Candlestick Charting FOR DUMMIES®

by Russell Rhoads

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About the Author

Russell Rhoads is a trader and analyst for Peak Trading Group in Chicago. His career in trading and market analysis covers over 17 years. He has a BBA and MS in Finance from the University of Memphis and has done graduate level work in Financial Engineering at the Illinois Institute of Technology. Russell also holds the Chartered Financial Analyst designation.

Dedication

To Bobbie, Dusty, Maggie, Emmy, and especially Merribeth.

Author's Acknowledgments

The most thanks must go to my wife Merribeth who through a very difficult year, that included producing this book, always was willing to yield to the time I needed to complete this project. Maggie, my daughter, was also always a helpful participant by working quietly alongside of Daddy when he needed to work. To Emmy, who discovered how to push buttons while this book was being written, thanks for not turning the computer off when Daddy hasn't saved his work.

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Introduction

Years ago, when I was playing around with my first quote machine on the floor of one of the Chicago exchanges, I came across the candlestick charting function. My personal charting software, which I ran on a DOS-based PC with no hard drive (yikes!), had no such function. When the candlestick chart popped up on the screen, I was fascinated by what came up, and my curiosity was piqued. The charting system looked useful and promising, but I didn't know much about it. It wasn't like I could just run an Internet search on candlestick charts to find out more, so I proceeded to the exchange library to find out about candlesticks.

The exchange library was stocked with just about every investment and trading related book in and out of print, but I was surprised to find very little information on my newly discovered method of charting prices. I could find only one book about candlestick charting, along with a couple of articles. And the articles were about the book! Not exactly what I'd call a wealth of information.

Fast forward to today. Candlestick charting is now far more of a mainstream trading tool than it was when I first saw it flash up on the screen of that primitive exchange floor computer. In fact, I recently noticed that the charts used in the *Wall Street Journal* are now candlestick charts. But although candlestick charts are more common in the financial world, not very many traders take full advantage of the vast potential of candlesticks.

I'm hoping to do my part to change that with this book. Candlestick charts can be hugely helpful in nearly every aspect of trading, and savvy traders should take the time to understand candlesticks and how they can enhance and enrich any trading strategy.

About This Book

This book isn't intended to be an end-all-be-all guide to profitable trading. It's meant to provide readers with some insight into how candlesticks are created and how they can be used to analyze the psychology behind what happens over the course of trading days. (When I say "psychology," I'm not trying to conjure up images of Freud and Rorschach tests; I'm talking about the motivating factors that help to determine how the market behaves.)

I hope that the candlestick methods described in this book help readers to make trading and investment decisions that lead to solid profits, but unfortunately, there's no guaranteeing that. What I can guarantee is that after reading this book (or even parts of this book), you can gain a useful understanding of what candlesticks are, what they represent, and how they can be used in trading.

Conventions Used in This Book

To help you navigate this book, I use the following conventions throughout:

- *Italics* are used for emphasis and to highlight new words that are presented with easy-to-understand definitions.
- **Boldfaced** text is used to indicate key words in lists.
- `Monofont` is used for Web addresses.

I make an effort to use as many examples as possible in the text, and each and every example I present is one that I found while searching through actual charts. I did that to show you not only how common it is to come across these candlestick patterns in everyday trading, but also how eminently possible it is to use them in live trades. They're out there, and they're waiting for you to harness their power!

Also, with each new candlestick pattern that I introduce, I present at least one case where it succeeds in producing a useful signal and one where it produces a dud. Candlesticks are terrific, but they're not perfect, and recognizing the failure of a signal is just as important as picking up on a valid signal.

What You're Not to Read

When you come across the Technical Stuff icon, you may skip ahead because this icon indicates information that's additive to trading knowledge, but not essential to gaining knowledge about candlestick charting.

You can also skip the sidebars that are placed throughout the text if you're pressed for time or you want only the essential information. Sidebars contain nonessential material, and you can tell them apart from the rest of the text because they're placed in gray shaded boxes.

Foolish Assumptions

Because knowledge of candlesticks varies widely from trader to trader — even traders with the same amount of trading experience can differ quite a bit in their candlestick know-how — I've made the assumption that you have at best a very basic understanding of what comprises a candlestick chart. My apologies if you already know a little about candlesticks, but hey, it never hurts to review and hone those essential candlestick skills. I build understanding from the ground up, beginning with how to create individual candlesticks and finishing with how complex candlestick patterns can be combined with other forms of technical analysis. Also, I'm operating under the assumption that you've had some sort of experience trading a stock or at least a mutual fund. I assume that you've spent some time looking over stock charts in the past too.

How This Book Is Organized

I've organized *Candlestick Charting For Dummies* into five parts. Each part offers a different set of information and skills that you can take away to incorporate in your personal trading strategy. You get a feel for candlestick basics or understand some simple candlestick patterns and how to trade based on them. You tackle some more complicated patterns and figure out how it's possible to use candlesticks in tandem with other popular technical indicators. The possibilities for candlestick charts are many and varied, and I do my best to touch on a wide range of their uses and benefits.

Part I: Getting Familiar with Candlestick Charting and Technical Analysis

In the first part of this book, I introduce candlestick charting and some other basic charting concepts. You may be wondering what advantages candlesticks have over other types of charts. Believe me, the rewards are plenty, and you can read all about them in Chapter 2. Want to know what price data elements are combined to generate a candlestick? That's all contained in Chapter 3, along with some information on how to embrace the other types of data that you may run into when reviewing candlestick charts. And in the last chapter of Part I, I also let you know how to tap into a variety of free and for-purchase electronic resources for charting, which are critical in today's high-tech trading environment. I even include a low-tech alternative: how to draw charts yourself.

Part II: Working with Simple Candlestick Patterns

Part II features descriptions and explanations of some of the most basic and common candlestick patterns. The simplest candlestick patterns involve just one day or one period of price data, and you can find information on those patterns in Chapters 5 and 6.

Two-stick candlestick patterns are one step up from those basic patterns, but just a single step up in complexity can provide quite a bit of additional information and versatility. Some extremely helpful two-stick candlestick patterns pop up frequently on candlestick charts, and if you want to really capitalize on candlesticks in your trading strategy, you need to know how to identify and trade them. Don't worry; I've got you covered in Chapters 7 and 8, which wrap up Part II.

Part III: Making the Most of Complex Patterns

Three-stick patterns are the most complex patterns that I deal with in this book, and their nuts and bolts are explained in this part. (Three-stick patterns in Part III — convenient, right?) Like their one- and two-stick counterparts, three-stick patterns tell you what a market or security is about to do next, and the added stick means that these patterns are a bit more rare but that much more exciting. You can get your three-stick candlestick pattern bearings in Chapters 9 and 10.

Part IV: Combining Patterns and Indicators

I begin Part IV with Chapter 11, which offers a more in-depth discussion of several other technical indicators. It's useful for any trader to understand a variety of indicators because you can use them alone, to confirm your candlestick signals, and in combination with candlestick patterns.

Although candlestick patterns alone have proven to be reliable trading tools, using them in combination with other indicators can greatly enhance their ability to predict the future direction of a market or a stock. In the rest of Part IV, I take some simple and complex patterns and combine them with pure technical indicators to show you how coupling the two techniques can lead to profitable trading. The chapters in this part are chock-full of fascinating real-world examples from a variety of markets and industries.

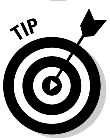
Part V: The Part of Tens

You can't have a *For Dummies* book without a Part of Tens, and this book is certainly no exception. The final part includes a few helpful lists, including myths about trading, a few things to keep in the back of your mind about charting, and some resources that you can consult to further your candlestick understanding.

Icons Used in This Book

I used the following icons throughout the book to point out various types of information:

When you see this icon, you know you want to store the accompanying nugget of candlestick or trading wisdom somewhere safe in your brain.



This icon offers hands-on advice that you can put into practice as you trade. In many cases, the information found next to this icon tells you directly how to conduct a trade on a pattern or technical analysis method.

If you ignore this information, you can wake up one day in a den full of writhing, angry pit vipers. Okay, so it's not *that* bad, but this icon really helps you avoid making costly trading mistakes.

This icon flags places where I get really technical about charting. Although it's great information, you can safely skip it and not miss out on the discussion at hand.

Where to Go from Here

To figure out which area of this book to dive into first, think hard about what facet of candlestick charting you want to understand. Want to get grounded in the basics, or polish up on a few candlestick fundamentals that you may have forgotten since you read that online article about candlestick charting months ago? Check out the next page, on which Part I begins.

If you want to get cracking and find out about a few real candlestick patterns and how they can tell you what a market or security is going to do next, I suggest that you flip to one of the chapters in Parts II or III. I cover many candlestick pattern examples in those chapters — more than enough to give you plenty to look for as you pore over charts on the Web or on a charting software package.

You may have been recently exposed to some other technical indicators and it's possible that reading about candlesticks alongside some of that familiar material may help you get your feet wet. If so, make a beeline for Part IV, and enjoy!

The water's fine no matter where you choose to dive in, and you're just a few page-turns away from adding a powerful weapon to your trading arsenal.

Part I

Getting Familiar with Candlestick Charting and Technical Analysis

The 5th Wave By Rich Tennant

"Trendlines? Channels? Breakouts? I say we stick the money in the ground like always, and then feed this guy to the sharks."

In this part . . .

I don't know of any traders or investors who've taken the time to fully understand candlestick charting and then not used the techniques in their trades. After you've taken the time to grasp candlestick basics, it's tough to deny their advantages over other types of charts, and the profits can certainly speak for themselves. But the basics must come first, and that's what Part I is all about.

I begin this part by setting candlesticks in context with several other types of charts, so you can get a feel for candlestick benefits. After that, I explain the price action and signals that candlestick charts generate, and I show you how a candlestick is constructed and what its variations can mean. To close Part I, you look at the range of electronic resources available for candlestick charting, which you can exploit with just a few clicks of your mouse.

Chapter 1

Understanding Charting and Where Candlesticks Fit In

In This Chapter

- Taking a look at options for charting and why candlesticks are superior
- Making sense of candlestick construction
- Exploring the wide variety of candlestick patterns
- Using technical analysis alongside your candlestick charts
- Understanding a few trading and investing basics

The advent of the Internet has leveled the playing field for securities traders. Access to markets once meant placing orders through a broker, and now it's little more than a couple of mouse clicks away. Commission rates are dramatically lower, and access to market information is now in many cases free. Getting into securities trading is now easier than it ever has been, and the result is a whole generation of investors and traders that handle their finances without professional help. Technology allows these people to enjoy many new types of market information, and one of the best tools available is candlestick charting.

Candlestick charting methods have been around for hundreds of years, but candlesticks have caught on over the past decade or so as a charting standard in the United States. I've been working with candlestick charts for quite a few years, and I've seen many traders — novice to professional — develop a fierce loyalty to candlesticks after taking the time to understand their uses and potential. I think you'll feel the same way, and this book is the first step on the path to conquering candlesticks.

The material contained in this chapter exposes you to many of the facets of candlestick charting that continue to fuel its rise as one of the most popular charting techniques. I begin with the overall role of candlesticks within the context of charting. I cover the advantages of candlestick charting, and the basics of candlestick construction. I also take the opportunity at the end of this chapter to discuss how to get started as well as give some insight into the characteristics and habits that successful traders employ in their pursuit of profits. Enjoy, and happy charting!

Considering Charting Methods and the Role of Candlesticks

With advancements in technology and the growing availability of trading and investing resources available to traders, many options exist for the charting of securities. There are several different types of charts and dozens of variations and features to be configured on each type. It's important that you're clear on the options and, perhaps more importantly, why candlestick charting is at the top of the heap. This section explains.

Getting a feel for your options for charting

When it comes to alternatives to candlestick charting, the three main charting contenders are as follows:

- **Line charts:** These charts are simple and helpful for short-term decisions, but they're quite limited in the amount of data presented.
- **Bar charts:** These are much more useful than line charts and are the most common, but they're not as versatile as candlestick charts.
- **Point and figure charts:** These are tried-and-true charting methods, and they're great for recognizing support and resistance levels, but they're far less dynamic than candlestick charts.

Each one of these charting methods can be used effectively to ratchet up the effectiveness of your trading strategy, but they pale in comparison to candlestick charts for a number of reasons, a few of which I describe in the next section.

Realizing the advantages of candlestick charting

You'd be hard pressed to find someone who's more enthusiastic about candlestick charting than yours truly. I can go on and on about the advantages that candlesticks afford. If you want to read more of my gushing about the many great advantages of candlestick charting, turn to Chapter 2, but here are my top reasons:

- One of the best features of candlestick charting in general is the visual appeal and readability. You can glance at a candlestick chart and quickly gain an understanding of what's going on with the price of a security. You can also tell whether sellers or buyers have dominated a given day, and get a sense of how the price is trending.
- Also, even after reading up on the most rudimentary of candlestick basics, you can easily spot the opening and closing price for a security on a candlestick chart. These price levels can be very important areas of support and resistance from day to day, and knowing where they are can be extremely helpful, especially for short-term traders.
- Candlesticks aren't just a pretty face. Candlestick charts also feature specific patterns that you can identify and use to decide when it's time to buy, sell, or wait on a trade or investment. These patterns can be a real boon to your work with securities, and you can combine them with other technical indicators for even more reliable results.

Understanding Candlestick Components

You can't trade and invest effectively by using candlestick charts unless you understand candlestick patterns, and you may have a very hard time understanding those patterns if you aren't familiar with basic candlestick construction. Candlestick charting starts with the knowledge of what it takes to make a candlestick and how changes in that basic information impact a candlestick's appearance and what it means. For starters, you need to know what goes into creating a candlestick's wick (the thin vertical line) and its candle (the thick part in the middle).

The following four pieces of information are combined to create a candlestick:

- **Price on the open:** The price at which a security opens on a given period is the first piece of information used in creating a candlestick. Depending on whether the security's performance is bullish or bearish, the opening price corresponds to either the bottom edge of a candlestick's candle or the top edge.

  Candlesticks that represent *bullish* price action appear *white* on a chart, and candlesticks that represent *bearish* price action appear *black*.
- **High price:** The highest price that a security reaches during a given period corresponds to the top of a candlestick's wick. If a security opens at a certain price and then trades consistently lower than that price throughout the period, there won't be any wick at all above the candle.
- **Low price:** The lowest price that a security reaches during a period corresponds to the bottom of a candlestick's wick. If the price action for that period is extremely bullish and prices trade higher than the open, there won't be any wick below the candle.

- **Price on the close:** After a security finishes trading during a given period, its closing price is the last piece of information used to create a candlestick. Depending on the security's performance during that period, the closing price can correspond to either the top edge of a candlestick's candle (if the period was bullish) or the bottom edge (if the period was bearish).

As a true candlestick devotee, I believe that you can gain far more insight into a period's trading by looking at a candlestick than you can by looking at another type of charting tool. Want proof? Take a look at Figure 1-1.

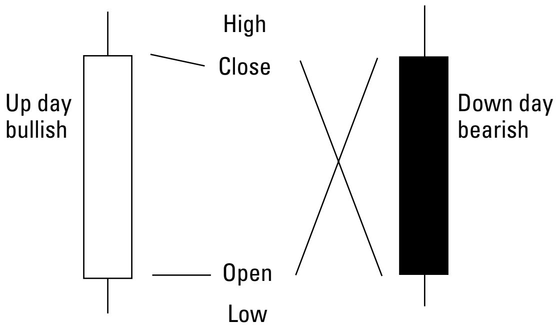


Figure 1-1: Bullish and bearish candlesticks side by side.

You can tell right away that the up day has a white candle and the down day has a black candle. That simple difference alone clearly reveals the nature of the price action that took place during that period. In the case of the candlestick with the black candle, there was more selling pressure than desire to buy. And the candlestick with the white candle indicates that there was more buying pressure than desire to sell.

Why is this so important? Candlestick charts quickly clue you in on the type of buying and selling that's been going on during a given period and where it may occur again. In many cases, the buyers continue to buy and the sellers continue to sell during subsequent periods or if the price reaches a level that has spurred them to action in the past.

For more information on candlestick construction, refer to Chapter 3.

Working with Candlestick Patterns

The components of a candlestick may be the bones of candlestick charting, but candlestick patterns are the heart and soul. Patterns appear on candlestick charts as simple, single-stick occurrences or complex, multi-stick