

How to Make Money Trading with CANDLESTICK CHARTS

"Highly recommended . . . discover ways
of profiting from candlestick trading"

With
examples
& charts
from Indian
markets

Balkrishna M. Sadekar

About the Book

How to Make Money Trading with Candlestick Charts

Japanese rice traders have successfully used candle signals to amass huge fortunes for nearly four centuries. Constantly refined and tested over time, candlestick signals are now being used the world over for trading all financial markets, including stocks, derivatives and currencies, etc.

This book explains step-by-step how you can make money by trading the powerful and proven candlestick techniques. Here is how:

- Explanation of major candle signals; how

to recognize them and use them effectively

- The underlying market psychology revealed by each candle formation
- How to combine candlestick signals with Western technical analysis to take advantage of high probability traders which generate explosive profits
- Stop loss settings for various candlestick signals for cutting losses. Master this and you will be way ahead of fellow traders
- How the use of candlesticks with technical analysis provides a simple mechanical trading system which eliminates emotional interference, panic and greed

- How to use candlestick charts for making money from longer term trading and investing
- PLUS: proven, market-tested trading ideas, tips and common mistakes to avoid based on the author's rich experience of trading stocks and options.

This book will enable both new and experienced traders derive systematic and consistent trading profits from the market through candlestick charting.

About the Author

BALKRISHNA M. SADEKAR is the founder of Profitable Candlestick Charting LLC., an educational company providing training to stock traders in the proper use of candlestick charting and technical analysis. He is also a member of Technical Securities Analyst Association (TSAASF.org), a leading authority for technical analysis in the United States.

With a Masters degree in Engineering, Sadekar has passionately blended technology with investor psychology analysis *via* candlestick charts. Himself a trader for more than a decade, he has trained and continues

training novice and experienced traders in correctly applying trading systems for profiting from equity markets.

Sadekar resides in Richmond, VA in the US and can be reached *via* his website, www.ProfitableCandlestickCharting.com.

With this book, which is one of the first candlestick charting books with Indian stock charts, Sadekar hopes to get Indian traders comfortable, confident and successful in the proper application of candlestick charting.

Media Acclaim



“Educative addition to the technical trader’s shelf.”

— *The Hindu Business Line*

“Clearly explains the message of each candlestick pattern. The manifold real life examples amplify the lessons being taught. Highly recommended . . . discover ways of profiting from candlestick trading.” — *Alan Northcott*

What the Readers’ Say

(Some Unsolicited Readers' Comments on
Amazon.in)



“One of the best books on this topic.” —
Praveen Kumar

“Excellent book . . . worth reading.” —
Prasad Revdekar

“It is a very good book for those who want
(to) learn trading.”

— *Ashish*

“Superb book with simple and lucid
language! Worth reading.”

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“It’s good . . . must purchase for every trader.” — *Senthil Kumar*

“I want people to know that this (author) is (an) amazing explainer — combined with simple, understandable language.”

— *Muhammed Momin*

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Trading with
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players. I am also thankful for all the good suggestions from members and students of Profitable Candlestick Charting.

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Lastly, this book would only have been an idea in my mind if not for two special people in my life — my princess daughter and my loving wife. They have been my support and my inspiration throughout.

Introduction

The Japanese art of candlestick trading has been around for nearly four centuries. Japanese rice traders successfully used these signal formations to amass huge fortunes. Since then, the signals have been refined, tested and utilized in a variety of markets. Wherever an instrument can be traded in an open market by traders, candlestick signals can be used to profit in such markets.

Candlestick signals depict change in investor psychology. They visually show a trader the

sentiments of the other traders in that particular stock or market. It does not matter if the signals are applied to commodities, stocks or futures. Candlestick signals work with all of them. It does not matter whether the market is the Nasdaq, the Nikkei, the German DAX or the Nifty. All of these markets can be analyzed and traded using candlestick charting.

Why do people around the world pour their hard earned money into the financial markets? Why do they not keep their money invested in fixed price no risk certificates? The answer is obvious. They take the risk of investing in stock, currency and futures markets in order to get higher returns on their money. The allure of hitting it big in the stock

market keeps their dream of financial independence alive. They look for a good nest egg to be built from the gains in the market for a comfortable retirement.

Yet the percentage of investors that actively manages its portfolios is paltry compared to those who keep pouring money in the market hoping they would strike gold someday. (Henceforth we will use the terms “market” and “stock market” to include the stock, commodity and the currency markets.)

Ask yourself which category you fit in from among the following:

- You listen to analysts on TV to get recommendations for buying stocks.

- You subscribe to a stock picking service for your stock investments.
- You try out the latest stock picking software, lose money and start all over again.
- You get your stock investment ideas from your friends, your colleagues or the local tea vendor.
- You have tried all of the above, lost money and given up on the stock market altogether.

If you have done any of the above, you are not alone. Most investors are the same everywhere. They keep searching for the one golden technique that will work each and

every time they put their money in the markets. They do not spend enough time to independently study the market itself. They tend to believe that analysts on TV, who do all the research and generously offer their recommendations are motivated by the idea of making *you* rich! That is being very naïve, indeed.

Most traditional investors believe in a “buy and hold” strategy. They believe in “averaging down” a stock. Their thinking is limited to “It will go up one day”. They will argue against timing the market. These are the people who spend more time thinking about what clothes to wear to office on any day, than they do about their investments and their financial future.

Part of this stems from the fact that real-time access to market data was very limited till just a few years ago. People used to be able to look at their investments only at the end of the day. Trading costs, i.e. buying and selling commissions, were also very high. But those factors are no longer valid. Information technology has changed the trading scenario. More and more people are now opening online trading accounts. They now have access to real-time instantaneous data. Technology has also helped to drive down trading costs considerably.

As the BSE and NSE equity indices rally because of underlying strong growth fundamentals of India, individual investors would naturally want to increasingly

participate in the markets. It is extremely important that these investors and traders educate themselves in learning the language of the markets. The markets speak in subtle ways. They are always giving clues to their directional movements. **Candlestick trading is all about reading this subtle language of the markets.**

There are more than fifty candlestick signals defined by Japanese traders. However, of these we will focus on the most common ones. You will find that these major candlestick signals occur often and repeatedly. Your time as a trader or investor will be well spent if you understand these major signal formations.

There have been a handful of books written on candlestick charting so far. Most of these books have been written from the perspective of trading the US markets. This book is specifically written with the Indian trader in mind. All the included charts are of companies trading on either the National Stock Exchange or the Bombay Stock Exchange.

By the end of this book you will be able to look at any chart and analyze it yourself. You will be able to turn off the analysts on TV and unsubscribe your stock picking service. You will discover within you the ability to diagnose the health of the market. That ability will bring with it the confidence to enter high probability big profit situations

which will, in turn, help your portfolio grow rapidly. However, let me warn you. This is not a “get-rich-quick-scheme” book. It will not turn you into an overnight *crorepati*. The intention of this book is to teach you how to use these powerful candlestick techniques correctly and effectively. Wealth generation will automatically follow!

The next chapter will go into detail about the construction of candlesticks and more importantly the psychology underlying those candlesticks.

Candlestick Trading: The Basics

This chapter is not going to be an essay on the science of psychology — though it would be very interesting to know what reputed psychologists like Carl Jung and Freud would think about the art of trading! This chapter will hopefully link in your mind the importance of psychological underpinnings of trading stocks.

If someone were to ask me what percentage

of trading is comprised of psychological warfare, I would put the number between 85% and 95%. The stock market is essentially a game of fear and greed. Supply and demand are by-products of these two emotions battling it out for dominance in the market.

Fear and Greed

Fear creates panic. And panic creates supply in the marketplace.

Greed produces exuberance, giving rise to demand.

As humans, we cannot escape these two emotions while trying to make money in the marketplace.

When you watch a stock you own go down, you get overwhelmed by fear and anxiety. Such emotions create havoc in the mind:

- How low will the stock go and how much will I lose?

- What if my spouse / parents / friends find out about this pathetic losing trade I made?
- Should I get out now?
- What if the stock turns around as soon as I sell it? How much of a fool would I be then? And on and on and on.

Notice the Fear

On similar lines, what do you think when the stock you don't own, but wanted to own, keeps going up?

- I always knew this would be 10-bagger.
- Should I buy it now? If I don't, and it goes up even more, what a fool I'll then be.
- This is *the* stock to own, let me get in *now*.
- Everybody I know owns this one, I have to buy it and ride it up. And, on and on.

Notice the Greed

We are all slaves to these two emotions. They are also the trader's worst enemy. If you are expecting that I am going to show you how to master these two, often overpowering, human emotions, you are going to be sorely disappointed. For that, please browse through the self-help section of your favourite bookstore.

The fact is that experienced and successful traders know that they cannot master these two emotions. They know that all profits will evaporate into thin air if they fall in the trap of trying to master them. What they do, however, is design a system and abide by the system's rules to execute their trades. They

realize that the market is much bigger than them and their egos. In order to win in the market, they have mastered the art of understanding the subtle hints of the market. This is where candlestick signals assert their dominance.

Candlestick signals, by the very nature of how they are constructed, point out the messages of the market. These signals have been time tested for over four hundred years. They would not have been around for this long if they wouldn't have had strong underlying market logic.

These signals depict the outcome of all the cumulative knowledge of the traders and investors playing that stock. Stock prices

have little to do with the actual fundamentals of a company. Instead, they have a lot more to do with the company's "perceived" fundamentals. It does not matter what a company has achieved till date. If the perceived growth of the company is doubtful, then the stock has little or no chance of appreciation. What would you rather be buying? A good, well known company but with little perceived growth or a company which traders and investors believe will grow for the next few years. I would buy the latter. This is what makes the stock market so dynamic. The fear of losing money and the greed for making more money creates the demand-supply imbalances that move stock prices.

If you take away one lesson from this book, let it be this — **as a trader, you should always be buying into other's fears and selling into other's greed.**

And this is not as complex as it sounds. Once you are done with this book, it will be very easy to recognize the emotions of the traders in that stock. Candlesticks make the analysis visually apparent.

This book is for those who want to make money in the stock market. And the easiest way to do that is to live by the above principle. You can either be a shark in the ocean or be eaten by one!

Candlesticks Light the Way

Let us now look at how candlesticks are drawn.

You need four price points to draw a single candlestick. Considering an example of a daily candlestick, you need:

- High price of the day;
- Low price of the day;
- Opening price of the day;
- Closing price of the day.

The two parts of the candlestick are:

- **The body:** This is the part between the

open and the close. In case the day's opening price is lower than the closing price, the colour of the body is white (some charting services will make this green). Conversely, when the day's opening price is higher than the closing price, the colour of the body is black (sometimes shown as red).

- **The shadows:** The upper shadow is the line above the body and the lower shadow is the line below the body. In the case of a black bodied candle, the upper shadow is from the day's open price to its high price and the lower shadow is from the closing price to the low price of that day. Conversely, in the case of a white bodied candle, the upper shadow

is between the closing price and the high price of the day, and the lower shadow is between the opening price and the low price of the day.

Note: Throughout this book, the words “white” candle and “light” candle have been used interchangeably. Also, the words “black” candle and “dark” candle have been used interchangeably.

[Figure 2.1](#) shows the construction of a candlestick when the closing price of the day is *higher* than the opening price of the day.

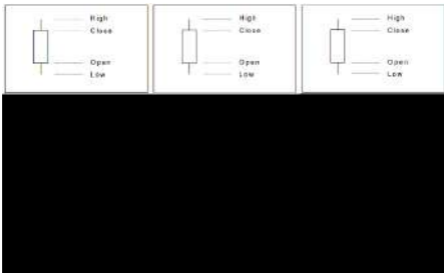


Figure 2.1: White (green) candlestick depicts that the day's closing price was higher than the opening price of the day

[Figure 2.2](#) shows a candlestick where the closing price of the day is *lower* than the opening price of the day.

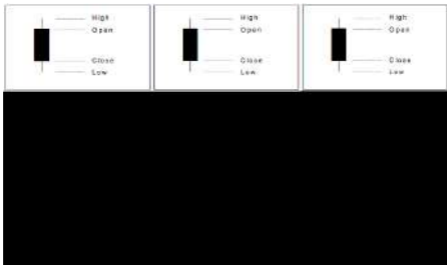


Figure 2.2: Black (red) candlestick depicts that the day's closing price was lower than the opening price of the day

It is not necessary for a candle to have both the upper and lower shadows. The following figures depict a few variations of the candle formation. The reader does not need to remember the names but should understand the formation instead.

White Morubozu

This is a white candle with no shadows at either end (see [Figure 2.3](#)).



Figure 2.3: White Morubozu

It depicts a day when the low of the day is the same as the open and the high of the day is the same as the close price of the day. This usually represents a very bullish formation as it shows the bulls had the upper hand

throughout the day.

Black Morubozu

This is a black candle with no shadows at either end (see [Figure 2.4](#)).

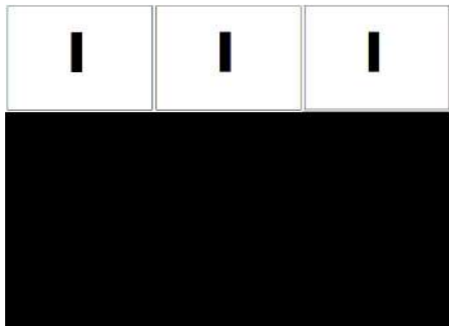


Figure 2.4: Black Morubozu

This occurs when the high of the day is the same as the open price of the day and the close of the day is the same as the low price

of the day. What does this candle represent? It shows domination by the bears throughout the day. Generally, this would be considered a very bearish candle.

Opening Morubozu

[Figure 2.5](#) shows two cases of an Opening Morubozu.

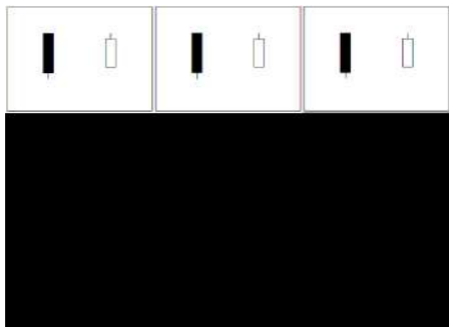


Figure 2.5: Opening Morubozu

As you can see, they do not have a shadow attached to their opening price end of the body. The white candle denotes that bulls

took control right from the start while the black candle suggests that the bears dominated right from the open.

Closing Morubozu

As can be seen from [Figure 2.6](#), the Closing Morubozu does not have a tail attached to the closing price end of the body.

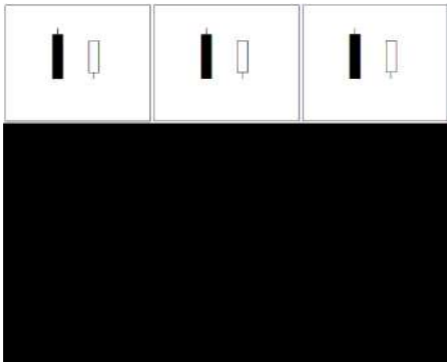


Figure 2.6: Closing Morubozu

The white candle implies that the bulls took

over control during the day and ended the day strong. On the other hand, the black candle suggests that the bears took over during the day and forced the price to close at the lowest level of the day.

Doji

The Doji is one of the most important candlestick formations. [Chapter 3](#) will discuss this signal in detail. For now, we will define the Doji as a candle where the opening and closing prices are the same. [Figure 2.7](#) shows a Doji candle.

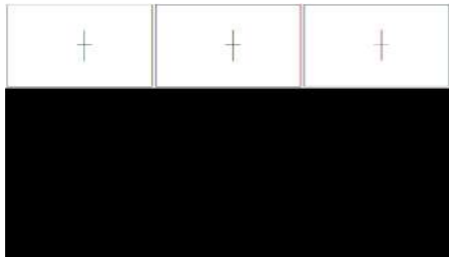


Figure 2.7: Doji

Please note that given how candlesticks are constructed, it is very much possible to have a dark candle even when the price closes higher compared to the previous day. Similarly, you can have a white candle form even if prices close down for the day. Each candle is independent of the previous day's candle. This is a very important point and you need to make sure you understand this concept clearly.

The following examples will help clarify the point:

- Let us assume for company XYZ, the share price closes at ` 50 today. If the price opens at ` 55 tomorrow, but closes at ` 53, what colour candle will you see

on the chart? You will see a dark candle. This is because while the price closed higher (` 53) than it did the day before (` 50) but it closed below the day's open (` 55), creating the dark candle.

- Consider the company XYZ again with a closing price of ` 50 for today. If the price opens at ` 45 tomorrow and closes at ` 48, you will see a white candle on the candlestick chart. This is because the day's price closed higher (` 48) than its opening price (` 45). The fact that it closed below ` 50 (closing price of the previous day) does not matter in the construction of the candle.

This is the key powerful concept behind

candlestick charting. The construction conveys a wealth of information to the candlestick trader, which a regular line chart reader would have no access to.

To illustrate this point and show the inherent power of candlesticks, we will compare [Figure 2.8](#) with [Figure 2.9](#). Both are charts of Bharat Heavy Electricals Ltd. for the same time period.

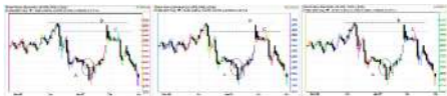


Figure 2.8: Candlestick chart of Bharat Heavy Electricals Ltd.

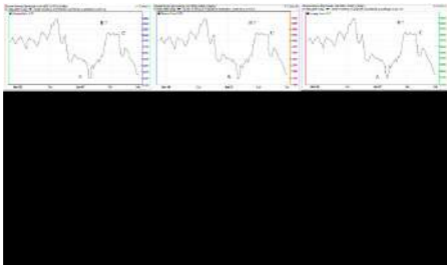


Figure 2.9: Line chart of Bharat Heavy Electricals Ltd.

Can you visually see the vast difference in the two charts? Here are some things which can be easily observed:

- Point A in the two charts shows a key reversal for the share. What would have

alerted a line chart trader to this reversal ([Figure 2.9](#))? Nothing. In the case of a candlestick trader, a candlestick buy formation would have been seen on Chart 2.8 and the trader could have acted on it.

- Point B does not even exist in the line chart ([Figure 2.9](#)). That is because a line chart uses only closing prices. The candlestick chart trader would have been way ahead of the competition in this case. It is easily seen from the chart ([Figure 2.8](#)) that prices failed precisely at the resistance level established in early December. The supply at price point B well exceeds the demand. The candlestick trader could have used this knowledge to go short.

- Point C in the line chart shows oscillatory behaviour at an earlier resistance level ([Figure 2.9](#)). However, the strength of the stock cannot be gleaned from the chart. Is it going to break the resistance and go higher or succumb to selling pressure? What do the probabilities say? The answer is uncertain at best. However, in the candlestick chart ([Figure 2.8](#)), one can easily observe the Doji and Spinning Tops (explained later) confirming resistance. The probabilities favoured the bears.

To give an analogy, say a patient with a broken bone walks into a doctor's clinic. The doctor can feel the affected area and try

to gauge the damage. But he cannot know what is going on internally. He needs an x-ray machine to visually show him the exact location and extent of the damage. **Candlesticks perform the function of the x-ray machine. They visually show you the internal dynamics of the market.** A simple analysis of the candlestick chart would then catapult you way ahead of your competition.

Why Bother with Bar Charts?

We could also compare bar charts with candle charts and come to almost the same conclusion. The candlestick chart incorporates everything that a bar chart does. In addition, it is visually more revealing. The black (red) and white (green) colour bodies make analyzing a candlestick chart much easier and more intuitive. Once you start looking at candlestick charts, other charting techniques seem dull and arcane. By the end of this book, you should be able to analyze any candlestick chart within a minute. That is my goal.

Stochastics

This book is written to help the reader maximize his or her investment or trading potential. One key ingredient of this strategy is to minimize downside risk. For this purpose, **we will look for highly profitable buy trades in oversold conditions and highly profitable sell trades in overbought conditions.** To find out when the shares are overbought or oversold, we need an oscillator. I have always used the stochastics oscillator for this purpose. It is a matter of personal preference and the reader can choose any other indicator he or she is familiar with.

Note: For those readers who are unfamiliar

with technical indicators and oscillators, I would recommend reading some of the technical analysis books mentioned in the Bibliography section of this book.

Note: The candlestick trader need not go into details of the stochastics indicator. It is described here for educational reading only.

The stochastic oscillator comprises of two lines: %K, or the raw stochastics, and %D, which is a moving average of the smoothed version of %K.

The following formula is used to calculate %K:

$$\%K = (C - L) / (H - L) * 100$$

Where,

C = Closing price.

L = Lowest price in last N days.

H = Highest price in last N days.

%K gives you a percentage between 0 and 100. From this formula, it can be seen that if the stock is closing at the highest level in N days, %K will be 100. This %K is generally very volatile and hence is often smoothed out over a certain number of days. This gives a much smoother line than %K itself. %D is the moving average over a certain number of days of this smooth version of %K.

In short, stochastics give you the relative position of the price as compared to the

range of the past N trading days. If the price closes towards the high end of the period, then the stochastics will be closer to 100. If the price closes towards the lower end of the range in that time period, then the stochastics will be a number closer to 0. **In general, any reading above 80 for the stochastics indicates an overbought condition. Any reading below 20 suggests that the shares are currently oversold.**

The stochastics indicator can be plotted by most of the charting software found online.

A question often arises as to what settings should be used to display the stochastics. In other words, what is the value of “N” mentioned above? I usually use a value of

12. Some traders use 14. The smaller the time period you choose, the more volatile the indicator will be. So, if you want to get rapid buy and sell signals, you would choose, say, 5. For swing trading, where you hold a position for a few days to a few weeks, you could choose 12 or 14. The correct procedure to get this number is by trial and error. Your goal is to see where the price reversed in the past and the corresponding stochastic setting. Those need to match up. The reversal from a high needs to match with stochastics in overbought conditions while the reversal from the bottom needs to match with oversold conditions of stochastics.

The other parameter you put in is the number of days to smooth out the %K. Generally, 3

days works very well. But you are free to experiment with other numbers.

It is vital to emphasize at this point that the use of any indicator is secondary in nature. The candlestick signals are the primary source for decision making.

The key is to find candlestick buy signals in oversold conditions and candlestick sell signals in overbought conditions. As you read the following chapters, you will notice that most of the charts will focus on the overbought-oversold conditions. For the beginner candlestick trader, these situations will be plentiful to take advantage of. They will enhance your confidence level while simultaneously increasing your portfolio

returns.



PART I

The first part of this book will focus on the explanation of the major candlestick signals. The nuances associated with individual signal formations are explained along with plenty of charts. Sometimes, you will see the important points being repeated in many places. Believe me, it will add to your mental reinforcement of the psychology of the signals. The goal here is to get your eyes trained to the signal patterns to the point where you instantly recognize and analyze the underlying demand-supply equation in that stock.

The following major signals will be covered

in depth:

- The Doji.
- The Hanging Man and the Hammer.
- The Inverted Hammer and the Shooting Star.
- The Bullish Engulfing and Bearish Engulfing signal.
- The Dark Cloud and the Piercing signal.
- The Harami.
- The Morning Star and Evening Star signals.

Please read and re-read these chapters before going on to Part II of this book. A

thorough understanding of the signal formations is of the utmost importance if you want to successfully trade with them.

3

The Doji

The Doji is one of the most important candlestick signals. The Japanese say that whenever you see a Doji, pay heed.

Doji

Description

[Figure 3.1](#) shows a Doji formation. Notice that the open and the close of the stock are at about the same price.

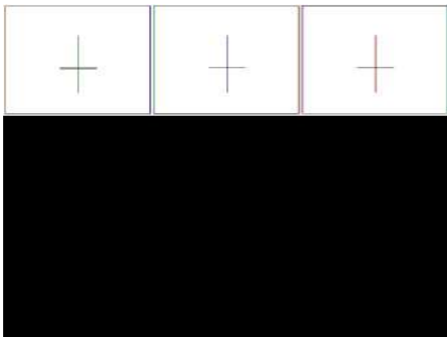


Figure 3.1: Doji signal

Criteria

For the Doji to be valid, the following conditions need to be met:

- The open and the close of the stock must be almost at the same price level.
- There can be an upper shadow or a lower shadow, or both.

[Figure 3.2](#) shows a few Doji variations:

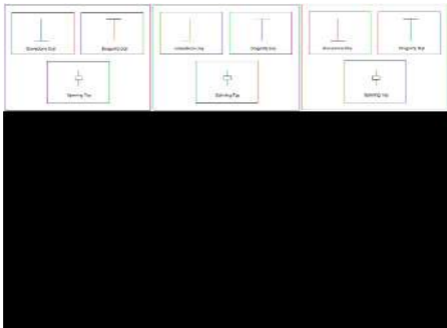


Figure 3.2: Doji variations

- When the Doji does not have a lower shadow, it is termed a Gravestone Doji.** The Japanese compare it to the soldiers going out to battle during the day and coming back to their original positions for rest during the night. **This type of Doji formation is very effective at the top of a trend.** The

logic being that though the bulls tried to rally the stock they failed at the end of the day.

- **A Doji without any upper shadow is known as a Dragonfly Doji, just because it looks like one. This kind of Doji would have powerful implications near the bottom of the trend.** It implies that while the bears tried to take the price down during the day, by the end the bulls were able to bring the price back to where it had opened.
- **When the Doji has a small body, it is also known as a Spinning Top.**

Note: These names are mentioned here only

for information purposes. As a candlestick trader, these names are irrelevant. The analysis of the formation is critical. That analysis will decide your survival in the marketplace!

A Doji can be found anywhere in the trend. The significance of the Doji varies according to its position in the trend. A simple analysis of [Figure 3.1](#) indicates that the bulls tried to drive the prices higher and failed. The bears tried to run prices lower and failed. So there is now equilibrium in demand and supply. Both sides of the equation balance out each other. The candlestick trader can use this battle impasse very profitably.

We will now analyze the Doji in various

scenarios.

Doji After a Stock is in an Overbought Condition

The Japanese say that whenever you see a Doji at the top, be prepared to sell. Consider a stock moving up in a trend. The bulls are happy with the white candles increasing their net worth. Then, one day, the candle forms a Doji. The bulls were running unchecked till now. Now the bears are starting to fight back. They are fighting back to the point where the bulls are not able to move the price much higher from the open. This gives rise to the Doji formation. The bulls are now tired. The bears sense this. If the price opens lower the next day, there is high probability

that the bulls have given in and the trend has reversed for a while.

Doji After a Stock is in an Oversold Condition

Now consider a stock that has been moving down for a while. The bears are happy. The black candles visually demonstrate their hold on the stock. Then, one day, the bulls step in. They fight the bears and finally the day ends as a Doji. What does this do to the bears' sentiment? They get nervous. They know they are tired. If the next day the price stays firmly positive, the bears move away. The trend reverses as the bulls get more confident.

Doji in a Sideways Market

Consider a stock moving sideways for a period of time. The bulls and bears are fighting it out. Then one day you notice a nice big Doji. This is where things get interesting. You now know that an equilibrium has been achieved. What you want to see now is a gap up or gap down scenario the next day. This indicates high probability that a trend will start in the direction of the gap. The reason being, after the Doji (say in your mind *indecision*), the traders have made up their mind as to the stronger force between the bulls and the bears. As a candlestick trader, you can now enter this market to ride the new trend.

The following conditions enhance the probability of reversal:

- Stochastics in oversold or overbought conditions.
- Heavy volume on the Doji day.
- Long upper and lower shadows implying great indecision at the point.
- A gap up or gap down open the next day.

[Figure 3.3](#) shows a Doji stopping the downtrend in Pfizer stock. You will notice that Pfizer was already in an oversold condition as indicated by the stochastics position. What happened the day after the Doji? A gap up bullish candle!

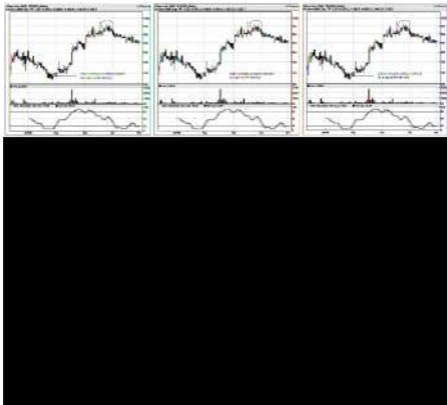


Figure 3.3: Doji at key reversal levels in Pfizer

The Doji told the candlestick trader to keep a close watch. It indicated that the sellers, who were so dominant till this point, were being challenged by the bulls. There is indecision in the market. There is, therefore, a good

probability that the trend reversal is near. However, there is need for confirmation buying. **The Japanese say that a Doji at the top warrants immediate selling, but a Doji at the bottom of a trend needs confirmation of strength from the bulls.** This is because the weight of the market can still drag the stock down if the bulls are not forceful enough. Hence, one needs to wait to see strength in the markets after a Doji type day.

What better way to see strength than a gap up bullish day as seen in Pfizer! The candlestick trader should immediately act on this signal. What signal do you see at the top of the trend? A Doji!

Examine the chart of Syndicate Bank in [Figure 3.4](#).



Figure 3.4: Doji formations in the chart of Syndicate Bank

The early part of May (Point A) shows a Doji type day stopping the downtrend. The next day provided the confirmation the

candlestick trader would have needed to go long. The rally lasted till mid-May, where a Doji (Point B) ended the bullish run. Upon going short after confirmation (yes, I wait for confirmation even after a Doji at the top), the trader would have again made a good profit. The third arrow on the chart (Point C) shows a spinning top and a Doji stopped the pullback.

[Figure 3.5](#) shows a chart of Hindalco. Notice the arrows showing quite a few Doji. This is why I like to see confirmation even for the Doji at the top.



Figure 3.5: Unconfirmed and confirmed Doji in Hindalco

The first two Doji did not have any confirmation selling following them. What can be inferred from that? It shows that after the up trend, the bulls merely rested. The day of indecision was followed by more buying, implying strength in the up trend. However,

after the third Doji the bears assumed control of the stock as seen by the big dark candle. There was no doubt after seeing this candle that the bulls had lost the battle.

Such analysis is what will distinguish you from traders who are not aware of the nuances of candlestick trading. It is not just a matter of visually recognizing a signal. You have to learn to analyze the signal in the proper perspective. This book will help you do that.

Let us conclude the discussion with [Figure 3.6](#). The chart shows Hinduja stock rallying after a Doji stopped its downtrend.

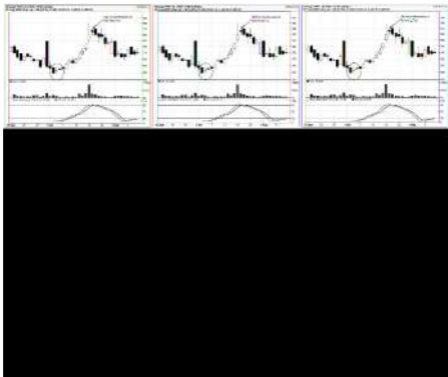


Figure 3.6: A spinning top candle in Hinduja

The candlestick trader would have entered the position after the Doji was confirmed by the next day's buying. The ride from ` 305 to about the ` 360 area would have generated handsome profits. Where would the trader have sold? Note the spinning top at the top of

the trend. The trader would have sold after the spinning top was confirmed by the dark candle the day after.



Hammer and Hanging Man Signals

The Hammer and the Hanging Man are one-day reversal signals. Traders should gear up to enter positions as soon as these signals get confirmed the following day.



Hammer

Description

[Figure 4.1](#) shows a Hammer formation. As can be seen, an ideal Hammer has a small body and a tail which is at least twice the size of the candle's body.

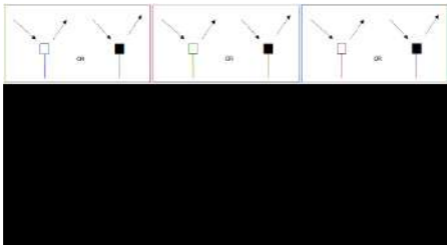


Figure 4.1: Hammer signal

Criteria

In order for the Hammer signal to be valid, the following conditions must exist:

- The price must have been in a definite downtrend before this signal occurs. This can be visually seen on the chart.
- The lower shadow must be at least twice the size of the body.
- The day after the Hammer is formed, one should witness continued buying.
- There should be no upper shadow or a very small upper shadow. The colour of the body does not matter, but a white body would be more positive than a

black body.

Why the Reversal Works

Consider a stock moving down for a period of time. Investors start panicking at some point. They want to get out and accept the loss. Finally, as the sellers pile on the stock starts selling off heavily during the day. But then smart money moves in. They are able to move the price all the way near where the stock had opened for that day. This gives the stock a hammer look. The Japanese call it *hammering out a bottom*. However, the stock needs to trade higher the next day to confirm that the bulls have actually reversed the trend. The candlestick trader should enter the market after seeing this confirmation.

The following conditions can make the Hammer signal a more compelling buy:

- There is a gap down from the previous day's close on the day of the Hammer.
- There is a spike in volume on the Hammer day.
- Stochastics are in oversold condition.
- The longer the lower shadow, the better.

[Figure 4.2](#) shows the chart of Bharat Forge Co. Ltd. Notice the long-legged Hammer in June 2006. The volume surged on the day of the Hammer, indicating people were panic selling the shares. The question is — who was buying when these “novice” traders were selling?



Figure 4.2: A Hammer in oversold condition in Bharat Forge

Also note the fact that the stochastics were near the oversold area. Another point to see in the chart is the day before the Hammer signal. That candle also had a long tail, indicating buyers stepping in to absorb some

of the selling. But it did not form the Hammer signal because the lower shadow was not twice the length of the body.

Consider [Figure 4.3](#) showing the Hammer formation in Punjab National Bank chart. If you watch closely, the Hammer has a small upper shadow. That is acceptable. Compared to the size of the lower shadow, the upper shadow is negligible. The stochastics are in the right place adding credence to the signal. Buying around the ` 430 area after confirmation and selling around the ` 470 area (after the Bearish Engulfing signal) would have given the candlestick trader good profits.

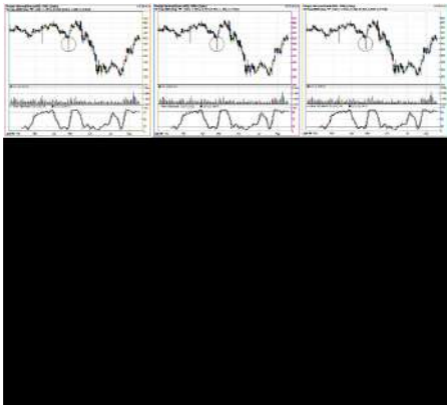


Figure 4.3: Punjab National Bank rallying after a Hammer

[Figure 4.4](#) shows a Hammer signal in Biocon Limited. Notice the stochastics were not in the oversold region, but were moving up. This was due to the price steady around the ` 330 area. What can be deduced from

this chart is that the investors lost patience with the stock. After weeks of downtrend, and then no movement at all, the investors finally gave up. That was the time smart money moved in and generated the classic Hammer signal. Strong profits would have been generated for a trader buying on confirmation of this signal.

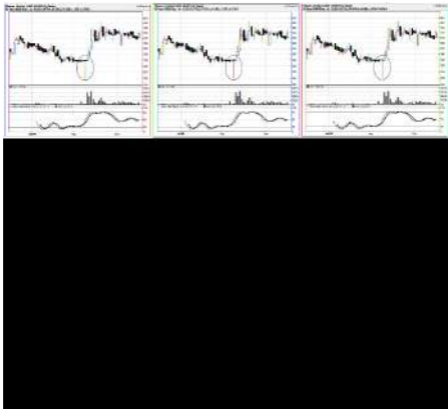


Figure 4.4: A Hammer and volume explosion in Biocon

What do the candlesticks in [Figure 4.5](#) show you? Can you see any sign before the actual Hammer signal that should have alerted you that the downtrend might be approaching its end? The big black candle the day before the

Hammer in oversold condition shows you visually the panic selling as a result of the fear experienced by novice traders. Remember, from now on, you are trading fear and greed, not stocks. That is what the market is all about — and successful traders take advantage of that everyday.

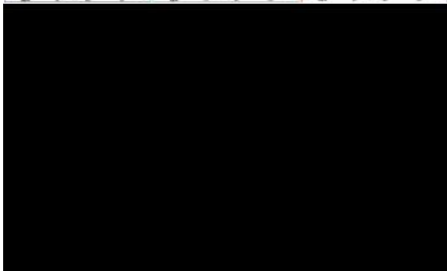
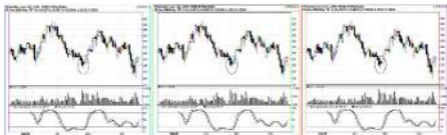


Figure 4.5: A Hammer in oversold condition in Hindustan Lever

We will conclude the Hammer discussion with the chart of ABB in [Figure 4.6](#). By now, hopefully, I have drilled into your psyche the conditions you need to be looking for when trading the Hammer signal. So, go ahead and analyze this chart for yourself. Candlestick signals are very simple if you know exactly what you are looking for.



Figure 4.6: A Hammer confirming previous support in ABB

Hanging Man

Description

[Figure 4.7](#) shows a visual depiction of the Hanging Man signal. No, I have not copied the image from [Figure 4.1](#) showing the Hammer. Please notice the difference in the two images. The formation of the signal is exactly the same, but the position of the signal in the trend has changed. **The Hammer comes after a downtrend and the Hanging Man comes after an up trend.**

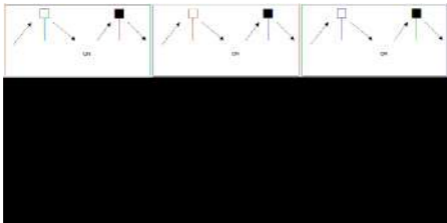


Figure 4.7: Hanging Man signal

Criteria

The conditions for the Hanging Man signal to be valid are:

- The stock must have been in a definite up trend before this signal occurs. This can be visually verified on the chart.
- The lower shadow must be at least twice the size of the body.
- The day after the Hanging Man signal should witness continued selling and a lower close.
- There should be no upper shadow or a very small upper shadow.

Why the Reversal Works

Consider a stock in an up trend. Investors and traders are happy that their portfolios are showing green. Then, one day, big money decides to take profits. They start selling the stock. Novice traders, who have seen the stock rise for the past numerous sessions, see this dip as a buying opportunity. They start absorbing the supply and are finally able to take the price up towards the top of the day's trading range. However, the bulls are now getting nervous. Their confidence in the stock is dropping. Their greed is turning into fear — fear of losing their hard earned profits. If the stock closes lower the next day confirming their fears, the downtrend will accelerate from that point on. The bears will

take control.

The following conditions make the reversal of the up trend more convincing:

- There is a spike in volume on the day of the signal.
- There is a gap up from the previous close on the day of the signal showing exuberant buying at the top.
- Stochastics are in overbought condition.
- The longer the lower shadow, the better. The colour of the Hanging Man body does not matter, but a black body would be a stronger confirmation.

[Figure 4.8](#) shows the chart of Satyam

Computer Services Ltd. This is an ideal Hanging Man signal. All the stars have aligned for the trader to take on the short side of the trade. Those who are averse to shorting stocks can at least sell their existing position and lock-in profits.



Figure 4.8: A Hanging Man in overbought

condition in Satyam Computer

Firstly, you can see the climactic buying as shown by the above average volume on the day before the signal. Secondly, stochastics are in the overbought area. The day after the Hanging Man signal, the stock gapped down, validating the fact that bears had taken control.

Notice in the chart of Punjab Tractors Ltd. in [Figure 4.9](#), that the stock gapped up on the day it formed the Hanging Man signal.



Figure 4.9: Hanging Man stops the up trend in Punjab Tractors

Though it was a relatively small candle, it satisfied all the requirements of the formation. Also notice that this signal was formed at the same area where the stock met resistance a few days back. This type of

confirmation should give a trader a high degree of confidence that the trend is reversing.

What can we see in [Figure 4.10](#)? Can you glean any information as a trader from the candle the day before the Hanging Man signal formed?



Figure 4.10: Hanging Man confirms spinning top in Jaiprakash Associates

That particular day visually depicts the battle between bulls and bears. The bears finally took control with the Hanging Man formation, which was confirmed the following day with a lower close.

After going through these charts and getting familiar with the Hammer and Hanging Man signals, think and analyse in your mind the signal formation day. This will reinforce your confidence as you will now know the reasoning behind your trade. Traders can only be so much successful if they don't understand their trades. Eventually, their losses will mount more than their profits. Understanding candlestick signals will give a big boost to your confidence and help you pull the trigger at the right place and at the right time.



Inverted Hammer and Shooting Star Signals

The Inverted Hammer and the Shooting Star signal also belong to the class of one-day reversal signals. We will basically flip the Hammer and the Hanging Man signals upside down to generate these new signals.

Inverted Hammer

Description

[Figure 5.1](#) shows the Inverted Hammer formation.

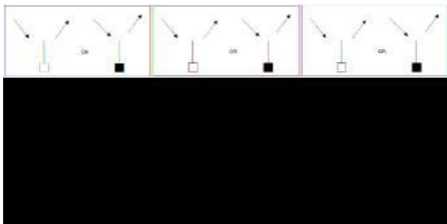


Figure 5.1: Inverted Hammer signal

As you can see from the directions of the arrows, the Inverted Hammer is found near the bottom of a downtrend.

Criteria

In order for the Inverted Hammer signal to be valid, the following conditions must exist:

- The stock must have been in a definite downtrend before this signal occurs. This can be visually seen on the chart.
- The upper shadow must be at least twice the size of the length of the body.
- The day following the Inverted Hammer should witness continued buying.
- There should either be no lower shadow or a very small lower shadow. The colour of the body does not matter, but a white body would be more positive than

a black body.

Why the Reversal Works

Imagine a stock in a downtrend. As portfolios start showing red, there is panic in the street. People want to get out. That is the time smart money likes to buy. One day, as the stock opens down or flat, the bulls start stepping in. They drive the price higher during the day. Eventually, the bears drive it back down and close it near the open of the day. The bulls have, however, shown their presence. They can now sense that the bears are getting weaker. If the bulls manage to close the price higher the next day, the downtrend is considered broken. The key here, as was in the case of the Hammer, is

that the bulls need to show confirmed buying the next day. Again, the Japanese candlestick traders have placed emphasis on the fact that the upper shadow must be at least twice that of the body size. The colour of the body does not matter, though a white body would be ideal. That would demonstrate the bulls managed to close the price higher than where the stock had opened up.

The following conditions can make the Inverted Hammer signal a more compelling buy:

- There is a gap down from the previous day's close on the day the Inverted Hammer is formed.
- There is a spike in volume on the

Inverted Hammer day.

- Stochastics are in oversold condition.
- The longer the upper shadow, the more the dominance shown by the bulls.

[Figure 5.2](#) shows the chart of Prism Cement.

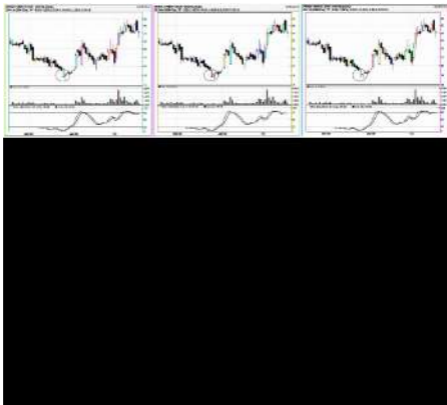
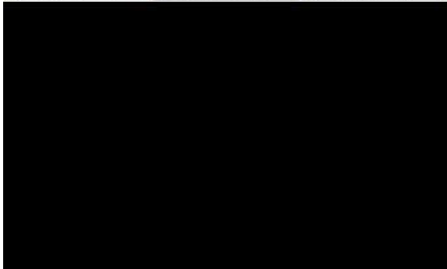


Figure 5.2: Gap down Inverted Hammer in Prism Cement

What a perfect visual depiction of panic selling! The gap down on the day of the Inverted Hammer in oversold conditions should immediately alert the trader for a possible trend reversal. The correct entry

procedure would be to wait for confirmation of buying the next day, which in this case was pretty evident.

[Figure 5.3](#) again shows the Prism Cement chart, this time focusing in the June 2006 period.



*Figure 5.3: Inverted Hammer in Prism
Cement*

We witness a gap down Inverted Hammer in oversold conditions. What should the candlestick traders do here? They should wait for confirmation. The next day the buying was confirmed as shown by the white candle. The traders are now ready to pull the trigger. What happens then is very interesting and worth elaborating. The day after the confirmation, the price gaps up. Many traders will now hesitate to jump in the market. Their rationale being, is it worth it to buy the stock after it has now gapped up? Have I lost my buy point?

The key to remember is “buy strength and sell weakness”. What the market has

essentially shown you is strength. Listen to the market. The market is never wrong!

[Figure 5.4](#) shows an Inverted Hammer in Dr. Reddy's Laboratories chart.

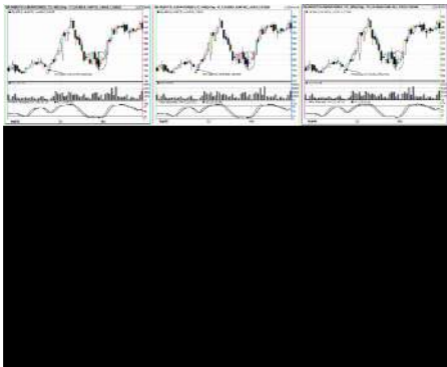


Figure 5.4: An Inverted Hammer proved very effective in Dr Reddy's

Notice the massive selling for three days in a row before the Inverted Hammer. With Stochastics in oversold conditions and confirmation buying on the following day, the market was offering a high probability reversal scenario to the trader. You can also notice an Inverted Hammer like formation in the chart in September. The upper shadow was not quite twice the body size. Stochastics were not in oversold conditions either. **It proved to be a good reversal, but it was not a candlestick signal.** The trader would be well advised not to chase these “almost” candlestick formations. There are hundreds of pure candlestick signals being formed every day. They have been tested thoroughly for centuries. Take advantage of them. Do not unnecessarily put your hard

earned money in trying to reinvent the wheel.

We will conclude the Inverted Hammer discussion with [Figure 5.5](#), showing the chart of Tata Power Co. Ltd.



Figure 5.5: An Inverted Hammer starts the next leg up in Tata Power

What can you observe before the downtrend reversed? You can see there was a Hammer. Would you buy the day after the Hammer? No. If you said yes, you might want to re-read the previous chapter. To be a true reversal, the Hammer signal needs confirmation. In this case there was none. However, the Hammer was followed by an Inverted Hammer. The day after that was a Doji day, where price closed higher and confirmed the presence of the bulls. I would probably have bought after prices gapped up following the Doji day.

Here, again, the market was giving strong signals to the trader who was tuning in. It gave him a Hammer, then followed that with an Inverted Hammer, then followed that with

a Doji, and then a gap up. All these signals were suggesting that the bulls were coming into the stock. Learn to analyze these formations and the market will reward you.

Shooting Star

Description

[Figure 5.6](#) shows a visual depiction of the Shooting Star signal.

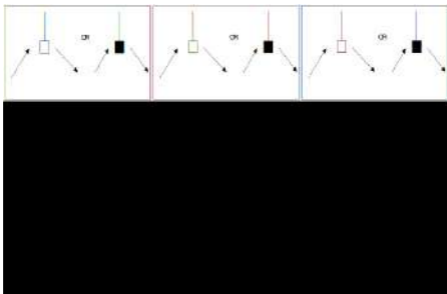


Figure 5.6: Shooting Star signal

It is formed after a stock has been in a

defined up trend. The formation looks like a shooting star with its tail pointing to the sky, hence the name.

Criteria

The conditions for the Shooting Star signal to be valid are:

- The stock must have been in a definite up trend before this signal occurs. This can be visually verified on the chart.
- The upper shadow must be at least twice the size of the body.
- The day after the Shooting Star signal should witness continued selling and a lower close.
- There should be no lower shadow or very small lower shadow.

Why the Reversal Works

Consider a stock in an up trend. When do most novice investors tend to buy? Right at the top! After a stock has gone up, they convince themselves that it will keep going up. Exuberance sets in. One day, as the stock opens higher or relatively flat, the investors jump in and create a huge white candle during the day. Smart money starts selling noticing the greed in the stock. The selling brings the price down, creating a long upper shadow. If the stock closes lower the day after the Shooting Star, the trend is said to be reversed.

The following conditions make the reversal of the up trend more convincing:

- There is a spike in volume on the day of the signal.
- There is a gap up from the previous close on the day of the signal, indicating exuberant buying at the top.
- Stochastics are in overbought condition.
- The longer the upper shadow, the better. The colour of the Shooting Star body does not matter, but a black body would be a stronger confirmation.

[Figure 5.7](#) shows a Shooting Star formation in the Tata Teleservices chart.

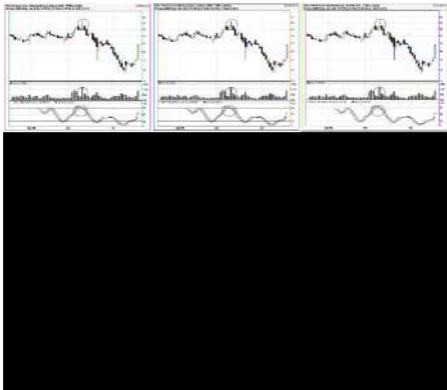


Figure 5.7: Shooting Star in Tata Teleservices starts its downtrend

The Shooting Star formation in overbought conditions and with above average volume gives a candlestick trader the perfect opportunity to enter into a short side trade. When would a trader enter the market in this

case?

Keep in mind that you are always looking for confirmation of the candlestick signal. This was provided by the bears the following day by closing the price below the low of the Shooting Star. The trader would have been handsomely rewarded for his chart analyzing talents in this case.

[Figure 5.8](#) shows a Shooting Star formation in Dr. Reddy's Laboratories chart.

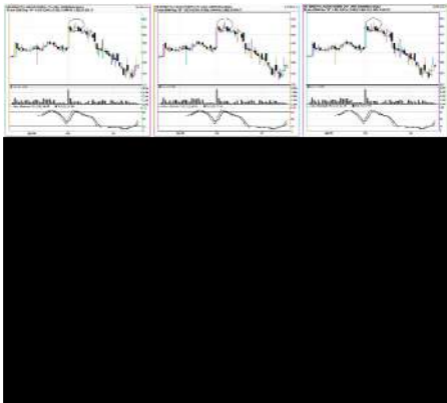


Figure 5.8: Dr. Reddy's heads south after a Shooting Star signal

This was a perfect Shooting Star followed by confirmed selling the next day. The stochastics turned down, also confirming the start of the downtrend.

Notice the chart in [Figure 5.9](#) showing an imperfect Shooting Star formation in Nocil.

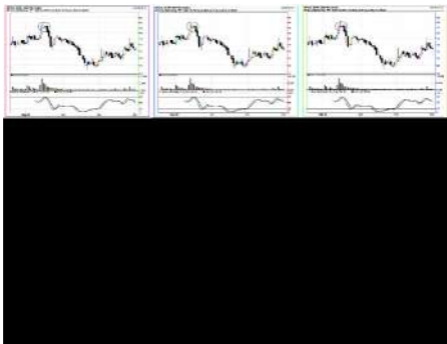


Figure 5.9: Bulls fail to hold on after the Shooting Star signal in Nocil

There is a tiny lower shadow in that Shooting Star. Given the size of the upper shadow, that length of lower shadow is acceptable. Notice the Shooting Star did not

confirm the next day as it was a Doji / Spinning Top. Correct entry point would be to enter the short trade after these signals got confirmed to the downside with a bearish candle.



We have now covered the major one-day reversal signals. The important point to remember about them is to wait for confirmation. In the next couple of chapters we will focus on and analyze the major two-day candlestick reversal patterns.

6

Engulfing Signals

There are two types of engulfing signals defined by candlestick formations. These belong to the two-day reversal patterns. We will first look at Bullish Engulfing pattern.

Bullish Engulfing

Description

[Figure 6.1](#) shows a classic Bullish Engulfing signal.

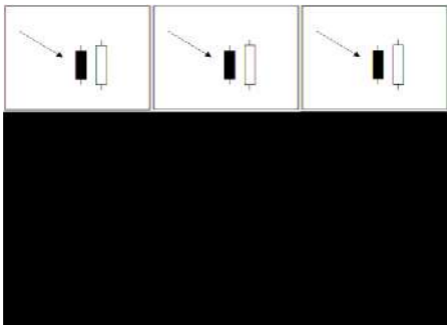


Figure 6.1: Bullish Engulfing signal

The signal is formed when a subsequent

white body completely engulfs the previous black body.

Criteria

In order for the bullish engulfing signal to be valid, the following conditions must exist:

- The stock must have been in a definite downtrend before this signal occurs. This can be visually seen on the chart.
- The second day of the signal should be white and the body should completely engulf the previous day's black candle body. Even if the first day is a Doji (described in [Chapter 3](#)), it is still a bullish engulfing signal.

Why the Reversal Works

Consider a stock which has been steadily moving down. The investors in the stock are getting nervous when they see red on their screen day after day. They hope the stock will somehow turn around. After days of continued anguish, the investors cannot take it anymore. They now convince themselves to get out of the stock. Where do most investors sell? At the bottom! This creates the long dark candle of the first day. Because of the huge selling pressure, the stock gaps down on the open the second day, below the close of the previous day. But now smart money moves in. The supply is absorbed by the demand. The stock finally closes above the open of the previous day, thus creating the white engulfing candle. The bulls have now taken over. The bulls have shown

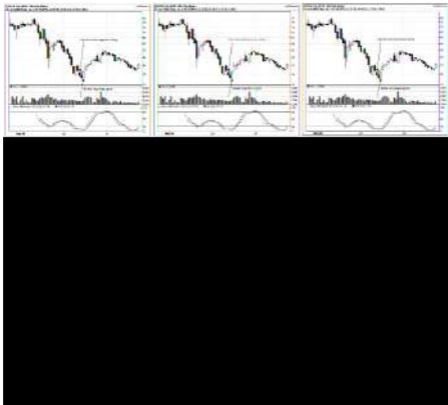
tremendous strength, which does not go unnoticed by the bears. The trend has a high probability of reversing at this point.

Strong as the signal is in itself, the following conditions make it more probable that the trend has reversed:

- The first day's dark candle body is very long compared to other candles in the current downtrend.
- There is a spike in volume on either of the two signal days.
- The first dark candle has gapped down from the previous trend. This shows the desperate need for the remaining panic sellers to get out of the stock.

- Stochastics are in oversold condition.
- The second day's white body engulfs more than one black candle from the previous trend.

[Figure 6.2](#) shows a chart of Essar Oil. Notice the stock gapped down two days prior to the big white engulfing candle. Also notice that the white candle engulfed the two prior black candles, lending significant force to the reversal. As a trader, this is what you want to buy into. Remember, always buy into strength.



*Figure 6.2: **Bullish Engulfing signal in oversold condition in Essar Oil***

Notice in [Figure 6.3](#) how India Cement reverses the down trend for a very profitable trade after a bullish engulfing signal.

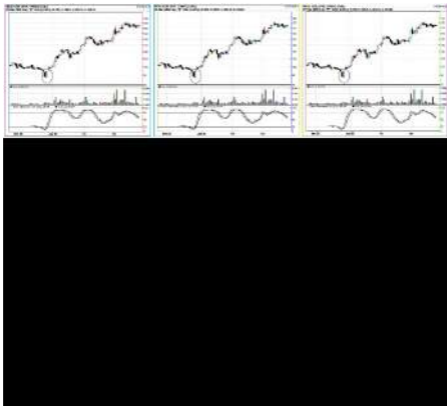


Figure 6.3: India Cement exhibiting a gap up after forming a Bullish Engulfing signal

Observe the large black candle showing panic selling by amateur investors. Smart money moves in the next day to readily take the stock from the panicky sellers. The up tick in volume also confirms the reversal. As

a trade, the probabilities are extremely high that the trend is now reversed. The bulls have stolen the thunder from the bears.

What should a buyer look for after any bullish reversal signal? More buying! This sounds like a simple answer and the fact of the matter is that it is. However, most investors and traders do not use this simple logic. The buyer should await some confirmation that the bulls are still in control of the stock. It is not uncommon to see some residual selling after a big bullish engulfing candle. Those sellers who had held on through the panic selling finally sell out after seeing the price higher than the last couple of days. For confirmation that he needs the buyer should make sure from the chart that

such selling is not heavy.

[Figure 6.4](#) shows a classic Bullish Engulfing signal. The stochastics are in oversold condition and the big white candle day is accompanied by a spike in volume. As a trader, the correct strategy is buying on confirmation the following day.



Figure 6.4: Bullish Engulfing signal with

heavy volume indicates possible trend reversal

Finally, [Figure 6.5](#) shows IPCL reversing its downtrend after a small bullish engulfing signal. Even though the engulfing candle is very small, it is still a bullish engulfing signal. The reader can also observe another bullish engulfing signal in the chart in late September which starts the next phase in the up trend.

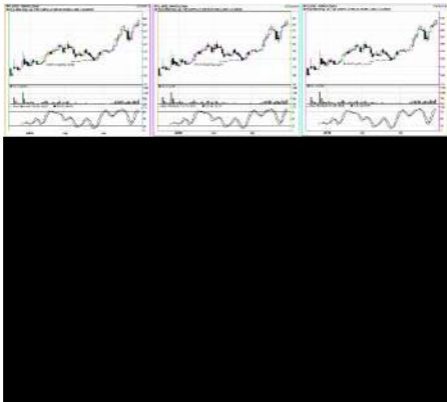


Figure 6.5: Bullish Engulfing signal reversing IPCL's downtrend

Bearish Engulfing

Description

[Figure 6.6](#) shows a classic Bearish Engulfing signal. As is seen, the signal is formed when a dark body completely engulfs a white body.

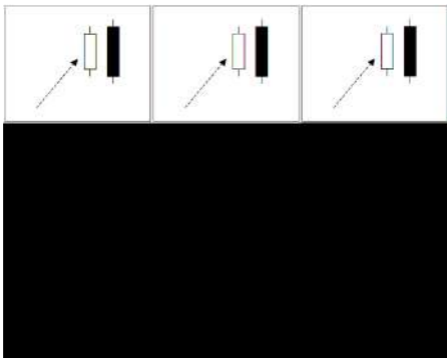


Figure 6.6: Bearish Engulfing signal

Criteria

In order for the bearish engulfing signal to be valid, the following conditions must exist:

- The stock must have been in a definite up trend before this signal occurs. This can be visually verified on the chart.
- The second day of the signal should be black and the body should completely engulf the previous day's white candle body. Even if the first day is a Doji, it is still a Bearish Engulfing signal.

Why the Reversal Works

Consider a stock which has been steadily

moving up. The investors in the stock are growing exuberant by the day they see the stock go up. The bulls are happy and relaxed. After days of continued up trend, the amateur investors finally convince themselves of buying into the stock. They cannot bear to watch its price go up and not participate in it. Again, where do most investors buy? At the top!

This creates the long white candle of the first day. The pent up demand makes the stock gap up the next day. But now the smart money is selling into the final rally. The demand of the novice investors is constantly filled by the supply from experienced traders. The stock finally closes below the open of the previous day, thus creating the dark engulfing candle.

The bears have now taken over. The trend has a high possibility of reversal.

Strong as the signal is by itself, the following conditions make it more convincing:

- The first day's white candle body is very long compared to the rest of the trading range.
- There is a spike in volume on either of the two signal days.
- The first white candle has gapped up from the previous trend. This shows the desperate need of the novice investors to get into the stock.
- Stochastics are in overbought condition.
- The second day's dark body engulfs more

than one white candle from the previous trend.

[Figure 6.7](#) shows another Bearish Engulfing signal.



Figure 6.7: Bearish Engulfing signal near overbought conditions in Hindustan

Motors

As you can see, candlestick charting clearly depicts investor sentiment changing in the stock. A candlestick trader could have long seen the deterioration in the health of this stock before the bearish engulfing signal finally broke it down.

[Figure 6.8](#) clearly reveals the exuberance of the novice investors buying into the top of the trend.



Figure 6.8: ITI Ltd. showing Bearish Engulfing signals after exuberant buying

How often do we get caught in this situation? When the stock rallied from below ` 30, the novice investor wanted to wait to see if this was a good stock. The investor was finally convinced that this stock deserves his or her

money somewhere in the ` 70 range. Finally, when it looks like everybody in the neighbourhood is buying in the stock, the novice jumps in. This is the last panic buying. Smart money then starts selling to the inexperienced investors.

JCT Ltd shows a Bearish Engulfing pattern in [Figure 6.9](#).



Figure 6.9: Bearish Engulfing signal in JCT Ltd.

Notice the gap up in overbought condition forming the white candle. The volume expanded showing a lot of shares changing hands. Finally, the bearish dark candle completed the pattern. What should a trader see after the Bearish Engulfing pattern? More

selling!

The candlestick signals have been tested through 400 years of trading. They signify a high degree of probability that the trend is about to reverse. The trader should always keep this in mind. This will help build confidence while actually placing a trade.

In the case of Manali Petro in [Figure 6.10](#), one can visually observe the climactic buying in the stock.

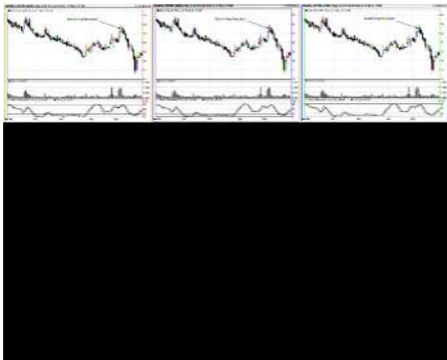


Figure 6.10: Manali Petro's Bearish Engulfing signal produces quick profits

Stochastics near the overbought area should have alerted the astute trader that exuberant buying was taking place. All the trader needs now is to patiently wait for the sell signal. On completion of the bearish engulfing signal, the trader should either sell his or her

shares or employ any number of other bearish strategies. Another high probability scenario to be taken advantage of!

[Figure 6.11](#) shows the Nifty index reversing its up trend after a bearish engulfing signal.



Figure 6.11: A Bearish Engulfing signal

takes down the Nifty

Stochastics indicated that the index was in an overbought condition. This created a high probability situation for trend reversal. If you do not want to trade the index itself, you can find stocks which are exhibiting sell signals at this time. With the market index showing a bearish engulfing pattern, there is a high probability that the component stocks with a bearish reversal signal will make for a profitable trade to the downside.

Candlestick signals are universal. They can be applied to indexes as well.

Exceptions

There is one unique set-up that sometimes

occurs the trend of bullish and bearish engulfing patterns, which can be summarized as follows.

If a bullish engulfing signal occurs when the stock is in an overbought condition, then the signal has bearish implications.

This is usually referred to as *last-gasp buying*. The novice investors seeing the price gap down are thrilled to get into the stock. Their enthusiasm drives the stock price higher for the day causing the bullish engulfing pattern. Unfortunately, the smart money is selling their stock. The trader must now be alert for signs that the trend is about to turn down.

Let us analyse the chart of Nagarjuna

Fertiliser and Chemicals Ltd ([Figure 6.12](#)), for the three days starting May 11th.



Figure 6.12: Bullish engulfing signal in overbought conditions is not a buy scenario

The stock had a bearish engulfing signal on May 11th. The trader should now be on guard to take profits if the signal is

confirmed.

On May 12th, the stock opened lower, but then immediately headed higher. This is not what you want to see after a bearish engulfing signal. By the end of the day, it had formed a bullish engulfing signal. The trader should now start expecting a sell signal anytime, knowing the reasoning behind this phenomenon.

The very next day witnessed a bearish engulfing signal, which was confirmed the day after by more selling.

Proper use of candlestick signals can lead to highly profitable trades. It helps the trader's confidence immensely if he also understands

the psychology behind the signals.

If a bearish engulfing signal is witnessed in an oversold condition, then the implications of such a signal are bullish.

Take a moment to visualize what is going on in such a case. After an extended downtrend, smart money has started buying. This pressure causes prices to gap up. The novice investors, looking to take advantage of the higher prices on the open, start selling causing the temporary bearish engulfing pattern. Most of the times the smart money is strong enough to turn the tide in the reverse direction.

Candlestick signals have stood the test of time and made huge fortunes for those who

have correctly utilized them. Learn to read and analyse the chart day by day. Always keep in mind the following two simple facts:

- If you witness a candlestick sell signal in overbought condition, it has to be followed by more selling to prove that the sellers are still around.
- If you witness a candlestick buy signal in oversold condition, it has to be followed by more buying to confirm that the buyers are forceful enough to turn the trend.

Simple as these facts may seem, they can make or break a trader!



Dark Cloud and Piercing Signals

This chapter will describe in detail the nuances of trading the Dark Cloud signal and the Piercing signal. These also belong to the class of two-day reversal signals. They are sort of like a “semi” completed version of the Bearish Engulfing and the Bullish Engulfing signal, respectively.

Piercing Signal

Description

[Figure 7.1](#) shows a classic Piercing Signal. As you can see, the signal is formed when a white coloured body opens below the low of the previous day's trading range and closes above the half-way point of that dark body.

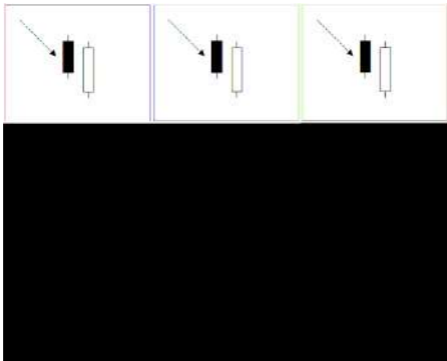


Figure 7.1: Piercing Signal

Criteria

In order for the piercing signal to be valid, the following conditions must exist:

- The stock must have been in a definite downtrend before this signal occurs. This can be visually seen on the chart.
- The second day of the signal should be a white candle opening below the trading range of the previous day and closing at least half way into the body of the previous day's dark candle.

Why the Reversal Works

Let us say stock XYZ is moving down

steadily. There comes a time when investors who are suffering losses in that stock begin doubting themselves. They start getting emotionally drained looking at their portfolios every day. Finally, they give up. Usually there is a climactic sell-off in the stock. Next day the stock gaps down and smart money pours in. The supply of shares is snapped up by the demand. The stock starts rising and finally closes up for the day creating the white candle body. Now, the Japanese give great importance to the number 2. They have found over centuries of trading that if the bulls can manage to close the second day's candle *more than half way* up the previous black candle, that puts the probabilities greatly in their favour that they have reversed the trend.

The existence of the following conditions makes the trend reversal more convincing:

- The first day's dark candle body is very long compared to the rest of the trading range.
- There is a spike in volume on either of the two signal days.
- The first dark candle has gapped down from the previous trend. This shows the desperate need for the last of panic sellers to get out of the stock.
- Stochastics are in oversold condition.
- The second day's white body opens way below the trading range of the previous day.

[Figure 7.2](#) shows a chart of Essar Oil. Notice how the trend reversed with a piercing signal. Also observe that the stochastics were in the oversold region, giving that much more weight to the probability of this happening.



Figure 7.2: Piercing signal in oversold

conditions in Essar Oil

Observe the chart of GE Shipping in [Figure 7.3](#).

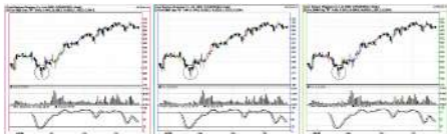


Figure 7.3: Start of an up trend after a Piercing signal in GE Shipping

The first day of the pattern was a gap down

dark bodied candle. Given the fact that the stochastics are in oversold condition, this was a clue for any trader to watch closely for a trend reversal sign. The trader at this point should visually be imagining the panic most investors are going through and should be ready to act at the first signs of smart money moving in. That sign was given the next day with a piercing signal.

[Figure 7.4](#) shows how the bulls reversed the downtrend with a Piercing signal.



Figure 7.4: Mahindra and Mahindra going up after a huge Piercing candle

Notice that in this case the stochastics were not in the ideal oversold conditions. However, one should remember that the candlestick signal is the primary factor. The oscillators are secondary factors. Though the

probabilities are higher for a trend reversing when the signal is formed in the oversold area, the trader should not neglect these opportunities. This is especially true in strong trending markets when the position never pulls back enough to get oversold.

[Figure 7.5](#) shows the chart of Rolta India Ltd. in the early part of June 2006.

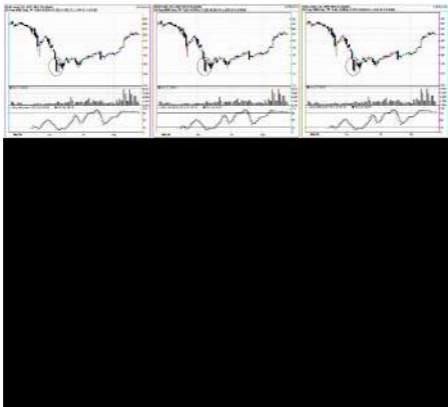


Figure 7.5: Rolta reverses its downtrend after panic selling is followed by a Piercing signal

By now you are well trained to recognize the Piercing signal. But look at the days preceding that signal. The dark coloured bodies are getting larger. Aren't they

shouting “panic!”?

Dark Cloud Cover

Description

[Figure 7.6](#) shows a Dark Cloud Cover signal. As can be seen, the signal is formed when a dark coloured body opens above the previous day's trading range and closes more than half way into the white coloured body.

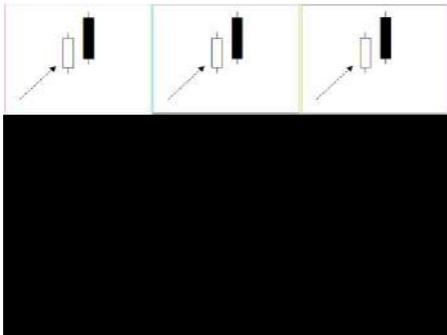


Figure 7.6: Dark Cloud Cover signal

Criteria

In order for the Dark Cloud Cover signal to be valid, the following conditions must exist:

- The stock must have been in a definite up trend before this signal occurs. This can be visually verified on the chart.
- On the second day of the signal, the candle should open above the previous white coloured body's trading range and close more than half way into it, thus forming a black body.

Why the Reversal Works

Consider a stock moving up. Things are rosy and investors are happy. Then one day the exuberance sets in forming a good sized white candle. The next day the price gaps up and smart money starts selling the stock to novice traders. The selling overwhelms the buying and finally the candle closes more than half way into the previous white candle. As in the case of the Piercing pattern, the important thing to notice is that the dark candle closes deeply, at least half way, into the previous candle.

The following conditions make it more convincing that the trend has reversed:

- The first day's white candle body is very long compared to the recent trading

range.

- There is a spike in volume on either of the two signal days.
- The first white candle has gapped up from the previous trend. This shows the exuberance of novice traders.
- Stochastics are in an overbought condition.
- The second day's dark candle opens way above the previous day's trading range.

[Figure 7.7](#) shows a Dark Cloud Cover signal in the chart of Allahabad Bank.

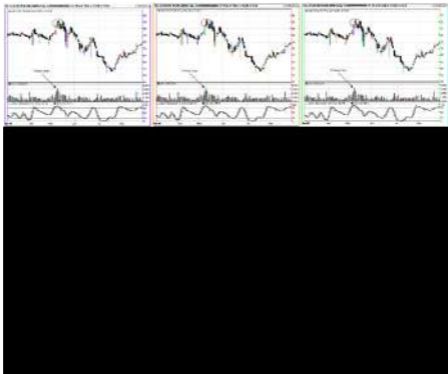


Figure 7.7: Dark Cloud Cover signal in overbought conditions in Allahabad Bank

A huge surge in buying can be seen from the volume on the day before the Dark Cloud signal. Notice that conditions were already overbought as indicated by the stochastics.

[Figure 7.8](#) shows the chart of Aegis Logistics

Ltd.

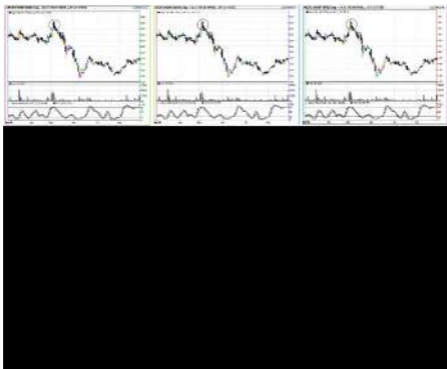


Figure 7.8: Aegis Logistics drops like a rock following a Dark Cloud signal

The stock had run up from ` 230 level to the ` 300 area. The bulls were getting excited. They gapped the prices higher, but could not sustain the momentum. Notice the climactic

volume surge. What followed the Dark Cloud Cover was almost a 180 point drop.

Look at the chart in [Figure 7.9](#). Try to analyze it from a technical trader's perspective.

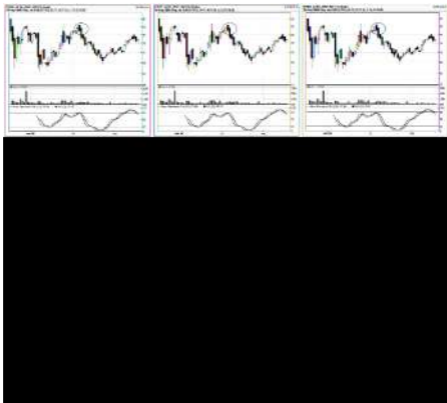


Figure 7.9: Dark Cloud Cover signal

confirming previous resistance in SAIL

Can you see the Dark Cloud Cover signal? Now trace back an imaginary horizontal line to the month of May and notice another candlestick signal (*Hint: see previous chapter*). This is a trader's delight. When one signal corroborates another signal at a previous resistance point, the probabilities are extremely high that the trend has reversed. [Chapter 10](#) will go in detail about using support / resistance lines.

[Figure 7.10](#) shows another Dark Cloud Cover.

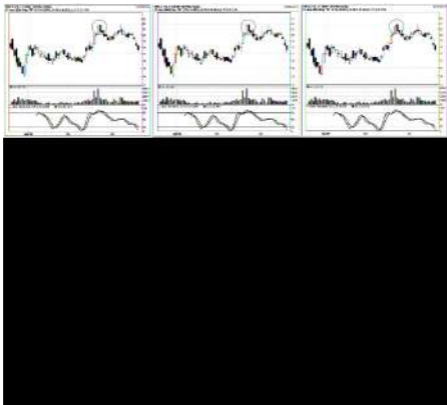


Figure 7.10: Dark Cloud Cover in Birla VXL

In May 2005, all the ideal conditions had lined up for a trend reversal in Birla VXL:

- Stochastics in overbought condition;
- There was exuberant buying as

represented by large bodied candles;

- Dark Cloud Cover signal.

As a candlestick trader, you are now seeing the market as a game of greed and fear. You are visually training your eyes to detect the panic and exuberance of other novice traders. Let me emphasize again the fact that these signals have been tested for about four hundred years by the Japanese. Have confidence in them.



The Harami

The Harami is another potent two-day reversal signal. The Japanese have named it Harami because of the way the signals looks, as though depicting a pregnant women with her belly sticking out.

The Harami occurring in an up trend implies that the buying has stopped. Likewise, a Harami occurring in a downtrend indicates that the selling has stopped. As in the case of the one-day reversal signals, it is best to wait for

confirmation the next day before taking on any position.

Bullish Harami

Description

[Figure 8.1](#) shows a Bullish Harami formation. The bigger engulfing candle is black or dark in colour and the subsequent smaller engulfed candle is white or light in colour. It is not necessary for the tails of the smaller candle to be engulfed by the previous candle.

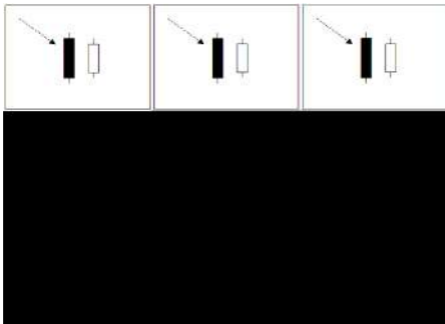


Figure 8.1: Bullish Harami signal

Criteria

In order for the bullish Harami signal to be valid, the following conditions must exist:

- The stock must have been in a definite downtrend before this signal occurs. This can be visually seen on the chart.
- The second day of the signal should be white and the body should be completely engulfed by the previous day's black candle body.

Why the Reversal Works

Consider a stock trending down. As usual, the novice investors and traders panic at the

bottom creating the long black candle. However, due to some news or change in perception after trading hours, demand gets generated for the stock. The next day the stock gaps up and smart money starts sapping up the supply. The bulls are able to close the candle towards the upper range of the previous day. This makes the bears nervous. Those who have shorted the stock in the hope that it will keep going down are now having second thoughts. They are waiting to see what happens the next day. If the bulls are still in the stock the next day, those with short positions begin to cover their positions, thus giving the stock more impetus in the upward direction. The bulls get more confident and the up trend begins.

The following conditions can make the Bullish Harami signal a more compelling buy:

- The longer the black engulfing candle and the white engulfed candle, the higher the chance that the trend will be reversed.
- There is heavy volume on either of the two days of the signal formation.
- Stochastics are in an oversold condition.
- The higher the white candle closes into the black candle body, the higher the probability of reversal.

Bearish Harami

Description

[Figure 8.2](#) shows a Bearish Harami formation. The bigger engulfing candle is white or light in colour and the following smaller engulfed candle is dark or black in colour. It is not necessary for the tails of the smaller candle to be engulfed by the previous candle.

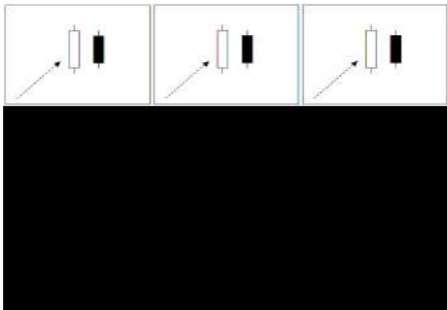


Figure 8.2: Bearish Harami signal

Criteria

In order for the Bearish Harami signal to be valid, the following conditions must exist:

- The stock must have been in a definite up trend before this signal occurs. This can be visually seen on the chart.
- The second day of the signal should be black and the body should be completely engulfed by the previous day's white candle body.

Why the Reversal Works

Consider a stock trending up. As is most often the case, the novice investors and

traders buy exuberantly at the top creating the long white candle. However, due to some news or change in perception after market hours, the stock becomes less desirable to own. The next day the stock gaps down and smart money starts selling. The bears are able to close the candle down towards the lower range of the previous day. This makes the bulls nervous. Those who have recently bought the stock in the hope that it will keep going up are now on the edge. They are waiting to see what happens the next day. If the bears are still in the stock the next day, the selling continues and the stock starts heading lower. Those with recent long positions start selling to get out with a small loss and along with the bears shorting, the stock tumbles down.

The following conditions can make the Bearish Harami signal more compelling to short:

- The longer the white engulfing candle and the black engulfed candle, the higher the chance that the trend will be reversed.
- There is heavy volume on either of the two days of the signal formation.
- Stochastics are in an overbought condition.
- The deeper the black candle closes into the white candle body, the higher the probability of reversal.

You will notice on some of the charts that the

second day of the signal (the engulfed candle) is one of the one-day reversal signals. In cases of a Bearish Harami, it could be a Hanging Man or a Shooting Star, or even a Doji.

Conversely, in cases of a Bullish Harami, it could be a Hammer or an Inverted Hammer or a Doji. This adds weight to the fact that reversal is about to happen. When you see more than one candlestick signal at any point in a trend indicating that a trend reversal is possible, take notice immediately!

[Figure 8.3](#) shows a Bullish Harami formation in Hindustan Motors.

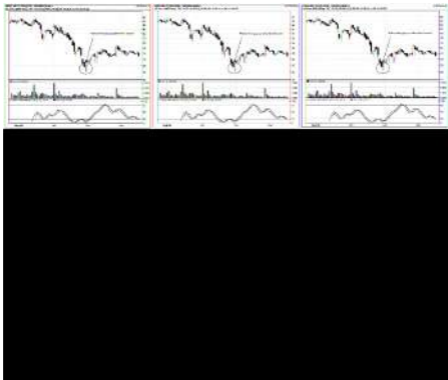


Figure 8.3: Bullish Harami in Hindustan Motors starts its up trend

Notice how the price gapped up the day after the Harami signal formed. What does this tell you as a candlestick trader? It tells you that other investors want to get into this stock in a hurry. After the downtrend, something has changed the perception towards the stock.

Maybe it was a good earnings report or a huge contract gain. As a trader, it is immaterial to find out what the news was that changed the perception. It is always helpful to know, but not necessary. As a trader, you are more concerned about the strength of the new upturn. Seeing the gap up should give you the required confidence that there is a strong force behind the up move. Time to jump in!

[Figure 8.4](#) shows the chart of IPCL.



Figure 8.4: Confirmed Bullish Harami reverses downtrend in IPCL

Notice the two arrows marked in the downtrend. Both are pointing to Harami formations. You can see that the selling continued after the first Harami had formed. The second Harami stopped the selling and a new upturn was initiated. The question to ask

yourself is — should you have considered buying after the first Harami? I would not. Why? Because there was no confirmation buying the day after the signal was formed. In fact prices gapped down after this Harami. This is not what you would expect after a candlestick buy signal. Stochastics were still heading down, too. How about the second Harami? Prices gapped up after this Harami and closed higher. Stochastics were oversold by this time, thus creating a high probability reversal situation.

This is not to say that all signals that get confirmed will result in a profitable trade. We will get into the signal failure scenarios in [Chapter 11](#). This example was just to show you that analyzing the signals and

understanding the nuances can avoid a lot of bad trades. This does two things, it helps preserve your capital and, more importantly, it helps keep your trading confidence high.

The chart of the Nifty index is shown in [Figure 8.5](#).

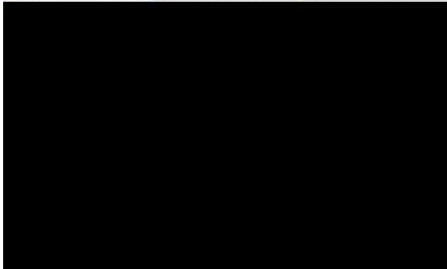


Figure 8.5: Bullish and Bearish Harami in Nifty

Notice the chart at point A. This formation looks like the Harami, but it actually is not. Nifty opened a point higher than where it had closed the day before. This does not satisfy the conditions needed for the Harami formation. Point B is a Bearish Harami. Nifty opened exactly where it had closed the night before. This is acceptable and satisfies the criteria of engulfment. Point C is a Bullish Harami. This stopped the pullback of the Nifty and was a precursor to a huge run up of the index.

[Figure 8.6](#) shows a Bullish Harami in the chart of Tata Tea. Notice the long dark candle in oversold conditions. This should

have been the trader's first alert. He should have been on the lookout for a buy signal from then on. The next day a Harami was formed. The trader should then have analyzed the Harami formation. Look at the long lower shadow. The bears tried to take control on that day, but failed.



Figure 8.6: Bullish Harami in upper region of a previous body is a very powerful buy signal

The bulls had not only managed to gap up the price from the previous close, but also to close it higher than the open. The ideal point would have been to buy the stock on confirmation after the Harami.

[Figure 8.7](#) shows the chart of Rolta India.

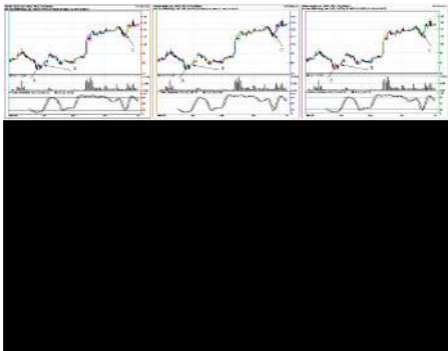


Figure 8.7: Bullish Harami in Rolta

Notice the couple of Harami formations in March 2005. The first Harami formation (Point A) would have resulted in a small loss, if a trader would have purchased the stock on the gap up after the Harami. Again, this will be dealt with in [Chapter 11](#). The second Harami formation (Point B) has a

high significance. It is a confirmation of the bulls entering the market. The fact that you can see two Harami formations at the same level indicates a great desire on the part of the bulls to not let the prices fall further. Guess what this confirmation Harami does to the bear's psyche? If the first Harami made them nervous, the second Harami at the same level dissolves their confidence. The shorts start covering their position. New buying comes in. The candlestick trader should be buying as soon as the prices open higher the next day. In this case, the prices again gapped up adding to the confirmation of trend reversal. Notice how in June 2005 the rapid pullback was also stopped with a spinning top Harami (Point C).

Finally, let us look at the chart of ABB Ltd. ([Figure 8.8](#))

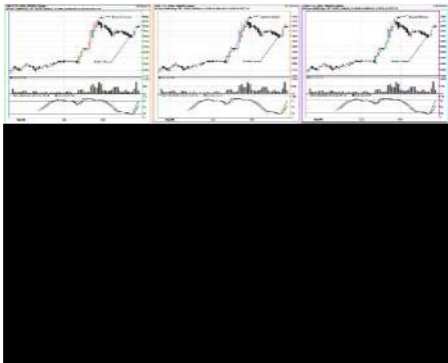


Figure 8.8: Bullish and Bearish Harami reversing trends in ABB Ltd.

Notice how after the price had risen from around the ` 2,800 area to the ` 3,300 area, the candles started getting bigger and the

volume started expanding. Investors were now buying exuberantly. If you had owned this stock, where would you sell it? The correct point would have been to sell as soon as the Bearish Harami got confirmed.

Remember, the point of trading is not to buy exactly at the bottom and sell exactly at the top. Leave that to somebody else to try. It is simply too difficult and not worth the risk. As a candlestick trader, you will try to capture the juicy middle part of the trend.



Morning Star and Evening Star Signals

The Morning Star and Evening Star are very powerful three-day reversal signals and once mastered they help traders reap huge profits.

Morning Star Signal

Description

[Figure 9.1](#) shows a Morning Star signal formation. The Japanese named it so because like the planet Mercury, which is known as the morning star, it foretells of good things to come (morning). In the case of stocks, it means that the prices will start moving higher from here on.

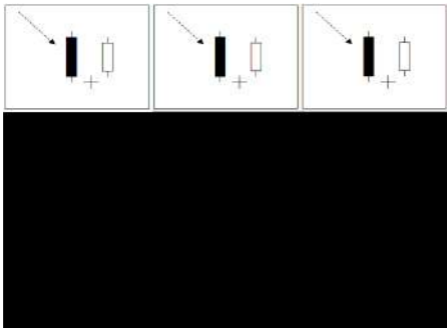


Figure 9.1: Morning Star signal

Criteria

In order for the Morning Star signal to be valid, the following conditions must exist:

- The stock must have been in a definite downtrend before this signal occurs. This can be visually seen on the chart.
- The first day of the signal must be a long dark body. The second day must be a day of indecision. The third day should be a long white candle reaching at least half way into the body of the first day's dark candle.

There are many variations of the Morning Star signal. [Figure 9.2](#) shows a few of these

variations.



Figure 9.2: Morning Star signal variations

Why the Reversal Works

Consider a stock which has been steadily moving down. Then one day panic grips the investors in that stock. They no longer want to hold on to the losing position. This panic

selling creates a long dark candle. The next day there is a battle between the bulls and bears. Smart money is buying and the final panicky sellers are happy to sell to them. This creates indecision. The bulls seize this opportunity to get control of the stock. The short sellers start covering their position leading to further upward movement. The signal is formed when bulls are able to close the candle half way up the dark candle formed two days back. Probabilities support trend reversal at this point.

The Morning Star signal is a very visual signal, where you can actually see the change in investor perception towards the stock. In [Figure 9.2](#), you can witness the various days of indecision. If the middle day is a one-day

reversal signal, that adds more weight to the Morning Star signal.

Notice the Abandoned Baby Morning Star signal shown in the same figure. This is a very powerful reversal signal. Analyze the formation. There is a gap between the low of the first day and the high of the second day. There is also a gap between the high of the second day and the low of the third day. What is going on in that formation in terms of fear and greed? The first gap shows panic selling in the stock. Then the bulls and the bears get locked into a fight. The third day shows the outcome of the fight. The second gap represents the strength of the victory. You as a candlestick trader have to be in this stock at this point!

The following circumstances will further enhance the probability of reversal shown by the Morning Star signal:

- The first day's dark candle body is very long compared to the rest of the trading range. By definition of the signal, this would necessitate that the bullish candle on the third day be large as well.
- There is a spike in volume on the indecision day.
- Stochastics are in an oversold condition.
- The second day forms one of the one-day candlestick reversal signals.

[Figure 9.3](#) shows the chart of Bharat Heavy Electricals Limited.

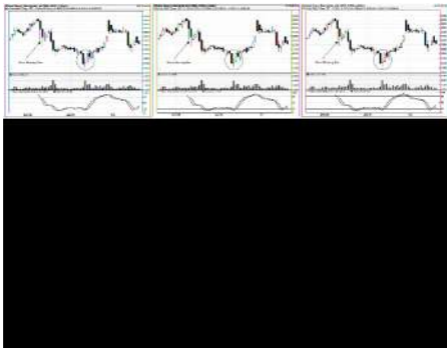


Figure 9.3: A big Morning star signal in oversold conditions in BHEL

Notice the excellent Morning Star formation in mid-January 2007. By now your eyes should be trained to notice some obvious things. The position of Stochastics, the heavy volume, and the large candles on the first and third day of the formation all lead to a text

book type Morning Star signal.

Also notice the arrow marked on the chart in mid-December 2006. Can you analyze why this is not a Morning Star signal?

If you noticed that the third day of the signal did not penetrate at least half of the first day's black candle, you are right. As mentioned before, the Japanese have placed a lot of emphasis on the half way point. The closing of the white candle over the half way point shows the credibility of the strength of the bulls. It was missing in this case.

[Figure 9.4](#) shows a Morning Star formation in Cummins India Ltd. chart.

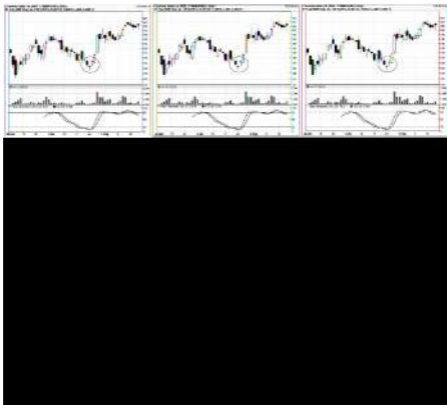


Figure 9.4: Morning Start signal reversing the downtrend in Cummins India

Notice in this chart that the stock gapped up after the indecision day, even though it traded down during the day. That gap up represents the forceful nature of the bulls. This always adds weight to the reversal.

[Figure 9.5](#) shows a Hammer Morning Star signal.



Figure 9.5: Morning star signal in Essar Oil

The Hammer tells you that all the remaining sellers got washed out. The stock changed

hands from the weak to the strong. The third day witnessed prices closing just above the half way point of the first day's dark candle.

Sometimes in a Morning Star formation, the middle day is not exactly a Doji type day. It is a small body, indecisive day (also called a Spinning Top). Analyze the signal formation in [Figure 9.6](#) (Point B) keeping in mind the action behind the scenes. After the first down day, the sellers were not able to drive down the price much lower. The bulls stepped in on the third day to take control after seeing the selling dry out.

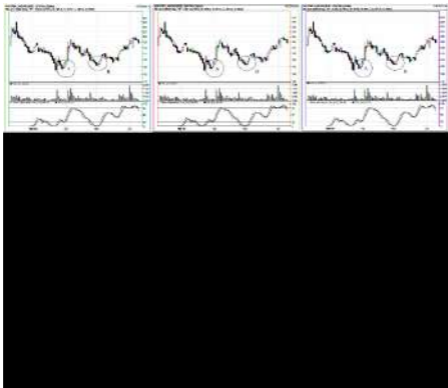


Figure 9.6: Bulls jumping in after Morning Star signals in Matrix Laboratories

Point A in the chart also shows the trend reversed with a Morning Star signal. What stopped this up trend? The Shooting Stars and the Bearish Engulfing signal.

Let us close our discussion of Morning Star

signals with [Figure 9.7](#) showing a chart of Tata Steel.



Figure 9.7: Tata Steel reversing after a Morning Star signal

We can see a well defined Morning Star signal form in mid-June 2006. Let us assume as a trader you buy into the position. Where

will you take profits?

As you can see from the chart, the correct place to take profits was after Point 5. Let us analyze why we should not have taken profits earlier:

Point 1: A Dark Cloud signal is formed in overbought conditions. What do you want to see the next day? Confirmation selling! In this case there was none.

Point 2: This is not a Bearish Harami. The colour of the candles is opposite to the definition of a Bearish Harami.

Point 3: This shows another Dark Cloud signal. The bears are really trying

hard, but fail yet again to produce confirmation selling.

Point 4: This is a repeat of Point 3.

Point 5: This shows a Bearish Harami in overbought conditions. What happens the next day? A gap down! As mentioned before, a gap up or gap down after a candlestick signal formation indicates tremendous strength in that particular direction. A simple analysis of the situation would have led you to take profits at this time.

Evening Star Signal

Description

[Figure 9.8](#) shows an Evening Star signal formation.

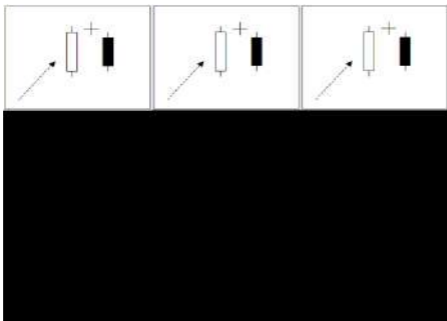


Figure 9.8: Evening Star signal

The Japanese named it so because like the

planet Venus, which is also known as the evening star, it foretells of gloomy things to come (night). In the case of the markets, it means that the prices will be heading lower from that point.

Criteria

In order for an Evening Star signal to be valid, the following conditions must exist:

- The price must have been in a definite up trend before this signal occurs.
- The first day of the signal must be a long white body. The second day must be a day of indecision. The third day should be a long dark candle reaching down at least half way into the body of the first day's white candle.

[Figure 9.9](#) shows a few of these variations of the Evening Star signal.



Figure 9.9: Evening Star signal variations

Why the Reversal Works

After an up trend, the novice investors finally start piling into the stock. This creates the exuberant white candle at the top. The next day, the demand is consistently met with supply from the smart money. The indecision day is followed by a large down day, indicating the bears finally taking control

from the bulls. As in the case of the abandoned baby Morning Star signal, seeing a gap between the first and second day and also a gap between the second and third day shows a massive change in investor psychology. Traders should immediately cash out their positions, or go short.

The following circumstances will further enhance the probability of reversal shown by the Evening Star signal:

- The first day's white candle body is very long compared to the rest of the trading range, indicating exuberant buying.
- There is a spike in volume on the indecision day.

- Stochastics are in overbought condition.
- The second day forms one of the one-day candlestick reversal signals. [Figure 9.10](#) shows an Evening Star formation in Hindustan Lever.



Figure 9.10: Hindustan Lever falls after an

Evening Star signal

Notice that a Bearish Harami is part of the three day signal. As I mentioned before, this adds more weight to the reversal. One more point to mention for this chart is the presence of a Hanging Man signal a couple of days before the Evening Star signal. The Hanging Man was not confirmed. The trader who bought into the stock after the confirmed Hammer signal should have got out after the Evening Star signal.

The chart in [Figure 9.11](#) shows a classic Evening Star signal.

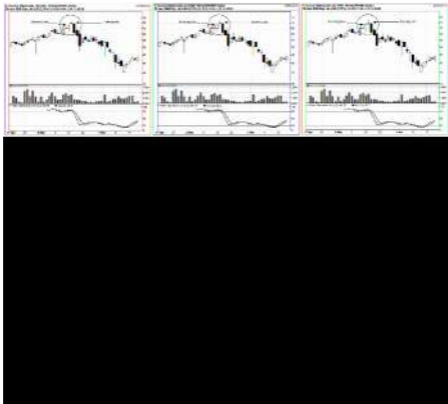


Figure 9.11: Combination of Shooting Star and Evening Star signals take down S. Kumars

The first sign of the bulls weakening was seen with the Shooting Star signal. The candlestick trader would not have acted on this as it did not get confirmed. Seeing the

Evening Star signal form in the immediate vicinity of the Shooting Star gives the candlestick trader greater confidence that the up trend is reversing.

Going short after the Evening Star signal in [Figure 9.12](#) would have given a candlestick trader very good profits.



Figure 9.12: Rapid fall after an Evening Star signal in Syndicate Bank

This chapter concludes the discussion of the major candlestick reversal signals. We have seen how the one-day, two-day and three-day reversal signals work and their effectiveness at producing strong profits.

What is expected of the readers at this point is a complete change in their perception of how the markets work. The stock markets, or for that matter all other financial markets, move because of change in investor sentiment. You are now learning to capitalize on this point. The sooner you learn to notice the fear and exuberance of other people as depicted in the charts, the faster you will grow your portfolio.



PART II

This part of the book concentrates on the practical aspects of using candlesticks for investing as well as trading. It is assumed at this point that you can visually recognize the major candlestick signals described in the first part. I also sincerely hope that you are analyzing the “behind-the-scenes” action whenever you look at a chart. Bears and bulls, supply and demand, greed and fear, these are the key metrics you need to think about when analyzing a chart.

The following chapters will sharpen your candlestick skills. You will learn that when you combine the high probability reversal

candlestick signals with western technical analysis, the combination generates explosive profits. You will learn the different stop loss scenarios, in case a signal goes sour. This is part of money management that every person invested in the financial markets needs to get disciplined about. Growing a portfolio is not just about making great profits. It is also about cutting your losses on bad investments. What is the use of making two good trades, gaining 20%, and then losing it all in one bad trade? Candlestick signals and your new mind-set about reading the charts will empower you to cut your losses and retain more of your profits.

Again, please read and re-read the chapters

that follow. Do not jump in the river without learning to swim. The river is unforgiving. But once you master swimming, you will enjoy being in the water for the rest of your life.

Combining Candlesticks with Technical Analysis

In this chapter we will look at candlestick signals in combination with other technical indicators. As you might have noticed, thus far in all the charts we have always used stochastics and volume in the lower portion of the chart. We will be consistent in doing that. If you are familiar and comfortable with RSI, MACD or any other oscillator which shows overbought / oversold conditions, that is perfectly fine. The key is to find high

probability trades utilizing candlestick signals when a security is in these extreme conditions.

We will discuss candlestick signals in conjunction with the following:

- Support / resistance trend lines; and
- Moving averages.

Every trader must read as many technical analysis books as possible in order to gain more and more in-depth knowledge of this field. Education is the most essential weapon in your trading arsenal. It takes years of education and training to become a successful doctor, an engineer or an architect. Please do not think trading is

otherwise. Trading might seem very easy when looking at it from the outside. But in reality it is not. A trader has to be armed with knowledge, patience and discipline if s/he wants to succeed long term in the marketplace.

Support and Resistance

The stock market is a dynamic arena. Prices fluctuate up and down, sometimes on news, other times seemingly with no justification. **Fundamentals of a company do not cause prices to move. It is the reaction of the people trading that stock that whipsaws the price.** If prices were to move based only on the fundamentals of a company, then the stock market would be a discrete market where the price jumps from one point to the next only after some news hits the wires. The rest of the time it would be at a constant, fixed price. We all know that does not happen. Prices change everyday. They change because somebody has a change in perception for that stock. Technical analysis

is the study of that perception change as seen in a chart. What better way to see this change of perception than using a candlestick chart.

[Figure 10.1](#) shows a stock vacillating back and forth between two price levels in a sideways market.

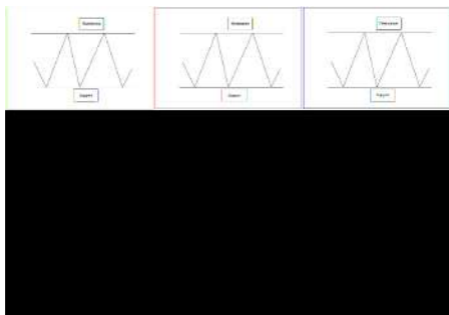


Figure 10.1: Support and Resistance

Whenever the stock approaches the top price level, it sells off. The supply side of equation becomes greater than the demand side. **This price level, where there is seemingly more supply than demand, is defined as a *resistance* level.** The stock is now under pressure. The bears continue to dominate and take it down towards another price level, where the perception towards that stock changes 180 degrees. The demand side of equation now becomes greater than its supply side. **This price level where there is more demand than supply is termed as a *support* level.**

Note: You can print out a chart and draw these support/resistance lines yourself. You can also use a Java charting application from websites

such as Icharts.in, which will allow you to draw these lines online.

So why does the stock keep doing what it does, i.e. go back and forth? The answer lies within us. We humans tend to remember things. Consider a stock which you wanted to buy but missed because of any number of reasons. What will happen when the stock pulls back to your original buy point? Naturally, you will jump in. Now consider thousands of traders doing that same thing. If the stock turns and starts heading back up, take a guess where you will start to feel panicky. It would be right about the same place where it started coming down from the last time. This process gets repeated until either the stock breaks the resistance level

and heads higher or else breaks the support and tumbles down.

[Figure 10.2](#) shows support and resistance lines for an up-trending and a down-trending stock. The logic behind the support / resistance lines, also referred to as trend-lines, is exactly the same as described above.

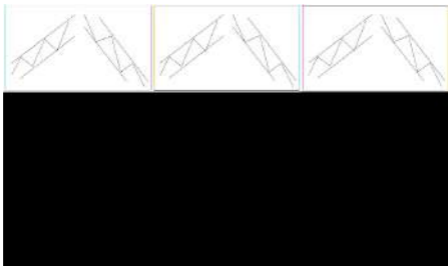


Figure 10.2: Trend channels

Let me emphasize this point again. You are trading human emotions in the market, not the actual stock. The faster you accept this mantra, the clearer you will hear the market signals.

A few points about these trend lines:

- Trend-lines can be horizontal or sloping.
- The more number of times the price tests the trend line, the stronger the support or resistance.
- **Once a support trend line is broken, not intraday, but on a closing basis, it will function as a resistance trend line from then on. Similarly, once a resistance trend-line is broken on a**

closing basis, it will function as a support trend-line from that point onwards.

This is better explained visually in [Figure 10.3](#) and [Figure 10.4](#).

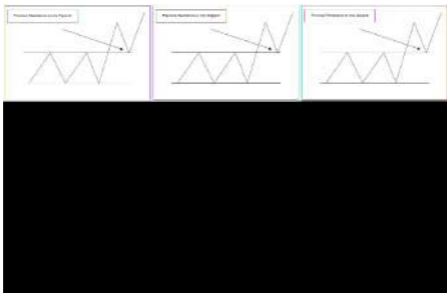


Figure 10.3: Previous resistance becomes support

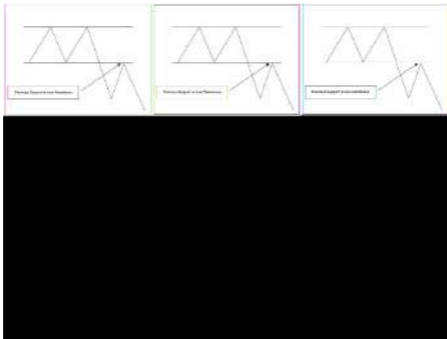


Figure 10.4: Previous support becomes resistance

[Figure 10.5](#) shows the chart of Polaris Software.

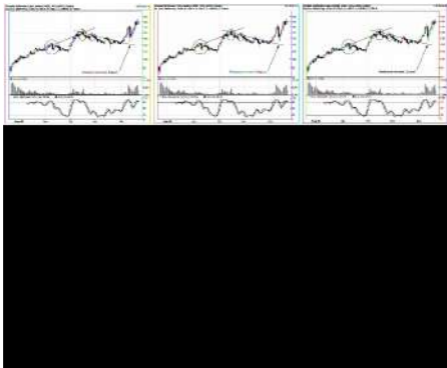


Figure 10.5: Support / Resistance lines in Polaris

Notice the different trend-lines that can be seen. Also notice that in December, the stock tested the old resistance line. This time, though, that line acted as support. If you are now thorough with the candlestick signals, you will recognize the bullish Harami which

stopped the selling in December, right on the support line. Please analyze the three signals that are circled in the chart.

The trader should also be aware of the fact that these trend lines are subjective. You can draw a trend line which can be different than the one I draw. After all, you are just taking two or more points on the chart and plotting a line through them. Then what is it that determines which is the correct trend line to be trading off?

Let the market tell you which the correct trend line is. As a candlestick trader, what would you expect the market to show when approaching a trend line? A candlestick signal! Therefore, whichever

trend line the signal is formed at is the correct trend line.

Figure 10.6 shows the well defined resistance area in Punjab Tractors.



Figure 10.6: Punjab Tractors unable to close above the resistance

Notice the following candlestick signals in the chart at that trend line:

1. A Bearish Engulfing signal in September:
2. A Piercing pattern in early October:
3. A Hanging Man in late October; and
4. A Piercing signal in early December.

Notice the chart of Satyam Computer in [Figure 10.7](#)

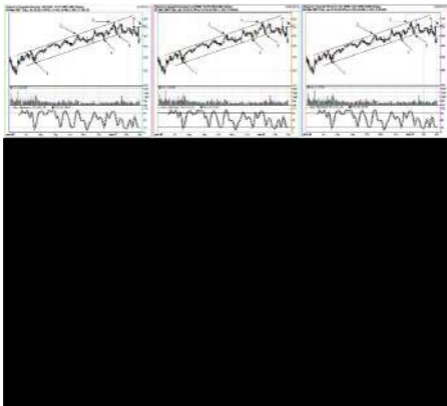


Figure 10.7: Satyam Computer riding up in a trend channel

This chart clearly defines a trend channel for the stock from around August 2006 till February 2007. Every time the stock hits the upper trend channel, the supply of shares exceeds the demand for them. Similarly, the

demand for the stock is heavy along the lower channel. These demand-supply imbalances make the stock fluctuate between those imaginary trend lines. Close observation of the chart at the reversal points along the trend channel indicates the following points:

Point 1: Bullish Harami.

Point 2: Hanging Man.

Point 3: Bullish Harami.

Point 4: Bearish Engulfing.

Point 5: Bullish Engulfing.

Point 6: This illustrates the previous trend

channel now acting as resistance.

The examples above show how candlesticks work with support and resistance lines. If as a trader you anticipate a reversal situation at a particular point on the chart, then the knowledge of candlesticks will add confirmation to your expectation. If you expect a stock to turn lower at a resistance point but candlesticks show a tall white candle breaching that point, then your expectation should be negated. You should realize at that point that the stock has broken resistance with good force. On the other hand, if you see a Doji followed by a Hanging Man and a lower close at that resistance point, you know your expectation is fulfilled. The probabilities are in the

favour of the stock heading down.

Moving Averages

Moving averages essentially provide a directional trend to a stock or the market. They smooth out the ups and downs of the trend and provide the immediate direction the stock is headed in. Moving averages have a lot of applications in technical trading. The most common way traders have used them in the past is to buy a stock whenever a shorter term moving average (MA) crosses upward through a longer term moving average. Conversely, they would sell a stock whenever the shorter term MA crossed below the longer term MA.

This application of moving averages is, however, usually not the best technique to

follow as it is a lagging method. What this means is that the signal to buy is often generated too late in the trend.

Using candlestick signals with moving averages enhances the returns on investment many-fold. These moving averages provide support and resistance to a trending stock just like the trend-lines we drew in the previous section of this chapter.

The most common moving averages are the simple MA and the exponential MA. For our discussion purposes, we will stick to the simple moving average (SMA). Readers should refer to other technical analysis books if they want further information on exponential MAs.

The simple MA is defined as follows:

$$\text{Moving Average (N)} = (A_1 + A_2 + A_3 + \dots + A_N) / N$$

Where N = the period over which the average is calculated.

$A_1 \dots A_n$ = closing prices over the last N days.

This is a dynamic curve and is calculated every day after prices close. Most money managers in the world use 50 MA or 200 MA. For trading purposes, having a 20- or a 30-day MA is optimal. The key to using the correct moving average is to let the stock chart tell you. Pull up a chart and put various moving averages on it. This is very easy nowadays with online charting. All you have to do is select “Simple Moving Average” and type in different numbers like 20, 30, 50,

etc. Once you have these lines on the candlestick chart, select the one from which the stock bounces off (reverses or supports) from the most. That is the moving average to use.

Candlesticks are excellent for finding reversal situations. They tell you the internal dynamics of the market. However, *they do not give you a target price.* You can calculate the price targets using other tools of technical analysis. One way is to see where the dominant moving averages are. Stocks will usually tend to fluctuate around particular moving averages.

As an example, [Figure 10.8](#) shows you the chart of Grasim Industries.

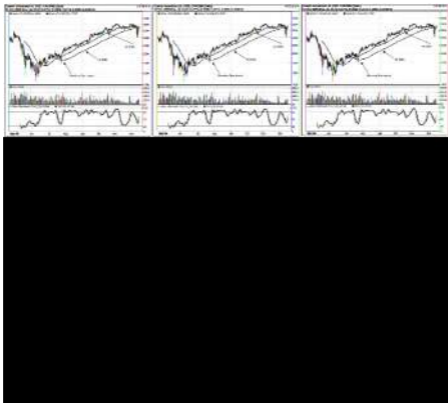


Figure 10.8: Grasim following its moving averages

You can notice in the figure that in July 2006 a Morning Star signal formed right on the 50-day simple moving average (SMA). From that point on, the stock price used the 20 SMA as support till December, when it

finally broke down below both the 50 SMA and 20 SMA.

The moving averages act like magnets for the price. The concept of moving averages is similar to the concept of trend lines which we discussed earlier. **Moving averages are dynamic trend lines.**

[Figure 10.9](#) shows a chart of Sujana Metal.

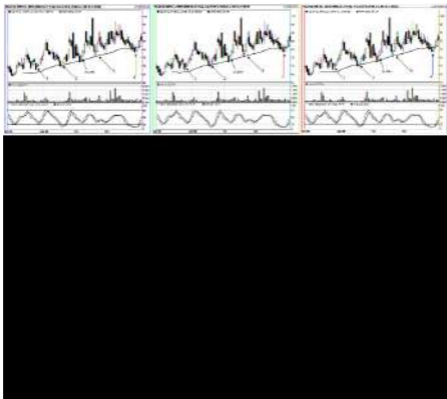


Figure 10.9: Sujana Metal using the 50 SMA as support

Traders would have had a fun time trading this chart. The 50 day SMA is a powerful force for this stock. Notice the following signals:

Point 1: Bullish Harami.

Point 2: Doji with a gap up next day. Remember, this is a powerful signal. The Doji showed the indecision on the part of bulls and bears and the gap up the next day, showed the decision being made in favour of the bulls.

Point 3: Morning Star signal.

Point 4: Bullish Harami.

In concluding this chapter, it would be appropriate to emphasize that a trader needs to have as much probability in his or her favour as possible. A combination of candlestick charts with technical analysis is

an excellent system to achieve this.



Trading Setup

Thus far we have learnt the major candlestick signals and how to use them with common western technical analysis. You have witnessed the high degree of accuracy of these signals in predicting reversals. The probability of the reversal is greatly enhanced when two or more signals confirm it. I have always put more weight on the Morning Star and Evening Star signals if the middle day is a one-day candlestick reversal signal, such as a Hammer or Hanging Man. If a bullish engulfing signal is forming at the

exact support level from where the stock bounced up the previous time, it brings that much more credibility to the reversal.

This knowledge should put you way ahead of your competitors. The next time when you see a stock fall 10 percent, you will not rush to buy it because it looks cheap. You have probably heard of the saying, “Don’t try to catch a falling knife”. That is very true. That stock which is down 10 percent can further go down another 20 percent. On the other hand, it could very well reverse and start a new leg up from here. You do not know which of the two might happen. All you know is the candle formation. Rely on the signals. Do you see a buy signal form? Are the stochastics in the right place? Is there

confirmation buying? These are the points you will be looking at.

As a candlestick trader, you are not looking to buy exact bottoms and selling at exact tops. You want the middle chunk of the trend.

I have written this chapter with two objectives in mind.

1. To show you the exit strategies when candlestick signals fail because, yes, they do sometimes fail!
2. To share trading ideas which I have found useful over years of trading stocks and options.

Getting Real — Candlesticks Fail, Too!

I would have liked to tell you that candlestick signals are 100% effective, that they never fail, that they are the magic charms you have been waiting for. Unfortunately, I cannot!

Candlestick signals are truly very effective. They have been tested for over four centuries. If they would not have worked, they wouldn't have been around this long. They show reversal points with a high degree of probability. But the key word is *probability*. There are going to be times, albeit only a few, when you have the perfect signal, stochastics are in the perfect place,

the signal is confirmed, you get in — and then the stock starts heading in the other direction. This is going to happen, guaranteed!

Trading is like a business. There are times in a business where you face losses. That is perfectly normal and expected by all good businessmen.

They know that in order to succeed, their gains must overcome their occasional losses. This is the exact philosophy a trader needs to have. Losses are inevitable in trading. You cannot control the market environment. The stock might be in an excellent buy scenario, but the market might be falling out of the bed. This will put pressure on the individual

stock. It will negate the buy scenario with some dark candles. In such a case the market would have proved you wrong. As a trader, you have two choices at this point:

1. Ride your ego. Ignore the fact that the market negated the buy signal. Assure yourself that you have more knowledge than the combined market and that the stock will go in your direction soon. Keep holding — and watch your losses mount.
2. Acknowledge the fact that this trade has failed. Get out with a small loss and wait for the next buy signal.

Most traders who choose the first option

equate the failed trade with a personal failure. They cannot accept the fact that even with all the technical analysis knowledge they possess, they still have a losing trade. *If you have to succeed at trading, you will have to overcome this pitfall.* It is by no means an easy one. But, nevertheless, you will have to do it. There is no way around it. All your candlestick and technical analysis knowledge will not make your portfolio grow if you cannot take a small loss.

The old but wise adage “Cut your losses short and let your profits run” is the only way to be a successful trader. So now the question arises, “Where do you cut your losses?” 2% down, or 5%, or 10%? Some technical analysis books suggest 5%, others

suggest 7%. These percentages do not mean much to a candlestick trader. The questions and answers that follow may look very basic. Yet, they contain the key to a trader's dilemma of placing a stop loss.

Question: Why is the candlestick trader long in the stock?

Answer: Because of a candlestick buy signal formation.

Question: Where would the candlestick trader place a stop loss?

Answer: The point which shows that the candlestick buy signal is negated.

Question: Why is the candlestick trader

short in the stock?

Answer: Because of a candlestick sell signal formation.

Question: Where would a candlestick trader place a stop loss?

Answer: The point which shows that the candlestick sell signal is negated.

As simple as that!

Just as there is a reason for buying a stock, there should be reason for taking a loss. Let us analyze the stop loss scenario. As a candlestick trader, you have found a perfect buy signal in oversold conditions. You wait for the confirmation and then buy. In other

words, the bears who were controlling the stock were overcome by the bulls, which is what formed the signal. The confirmation gave you the trigger and confidence that the bulls were still in it. After a couple of days, because of whatsoever reason, there is a dark candle which takes the stock price back to the buy point. What does that imply? It implies that the bulls have lost control to the bears. This is not what should have happened after a candlestick buy signal. The trend should have been reversed. However, the signals now are telling you that the bears have been able to drive the price back through the point where the bulls had assumed control previously. Why, then, would you want to be long in this “bear-controlled” stock? As you noticed from this

scenario, a stop loss is not a question of setting arbitrary percentages. **It is analyzing each situation independently to find the point where the bulls or bears cede control to the other.**

We will look at some of the common candlestick signals and how to set stop losses if these signals fail.

Hammer

As shown in [Figure 11.1](#), the bottom of the Hammer is a good support point. The bulls had shown their dominance at that point, bringing the prices all the way up. It is quite logical to assume that if the price drops below the low of the Hammer, the signal is negated.

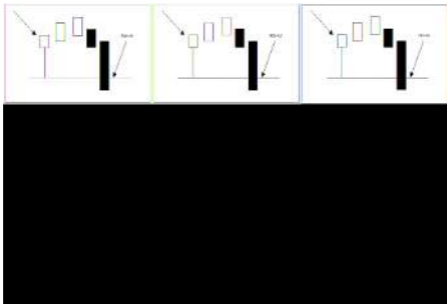


Figure 11.1: Stop out level for a Hammer signal

Inverted Hammer

The bottom of the body of the Inverted Hammer ([Figure 11.2](#)) is considered a strong support area.

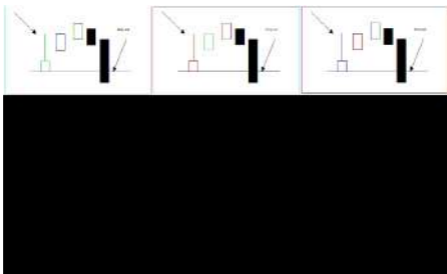


Figure 11.2: Stop out level for an Inverted Hammer signal

If the price declines below this point, it shows that the bulls were not able to hold the

support. Getting out of the trade is then the prudent thing to do.

Bullish Engulfing Signal

As [Figure 11.3](#) shows, the bottom of the bullish candle is logically analyzed to be a strong support.

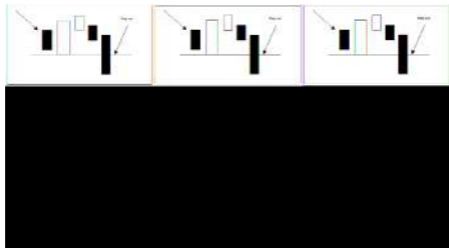


Figure 11.3: Stop out level for a Bullish Engulfing signal

That is the price at which the bulls started taking control from the bears. After the signal is confirmed, prices should not get back

through this point.

Piercing Signal

Where did the bulls take control from the bears in the Piercing signal in [Figure 11.4](#)?

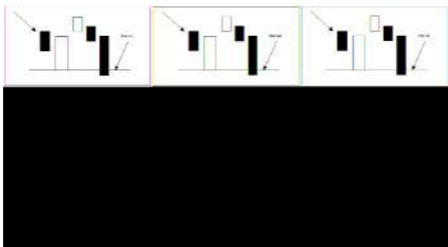


Figure 11.4: Stop out level for a Piercing signal

The bottom of the bullish candle! It then makes logical sense to put your stop loss just below (typically 0.1% below) this price point. The piercing signal is considered

negated if prices come back down through this point.

Bullish Harami

In the case of a Bullish Harami, the logical point to set the stop loss is just below the bottom of the bullish candle as shown in [Figure 11.5](#). The bulls had assumed control at that point and should not be letting the price slip below that.

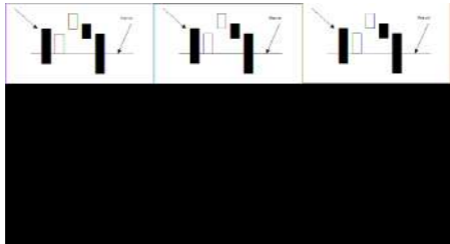


Figure 11.5: Stop out level for a Bullish Harami signal

Morning Star Signal

[Figure 11.6](#) shows a Morning Star stop loss scenario.

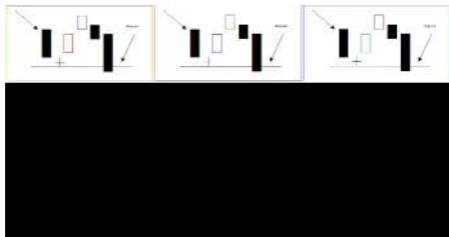


Figure 11.6: Stop out level for a Morning Star signal

As long as the price does not trade below the low of the signal formation, the bulls are still in control. The Morning Star signal is very powerful and rarely will one fail. But a

trader should be aware of the stop loss setting just in case it were to happen.

Hanging Man Signal

As shown in [Figure 11.7](#), the top of the Hanging Man signal is considered resistance. This is because the bears had seized control from the bulls at that price. If the bulls can take the price above the body of the Hanging Man, the signal is considered failed.

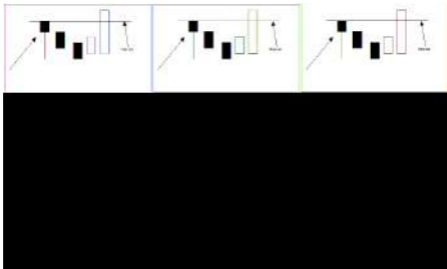


Figure 11.7: Stop out level for a Hanging Man signal

Shooting Star Signal

[Figure 11.8](#) shows the stop loss setting for a Shooting Star.

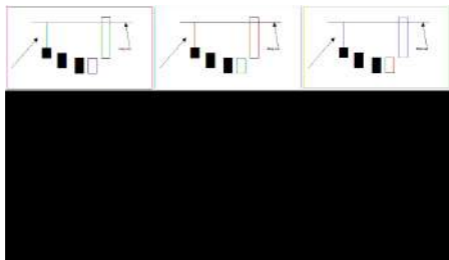


Figure 11.8: Stop out level for a Shooting Star signal

If you go short on a confirmed Shooting Star signal, get out immediately if the bulls manage to trade the stock above the high point. That piercing of the high point shows

strength on the part of bulls, something you as a short seller don't want to see!

Bearish Engulfing Signal

The bulls would be considered in charge of the stock again, if they can manage to close prices above the body of the dark candle as shown in [Figure 11.9](#). As a short seller, you do not want to be in this trade anymore.



Figure 11.9: Stop out level for a Bearish Engulfing signal

Dark Cloud Cover

It is recommended to set your stop loss just above the open of the dark candle of the Dark Cloud Cover in [Figure 11.10](#). That is the point where the bears seized control from the bulls previously. Prices trading above this point will negate this signal.

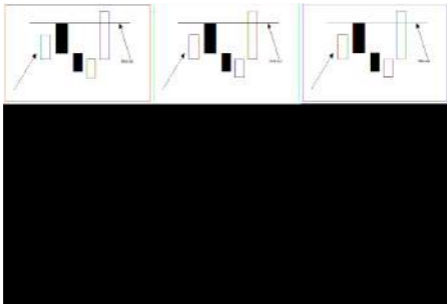


Figure 11.10: Stop out level for a Dark

Cloud signal

Bearish Harami Signal

As shown in [Figure 11.11](#), the open of the dark candle is resistance. It is recommended to place a stop just above this level. The bulls are assumed to be still in control if prices trade above this point.

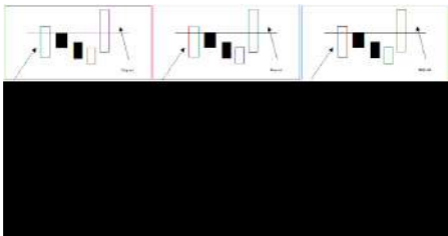


Figure 11.11: Stop out level for a Bearish Harami signal

Evening Star Signal

[Figure 11.12](#) shows an Evening Star signal stop loss scenario. The high of the Evening Star is a logical resistance point. Placing a stop loss just above this point would allow the candlestick trader to get out with only a small loss.

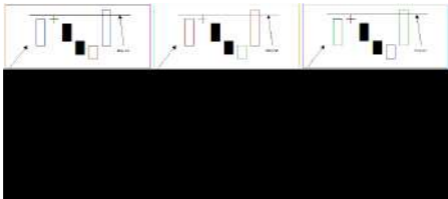


Figure 11.12: Stop out level for an Evening Star signal

The key point is to analyze what price action

is shown by the signals once you have entered the market. The price action should follow your expected path. This analysis should be done daily for all the positions held in the account. It should not take too much time to do this analysis once your eyes are trained and the signals are properly understood. That is the reason I have emphasized the importance of understanding the psychology behind the candlestick signals.

[Figure 11.13](#) shows the chart of Jaiprakash Associates.

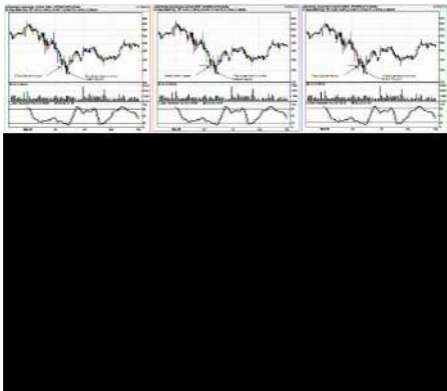


Figure 11.13: Failed Bullish Harami

You can notice in this chart that the first Bullish Harami would have given the trader a small loss. The trader should have got out as soon as the bears drove the prices below the open of the white Harami candle. A couple of days later, the trader should have

got back in on another Bullish Harami signal. This trade would have made a very good profit. You have to cut your losses short and let your profits run!

Some of you might be thinking — Why did I need the stop loss? Even if I would have held on after the failure of the first Bullish Harami, I would have not had much loss. The stock eventually rebounded.

Yes, you are correct that the stock rebounded. But would you have known that when the stock came down through the open of the Harami? How would you have known the extent of the downward slide from that point on? In reality, there is no way to know that. Hindsight is always 20 / 20. Then why

risk your money. Take the small loss and find another high probability signal. If you like this stock, then keep monitoring it. You have already witnessed one buy signal. The stochastics are oversold. Just wait for another buy signal. You would have been handsomely rewarded in this case if you would have entered on the second buy signal.

[Figure 11.14](#) shows the chart of Grasim Industries Ltd.

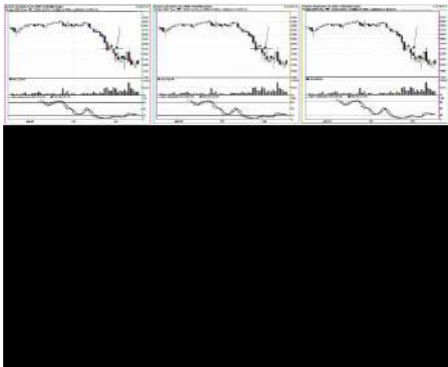


Figure 11.14: Failed Bullish Harami in Grasim

If a candlestick trader had bought this stock on 27 February 2007, right after the Bullish Harami in oversold condition, s/he would have been following the rules. The probabilities indicated that the Harami might have stopped the selling and the gap up next

day might have indicated some bullish sentiment. However, the trader should have sold out as soon as the stock breached and closed lower than the open of the Harami day. The probabilities were no longer in his or her favour. The stock can go down 10 more points from here, or 50 more points. Always trade with the probabilities!

[Figure 11.15](#) shows the chart of Syndicate Bank.

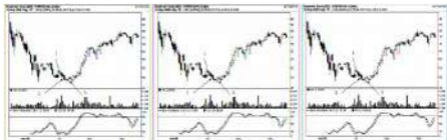


Figure 11.15: Trading the candle signals in Syndicate Bank

At the beginning of July 2006, we notice a bullish Harami Doji being formed. The next day there is confirmation buying (Point 1). The candlestick trader would get in at this point. There were two more conditions

which made this a good buy point:

1. Stochastics were in an oversold condition; and
2. The bullish Harami Doji formed near the same level where the stock found support in mid-June 2006.

As you can see from the chart, things did not go as anticipated. The candlestick trader should have sold out his position as soon as it closed below the bottom of the Harami (Point 2). Getting in the stock again after the Bullish Engulfing signal (Point 3), would have yielded a very profitable subsequent trade.

[Figure 11.16](#) shows the chart of L&T Ltd.



*Figure 11.16: Resistance becomes support
in L&T*

The Bearish Engulfing signal at the beginning of November (Point 1) was an excellent point to short sell the stock. The stochastics were in over bought conditions and the

signal confirmed a previous resistance point from mid-September. Let us analyze what happened from then on:

- A Morning Star signal stopped the downtrend. The trader would still be okay at this point.
- We then witnessed a Doji, then a Spinning Top, another Doji and another Spinning Top. All these indecisive days occurred at the same resistance level.
- Then a Shooting Star was formed. At this point the candlestick trader should be comfortable that the bears are not giving up on the stock. Though the bears are not too forceful in driving the prices lower, they are still the dominant party.

- The trader would then have witnessed the big dark candle confirming the Shooting Star. Everything is still implying that the supply exceeds the demand at around the ` 1,360 price range.
- Then we see a Bullish Harami occur. No reason to panic yet. The trader is still in the trade.
- The next day prices gap up over the resistance area indicating a change in investor sentiment. This is not what the stock should have been doing if the bears were still in control. It's time, therefore, for the trader to get out. The market has handed over control to the bulls.

[Figure 11.17](#) shows the chart of Hindustan

Petroleum Ltd.



Figure 11.17: Failed trade in Hindustan Petroleum

You will notice that a bullish Harami formed at the beginning of December 2006. Stochastics were in oversold conditions. The next day provided confirmation buying for the candlestick trader to get in. What should

be expected after that? Continued buying! However the trade fizzled out and the trader should have been stopped out as shown in the chart.

I would like to ask you to look at the chart in [Figure 11.17](#) again in a different perspective. Should you have even made this trade? Analyze the chart thoroughly. I have defined the “buy point” and the “stop out point” earlier. What is the target point in this case? Where do you expect the stock to reach?

Hint: Use concepts from the previous chapter.

[Figure 11.18](#) is the same as [Figure 11.17](#), but with the target point.

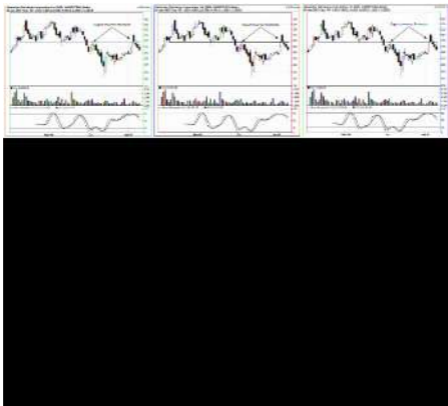


Figure 11.18: Re-visiting the previous trade with technical analysis

The target point in this case is the extension of the old support line. Notice the Head and Shoulders formation beginning in October and lasting till the end of November. The market broke the neck-line and then tried to

rally back above it, but failed.

So the candlestick trader, upon seeing the buy scenario, should have waited to get into the market until the new resistance was successfully breached to the upside. Otherwise the reward-risk ratio (described in the next section of this chapter) did not warrant the trade.

Also notice the stock failing to breach the resistance in January 2007.

As emphasized in the previous chapter, the concepts that “old resistance becomes new support once breached” and “old support becomes new resistance once breached” are a very powerful tool in the trader’s arsenal.

Hopefully, by now you have gained some confidence in the stop loss procedures using candlestick signals. Remember that the signals convey all the information you need to take a logical decision.

Trading Tips from a Candlestick Trader's Perspective

This section will detail some of the nuances that will help you improve your trading one notch further. These are not hard and fast rules, but a collection of my trading guidelines. Some have been learnt from observation and others of a trade from actual trading experience.

Always Work Out the Risk-Reward Ratio

If you have read any trading book, you know of the three basic price points you need to be aware of even before placing the trade:

- **The entry point** — this is the point to buy after a confirmed candlestick signal.
- **The stop loss point** — this is the point to exit the trade if the stock is not performing as expected.
- **The target point** — this is the point where you expect the stock to reach if the trade is successful, usually a previous high or perceived resistance level.

These points help you define the “reward to risk ratio” as follows:

$$\text{Reward / risk ratio} = \frac{(\text{Target point} - \text{Entry point})}{(\text{Entry point} - \text{Stop loss point})}$$

The higher the reward-risk ratio, the more compelling is the trade. Traders normally like to have at least a reward-risk ratio of 2, or higher. Personally, I like to see 3 or higher. You will have to decide what ratio you are comfortable with.

Just because you notice an excellent candlestick buy signal does not mean you have to enter the trade. Always calculate the reward-risk ratio. If you could lose ` 10 for a possible gain of ` 15, the trade is not worth

it, no matter how good the candlestick signal.

Don't Turn a Trade into an Investment

This is the most common mistake committed by traders. They see a good buy situation setting up. They notice the stochastics are oversold and can sense panic selling in the market. Then the buy signal is formed. They know their entry point, their target point and also their stop loss point. They enter the market feeling confident that the trend has reversed. The stock moves up as expected. The traders are happy. Everything is good and rosy. Soon, however, the stock starts dropping. The bears start taking control of the stock and push it down past through the stop loss point. The trader hesitates at this

critical juncture. Something inside his mind knows, now is the time to sell and accept the loss. But, then, hope crawls in. Hope, that ultimate trickster! The trader convinces himself that the stock will rebound anytime now. He promises to himself to get out as soon as the stock comes to break even. Alas, the market is unforgiving to such “weak hearted” traders. By the end of the day, the stock is down considerably. This leads to the biggest mistake of all. Now the trader convinces himself that the company whose stock he just bought is fundamentally very sound. The prospects for the company are great. He will keep holding and buying more, so he can average out the price.

The problem with this scenario is multifold:

- The trader has no inkling how far down the stock is going to go. So his portfolio is not under his control anymore.
- His money is now tied into an “investment” which is losing its value.
- He is losing other valuable opportunities by not having that money at his disposal, and, most importantly,
- He is mentally shaken and his confidence rattled by watching his portfolio go down.

Do not turn your losing trades into a long term investment. Get out if the candlestick signals fail and wait for another buy opportunity.

Avoid Trading Low Volume Stocks

Candlestick signals indicate the sum total of all the investment knowledge of the traders in that particular stock. The larger the number of traders participating in the stock, the better is the signal. High volume stocks are better to trade using candlesticks than very low volume stocks. [Figure 11.19](#) shows a chart of ACE India Ltd.



Figure 11.19: Avoid these kind of low volume stocks

This is not a good chart to trade from. As a candlestick trader, you want the chart to be clean. Look at previous reversal points on the chart. Usually, if a chart has given good signals in the past, it will give good signals

in the future. If you find a chart which is difficult to analyze, skip it. There are plenty of other charts to play with. Always get all the variables in your favour before you step into a trade.

Avoid Taking a Position before Earnings Reports

As a candlestick trader, you are relying on the signals on the chart. This is, by definition, technical trading. You do not want to engage yourself in fundamental decision making processes. When fundamental news hits the wires, technicals will take a backseat. Earnings declarations are one of the fundamental news a trader needs to stay away from. It is highly recommended to not have a position in a company which is about to declare its earnings. It is just not worth it. You can employ various hedging positions, but that is beyond the scope of this book. If you are in a stock whose earnings are

scheduled to be released after the bell, exit the position during the day. This does not mean that you should not trade during earnings season every quarter. Just make sure you exit the position before earnings are released. There are many other opportunities in the market to trade from. As a candlestick trader, you can watch what candle formations occur after the earnings news is released and then take a decision to go long or short. Similar fundamental news, such as a drug approval decision, a huge contract decision, takeover speculation, etc., should be treated the same way. Always keep in mind that you are a trader, not a gambler. Any trading situation in which a news outcome can completely disrupt your rationale for entering a position should be avoided. I

cannot emphasize this enough.

Don't be Trigger-Shy

Many traders experience hesitation in entering the market at the right time even after an excellent signal appears. This happens primarily because of a lack of confidence in one's trading skills. Such traders come up with different excuses as to why they should not trade "this time".

How many of the following excuses have you given yourself?

- The signal is good but somebody in the online chat group said not to buy this stock.
- Let me paper trade just this one more

time. I will buy from the next time onwards.

- Analysts on TV and newspapers are saying the market will go down now. So I will pass this good buy signal.
- Even though I can see a sell signal, everyone else is buying. The signal might be wrong. Let me pass this trade.
- I am not wearing my favourite coloured shirt, my hair is not combed, my makeup today is not good, and so on.

You get the point!

As a candlestick trader, you have centuries of testing backing you up. You understand the psychology behind the formations. You are

now able to see the market from the greed and fear perspective. You have confidence that the signals represent high probability reversal situations. You are also aware that should the signal go sour, you have decided the precise point to get out with a small loss. Trade confidently. You have to start. Otherwise, you cannot win.

Don't Target Buying Exact Tops and Selling Exact Bottoms

As a candlestick trader, you should not be concerned with buying at the exact bottom or selling at the exact top. That is a very difficult task compared to taking the chunk of the trend in between the top and the bottom. Some traders see a good bullish engulfing signal, prepare to buy on confirmation, but never do. They lament about not getting in at the bottom of the long engulfing candle. They do not look at the trend reversal and the fact that the stock can now give them a good up trend.

As a candlestick trader, you will only buy on

confirmation of the signal. You will only sell or short on confirmation of a sell signal. Nothing else matters.

Overbought and Oversold Conditions are Secondary to Candlestick Signals

We have used stochastics throughout the book to indicate overbought and oversold conditions. These are to be used only as indicators. The over-riding factor in any buying or selling decision should be the candlestick signal.

If you bought a stock on a buy signal when stochastics were in oversold conditions, then you will sell only when you analyze that the bears have taken control. Just because the stock has become overbought should not in itself mean anything to you. A stock, or any market for that matter, can stay overbought

for weeks or even months. Similarly, a stock or a market can stay oversold for a long time. This happens when the stock or market is in a trend. The trend channel, as described in the previous chapter, becomes the support and resistance for the stock. If the stock is in an up trend, it might not get to oversold conditions till the time it moves from the upper trend line to the lower trend line. Now, in such trending stocks you need to decide if you want to get out on a sell signal at the top of the trend and buy again when it gets to the bottom, or just keep holding the stock until it breaks the up-trending channel. This is a personal matter of choice.

The Trend is Your Friend

“The trend is your friend” is another adage in the stock trading world, which every trader should make use of in his trading. What this implies in simple terms is that a trader should trade only in the direction of the trend:

- If a stock is trending up, then only buy on candlestick buy signals and sell out on sell signals. Do not short sell on a sell signal.
- If a stock is trending down, then short sell on a candlestick sell signal and buy back on a buy signal. But do not buy long.

Imagine the market to be like a flowing river. If the river is flowing upstream, then why would you want to swim downstream, against the current? Use the strength of the current to your advantage. Swim upstream. So, too, with the markets. In an up trending stock, always buy on a candlestick buy signal. You can sell out when a sell signal appears to protect your profits. But shorting the stock is not advisable because the weight of the market is against you. When the stock breaks the up trend line, a new dynamic is generated. Use the candlestick signals to short the stock at the right time.

Targets are Only Targets

When you decide to enter a trade, you have a certain target in mind that you analyze the stock should be able to reach. You will take your profits at that point if the signals tell you to. This target point could be either:

- A previous major high or low;
- A major trend line;
- A Fibonacci re-tracement level; or
- A major moving average.

That is all very good. You have taken all the steps a trader needs to take before entering a trade. However, you must realize that the

market does not care who is trading it, what price level you entered at, or what price level is your target. That is all in your head. Those are parameters you have decided for your trade. It can very well happen that after you buy a stock, it goes up, but forms a candlestick sell signal before reaching your target. Please take profits. The markets are sending you a signal. Ignore it at your own risk. Targets are just that, targets. Nothing more! The signal is the over-riding factor.

If you see the stock climb back up after you sold on a sell signal, do not fret about it. You made a good trade and, more importantly, you abided by your rules. This will ensure your long term success.

Don't Become a Victim of Analysis Paralysis

There are over a hundred technical indicators which traders can use to help them decipher which way a stock is heading. Online charting has helped revolutionize technical trading. Traders can now program their own indicators and back-test them on different stocks. That shows them how accurate the indicators have performed in the past. They can then tweak the parameters which define the indicators and try to make them as accurate as possible. Technical traders take great pride in doing these exercises. However, many a time traders face the “analysis paralysis” phenomenon.

They have too many indicators and oscillators on the chart. This crowds the price action of the signal leading to indecision. Your goal as a trader is to identify the best possible support and resistance levels for the stock and act accordingly. If you have five different moving averages, Fibonacci re-tracement levels, support-resistance lines, along with stochastics, MACD, RSI, volume, on balance volume and a few other oscillators set up on the chart, it is going to get very confusing. The trader will never enter a trade if there are too many price points which could act as resistance or support, whichever the case may be. Let the chart be clear. Pick your favourite oscillator, a couple of moving averages and your trend lines.

You should also be aware that different oscillators will show oversold and overbought conditions at different times. One oscillator might suggest that the stock is still heading down while another might suggest it has bottomed. This again will lead to indecision on the part of traders as they will not be confident about the direction of the trade. So, keep the charts simple.

Money Management

Diversification is an important tool for traders as well as investors. If you have ` 10 lakh in your portfolio, please do not use the entire amount to invest or trade shares of just one company. That would be suicidal. A lot of traders and investors have been burnt because of lack of diversification. Any position you buy should not be such that it dramatically affects your portfolio upon getting a drastic hit though the position should be large enough to make you pay attention to it.

The following is an example of how I would build a portfolio with ` 10 lakh of capital. Let me emphasize — this is just an example.

You will have to decide what suits you and your trading style.

I would divide the capital into 10 parts, giving me ` 1 lakh each for ten trades. I would then find 10 stocks with candlestick buy or sell signals and enter into 10 different trades.

If the share price of a company is ` 50, I would buy 2,000 shares. If the share price is ` 500, I would only buy 200. This is to make sure I only use ` 1 lakh for each trade.

This keeps emotional buying out of a trade. Sometimes traders see an excellent buy signal in perfect conditions. They are sure beyond any doubt that this will be a winning

trade. So they buy more shares for this position. Unfortunately, if the trade goes the other way, they will be sitting on a much higher loss than should have been the case. Remember, you are always dealing with probabilities! Think of every trade as having the same probability of success. Do not favour one trade over the other.



12

Candlesticks for Longer Term Trading

Trading for the “Not-So-Active” Trader

Candlesticks work very well for investing purposes, too. There are people who do not like getting in and out of stocks very often. They want to participate in wealth building through financial instruments on a long term basis. Historically, markets have a tendency to drift higher. Most companies, after all, list themselves on the stock exchange to increase, and not diminish, their shareholder value.

These investors are willing to ride out the ups and downs of the market in anticipation of long term gains. It might work or it might not. In the world today where technology is

changing by the minute, there is no guarantee that a leading company today will be in existence even one year from now. To make sure that as an investor you are not investing in companies that will eventually wipe out your portfolio, you need to monitor the companies. Maybe not every day as a trader would, but at least once a week. When a company has something negative which would affect it in a fundamental way, guess where you will notice it? On the charts! In cases where a deterioration of company fundamentals is happening, most individual investors will not have a clue until the share prices tank. But the candlestick charts will show the investor what the company management is unwilling to.

Work with Weekly Charts

As an investor, you will look at the charts displayed on weekly time frame. Most charting services will allow you to display a chart in a daily, weekly or monthly time frame. You may have noticed that most of this book uses daily charts. However, candlestick signals work just the same way on a weekly chart or on a monthly chart. Nothing changes. The signal formations and the psychology behind them are exactly the same. For a weekly chart, the candle opens at the start of the trading week and closes at the end of the trading week. For a monthly candlestick chart, the candle opens at the start of the month and closes at the end of the month. For a weekly chart, the high and the low of the

candle are the highest price the stock reached in that week and the lowest price the stock reached in that week, respectively. For the monthly chart, the high and low are the highest price the stock reached in the month and the lowest price the stock reached in the month, respectively.

In general, if you are using weekly charts, you would expect to be in the market for weeks, or maybe even months, at a time. Your gains will be much higher than if you were trading the daily charts. On the flip side, if a signal faults out, you will not know of it until the end of the week when the candle closes. That would translate into a higher loss. But remember, again, the probabilities are on your side when you buy

and sell on a candlestick signal.

[Figure 12.1](#) shows the weekly chart of Bank of India.

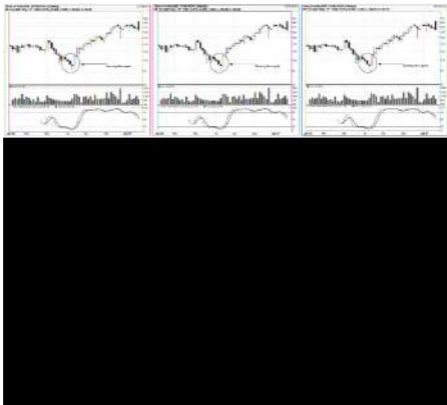


Figure 12.1: Morning Star in Bank of India with stochastics oversold

After weeks of selling and domination by the bears, the stock formed a Morning Star reversal signal. Also notice that the stochastics were in oversold conditions. The perfect time to buy would have been in the week after the week of the Morning Star signal.

As I mentioned before, none of the procedure for buying or selling changes when using weekly charts. The only change is the time frame of trading. The trader or investor using this chart would have stayed in the position for at least 2 months before exiting.

[Figure 12.2](#) shows the weekly chart of Syndicate Bank.



*Figure 12.2: Evening Star signal starts the
downtrend in Syndicate Bank*

In the early part of May 2006, you will notice an Evening Star formation. Long term traders could have put on short positions as soon as the signal got confirmed. The downtrend was stopped by a Doji-type

week, followed by a Bullish Engulfing signal.

[Figure 12.3](#) shows the Nifty index plotted with a weekly time frame.

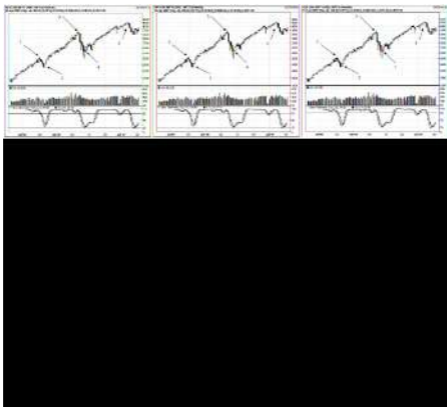


Figure 12.3: Trading candle signals on the Nifty weekly chart

This chart is proof that candlesticks work very well for indexes on a weekly time frame, just like they do on daily time frames. Notice the following points about the chart:

Point 1: An Evening Star signal stopped Nifty's advance at the beginning of October 2005.

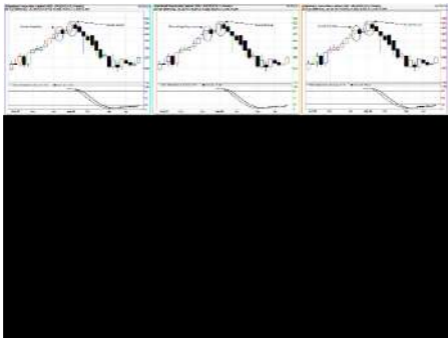
Pont 2: A bullish Harami signal ended the short downtrend in November 2005.

Point 3: The Nifty had a very good run till May 2006, where an ugly Evening Star formation broke its trend.

Point 4: This particular downtrend was broken in June 2006 by a Morning Star signal.

Point 5: In February 2007 you can witness a Doji type week, followed by a Hanging Man signal.

[Figure 12.4](#) shows the weekly chart of Jaiprakash Associates. Notice the strong up trend till ` 500 was broken with the formation of a Bearish Harami. The chart also points out a Bearish Engulfing signal prior to where the up trend reversed. At this point, and ask yourself, if one should have shorted the stock? Looking at the chart it is obvious that you should not have. What is the significant difference between the Bearish Harami and the Bearish Engulfing on this chart? Confirmation of the candlestick signal!



*Figure 12.4: Bearish Engulfing signal
topples Jaiprakash Associates*

It is very important for any candlestick signal to be confirmed before initiating a position. Notice that the Bearish Engulfing signal was negated with a Bullish Harami formation. The Bearish Harami formation was confirmed with another bearish candle and lower close. This would be the place to go

short anticipating a down move.

Observe the weekly chart of GMR Infrastructure in [Figure 12.5](#).



Figure 12.5: Trading with candles signals in the weekly chart of GMR Infrastructure

After a few Spinning Tops and small body candles throughout March 2007, the stock formed a Hammer signal. This was confirmed in the next couple of weeks

indicating the possible start of an up trend. This rally ended with a Shooting Star formation, confirmed by a bearish candle in the following week. Could this possible pullback have been anticipated? Maybe.

Where do most investors buy? Near the top! Notice the candles getting larger as the rally gained steam and the stock more than tripled. This is where the common man decides to jump in so as not to miss the boat. A very good sign that the stock is about to reverse.

One more point to emphasize is that technical analysis can be applied to weekly charts, just as it would to daily charts. Support / resistance lines, trend channels, technical patterns are formed by repetitive and

unchanging human behaviour. Fear is fear whether on a daily chart, a weekly chart or even on a 15 minute chart. There is nothing magical about it. We are prone to act the same way, no matter what our trading time horizon is.

[Figure 12.6](#) shows Infosys Technologies breaking out of a long downtrend on a weekly chart. Here are some key points to observe:

Point 1: An Evening Star formation starts the downtrend.



Figure 12.6: Using support / resistance on weekly charts

Point 2: A Bullish Harami confirmed the day after. Would one buy at this point given the downtrend line resistance just overhead? That would not be a good idea.

Point 3: A Hammer formation confirmed the day after. Apply the same logic as

Point 2.

Point 4: A Morning Star signal. There is a difference this time around. The investor sentiment has changed to a point where the stock breaks the downtrend resistance with a strong bullish confirmation. A good place to get in for a trade!

Point 5: An Evening Star signal confirmed one should get out of the trade.

Point 6: This emphasizes that old resistance once broken acts as support. A Morning Star signal at this point should prompt profit taking on the short side.

Finally, let's look at a weekly chart of MTNL in [Figure 12.7](#).



Figure 12.7: Candlestick signals on MTNL's weekly chart

The stock had been in an up trend from the end of July till the start of January. A few points to notice about the Bearish Harami

that formed at this point:

1. The Harami was confirmed with a bearish candle the following week;
2. The close of this confirming candle was below the up trend support line; and
3. The volume surged near the peak indicating last gasp buying from the bulls. This is a very good indication that the trend is about to be reversed. It is a simple point, no more buyers means lower prices.

For a trader who went short on a break of the up trend support line, a good place to exit the position would have been after a string of Doji were confirmed with a bullish candle in

March.

As you can see, the candlestick signals work the same in all time frames. For those investors who are seeking to ride the bigger trends and who do not have the time or passion to monitor the markets often, using weekly charts with candlestick signals would be an ideal scenario. However, remember that you still need to monitor the markets once in a week. Spending this time now monitoring your investments will generate huge rewards later in life.



Conclusion

I have made a sincere effort to write a no-nonsense book about trading using Japanese candlestick signals. I wanted to include a lot of history regarding the signals, but decided otherwise. The history and the Japanese nomenclature have no bearing on one's trading. The key is to understand the major signals and use them effectively.

I would like to urge readers to re-read the book until their eyes get visually trained to recognize the various signal formations. This

is because the signal recognition process should be instantaneous. A minute or two can then be spent analyzing the support-resistance levels and stop loss levels. Soon this entire process of finding potential profitable trades will be second nature to you. You will instantly know which charts look “tradable”. Instead of trying to find trades in all the charts, your experienced eyes will visually select the most profitable opportunities.

As mentioned before, it takes practice, patience and dedication to become a successful investor and trader. One of my early mentors in candlestick trading had a very good idea about practice trades. He used to put on his usual 5 to 10 trades at a

time. But, along with that, he also used to paper trade another 5 to 10 trades. This is an excellent way to test one's knowledge and get to know the market at the same time. If you involve yourself only in paper trading, you will be leaving out the key point — your emotional interaction with the market!

Start your journey with a small, but real position in the market. Then, as the profits grow, so can your trade size.

Do not fall prey to those who say you cannot time the market. With the right knowledge and practical money management techniques, you can reap huge rewards from any investment instrument. Also remember that you are not limited to trading only shares any

more. You can use candlestick signals for trading currencies and commodities as well. It is up to you to find your niche in the market. Not all traders like to trade everything. Some specialize in shares, some in commodities and some in currencies. You now have a powerful tool to use in whichever market you find comfortable.

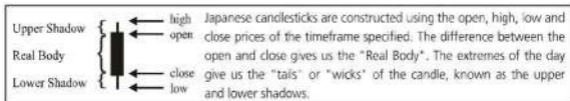
From now on, the market will look less chaotic to you. Though you cannot control the ups and the downs of the market, you will be able to take advantage of the swings. I would highly recommend the readers to get proficient in playing both sides (long and short) of the markets. Many traders develop a liking to trading to only the upside. Some are under the wrong impression that shorting

stocks is dangerous. With proper stop loss procedures, the risk in going short is the same as in going long. Traders who trade only side miss out when the markets are correcting, which inevitably happens. There is no difference as far as candlestick trading is concerned. This book has thoroughly discussed the candlestick sell signals and the readers should take advantage of them. Once you get fluent playing both sides, there will never be a dull moment in the market for you.

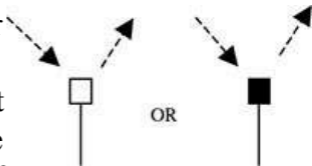
It is a big world out there with billions of rupees trading hands every day. It is my innermost belief that this book can help you put some of that abundance in your pocket!

Happy wealth building!

Appendix: Important Candle Signals - A Ready Reckoner



Hammer The lower shadow must be at least twice the size of the body length. There should be no upper



shadow or
a very
small
upper
shadow.

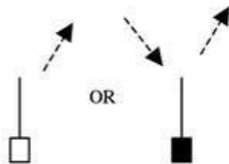
The colour
of the
body does
not matter,
but a white
body
would be
more
positive
than a
black
body.

Inverted Hammer

The upper shadow must be at least twice the size of the body length.

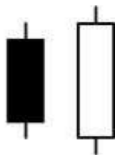
There should be no lower shadow or a very small lower shadow.

The colour of the body does



not matter,
but a white
body
would be
more
positive
than a
black
body.

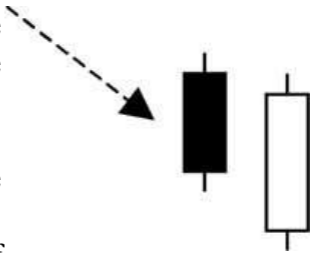
Bullish Engulfing
The second
day of the
signal
should be
a white
candle
opening



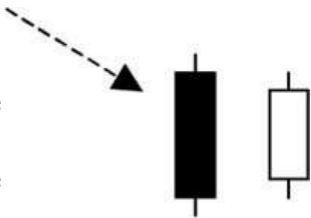
below the
Close of
the
previous
day and
closing
above the
Open of
the
previous
day's
black
candle.

Piercing The
Signal second
day of the
signal

should be a white candle opening below the trading range of the previous day and closing at least half way into the body of the previous day's dark candle.



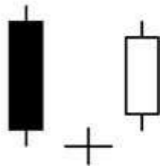
Bullish Harami The second day of the signal should be white and the body should be completely engulfed by the previous day's black candle body.



Morning The first

Star

day of the signal must be a long dark body. The second day must be a day of indecision. The third day should be a long white candle reaching at least halfway into the



body of
the first
day's dark
candle.

**Bullish
Kicker** The first
day of the
signal
must be a
long black
body. The
second
day must
be a long
white
candle
opening
above the

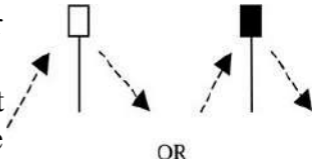


open of the
previous
day. An
ideal
Bullish
Kicker
will have
a GAP
between
the two
candles.

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Important Candle Signals - A Ready Reckoner

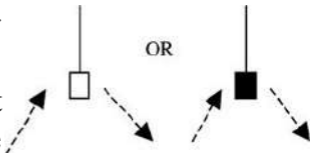
Hanging Man The lower shadow must be at least twice the size of the body length. There should be no upper shadow or a very small upper shadow.



The colour of the body does not matter, but a dark body would be more positive than a white body.

Shooting Star

The upper shadow must be at least twice the size of



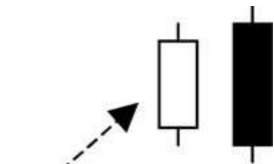
the body
length.

There
should be
no lower
shadow or
a very
small
lower
shadow.

The colour
of the
body does
not matter,
but a dark
body
would be
more

positive
than a
white
body.

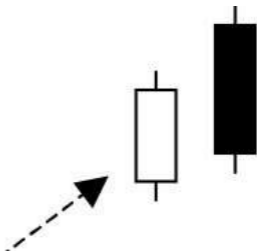
Bearish Engulfing The
second day of the
signal should be
a black candle
opening
above the
Close of
the
previous
day and



closing
below the
Open of
the
previous
day's
white
candle.

Dark
cloud
Cover

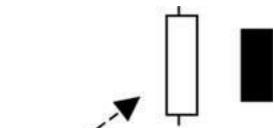
The
second
day of the
signal
should be
a dark
candle
opening
above the



trading
range of
the
previous
day and
closing at
least half
way into
the body
of the
previous
day's
white
candle.

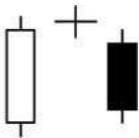
Bearish Harami The
second
day of the

signal
should be
black and
the body
should be
completely
engulfed
by the
previous
day's
white
candle
body.



Star

day of the signal must be a long white body. The second day must be a day of indecision. The third day should be a long dark candle reaching down at least halfway



into the
body of
the first
day's
white
candle.

Bearish
Kicker

The first
day of the
signal
must be a
long white
body. The
second
day must
be a long
dark



candle
opening
below the
open of the
previous
day. An
ideal
Bearish
Kicker
will have
a GAP
between
the two
candles.