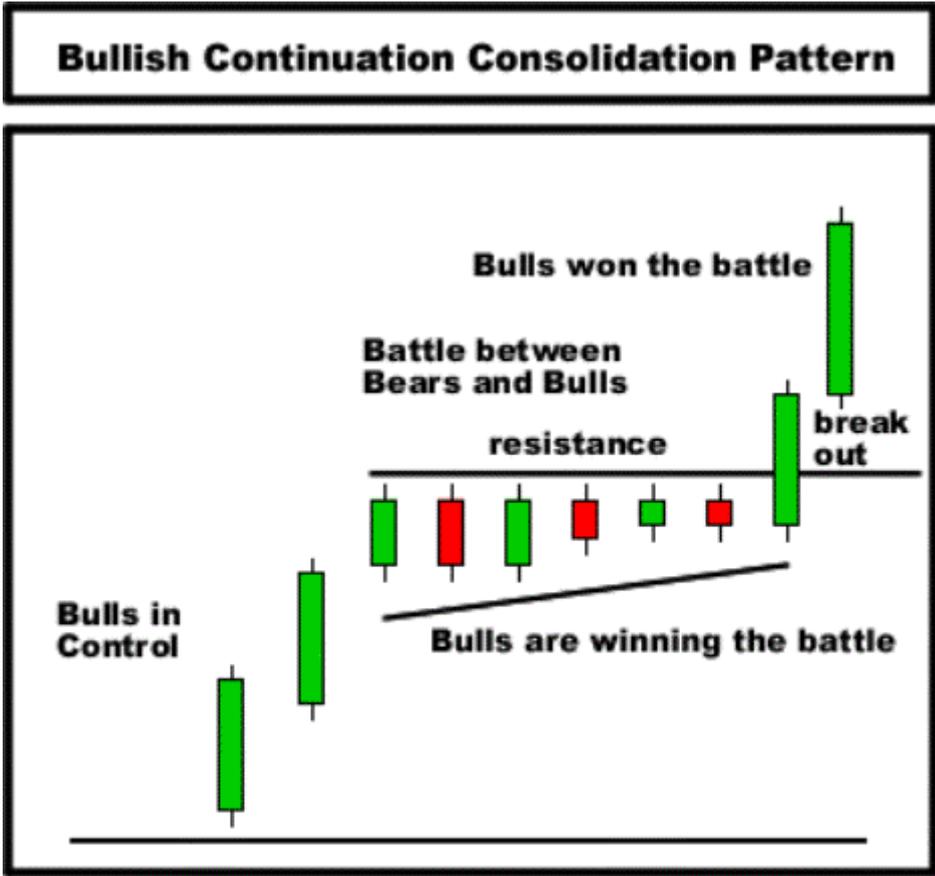


Figure 15

Increasing The Odds

As we learned in the last section, the best trading opportunities present themselves just after a breakthrough in price consolidation.

Not every consolidation pattern; however, is tradable. There are additional patterns, which significantly increase the odds of the trade following through in the desired direction.

The tools, which we present, are 1) support/resistance 2) trends, 3) moving averages.

Support and Resistance

Support and resistance are general price areas that have halted the movement of stock in the past.

Support lines are horizontal lines that correspond with an area where stock previously bounced.

Resistance lines are horizontal lines corresponding with an area where stock resisted moving through.

Support and resistance lines are used to help access how much the stock price will remove before it is halted.

There are two main types of support and resistance; 1) Major price support/resistance, and 2) Minor price support/resistance

Major Price Support/Resistance

Major Price Support is an artificial horizontal line representing an area where a stock's downward movement was halted to give way to a new upward movement (Figure 16).

Therefore, the price level is supporting the price of the stock.

Similarly, Major Price Resistance is an artificial horizontal line representing an area where a stock's upward movement was halted to give way to a new downward movement.

Therefore, the price level is resisting the price of the stock.

When considering a stock as a trading opportunity it is important to note the location of the nearest support and resistance levels.

Stocks near areas of support make for better buy opportunities and stocks near areas of resistance make for better short opportunities.

In the same way, the trader should be more cautious about shorting stock above areas of support, and buying stock near areas of resistance.

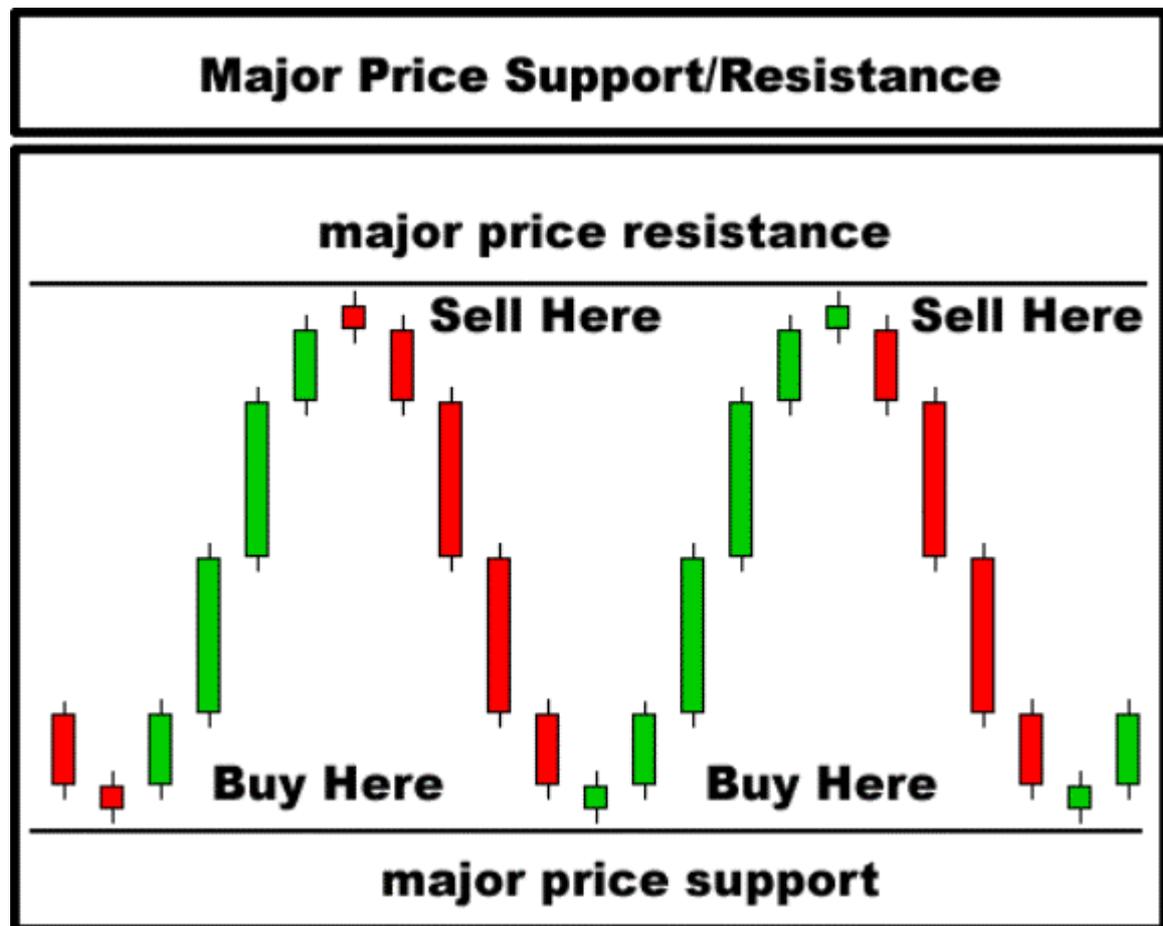


Figure 16

Minor Price Support/Resistance

Minor Price Resistance



Figure 18

Trends

Every stock is in one of three states: 1) Up Trend, 2) Down Trend, and 3) Sideways Trend (Figure 20).

An Up Trend is defined by a series of higher highs and higher lows.

A Down Trend is defined by a series of lower highs followed by lower lows.

A Sideways Trend is defined by a series of relatively equal highs and lows.

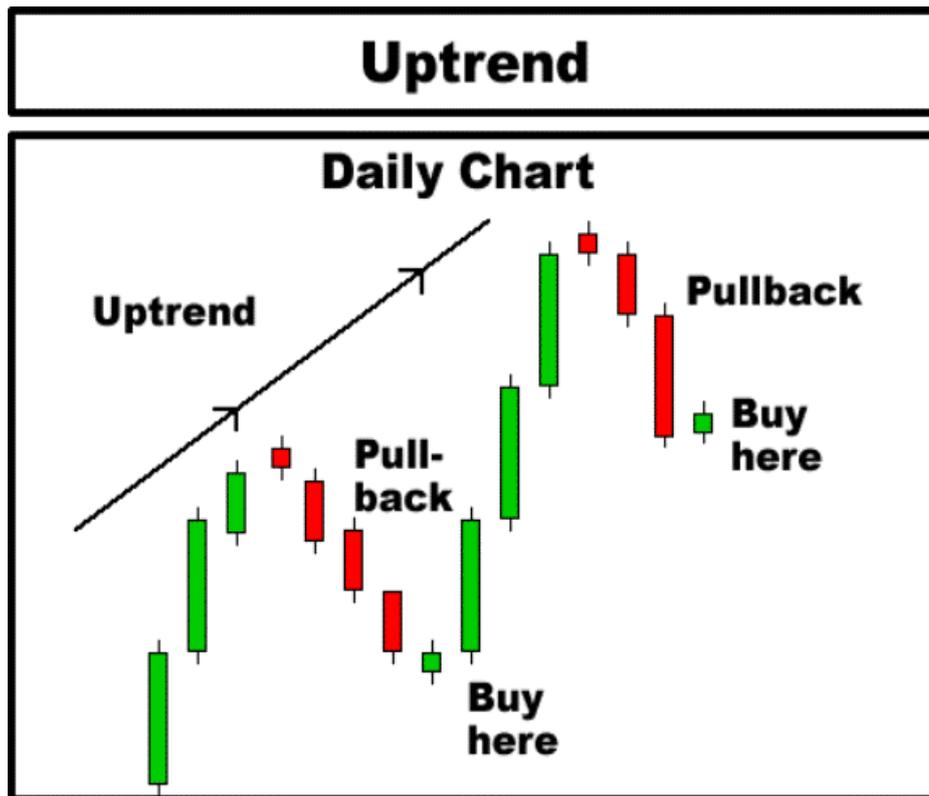


Figure 20

Even the strongest stocks will need a period of rest through a pullback in price or a period of marking time with little to no price movement.

A strong stock will often pull back in price as short to medium term traders take their profits off the table, and in the process, increase selling pressure, which will temporarily push the stock lower.

A strong stock, after rest will often resume its rally after these slight pullbacks.

The trader has better odds in his favor by playing the stock in the direction of the trend.

For example, stocks in and up trend can be bought, and stocks in a downtrend can be shorted (Figures 21 & 22).

A stock in a sideways pattern can be either bought or shorted if the stock is on strong price support or resistance.

In otherwise, the trader should enter long positions only on up trending stocks that have pulled back for rest ready to resume the rally.

Likewise, the trader should enter short positions on down trending stocks that have pulled back for rest ready to resume the decline.

Uptrend

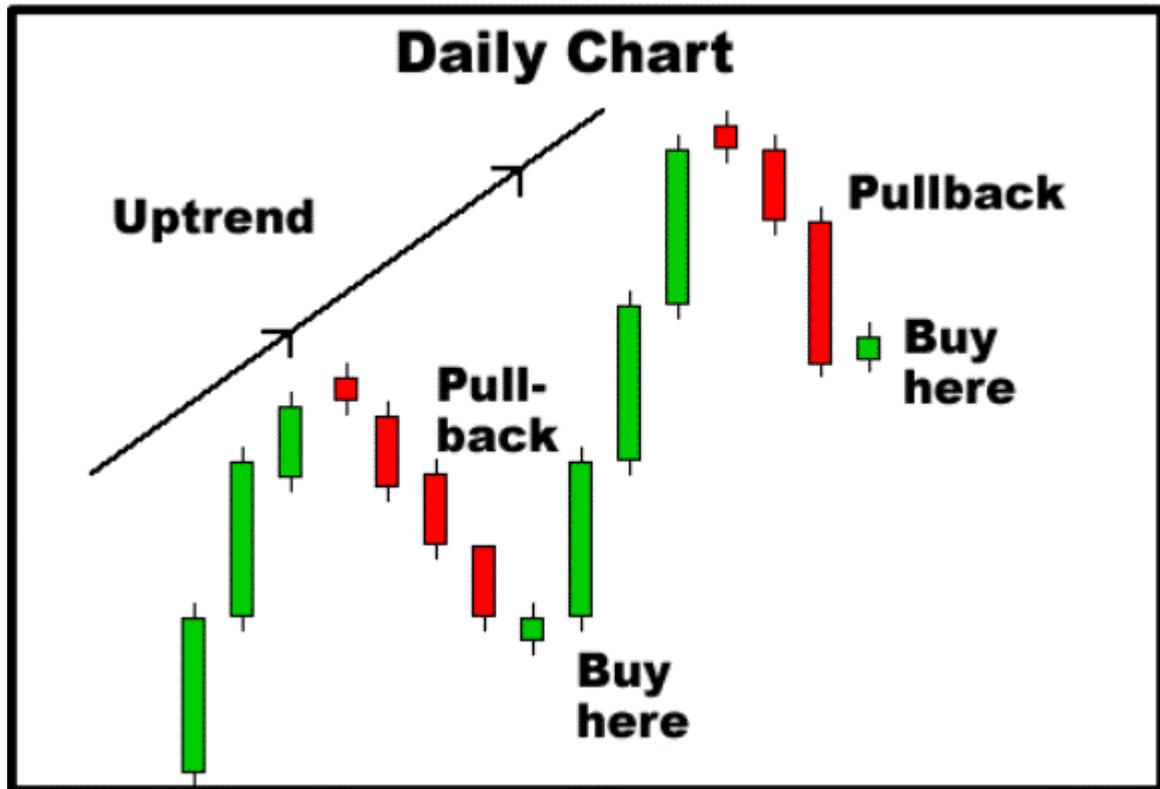


Figure 21

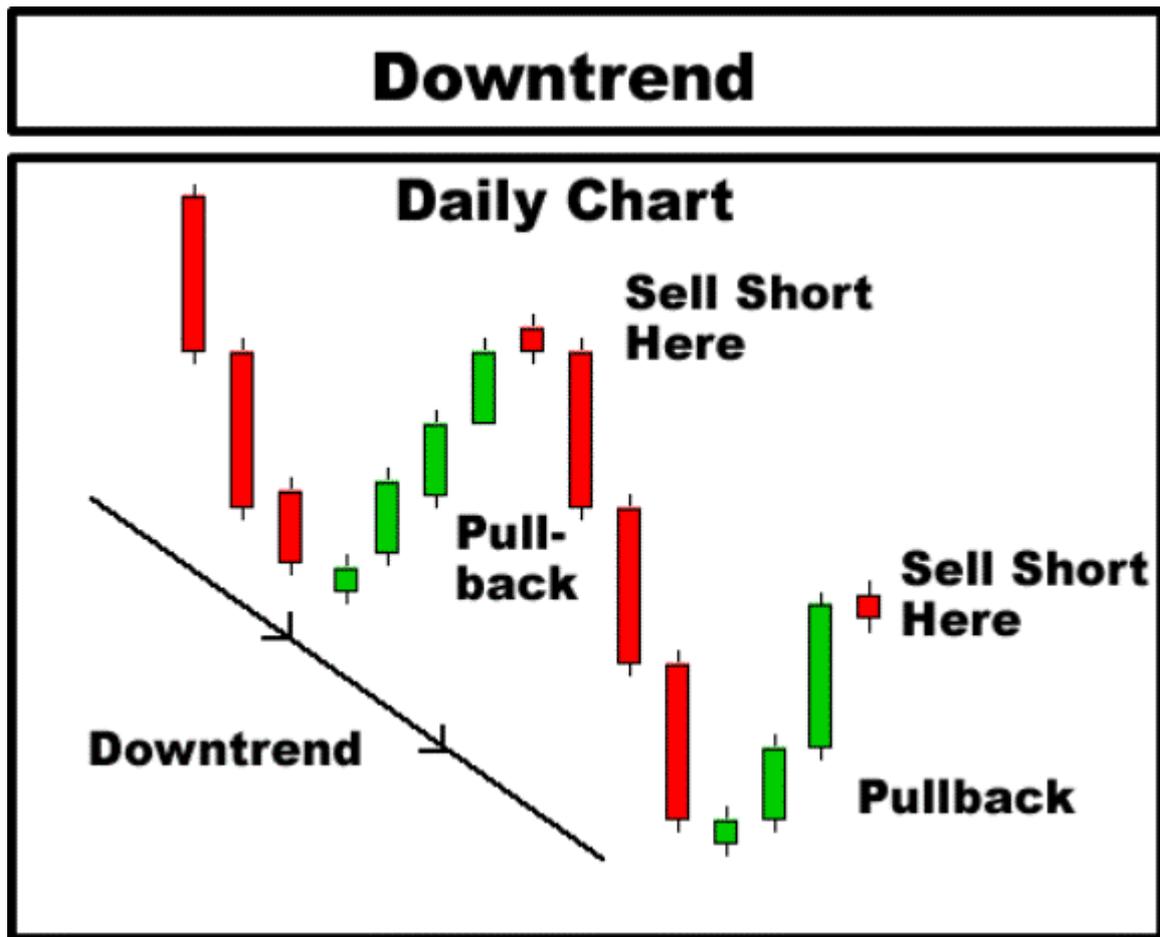


Figure 22

Moving Averages

The most basic form of moving average, and the one we recommend to all our traders is called the simple moving average.

The simple moving average is the average of closing prices for all price points used.

For example, the simple 10 moving average would be defined as follows:

$$10MA = (P1 + P2 + P3 + P4 + P5 + P6 + P7 + P8 + P9 + P10) / 10$$

Where P1 = most recent price, P2 = second most recent price and so on

The term "moving" is used because, as the newest data point is added to the moving average, the oldest data point is dropped.

As a result, the average is always moving as the newest data is added. Moving averages can be used as support and resistance levels.

Stocks tend to rebound off of moving averages much in the same way that they rebound off major and minor support and resistance lines.

A moving average can be plotted using any period; however, the periods that seem to provide the strongest support and resistance for short term trading are the 10MA, 20MA, 50 MA, 100MA and 200MA.

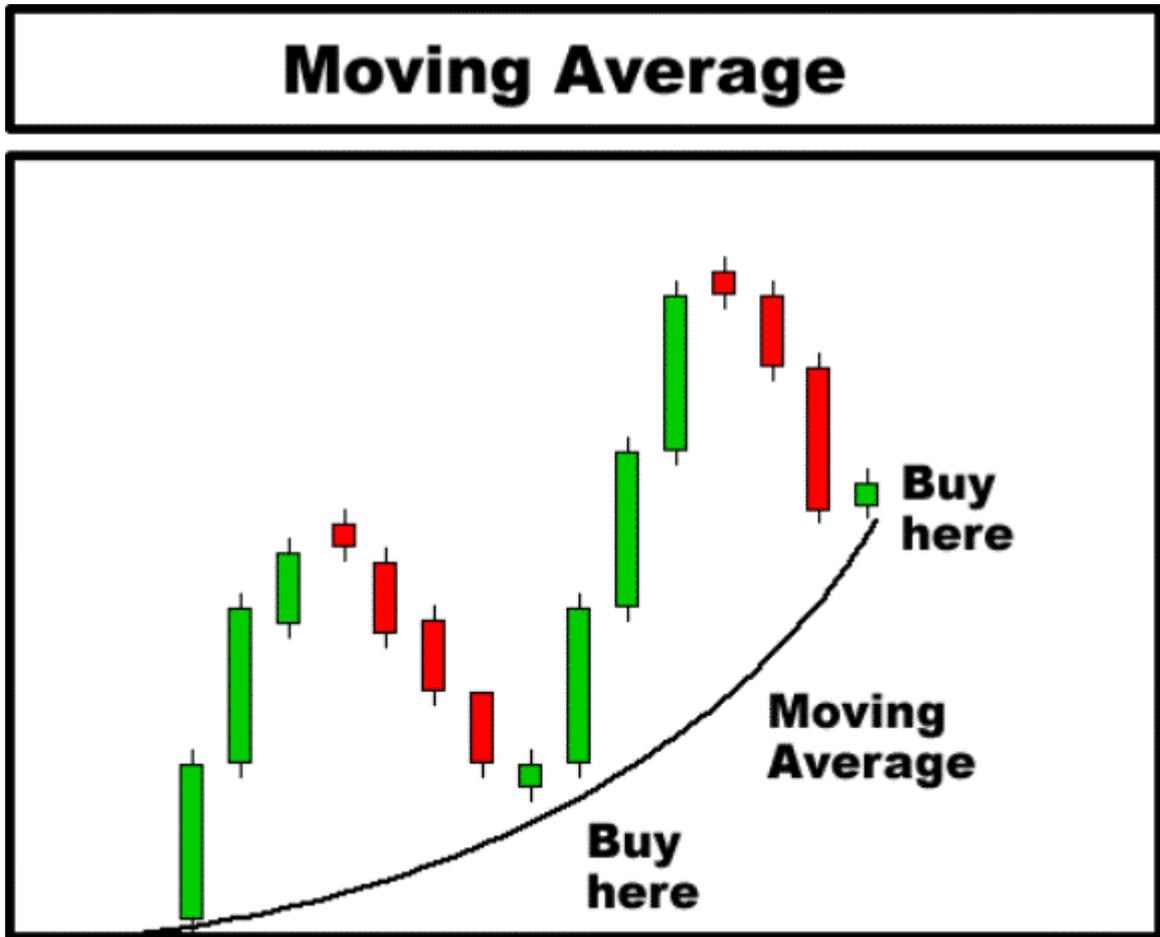


Figure 23

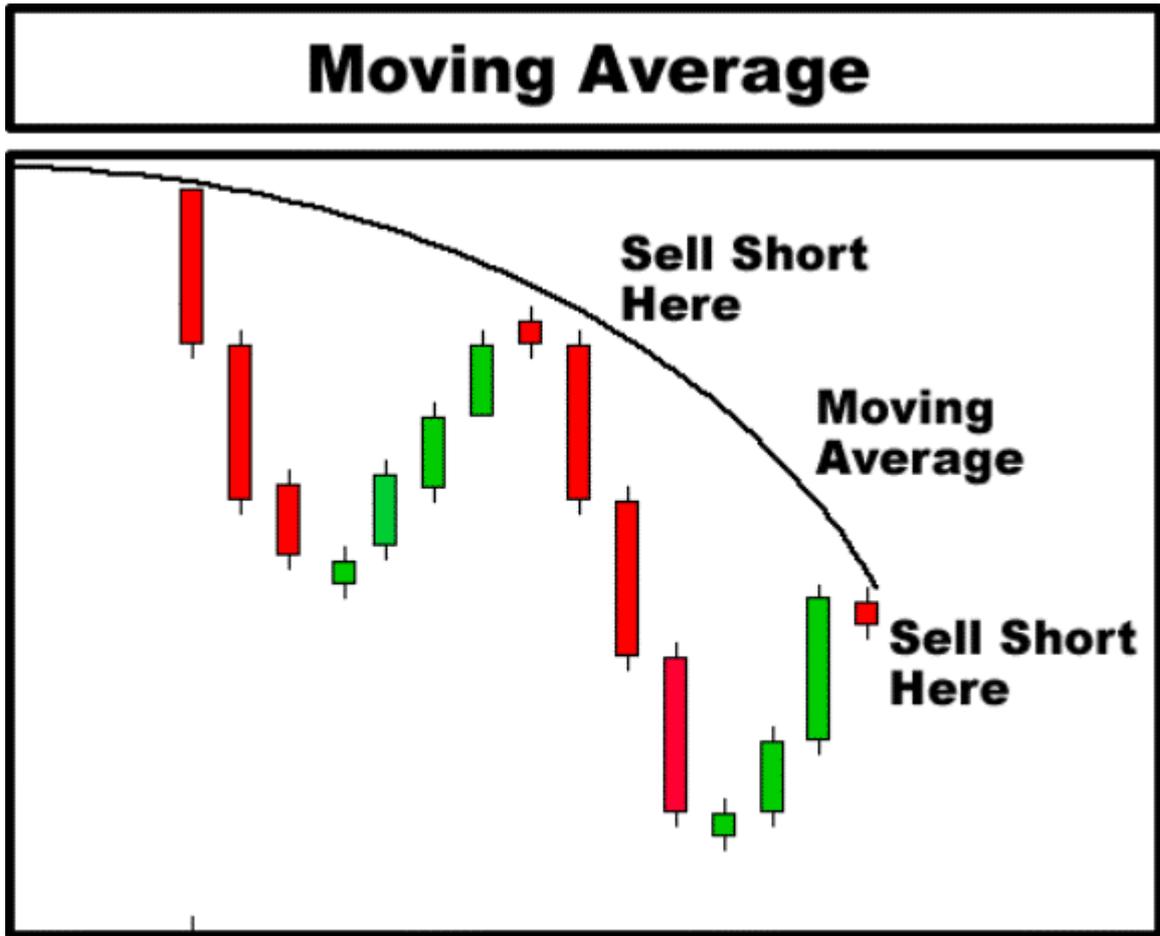


Figure 24

Candlestick Line Time Frames

One of the beautiful attributes of the candlestick line is that the same analysis can be applied to multiple time frames.

The time frame of a candlestick line is the time duration between the candlestick's opening price and closing price.

For example, a daily candlestick chart would consist of candlestick lines with opening prices corresponding with the day's opening price, and closing prices corresponding with the day's closing price (Figure 25).

A 5-minute candlestick chart would have candlestick lines with time duration of 5 minutes between each candlestick's opening price and closing price.

Most good computer charting software allows easy conversion from one time frame to the next.

As we will see in latter examples, utilizing several different time frames in viewing a stocks candlesticks pattern is a very effective way to read the underlying sentiments behind a stocks movement.

Candlestick Time Frames

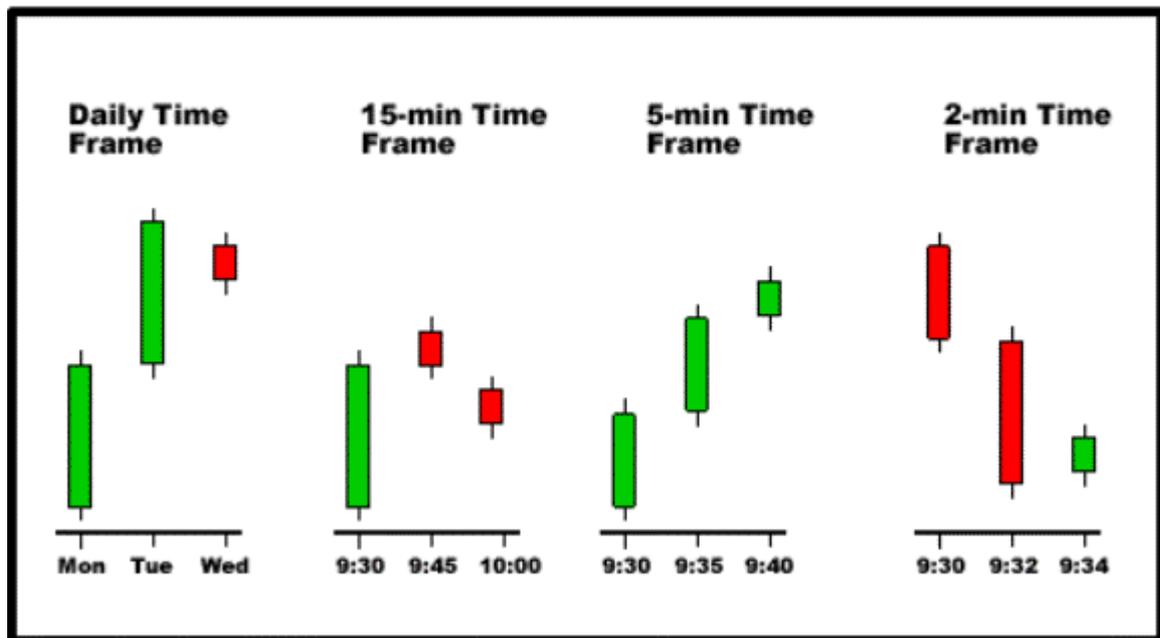


Figure 25

Dissecting a Candlestick

Changing time frames when viewing candlestick patterns is a useful tool when looking for patterns leading up to good trading opportunities.

For example, consider the Bullish Harami Pattern that is manifested on the Daily time frame chart (Figure 26).

The same stock plotted on a 15 min time frame chart shows that the stock is actually setting up for a Bullish Reversal Consolidation pattern.

Using the Daily chart and the 15 min chart together make it easier to find possible trade opportunities.

For example, the trader can scan for Harami setups on the Daily chart, and then pull up a 15 min chart to confirm the stock is experiencing a consolidation pattern preparing for a break out.

The Bullish Harami

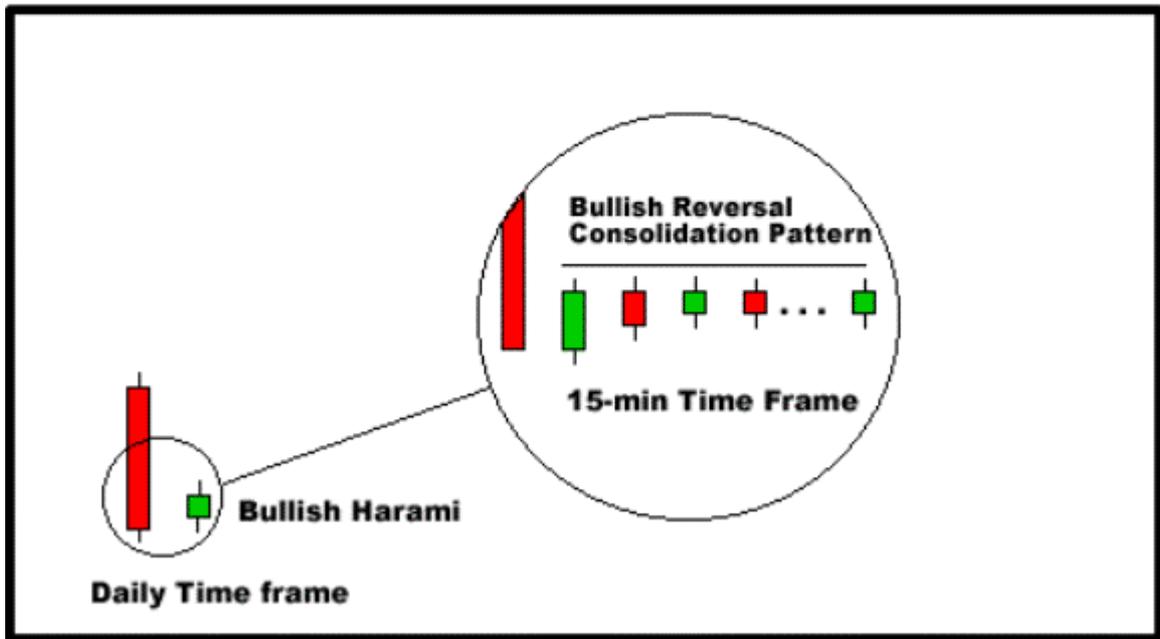


Figure 26



Figure 27

