Candlesticks (StockCharts.Com)

History

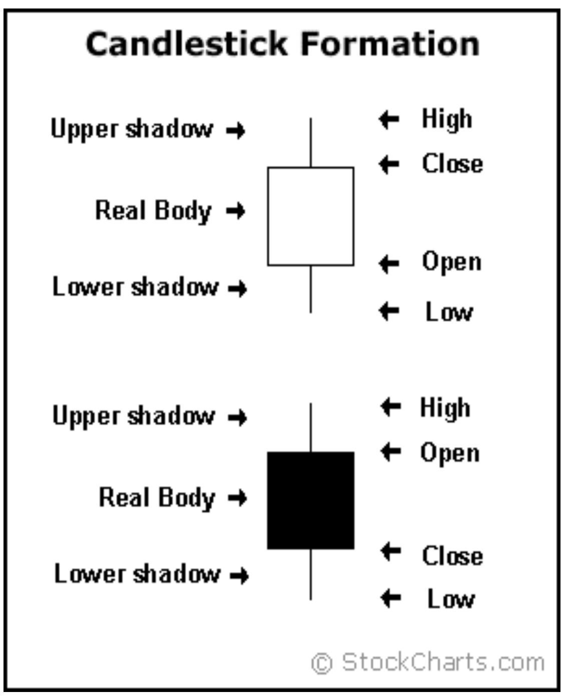
The Japanese began using technical analysis to trade rice in the 17th century. While this early version of technical analysis was different from the US version initiated by Charles Dow around 1900, many of the guiding principles were very similar:

- The "what" (price action) is more important than the "why" (news, earnings, and so on).
- All known information is reflected in the price.
- Buyers and sellers move markets based on expectations and emotions (fear and greed).
- Markets fluctuate.
- The actual price may not reflect the underlying value.

According to Steve Nison, candlestick charting first appeared sometime after 1850. Much of the credit for candlestick development and charting goes to a legendary rice trader named Homma from the town of Sakata. It is likely that his original ideas were modified and refined over many years of trading eventually resulting in the system of candlestick charting that we use today.

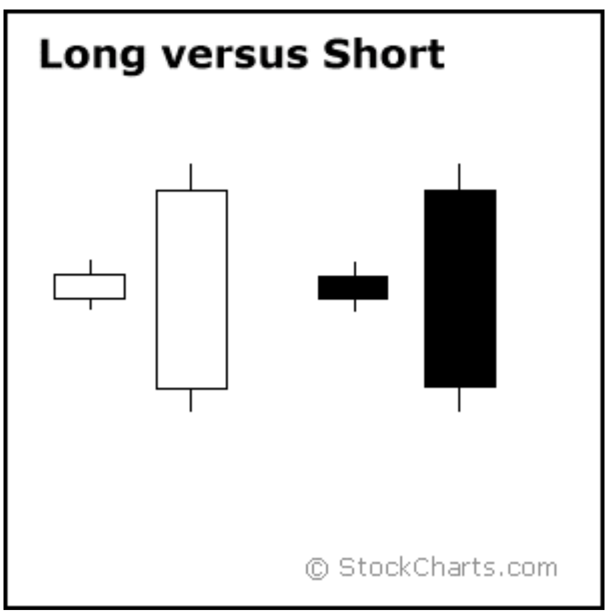
Formation

In order to create a candlestick chart, you must have a data set that contains open, high, low and close values for each time period you want to display. The hollow or filled portion of the candle 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 closes higher than its opening price, a hollow 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 closes lower than its opening price, a filled candlestick is drawn with the top of the body representing the opening price and the bottom of the body representing the closing price.



Compared to traditional bar charts, many traders consider candlestick charts more visually appealing and easier to interpret. Each candlestick provides an easy-to-decipher picture of price action. Immediately a trader can see compare the relationship between the open and close as well as the high and low. The relationship between the open and close is considered vital information and forms the essence of candlesticks. Hollow candlesticks, where the close is greater than the open, indicate buying pressure. Filled candlesticks, where the close is less than the open, indicate selling pressure.

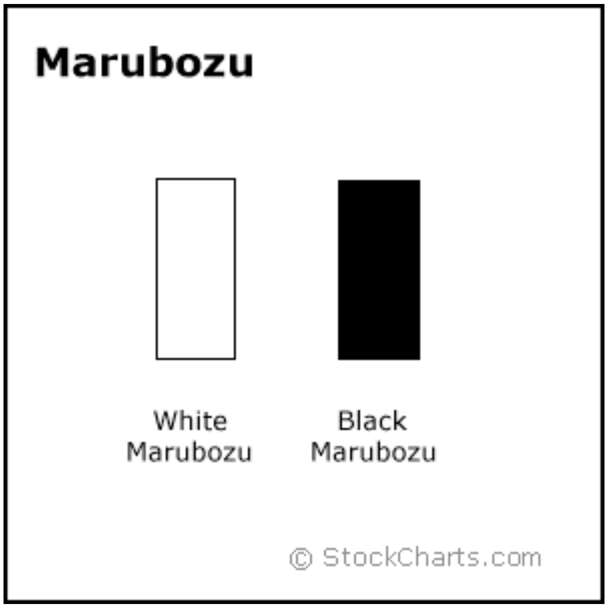
Long Versus Short Bodies



Generally speaking, the longer the body is, the more intense the buying or selling pressure. Conversely, short candlesticks indicate little price movement and represent consolidation.

Long white canclesticks show strong buying pressure. The longer the white candlesticks is, the further the close is above the open. This indicates that prices advanced significantly from open to close and buyers were aggressive. While long white candlesticks are generally bullish, much depends on their position within the broader technical picture. After extended declines, long white candlesticks can mark a potential turning point or support level. If buying gets too aggressive after a long advance, it can lead to excessive bullishness.

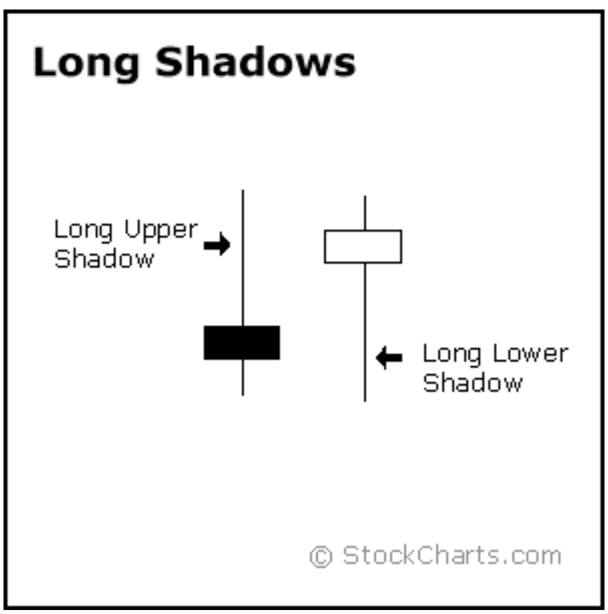
Long black candlesticks show strong selling pressure. The longer the black candlestick is, the further the close is below the open. This indicates that prices declined significantly from the open and sellers were aggressive. After a long advance, a long black candlestick foreshadows a turning point or mark a future resistance level. After a long decline a long black candlestick can indicate panic or capitulation.



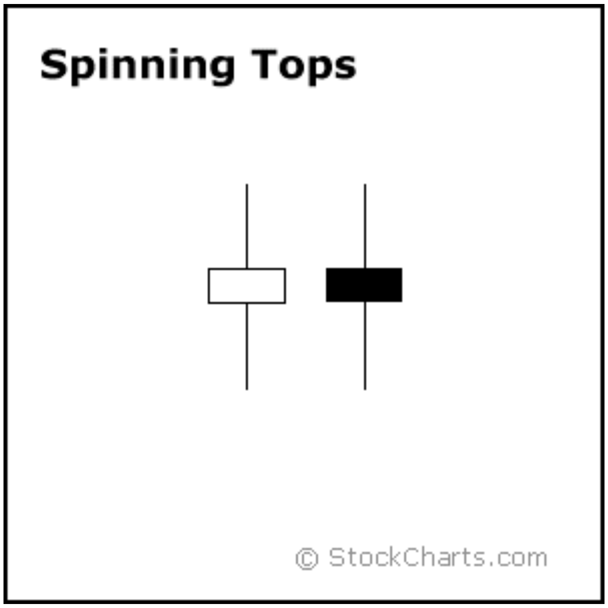
Even more potent long candlesticks are the Marubozu brothers, Black and White. Marubozu do not have upper or lower shadows and the high and low are represented by the open or close. A White Marubozu forms when the open equals the low and the close equals the high. This indicates that buyers controlled the price action from the first trade to the last trade. Black Marubozu form when the open equals the high and the close equals the low. This indicates that sellers controlled the price action from the first trade to the last trade.

Long Versus Short Shadows

The upper and lower shadows on candlesticks can provide valuable information about the trading session. Upper shadows represent the session high and lower shadows the session low. Candlesticks with short shadows indicate that most of the trading action was confined near the open and close. Candlesticks with long shadows show that prices extended well past the open and close.

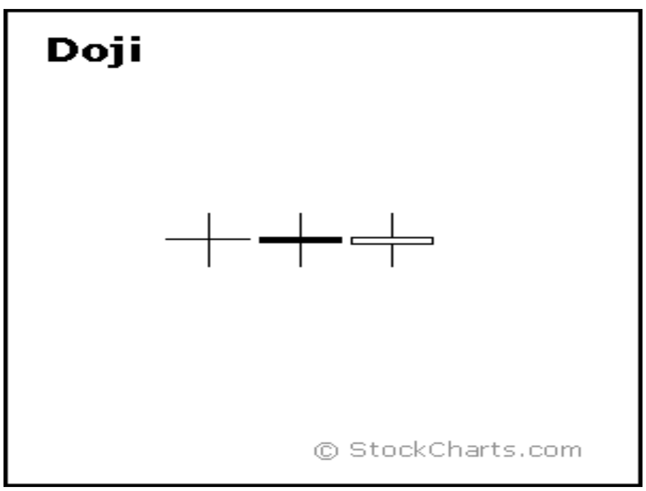


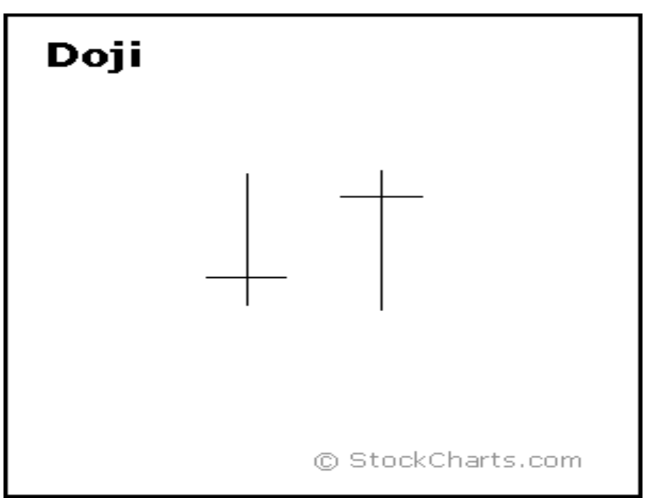
Candlesticks with a long upper shadow and short lower shadow indicate that buyers dominated during the session, and bid prices higher. However, sellers later forced prices down from their highs, and the weak close created a long upper shadow. Conversely, wcandlesticks with long lower shadows and short upper shadows indicate that sellers dominated during the session and drove prices lower. However, buyers later resurfaced to bid prices higher by the end of the session and the strong close created a long lower shadow.



Candlesticks with a long upper shadow, long lower shadow and small real body are called spinning tops. One long shadow represents a reversal of sorts; spinning tops represent indecision. The small real body (whether hollow or filled) shows little movement from open to close, and the shadows indicate that both bulls and bears were active during the session. Even though the session opened and closed with little change, prices moved significantly higher and lower in the meantime. Neither buyers nor sellers could gain the upper hand and the result was a standoff. After a long advance or long white candlestick, a spinning top indicates weakness among the bulls and a potential change or interruption in trend. After a long decline or long black candlestick, a spinning top indicates weakness among the bears and a potential change or interruption in trend.

Doji



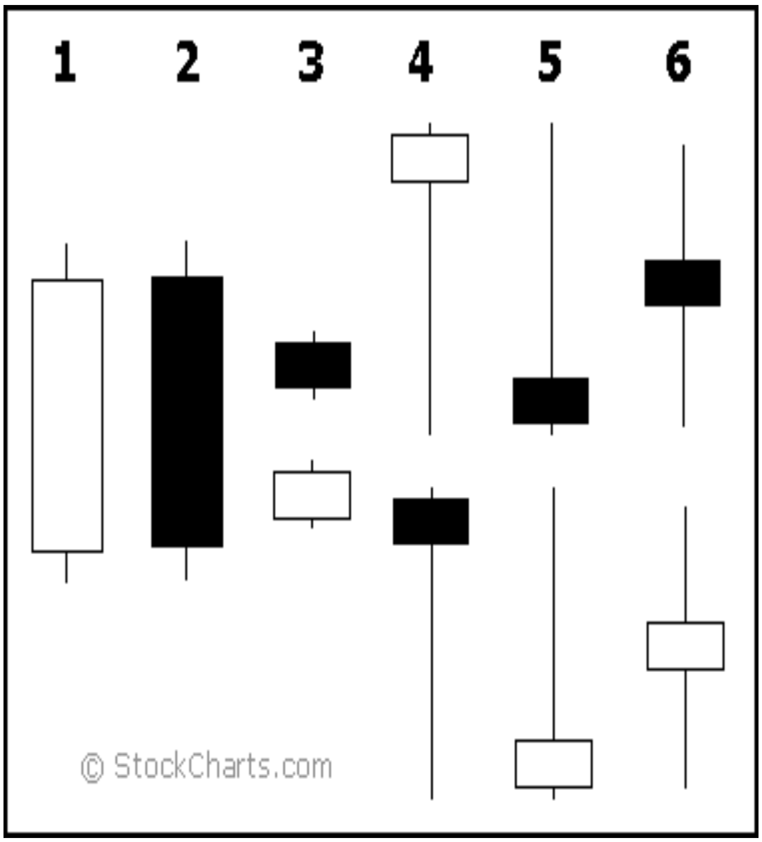


Doji are important candlesticks that provide information on their own and as components of in a number of important patterns. Doji form when a security's open and close are virtually equal. The length of the upper and lower shadows can vary and the resulting candlestick looks like a cross, inverted cross or plus sign. Alone, doji are neutral patterns. Any bullish or bearish bias is based on preceding price action and future confirmation. The word "Doji" refers to both the singular and plural form.

Ideally, but not necessarily, the open and close should be equal. While a doji with an equal open and close would be considered more robust, it is more important to capture the essence of the candlestick. Doji convey a sense of indecision or tug-of-war between buyers and sellers. Prices move above and below the opening level during the session, but close at or near the opening level. The result is a standoff. Neither bulls nor bears were able to gain control and a turning point could be developing.

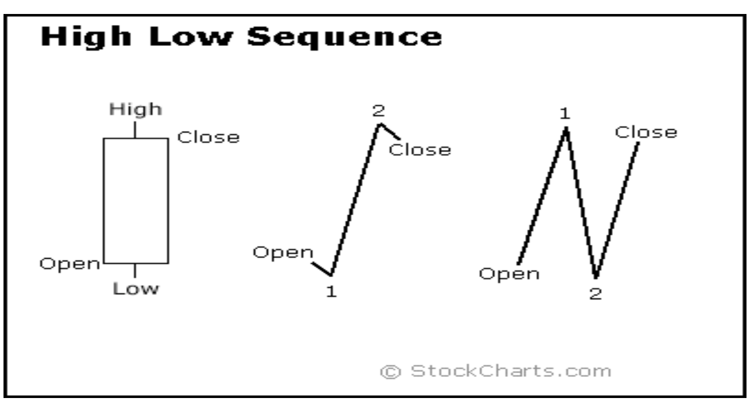
Bulls Versus Bears

A candlestick depicts the battle between Bulls (buyers) and Bears (sellers) over a given period of time. An analogy to this battle can be made between two football teams, which we can also call the Bulls and the Bears. The bottom (intra-session low) of the candlestick represents a touchdown for the Bears and the top (intra-session high) a touchdown for the Bulls. The closer the close is to the high, the closer the Bulls are to a touchdown. The closer the close is to the low, the closer the Bears are to a touchdown. While there are many variations, I have narrowed the field to 6 types of games (or candlesticks):



1. Long white candlesticks indicate that the Bulls controlled the ball (trading) for most of the game.
2. Long black candlesticks indicate that the Bears controlled the ball (trading) for most of the game.
3. Small candlesticks indicate that neither team could move the ball and prices finished about where they started.
4. A long lower shadow indicates that the Bears controlled the ball for part of the game, but lost control by the end and the Bulls made an impressive comeback.
5. A long upper shadow indicates that the Bulls controlled the ball for part of the game, but lost control by the end and the Bears made an impressive comeback.
6. A long upper and lower shadow indicates that the both the Bears and the Bulls had their moments during the game, but neither could put the other away, resulting in a standoff.

What Candlesticks Don't Tell You



Candlesticks do not reflect the sequence of events between the open and close, only the relationship between the open and the close. The high and the low are obvious and indisputable, but candlesticks (and bar charts) cannot tell us which came first.

With a long white candlestick, the assumption is that prices advanced most of the session. However, based on the high/low sequence, the session could have been more volatile. The example above depicts two possible high/low sequences that would form the same candlestick. The first sequence shows two small moves and one large move: a small decline off the open to form the low, a sharp advance to form the high, and a small decline to form the close. The second sequence shows three rather sharp moves: a sharp advance off the open to form the high, a sharp decline to form the low, and a sharp advance to form the close. The first sequence portrays strong, sustained buying pressure, and would be considered more bullish. The second sequence reflects more volatility and some selling pressure. These are just two examples, and there are hundreds of potential combinations that could result in the same candlestick. Candlesticks still offer valuable information on the relative positions of the open, high, low and close. However, the trading activity that forms a particular candlestick can vary.

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