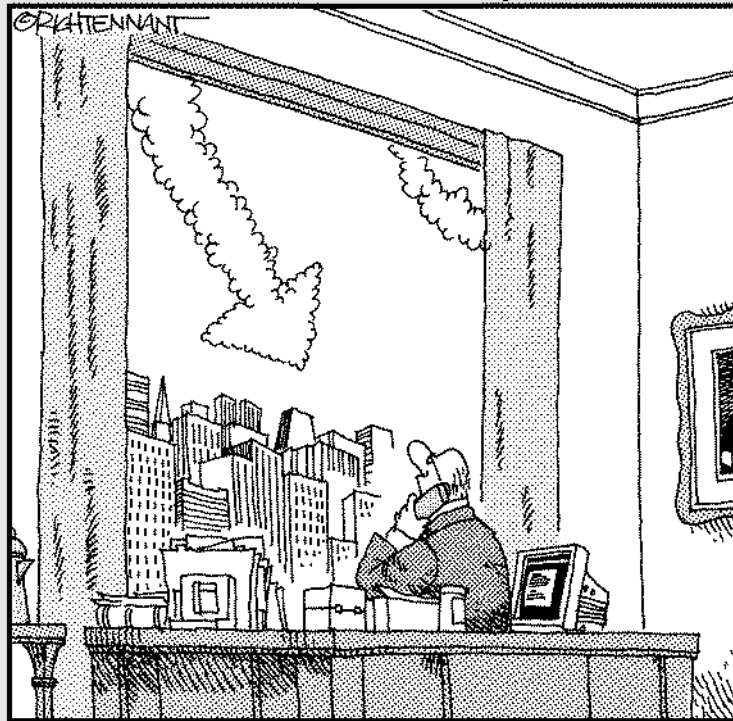


# Part II

# Working with Simple Candlestick Patterns

The 5th Wave

By Rich Tennant



"Sell."

## *In this part . . .*

**M**any traders get interested in candlestick charting because of the usefulness of candlestick patterns for figuring out what a market or security is going to do next. In fact, there's a good chance that you picked up this book with hopes of tapping into the potential of candlestick patterns. If that's the case, you're going to love Part II.

This part is loaded with explanations of simple — one- or two-stick — candlestick patterns. I explain how to identify the patterns on a candlestick chart and how you can use them to make wiser trading decisions. All the discussions center on real world examples, so you can quickly see how these patterns play out in a variety of markets.

## Chapter 5

# Working with Straightforward Single-Stick Patterns

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### *In This Chapter*

- ▶ Taking advantage of purely bullish single-stick patterns
  - ▶ Understanding bearish single-stick patterns and their uses
- 

**I**t's time to begin diving into individual- and multi-period candlestick patterns. Many patterns give buy and sell signals, and some serve as a heads-up that a big move is on the horizon (although it's not always clear just what that big move will be!)

Most candlestick patterns are valid based only on the market activity of the previous few days. For instance, some patterns indicate a change in trend. Using one of these without knowing about the previous trend wouldn't be very useful. Usually, the context in which you find a pattern tells you a great deal about what you should do based on that pattern. There are, however, some single-stick patterns that are considered either bullish or bearish regardless of the context, and those patterns are what I focus on in this chapter.

This chapter explores the signals that may be given off from single-stick candlestick patterns, some bearish and some bullish. (The constructions of these patterns are covered back in Chapter 3 if you need to have a quick look at what's behind these patterns.) I demonstrate what may have happened during a particular day trading-wise to result in the formation of a significant single candlestick on your chart. (I say significant, because candlestick patterns are often used to forecast future price action.) I give examples of a candlestick signal working well and also cases where the pattern may not give such a positive signal. If you know how to recognize and trade on these examples, they should provide some reliable tools that you can add to your trading toolbox.

## The Bullish White Marubozu

The most bullish of patterns is the long white candle. It represents a day during which the bulls control trading and push prices higher from the opening to the closing. As the price moves up, sellers come in, but not enough to keep the price from continuing its rise. Any time sellers show up during this day, the buyers buy from them, and prices move higher. With the long white candle closing near the high, odds are the bulls aren't done with their buying and will be back for more on the following day. There just wasn't enough supply of stock by sellers to keep the buyers from pushing the price up.



The Japanese term for a long white candle is the *white marubozu*. There's a slight difference between a marubozu and a long white candle: The long white candle may have some wick exposed on both ends. A true white marubozu has either the opening price equal to the low for the day, the closing price equal to the high, or both. A long white candle may not have the open equal to the low or the close equal to the high, but its open should be near the low and the close near the high. A true white marubozu has either the opening price equal to the low for the day, the closing price equal to the high, or both leaving no wick.



The Japanese names given to certain candlestick patterns or individual candlesticks can reveal important characteristics. Loosely translated, marubozu means bald or little hair. These single-stick patterns earned their name because they don't have much of a wick on either end of the candlestick. The sticks are bald!

Due to the baldness, the marubozu is a unique type of white candle. There are several specific types of long white candles. Although they all depict bullishness during the day, there are some unique characteristics to keep an eye out for, which are covered in this section.

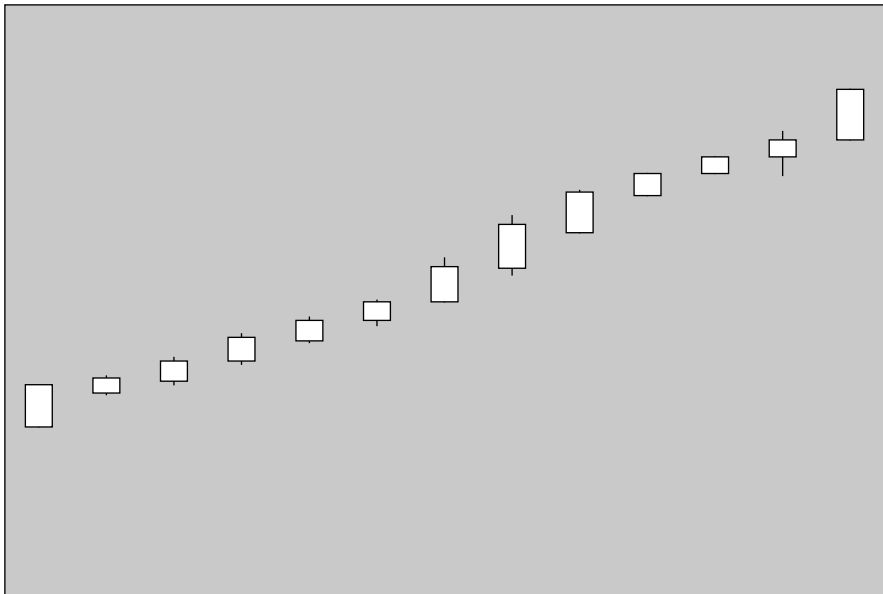
### Understanding long white candles

One common feature of the long white candle (see Figure 5-1) is an open near the low of the day and a close near the high of the day. This indicates that buying has taken place throughout the day.

Figure 5-2 is an intraday chart of the price action that results in a long white candle on a daily chart. An *intraday chart* is a chart that depicts the price action during a time period that is less than a day, such as on a 5-minute or 30-minute basis. Each candlestick represents the price action for this subperiod of a day. The day that corresponds to Figure 5-2, which is the price action of a single day made up of 30-minute pricing periods, features an opening price near the low of the day and a closing price near the high of the day. A textbook long white candlestick has a long candle with no wick, but that doesn't happen very often, and long candles that have a little wick on either or both ends are still considered long white candles.



**Figure 5-1:**  
A long white candle.



**Figure 5-2:**  
A 30-minute chart that produces a long white candle on a daily chart.



To figure out if you're looking at a long white candle, determine the area covered by the difference between the close and the open. If it's at least 90 percent of the area covered by the difference between the high and low, you have a long white candle.

For the day in Figure 5-2, the bulls were in charge from the beginning of the day to the end. There's just no disputing this, because the price does nothing but go higher over the course of the day, and the close is near the high of the day; the bulls will probably stay in charge for the near future. It's just that bullish. You usually have the chance to act on such a case because there may be some trading below the closing price of the long white candle in the next couple of days, and you can place a buy order lower than the closing price but within the range of the long white candle to try to get an attractive entry point.



On a long white candle day, a lot of price action is covered in a very short amount of time. Stocks — and markets for that matter — don't move in one direction without some sort of move in the opposite direction. This normal retracing of prices gives you a chance to act on this bullish signal.

### *The long white candle signaling an uptrend*

Check out Figure 5-3, where you can see a few days where the price action is lower than the high of the long white candle. After seeing this bullish signal, you have several days to buy.

Sometimes signals don't work, and it's critical that you recognize this. With long white candlesticks, the low price on the candlestick is a good support level.



*Support* is a level where if market conditions are consistent, buyers are expected to support the price of a security. If this support doesn't hold, whatever buy signal you're dealing with has changed, and the signal shouldn't be acted on. In that case, you should exit your position fairly quickly. You may take a small loss, but getting out before prices fall even lower prevents you from taking a much larger loss later on.

Look again at Figure 5-3, where I point out the low of the day on the long white candle and also note that the price doesn't trade below that support level over the next few days. If you watch that stock and see that the support level is broken, you should consider that the bullish signal failed and no longer valid.

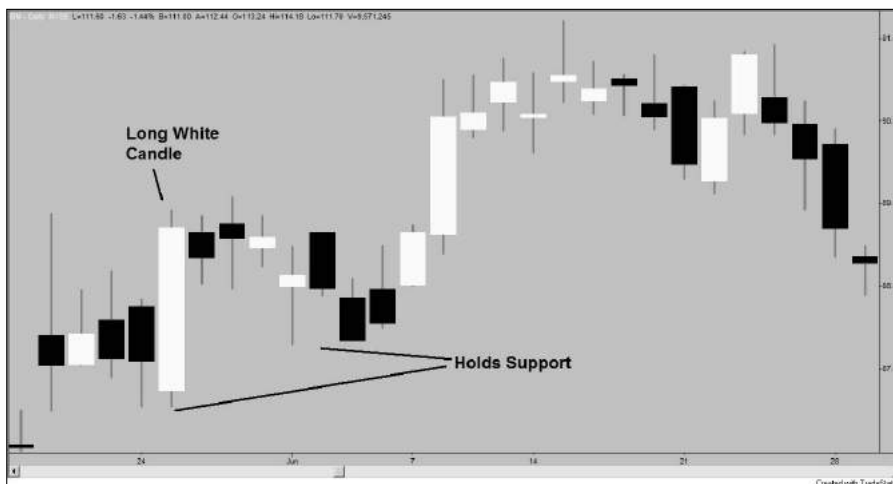


I can't stress enough that when a signal is no longer valid, any trades based on that signal should be exited, and no new positions based on it should be undertaken. Many small losers turn into big losers when the small loss isn't quickly realized and corrected.

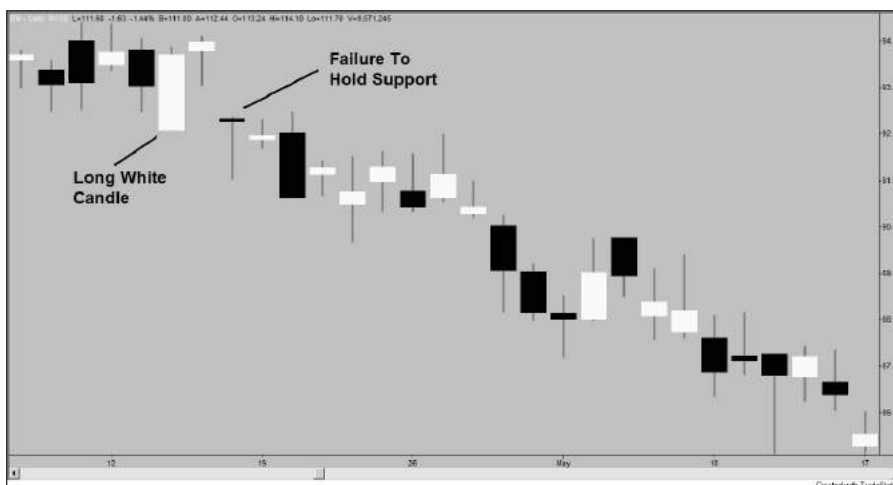
*The long white candle failing as a long signal*

What happens when the support level revealed by a long white candle is broken? Take a look at Figure 5-4. This chart shows a nice long white candle and then a quick violation of its support level. The failure of this stock to hold support means that the long white candle on the chart doesn't mean bullish action is going to continue!

**Figure 5-3:**  
A long white candle followed by a nice buying opportunity.



**Figure 5-4:**  
A chart showing the failure of a long white candle to hold support and the resulting price action.





How do you cope with a failed signal? Take preemptive action. Place an order that triggers when a signal fails. This process is known as a *stop order*. When you're trading long, stop orders are known as *sell stop orders* or *sell stops*. A sell stop is placed below the current market price of a stock and triggered when the price reaches this level. For example, if a stock is trading at 51, you can place your sell stop order at 50. As long as trading stays over 50, nothing will happen. However, once the price hits 50, a sell order is executed, protecting you against further drops in price. Use stops when initiating positions to minimize the damage caused when a signal turns bad.

## *Identifying the three variations of the long white candle*

There are three versions of the long white candle. Although slightly different in appearance, the three variations of the long white candle or marubozu single-day pattern all represent a day during which the bulls were in control from the open to the close.

### *The white marubozu*

The first is the most bullish of them all: a long white candle with no wick. The day begins on the low and finishes on the high. This results in a white marubozu, or as my three-year-old would call it, a white rectangle. Check out Figure 5-5 for the result.



**Figure 5-5:**  
A white  
marubozu.



### *The closing white marubozu*

The second version of the long white candle is another white marubozu, which is known as the closing white marubozu. On this single-stick pattern, the close is equal to the high, so there is no wick on top of the stick. Figure 5-6 is a closing white marubozu.

### *The opening white marubozu*

The third variation of the long white candle is the opening white marubozu. This pattern's opening price is equal to the low of the day, and as a result, there's no wick on the bottom. Figure 5-7 is an opening white marubozu.

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**Figure 5-6:**  
A closing  
white  
marubozu.

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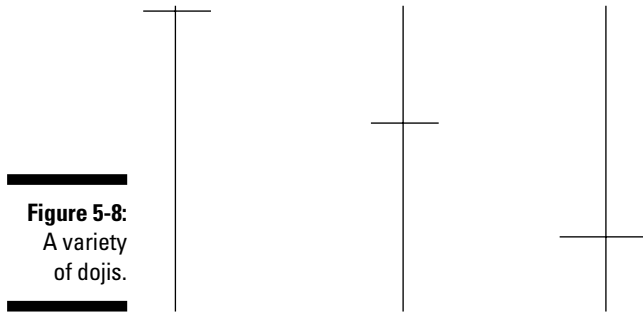
**Figure 5-7:**  
An opening  
white  
marubozu.

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## The Bullish Dragonfly Doji

The *doji* is a type of candlestick pattern with variations and is created when the open and close are equal, so there's essentially no stick on the candlestick. Dojis are almost all wick. Take a look at Figure 5-8, which includes a few different types of dojis. As you can see, a doji looks more like a cross or a *t* than a pattern on a candlestick chart.



**Figure 5-8:**  
A variety  
of dojis.



Loosely translated, doji means *blunder* or *mistake*. It's said that the pattern got its name because a whole day's worth of trading just to end up back at the starting point seems like a goof, but price action isn't ever a mistake, so I'm not crazy about that explanation.

Although there are several varieties of dojis, you can count on them all to be fairly frustrating for traders. For a doji to be created, a day must begin and end with the same price, so a whole lot of trading takes place, but when it's all said and done, the price is right back where it started. Dojis are differentiated by the location of the open and close on the wick — where trading begins and ends on a given day.



At first glance, dojis may not seem very exciting, but don't be fooled. Doji patterns are usually associated with a market turn, even though they depict a day where the battle between bulls and bears is fairly equal. Even though the battle for the day is a draw, one side soon overpowers the other. It's like a prolonged tug of war that ends when one team is violently yanked into the mud. For the tug of war that's a doji pattern, that yank in price action usually occurs sometime in the next few days or even on the following day.

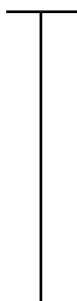
Although dojis do indicate some indecision, in some instances, a doji may be more bullish or bearish depending on the price action. A dragonfly doji is one of those cases. It is fairly bullish in nature due to the price action that is behind this pattern.

## *Recognizing a dragonfly doji*

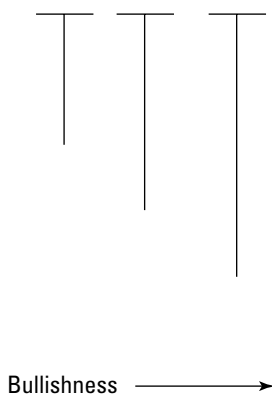
The dragonfly doji is unique in that three of the four candlestick components — the open, high, and close — are equal. A dragonfly doji comes from a day when a stock opens, trades down during the first part the day, and then at some point starts to trade back up, eventually closing on the high (which is also the open). In terms of bears and bulls, on a dragonfly doji day, the bears initially decide they're going to rule the day, and the resulting lower prices lead the bulls to decide it's time to buy. The bulls then take over and push the price up as they dominate the rest of the day, until the price is right back where it started. Refer to Figure 5-9 for a classic example of a dragonfly doji.

For an illustration of the inner workings of a day that results in a dragonfly doji, check out Figure 5-10. This figure features a 30-minute chart of the price action that occurs over the course of a day to cause a dragonfly doji. The bears dominate the first half of the day, but the bulls take over in the afternoon, and the result is a close equal to the open — all that struggling during the day for nothing.

**Figure 5-9:**  
The  
dragonfly  
doji.



**Figure 5-10:**  
The bullish  
significance  
of the  
dragonfly  
doji.

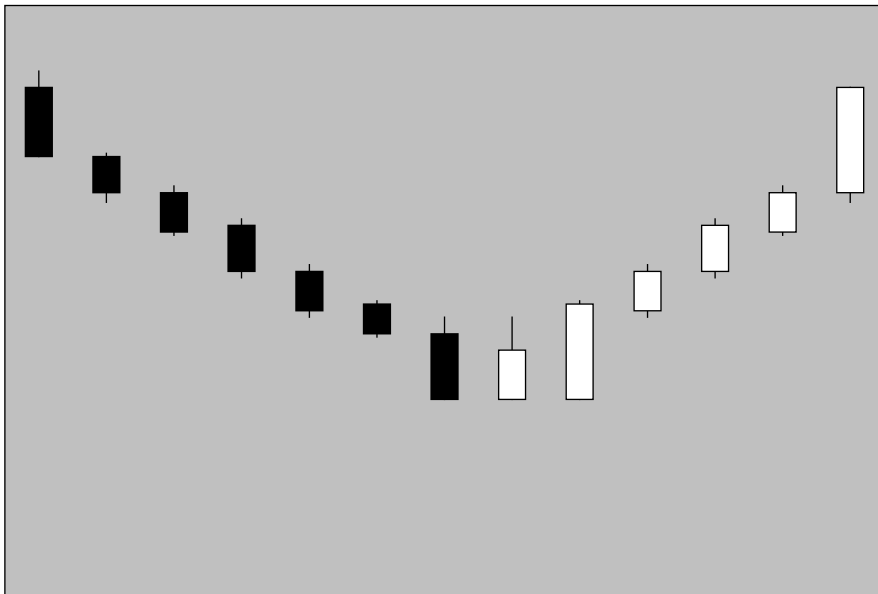




The price action behind a dragonfly doji bodes very well for those hoping that prices go higher, because a price at which people buy aggressively has been set at the low end of the wick. The low of a dragonfly doji day is considered a near-term support level, because it's clear that buyers came in at that level and turned the trend from down to up.

The length of a wick from the high to low doesn't have to be any specific distance to qualify as a dragonfly. However, the wick length can signify the amount of bullish significance a dragonfly doji has for future price action. Put simply, the longer the wick, the more bullish the pattern. Figure 5-11 illustrates this point.

Figure 5-11 displays price action that creates a dragonfly doji on a daily chart. Dragonfly dojis appear when the open and close are very near or equal to the high, so the beginning and ending of this chart are equal. The price action during this day is very interesting. The bears take over from the open and push the price down. Eventually, though, lower prices entice buyers and they get aggressive, pushing the price back up to the open and settling on the high of the day.



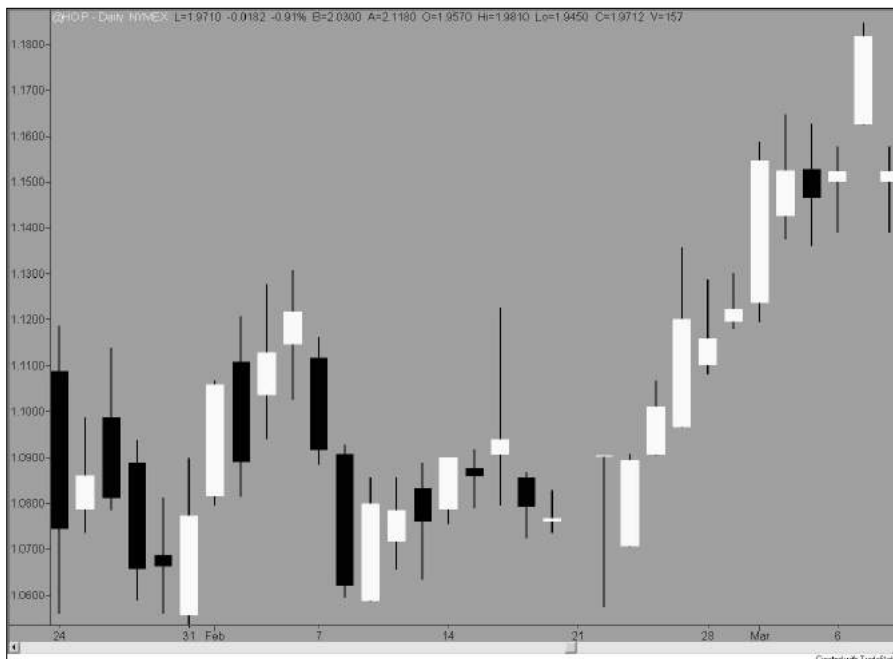
**Figure 5-11:**  
Intraday  
action that  
results in a  
dragonfly  
doji on a  
daily chart.

## Trading based on a dragonfly doji

You can make smart trades based on the dragonfly dojis you see in your charts. Two charts can help:

- ✓ One in which a dragonfly doji indicates a nice buying opportunity
- ✓ One in which a dragonfly doji fails pretty badly

First the good one. Much like the long white candle I discuss earlier in this chapter, the dragonfly doji helps you establish a solid support level to buy with confidence. In Figure 5-12, notice how the bottom end of the dragonfly doji wick works as a support level, which is held as the security remains bullish for several days. The dragonfly doji appears after some range trading, and it's followed by a quick breakout of prices that reach new highs. Although the first day following the dragonfly doji shows an opening price lower than the previous close, the dragonfly's low price isn't violated, and the signal remains valid. Sticking with this valid signal leads to some nice profits!



**Figure 5-12:**  
A dragonfly  
doji that  
pays off.

Now for a dragonfly doji that doesn't work out too well. The dragonfly that appears in Figure 5-13 looks promising, but it's followed the next day with a low that's lower than the bottom of the dragonfly's wick. And as you can see, the next moves are even lower.



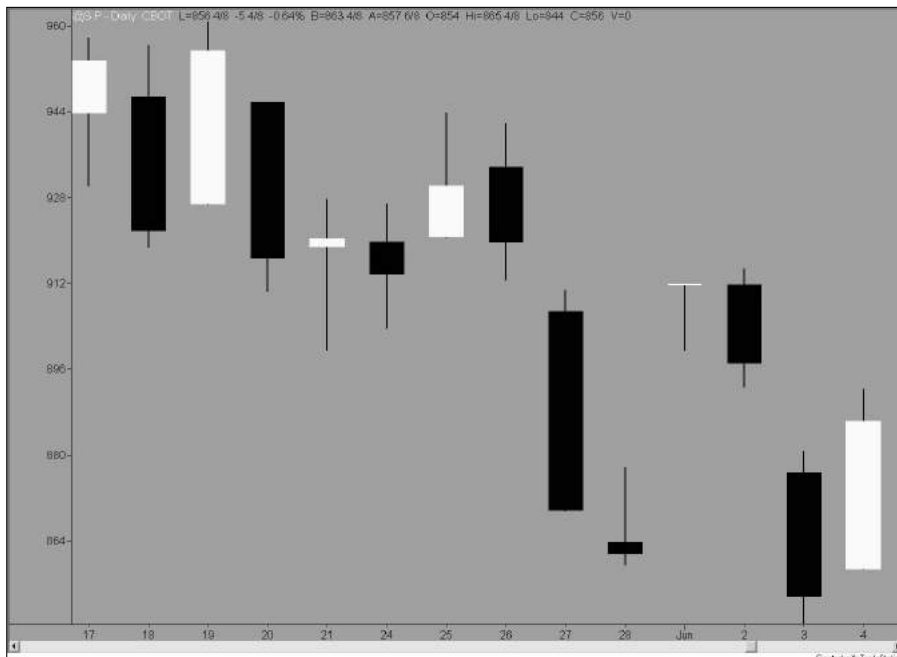
The low of the dragonfly doji is a significant support level, but when that level is violated, it negates the dragonfly's buy signal. When a level is violated, get out as soon as possible.

## The Bearish Long Black Candle

The long black candle is a direct counterpart of the long white candle discussed earlier in this chapter. It's a long candlestick compared to other candlesticks on the same chart, and most or all of it is made up by a solid candle.



The long black candle is as bearish as it gets. To see one of these candles means that sellers take over at the beginning of the day and push prices lower and lower until the end of the day. Typically, these sellers are just selling to get out, and their price sensitivity is low. Seeing this type of enthusiastic selling should give you confidence that the bears will be in control for a few more days after the long black candle appears, and you can capitalize on that.



**Figure 5-13:**  
A dragonfly  
doji not  
working out  
too well.

## Understanding long black candles

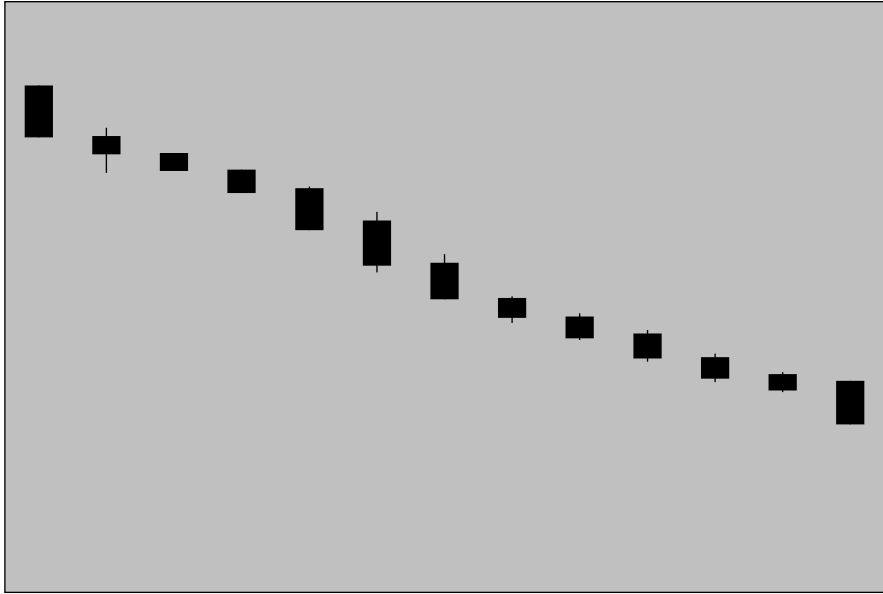
A long black candle is created when the bears seize control at the start of a day and push until the day's end. Figure 5-14 is a picture of a typical long black candle.



For some quick insight on the numbers involved, have a look at Figure 5-15, which is an intraday chart of price action that creates a long black candle. Keep in mind that the figure is just one example, and that there are several other intraday patterns that can produce a long black candle on a daily chart. Basically, any pattern that begins near the high of the day and ends near the low of the day results in a long black candle, even if the action that got the price to the low occurred in just a couple of the 30-minute bars. The potential intraday action is limitless; the important thing is to know the bears pushed hard and down, and the bulls weren't able to hold up the price.



The most important thing to *bear* in mind (pardon the pun) is that the long black candle indicates that the bears were in charge for the majority of a day. The day begins with the bears controlling the activity, and it ends the same way.



**Figure 5-15:**  
A 30-minute  
chart that  
produces a  
long black  
candle on a  
daily chart.



A useful rule of thumb for the long black candle is that the candle section should cover at least 90 percent of the candlestick. The wicks should be barely visible or completely missing.


The long black candle also usually indicates that many price levels have been covered over the course of one day. A reversal is very possible in the short term, but the long black candle shows the bears are being aggressive and suggests that this aggression will continue.

## Identifying black marubozus


Like the long white candles described earlier in this chapter, there are marubozu versions of the long black candle, which are cleverly called *black marubozus*. The black marubozu features an open equal to the high and a low equal to the close. Figure 5-16 is a black marubozu, or as my toddler son would say, a black rectangle.

Just like their bullish counterparts, there are three variations of the black marubozu. Figure 5-16 is the first variation, which is a marubozu that opens on its high and closes on its low. The second is the closing black marubozu. You can spot a closing black marubozu by recognizing that there's no wick on the candlestick at the bottom or closing end of the candlestick. The close is equal to the low, while the open is a little bit lower than the high for the day. Figure 5-17 is a closing black marubozu.



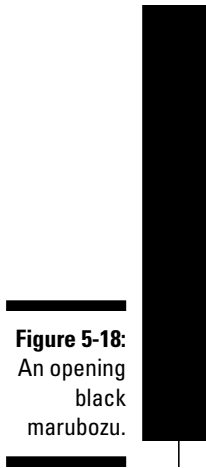


**Figure 5-16:**  
A black  
marubozu.



**Figure 5-17:**  
A closing  
black  
marubozu.

The third variation is the opening black marubozu. This pattern is created when the open is equal to the high of a day, and the close is just above the day's low. A small wick appears only on the bottom of this candlestick. Figure 5-18 is an example of a typical opening black marubozu. The appearance of a small wick on the bottom of this candlestick indicates the possibility of some late-day buying or that the low price of the day enticed some buyers. This source of speculation leads some to regard the opening black marubozu as the least reliable of the three black marubozu variations.



**Figure 5-18:**  
An opening  
black  
marubozu.

## *Trading based on long black candles*

Now it's time to see how you can trade using long black candles in the real world. Figure 5-19 is near and dear to my heart because it represents a trade I actually executed while writing this book. This is a chart of the November soybean futures contract that trades at the Chicago Board of Trade. At the time, I wanted to take a short position in the soybean contract, but was waiting for a confirming trading signal or bearish chart pattern before I executed my position. The long black candle highlighted in Figure 5-19 provided the short signal I sought.

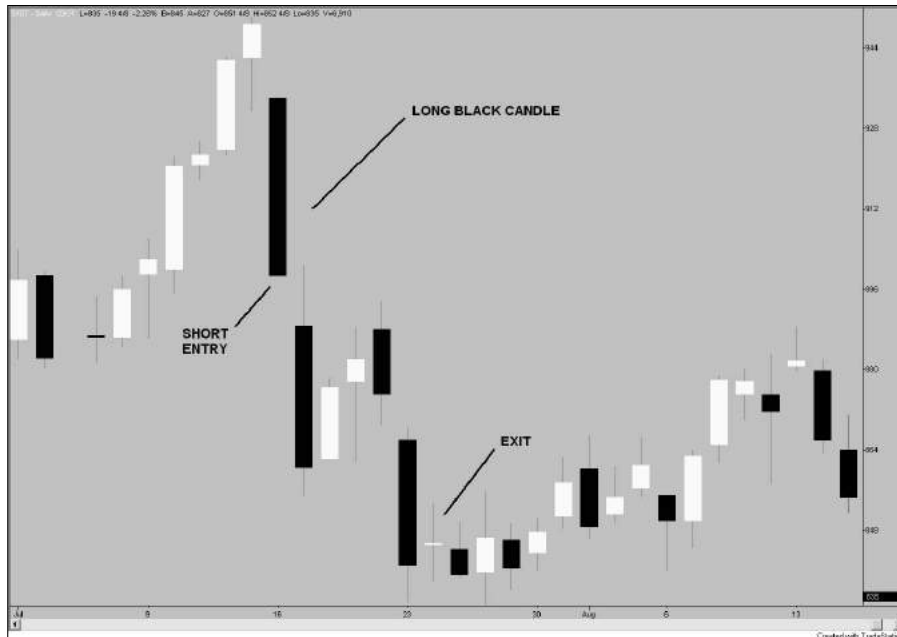


### *Getting a good bearish signal from a long black candle*

I've noticed in the past that long white or black candlesticks are generally followed by continuations of their up or down moves more often with commodities than with stocks. Futures on commodities tend to have strong trends. This tendency makes me quicker to initiate a position in futures than in stocks. And by the same token, I'm usually quicker to concede that I'm wrong on a futures trade than on a stock trade. Keep these differences in mind and use them to your advantage. (Chapter 11 covers trends in more detail.)

Back to my soybean trade. For fundamental reasons, I was looking for a signal that told me to short the soybean futures contract. When I saw the long black candlestick on a particular day, I put on a short near the close of that day. I was quickly rewarded the next day, as another very bearish day followed.

**Figure 5-19:**  
A long black candle  
provides a  
nice sell  
signal.



If things hadn't worked out as I'd planned, I still wouldn't have suffered big losses, because I also entered a protective order called a *buy stop*, which is the opposite of the sell stop mentioned earlier in this chapter (see "Understanding long white candles"). My buy stop level was the high of the long black candle — the resistance level that if broken, would negate the sell signal given by the long black candle.



Keep in mind that resistance levels are where chartists believe sellers will be brought into the market and keep prices from going higher. In candlestick charting, resistance is generally the highest level of one of the candlesticks that created a sell signal. After this resistance level is broken, the signal isn't considered valid anymore.

Luckily, that level was never reached, and the trade turned out to be a profitable one. I continued to monitor the short position from day to day and exited on the day indicated on the chart. The pattern for that day is a regular doji, which often signals the reversal of a trend. I cover regular dojis in more detail in Chapter 6.

### *A long black candle failing as a short signal*

As with long white candles, and any candlestick patterns for that matter, long black candles don't always work out perfectly. Long black candles do fail, as you can see in Figure 5-20. In fact, this figure includes two instances of long black candle failures!

Figure 5-20 contains a chart of the futures contract trading on crude oil from the summer of 2007. If you were involved with any oil or other energy-related commodity trading during that time, you'll remember that shorting was a hard row to hoe then.

Two long black candles appear in Figure 5-20. Both fail. One crashes and burns after a few days, and the other follows suit the very next day. For clarity's sake, I labeled them #1 and #2:

- ✓ Long black candle #1 was followed by an up day, but this up day didn't break resistance or the high of the signal candle. It managed to stay below resistance for a few days before breaking out and then trading higher for several days in a row. Note that if you didn't get out of a short position on the day that resistance was broken, you never had a shot to get out at that level again. Without a protective buy stop at the failure level, your losses would've continued to pile up.
- ✓ Long black candle #2 doesn't work out too well either, but at least it failed quickly. The possibility for a successful trade was clearly over at that point, and if you were involved, you could've moved on to the next trade. The trait that #2 shares with #1 is that if you didn't exit when the resistance level was violated, you basically didn't have a chance to get out at a lower level to limit your losses. Your losing trade would've just gotten worse. Getting out of trades quickly is just as important as finding and executing winning trades.

## *The Bearish Gravestone Doji*

The doji is one of the most significant candlestick formations and is created when the open and close for a day are equal. It doesn't matter where this occurs on a wick for a candlestick to be classified as a doji, but the location dictates what kind of doji it is.

### *Identifying the gravestone doji*

When the open and close are both equal to the low of the day, the result is the most bearish of doji: the gravestone doji. Figure 5-21 is a good example of a bearish gravestone doji.



**Figure 5-20:**  
A long black  
candle as a  
failing sell  
signal.

**Figure 5-21:**  
A bearish  
gravestone  
doji.

The price activity that creates a gravestone doji begins and ends at the low of a day. The progression for the day includes the following:

1. A security opens and trades up during the day, as the bulls dominate the activity.
2. Higher prices attract sellers, and the selling becomes strong enough to overwhelm the bulls.
3. As the bears take over, the price is moved back down to the open, which was also the low of the day.

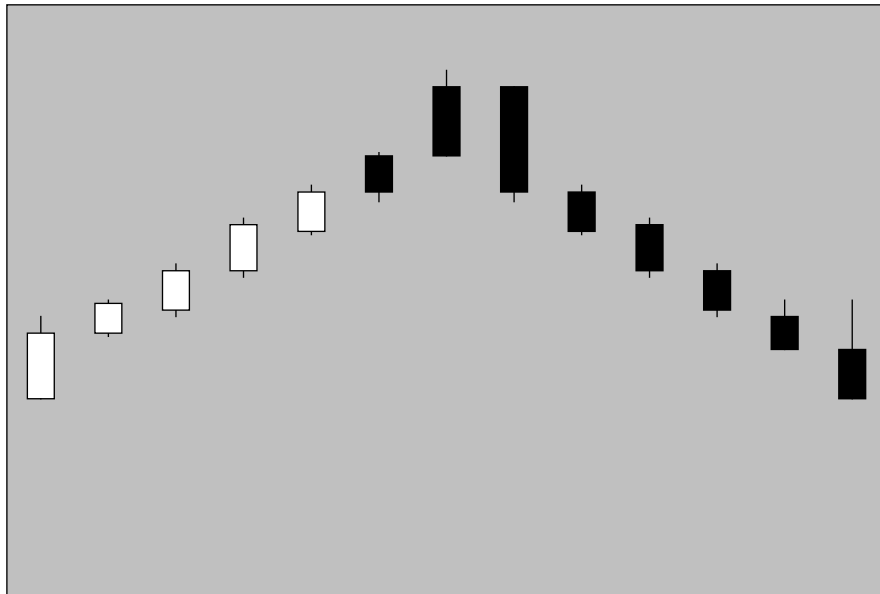
Closing at this level after trading up during a day doesn't bode well for the bulls in the near term. Figure 5-22 provides an example of such a day, which would be a fearful one for the bulls.

## *Trading based on gravestone dojis*

Take a look in this section at a couple of examples of gravestone dojis that have popped up in the real world and what happened afterward. The two examples I provide are for stocks, not commodities. The first example, which you can see clearly in Figure 5-23, is a gravestone doji that offered a useful sell signal followed by lower prices.

I included several days of price action to show a combination of interesting factors:

- ✓ First, notice that this gravestone doji signals the beginning of a pretty prolonged downtrend in the stock.
- ✓ Second, notice that during the downtrend, there are a couple of smaller gravestone dojis. If you'd shorted on the first gravestone doji and kept on the short position, you would've been pretty happy with the results. The appearance of a couple more bearish formations would've given you the confidence to maintain your short position.



**Figure 5-22:**  
A 30-minute  
chart of a  
day that  
creates a  
gravestone  
doji on a  
daily chart.

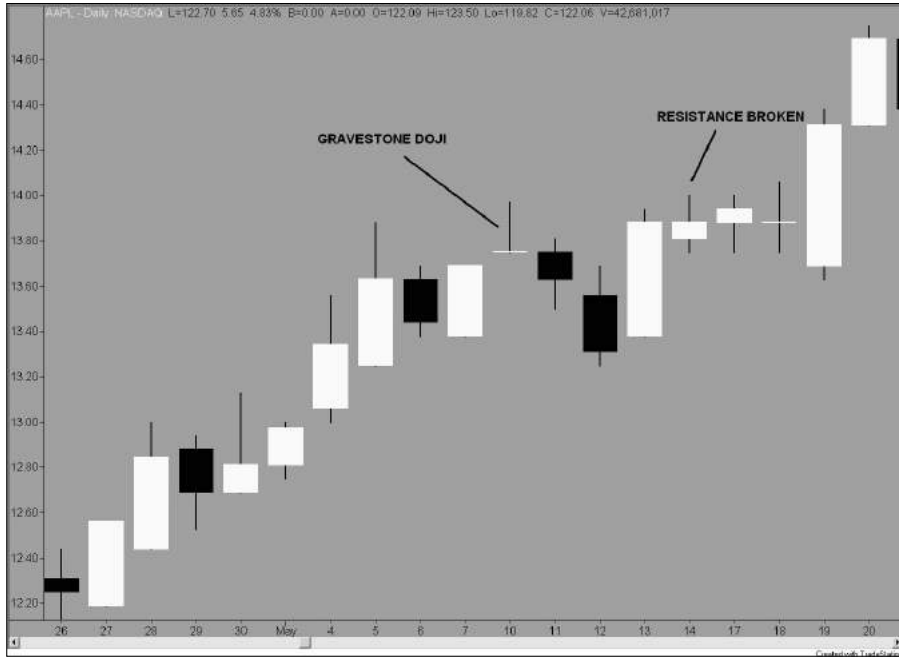


**Figure 5-23:**  
A great example of the gravestone doji working as a sell signal.

➤ Finally, there's a fourth gravestone doji toward the end of the downtrend. Notice that it fails fairly quickly, as the following day has a high equal to the original gravestone doji's high. If you'd ridden the stock price down to this level and seen a sell signal fail, it would've been time to buy the stock back, take your profit, and move on to the next trade. That would be a profitable outcome for you.

The next example shows what can happen if you're not as fortunate. Figure 5-24 is a chart of Apple Computer's stock (AAPL). A gravestone doji appears in the middle of the chart and during an uptrend. Dojis are often associated with a trend change, and seeing the bearish doji in an uptrend may be a signal of a trend change to the down side. Unfortunately for anyone trading this sell signal, things don't work out so well.

The gravestone doji is initially followed by a couple of down days, and it does appear that the trend may be changing. However, a couple of positive days put this trend change in doubt. A couple of days later resistance is tested and broken, and the uptrend continues. The sell signal failed, but a nimble trader would've placed a buy stop to limit the losses on this failure.



**Figure 5-24:**  
The gravestone doji failing on a chart of AAPL.



## Chapter 6

# Single-Stick Patterns That Depend on Market Context

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### *In This Chapter*

- ▶ Identifying market environments
  - ▶ Digging into doji details
  - ▶ Understanding spinning tops
  - ▶ Encountering belt hold basics
  - ▶ Taking a look at hanging men and hammers
- 

**I**n Chapter 5, I cover a few of the more basic and easily defined single-stick candlestick patterns, which are either bullish or bearish indicators regardless of their location on a chart. For those patterns, the price action that occurs during the previous few days just isn't that significant.

But not all single-stick patterns are that straightforward. Some extremely useful single-stick patterns rely heavily on their location on a chart. Making yourself familiar with these patterns and how to identify and trade based on them is another way that you can add a versatile weapon to your trading arsenal. That's what this chapter is all about. Also, context is essential to the single-stick patterns that are covered in this chapter. This isn't always the case, but for this chapter, you need to know the market environment before deciding if a signal or pattern is valid.

A variety of single-stick patterns can provide some terrific trading opportunities if you can spot them in the right market environment. I begin this chapter by quickly touching on how you can define a market environment, and then I cover some of the most significant single-stick patterns that you can exploit for profitable trading.

## Understanding Market Environments

In order to take full advantage of single-stick patterns that rely heavily on the market context in which they appear, you first need to know how to quickly and effectively determine the market environment. Being aware of the current market environment is key to properly using most candlestick patterns in general, but especially for the ones I describe in the rest of this chapter.

### *The three market states*

A market or stock is usually defined as being in one of three states:

- ✓ **Bullish:** Price behavior trending up
- ✓ **Bearish:** Price behavior trending down
- ✓ **Range bound:** No discernable trend



Deciding which of the three states a market is in can be as easy as looking back a few weeks on a chart and spotting a general direction or drawing a line that shows the market's trend. It may also be as complicated as using a technical indicator to reveal the direction of the market. These indicators are covered extensively in Chapter 11, but for this chapter, I use examples where the market trend is easy to decipher.

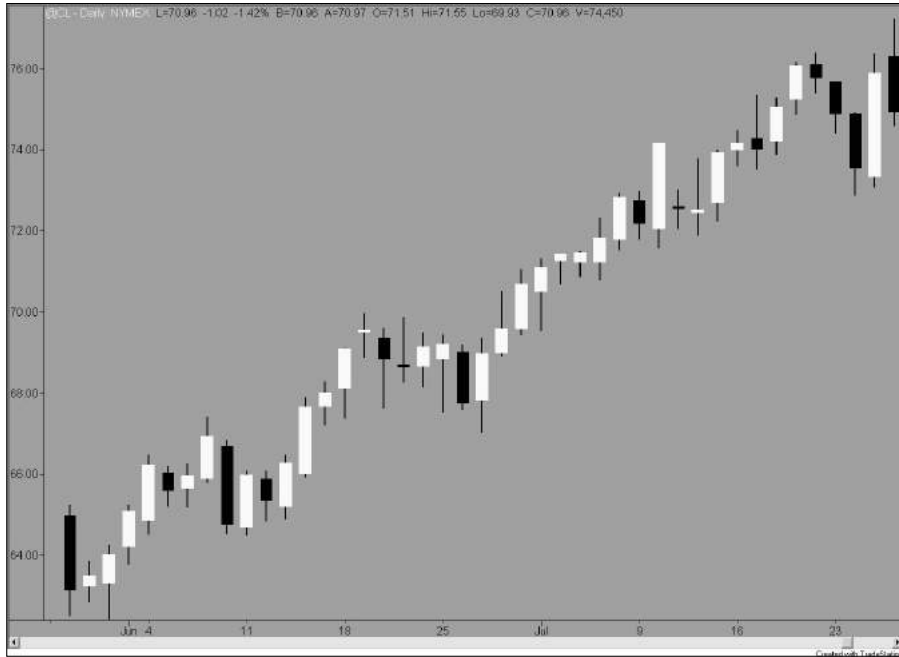
### *Identifying the market trend*

For a quick visual representation of what an uptrend or downtrend looks like on a chart, check out these figures; it doesn't get much clearer. Figure 6-1 shows an uptrend.

Figure 6-2, conversely, shows a downtrend.



At times, the market environment may not be completely apparent or obvious. Either different people may see the trend or lack of trend in a different way or the time frames participants are using may cause different traders to have differing views of the trend or lack of trend. If that's the case, then pass on any trades you're considering. The uncertainty is just too high, and there will always be another trading opportunity in the future.



**Figure 6-1:**  
A chart  
with a nice  
uptrend.



**Figure 6-2:**  
A chart  
with a nice  
downtrend.

## Delving Into Dojis

A *doji* is a single-stick pattern in which the open and close for a day are equal (see Chapter 5 for more discussion on dojis). This level of exactness is a rarity, though, and some candlestick chartists are flexible and say that if the open and close are very near each other, it's still considered a doji. I agree, although I do think that they need to be the same in the case of the dragonfly and gravestone — two dojis that are indisputably bullish and bearish, respectively. But there are other varieties of dojis for which the market context is critical, and I cover a few of the significant ones in this section.



Dojis are often associated with the reversal of a trend and can serve as outstanding reversal indicators. If a doji appears in an uptrend, it could very well indicate that the trend may be changing to a downtrend soon, especially if the doji is a gravestone doji. Likewise, if a doji (especially a dragonfly doji) appears during a downtrend, there's a good chance that things will look up soon.

### *The long legged doji*

In addition to the dragonfly and gravestone dojis (covered in Chapter 5), one last doji is significant enough to merit a specific name. This one is cleverly called the long legged doji.



A long legged doji is considered a reversal signal when appearing in an uptrend or downtrend. This doji indicates that there has been much uncertainty in the market after a period of directional certainty. This change of conviction often results in a change in trend.

### *Identifying long legged dojis*

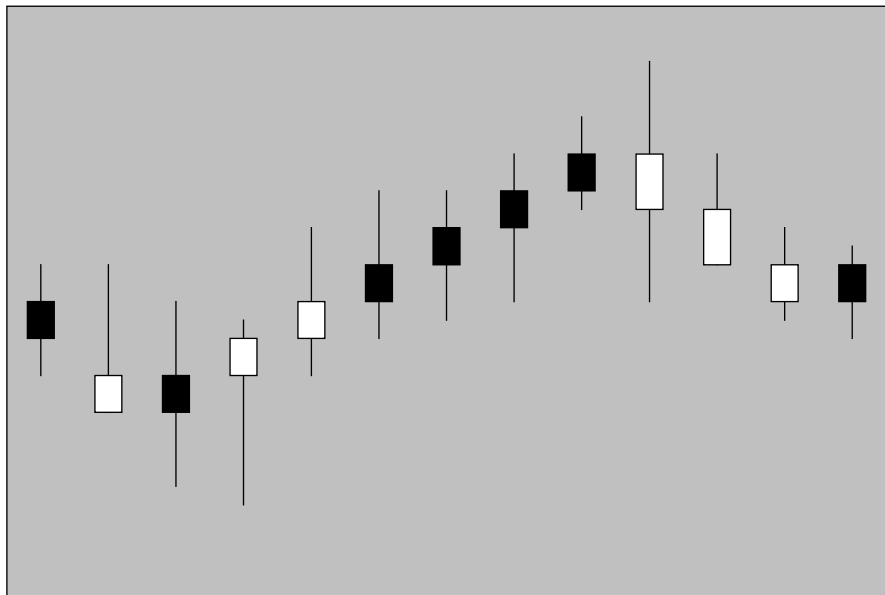
The long legged doji has a fitting name: It features a small stick with very long wicks (or legs) on each end. The small candle on a long legged doji is normally located very close to the center of the candlestick. Check out Figure 6-3 for a classic example of a long legged doji.

In addition to its unique appearance, the long legged doji is singled out due to the unusual price action that causes the formation of this candlestick pattern on a daily chart. Figure 6-4 provides a look at a 30-minute chart that translates into a long legged doji.

Figure 6-4 just looks like a roller coaster ride. Imagine trying to trade during a day like that and ending up where you started. You can really lose (or win) big on such a day.



**Figure 6-3:**  
A long legged doji.



**Figure 6-4:**  
A 30-minute chart that creates a long legged doji on a daily chart.



If you've just started trading or don't feel quite comfortable with your trading abilities yet, it's probably best for you to steer clear of day trading on extremely volatile days. I've been trading for years, and I have taught myself to lay off the day trading when things are particularly hairy.

### *Using long legged dojis as buy signals*

As I mentioned earlier in this section, the long legged doji may be a buy or sell signal depending on prior price action. In a downtrend, the signal can forecast a change to an uptrend and act as a buy signal, and in an uptrending market, the long legged doji can indicate that the uptrend is coming to an end and serve as a sell signal. I provide a couple of examples where a long legged doji is a good buy signal and then demonstrate where it doesn't work out too well.

### *The long legged doji giving a good buy signal*

Figure 6-5 is a long legged doji that occurred in late 2002 on the futures contract of the Canadian dollar. It occurred after three very bearish days in a row and was followed by a very nice uptrend. This example shows how a long legged doji works when it signals the end of a down move. Unfortunately, I didn't trade this particular scenario, but I definitely will if I see the same pattern in the future!



**Figure 6-5:**  
Canadian  
dollar  
futures  
contract  
with a nice  
buy signal  
from a long  
legged doji.

Notice that the doji buy signal in Figure 6-5 works almost immediately — what's expected of a trend changing signal. If the signal doesn't seem to be working very quickly, beware.

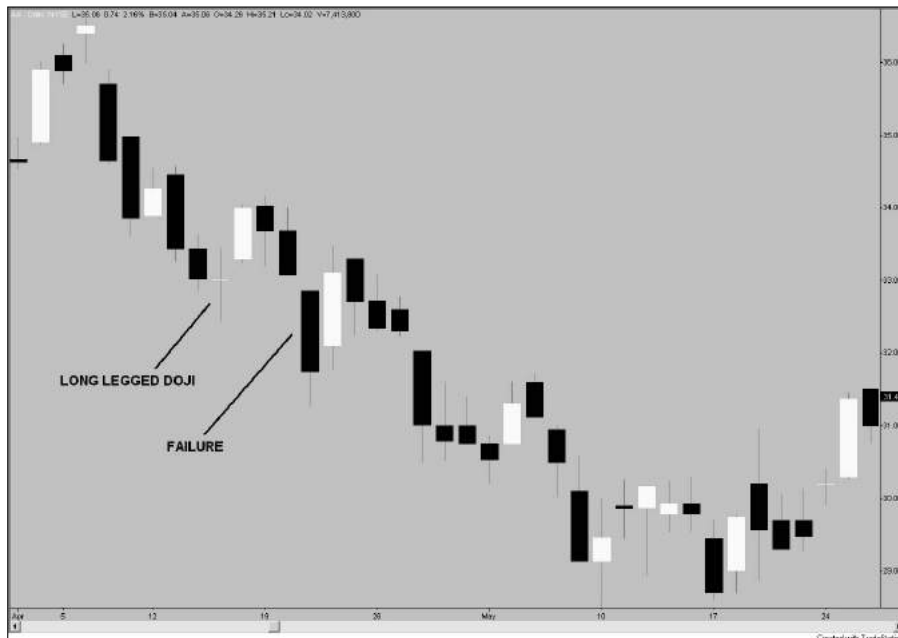


Trading against a trend is a very dangerous prospect. You need to be sure you're prepared to take a loss and move on quickly to the next trade if things go sour.

### *A failing long legged doji*

Now on to the bullish long legged doji that didn't work too well. In all honesty, it was difficult to find a good real-world example. The long legged doji is fairly rare, and when it shows up during a trend, it usually does signal an impending trend change. It does happen, though, and Figure 6-6 is an example of a long legged doji that didn't signal a change in trend.

Figure 6-6 features price action for a stock with a long legged doji showing up after a few downtrending days. The price trends up for the next day or two and things look fine, but then the long legged doji's low is broken, and the signal is no longer valid. If you were trading this stock and didn't get out at that critical point, where a stop order should've been placed or an exit trade should've been executed, you would've endured some pretty painful losses.



**Figure 6-6:**  
A long legged doji buy signal that fails quickly.



Be sure you're prepared to get out of a trade immediately after the signal you're trading goes bad. Use that as a rule, and follow that rule regardless of how much it may hurt. To help me remember the importance of these rules, I taped the following quote from *Zen in the Markets* by Edward A. Toppel to the monitor on my trading desk: "You can break the rules and get away with it. Eventually the rules break you for not respecting them."

### ***Using long legged dojis as sell signals***

Just as a long legged doji that appears during a downtrend can be considered a buy signal or the end of the downtrend, a long legged doji that appears in an uptrend may be considered an uptrend reversal or sell signal that can be extremely helpful if you're looking to short a security.



Sometimes in the market no trend is obvious or exists. If you see a long legged doji during one of these times, do nothing. The long legged doji is only useful as a signal when it appears during a trend.

### ***Seeing a good short signal on the long legged doji***

Have a look at Figure 6-7 for an example of a long legged doji that provides a useful signal for shorting. This daily stock chart is for Gap, Inc. (GPS). The long legged doji appears in the middle of an uptrend. Notice that there wasn't much of a chance to get out of a long position, and although the opportunity to put on a short was definitely there, you would've had to have been on your toes to pull it off. The stock opened up slightly the next day, and then the bears took over and dominated most of the day. Even the bears that were late to the party toward the end of the day were rewarded with a substantial gap down the next day.

### ***The long legged doji sells signal failing***

As always, an example that didn't work too well is in order. Figure 6-8 is a chart of the futures contract that trades on the Canadian dollar. In the center of the chart is a nice long legged doji that appears in an uptrend that may seem to be rolling over. *Rolling over* means that the price action on a chart has been strong but is starting to top out. I've highlighted the uptrend and then where the price begins to roll over or top out. Toward the right side of this rolling price action, a long legged doji appears. Things look good for a little while, and then the high of the doji is overtaken, and the price is off to the races once again.



**Figure 6-7:**  
A long legged doji sell signal on GPS that works out quite well.



**Figure 6-8:**  
A long legged doji sell signal on Canadian dollar futures that fails.

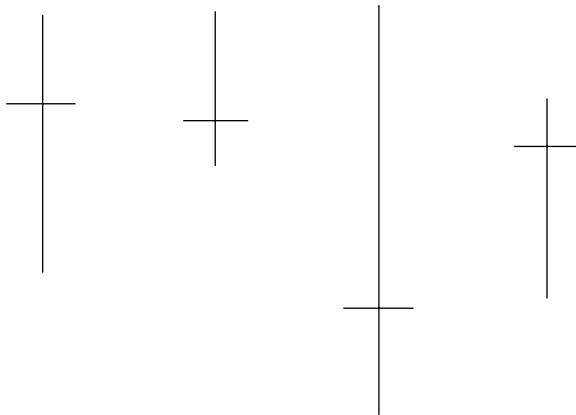


## Other dojis

The long legged doji, bullish dragonfly doji, and gravestone dojis are powerful but rare. You're more likely to see a doji with an open and close that appear somewhere other than the center or one of the ends of a wick. These dojis are still useful as reversal indicators, and because they appear more often than the named dojis, they offer more trading opportunities. Figure 6-9 highlights a variety of dojis.

**TIP**

When evaluating a doji, I look for the candle to appear on the top half of the wick if I'm using the doji as a buy signal or on the bottom half of the wick if I'm using it as a sell signal. With the open and close near the high, I feel that the bulls are winning the day, and if the open and close are near the low, I feel that the bears are coming out on top.



**Figure 6-9:**  
A variety  
of dojis.

Figure 6-9 looks like a chart that my three-year-old created while she was learning how to write the letter *t*. Basically dojis just look like *t*'s or upside down *t*'s.

### *Using regular dojis to trade long*

Figure 6-10 is a chart of the stock Capital One Financial Corp. (COF). Notice the long doji on the left. After that doji, the stock takes off on a very nice uptrend. The doji is a great example because the candle that marks the open and close is clearly in the top half of the price action for the day. I really have more comfort buying a doji signal when the price closes near the high; I just feel that more bulls are on my side.



**Figure 6-10:**  
A regular  
long doji  
appearing  
on a chart  
of COF.

For an example of a failing doji signal, see Figure 6-11. It's a chart of the futures contracts that trade on the Japanese Yen. In the center of the chart is a doji appearing during a definite downtrend. The signal is negated the following day with a violation of the low of the day in which the doji appeared. Once again, if you traded this signal and you didn't call it quits after the violation and signal failure, you'd be in for a painful ride down.

### *Using regular dojis to short*

Regular dojis work well in short or selling situations, too. Figure 6-12 shows a short doji formation in an uptrend that quickly reversed for a nice short selling opportunity in the U.S. Treasury bond futures. The short doji is high-lighted, along with another doji. The day after the short doji, the rarest of all dojis appears on the chart: the four-price doji, which occurs when the open, high, low, and close are the same on a chart. This occurrence is very rare and usually happens on a very low volume day. The incidence may also represent a data error. In this case, having a source to double-check the data behind the chart would be very helpful. (See the "Data Integrity" sidebar in this chapter for more details.)

**Figure 6-11:**  
A regular long doji appearing (and failing) on a chart of the Yen futures.



**Figure 6-12:**  
A short doji on U.S. Treasury bond futures.



The signal doji in Figure 6-12 meets the criteria of appearing in an uptrend and then also appears to have the open and close in the bottom half of the day's price action. No violation negates the signal, and the signal is quickly followed by a downtrend lasting several days. I wish all my trades were so easy to identify and profit from.

Like all other signals, short dojis aren't perfect. Have a look at Figure 6-13, a chart of IBM. This figure shows two failures of a short doji signal within the span of just a couple of weeks. Both are highlighted on the chart, and both fail pretty quickly.



This leads me to another fact I've picked up over the years. Each market or stock may have its own individual trading characteristics. Although shorting a doji formation in an uptrend may be a highly successful trading method for the majority of financial instruments, there may be some out there who continuously shrug off this sell signal. Unfortunately, knowing what works well in various markets is just a matter of putting in time and gaining experience.



**Figure 6-13:**  
Short dojis  
failing on  
IBM.

## Data integrity

With so many financial products trading in the world today and so much data floating around, data errors are bound to occur. In the case of a four-price doji, having a second source to check the price action of the day is extremely valuable. As a professional trader, I use multiple charting software packages and data sources to assure that the data I'm using accurately reflects the price action that occurred in the past. With fewer resources, you may want to consult an exchange's Web site for data accuracy or free

data sources such as Yahoo! ([www.yahoo.com](http://www.yahoo.com)) or MarketWatch.com ([www.marketwatch.com](http://www.marketwatch.com)). (Flip back to Chapter 4 for more information about online and electronic sources of charting information.)

MarketWatch.com has a terrific function that allows you to enter a stock symbol and a specific date to check for accuracy. Either way, when you see some price action that looks out of place on a chart, doing a double check can save you frustration and money in the long run.

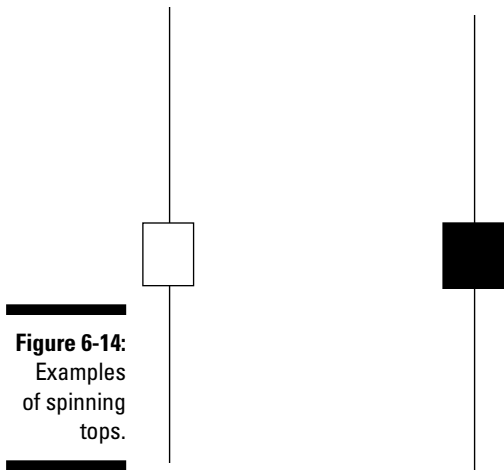
## Looking At Other Patterns: Spinning Tops

Like the doji, the *spinning top* is another single-stick pattern that depends on market context and reveals a tight battle between bulls and bears. Whenever the bulls-versus-bears battle is close, eventually one side has to give, and when this happens, an explosive move in one direction is possible. My favorite analogy for that scenario is a coiled spring being pushed hard on both sides. Eventually one side gives in, and that's the direction the spring flies.

The key is picking the right direction, and considering the market environment where you find your pattern helps you make the right pick. For spinning tops or any other patterns that indicate a tight battle between bulls and bears, if the bulls have been in charge for some time leading up to the pattern, it usually indicates that the bears are starting to gain some strength. And the reverse is also true: If the pattern appears during a bearish trend, it generally indicates that the bulls are going to make a run (and you don't have to be in Pamplona to run with them).

### Identifying spinning tops

To qualify as a spinning top, a candlestick should have a small body and wicks that stick out on both ends. The body should appear close to the center of the range of the day's price action. Also, the wicks should both be at least as wide as the candle section of the candlestick. For a clear picture of what a spinning top looks like, check out Figure 6-14.



**Figure 6-14:**  
Examples  
of spinning  
tops.



The color of a spinning top's candle isn't terribly important, although it's nice to see a dark body if you're expecting a reversal of an uptrend (sell signal) or a white body if you're expecting a reversal of a downtrend (buy signal).

One of the best features of spinning tops as compared to dojis is that spinning tops appear much more frequently. Dojis are powerful signals, but they can be pretty rare. I scanned many charts to come up with the examples for this book, and it was much, much easier to find good examples of spinning tops than it was to track down dojis. And with more appearances come more chances to trade and make more profits!

## *Using spinning tops for profitable trading*

Like dojis, spinning tops are nice indicators that a trend may be about to change direction. Catching an early trend change can be a very profitable endeavor, and in the sections below, I give you an idea of how you can execute some fruitful trades by using spinning tops.

### *Recognizing a buy signal with a spinning top*

Figure 6-15 is a chart of the futures contracts that trade on the Standard & Poor's 500 Index (S&P 500). The low of a downtrend culminates with a spinning top, and a trader who recognizes this signal is rewarded with a nice up move if she shows a little patience.

For this reversal pattern, I wanted to use a chart that appeared to be failing initially. Although the futures contract in Figure 6-15 didn't immediately reverse to an uptrend, it also didn't match the low of the signal day. The contract came close, but the low was never broken, so the signal was never violated. Such a case may test your patience, but sticking with this buy signal would've been rewarded after a few days of watching it go nowhere.

### *Looking at an example of a failing spinning top*

On the flip side, take a look at Figure 6-16, which is a chart of the futures contracts that trade on the ten-year U.S. Treasury notes. I've highlighted a spinning top that appears in a downtrend. The next day shows a quick failure, with the downtrend continuing for several days afterward. Although the appearance of the spinning top on this chart may have been a hopeful sign for someone choosing to go long, that hope was dashed pretty quickly.

### *Getting a nice short signal from a spinning top*

Spinning tops may also be used quite effectively to recognize a shift from an uptrend to a downtrend. Figure 6-17 is a chart of the futures contract on the Euro currency. A spinning top appears just as an uptrend is rolling over, which is a favorite situation of mine. The next day's high comes very close to penetrating the high of the spinning top signal day, but doesn't quite get there. The result is a downtrend that lasts almost a month.

**Figure 6-15:**

A long spinning top on S&P 500 futures contract that yields a nice profit.





**Figure 6-16:**  
A long spinning top that fails.



**Figure 6-17:**  
A short spinning top on Euro futures indicates the beginning of a downtrend.



To capitalize on the scenario presented in Figure 6-17, you would initiate a short position on the futures contract either near the close of the day on which the spinning top appeared or the next day, when the spinning top was validated by the fact that the day's high didn't violate the high of the previous day.

### *Seeing a failing spinning top short*

Figure 6-18 shows a chart where spinning tops just keep failing. This chart is of the stock for Yahoo!, which carries the symbol YHOO. I've highlighted three spinning tops that appear after some small uptrends. Each fails pretty quickly and miserably.

## *Discovering More about Belt Holds*

More single-stick patterns that depend on market context *and* offer outstanding trend reversal signals are *belt holds*. But wait — if you read Chapter 5, you and belt holds have already been introduced, although you may know them by a different name.

Belt holds are exactly the same as marubozus that have no wick on the opening end of the candlestick formation. As with the other patterns in this chapter, the difference is that the usefulness of belt holds as trend reversal signals depends heavily on the market environments in which they appear.



**Figure 6-18:**  
Spinning  
tops on  
a Yahoo!  
chart that  
don't pan out.

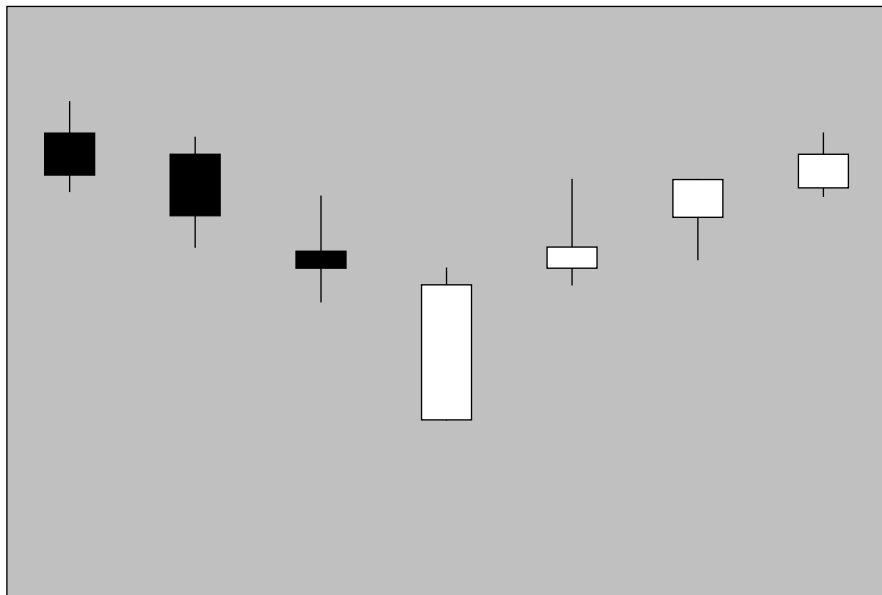
## *Spotting belt holds on a chart*

There are two types of belt holds: bullish and bearish. Bullish belt holds feature an open equal to the low and a close near the high, which leaves a small wick on the top of the candle. Bullish belt holds appear during downtrends. For an ideal example of a bullish (long) belt hold, take a peek at Figure 6-19.

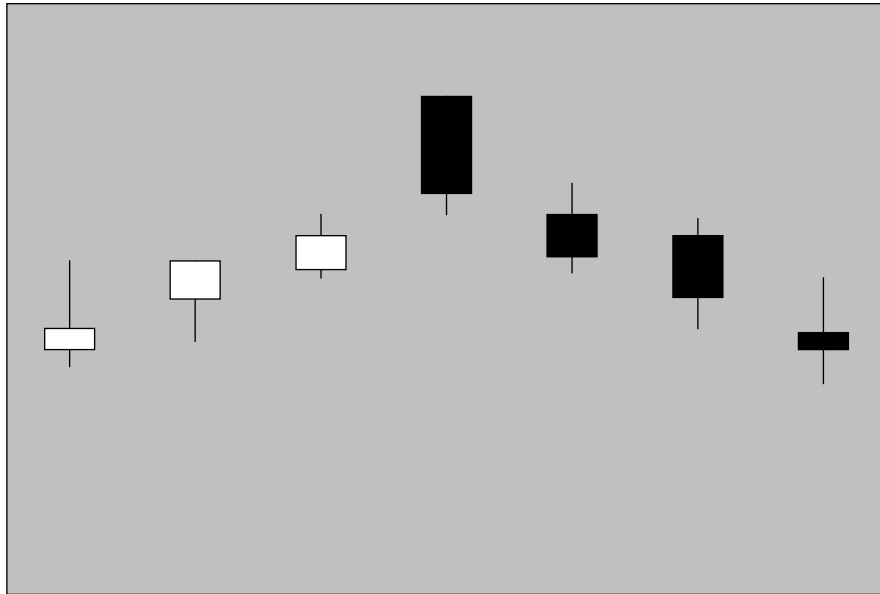
Bearish belt holds, on the other hand, open on their highs and close near their lows, thus leaving a small wick on the bottom of the candle. Bearish belt holds show up in the midst of uptrends. You can find a picture perfect version of a bearish (short) belt hold in Figure 6-20.

## *Buckling down for some belt hold-based trading*

It's time to investigate what it's like to trade signals. These are pretty powerful and common patterns that can be used. The dramatic reversal from the opens they represent often does show a trend change occurring over the course of just one day.



**Figure 6-19:**  
Textbook  
example  
of a long  
belt hold.



**Figure 6-20:**  
Textbook  
example of  
a short belt  
hold.

The price action behind a belt hold is pretty directional. For example, a stock in a defined downtrend may open on its low and then spend most of the day rallying. As a downtrend presents itself, the bulls have finally had enough and start buying. Prices reach a low enough level to encourage not just buying, but aggressive buying.

### ***Belt hold as a long signal***

Figure 6-21 is a chart of Wal-Mart stock. The long belt hold pattern actually shows up on the chart on the day after Christmas in 2006. I like this chart because in addition to this being the company's most important time of year, it shows how sentiment changed relative to the retailing environment right after the crucial holiday season had ended.

Two factors contribute to the strength of this long belt hold.

- ✓ **The sheer length of the candlestick:** Very aggressive buying is exhibited by the size of the candle and overall candlestick.
- ✓ **The fact that the gap from the opening price was filled:** Also, you can find another bullish indication in the fact that the stock gapped lower than the previous low on the open (it means that the price attracted buy interest immediately). Notice that the whole price action of the previous day was covered. That's bullish stuff.

**Figure 6-21:**  
Chart of a  
long belt  
hold in Wal-  
Mart stock.



### *Belt hold failing on the long side*

Want to know what happens when bullish belt holds go bad? Look at Figure 6-22. This figure is a chart of the futures contract that trades on soybeans. The bullish belt hold comes on the heels of some pretty bearish trading that occurred over the course of a few weeks. For the sake of full disclosure, I'll fess up and say that I actually traded this signal because I was looking for a short-term bottom and was encouraged by the price action of that day. However, I was a little less wealthy the next day because the signal failed. Happens to the best of us.

Bearish belt hold signals occur when there's an obvious uptrend with a day that opens on its high and closes very near its low. This signal appears as a dark candle with just a small part of the wick appearing on the bottom. It's a day when the bears rule for most of the day after being pushed around by the bulls for several days prior.

### *Bearish belt hold working out*

For a nice bearish belt hold scenario, look at Figure 6-23. This chart of exchange traded funds represents a basket of biotech stocks also known as the Biotech Holders (BBH). The BBH bears had been overtaken by the bulls, but the short belt hold reveals that the bears are clawing their way back into the action.

**Figure 6-22:**  
Chart of a failing bullish (long) belt hold in soybean futures.



**Figure 6-23:**  
Chart of a nice short belt hold signal on the BBH.



Take a closer look at Figure 6-23. Notice any additional bearish patterns? I chose this chart specifically to try to push you to start looking beyond what I highlight on a chart. Give yourself a pat on the back if you notice the doji the day before the belt hold. Give yourself two pats if you notice the doji's short signal was intact while you received a short signal from the belt hold. I'd give you a chance to give yourself three pats on the back, but that can be hard on your rotator cuff.

### *A failing bearish belt hold*

Just so you'll know what to look for if you suspect that a bearish belt hold may be failing, check out Figure 6-24. It depicts the futures contract that trades on the Japanese Yen.

It's a really nice bearish belt hold pattern, except that it just doesn't work out. The belt hold appears during an uptrend that's been in place for several days, and it's pretty encouraging that lower trading occurs during the next few days. However, seven days after the signal appears, the Yen futures trade over the high of the belt hold day and then trade much higher pretty quickly.



Sometimes signals take a few days to fail. They don't immediately show signs of failure, so stay on your toes and keep your eyes out for signs of trouble.



**Figure 6-24:**  
Chart of a  
bearish belt  
hold on the  
Japanese  
Yen that  
fails.

## *Deciphering between the Hanging Man and the Hammer*

The last single-stick patterns that rely on a specific market environment that I present in this chapter are the hanging man and the hammer. I paired them together in this section because they appear exactly the same. Don't be fooled, though — the two patterns aren't identical. The hanging man is considered bearish, and the hammer is considered bullish, and the difference between the two is where they appear on a chart.

### *Spotting and distinguishing the hanging man and the hammer*

The first step in working with the hanging man and the hammer is understanding how to spot them on a chart. The pattern is fairly distinctive, so identifying it usually isn't a problem.

The hammer or hanging man is recognized by a small candle that appears at the very top of the pattern. There's usually a pretty long wick on the bottom. If you see this pattern at the bottom of a downtrend, you're looking at a hammer. If it appears at the top of an uptrend, it's considered a hanging man. (Both cases assume that the patterns are actually good signals, of course.) Also, in less than ideal cases, it's possible for a small wick to be sticking out of the top of the candle.

For a classic example, look at Figure 6-25.



**Figure 6-25:**  
A hammer  
or hanging  
man  
(depending  
on the  
market  
context).





Although the hammer and the hanging man are individual patterns, there's one extra step to them: the confirmation of the pattern. The confirmation comes on the following day's opening price. If the opening price on the very next day is in the direction of the signal, you're working with a true hammer or hanging man. If you think you have a hanging man appearing in an uptrend, you wouldn't trade on it unless it's confirmed the next day with an opening price lower than the previous close. By the same token, if a hammer appears during a downtrend, you need to confirm it with an opening price on the next day that's higher than the hammer's close.

## *Trading on the hanging man and the hammer*

To better illustrate the intricacies of the hanging man and the hammer, I show you examples of both patterns that were either confirmed the next day or not confirmed. If you're planning to dig into later chapters and read more about complex patterns, get used to the idea of confirming patterns, because it pops up continually throughout the rest of the book.

### *Going long with a hammer pattern*

Figure 6-26 is a chart of Dell, Inc. (DELL) stock with a hammer that pops up during a downtrend. The following day, the stock opens higher than the close of the previous day for DELL. That's the confirmation that indicates that the hammer is a good long signal, and you'd be very wise to wait for it before buying. Be patient and wait for the confirmation, even if you're completely convinced that it's hammer time!

The confirmation may cost you a little in profits because you pay a slightly higher price, but Figure 6-27 shows what it may cost you if you choose not to wait.

Figure 6-27 is also a chart of DELL. This one contains a potential buy hammer that isn't confirmed on the next day. In fact, the opening the next day is lower than the low that occurred on the day that the hammer appeared. Not only would you have saved yourself the effort of trading in and out of this stock by waiting for confirmation, but you'd also have saved yourself a little in losses.



If a candlestick signal calls for some sort of confirmation, always wait for the confirmation. Don't try to get ahead of the confirmation day by trading in early. In the long run, it catches up with you!



**Figure 6-26:**  
A hammer with confirmation on a chart of DELL stock.



**Figure 6-27:**  
A hammer with no confirmation on a chart of DELL stock.

### *Shorting with a hanging man pattern*

Now for a look at a successful hanging man. Figure 6-28 is a chart for the stock of Toll Brothers, symbol TOL. If you aren't familiar with Toll Brothers, it's a homebuilder focusing on the higher end of the housing market. If you remember what happened to the housing market in 2007, you can see why this is a good short example.

Figure 6-28 shows how you could have made money when the housing market first started to tank. I'm not saying that trading housing-related stock is the way to offset any potential losses in the value of your home, but this was a chance to take advantage of the fall in value of a home-building company as it anticipated the drop in housing prices and home sales activity.

Right at the very peak of a trend in the TOL stock, a hanging man appeared. If you happened to already own this stock (also called *being long*), that was a pretty scary signal that may have suggested that it was time to take your profits and move on to a less risky investment. If you were in the market looking for a stock to short, that would've looked like a swell opportunity. After the hanging man, a very dramatic reversal occurred, and the downtrend continued for several weeks.



**Figure 6-28:**  
A hanging man short signal on TOL.

Finally, I provide you with a hanging man that doesn't get confirmed. Sorry for the abundance of examples using retail stocks, but I've had a profitable history with them, and they often make good examples. Figure 6-29 is a chart of the stock for Kohl's Stores (KSS).

A very encouraging hanging man appears on the chart in a defined uptrend. However, after waiting patiently overnight for confirmation of the end of the uptrend and a shorting opportunity, a trader is surprised to see a gap opening and a continuation of the uptrend. If she's following the rules (as she should be) and waiting for the confirmation of the hanging man, all she gets is disappointment. But it could be worse: If she'd jumped the gun and sold, it would've cost her even more.



**Figure 6-29:**  
A failing  
hanging  
man short  
signal on  
KSS.

## Chapter 7

# Working with Bullish Double-Stick Patterns

---

### *In This Chapter*

- ▶ Understanding double-stick patterns that signal a trend reversal
  - ▶ Working with double-stick patterns that tell you a trend will continue
- 

Compared to the single-stick patterns in Chapters 5 and 6, double-stick patterns are difficult to come by. But these patterns can be very powerful and profitable if you put in the time and effort to monitor them.

I tackle a number of double-stick patterns in this chapter, and each of them consists of two days. I'll refer to the first day as the setup day, and I'll call the second day the signal day. When you're looking for double-stick patterns, you'll have to start paying attention to the possibility of a pattern developing on the setup day, and you'll react (trade) if you see what you need to see on the signal day.

In this chapter I cover some double-stick patterns that signal a trend reversal and a few that signal a trend continuation. The reversal signals are more fun, because they help you to outsmart the crowd and buy near the end of a trend. The trend confirming signals are useful if you're already on the right side of a trend, or if you're considering going against a trend, and you're looking for a signal that can kindly tell you to reconsider.



If you want to go hunting for double-stick patterns, I must warn you that you're bound to suffer some disappointments. Often, you see the beginnings of a double-stick pattern on the first day, but you can get discouraged when the pattern doesn't shape up correctly on the second day. Your patience may be tested, and you may want to bag it and work only with single-stick patterns, but doing so is like playing the game without all the equipment you need to play it well.

## *Bullish Reversal Patterns*

A wide variety of two-day patterns signal the end of a downtrend and the beginning of an uptrend, and those patterns are the focus of this section. There's an old saying in trading that "the trend is your friend." It's based on the idea that getting (and staying) on the right side of the trend is the best way to make a profit in the market. I don't disagree with that sentiment, but plenty of traders make a good living catching changes in trend. It's not the easiest type of trading, but it can be rewarding. This type of trading basically involves trying to pick a top or bottom of a trending move. Because this involves going against the current type of market and against the majority of participants, it's a difficult process.



If your trading strategy is dependent on catching trend changes, make sure that you're humble and quick to acknowledge when you're wrong about a trade. Use orders that force you to take a small loss before you rack up big losses.

Throughout this section, I include patterns that work and ones that fail, and I point out where a trade starts to go wrong. In these examples, you can see how bad a trade can get if you don't play it safe and take a small loss to prevent losing big.

### *Bullish engulfing pattern*

The first two-stick pattern is the bullish engulfing pattern. The pattern's name comes from the fact that the signal day engulfs the setup day. Both the wick and the body of the second day completely cover the same ground as the first day and then some. Also the first day of this bullish pattern is a down day, with the second day starting out looking like there's going to be more bearish trading, but this selling is reversed by the emergence of buying — so much buying that the previous day's open and highs are both surpassed. (There's also a bearish version of this pattern, and it's covered in Chapter 8. In fact, most of the bullish two-stick patterns I discuss in this chapter have a bearish counterpart.)

#### *Spotting the bullish engulfing pattern*

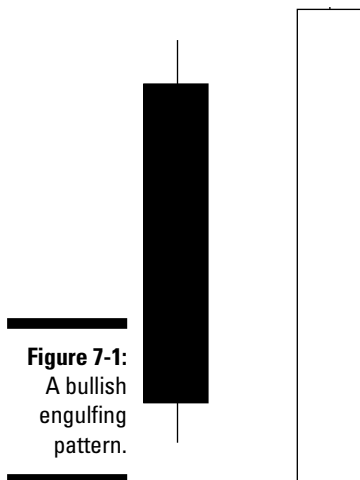
To find the bullish engulfing pattern, take these steps:

- 1. First look for a setup day with a dark candle.**
- 2. Then look to see if the signal day is bullish.**

If so, you're on the right track, but the following statements must also be true in order for your pattern to be a full-fledged bullish engulfing pattern:

- The wick of the signal day is longer than the wick of the setup day.
- The high of the signal day is higher than the high of the setup day.
- The low of the signal day is lower than the low of the setup day.
- The candle of the signal day is longer than the candle of the setup day. (In this case the signal day's close is higher than the setup day's open, and the open of the signal day is lower than the close of the setup day.)

Figure 7-1 includes two days that create a bullish engulfing pattern.



The trading activity that creates this pattern is extremely bullish:

- ✓ On Day 1 (the setup day) the bears dominate.  
The open is near the high, and they push the price down all day until the close ends up near the low.
- ✓ On Day 2 (the signal day) the bears are at it again and move the price a bit lower before the bulls come roaring in.  
They arrive on the scene and immediately start pushing prices up, and they don't stop. The bulls exceed the prices from the previous day and even push the closing price up over where trading commenced the previous day.



When a bullish engulfing pattern occurs in a downtrend, that indicates that the bulls have been pushed around for some time before the pattern developed and that they're geared up to continue their buying assault on the bears for days to come.

### Using the bullish engulfing pattern for savvy trading

If you're vigilant and lucky enough to spot a bullish engulfing pattern, trading on it can yield some very appealing results. Figure 7-2 is a real-world example of the bullish engulfing pattern on a chart of the ETF that represents the members of the Dow Jones Industrial Average (DJIA), which is known as the Diamonds because its symbol is DIA. (An ETF or *exchange traded fund* is a security that trades like a stock, but represents a basket of stocks or an index.)



The DIA is a popular trading vehicle among short-term traders who try to profit from the direction of the Dow Jones Industrial Average from day to day and also among long-term investors who seek exposure to all DJIA stocks without having to buy all 30 of them individually.

Although it's not picture perfect, Figure 7-2 is a useful example of how the bullish engulfing pattern develops and how it can work out profitably. The bears dominate the setup day, leaving the close near the low. On the signal day, the DIA opens lower than the previous close and appears to trade lower — bad news for the bulls. But at some point during the day, the bulls rally with some strong buying and push the DIA much higher, to the point where the close of the day is higher than the high of the setup day. The resulting price action includes several days where the bulls are firmly in the driver's seat.



**Figure 7-2:**  
A bullish engulfing pattern developing on a chart of the DIA ETF.



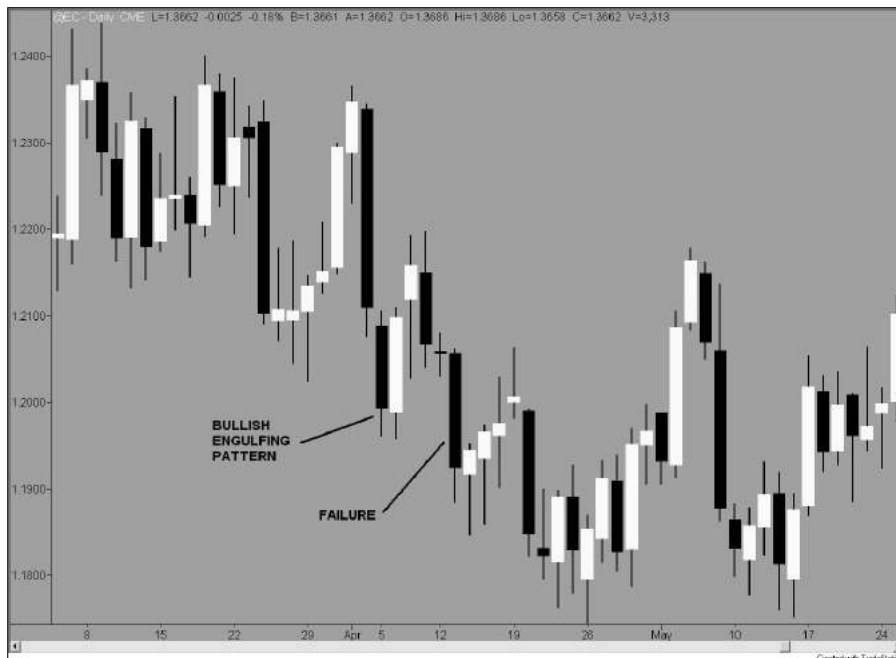
That leads me to an important question: How do you know when the bullish engulfing pattern's signal is no longer valid? My rule of thumb is if the low of the setup day is violated, then the signal is no longer good. To work this rule into your trading strategy, place a sell stop on the low of the setup day, not the signal day. Other traders may suggest that the sell stop be placed on the closing price of the setup day or even the opening price of the signal day, and you may want to consider those options as you get comfortable trading on the bullish engulfing pattern. Keep in mind, though, that things can get pretty miserable if you hold onto this trade for too long.

### *A failing bullish engulfing pattern*

Figure 7-3 is an example of what happens when good bullish engulfing patterns go bad, using the Euro currency futures contracts to show the price action when the setup day's low is violated a few days after the pattern arises.

The setup day in this example is very encouraging. There's a definite downtrend, and all the other bullish engulfing pattern criteria check out. But things sour quickly. The bulls lose the fight, and the result is a very bearish day. No matter what you choose to be your failure level, this day should be when you throw in the towel.

**Figure 7-3:**  
A bullish engulfing pattern that fails on a Euro currency futures chart.





As I was compiling real-world examples for this book, I had an extremely tough time finding a bullish engulfing pattern that didn't work out profitably if it was correctly traded. Bullish engulfing patterns don't *always* work, but finding one is an exciting prospect, and the chances are very good that if you trade on it wisely, the result will be bright.

## *Bullish harami*

In general, a *harami* is a two-day pattern with the candle of the setup day that's longer than the candle of the signal day. This pattern can almost be considered the opposite of the bullish outside day and be called a bullish inside day.

The first day is very bearish and occurring in a downtrend. On the second day, the bulls take a shot at moving prices higher. There's not too much success because although the second day closes up slightly, it closes lower than the first day's open, and the first day's high is never surpassed. However, it's a day where the bulls may have started to take a stand and stop the current downtrend, because the second day is an up day and the low of the first day isn't penetrated.



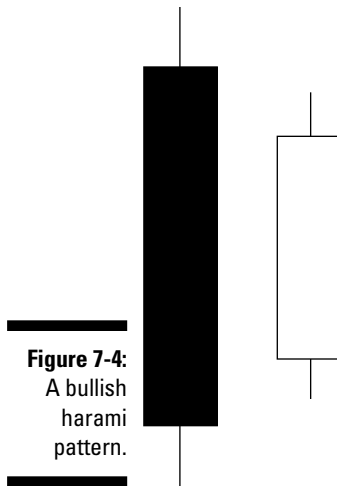
Harami is the Japanese word for *pregnant*; if you draw an outline of the harami pattern, it looks like a pregnant woman.

### *Identifying the bullish harami*

If you want to identify a true bullish harami, the pattern and the market must have the following features:

- ✓ The relevant market or stock is in a downtrend.
- ✓ The setup day has a longer candle than the signal day.
- ✓ The setup day has a black candle, with the open greater than the close, and that candle is fairly long.
- ✓ The signal day's candle has an open lower than its close.
- ✓ The open of the signal day is higher than the close of the setup day.
- ✓ The low of the setup day is lower than the signal day's low, and the high of the setup day is higher than the high of the signal day.
- ✓ The signal day's open is higher than the setup day's close.
- ✓ The signal day's close is lower than the setup day's open.

Figure 7-4 is a picture of two days that create a bullish harami. **Note:** The high and low of both days don't come into play on this pattern — just the open and close.



The setup day of the harami is a down day that follows a bearish trend. On the signal day, the open is up from the first day's close, and the bulls rule the day, because the close is higher than the open. Since there has been a downtrend, the bulls may be a bit timid, worried that the bears are going to come back and push to new lows. The confidence the bulls gain when this doesn't occur should translate to more buying, and a reversal of the downtrend that culminated in the bullish harami.

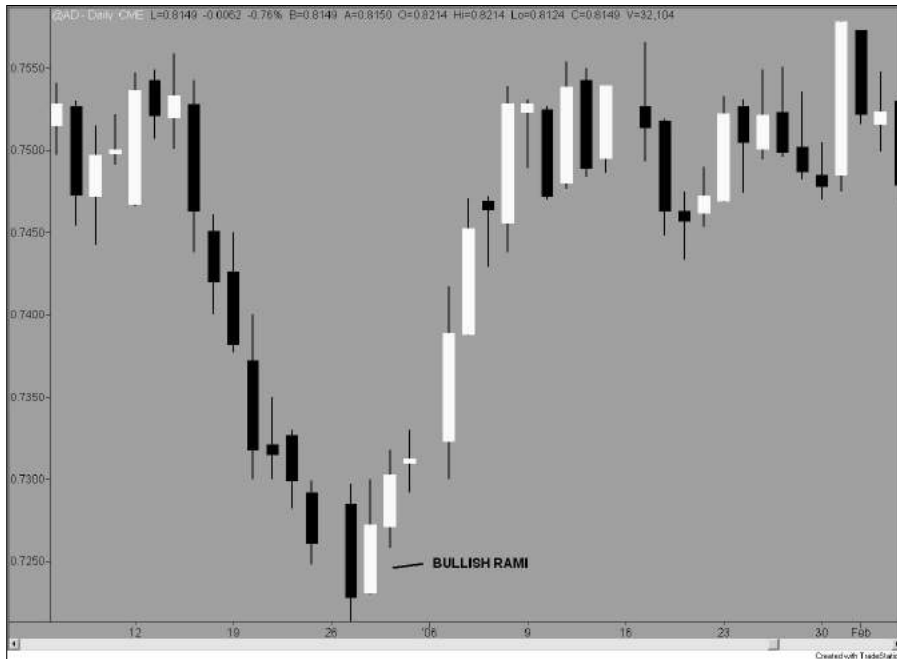
### *Trading based on the bullish harami*

Now for a couple of examples of the bullish harami that help you figure out what to do (or not do) when you spot one on your own. I start with a successful appearance of the pattern at the end of a downtrend. The result is an attractive trend reversal.

### *Getting a nice buy signal on the bullish harami*

Figure 7-5 is a chart of the futures contract that trades on the Australian dollar. The bears push the price down from the open until the close for eight days in a row. Finally, on the signal day of the bullish harami, the bulls find a level where they're ready to start buying. This day is the first of many days where the bulls push prices back up from the depths where the bears had pushed them.

Notice in Figure 7-5 that the high of the signal day is a little higher than the setup day. This example helps me make the point that the bullish harami is just the opposite of the bullish engulfing pattern. (See the earlier section entitled "Bullish engulfing pattern".) With a bullish engulfing pattern, all four price components of the candlestick are involved, but only the open and close matter when you're working with a harami.



**Figure 7-5:**  
A bullish  
harami on a  
chart of the  
Australian  
dollar  
futures.

### *Seeing a bad example of the bullish harami*

Like most other patterns, the bullish harami can go awry. Figure 7-6 is a chart of IBM. A bullish harami appears because IBM's stock has been trending down slowly. Some up days exist, but most are down days for a few weeks leading up to the harami pattern. Any bullish inklings from the harami don't last very long.

The failure level of a bullish harami can vary depending on your preference. I use the open of the signal day as my stop level, and I suggest you use the same level in your trading efforts. In Figure 7-6, this level holds up for less than a day, and although there's some sideways trading for a few days, the downtrend resumes in time.

### *Bullish harami cross*

Much like the doji with all its variations, the harami has more than one version. A doji pattern has an open that's higher than the close of the setup day and a close that's lower than the open of the setup day. This section covers the bullish harami cross — a special variety of harami — which actually involves a doji pattern, which is covered in Chapter 6, but should always be considered an indicator of a potential reversal.



**Figure 7-6:**  
A bullish harami on a chart of IBM followed by bearishness.

### *Recognizing the bullish harami cross*

The bullish harami cross starts out just like its cousin the bullish harami (see the previous section, “Bullish harami”), and it must contain the following characteristics:

- ✓ It appears during a downtrend.
- ✓ Its setup day is a long black candle.
- ✓ Its signal day is a doji.

It’s much easier to understand the specifics of the bullish harami cross if you see a good example, so check out Figure 7-7.

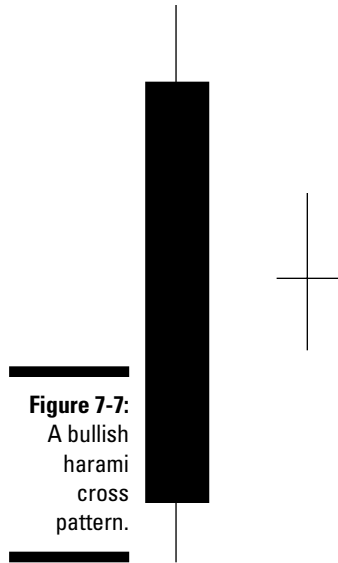


### *Using the bullish harami cross for profitable trading*

The bullish harami cross isn’t a common pattern, but when it appears, the trend reversal may be pretty abrupt. Also, if the pattern doesn’t hold and the downtrend continues, this failure usually happens quickly.

### *A nice buy signal from the bullish harami cross*

To get an idea of how you can trade to turn a profit with the bullish harami cross, look at Figure 7-8. That’s a chart of the Australian dollar futures, with a bullish harami cross that successfully signals a trend reversal. I actually traded this pattern, and the results were strong.



When this pattern reared its head, I was looking for an entry point for trading long on the Australian dollar futures contract. I had been monitoring it for a while, and I bought near the close of the bullish harami cross's signal day. This pattern adheres to the rules for a buy signal because it's at the bottom of a downtrend, and the doji's open and close fall within the setup day's open and close. Soon after I got in, I was happily rewarded with an uptrend that lasted for several weeks, and you can enjoy the same kind of results if you spot the bullish harami cross in a similar environment.

### *Failing to give a good buy signal*

Look again closely at Figure 7-8. There was a failed harami cross a few days before the successful one. I noticed this pattern, and it cost me a little before I profited from the one that worked so well. Figure 7-9 adds a highlight where the failed signal occurred.

For this failed signal, I placed my sell stop on the low of the doji day. I know that contradicts what I said in the regular bullish harami section earlier in this chapter, but since the open and close of the signal day on a bullish harami cross are in such a small range, I generally use the close of the previous day as a stop.

**Figure 7-9:**  
A failed  
bullish  
harami  
cross on an  
Australian  
dollar  
futures  
chart.





Sometimes using stops that don't allow for some market fluctuation gets you out of a successful trade too quickly. On the other hand, placing a stop with too much wiggle room can get you out of a bad trade long after it would've been prudent. Placing stops is as much an art as a science; it's one of the more difficult parts of trading. See Chapter 5 for a quick refresher on stops.

## ***Bullish inverted hammer***

The bullish inverted hammer is a fairly rare pattern. This pattern occurs in a downtrend, and the first day (setup day) is a bearish candle — usually a long bearish candle. The second, or signal, day is actually the inverted hammer; this is the rare part because the price action that creates an inverted hammer is fairly rare.



In order to get the inverted hammer as the signal day, you should start with gap down and end with a close near the opening gap price. Usually with much volatility associated with a gap opening, it would be rare to have the open and close in the same price proximity.

In this section, I demonstrate what the two days that create the bullish inverted hammer look like.

### ***Spotting the bullish inverted hammer***

Like many bullish patterns, the bullish inverted hammer is preceded by some sort of downtrend. The setup day is a down day — a continuation of the prevailing downtrend. The signal day is the inverted hammer. I explain the hammer in Chapter 6, and this pattern is just an opposite version of it.

The inverted hammer has a long wick on the top, and its candle takes up a small part of the bottom of the whole candlestick. The body may be white or black, but because the high is way above the rest of the candlestick, you can tell that most of the trading activity occurs in a small area near the low. The low serves as a support level for upcoming days. Take a look at Figure 7-10 for a handy visual representation.

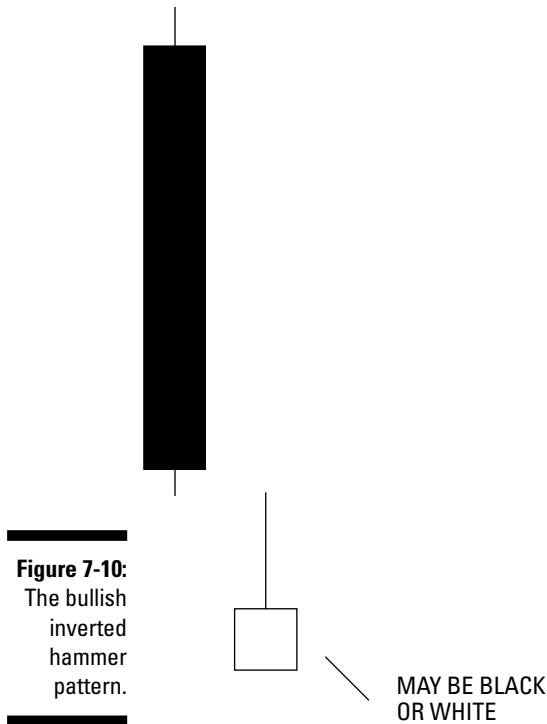


### ***Understanding how to trade on the bullish inverted hammer***

To initiate a trade using the bullish inverted hammer, wait until the open of the subsequent day. Initiate a position only if the open of that day is higher than the low of the inverted hammer day.

Think of it this way. For the bullish inverted hammer to be considered valid, it needs to be confirmed by the open of the day immediately after its appearance. If that open is higher than the signal day's low, you're clear to buy, and you should put your stop in at the same time.





### *Checking out a successful bullish inverted hammer*

Figure 7-11 is a chart of an ETF that focuses on financial stocks. The official name is the Financial Select Sector SPDR, and the symbol is XLF. I'm going to stick with XLF for simplicity's sake. The inverted hammer appears after a down day and is confirmed by a higher opening. I chose this specific chart because there's no question that the open on the day after the pattern confirms the bullish signal. If you see a bullish inverted hammer confirmed like this, you should put on a long trade quickly because an uptrend is likely on the way.



The bullish inverted hammer often appears, and the following day's open won't confirm the bullish signal. If you see that develop, wash your hands of any trades involving that pattern immediately.

### *Seeing a failed confirmation*

Figure 7-12 is a chart of an unconfirmed bullish inverted hammer of the stock for Caterpillar, Inc., the manufacturer of large construction equipment that trades under the symbol CAT. With a downtrend in place and after a down day, a bullish inverted hammer appears. But on the following day, the opening price isn't higher than the previous low or the low of the inverted hammer. The pattern's bullish signal isn't confirmed, and no trade should be initiated.

**Figure 7-11:**  
The bullish inverted hammer confirmed on a chart of the XLF ETF.



**Figure 7-12:**  
An unconfirmed bullish inverted hammer on a chart of CAT.



You may be asking, “Why look at a signal that ends up not being a signal at all?” This won’t be the last candlestick pattern that requires some sort of confirmation on the opening or even the closing of the day after the pattern appears, so it’s worth getting used to the concept. And you can also rely on similar confirmations when trading on some of the patterns I cover in previous chapters of this book. Instead of buying a close on a bullish signal, you can wait until the next day and buy the opening if it appears to be going in the same direction of the signal or doesn’t negate the previous day’s signal.

Finally, although I spend all my working days in front of monitors looking at charts and markets, most new or casual traders don’t. Being able to look at charts outside of market hours and then being prepared to initiate a trade the next day can be very appealing for traders who can’t or won’t be glued to a monitor all day.

## *Bullish doji star*

The bullish doji star is very similar to the bullish inverted hammer. (See “Bullish inverted hammer” earlier in the chapter.) It occurs in a downtrend and signals that the bulls have had enough. The doji pattern always indicates that the battle between bulls and bears was a tight one, and when it appears as the second day of a two-day bullish doji star pattern, it means that the bulls are starting to seize control.

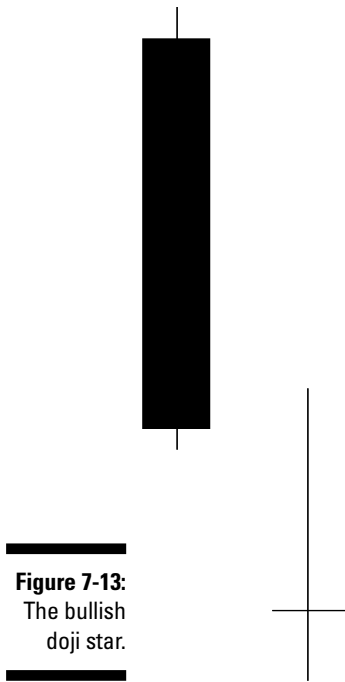
### *Identifying a bullish doji star*

A bullish doji star is a two-day pattern with a doji appearing on the signal day, and it must appear during a downtrend. A genuine bullish doji star must also include the following features:

- ✔ A down setup day, preferably with a long black candle.
- ✔ A signal day that includes an open and close that are equal or very nearly equal, preferably in the middle of a relatively short trading day. (This indicates an almost equal battle between the bulls and bears, where neither faction can claim victory.)
- ✔ A gap down opening between the long black candle of the setup day and the doji of the signal day.

This last feature shows that a gap down is met with buying but only enough buying to keep the price stable.

Figure 7-13 shows two days of trading activity that creates the bullish doji star.



### *Wishing (and trading) on a bullish doji star*

Figure 7-14 shows a bullish doji star working out in a downtrend reversal for the stock Hewlett Packard Co., symbol HPQ. Notice the doji that appears after the gap down from the previous day, which was a down day. The low of the doji is never violated, and a buyer is handsomely rewarded with a huge day for the bulls three days after the pattern appears. If only all buy signals resulted in a 10 percent up day!

### *Failing on a long signal*

Unfortunately, some bullish doji stars are more like falling stars than shooting stars. Check out Figure 7-15 for an example. It's a chart of the futures contract that trades on U.S. Treasury bonds. A doji star appears after a down day and in the midst of a downtrend. Very encouraging! For the next couple of days, the downtrend looks like it has come to an end. But just when the bulls think they are going to make a move, the bears come in with a vengeance and push prices lower than the low of the doji signal day. The downtrend kicks right back into gear.

**Figure 7-14:**  
The bullish doji star working well as a buy signal on a chart of HPQ.



**Figure 7-15:**  
The bullish doji star failing on a chart of the U.S. Treasury bond futures.



## *Bullish meeting line*

The bullish meeting line is another great example of a pattern that offers a heads-up that a trend reversal is on the way. It's an interesting (and rare) pattern.

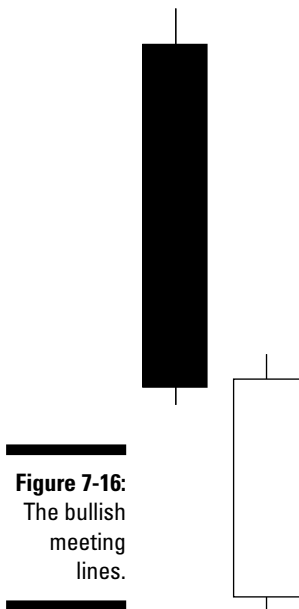
### *Recognizing a bullish meeting line pattern*

The setup day of this pattern is a long black candle, and the signal day is a long white candle. The closing prices of the two days are equal or nearly equal, which indicates that the bears controlled the setup day. There's also a gap down opening, which shows that the bears are still in control at the beginning of the signal day, but the bulls soon arrive on the scene. As the signal day progresses, the low opening price brings in buying activity and a close that reaches the previous day's close and eliminates the gap that was created on the opening.

Figure 7-16 is a picture of how bullish meeting lines appear on a chart.

### *Making a successful trade using bullish meeting lines*

For a successful example of trading on the bullish meeting line pattern, I use an example of Post Properties, Inc., a real estate company specializing in apartment complexes (and a former landlord of your author). The company trades under the symbol PPS.



The chart in Figure 7-17 reveals a pattern that shows up during a downtrend, and the setup day is very bearish. The signal day has a gap opening on the down side, but after trading lower, appears to recover and close near the previous day's close, completing a bullish meeting line pattern. The following day has a threat of support being broken as the stock trades lower than the signal day's open, but the low of that day holds. The result is a few days of very bullish trading. Spotting the bullish meeting lines and getting in at the right time would yield some substantial profits in a case like this.

To give you an idea of what failing bullish meeting lines look like, check out the chart of U.S. Treasury bond futures in Figure 7-18. True to form, the contract is in a downtrend, and the pattern shows up where I've highlighted on the chart. The pattern appears to be validated as the next couple of days aren't necessarily bullish, but the low of the signal day isn't violated. However, on the third day after the pattern is completed, the bears take over again, and the downtrend is back in place. Again, putting a wise sell stop in place at either the low or the open of the signal day would served as a nice tourniquet.



**Figure 7-17:**  
The bullish meeting line pattern on a chart of PPS.



**Figure 7-18:**  
A failing  
bullish  
meeting line  
pattern on a  
chart of U.S.  
Treasury  
bond  
futures.

## *Bullish piercing line*

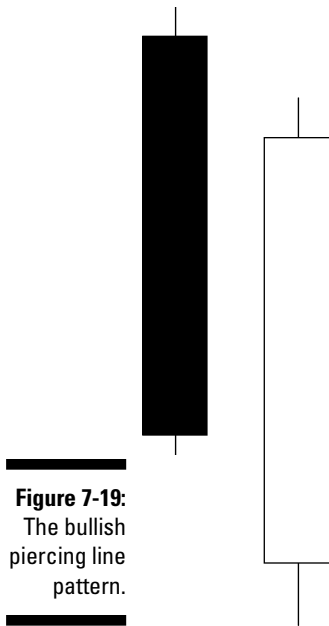
The bullish piercing line is one more bullish double-stick pattern that signals a trend reversal. Just like the other patterns discussed earlier in this chapter, it's crucial that the bullish piercing line appears during a downtrend for it to be considered valid.

### *Identifying a bullish piercing line pattern*

Like the bullish meeting line pattern (see the previous section), the bullish piercing line consists of a long black candle on the setup day and a long white candle on the signal day. The open of the signal day should be lower than the low of the setup day. This means that bearishness persists on the setup day, and then the open of the signal day reveals more selling because the open is lower than the setup day's low. The signal day's close is much higher than the open, which means that the bulls came in as a reaction to the lower opening price and pushed prices higher. The tide, therefore, has turned in favor of the bulls.

Figure 7-19 is a good example of what a bullish piercing line looks like.





### *Trading on the bullish piercing line*

The bullish piercing line pattern combines a setup day that's a long black candle. The signal day is a bullish candlestick that opens with a gap down, but closes well within the range covered by the first day. This is a case where the bulls show up after a bearish open and decide it's time to take charge and push prices up.

Figure 7-20 is an example of a bullish piercing line appearing on the chart of a railroad stock for Burlington Northern Santa Fe Corp., which trades under the symbol BNI. You can't beat this example for a clear representation of the bullish piercing line pattern showing up and signaling the end of a downtrend.

The setup day is a long black candle, and the signal day has a gap opening before the bulls show up and make a solid bullish run. Notice that the signal day doesn't have a high that exceeds the high of the first day. If it did, and if its close exceeded the setup day's open, this would be a bullish engulfing pattern. (I cover the bullish engulfing pattern earlier in this chapter.)

The bullish piercing line failure example I provide here occurs on a chart of FedEx Corporation (symbol FDX). In this case, the bullish piercing line doesn't deliver. As you can see in Figure 7-21, in the midst of a downtrend, a bullish piercing line appears. The following day, the low price of the bullish piercing line is violated by that day's low. This sign is clear that the bullish activity from the previous day isn't as strong as the long white candle day indicated. It takes a couple of days, but the downtrend in FDX continues.

**Figure 7-20:**  
The bullish  
piercing line  
appearing  
on a chart  
of BNI.



**Figure 7-21:**  
A failing  
bullish  
piercing line  
on a chart  
of FDX stock.



## ***Bullish Trend-Confirming Patterns***

Not all double-stick patterns indicate that a trend reversal is forthcoming. Some of them actually tell you that the market is going to continue in the direction it's already going. It may not sound very exciting, but there are some benefits to getting confirmation that a trend is going to stay in place.

First, if you're considering selling a stock because you believe the price is close to peaking, the appearance of a pattern showing the trend is still in place may help you improve your exit price. After all, it's always frustrating to sell and then watch as a stock continues to climb in value. Also, everyone has heard that the way to make money buying securities is to buy low and sell high, but there are plenty of traders that buy high and sell higher.

These people are known as *trend followers*, and they can embrace these trend confirmation signals to the tune of some outstanding returns. Think you may want to join their ranks? If so, read on for a few examples of bullish double-stick patterns that do a terrific job of confirming the continuation of a trend.

### ***Bullish thrusting lines***

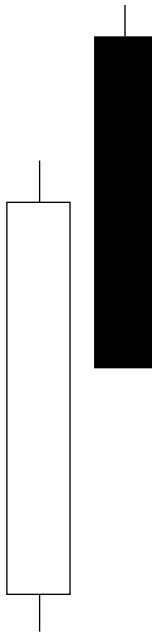
The first trend-confirming pattern I cover here may be a bit difficult to pick out of a chart at first glance, but it's worth understanding and looking out for it. Unlike the double-stick patterns I describe in the preceding sections in this chapter, it's critical that the bullish thrusting line pattern appears during an uptrend, not a downtrend, because this pattern would be confirming the direction of an uptrend, but wouldn't have much significance during a downtrend.

#### ***Recognizing a bullish thrusting line pattern***

The setup day of a bullish thrusting line is a long white candle, bullish in pretty much any market. The signal day is a black candle. This black candle should have a gap opening higher than the high of the setup day and a close near the day's low. However, the close of the signal day should be above the midpoint of the first day. For a bona fide bullish thrusting line, check out Figure 7-22.

#### ***Trading on a bullish thrusting line***

On the setup day of a bullish thrusting line (and for several days before that), the bulls have been in charge of the price action. On the signal day, the bulls push a stock to a gap opening, which brings in some sellers, but the sellers don't push hard enough to get the closing price under the midpoint of the previous day. This means that the bulls are still around and poised to take control. That can be a big help if you're considering buying, because the bullish signal from this pattern can give you a chance to get on board at a reasonable price before the stock continues to go up.



**Figure 7-22:**  
The bullish  
thrusting  
line.

Figure 7-23 is an example of the bullish thrusting line showing up on a chart of International Paper Co., symbol IP. The setup day is an up day, followed by a gap opening. The stock trades off a bit on the signal day after opening higher, but it manages to close above the midpoint of the first day of the pattern (hooray!). For a few days after this signal, the stock trades sideways, but then resumes the uptrend.



**Figure 7-23:**  
The bullish  
thrusting  
line on a  
chart of IP.



Notice that the stock doesn't violate the low of the first day of the pattern — that's the stop level I use when trading on this pattern. I suggest that you use the same, and you can see why in the next example.

### *Failing to indicate the continuation of an uptrend*

Figure 7-24 is a chart of the investment banking firm The Bear Stearns Companies, Inc. (symbol BSC). A bullish thrusting line pattern develops in an uptrend, but the following day, the low violates the low of the pattern's setup day. Some bullish trading occurs after this violation, but a few days later, a pretty ugly downtrend begins.



If you bought BSC based on that bullish thrusting line and failed to put a stop at the low of the setup day, you lost more than you could bear. A failing trade like that can make even the most grizzled traders want to curl up and hibernate.



**Figure 7-24:**  
The bullish thrusting line failing on a chart of BSC.

## *Bullish separating lines*

For another double-stick pattern that confirms a trend, consider the bullish separating lines. It isn't exactly what it sounds like, because the lines involved may actually overlap a bit, but it's a useful pattern and certainly one worth understanding in depth.

### *Singling out the bullish separating lines*

Like all its trend-confirming relatives, the bullish separating lines pattern must appear during an uptrend. The setup day of the bullish separating lines is a down day and usually a long down day at that. The signal day is an up

day, bullish right from the open. The unique feature of this pattern is that the opens of both days are equal or almost equal. Figure 7-25 is a terrific example.

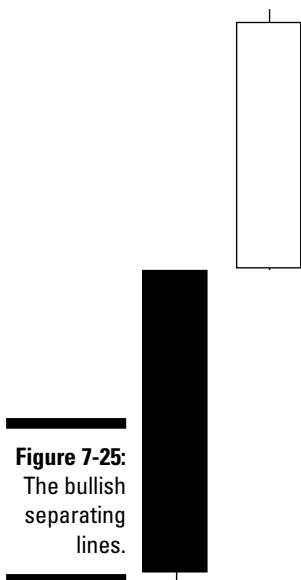
### *Understanding how to trade on the bullish separating lines*

The bullish separating lines confirm uptrends, but the signal day of the pattern is actually a bearish day. The bears decide that the price is right to start selling, and they dominate the bulls, pushing prices lower throughout the day. On the signal day, the bulls come in and are ready to start buying again. There's so much bullishness that the opening price of the signal day is equal to the opening price of the setup day, and from that point on, the bulls dominate the day, and the uptrend remains intact.

### *The bullish thrusting lines and a trend that comes to an end*

Figure 7-26 is a chart of the stock for Transocean, Inc., a company that builds large drilling machinery for extracting oil in deepwater environments. Not coincidentally, its symbol is RIG. (Looks to me that the symbol assignment was rigged.) I've highlighted the pattern forming at the beginning of an uptrend.

I love this example because the pattern occurs early in an uptrend, so a trader may feel that he hasn't completely missed the bull run by using this signal as an entry point. If he kicks himself for missing a buy at a lower price but still has some interest in getting in on a trade, this pattern may give him the confidence to step up to the plate and buy the stock.



**Figure 7-26:**  
The bullish  
separating  
lines on a  
chart of RIG.



Conversely, Figure 7-27 is an example of the bullish separating lines showing up at the end of an uptrend. The stock charted is for The Home Depot, Inc. (HD), a store I seem to visit every weekend. If you bought HD based on the pattern in this figure popping up during an uptrend, you wouldn't have taken too bad of a loss. The stock doesn't change to a downtrend, but instead, it just starts to trade aimlessly in a nontrending fashion. Using a stop wouldn't have saved you massive amounts of cash, but it would've saved you the angst of trying to figure out if the trend was reversed or just flat.



You have a few options when it comes to determining failure for the bullish separating lines. You may choose the low or close of the setup day or the open or low of the signal day. It really depends on how aggressive you feel and how certain you want to be that the pattern's signal has failed.

In the case of the HD example in Figure 7-27, the day before failure would take out the signal day close while the following day (the day highlighted as a failure) would take out all the other options.



**Figure 7-27:**  
The bullish separating lines failing on a chart of HD.

## *Bullish neck lines*

The *bullish neck line* is a trend confirmer and more of a classification than a distinct pattern. There are two neck line patterns: the *in neck* and the *on neck* patterns. At times it may be difficult to tell them apart without getting out a magnifying glass to look at a chart. But because they look very much alike, I decided to group the two together in this section. Keep in mind that the bullish neck lines I describe must occur during an uptrend to have any real significance.

### *Identifying bullish neck lines*

The setup day of the bullish neck line pattern is a long white candle that indicates a lot of buying, and the signal day is a black candle that may be long or short. The close of the signal day will be very near the close of the setup day. If that's the case, it may be said that it's "on neck." If the close of the signal day is a little lower than the close of the setup day, the pattern is instead said to be "in neck." You can see examples of both in Figure 7-28. Notice that they're pretty similar.

Both the on neck and in neck bullish neck line patterns tell the same story, so it's not necessary to separate them for discussion. As I mentioned, they occur during an uptrend. The signal day has a gap opening that brings in

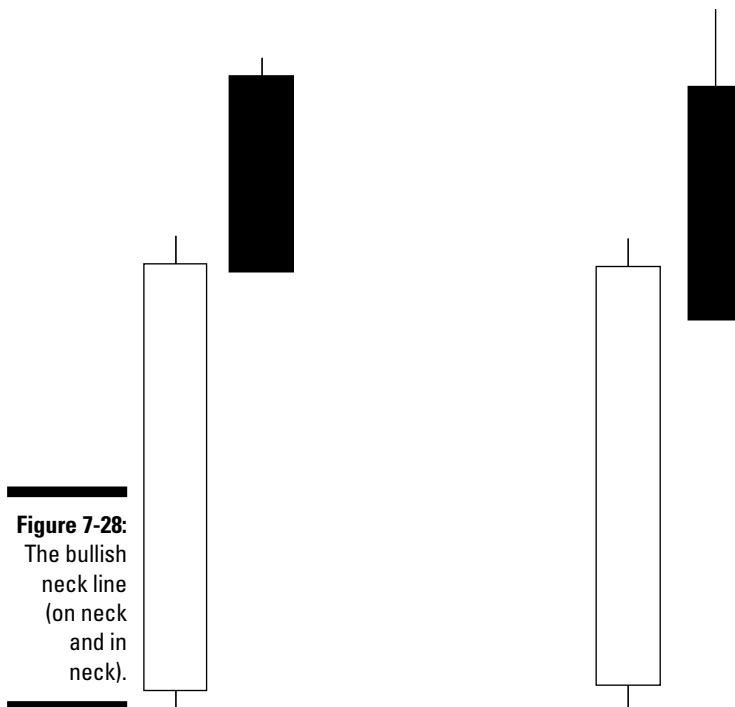


sellers, but there's not enough selling to trade too much (or at all) below the previous day's close. You may recognize these patterns as more bullish versions of the bullish thrusting lines discussed earlier in this chapter.

### *Trading on the bullish neck line pattern*

This section gives an example of the bullish neck line working well to signal a trend that continues to the upside as the bulls push back and hold prices near the close of the first day of the pattern when the bears try to make a push.

Figure 7-29 is a chart of Amgen, Inc., one of the world's largest biotech companies. It trades under the symbol AMGN. The bullish neck line appears during a small pullback during a longer term uptrend. It's slightly in neck, almost to the point that it may not qualify as a bullish signal. However, a trader that takes this as a buy signal and places a stop at any appropriate level would be handsomely rewarded with a continuation of the longer term uptrend. In this case, the potential stop levels would be the low of the setup day or the low of the signal day. I'm always placing stops very close to the entry point, so I probably would've chosen the low of the signal day, or the higher of the two choices.





**Figure 7-29:** The bullish neck line working well on a chart of AMGN.

### *Bullish neck line fails to signal a trend continuation*

I hate to end the chapter on a down note, but I need to show you what it looks like when the bullish neck line pattern fails. Figure 7-30 is a chart of the U.S. Treasury bond futures. A bullish neck line appears near the top of this bullish move. There's only one day where the bulls are happy for making a move based on this signal, and then the tide turns quickly. The only positive I can say about this scenario is that it happened quickly, so you can move on to the next trade without a long and painful failure. And any stop level you picked would've been taken out by that ugly black bar.

That's it for the bullish double-stick patterns for now. In later chapters they come back, teamed up with technical indicators that may signal it's time for a reversal or that a strong trend is in place.



**Figure 7-30:**  
The bullish neck line failing on a chart of the U.S. Treasury bond futures.



## Chapter 8

# Utilizing Bearish Double-Stick Patterns

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### *In This Chapter*

- ▶ Working with bearish double-stick patterns that signal a trend reversal
  - ▶ Predicting the continuation of a downtrend by using bearish double-stick patterns
- 

**I**n Chapter 7, I discuss the nature and usefulness of bullish double-stick patterns, but they aren't the only double-stick show in town. As with most bullish patterns, bearish two-day counterparts exist, too, and you should know how to recognize and trade them, and that's what I focus on in this chapter. These patterns work as effective sell signals, and keep in mind that when a sell signal pops up, even if you don't have a long position on, you can use the opportunity to initiate a successful short position.



Just like the bullish patterns in Chapter 7, the bearish double-stick patterns in this chapter may appear as reversal patterns (signaling that an uptrend is coming to an end) or as continuation patterns, which tell you that a prevailing downtrend will continue. These bearish examples have two parts: the first day, which I refer to as the setup day, and the second day, which I call the signal day.

## *Understanding Bearish Reversal Patterns*

I'm definitely biased toward bearish reversal patterns. I've always been a bit of a countertrend trader, and because many candlestick patterns signal trend reversals, I've always found plenty to use in my trading. But trading in anticipation of trend reversals isn't always a cakewalk. In fact, it almost put me out of the business during the strong bullish markets that have become known as the dot.com bubble. I managed to keep from going broke during that period, and I learned some expensive lessons about money management and using stops that I include in my explanations throughout this chapter.



A bit of a warning about using short reversal patterns: First, remember that in theory, a short has an unlimited loss. Also, keep in mind that when you're shorting stocks, you're working against a general long-term uptrend in stock prices. Some successful traders are exclusive shorts, but they're pretty rare. Don't get me wrong. I do believe that shorting should be part of any trading or investing program, but please use shorting as part of a larger trading strategy, not as your primary way of working the markets.

You can use many extremely useful patterns for shorting, as signals for exiting from a long, or as exercises in patience before buying. Take a look at this section, which covers those patterns.

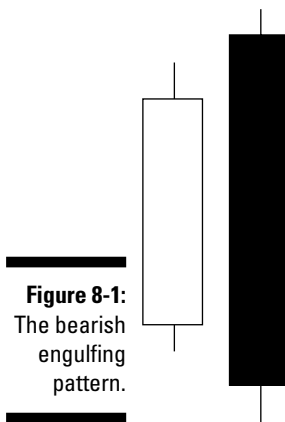
## *The bearish engulfing pattern*

The bearish engulfing pattern is one of the best patterns to start with because of the dramatic nature of the bearish second day that appears on the pattern. The pattern involves the bears taking control after an extended period of bullishness, and the trend is definitely one to watch.

### *Identifying the bearish engulfing pattern*

Check out Figure 8-1 for an example of the bearish engulfing pattern.

Leading up to and including the setup day of this pattern, the bulls have been in the driver's seat. On the open of the signal day, the sellers or shorts finally have had enough, and they decide that the price has gone up enough to bring them into the action. They push the price down dramatically and quickly (in one day). But these bears aren't finished with their selling, and the close of the signal day is near that day's low. That will most likely continue — to the point where a downtrend develops — because the sellers aren't done putting pressure on the stock or market.



**Figure 8-1:**  
The bearish  
engulfing  
pattern.

### *Trading on the bearish engulfing pattern*

For a real-world example of a bearish engulfing pattern that can be used for a profitable trade, have a look at Figure 8-2. Here you see the pattern appear on a chart of the exchange-traded fund (ETF) that represents the 30 stocks that trade in the Dow Jones Industrial Average (DJIA).

On this chart, there's a bearish engulfing pattern right at the end of a nice uptrend. The bulls control the setup day; an uptrend is in place, and those bulls keep it going. At the start of the signal day, the bulls continue on their buying spree and cause the opening to be higher than the setup day's close. Then the bears come in and push hard — so hard in fact that although the price had opened higher than the setup day and even traded above that day's high, the bears are still able to push things down below the setup day's low. Those bears mean business!

The overwhelming push by the bears that stops an uptrend dead in its tracks is the key to the bearish engulfing pattern. The DIA (the symbol of the ETF that trades based on the level of the DJIA) chart in Figure 8-2 is a great example of a bearish engulfing pattern scenario that can lead you to profitable results. After the bears reverse the uptrend, the signal holds, and the next day's trading doesn't come near the pre-reversal prices. If you short at the end of the pattern and ride the downtrend for a while before buying back, you have a profitable trade.



**Figure 8-2:**  
A bearish  
engulfing  
pattern  
signaling a  
sell on the  
DJIA ETF.

### *The bearish engulfing pattern fails*

I provide an example of a failing pattern for every successful pattern in this book, and in Figure 8-3, I highlight what can happen when a bearish engulfing pattern goes wrong. This unfortunate outcome occurs on a chart of the Japanese Yen futures. The bearish engulfing pattern shows up but fails pretty quickly, and the uptrend just keeps going higher.

This scenario looks ripe for a bearish engulfing pattern: A clear uptrend is in place and actually appears to be slowing a bit (a good sign). The bulls continue the trend on the setup day, and then on the signal day, a small gap opening appears. At first the bulls push prices much higher, but then the bears take over, and when they start selling, it's powerful enough to cover the setup day's bullishness, and then some. If you see this pattern on a chart, you may have good reason to get excited, but things go sour quickly.

The day after the pattern appears, the bulls get back in on the action, and the price closes higher than the opening of the signal day. The pattern clearly fails, but if you trade on it, you can avoid heavy losses if you place a stop at the right level.



When working with bearish engulfing patterns, I place my stops at the open of the second day. That's when I can tell that the bulls have again seized control of the price action, and I know that can continue for some time. It's always prudent to have a stop in place, and that may be a good level to choose to put your stop. I advise you to place your stops at the same level.



**Figure 8-3:**  
A bearish engulfing pattern that fails on a chart of the Japanese Yen futures.

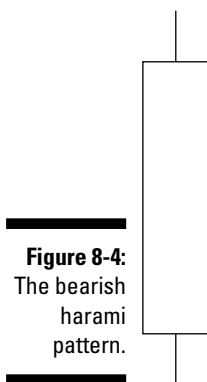


## The bearish harami pattern

The bearish harami pattern can tip you off that an uptrend is about to be reversed. Loosely translated from the Japanese, *harami* means *pregnant*. If you use your imagination and squint a little, you can see in Figure 8-4 how the pattern got its name. I guess if you draw a line to circle the area that a harami covers, you end up with something that resembles the outline of a pregnant woman. Okay, so it's not going to fetch much at an art auction, but it can pay off if you understand how to identify and trade on it.

### Spotting a bearish harami

The setup day of a bearish harami pattern is a continuation of a prevailing uptrend — a strong up day. At first glance, the signal day isn't much to jump up and shout about, either. It's a day where the price action doesn't stray outside of the high and low of the setup day, and it indicates that the bears take over on the open, and neither side makes much progress pushing around the price action. But since this trend occurs after a bullish day and during a marked bullish trend, it can very well serve as a sign that the bears are starting to take control of the price action. Figure 8-4 shows an extremely straightforward illustration of the bearish harami pattern.



Another name for the signal day in this pattern is an *inside day*, where the high is lower than the previous high, and the low is lower than the previous low. When they occur on their own, inside days indicate a lack of conviction by both the bulls and the bears. But combine an inside day with a preceding bullish day and a bullish trend in place, and the combination can show you that the bull run is coming to an end.



When a prevailing trend starts to fade away into indecision, the next dominant trend is likely to go in the opposite direction.

### *Using the bearish harami pattern for a clever trade*

For a good look at what the bearish harami looks like on a real chart, check out Figure 8-5. The chart is of the ETF that represents a group of the largest retail stocks, including Wal-Mart, Home Depot, and Walgreens. The trading symbol for this ETF is RTH. I have an affinity for retailers because I covered them fundamentally, and I've traded them at various firms. I also like this ETF and individual retailers as trading vehicles because their performances are closely linked to the state of the economy. With fluctuations in economic opinion comes volatility in these stocks, and with volatility comes trading opportunities!

The setup day of this two-day bearish harami pattern is a very strong up day that occurs in the midst of an uptrend that's been in place for several weeks. The signal day is an inside day that's a little on the bearish side. After that day the price falls quickly, back to the level where the uptrend began. The fall occurs much more quickly than the ascent, which is often the case with downward moves. They tend to happen much more quickly than uptrends. I guess fear is stronger than greed in the stock market.

### *A failing bearish harami pattern*

Figure 8-6 provides a solid example of how the bearish harami can fail, because it happens twice in a row on this chart. This double dose of pattern failure should open your eyes to what can go wrong when the bearish harami doesn't play out favorably.

Figure 8-6 is a chart of the futures contract that trades based on the price of crude oil. As you can see, the bearish harami appears twice in a row. The setup day of each pattern is a nice up day (in the middle of an uptrend), and both of the signal days are inside days with dark candles that indicate bearish trading. These two patterns have something else in common, as well. They both fail immediately! Both patterns crash and burn the day after they appear on the chart. If you trade these patterns and take a small loss, I bet the next time a bearish harami rears its head, you think twice before putting on a trade.

The setup day of the second bearish harami on this chart is actually the same day that the first pattern fails. I define a bearish harami failure as a violation of the high of the signal day. This violation occurs on both patterns in Figure 8-6, and both fail the day after the pattern appears. (My definition for failure on a bearish harami pattern isn't the only one; a failure can also be a violation of the close of the setup day, or even the high of the setup day.) After trading achieves any of these levels, the prevailing uptrend becomes apparent. You need to figure out your level of risk tolerance and decide for yourself what level to use as a failure point for the bearish harami, but using my definition (the violation of the signal day's high) is a good starting point. This level is a good one to place a stop order to avoid a loss getting out of control.

**Figure 8-5:**  
A successful bearish harami working on a chart of the RTH ETF.



**Figure 8-6:**  
A bearish harami pattern failing twice on a crude oil futures chart.

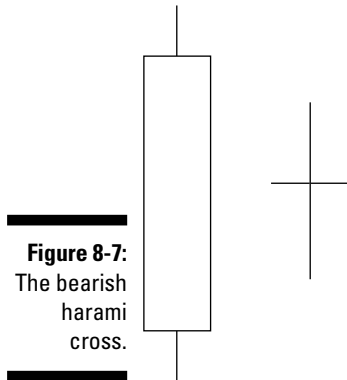


## *The bearish harami cross pattern*

The next bearish two-day pattern is closely related to the pattern I discuss in the previous section (“The bearish harami pattern”), and it can be used in a similar manner. This pattern — the bearish harami cross — also marks the first return of the doji in this chapter. A *doji* is a candlestick pattern that looks like a cross and usually indicates some sort of indecision in the market. (Dojis are covered more in Chapter 6.) When this indecision occurs in a trend, it may signal that the trend is preparing to reverse.

### *Recognizing the bearish harami cross*

The bearish harami cross occurs in an uptrend and consists of an up setup day followed by a doji for the signal day. The signal day doji must be both a cross and an inside day. Take a look at Figure 8-7 for an illustration of the bearish harami cross.



Because the doji indicates that indecision ruled the day, I actually prefer the bearish harami cross to the plain old harami reversal pattern. Dojis are rare, and the occurrence of a bearish harami cross pattern is more of an event than the appearance of the bearish harami.

### *Trading on the bearish harami cross*

The chart in Figure 8-8 gives you an idea of how the bearish harami cross can spell market success for you. This figure shows the pattern appearing on a chart of one of my favorite commodity contracts: frozen concentrated orange juice, or OJ.

In the movie *Trading Places* (one of my favorites), commodities are being explained to ersatz trader Eddie Murphy. There's a table that displays several traded commodities (including orange juice), and when the conniving old Dukes brothers get to the OJ, one of them says, "orange juice, like you may have had for breakfast this morning" in a tone he could've used to explain the concept to a first grader. The look Eddie Murphy gives the camera is priceless.

Anyway, Figure 8-8 shows the bearish harami cross appearing in a choppy uptrend. The setup day is clearly an up day, and the contract reaches new highs. The cross or doji day follows, and the bulls are clearly running out of steam. After that, you see a very bearish day with no violation of the high for the setup day, which is what I like to use as the failure level for this pattern, and then a downtrend that lasts a few weeks. If you put on a short position and ride the downtrend for a while, you end up with an attractive profit.

For a failing bearish harami cross, I use Transocean Offshore (RIG). This company builds drilling rigs for use in deep water. The stock is a great trading vehicle due to the company's exposure to the energy markets.

*Signaling a losing trade*

In Figure 8-9 you can see that during an uptrend, a little cross appears after a bullish day. This cross or doji is actually a slight up day, but a doji just the same in my book. Much like the price of energy, the stock prices of energy-related stocks have been on a tear, and RIG is no exception. This bearish harami fails pretty quickly, and the uptrend stays intact.

**Figure 8-8:**  
A bearish harami cross that produces a favorable result on a chart of OJ.



**Figure 8-9:**  
A bearish harami cross pattern fails on a chart of RIG.



You may notice that although this signal failed, there were a few days after the failure where the chart still appears to reveal a change in trend. This confusing start-stop-start situation is part of the game.



Signals sometimes fail and trades get stopped out temporarily, only to eventually reveal price action that could've produced profitable results. These occurrences are frustrating, but I've never been upset with myself for following trading rules or signals, even when it's clear a few hours or days later that I could've made money if I had overridden a stop or ignored a failure signal. When I consistently follow the rules, I can't second guess myself, but if I don't follow the rules and a trade fails, I can only blame myself. I suggest that you adopt the same philosophy, especially if you're just starting to trade.



I can't emphasize enough that sticking with a trading plan and following your rules may be the most key components to becoming a successful trader.

## *The bearish inverted hammer pattern*

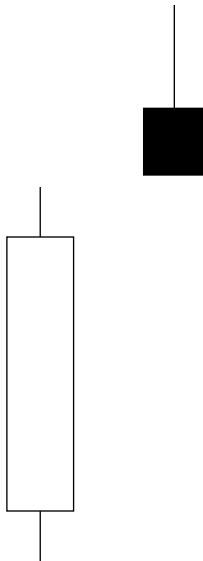
Like many of the bearish reversal patterns described in this chapter, the bearish inverted hammer is set up with a long white candle that occurs during an uptrend. Then there's a gap opening and even more buying to start the signal day. However, at some point the bears are called to action and start to push prices lower, and if you keep your eyes peeled for that move and trade accordingly, you should be able to turn a profit.

### *Identifying the bearish inverted hammer*

The bearish inverted hammer is depicted in Figure 8-10. The inverted hammer is actually the second day of the pattern. The setup day is a long white candle, which indicates a very bullish day. The start of the signal day (also called the hammer day) sees a gap opening and continued bullishness; that process carries on for part of the day, and higher prices are achieved. At some point during the signal day, the bears have had enough and selling begins. The bearish action pushes prices down below the opening price, and the close is equal to or very near the day's low.

### *Using the bearish inverted hammer in your trades*

To provide you with a winning scenario for the bearish inverted hammer (Figure 8-11), I offer a pattern that actually came up while I was searching for an example for this section. This chart is for the Financial Select Sector Fund, symbol XLF, which is an ETF that represents a handful of large financial stocks such as Citigroup, American International Group, and Bank of America. You can see the bearish inverted hammer near the top of the chart. When I saw the pattern, I figured I should put my money where my mouth is. I knew that even if the trade didn't work out, I'd still have an example of a failing pattern for later in this section. Luckily, though, that wasn't the case.



**Figure 8-10:**  
The bearish inverted hammer.



**Figure 8-11:**  
A bearish inverted hammer that works on a chart of the XLF ETF.

I shorted the XLF on the signal day of the pattern, held it for four days, and exited on the first up day. I also placed a buy stop order at the open of the signal (or hammer) day. That's a very tight stop, but this trade was outside of my normal trading activity, and I felt it was prudent to place a close stop. More aggressive traders may have chosen the high of the signal day for their stop.

The example in Figure 8-11 is doubly useful because it also shows you how to exit a trade. I don't discuss exiting trades much in this book — too many methods and goals exist once a trade has been initiated to cover here — but

this situation is definitely worth pointing out. I chose my exit in this trade because the reciprocal version of the bearish inverted pattern appeared. I saw the bullish pattern, and I was happy to exit and take a profit of just over a dollar on one hundred shares — I'll let you do the math — and take my wife to dinner on the proceeds. I ended up with material for this book and a nice dinner for Merribeth. Now that's a perfect trade.

### *Recognizing a losing trade*

On a somewhat gloomier note, have a look at Figure 8-12 for an example of a couple of failing bearish inverted hammers. Figure 8-12 is a chart of the ETF that represents the 30 stocks that comprise the Dow Jones Industrial Average and trade with the symbol DIA, sometimes called the Diamonds. Luckily for this author and trader, there wasn't a real-life trade involved with this example.

Both patterns appear in an uptrend, and both feature an up setup day followed by a gap opening and strong activity during the signal day that reverses with a lower close. Although usually an indication of a reversal, both times these signals were proven to be false fairly quickly.

In the case of the first pattern, all possible resistance levels were violated and the uptrend continued. For the second pattern, I highlight two failures:

- ✓ One is a violation of the open of the hammer day.
- ✓ The other is a violation of that day's high.



**Figure 8-12:**  
Two bearish  
inverted  
hammer  
failures on a  
chart of the  
DIA ETF.



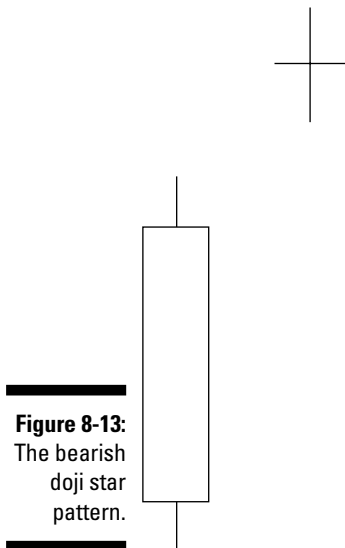
The second pattern takes a little longer to fail, but it does eventually. The second pattern is interesting because it does occur toward the end of the uptrend. But the signal is violated, and a trader following the rules would have exited the short. This additional illustration shows how you sometimes have to just follow the rules and move on, even when it's clear later that you could've turned a profit if you'd stuck with the position. Don't look back and say "what if?" Be confident in the fact that you followed set rules and that over the long haul, following the rules results in more consistent trading profits.

## *The bearish doji star*

The bearish doji star is another bearish reversal pattern that contains — you guessed it — a doji. This pattern is also an extension of the bearish inverted hammer, which I discuss in the previous section.

### *Spotting the bearish doji star*

The bearish doji star always occurs in an uptrend, and the setup day is an up day. The signal day is a doji that's sort of hanging out there by itself, because the opening of the signal day is gap down from the previous day's price action. Figure 8-13 is an example of how the two days that make up a bearish doji star appear together on a chart.



### *Understanding how to trade using the bearish doji star*

Figure 8-14 is a chart that shows the bearish doji star in action. In this example, this doji star pattern is working well to signal an impending drop in the stock for microchip maker Intel (symbol INTC). An uptrend is in place, and the setup day of the pattern is a bullish day in accordance with the trend. The signal day is a doji, with the combined open and close outside of the range covered by the setup day's trading activity. After all the bullishness of the previous few days, the bears are finally making a stand.

The day after the pattern is a very bearish day, so if a trader didn't put on the trade during the doji day, he doesn't have a chance. Then the day after the long black candle appears, the stock gaps down tremendously. This change is a quick victory for any sellers that are attracted to short this bearish doji star.

### *Failing to give a good short signal*

For the losing example of a bearish doji star, I present Figure 8-15, which is a chart of the stock for Apple Computer (symbol AAPL). The bearish doji star I highlight in the figure showed up during a bullish trend, and you can see that this chart includes a nice up day followed by a doji. All the bearish doji star criteria are in place, but the pattern fails swiftly and mercilessly, and the trend continues with a very strong up day directly after the pattern. The potential Apple trade goes rotten.

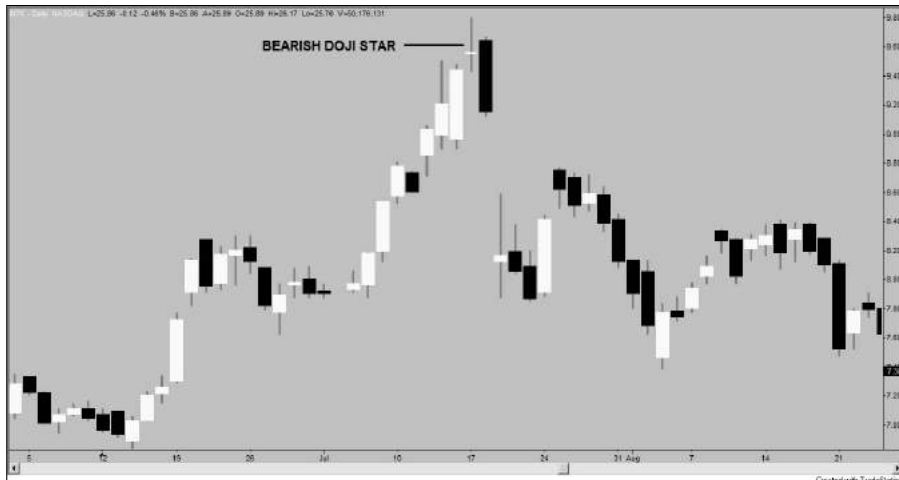


My failure level for a bearish doji star is the high of the signal day, as opposed to that day's open or close. Using the combined open and close area of the doji doesn't provide much room for volatility on a stop. If the stock opens just slightly up the next day, then it will hit the buy stop, which is very likely to happen even in the case of a trend reversal. In order to avoid regular market noise forcing me out of a trade, I prefer to rely on the high of the signal day for my stop exit.

## *The bearish meeting line*

Although rare, the bearish meeting line pattern is worth understanding as you build your arsenal of double-stick bearish patterns that signal a trend reversal. This line can be a clear indication of a change in trend due to the stark contrast of the two days that combine to form the pattern.

**Figure 8-14:**  
A bearish doji star pattern working on a chart of INTC.

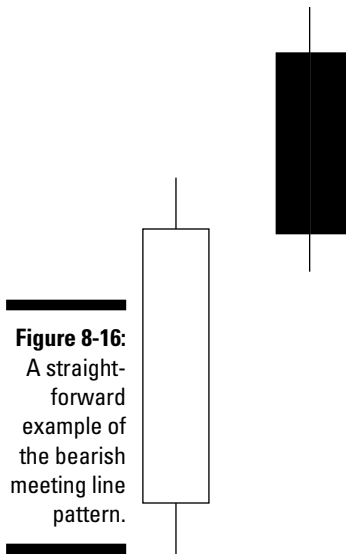


**Figure 8-15:**  
The bearish doji star pattern fails on a chart of AAPL stock.



*Understanding how to identify the bearish meeting line*

If you're looking for an ideal visual representation of the bearish meeting line, it doesn't get any better than Figure 8-16.



**Figure 8-16:**  
A straight-forward example of the bearish meeting line pattern.

On the setup day of the bearish meeting line, as with most of the two-day bearish patterns, you see a strong up day. Then, on the signal day, you notice a gap opening, which quickly entices some sellers. The selling continues until the close. A long black candle is the result, with the close of the day being very near its low. The close of the signal day also happens to be very near the close of the setup day, and the meeting of these lines gives the pattern its name.

### *Trading on the bearish meeting line*

For an example of the bearish meeting line pattern producing a scenario that's ripe for a successful trade, see Figure 8-17. That's a chart of the aluminum maker Alcoa (symbol AA). As a producer of a material used in many everyday products, Alcoa is another stock that has strong ties to the overall economy. AA is a volatile stock at times, creating both long and short opportunities.

A definite uptrend exists on this chart — the first criteria for keeping any eye out for a bearish reversal signal. The setup day is a very nice up day, and then the signal day opens with a gap higher. The bulls are ruling the trading activity, and the situation is perfect for a successful bearish meeting line pattern.

If you were watching this pattern develop, you'd be pleased to see that sellers come in and push prices lower than the previous day's close, and although the stock rebounds a little, the price settles on the signal day near where the stock closed on the setup day.



**Figure 8-17:**  
A bearish meeting line pattern that turns out well on a chart of AA.

Then the trend reversal begins. And what a trend reversal it is! Six black candles line up in a row, signaling that the uptrend has definitely ended. Any trader not prepared on the day the signal was completed misses out on a good part of the outstanding downtrend.



To get in on the close of a day that a pattern is completed, watch for the patterns as they develop during a trading day. Usually, with five to ten minutes left in a trading day, you can tell whether a pattern is forming or not. The problem for you if you're a new or part-time trader is that you probably have a job or other responsibilities that may prevent you from being available to trade during these important time periods. Be sure to factor in your own availability when developing your trading strategy.

### ***An unsuccessful bearish meeting line***

An example of the bearish meeting lines failing to signal an uptrend reversal appears in Figure 8-18, which is a chart of the futures contract that trades on the level of the Euro currency versus the U.S. dollar. The uptrend is in place, and the formation appears as it should. This pattern is very encouraging for a trader who's been waiting for a good time to short. In this example, however, that enthusiasm from a short seller is fleeting.

The day that follows the pattern proves it to be invalid. Prices trade higher than both the open and the high of the pattern's signal day, making it clear that the pattern is a bust.



When shorting based on the bearish meeting line pattern, I usually place my stops on either the high of the signal day or the open of the signal day.



**Figure 8-18:** The bearish meeting line pattern fails on a chart of Euro currency futures.

## *The bearish piercing line or dark cloud cover pattern*

Another two-day bearish reversal pattern is the bearish piercing line, also known as the dark cloud cover, because some say that the signal day is an ominous dark cloud that hangs over the setup day. It requires a little use of your imagination.

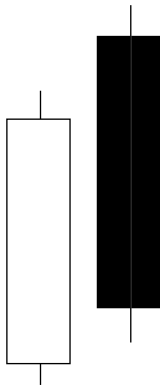
### *Identifying the bearish piercing line pattern*

You can see a straightforward illustration of the bearish piercing line in Figure 8-19. Just like all the bearish two-stick reversal patterns I describe in the preceding sections of this chapter, this pattern must appear in an uptrend. Also, in keeping with the other bearish reversal patterns, the setup day for the bearish piercing line is a bullish day. The signal day is a long black candle with an opening that's higher than the setup day's high. The signal day indicates that some sellers came rushing in, pushing prices down through the setup day's opening price and below its midpoint.

### *Making trades based on the bearish piercing line*

The bearish piercing line pattern can be used to put on a profitable short, as you can see in Figure 8-20. This chart shows the bearish piercing line on a chart of Intel (INTC).

The pattern occurs in what appears to be the late stages of an uptrend. The price is still working higher, but not with as much momentum as it did where I've pointed out the first stage of the uptrend. If you see a reversal pattern when you believe a trend is starting to lose steam, that's more encouraging than when the pattern appears in a strong trend. In later chapters I discuss how to use indicators to make these distinctions (see Chapters 11, 14, and 15).



**Figure 8-19:**  
The bearish piercing line pattern.



**Figure 8-20:**  
The bearish piercing line pattern at work on a chart of INTC.

### *Falling short with the bearish piercing line*

This INTC chart is another example of the limited amount of time you may have for initiating certain trades. Unless you keep a close eye on the chart, you miss your chance to put on a successful short. So what does a bearish piercing line pattern look like when the pattern fails? For an answer, see Figure 8-21.

**Figure 8-21:**  
The bearish  
piercing line  
pattern fails  
on a chart  
of DELL.

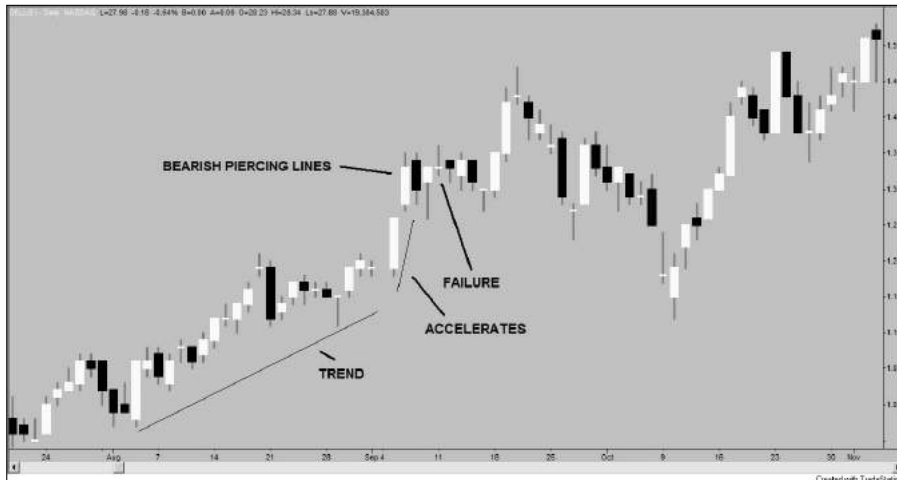


Figure 8-21 shows a chart of the stock for another technology company, Dell Inc. (symbol DELL), which was founded by Michael Dell. (Maybe I'm too focused on the market, but how cool would it be to have your name become a stock symbol?) Here you can see a bearish piercing line that occurs during an uptrend. The uptrend continues on, and the failure of the pattern (and the appearance of higher prices) takes a couple of days. If you jump the gun on this pattern and put on a short without a smart stop, you see some losses.

## *Making a Profit with Bearish Trend Patterns*

In addition to double-stick patterns that tell a trader it's time to sell or put on a short after an uptrending move, some patterns also indicate a downtrend continuation is on the horizon. These patterns can tell you when you still have room to profit on a short. You can also turn to them when you're looking to buy a stock that's been in a downtrend and looks to be "getting cheap." A bearish double-stick trend continuation pattern can let you know that a stock is going to get cheaper and can therefore be had at an even lower price.



## A quick note on trend strength

Allow me to point out an interesting side note and comparison of Figures 8-20 and 8-21. The successful bearish piercing line occurs when the trend appears to be moderating. On the DELL chart, which contains the failing pattern, the opposite occurs. The trend is strong, but the pattern appears after an acceleration of momentum. This burst of uptrend momentum

can indicate to an observant trader that even though a bearish pattern has appeared, it's probably smart to use caution when putting on a short. It can also signal that a quick exit may very well be in order. Remember to keep on the lookout for these increases in trend strength. To help you train your eye, I've highlighted the relevant area in Figure 8-21.

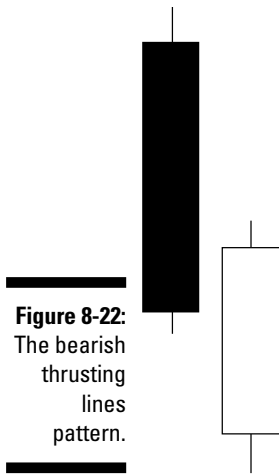
All the two-day bearish trending patterns covered in this section require that the market or stock in question be in a down-trending mode. Determining the trend can be subjective and can also be a matter of the time frame in which you're trading. I go into great detail on determining trend in later chapters (especially Chapter 11), but for this section, just concentrate on the pattern and don't worry as much about whether you agree with my assessment of the prevailing trend.

## *The bearish thrusting lines*

The first two-day pattern that indicates the continuation of a downtrend is the bearish thrusting lines pattern. I like this pattern because the signal day is an up day. You may scratch your head and wonder why I would like an up day that indicates the continuation of a downtrend. At first blush it does sound counterintuitive, but the presence of an up day on the signal day of this pattern means that a great opportunity exists to put on a short at prices higher than the previous day of the downtrend.

### *Understanding how to spot the bearish thrusting lines*

Figure 8-22 shows you exactly what the bearish thrusting lines look like on a chart. Again, the prevailing trend should be down, and the setup day is a long black candle. On the signal day, prices open weak, but then the bulls come in and try to reverse the trend and take over. They seem to be succeeding, but they're not quite strong enough to get prices to the upper half of the candlestick that was created by the setup day's trading. This activity means that although the bears don't completely control the day, they're still around and are eager to reassert themselves in the coming days.



**Figure 8-22:**  
The bearish  
thrusting  
lines  
pattern.

### *Trading on the bearish thrusting lines*

For an example of the bearish thrusting lines working well, turn to Figure 8-23 and a chart of the stock for the Toll Brothers (symbol TOL), which is a high-end home-building company. During the recent contraction of real estate prices, the publicly traded home-building stocks lost a lot of ground, and TOL was no exception.

The bearish thrusting lines actually pop up three times on this chart, and for each of those three occurrences, the stock's price drops for days after the pattern appears. For the sake of emphasis, I added a downtrend line to show the continuing downtrend.



**Figure 8-23:**  
The bearish  
thrusting  
lines pattern  
works on  
a chart  
of TOL.



A successful trade based on the bearish thrusting lines in this chart starts with the close of the first pattern's signal day. If you're short from the top of this downtrend, you definitely feel like a skilled trader. You can easily monitor the continuation patterns and follow the trend as it heads down. But where would you exit the short?

An exit would be prudent when the price trades over the hand-drawn line on the chart. (See Chapter 11 for more information on how to draw trendlines.) At that point the downtrend has been broken, and the easy money on the short has been made, so be smart and take your tidy profit and move on.

### *Recognizing a disappointing bearish thrusting line pattern*

Want to see what happens when the bearish thrusting lines fail? Look no farther than Figure 8-24, which is a chart of the futures contracts that trade based on the level of the Japanese Yen versus the U.S. dollar. You can see that toward the end of this downtrend, two double-stick patterns actually fail to indicate the end of the downtrend. Both two-day patterns and the failing days are highlighted on the chart.

I hate to see the patterns in Figure 8-24 fail. They both start out with so much promise! Both patterns appear in downtrends and meet the criteria of having a long black candle setup day followed by an up signal day that retraces some of the long black candle day's area but doesn't close higher than its midpoint. The failures occur when the highs of the signal days are violated on the days that follow each pattern. You can even say that the violations occur when days that follow the patterns have prices that exceed the midpoint, open, or high of the setup day. It doesn't matter which level you choose — they all get violated, the patterns fail, and the trends turn upward quickly.



**Figure 8-24:**  
The bearish thrusting lines fail at the end of a downtrend on the Yen futures.

## *The bearish separating lines*

The next continuation or trending pattern is referred to as the bearish separating lines pattern. If you flip back to Chapter 7, you can read all about this pattern's bullish counterpart.

### *Identifying the bearish separating lines*

The setup day of the bearish separating lines pattern is a long white candle, which can make some bears or shorts a bit nervous when it appears in a downtrend. A little relief for those factions comes on the signal day, however, when the opening price is near the setup day's open. That relaxes them a bit, and they decide that the up day wasn't justified, so they keep right on selling on the open of the signal day. But what happens to the bulls that had a ball on the setup day? They can't take the heat, so they sell their positions, and the price just keeps on trending lower and lower. For a graphical representation, check out Figure 8-25.



This pattern is somewhat rare because it's unusual for the open of the signal day to be equal or near the setup day's open. It really amounts to a gap down opening, with all the prices from the setup day not even trading on the signal day. Short-term buyers on the setup day hardly have a chance to get out with a profit on the signal day, which is a very discouraging prospect for a buyer.

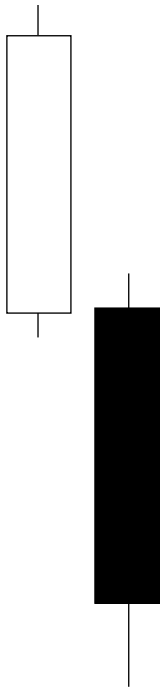
### *Understanding how to trade on the bearish separating lines*

The example I use in Figure 8-26 for illustrating how you can use the bearish separating lines for your trading purposes is an unusual stock chart for this book. The stock represented is Inco (symbol N), a large producer of the metal nickel. The model is uncommon because Inco merged out of business with another company at the beginning of 2007, and it doesn't trade publicly in the U.S. anymore. Still, though, the example is a sound one, and it shows you how the bearish separating lines can really sing when the conditions are just right.

Figure 8-26 clearly shows a downtrend in place, but then a couple of white candles appear and make the shorts a little twitchy. The second white candle in the highlighted area is the setup day of the bearish separating lines pattern. It reveals that either some bulls think the price is right to buy or the shorts are starting to take their profits and get out. However, the signal day of the pattern shows the price opening near the open of the setup day. Behold the bearish separating lines! That means the bears aren't done selling, and they push the price lower throughout the day and keep the downtrend going.



The pattern in Figure 8-26 is very well formed, but it may not be the best pattern to rely on if you're interested in initiating a new trade. If you trade it on the close, you sell at the bottom of a long black day, so quite a bit of ground will be covered in the direction you want to trade. This particular pattern is best used as a confirmation that the downtrend is intact, and you're lucky to see it if you want to hold onto a short position for a little while longer.



**Figure 8-25:**  
The bearish separating lines pattern.



**Figure 8-26:**  
The bearish separating lines working beautifully on a chart of Inco.

*The failing bearish separating line*

Just when you thought you'd always love the bearish separating lines, here I come with an example of what happens when they go bad. Figure 8-27 is a chart of General Electric (GE), a conglomerate that stretches from the NBC

television networks to appliances to aircraft engines. You'd be hard pressed to find someone who hasn't been exposed to a branch of GE at some point in his life. (I say that, of course, with my CNBC on in the background.)

The downtrend on the chart in Figure 8-27 is a strong one, and when the pattern appears, it looks like the downtrend has been underway for several weeks. The setup day of the pattern is an attempt by some buyers to pick a cheap place to buy. Then, on the signal day, the bears take over from the open and push prices lower. But notice that on the day immediately after the pattern, the open and high of the signal day are both violated. That's a pretty good sign that the pattern may not be indicating that the trend will continue.

Shortly after the pattern in Figure 8-27 is violated, a trend reversal occurs. If you're considering buying before you see the bearish separating lines, that pattern may keep you from doing so. If you're short and you see the pattern, you may have waited to cover. Because the pattern didn't hold and the trend was broken, buyers can change their minds more easily and start buying. That's certainly the case here, and you can see that the price of GE heads higher for several days as a result.

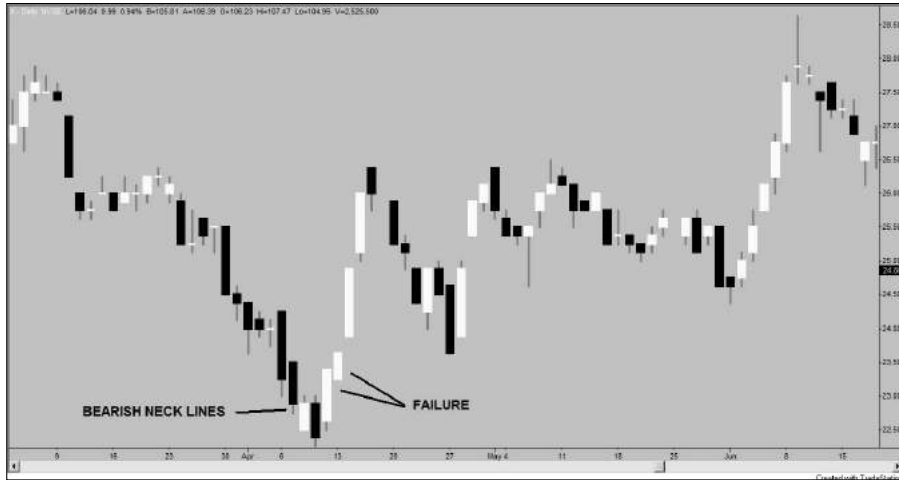
## The bearish neck lines

The last bearish double-stick pattern in this chapter is the bearish neck lines, and just like its bullish counterparts from Chapter 7, this pattern is more of a pattern classification than one single pattern.



**Figure 8-27:**  
The bearish separating lines fail on a chart of GE.

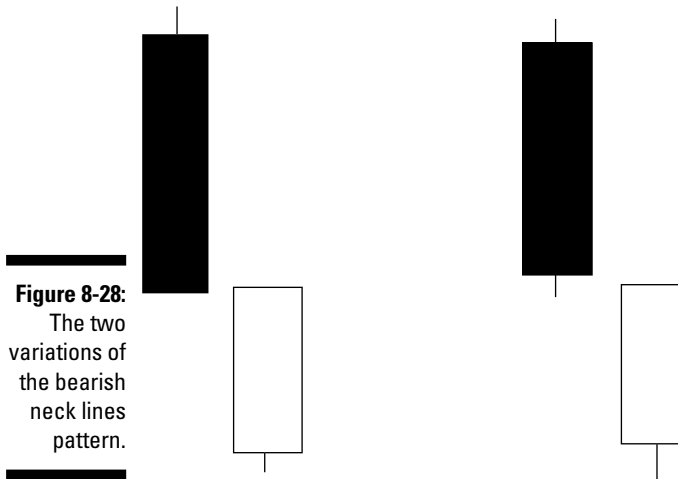
**Figure 8-30:**  
A failure of  
the bearish  
neck lines  
pattern.



### *Recognizing bearish neck lines*

Bearish neck lines have two types: bearish *on neck* lines and bearish *in neck* lines. The difference between the patterns is so small that you don't have to separate them out into two sections.

Figure 8-28 includes both bearish in neck and bearish on neck patterns. The only difference is that the wick of the in neck setup day may overlap some with the signal day of the pattern. Both variations have a long black candle for the setup day followed by a gap down and a rebound attempt that manages to trade back only to the close of the setup day. The bears hold their ground at this level.



**Figure 8-28:**  
The two variations of the bearish neck lines pattern.

### *Using the bearish neck lines for profitable trading*

Figure 8-29 shows a chart of the futures contract that trades based on the prices of 30-year bonds issued by the U.S. Treasury. The bearish neck lines on this chart are in neck because the setup day overlaps with the signal day. The bulls try to rebound the futures price, but they're met with bearish resistance at the previous opening price. Then you see a brief battle between the bulls and bears followed by a continuation of the downtrend.



This pattern is valid even though prices don't immediately continue down on the following day. The trend doesn't really break, and the price levels of the long black day aren't violated. The next couple of days may be nerve-wracking for bears, but those that hold their ground on a short are rewarded with lower prices.



**Figure 8-29:**  
The bearish neck lines working on a chart of the U.S. Treasury bond futures.



### *Noticing an unsuccessful bearish neck line*

Just like the rest of the two-stick patterns in this chapter, the bearish neck lines can fail. Refer to Figure 8-30.

Figure 8-30 is a chart of the stock representing ownership in U.S. Steel (symbol X). Because U.S. Steel is such a large producer of an eminently vital material, the company is very economically sensitive, and its stock is volatile for trading both long and short.

The bearish neck lines appear during a downtrend, and the other criteria are in place; the setup day is represented by a long black candle, which is followed by a gap down. Prices then rebound, but the bears hold the price steady. All appears to be well, but then a couple of days after the pattern appears, the bulls get rolling on a more successful run and the trend changes.

I point to two days as failure days in Figure 8-30. Choose whichever resistance level you want, but when a long black candle day is involved, picking the midpoint may be prudent if you hope to get out of a short or buy before the trend is in full swing and the prices you're facing aren't too steep. The first failure day trades through the midpoint, the second trades over the high, and then the uptrend is in place.

