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Understanding The 10 Key Reversal Candlestick Patterns

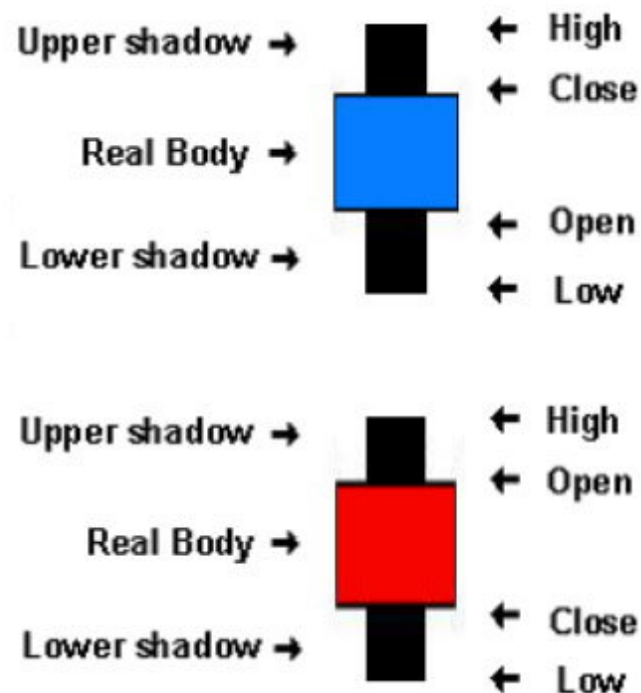
Candlestick Basics – Understanding Price Action & Volume

Candlestick charts are my personal preference for analyzing the market. What I like about them is the fact that price patterns are easy to see. But in order to read and trade off the charts you must understand how to read candles and candlestick patterns.

There are 4 data points to a candle which are the open, high, low and close values. The colored portion of the candlestick is called "the body" (also referred to as "the real body"). The long thin lines above and below the body represent the high/low range and are called "shadows" (also referred to as "wicks" and "tails"). The high is marked by the top of the upper shadow and the low by the bottom of the lower shadow. If the stock or etf closes higher than its opening price, a blue candlestick is drawn with the bottom of the body representing the opening price and the top of the body representing the closing price. If the stock or etf closes lower than its opening price, a red filled candlestick is drawn with the top of the body representing the opening price and the bottom of the body representing the closing price.

While there are dozens if not hundreds of candlestick patterns out there, most are just variations of these key reversal patterns below. I focus on the ten key reversal patterns which work on any time frame.

Candlestick Formation



Doji Candles - (Neutral)

Pattern Type: Reversal



Identification:

1. Long upper and lower shadows
2. Real body is small and in the middle of candle

The Psychology Behind The Move

This candlestick has long upper and lower shadows with the Doji in the middle of the day's trading range, clearly reflecting the indecision of traders. This pattern does not mean much as it could be a pause before price continues or it could be the beginning of a trend change. While many people try to trade doji's the fact is they don't show if there is strength or weakness. Only when it occurs at a support or resistance level would it have some potential as a reversal candle.



Bullish Hammer Candle

Pattern Type: Reversal



Identification:

3. Small real body near the top of candle.
4. Color of the body is not important.
5. Lower shadow is at least twice the length of real body.
6. Little or no upper shadow.
7. Previous trend should be down (bearish).

The Psychology Behind The Move

In a downtrend or within a pullback of an uptrend, a sharp intraday sell-off is followed by a reversal which causes the stock or etf to close near its opening price near the day's high. This hints at the possibility of a reversal back up. The bulls most likely were shaken out by the intraday weakness from a breakdown a short term support level, and shorts start getting a little worried with the end of day bounce. This pattern is a slightly more reliable if the real body is blue, but a strong following day on solid volume is still needed to confirm the pattern.



Hanging Man Candle

Pattern Type: Reversal

Identification:

1. Small real body near the top of candle.
2. Color of the body is not important.
3. Lower shadow is at least twice the length of real body.
4. Little or no upper shadow.
5. Previous trend should be up (bullish).



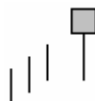
The Psychology Behind The Move

In an uptrend or within a bounce of a downtrend, a sharp intraday sell-off with heavy volume is followed by a reversal and drift up on light volume which causes the stock or etf to close near its opening price near the day's high. Although the stock or etf recovers from its intraday sell-off, it suggests that the bulls are starting to lose strength, and a reversal may occur. The pattern is a slightly more reliable if the real body is red. Selling the following day on solid volume is still needed to confirm the pattern.



Hanging Man Candle

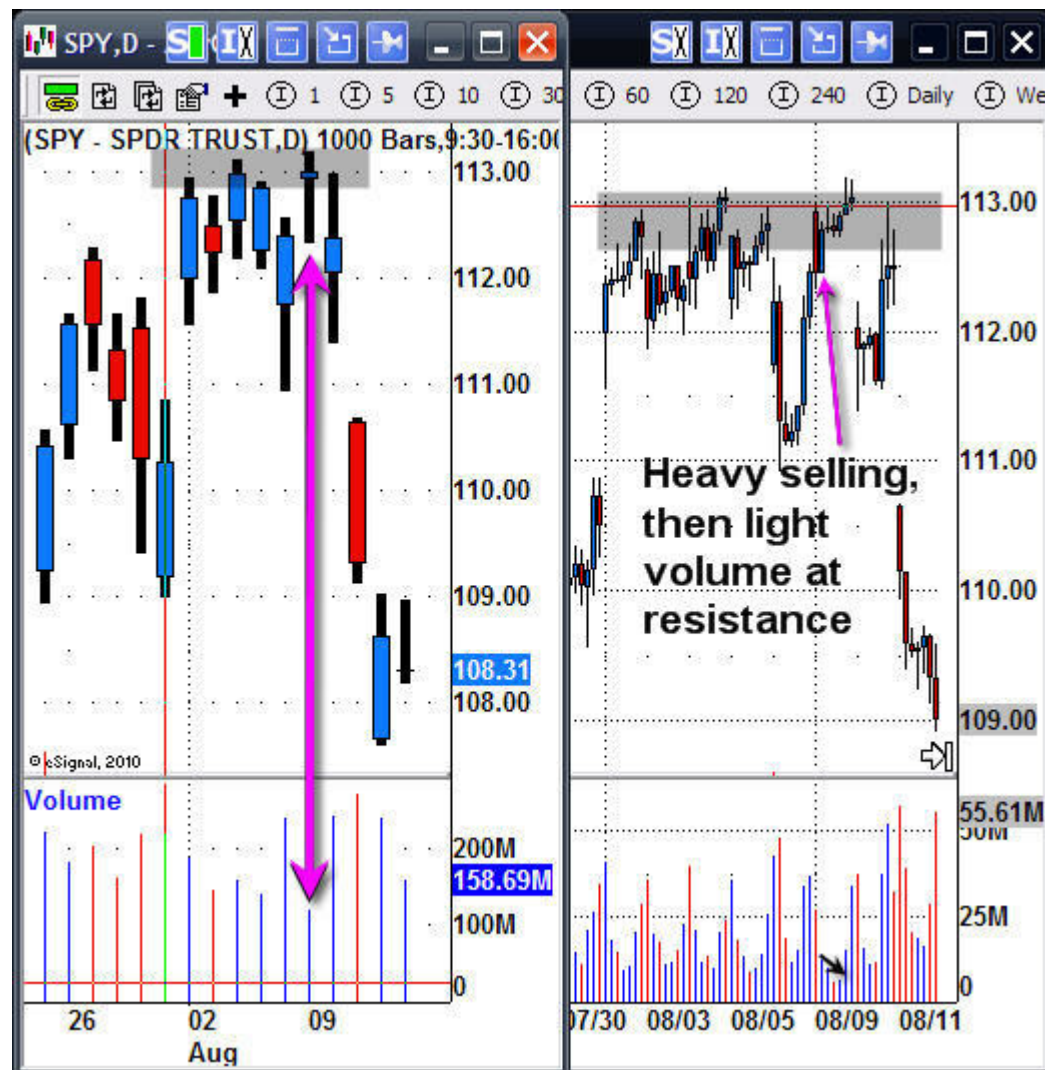
Explained w/ Intraday Chart



Daily chart on left, 60 minute chart on right.

The Psychology Behind The Move

In an uptrend or within a bounce of a downtrend, a sharp intraday sell-off with heavy volume is followed by a reversal and drift up on light volume which causes the stock or etf to close near its opening price near the day's high. Although the stock or etf recovers from its intraday sell-off, it suggests that the bulls are starting to lose strength, and a reversal may occur. The pattern is a slightly more reliable if the real body is red. Selling the following day on solid volume is still needed to confirm the pattern.

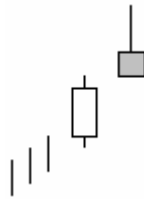


Shooting Start – Bearish

Pattern Type: Reversal

Identification:

1. Price gap open to the upside.
2. Small real body formed near the bottom of the price range.
3. Color of the body is not important.
4. The upper shadow at least two times as long as the body.
5. The lower shadow is small or nonexistent.



The Psychology Behind The Move

In an uptrend or within a bounce of a downtrend, the stock or etf gaps up. An attempt is made to rally the stock or etf, but the strength subsides and the stock or etf falls to close near the day's low and near its opening price. The fact that the price could not hold up suggests the bulls may be losing strength. Although this is not necessarily extremely bearish, it is a sign of short term weakness, so stops should be moved up or profits taken on longs. For a reversal to confirm the following day should continue lower.



Engulfing Candle Pattern – (Bullish)

Pattern Type: Reversal

Identification:

1. Gaps below the previous day's low and rallies to close above its high.



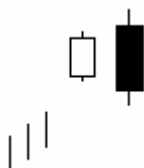
The Psychology Behind The Move

In a downtrend or within a pullback of an uptrend, the gap down may be the panic washout out that causes the bulls to throw in the towel. When selling subside, bottom fishers and short covering rally the stock or etf to close above the previous day's high.



Engulfing Candle Pattern – (Bearish)

Pattern Type: Reversal



Identification:

1. Gaps above the previous day's high and closed below the previous days low.

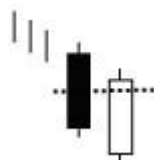
The Psychology Behind The Move

In an uptrend or within a bounce of a downtrend, the gap up may be the last surge of panic buying that causes the shorts to throw in the towel and cover. Meanwhile the smart money is selling and getting short and the selling activity is so strong, the stock or etf closes below the previous day's low.



Bullish Piercing Line – (Bullish)

Pattern Type: Reversal



Identification:

1. Overall trend should be down
2. Opens below the low of the 1st day.
3. 2nd day closes within, but above the midpoint of the 1st day's candle.

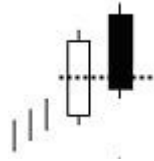
The Psychology Behind The Move

In a downtrend or during a pullback within an uptrend, the stock or etf gaps down, buyers step in and then rallies. This is more reliable if the gap down occurs at or just below support and the blue candle is accompanied by a surge in volume.



Dark Cloud Cover – (Bearish)

Pattern Type: Reversal



Identification:

1. Overall trending should be up.
2. Opens above the 1st day's high.
3. 2nd day closes within the 1st day, but below the midpoint.

The Psychology Behind The Move

In an uptrend or within a bounce of a downtrend, the stock or etf gaps up and immediately sells back down. This is more reliable if the gap up occurs at or just above resistance and the red candle is accompanied by a surge in volume.



Candlestick Test Of Support – (Bullish)

Major Price Support - an area of price where a stock or etf hits support, reverses direction with strong volume, and then retests the same general area of support a second time fading back down on lighter/declining volume.

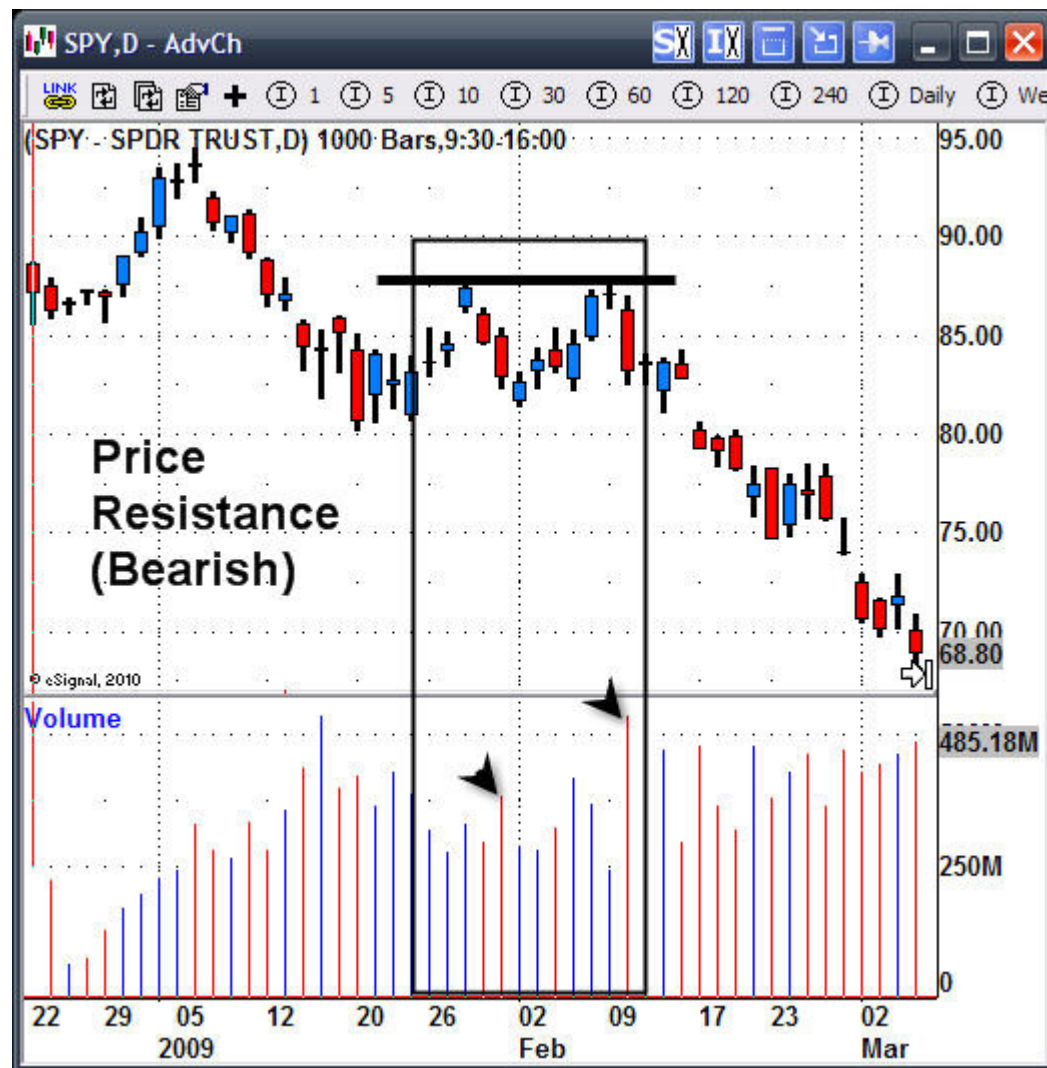
Generally the previous low is pierced on an intraday basis triggering the bulls stop orders, only to have a strong rally into the close as the shorts start to cover helping the rally. The result is a high volume reversal candle.



Candlestick Test Of Resistance – (Bearish)

Major Price Resistance - an area of price where a stock or etf hits resistance, reverses direction, and then retests the same general area of resistance a second time with lighter/declining volume.

Generally the previous high is pierced on an intraday basis triggering short covering and breakout traders to buy. But a strong sell off into the close or the following day causes the bulls to sell their positions resulting in a heavy volume reversal.



Trading On News or Hot Tips Almost Always Results in a Losing Trade

Generally the information is already factored into the market. This is why we see the index or individual stocks sell off when positive news is released and rallies after bad news.

Trade What The Technical's Are Signaling

Focus on the price and volume as it tells you the most information. If you find you're self praying for a move to go in your direction it's best to just get out and wait for another setup.

Low Risk Entry Points Are Everything

Step back and wait patiently for a setup. It is tough to watch the market fluctuate and in many cases make large moves without us but that is just part of trading. Wait for extreme market conditions using volume, market internals and candlestick patterns before taking a position.

Patience

Stay in cash and wait for the perfect time to jump on the trade.

No trader Ever Went Broke Taking A Profit

Once your position is in the money I always like to take a little profit. This not only puts a little money back into your account but it lowers your overall risk and relieves some of the emotions related to trading.