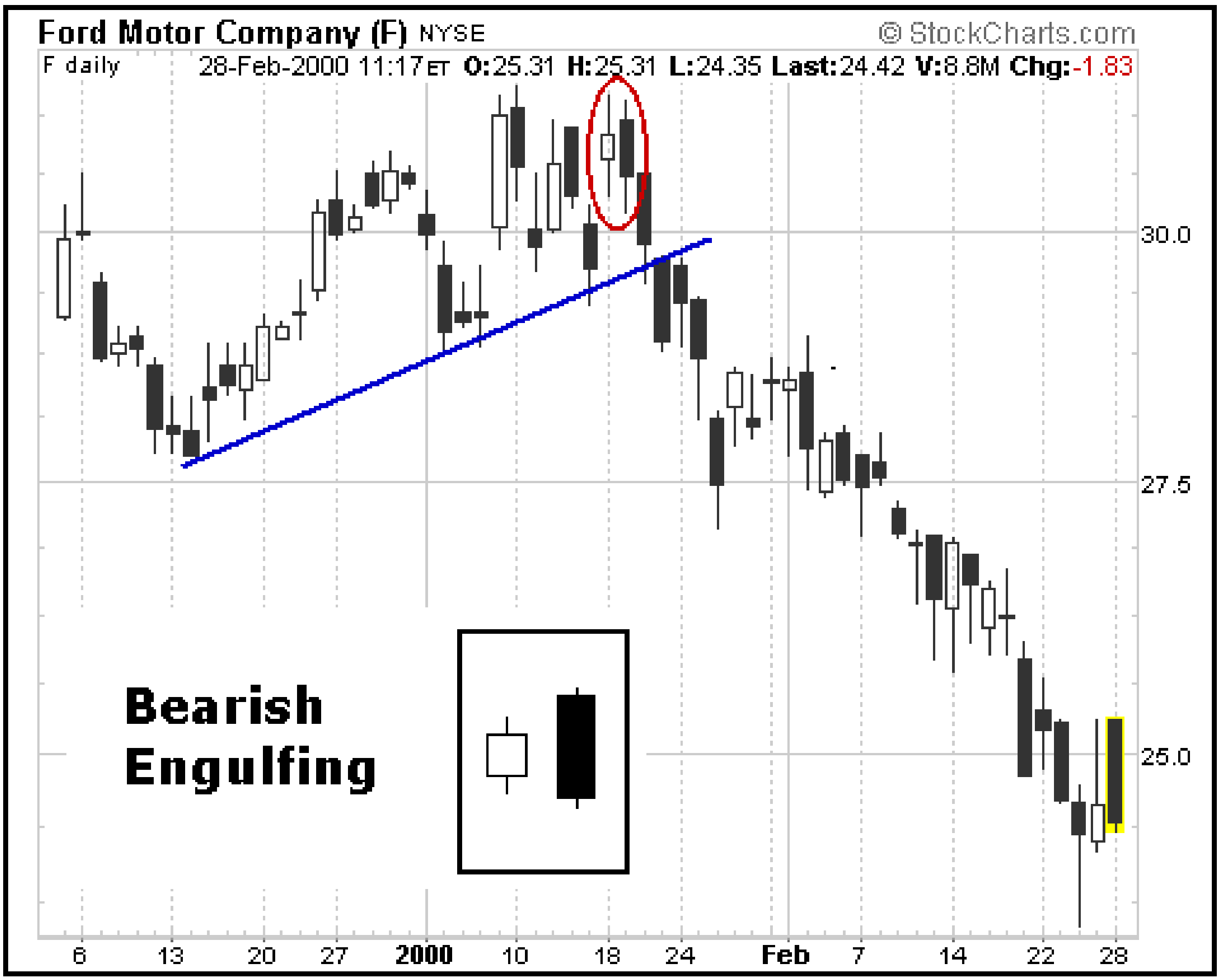
Candlestick Bearish Reversals Part 2

Bearish Engulfing

The bearish engulfing pattern consists of two candlesticks; the first is white and the second black. The size of the white candlestick is not that important, but should not be a doji, which would be relatively easy to engulf. The second should be a long black candlestick. The bigger it is, the more bearish the reversal. The black body must totally engulf the body of the first, white, candlestick. Ideally, the black body should engulf the shadows as well, but this is not a requirement. Shadows are permitted, but they are usually small or nonexistent on both candlesticks.

After an advance, the second black candlestick begins to form when residual buying pressure causes the security to open above the previous close. However, sellers step in after this opening gap up and begin to drive prices down. By the end of the session, selling becomes so intense that prices move below the previous close. The resulting candlestick engulfs the previous day's body and creates a potential short-term reversal. Further weakness is required for bearish confirmation of this reversal pattern.



After meeting resistance around 35 in mid-January, Ford (F) formed a bearish engulfing (red oval). The pattern was immediately confirmed with a decline and subsequent support break.

Dark Cloud Cover

The dark cloud cover pattern is made up of two candlesticks; the first is white and the second black. Both candlesticks should have fairly large bodies and the shadows are usually small or nonexistent, though not necessarily. The black candlestick must open above the previous close and close below the midpoint of the white candlestick's body. A close above the midpoint might qualify as a reversal, but would not be considered as bearish.

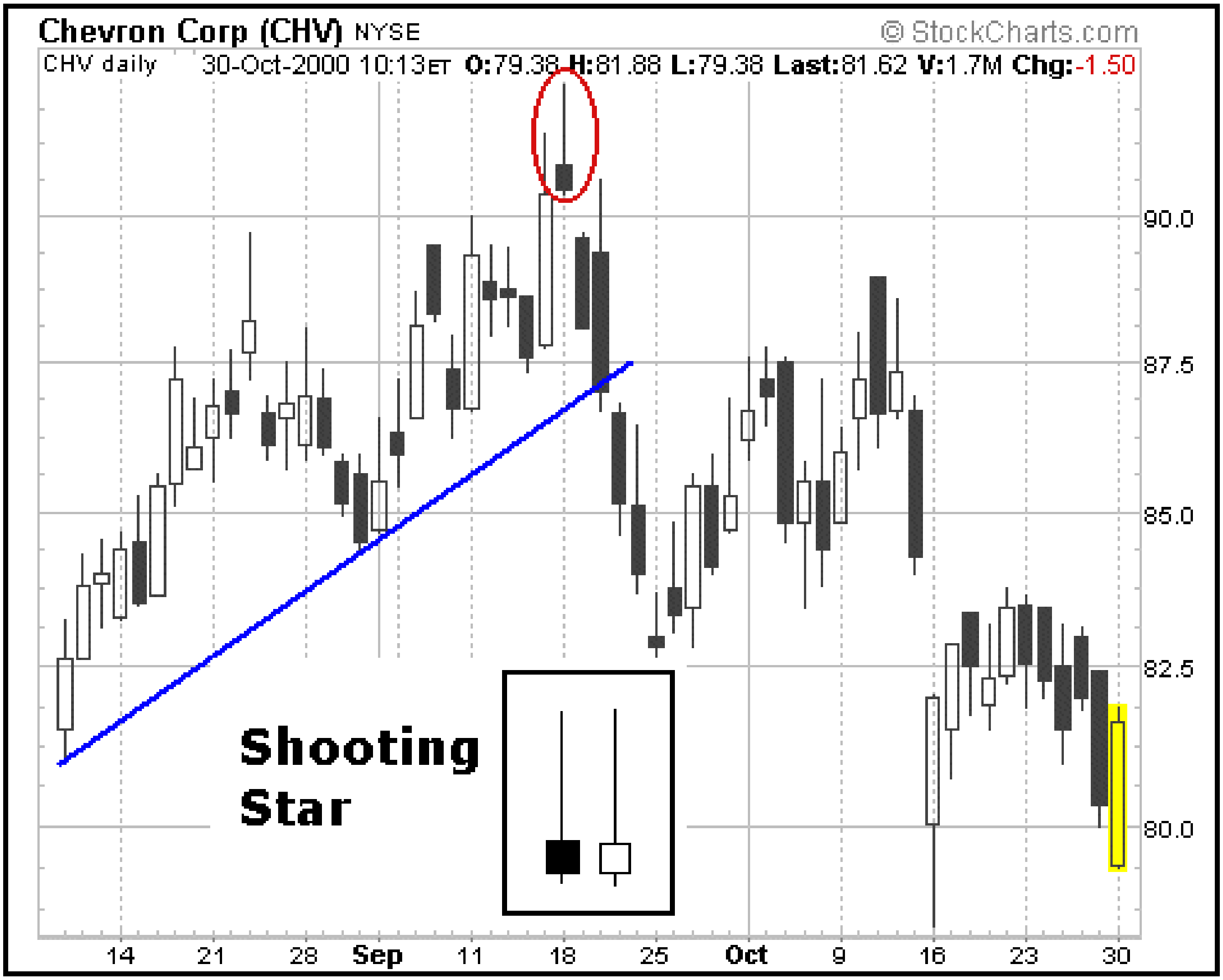
Just as with the bearish engulfing pattern, residual buying pressure forces prices higher on the open, creating an opening gap above the white candlestick's body. However, sellers step in after the strong open and push prices lower. The intensity of the selling drives prices below the midpoint of the white candlestick's body. Further weakness is required for bearish confirmation of this reversal pattern.

After a sharp advance from 37 1/2 to 45 in about 2 weeks, Citigroup (C) formed a dark cloud cover pattern (red oval). This pattern was confirmed with two long black candlesticks and marked an abrupt reversal around 45.

Shooting Star

The shooting star is made up of one candlestick (white or black) with a small body, long upper shadow and small or nonexistent lower shadow. The size of the upper shadow should be a least twice the length of the body and the high/low range should be relatively large. Large is a relative term and the high/low range should be large relative to the range over the last 10-20 days.

For a candlestick to be in star position, it must gap way from the previous candlestick. In Candlestick Charting Explained, Greg Morris indicates that a shooting star should gap up from the preceding candlestick. However, in Beyond Candlesticks, Steve Nison provides a shooting star example that forms below the previous close. There should be room to maneuver, especially when dealing with stocks and indices, which often open near the previous close. A gap up would definitely enhance the robustness of a shooting star, but the essence of the reversal should not be lost without the gap.



After an advance that was punctuated by a long white candlestick, Chevron (CHV) formed a shooting star candlestick above 90 (red oval). The bearish reversal pattern was confirmed with a gap down the following day

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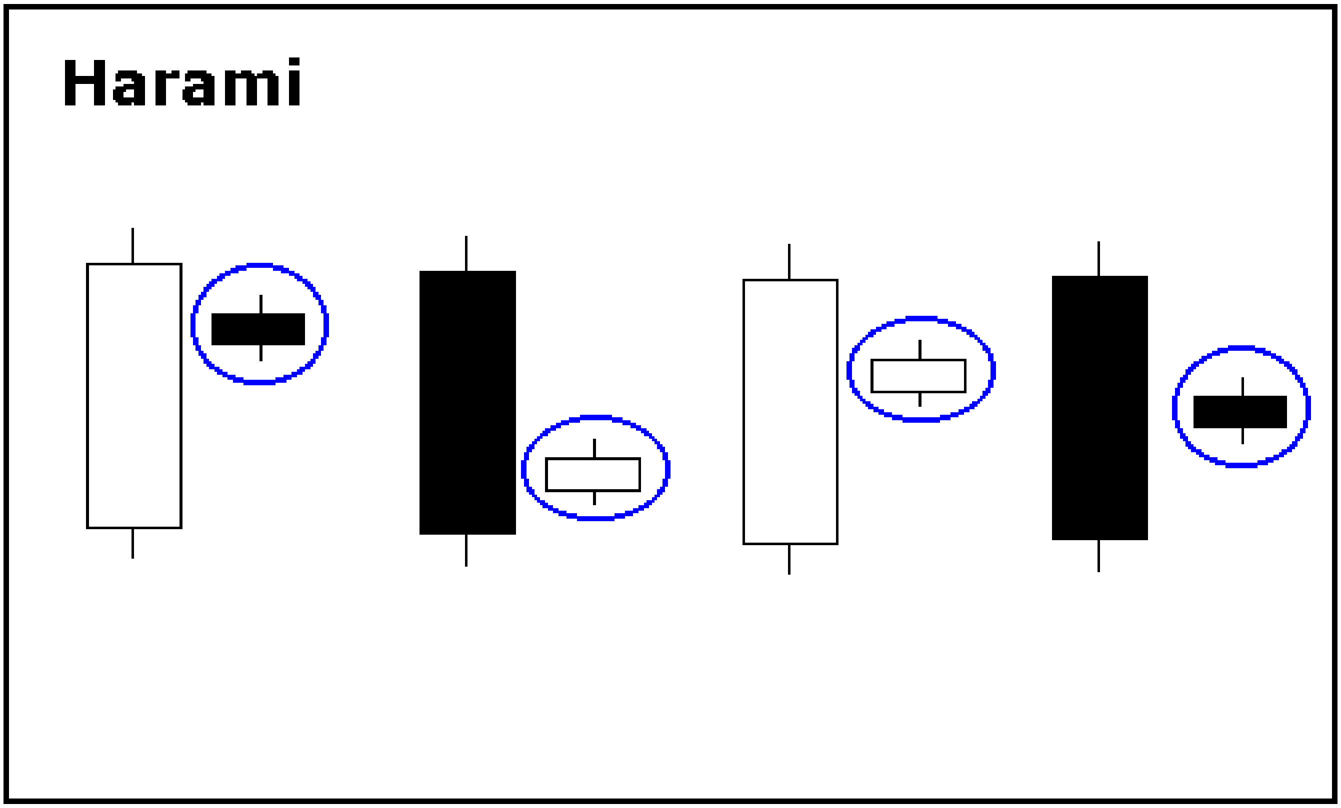
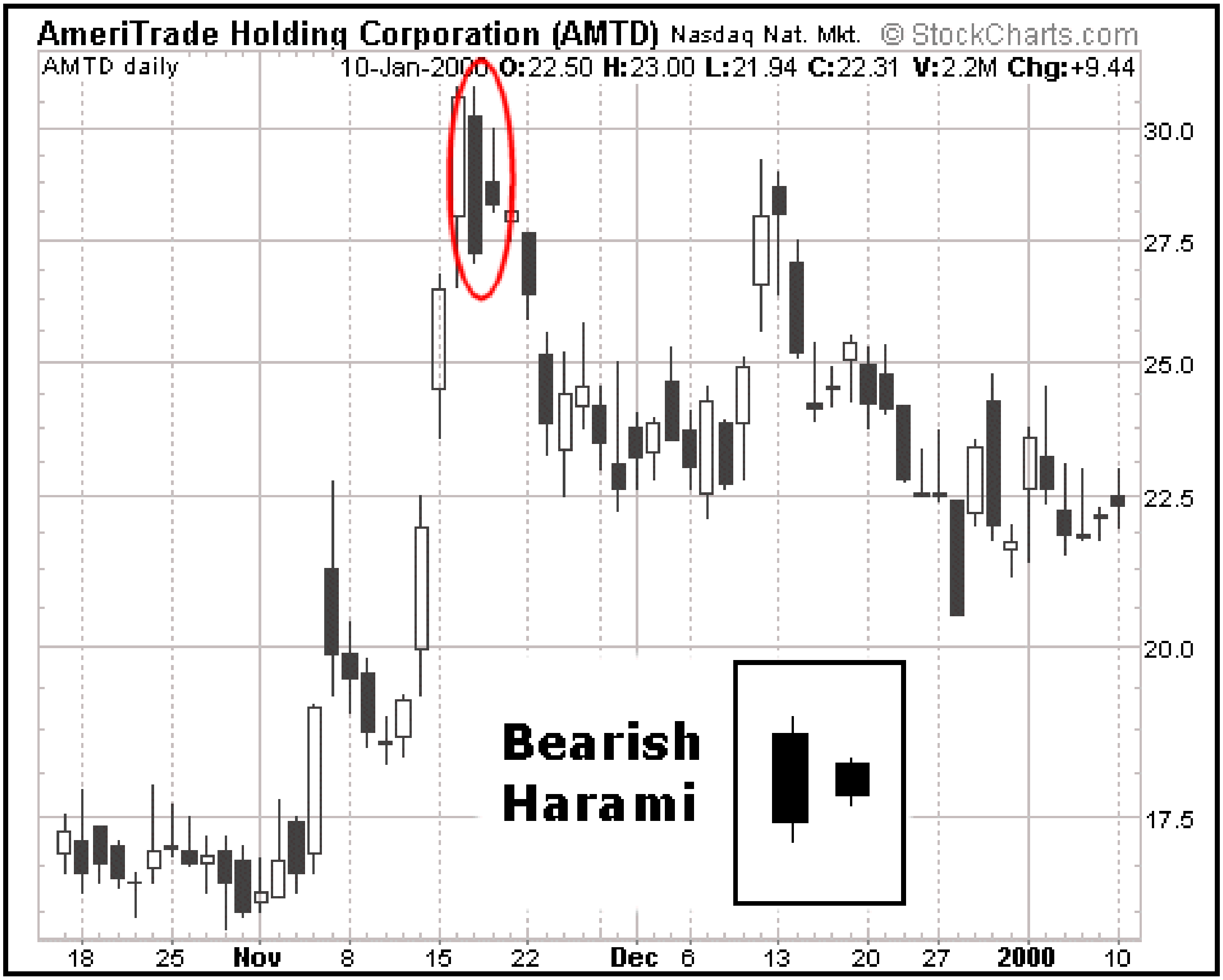
Bearish Harami

The bearish harami is made up of two candlesticks. The first has a large body and the second a small body that is totally encompassed by the first. There are four possible combinations: white/white, white/black, black/white and black/black. Whether a bullish reversal or bearish reversal pattern, all harami look the same. Their bullish or bearish nature depends on the preceding trend. Harami are considered potential bearish reversals after an advance and potential bullish reversals after a decline. No matter what the color of the first candlestick, the smaller the body of the second candlestick is, the more likely the reversal. If the small candlestick is a doji, the chances of a reversal increase.

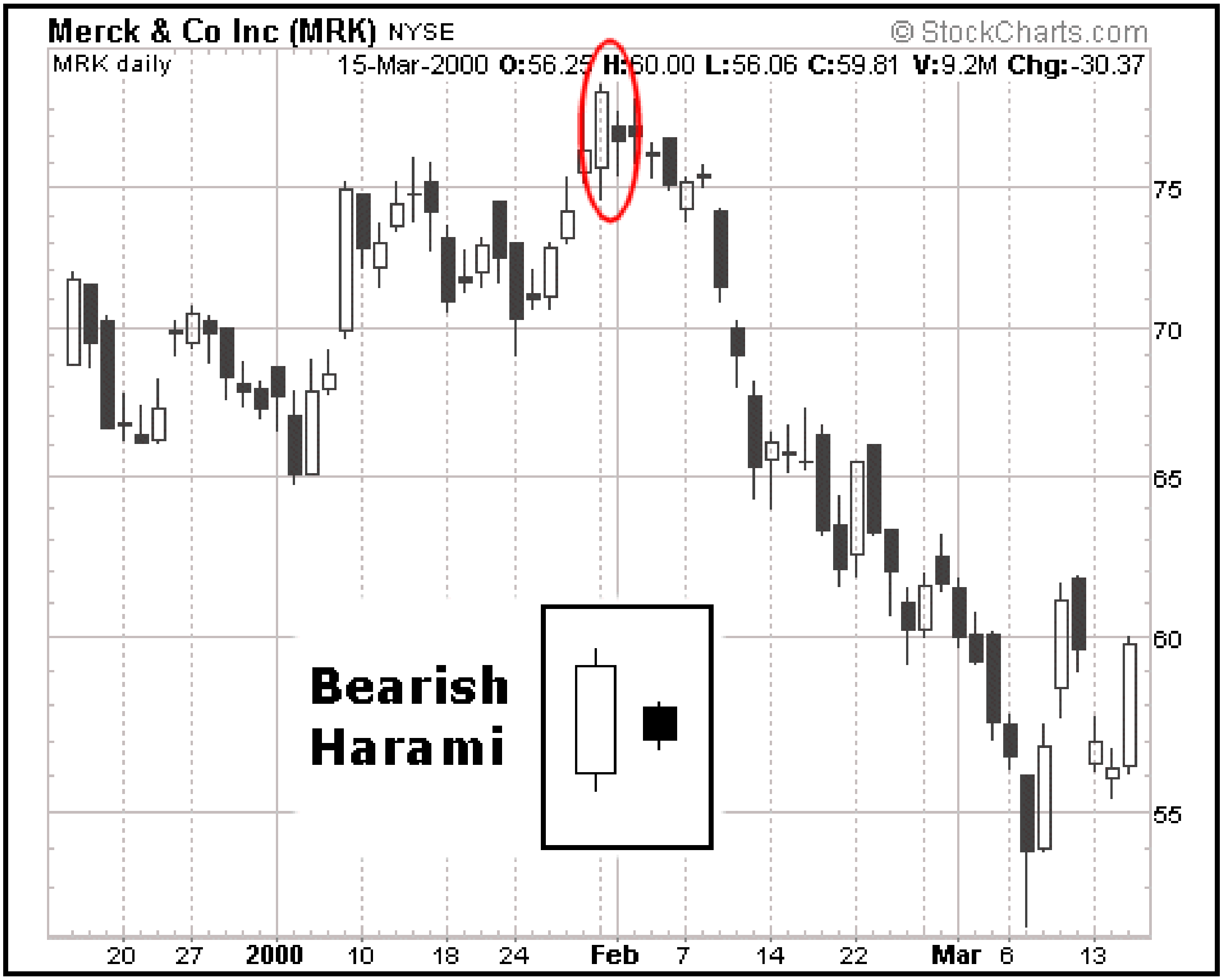


In his book, Beyond Candlesticks, Steve Nison asserts that any combination of colors can form a harami, but the most bearish are those that form with a black/white or black/black combination. Because the first candlestick has a large body, it implies that the bearish reversal pattern would be stronger if this body were black. This would indicate a sudden and sustained increase in selling pressure. The small candlestick afterwards indicates consolidation before continuation. After an advance, black/white or black/black bearish harami are not as common as white/black or white/white variations.

A white/black or white/white combination can still be regarded as a bearish harami and signal a potential reversal. The first long white candlestick forms in the direction of the trend. It signals that significant buying pressure remains, but could also indicate excessive bullishness. Immediately following, the small candlestick forms with a gap down on the open, indicating a sudden shift towards the sellers and a potential reversal.



After a gap up and rapid advance to 30, Ameritrade (AMTD) formed a bearish harami (red oval). This harami consists of a long black candlestick and a small black candlestick. The decline two days later confirmed the bearish harami and the stock fell to the low twenties.



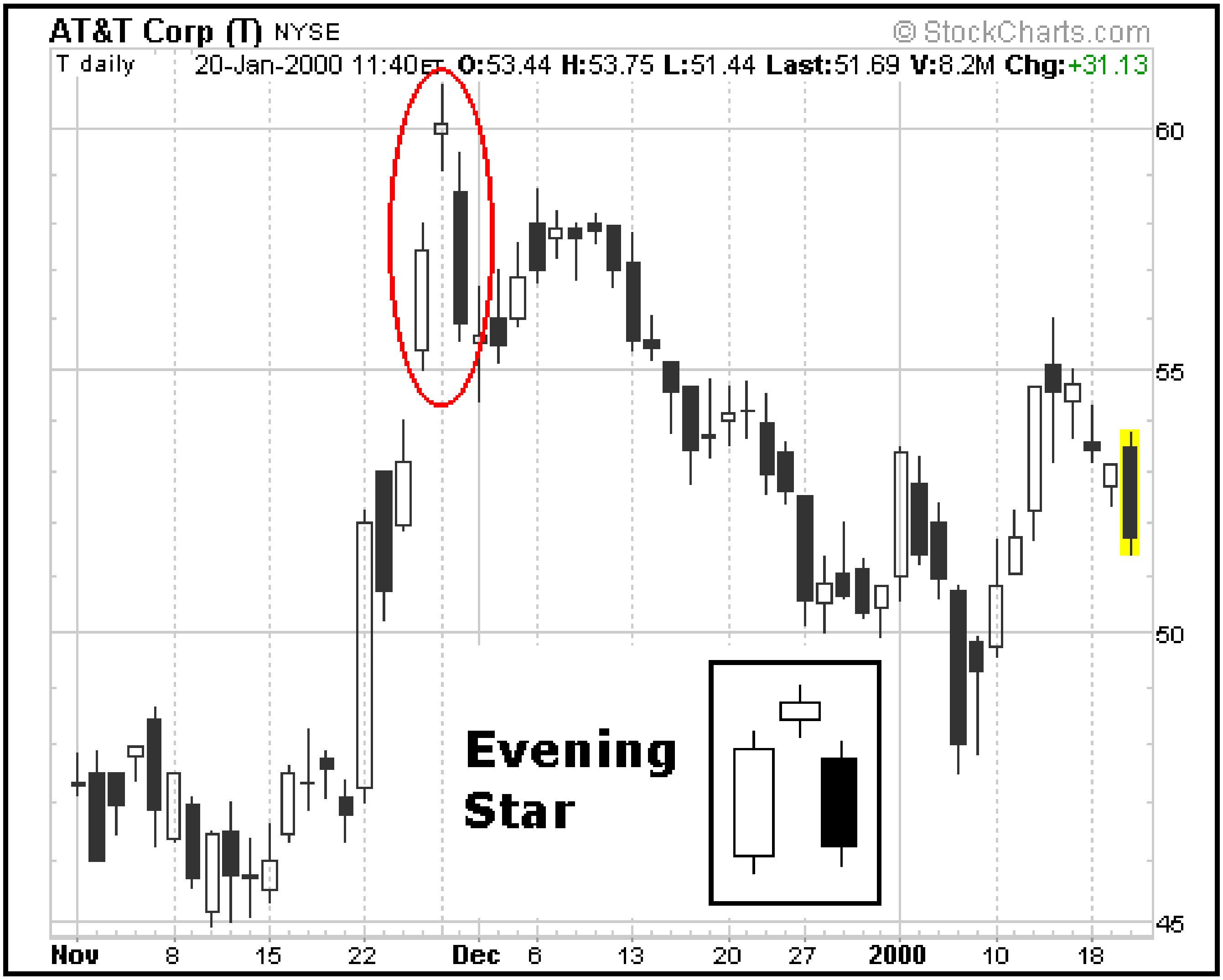
Merck (MRK) formed a bearish harami with a long white candlestick and long black candlestick (red oval). The long white candlestick confirmed the direction of the current trend. However, the stock gapped down the next day and traded in a narrow range. The decline three days later confirmed the pattern as bearish.

Evening Star

The evening star consists of three candlesticks:

1. A long white candlestick.
2. A small white or black candlestick that gaps above the close (body) of the previous candlestick. This candlestick can also be a doji, in which case the pattern would be a evening doji star.
3. A long black candlestick.

The long white candlestick confirms that buying pressure remains strong and the trend is up. When the second candlestick gaps up, it provides further evidence of residual buying pressure. However, the advance ceases or slows significantly after the gap and a small candlestick forms, indicating indecision and a possible reversal of trend. If the small candlestick is a doji, the chances of a reversal increase. The third long black candlestick provides bearish confirmation of the reversal.



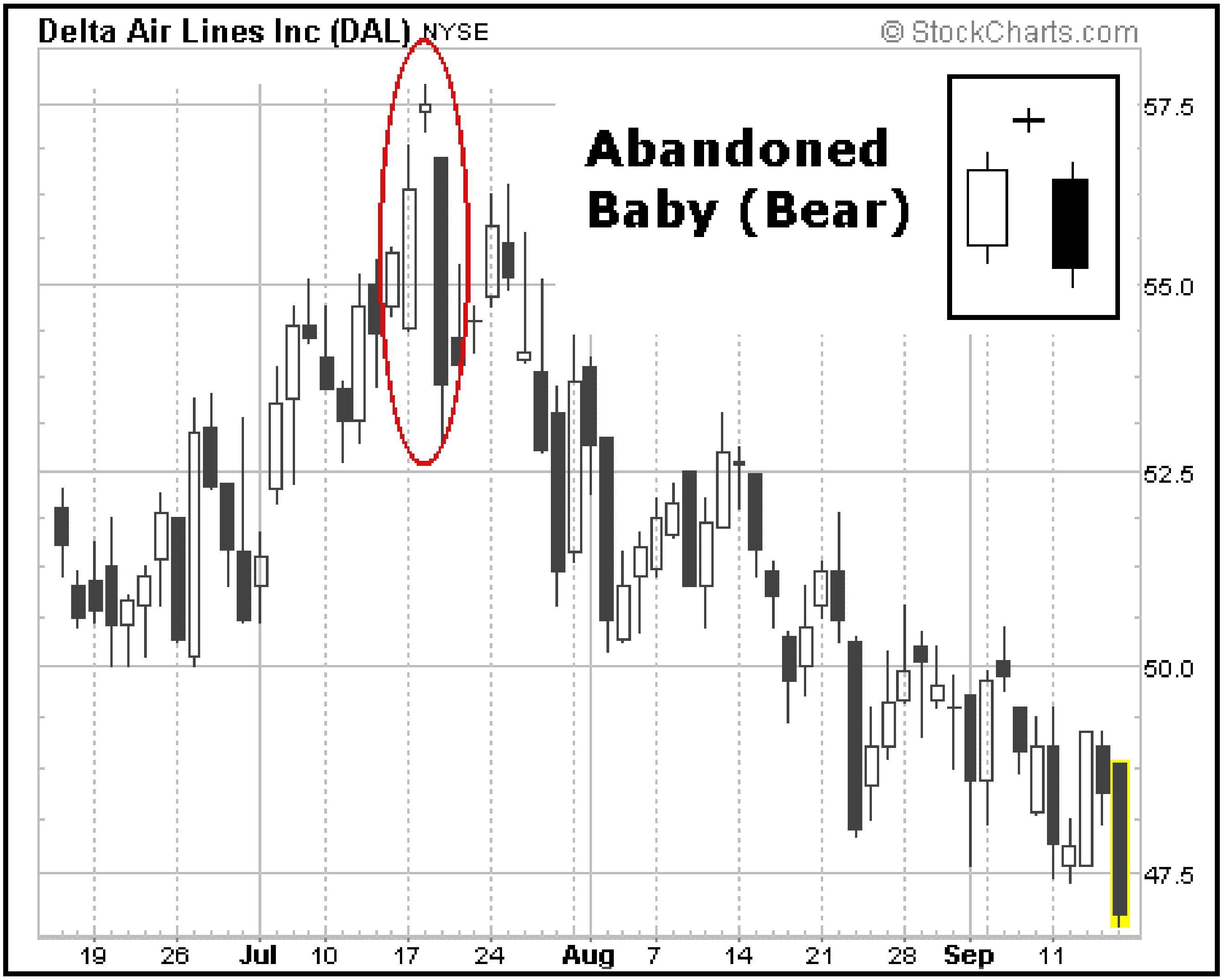
After advancing from 45 to 60 in about two weeks, AT&T (T) formed an evening star (red oval). The middle candlestick is a spinning top, which indicates indecision and possible reversal. The gap above 60 was reversed immediately with a long black candlestick. Even though the stock stabilized in the next few days, it never exceeded the top of the long black candlestick and subsequently fell below 50.

Bearish Abandoned Baby

The bearish abandoned baby resembles the evening doji star and also consists of three candlesticks:

1. A long white candlestick.
2. A doji that gaps above the high of the previous candlestick.
3. A long black candlestick that gaps below the low of the doji.

The main difference between the evening doji star and the bearish abandoned baby are the gaps on either side of the doji. The first gap up signals a continuation of the uptrend and confirms strong buying pressure. However, buying pressure subsides after the gap up and the security closes at or near the open, creating a doji. Following the doji, the gap down and long black candlestick indicate strong and sustained selling pressure to complete the reversal. Further bearish confirmation is not required.



Delta (DAL) formed an abandoned baby to mark a sharp reversal that carried the stock from 57 1/2 to 47 1/2. Although the open and close are not exactly equal, the small white candlestick in the middle captures the essence of a doji. Indecision is reflected with the small body and equal upper and lower shadows. In addition, the middle candlestick is separated by gaps on either side, which add emphasis to the reversal.

Written by Arthur Hill

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