

Part III

Making the Most of Complex Patterns

The 5th Wave

By Rich Tennant



"I was so into my charts that one day she came in and told me she was running away with the pool boy. Now there's a trend I didn't see coming."

In this part . . .

Rome wasn't built in a day, or even two, and many candlestick patterns share that construction schedule. Some of the most useful and interesting candlestick patterns take three days to form. I call these complex patterns, and I cover them throughout Part III with explanations of how you can spot the patterns and use them to inform your buying and selling decisions. To close the part, check out the explanations of a few technical indicators, which can complement your candlestick charts and enhance your results.

Chapter 9

Getting the Hang of Bullish Three-Stick Patterns

In This Chapter

- ▶ Three-day patterns that signal the end of a downtrend
 - ▶ Predicting an uptrend continuation using three-day patterns
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The addition of three-stick candlestick patterns to your trading arsenal makes your trading strategies more complicated, more interesting, and hopefully, more profitable. In this chapter, I cover some of the bullish three-stick patterns that you can use to make effective and efficient trades.

The three-stick patterns are a little more of a challenge than their one- and two-stick counterparts because there are several rules that each must follow in order to emerge as a valid signal. Three-stick patterns can also be a bit frustrating. You may watch the first two days of your favorite (and most reliable) pattern begin to emerge only to see it fizzle out on the third day. But if you're up to the challenge and willing to deal with the occasional annoyance, these patterns can be valuable tools when trying to predict trend reversals or confirm that a current trend is going to stay in place.

Understanding Bullish Three-Stick Trend Reversal Patterns

The three-stick patterns in this section offer you a heads-up when a downtrend is about to switch gears and turn into an uptrend. Many of these three-stick patterns exist, and in the pages that follow I cover many of the most common ones. With three days needed to complete each pattern, you have time to watch as the patterns shape up, and you should be focused in when the third day rolls around, and you've noticed some interesting developments during the two preceding days.



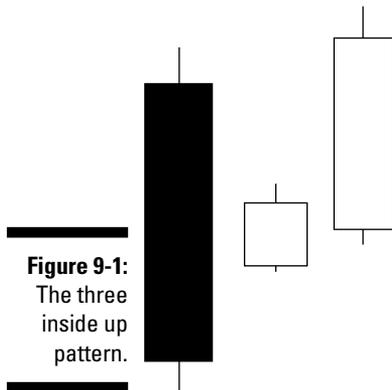
When working with three-day patterns, be prepared by closely monitoring days that follow two days of promising price action. If a pattern is completed as you'd hoped, you need to be ready to put on the appropriate trade and stop order near the close of the day on which the pattern is completed.

The three inside up pattern

The three inside up pattern is a good place to begin my discussion of the bullish three-stick patterns that can let you know when a downtrend is about to be reversed. This pattern is a straightforward pattern that you can recognize with just a little practice.

Identifying the three inside up pattern

The three inside up pattern has a peculiar name, but a quick look at Figure 9-1 should give you a good idea of where the name originated. The *three* part comes from there being three days involved in creating the pattern. There are three sticks, and the second day is an inside day relative to the first day, which is a long down day. The final day is an up day that closes higher than the open of the first day.



The trading activity that results in a three inside up pattern involves a gradual shift of power from the bears to the bulls. I like this pattern and the way it develops because it usually gives a trader time to put on a trade before too much of the reversal has occurred. Traders can always buy high with the intention of selling higher, but it's nice when buying high doesn't mean they're buying *too* high.

Making effective trades using the three inside up pattern

The chart in Figure 9-2 gives you a very good idea of how the three inside up pattern can tip you off as to when to buy in advance of a forthcoming uptrend. It's a chart of the futures contracts that trade based on the ten-year Treasury bonds issued by the U.S. government. It's one of the most actively traded futures contracts, and it's a very economically sensitive security.

This chart shows an extended downtrend in the price of the ten-year futures. There have been a couple of attempts to change the course of the trend, and before the pattern arrives, it appears that the downtrend has been moderating. I include a couple of trendlines on the chart as an illustration.



If you're looking for trend reversal patterns, a good sign is when you see that the prevailing trend is starting to moderate. When you spot a moderating trend, be sure to keep your eyes peeled for a candlestick pattern indicating that a trend reversal is on the way.

The first day of the three inside up pattern in Figure 9-2 is a long black candle, which is followed by a slight up day that's an inside day relative to the first day. The third and final day is a strong up day that closes above the open of the first day of the pattern and completes the bullish signal. Then it's off to the races, and the trend starts shooting upward.

Are you wondering where you may place a wise sell stop order when you're working with the three inside up pattern? If so, good question. You have several choices. In most cases, I use the open or low of the second day. If those levels are violated, I regard the pattern as invalid. You can also use the open or low of the third day; both are viable alternatives.

Figure 9-2:
The three inside up pattern offers a useful buy signal on a chart of ten-year U.S. Treasury bond futures.





Avoid using the first day, because if the security breaks through the lows of the first two days, then there's a good chance that the first day levels are going to be tested if not violated. Wouldn't you rather be out of the long trade before this occurs?

The three inside up pattern not working out too well

This section gives you an example of what can happen when a three inside up pattern fails. Take a look at Figure 9-3, where you can see a three inside up pattern that appears in a downtrend but doesn't signal a trend reversal. It's a chart of the futures contracts that trade based on the level of the Australian dollar versus the U.S. dollar. This isn't the most liquid of currency futures pairs, but it's still active enough to make money on both the long and short side.

The first day of the pattern in Figure 9-3 is a down day, and the second day shows a gap up but doesn't have a low that violates the low of the first day. The second day's close is also higher than its open, but the second day's close stays between the open and close of the first day. And if you're thinking that the second day is an inside day, you're absolutely right! Finally, the third day is also an up day — a long white bar — with an open that's higher than the open of the second day. So where does the pattern go wrong?

The day after the pattern is the culprit. On that day, a long black candle violates anything a savvy trader considers a support level, and that's all she wrote. Even though the pattern fails, the failure day can be a blessing for buyers who have solid stops in place, because that little bit of failure (and the subsequent stop-induced end of the trade) would save them from the effects of a downtrend that continues for several days.

Figure 9-3:
The three inside up pattern fails on the Australian dollar future contracts.



The three outside up pattern

The three outside up pattern is another relatively simple three-stick reversal pattern that you can pick up on with a little patience and a basic understanding of the necessary components. This section gives you the full scoop.

Spotting the three outside up pattern

Like all bullish reversal patterns, the three outside up should occur in the midst of a downtrend. Here is how the days play out:

- 1. Day one: The pattern's first day is actually a down day, but just a slight down day.**
- 2. Day two: The second day opens with a gap down from the first day, but prices don't stay down for long.**

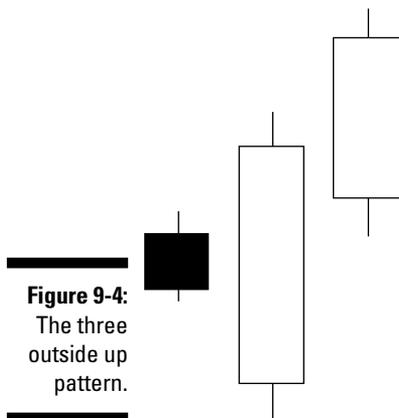
This day creates an “outside day” relative to the first day with the high being higher, the low being lower than the first day. Also, the open of the day is lower than the previous close, and the close of this second day is higher than the open of the first day.

The bulls take over at some point during the second day and push prices higher until the close is near the day's high. The second day is a long white bar, and it's an outside day relative to the first day. *Outside* means that the price action for the second day traded outside of the high and low of the first day.

- 3. Day three: The third day completes the pattern with another up day.**

On the third day it's clear that the bulls aren't done, and the day closes higher than the high of the second day. The trend has definitely turned, and it's headed up, up and away.

For a straightforward example of the three outside up pattern, see Figure 9-4.



Trading on the three outside up pattern

For a real-world example of the three outside up pattern, I use a chart of the stock for a company that helps its customers escape the real world. The chart is in Figure 9-5, and the company is Electronic Arts (ERTS), which produces some of the world's top video games. Its Madden Football games comprise its flagship series, and the company's stock is great on both the short and long side because it has many volatile moves based on the popularity of individual games and the platforms on which the games are played.

On the chart in Figure 9-5, ERTS stock appears to have found a bottom, and it looks like an uptrend is on the horizon. When you're working with three-day reversal patterns, try to buy at the beginning of a trend when prices are relatively low compared to recent history. The pattern plays out fairly well: The trend is down, and a down day — albeit not a very convincing one — occurs on the first day. It's followed by an outside up day, and then the third day is an up day that outpaces the bullishness of the second day.

The three outside up pattern comes before more bearishness instead of bullishness

The three outside up pattern is a thing of beauty, but Figure 9-6 shows you the pattern's potential for ugliness when it goes bad. The chart is for Hewlett Packard (HPQ). The pattern shows up in a downtrend, and the first day is indeed a down day. The second day is an up day, and it's an outside day relative to the first day. Very promising! Then, to top it all off, the pattern is completed with an up day on the third day that exhibits some bullish behavior.

Figure 9-5:
The three outside up pattern makes for a winning trading scenario on a chart of ERTS.



Figure 9-6:
The three
outside up
pattern fails
on a chart
of HPQ.



But the bullishness isn't meant to last. On the very next trading day after the pattern appears, the stock never even gets over the previous day's closing price. The gap is quickly filled, and then in a few days anything that may be considered a support level is compromised. Easy come, easy go.

The three white soldiers pattern

The three white soldiers pattern includes three bullish candles in a row. If the pattern occurs with a downtrend in front of it, you can consider it a possible signal that the bulls have had enough and are buying in force.

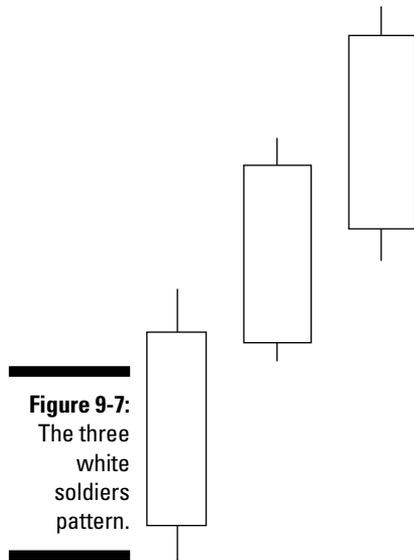


Although it's a nice indication to buy, a small drawback to the three white soldiers is the amount of ground that's already been covered at the completion of the pattern.

Recognizing the three white soldiers

To locate the three white soldiers on a chart, look for three consecutive up days that occur in a prevailing downtrend. Then look closer. If the open, high, low, and close of the second day are higher than those of the first day, and those four points are also higher on the third day than the second, then you're looking at the three white soldiers pattern. Make sense? Have a look at Figure 9-7 for a visual.

The price action behind these days is dramatic, and it normally indicates a quick shift from a downtrend to an uptrend. The three white soldiers mean that the bulls are in control for three straight days beginning with the open of the first day.



Using the three white soldiers to make a profitable trade

The example I use to show you how to make trades based on the three white soldiers pattern is near and dear to my heart. It's a chart of the futures contracts that trade on the level of the Euro, and I executed a successful trade based on this very pattern. Prior to spotting the pattern, I'd been looking for an indication that the downtrend was coming to an end, and so I was delighted to see the three white soldiers shown in Figure 9-8.

Figure 9-8:
A
successful
example of
the three
white
soldiers
pattern
on a Euro
futures
chart.



After such a dramatic move, there's sometimes an opportunity for a pullback (a small trend down from a higher level), but I bought the Euro futures very close to the closing price of the third day of the pattern. I had a plan in place to buy the Euro when it appeared the downtrend was coming to an end, so I was a little more aggressive than I needed to be. With a little patience I could've gotten a better price the next day, but I didn't want to risk missing the trade altogether — something that can sometimes feel worse to me than losing money.

I also highlight on the chart in Figure 9-8 where I chose to exit the position. The trend had been in place for a few weeks, and the long black candle broke the low of the two previous days. I'd been using a sell stop order and continued to move the stop higher as the futures contract price increased. My stop was in place at the low of the day that came two days before the long black candle because I felt this level would indicate the trend was starting to fade. I also kept an eye out for any problematic reversal formations, which you should also do if you find yourself in a similar situation.

Although I exited the trade before the trend reversed again, I was still very happy with this trade. I had a plan, executed it, and profited from it. Why can't all trades be as easy as this one?

The three white soldiers fail to signal bullishness

The three white soldiers is a pretty strong bullish trend reversal pattern, but like all other patterns, it does have the potential for failure. Figure 9-9 shows you what can happen when the three white soldiers doesn't fare so well in battle. It's a chart for the stock that represents ownership in Disney (DIS). I'm assuming that most people have some familiarity with Disney. With a three-year-old in the house, I'm more familiar with the company these days than I want to be.

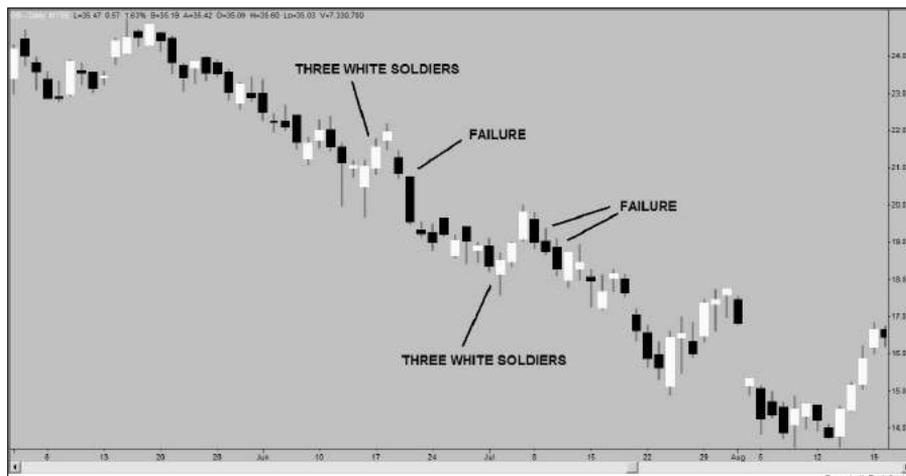


Figure 9-9:
The three
white
soldiers
pattern fails
on a chart
of DIS.

The three white soldiers pattern actually fails twice on the chart in Figure 9-9, and both failures are highlighted. If you see this situation developing and make the decision to trade on it, you'd be smart to place your initial sell stop at the low of the pattern's second day. Most traders cover a lot of ground before they put on a trade, so some retracing of the new uptrend should be expected. Placing a liberal sell stop allows for that.

The morning star and bullish doji star patterns

The morning star and bullish doji star are recognized as separate patterns, but because they have very similar characteristics, I've grouped them together in this section.

Identifying the morning star and bullish doji star

You can see basic examples of both the morning star and bullish doji star patterns in Figure 9-10. The only real difference between the two patterns is the second day. The second day of the bullish doji star is a true doji, while the second day of the morning star pattern is *almost* a doji.



The price action behind these two patterns is very similar. The first day for both patterns is a down day, which is to be expected in a bullish reversal pattern. The second day for both patterns starts with a gap opening, indicating that the bears are continuing to push down the price. Then the rest of the second day is made up of very tight price action between the open and close. The third day is very bullish, with prices rising to cover some or all the ground from the down day. When you spot one of these patterns in a downtrend, it usually means that the trend is ready to reverse.

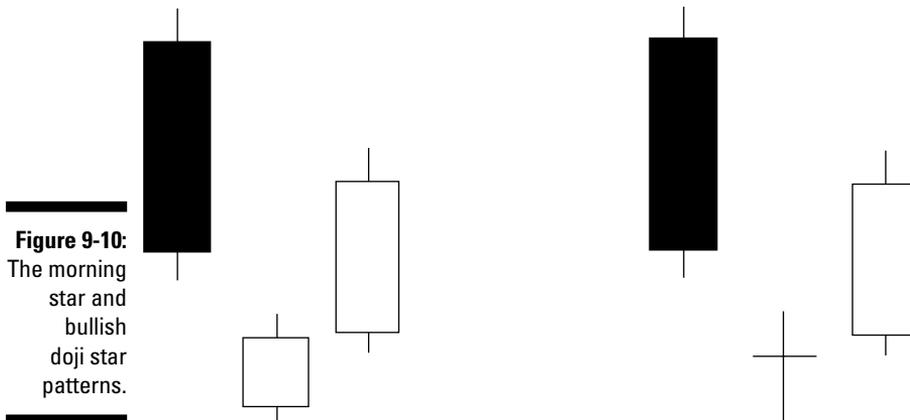


Figure 9-10:
The morning star and bullish doji star patterns.

Trading on the morning star and bullish doji star patterns

Figure 9-11 is a chart of the Euro futures, and it's a good example because the bullish doji star pattern in the chart indicates that the trend has reached the bottom. Keep in mind that the bullish doji star here could just as easily be a morning star pattern, and the result would be the same.

The days play out in the following pattern:

1. The first day of the pattern is actually the third of three bearish days.

Leading up to this pattern, the bears are ruling the price action.

2. The second day features a gap opening that's a little lower than the low of the first day, and the day ends up forming a doji after some back and forth between the bulls and bears.

The doji has pretty long legs, indicating an intense battle for price action during the day.

3. The third and final day of the pattern is a white candle, indicating that the bulls ruled the day.

It closes high and into some of the range covered by the first day. The two days after the pattern see a bit of bearish price action, but no significant support levels are violated, and then three days later the bulls really get rolling, and it's clear that an uptrend is in place. And what an uptrend it is!



To take advantage of this type of bullish doji star pattern (or a morning star pattern in the same situation), you should either try to buy near the end of the pattern, or possibly attempt to put on a long position on any sort of near-term price weakness that doesn't violate a stop level.

Figure 9-11:
The bullish doji star pattern performs favorably on the Euro futures chart.



As you can see, raking in a profit on a trade based on the bullish doji star or morning star is a definite possibility if you keep your eyes open and place your trades wisely. But the pattern can also fizzle out and cause losses.

The bullish doji star not working too well

Figure 9-12 is a chart with a morning star pattern that has the potential to cause some heartbreak. It's a chart of the stock for Janus Capital Group (JNS), which is an asset manager of over \$150 billion in investments. Yes, that's *billion*, with a *b*. Keep in mind that this could also be a bullish doji star because the patterns are extremely similar and basically interchangeable for your trading purposes.

The morning star arrives after a downtrend has been in place for a few weeks. The trend appears to be moderating a bit — an encouraging sign if you're looking to buy a stock. The pattern is completed in textbook fashion, with just one exception. The stock doesn't change trend very quickly. The price levels established by the pattern that you may use as stops are violated a few weeks after the pattern appears; you may want to bail out on this trade long before that.



Another factor that may be used when you're determining when to exit a trade is time. A violated price level isn't the only way a pattern can fail. You can also consider a pattern a failure due to the passage of time. If you see a promising pattern that doesn't fail but the hoped for price action doesn't occur, feel free to call it a failure and get out. How long you wait before bagging it is up to you, but using a time stop is a very useful trading tool.



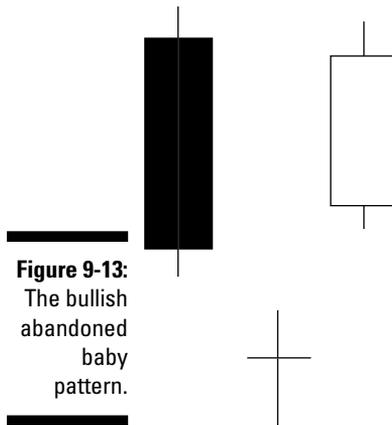
Figure 9-12:
The morning
star pattern
fails on a
chart of
JNS.

The bullish abandoned baby pattern

The next bullish three-stick trend reversal pattern I cover in this chapter is the *bullish abandoned baby pattern*. It's a close cousin of the morning star and bullish doji star patterns, and although its name sounds sad, you can end up very happy with the results if you trade it wisely.

Identifying the bullish abandoned baby pattern

The bullish abandoned baby gets its name from the second day of the pattern, which just kind of floats out on the chart by itself like it's been abandoned by the first and third days. The second day is also smaller than the other two candlesticks, so it's the baby of the pattern. Look at Figure 9-13 for an example.



The first day of the pattern is a bearish day. The second day gaps lower and has pretty tight price action, especially compared to the other two candlesticks in the pattern. Day three is a very bullish day that gaps higher than the second day.

Making a trade based on the abandoned baby pattern

For a look at a bullish abandoned baby pattern that provides a great buying signal, see Figure 9-14. It's a chart of ITT Corporation, a conglomerate with businesses in a variety of industries. Its products range from electronics for defense systems to solutions to treat wastewater.

Figure 9-14:
The abandoned baby pattern behaves as expected on a chart of ITT.



The pattern develops with a bearish day in the midst of a downtrend. The second day opens with a gap down, and the price action for that day occurs in a fairly tight range. (A gap on a chart occurs when there's an area or price action that isn't covered by two consecutive bars. The area or price range where no trading occurs is known as the gap.) The high of the second day never goes higher than the low of the first day, leaving a gap on the chart. The final day gaps up above the high of the second day, and that gap isn't filled. The final day is also a very bullish day, and anyone watching can see that the bulls are in the driver's seat.

The gap openings in the abandoned baby pattern may remind you of the old rule of thumb that "gaps always get filled." That nugget does hold true, but for this pattern it's quite possible that the gap won't be filled for quite some time. It can take months, or even years — long past the points at which you can profit from the trade.

The abandoned baby that didn't work too well

In addition to successful examples of the abandoned baby pattern signaling a trend reversal (see the preceding section), in some cases you'd be better off, well, abandoning a trade involving this pattern.

Figure 9-15 is an unusual chart to say the least, but a good example of an abandoned baby that didn't work and probably shouldn't have been traded in the first place. The stock represented on this chart is for Edison International (EIX), a power company that does business primarily in southern California.

Even before the pattern on Figure 9-15 emerges, this stock doesn't necessarily look like one you'd want to trade. There are several gaps on the chart before the pattern emerges, indicating that it's not the most liquid stock in the world.

Figure 9-15:
An
abandoned
baby pattern
fails on a
chart of EIX.



The second day of this bullish abandoned baby does appear after a few down days and a bearish move of over 40 percent, so the pattern is complete. But it comes very close to recent highs and reaches a level that the stock has had a difficult time exceeding in the past. Because of this distance covered by the last day of the pattern, I recommend avoiding entering on the close of the third day, and I'd probably ignore this pattern altogether. I know that's easy to say when the results are readily available, but truthfully, that's enough information for me to shy away from the trade.

The bullish squeeze alert pattern

The bullish squeeze alert pattern is one of my very favorite bullish patterns. It's a versatile three-stick pattern, and it pops up on a relatively frequent basis, meaning that the opportunities to trade it are more common than some of the other patterns I discuss.

Spotting the bullish squeeze alert pattern

The rules that govern the formation of a bullish squeeze alert allow for a little wiggle room. The strictest rule is that the first day of the pattern must be a down day. After that, the second day has to be an inside day of the first and the third an inside day of the second. Beyond that, though, the rules are kind of flexible. The second and third days can be up days, down days, or a combination of the two. The only strict criteria governing the second and third days are that they must be inside days, and they have to form a triangle.

Figure 9-16 shows a variation of the bullish squeeze alert that includes black candles for the second and third days.

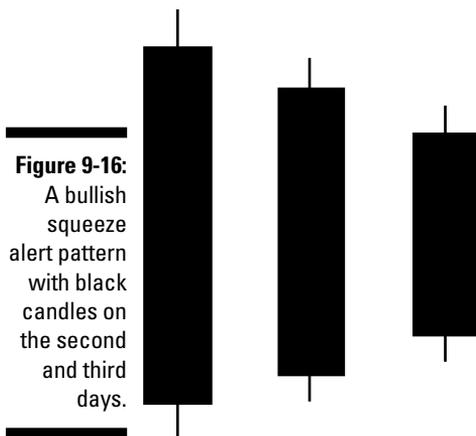


Figure 9-16:
A bullish
squeeze
alert pattern
with black
candles on
the second
and third
days.



I love this pattern's versatility, and it owes that attractive trait to the presence of a triangle. Regardless of how they're formed, I've found that triangles usually lead to some volatile moves. Keep on the lookout for triangles as you scan your candlestick charts. A triangle formed on a chart shows that prices are coiling together and will soon be ready to spring in one direction or the other.

Executing trades with the bullish squeeze alert

You can see the bullish squeeze alert at its bullish best in Figure 9-17. It's a chart of Southern Company (SO), which is a power company or utility that serves customers in Alabama, Florida, Georgia, and Mississippi.



Utility stocks aren't the most exciting stocks to trade, but the advantage is that you generally won't rack up massive losses on a trade in this sector that doesn't work out.

The pattern appears during a downtrend, and the first day is a long black candle. The second day is an up day, but also an inside day relative to the first day. The final day is a down day, but according to the rules, it's also an inside day relative to the second day. I chose this chart to show that the second and third days don't have to be specifically down or up, but do have to be days that are inside days of the preceding day.

The pattern forms a triangle, which means you can expect quick price moves in either direction. Because of this high level of volatility, I like to use the low of the pattern's first day as my sell stop. That gives the security the opportunity to move without being stopped out just before a move in the right direction. This pattern is followed by some lower trading, but then the stock takes off like it should.

The bullish squeeze alert failing to bring on higher prices

If you want to see a bullish squeeze alert pattern in a failure situation, look no farther than Figure 9-18. The figure features a chart of Target (TGT) stock. The days go like this:

1. The first day of the pattern is a very long black candle.
2. The second day is a very encouraging (for the bulls) white candle, which is an inside day relative to the first day.
3. Finally, the pattern is capped off with a down day, but it's an inside day relative to the second day, so the pattern is complete.

Figure 9-17:
The bullish squeeze alert pattern performs well on a chart of SO.



Figure 9-18:
A bullish squeeze alert pattern fails on a chart of Target stock.



The stock shows lackluster trading for a few days after the pattern appears, and although the high of the pattern's third day isn't violated, the lack of uptrending action may indicate that the pattern is a dud. There's no real need to wait around for lower prices to get out; it's probably best just to exit and move on, or if you wait on confirmation, just bag the idea of a trade and start looking elsewhere. You should try to be liberal with your stops on the bullish squeeze alert, but sometimes it's best to also require some confirmation that the squeeze is going in the desired direction a couple of days after the pattern appears. If it's not, feel free to stop waiting around and go on to your next trade.

Working with Bullish Three-Stick Trending Patterns

In addition to the trend reversal patterns that take three days to develop, there are also a handful of three-day trending patterns. These patterns usually include a long white candle followed by a gap of some sort. Generally, the gap or the low of the first day of the pattern may serve as a useful support level to let you know when the prevailing trend is still intact.

Three-day patterns have three uses for traders as follows:

- ✓ If you're considering buying a stock but hate to pay up when the price has been rising, three-day bullish trending patterns can give you confidence that the price you pay is as good as the price is going to be for a while.
- ✓ If you're interested in shorting, a three-day bullish trending pattern can tell you when to hold off for just a little longer to allow for the trend to provide you with a better price to use in your trade.
- ✓ If you're shorting a stock, a three-day bullish trending pattern can tell you that it's time to buy back and move on, because the trend definitely isn't your friend.

In this section I describe a number of three-stick trending patterns and how you can incorporate them in your trading strategy.

The bullish side-by-side white lines pattern

The first bullish three-day trending pattern is the bullish side-by-side white lines pattern, and it's about as bullish as it gets. If you see this pattern on a chart, you can feel pretty confident that the prevailing uptrend is going to continue in grand fashion.

Spotting the bullish side-by-side white lines pattern

To locate the bullish side-by-side white lines pattern on one of your charts, first look for a day with a long white candle that's followed by a gap opening on the second day. That second day should develop into an up day that never retraces prices down to the high of the first day. Finally, look for an up third day that basically covers the same ground as the second day and definitely doesn't retrace to close the gap to the high of the first day. Sound confusing? The straightforward example in Figure 9-19 should clear things up.

Trading on the bullish side-by-side white lines

I provide a solid scenario for trading the bullish side-by-side white lines pattern in Figure 9-20, which is a chart of Tyson (TSN). Tyson is a large distributor of chicken, beef, and pork products. Because these commodities' prices vary due to tastes, weather, or competition, TSN can actually be a pretty interesting stock to trade.

The pattern in Figure 9-20 emerges in an uptrend that hasn't been in place for long. This sign is a positive in my book because the longer the trend, the more likely it will be reversing in the near future. The first day of the pattern is a white candle, followed by two more white candles that cover similar ground but don't close the gap with the high of the first candle. It's obvious that the bulls have been moving the price in their direction and the bears are continuing to lose the battle. And as you can see, that action continues for quite some time.

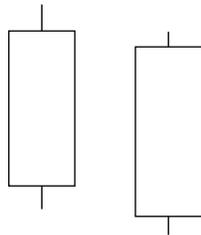
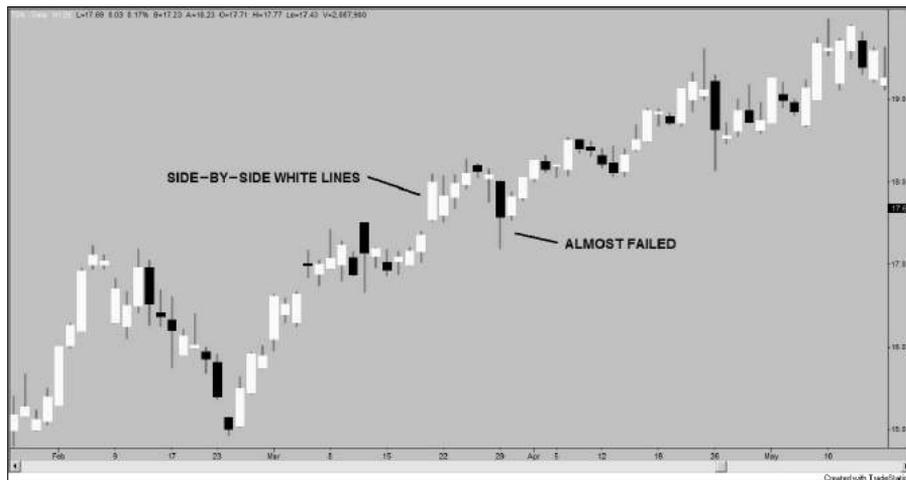


Figure 9-19:
The bullish
side-by-side
white lines
pattern.



Figure 9-20:
The bullish side-by-side white lines pattern works well on a chart of TSN.



Although it can be considered a bit liberal, I like to use the low of the first day as a stop for this pattern. I choose that level because there's a gap involved in the formation of the pattern. Gaps are made to be filled, and I know that the bears will try to make a run at a gap like this. I would prefer not to be stopped out until they've succeeded in running the price below the low of the first day. On the chart in Figure 9-20, I highlight where the bears make a run at the bulls, but the bulls push back, and the uptrend remains in place.



When you spot a trending pattern that includes a gap, there's a possibility for some aggressive trading. There's a chance that the gap will be filled with the trend still in place, so you can place an order to buy in the gap and a stop at the low of the pattern. This strategy is aggressive because you can buy and sell in a short period of time as the bears take over. But if you can execute the move properly, it'll allow you to enjoy a very good entry price in the midst of an uptrend.

The bullish side-by-side white lines failing to indicate more bullishness

Even though the bullish side-by-side white lines pattern is generally a bullish powerhouse, it's possible for the pattern to fail. For an example, take a look at Figure 9-21.

Figure 9-21 is a chart of Analog Devices Inc. (ADI), a producer of semiconductors used in products that range from computers to DVD players. Because its chips are used in several products that can be considered discretionary purchases, its stock — as well as the stocks for just about every other company that makes semiconductors — hinges on the overall economy and is therefore very volatile.

Figure 9-21:
The bullish
side-by-side
white lines
fails on a
chart of ADI.



The pattern in Figure 9-21 emerges at what appears to be the beginning of a very strong uptrend. There are a few strong up days followed by a gap up and two more white lines, which make up the pattern in this case. Because so much ground was covered so quickly by the pattern, it may be prudent to place a buy order in the gap that was created with the pattern, because there may be some price retracement where a better buying point would occur. Then you may place a sell stop below the low of the first day. It turns out to be a lousy prospect because the gap and the low were both taken out on the day I labeled as the failure day, but those losses pale in comparison to what you could expect if you bought at the end of the pattern.

The bullish side-by-side black lines pattern

The bullish side-by-side black lines pattern occurs during an uptrend, and although it includes some bearish trading, it doesn't violate the uptrend's validity. It has some bearish undertones, but it's still a fairly bullish indication of an uptrend continuation.

Recognizing the bullish side-by-side black lines pattern

The first day of the bullish side-by-side black lines is a long white candle that occurs during an uptrend. The second day opens with a large gap relative to the first day and then trades off some during the day. However, a gap is established between the first and second days even though prices trade down

during the second day. The third day opens higher, much like the second day. Prices trade lower during the first day, but the gap that was established between the first and second days stays intact. The picture in Figure 9-22 is worth more than a thousand words in this case.

It may seem a bit odd that a three-day bullish pattern has two black candles as the final two days, but that's what it takes to create the bullish side-by-side black lines. It works out because the bullishness of the prevailing uptrend and the first day of the pattern are strong enough to keep the bears from closing the price gap.



If you choose to enter on the completion of the side-by-side black lines pattern, your entry point will be a lower price point than if you made the same decision with the bullish side-by-side white lines.

Using the bullish side-by-side black lines for a profitable trade

For an example of the bullish side-by-side black lines paying off in a real-world trading scenario, take a look at Figure 9-23. It's a chart of Gannett (GCI), publisher of *USA Today* and operator of several high profile Web sites including CareerBuilder.com.

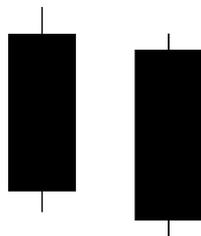


Figure 9-22:
The bullish
side-by-side
black lines
pattern.



Figure 9-23:
The bullish
side-by-side
black lines
pattern pays
off on a
chart of GCI.



The days play out as follows:

- 1. The first day of the pattern is a white candle that occurs during a small pullback of the prevailing uptrend.**
The trend appears to remain intact, but it can be moderating.
- 2. The second day has a gap opening and a little selling during the day.**
A gap is established between the first and second days.
- 3. The third day of the pattern has a slightly higher opening, and some selling takes place during the day.**

The gap still exists, and the day closes slightly below the open. It takes three or four days, but eventually, the uptrend is back in place and the pattern in Figure 9-23 turns out to be a winner.

Failure of the bullish side-by-side black lines pattern

For my example of a failing bullish side-by-side black lines pattern, I turn to Figure 9-24 and a chart of the drug company Bristol-Myers Squibb (BMY). This company is a very large drug corporation that develops new drugs and sells many high profile drugs already in existence. It's a great stock to trade because of the competitive nature and constant change in the pharmaceutical industry.

Figure 9-24:
The bullish
side-by-side
black lines
pattern fails
on a chart
of BMY.



The first day of the pattern featured in Figure 9-24 is a very bullish day, and it helps to continue a choppy uptrend. The second day has a gap opening, and the long wick at the top of the candle tells you that the day saw some pretty heavy buying. The second day does close lower, but a gap between the first and second day is established. Prices open higher on the third day, and more selling takes place during the day. Notice that the low of the second day isn't violated, and the gap remains in place.

This signal appears to have legs for the first few days, but prices soon start to roll over. After a couple of weeks, the low of the first day is eventually violated and the signal fails. In this instance, it's prudent to exit the trade even before the stop is hit. That's easy to say after the fact, of course, but the sheer amount of time that passes while the price action appears indecisive should be enough for a trader to call it quits on the trade.

The upside tasuki gap pattern

The three-stick trending pattern in this section can be considered a deviation of the patterns described in the preceding two sections. The upside tasuki gap can just as easily be called the upside white line beside black line pattern.



The name *tasuki* is a Japanese word for a sash that holds up a shirt sleeve. I've got to be honest: I'm not sure how that relates to the pattern, but it's fun to say, and the pattern can lead you to some great trades, so I won't question it.

Spotting the upside tasuki gap pattern

The upside tasuki gap starts with a white candle in an uptrend. The second day is much like the second day of the side-by-side white lines pattern that I explain earlier in this chapter. It gaps higher and closes higher for the day. The third day is much like the third day of a side-by-side black lines pattern (described in this chapter in the section “The bullish side-by-side black lines pattern”). There’s an opening in the same range as the second day and then some lower trading, but the gap isn’t completely filled in. Check out Figure 9-25 for a visual representation.

I like this pattern because it offers an attractive entry point, especially when compared to the side-by-side white lines pattern. Getting to buy on the low end of any candle when there’s a bullish signal is fine with me.

Using the upside tasuki gap pattern for a successful trade

The chart in Figure 9-26 forms the basis for my explanation of how you can use the upside tasuki gap to make a profitable trade. The chart is for the stock of Illinois Tool Works (ITW). It’s a great proxy on the overall economy because its interests are wide and varied. The company creates products that are used in just about every type of mechanical product you can imagine, from semiconductors to dishwashers.

Figure 9-25:
The upside
tasuki gap
pattern.

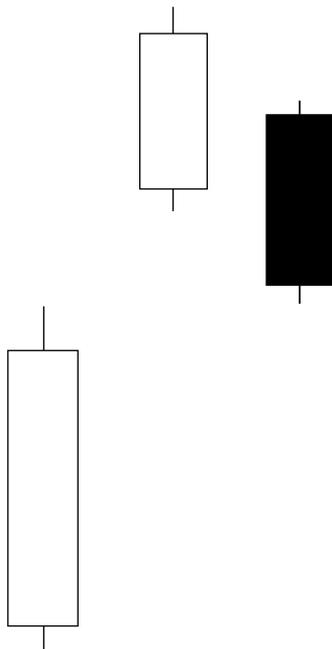


Figure 9-26:
An upside
tasuki gap
pattern that
provides a
useful signal
on a chart of
ITW.



The tasuki gap in Figure 9-26 just barely passed the rules for the pattern. The gap between the high of the first day and the range of the last day was so miniscule that I had to double-check the data to make sure it was valid. There's a gap there, but you have to get out the magnifying glass to see it!

I also chose to include more history on this chart than I do for the other examples in this chapter, to show that although the trend is sort of flat in the near term, there's a longer term uptrend in place, and that trend is actually tested with this pattern. I include a trendline on the chart to reinforce that point.

The nuts and bolts of the pattern are where they should be. The first day is a long white candle in the middle of an uptrend, and it's followed by a gap up and another up day. The third day encroaches the gap, but the gap is still intact at the end of the day, offering evidence that the trend should continue, as it does. If you spot this pattern and choose to take on a long position, you can ride the trend for a nice profit. You can also put on a long position knowing that you need to either get out of the trade on the appearance of a bearish reversal signal or some sort of trend break.

The tasuki gap fails to indicate more bullishness

I'm fond of the upside tasuki gap pattern, but it certainly does have, well, a downside. Have a look at Figure 9-27 for an example of what can happen when the upside tasuki gap turns out to be a dud.

Figure 9-27:
The upside tasuki gap offers a bad signal on a chart of FedEx stock.



The chart in Figure 9-27 is for the stock that represents ownership of FedEx Corporation (FDX). This is another stock that I love to trade, for a few reasons. First, on the business side, FedEx is exposed to the energy markets on the cost side of its business and the overall economy on the income side. As a result, it proves itself to be a very volatile (and fun to trade) stock. Second, the first industry for which I was ever given investment responsibility was transportation, and FedEx (Federal Express at the time) was an early company in my coverage. Finally, I grew up in Memphis (FedEx headquarters), where everyone knows someone at FedEx. Needless to say, the company is close to my heart.

On to the chart. During a well-defined uptrend, a long white candle appears on the chart, and that forms the pattern's first day. It's actually laying on a support line, which would be considered a bonus in this situation. I include a trendline on the chart. The second day is an up day, and a gap between the first and second day is created. Finally, the third day is a down day that encroaches but doesn't close the gap.



The pattern looks like a winner, and the failure takes a while to occur. But note that the low of the first day is violated — a sure sign of failure in this scenario. To introduce another possible level of failure, I also extended the trendline out to where the failure occurred. You can use this line as a stop that adjusts as time moves along. That's just another one of the countless ways you can exit a position when the theory behind the trade is no longer valid.

The upside gap filled pattern

The final bullish three-day pattern that I explore in this chapter is the upside gap filled pattern. It offers bullish trend confirmation, but it's particularly nice because the gap that's created gets filled without violating the prevailing uptrend. Sometimes gaps on charts are targets for either longs or shorts to push trading to fill the gaps. But with this gap filled, there isn't a gap present to encourage the shorts to take action.

Recognizing the upside gap filled pattern

The upside gap filled pattern is aptly named, as you can see in Figure 9-28. The first day is a white candle that occurs in an uptrend. The second day is bullish, with a gap opening and a closing that establish a gap. The third and final day is bearish, and it actually closes the gap, but it doesn't violate the low of the first day.



A low level for entry on the final day makes this pattern very attractive in my opinion. Also, as the low of the first day would be considered a stop level, losses are typically minimal when the pattern doesn't work as planned.

Making wise trades using the upside gap filled pattern

Examine the price action depicted in Figure 9-29 for a look at how you can profit from a trade by using the upside gap filled pattern. The stock charted is Edison International (EIX), a utility that deals primarily in southern California. This is actually the second time EIX has been used as an example in this chapter. (Have a look at Figure 9-15 for the first.) I guess utilities can be fun to trade!

The pattern in this chart emerges pretty early in an uptrend. The first day is an up day, and it's followed by a white candle for the second day, which gaps up. The third day is a down day that fills in the gap and closes in the range of the first day. The upside gap is filled!

The price action following the pattern is muted for a few days, and it even looks like the pattern will fail as prices come close to the low of the first day. But the bulls prevail, and the trend continues upward for some time.

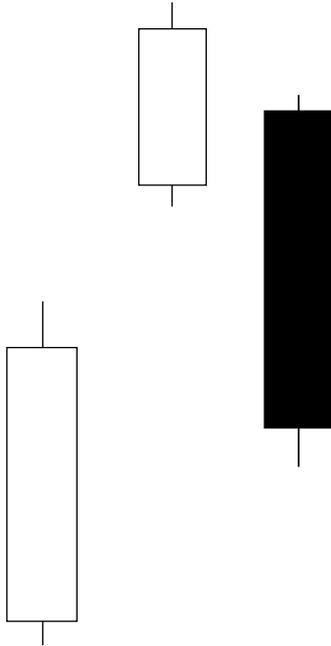


Figure 9-28:
The upside
gap filled
pattern.



Figure 9-29:
The upside
gap filled
pattern
creates an
appealing
trading
opportunity
on a chart
of EIX.

The upside gap followed by lower prices

But the bulls don't always prevail, of course. The upside gap filled pattern can go wrong, and although it's ugly, you need to know what it looks like when it happens. Check out Figure 9-30. It shows a pattern failure on a chart for the stock of Comcast (CMCSA), which provides cable TV, Internet, and phone services to many Americans.

The pattern on the chart in Figure 9-30 occurs at what would've been the very beginning of an uptrend, *if* the pattern had worked out. There are a few up days that start to indicate that the trend is positive, and then the first day of the upside gap filled pattern appears as a very long white candle. It's followed by an upside gap that closes, leaving that gap in place. Finally, the third day is a down day that closes the gap and closes within the first day's range.

This pattern takes a while to fail, and like several of the other examples in this chapter, it may illustrate a situation where you'd be better served by bailing out of the trade because of time concerns than by exiting because of a clear price level violation. After all, you can probably do more with your money in another trade than you can with it tied up for what seems like forever in a questionable upside gap filled pattern trade.



Figure 9-30:
The upside gap filled pattern fizzles out on a chart of CMCSA.

Chapter 10

Trading with Bearish Three-Stick Patterns

In This Chapter

- ▶ Predicting a trend reversal with bearish three-stick patterns
 - ▶ Working with bearish three-stick patterns that signal a downtrend continuation
-

In this chapter, I focus on the biggest bearish formations included in this book: the three-stick bearish candlestick patterns. Throughout the next few pages I cover some of the most common bearish three-stick patterns that pop up on your charts.

If you flip back to Chapter 9, you can read about a variety of bullish three-stick patterns that can tell you when a downtrend is about to shift upward, as well as a few of those patterns that reveal when a downtrend continues. This chapter features the bearish counterparts of those patterns, and they can reveal when an uptrend is about to fall apart and head downward or when a downtrend is likely to continue. Use these patterns when you're looking to put on a short position or as sell signals if you've already established a long position.

Understanding Bearish Three-Stick Trend Reversal Patterns

Much like their bullish counterparts from Chapter 9, a host of three-day bullish patterns commonly indicate that a trend reversal is forthcoming. The patterns in this section tell you when an uptrend is nearing its end and when a downtrend is ready to begin. The bearish reversal patterns can be very useful for shorts, but keep in mind that shorting — especially with stocks — when the trend is up can be a difficult undertaking.

The three inside down pattern

The three inside down pattern is a handy reversal pattern that shows up fairly regularly. The indecision implied by the pattern's second day (an inside day) provides great insight into the action, telling you that the bears are starting to push against the trend.

Figuring out how to spot the three inside down pattern

The three inside down always occurs in an established uptrend:

1. The first day of the pattern is an up day.

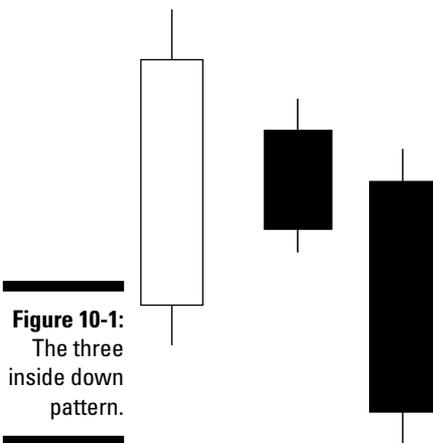
The bulls are in control on the first day of the three inside down.

2. The second day is bearish, and it's also an inside day relative to the first day.

(The open is lower than the previous day's close, and the close is higher than the previous day's close.) The high and low of the second day also fall within the high/low range established on the first day of the pattern. The bears take over on the second and third days (see next bullet point).

3. The pattern is completed on the third day with another down day that actually violates the low of the first day.

As you may guess, this formation is usually a great sign that an uptrend is set to fizzle out. For an example, see Figure 10-1.



Trading on the three inside down pattern

The preceding section shows how to identify the three inside down pattern, so now set your sights on Figure 10-2 for a real-world trading scenario where the pattern can potentially help you turn a profit. The chart in this figure is of Tribune Corporation (TRB), the owner of the *Chicago Tribune* newspaper, as well as the owner (as of this writing) of the Chicago Cubs. (The Cubs have been in what you could call a downtrend for the last 100 years, but that's a different story altogether.)

The three inside down pattern is the opposite of its bullish counterpart discussed in Chapter 9. It starts out with a bullish first day, but things start to turn bearish after that. Here's how the pattern unfolds:

1. The first day is a long white candle that occurs in the midst of a pretty strong uptrend.

2. The following day, in textbook fashion, a down, inside day appears.

The open of the second day is lower than the close of the first, and the close of the second day is higher than the first. Both the wick and the body are “inside” the first day's price action.

3. The third day reveals a takeover by the bears, and they begin to push prices down.

The stock opens lower and continues to trade down below the low of both the first and second days. The ensuing downtrend is strong, and it lasts for a few weeks.



If you watch this pattern develop and look to make a trade, you need to either be prepared to short near the close of the first day or pick an entry level to try to sell short on the second day.



Figure 10-2:
The three inside down pattern precedes a trend reversal on a chart of TRB.

Failing to give a good bearish signal

If you've read through any of the preceding chapters, you already know that I never provide a winning pattern example without following it up with a similar pattern that fails. For my failure example of the three inside down pattern, I offer up the chart in Figure 10-3. This chart is for BEA Systems (BEAS), a provider of business-oriented software. As far as stock trading goes, software stocks offer as much volatility as any industry, and BEAS has been a great one to trade for years.

Figure 10-3 shows that the inside down day on BEAS occurs at the very beginning of an uptrend. It appears after some relatively strong days, so by trading it, you're either fighting a strong trend or catching the stock when it's due for a turnaround.

The first day in the three inside down pattern in Figure 10-3 is an up day, but it's nothing spectacular because of the recent bullishness. The second day is an inside day, and the third day reveals a rally by the bulls that falls short when the day closes down. The price action that plays out shortly after the pattern is pretty encouraging for the bears, but after a couple of weeks, the trend turns back up and the pattern clearly fails. The most liberal stop level for the three inside down is the pattern's high, but you can always go with a more conservative stop, such as the high of the last day.

Figure 10-3:
The three
inside down
pattern fails
on a chart of
BEAS.



The three outside down pattern

Like the closely related three inside down pattern from the preceding section, the three outside down pattern should show up pretty frequently on your charts. The pattern is a solid three-stick bearish trend reversal, and if you know how to correctly identify it, you can rely on it for some lucrative trades.

Spotting the three outside down pattern

This pattern shows up during an uptrend and commences with another up day in the bullish run. On the second day, the bulls get started again with a gap opening, but they don't control the price action for long. The bears find a selling point above the previous day's close and go to work driving down the price. This means that the second day has a close lower than the first day and a low that's lower than the first day. The second day is, therefore, an outside day relative to the first day.

On the third day of the three outside down pattern, the bears call the shots from open to close. The day produces a black candle with the open, high, low, and close all lower than the previous day's levels. The bears are now firmly in control. For an illustration, check out Figure 10-4.

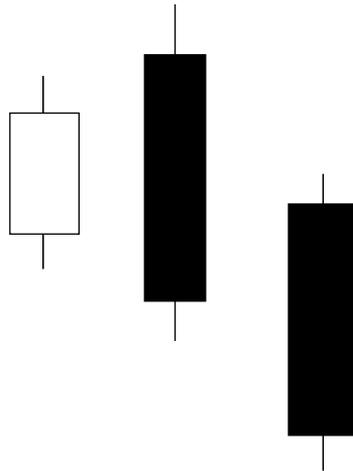


Figure 10-4:
The three
outside
down
pattern.

Making trades with the three outside down pattern

The three outside down pattern does an outstanding job of picking up a change in trend and offering a useful sell or short opportunity, and you can see it really sing in Figure 10-5. The chart in this figure is for Applebee's International (APPB). Applebee's operates in the restaurant industry, and stocks in that industry experience a lot of unpredictability. Restaurant stocks fluctuate with the economy, people's tastes, and even the weather. (Bad weather every weekend during a month can mean a bad month for a restaurant.)

Figure 10-5:
The three
outside
down
pattern
offers a
sound signal
on a chart of
APPB.



The first day of the pattern featured in Figure 10-5 is an up day, and although it's nothing to write home about, it's still an up day occurring in a prevailing uptrend. It's followed by an outside and down day. Both the body and wick of the second day are outside relative to the first day. Finally, on the third day of the pattern, the bears seize control and begin pushing prices down at the start of what becomes a sustained downtrend. In fact, it takes a couple of weeks before the bulls even attempt some sort of rally. The three outside down pattern predicted a trend reversal, and that's exactly what played out.

Offering a failing signal

But what happens when the three outside down pattern doesn't deliver on its suggestion that a downtrend is on the way? For an answer, take a look at Figure 10-6. The chart in Figure 10-6 displays price action for the stock of the biotech company Millennium Pharmaceuticals (MLNM). Biotech stocks can be wildly volatile and fun to trade. This chart is interesting because there's more there than just a failure of the three outside down pattern, and I explain the extra features in a moment.

The outside down pattern on this chart is a classic example of how the pattern appears as it gives a sell signal. The first day is bullish in a bullish trend, followed by a second day where the bulls push higher on the opening, but then the bears push back, creating a down day that's outside compared to the first day. Finally, the bears are in control on the final day as they push prices even lower.

After the pattern, a couple more bearish days exist, and then the trend takes a turn to the upside. As I said, biotech stocks can be highly unpredictable! The pattern fails and then something funny happens. Take a look. You may think I highlighted another instance of the bearish outside day pattern, but that's not the case.

Figure 10-6:
The three outside down pattern offers a failing signal on a chart of MLNM.



It's a little difficult to tell, but the highs of the first and second days marked with ??? are equal. This disqualifies the pattern as an outside down pattern. So does a penny of price action on the second day really mean that there was a huge difference in the trading behind these three days? Apparently not. A new downtrend that lasts several weeks pops up right after the appearance of what you may call the “almost bearish outside pattern.”



Splitting hairs on candlestick pattern formation can cost you a profitable trade. Just because there's a very small price difference that seems to disqualify a pattern, don't be too quick to disregard the formation altogether. The psychology behind the pattern that almost panned out is the same as what drives a by-the-book pattern, and you may be able to make a successful trade, if you aren't harshly strict with your pattern evaluations.

The three black crows pattern

The pattern featured in this section looks just plain ugly. The three black crows pattern certainly isn't much to look at, but it can benefit your trading activities if you can spot it and trade it wisely.

Identifying the three black crows pattern

If you're into the kind of bird watching that can lead to profits on the stock market, keep on the lookout for the three black crows. This pattern includes three down days in a row, and it must occur during an uptrend for it to be valid. Set your sights on Figure 10-7 for an example.

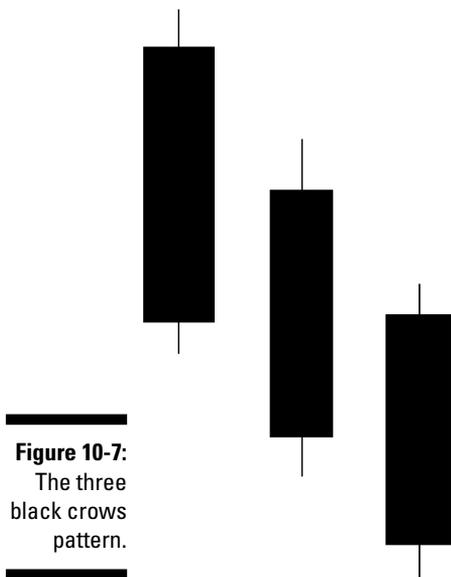


Figure 10-7:
The three
black crows
pattern.



The first day of the pattern may actually include a gap opening when compared to the previous day, but even if the bulls are in charge at the start of the day, it doesn't last long. The bears push prices lower, and the result is an obvious down day. The next two days see lower price levels across the board. Both the second and third days are black candles with lower opens, highs, lows, and closes. The bears have definitely taken over.

Making trades with the three black crows pattern

The example of a successful three black crows pattern that I provide is based on a chart of a stock that's closely tied to the stock market. TROW is the symbol for T. Rowe Price Group, which is an asset management firm that provides mutual fund investments for individuals and retirement plans. Its business is based on people's confidence in investing in the market. This confidence moves right along with trends in the stock market, so TROW and other asset management stocks are always good trading vehicles. Take a moment to review Figure 10-8 and allow me to explain how the three black crows can take flight for an attractive trade.

The three black crows show up shortly following a gap up in an uptrend. The black crows fill the gap up, which I consider to be a pretty encouraging sign. As you can see, each day of the pattern is a black candle, and each level is lower than the previous day's levels.

It's safe to say that this sign is pretty bearish. After all, sellers are putting pressure on a stock for three straight days. This also means that there's been a lot of downward price movement in a short period of time — an indication

that there can be an opportunity to make a sale a little higher than the close of the pattern. That's the case with the pattern in Figure 10-8, and for the next few days, the pattern holds, despite a weak attempt by buyers to resume the uptrend. A patient trader that sold even the day after the pattern would be rewarded with a nice entry point.

Figure 10-8:
The three black crows predict a trend reversal on a chart of TROW.



Failing to signal lower prices ahead

If you're the kind of trader who insists that this pattern always works out when it appears, you may end up eating crow. The three black crows can fail, as you can plainly see in Figure 10-9.

Figure 10-9:
The three black crows pattern fails on a chart of INTC.



Figure 10-9 is a chart of Intel (INTC). Intel produces semiconductors, but you'd think they make birdfeeders with all the black crows flocking on this chart! Okay, maybe not. The chart is a little unusual because it includes two failures of the three black crows pattern:

- ✓ The first occurrence of the pattern appears in an uptrend that starts with a gap up on the first day, which brings in three solid days of selling. The bulls make a run, but the signal stays valid because, although there's a slight uptrend, no price action violates the levels set by the three black crows — for the time being, at least.
- ✓ The second occurrence of the three black crows comes in the continued uptrend, but it features slightly lower levels than the first pattern. A hopeful trader may be excited by the presence of two sets of the three black crows pattern, but his hopes will soon be dashed when the high of both patterns is violated.

The three black crows covers a lot of ground on the down side, and placing a stop at the high of the first day leaves you with a lot of room to accumulate losses before getting out of the position.



When working on a three black crows trade, try to pick a stop that achieves a middle ground between what you can tolerate in terms of losses and where you really believe the pattern will no longer be valid. You may first consider the midpoint of the pattern, which can be a prudent level depending on your ability to take a loss.

The evening star and bearish doji star patterns

You didn't think I could get through a chapter without discussing a doji pattern, did you? I confess my love for the doji several times in this book, and I'm happy to report that the two patterns described in this section make me grow only fonder of dojis and the trading opportunities they present.

The evening star and bearish doji star patterns are technically two different patterns, but they're so close and the trading psychology behind them so similar that I lump them together in this section.

Recognizing the evening star and bearish doji star

Both the evening star and bearish doji star patterns start with an up day, followed by a gap opening and then a doji for the second day (for the bearish doji star), or at least a day with very tight trading action in either direction (for the evening star). The gap between the first and second days attracts sellers, which keeps the stock from going much higher than the first day's open. The third and final day is down, and this final day closes the gap

between the first and second days. After the struggle of the doji or near doji second day, the bears show their teeth on the third day, and the price action begins to trend downward. Take a gander at Figure 10-10 for an example of both the evening star and bearish doji star patterns.

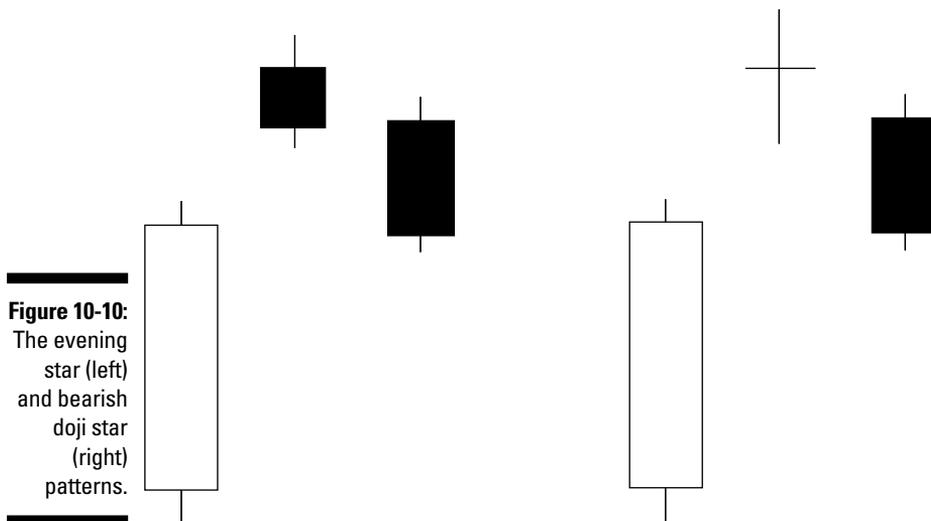


Figure 10-10: The evening star (left) and bearish doji star (right) patterns.

Using the evening star and bearish doji star patterns to make trades

For a sound example of the evening star pattern that pans out in a real-world trading environment, check out Figure 10-11. The chart in that figure is for a company called Archer Daniels Midland (ADM), a large distributor of corn.



Figure 10-11: The evening star pattern works on a chart of ADM.

As you look at the chart, notice the following:

- ✓ The first day is just another up day in a very long uptrend.
- ✓ The second day adheres to the price action that occurs on the second day of a doji or evening star pattern; there's a small gap up and a tight trading range between the open and close. It's not quite a doji, but it's certainly enough to qualify as the second day of an evening star pattern. (If it were a bona fide doji, then the pattern would be a bearish doji star pattern, but the price action and result would be basically the same.)
- ✓ Finally, the third day is a down day, and the pattern is complete.

I like the example in Figure 10-11 because it works quickly and includes a nice gap down that probably resulted from some negative news about the company. Without that news (and the corresponding gap down), the pattern wouldn't have formed correctly, and predicting the trend reversal would've been much more difficult.

Failing to indicate lower prices

You can find a case where the evening star pattern fails in Figure 10-12. It's a chart of Pep Boys (PBY), which is an auto parts retailer. (I've been analyzing and trading retail stocks for years, so forgive all the examples.) I believe retail is a good sector for novice traders to focus their efforts because the retail business is easy to understand, and plenty of public retailers exist for trading.



Figure 10-12:
The evening star pattern loses pep and offers a failed signal.

The evening star pattern in Figure 10-12 shows up during an uptrend, and it begins as it should, with an up day. The trend in question appears to be rolling over a bit — an encouraging signal. The second day is also up, with a

small gap created between it and the first day. Note that the open and close of the second day are closer to the low than the high, which is also encouraging as the pattern develops. The third day is a down day, and it appears that a downtrend is commencing. Looking good!



But then disaster strikes. The downtrend is short lived, and anyone trying to short the signal is out of luck. Just a couple of days after the pattern emerges, the stock starts to trade higher again, and then with a gap opening and a strong bullish day, the pattern completely fails.

The bearish abandoned baby pattern

The bearish abandoned baby pattern is fairly rare, but when it pops up, it can be a very powerful indication that a quick trend change is in the works. In fact, the abandoned baby pattern examples in this book — both the bullish examples in Chapter 9 and the ones I present on the following pages — were some of the most difficult patterns for me to find when I was gathering chart examples. And it's worth noting that it was especially hard to find examples where the pattern failed.

Spotting the bearish abandoned baby pattern

A bearish abandoned baby pattern starts with an up day in an uptrend. That's followed by a day that sticks way out by itself on the chart, and that day is often a doji with a gap opening that isn't filled in. The third day is down and includes a gap down opening between the second and third days. You can see a bearish abandoned baby in Figure 10-13, but please don't call child services. It's only a candlestick, after all.

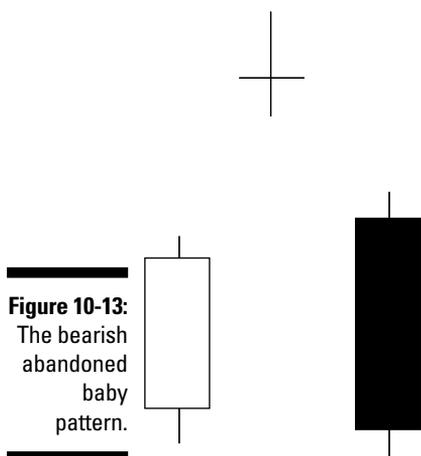


Figure 10-13:
The bearish
abandoned
baby
pattern.

Trading on the bearish abandoned baby pattern

I'm fond of the bearish abandoned baby example on the chart in Figure 10-14 — a chart of the stock for eBay — because the trend is rolling over at the same time that the pattern shows up. The first day is clearly bullish, and the uptrend is in place, even though it looks to be rolling over. There's a gap between the first and second day, and the open and close of the second day are in a tight range. That range falls near the low end of the wick, which serves as a bearish indicator. The third day is up, but only after a very large gap down opening. Even though the bulls make a run on the third day, the close is pretty discouraging for them, because it falls near the low of the first day. After the final day, a sustained downtrend kicks in, and anyone who was working a clever short would be in for some profits.

Figure 10-14:
The bearish abandoned baby pattern comes out a winner on a chart of eBay stock.



Failing to signal lower prices ahead

Now for a failing bearish abandoned baby. It's a rare occurrence, but it does happen. In this case it happens on a chart (in Figure 10-15) of Xilinx, Inc. (XLNX), a maker of basic semiconductors that go into just about any electronic product you can think of. XLNX has so many ups and downs that I honestly believe you can make a trading career trading only its stock. It's a wild ride.

The bearish abandoned baby appears in Figure 10-15 at the beginning of an uptrend. The pattern has an up first day, followed by a gap opening and a second day with a fairly narrow range. The third day kicks off with a gap down opening, and the gaps on either side of the second day mean that the pattern is in place.

Figure 10-15:
The bearish
abandoned
baby pattern
fails on a
chart of
XLNX.



The signal doesn't hold up for very long. A long white candle occurs just two days after the pattern, invalidating the trend reversal signal. Shorts would be stopped out, and sellers would be disappointed because the price is headed higher in the short term.

The bearish squeeze alert pattern

Like its bullish counterpart from Chapter 9, I'm fond of the bearish squeeze alert. This signal either works or doesn't work quickly, and it appears frequently because the criteria for the pattern are relatively flexible.

Familiarizing yourself with the bearish squeeze alert pattern

The bearish squeeze alert pattern can take on a few different forms, and you can get a feel for one of them by reviewing Figure 10-16. The first day of the pattern has to be a down day, and the longer the better. The second and third days can be up or down, just as long as they're inside days relative to the previous day. That means that both days must have a high that's lower than the previous high and a low that's higher than the previous low. In other words, the body of each candle has to have a range that doesn't exceed the upper or lower ends of the body of the previous day's candlestick.

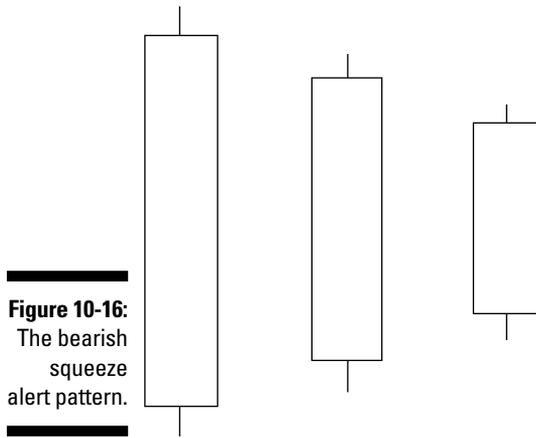


Figure 10-16:
The bearish
squeeze
alert pattern.

Using the bearish squeeze alert pattern in your trades

After you've figured out how to spot the various forms that the bearish squeeze alert can take, consider how to use it for trading. To get started, take a look at the chart in Figure 10-17. The chart shows the price action for the stock of the investment bank JP Morgan Chase (JPM). The stock has close ties to the market, and the company has operations in just about every facet of the financial world. JPM is also one of the oldest banks in America, dating back to 1823. That probably seems like a long time, but remember that candlestick charting was around several hundred years before J.P. Morgan hung out his shingle.



Figure 10-17:
The bearish
squeeze
alert pattern
comes
through with
a useful
signal on a
chart of
JPM.

The bearish squeeze alert in this chart occurs at the top of an uptrend that appears to be fading a little. The first day is an up day, but it doesn't quite make a new high for the recent uptrend. The second and third days are both inside days relative to the first day, and the bears would be happy to see that both days are also black candles.



When you see black candles for the second and third days of the bearish squeeze alert pattern, it's a good sign. The bears are controlling the price action and offer additional assurance that the prevailing uptrend is about to roll over.

The bears also appreciate the third day, where the body of the candlestick is low in the range of the day's trading action and near the low of the day. If you spot a similar pattern in a similar environment, get ready to short!

Falling short with the bearish squeeze alert pattern

Like the successful bearish squeeze alert pattern example in Figure 10-17 (see preceding section), the failure example in Figure 10-18 happens on the chart of an American icon: Coca-Cola (KO). As a steadily growing consumer company, Coca-Cola's shares usually aren't terribly volatile and, therefore, may not be the best trading stocks around.

There's a very solid uptrend in place before the pattern in Figure 10-18 emerges. A long white candle shows up on the first day, followed by two inside days, both of which are black candles. The pattern is completed, but the bears have only one day to feel good about their short position before the pattern is proved invalid. The day after the pattern is a bearish day, and it really does appear that the trend will turn, but then the bulls show up on the second day after the pattern and violate any level that can be considered resistance.



Figure 10-18:
The bearish squeeze alert pattern doesn't work out too well on a chart of KO.

Forecasting Downtrend Continuations

Like the patterns described in the preceding pages of this chapter, the bearish three-stick patterns that foreshadow the continuation of a downtrend are mirror images of their bullish counterparts, which you can read about in Chapter 9. The patterns in this section are useful, but more so as confirmations for trades that are already on than as inspiration to initiate a new trading position.



You can initiate new positions by using bearish three-stick continuation patterns, but keep in mind that with trending signals there's already been some price movement in the direction you'll be trading (sometimes considerable price movement). Trends are your friends, but they don't last forever.

The bearish side-by-side black lines pattern

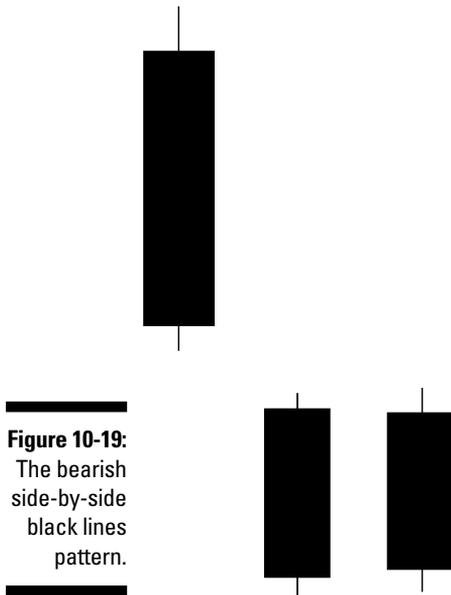
The first of the bearish three-stick trending patterns is the bearish side-by-side black lines. It's just plain ugly if you're a bull or an owner of the security with price action that produces the pattern on a chart. The pattern is extremely bearish, and if you see it as you're looking through your charts, you can feel pretty confident that the prevailing downtrend will keep on diving.

Identifying the bearish side-by-side black lines

The bearish side-by-side black lines pattern has a distinctive appearance, and you can see it firsthand in Figure 10-19.

The days play out like this:

- ✓ The first day is a down day that comes on the heels of a downtrend.
- ✓ The second day has a gap down and also trades bearishly. Note that the gap between the high of the second day and the low of the first day isn't filled.
- ✓ On the third and final day, the bears have their way again and, like the second day, there's a lasting gap. The bears are definitely in charge.



Using the bearish side-by-side black lines pattern

You can harness the bearish power of the bearish side-by-side black lines to give yourself confidence that a downtrend will continue. For an example, see Figure 10-20, which includes a chart of one of my favorite companies. I'm a red-blooded American, and I love my Direct TV (DTV). Even though I love the company's products and service, if the right pattern shows up, I'm more than happy to short the stock and cheer for it to drop. Seems a little odd to be watching financial television stations on Direct TV and using the information to profit when the company's stock heads south, but such is the ironic life of the trader.



It's also worth noting that because of the competitive nature of its industry, DTV has been a great stock to trade for years.

As you can see in Figure 10-20, the stock is already in the early stages of a downtrend when the bearish side-by-side black lines start to develop. The first and second days are down, and there's a substantial gap between them. The third day is also a bearish day, and so the pattern is complete, and the downtrend continuation is verified.

Figure 10-20:
The bearish
side-by-side
black lines
pattern
successfully
confirms a
downtrend
on a chart of
DTV.



Failing to confirm a downtrend

Although normally there's some rebounding shortly after the appearance of a trending pattern like the side-by-side black lines, that's not the case with the pattern in Figure 10-21. You can spot a little bit of bullishness a few days after the pattern shows up, but there's no real move into the gap.

You may ask yourself if an ultra bearish pattern like the bearish side-by-side black lines can ever fail. The answer is a resounding yes. For an illustration, consider Figure 10-21, which features a chart of CenturyTel (CTL), a provider of telecommunication services in 25 states. Telecommunication companies have to deal with constant change and competition, and their stocks are very volatile and, therefore, great for trading.

The chart in Figure 10-21 is a fun one because two instances of the bearish side-by-side black lines pattern show up. One appears early in a downtrend, and the other one pops up a little later. The gaps are small on both patterns, so not a lot of distance is covered. And each pattern is followed by some buying, which gives patient traders a better entry level for a short than they would've found at the completion of the pattern. The entry opportunity is fine, but the pattern turns out to be a dud. Both patterns fail at the same time, and I indicate exactly where and when that failure occurs. The bearish side-by-side black lines pattern is rare, and when it appears, it's almost always legit, so don't expect to see too many examples similar to this one.

Figure 10-21:
The bearish side-by-side black lines pattern fizzles out on a chart of CTL.



The bearish side-by-side white lines pattern

The bearish side-by-side white lines pattern is similar to the pattern in the previous section, but its second and third days are white candles instead of black ones. It's still a bearish pattern, but not quite as bearish.

Spotting the bearish side-by-side white lines pattern

The first day of this pattern is a long black candle in a downtrending market or stock. The second day kicks off with a gap down opening, and throughout the course of the day, the bulls push prices higher. The bulls try hard, but they're unable to push prices over the low of the first day, and this failure results in a gap.

The final day of the pattern once again sees a lower opening and a push at higher prices, and once again, the first day's low isn't reached. After two days of effort from the bulls, a gap still remains on the chart. You can see what I mean in Figure 10-22.

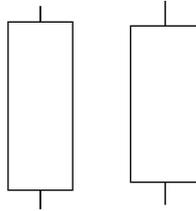


Figure 10-22:
The bearish side-by-side white lines pattern.

Working with the bearish side-by-side white lines

Figure 10-23 offers a look at a successful occurrence of the bearish side-by-side white lines pattern. The figure is a chart of Monsanto (MON), which is a supplier of agricultural products to farmers in the United States and Germany. The stock's exposure to agricultural markets means that it's unpredictable and presents some nice trading opportunities as a result.

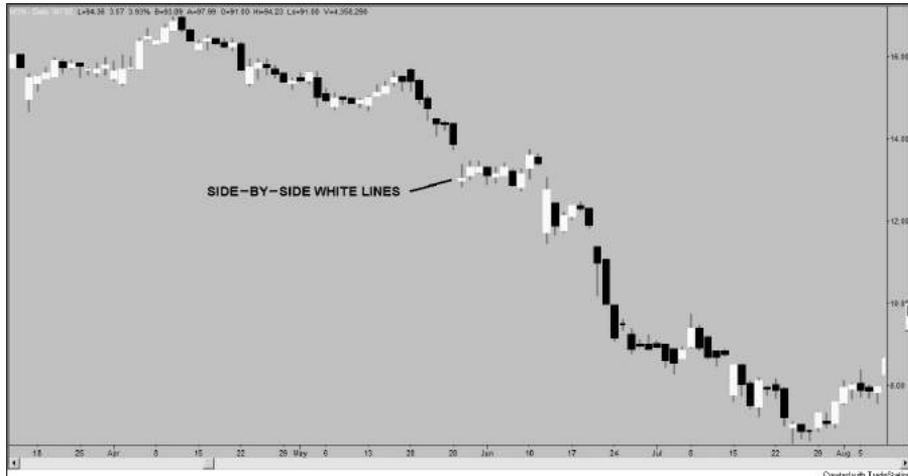


Figure 10-23:
The bearish side-by-side white lines pattern predicts a downtrend continuation on a chart of MON.

The bearish side-by-side white lines show up in Figure 10-23 in a downtrend, and the first day is a down day. The second day opens with a gap down, but the bulls go to work and the stock trades up a little. However, there's a fairly substantial gap left between the first and second day. The third day opens lower, and once again, the bulls give it a go, but they don't do much to move the price into the gap between the first and second days. The result? A bearish side-by-side white lines pattern. Then for the next few days the stock is basically trendless, but soon a patient short is rewarded as the downtrend starts up again.

Failing to predict a downtrend continuation

In a perfect world the bearish side-by-side white lines pattern would always provide a safe, comforting signal that a prevailing downtrend will continue for days, weeks, or even months to come. But this is the real world, and sometimes these things fail. For a look at how a failure can happen, refer to Figure 10-24, which represents ownership in Exxon Mobil (XOM). I'm using it for an example of a pattern with side-by-side white lines, but it's better known for a product that keeps automobiles everywhere running *between* the white lines.



Figure 10-24:
The bearish side-by-side white lines pattern fails on a chart of XOM.

As for the chart, the pattern appears with a downtrend in place. The first day is a long black candle, and it's followed by a big gap and a bullish second day. The gap begins to get filled during the bullish third day, and that upward momentum continues. If you wait for a rock solid failure level before exiting a short, you have to wait a few weeks, but you probably recognize the strong uptrend and exit before that painful level is reached.

The downside tasuki gap pattern

The downside tasuki gap pattern is the mirror image of a bullish version that you can read about in Chapter 9. Compared to the other bearish three-stick trending patterns in this chapter, this pattern is more useful for you if you're looking to put on a new trade. This is because of the higher closing price that occurs when the close of the third day moves into the gap between the first and second day.

Understanding how to identify the downside tasuki gap pattern

The downside tasuki gap begins with a black candle that appears during a downtrend. The second day sees a gap opening downward and bearish trading that result in a lower closing. When the third day rolls around, however, the bulls show up to push prices higher. They push enough to make the third day an up day with a closing price that's higher than the high of the second day. But don't count on the bullish behavior to continue. The bears are willing to sell within the gap between the first and second days, and they soon stop the bulls in their tracks. Want to see an example? Check out Figure 10-25.

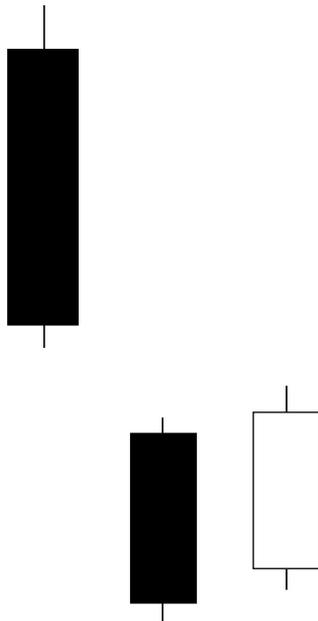


Figure 10-25:
The
downside
tasuki gap
pattern.

Making a trade with the downside tasuki gap pattern

The downside tasuki gap is one of the bearish three-stick trending patterns that makes for a good candidate when you're looking to initiate a short position.

Figure 10-26 is a chart of International Paper (IP). The downside tasuki gap shows up in a downtrend, and coincidentally enough, the action that takes place before and including the first day of the downside tasuki gap is another pattern that I cover in this chapter: the three black crows (see the section, “The three black crows pattern” earlier in this chapter).

The second day of the downside tasuki gap pattern sees a gap down that isn’t filled. The third day is an attempt by the bulls to move the price higher, and it stalls very low in the gap between the first and second day. The pattern is then followed by a pretty sustained downtrend.



Because the tasuki gap finishes close to the high of the pattern, you may want to enter on the close of the third day if you’re looking to short. In this example, that strategy would’ve provided you with an excellent short entry before the continuation of the downtrend.

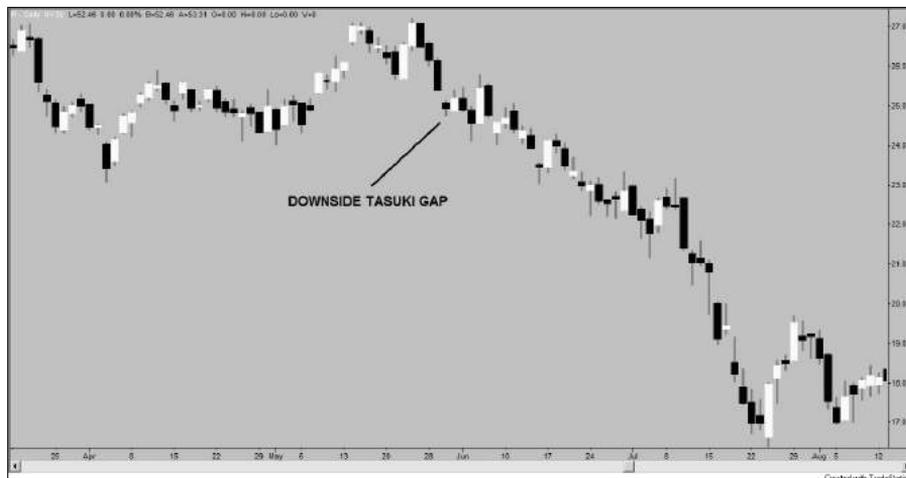


Figure 10-26:
The
downside
tasuki gap
pattern
works on a
chart of IP.

Catching the failing trend at the end of the pattern

For my failure example of the downside tasuki gap, I turn to a chart of Harrah’s Entertainment (HET). Harrah’s operates casinos throughout the United States, and just like gambling in their establishments, trading their stock can be quite exciting because it’s an unstable security in an unpredictable industry. The chart appears in Figure 10-27.

Figure 10-27 is a fun example of the downside tasuki gap. If you’ve read through any of the other examples in this chapter, then you’re probably expecting an outright pattern failure, but in this case an exit signal shows up before the pattern fizzles out. An astute user of candlestick patterns may have caught this signal before the trend changed and taken a profit instead of being stopped out for a loss.

Figure 10-27:
The
downside
tasuki gap
pattern (kind
of) fails
on a chart
of HET.



The first day is a down day at the upper end of the downtrend. This day is followed by a gap down that isn't filled during the day and a down second day. Finally, on the third day of the pattern, a small rally occurs, and prices trade inside the gap, but the gap isn't filled.

Trading after the pattern in Figure 10-27 is interesting, with a few attempted rallies that get into the gap but don't trade over the high of the first day. There's also a drop to new lows, so the price action is really quite varied. Then, after the drop, a bullish reversal pattern shows up!

One more thing to look for in Figure 10-27: I highlight an outside up day — a bullish reversal pattern — that precedes a change to an uptrend. A wise candlestick pattern user would use that as an exit signal or even a chance to put on a long position. On the flip side, a short who isn't looking out for candlestick patterns wouldn't see the writing on the wall and would probably be stopped out in the next few days as prices exceed the pattern's highs.

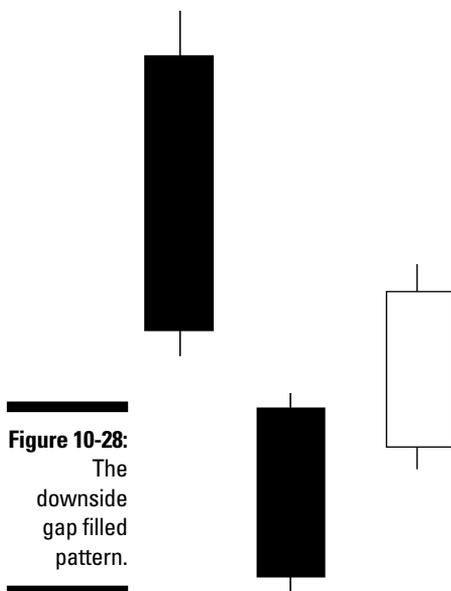
The downside gap filled pattern

The downside gap filled pattern rounds out my discussion of the bearish three-stick trending patterns. It's the most tradeworthy of all the patterns in this section because its close is higher than the others. It also calls for some pretty tight stops, so you'll know quickly whether the pattern is going to succeed or fail.

Recognizing the downside gap filled pattern

As you can see in Figure 10-28, the downside gap filled pattern starts off with a down day in a downtrend. Like the other trending patterns in this chapter,

the second day is a gap down, and it's bearish. At first the gap between the first and second day isn't filled and remains on the chart. On the third and final day there's a lower open, but then the bulls push the price higher over the course of the day. The gap between the first and second day is then filled. However, at some point the bears decide it's time to take over again and the rise in prices stops, usually in the lower half of the first day's trading range. The downtrend is still in place.



Trading the downside gap filled pattern

To give you an idea of how you can trade the downside gap filled pattern, I provide the example in Figure 10-29. It's a chart of Ingersoll Rand (IR), a manufacturer of various commercial and consumer machinery goods. The company is tied to the overall economy, so the stock can experience periods of volatility that present ample trading opportunities.

The downside gap filled pattern appears at the upper end of the downtrend, beginning with a black candle for the first day. There's a gap down opening for the second day, and the gap isn't filled as the day progresses bearishly. The third day completes the pattern with an up day that fills in the gap, and the downtrend continues after that.



If you shorted using this pattern, you'd be pleased to see some bearish action that continues for a while after the pattern is completed. However, after a few weeks, a bullish reversal pattern emerges. There's a doji followed by an up day in a downtrend, which is usually an indication that prices have reached a bottom. That would mean that it's time to exit your short position and walk away with your profits.

Figure 10-29:

The downside gap filled pattern predicts a downtrend continuation on a chart of IR.



Failing to signal a continuing downtrend

I hate to end the chapter on a down note, but I do feel obligated to present you with a failing example of the downside gap filled pattern. For that I turn to Figure 10-30, a chart of DuPont (DD).

The pattern emerges in a downtrend, with a black candle that's followed by a gap down, which is eventually filled on the third day. All is as it should be in terms of pattern formation, but if you look closely, you can see an indication that the pattern may not hold up for too long. The strength of the downtrend appears to be moderating, and because the trend has been in place for a long time, it may lead you to believe that a reversal is on deck. These indications prove to be true when the trend turns upward over the course of the next couple of weeks. The high of the pattern is violated, rendering it null, void, and more than a little annoying.

Figure 10-30:
The
downside
gap filled
pattern
provides a
dud signal
on a chart
of DD.



