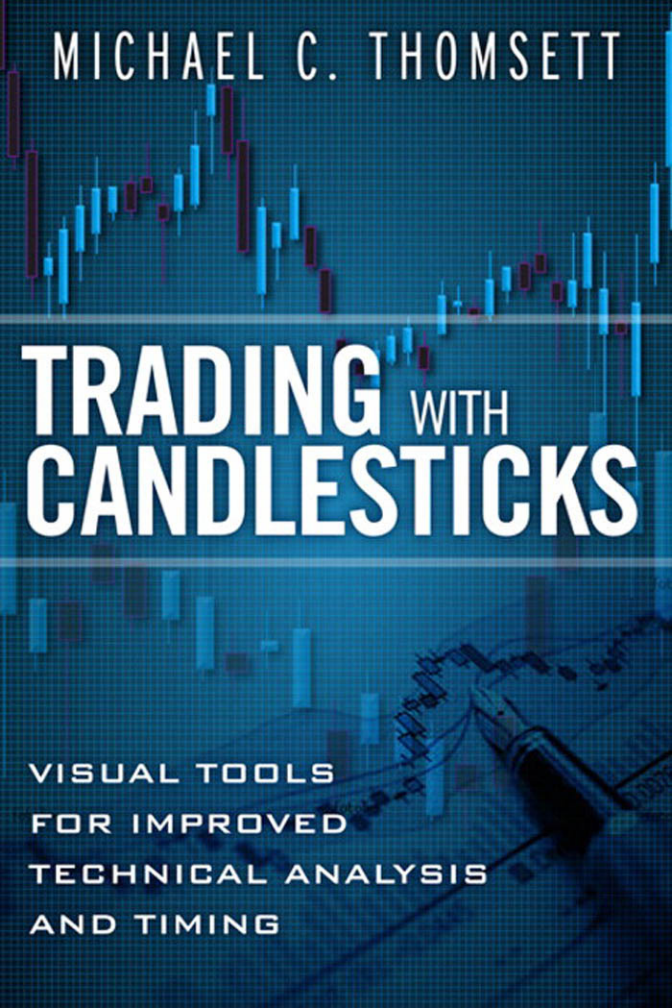
MICHAEL C. THOMSETT
TRADING WITH CANDLESTICKS
VISUAL TOOLS FOR IMPROVED TECHNICAL ANALYSIS AND TIMING

Vice President, Publisher: Tim Moore
Associate Publisher and Director of Marketing: Amy Neidlinger
Executive Editor: Jim Boyd
Editorial Assistant: Pamela Boland
Operations Manager: Gina Kanouse
Senior Marketing Manager: Julie Phifer
Publicity Manager: Laura Czaja
Assistant Marketing Manager: Megan Colvin
Cover Designer: Alan Clements
Managing Editor: Kristy Hart
Project Editor: Anne Goebel
Copy Editor: Chuck Hutchinson
Proofreader: Kathy Ruiz
Senior Compositor: Gloria Schurick
Manufacturing Buyer: Dan Uhrig

© 2011 by Pearson Education, Inc.
Publishing as FT Press
Upper Saddle River, New Jersey 07458

This book is sold with the understanding that neither the author nor the publisher is engaged in rendering legal, accounting, or other professional services or advice by publishing this book. Each individual situation is unique. Thus, if legal or financial advice or other expert assistance is required in a specific situation, the services of a competent professional should be sought to ensure that the situation has been evaluated carefully and appropriately. The author and the publisher disclaim any liability, loss, or risk resulting directly or indirectly, from the use or application of any of the contents of this book.

FT Press offers excellent discounts on this book when ordered in quantity for bulk purchases or special sales. For more information, please contact U.S. Corporate and Government Sales, 1-800-382-3419, corpsales@pearsontechgroup.com. For sales outside the U.S., please contact International Sales at international@pearson.com.

Company and product names mentioned herein are the trademarks or registered trademarks of their respective owners.

All rights reserved. No part of this book may be reproduced, in any form or by any means, without permission in writing from the publisher.

Printed in the United States of America

First Printing August 2010
ISBN-10: 0-13-138094-X
ISBN-13: 978-0-13-138094-3
Pearson Education LTD.
Pearson Education Australia PTY, Limited
Pearson Education Singapore, Pte. Ltd.
Pearson Education North Asia, Ltd.
Pearson Education Canada, Ltd.
Pearson Educatión de Mexico, S.A. de C.V.
Pearson Education—Japan
Pearson Education Malaysia, Pte. Ltd.

Library of Congress Cataloging-in-Publication Data:
Thomsett, Michael C.
Trading with candlesticks : visual tools for improved technical analysis and timing / Michael C. Thomsett.
p. cm.
Includes index.
ISBN-13: 978-0-13-138094-3 (hardback : alk. paper)
ISBN-10: 0-13-138094-X
1. Stocks—Charts, diagrams, etc. 2. Investment analysis. 3. Portfolio management. I. Title.
HG4638.T46 2011
332.63'2042—dc22

2010010281

Contents

Acknowledgments viii
About the Author ix
Introduction 1

Chapter 1 The Basic Candlestick 5
The Origin and Meaning of the Candlestick 6
Strengths and Weaknesses of Candlesticks 9
Paper Trading as a Testing Ground 12
The Skills Every Trader Needs 14
Candlesticks: General Observations Concerning Their Use 18
Expanding the Information Pool Effectively 20
Endnotes 22

Chapter 2 Single-Stick Signs 25
Uptrends and Downtrends 25
The Significance of a Candlestick's Shape 28
Variations on the Bullish Long Candlestick 30
The Mistake Pattern 32
The Spinning Top, Hanging Man, and Hammer 37
The Significance of Tails 42

Chapter 3 Double-Stick Moves 47
Two Reversal Moves: Engulfing and Harami 48
More Reversals: The Inverted Hammer and Doji Star 53
Even More Reversals: Meeting Lines and Piercing Lines 56
Confirming Patterns: Thrusting, Separating, and Neck Lines 60
Reversal and Confirming Moves—Relative Values 66

Chapter 4 Complex Stick Patterns 69
Reversal Trend Change Patterns 71
Reversal Trend Inside and Outside Formations 74
Reversal Stars and Abandoned Babies 78
Complex Trend Patterns 82
Complex Gap Trends 86

Chapter 5 Reversal Pattern Analysis 91
Recognizing the Bull Reversal 91
Recognizing the Bear Reversal 94
The Doji as a Reversal Signal 97
Reversal Patterns with Gaps 101
Reversals Setting New Support or Resistance 104
More Resistance and Support Reversals 108
Multisession Gap Reversals 111

Chapter 6 Volume and Volatility 119
Volume as a Price Indicator 119
Volume Indicators 122
Volume Indicators and Candlesticks 126
Testing Price Volatility 131

Chapter 7 Buy and Sell Setup Signals 141
Price Spikes and Reaction Swings 143
Percentage Swing Systems 146
Short-Term Gapping Behavior 149
Anticipating the Trend During Consolidation 153
The Setup Pattern and Swing 156
Support and Resistance in the Swing Trade 165

Chapter 8 Swing Trading with Candlesticks 171
A Swing Trading Overview 171
Quantifying Price Movement with Candlesticks 174
The Importance of Convergence and Divergence 178
Primary Trends and Candlestick-Based Entry or Exit 182
Setup Criteria and Action Points 186
Selling Short in Swing Trades 190

Chapter 9 Spotting Trends and Using Trendlines 193
Identifying the Trendline 194
Trendlines and Candlesticks as Confirmation 200
Applying Moving Averages to Candlestick Analysis 203
Chapter 10 Technical Indicators 207
The Value of Confirmation 207
A Review: Technical Analysis Basics 209
The Significance of Gaps 212
A Key Framework: Support and Resistance 215
Overbought and Oversold Indicators 217
The Potential of Candlestick Signals 222
Glossary 225
Index 235

Introduction

Confusion and uncertainty: the two common attributes of the stock market. The random short-term movements in public trading create a lot of confusion and certainly add to uncertainty among traders. A novice understands this reality, but even experienced professionals who have been trading for years suffer the same affliction.

This is where chart analysis becomes valuable. No one can claim a perfect record of timing buy and sell decisions, and no one realistically expects to beat the market with every trade. It is enough to beat the averages and to outperform the typical profit or loss experience ratio. For many, today's profits are eroded by tomorrow's losses, and so many individual traders find themselves seeking trades just to get back up to dead even. The candlestick chart is a valuable tool that helps you anticipate trends in a stock's price and improve the timing of buy and sell orders. Ironically, even experienced traders who refer regularly to candlestick charts often are not well versed in recognition of patterns or their significance.

This book first describes candlestick charts in detail and shows how they are constructed. The advantage with this visual aid is that you can find all the price information in one symbol. This includes a day's opening and closing price, the trading range, and direction (upward or downward) of movement. The candlestick also shows each day's *breadth* of trading range. When you view an array of charts over a number of trading periods, you can determine in an instant whether a stock is high- or low-volatility, whether it is trending upward or downward, and most of all, *when* to make a move. Collectively, this is a valuable set of statistics. Most traders who have analyzed price movement using candlesticks understand these basic attributes, but if this is the extent of your understanding, you need more.

Beyond the basics, this book explains how to recognize different kinds of signs, moves, and patterns (bull, bear, reversal, and market) and how to employ double and triple stick formations to better understand why prices are behaving in a particular manner. Many of these moves and patterns are subtle, and their meaning is easily lost in the more recognizable patterns most traders seek.

Candlesticks are also valuable when analyzed in combination with other indicators. For example, two factors often overlooked in price-focused technical analysis are the critical attributes of price movement and risk: volume and volatility. This book explains how candlestick chart analysis employing these important features will help you improve your mastery of stock trading. Advanced technical analysis can be greatly enhanced by combining candlestick indicators with the better-known price patterns and trends.

Chapter 7, "Buy and Sell Setup Signals," examines and analyzes the use of swing trading techniques to improve the timing of trades. A setup is a sign found in candlestick movement and breadth, pointing to the best timing of either buy or sell, and also serving as a confirmation tool. Adding to this the trend indicators found in moving averages, you gain valuable insights that will become indispensable in your daily trading strategy. Moving averages show you not only where prices are today, but how these are significant in terms of what will happen next. Unfortunately, the popular convergence signals often come too late to take action and maximize the timing advantage. This is where candlestick patterns can help you anticipate trends well before other indicators solidify the information.

The entire range of technical indicators involves timing of decisions. Candlestick charts are timing tools not only for trends in upward or downward directions, but also for determining the strength of the current movement or its weakness. Some patterns are easily identified, whereas others reflect a lot of uncertainty among traders. The endless struggle between buyers and sellers usually involves one side or the other dominating the price movement, but at times buyers and sellers are deadlocked. This condition is just as important as a strong bull or bear pattern because it also helps time your decision to buy, sell, or take no action.

After introducing the patterns of single and combined candlesticks, exploring setup signals, and examining moving averages, *Trading with Candlesticks* concludes with an analysis of candlesticks used in combination with technical indicators that most chart analysts employ. Analysis of price movement requires at least a rudimentary appreciation of a few very important price patterns, and these are most readily recognized with candlestick patterns. Whether you are an active day trader, a swing trader, or a technician, this book provides the essential visual and interpretative information you need to expand your technical knowledge. Even the conservative value investor who dabbles in speculation from time to time will find great value in the study of candlestick charts.

The book combines several important features to help you. They include sidebars with key points and definitions, ample checklists, and examples and charts of actual companies demonstrating candlestick chart movement and their interpretation. A word about the charts of actual companies: No matter which company's charts are used or when they are picked, any chart is likely to reflect a range of prices that is out of date by the time this book is published. Most of the charts in this book are from familiar Blue Chip companies because these names are well known to most people, and that familiarity makes the analysis more accessible and practical for most readers. Remember, though, that even an out-of-date chart is revealing. It's not the price level or current condition of a stock that matters, but the pattern and strength or weakness of price movement. The observations based on these charts apply to all stocks and at all price levels.

The charts are also consistent in their time frame. They are mostly one-month daily summaries of price movement. This approach was selected because a majority of traders think in terms of the opening and closing price, breadth of trading, and direction on a *daily* basis. Stocks open and close within the easily defined day, and this is the best-known trading period. But it is also important to understand that chartists use a variety of different trading periods—hourly, 15-minute, or 5-minute charts, for example. The amazing thing about charting is that no matter what length of time you use in your chart analysis, the same rules and observations apply. A pattern is going to be found in a daily or weekly chart and likewise in a one-minute chart. The significance of movement is identical even though the timing of trade decisions is different. So a trader oriented to making decisions from day to day is going to act in the venue of "daily" change. A day trader, in comparison, is likely to use the shorter-term charts and make decisions in terms of hours or even minutes. Both are using the same trading information, moving averages, and patterns; that is the fact worth remembering.

Finally, the question must arise: Where do you find free charts? Many Web sites offer free charts for virtually any listed stock, and you can use these sites to get what you need for stocks you want to track and trade. These sites also offer subscriptions that include more advanced features beyond the basic delayed-quote chart. For many traders, the free information provided by brokerage firms, financial companies, and others is enough. For other traders, the cost of a subscription makes the added information worth the price.

This book is intended for the experienced trader and technician who wants to find out how charting can improve technical analysis or who needs to add to a body of knowledge about interpreting technical patterns and time buy, sell,

and hold decisions. Candlesticks are one of the best tools for aiding analysis of stock prices and confirming indicated reversals and continuations or, equally important, spotting signals that are going to fail. The point of adding to technical knowledge through confirmation signals is to improve timing and to employ more traditional technical indicators in an effective timing strategy.

Index

A

abandoned baby, 78-82
accumulation/distribution (AD), 125-126
Alcoa (AA):
- bearish volume indicator, 129
- bull squeeze alert, 73
- falling wedge, 138-139
- inside down, 76
- marubozu with volume spike, 157-158
- three black crows false reversal, 95

American Express (AXP):
- bullish volume indicator, 127-129
- consolidation with marubozu breakout, 154-155
- engulfing moves, 49
- white soldiers and black crows, 71-72

anticipating the trend, 153-156
Apple (AAPL):
- continuation after exhaustion gap, 214
- exit signals followed by continuation, 188
- gaps, 213
- inside up, 75
- percentage of change system, 147

ascending triangle, 134-135
average holding period, 210

B

Bank of America (BAC):
- ascending triangle, 135
- bull abandoned baby, 80-81
- consolidation with inverse head and shoulders, 155
- meeting lines, 57-58

bear:
abandoned baby, 81-82
belt hold, 103
breakaway, 112-113
reversal, 94-97
squeeze alert, 73-74
stick sandwich, 106-107
bearish volume indicator, 129
belt hold, 102-103
Best Buy (BBY):
bullish tail, 42-43
false indicator: marubozu with volume spike, 157-159
outside up and down, 77
rising wedge, 137
black crows, 71-72
Boeing (BA):
bear breakaway, 112-113
bear inverted hammer, 54
CMF move with repetitive price gaps, 162-163
downside gap filled, 89
Bollinger bands, 220
breakaway gap, 212
breakaway pattern, 111-113, 145
bull:
abandoned baby, 80-81
belt hold, 102-103
breakaway, 112
reversal, 91-96
squeeze alert, 72-73
stick sandwich, 105-106
bullish:
long candlestick, 30-32
tail, 43
volume indicator, 127-128

C

candlestick:
attributes, 8-9
bullish long, 30-32
chart, defined, 5
complex patterns, 69-70
confirmation, 200-203
entry or exit, 182-186
formations, 19
moving averages, 203-206
observations of, 18-20
potential, 222-223
shapes, 28-30
strengths and weaknesses, 9-11
swing trading with, 174-178
volume indicators and, 126-131
Caterpillar (CAT):
downward trendline ending, 200-201
morning star false reversal, 93-94
moving averages with candlestick trends, 180-181
price gap with volume spike, 160
Chaikin Money Flow (CMF), 126-131, 153, 157, 162-164, 208
Chevron Corp (CVX):
bear stick sandwich, 106-107
false indicator: CMP move with repetitive price gaps, 163-164

Cisco (CSCO):
bear squeeze alert, 73-74
breakout with no volume spike, 121-122
Coca-Cola (KO):
marubozu, 31-32
neck line move (bull), 64-65
piercing lines, 59
trend with marubozu but no breakout, 167-168
coil, 133
common gap, 87, 212
complex trend patterns, 82-85
concealing baby swallow, 104-105
confirmation, 19-20, 200-209
confirming indicators, 60-61
confirming moves, 66-67
consolidation, 153-156
contradictory volume indicator, 130
contrarian investor, 142-143
convergence/divergence, 178-182

D

dark cloud cover, 59
descending triangle, 135-136
Disney (DIS):
harami, 51
neck line (bear), 65-66
tasuki gap, 86-87
three rivers bottom, 110
dividend yield, 21
doji:
dragonfly, 33-34
gravestone, 35
long-legged, 35-37
narrow-range day, 32
near, 98
northern, 98
reversal signal, 97-100
southern, 98
star, 53-56
tri-star pattern, 99-100
downside:
gap filled, 89
tasuki gap, 86
downtrends, 25-28
dragonfly doji, 33-34
DuPont (DD):
bear abandoned baby, 81-82
contradictory volume indicator, 130
exit signals followed by reversal, 189
ladder top, 116-117

E

engulfing, 48-52, 76-77
entry signals, 186
evening star, 79-80
exhaustion gap, 213-214
exit signals, 187-189
Exxon-Mobil (XOM):
bull belt hold, 102-103
bull breakaway, 112
dragonfly doji, 33-34
failing spinning tops, 39
falling three pattern, 114-115
multiple reversal signals, 176-177

side-by-side white lines bear, 85
three white soldiers false reversal, 92
trendline in a downtrend, 199

F

falling three pattern, 114-115
falling wedge, 138-139
fundamental volatility, 132

G

gap:
breakaway, 212-213
common, 87, 212-213
complex 86-90
exhaustion, 213-214
filled, 87-88
multisession reversals, 111-117
repetitive, 162-164
reversal patterns with, 101-104
runaway, 212-213
short-term behavior, 149-153
significance of, 212-215
tasuki, 86-87
trend, 150-152
with volume spike, 160-162
without breakout, 168-169
General Electric (GE):
harami cross, 52
northern and southern dojis, 99
Gold Trust Shares (GLD),
overbought/oversold indicators, 220-221
Google (GOOG):
bear belt hold, 103
ladder bottom, 116
spinning top, 37-38
gravestone doji, 35

H

hammer, 37-41, 79
hanging man, 37-41
harami, 48-52, 74-75, 167
harami cross, 51-52
Hewlett-Packard (HPQ):
percentage of change system, 148-149
trendline in an uptrend, 198
Home Depot (HD) upside gap filled, 88

I

in neck, 64-66
information pool, 20-22
inside formations, 74-77
Intel (INTC):
evening star, 79-80
spike with breakaway and new range, 144-145
inverse head and shoulders, 155
inverted hammer, 53-56

J

JCPenney (JCP):
bull stick sandwich, 106
dragonfly doji failure, 34-35

hammer, 40-41
three rivers top, 111
Johnson & Johnson (JNJ):
bull side-by-side black lines, 84
evening star false reversal, 96
moving averages to support trends, 203-204

K

kicking, 101-102
Kraft Foods (KFT):
false indicator: price gap with volume spike, 161
short-term trends within the primary trend, 183

L

ladder pattern, 115-117
long-legged doji, 35-37

M

MACD (moving average convergence/divergence), 219
major yin, 124
marubozu, 30-32, 124, 128, 154-160, 166-168
mat hold, 113-114
matching pattern, 107-108
McDonald's (MCD):
bull inverted hammer, 53
concealing baby swallow, 104-105
gapping trend, 152
hanging man, 39-40
morning star, 78-79
upward trendline ending, 201-202
meeting lines, 56-60
Merck (MRK):
price direction confirmed within a primary trend, 185
short-term trends with strong candlestick signals, 183-184
Microsoft (MSFT):
symmetrical triangle, 133-134
trend with gaps but no breakout, 168-169
mistake pattern, 32-37
MMM (3M Co.), volume as a leading indicator, 123-124
momentum oscillator, 218
money flow index (MFI), 125
morning star, 78-79
moving average (MA), 179-181, 203-206

N

narrow-range day (NRD), 32, 38, 145, 189
near doji, 98
neck lines, 60-66
nonrecurring price spike, 143-144
northern doji, 98

O

OHLC (open, high, low, close) chart, 7-10, 29
on neck, 64-66
on-balance volume, 124-125
outside formations, 74-77
overbought and oversold conditions, 217-222

P-Q

P/E (price/earnings) ratio, 21, 132
paper trading, 12-14
percentage swing systems, 146-150
Pfizer (PFE):
    mat hold, 113-114
    price breakout following marubozu, 166
    separating lines, 63
    trading range test with successful breakout, 216-217
piercing lines, 56-60
price oscillator, 219
price spikes, 143-146
primary trend, 178-179, 182-186
Procter & Gamble (PG):
    nonrecurring price spike, 143-144
    trading range tests with failed breakout, 215-216

R

reaction swings, 143-146
real body, 9
relative strength index (RSI), 218
resistance:
    key framework, 215-217
    reversals and, 104-111
    swing trade, 165-169
reversal:
    formations, defined, 47
    multisession gap, 111-117
    patterns with gaps, 101-104
    stars, 78-82
    support and resistance, 104-111
    trend change patterns, 71-74
reversion to the mean, 194-195
rising wedge, 137-138
risk tolerance, 14
runaway gap, 212

S

selling short, 190-192
separating lines, 60-66
setup, 48, 156-164, 186-190
shadow, 9
short-term gapping behavior, 149-153
side-by-side lines, 82-85
signal session, 48
southern doji, 98
spike, 143
spinning top, 37-41
squeeze alert, 72-74
stick sandwich, 105-106
stochastics, 219

support:
key framework, 215-217
reversals and, 104-111
swing trade, 165-169
swing trade:
defined, 141-142
overview, 171-174
price movement, 174-178
setup pattern, 165-169
short selling, 190-192
symmetrical triangle, 133-134

T

tails, 42-45
tasuki gaps, 86-87
technical analysis, 209-211
testing price volatility, 131-139
three rivers pattern, 110
three stars in the south, 109
thrusting lines, 60-66
total capitalization, 21
trading range, defined, 7
trading skills, 14-18
Travelers (TRV):
retreating volume trend, 121
uptrends and downtrends, 27-28
trend, defined, 6
trendline:
candlestick confirmation, 200-203
defined, 193-194, 197-198
identification, 194-200
triangles, 133-136
tri-star pattern, 99-100
true range, 149-150

U

United Technologies (UTX):
doji star, 55-56
matching moves, 107-108
upside gap filled, 87-88
upside tasuki gap, 86
uptrends, 25-28

V

Verizon (VZ):
ascending triangle, 135-136
side-by-side lines, 83
volume as price indicator, 119-122

W-X

Wal-Mart (WMT):
long-legged doji, 36
price breakout following bullish harami, 167
thrusting lines, 61-62
wedge, 136-139
white soldiers, 71-72

Y-Z

Yahoo! (YHOO):
gapping trend, 151
multiple reversal signals, 175-176
three stars in the south, 109