Candlestick- The Price Doctor

Way2Profits

Technical Research Advisory

Research oriented, detail-driven professional having 4 years of experience in the areas of Technical Research, Advisory, Portfolio Management. In-depth knowledge of the research processes, and dynamics of the market. Energetic and goal oriented with a genuine passion for stock markets and investment strategies and a well rounded background in supporting a progressive organization in optimizing performance and growth.

PREFACE

Hello Friends,

Concept of writing this e-book comes from my own need. I have severe habit of forgetting name of candlestick, even though I know what type price behavior it is suggesting. Every time I have to reconfirm that the label which I have attached to formed pattern is right or not. To overcome this I thought I should have one-page note on all the candles, and by quickly looking at it I come to know characteristics and behavior of formed pattern.

Before moving ahead let me make it very clear, what I am writing is my own words, but still I am compiler because I have learnt originally from candlestick master Steve Nison, from his very famous book Beyond Candlesticks. So if any reader wants to do in depth study on candlestick than please refer to above mentioned book. I am clarifying this thing because I am really dismay by few bloggers, who don't care to give any credit to original writers and expressing themselves like they are the inventor and all thoughts are their own. Anyways, let me clarify here I try to give fresh approach to candlestick, but main idea is taken from above book. And I don't take any credit of this writing, because I am just a compiler, only presenting you in a best possible manner.

I think it's enough…

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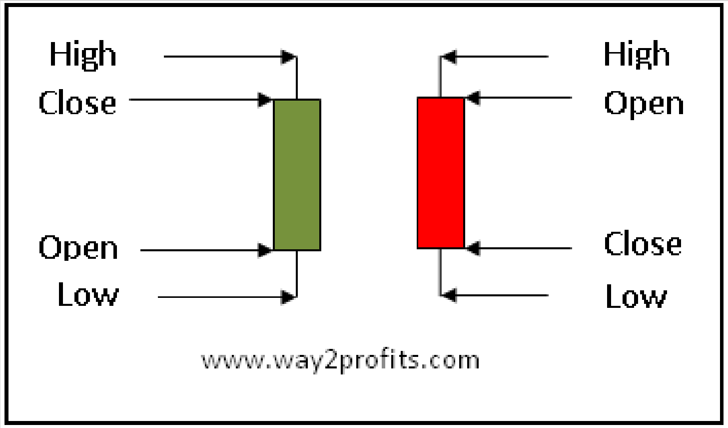
Basics of Candlesticks

Before moving in to subject, let us discuss some basics of candlesticks, which will be more useful to beginners and novice traders. Candlesticks study originated in 11^{th} century at Japan. It was brought to the notice of the Western world through the efforts of Steve Nison. Candlesticks with other technical tool can create a powerful synergy of techniques.

As I mentioned in my heading Candlesticks- The Price Doctor, to say this I have a reasons. Candlestick study helps you to understand psychological component of the market. By very few means any trader can gauge the health of the market, out of that candlesticks is one.

"An ounce of emotion can be worth a pound of facts – Steve Nison."

Candlesticks are a colorful mechanism used to describe the emotional health of the market. Candlestick chart uses the same data points as the other charts i.e. the open, High, Low and Close. A traditional Japanese chart consists of a real body, representing the open and close, and upper and lower shadows, representing the high and low of the day. Pictorially, it would look as follows:



It can be seen in the picture above that two candles are shown, both with different colors. It can be noticed that all the four data points- O, H, L, and C- are featured chart. The major difference is in the fact that the area between the open and the close has been broadened a bit which makes the picture resemble that of a candle. The small vertical line above the mid thick portion- which is the body – are the "shadows" or the wick of the candle. Since the entire picture looks like a candle, this form of charting also came to be known as "candlesticks" charts.

It is also seen in the picture above that there are two colored candles shown. The one to the left is shown in green and if one observes closely, it will be found that the Open is shown to be lower than the close. Exactly vice versa is the case in the example on the right. Here the close is shown to be higher than the open.

This is the major differentiating factor between the candles of different colors and that is what given them a greater visual impressionability. It is to be noted that the body of the candle is what is colored and not the shadows. By color – coding the body, an immediate idea of the close vis-à-vis the open is understood by the analyst.

The importance of the open and the close

The reason why the candlestick pattern lays so much emphasis on differentiating between the open and the close – and to a large extent, disregarding the importance of the highs and lows – lies in the fact that open and these two are the most important valuation areas of the price for the day. The open is the sum total of all the facts/news known up to that moment and the view formed on these. Then the market trades during the day to establish the high and the low for the day. Finally, the overnight news and views along with the input from the day's trading pattern gets distilled to form the view near the close. Hence maximum valuation goes into computation of the open and close.

If the open is higher than the close, then it would mean that the day's trading pattern was such that people ended the day more bearish than where they began. Likewise, if the close is higher than the open, it would mean that the view at the close was more bullish than when the market began. This has a bearing on the market for the next day.

Therefore, by depicting this more visually, by color – coding the candle body – a different color for bullish and bearish set ups – the candlestick gives a more immediate make of the market. Through in the example above, the colors are shown to be green and red, the general convention has been to show the bearish candle (i.e. close below open) as black and the bullish candle (i.e. close above open) as white. Hence by common usage, you have the back candle referring to bearish close and white candle referring to bullish close.

The body size

The next consideration in the candlestick chart part is the size of the body. Those who have b now followed the concept of the construction would immediately realize the value of the size of the body. Since the body is made up of the distance between the open and the close, it is natural to note that its length will depend upon how far away from the open the market or the stock closed. If the open and close were wide apart we would have a very long bodied candle while if the close came back to near or at where the market opened, we would have a very small bodied candle. In common usage, one would also be frequently hearing of "long" and "small" bodied candles and these are then combined with the color of the body and are called "long white" or "long black". One usually does not refer to the color of the small body candle. The reasons for the same will become clear as the discussion on candlesticks unfolds.

It should be pretty clear that when the close ends a good distance away from the open, the stock has had some clear directional movement. To put it in a different way, after the market opens, if the stock begins moving away from the opening price in one direction and closes far away from it, some particular reasoning must have prevailed in the market on that day to ensure such a movement. Directional movement in prices can only occur when there is a conviction about the direction. Hence a long body candle represents the predominance of a view. Depending upon the color, the view would be either bullish or bearish. Sentiment wise, long body represents decisive action by market participants.

In exactly a similar way, the small bodied candle represents the opposite of the above – that is, the close of the day ends quite near the open. This would mean that the stock, after opening at a price, went up and down to establish the high and low of the day (i.e. the range for the day) and then decided to move back to near where it opened. Such a movement depicts the non directionality of the price move. Looked at from the mental perspective, it suggests that the players are unsure on the days movements and the news and therefore returned to the valuation that they placed on the stock near the open. Therefore, small body represents indecision by market participants. Since indecision prevails, it matters only marginally whether the candle is black or white.

There are some situations where the market will close at the level of the open. In such a case, there is no body and a horizontal line depicting the open and the close- just like in the normal hi-low chart-represents the candlestick. This special condition will be dealt with under patterns of candlesticks in future tutorials.

Part 2 will cover types of Candlestick Patterns……….