Advanced technical analysis - Candlestick Charting

Hello my name is Clive Lambert and I would like to welcome you to this video lesson which forms part of the advanced online three month Institutional Trader Programme developed by Knightsbridge Trading Academy in association with London Stock Exchange Group Academy. This lesson is divided into four modules.

Module 1 is a refresher and recap on the concept of candlestick charting, then in module 2, we take an in depth look at the hammer pattern. The third module explores some of the different patterns to look out for and what they signify and the final module explores more patterns and provides some handy tips on how to keep these in mind.

Now let's turn to Module 1.

Candlestick charts have only become popular in the western world in the last 30 or so years, however this is not a passing fad. The psychology behind it has been used by Japanese traders as far back as the 1700s. Chart similar to those today probably came into use is around the late 1800s.

Until the mid 1980's candlesticks were only used by Japanese traders. Then Steve Nison, who at the time was Technical Analyst at Merrill Lynch in New York, kindled an interest in the Western world which he ignited with the publication of his excellent book "Japanese Candlestick Charting Techniques".

In January 2009 my book; "Candlestick Charts – An Introduction to using Candlestick Charts" was published by Harriman House.

As you have seen previously a Candle chart is very similar to a Bar chart as it uses the same data, opening, high, low and close, but it applies a colour scheme. So let's look at the colour scheme. You can see on the left hand side we have an open, white or green candlestick which is bullish. This represents a day where the market closed higher than where it opened. On the right hand side we have what's known as the filled or black or red candlestick, where the close was below the opening price.

This is the generally accepted colour scheme these days, although it is a western version, and not in keeping with the traditional colour scheme used in the early days of hand drawn charts. The original hand drawn charts used black and red ink, red for the up days in fact, as red is considered a "lucky" colour in Japanese culture.

Now let's remind ourselves of the terminology with respect to candlesticks: The bit in the middle, whether it's the green, red, black or white, is called the real body of the candlestick. Above the real body, the difference between the top of the real body and the high of the day is called the upper shadow. The lower shadow is the difference between the low of the real body and the low today. It is important to have a good understanding of this terminology as we go through this module.

The Japanese used Candlesticks as a graphical representation of the psychology of the market. It is important to think of them in this way

Candlesticks give you a graphical representation of the state of mind of each group. Technical Analysts and traders often talk about the markets as two groups; the bulls and the bears; the buyers and the sellers; those who are interested in the market going up or down, respectively. And a candle chart, in fact any chart, is there to try and help us answer questions like:

- Who is winning the battle?
- In an uptrend are the Bulls in charge or are the Bears emerging from the sidelines?
- In a downtrend are the Bears running out of steam, finding it hard to continue relentlessly selling?

Even the shape of a candlestick on its own can give us clues as to what's going on in the markets and give us ideas as to who is in charge between the bulls and the bears. On the left-hand side we can see a Doji candlestick, a candlestick with hardly any real body at all. This means we open and close at very similar levels. What does it tell us about the balance between buyers and Sellers?

It tells us it was an even balance. Nobody won on that day.

On the right hand side we have a couple of Marabuzo candlesticks. These are candlesticks with hardly any upper or lower shadows. These represent days where one group dominated all day. On this one the opening price was the high of the day and we sold off relentlessly through the day, closing on the lows. The right hand candlestick shows an open followed by strong buying through the day resulting in a strong close near the highs.

So the Doji candlesticks represent indecision and balance between bulls and bears, whereas the Marabuzo candlesticks show strong conviction in one direction.

This chart shows a number of Doji candlesticks ending a move higher. Until their appearance the trend was steadily higher and lots of green candlesticks had been posted. Then the Doji candlesticks appeared, and subsequently we saw a significant sell-off. The Doji candlesticks signalled a reversal in the trend.

In this chart we can see a Doji candlestick signalling a reversal after a down move, and interestingly this reversal occurred at a previous support level. The Doji was the signal that the selling had ended and the buyers have returned.

And that concludes module 1.

Module 2

Now let's begin module 2 where we explore the different types of candlesticks and what they signify.

Now we are going to look at the "Hammer" candlestick. Every candlestick has a set of rules, so let's look at the rules for hammer.

Firstly a hammer is a candlestick with a small real body, so like the Doji the open and close were at similar levels.

In the case of the hammer this real body is at the top end of the day's range, which means there is very little upper shadow, or none at all.

The hammer has a long lower shadow, which should be at least twice the length of the real body.

Importantly, number four, this is a reversal candlestick if it is seen during a downtrend.

As you can see from this chart it was a Hammer candlestick that reversed this sell off in Brent crude oil. In the month following this Hammer, on the daily candlestick chart we saw a $12.00 rally in Brent crude; almost 30%!

So what has to happen to create a hammer candlestick? Let's have a look at how the intraday price action gave us this particular hammer.

To form a hammer on the daily charts, we only need four pieces of data: We need to know the open, the higher, the low, and the close. This chart is a 10 minute chart of the day that former the Hammer on the previous chart, so each candle shows 10 minutes' worth of price action. If we transpose across the four pieces of data we need for the daily candle, you can quickly see what has to happen to create a hammer.: The long lower shadow is the result of a sharp sell off followed by a strong rally and a strong close. This gives us a candlestick with a long lower shadow, a sign of downside rejection.

At the start of the session in question the market was travelling lower, as it had been doing in preceding sessions. This was no surprise to anyone, then. Remember we are in a bear market, so we are used to seeing selling.

But then, there was a change: Buyers came into the market and pushed prices higher. By the end of the session we were right back up to where we started the day, on the highs.

This is a significant change from what has gone before and suggests that the market has found support.

In this instance the Hammer did indeed stop the rot and we subsequently saw a strong rally, adding over 20% in under a month.

It is important with candlesticks to wait for confirmation. Both of the hammers on this chart appeared at the bottom of their respective moves and did indeed signal a reversal. However there are two more hammer candlesticks on this chart… Can you see them?

…Here they are, halfway down the first move lower on our chart. As you can see, these two hammer candlesticks did not signal a reversal at all. In fact the red candle after these two was one of the biggest red candles on the chart. It is important therefore to wait for confirmation, to wait and see, to see at least one more candle, to understand whether the market has indeed reversed.

You might wait to see if the next candle is green, or wait for a move above the Hammer candle's high, or you might ask for some other form of confirmation, maybe an indicator like RSI or MACD also agreeing.

Candlesticks can also be used on short term timeframe charts. This is a 30 minute chart showing one days worth of price action for the DAX futures and, as you can see, there were several occasions where the market sold off then swiftly rejected the downside posting Hammer candlesticks, then subsequently rallying, providing opportunities to get long.

And that concludes Module 2.

Module 3

Welcome to Module 3. Now let's explore some more patterns that you will come across and what they mean.

The direct "opposite" to the Hammer is the Shooting Star, with all the "rules" turned on their head:

1. Small real body
2. Real body at the bottom end of the candle with little or no lower shadow
3. The long upper shadow must be at least twice the length of the real body
4. Shooting Stars are reversal patterns when seen in an Uptrend

On this chart you can see an example of a Shooting Star signalling a reversal in the FTSE back in 2014, when the Index hit strong resistance at 6800.

This chart shows several Shooting Star candles all at similar levels that kept signalling the end of rallies during a period of rangy trading in the Aussie Dollar/US Dollar.

Many patterns involve more than one candlestick. The powerful engulfing patterns are worth noting. These are two candle patterns. Let's look at the Bullish Engulfing Pattern first.

The first candle is a Bearish candle in the downtrend. On the second day the market opens weaker, below the previous day's close, before rallying strongly to close above the previous day's open. Effectively, what we're seeing is the "V" shaped direction of travel that forms a Hammer, but over two sessions.

This means that the second candlestick is an open/green candle and it's real body totally envelops, or "Engulfs" the first's real body

The upper and lower shadows do not matter in this pattern, it's all about the real bodies, which makes them slightly different to their western equivalent; the "Outside Day".

This Bullish Engulfing Pattern in Brent Crude Oil halted a sell off that had seen close to $10 lost in just over a month, and over the next 2-3 weeks all of these losses were retaken.

The opposite pattern to a Bullish Engulfing Pattern is, of course, a Bearish Engulfing Pattern. This is a Bearish pattern when seen in an Uptrend.

The first candle is a Bullish candle in line with the prevailing uptrend. Then, on the second day the market opens stronger, above the previous day's close, before selling off sharply to post a weak close, below the previous day's open.

We end up with two candles, the real body of the second totally engulfing/surrounding the real body of the first.

Here we can see two Bearish Engulfing Patterns on the same chart. Of course the first one didn't work as the very next day we made a fresh new high. A week or so later the same combination appeared and interestingly the following days saw a failure at Marabuzo resistance which portended the weakness that followed. You may also spot the "Hammer" that ended the sell-off towards the bottom right of the chart.

This chart shows a number of Bearish Engulfing Patterns and illustrates the importance of waiting for confirmation. As you can see from the top right we gapped higher a few days before the Bearish Engulfing Patterns appeared. If you had asked for a break below the gap support to confirm the reversal you would never have got the confirming signal and would have avoided a bad trade/signal.

And that concludes Module 3. In the next module, we are going to look at some more patterns and provide some tips on how to monitor all these patterns.

Module 4

Welcome to Module 4. Let us look at some more patterns.

Dark Cloud Cover leaves little to the imagination as to whether it's bullish or bearish.

Effectively it is a Bearish Engulfing Pattern that never quite made it!

The second candle, which is red/black/filled, sees a close "well into" the real body from the candle before.

Commonly the Marabuzo line is used to define “well into”, so find the Marabuzo line of the first candle and ask that we close below here on the second day to confirm it as a reversal.

Traditionally this is a powerful pattern on the daily chart for the FTSE, having been present at a number of the significant highs over the last 30 years.

The Morning and Evening Star formations are very powerful and are formed using three candlesticks.

The morning star is a reversal candle stick in a downtrend. The first candle is a bearish candle, the second candle is a small body candle, and the third candle is a day that belongs to the bulls and sees a close well into the real body of the first candle. In fact what has happened here is the same as what we see with a hammer candlestick, but it took three candles instead of one.

The Evening Star is the same combination but everything is turned on its head, so is a bearish combination when seen in a rising market.

The Japanese place particular importance on these patterns. As with previous patterns if you think about the direction of travel over the three sessions combined, it is similar to what you’d see on a Hammer or Shooting Star day.

Another rather esoteric pattern is the “Abandoned Baby” which is a Star with a gap either side of the middle candle. I’ve found over the years that talking too enthusiastically about Abandoned Babies can result in you getting some funny looks. Just a word of warning!

Here we can see A Morning Star that gave us a reversal then a rally that stalled when an Evening Star appeared.

And this chart shows an example of an Abandoned Baby pattern. One thing to consider about a number of the patterns we’ve just looked at is price gaps. In the Evening and morning Star and the Abandoned Baby we talk about candles opening above or below the previous day’s low. This means you are unlikely to see these patterns on Forex charts for example, when one day ends as another ends, meaning gaps are very unlikely. Also some flexibility of interpretation is needed when viewing intra-day charts, for the same reason.

It may seem a bit daunting with so many patterns to remember but it’s worth persevering with, as candles will turn out to be a strong ally for any trader or chartist

Keep a “Cheat Sheet” next to you and refer to it when you see a pattern that looks familiar

Look for patterns on different timeframe charts that are saying the same thing, so if you have reversal patterns on the 10 minute and the hourly charts you can feel higher conviction that a reversal has indeed occurred.

Reversal patterns at support or resistance levels are worthy of extra attention and can be very potent.

Find the patterns which work in your market and your timeframe(s). Engulfing Patterns are generally more potent than say, Dark Cloud Cover, but if you find this to be not to be the case for the market you follow then great! You have to do your homework though!

Thank you for watching and listening. If you have any questions about anything we have covered, please do send me a question via the Institutional Trader Programme platform or ask your online course tutor during the course of your three month online programme. Thank you for listening.