

INTRODUCTION TO CANDLESTICK PATTERNS

Learning to Read Basic Candlestick Patterns



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What are Candlesticks?

Put simply, candlesticks are a way of communicating information about how price is moving.

Candlestick charts are available on ThinkForex trading platforms for all assets individuals can trade on the platforms. Below is a sample of a candlestick chart derived from the ThinkForex web trading platform:



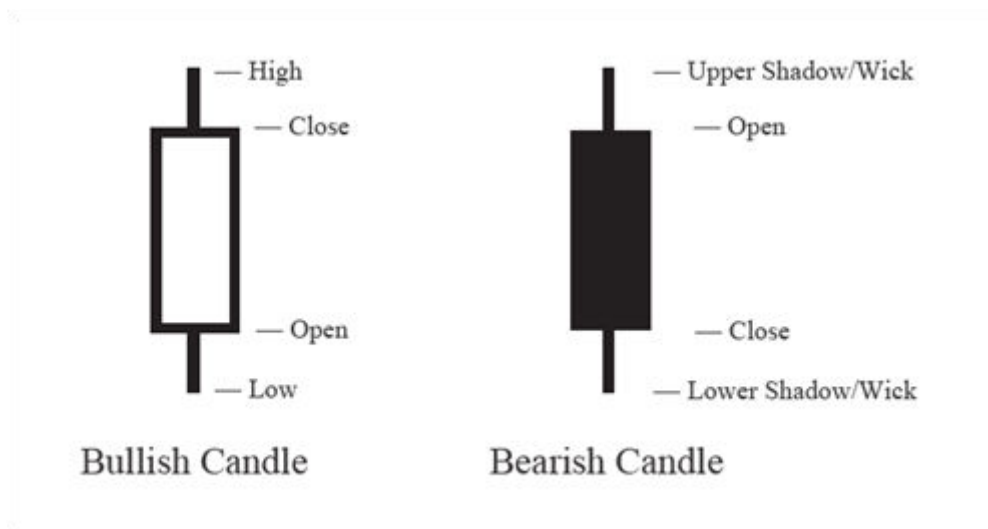
This chart shows price on the right (vertical) axis, and time on the bottom (horizontal) axis.

Moreover, the chart is made of bars that have little lines stemming from the top and the bottom; these are known as candles. The candle conveys four pieces of information:

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

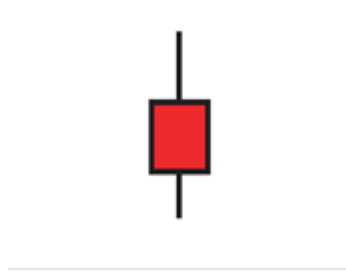


Candles refer to that information for a specific unit of time. For instance, the chart above is a daily chart; each chart represents one day. And thus, each candle constitutes, the open, close, high, and low price for that given day. The horizontal axis at the bottom of the chart can be used to understand which day corresponds to which candle. Below is an image that illustrates how those four pieces of information the open, low, high, and close for a given period of time are visualized in the context of a candle:



The wicks, or shadows, are the thin lines that go outside the rectangular body of the candle. They represent the high and the low price during that time period.

The color of the candle is also significant in understanding whether the open price was higher or lower than the close price. If the candle is red, or denoted as bearish in some other manner, this means that the open price is lower than the close; and the opposite is true if the candle is green, or denoted as bullish.



Consider the candle above. The absolute highest point on the candle, the top of the upper line above the rectangular body, is the high price; the absolute lowest point shows how far price fell during the time period in question. The top of the candle is the opening price of the time period, while the bottom of the candle is the closing price. Thus, from this candle, we see that price rallied and fell from its open but bears were ultimately able to push it lower than the open, while bulls came in before the close to push price up a bit.

Why do Candlesticks Work?

Price action traders rely on candlesticks because they convey a great deal of information about each trading period in a visual format that is easy to interpret, allowing traders to compare the behavior of price in different time periods with a quick glance at a price action chart. Each candlestick can be “read” as a meaningful part of the developing narrative of price. They communicate the “market sentiment”: whether (and to what extent) bears or bulls were in control, and how far traders managed to push price in both directions. For example, a long candle’s body with no wicks indicates a definitive shift in this struggle for power, whereas a candle with a long upper wick beyond its body indicates a more contentious period with an effort by bulls to push price higher that was pushed back by pressure from bears before the close of the candle. Certain re-occurring candlestick patterns have become popular among traders as reliable signals of future market behavior. This guide is intended as an introduction to some of these patterns, which help traders make sense of market conditions and recognize advantageous times to enter trades.

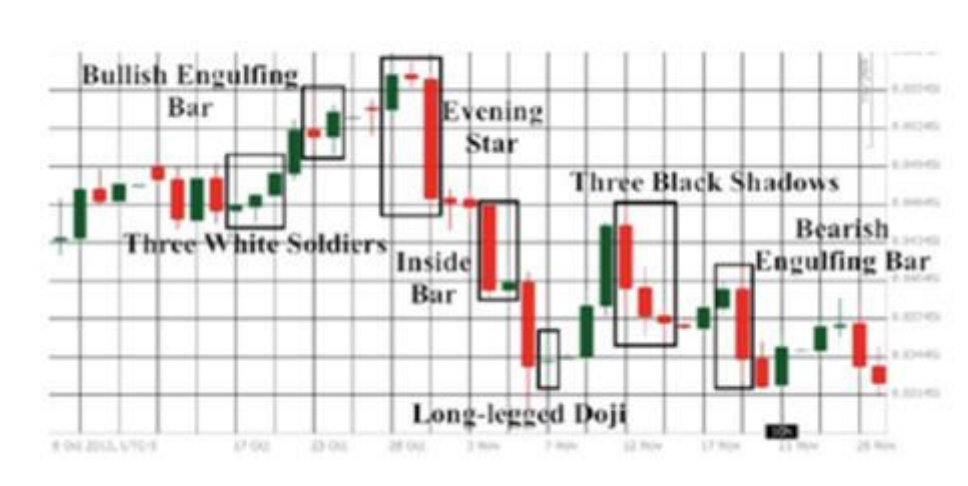
The ability to read candlesticks allows the price action trader to become a meta-strategist, taking into account the behaviors of other traders and large-scale market-movers. In other words, candlestick patterns help traders.



What are Candlesticks?

Calibrate their own trading with the fluctuations and reversals of larger, more influential participants in market, often referred to as “Smart Money”, so that traders can identify and participate in significant price moves.

The chart below demonstrates some of the innumerable patterns formed by candlesticks in the context of a daily price action chart. These patterns will be discussed and elaborated upon in the remainder of this guide.

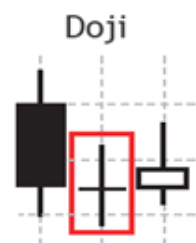


Doji

This candle has zero or almost zero range between its open and close.

Rather than implying potential reversal or the clear dominance of either bears or bulls, these candles suggest indecision or balance between the two forces.

Neither buyers nor sellers are fully in control. A doji that occurs in the context of a strong trend implies the weakening of the dominant force that resulted in that trend. A “long-legged doji” has long wicks in both directions, implying strong, balanced pressure from both buyers and sellers.



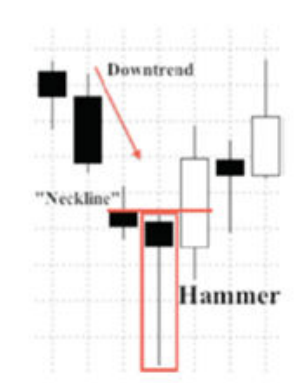


The “dragonfly” and “gravestone” doji imply, respectively, that sellers and buyers controlled the market for most of the trading period, but then the opposite group managed to push price back to the open before the close. While tradition and long-legged dojis are reflective of indecision and stalling, gravestone and dragonfly are generally clearer, stronger indicators that a force is stepping in to push the market in the direction of the wick and away from the body. In this respect, gravestone and dragonfly dojis are similar to hammer and hanging man patterns, which are discussed later in this guide.



Hammer

A “hammer” is a candlestick with a small body (a small range from open to close), a long wick protruding below the body, and little to no wick above. In this respect it is very similar to a dragonfly doji; the primary difference is that a dragonfly doji will have essentially no body, meaning the open and close prices are equal.



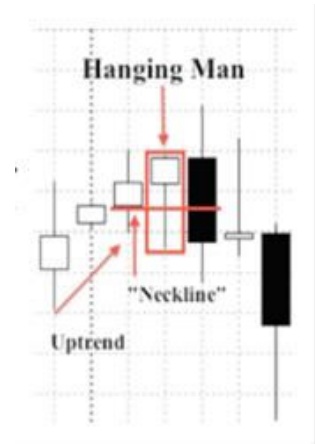
When a hammer appears at the bottom of a downtrend, its long wick implies an unsuccessful effort by bears to push price down, and a corresponding effort by bulls to step in and push price back up quickly before the period closed. As such, a hammer candlestick in the context of a downtrend suggests the potential exhaustion of the downtrend and the onset of a bullish reversal. The “neckline,” often determined by the high of the previous bar, is the level that price must hit on the next candlestick in order to confirm the hammer’s reversal signal.



Hanging Man

The “hanging man” is the name given to a candle that is identical in shape to the hammer; the difference is that while hammers occur in downtrends, the hanging man pattern occurs in uptrends. In this case, the wick extends down, contrary to the uptrend, and suggests the emergence of bearish demand capable of pushing the price down. It is often the first sign that the uptrend is exhausting, and bears are stepping in to create a reversal.

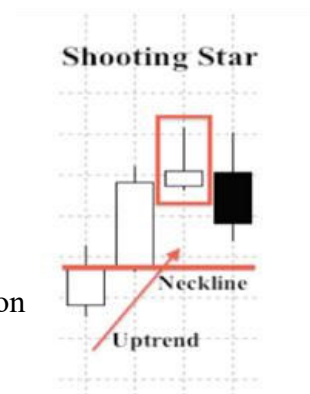
For the reversal signal to be confirmed, the consequent bearish bar should reach the “neckline” established by the open of the bullish bar on the other side of the hanging man.



Shooting Star

This candlestick is simply the inversion of the hanging man: it has a small body and a long wick protruding above it, with little to no wick below.

The “shooting star” occurs at the height of an uptrend; its long wick implies that resistance to further bullish movement has been encountered above the close, and a bearish reversal may be imminent. In this case, a strong black candle or a price at the level of the previous bar’s open can act as confirmation or an entry point. Often, shooting stars are further characterized by a gap between the previous bar’s close and the relatively higher open of the shooting star.





Checkmate

Checkmates occur when price becomes locked in a narrow trading range preceding a reversal in direction. In a typical bearish checkmate (right), an uptrend meets a resistance level that is tested and then rejected due to consequent pressure from holding the level. In these cases, the checkmate begins as the first candle in the range reaches a high that the pressure from bulls is unable to surpass. Price remains deadlocked in a tight trading range before the range is broken with a long bearish candlestick, indicating that the reversal has begun. As an entry signal, this pattern requires confirmation from one or two strong bearish bars.



In a bullish checkmate (right), the opposite occurs, typically at a support rather than resistance level. The long lower wick of the first pinbar in the red box establishes a low that the bears cannot achieve; price is trapped thereafter in a narrow trading range, the checkmate, until bulls successfully reverse the trend. The tall white bar immediately after the box confirms the bullish reversal.

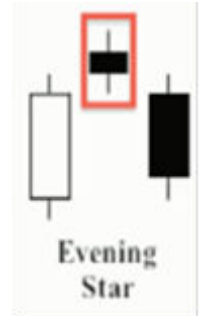


In the patterns that have been presented thus far, a simple concept should be emerging: when a long wick appears in the context of a trend, it often signals a potential reversal of that trend.



Evening Star

The “evening star” is the small-bodied middle candle of a 3-bar pattern that can provide an early indication of a reversal from a bullish to a bearish trend, typically with an opening price at or a gap above the close of the previous candle (a gap indicates space between the body of the previous candle and the open of the consequent candle). The pattern represents a potential top, and therefore a potential signal to sell. These are the characteristics of the three candles:



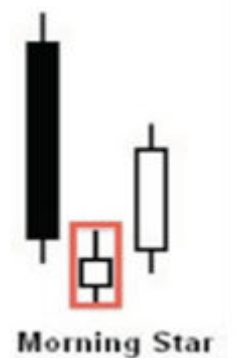
1. A long bullish candle
2. A small-bodied bullish or bearish candle or a doji that opens at or above the close of the previous candle.
3. A black candle that opens at or below the low point of the previous candle’s body and closes at or below the center of the first candle.

In order for the pattern to be valid, the sequence of candles must be as described above.

Moreover, the pattern should appear in the context of an uptrend in order to signal a reversal and the start of a downtrend.

Morning Star

The “morning star” is the inverse of the evening star, a 3-bar pattern in which the “star” is a small-bodied candle, typically opening at the close of the previous candle or opening a gap below it, indicating that a trend is transitioning from bearish to bullish. The morning star constitutes a potential bottom to the preceding bearish leg, and functions therefore as a buy signal.



The three candles are as follows:

1. A long bearish candle
2. A small-bodied bullish or bearish candle or a doji that opens at or below the close of the previous candle



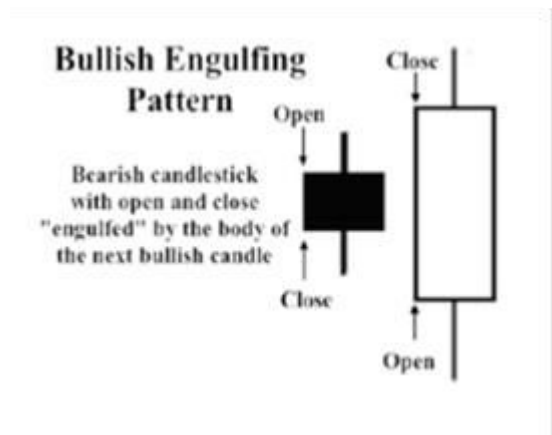
3. A white bullish candle that opens at or above the high point of the previous candle and closes at or above the center of the first candle.

While an evening star pattern after an uptrend signals a reversal, the opposite a morning star pattern in a downtrend can also signal reversal, and a change in the balance of power between bears and bulls.

Bullish Engulfing

In this pattern, the real body of a bearish candle (the range from open to close) is encompassed by the body of a consequent bullish candle. This indicates an increase in activity from both bears and bulls, and a shift of overall market sentiment towards bullishness. Like with all the patterns we've discussed

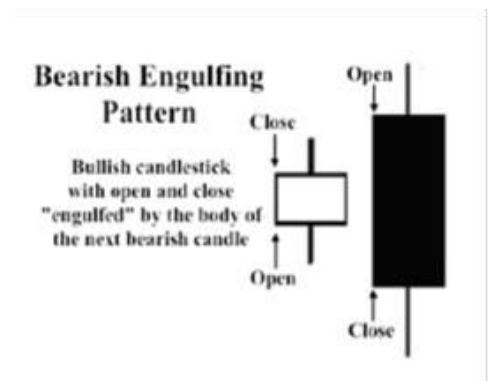
thus far, this pattern should be viewed in consideration of the trend at the time: if a bullish engulfing pattern appears in a downtrend, it can suggest a shift price trend and the onset of buying demand becoming the prevailing force that will ultimately push price higher in the context of the timeframe being viewed.



Bearish Engulfing

This pattern is the converse of a bullish engulfing pattern, wherein the body of a bullish candle is encompassed by the body of a consequent bearish candle. This indicates an increase in activity from both bears and bulls, and a shift of market sentiment towards bearishness. As we have observed with other patterns,

the context of the trend is critical; a bearish engulfing pattern is most indicative of the onset of a bearish price move when it appears in the midst of an uptrend.

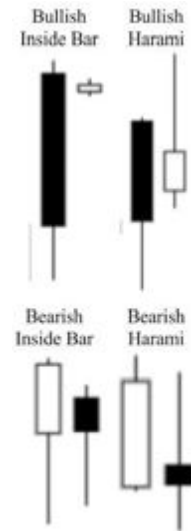




Harami/Inside Bar

This pattern is a two-candlestick pattern in which the first candlestick vertically encompasses the one that follows it. This signal is interpreted in two ways:

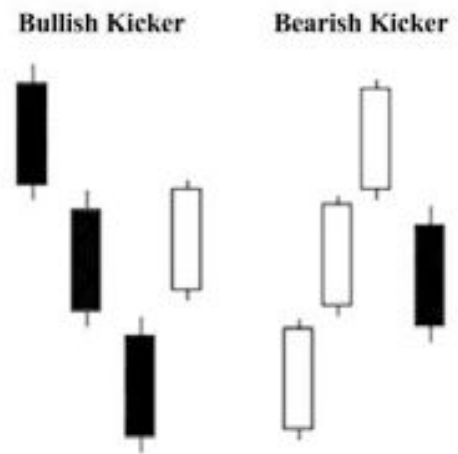
1. An indication that an increase in volatility is imminent. This affords traders the opportunity to create trades that speculate not so much on direction, but rather on an increase in volatility on a breakout in any specific direction.
2. In the context of a trend, a harami/inside bar can be indicative of exhaustion and the onset of a reversal. In this manner, it is similar to long wick patterns and evening star/morning star patterns examined earlier in this guide.



Kicker

A kicker signal, also known as a professional gap, occurs when the following conditions are met:

1. Price is moving in a trend.
2. Suddenly, a gap appears in the chart. A gap is defined as when the open price of one candle is not equal to the close price of the candle that precedes it; there is a gap in the price movement. The gap is in the opposite direction of the trend. For instance, imagine that price closed at 10 after rallying over a number of days from 2. The next day, price opens at 8. In this instance, we have a gap down, or a bearish kicker. Conversely, if price fell from 10 to 3 and then opened the next day at 5, it would signal a bullish kicker, a bullish sign for traders.

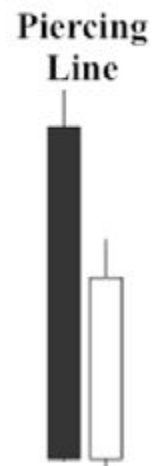




A kicker signal can be a very powerful sign that a trend is reversing. It is often interpreted as a sign that professional investors have quickly realized that a trend is over, and are looking to get out immediately. As such, this signal often precipitates a rapid reversal of the prior trend.

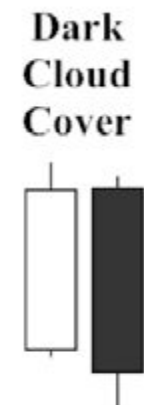
Piercing Line

A bullish signal that occurs in the context of a downtrend when, after a long bearish candle, a bullish candle opens at a new low and then closes at a level at least halfway up the body of the previous bar; this signal is reliable as a two-bar indicator of a trend reversal in proportion to the height of the second bullish bar. As the strength of the reversal signal is related to the size of the second candle, this pattern is similar to the Tweezer pattern, which is discussed later in this guide.



Dark Cloud Cover

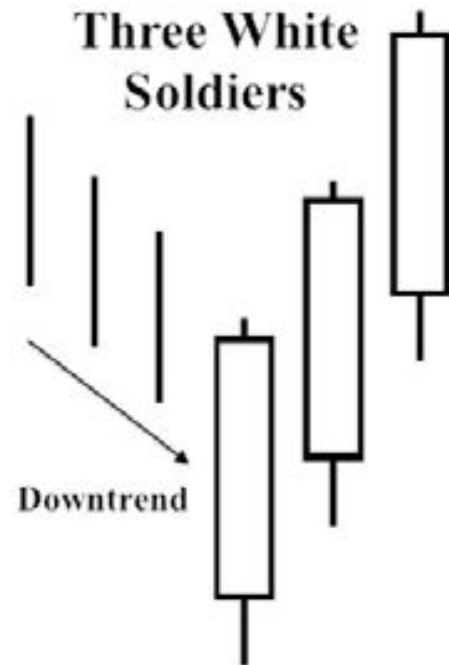
This two-candle bearish reversal pattern is the bearish converse of the piercing line, occurring at the top of a bullish trend. The first bullish candle is followed by a bearish candle that opens at a new high and then closes at least halfway down the body of the bar preceding it. The strength of the reversal signal is proportionate to the length of the second candle. This pattern is clearly conceptually and mathematically similar to the Piercing Line and Tweezer patterns.





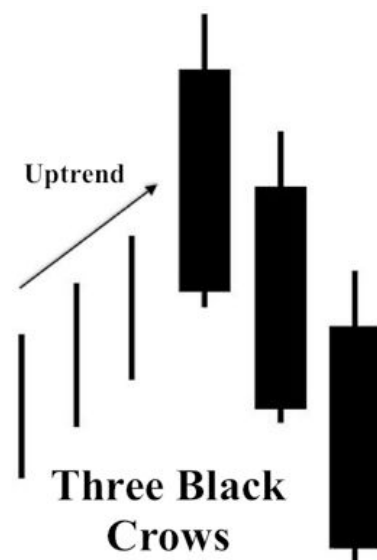
Three White Soldiers

This is a 3-candle bullish pattern that implies a reversal at the bottom of a bearish trend. The three soldiers are bullish candlesticks that open within the body of the previous candlestick and close near the high of the day. This applies to all three candles; they should all be strong bullish candles, with small wicks and a close near the top. These high closes imply a strong reversal from bearish to bullish market sentiment.



Three Black Crows

This 3-candle pattern is the opposite of "Three White Soldiers;" it signals the reversal away from bullish control at the top of an uptrend. It consists of three successive bearish bars that open within the preceding bar's body and close below its close.





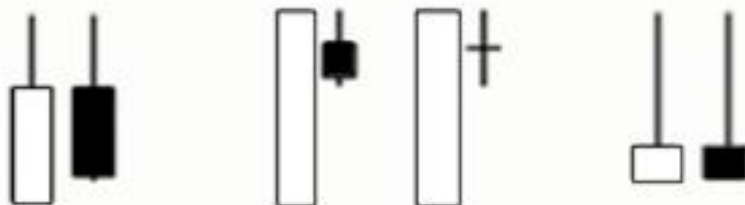
Tweezer Pattern

These two-candlestick reversal patterns appear as either the tops or bottoms of trends in which two consecutive candlesticks share either a high or low, but represent movements in opposite market directions. In the case of a tweezer top, the first bullish candlestick occurs in an uptrend and closes near the same level as its high, which then becomes the high of the second candlestick, which moves bearishly downwards throughout the day. A tweezer bottom is the opposite, wherein an initial bearish candlestick continues a downtrend, closing at or near a new low, which then becomes the low price of a consequent bullish candlestick. Tweezers indicate that once price reached a significant level (the top or bottom shared by the two bars), there was a transfer of dominance between bears and bulls. As noted previously, it is similar to the Piercing Line and Dark Cloud Cover patterns.

Tweezer Bottoms (Bullish Reversal - Shared Low)



Tweezer Tops (Bearish Reversal - Shared High)





Confluence

In technical analysis, there is no such thing as a “sure bet.” The nature of trading securities is that the possibility of profit comes hand in hand with the possibility of risk. With this uncertainty in mind, the successful application of technical analysis depends on entering the market at the moment when there are as many indicators of an advantageous outcome as possible. This is the concept of “confluence,” the idea that the best market moves are those that are supported by multiple converging factors or indicators that all testify to the advantageous conditions of the trade.

Accordingly, consider the examples below. They show instances in which candlesticks and other signs – often support and resistance levels -- have converged to show the same sign. While the images below illustrate profitable trades, it is worth re-iterating that candlestick patterns, like virtually all textbook techniques, are not guarantees; they communicate probabilities rather than certainties. As such, a probabilistic mentality and risk management perspective must be maintained.

Doji at Support





Hammer, Dojis, and Bullish Checkmate at 200 Exponential Moving Average





Educate Your Trading

Thank you for reading this introduction to Price Action trading! Hopefully it has piqued your interest in this methodology. Now you're ready to discover how this and other technical analysis methods can be put to use for your own account. You can continue learning about Forex trading with the educational resources available from ThinkForex, including guides like this one and technical analysis videos and seminars from professional traders.