Illuminate your trading with candlestick charts

Candlesticks charts are a favourite of many traders for the amount and variety of information that can be captured within its price patterns. Ng Ee Hwa explains the basics of candlesticks with two common chart patterns that are often observed.

There are many types of price charts available today and one of my favorite is the Japanese Candlestick chart. They are very similar to bar charts except for the many reversal or continuation patterns which can be visually interpreted from a group of successive candles found on the chart. These patterns reflect the change in psychology of traders and is useful in identifying turning points on the chart.

A candlestick is made of the candle body which denotes the opening and closing price and the shadows which denote the intra-period high and the intra-period low where the period can be an hour, one day, a week or a month. The color of the candlestick body tells us if the bulls or the bears won the day. Whenever a candlestick has a white body, it means that the bulls were stronger than the bears and managed to close the price higher than the opening price.

On the other hand, a candlestick with a black body means that the bears were stronger than the bulls and managed to close the price below the opening price. Hence, just by looking at the color of the candlestick body, we are able to deduce which side of the market has won the day. As for the shadows (intra-period high or low), they give us a measure of how much territory the bulls and bears are willing to give to the other. In the case of long shadows, this also often reflects that there was a sudden and abrupt change of power between the bulls and the bears.

For example, if Stock A open at $1.00 and during the trading day it went up to $1.30. With such a surge in price, the bulls are firmly in control as many would have expected. However, if by the closing bell, the stock price falls from the intra-day high of $1.30 to close at $1.00, this will leave a long upper shadow which starts at the candle body and ends at the intra-day high (assuming we are looking at a period of a day to draw the candlestick). For the price to fall from its intra-day high of $1.30 to $1.00, massive selling is required. This long upper shadow thus showed an abrupt and sudden change of power from the bulls to the bears. The opposite is true for the lower shadow. In this case, the

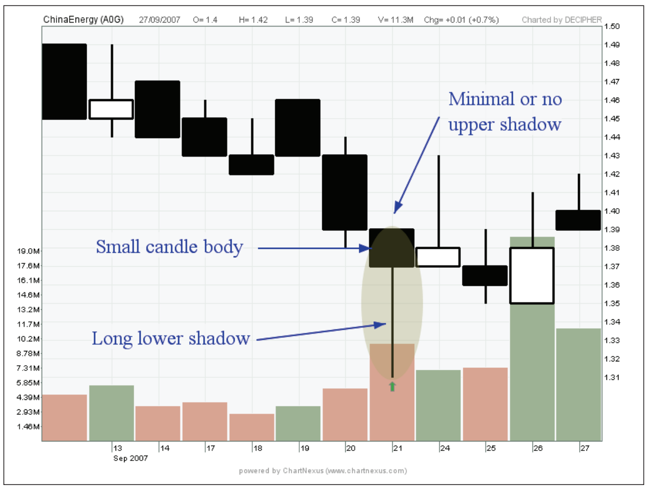

Figure 1: Example of a Hammer.

change of power is from the bears to the bulls and we get a long lower shadow.

THE HAMMER & HANGING MAN

A Hammer is formed if the lower shadow is longer by more than 2 times the candle body. The upper shadow should be very minimal (smaller or equal to candle body) or even non existent. It has a small candle body which is very close to the upper shadow.

In order to use a Hammer pattern effectively, we have to identify the preceding trend before the pattern is formed. This is because while the pattern formed after a downtrend is known as a Hammer, the same pattern can be formed after an uptrend and is known as a Hanging Man. The interpretation is different. When a Hammer pattern is formed, we observe that the bulls are strong and managed to beat the bears by closing the price way above the low of the day. However, when a Hanging Man is formed, we interpret the pattern differently. We observe the long lower shadow as evidence that the bears are flexing their strength in the uptrend but the bulls still manage to stay in control and close the price way above the low during that day. When we trade a Hammer or Hanging Man, we want to see a white confirmation candle and a black confirmation candle respectively.

Figure 2: Hammer with white candle confirmation

As seen in Figure 2, there was a preceding downtrend before we observed that a Hammer was formed which is then followed by a white candle confirmation.

In Figure 3, the price was moving in an uptrend before being interrupted by a Hanging Man pattern. A black confirmation candle then formed and the price began to retrace.

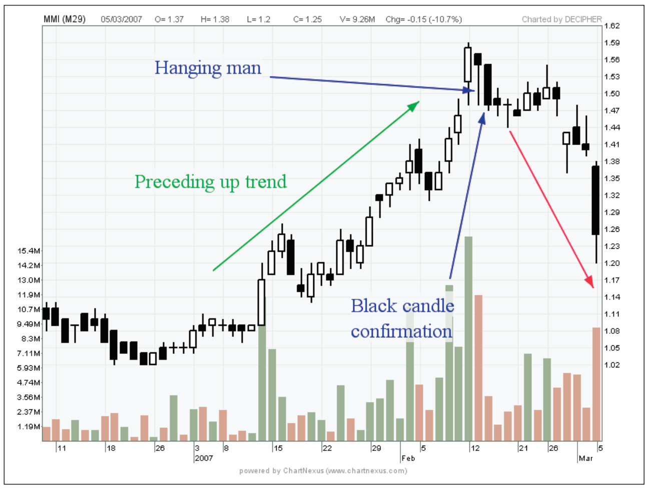

Figure 3: Hanging Man with black confirmation

After learning how to interpret Hammer and Hanging Man patterns, we are going to explore another way of using this Hammer pattern to our advantage with or without the white candle confirmation. Since Hammer and Hanging Man reflects a strong change in power between the bulls and the bears, it will be very effective if we can spot them near support or resistance levels. These can be determined either by trend lines, Fibonacci levels, moving averages and so on. Alternatively, we can use an oscillator like Relative Strength Index (RSI) or Stochastics together with the pattern too.

Figure 4: Example of Hammer resting on support

In Figure 4, we show how to interpret a Hammer pattern together with both the 50 day moving average and the Stochastic indicator. Firstly, the price had been trading lower since early April'07 and a Hammer pattern was formed (denoted by the small arrow). It was then observed that the end of the lower shadow sits on the 50-day moving average. As the moving average can either be used as a support or resistance level; in this case, we say that the price is supported by the 50-day moving average.

Lastly, the stochastic indicated that an oversold level was reached. When the stochastic goes into oversold levels, there is a possibility of the price moving up again. Hence with the Hammer pattern indicating a strong change in power from the bears to the bulls along with the moving average supporting the price and the Stochastic indicating an oversold condition, the probability of the price turning higher becomes very high.

In this article we have learnt to interpret two common candlestick patterns, namely the Hammer and Hanging Man. Also, we have discussed how to combine this analysis with other indicators to give us the all-important upper hand in trading. **SI**

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