Candlestick Bullish Reversals Part 1

There are dozens of bullish reversal candlestick patterns. I have elected to narrow the field by selecting the most popular for detailed explanations. Below are some of the key bullish reversal patterns with the number of candlesticks required in parentheses.

- Bullish Engulfing (2)
- Piercing Pattern (2)
- Bullish Harami (2)
- Hammer (1)
- Inverted Hammer (1)
- Morning Star (3)
- Bullish Abandoned Baby (3)

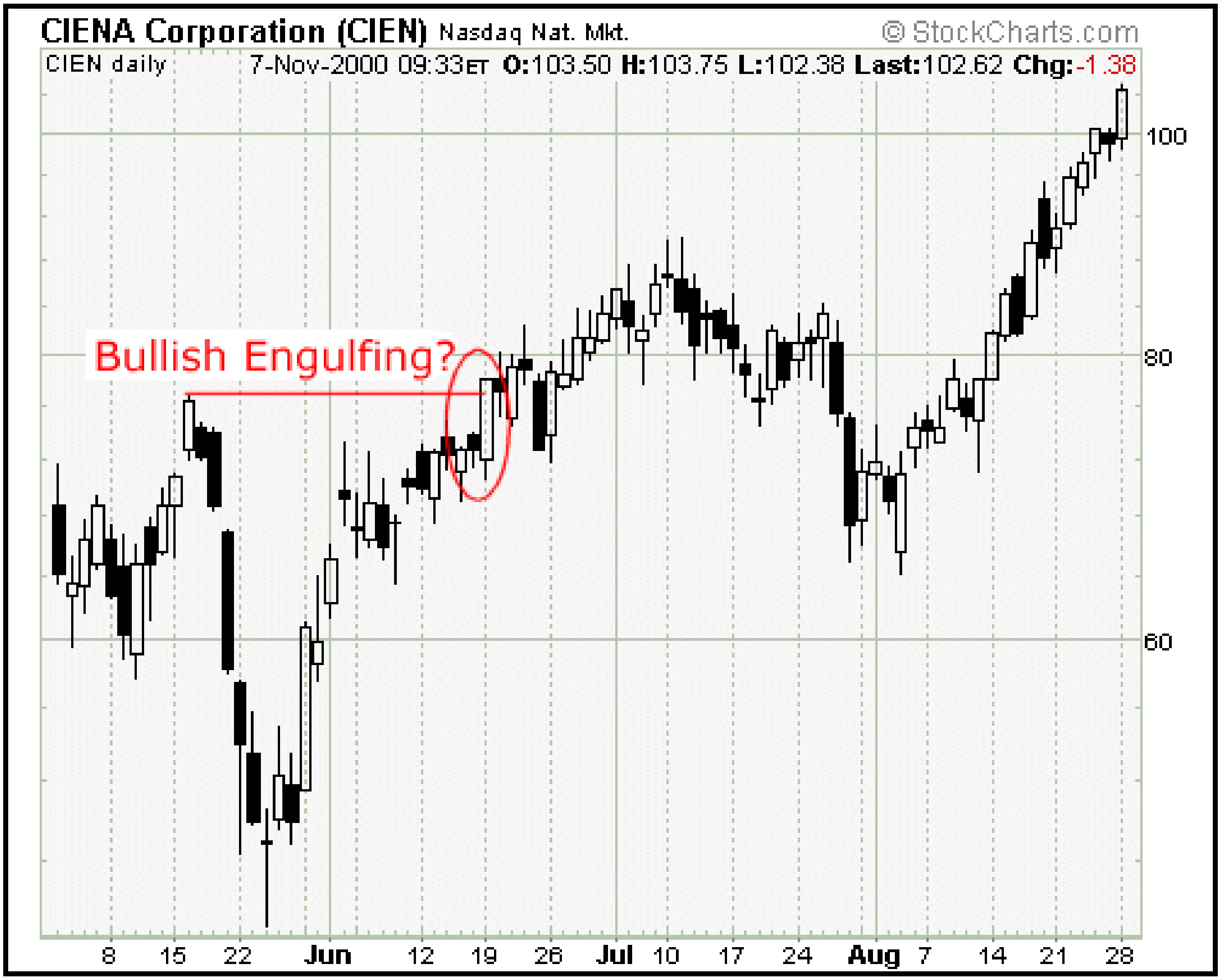
The hammer and inverted hammer were covered in Introduction to Candlesticks Part 4. This article will focus on the other six patterns. For a complete list of bullish (and bearish) reversal patterns, see Greg Morris' book, Candlestick Charting Explained.

Before moving on to individual patterns, certain guidelines should be established:

- Most patterns require bullish confirmation.
- Bullish reversal patterns should form within a downtrend.
- Other aspects of technical analysis should be used as well.

Bullish Confirmation
Patterns can form with one or more candlesticks; most require bullish confirmation. The actual reversal indicates that buyers overcame prior selling pressure, but it remains unclear whether new buyers will bid prices higher. Without confirmation, these patterns would be considered neutral and merely indicate a potential support level at best. Bullish confirmation means further upside followthrough and can come as a gap up, long white candlestick or high volume advance. Because candlestick patterns are short-term and usually effective for only 1 or 2 weeks, bullish confirmation should come within 1 to 3 days after the pattern.

Existing Downtrend
To be considered a bullish reversal, there should be an existing downtrend to reverse. A bullish engulfing at new highs can hardly be considered a bullish reversal pattern. Such formations would indicate continued buying pressure and could be considered a continuation pattern. In the Ciena example below, the pattern in the red oval looks like a bullish engulfing, but formed near resistance after about a 30 point advance. The pattern does show strength, but is more likely a continuation at this point than a reversal pattern.



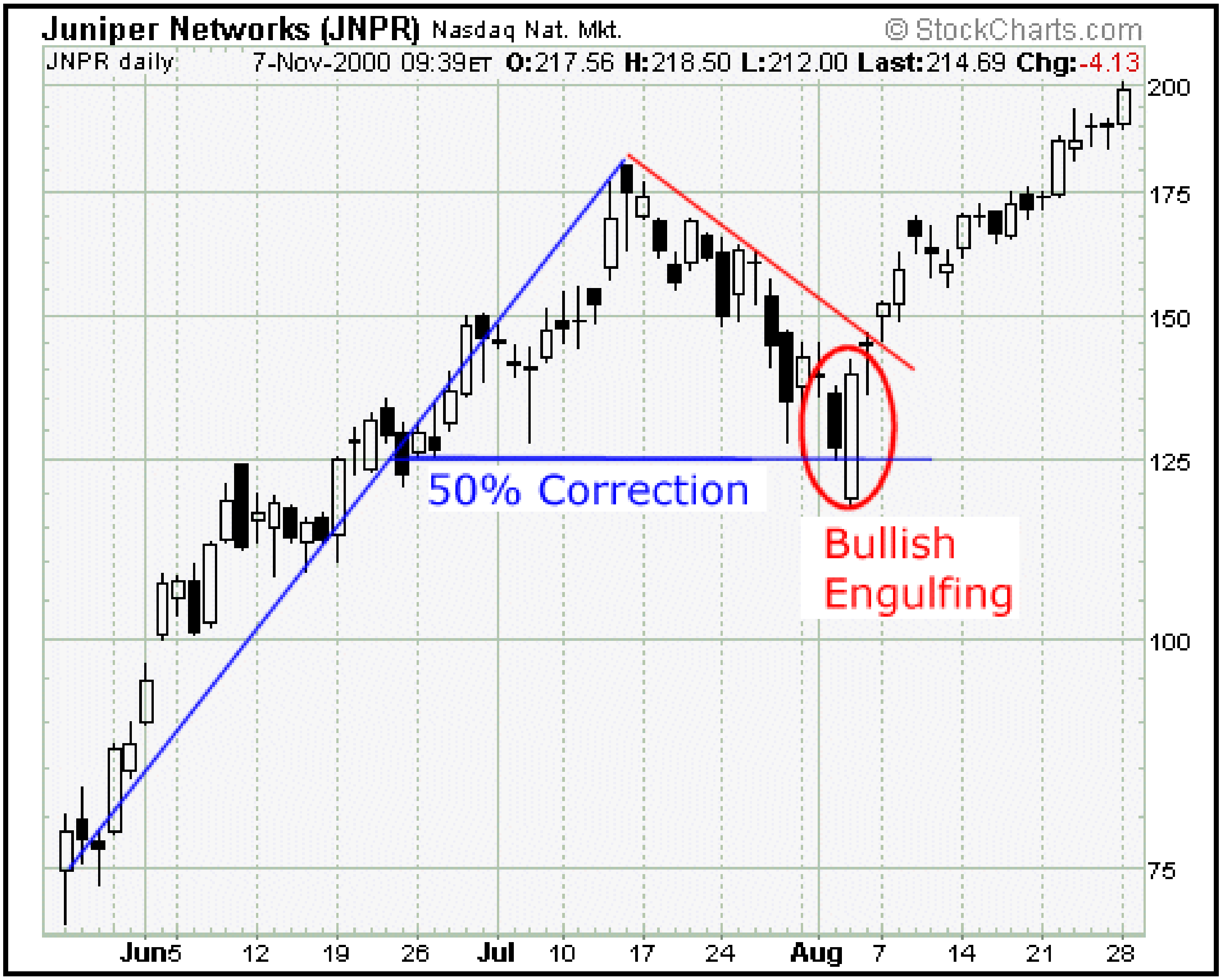
The existence of a downtrend can be determined by using moving averages, peak/trough analysis or trendlines. A security could be deemed in a downtrend based on one of the following:

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

These are just examples of possible guidelines to determine a downtrend. Some traders may prefer shorter downtrends and consider securities below the 10-day EMA. Defining criteria will depend on your trading style 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 reversal robustness. Below are three ideas on how traditional technical analysis might be combined with candlestick analysis.

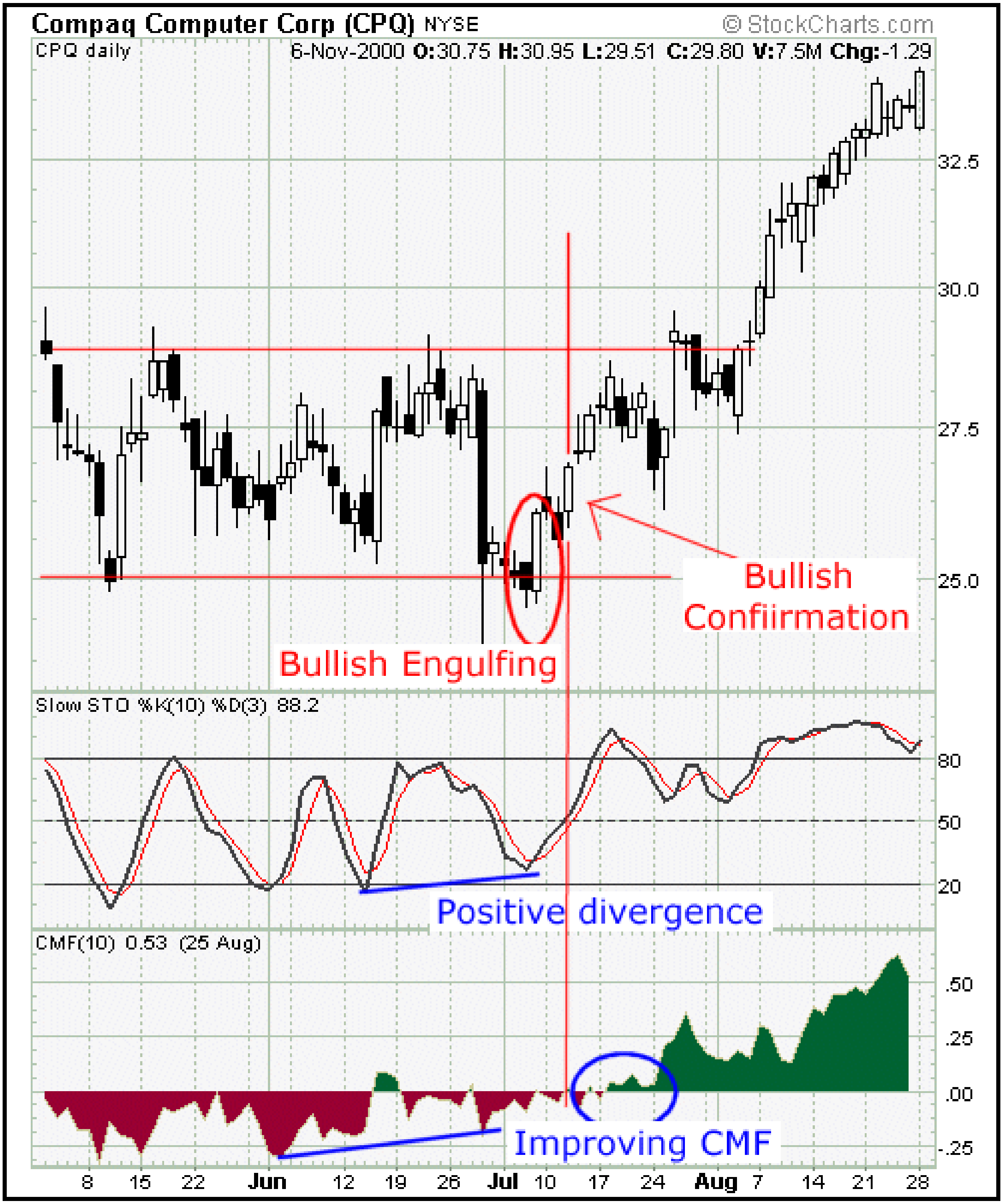
1. Support: Look for bullish reversals at support levels to increase robustness. Support levels can be identified with moving averages, previous reaction lows, trendlines or Fibonacci retracements.



Juniper Networks (JNPR) advanced from 75 to 175 in less than two months. The stock retraced about 50% of this 100 point advance and formed a large bullish engulfing pattern around 125. This pattern was confirmed with two subsequent advances above the down trendline.

2. Momentum: Use oscillators to confirm improving momentum with bullish reversals. Positive divergences in MACD, PPO, Stochastics, RSI, StochRSI or Williams %R would indicate improving momentum and increase the robustness behind a bullish reversal pattern.
3. Money Flows: Use volume-based indicators to access buying and selling pressure. On Balance Volume (OBV), Chaikin Money Flow (CMF) and the Accumulation/Distribution Line can be used in conjunction with candlesticks. Strength in any of these would increase the robustness of a reversal.

For those that want to take it one step further, all three aspects could be combined for the ultimate signal. Look for bullish candlestick reversal in securities trading near support with positive divergences and signs of buying pressure.



A number of signals came together for Compaq (CPQ) in early July. After a steep decline in late June, the stock formed a series of spinning tops near support at 25. A bullish engulfing pattern formed in early July and this was confirmed three days later with a strong advance above 27. The 10-day Slow Stochastic Oscillator formed a positive divergence and moved above its trigger line just before the stock advanced above 27. Although not in the green yet, CMF showed constant improvement and moved into positive territory a week later.

Written by Arthur Hill

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