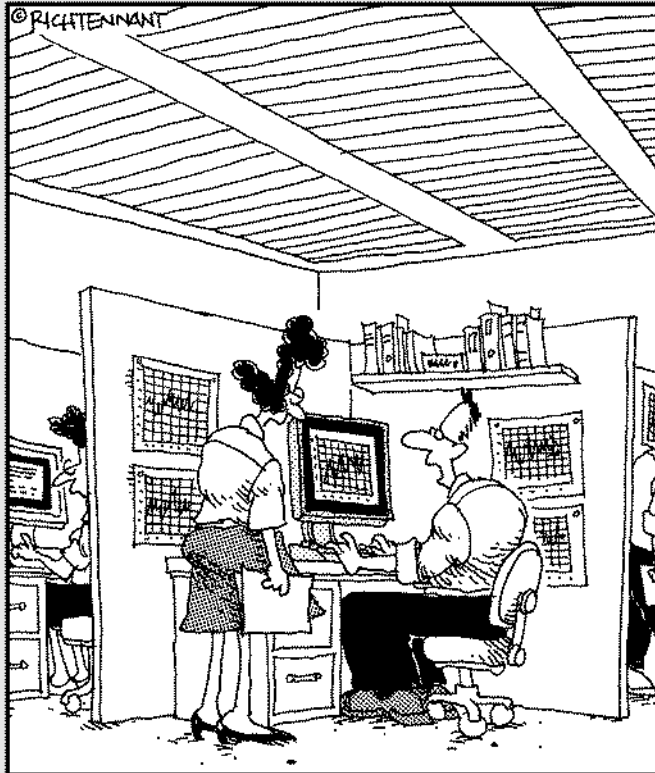


# Part IV

# Combining Patterns and Indicators

The 5<sup>th</sup> Wave

By Rich Tennant



"Right now I'm working with a combination of charting techniques. Japanese Candlesticks, some Elliot Waves, and a dash of Magic 8-Ball."

## *In this part . . .*

**S**ometimes I get worried that my vocal cords are going to give out because I spend so much time singing the praises of candlestick charts. In Part IV, though, I sing a different tune. No, I don't discourage you from using candlestick charts — far from it — but I do show you how to combine candlestick charts with other types of technical indicators and encourage you to use those combinations in your trading strategy.

## Chapter 11

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# Using Technical Indicators to Complement Your Candlestick Charts

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### *In This Chapter*

- ▶ Taking advantage of trendlines
  - ▶ Using moving averages to inform your decisions
  - ▶ Appreciating the relative strength index
  - ▶ Adding stochastics to your bag of tricks
  - ▶ Jumping on the Bollinger band bandwagon
- 

**Y**ou can use nothing but candlestick patterns when trading, and some traders have proven that to be a profitable route. But that shouldn't make you think twice about combining candlesticks with other technical indicators. You can take advantage of a wide range of indicators to confirm the conclusions you draw from your candlestick charts, and your results are often more reliable and profitable. You may very well find that you can't live by candlesticks alone!

Many candlestick patterns — from single sticks to complex multiple-stick formations — depend on the market context in which they appear. For example, a bullish signal in a bearish market sparks skepticism and may even be ignored. But what constitutes a bull or bear market? (As I write this, I have a financial TV show on in the background and two market professionals are vigorously debating whether we're in a bull or bear market. If these market pros can't agree on the nature of the market, how are individuals supposed to figure it out?) It's simple: use technical analysis! More specifically, use indicators that attempt to define the market trend.

Traders use many different types of technical indicators to enhance and complement their trading styles. Traders are always trying to come up with the perfect combination of indicators and signals. (I confess to walking around with old business cards and a pen so I can jot down trading ideas when they pop in my head.) You never know when inspiration will strike! That brilliant

new way to incorporate candlestick charting in a new trading scheme may reveal itself at any moment.

Technical indicators share one of a couple of goals. The first is to define the current trend, whether up, down, or even sideways (more on that later). To quote a popular trading saying, “The trend is your friend.” The other indicators try to identify market extremes or reversals. That information allows a trader to “fade the market,” or go against the trend in hopes that the trend will soon fade out and reverse. There are heated arguments over whether trading with the trend or trying to profit from reversals is the key to successful trading, and as long as traders are still making a living (and losing their shirts) using both styles, the debate will continue.

There are more complex indicators than you can shake a (candle)stick at. (In fact, *Technical Analysis For Dummies*, by Barbara Rockefeller [Wiley] covers them extensively.) In this chapter, I clue you in on a few tried-and-true indicators that you can use to determine the trend of the market and make your candlestick-based decisions even more reliable. These indicators include trendlines, moving averages, relative strength index (RSI), stochastics, and Bollinger bands.

## Using Trendlines

Trendlines can be the most basic of all technical indicators. A trendline is exactly what it sounds like: a line on a chart that shows the general direction a stock is trending. If a stock is moving up in price, its trendline slopes upward from left to right. If a stock is trending down in price, its trendline slopes downward from left to right.

In this section, you discover how to draw a trendline on a chart. Also, some hints on how to determine the direction (up or down) are given. Finally there’s a quick overview of how machines (a computer) can draw trendlines for you.

### *Drawing trendlines*

Trendlines seem pretty straightforward, but drawing a trendline can be tricky. Based on how you think a stock is performing, you draw a line of support (in a bullish case) or a line of resistance (in a bearish case).

You can construct a trendline with nothing more than a printed out chart, a ruler, and a pencil. If you can’t find a ruler, just close this book and use the spine. Anything that allows you to draw a straight line between two points will do. To draw a trendline, simply draw a line that connects two or more low price points (for an upward trending line) or two or more high price points (for a downward trending line). Figure 11-1 shows a prime example of a trendline.

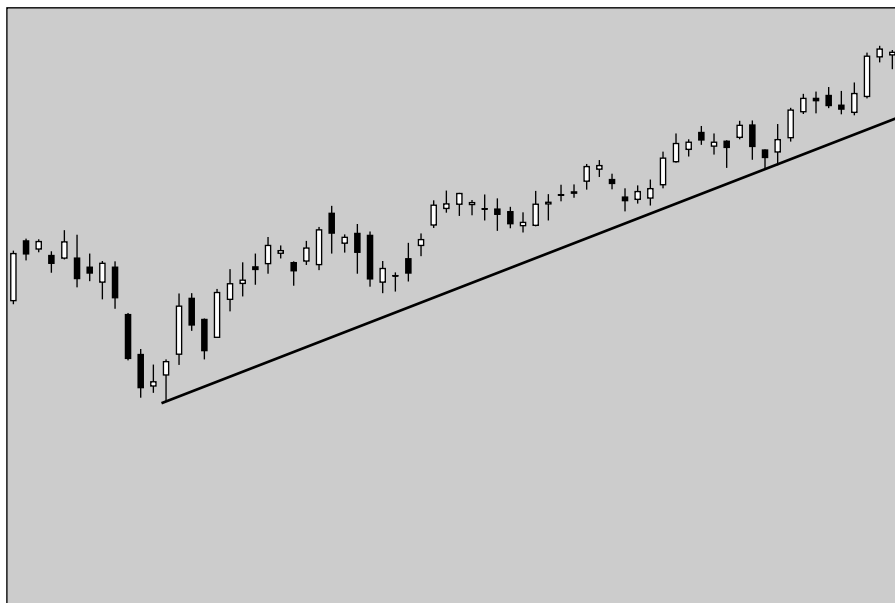


Don't let the ease of trendline construction fool you into thinking that trendlines are simple or cut-and-dried. In fact, it's difficult to refer to a trendline on a chart as a technical indicator because the drawing of the line is such a subjective task. Much like the market experts debating on TV, it's very likely that two traders can come up with completely different lines when asked to draw what they consider the most significant trendline on a chart. If a trader happens to be biased against a certain stock for some reason, she may be more inclined to look at a chart and find a downtrend.

Despite all the subjectivity involved with drawing trendlines, some very successful traders rely heavily on them for their buy and sell decisions. When I began my career as a runner in the cattle trading pits 15 years ago, a very successful trader I knew based decisions on nothing more than daily charts and trendlines that he'd drawn during his train ride every morning. I've heard that he's still using the same method today.

## *Considering trendline direction*

Although different trendlines drawn on the same chart may differ a bit, you'll usually find that at least the direction of the trendlines are the same. Trendlines can trend up, down, or not at all. For simplicity's sake, Figure 11-1 has an obvious up (bullish) trend. (I say it's obvious, but I wonder how many of my colleagues will insist I'm wrong!) After you determine that a trend is bullish, you may consider it with a bullish candlestick pattern and look to buy. On the other hand, if you witness a bearish candlestick pattern, you may be inclined to ignore it, or at least to take caution before implementing a sell signal.



**Figure 11-1:**  
A chart showing a trendline with a positive trend.

Taking trendline direction into consideration helps you determine the status of the market. Understanding the market helps you use the most appropriate candlestick pattern — one that makes your trading decisions more effective and profitable. Trendlines can be subjective, but there's no easier or quicker way to define a trend.

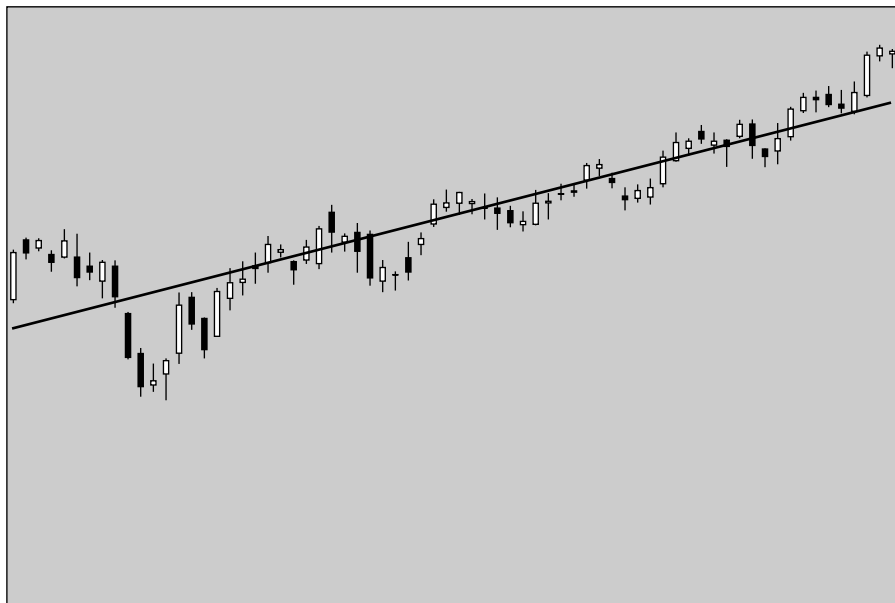
## *Taking advantage of automated trendlines*

You can take some of the subjectivity out of trendline drawing by using a software package that constructs trendlines for you. All you have to do is choose your preferred time frame, and the software does the rest. Even Microsoft Excel includes this option in its charting function. (In Chapter 4, I explore how to use Excel for charting, but for now, I point out the way Excel determines a trendline for the data presented.)

Figure 11-2 displays the same data as Figure 11-1, but instead of the hand-drawn approach, this trendline was generated by Excel. The placement of the line is a bit different than in Figure 11-1, but the trend is still clearly positive.



Using software cuts down on the subjective nature of trendlines, but it doesn't completely remove subjectivity. There's still a subjective component to software-drawn trendlines. The user still determines the time frame for the trendline, which can have a definite impact on the type of line that's generated. As with any computer program that involves user input, the data you get out is only as good as what you put in.



**Figure 11-2:**  
A chart with  
an  
automated  
trendline  
placed on it.

## *Utilizing Moving Averages*

When it comes to technical analysis, it doesn't get much easier than drawing a trendline. But what if you're in need of a slightly more complex indicator? The next step up from drawing trendlines is calculating moving averages. Put simply, a *moving average* is the average of the closing prices of a stock over a certain period of time. You can compare a closing price with a moving average to help you determine a trend.

Like most technical indicators, there are several different types of moving averages, and I explain a few in this section. First, though, it's important that you understand how to make good choices about the time frames you use when calculating your moving averages.

### *Selecting appropriate moving average periods*

The time frames of your moving averages are determined by the number of closing prices you include. To decide on that number, consider the types of trading decisions you make based on your moving average. Pick a time frame that's appropriate for the amount of time you intend to have a trade on. For a trade that's to be held for only a day or two, a five- to ten-day moving average will suffice.

For instance, the five-day example in Figure 11-3 is very short-term and is most useful for traders who trade for a day or two, or even for less than a day. I trade a system based on a moving average that uses data from only the two previous days' closing prices. The holding period for this system is just half a day, so the short moving average makes perfect sense.

The range of moving averages I've seen used on charts varies from 2 days to 200. A 200-day moving average is very long-term, but in many circles it's considered very significant when determining a stock's long-term trend. In fact, the common definition of a long-term bull or bear market can be whether an index is trading above (bull) or below (bear) its 200-day moving average.

### *Using simple moving averages*

The most basic type of moving average is the simple moving average. It's also the easiest to calculate and the most common — so common, in fact, that the word “simple” is often left off when a simple moving average is displayed on a

chart. Look at Figure 11-4, where a five-day simple moving average is calculated by using the closing prices from five previous days. It can't be much easier: The five closing prices are added up and divided by five. If you keep the number of closing prices in your simple moving averages low, you can easily work them out with a calculator.

The five-day simple moving average in Figure 11-4 comes out at 114.20, and the closing price on the fifth day is 113.87. Some technical analysts would say that indicates a downtrend, because the close on the final day is lower than the moving average. That can be very useful information if you're working on a short-term trade.



**Figure 11-3:**  
A chart with  
a five-day  
moving  
average  
on it.

	Day	Close
	1	114.70
	2	114.73
	3	114.14
<b>Figure 11-4:</b>	4	113.56
A quick	5	113.87
calculation		
of a five-day	Total	571.00
moving		
average.	Total / 5	114.20



But if you've got a longer term trade in mind, it wouldn't make much sense to fret over the fact that a closing price dipped below a five-day moving average. There just aren't enough data points (closing prices, in this case) involved — a relatively minor change in a closing price can have a sizable impact on the average. A moving average calculated over a longer period of time (with many more closing prices) — say, 100 days or more — is less likely to reveal any closing prices that cross the average.



The longer your time horizon for a trade (or even an investment), the longer the moving average you need.

Figures 11-5a and 11-5b contain the same pricing data, but Figure 11-5a has a 5-day moving average, while Figure 11-5b uses a 20-day moving average. Notice the extreme differences in trends between the two charts.

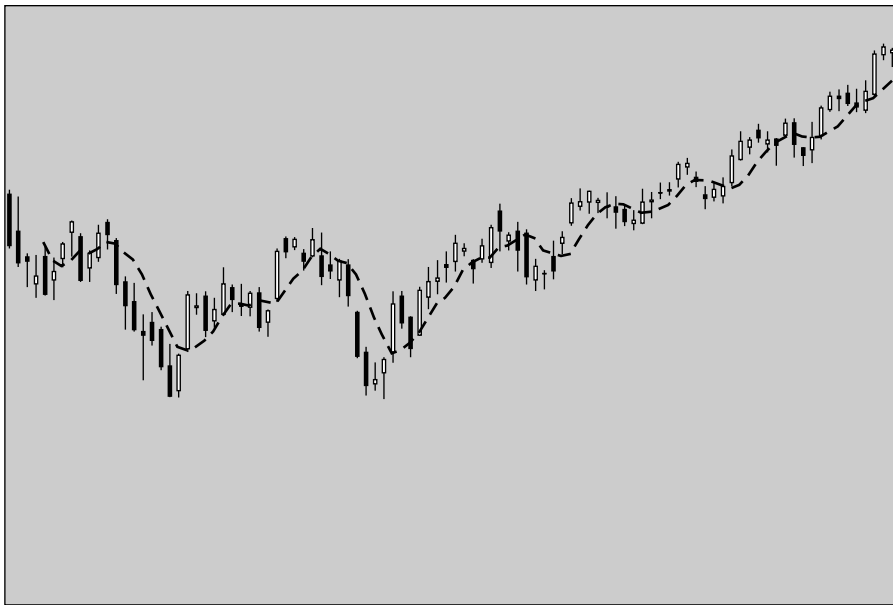
## *Using other types of moving averages: What have you done for me lately?*

Two fairly common deviations on the simple moving average are the *weighted* moving average and the *exponential* moving average. These types of moving averages are calculated in different ways, but they both have the same goal: to place more emphasis on recent prices.

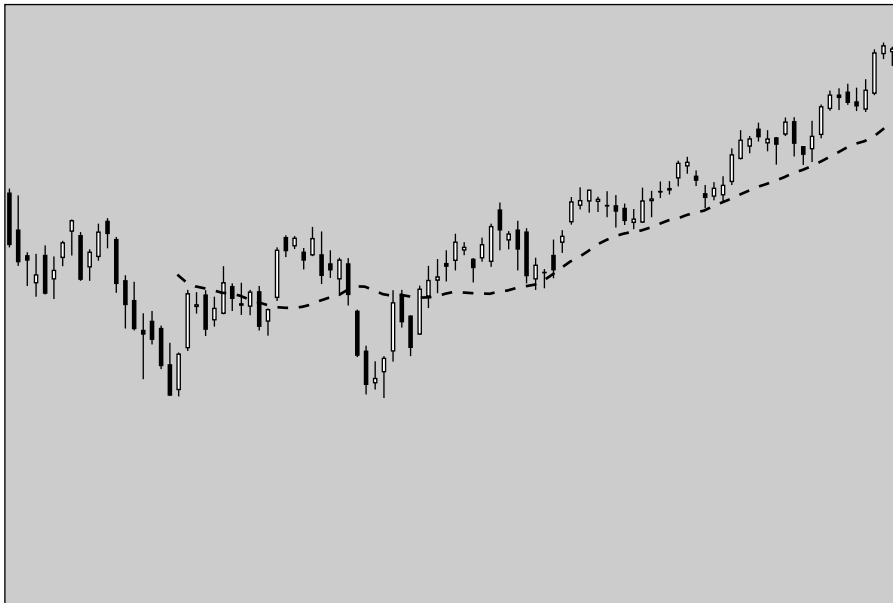
Why would a trader want to explore more complex moving averages? Well, the major advantage one of these more complicated moving averages has over the simple moving average is that it's better at revealing a change in trend more quickly. Being able to detect trend changes faster helps to make you a more agile trader. Also, traders (especially short-term traders), have very short memories. Ask me what the market did yesterday, and I'm pretty sure I can give you a quick answer. Ask me what it did two Fridays ago, and I would be quickly pulling up a chart (a candlestick chart, of course!) to get you an answer. Because a short-term trader places more emphasis on more recent price action, using a charting method that does the same typically works better for shorter term styles of trading. Weighted and exponential moving averages both emphasize recent price action, and the only substantial difference between the two is the method of calculation.



If you were to rank the three most commonly used types of moving averages — simple, weighted, and exponential — according to their emphasis on recent price action, exponential moving averages, which place *a lot* of emphasis on recent prices, would top the list. Weighted moving averages would be a close second and simple moving averages a distant last.



a



b

**Figure 11-5:**  
A 5-day and  
20-day  
moving  
average  
compared  
together.

**Calculating a weighted moving average**

To calculate a weighted moving average, multiply the most recent stock price by the total number of prices in your chosen time frame. Then multiply the second most recent stock price by the total number of prices *minus one*, and — using the same method — work your way back to the first price in your time frame.

For Figure 11-6, I've taken the same five-day data used for the simple moving average in Figure 11-4 and calculated a weighted moving average. **Note:** For Day 5, the weighted close is equal to  $5 \times 113.87$  or 569.35, while the weighted close for Day 1 is simply the closing price  $\times 1$  (114.70). To determine the weighted moving average, the weighted closing prices are added up and divided by the sum of the weights. In this case, that number is

$$[(1 \times \text{Day 1 closing price}) + (2 \times \text{Day 2 closing price}) + (3 \times \text{Day 3 closing price}) + (4 \times \text{Day 4 closing price}) + (5 \times \text{Day 5 closing price})] \div 15.$$

Day	Close	Weighted Close
1	114.70	114.70
2	114.73	229.46
3	114.14	342.42
4	113.56	454.24
5	113.87	569.35
15 Total		1710.17
Total / 15		114.01

**Figure 11-6:**  
A  
calculation  
of a 5-day  
weighted  
moving  
average.

Refer to Figure 11-4 and Figure 11-6 for the difference between the simple moving average and the weighted moving average. There's a pretty significant difference! The lower recent prices mean that the weighted moving average is quite a bit lower.

**Calculating an exponential moving average**

You can calculate an exponential moving average in a handful of different ways, and I suggest that you use . . . none of them. The math involved in the calculations is a bit complex, and for your purposes, I recommend leaving the hard work to a charting package. (See Chapter 4 for more info on popular charting software.)

## *Combining two moving averages*

Comparing closing prices with moving averages is a great way to use moving averages to determine a trend, but it's not the only way. You can also combine and compare two moving averages to define the current trend. For example, you may calculate both a 5- and 20-day moving average for a stock, and then compare them to spot a trend. To do so, work your way through the following steps:

- 1. Calculate the two moving averages, using the process described earlier in this chapter.**
- 2. Determine which of your two moving averages is fast, and which is slow.**

The fast moving average is always the one with the fewest number of data points (closing prices). It's labeled "fast" because its small number of data points makes it prone to change much more quickly (completely different than the reasons someone gets labeled "fast" in high school). The slow moving average is slower to change because of its heftier number of data points.

- 3. Compare your moving averages to spot a trend.**

If the fast moving average is higher than the slow moving average, that indicates an uptrend. The logic is exactly the same as comparing a closing price to a moving average to determine trend, but the fast moving average takes the place of the closing price.



If you notice this type of trend, be more inclined to follow a bullish candlestick pattern and consider buying. If the fast moving average is lower than the slow moving average, that indicates a downtrend. If that's what you see, you should follow a bearish candlestick pattern and look to sell.

Take a look at Figure 11-7, which contains the same data as the previous charts in this chapter, but overlays both a 5- and 20-day moving average. The 5-day moving average is represented by the solid line, while a dashed line is used for the 20-day moving average. You can clearly see the higher volatility of the 5-day moving average compared to the 20-day. And you can also see that the chart indicates an uptrend!

Experts often use a combination of the 5- and 200-day moving averages to define a long-term bull or bear market. These choices may seem somewhat arbitrary, but they've been cemented as rules of thumb in the market.

## *Combining three moving averages*

Two moving averages can be pretty useful company, but is three a crowd? Who really needs to use three moving averages? Believe it or not, some very

successful longer term trading systems make comparisons using three moving averages. The technique is useful because it allows the market to be defined as having no trend, as opposed to either an up or downtrend.

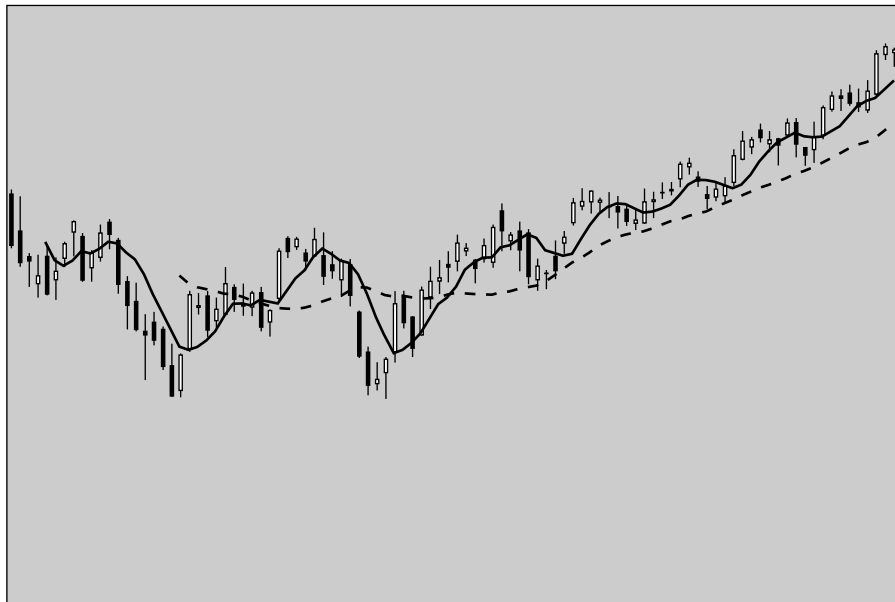


You may be thinking, “No trend? The market and stock prices change daily! There has to be a trend!” But some markets (and individual stocks in particular) have long droughts without an up or downtrend. Identifying a market without a trend can be extremely helpful, as it’s pretty difficult to make money trading when there isn’t much price movement. With that in mind, taking a look at combining three moving averages is certainly worth the time.

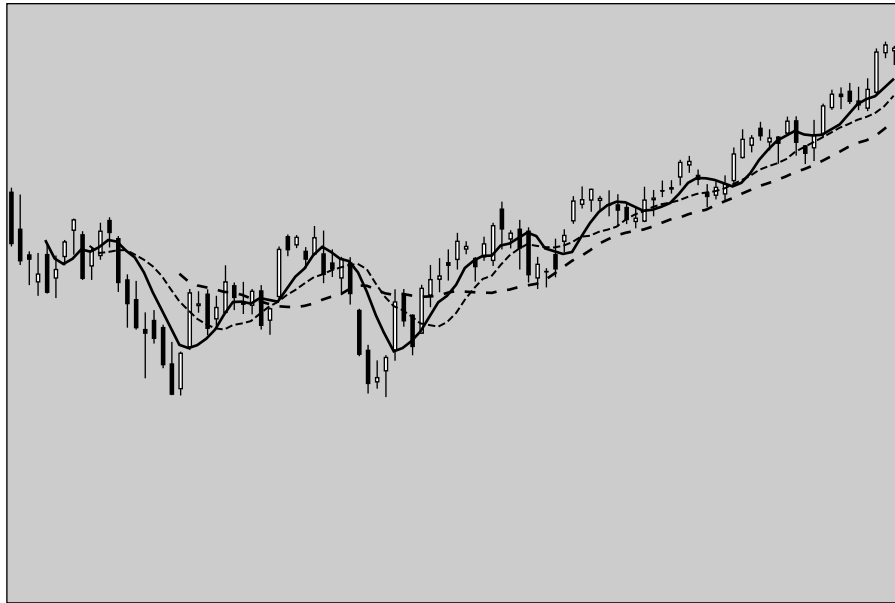
Comparisons using three moving averages are made by identifying each average as either fast, medium, or slow. Just like comparisons with two moving averages, the one considered “fast” has the lowest number of data points. The slow moving average has the most data points, and the medium one is somewhere in the middle. To help you visualize, see Figure 11-8, which contains a 5- and 20-day moving average but also includes an additional 10-day moving average.

In Figure 11-8, the averages are represented by different lines:

- ✓ The 5-day moving average is represented by the solid line.
- ✓ The line with long dashes is the 10-day moving average.
- ✓ The 20-day moving average is the line with the short dashes.



**Figure 11-7:**  
A chart with  
both a 5-day  
and 20-day  
moving  
average.



**Figure 11-8:**

A chart showing a 5-, 10-, and 20-day moving average combined.

With any chart containing three moving averages, you can pick out an uptrend when the fast moving average is higher than the medium one, and the medium one is higher than the slow one. You can see an uptrend on the right side of this chart, where all three moving averages are in order and trending together.

You can identify a downtrend when the fast moving average is lower than the medium one, and the medium one is lower than the slow one. If the fast-, medium-, and slow-moving averages aren't lined up either fast to slow or vice versa, you can safely say that the market has no trend.



Knowing the type of market you're dealing with is key to using many candlestick patterns correctly, so you may need to use three moving averages. That's especially true for longer term trading. The more certain you can be about a trend, the more likely you are to properly identify and trade effectively on a bullish or bearish candlestick pattern.

## *Examining the Relative Strength Index*

My personal favorite indicator is the relative strength index (RSI). The RSI compares the strength of a stock's up days against the strength of its down days, and RSI proponents believe that as a result, the RSI can cut through erratic changes and really confirm price movement. This index is considered a leading indicator because you can usually count on the direction of a security's RSI to change ahead of its price action.

## The origin of overbought and oversold levels

You may be wondering how the overbought and oversold levels were established. Those benchmarks came from the mind of renowned technical analyst J. Welles Wilder, who introduced the RSI in his 1978 book *New Concepts in Technical Trading Systems*. In the book, Wilder recommends using 30 as an oversold level (an attractive area to buy) and 70 as an overbought level

(an area to exit or sell short). Look at Figure 11-9. The oversold level of 30 and overbought level of 70 are indicated with lines along the bottom of the chart to allow you to see when the level penetrates either of these significant levels. He also suggests using 14 as the standard number of price periods for calculating RSIs, which is the input used for the chart in Figure 11-9.



The RSI is classified as a *momentum oscillator*. The “momentum” in that term comes from the fact that as a security is in an up or downtrend, the RSI’s trend should correspond. And it’s an “oscillator” because RSIs fluctuate between 0 and 100 percent.

Another attractive feature of RSIs is they include levels that indicate when a security is considered overbought or oversold. When the security reaches one of these levels, a savvy trader should be on his toes, waiting for a corresponding change in the trend of the RSI, or even better, some sort of revealing bullish or bearish candlestick pattern that lets him know it’s time to buy or sell.

## Calculating the RSI

Calculating an RSI is fairly complex, even when using a spreadsheet. Instead of spending several pages going through the steps for calculating an RSI, I give you a brief overview of the formulas that drive it:

1. **Add up the price change on up days and the price change on down days for the number of periods (usually 14) in your look-back range.**
2. **Take those individual sums and divide them by 14.**
3. **Then calculate the relative strength (not the relative strength index) by dividing the up day average by the down day average.**

$$RS = \text{Average up days} \div \text{Average down days}$$



The RSI takes the up and down days and plugs that data into a fairly complex formula, resulting in a reading between 0 and 100. The following equation explains the math behind the RSI:

$$RSI = 100 - (100 \div \text{Relative Strength})$$

## Reading an RSI chart

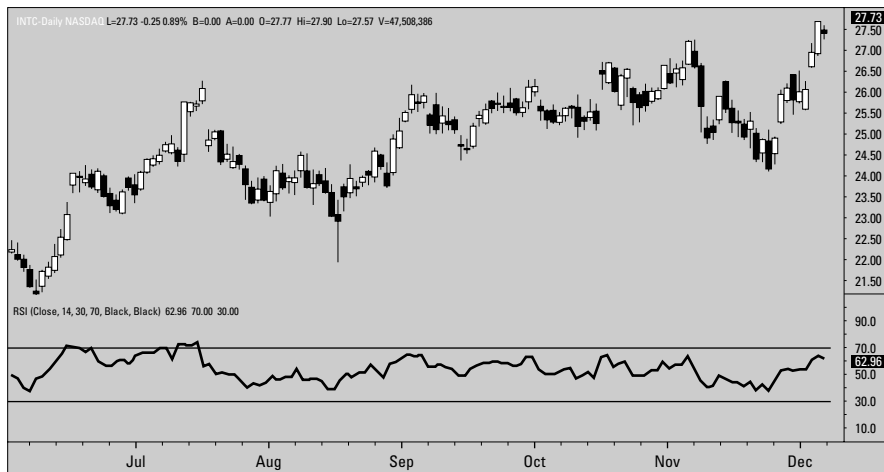
As with many technical indicators, RSIs are much easier to digest in chart form. In Figure 11-9, the lower chart is a daily six-month long chart on Intel, (symbol INTC). The top section of the chart is a basic candlestick chart depicting the price action in Intel stock from July to December 2007. Numerous bullish and bearish candlestick formations are charted on this chart, but for now, just focus on the RSI component.

In the bottom quarter of the chart in Figure 11-9, there's a slow-moving line that depicts the RSI. This line is normally how an oscillator is depicted on a chart. Unlike a moving average, which is imposed on top of a chart's price component, the RSI (or any other similar indicator) appears *below* the price component. Note how the RSI seems to flow along and mirror the movements of the closing prices. However, at times the RSI either flattens while the price continues to move or even moves in the opposite direction. This change is called a divergence.



Divergences are the key to using the RSI, and a divergence combined with a corresponding candlestick pattern that matches the direction of the divergence can provide you with a profitable trade signal.

But the RSI's usefulness doesn't end with its role as a momentum indicator. RSIs may also be used as signals that reveal when the price of a security has reached a level that's too high or too low for the near term, or a level where a reversal of trend is more likely.



**Figure 11-9:**  
A chart of  
INTC with  
the RSI on it.





The simplicity may sound too good to be true, and of course, it is. Using the RSI by strictly buying when it hits 30 or selling when it hits 70 is a disastrous strategy. It does make for a good rule of thumb, however, when you consider it alongside a signal from a candlestick pattern or a divergent move in the RSI relative to the price chart.

Combining a divergent RSI with a candlestick pattern is a smart move, and adding the overbought or oversold levels into the equation is even smarter, and can provide you with much more reliable buy and sell signals. The strength of the RSI as both a momentum and oscillating signal is why it's one of my personal favorite indicators.

## Cashing In on Stochastics

Another useful indicator with an extremely clumsy name is the *stochastic oscillator*. This momentum indicator considers the current closing price of a security in relation to a high-low range of prices over a set number of look-back periods. This oscillator can be very useful when used in tandem with your candlestick charts. And in addition to its usefulness as an indicator of momentum, the stochastic oscillator may also be used as an overbought or oversold indicator when readings are at extreme levels: 30 percent for oversold and 70 percent for overbought (see the section on RSI earlier in this chapter).

### Grasping the math behind the stochastic oscillator

George Lane developed the stochastic oscillator in the late 1950s. The math behind it is pretty remarkable for an indicator some 50 years old. There are actually two readings for a stochastic oscillator that are combined on a chart. They're referred to as the slow (%D) and the fast (%K) stochastics. The slow one is generally a moving average of the fast one.

The formulas for the slow and fast stochastic oscillators are as follows:

✔ **Fast Stochastic:**

$$\%K = 100 \times (\text{Recent Close} - \text{Lowest Low}(n) \div \text{Highest High}(n) - \text{Lowest Low}(n))$$

N = number of periods used in calculation

✔ **Slow Stochastic:**

$$\%D = 3\text{-period moving average of \%K}$$

## *Interpreting the stochastic oscillator*

Luckily, most (if not all) charting software calculates the stochastic oscillator for you, so you don't need to memorize or even fully understand the formulas behind it (whew!). You really just need to know how to interpret the lines on a chart. For a depiction of how the stochastic oscillator shows up on a chart, refer to Figure 11-10. This is a chart of the same INTC data in Figure 11-9, but the RSI has been removed, and a stochastic indicator has been inserted.



When interpreting the stochastic oscillator, you use methods similar to those used in interpreting the RSI and moving averages (see respective sections earlier in this chapter).

### *Using stochastic oscillators as you would two moving averages*

Knowing how to use two moving averages is helpful when interpreting stochastic oscillators. For defining a trend, if both the fast (%K) and slow (%D) stochastics are trending higher, and the fast line is higher than the slow line, you're looking at an uptrend. It's like when you're using two moving averages, and the moving average with the shorter look-back period is up above the moving average with the longer look-back period: The trend is considered up.

Another parallel to using two moving averages is that a change in trend may be signaled when the fast stochastic changes from being over or under the slower stochastic. Keep an eye out for those important changes.

The rule on this is if the fast stochastic is above the slow one, an uptrend is in place; if the fast one is under the slow one, a downtrend is in place. When they cross, there's a trend change! When they are in overbought territory and the fast one crosses under the slow one, that may be considered a good selling opportunity. Conversely, when they are in oversold territory and the fast one crosses over the slow one, it's a good buying opportunity.

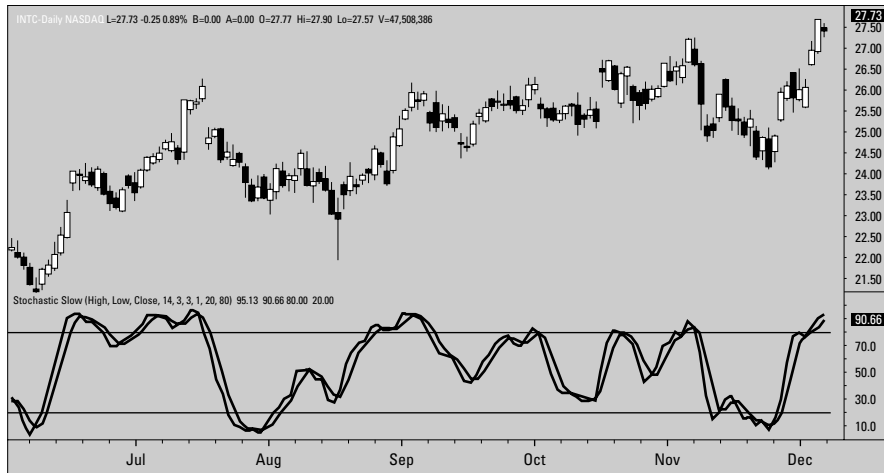
### *Using stochastic oscillators as you would the RSI*

You can use the stochastic oscillator as an overbought or oversold indicator, just as you use the RSI (covered in the section, "Examining the Relative Strength Index"). Like the RSI, both the fast and slow stochastic levels oscillate between 0 and 100 percent. Below 30 is considered oversold (a buying level), and above 70 is considered overbought (sell level).



The benefit of having a slow and fast stochastic is that when the overbought or oversold levels are reached and a corresponding crossover of the fast and slow stochastic occurs, you can enjoy a much more reliable signal. For example, if both of the stochastics are in overbought territory, and you see the slow stochastic move from over to under the fast one, that's considered a sell signal. The reverse is also true: If both stochastics are oversold, and the slow one moves from under to over the fast one, that makes for a nice buy signal.

**Figure 11-10:**  
A chart of  
INTC with  
the  
stochastic  
oscillator.



## Buddying up with Bollinger Bands

The idea behind Bollinger bands is that when a price for a security gets too high above or below a moving average, that security may be considered overbought or oversold. Bollinger bands look just like moving averages on a price chart (see “Utilizing Moving Averages,” earlier in the chapter), but they’re positioned a certain distance above and below the real moving average on a chart. The bands mark the areas where a security may be considered overbought or oversold.



Bollinger bands received their name from the renowned technical analyst John Bollinger.

## Creating Bollinger bands

You may do well to leave the necessary calculations of Bollinger bands to a charting package, but it starts out simple enough with the calculation of a simple moving average of a price series. (Find that process in this chapter’s “Using simple moving averages” section.) Bollinger suggests a 20-day moving average, and many charting software programs use that as the default, so that’s always a good place to start.

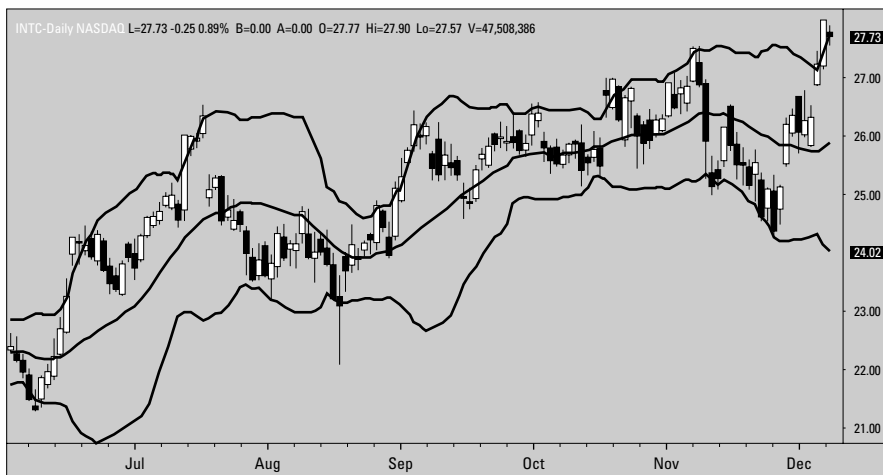
After calculating the 20-day moving average, things get a bit trickier. The bands that run above and below the moving average are based on a statistical measure known as *standard deviation*. The bands are placed a certain number of standard deviations higher and lower than the moving average.

Without getting into too much detail, the distance of the bands from the moving average is determined by the amount of volatility in the market. The more the market is moving around, the wider the bands are spread.

As the standard deviation rises and falls with the level of market volatility, the overbought and oversold levels tend to adjust for the market environment. An excellent example of a Bollinger band chart can be seen in Figure 11-11. This is the same data used in the previous two figures, but now the only indicators on the chart are the Bollinger bands.

## Using the bands

Bollinger bands make for great overbought or oversold indicators. Broadly speaking, when the price of a security is higher than the upper Bollinger band on a chart, you're in a sell area, and when the price is lower than the lower Bollinger band, you're in buy territory. As you can see in Figure 11-11, there are plenty of buy and sell opportunities using these bands. But not every one of those opportunities is worth acting on immediately, so combining them with your handy candlestick charts can be an ideal way to minimize risk and separate the great signals from the mediocre ones.



**Figure 11-11:**  
A chart of  
INTC with  
Bollinger  
bands.

## Chapter 12

# Buy Indicators and Bullish Reversal Candlestick Patterns

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### *In This Chapter*

- ▶ Making successful long trades by combining the relative strength index and candlesticks
  - ▶ Using stochastic indicators and candlestick patterns for profitable long trading
- 

**T**his chapter clues you in on the ways in which you can begin combining your trading tools to make your trades even more efficient and profitable. More specifically, the strategies I describe in the next few pages help you understand how you can use two buy indicators (the relative strength index — RSI — and stochastics) in tandem with bullish trend reversal candlestick patterns to pick the best times and situations for entering and exiting long trades.



I've found the two technical indicators I discuss in this chapter to be reliable and relatively easy to combine with candlestick patterns. However, please don't think for a second that the RSI and stochastic indicators are the only ones that work well with candlesticks. There are several others, and I strongly encourage you to research those indicators and find some that work best with your personal trading style.

## *Buying with the RSI and Bullish Reversal Candlestick Patterns*

The *relative strength index* (RSI) is a fairly reliable indicator that can tell you whether a stock or market is overbought or oversold. The RSI fluctuates between 0 and 100, although it hardly ever reaches either of those levels. You can choose the levels between 0 and 100 that you think indicate that a stock is overbought or oversold, but for the sake of analysis in this chapter, I use 30 as my oversold level and 70 as my overbought level. Therefore, RSI readings under 30 tell you that a bottom could be coming soon and that you should be ready to buy, and readings over 70 should lead you to consider putting on a

short or selling a long. (For more of the nitty gritty details of the RSI, check out Chapter 11.)

The RSI has two potential uses when you're working on candlestick analysis:

- ✔ You can combine the information from an RSI with reversal patterns to further confirm that a reversal is imminent, and it's time to take a long position.
- ✔ You can also use the RSI to help you select your exit levels, whether they are stops to prevent losses or exits that allow you to walk away with a tidy profit.

## Using the RSI to help pick a long entry point

In this section, Figure 12-1 provides a solid example of the type of situation that calls for using the RSI in combination with a bullish reversal pattern. This chart is from Applied Materials (AMAT), which is a very large technology company that creates machinery used to manufacture semiconductors. The free-wheeling, rock 'n' rollin', throw-caution-to-the-wind experts in this industry refer to it as the semiconductor equipment industry.



A three inside up reversal pattern appears after a couple of bearish days, during a short-lived downtrend. (Check out Chapter 9 for more on the three inside up pattern.) The RSI helps confirm that the candlestick pattern is sound because the RSI closes under 30 on the pattern's first day. That means that the stock is oversold if the standard oversold level 30 is being used, and bullish buyers will soon be on the scene to drive up the price of the stock.

**Figure 12-1:**  
A combination of the RSI and a three inside up pattern on a chart of AMAT.



The last two days of a three inside up pattern are bullish days. Bullish behavior generally means that the RSI is moving out of the oversold level. Consider RSI levels over the course of a pattern, not just on one of the pattern's days.

Bullish reversal patterns like the three inside up usually end with bullish moves, so it would be pretty rare to find an RSI reading under 30 (or whatever level you consider oversold), at the end of a pattern.

It's also worth mentioning that some traders use the RSI to buy when it goes below the oversold level and then moves back above this level. That move is more important to them than the simple act of the RSI dipping below the oversold level, and they use it as confirmation that the trend has reversed.

On the AMAT chart in Figure 12-1, the trend definitely reverses on the three inside up pattern combined with an RSI reading under 30. The result is an uptrend that lasts for a few weeks but never quite reaches the overbought level. If you watch a stock and see a bullish trend reversal candlestick pattern that coincides with an oversold reading on the stock's RSI, buy and look for an uptrend to dominate the chart soon.

I offer one more example of how you can use the RSI in combination with a bullish reversal pattern in Figure 12-2. This figure features a chart of the stock for Amazon (AMZN). The RSI on the chart in Figure 12-2 spends some time trading around the oversold level of 30, dipping below and then rising above that level on two different occasions. What's the difference between these two instances? The second (and successful) move was accompanied by a bullish reversal pattern.

**Figure 12-2:** An RSI and trend reversal pattern indicate where to buy on a chart of AMZN.





A bullish three outside up pattern (refer to Chapter 9 for details) appears on this chart at a time when the RSI closes under 30 and then rises over the oversold level. The resulting move is an uptrend that lasts a couple of weeks and then rolls over. If you spot those developments and quickly establish a long position, ride the uptrend for a while and then trade out when things start heading south. The result is a nice quick profit. In fact, from the bottom of the pattern to the spot where the stock rolls over is a move of 100 percent, or a double-your-money move from below 20 to just about 40. All that in about four weeks! You can see how combining candlestick patterns with RSI signals can tip you off to the best spots to enter a long position.

## *Using the RSI to help pick long exits*

An additional benefit to using technical indicators for determining entry points is that they may also help you figure out when it's time to exit a position. When used properly for entries, an indicator tells you when to buy an oversold security or sell short when a security's price reaches an overbought level. You can take advantage of that same concept when deciding when to exit trades.

For example, suppose you took a long position on a stock when you saw that its RSI was oversold, and as a result you're sitting on what could turn out to be a handsome profit. But then the RSI changes course, and soon it's into the overbought level. What should you do? You may have a trading rule in place that tells you that it's time to exit the trade without considering other options. But you may also take a slightly more liberal tack and simply keep a close eye out for trend breaks or reversal patterns. You can play out the situation in several ways, and if you can combine the technical indicator with your knowledge of candlestick patterns, you stand a much better chance of exiting the trade at the most opportune moment.

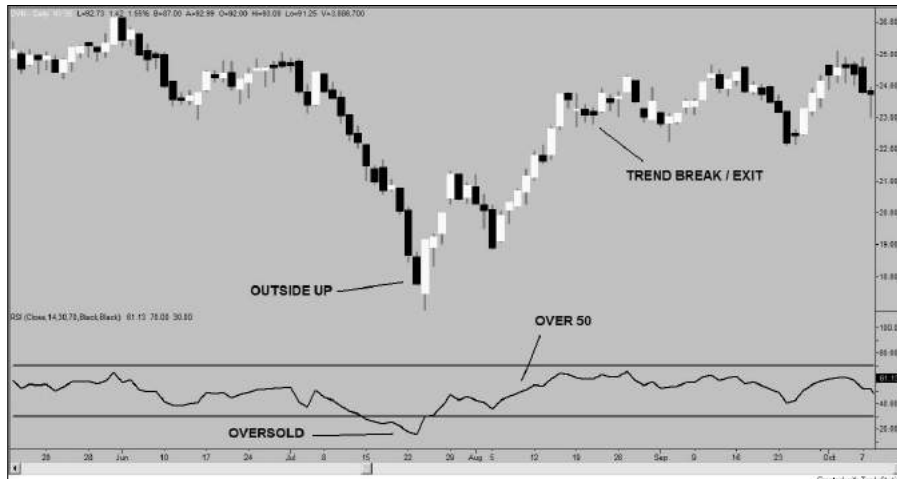


For short-term long trades involving the RSI, I begin to look for an exit point when the RSI trades over 50. Until that level is reached, I stick to the stop level prescribed by the candlestick pattern I used to enter the trade. After the RSI reaches 50, I start to watch for a reversal or trend break. You may think that I'm potentially leaving too much profit on the table, but just because a stock has traded higher and the RSI is above 50 doesn't mean I'm out. It just means I'm more cautious if I think things are going to turn. Consider a similar strategy for yourself.

For an idea of how you can combine candlestick patterns with the RSI to figure out when to enter and exit a trade, look at Figure 12-3 — a chart of the oil and gas exploration company Devon Energy (DVN). As you can see, the stock trades off pretty hard, and the RSI is well under 30. Then around the time that the RSI trades back up to about 50, a bullish reversal pattern appears. It's the three outside up pattern, and you can read all about it in Chapter 9.



**Figure 12-3:**  
Using the RSI and a candlestick pattern to select an entry and exit on a chart of DVN.



If I were trading the scenario you see in Figure 12-3, I'd place a stop loss order based on the low of the candlestick pattern and keep that stop in place until the RSI crosses above 50. That way I'd still be in the trade even if a small pullback occurred. After the RSI reached 50, I'd simply keep an eye on the trend. The trend eventually heads higher with a clearly defined trend break, and when that trend break occurs, I'd execute a sell order and pocket a nice profit. I know that it looks quite easy in hindsight, but it really is a prime example of how you can use the RSI in conjunction with candlestick patterns, particularly bullish reversal patterns.

Still not convinced? I offer another example in Figure 12-4. That figure features a chart of Texas Instruments, which is a technology and semiconductor company that trades under the symbol TXN. You can see that the ideal entry point is when the RSI has been under 30, and then a three outside up pattern appears which indicates that the trend is headed upward, and you need to buy and take on a long position.

After a promising start, the stock stalls out and things look a bit disappointing. The trading is essentially trendless for a couple of weeks. The support level isn't broken, and an uptrend doesn't develop. If you stay patient, though, eventually you see the stock make a small run. The RSI gets back up to 50, and then on the following day, a hanging man pattern appears. (Flip back to Chapter 6 for more on the hanging man.) That's a reversal signal, which indicates that the trend is heading southward, and the time has come to sell the stock, enjoy a small profit, and move on to the next trade.

**Figure 12-4:**  
Combining  
the RSI and  
candlesticks  
to select an  
entry and  
exit on a  
chart of  
TXN.



## *Buying with the Stochastic Indicator and a Bullish Reversal Candlestick Pattern*

The stochastic indicator is another very useful indicator for detecting overbought or oversold security conditions. It has two components: the slow and the fast stochastic. When the fast is under the slow, there's a downtrend in place, and when the fast is higher than the slow, there's an uptrend. The slow and fast stochastic indicators oscillate between 0 and 100 and have fairly complex look back periods, much like the RSI. (See “Buying with the RSI and Bullish Reversal Candlestick Patterns” earlier in this chapter for more info on RSI.)

For simplicity's sake I use the 14-period look back, which is a standard level in charting packages. The standard oversold level for a stochastic indicator is 20, and the standard overbought level is 80. For a detailed explanation of the nuts and bolts of the stochastic indicator, flip back to Chapter 11.



You can use the trend reversal signals that stochastic indicators provide in combination with candlestick patterns to pick outstanding entry points for your trades. And you can also utilize stochastic indicators to select exit points — just keep an eye out for when the slow and fast stochastics cross. Allow me to elaborate in the following sections.

## Using the stochastic indicator to help pick a long entry point

You can use the stochastic indicator to determine a good time to buy a stock if you watch for instances where the slow and fast levels both trade below the oversold level of 20, and then the fast stochastic crosses over or goes higher than the slow stochastic. I've always felt confident in the stochastic indicator because of that feature; even though the levels are technically oversold, it's not truly a buy signal until the trend starts to move just a little bit higher. And it's even more comforting when you combine it with a bullish reversal candlestick pattern. You can see what I mean in Figure 12-5.

Figure 12-5 is a chart of Johnson Controls (JCI), a manufacturer of large systems and parts for cars and buildings. The company is very much tied to the overall economy, and I like trading it for that reason.

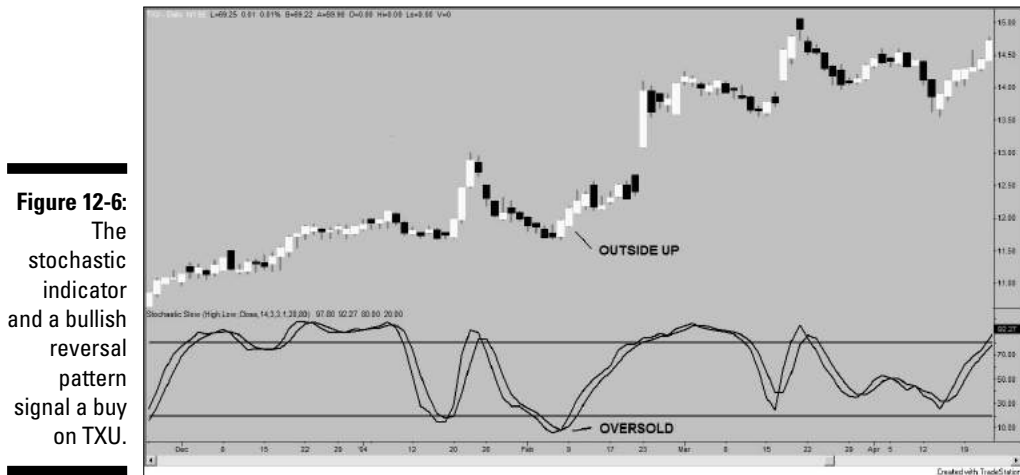
The chart begins with a downtrend. The slow and fast stochastic levels trade below the oversold level of 20. Then a three outside up reversal pattern appears on the chart, when the stochastic levels are still well under the 20 level. But the second two days of this pattern are very bullish, and the slow and fast stochastic readings start to move higher. The icing on the cake is a cross of the fast stochastic over the slow. The stochastic indicator is indicating an uptrend, the stock has been oversold, and a bullish reversal pattern has developed on the chart. It's the perfect time to put on a long position!

**Figure 12-5:**  
The stochastic indicator and a bullish reversal candlestick pattern signaling a buy on a chart of JCI.



The trend that follows the sequence of events in Figure 12-5 is pretty impressive. It's so strong that the stochastic indicator stays in an overbought state for several weeks.

You can see another example of how you can combine the stochastic indicator with a bullish reversal pattern in Figure 12-6. The chart in this figure is of the stock TXU, a Texas utility that was taken private while I was in the process of writing this book.



The stock has clearly been in a downtrend. (Note that the downtrend occurred after a bearish pattern appeared on the chart a few weeks prior — aren't candlesticks great?) The stochastic readings reach the oversold level, and a three outside up pattern develops. At just about the same time, the fast stochastic moves above the slow one, signaling a change in trend from down to up. It's time to buy, buy, buy! The uptrend continues for several weeks, and a savvy trader who identifies the combination of the stochastic indicator and the bullish reversal pattern will have her profits piling up.

## *Using the stochastic indicator to help pick long exits*

You can also use the stochastic indicator to help you determine when it's time to exit a long trade. For instance, if you're in a long position and the fast

stochastic moves below the slow stochastic, that can tip you off that the uptrend may be changing to a downtrend, and the time for getting out of your long is probably drawing near.



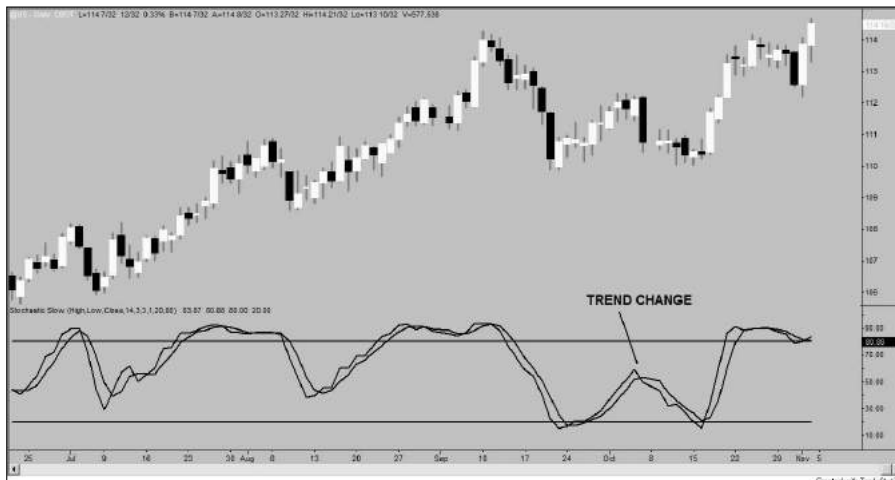
Stochastic indicators can signal a trend change even when the stochastic readings haven't yet reached an overbought or oversold level. For an example, check out Figure 12-7 — a chart of the 30-year U.S. Treasury bond futures. I highlight a case where an uptrend changes to a downtrend outside of a stochastic indicator's overbought level. Notice, too, that some other mid-level trend changes appear earlier on the chart.

Just keep in mind that with your exits, you may need to act and get out of a trade when the fast and slow stochastics cross, regardless of whether they're in overbought or oversold territory.

I provide an excellent example of how you can combine the stochastic indicator with a candlestick pattern to identify a successful entry point and profitable exit in Figure 12-8. This chart of Plumb Creek Timber (PCL) shows the company's timber lands throughout the United States.

You can see that the entry point shows itself after a downtrend, when the stochastic levels make an upward break after spending some time under the 20 buy level. The break coincides with a three outside up bullish reversal pattern, and that combination of factors is a crystal clear indication that it's a good time to get in on a long trade. The uptrend gets going quickly after that.

**Figure 12-7:**  
The stochastic indicator signaling a trend change on a chart of the 30-year U.S. Treasury bond futures.



**Figure 12-8:**  
The stochastic indicator and a bullish reversal candlestick pattern provide useful entry and exit levels on a chart of PCL.



The stock trades higher, and both the slow and fast stochastic readings move up with it. They both reach an overbought level, and then as the trend dwindles, the fast stochastic crosses under the slow one. That's a good indication that the uptrend is on its last legs, and it's especially true in this case because the crossover occurs with both stochastics above the overbought level of 80. The stock does continue to grind higher but not for long.

The final example to close out the section is a bit different from the other examples in this chapter because it's a relatively lousy trade (albeit one with a small profit) and it includes a doji (dojis are covered in Chapter 5). It's all included in Figure 12-9, which features a chart of Apple Inc. (AAPL).

**Figure 12-9:**  
The stochastic indicator and candlesticks giving all kinds of mixed signals on a chart of AAPL.



The chart shows that the stochastic levels are under 20 after a short-lived downtrend. The levels then cross, forecasting the emergence of an uptrend. There's also a doji hanging out all by itself — another indication that the trend direction is about to change. The stochastic levels get over 80 pretty quickly, and the early stages of an uptrend begin to appear. It looks like it's time to buy.



But wait. Although the stochastic levels run to 80, they then cross again, indicating that the uptrend may not be around much longer. A nimble trader can recognize this sign as the time to exit and be happy with a profit, no matter how small. An even nimbler trader notices that just after the crossover to a downtrend, a bearish reversal candlestick pattern emerges.

I didn't highlight it, but if you look closely, you can see a three inside down candlestick pattern. You can also see that the stochastic readings indicate a forthcoming shift to a downtrend. Many traders see that and think that an opportunity to make some money on a short is on the way. They're wrong. The stock climbs much higher and stays overbought for some time. If a trader initiated a short position, hopefully he included a solid protective stop.





## Chapter 13

# Sell Indicators and Bearish Reversal Candlestick Patterns

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### *In This Chapter*

- ▶ Using the relative strength index and candlestick patterns for your short trades
  - ▶ Shorting with combinations of the stochastic indicator and bearish candlestick patterns
- 

**T**echnical indicators are useful in many trading situations, and as I describe in the other chapters in Part IV, you can use them in tandem with candlestick patterns to conduct some outstanding trades. In this chapter, I fill you in on how to combine a couple of common technical indicators with bearish candlestick patterns to help you make wise decisions about short trades.

I focus much more on the prospects for shorting than the opportunities to use candlesticks and indicators to tell you when to exit a long trade, because realizing when to exit a long is relatively easy: If it looks like a trend is ready to tank, sell and get out!

I know some people are resistant to short selling, but it's part of the game, and not using the short side of trading puts you at a disadvantage. Risks are involved, but if you employ the methods I describe in this chapter, you can minimize those risks. With any luck, after reading my Chapter 13, you won't have to file Chapter 13!

## *Shorting with the RSI and Bearish Candlestick Patterns*

The *relative strength index* (RSI) is an indicator that can reveal an oversold or overbought security. The RSI typically appears in an area below a chart, and visually, it's represented by a line that moves up and down between 0 and 100. It's really up to you to choose which levels in that range will be considered overbought and oversold, but in this chapter, I use 30 as my oversold

level and 70 as my overbought level. That means that an RSI reading under 30 tells you that a bottom is forthcoming. Be ready to buy when that situation presents itself. Using 70 as an overbought level means that an RSI over 70 should alert you to either put on a short or sell a long position, because the trend is about to head south. You can read all about the nuts and bolts of the RSI in Chapter 11.

When combined with candlestick patterns, the RSI can provide an even stronger indication of when the situation is ripe for executing short trades or selling on long positions. In this section, I discuss the ways in which you can combine your candlestick charts with the RSI to make some clever, profitable trades.

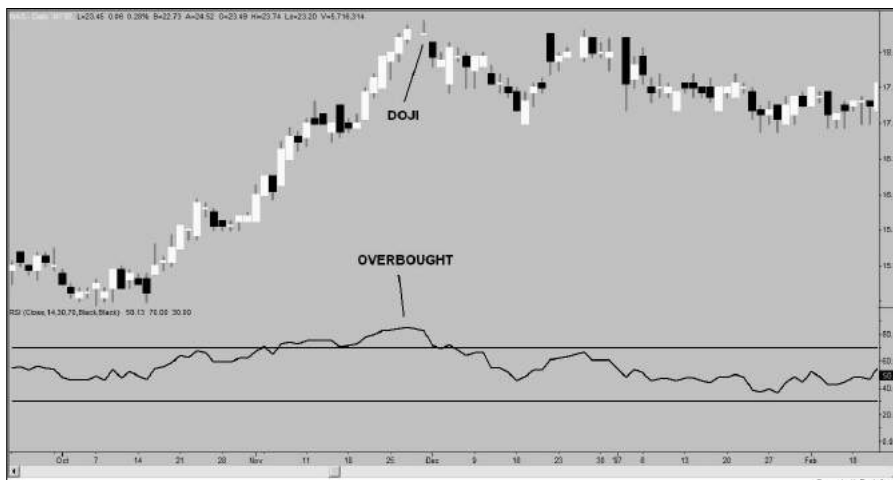
## *Picking short entry points with the RSI and candlesticks*

When using the RSI combined with a candlestick pattern to pick a good time to enter a short position, you want to see an RSI reading over 70 (or your personal overbought level) that coincides with the formation of a bearish candlestick pattern. If you have your eye on a chart and you see those two things come together, get your short pants on! (That's just a figure of speech, of course — I encourage everyone to wear pants of an appropriate length while trading.)

What better way to master these scenarios than to see them on a chart, so please take a gander at Figure 13-1. This example is a situation when you can combine the RSI with a bearish reversal candlestick pattern to figure out when to put on a short. The chart in Figure 13-1 is of the stock for Masco (MAS), a manufacturer and distributor of home improvement and building products. With fundamental exposure like that, it's an excellent stock to trade when the economic outlook is in question.

The RSI in Figure 13-1 goes into the overbought range early in November, and when you see that happen, start looking for bearish reversal candlestick patterns. In this example, the pattern comes in the form of a gravestone doji. (Check out Chapter 5 for the gravestone doji details.) The gravestone doji can indicate a reversal in either direction, but in this case there's an established uptrend, and the RSI reading has been overbought for some time, so it's very safe to say that this particular gravestone doji is signaling a bearish reversal.

**Figure 13-1:**  
An overbought RSI reading and a doji reversal pattern signal when to initiate a short on a chart of MAS.



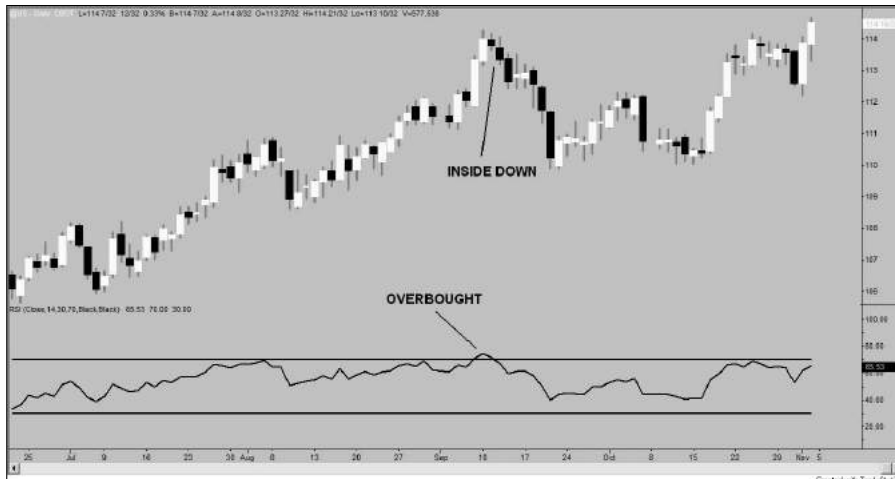
If you keep an eye on this overbought RSI and you spot the gravestone doji, you'd put on a short position, because the gravestone doji really shows that the bears are taking control of the price action after a run by the bulls. The pattern is followed by a small downtrend that lasts just a couple of weeks. You wouldn't be able to go out and start shopping for yachts if you trade this pattern successfully, but it's certainly worth studying, because it's a fairly reliable indication of bearishness.

Perhaps it's most important to note that this example shows you how the RSI (or other technical indicators, for that matter) can be very useful when you spot a reversal signal that doesn't tell you definitively which way the trend will go. You've got to really be sure of the market environment in those cases, and the RSI can tell you what you need to know.

Good things do come in pairs, so I provide another example of how you can combine the RSI with a bearish candlestick pattern in Figure 13-2. This figure features a chart of the futures contracts that trade based on the level of U.S. Treasury bonds.

You can see in Figure 13-2 that the price action produces a three inside down pattern, which is a pretty reliable bearish reversal pattern that I describe in detail in Chapter 10. The pattern's first day is a white candle that occurs in an uptrend. More importantly, this first day combined with the price action leading up to it causes the RSI reading to close over 70, which tells you that you're looking at an overbought situation. The pattern is complete with a bearish second day that's inside the first day, and a down final day.

**Figure 13-2:**  
A chart of  
the U.S.  
Treasury  
bond futures  
with the RSI  
and a bearish  
candlestick  
pattern  
signaling a  
useful short  
position  
entry.



If you want to capitalize on a situation like this, enter a short sale near the completion of the pattern or be prepared to put on a short on any small rebound during the next couple of days. The combination of the candlestick pattern and the overbought level of the RSI turns out to be a solid sell signal. The price action following the end of the pattern results in a quick drop of over three points in the Treasury bond futures. Although three points may not sound like a lot, consider that a point move in a single contract is worth \$1,000 (when you're on the right side).

## *Using the RSI to help pick short entry and exit points*

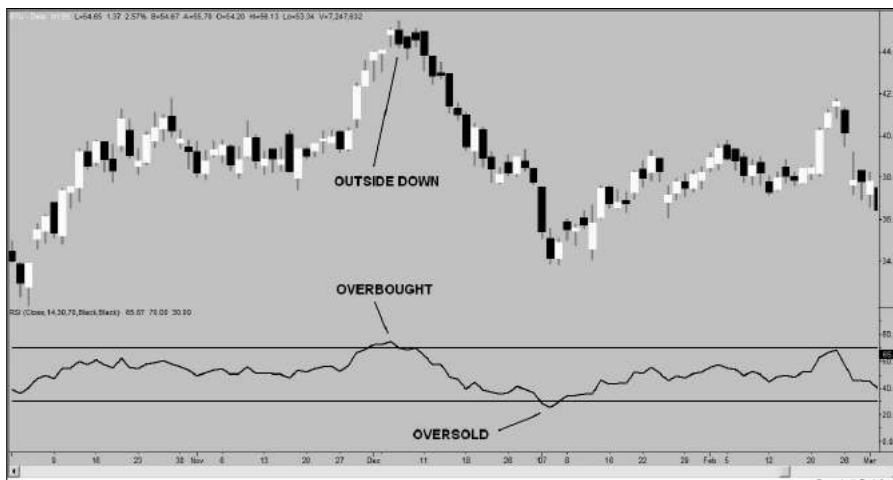
You can combine the RSI with your candlestick patterns to pick wise entry points for a short trade. But that's not the whole story. You can also use that same combination of trading tools to indicate when you should exit a short.

Figure 13-3 presents a situation in which a combination of the RSI and a bearish candlestick pattern can show you when to get in *and* out of a short position. The chart is for Peabody Energy (BTU), a mining company that focuses on coal production.



Peabody Energy's symbol may seem a little odd at first, but BTU stands for British Thermal Unit, which is a measure of the heat value of various fuels. Makes sense for a coal producer, right?

**Figure 13-3:**  
A chart  
of BTU  
where a  
combination  
of the  
RSI and  
candlesticks  
indicate a  
short entry  
and exit  
point.



The bearish candlestick pattern in Figure 13-3 starts to develop after several up days in a row. Along with this strength in the stock's price, the RSI rises to a level over 70 (overbought). The three outside down pattern then appears, with a black candle on the second day that's an outside day relative to the first day. The pattern is completed with a down day on the third day. (To understand the inner workings of the three outside down pattern, check out Chapter 10.) The uptrend is reversing to a downtrend, so the time is right for entering a short.



There's another element to the chart in Figure 13-3 that's worth highlighting. The three outside down pattern is completed when the RSI level is just a hair over 70. Seeing the RSI in an overbought range when a reversal pattern is completed is pretty rare, because a reversal pattern normally occurs when a trend changes direction, and when that happens, the RSI usually ends up in the middle range between overbought and oversold.

The exit level for this short isn't set in stone, but it should definitely yield a profit on the trade. The RSI moves down below 50 fairly quickly with the downtrend, and that should serve as a signal to start keeping an eye out for some sort of exit pattern or reversal in the downtrend. Unfortunately, another reversal pattern doesn't come along to tell you when to exit the short. But that doesn't mean that you have to just take a stab in the dark to figure out when to get out. There's a period of four days where the downtrend appears to be in trouble; the trend flattens and a couple of bullish days pop up. You can decide at that point that the trend has run its course, and it's time to get out and take a profit. You can enjoy even larger profits if you hold on just a little while longer, because the downtrend kicks back in and the stock trades lower still. But you have to exit the position sometime, and a good opportunity for that comes when the RSI pushes below the oversold level. Even without a pattern to confirm it, that should serve as a pretty solid signal that it's time to exit and book your profits.

I provide one more example of how you can use the RSI in tandem with bearish candlestick patterns to flesh out short entries and exits for short trades in Figure 13-4. This chart is of Radio Shack (RSH), which is an electronics retailer that covers the U.S. with more than 1,000 stores.

The RSH stock in Figure 13-4 is in a well-defined uptrend with the RSI reaching just a tad over 70. The day that the RSI reaches 70 is also the first day of a three outside down pattern (see Chapter 10 for details), and that serves as a signal for you to enter into a short trade.

If you short after seeing this combination of an overbought RSI and a bearish reversal candlestick pattern, you're quickly rewarded with a gap down on the opening of the day after the pattern is completed. You may shudder a bit two days later when there's a gap up and the high of the pattern (a resistance level) is approached, but that level isn't violated and the signal remains valid. The stock continues to trade off, and during this downtrend the RSI works its way down to below 50. Here is where you should start watching out for an exit point.

The exit signal in Figure 13-4 comes quickly, with a one-day reversal pattern. With the downtrend in place and the RSI in the bottom half of its range, a hammer day appears. (You can read all about the hammer pattern in Chapter 6.) The signal is a reversal pattern, and determining the trend that follows the pattern generally depends on the market context in which the pattern appears. The prevailing trend is clearly down in this situation, so you can bet that the hammer indicates that a switch to an uptrend is in the works. That turns out to be just the case, and the stock starts trading higher.

**Figure 13-4:** A chart of RSH where the RSI and two bearish candlestick patterns tip you off on the best entry and exit points for shorting.



The hammer pattern serves as a useful short exit signal in Figure 13-4, but the profits on the trade weren't exorbitant. However, you still earned some revenue, and by using the candlestick pattern for an exit signal you avoided seeing your earnings winnowed down (or even turned into losses) as the trend heads upward for a stretch.

## Using the Stochastic Indicator and Bearish Candlestick Patterns for Shorting

If you're interested in another reliable technical indicator that you can combine with bearish candlestick patterns to help you in your short trades, look no farther than the stochastic indicator. The *stochastic indicator* can be a very useful trading tool when you're trying to determine when a security is overbought or oversold. You can read all about the stochastic indicator in Chapter 11, but for this discussion just keep in mind the following points:

- ✔ The stochastic indicator includes two components: the fast and slow stochastic.
- ✔ The fast and slow stochastics oscillate between 0 and 100.
- ✔ When the fast stochastic is under the slow stochastic, there's a downtrend in place.
- ✔ When the fast stochastic is above the slow stochastic, there's an uptrend in place.
- ✔ The stochastic indicator can be based on a variety of look back periods. In this chapter my examples have a 14-period look back, which you'll find is a standard level in charting packages.
- ✔ Overbought and oversold levels on the stochastic indicator can vary, but in this chapter I use the standard levels of 20 for oversold and 80 for overbought. Keep in mind that this is slightly different than the standard oversold and overbought levels used for the RSI.

This section focuses on how to use the stochastic indicator alongside your candlesticks in shorting situations. Keep in mind, though, that you can use the same information to help you figure out when to get out of a long position. The rule is fairly simple. If you have a long position and the trend looks like it's going to head downward, exit and book your profit!

## Picking short entry points

Picking the best entry point for a short can be a difficult undertaking, but using the stochastic indicator as a supplement to your candlestick patterns can make the task much easier. For a prime example of how the stochastic indicator can be used with a bearish candlestick pattern to pick a short entry, take a look at Figure 13-5.

In the figure, you see a chart of Convergys Corporation (CVG), a provider of specialized software solutions for business customers. Its headquarters is in Cincinnati, Ohio, and Cincinnati's airport code is CVG. Coincidence? Nah, probably not. As you can see, the stock's price action is pretty bullish for a few days, and the result is a stochastic indicator reading over 80. The three inside down candlestick pattern forms shortly after the indicators reach this overbought level. Feel free to flip back to Chapter 10 for more information on the three inside down candlestick pattern.

The situation is ripe for a short entry, and the short entry situation gets even better when the fast stochastic crosses under the slow stochastic while both are still in overbought territory. If you see that combination of factors come together, you should be quick to enter a short position, because all signs point to a forthcoming downtrend.

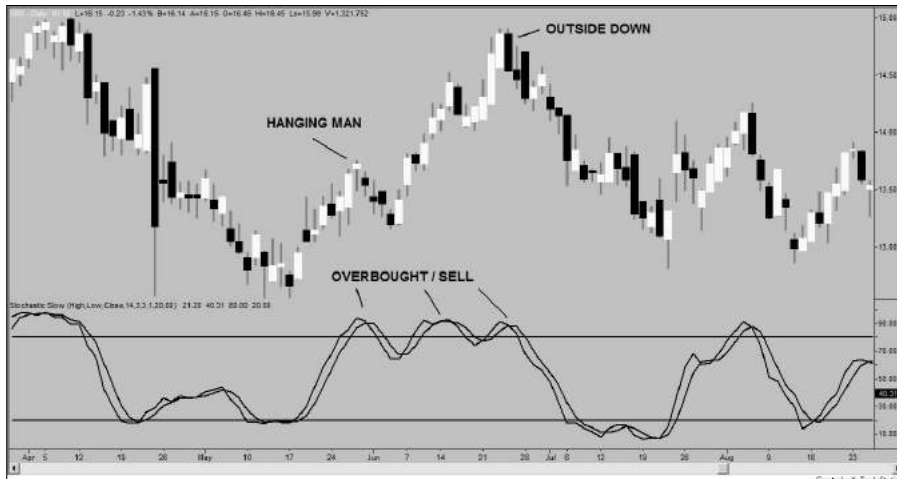
For a second example, see the chart of Xerox (XRX) stock in Figure 13-6. Xerox has become synonymous with document solutions for all businesses great and small.

**Figure 13-5:**  
A bearish candlestick pattern and the stochastic indicator reveal a short entry on a chart of CVG.





**Figure 13-6:** Short entry points are signaled by bearish candlestick patterns and the stochastic indicator on a chart of XRX.



In the middle of the chart in Figure 13-6, I highlight three points where the stochastic reading is overbought. Two of those points are accompanied by bearish candlestick patterns, and one isn't. Guess which ones provide the best entry point signals? I explain each scenario:

- ✓ The first of the three points at which the stochastic indicates that the stock is overbought occurs as the stochastic indicator comes to the end of an uptrend that was in place for a few weeks. The overbought level is reached just when a hanging man (a bearish reversal signal covered in Chapter 6) appears on the chart. On the very next day, the fast stochastic crosses under the slow stochastic, which signals a short entry point and a confirmation of the hammer pattern as a reversal signal.



Initiating a trade on this day, can prove profitable. Bearish activity prevails for a few days after the signal, but it's not the significant downtrend a short seller would hope for. Still, though, it can result in a profitable trade.

- ✓ The second of the three points comes when the stochastic indicator rebounds into overbought territory. The indicator almost provides some signals, but nothing really comes of it for a few days. Finally, the indicator appears to signal a short entry opportunity, but as you can see, there isn't a corresponding bearish candlestick pattern.



If you rely solely on the stochastic indicator in this situation and initiate a short position, you'll be sorry. The downtrend promised by the stochastic indicator doesn't appear, and the stock continues to trade higher. Ouch!

- ✓ The last and best of the three signals occurs after the trend has continued upward and the stochastic readings have reached an overbought level yet again. This time, though, the three outside down pattern (see Chapter 10 for more details) emerges, and during the pattern's formation the fast stochastic crosses under the slow one. A downtrend is probably on the way, and entering into a short position is smart at this time. Then you'd be rewarded handsomely, because the stock trades off heavily for quite some time and the potential profit is quite attractive.

## Deciding when to get in and out of shorts

Knowing when to exit a trade can be as important as knowing when to make an entry, and luckily the stochastic indicator — when used in combination with bearish candlestick patterns — can provide you with guidance for covering a short. Truth be told, the stochastic indicator actually does an okay job on its own, but when you use this indicator correctly with candlesticks, the odds of success are in your favor. To close out this chapter, I present a couple of examples of how you can use the stochastic indicator with bearish candlestick patterns to determine when to get in *and* out of a short.

The first example comes in the form of Figure 13-7 and a chart of First Horizon National (FHN), which is the parent company of First Tennessee Bank and some other financial subsidiaries. Also, for the sake of full disclosure, I used to work for this company, and their stock is the first I ever owned. But I'm talking about Wall Street, here, not Memory Lane, so let me get on with it.

**Figure 13-7:**  
The stochastic indicator and bearish candlestick patterns signal entry and exit points on a chart of FHN.



The stochastic readings in Figure 13-7 are in overbought territory when the first day of a three inside down candlestick pattern emerges. Coincidentally, the fast stochastic crosses under the slow stochastic as the pattern comes together, and the result is a full-blown short-sell signal.

The resulting downtrend stays in place for a couple of weeks, and the stochastic levels finally reach an oversold level after a long black candle pushes prices down. The following day sees a small rebound, and more importantly, a cross of the fast stochastic over the slow one. That's your exit signal.



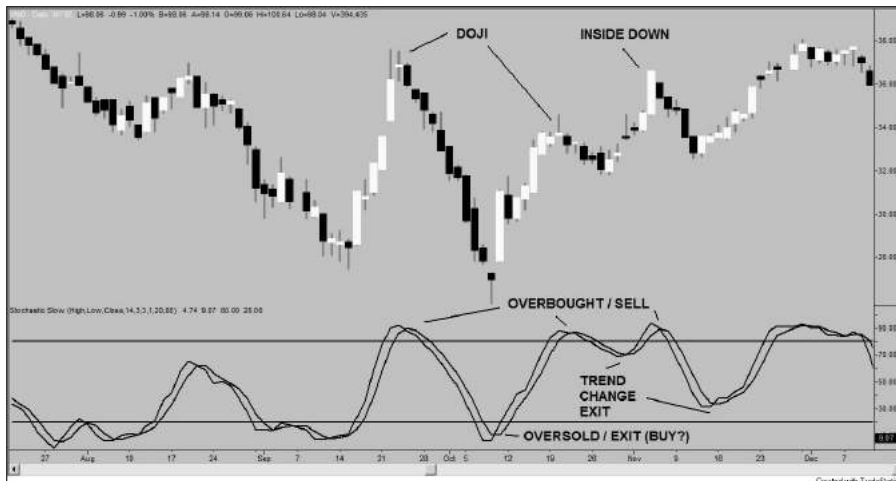
Keep in mind that generally speaking, you can forego a revealing candlestick pattern and rely on another technical indicator when picking a spot to exit a trade. Exits are usually a little less precise, and often one technical indicator is enough to go on. It's better to have a candlestick pattern for confirmation, but it isn't absolutely necessary.



You'd need to get out of the short in Figure 13-7 quickly, because the next day gaps higher and the gap isn't filled. Prices just keep moving up, which is pretty scary for a short in this position. Not exiting quickly when a stop loss signal is hit can result in worse losses. Figure 13-7 is a prime example.

Figure 13-8 is a real beaut. This chart is of Vornado Realty Trust (VNO), a real estate investment trust that owns office buildings in the New York City area.

**Figure 13-8:** Bearish candlestick patterns and the stochastic indicator provide entry and exit signals on a chart of VNO.



This chart is another good example because there are three potential actionable signals in a row, each with its own unique characteristics. Working from left to right:

- ✓ The first highlighted candlestick reversal pattern is a doji that occurs after several very strong days in a row that have pushed the fast and slow stochastic readings into the overbought range. The fast stochastic crosses under the slow stochastic on the day after the doji, and that cross confirms the doji and offers a short entry point. The resulting bearish price action is pure happiness for shorts: ten bearish days in a row after the confirmation day. It culminates with both stochastic readings reaching the oversold level.

Then, on the tenth down day, another reversal signal appears! It's a hammer pattern, and given the market environment, it's pretty clear that this hammer indicates that the trend will be heading upward soon. It's time for the shorts to cover and walk away with an appealing profit.

Before I move on to the second sell signal on this chart (the next bullet point), note that the hammer pattern isn't just an exit signal. It can also be used as a buy signal for a long trade! There's nothing wrong with making money on the same stock being both long and short. From personal experience I can tell you it's actually a lot of fun, and can be quite profitable!



- ✓ The second sell signal on the chart in Figure 13-8 is a gravestone doji, and it appears because the stochastic levels are both in overbought territory (details of the gravestone doji in Chapter 5). Much like the first signal, it's followed by a down day that results in a crossing of the fast stochastic under the slow one. That's confirmation that the gravestone doji indeed signaled a trend reversal, and it presents a short entry opportunity.

The second trade doesn't work out quite as well as the first, but if you trade nimbly you may break even at the very worst, and you more than likely will book a small profit if you follow the rules. The entry day is followed by a little bearishness, but the bulls come in and cause the stochastic indicator to show a change in trend to the upside. A quick exit of the short would be in order.

- ✓ The third sell signal has a pattern that's a little more elaborate and is a three inside down reversal pattern (covered in Chapter 10). Like the previous two reversal signals (previous two bullets), it occurs with the stochastic indicator in the overbought range, and during the pattern formation the stochastic indicator signals a change in trend to the downside. You guessed it: That serves as a short entry signal.

The exit on this last trade is pretty quick and not terribly profitable. Once again the stochastic indicator changes trend just a few days after the short entry point. Luckily, if followed correctly, a small profit would've been booked.

## Chapter 14

# Using Technical Indicators Alongside Bullish-Trending Candlestick Patterns

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### *In This Chapter*

- ▶ Combining trendlines with bullish-trending candlestick patterns
  - ▶ Making profitable trades with moving averages and bullish-trending candlestick patterns
- 

**Y**ou can combine candlestick patterns effectively with a variety of technical indicators to produce information that helps you decide when to put on and get out of trades. Like candlestick patterns, many technical indicators tell you when a trend is about to reverse, but several others can let you know that a prevailing trend continues. These indicators are powerful weapons that can add to the versatility of your trading arsenal.

If you understand how to use technical indicators in tandem with bullish-trending candlestick patterns, it's easier for you to spot situations where buying to enter a long position is a wise move. And you can also use technical indicators to confirm market or individual security predictions that you've made based on candlestick patterns.

I cover all that and more in this chapter, and I focus my discussion on two of the most common technical indicators: trendlines and moving averages. If you need a refresher on those two indicators, flip back to Chapter 11. If you have a basic understanding of how they're created and how they work, read on and get trading!

## ***Using Trendlines and Bullish-Trending Candlestick Patterns for Buying and Confirmation***

The trendline is one of the oldest and easiest to understand of all the technical indicators. You'd be hard pressed to find any current charting software that won't draw a trendline automatically for you, but you can also hark back to the good ol' days and draw a trendline yourself with nothing more than a chart, a ruler, and a pencil. If you need to get familiar with trendlines or brush up on what you already know, flip back to Chapter 11.

Trendlines have a positive slope during an uptrend or a negative slope during a downtrend, and those simple signals can be very useful when you're trying to confirm your opinion of the market trend.

In this section, I show you how to use the trend confirmation that trendlines provide in combination with bullish-trending candlestick patterns, which signal that a trend in place will continue. You can use the combinations to decide when it's time to buy to enter a long position or when you should stick with a trade to realize additional profits.

### ***Using trendlines and bullish-trending candlestick patterns to pick long entry points and confirm trends***

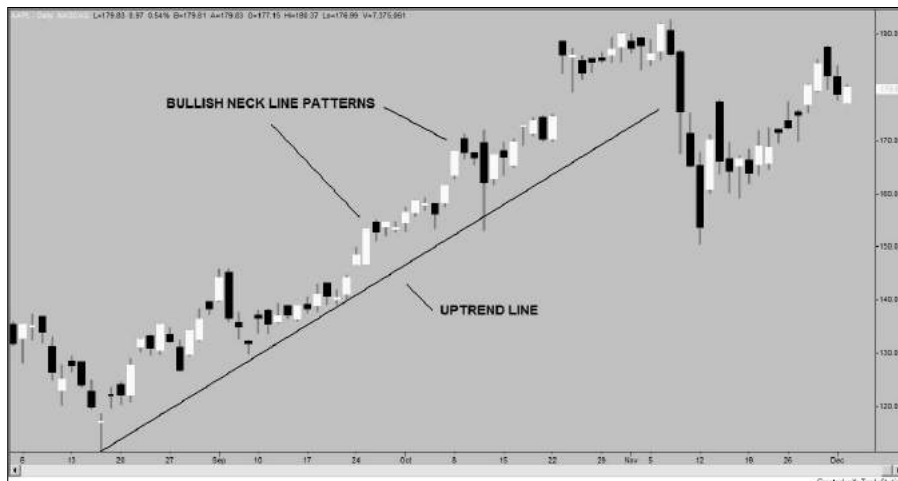
Because trendlines are so useful for trend confirmation, you can trade with confidence when you combine bullish trendlines with bullish candlestick patterns. That tandem can help you decide when to stick with a position or initiate a new one.

It's pretty obvious where a trendline should be drawn on a chart, but sometimes you may question its placement. Don't stress about it too much, because as a trend goes along and changes, you can always alter the trendline accordingly. I present a couple of examples of how you can combine a positive trendline and bullish-trending candlestick patterns in this section.

#### ***The trendline and bullish pattern on a chart***

Figure 14-1 is a chart of Apple Inc. (AAPL), the computer company turned consumer electronics company that's scored big with iPods and iPhones.

**Figure 14-1:**  
A chart  
of AAPL  
with  
a couple  
of bullish-  
trending  
candlestick  
patterns and  
a positive  
trendline.



Both of the patterns on this chart are bullish neck line patterns, where a bullish day is followed by a gap opening. (You can read all about the bullish neck line pattern in Chapter 7.) That attracts some bears, and they push the closing price down near the point where the bulls raised the price the previous day. If you spot these patterns while reviewing charts, you can feel quite confident that an uptrend is indeed in place, and you'd be wise to anticipate higher prices and a buying opportunity.

The first of the two bullish neck line patterns occurs after the uptrend has been in place for only a few days. After recognizing that pattern, you should draw a trendline to better define the uptrend and buy to enter a long position. The trendline makes it easier to see the strength of the uptrend, and it provides a support level for several days to come.

In the midst of the established uptrend, another bullish neck line pattern appears. It's a bit above the trendline, and it shows up after the trend has been in place for quite awhile, so buying to get into a long position may not be the best move. It's like a stale green traffic light: You know it's going to turn soon. On the other hand, it's still a bullish-trending candlestick pattern, so if you saw it and were already in a long position, you can be confident that the uptrend carries on at least a little farther.

### ***Another example of a trendline working with a bullish pattern***

My second example of bullish candlestick patterns and trendlines working together is present in Figure 14-2. In that figure, you see the exchange-traded fund (ETF) based on the 100 biggest stocks trading on the NASDAQ exchange. The symbol for this ETF is QQQQ. Hopefully, I can provide some A's for all those Q's.

**Figure 14-2:**  
A chart of  
QQQQ with  
a bullish  
trendline  
and a bullish  
thrusting  
line pattern.



On the chart in Figure 14-2 a bullish thrusting line pattern emerges as QQQQ is just a few days into an uptrend. This pattern is one of my favorites because the close is an attractive entry point due to a bit of retracing of the price into the range of the pattern's first day. Buying low while in an uptrend is the best of both worlds!

This bullish thrusting line pattern shows up several days into a bullish trend. If you see it on a chart, you may want to draw a trendline to further define the uptrend and give yourself a support level. If that level is violated, you know it's time to sell and exit the trade.

## *Picking long exits and determining stop levels with trendlines and bullish-trending candlestick patterns*

In addition to confirming trends and letting you know when to get in on a long trade, trendlines can also help with your decisions on when to exit a trade. Put simply, a bullish trendline may serve as an exit point when it occurs in a bullish trend. It's not always easy, because trendlines are constantly changing, but that can also be a plus because the trendline is moving in the same direction of your position (higher). Sound confusing? Let me clear things up with a couple of examples in the next sections.



### *Trendline and patterns for entries and exits*

Figure 14-3 is the same chart I use in Figure 14-2, but the trendline has been expanded a bit to include a level where you exit a long trade if you use the trendline to define the prevailing uptrend.

**Figure 14-3:**  
A chart of  
QQQQ  
where a  
bullish-  
trending  
candlestick  
pattern and  
a bullish  
trendline  
indicate an  
entry and  
exit point.



Once again, the pattern is a bullish thrusting line pattern that pops up in an uptrend, and the trendline, which offers a support level for the uptrend, is established. In a nutshell, if the stock continues to trade above this line, it's still in an uptrend. And as long as it's in an uptrend, you want to be on board with a long position!

You can clearly see the exit level in Figure 14-3. The stock has a day where it drops below the trendline, and that's where you want to get out. In fact, placing a stop order on the level of that trendline would be a good idea, so that any dip below it would result in an exit. You may be a bit dismayed shortly after because the stock quickly recovers and the trend resumes for a few more days. There was still a little more money to be made, but you can take comfort in the fact that you followed the rules and exited the trade when it was prudent. Hindsight is 20/20, of course, and in the long run you come out ahead if you stick with your rules.

### *Another entry and exit with a trendline and bullish pattern*

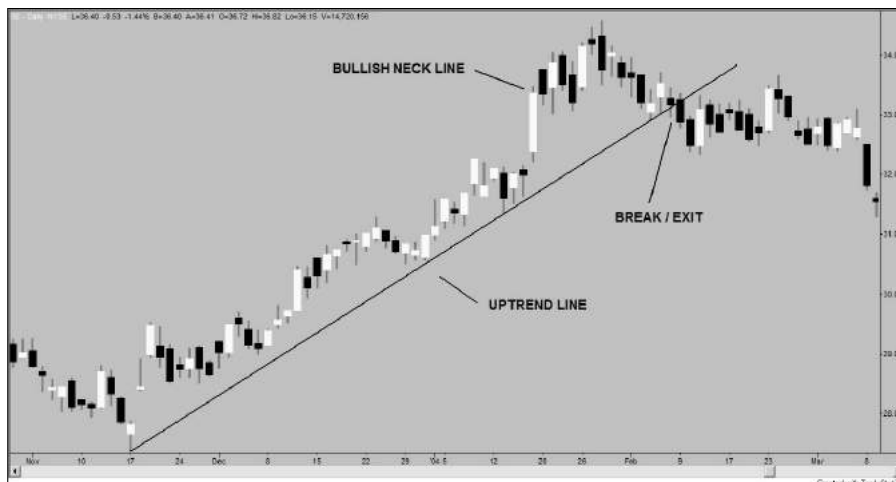
I provide one more example of how you can use a trendline alongside a bullish candlestick pattern to pick an exit level in Figure 14-4. The chart in this figure is for the stock of General Electric (GE). At this point it's pretty difficult to get away from GE if you're living in the developed part of the world.

## Exiting with a trendline

You may be wondering how it's possible to use a trendline as an exit stop level because it moves every day. That's a valid concern! Unlike the set points associated with candlestick patterns, a trendline's level on a chart changes daily. You can deal with that challenge in one of two ways:

- ✓ The first is to determine the level of the support trendline each and every day, and place an appropriate stop order that's good only for that day. That strategy works well because the line moves with the trend and your exit point moves accordingly daily. On the downside, you do have to commit to making the change every single day, which can be tough for some busy amateur traders.
- ✓ Second, you can choose to exit the trade only if the closing price is lower than the trendline. Going with that strategy keeps you from having to place trades everyday, but it does require you to check your chart toward the close of each day. It's attractive because it can keep you from getting stopped out of a potentially valid trade if the price happens to take a slight dive. On the flip side, though, the price can fall dramatically under the trendline during the day and close at a low level as well, meaning that your exit would be far lower than if you went with the first stop level strategy.

**Figure 14-4:**  
A bullish  
candlestick  
pattern and  
a trendline  
point to an  
exit on a  
chart of GE.



The chart in Figure 14-4 is interesting because the bullish neck lines pattern appears and there's an uptrend in place, but what to do in terms of trading action is a little blurry. The prevailing trend is a long one, and the pattern occurs with quite a lot of price difference between its close and the trendline that would be drawn at that time. (The trendline on the chart would be old news by then.)



Even though the trend is your friend, sometimes stocks get so far ahead of the trend that holding out for a better entry price — on both the long and short side — or possibly just skipping the trade altogether is wise. The example chart in Figure 14-4 proves prudent to pass on the trade, because if a long position is initiated, then its exit level comes up rather quickly and the trade appears to be a small loser.

## *Combining Moving Averages and Bullish-Trending Candlestick Patterns*

The moving average is a technical indicator that is reliable and easy to understand, at least as far as technical indicators go. See Chapter 11 for more info on moving averages.

In basic terms, a moving average is the average of the closing prices of a security over a certain period of time. Moving averages can be helpful when you're looking to confirm a trend, so you can rely on them to boost your confidence in the trading decisions you make based on bullish-trending candlestick patterns.

### *Using moving averages with bullish-trending candlestick patterns to confirm trends*

If you haven't yet made your way through my discussion of technical indicators in Chapter 11 or you need a refresher, the first rule of thumb with using moving averages as trend indicators is if a security's price is above the moving average, an uptrend is in place. With that in mind, take a gander at my first example of combining moving averages with bullish-trending candlestick patterns.

#### *Charting the moving average and a bullish-trending pattern*

Figure 14-5 is a chart of the stock for Yum! Brands (YUM). When you realize that Yum! Brands operates various fast food restaurants, including KFC, Taco Bell, and Pizza Hut, you can understand where it got its company's name and stock symbol.

**Figure 14-5:**

A chart of YUM featuring a couple of bullish-trending candlestick patterns and ten-day moving average that confirm an uptrend.



In Figure 14-5, YUM is trading over its ten-day moving average for several weeks. In the middle of that sustained uptrend, two bullish thrusting line patterns appear. The patterns appear about two weeks apart, and after both occurrences, the stock continues to trade higher. These patterns and the ten-day moving average certainly confirm each other on this chart. The moving average is tested several times, but the price holds for quite awhile until it starts to top out on the right side of the chart. If you monitor this situation on a chart, you'd initiate a long position after spotting one of the two patterns, and ride it until you stopped out or noticed a trend reversal signal of some sort.

The trend reversal signal shows up rather quickly, and before I move on to the next example, I want to point out just where the uptrend in Figure 14-5 starts reversing. I didn't highlight it on the chart, but if you look closely, you can spy a bearish reversal candlestick pattern at the top of the uptrend. It's a three outside down pattern, and it's another case of how getting very familiar with the appearance of candlestick patterns can pay off when trading.



The example in Figure 14-5 uses only one moving average, but don't feel like you have to stick to using just one. You may very well want to add more moving averages to your charts, and using two or more can be revealing if you can keep up with them all.

### *Using a couple of moving averages and a bullish-trending pattern*

When you use two moving averages on a candlestick chart, the trend is defined by the location of one moving average relative to the other moving average. When the moving average with the lower number of days is trading higher than the one with more days, the trend is positive. For the examples in this chapter that include two moving averages, I use 10- and 20-day moving averages. So when the 10-day moving average is higher than the 20-day moving average, the trend is positive. Sound simple enough? I'll dive right in with an example.

Sticking with the fast food theme, Figure 14-6 is a chart of McDonald's (MCD). It's an Illinois-based chain of hamburger restaurants that often uses a clown in its ads — maybe you've heard of it? This chart includes both a 10-day and a 20-day moving average, and for much of the chart the former is higher than the latter, which means that an uptrend is in place, and after looking at the chart it's hard to argue.

**Figure 14-6:**  
A chart of MCD with a 10- and 20-day moving average and a bullish-trending candlestick pattern that confirm an uptrend.



As if the evidence provided by the moving averages weren't enough, further assurance of the bullish trend comes in the form of a bullish thrusting line pattern. It turns up just a few days after the 10-day moving average has cleared the 20-day moving average. Looks like an uptrend is on the way! And nothing makes traders hungrier than a strong bullish candlestick pattern appearing early in an uptrend.

## *Using the moving average and bullish-trending candlestick patterns to pick long exits and determine stop levels*

Making a wise decision when it comes time to pick an exit point or stop level for a long trade can be the difference between booking a tidy profit and suffering a frustrating loss.

In the preceding section, I explain how you can use moving averages when you're deciding when to get in on a long trade, but you can just as easily use them when you're trying to figure out when to exit a trade. If you're in a long position and a moving average reading tells you that the trend is headed for a reversal, be prepared to sell and get out. Allow me to elaborate with a couple of examples.

### *An entry and exit with a single moving average and bullish pattern*

Figure 14-7 is a chart of the oil giant Exxon Mobil (XOM). Over the course of several days, the stock on this chart establishes an uptrend and it's solidly over the ten-day moving average. Although quite a bit of ground has been covered, the bullish thrusting line pattern shows up, and the conditions are ripe for a buy signal.

**Figure 14-7:**  
A chart of XOM where a bullish thrusting line pattern and a 10-day moving average provide an exit signal.



After the buy signal, the stock continues to work its way higher until there's a break of the ten-day moving average. That break signals the potential end of the uptrend, and it means that if you entered a long position after spotting the bullish thrusting line pattern, you need to exit. The price at the exit is high above the level of the pattern, so you walk away with a tidy profit. Not bad!



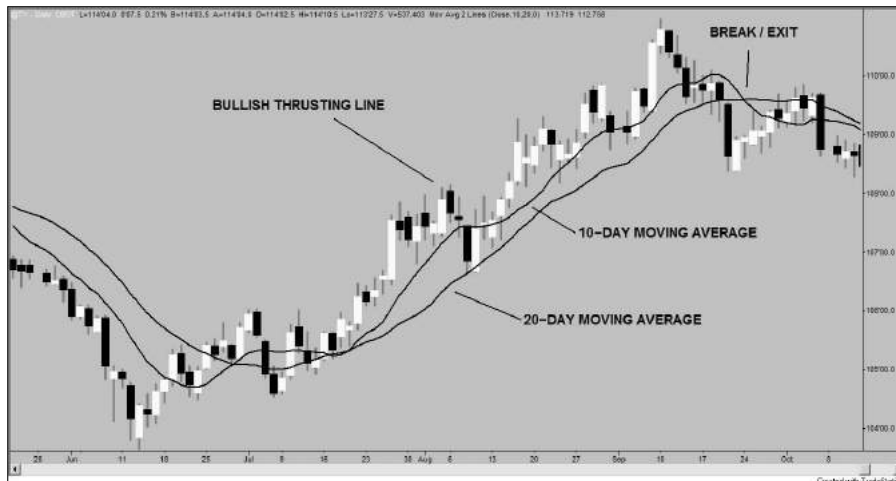
Setting stops is trickier with moving averages than it is with trendlines. You can anticipate the level of a trendline because it's simply the slope of the line moving forward by a day (or other time period). However, the moving average level changes more erratically, depending on the price action.

If you can't constantly monitor your trading positions, use the previous day's moving average as a stop. If a security dips below the prior day's moving average, initiate a sell.

In the case of the XOM trade in Figure 14-7, a stop should've been in place because the price continued to fall and settled well under the moving average on the day it broke this support level.

### *An entry and exit with two moving averages and a bullish pattern*

Another example of how to combine moving averages with bullish candlestick patterns comes in the form of Figure 14-8, a chart of the futures contract that trades based on the level of the United States ten-year Treasury notes. This chart has a great uptrend that can lead to a very appealing entry and exit if a trader makes the right moves.



**Figure 14-8:**

An entry and exit with two moving averages and a bullish pattern.

The bullish thrusting line pattern appears several days into the uptrend, but it's so close to the ten-day moving average that it's hard to think that the contracts have gotten too far ahead of themselves. Looks like a pretty reasonable level to enter a long trending trade.

After the entry has been executed, things continue to go swimmingly with the 10-day moving average staying above the 20-day moving average. The 10-day and even the 20-day moving averages are violated by the absolute price of the contracts, but that's not an exit signal because the trend changes when the 10-day moving average moves under the 20-day. In this case, keeping that in mind keeps you from getting out of the trade too early and missing profits or even taking a loss.



The added check offered by the combination of two moving averages is one of the primary reasons I use more than one moving average with my candlestick charts whenever possible.



The downside to using two moving averages is that you have a tougher time figuring out just where to set your stop orders. If you want to use a moving average crossover as an exit signal, you may find it very hard to do so if you have a job or another reason that you can't check in on your trades throughout the course of the day. Some commercial software packages send you an e-mail when a crossover is imminent, but if you can't access your e-mail all day, that's not much help.

My advice is that if you want to use a moving average crossover as your stop level, don't worry about a crossover that may occur during the day until the moving averages get close to each other. After you see that happen, you can start to estimate where an appropriate stop should be placed. And you can always just wait until the crossover has occurred and exit on the following day, if you can deal with the occasional slight erosion of your profits on a trade.



## Chapter 15

# Combining Technical Indicators and Bearish-Trending Candlestick Patterns

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### *In This Chapter*

- ▶ Using trendlines in tandem with bearish-trending candlestick patterns
  - ▶ Trading with a combination of moving averages and bearish-trending candlestick patterns
- 

**I**n this chapter, I explore the ways you can use trendlines and moving averages with bearish-trending candlestick patterns to uncover promising trading opportunities. Those two versatile types of technical analysis methods are great for detecting downtrends, and when you pair them with bearish-trending candlestick patterns, it can be much easier for you to pick the best spots for entering short selling trades. And as if that weren't enough, you can also use that potent combination to determine when it's time to cover your short position and (hopefully) pocket a profit.

## *Putting Trendlines Together with Bearish-Trending Candlestick Patterns for Selling and Confirmation*

Trendlines are one of the most straightforward technical indicators. If an uptrend is in place, a trendline has a positive slope. If a downtrend is the order of the day (or week or month), a trendline has a negative slope. This concept sounds simplistic, but it can be hugely helpful when you're trying to determine a market's trend. If that trend turns out to be down, you can use a downward-sloping trendline alongside bearish-trending candlestick patterns to inform your short trading decisions.

If you're blanking on trendlines, make a quick flip to Chapter 11, where I discuss them in detail.

## *Short trades and trend confirmation with trendlines and bearish patterns*

Selecting the most appropriate time to get into a short trade can be a trying task. Timing is critical, and any decision-making help can be a real blessing. Luckily for you, considering trendlines and bearish-trending candlestick patterns together can provide just that type of help. I show you what I mean in this section with a couple of real-world examples.

### *A short trade example with a bearish trendline and candlestick pattern*

You can find the first example in Figure 15-1, which features a chart of Altera Corp. (ALTR), a maker of semiconductors that go into a variety of electronic and industrial products.

**Figure 15-1:**  
An ALTR chart where a few bearish-trending candlestick patterns and a very long bearish trendline reveal a short trade entry.



The downtrend in the chart in Figure 15-1 is about as convincing as you can find. The stock just keeps grinding lower. Short sellers would be pinching themselves with each passing day! The downtrend is so pronounced, in fact, that I run out of room for it on the right side of the chart.

The first bearish pattern that pops up on the chart is the bearish-thrusting line pattern (see Chapter 8 for details), and its bearish prediction should be just what you need to initiate a short position. This pattern's appearance helps to establish a bearish trendline, which just keeps on extending until the chart runs out of room.

The second pattern is another bearish-thrusting line pattern, and it signals that the price will continue to drop. It also makes for a nice second chance for any traders who didn't get on board with a short position after the first pattern, because the downtrend looks to still be in its early stages.

This trend stays in place for a fairly long time, and then a new bearish-trending pattern appears. This time it's a bearish neck line pattern (also described in Chapter 8), which predicts a continuation of the downtrend; at this point, however, the downtrend has been in place for quite a while, and it's probably too long to initiate a new short position. However, if you're already in a short, it's very comforting to see some assurance that even lower prices may be on the horizon in the immediate future. If that's the case, hang on and ride the downtrend just a bit lower to maximize your profit!

### *Another bearish trendline and bearish pattern leading to a short trade*

One more example of how you can combine a bearish trendline and a bearish-trending candlestick pattern is on display in Figure 15-2. This diagram is a chart of Motorola Inc. (MOT). Originally a maker of radios and an innovator in the creation of the car radio, it's now known mostly for its cell phones.

**Figure 15-2:**  
A chart of MOT where a bearish-trending candlestick pattern and a bearish trendline signal a short trade entry point.



As you can see, a downtrend is in place when the bearish-thrusting line pattern appears not once but twice. (The bearish-thrusting line pattern appears *many* times in Chapter 8, where I discuss it extensively.) When the first pattern appears, the stock has moved so much in such a short period of time that it's tough to place a trendline based on recent activity. More aggressive traders initiate a short sell after seeing this first pattern, even though a definable downtrend isn't really in place. Then after the appearance of the second pattern, you have a good opportunity to draw a downtrend line by using the high of the rally between the two patterns.

The second pattern presents another possible entry point, and some may think it's more reassuring than the first pattern because of the downtrend line. The trend points down and the pattern pops up, but there's a lot of room between the end of the pattern and the trendline, so the risk level is relatively high. It's a pretty perilous short trade to enter at this point.

## ***Bearish trendlines and candlestick patterns leading to short entries and exits***

Trendlines are useful not only for determining the ideal time to get into a short trade but also for figuring out when to exit. This section focuses on the ways you can evaluate trendlines alongside bearish-trending candlestick patterns to pick the best time to cover a short.

### ***Shorting and covering using a trendline combined with a candlestick pattern***

Figure 15-3 features a chart of the stock for one of The Big Three — Ford Motor Company (F).

The candlestick pattern highlighted on the chart in Figure 15-3 is the bearish-thrusting line pattern, and it pops up in the midst of a pretty significant downtrend. The trendline is established based on the peak of the last bullish trend and the high a few days later. If you're looking for an illustration of the nature of the downtrend, this trendline fits the bill, and the stock price stays under this trendline for some time.

You can see that midway between the pattern and where the trendline is broken, the high comes perilously close to pushing above the trendline at one point. That event offers a trendline validation of sorts. Then a few weeks later, the trend flattens out, and the trendline is broken. If you short this stock, that's when you want to get out of the trade.

## Determining trading levels with trendlines

Trendlines are great indicators for a lot of reasons, but one slightly tricky feature of trendlines is figuring out how to use them as exit stop levels. This judgment is difficult because they move every day. How can you deal with that? You have a couple of choices:

➤ First, you can draw a new trendline every day, to keep up with the changing price action. This method works because your line moves consistently with the trend, and you can place corresponding stop orders that are good for that day only. But that method can also be taxing, because you have to commit to changing the trendline every single day.

➤ The other option is to set up a stop that gets you out of the trade only if the close for a day is above your trendline. That strategy eliminates the need for a daily trendline change, but it does require that you check your chart toward the close of each day.

Some traders also like the second option because it keeps them from getting stopped out of a trade if the price makes a little run above the trendline, but other traders contend that the price can rise dramatically (and close quite a bit higher) and erase profits or even cause losses before the stop took effect. It's up to you to decide which method works best with your trading strategy and style.

**Figure 15-3:**  
A chart of F with a downtrend line and bearish-thrusting line pattern revealing a short exit.



One final note on the chart in Figure 15-3 before I move on. Astute chart observers will notice a bullish reversal pattern at the bottom of the downtrend; did you catch it? It's the *bullish three outside up* pattern, and it signals that the downtrend is about to change directions and head up. You can always use a reversal pattern as an exit when it shows up on a chart, and in this case it helps you lock in just a little more profit on the short trade. Also, if you're so inclined, you may use this bullish pattern to establish a long position.



Exiting one trade doesn't mean that you have to stop working with a particular security for any period of time. If you're in a trade and riding a prevailing trend, and you spot a trend reversal candlestick pattern, don't rule out the possibility of exiting the current trade and jumping right back in with another trade that rides the trend in the opposite direction!

### *Shorting and covering with a downtrend line and bearish pattern*

I'll offer one more example before I wrap up this explanation. Figure 15-4 is a chart of the futures contracts that trade based on the Swiss franc level versus the U.S. dollar.

**Figure 15-4:** A bearish-trending candlestick pattern and a downtrend line reveal a short exit on a chart of the Swiss franc futures.



The contracts are in a downtrend when the bearish-thrusting line pattern shows up. The trendline I drew on this chart leaves a lot of room for retracing to a stop, but if you see this signal and decide to take the risk, your reward can be pretty amazing.

Soon after the exit, this chart becomes a little heartbreaking for the shorts because the stock moves even lower and it's clear the shorts could've made additional profits. It's frustrating, but you have to make sure that you don't let situations like this get you down. As I say time and time again, it's better to stick with trading rules and exit when it's prudent than to break rules, take risks, and lose your shirt in the long run.

## ***Combining Moving Averages and Bearish-Trending Patterns for Short Situations***

The moving average is another technical indicator you can combine with bearish-trending candlestick patterns to help figure out when to enter and exit your short trades. You can read all about moving averages (and several other technical indicators) in Chapter 11, but, broadly speaking, a *moving average* is the average of the closing prices of a security over a certain period of time.

Moving averages are very useful in confirming trends, and that functionality makes them good bearish-trending candlestick pattern partners. Read on to find out more.

### ***Pinning down short entry points and confirming trends***

You can use one or multiple moving averages to determine trends on a chart, and in this section I work with real-world examples of both.

#### ***A short trade using a signal moving average and bearish pattern***

Figure 15-5 is a chart of Merck & Co, Inc. (MRK) — one of the world's largest pharmaceutical companies. I like this example because you can clearly see how the moving average defines the trend and how that trend is enthusiastically confirmed by a bearish-trending candlestick pattern (or two).

It's hard to argue that the stock is in a downtrend when the first bearish-trending candlestick pattern appears. That pattern is followed quickly by a bearish-thrusting line pattern. All this bearish signaling occurs over the course of just four trading days and with the stock well under the ten-day moving average.

This chart makes a very good case for the use of moving averages over trendlines because when the first candlestick pattern appears, it's very difficult to draw a line that corresponds with the recent price action. But moving averages avoid this problem by relying on mathematically defined levels that don't have to be shaped to fit recent prices, and in this case a ten-day moving average is appropriate.

**Figure 15-5:**  
A chart of MRK with two bearish-trending candlestick patterns and a ten-day moving average that signal a short trade entry.



If one moving average is good, are two moving averages great? That's often the case, because you can compare the two moving averages to glean even more information about the nature of the price action and the prevailing trend.



When using two moving averages on a chart, you can detect a bearish trend when the moving average with fewer days looking back, or the one that uses a fewer number of days in the calculation (the fast one), is below the moving average with more days looking back (the slow one).

### *Two moving averages and a bearish pattern giving a short signal*

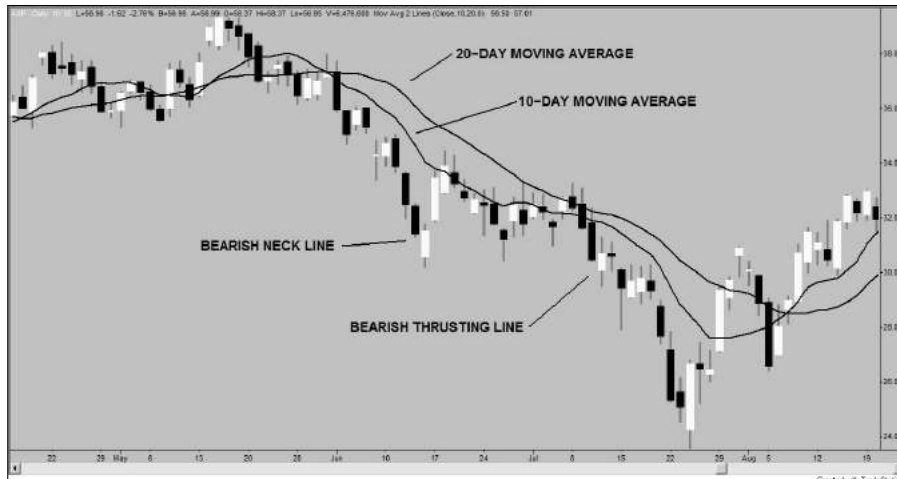
You can see a great example of how it's possible to combine two moving averages with bearish-trending candlestick patterns in Figure 15-6, which is a chart of American Express (AXP), a company best known for its credit card business. This chart is dominated by a bearish trend, revealed by a 10-day moving average that stays mostly below the 20-day moving average.

Two different candlestick patterns show up on the chart in Figure 15-6. The first pattern is a straightforward bearish neck lines pattern that pops up while trading is going on well below both moving averages. A signal like that is enough to justify an entry point in most similar situations.

The second pattern is a bearish-thrusting line pattern, and it appears while the downtrend is still in place. Note that part of the first day of the pattern shows trading over the moving averages, and a few of the days before the pattern show trading over the moving averages as well. But the trend remains bearish, and the 10-day moving average stays below the 20-day moving average. That means the downtrend is still intact, and you want to hang on to your short position for the immediate future.



**Figure 15-6:**  
A chart of  
AXP where  
two moving  
averages  
and a  
couple of  
bearish-  
trending  
candlestick  
patterns  
reveal an  
entry point.



## *Using moving averages and bearish-trending candlestick patterns to pick short exits and select stop levels*

Moving averages can be a huge help when you combine them with bearish-trending candlestick patterns to pick short trade entry points, but you can also use that dynamic duo to help you determine stop levels and exit points. I wrap up this chapter with a couple of examples that show you how to do just that.

### *A single moving average and bearish pattern for a short trade and trade exit signal*

Figure 15-7 features a chart of the stock for the media conglomerate Time Warner (TWX). This chart has a single ten-day moving average, and the bearish trend is in place when the stock price is lower than that moving average.

The stock is trading under the ten-day moving average when a bearish-thrusting line pattern appears. If you watch this chart and wait to initiate a short position, that's the wisest place to do it. At that point the price has been under the moving average for only a couple of days, but it appears that a downtrend has been in place for some time. The price works lower, but enough volatility exists to cause the stock to trade over and under the ten-day moving average fairly frequently.

**Figure 15-7:** A ten-day moving average and a bearish-thrusting line pattern on a chart of TWX reveal a short trade exit point.



This frequent volatility ends up really frustrating a short seller on this trade. Even though the trend continues lower for some time, a short seller with a stop that kicks in when the price moves or closes over the ten-day moving average — both logical stops — would be stopped out of position fairly quickly. But the downtrend continues, and more profits can be made. This *whipsawing* (quick moving around) of the price action makes a good argument for using two moving averages, and you can see an example of that strategy in the next section.



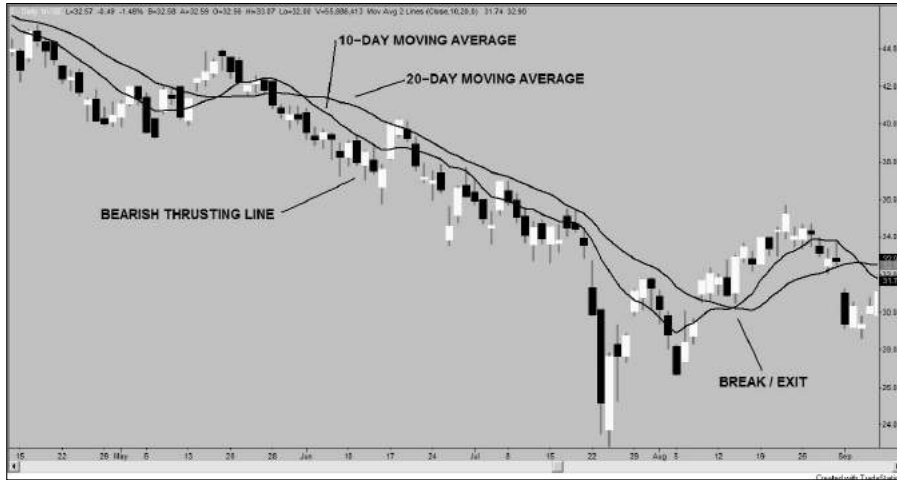
In cases where there's such volatility, it may be best to leave trading in this stock to the more seasoned traders or possibly just trade fewer shares of this stock than you normally would until you become more familiar with this type of action.

### ***Two moving averages along with a bearish pattern for a short sale and exit trade***

Figure 15-8 is a chart of Citigroup Inc., (C), and it includes both a 10- and 20-day moving average. For the majority of the time covered on this chart, the 10-day moving average is under the 20-day moving average, indicating that a downtrend is in place.

A bearish-thrusting line pattern shows up on this chart during the prevailing downtrend, providing a potential entry point for a short trade. It turns out to be an attractive entry point, because the 10-day moving average doesn't cross over the 20-day moving average for several potentially profit-producing days.

**Figure 15-8:** A chart of C where 10- and 20-day moving averages combine with a bearish-thrusting pattern to reveal a short trade exit.



Picking stop levels and exit points can be difficult when you're working with more than one moving average on a short trade, so consider taking an easy route and setting a stop level that gets you out of a short on a close after the moving averages have crossed.

It's also worth noting in Figure 15-8 that the price trades above the 10-day moving average several times, and even over the 20-day moving average on a few occasions. This occurs even though the downtrend stays in place and the 10-day stays below the 20-day. Using these two moving averages together keeps you in the trade longer, making for a much more profitable trade.

