Rick Saddler's
Introduction to Trading with
Japanese Candlesticks

Learning to Read Stock Charts
with
Japanese Candlesticks

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Introduction to Trading with Japanese Candlesticks

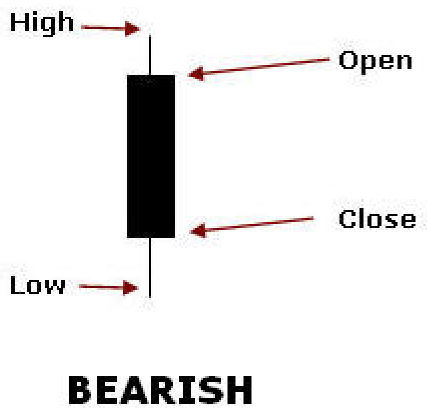
Japanese Candlesticks are gaining popularity among individual traders, mainly because they are easier to learn and interpret versus bar charts. Of equal importance is the fact that they fall into the category of leading indicators. Unlike lagging indicators (for example; a moving average) which appear after the fact, the Japanese Candlesticks signals are leading indicators because they provide early warning alerts to possible price movements. **When you see one of these alerts confirmed by moving averages, they can provide profitable trade opportunities**.

Rather than bore you with the history of Japanese Candlesticks, suffice it to say they have been in use for over 400 years. They are reliable and provide traders with extremely valuable insight to potential price movements.

Many traders use Japanese Candlestick charts simply because they are more visually appealing than bar charts and as a result they are easier to read and interpret. The candlestick chart appears to be three-dimensional making it easier to see the relationship between the open and close and the high and low. Each candlestick allows you to more easily detect the price action that is indicative of either selling pressure or of buying pressure. The body of the candle itself is thicker than the shadow also making it far easier to see how the close price relates to the open price than when reading bar charts.

Japanese Candlesticks also provide more of a real time depiction of market sentiment whereas bar charts often only signify market noise. Candlesticks utilize one to three time periods and are able to visually block out market noise unlike bar charts. Bar charts will actually allow spikes to highs and lows to be prominent in their data unlike candlesticks which are able to focus on what the market actually did to force price action during a period of trading.

The image below illustrates the construction of Japanese Candlesticks.



The hollow Bullish candle forms when the stock price closes higher than its opening price.

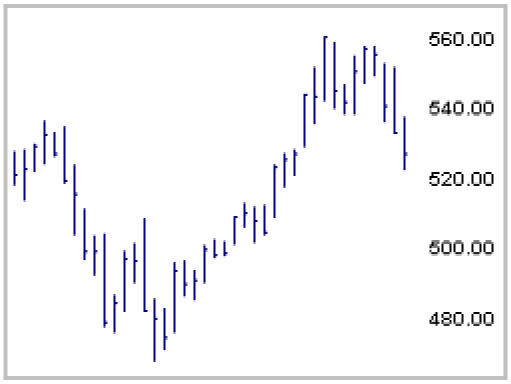
The solid Bearish candle forms when the stock price closes lower than its opening price.

Candlestick charting methods have quickly gained popularity over the last several years. Whether you are a novice trader, or experienced professional, I believe once you understand the power behind the signals you will never go back to other charting methods again!

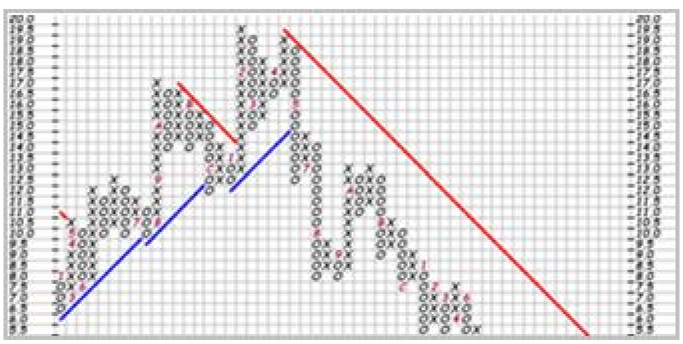
The art is not in making money, but in keeping it!" – Unknown

Compare Japanese Candlesticks to other charting options.

- **Bar Charts**: Better than line charts for displaying opening and closing prices, yet still visually limited.



- **Point and Figure Charts**: Good for visualizing support and resistance but so are candlesticks and not as easily learned.



- **Line Charts**: straightforward illustrations best used for short trading frames but limited data compared to candlesticks.

- **Japanese Candlesticks Chart:** obviously my chart preference, as the balance of this document will attest to the many attributes of the effectiveness of utilizing the signals and patterns.

Now that you can visibly compare the other charting choices, let's look at some of the advantages of trading with Japanese Candlesticks.

- ✓ Quickly see opening and closing prices, which are important indicators for support and resistance levels.
- ✓ One quick glance is all you need to see whether the buyers or sellers are in control.
- ✓ Each individual candlestick tells a story of investor sentiment, giving you an insight not only *how* to trade but *when*.
- ✓ The majority of popular charting systems utilize candlestick signals and patterns in their scanning systems. What a great way to narrow down thousands of trades into a manageable list.

"Never spend your money before you have it"- Thomas Jefferson

Why I have a passion for Candlestick Signals and Patterns

Once upon a time, maybe just like you, I began my education to learn how to make profits from trading the markets. I chose to focus mainly on technical analysis versus fundamental analysis. My first obstacle was to wade through copious declarations of the latest 'Holy Grail' of trading techniques. ***My decisions became much easier once I was introduced to Japanese Candlesticks.***

There are a number of complex, and often over-whelming, amounts of information for new investors. Even if you are able to refrain from falling victim to the latest gimmicks, the tried and true methods can sometimes be mathematically challenging. Interesting observation; many of these indicators suggest using a wave, arc, fan, or some type of visual cue to use in conjunction with the resulting data.

The visual picture provided by candlesticks gives us a quick assessment of anticipated price movement. By learning a few basic signals, even a new chartist can easily see the 'story' behind the candlesticks.

Most every trading platform available includes scanning ability for utilizing candlestick signals and patterns. This is especially important if you don't want to waste your time reviewing thousands of charts. Considering there are over 10,000 entities from which to choose, time management is a must.

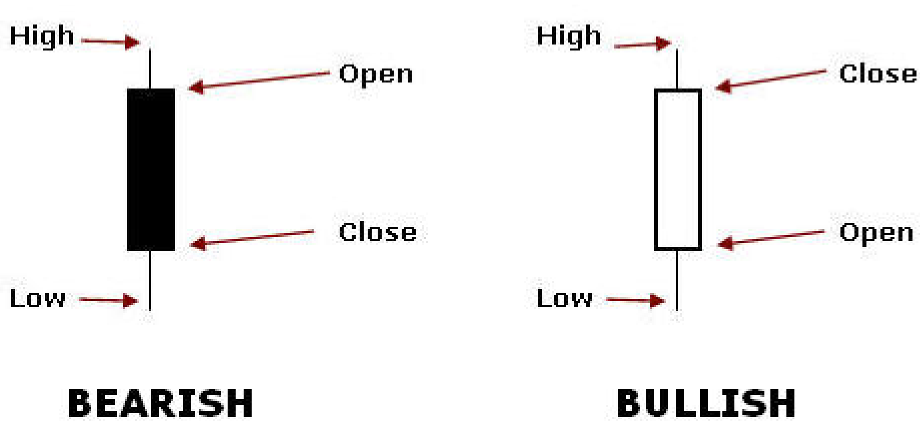
And, my most popular reason for using candlesticks? They work exactly the same in varying time periods. So whether I want to run a quick scalp, place a day-trade, or research for a long-term options position – **Candlestick signals work equally well in all time frames**.

Recognizing the story behind the signals

*T*o effectively trade with candlesticks one must first understand the information contained in the construction of the signal and the meaning behind the variations in the different candlestick signals and patterns. But, don't worry, there are only a dozen main signals. Once you're familiar with these major signals, the rest falls into place quite nicely.

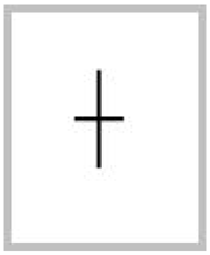
There are 4 main components that build a candlestick:

1. **Opening price**; is the first piece of data needed and will start the candlestick either at the top or bottom part of the candle, depending on whether the underlying security is *Bullish* or *Bearish*. As illustrated earlier, the Bullish candlesticks are usually represented by a white, or green body on the chart. The Bearish candlesticks are usually black or red, depending upon your charting program.
2. **Highest price**; is illustrated by a wick (or tail) above the body of the candle unless the price never goes above the opening price. In this case there is no wick above the body of the candle.
3. **Lowest price**; is also represented by a wick (or tail) below the body of the candle. Again, if the underlying stock is experiencing considerable Bullish action, there may be no wick below the bottom body of the candle. (illustrating the price never traded below the close of the day.
4. **Closing price**; the final piece of data needed to complete the candlestick signal. The closing price finishes the body of the candle anywhere between the top (if Bullish) or the bottom (if Bearish).



Doji and **Doji Variations**

Doji



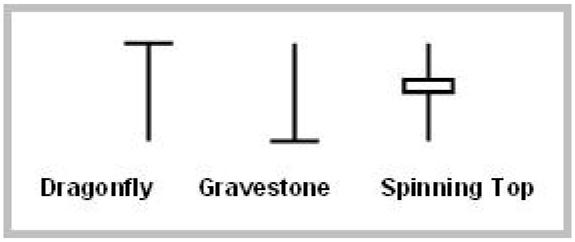
The Doji is one of the most informative signals in Candlestick trading and is comprised of one candle. It forms when the open and close occur at the same level (or very close) in a specific timeframe.

In order for a doji signal to be valid it must meet two conditions. **First,** the open and the close of the stock must be almost at the same price level (as stated above). **Second**, there must be an upper shadow or a lower shadow, or both.

When a doji candlestick is formed, a cross formation appears (as seen above) with the horizontal line representing the open and close occurring at the same level. The vertical line on the doji candlestick chart represents the total trading range during that timeframe. This clearly indicates that the bulls and the bears are at an equilibrium signifying a state of indecision. When this occurs the trader should keep an eye out for a trend reversal.

Doji lines are patterns in the doji candlestick chart with the same open and close price. There are three special types of Doji lines explained on the next page.

Doji Variations



1) **Long-legged Doji** – This doji line has a long upper and lower shadow with the price in the middle of the range. It is a very important reversal signal and it signifies a great amount of indecision in the market. It is formed when prices trade well over and below the day's opening price, but then close almost at the same level as the opening price.

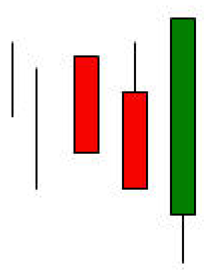
2) **Dragonfly Doji** – This doji line has a long lower shadow and no upper shadow and it indicates a bearish trend reversal. This type of doji opens at the high of a session, has a significant inter period decline, then it climbs back up closing at the sae level as the open.

3) **Gravestone Doji** – This doji line has a long upper shadow and no lower shadow and indicates a bullish trend reversal. It is derived by the formation of the signal looking like a grave stone and is formed when the open and close occur at the low of the day. Its specialty is for calling market tops and it could indicate imminent disaster for a stock.

Engulfing Patterns

Engulfing patterns form when the body of the second candlestick completely *engulfs* the first. They often complete other reversal patterns, showing even stronger evidence that an eminent change will occur. Therefore; *Engulfing Patterns* are frequently spotted at the top or bottom of a move.

Bullish Engulfing Pattern



This is a major reversal pattern comprised of two opposite colored bodies. It is formed after an established downtrend, and it opens lower than the previous day's close; and closes higher than the previous day's open. The first candlestick represents a falling share price (red or black image) and the second candlestick represents the share price starting low and ending up at or near its highs (green or white image).

To qualify as a Bullish Engulfing pattern these conditions must be met.

1. There must be a definable downtrend.

2. The green candle must completely engulf the body of the previous red candle.

3. The body of the engulfing candle must be the opposite color of the first candle. (the exception would be if the first candlestick is a Doji, or small bodied candle)

The size of the red candlestick is of no consequence, however the shadows (or tails) of the small candlestick (red) are short, which enables the body of the large candlestick (green) to cover the entire candlestick from the previous day. The size of the green candle is of more consequence because the larger it is, the more bullish the anticipated reversal.

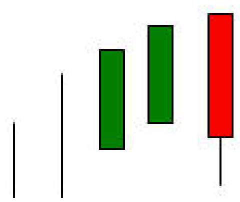
What does this reversal pattern indicate is happening in the markets?

The bullish engulfing pattern is used when a stock has been declining and it typically represents a change in investor sentiment. The assumption that this pattern carries is that after a period of selling pressure, the green candle forms because the stock has opened below the previous close; the buyers moved in and pushed the price higher. (The exception to this rule, however, is if the first real body of the engulfing pattern is a doji or an extremely small body. A doji candlestick chart engulfed by a very large green real body could be a bottom reversal).

To confirm this pattern, the share price must strengthen further in the following time period, or in other words, **a bullish confirmation should come within 1 to 3 time frames after the pattern**.

The name of this pattern implies that the bulls have taken control of a security's price movement from the bears. The bullish engulfing pattern is associated with a declining trend in a security, which implies that a low or end to a security's decline has occurred.

Bearish Engulfing Pattern



The bearish engulfing pattern consists of a small green candlestick (or white) with short shadows or tails followed immediately by a large red (or black) candlestick that *engulfs* the previous candle.

To simplify, engulfing patterns are when the body of the second candlestick engulfs the first and are considered reversal patterns.

To qualify as an engulfing candlestick, certain conditions must be met.

1. There must be a definite uptrend.

2. The second real body (do not include the tails) should have the opposite color of the first real body.

3. The second day's body should completely engulf the previous day's body. (I use the example of 'day' but it is the same in all time periods)

The first day's color is the same as the trading trend. In order to be considered a bearish engulfing pattern, the second day of the signal should be a red (or black) candle opening above the close of the previous day and closing below the open on the previous day's green (or white) candle.

It is found at the top of an uptrend, meaning the stock must be in a definite uptrend before this signal occurs. It is important to note that this signal often follows or completes the doji, the hammer, or the gravestone patterns.

What does the bearish engulfing pattern indicate is happening in the markets?

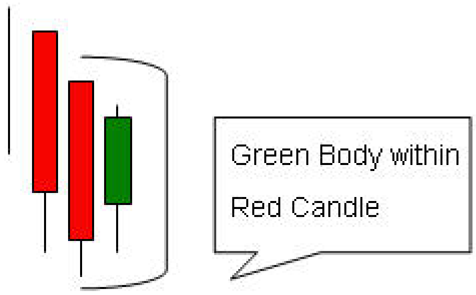
This pattern typically is accompanied by an uptrend in a security and can indicate a peak or a slowdown in its advancement. It may signal a future bearish trend which means that the bears are overwhelming the bulls and prices will move down.

The second red (or black) candlestick begins to form, after an advance, and when residual buying pressure causes the security to open above the previous close.

Sellers then begin to drive the prices down and by the end of the session, the prices will move below the previous open. As a result, the second candlestick (red or black) engulfs the previous day's body and creates an apparent short-term reversal. The bearish engulfing pattern creates a very strong probability that the buying is over and that there is opportunity for creating a good short position.

This pattern is the exact opposite of the bullish engulfing pattern. Both indicate reversals at the tops and the bottoms and are easily recognized indicators at the end of a trend. The signals are extremely accurate when a bullish engulfing pattern occurs during oversold conditions, and the bearish engulfing signal is equally valid when it occurs in the overbought area.

Harami Candle - Bullish



The bullish harami candle is found at the bottom of a downtrend, and is the reverse of the engulfing pattern. The Japanese definition of this candle means *pregnant woman* or *body within*. When identifying a bullish harami candle the body of the first candle must be the same color as the current trend and should be a long red (or black) candle. The body of the second candle is a green (or white) candle and it opens and closes **within the body** of the previous day's candle.

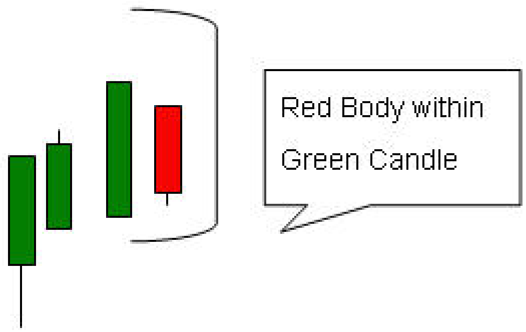
Additionally, as mentioned above, the downtrend must have been evident for a good period of time with a long red candle occurring at the end of the trend. The presence of this candle indicates that the trend is over. Also, the location and the size of the second candle can determine the magnitude of the reversal.

What does this bullish candlestick pattern indicate is happening in the markets?
This bullish signal occurs during a downtrend when the bulls step in and open the price higher than the previous day's close. The stock goes up as the bulls continue to preside. This is a result of investors holding their positions, in hopes of a reversal only to eventually give up and sell, indicating that the trend is over. In other words, the bears are concerned and the shorts begin to cover their positions. The bulls are then able to close the candle higher into the previous day's body.

Confirmation is required the following day. The bulls must stay in control, convincing the bears that the trend is over. This is a great opportunity to enter into a long position.

When identifying the bullish candle it is important to note two things. **First**, the higher the green candle closes up on the red candle, the more convincing it is that a reversal has occurred. **Second**, the longer the red candle and the green candle the stronger the reversal.

Candlestick Harami – Bearish



The bearish candlestick harami is found at the top of an uptrend, and is the exact opposite of the bullish harami candle. It is also defined as *pregnant* or *body within* and it is a two candle formation.

To be valid it must contain the following criteria. **First**, the body of the first candle is green (or white) and the body of the second candle is red (or black). **Second**, the stock must have been in a definite uptrend in order for this signal to occur. This can be visually identified on a chart when the long green candle occurs at the end of the trend. In other words, when identifying this pattern, the body of the first candle must be the same color as the current trend. The next day (or time period) should be a red candle opening below *or lower* than the close of the previous day, and closing above or higher than the open of the previous day's green candle. This also means that the first body of the pattern is a long body and the second body is smaller. Confirmation is needed and the next day (or time period) must show continued weakness.

What does the bearish candlestick harami pattern indicate is happening in the markets?

This is an exciting candlestick pattern because is occurs at the top of a trend! The bears step in and open the price lower than the previous day's close. The bulls then begin to take their profits and get out before the price closes lower for the day. In other words, more experienced investors know when they see this signal that they must take their profit and move on before the trend reverses. Otherwise, they will watch their profits quickly diminish.

Additional information of interest - The longer the green and red candles, the more forceful the reversal. Second, the lower the red candle closes down on the green candle, the more convinced investors are that a reversal has occurred, regardless of the size of the red candle.

Kicker Signals

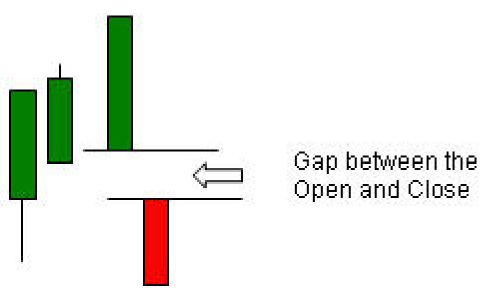
Kicker signals are one of the most powerful signals and they indicate a severe change in investor sentiment. This signal is most relevant when it occurs in the oversold or the overbought area, and it works equally well in either direction (bullish or bearish).

This two candle pattern formation occurs when **two candles of opposite colors** form next to each other **with a gap** between the candles.

The Kicker Signal is considered one of the most important candlestick signals, as it illustrates a strong change in investor opinion. The change in sentiment is so severe that it creates a dramatic visual change of not only an abrupt change in direction but with such strength it creates a gap (void) between the changes.

The first candle opens and moves in the direction of the current trend. The second candle opens at the same opening price of the previous day but it then heads in the opposite direction of the previous day's candle. There is typically little or no upper wick when seeing this signal.

Bearish Kicker Signal

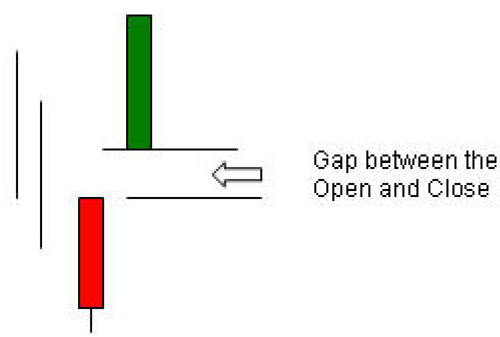


First, notice that the **price never retraces into the previous day's trading range**. Second, the price movement is in the opposite direction from the opening price and the first day's open and the second day's open are the same. Third, the trend is irrelevant for this signal. Lastly, the signal often occurs as a result of surprising news, released before or after market hours, that affects investor reaction. A bearish signal of this nature indicates very strong selling pressure.

There are also instances in which bearish kicker signals are strengthened. A longer candles makes the reversal more dramatic, as does a larger gap.

What do bearish kicker signals indicate is happening in the markets?
As previously discussed, this signal illustrates a dramatic change in investor outlook due to surprising news that changes the direction of the price. A true kicker signal demonstrates such a drastic change in direction that the new direction will continue with significant strength for a good period of time.

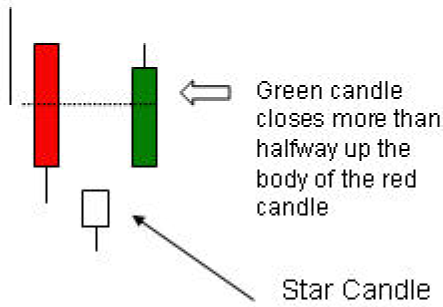
Kicker Signal – Bullish



This signal is the exact opposite of it's Bearish counterpart. The first candle opens up and moves in the direction of the current trend. The second candle opens up at the same open of the previous day and it heads into the opposite direction of the previous day's candle. When witnessing the bullish kicker signal, the first candlestick (red or black) closes lower than the open, in the direction of the down trend. Then the open the following day is equal or close to the open the previous day moving in the opposite direction. The price continues to move in the bullish direction and the gap up from the previous day's close is huge.

It is important to note that the trend is irrelevant for this signal. This signal typically occurs due to surprising news likely to affect investor sentiment. The first day's open and the second day's open are the same, and the price movement is in opposite directions from the opening price. The price should never retrace into the previous day's trading range.

Morning Star



The morning star is a bullish reversal signal found at the bottom of a downtrend. It is a is a **three candle pattern** and suggests that *good things are to come*. Or, in other words, that **prices are going to increase**.

To qualify as a morning star signal four criteria must be met.

1. The stock must be in a definite downtrend before this signal can occur.

2. The first day of the signal must confirm the current downtrend by displaying a long red (or black) real body. (**the bears are in complete control the first day**)

3. The second day displays a candle formation that indicates a state of indecision as the **star candle** gaps away from the first day. (The star may also be a Doji Candle) Supply and demand is equal on this day.

4. The third day should display a green (or white) candle that should close at least halfway up the red (or black) candle. In other words, the long green body gaps up from the prior day. This third candle provides the confirmation needed to indicate a reversal. (**This confirmation is apparent in the morning before the sun rises, thus giving this signal its name**.)

Additional pattern notations for the morning star candlestick:

~The larger the candles, the greater force for a reversal.

~A gap (or window) between the first and second day, adds additional odds for the reversal.

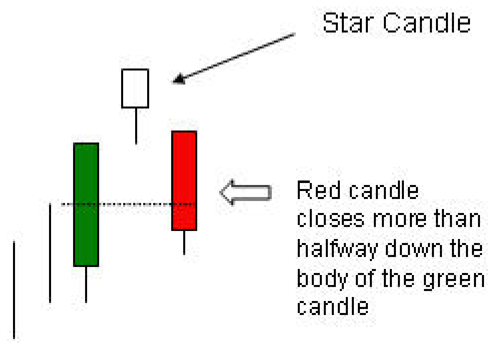
~Even more advantageous; a gap occurring before and after the star candle Note: A gap is not as common and is not required, but when you witness a gap 'pay heed' there is potential for even greater force.

~The higher the third day's candle comes up in relation to the first day's red candle, is even more compelling as it will cause the reversal to occur with greater strength.

What does this signal indicate is happening in the markets?
Again, this trend means that a strong downtrend has been in effect and the bears are in full control. A tug-of-war ensues causing great concern for the bears, and eventually the bulls are able to take over.

"If you can count your money, you don't have a billion dollars!"
`J. Paul Getty

Evening Star Candlestick



The evening star candlestick indicates *bad things are on the horizon* for traders. Or, in other words, lower stock prices may be on the way. This pattern is a **top reversal signal** and is the opposite of the morning star signal. Investors must be careful when identifying the evening star candlestick pattern since it tends to be more difficult to identify than other Japanese candlesticks patterns.

The criteria required, in order for this signal to be valid includes the following conditions.

1. The stock must have been in a definite uptrend before this signal can occur. (**The bulls are in complete control on the first day**.)
2. The first day of the signal must be a long green (or white) body continuing the current uptrend.
3. The second day (indecision day causing the **star candle formation**) increases the probabilities of a reversal. (The star may also be a Doji Candle) Supply and demand is equal on this day.
4. The third day should be a long red (or black) body that closes down at least **halfway into the body of the first day's green candle**. This is proof the bears have stepped in with strength. (supply is far greater than the demand)

Additional pattern notations for the evening star candlestick:

~The larger the candles, the greater force for a reversal.

~A gap (or window) between the first and second day, adds additional odds for the reversal.

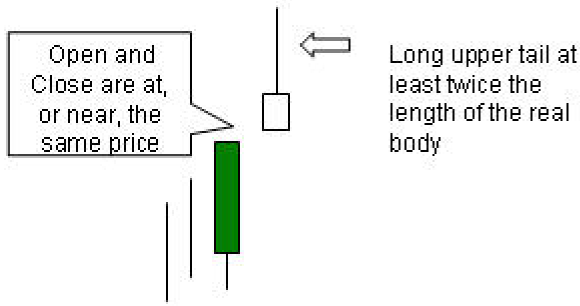
~Even more advantageous; a gap occurring **before and after** the star candle Note: A gap is not as common and is not required, but when you witness a gap 'pay heed' there is potential for even greater force.

~The lower the third day's candle comes down in relation to the first day's green candle, is even more compelling as it will cause the reversal to occur with greater strength.

What does the evening star candlestick indicate is happening in the markets?
Again, this trend means that a strong uptrend has been in effect and the bulls are in full control. A tug-of-war ensues while the sellers begin to take profits. This causes great concern for the bulls, and eventually the bears are able to take over.

"Of one thing, be certain: if a CEO is enthused about a particularly foolish acquisition, both his internal staff and his outside advisors will come up with whatever projections are needed to justify his stance. Only in fairy tales are emperors told that they are naked. " ~Warren Buffet

Shooting Star



The Shooting Star candlestick signal is a Bearish Reversal Signal indicating price has reached the top of its uptrend. It sends an important alert for those traders with open long positions that it is time to close their trade. For experienced traders watching for new short positions, it offers an early opportunity for greater profits.

To form the Shooting Star Candlestick reversal signal you will need the following price activity.

First, there is an established uptrend.

The pattern forms when the open and close are near the same price, signifying indecision between the Bulls and Bears.

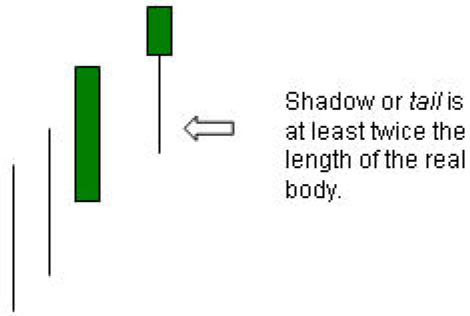
There is a long upper tail, or shadow equaling **at least twice the length of the real body**. (The upper tail shows the extent of the price movement during the trading period) There should be little, or no, lower shadow (or tail).

While not required, this pattern has even greater importance when there is a gap between the real body of the previous trading period.

What does this signal indicate is happening in the markets?
This candlestick formation depicts the battle between the Bulls and Bears. The Bulls are in charge with an established uptrend. The Bulls continue to push prices higher on the market open, but the Bears step in and bring the price back down to near the initial starting point.

This serves as an early warning that while the Bulls may have kept the price movement positive, they are loosing their ability to maintain control.

Hanging Man Candle



The hanging man candle is a reversal pattern in which a small real body forms at the upper end of the trading range with a long lower shadow with no, or almost no upper shadow. The longer the shadow (or tail) the more bearish the reversal.

The hanging man occurs during an uptrend and it is named as it looks like a hanging man with dangling legs. When identifying a hanging man candle, there are four criteria that must be met.

1. A long lower shadow should be at least two times the length of the real body.

2. There should be no upper shadow or a very small upper shadow with the real body at the upper end of the trading range. (The color of the body is not important, but a black body has slightly more bearish implications).

3. The stock must have been in a definite uptrend before this signal can occur.

4. The day after the hanging man is formed confirmation must occur in the form of a black candle, or a gap down with a lower close.

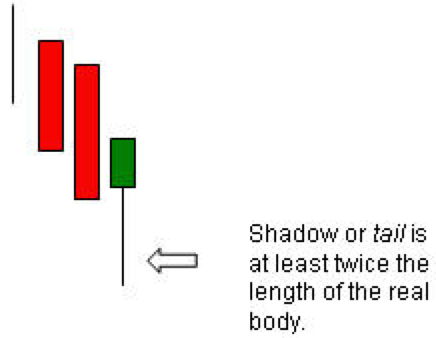
It is important to note that the longer the lower shadow, the more likely a reversal is to occur and the pattern is slightly more reliable if the real body is black.

What does the hanging man candle indicate is happening in the markets?

This signal indicates trend exhaustion and suggests a bearish reversal. The long lower shadow of this signal designates sellers are stepping into a trend. The price opens higher after a strong up-trend has been in effect but it then starts to move lower as the bears take control. The bulls however still have control and the price is increased at the high end of the trading range, thus creating a small real body. While the bulls were able to keep the price high, selling was still apparent with the bulls losing strength, signaling a reversal may occur. The lower open (or black candle) the following day confirms the selling. Basically, even though the sellers brought the market very low, in the end the buyers brought the closing price back up near the market open. This signal indicates that buyers are losing control and bearish traders are gaining strength.

"If investing is entertaining, if you are having fun, you're probably not making any money. Good investing is boring."
~ George Soros

Candlestick Hammer Signal



The candlestick hammer signal is a bullish reversal pattern that forms after a decline, and signifies that the market is "hammering" out the bottom. In order to qualify as a hammer signal, there are three conditions that must be met.

1. The stock must be in a definite downtrend before this signal can occur.

2. The long lower shadow must be a minimum of two times the real body.

3. There is little, or no, upper shadow on the real body.

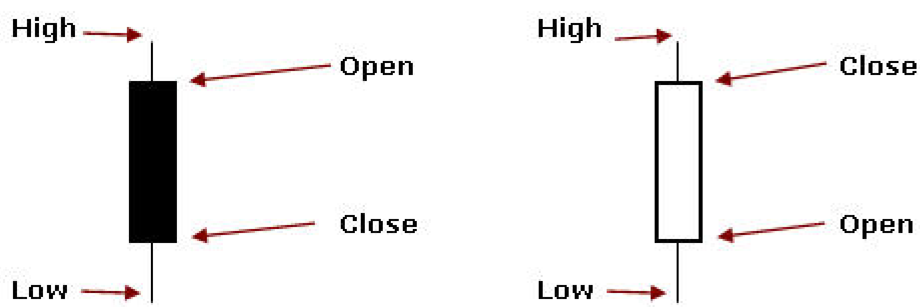
4. The day after the hammer is formed, the markets should display continued buying because the real body is at the upper end of the trading range.

When detecting a hammer signal, the color of the real body is not important. However the longer the lower shadow, the more significant this candle becomes. It can also be said that a black body has slightly more bearish indications and a white body has slightly more bullish indications. (although the color is not really as important) Basically, the hammer signal is a reversal signal from down trend to up trend and it is only effective when it appears in an established down trend.

What does the candlestick hammer signal indicate is happening in the markets?

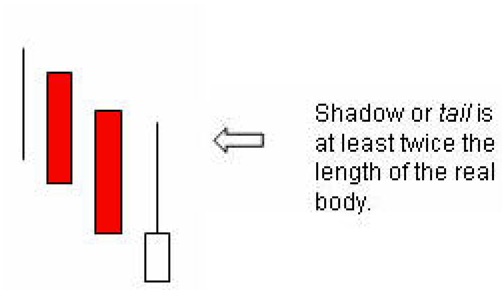
Basically it means that on the day of the hammer candle, there is strong selling taking place in the markets. As the day progresses the market recovers and closes near the unchanged mark, or higher in some instances. After a decline, the ***hammer*** signals a bullish revival. The long lower shadow indicates that sellers drove the prices lower during the session, but that buyers regained momentum and ended the session on a strong note. Since the low of the candlestick hammer signal shows that more sellers remain, a bullish confirmation is required on the next day.

This seems like a good opportunity to review candlestick construction and shadows. It is important to discuss the shadow because it plays a significant part in the recognition of the candlestick hammer signal. The shadow is depicted by long thin lines above and below the body, which represents the high and low price range. The high is marked by the top of the upper shadow and the low is marked by the bottom of the lower shadow. If the stock closes higher than it's opening price, then a hollow (or green) candlestick forms and the bottom of the body represents the closing price. Conversely, if the stock closes lower than its opening price, then a filled candlestick is formed (black or red) and the top of the body represents the opening price and the bottom of the body represents the closing price.



"Education is the foundation of success. Just as scholastic skills are vitally important, so are financial skill." ~ Robet Kiyosaki

Inverted Hammer Signal



The inverted hammer candlestick is a bullish reversal pattern that occurs after a downtrend, at the support, or during a pullback within an uptrend. It is characterized by a long upper shadow and a small real body, preceded by a long red (or black) real body.

In order to be considered an inverted hammer, there are four criteria which must be met.

1. This signal must occur in a established downtrend.
2. The small real body must form near the bottom of the price range.
3. The upper shadow is usually two or more times the length of the body.
4. The lower shadow is small or nonexistent.

The inverted hammer candlestick requires bullish confirmation before any action should be taken, and it can be confirmed by a "gap-up" or by a long white candlestick with heavy volume.

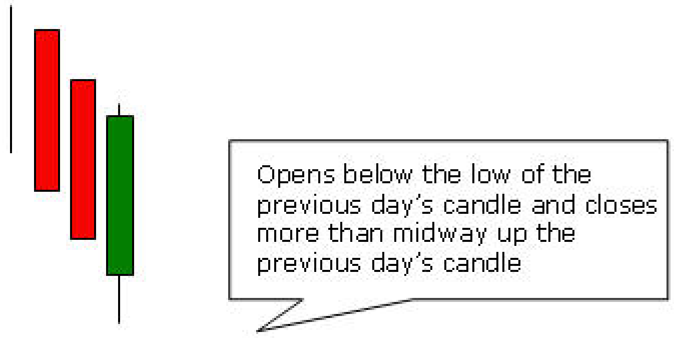
Another factor to take into consideration with this signal is the "gap." The larger the gap, the stronger the confirmation. In order to detect a "gap," measure the distance between both real bodies, first measuring the higher of the open or the close for the inverted hammer and then by measuring the lower of the open or close for the previous session. A "gap" is present if the hammer's higher value is less than the previous session's lower value. Gaps should be used as strength indicators and they form in many places. The witnessing of a gap at the beginning of a new trend produces profitable opportunities.

What does the inverted hammer signal indicate is happening in the markets?

This candlestick pattern is formed when the market opens at or near its low and it occurs in bearish conditions. Prices then change direction and the bulls are able to rally the prices up briefly but without the ability to sustain buying pressure. As a result prices close at or near the low of the day and the bears take the necessary actions to protect their gains. If the next day opens above the body of the inverted hammer, it means that those who shorted at the opening or closing of this signal lose money. The longer the market can hold above the inverted hammer's real body, the more likely these shorts will attempt to cover their positions.

NOTES:

Candlestick Piercing Pattern



The Candlestick Piercing Pattern is a reversal in a down trending market (similar to the bullish engulfing pattern) and is therefore considered bullish. This pattern is made up of a long red (or black) body, showing a price decline. It is then followed by a long green (or white) body, showing price increase. The green body must start below the bottom of the red body and close at least halfway up the previous day's candle, thus *piercing* the previous candle.

To classify as a candlestick piercing pattern four criteria must be met.

1. The two-day pattern illustrates a red candle (down day) followed by a green candle (up day).

2. The pattern appears in an established downtrend.

3. The second day opens lower than the trading of the previous day.

4. The green candle closes at least midway up, or more than halfway up, the red candle.

When dealing with the piercing pattern there are things to look for to indicate a stronger reversal. The longer the red candle and the green candle the stronger the reversal of the pattern. The higher the green candle closes into the red candle the more prominent the reversal is for this pattern. Lastly, the greater the gap down from the prior day's close the stronger the reversal. It is also important to note that the day before the piercing candle appears, the daily candle should have a fairly large dark red body to signify a strong down day.

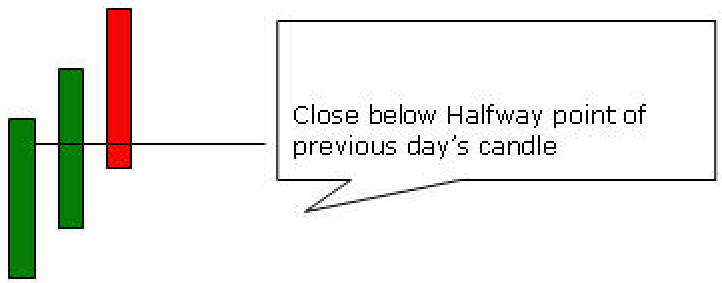
What does the candlestick piercing pattern indicate is happening in the markets?

This pattern indicates that the stock has shifted from a declining price trend to a rising price trend. The theory behind the appearance of this pattern indicates that the bears have been in control of the stock (in the downtrend) and then the stock opens below the close of the first candle and the bulls take over.

Basically, if you see this pattern, it is a signal to buy the stock and ride the increasing price up for a profit. Investors can maximize any profit they obtain when seeing this pattern. This is due to the fact that this pattern appears at the beginning of a trend so it also appears right when the stock shifts from a declining pattern to a rising pattern.

NOTES:

Dark Cloud Cover



A Bearish reversal pattern composed of a green (or white) body followed by a red (or black) body. It is the opposite of the candlestick piercing pattern which is a Bullish reversal pattern. This pattern occurs at the end of an established uptrend. (whereas the piercing pattern occurs at the end of a downtrend)

To qualify as a Dark Cloud Cover, four conditions must be met.

1. The stock price must be in a definite uptrend.

2. There is a positive candle (either a green or white body) followed by a negative candle (either a red or black body).

3. The red body passes the midpoint of the prior day's green candle. To clarify, the candle body should open above the high of the previous day and close more than halfway into the body of the previous day's green candle.

4. Fourth, the following day's price must continue to drop and close lower in to provide confirmation of this pattern.

What does this reversal pattern indicate is happening in the markets?

The bulls were in control during the uptrend. We see continued confidence as they gapped up the price on the open, but the bears stepped in to close prices near the low of the day. The bulls were unable to maintain the upward momentum and are therefore less likely to buy stock at higher price levels. It appears that the uptrend has stopped and the bears increase their sales at the lower share price. If the bears can hold control the day after the dark cloud cover, then the probabilities of a reversal are very high. This can be either a gap down the next day, or a lower close on the next trading day.

When witnessing this bearish reversal pattern it is important to note a few things. The higher the gap up from the previous day's close, the more prominent the reversal because the market was unable to sustain the high price level. Also, the longer the green candle and the red candle the stronger the reversal, and the lower the red candle closes into the green candle, the stronger the reversal as well.

Additionally, if the volume is high during both days, then the pattern is considered to be more valid. Traders must be careful that they don't mistake a bearish engulfing pattern for this pattern. If the dark cloud cover were to close lower (below the open of the previous day), it becomes a bearish engulfing pattern, which has slightly stronger bearish connotations.

NOTES:

"If you owe the bank $100 that's your problem. If you owe the bank $100 million, that's the bank's problem." ~ JP Getty

That's a Wrap!

I hope you've found this introduction to Japanese Candlesticks helpful. As I said in the beginning of this e-Book; I was once in your shoes and struggled to find profitable trading strategies. I found that incorporating Japanese Candlesticks into my charting analysis provided a strong basis for building additional techniques. The major signals covered in this e-Book will provide you with more potential stock trades than you will ever need. However, as you grow in your trading career, you will want to be familiar with additional Candlestick Patterns, Technical Analysis techniques, and Exchange Traded Funds. All this and more is covered in the Hit & Run Candlestick Blog.

The H&R Mission is to provide a simple and mechanical way to make a living trading stocks. We strive to find stocks that are poised for a move in a profitable direction and to cycle profits from the market to your pocket as the stock moves.

Read more about Rick's Personal Journey from *employee* to **Trading for a Living.**

Keep it Simple – Keep it Mechanical **~Rick Saddler**

Stock Market Glossary

Use this quick reference guide to the most common stock market terms. Traders have their own language and our glossary will have you speaking the lingo in no time!

Individuals who are new to trading tend to feel a bit overwhelmed with all the new stock market terms. Our goal is to provide you with the information necessary to learn about and study the stock market by making it as easy as possible. We try to take stock market definitions and put them into words that make it easier for new and even non-investors to understand. We also do this in our Blog under the Japanese Candlesticks section and the Technical Analysis section of The Hit & Run Candlesticks website. In these sections you can learn about the most profitable technical indicators available and also about the different types of Japanese Candlestick patterns utilized by individual traders.

Stock Market Glossary from A to B

Ask (or Offer)
The price Market Makers are willing to sell. The current price traders are able to purchase a security.

All-or-None Order
A method to place an order, that must be filled completely or your trade will not take place.

Assets
Everything a company owns, such as money, securities, equipment and real estate. Assets include everything that is owed to the company and can be found on a company's balance sheet.

At the Money
Used in options, where the strike price is the same as the current stock price.

Averaging Down
Buying more of a security at a lower price than one paid for the initial asset. The intention of averaging down is to reduce the overall average cost per unit.

Bar Chart
The usual graphic portrayal of price activity using vertical lines to illustrate high to low prices during a time period. The opening price is

represented by a short horizontal line attached to the left side of a vertical line. The closing price is represented with a horizontal line to the right. Price is denoted on the vertical scale of the chart. Time is denoted on the horizontal scale.

Breakout
Price movement that pushes through previous resistance or support levels.

Bearish
Outlook someone has where they believe the stock market or individual security will continue to go down in price.

Bid Price
Price option buyer is willing to buy.

Bullish
Outlook someone has where they believe the stock market or individual security will continue to go up in price.

Block Trades
Trades greater than or equal to 10,000 shares in size and greater than or equal to $100,000 in value.

Blue Chip Stocks
Stocks of established companies that are well known with a history of dividend payments and/or other strong investment characteristics.

Bonds
Promissory notes issued by a corporation or government to its lenders, usually with a set amount of interest for a specific period of time.

Broker or Brokerage Firm
A securities firm which serves as the link between investors and the stock market. Brokers act as agents for traders and charge varying commissions for their services. A Full Service Broker deals directly with traders and executes your orders. You pay higher commissions for their service, but they can come in handy if you are new to trading. A discount broker works at a firm that offers low commission rates.

Buy To Close
Buy back an option contract to close out a position that you previously shorted.

Bear Market
Strong downtrending market in which stock prices are falling.

Bull Market
Strong uptrending market in which stock prices are rising.

Bid / Ask Spread
The difference in price between the bid and ask price in an option contract.

Buy to Open
Option trading order to go long (buy) a position in an option contract.

Candlestick Signals
Japanese candlesticks also provide more of a real time depiction of market sentiment whereas bar charts often only signify market noise. Candlesticks utilize one to three time periods and are able to visually block out market noise unlike bar charts. Bar charts will actually allow spikes to highs and lows to be prominent in their data unlike candlesticks which are able to focus on what the market actually did to force price action during a period of trading.

Confirmation
When a move or anticipated action is verified by another indicator.

Congestion area
When price movement stays within a trading range for an extended time period.

Call Option
An option giving the holder the right, (but not the obligation) to buy a set amount of an underlying stock at a specified price within a fixed timeframe. Investors purchase calls when they anticipate a price increase.

Commodities
Products that are traded on the commodities exchange. Such as agricultural products, timber, oil and metals. Commodities are the basis for futures contracts.

Contract Size
The amount of underlying stock covered by an option contract. In the U.S this is 100 shares.

Closing Order
An order placed to close an open position, whether it be a sell to close or a buy to close order.

Day Order
An order that expires at the end of the trading day if it is not filled.

Day trading
The practice of making multiple trades which you plan to open and close within the same trading day. ****This is personally one of our favorite trading styles at Hit and Run Candlesticks. Check out the Profit Scanner we use to grab quick profits.**

Dividend
Distribution to shareholders of cash or stock declared by the company's board of directors.

Derivatives
A financial instrument where the value is 'derived' based upon the value and characteristics of another financial instrument. (Stock Options are derivatives of the corresponding stock.)

Divergence
Difference between indicators after a price move. One indicator confirms the move, while another indicator shows the opposite.

Double bottoms
Prices forms a W-shaped bottom where prices reverse at just about the same lows.

Double tops
Price forms an M-shape where the highs are approximately the same.

Exponential moving average (EMA)
Used in Technical Analysis and is similar to a simple moving average, except greater weight is given to the most recent price data and therefore moves more quickly.

Earnings
Income of a business (revenue minus expenses).

Earnings per share or EPS:
Income (earnings) for a particular period (typically quarterly or end-of-

year) divided by the average number of shares outstanding during that period.

Expiry Date
Date that an option contract expires.

Exercise
The procedure of satisfying the put option contract and buying or selling the shares.

Fibonacci numbers
A sequence of numbers that are derived by adding the two previous numbers to obtain the next number. (The first number of the sequence is 0, the second number is 1, and each subsequent number is equal to the sum of the previous two numbers of the sequence itself.) The series of numbers produces ratios used by technical analysts to plot trading algorithms. Classic forms include: the Fibonacci fan, Fibonacci Arc, Fibonacci Retracement and the Fibonacci Time Extension. A popular indicator used in Technical Analysis.

Fair Value is used in options to depict the value by mathematical calculations.

Fundamental Analysis is the evaluation of a companies fiscal details to form an opinion as to potential price moves in the future.

Gap
A price void often caused by news after the stock market closes. When the market reopens, it jumps (or gaps) to a new high or low causing a hole (or gap) in the chart pattern.

Good Until Canceled is an order that remains effective until it is cancelled or filled.

Greeks is the mathematical criterion used to calculate stock option prices.

Hedge is to protect against potential losses.

High of Day simply stated, is the highest price a stock trades during the day.

In the Money
A call option is in-the-money when the underlying stock price is higher than the strike price of the call, and a put option is in-the-money when the stock price is below the strike price.

Inside session
Trading session where the high and low of a trading period stays within the high and low of the previous trading session.

Intra-day
Trading periods that begin and end within a one-day time frame.

Intrinsic Value
This stock market trading term is the difference between the current stock price and the strike price. This is the amount by which an option is in the money, and indicates the value of an option if it were to expire right now.

IPO: A company's first sale of stock to the public

Limit Order is an order to buy or sell options at a certain, or limited price.

Long; if you go long in the market you are buying

Liquidity is how easily you may buy or sale an equity. The higher the volume, the more liquid. This is why you set filters on your stock scanning tool. It can become dangerous to be in a stock that is not liquid, making it difficult to find buyers.

Market Maker is an exchange member whose function it is to assist in the making of a market. The broker/dealer offers both bids and offers, when there are no public buy or or sell orders.

Market Order is an order to buy or sell options at the current market price.

Moving Average Convergence-Divergence\ (MACD)
A combination of three exponentially smoothed moving averages.

Mutual Fund: Fund run by an investment company that raises money from shareholders and then invests it in bonds, options, stocks, commodities or money markets.

Naked Option or Uncovered Option is where an investor buys or sells an option without owning the underlying security.

On-Balance Volume (OBV)
This stock market definition means cumulative volume. If prices close higher than the previous trading session, the volume for the higher day is added to the OBV. On the other hand, volume is subtracted from the OBV on days when prices close lower than the prior day.

Open interest
In futures contracts it is the number of outstanding contracts. It is equal to the total number of long and short positions.

Overbought
A term used when a price has moved too far, too fast in an upward direction.

Oversold
A term used when price has moved too far, too fast in a downward direction.

Open Interest is the total number of outstanding open contracts in a particular option series.

Out of the Money
In options a call is out-of-the-money when the stock price is below the strike price. (conversely, a put option is out-of-the-money when the stock price is higher than the strike price.

Overvalued
A term used to describe when a stock is trading at a higher than reasonable price.

Paper trade
A popular way individuals new to investing can simulate real-life trade circumstances, using imaginary (or paper) money.

Position
A term used to describe a current open trade. i.e. If you bought 100 shares of XYZ, your position would be long 100 shares of XYZ .

Portfolio: The combined holdings of an individual's of assets, including stock, bonds, commodities, real estate investment, etc

Protective Stop
To limit losses on an open position, investors place a 'protective stop', or a 'stop order' to close the position at a predetermined level.

Put Options
The right (but not the obligation) to sell the underlying stock at a predetermined price within a certain time period.

Relative Strength Index (RSI)
An oscillator developed by Welles Wilder, which compares the ratio of positive to negative closes over a specific time period.

Resistance Level
A trading level where evident selling holds the prices from advancing.

Retracement
Price movement in the opposite direction of the recent trend.

Reverse Stock Split
A balanced decrease in the shares of stock held by stockholders. i.e. a 1-for-2 stock split would result in stockholders owning 1 share for every 2 shares owned before the split. (companies will initiate a reverse split to increase the market price of its own stock)

Resistance
A technical analysis stock market definition used to identify a price level that is higher than the current stock price and where the stock has previously traded but failed to break through.

Reward / Risk Ratio
Pertains to the amount of risk involved in a position as compared to the potential profit. Divide the maximum profit by potential loss. A risk/reward ratior of 1 or better mean the potential profit is higher than the potential risk.

Return on Investment
The percentage of profit (or loss) you might make on an investment.

Simple moving average (SMA)
Adding prices together and smoothing the price data to obtain an average. 'Moving' is added because each day the new price information is added to the number, dropping the oldest data.

Stochastics
An oscillator measuring the position of closing prices compared to the trading range over a set period of time. %K refers to the fast stochastic, %D refers to the slow stochastic.

Stock Options awards the holder the right (but not an obligation) to buy or sell particular shares of stock for a set price within a fixed time period. They can be traded in very much the same way as their underlying stocks.

Stop Loss
Pre-determined price where you will exit a position if that price is reached.

Stop Order
A stop loss order is used to instruct your broker to close a position when it hits a predetermined price.

Stock
Owning shares of a stock with rights to ownership on the company's earnings and assets.

Strike price
In options, a specific pre determined price where you can buy or sell the shares.

Short
Sell a stock to which you do not own the underlying security.

Support level
Level where buyers are known to step in and hold prices above that level.

Tick volume
The number of trades occurring during a specific time interval.

Trend
A price's prevalent direction.

Trend-line
A line that can be drawn along a series of highs or lows. The more points that can be connected, the more strength.

Support
A technical analysis term used to identify a floor(or level) lower than the current price of the stock, where previous demand 'supported' and price did not go past this point. The anticipation is that history will repeat itself and the price will stop declining at this level. (Not only is this term explained in this glossary of stock market terms, but it will also be addressed in the technical analysis section of this site).

Underlying Security
The stock an option taker has the right to buy or sell if they choose to exercise their option.

Volatility
Measurement of an underlying stock is expected to vary or fluctuate in a given time period

Volume
The number of transactions that took place within a trading day, indicating the number of buyers and sellers.

Weighted moving average
Another moving average where the most recent data is given greater value over the oldest data. (See additional different types of moving averages)