

Candlestick Trading Strategies

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Candlestick Patterns

Using **candlestick patterns** is an effective trading strategy for technical analysts.

A **candlestick chart** reveals many insights using well-known Japanese candlestick formations and can be a leading indicator of market activity. Although many people are aware of Candlestick analysis, few actually understand how or why it actually works.

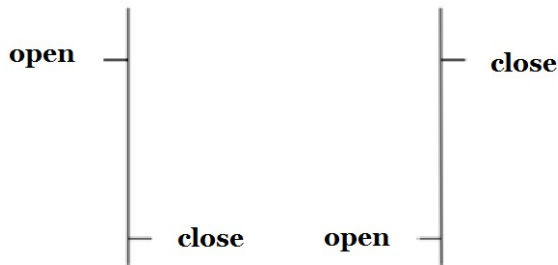
Understanding candlesticks can improve trader's investment profitability and is useful for those who [swing trade](#).

How to Read Candlestick Charts

What is the difference between candlestick charts and bar charts?

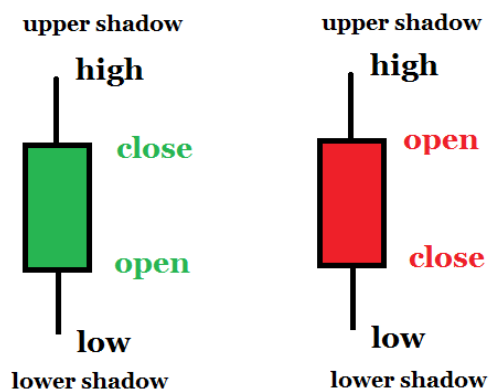
Once you start using **candlestick charts**, you will realize that bar charts do not provide the same clarity. A vertical line, as shown in the below picture, represents the daily price movement on a bar chart. The bottom of the line is the low of the day while the top of the line is the high of the day. A notch to the right side shows the closing price while a notch to the left side shows the opening price.

Bar Chart



In a candlestick chart, the horizontal lines represent the open and close. They form a box, called the real body. If the close is higher than the open, the body is green. If the close is lower than the open, the body is red. The lines extending from the body represent the extremes of the daily price movement. These are called upper and lower shadows.

Candlestick Chart



The contrasting colors of the bodies give us rapid visual interpretations. For example, when there is a series of declining red candles followed by an appearance of a green

candle, we would notice that immediately. That may not be something we notice right away when looking at conventional bar charts. These colors are for illustration only.

Some charts will use white instead of green and black instead of red.

Also, keep in mind that a green body does not mean that price was up from previous day and a red body does not mean that the price was down from the previous day. The body color only indicates where the close was compared to the open.

Candlesticks give us clues to price action and the market's mood. For example, bullish candles form when a stock opens, moves lower, tests support, and then bounces back to close at a high.

Candlesticks may be created for any time period – monthly, weekly, hourly, and even a minute. However, they should not be judged in isolation. Traders should see if there is a follow-up action to confirm the buy or sell signal.

Top 10 Candlestick Patterns

There are more than 100 candlesticks and **candlestick patterns**. This may seem daunting, but rest assured, we will focus on the candlestick patterns that are most popular and useful.

Each candle formation has a unique name. Some have English names and some have Japanese names. Let's learn about the most **common candlestick patterns**.

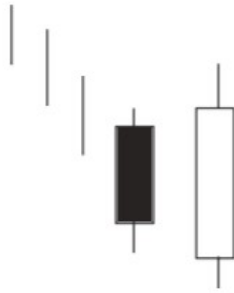
Doji

A [doji candle](#) is one of the most **important Candlestick signals**. It is a single-candle pattern that occurs when the stock opens and closes right at or near the opening price, forming a horizontal line. The lengths of the shadows can vary. The longer the shadows are, the more significant the Doji becomes. A doji represents uncertainty, indecision, and equilibrium between supply and demand. Neither the bulls nor bears are winning. Traders should not make decisions based solely on the doji. They should wait for the next candlestick to make an appropriate trade.



Bullish Engulfing

[Bullish engulfing](#) is one of the most well-known candlestick patterns and occurs when the price of a stock moves past the high and low of the previous day range. This pattern consists of two opposite colored candles and is easy to identify. The first candle is a narrow range that closes down for the day followed by a wide range candle that “engulfs” the body of the first candle and closes near the top of the range.



Bearish Engulfing

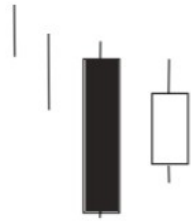
This is the opposite of bullish engulfing candlestick pattern. A [bearish engulfing](#) candlestick pattern composes of two candles, where the first one is a narrow bullish candle followed by a large bearish candle that “engulfs” the body of the first candle.



Bullish Harami

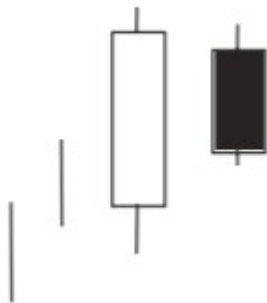
The Haramai pattern comprises of a two-candle formation in a downtrend. In a Bullish Harami pattern, the body of the first candle is long and is the same color as the current trend. This is followed by a narrow range candle that closes up for the day. The open and

close occur inside the open and close of the first candle. This pattern signals that the momentum preceding it has stopped and the trend is over.



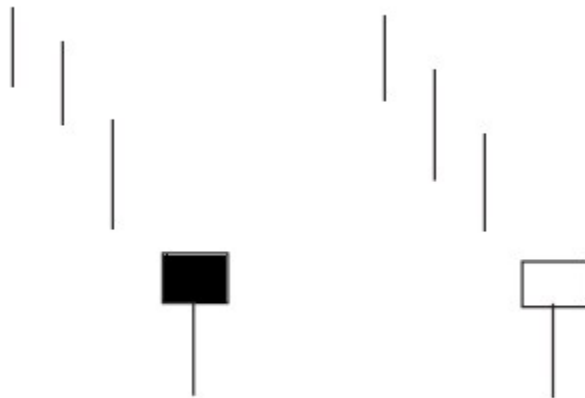
Bearish Harami

The Bearish Harami pattern is the exact opposite of the Bullish Harami pattern. It occurs when two candles form in an uptrend, where the first candle is long and is the same color as the current trend. The second candle is narrow and closes down for the day. The candle opens and closes inside the open and close of the previous candle. This pattern indicates that the trend is over.



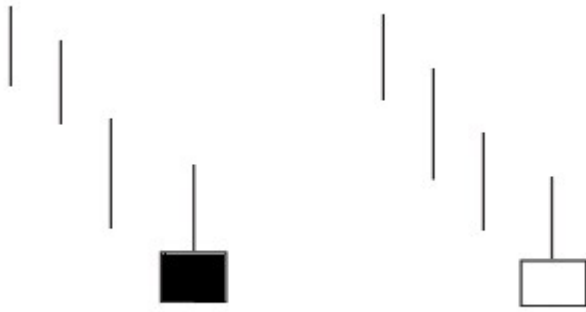
Hammer

The Hammer pattern consists of one candle that has a small body and a lower shadow at least two times greater than the body. It tends to appear in the shape of a hammer, hence the name “hammer.” It is found at the bottom of a downtrend and signals that the bulls started to step in. The color of the body is insignificant; however a green candle has slightly more bullish implications than a red candle. A positive day is required the next day in order to confirm this signal.



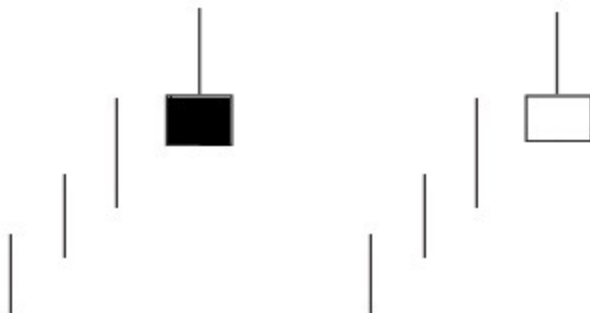
Inverted Hammer

The Inverted Hammer candlestick pattern is the reverse of the Hammer candlestick pattern. It also has a small body, where the open, close, and low are near the low of the candlestick and the upper shadow is at least two times greater than the body. This pattern is found at the bottom of a downtrend.



Shooting Star

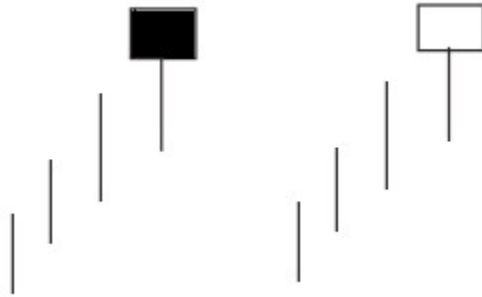
The Shooting Star has the same shape as Inverted Hammer, consisting of one candle with a small body and an upper shadow at least two times greater than the body. The difference is that the shooting star is found at the top of an uptrend. This pattern looks like a shooting star falling from the sky with the tail trailing it, hence the name “shooting star.”



Hanging Man

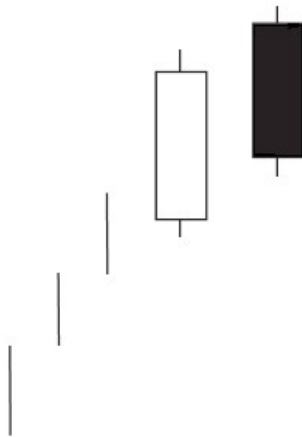
The Hanging Man has the same shape as Hammer, consisting of one candle with a small body and a lower shadow at least two times greater than the body. The difference is that

the hanging man is found at the top of an uptrend. This pattern looks like a head with the feet dangling down, hence the name “hanging man.”



Dark Cloud Cover

The Dark Cloud Cover pattern consists of a two-candle formation in an uptrend. The first candle is green, a continuation of the existing trend, and is followed by a red candle. The red candle's open is higher than the high of the previous day. It closes more than half way down the first candle.



How to Trade Doji Candlestick Patterns

Doji Candlestick Pattern

The **doji** is one of the most popular [candlestick patterns](#), as many traders think that it is one of the best ones to trade. It is a single candlestick pattern that occurs when the stock opens and closes near the opening price, forming a horizontal line. The body of the candle is usually very small and can have long wicks.



Doji Candlestick Analysis

A doji represents equilibrium between supply and demand where neither the bulls nor bears are winning. It signifies indecision and uncertainty in the price action of a stock. Although the lengths of the shadows vary, the longer they are, the more significant the Doji becomes. The Doji is an important alert at both the bottom and top of trends.

After an uptrend or a downtrend, the presence of the Doji candle shows that there is indecision between the bulls and bears. The price opens at a level, the bulls and bears move the price up and down during the day, but closes at the level that it opened. This signals that the trend might have lost its steam.

Trading Doji

The Doji candle is usually not a great entry candle for a trade and traders should not make decisions based solely on the doji. This is because the doji can be broken either way by the bulls or bears. Traders should wait for the next candlestick to make an appropriate trade, but it does signal that sentiment may be changing.

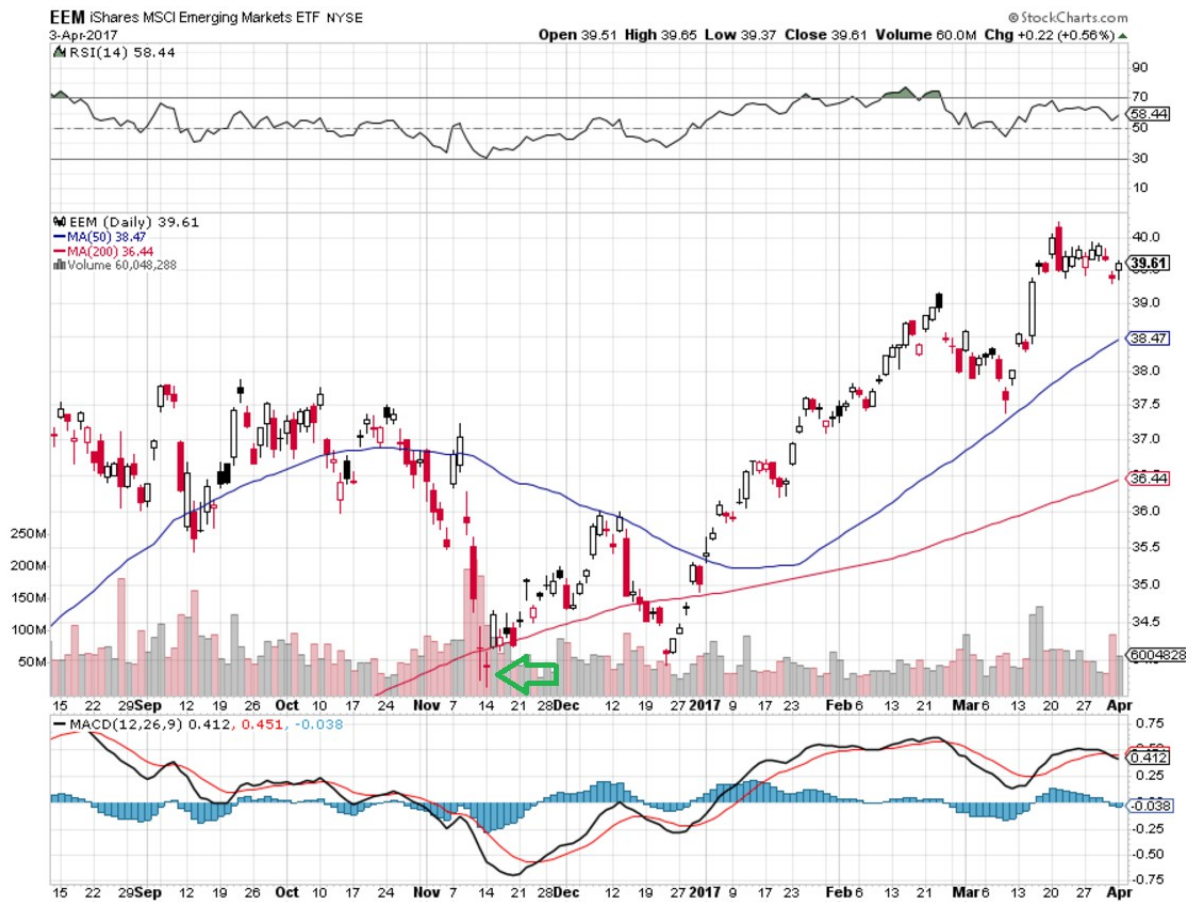
After an uptrend, the presence of a doji can be a warning that the trend has peaked or is close to peaking. The opposite is true when a doji that appears at the end of a downtrend. After an uptrend, the Doji signals a reversal without needing confirmation but after a downtrend, the Doji requires a bullish day to confirm.

It is important to pay attention to where the doji occurs. For example, if the stock is in the early stages of an uptrend or downtrend, then it is unlikely that the doji is signaling its peak or its bottom. It could just be a pause in the current trend move.

Making trading decisions based on doji candles is enhanced when there is large volume on the signal day and if it's after a long candle body.

Take a look at EEM's chart below. After a downtrend, there is a doji, signaling that the trend might be ending. As previously discussed, after a downtrend, it is better to wait for

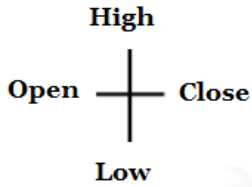
a bullish day to confirm the reversal. The price gapped up the next day, leading to an uptrend that lasted for over 4 months. You can use this bullish day as an entry point for this stock. There was also high volume during the appearance of the doji and it was after a long candle body, enhancing the reversal signal.



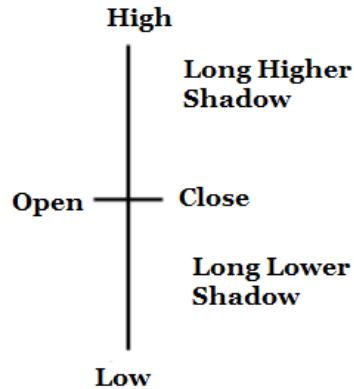
Types of Doji

The Doji has different names depending on the location of the opening/closing price and the lengths of the upper and lower shadows.

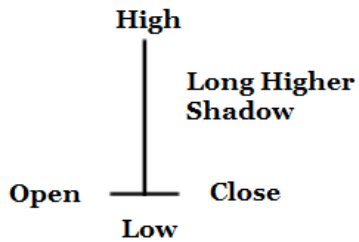
Neutral Doji



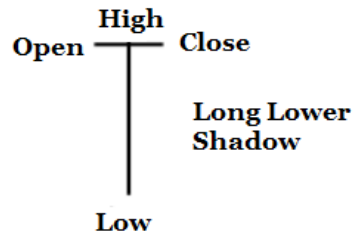
Long-Legged Doji



Gravestone Doji



Dragonfly Doji



A **Neutral Doji** is a small candlestick pattern where the price opens and closes in the middle of the day's high and low.

The **Long Legged Doji** (Juji) is similar to a neutral doji, but with long upper and lower shadows. This means that the price moved up and down significantly yet closed at or near the opening price. This reflects great uncertainty and indecision between the bulls and bear.

The **Gravestone Doji** is when the open and close is at the low of the trading range. The price opens at the low of the day, rallies, and then closes back down to the opening price. It signifies that all victories of the day have been lost by the end of the day, hence the name “Gravestone Doji.” At the top of a trend, a Gravestone Doji is a variation of the **Shooting Star**. At the bottom, it is a variation of the **Inverted Hammer**.

How do you trade a Gravestone Doji? A Gravestone Doji is a reversal pattern which can be either bullish or bearish depending on the position of the candlestick. If a Gravestone Doji appears after an uptrend, it may signal that the trend may start to reverse to a downtrend. Wait to see if the doji low is broken on the next candlestick. If it does, it gives you a sell signal.

The **Doji’s Dragonfly** is when trading opens at the high of the day, trades lower, and the closes at the open price. A long shadow at the bottom of a trend is very bullish. At the top of a trend, it is a variation of the **Hanging Man**. At the bottom of a trend, it is a variation of a **Hammer**.

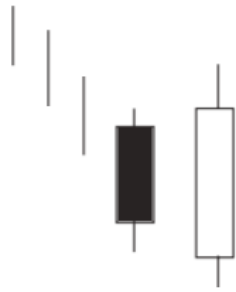
How do you trade a Doji’s Dragonfly? Although a Dragonfly Doji can be either bullish or bearish, the pattern works better for bullish reversals. If a Dragonfly Doji appears after a downtrend, it may signal that the trend may start to reverse to an uptrend. If the doji high is broken on the next candlestick, it gives you a buy signal.

How to Trade Bullish Engulfing Candlestick

Chart Pattern

Bullish Engulfing and **bearish engulfing** are amongst the top reversal patterns that traders use. They are one of the most popular [candlestick trading strategies](#). Both patterns consist of two opposite colored bodies. The **bullish engulfing pattern** forms after a downtrend, where its price opens lower than the previous day's close and closes higher than the previous day's open, thus "engulfing" the body of the first candle. The first candle is a black colored body that closes down for the day and the second candle is a white colored body that closes past the previous day's open. This pattern has to appear at a **support level**, after a bearish swing. Otherwise, if it appears at a resistance level, it is not a bullish engulfing.

The **bearish engulfing pattern** is the exact opposite. It forms after an uptrend, where its price opens higher than the previous day's close and closes lower than the previous day's open. In other words, the black candle engulfs the previous day's white candle. This pattern has to appear at **resistance level**, after a bullish swing. If it appears at a support, it is not a bearish engulfing.



Bullish Engulfing



Bearish Engulfing

To be considered an engulfing pattern, the second body has to completely engulf the first body. Shadows are not taken into consideration. The first candle should be the color of the previous trend and the second candle should be the opposite color. The only exception is when the first candle is a Doji. Prices also have to be in an uptrend or downtrend, even if it is short term.

Engulfing Candle Pattern

The **engulfing patterns** are more significant after a prolonged downtrend or uptrend. During the day of the bullish engulfing, prices usually open and start falling. Before the end of the day, strong buying interest comes in and the price rises and closes above the previous day's open. This shows that previously there was more supply than demand, but now the buyers are taking control.

On the contrary, during the day of the bearish engulfing, prices usually open and start rising. Then, strong selling interest comes in and the prices decreases and closes below the previous day's open.

Engulfing Candle Trading Strategy

Trading the engulfing candle patterns is a common [swing trading strategy](#). Like most **reversal patterns**, when you see these engulfing candles, it is a signal that the trend is about to reverse. You should consider exiting any positions you're holding or tighten your stops. Also, determine what additional confirmations you need to confirm the new trend.

When analyzing the engulfing patterns, pay attention to the size of the candle. The larger it is, the more significant the reversal may be. For example, an engulfing candle that “engulfs” several of the previous candles is more significant than one that just engulfs the previous day's candle. The ROSG chart below shows a good example of this.

After an upswing, a bearish engulfing pattern formed on November 23, 2016. This large candle engulfs many of the preceding candles in the short uptrend, indicating a strong reversal. This formation was followed by a downtrend that lasted for over four months. To enter the trade, a trader should not short sell on November 23 but rather wait for that day's low to be broken. Entry confirmation came on November 24 and a short sell can be initiated then. You can set up a stop loss at the November 23 high.



The below stock chart of IART has an example of a bullish engulfing pattern. After a downswing, a bullish engulfing pattern formed, indicating that the trend may reverse. To enter the trade, wait until that day's high is broken. Entry confirmation came the next day so you can purchase the stock then and set up a stop loss at the previous day low.



Engulfing Pattern Indicators

There are several key indicators that enhance the engulfing **reversal patterns**. It is important to look out for them because they increase the chances of a reversal.

- A large candle body engulfing more than one previous body indicates a strong reversal.
- If a candle body engulfs the previous day's candle body and shadows, it increases the chances of a reversal.
- Large volume on the engulfing day increases the chances of a reversal.

- The more the open gaps from the previous close, the greater the chance of a reversal.

To screen for the latest Bullish Engulfing stocks, use our [Bullish Engulfing Screener](#).



The above chart of MYOK shows a Doji's Dragonfly after a downtrend. It is followed by a bullish candle, giving us a buy signal. The stock reversed and continued to go up for about a month.

Trading doji patterns is one of the most popular [swing trading strategies](#).

Doji Screener

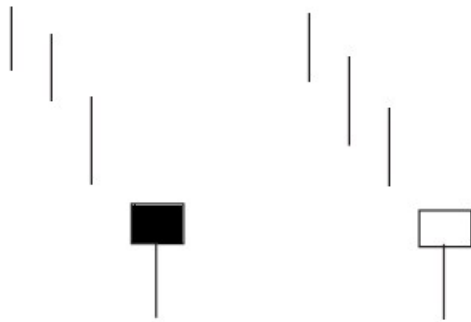
To find a list of stocks with a doji pattern, try the [doji screener](#).

How to Trade the Inverted Hammer Candlestick Pattern

Hammer and inverted hammer are amongst the top candlestick patterns. They are key reversal signals that traders look out for. First, let's understand the differences between a hammer candlestick pattern and an inverted hammer candlestick pattern.

Hammer Candlestick Pattern

The Hammer candlestick looks like a hammer, with a small body and a lower shadow at least two times greater than the body. The body is at the upper end of the trading range and there should be no upper shadow or a very small upper shadow. Overall, the shape looks like a hammer, hence its name. A hammer candlestick is found at the bottom of a downtrend and signals that, although the selling is still going on, the bulls have started to step in. The color of the candle body is insignificant but a white candle provides a more bullish signal than a black candle. A strong bullish day is needed the following day in order to confirm the Hammer signal.

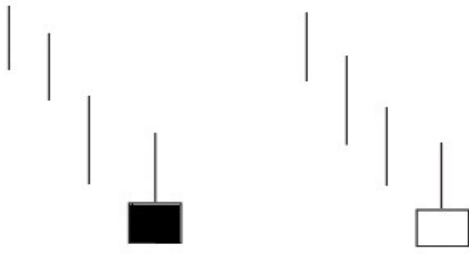


Hammer candlestick patterns represent weakness of the bears. They pushed the price lower after the stock opened but were unable to hold the price at its lows by close. The sellers were able to bring down the price down but the bulls stepped in and took over.

The Hammer has the same shape as the Hanging Man. The difference is that the hanging man is found at the top of an uptrend whereas the hammer is found at the bottom of a downtrend. The hanging man is the bearish version of the hammer.

Inverted Hammer Pattern

The Inverted Hammer pattern is the reverse of the Hammer candlestick pattern. Unlike the hammer pattern that has a lower shadow, this pattern is comprised of one candle that has a small body with an upper shadow that is at least two times larger. The open and close are near the low of the candlestick and there is no lower shadow or a very small lower shadow. An inverted candlestick is also found at the bottom of a downtrend and signals that the bulls have started to step in. Similar to the hammer pattern, the color of the small body is insignificant but a white body is more bullish than a black body. A strong bullish day is needed the next day in order to confirm the Inverted Hammer signal.



With an inverted hammer pattern, the buyers pushed the price higher after the stock opened but were unable to maintain it as some significant selling occurred. The stock closes near its opening price, with a rally in between. The presence of an inverted hammer signals a potential reversal upward.

The Inverted Hammer has the same shape as the Shooting Star. The difference is that the shooting star is found at the top of an uptrend whereas the inverted hammer is found at the bottom of a downtrend. The shooting star is a bearish version of the inverted hammer.

How to Trade Hammer Candlestick

During a downtrend, the bears are in control. The presence of a hammer signals that the bulls have started to step in. If the stock opens higher the day after Hammer day, a buy signal is triggered, confirming that the bulls have taken control and are trying to bring the price back up towards the top of the trading range.

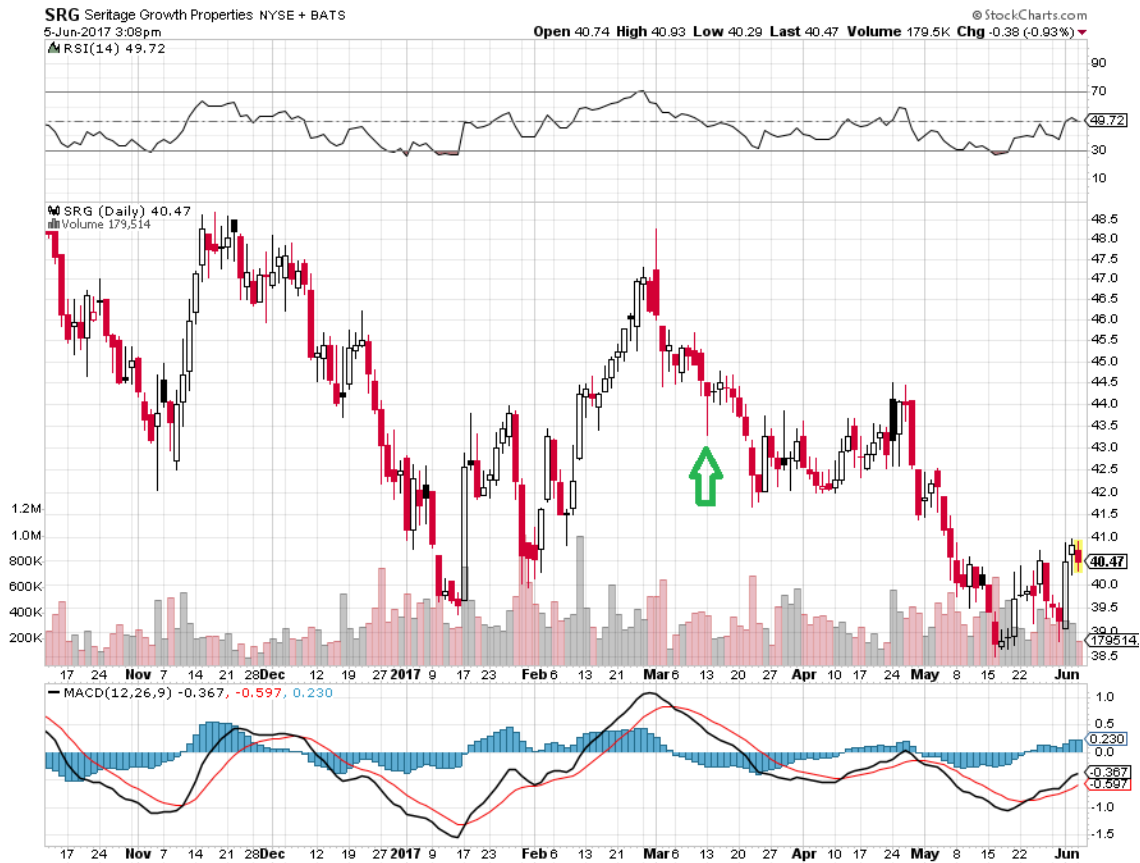
There are certain signals that enhance the likelihood of a trend reversal. For example, the longer the lower shadow of the hammer, the higher the possibility of a reversal. If there is large volume on the inverted hammer day, it also increases the chances of a reversal.

Take a look at the below chart of SU.



On the day of the hammer, the price opened and started to trade lower. The bears were still in control but by the end of the day, the bulls start to take over, forming a small body with a large lower shadow. The body is bearish, where the price closed below the open price. During the day of the hammer, there was a larger trading volume, meaning there is a higher chance of a reversal. The day after the hammer, the price gapped up, confirming a buy signal. The bulls are attempting to bring the price back upwards toward the top of the trading range. This shows that the bears were not able to maintain control. When trading the hammer, put a stop loss below its lowest point.

A bullish day after the hammer is needed in order to confirm the trend reversal. This doesn't always happen. For example, take a look at SRG below.



A hammer formed on low trading volume. Although a hammer formed, the price did not open higher the next day. Thus, a buy signal was not confirmed.

How to Trade Inverted Hammer Candlestick

The formation of an inverted hammer after a downtrend is bullish. The below chart of COST is an example of an inverted hammer pattern.



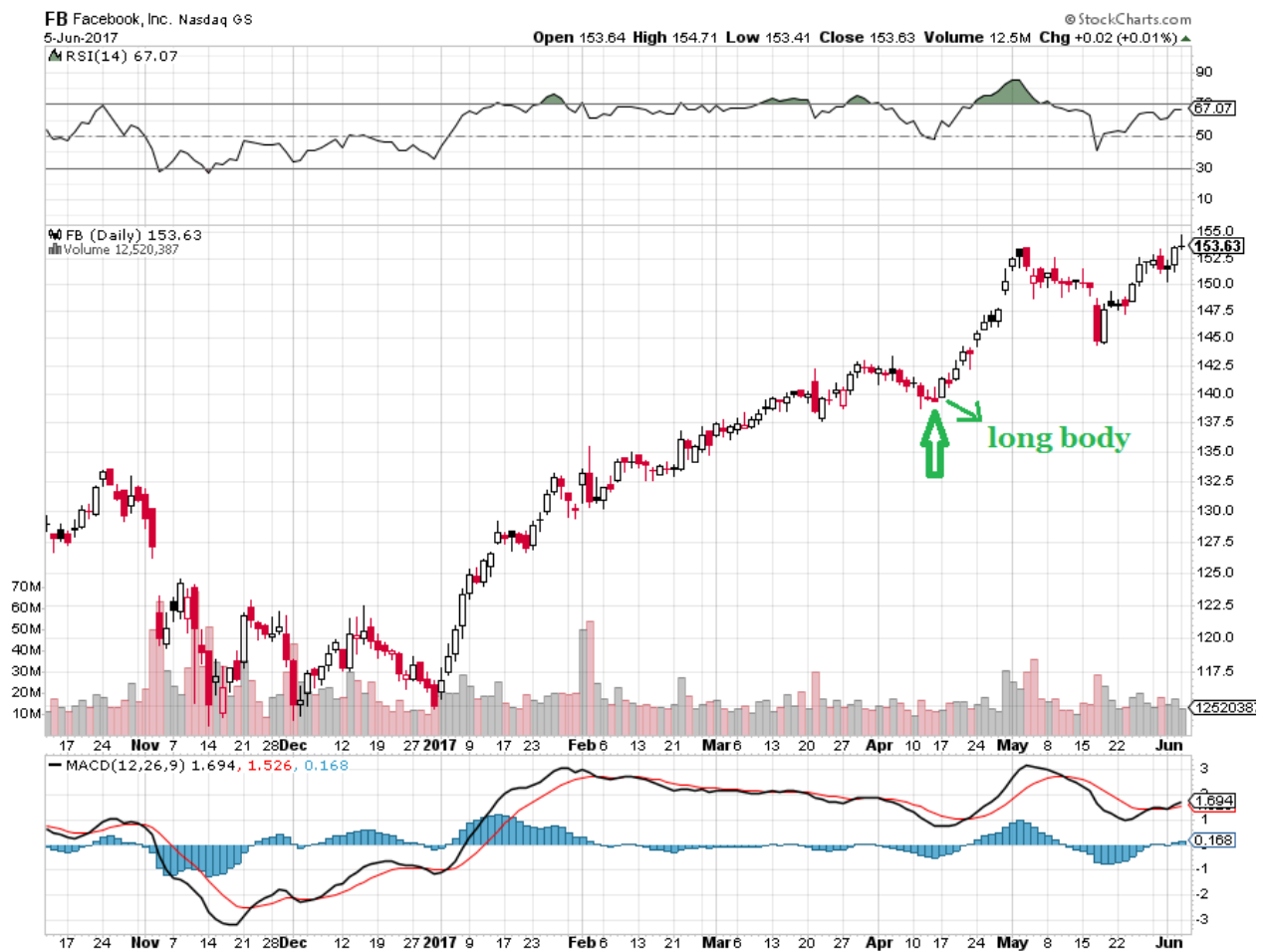
Prices stopped their movement downwards by rallying significantly during the day.

However, sellers took control back and pushed prices back near the open. The body is bearish, where the price closed below the open price. The fact that prices were able to increase significantly during the day shows that bulls are stepping in. If the stock opens lower the day after the market forms an inverted hammer, a sell signal is triggered. Since the stock opened higher, a buy signal is confirmed. If you are selling below the low of inverted hammer, you should put a stop loss above the pattern's highest price.

There are certain signals that enhance the likelihood of a trend reversal. For example, the longer the upper shadow of the inverted hammer, the higher the possibility of a reversal. If the body of the confirmation candlestick is large, the reversal long trade setup signal is

stronger. If there is large volume on the inverted hammer day, it also increases the chances of a reversal.

The below graph of FB shows an inverted hammer followed by a bullish candle with a large body. This large body confirmed a strong trend reversal. You can go long on the trade and set up a stop loss below the Inverted Hammer candlestick's close price.



It is important to note that a hammer or inverted hammer formation is not the signal to go long, but rather there are other indicators such as a confirmation candle that is needed the following day to confirm a buy signal. Although hammers and inverted hammers are reversal signals, they are not strong by themselves and need confirmation.

Understanding the hammer and inverted hammer patterns is one of the many [swing trading strategies](#).

Free Trading Ebooks

The following are ebooks on how to trade using technical analysis and stock chart patterns.

1. [Most Inspiring Trading Strategies](#)



Learn the 3 strategies that expert traders are using to beat the Forex and the stock markets. These trading strategies may give you inspiration on how you trade the market.

2. [Technical Analysis Ebook](#)



Learn how technical analysis work and how to use trend lines to recognize profitable trade setups.

3. [10 Keys to Successful Trading](#)

