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CANDLESTICKS AND THE DOW

Assessing the effectiveness of candlestick chart signals during the recent market turmoil

By Steve Bigalow

Where is the market going to go in 2010? This is a question most investors concern themselves with during the early weeks of a trading year. However, is that a viable question? Candlestick analysis provides a much more accurate approach for making money in the coming year. Obviously nobody knows where this market is going to go. It was the anticipatory projections of where the market was heading, starting in 2008, that lost most investors huge percentages in their portfolio.

Candlestick analysis does not try to project where prices might move in the future. The information built into candlestick signals and patterns provide valuable insights into how you should be investing now. They provide the ability to project market moves, sector moves, and individual stock price moves for the near future. That may be a three week to three month time frame versus a 12-month outlook. Fortunately, the analytical capabilities of candlestick signals and patterns does allow for the contiguous analysis of price trends.

What was the general investment prognosis for 2009? Most professional money managers, after closing out positions in the first quarter of 2009, remained in cash, waiting for the next shoe to drop before recommitting to the market. Their confidence was so devastated that they needed to sit in cash until the markets gave them an opportunity to get back in.

The candlestick trader, however, has a completely different perspective of the markets. When the Dow was trading at 14,000, it was still projected that it would go much higher. However, the candlestick trader witnessed a different prognosis based upon candlestick signals; Q1 of 2007 revealed candlestick sell signals. This produced a portfolio

trates candlestick sell signals upon retesting major moving averages, after they had been breached to the downside.

Another valuable confirming indicator, the 8-period exponential moving average, known as the T-line, continued to act as a resistance until Q1 of 2009. The T-line (known as the trigger line) is



Figure 1

strategy that was oriented toward the short side. The introduction of short funds, and leveraged short funds, allowed for consistent profits as the market continued to move lower. The Dow Jones chart (Figure 1) clearly illus-

an excellent trend indicator when used in conjunction with candlestick signals. As a general rule, upon seeing a candlestick 'buy' signal and a close above the T-line, the uptrend will continue until the appearance of a candlestick →

'sell' signal and a close below the T-line. During the downtrend, although there were periods where a bullish reversal could occur, the movement in and out of the short funds made the long decline a reasonably profitable time frame. There were not any candlestick sell signals in Q4 of 2007 that would have provided the insights to project the Dow pulling back to the 6600 level. The profits exploited from the markets were the results of analyzing progressive sell signal conditions during the whole downtrend.

The Dumpling pattern

The summer of 2008 showed signs of a potential bullish reversal. But as time went on, the slow curvature of the trading revealed the potential of a Dumpling Top pattern. A Dumpling Top pattern is created by slow indecisive trading that produces an extended rounded top formation. Having the ability to recognize that pattern produced valuable information for the candlestick trader.

There are two options one can take in a Dumpling Top pattern market condition: the indecisive trading is going to warrant extremely short-term scalping, or taking funds out of the market completely and taking a break. Taking a break was the appropriate strategy especially during the slow late summer months. However, the Dumpling Top pattern has a high probability expected result. There is going to be a strong down draft in the price trend at the end of a Dumpling Top. This information allows a trader to make profits by shorting the next price move. It also adds more confirmation that the downtrend is still in progress.

The Dumpling Top in Q3 of 2008 (Figure 1) indicated more downtrend and the Pennant formation in Q4 of 2008 revealed more potential downside. The Dow finally bottomed out in March of 2009 with a small candlestick Cradle pattern (Figure 2). When the signal appeared, the candlestick trader had a different perspective of what should be done with portfolio positions. They were coming off of a very

profitable downtrend and the bullish Cradle pattern instigated closing the short positions and starting to establish new long positions. A bullish Cradle pattern is visually easy to identify. It consists of a large dark candle at the end of a downtrend. It is then followed by a flat trading period, (3 to 6

occur until March of 2009.

While most professional money managers maintained heavy cash positions during 2009, the candlestick trader was heavily invested in the markets in long positions. The Cradle pattern, witnessed in March of 2009, provided an excellent buying opportu-



Figure 2

trading days on average) consisting of a combination of Doji's, small hammer signals, inverted hammer signals, all indicating indecisive trading. The bullish signal is then confirmed with a strong bullish candle at the end of flat trading. The signal looks like a cradle hanging down between two trends (branches). The resulting price move from this signal is a strong uptrend.

Candlestick analysis makes analyzing a trend very easy. Utilizing the fact that signals represent investor sentiment, it becomes much easier to analyze what is occurring at support and resistance levels. 2008 clearly demonstrated that each time down-trending moving averages were touched, candlestick sell signals would appear. The simple assumption is that a downtrend will continue until a candlestick 'buy' signal appears and prices can close above specific moving averages. This combination did not

nity. But going long in March of 2009, did not involve extensive research as the bullish signal told traders what was going on with market sentiment.

So, what is the market going to do in 2010? The market is still moving in a slow consistent uptrend. Until a strong candlestick sell signal is created AND the markets close below the influential moving averages, the trend has to be considered still in an uptrend. ■

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