ENCYCLOPEDIA OF CANDLESTICK PATTERNS

2-DAY TRADER

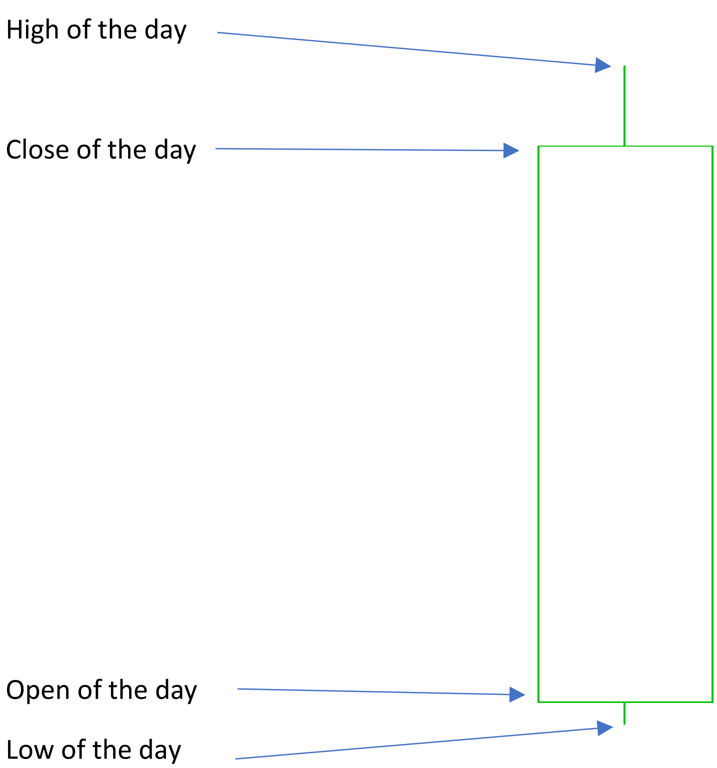
Candle Stick Basics

How do we break down a candlestick?

Candlesticks, originally developed by Japanese rice trader, Munehisa Homma, can offer a snapshot of price action and they are often used as a fundamental tool of technical analysis.

A candlestick in charting is made up of four components, the high, low, open, and close of any given timeframe. Candlesticks can be used to summarize price action on daily, weekly and monthly charts. As well as short time frames such as hourly charts, 30-minute charts, 15-minute and even one-minute charts. Just like in other aspects of technical analysis, timeframe matters! The longer your time frame, the more confidence you can have in the set up. Using a one-minute chart, it is very likely to get fake outs and find noise; whereas a daily chart can eliminate much of the noise and reduce fake outs.

The candlesticks can illustrate a summarized version of the price action versus a conventional line chart that simply shows only one component of the price action, often the close of the given timeframe. Below is a breakdown of the candlestick.



The "real body" is referred to as the range of the candlestick that is represented by the open and close. The shadows or "wicks" are the pieces outside of the real body that represent the high and low of the price action.

Why are candlesticks important?

As previously mentioned, candlesticks are an integral piece of modern technical analysis. Candlesticks can illustrate the psychology of the marketplace based on a candle's formation. Candlesticks can help traders identify momentum, reversals and periods of indecision.

As you read further, we will break down the psychology and analysis of price action using candlestick formations.

Hanging Man Candlestick Pattern

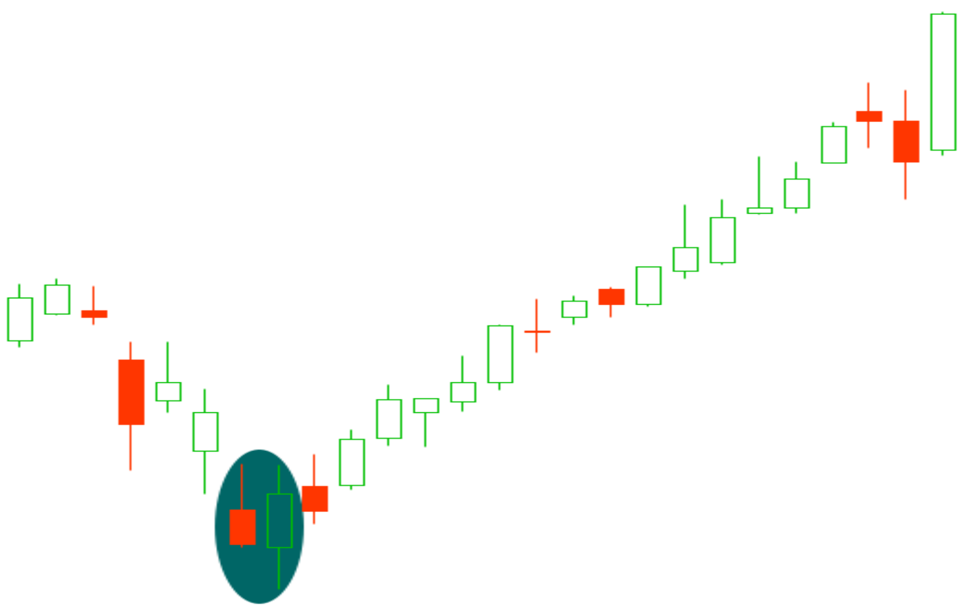
An often forgotten yet powerful one-day pattern is the hanging man candlestick. This candle is simply a reversal pattern that is present after an uptrend. These patterns must have long lower wicks (At least half the range should be in the lower wick) with a tight or small body and a small or no wick at the top of the candle. For this pattern to occur, the price action must be at the top of a trend or simply in an uptrend ~ bullish trend.

This is UPS from May of 2022. Prior to the hanging man candle, we see three green days in a row. On the day of the hanging man, we are trading right into short term resistance. On this day, we see deep selling yet bulls are able to step in and only close right where UPS opened that morning. The market indicates that UPS can begin selling if bulls are unable to step in the next day. Another way you can think of this is that bears were able to reveal vulnerability during the trading day. Overall, this pattern should induce caution for any longs as this is day 1 of deep selling after a short-term uptrend.

The market opens lower the next morning and those holding long will be looking to for a chance to close their long positions creating more selling to occur. This continues to be the trend for the following days proving bears have control.

Bullish Engulfing Candle

Engulfing candles are viewed as a reversal pattern. Engulfing candles are made up of two consecutive candles with the second candle having a dramatic move that goes against the current trend. The wicks of the candles are irrelevant to this pattern as the body is what determines the pattern of this candle. For this explosive pattern to occur, the first and second candle must have opposite colors and the second candle's body must completely engulf the first candle's body. Meaning, the open must be lower than the close of the initial candle, and the close must be higher than the previous candles open.



In this example, AAPL was in a downtrend for multiple weeks (weekly chart). On the engulfing candle, buyers have stepped in after the close of the previous candle was breached and it is safe to stay that AAPL bulls have found value as they bought price above the previous candles close. The overwhelming move can signal a possible end to the current trend. You can see from this AAPL weekly chart that AAPL climbed higher for consecutive weeks after the bullish engulfing candle.

Since the second candle engulfs the initial candle, we can see new buyers have overwhelmed the AAPL bears and signaled a shift in sentiment.

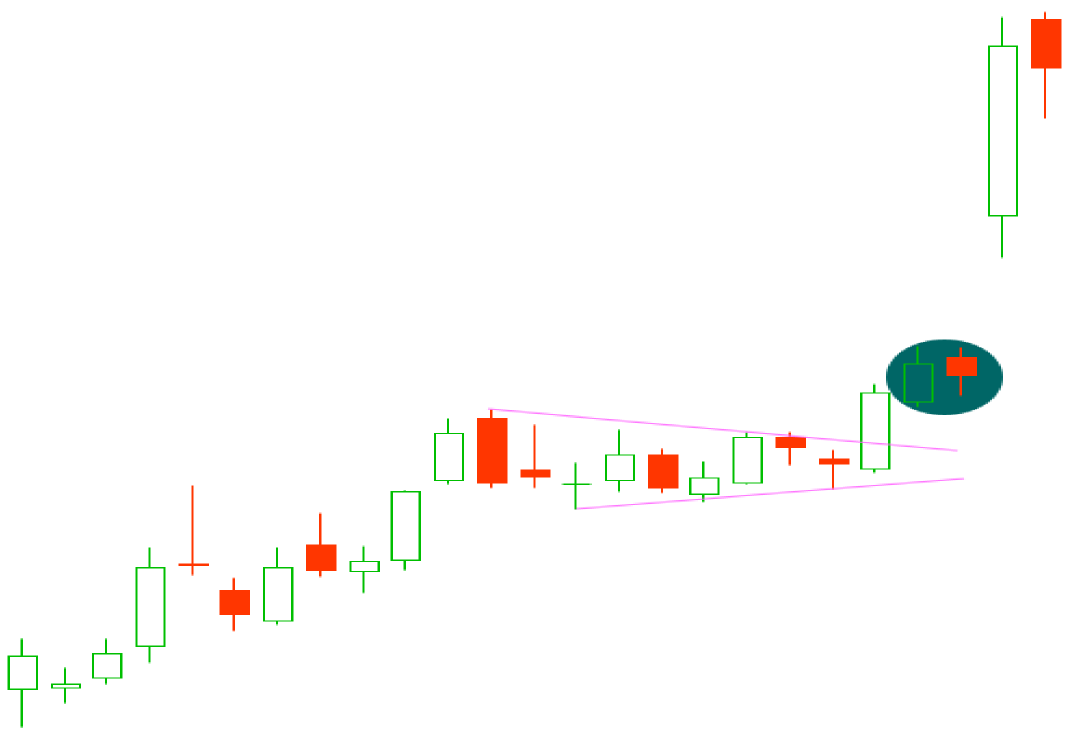
Bearish Engulfing candle

Bearish Engulfing candles are the exact opposite of bullish engulfing candles. We need to see the second candles body completely engulf the first candles body after a sustained uptrend.

In this example, the second candle overwhelmed the bulls after a sustained uptrend. The bulls, who are already long, are unable to continue buying to retain the advantage over bears. This is an indication of a sentiment shift amongst the market and bulls are beginning to lose control and unable to maintain a push higher.

Inside Day

Consolidation leads to amplification. Simply, an inside bar illustrates quick consolidation prior to a dramatic move. Due to a quick consolidation during a current trend, inside days are typically continuation moves. An inside bar is defined as the second bar, including wicks, trading completely inside the prior bar. The low must be higher than the low of the previous bar and the high must lower than the high of the previous bar thus creating an inside day candle. Inside bars will typically move in the direction of the current trend.



In this chart, we see a current uptrend that is now consolidating above a bull flag chart pattern. Price is now breaking through the flag and we have consolidation above the flag.

This tight consolidation shows that on a day of low volatility, bulls would not allow any budge below the prior days low and that the buyers are still present.

Conclusion of candlestick patterns

Just like in all aspects of trading, there is no one "quick fix". These patterns are ever present across indices and securities and shouldn't be used solely as justification to enter any one trade. It is important to use various elements to boost the probabilities of any trade put on and candlestick patterns should never be the only element.

At 2 Day Trader, we use various criteria and elements beyond candlestick patterns to enter a trade to improve probabilities of success. The candlestick formations are a major piece of the system, but candlestick patterns alone prove to be noisy and inconsistent due to overall frequency of these candles. Traders must use rigid conditions and filters to determine favorable trades to place.

After 29 months of testing, 2 Day Trader has been able to generate $31,072 in profits on a $10,000 model account using our proprietary trading strategy built around the fundamental aspects of these candlestick patterns. Note: Up to $1,000 invested per trade, results are before commissions, past performance is no guarantee of future success and trading involves risk.

If you're interested in learning more about the 2 Day Trader strategy, please visit 2daytrader.com.