Candlesticks

Made Easy

...because it's easier than you think!

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Content

A Note from Chris

Hi, this is Chris Lee from PipMavens.com and I'd like to congratulate you for taking the next step in furthering your Forex trading education!

Candlesticks are one of the most misunderstood aspects of Forex trading, and this book was designed to teach you how to interpret them properly. You're not required to memorize anything here; instead, I'm going to show you how you can understand any market situation simply by looking at a bare trading chart.

Before we begin, there's one thing I'd like to point out – the concepts that I'll reveal in this book have been carefully presented to be as 'easy to understand' as possible. However, don't confuse simplicity with ineffectiveness.

The trick is in being able to understand, appreciate and translate these concepts into **real profits**. That's what most people fail to do. Many *think* they know how to read candlesticks, but yet keep losing trades. Don't be one of these people. Take the time to read each section slowly, deliberately and go over them a few times. You'll often find a few ideas you didn't catch on the first read.

By the time you're done with this book, you'll be light years ahead of your trading peers – most retail traders focus so much on technical indicators that they don't realize the wealth of information that candlesticks alone can provide.

Congratulations once again for making the right choice.

To Your Trading Success!

CHRISTOPHER LEE

What's new in this version?

Since this book was first published almost 4 years ago, I've had the incredible privilege of communicating with traders just like you, from all over the world.

I've talked to you guys from the United States, Malaysia, Australia, United Kingdom, Indonesia, Canada, South Africa, New Zealand, Italy, India, Germany, Brazil, Netherlands, Belgium, France, Russia, Poland, Mongolia, just to name a few!

Your questions and comments have helped me better understand the challenges you face in the markets, and deepened my understanding of candlesticks and how to interpret them.

This new version of *Candlesticks Made Easy* would never have happened without your ongoing support, so **thank you** for helping me share this passion with the world.

Based on the feedback received, I've revamped the whole structure of this book. Some unnecessary portions have been removed, and a number of completely new sections have been added.

Notably, I'll be introducing a more coherent "1-2-3 step" approach to interpreting candlesticks, as well as adding on a section about the dynamic psychology behind the candlesticks you see on a price chart.

Also, we'll be spending some time learning how to identify price randomness, as not all candlestick signals are created equal. This is the one common topic I've found most traders to be struggling with, so I'll be addressing that thoroughly.

Please keep your questions and comments coming in – they help me get a clearer picture of how I can better transfer my knowledge about trading, to you. This book will keep evolving based on your feedback.

Thank you for your support.

Introduction

Being a trader is very much like being a detective. Imagine you're a detective who's trying to solve a murder case... what's the first thing you'll need to do?

You'll have to conduct a general survey of the crime scene, question all witnesses and try to determine the motives of the possible suspects. This will give you a general idea of how, why, when, and by whom the crime was committed.

But that's not enough to solve the case, is it? 'General ideas' are not enough... You'll need to gather evidence to support your claims!

And so you zoom-in on the details of the crime scene: you dust for fingerprints, carry out DNA testing, and go through the video recordings before, during and after the crime. All these pieces of evidence need to point to the same suspect in order for him/her to be convicted of the crime. Without the evidence, you can't solve the case.

So what has all this got to do with Forex trading?

You see, profitable trading involves this exact same process... You'll first need to step back and take a look at the big picture: What's the current market trend? Where are the major support and resistance levels? What's the general outlook for the U.S. Dollar over the next two months?

These are all questions that will give you a rough idea of where the market is headed. But just like in the 'detective' example, this information alone should not be convincing enough for you to take any action... you'll need to zoom-in on the candlestick activity to confirm your suspicions before you can place a high win-probability trade.

Candlestick analysis is how you gather evidence to support your trading decisions. And once you understand how to properly interpret candlesticks, you'll be able to enter and exit the market with pinpoint accuracy for maximum profits!

Overview

Here are the 4 main candlestick concepts we'll be covering:

1. Solitary candlesticks

We'll begin by first discussing candlesticks that have significance on their own. These are single candles that convey a particular message about what's happening in the market.

2. Relative candlesticks

Next, we'll look at how neighboring candles can give you a better picture of the recent market price action. If a single candlestick can reliably predict future market direction, imagine how powerful a <u>cluster</u> of candlesticks can be! In this section I'll teach you how to read and understand relative candlesticks so you won't have to memorize any candlestick patterns.

3. Significant price formations

Once you've understood the underlying mechanics behind relative candlestick analysis, it's time to expand our scope to even more significant formations; this time in relation to crucial price levels in the market.

4. Explosive formations

The last of the core concepts, this section will provide you with 2 incredibly reliable candle formations that have time and time again provided me with consistent profits. These formations aren't 100% accurate, but they're pretty darn close! You've to see it to believe it.

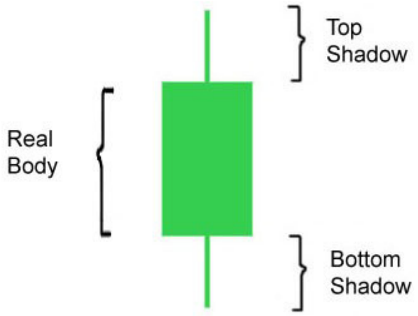
Lastly, I'll wrap up with a couple of key principles so you'll get a complete picture of how to execute your trades with pinpoint accuracy.

Solitary Candlesticks

Just in case you're new to candlesticks, here's a quick introduction…

What are candlesticks?

Candlesticks are graphical representations of market price movements within a specified time period. A candlestick may represent price movement that occurred in the last 5 minutes; 15 minutes; 30 minutes; 1 hour; 4 hours; 1 day; 1 week; or 1 month for example.

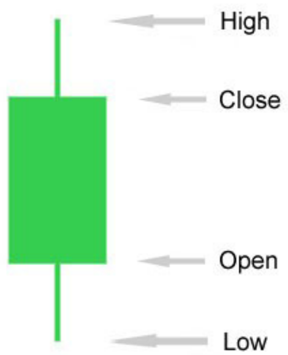


This is what a candlestick looks like. The thick portion is known as the real body, and the thin parts are known as the shadow.

Got it? Now let's now see what the real body and shadow can tell us about how market prices have moved.

Remember that each candlestick represents a specific time period?

Let's assume the the candlestick to the right represents price movement in a 1 hour period.



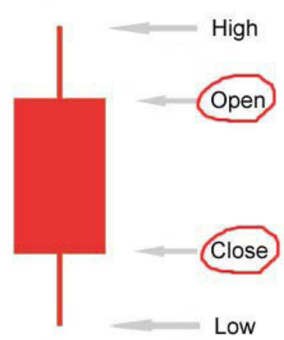
The 'open' would be the market price at the beginning of the 1 hour. The 'close' is the market price at the end of the 1 hour. The 'high' and 'low' are the highest and lowest prices that were traded within that 1 hour, respectively.

You may have wondered at this point why the candlestick is green in color. Most trading platforms today will allow you the option to change the color of the candlesticks you see on your charts, so it doesn't really matter. For the rest of this book, let's use **green** to represent a bullish candlestick, and **red** to represent a bearish candlestick.

What's a bullish/ bearish candlestick?

A bullish candlestick represents market prices that are moving up. If you look back at the 1 hour candlestick (in the previous page), you'll see that the 'close' (end) price is higher than the 'open' (beginning) price. This means that in that 1 hour, the market has moved from the 'open' price, up to the 'close' price.

And now here's a bearish candlestick:

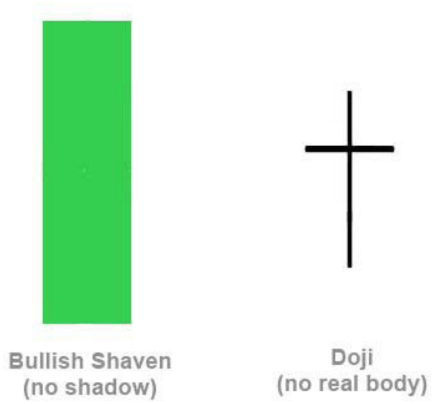


Notice that a bearish candlestick is the opposite of a bullish candlestick: it shows how prices have moved down within the time frame that the candlestick represents.

Bearish candlesticks are usually represented by the color red.

Special candlesticks

Occasionally, you'll come across candlesticks that have no shadows, or have no real body. These are very special candlesticks that can provide you with crucial information about here market price may be headed. I will discuss more about these special candlesticks next.



The Power of Momentum

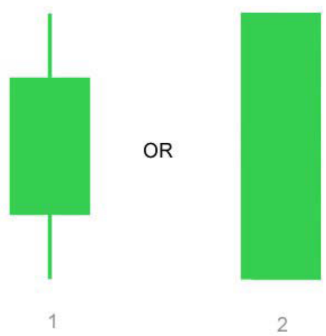
This is potentially the most important concept in candlestick analysis. If there's only one thing you can learn from candlestick analysis, I recommend that you learn about how to read momentum.

So what is momentum?

Momentum is essentially a measure of **<u>how strong</u>** price movement is.

Try to answer this question:

Which of these candlesticks show a <u>stronger</u> upward price movement?



Using what you've just learned about how to read candlesticks, take a moment to think about your answer.

Turn to the next page when you've decided on your answer...

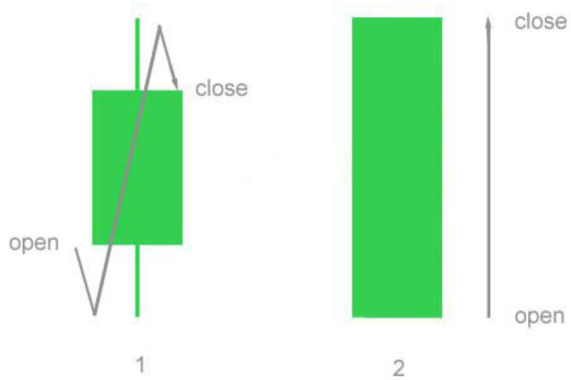
FOREX WINNERS

Did you guess candlestick 2? If you did, good job!

So why does candlestick 2 show a stronger upward momentum?

Although both candlesticks have the same high-low price range, candlestick 2 shows **no hesitation in upward price movement**. Also, candlestick 2 shows a **higher closing price**.

Here's an example of how prices moved:



Can you see how candlestick 2 shows the price moving straight up? This is an indication of a strong upward momentum.

Candlestick 2 is often called a **bullish shaven candle**. The opposite of a bullish shaven candle is called a bearish shaven candle. (duh)

But how does understanding price momentum help you make money in trading?

Let's now look at an example of how shaven candles can help...

Here, we see a bearish shaven candle that is soon followed by a further drop in prices. If you sold the market after seeing this bearish shaven candle, you would have made money!

Now, if you open up your trading charts and take a look, you'll be able to find many similar instances where a bearish (or bullish) shaven candle is usually followed by a subsequent drop (or rise) in prices.

Go ahead and check out your trading charts now. It's important that you're convinced of the strong influence of shaven candlesticks on future price direction.

...

Turn over the page when you're ready...

All right Chris, I'm convinced.

But why are shaven candles so accurate in predicting the direction of future prices?

The answer is because shaven candles indicate **strong momentum** in price movements. In the above bearish shaven example, there was no shadow because the sellers in the market completely overwhelmed the buyers; the buyers couldn't drive the price up at all! The sellers were too strong.

And once the buyers are temporarily defeated, prices will continue to free-fall until the buyers can regain their strength and start pushing prices back up again.

Wow that's great! Are shaven candles 100% accurate in predicting future price movements?

Nope. Not a chance. If it did then all traders would be rich by now. Haha... nice try.

Sometimes, shaven candles are immediately followed by prices moving in the <u>opposite</u> direction of them... as is often the case during the release of certain economic news announcements.

<u>Important</u>: All types of technical analysis (including candlestick analysis) is likely to be ineffective during high-impact news releases, such as the Non Farm Payroll report on the first Friday of every month. Do not, I repeat, do not trade during these periods.

Shaven candles aren't the only indicators of strong momentum in the market. There are several other ways to identify the strength of market price movements. However, shaven candles are one of the most reliable indicators that I've come across.

To summarize...

I hope you now have a good idea of how momentum works... the main point you should remember is that momentum is like throwing a stone: the stronger the initial thrust, the further the stone travels. In this sense, the larger a shaven candle, the more likely (and further) prices will continue move in the direction of that candle.

However, you should remember to ignore any shaven candles on the charts during times when important economic news is announced.

BUT!

As with all other trading indicators and analysis tools, you should never, ever, ever (EVER) rely solely on candlestick analysis to trade. This means that you shouldn't just blindly enter into a BUY trade the moment you see a bullish shaven candle.

Candlestick analysis is meant only to be one criteria out of the many trading criteria you should have in your own trading system.

Use candlestick analysis <u>together</u> with your technical indicators (or trading method). If you see a bullish shaven candle, but your other technical indicators tell you not to enter into a BUY trade, then please **don't** buy!

In the next section, I'll discuss about markets with weakening momentum...

When Momentum Is Lost

When momentum is strong in the market, it's a good time to enter into a trade. But when do you exit the trade?

The answer is when that momentum begins to slow down. And as you might have guessed, the candlestick that best shows the lack of momentum is the Doji:

On the trading charts, a Doji looks like a cross because the open price is the same as the close price; therefore, this candlestick has no real body at all.

A Doji can represent either one of two things:

1. Buyers and sellers are equally strong
2. Indecision in the market

1. <u>Buyers and sellers are equally strong</u>

When the buyers and sellers of the market are fiercely fighting each other, prices may not fluctuate much. This is because both sides are equally strong <u>at that point in time</u>, and are caught in a deadlock. However, the moment one of the sides starts to lose strength, the other side will usually push prices strongly in their direction.

<u>2. Indecision in the market</u>

Sometimes when the market is behaving unpredictably, traders in the market don't know whether to buy or sell. This results in a Doji candlestick on the charts because neither buyers nor sellers are strong... they're both weak! This is the opposite of the (above) point 1 when both sides are exerting strong buying/selling pressure.

How to trade using a Doji candlestick

Many Forex books and websites claim that a Doji candlestick indicates a change in market direction. Now that you understand the reasons for the formation of a Doji, do you agree with what these books and websites say?

Not necessarily, right? Whether or not a Doji indicates a possible change in market direction depends on the reason for the formation of the Doji. For example, indecision in the market is unlikely to cause a change in market direction! Weak buyers/sellers will not be able to push price in any direction at all.

Summary

By now, you should know that long shaven candles signify strong price momentum in the market, and that strong momentum is a good indicator of the direction of future price movements.

You also now know that a good time to exit your 'in-the-money' trades is when loss of momentum is observed in the market. A Doji signifies a loss in momentum, although this does not mean that prices will definitely reverse in the opposite direction. Never try to predict trend reversals (and enter the market) based on a single Doji candlestick!

One more thing about the Doji before we move on – you may have noticed that the 'hammer' and 'hanging man' candlesticks have similar characteristics to it:

So for trading practical purposes, just treat them in the same way you'd treat a Doji!

Let's move on to the next important candle characteristic: Long shadows.

Long shadows

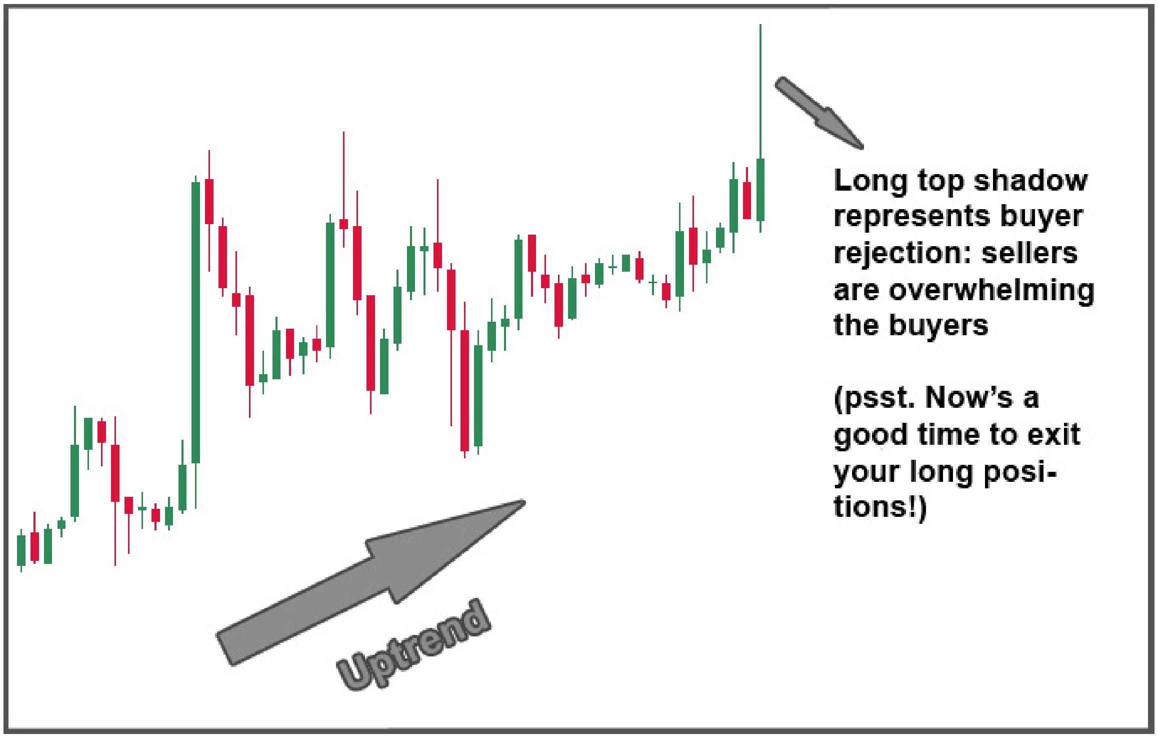
A long <u>top</u> shadow means that the **buyers** in the market <u>tried to push prices up</u>, but the **sellers** were <u>strong enough to push prices back down again</u>.

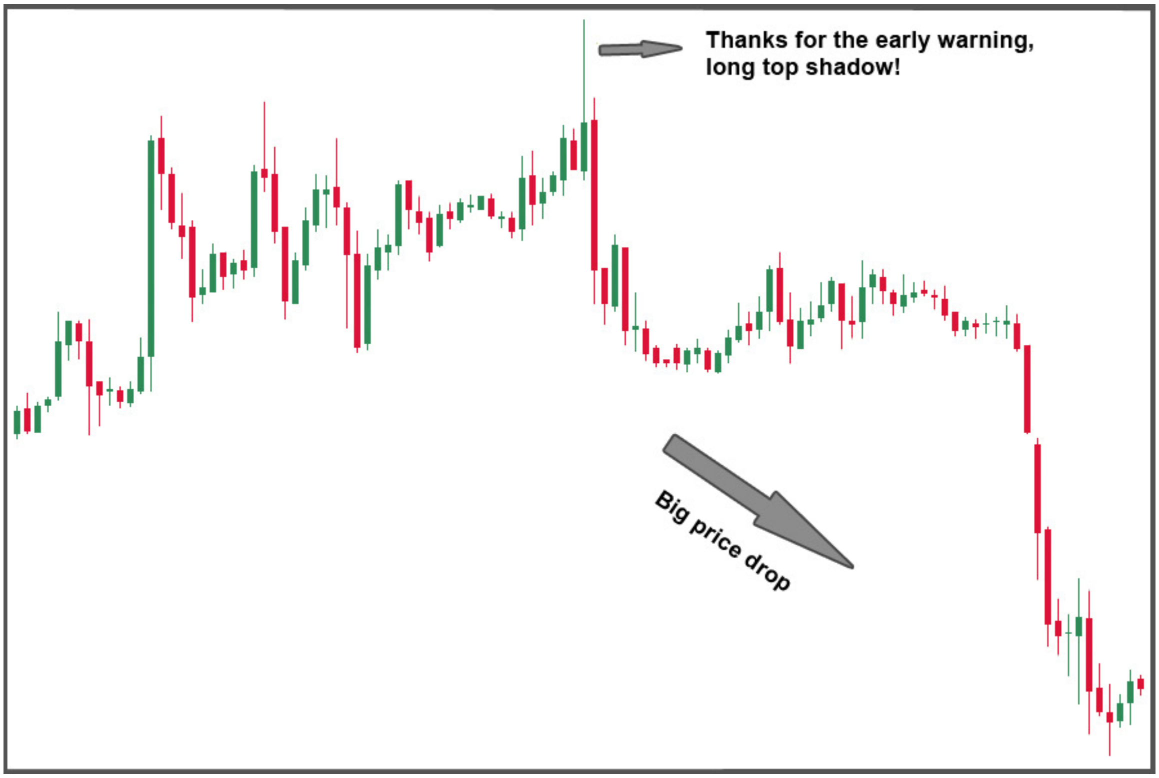
A long <u>bottom</u> shadow means that the **sellers** in the market <u>tried to push prices down</u>, but the **buyers** were <u>strong enough to push prices back up again</u>.

Long shadows represent buyer/seller rejection.

Here's an example: We entered into a Buy trade a few days ago, and the market has been on an uptrend... we're currently in-the-money!

Suddenly, we see a long top shadow form right at the top of the market:





Phew! Did you see how fast the price dropped? Thank goodness we took our profits before this happened!

At this point you might like to open up your trading charts and see if you can find more of such examples; I'm sure you'll see many similar setups.

As you can see, long shadows serve as an indicator of the comparative strengths between the buyers and the sellers. They indicate a high chance of market prices going in the opposite direction (of the shadow).

One more thing: the longer the shadow, the more likely prices will move in the opposite direction of the shadow.

That's about all there is to it. Pretty simple, huh?

Let's talk about multiple shadows next...

Multiple shadows

Unlike a single long shadow, the presence of multiple shadows usually indicates the **weakening of support or resistance levels**.

While a **single long shadow** indicates a likelihood of prices moving in the opposite direction of the shadow, a cluster of **multiple shadows** indicate that prices are likely to move in the same direction as the shadows.

Confused? Let's look at an example…

Here, we see multiple shadows trying to penetrate a support level. Also note that the closing prices are getting lower and lower. **What this means is that the sellers are aggressively testing the strength of the support level…**

In instances like this, the buyers are looking weak! I would expect the sellers to overpower the buyers soon…

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Reverse Rejection

Rejection candles do not always signal a reversal, so you'll need to know how to tell when a rejection has failed, and how to react accordingly.

The best way to understand this is through an example:

Here, we see the market moving down. The latest candle shows a long bottom shadow, indicating seller rejection. This may be a good time to enter a BUY trade.

Let's see what happens next…

Three candles later, we see that prices have NOT continued to move up.

This means that the rejection signal has *failed*.

When this happens, prices are highly likely to keep moving in the same **same** direction (in this case, down).

It would thus be a good idea to exit any BUY trades, and SELL instead.

What happened next?

Prices continue to drop and a nice profit is made.

As a rule of thumb, reverse rejection occurs when prices *close* halfway (or more) of the long shadow of the rejection candle.

This is a simple but deadly effective method for minimizing losses and getting onto the right side of the market.

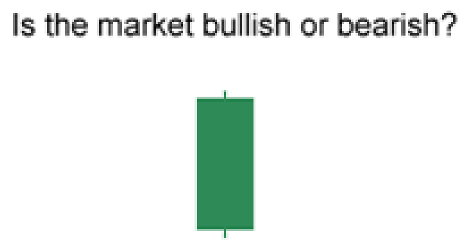
The important thing here is to understand the reason behind the concepts you've just learned. This may take some time to get used to, but keep at it and it will soon become easily to you.

All right! This wraps up this section. Let's now move on to the more exiting part… Relative Candlesticks!

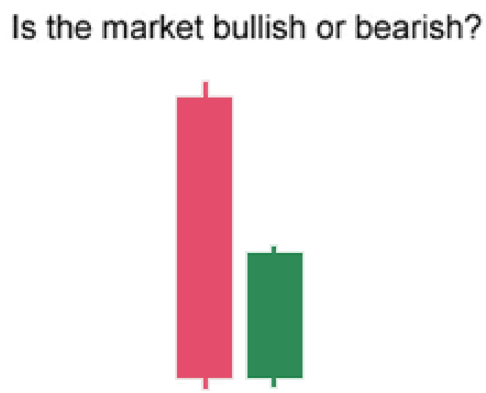
Relative Candlesticks

A cluster of candles can give you a good understanding of the context of price action.

Allow me to illustrate this with a question:



If we look at this single candlestick, we might say that the market is bullish. However, if we take a step back and look at the candle before it…



…then we might come to a completely different conclusion.

This is essentially what relative candlestick analysis is about. It shows you how current prices are moving in relation to past price movements.

As shown in this example, a single bullish candle doesn't mean that the market is necessarily bullish. To make a better judgment, you'll need to take a look at the bigger picture… and that's why single candlestick analysis is not enough – you'll need to learn about relative candlestick analysis too.

Relative Momentum

Remember how we talked about momentum before?

The same principle can be applied to relative candle analysis.

Here's how...

Let's assume we see a bullish shaven candle and enter a BUY trade:

Now, notice how the uptrend is becoming <u>less and less steep</u>.

Prices are still going up, but at a <u>slower</u> pace.

Also notice how the bullish candles became shorter. **This is an indication of the slowing down of momentum**.

Now is a good time to consider exiting the trade and taking profits.

…next, we see what looks like the beginning of a price reversal.

If we didn't notice the slowing down of momentum and exited our trade, we would have a lost a big portion of our profits by now!

Cool! Is this 100% accurate at predicting price reversals?

Nope! The slowing down of price momentum is <u>not a guarantee</u> that the market is going to reverse. **It only indicates a <u>higher chance</u> of prices moving <u>in a different direction</u>.**

Sometimes, the prices will reverse; and sometimes the prices will continue to shoot up.

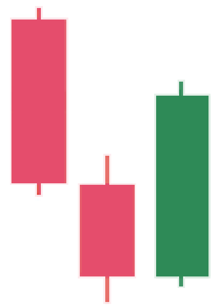
Of course, it's equally likely for prices to start ranging too. It's up to you to decide whether to exit the market in such a situation. It depends on your risk appetite and what your technical indicators are telling you.

In general, slowing momentum is an indication that the buyers (or sellers) are losing ground to the sellers (or buyers), and a change in price direction may be coming.

Reading Candle Patterns (without memorizing)

If you've been following me so far, this should be easy for you to understand.

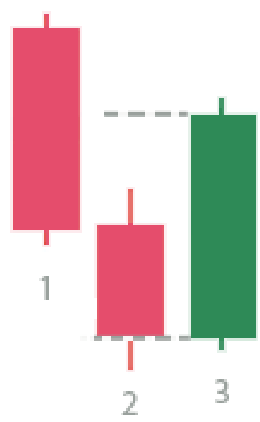
What does this situation tell you about market prices?



Take a moment to think about your answer based on what you've learned so far. Where do you think prices are *not* likely to go after this?

Did you guess that prices are *not* likely to move down?? If you did, good job!

Let's examine why:



Candles 1 and 2 indicate that the market is on a downtrend. But although candle 1 shows strong downward momentum, we can see a slowing down of this momentum in candle 2 (candle 2 has a smaller body).

Next, we see candle 3 is showing strong upward momentum, as it completely covers the body of candle 2. This is an indication of the weakness of sellers in the market, as the buyers completely overwhelm them.

Candles 2 and 3 form a candlestick pattern called the 'engulfing' pattern. You don't have to memorize this candle pattern... you just have to understand how it works, and you'll be fine!

There are also many other candle patterns you can memorize, but with these reading techniques you've just learned, you won't need to. Everything you'll need to know is already in your head!

Anchor Candles

Occasionally, prices will reverse without forming a clear reversal pattern. In these situations, how do we know whether a counter-trend move is going to be a temporary retracement, or a full-blown reversal?

Here's the trick.

You'll first have to identify what I call an 'Anchor' candlestick.

It's basically a candlestick that has a **longer body than the surrounding candlesticks.**

Example:

Example:

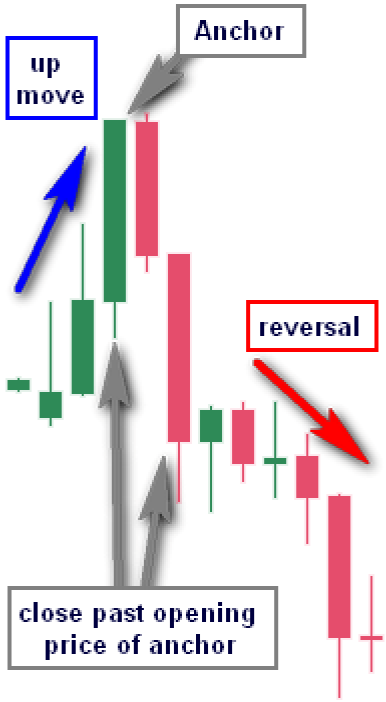
There's no scientific rule to determine an Anchor candlestick. Simply use your judgment – they're pretty easy to find.

If you're having problems looking for one, it probably isn't there.

When a candlestick closes past the opening price of the Anchor candle, a reversal is likely to happen.

If not, it's just a retracement.

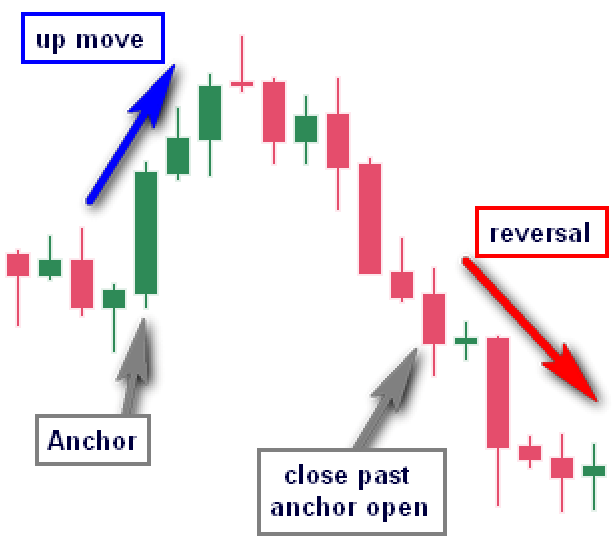
Let's take a look at what I mean…



Here, we see prices moving up, forming an Anchor candlestick.

Two candlesticks later, the market closed past the opening price of the Anchor, and the market consequently reversed.

Here's another example:



Another example:

The market moved up with a strong anchor, and then dropped back down again. This *looks* like a reversal… but is it really?

Let's see what happened next:

Ah… it turned out to be a strong retracement! Could we have known it was probably a retracement beforehand? Yes! If you look closely, prices did not close past the opening price of the Anchor candlestick!

One more example:

This is pretty straight forward. Prices dropped significantly, forming an obvious Anchor candle.

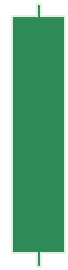
Two candles later, the market closed past the opening price of the Anchor, confirming the reversal. Subsequently, prices continued in the direction of the reversal.

Reverse Candlestick Psychology

This is a powerful method of identifying where a ready pool of buyers and sellers are in the market.

Did you know that a single candlestick (on its own) is by its nature, an area of support/resistance?

Let's take the example of a bull candle:



A bull candle tells us there are a larger volume of buyers than sellers (nothing new here). But this information is based on something that had *already happened*.

How does this help us make trading decisions in the *future*?

The answer:

A bull candle tells us <u>at what price</u> there is a ready pool of sellers in the future

Does this make sense?

OK, imagine…

You've just entered a BUY trade, and prices start moving up – that's great! Your trade is making money.

Soon, however, you notice that prices are starting to move back down again… your position is still making money, but the market is now moving dangerously close to your trade entry point. What would you do?

If you're like most traders, you'll hang on to the trade… and wait for it to move back up again!

But what happens when prices continue to move even closer to your entry point? What do you think most traders would do then?

They will attempt to get out of the trade at breakeven – most traders would have already moved their stop loss to breakeven, or if not, will manually get out of their BUY trades as soon as the market moves to the breakeven price.

And so, all the traders who entered a BUY trade along this bull candle are **now looking to SELL to close the trade**.

A bull candle thus represents the *range of prices* where the previous buyers are now looking to sell to close their previous (buy) trade.

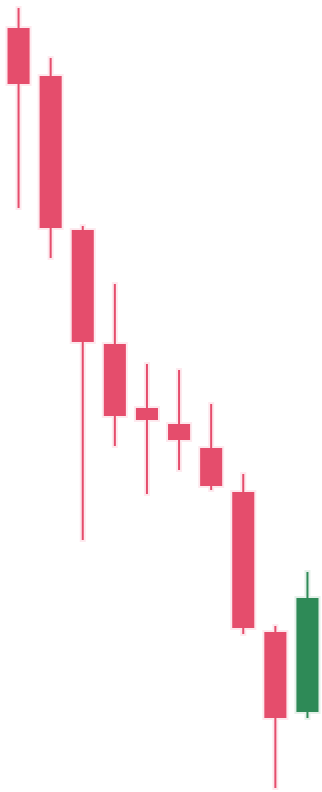
A bull candle represents the price range where there are a bunch of traders looking to SELL.

A bear candle represents the price range where there are a bunch of traders looking to BUY.

On a practical level though, it would be insane to apply this concept to every candlestick on the trading chart.

A much better (and more effective) way to use this concept is in the situation where there are a series of strong bull/bear candles.

Here's an example:



Prices have been falling rapidly with a series of consecutive bearish candlesticks. This is where you have a large pull of traders waiting to BUY to close their trade positions.

The latest (bullish) candlestick shows that the buyers are now attempting to push prices up. If they manage to push the market up high enough, the previous sellers will exit their trades (becoming buyers too).

When this happens, the market will shoot up quickly, like a row of dominos as each closing trade pushes the market even higher:

This simple but rarely applied knowledge will aid you greatly in deciding if you should keep any existing trades open, or if you should consider opening a new trade to take advantage of such a situation.

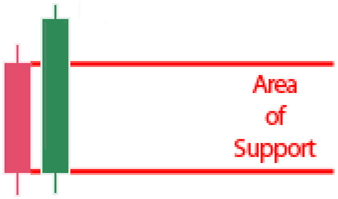
(By the way, did you also notice the bearish Anchor candle? Did you see how a close above its opening price signaled a reversal?)

Remember: although I'm describing each concept here separately, in practice all of them work should be applied at the same time.

How Reversal Patterns Work

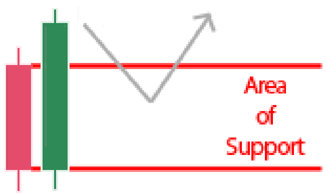
Reversal candlestick psychology is one of the reasons why reversal patterns are such effective predictors of price reversals.

Here's an example:



In the above diagram, the bullish engulfing pattern has formed and the market is moving up. All the previous sellers (from the bear candlestick) are now at a paper loss, and will be looking to exit their positions (at breakeven, or so they hope) with BUY trades, forming an *area of support*.

If prices move back down into the range of the bearish candlestick body, you can bet that the previous sellers will quickly BUY to close their trades, pushing the market price back up.



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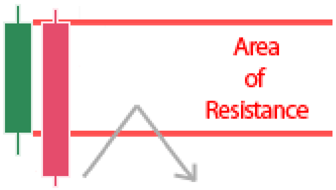
Similarly, after a bearish engulfing pattern has formed and prices continue to move down, the previous buyers (from the bull candlestick) are suffering a paper loss and will be looking to exit their trades at breakeven with SELL trades, forming an *area of resistance*.

If prices move back up into the range of the bull candlestick body, the previous buyers will immediately exit their positions (with SELL trades), pushing the market price down again.



This is an extremely powerful concept and you will do well to trade according to it.

Take a moment now to 'digest' this information.

Re-read this section again if you have to. If you don't understand what's going on here, the next section will probably confuse you.

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Trick candle pattern: Profit taking

Before we move on, it's important that you understand the implications of profit taking in the market. When traders don't take into account profit taking behavior, they'll often be tricked into placing low winning-probability trades.

Here's what I mean:

In the candle formation to the right, we might be fooled into thinking that this is the start of a price reversal – after all, we can see the strong momentum of the bear candle (not to mention a bearish engulfing pattern), right?

But in this case, a large bear candle doesn't necessarily mean that the sellers are getting stronger…

Due to the strong upward trend of the first three bull candles, we must now take into consideration the possibility of buyers who are now taking their profits (i.e. buyers with in-the-money trades who exit their positions).

If you noticed, the **close price of the last bear candle did not go lower than the open price of the first bull candle** (which is… you guessed it! An Anchor candle!)

This means it's entirely possible for most of the selling activity (at this point) to be coming from the buyers who are exiting their positions. We'll need to see more commitment from the sellers (who aren't the previous buyers) before we can say that prices are likely to reverse.

A stronger signal for a price reversal would be this:

See how the close price for the last bear candle is lower than the open price of the anchor candle? This tells us that it's likely that there are **more** sellers in the market than just the previous buyers.

How will I know for sure when 'profit taking' is happening?

Unfortunately, you can't know for sure. You'll just have to consider other factors that can increase your chances of making a well-informed guess.

For example, traders are more likely to take their profits at prominent support/resistance levels (we'll talk more about this later).

Reading Price Action

If you're following me so far, you've pretty much learned the steps to understand price action.

The 4 steps of reading Price Action:

1. Observing how prices moved in the past
2. Observing how prices are moving now
3. Predicting where prices are *not* likely to go next
4. Predicting the possibilities of where prices may go next

The first 2 steps are about accessing what the market has already done. Based on your interpretation of how prices have moved, you can then move on to step 3.

If the bullish momentum is strong, you know that prices are unlikely to move down in the immediate future. If you see a close below the opening price of a bullish Anchor candle, you know that prices are unlikely to keep moving up in the immediately future.

So all you need to do now (step 4) is to take, or manage your trades accordingly.

Time for an exercise!

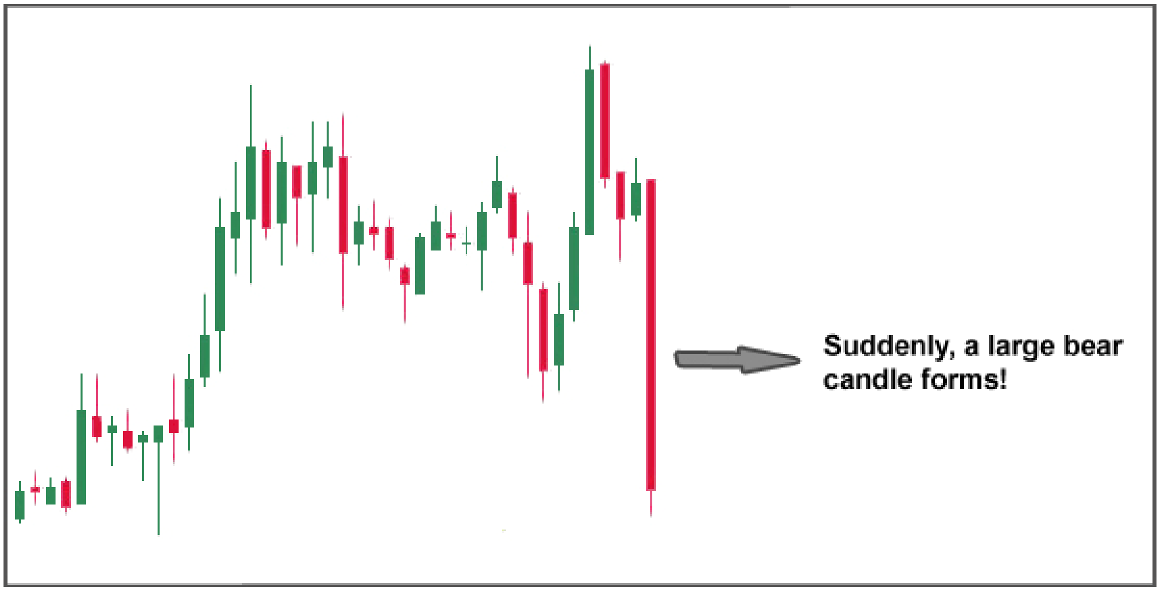
Now let's go through a quick analysis example to see if you're on the right track:

Recent price action indicates a mostly ranging market. There's no obvious buy or sell signal here (in the chart below).

Can you tell where the latest anchor candle is? (hint: it's a bull candle)

So far, prices have not closed below the Anchor candle, so we must be prepared for the possibility of a continuation of the up-move.

Let's see what happened next...



Now, we see a huge bear candle. Strong bearish momentum? Check. Close below the Anchor candle? Check.

This indicates a good SELL signal.

Yes! If we took the SELL trade, we would be in-the-money now! But we should be careful because the downward momentum is slowing down…

We know that the downward momentum is slowing down because:

1. The bearish candles are getting smaller.
2. A bullish candle approximately the same size as the previous bearish candle is formed.

This indicates a lack of momentum in the market because neither the buyers nor sellers are strong enough to push prices further in their direction.

This might be a good time to take our profits in case the buyers start to take over and push prices back up.

However, if (for whatever reason) we think that prices might keep falling, we can just place a stop order to secure some of our profits.

Let's see what happens next…

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It seems that prices continued to go up for a little bit, but now the upward momentum is getting weaker. Prices might just come down again!

***Important note:** Weakening momentum is **not** a good trade entry signal. It only indicates that the current trend is ending, so it's only useful as a trade **exit** signal.

Weakening momentum does not tell you where prices are likely to go – so don't enter into a trade just because you see weakening momentum. Prices are just as likely to go up or down afterwards.

Right, let's go ahead and see what happens next!

Prices went down again, but we can also see the subsequent loss of downward momentum (smaller bearish candles).

And in the last candle, we see the buyers coming in with a strong bullish momentum.

So will prices go up next? (hint: where's the latest Anchor candle?)

Let's take a look…

As you can see, the market was far from closing above the opening price of the Anchor candle.

So although we didn't entirely expect prices to immediately drop down again (due to the strong bull candle), we knew that prices would not necessarily continue to move up either!

We've just identified a 'random area' on the chart – when you get conflicting signals and prices don't show any particular likelihood of moving up *or* down.

During these periods prices tend to move randomly so we shouldn't be looking to place a trade

Practice identifying these areas and be wise enough to stay OUT of the market.

Let's see what happens next…

Interesting… prices came down for a bit, but soon climbed straight up. This is completely random movement! Traders who try to predict market prices during this period will be in for a frustrating ride…

Notice the market continued to move up after prices closed above Anchor 2, and subsequently Anchor 1.

And at the latest candle, we can see a long top shadow. If we had taken either one of the BUY trades, now may be a good time to exit.

Are prices are going to go back down? Let's find out…

…and yes, prices did go down.

Can you see how the bearish candles closed below each bullish Anchor candle? This indicates that the market is likely to keep moving down.

I could go on with this analysis forever… but let's just stop here, shall we? I think you get the idea.

As you can see, candlestick analysis is incredibly helpful in predicting short-term future market trends. For best results, these concepts should be applied on the 1 hour time frame and above.

Remember though, candlestick analysis is not 100% accurate. No single analysis tool is. Always protect your capital with well placed stop orders, just in case.

Let's now proceed to the next section!

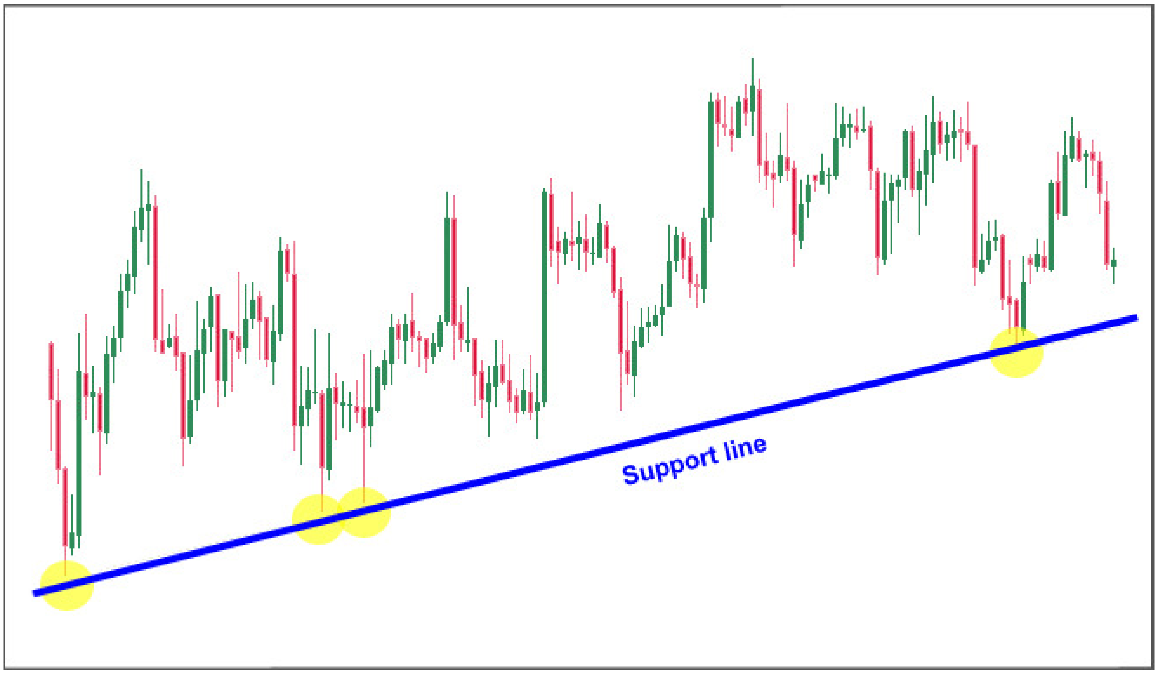
Significant Price Formations

Now that we've learned how to read clusters of candlesticks, let's apply this to an even wider scope: support and resistance levels.

While it's beyond the scope of this book to examine support/resistance levels in detail, here's how they generally work:

A support level is a price level at which <u>buyers are expected to enter the market</u>.

It's an arbitrary line indicating the price(s) that the market sellers are unable to push below. Here's an example of a support line:



Can you see how prices were unable to penetrate below the yellow line? In this chart, the yellow circles indicate the times when the sellers tried to push prices further down. However, they were unsuccessful and so we say that the yellow line has become a support level.

What about resistance levels?

Basically, a resistance level is the opposite of a support level. Simple, eh?

When support and resistance levels are almost parallel to each other, we call them a **channel**:

As you can see, market prices were unable to break through either sides of the channel.

What do support/resistance levels have to do with candlestick analysis?

When there is a **congruence** of candlestick analysis and support/resistance, you have a better chance of entering into a high winning-probability trade.

For example, when market prices hit the resistance level with a long top shadow, it might be a good idea to consider a Sell trade. This is because resistance levels and long top shadows both indicate that prices are likely to go down. Both analysis tools are telling you the same thing.

In general, the more analysis tools are in congruence about where prices are headed, the better.

Let's now take a look at some other important support/resistance concepts…

Double Top/ Double Bottom

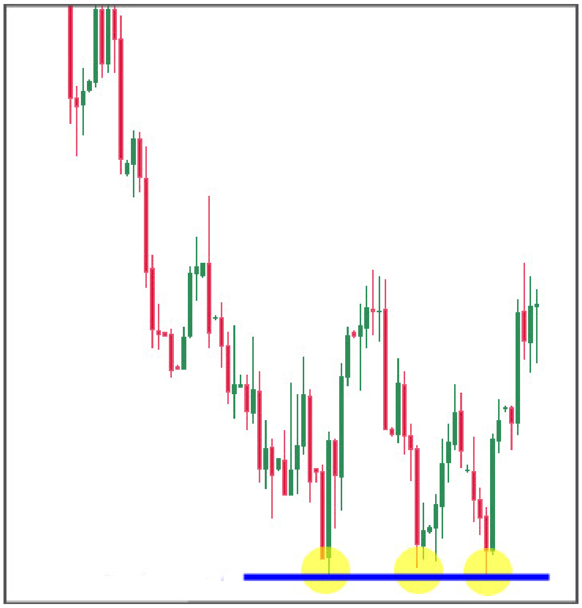
This formation occurs when prices attempt to break a support/resistance line **twice**. It typically forms at market bottoms.

Here is what a double bottom looks like:

Can you see how prices first hit the support level, went up for a bit, and came back down to re-test the support level again before moving back up?

Double bottoms/tops are reliable indicators of price reversals.

Triple Top / Triple Bottom



This is very much the same as double tops/bottoms, except that the support/resistance line is tested 3 times, instead of just 2.

And because these support/resistance levels have not been broken despite 3 separate attempts, they are considered to be stronger resistance/support levels.

Trading Breakouts

Breakouts occur when prices close past a support/resistance level:

Now I'm going to reveal to you one of the biggest secrets of how to properly trade breakouts.

But before you can appreciate the beauty of this trading technique, you'll first need to understand how most people typically (and wrongly) trade breakouts.

Usually, traders will place a pending BUY or SELL order 1-5 pips below a support level (or above a resistance level) to catch the breakout as it happens. While this may seem like a logical thing to do, it's actually a risky way to trade.

Why?

This is because explosions are periods of time where there is a lot of emotional trading in the market.

What I mean by "emotional trading" is that there will be many traders who are allowing fear and greed to guide their trading actions… and it is during these times that the institutional traders (i.e.. the market sharks) like to prey on such behavior. I won't go into too much detail regarding this because frankly, the only thing you'd need to know is not to trade on the initial break above or below a support/resistance level.

Remember: Don't trade on the initial breakout.

So how do we properly trade breakouts?

The trick here is to first let the emotional trading subside, and wait for the market to settle down and THEN tell you whether the bulls or bears are taking over.

Here's how to trade on an explosion: below we see a channel breakout to the downside (on a 1-hour chart):

At this point, we'll wait for the candle to fully form (i.e. wait till the hour is up) before placing our trade.

Once the explosion candle has completely formed and is shown to be a valid breakout (i.e. the candle does not close back above the support line), we'll place a pending trade orders as such:

- **Pending SELL order:** 5 pips below the 'low' of the explosion candle

- **Stop Loss order:** At half the body of the explosion candle

Like this:

And of course… we make money! :D

This is how you should trade breakouts.

The fundamental idea behind this technique is to first LET the market tell us that the breakout is a valid one.

Many other traders will be greedy and want to trade on the explosion immediately as it happens… and those are the traders that that get eaten up by the sharks.

Summary

Generally, you should be careful when prices are heading towards prominent support/resistance levels. Try to enter into a trade only when **both** candlestick analysis and the support/resistance levels <u>complement</u> each other.

For example, if you see a large bullish shaven candle hit a strong resistance level, don't enter a BUY trade… it's not a good idea to do that!

Likewise, if prices close below a bullish Anchor candle at a support level, don't enter into a trade either!

When prices are nearing a support level, it's a better idea to wait for a loss of downward momentum and/or a close above a bearish Anchor candle before you consider a BUY trade.

And if you see a breakout below a support level that closes below a bullish Anchor candle, you've got a high win-probability SELL trade setup!

If you understand these examples, you're doing excellent!

If not, please re-read this book until you can picture these examples in your head. It gets easier with practice.

And that concludes this section…

…phew! ☺

In the next section, I'll show you a special, "explosive" trading pattern!

Explosive Formations

Imagine that you're holding a metal spring between your index finger and thumb. As you press the spring together, it becomes harder and harder to keep it compressed. When you release either your index finger <u>or</u> thumb, the spring will jump out violently in the direction of where pressure was released.

Very amusing, Chris.

But what's this got to do with Forex trading?

Let me share with you my little secret…

This is exactly how some of the most profitable candle formations work.

Here's an example of a triangle formation:

It's called a triangle because when you draw the support and resistance lines, you get the shape of a triangle…

…like this!

For there to be a valid triangle formation, prices must hit the support and resistance lines at least **4 times**.

In this example, we see that prices actually hit the support and resistance lines 5 times.

All right, back to analyzing the triangle…

Can you see how prices fluctuated less and less over time **inside the triangle?**

This indicates a buildup of pressure, much like in the metal spring example I mentioned earlier.

And when either the resistance or support level is broken, prices will shoot out in the direction of the break.

That's it. Pretty simple, huh?

Warning: You'll have to be careful about where you place your stop orders when you trade on these 'explosions'. After support/resistance is broken, prices will occasionally fall back a little before continuing in the direction of the break.

In the above example, we see that prices did fall back into the triangle briefly, before continuing with the uptrend. Many traders' stop loss orders would have been triggered there, since most people like to place their stop orders just above or below support/resistance lines.

If you're trading on a triangle 'explosion', make sure your stop loss allowances are not too tight!

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What About Profit Targets?

Profit targets are a little tougher to estimate for maximum profits... But here are four guidelines you may wish to follow when placing your profit targets:

- At least 2 times your stop loss allowance
- At a prominent support/resistance level
- At a round number (ex. 1.5600, 109.00 etc)
- When you see a slowing down of momentum

And… That's it!

You now have two simple but incredibly powerful concepts to be trading with. These formations can be found in almost all time frames, so you'll come across them pretty often.

Keep in mind that the longer the time-frame these formations are found in, the more significant (and reliable) they are. For example, a triangle breakout on the daily chart is going to net you more pips than a triangle breakout on a 1-hour chart.

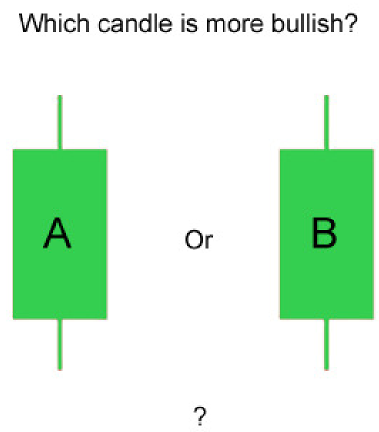
Also, be careful when using these techniques on charts that are on a lower time frame than the 1-hour chart (i.e. 5-minute chart, 15-minute chart etc). The stop loss allowances will be quite small and may get prematurely hit, especially during periods of news announcements.

The Time Frame Principle

Here's one trading principle I'd like you to pay attention to...

To the right are two 1-hour candles.

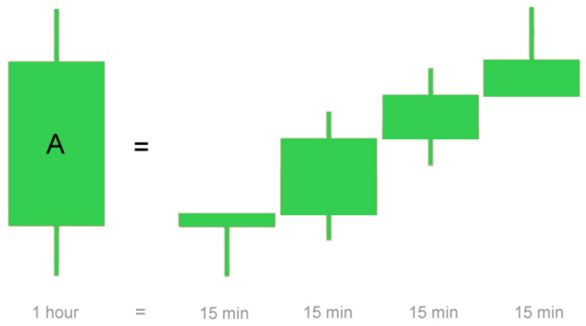
Try to answer the question as best you can.

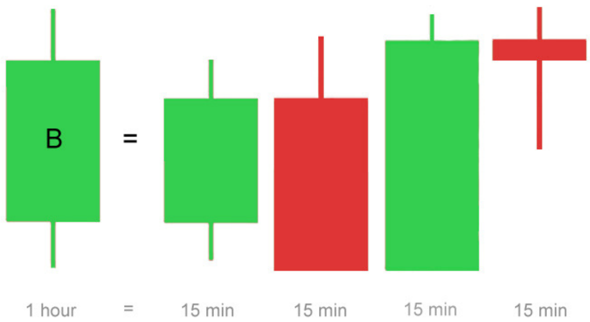


Of course, this is a trick question… well, sort of. The point I'm trying to make is that sometimes you can't tell how bullish or bearish a candle is simply by looking at a single time frame.

Let's now take a closer look at these 1-hour candles by zooming in to their respective 15-minute time frames…

Take a moment to compare candles A and B this time:





Although they look exactly the same in the 1-hour time frame, when we look at the 15 minute chart they paint a completely different picture from each other!

In this case, candle A is obviously more bullish.

Can you see the importance of 'zooming in' to the shorter time frames? Shorter time frames can provide you with details that the longer time frames can't.

A good habit to cultivate when trading is to occasionally look at the shorter time frames to support your trading decisions.

Never Forget To...

One last thing you'll need to remember:

Always wait for the candle to <u>complete</u> its formation before placing your trade

Here's what I mean…

Let's imagine we see a break below a channel on the <u>1-hour chart</u>.

<u>The time now is 4.30pm</u>

Many traders will get excited and scramble to enter into a Sell trade. In their excitement, they forget that the last candle is <u>not completely formed yet</u>!

<u>The time is now 5.00pm</u>

And here's what happens when the hour is up and the candle is fully formed – prices shot right back up into the channel again. This was a false break!

If those earlier traders had waited for the hour to be up before trading, they wouldn't have been caught in such an unpleasant situation.

Don't be like those poor traders… learn how to protect yourself against these unnecessary losses!

Rule Of Thumb

Only trade breakouts after a candle <u>closes</u> above a resistance level, or below a support level.

Don't trade on breakout candles before they have completely formed.

This is the reason why I advise traders never to trade on the initial breakout of a triangle or channel formation.

Go Make Some Money!

Congratulations on making it this far!

The concepts you've learned have been carefully chosen and explained to give you the best chance of making significant profits… so please follow them carefully!

"What about all the other candlestick formations?"

I know, I know… you've probably heard about the 'head and shoulders' or some other more commonly-known candlestick formation...

The reason why I didn't discuss them here is because you'll get to the same conclusion just by following the concepts covered in this book. For example, a head and shoulders pattern essentially signals a loss of upward momentum (possibly leading to a close below an Anchor candle), which would lead you to close any profitable BUY trades, and consider taking a SELL trade.

So what you've learned here is the underlying reasons behind ALL candlestick formations – so you won't need to memorize them, and still get to the same conclusion.

Now THAT'S an education worth having.

Thanks For Reading!

Thank you so much for taking the time to read and understand this book. I hope you've gained some valuable insights that will give your trading profitsa big boost!

Take care, and I'll talk to you soon!

Best wishes,

Christopher Lee