Chart School

Candlestick Bearish Reversals Part 1

There are dozens of bearish reversal patterns. I have elected to narrow the field by selecting a few of the most popular patterns for detailed explanations. For a complete list of bearish and bullish reversal patterns, see Greg Morris' book, Candlestick Charting Explained. Below are some of the key bearish reversal patterns, with the number of candlesticks required in parentheses.

- Bearish Abandoned Baby (3)
- Bearish Engulfing (2)
- Bearish Harami (2)
- Dark Cloud Cover (2)
- Evening Star (3)
- Shooting Star (1)

I believe in certain guidelines relating to bearish reversal patterns:

- Most patterns require further bearish confirmation.
- Bearish reversal patterns should form within an uptrend.
- Other aspects of technical analysis should be used as well.

Bearish Confirmation

Bearish reversal patterns can form with one or more candlesticks; most require bearish confirmation. The actual reversal indicates that selling pressure overwhelmed buying pressure for one or more days, but it remains unclear whether or not sustained selling or lack of buyers will continue to push prices lower. Without confirmation, many of these patterns would be considered neutral and merely indicate a potential resistance level at best. Bearish confirmation means further downside followthrough, such as a gap down, long black candlestick or high volume decline. Because candlestick patterns are short-term and usually effective for 1-2 weeks, bearish confirmation should come within 1-3 days.

AOL advanced from the upper fifties to the low seventies in less than two months. The long white candlestick that took the stock above 70 in late March was followed by a long-legged doji in the harami position. A second long-legged doji immediately followed and indicated that the uptrend was beginning to tire. The dark cloud cover (red oval) increased these suspicions and bearish confirmation was provided by the long black candlestick (red arrow).

Existing Uptrend
To be considered a bearish reversal, there should be an existing uptrend to reverse. It does not have to be a major uptrend, but should be up for the short term or at least over the last few days. A dark cloud cover after a sharp decline or near new lows is unlikely to be a valid bearish reversal pattern. Bearish reversal patterns within a downtrend would simply confirm existing selling pressure and could be considered continuation patterns.

There are many methods available to determine the trend. An uptrend can be established using moving averages, peak/trough analysis or trendlines. A security could be deemed in an uptrend based on one or more of the following:

- The security is trading above its 20-day exponential moving average (EMA).
- Each reaction peak and trough is higher than the previous.
- The security is trading above a trendline.

These are just three possible methods. Some traders may prefer shorter uptrends and qualify securities that are trading above their 10-day EMA. Defining criteria will depend on your trading style, time horizon and personal preferences.

Other Technical Analysis
Candlesticks provide an excellent means to identify short-term reversals, but should not be used alone. Other aspects of technical analysis can and should be incorporated to increase the robustness of bearish

reversal patterns.

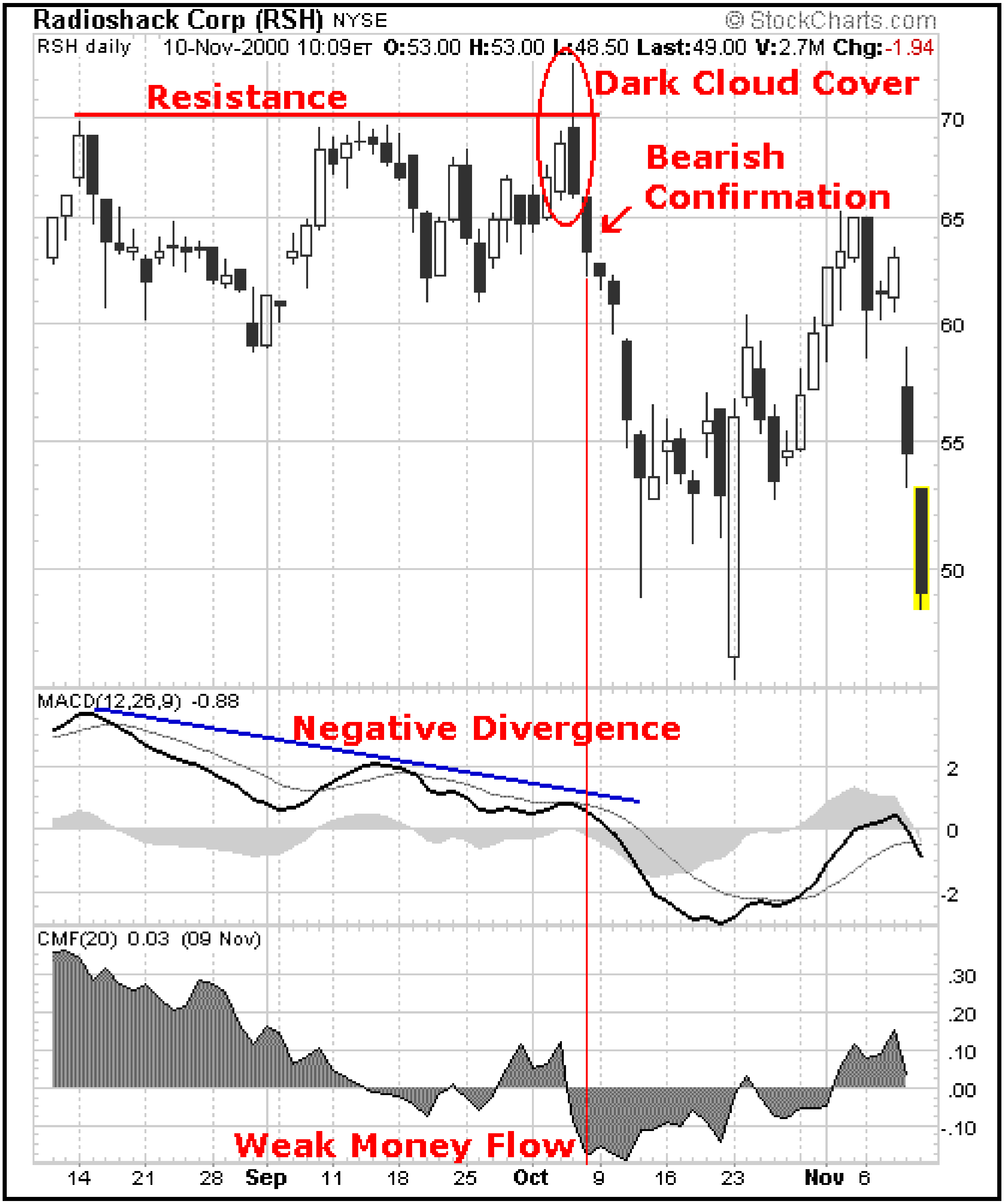
Resistance: Look for bearish reversals near resistance levels to increase robustness. Resistance levels can be determined using moving averages, previous reaction highs or trendlines.

In Jan-00, Nike (NKE) gapped up over 5 points and closed above 50. A candlestick with a long upper shadow formed and the stock subsequently traded down to 45. This established a resistance level around 53. After an advance back to resistance at 53, the stock formed a bearish engulfing pattern (red oval). Bearish confirmation came when the stock declined the next day, gapped down below 50 and broke its short-term trendline two days later.

Momentum: Use oscillators to confirm weakening momentum with bearish reversals. Negative divergences in MACD, PPO, Stochastics, RSI, StochRSI or Williams %R indicate weakening momentum and can increase the robustness of a bearish reversal pattern. In addition, bearish moving average crossovers in the PPO and MACD can provide confirmation, as well as trigger line crossovers for the Slow Stochastic Oscillator.

Money Flows: Use volume-based indicators to assess selling pressure and confirm reversals. On Balance Volume (OBV), Chaikin Money Flow and the Accumulation/Distribution Line can be used to spot negative divergences or simply excessive selling pressure. Signs of increased selling pressure can improve the robustness of a bearish reversal pattern.

For those that want to take it one step further, all three aspects could be combined for the ultimate signal. Look for a bearish candlestick reversal in securities trading near resistance with weakening momentum and signs of increased selling pressure. Such signals would be relatively rare, but could offer above-average profit potential.



A number of signals came together for RadioShack (RSH) in early Oct-00. The stock traded up to resistance at 70 for the third time in two months and formed a dark cloud cover pattern (red oval). In addition, the long black candlestick had a long upper shadow to indicate an intraday reversal. Bearish confirmation came the next day with a sharp decline. The negative divergence in the PPO and extremely weak money flows also provided further bearish confirmation.

Written by Arthur Hill

Part 1 | Part 2

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