“Big Profit Patterns Using Candlestick Signals And Gaps”

How To Make A Living Trading The Markets By Mastering Easy To Learn Techniques Hardly Anyone Else Knows About

A Candlestick Forum publication – Years of Candlestick Analysis made available in concise formats. Information that when learned and understood will revolutionize and discipline your investment thinking.

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Powerful Implications of Gaps

How Do They Produce Profits With Candlesticks?

Gaps (Ku) are called windows (Mado) in Japanese Candlestick analysis. A gap or window is one of the most misunderstood technical messages. Most investment experts advise ***not*** to buy after a gap. This is true only about ten percent of the time. The other 90% of the time, the gaps will reveal powerful high profit trades. Candlestick signals, correlated with the appearance of gaps, provide valuable profit-making set-ups.

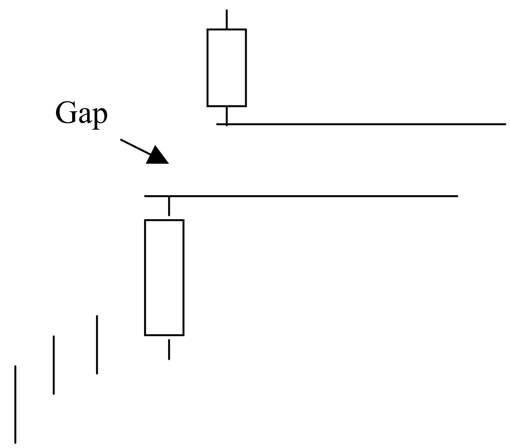
What is the best investment you can make? Simple! Learning investment techniques that make you independent of having to rely on any other investment consultation. You can easily learn and quickly master common sense analysis that will dramatically improve your returns for the rest of your life. You will feel confident in every trade you put on. No more “hoping” that a trade will move in your direction. The unique built-in forces encompassed in the candlestick signals and the strength of a move revealed by the existence of a gap produce powerful trade factors. You can rest easy! Obtaining the knowledge that this combination of signals reveals will produce consistent and strong profits.

These are not “hidden” secret signals or newly discovered formulas that are just now being exposed to the investment world. These are a combination of widely known but little used investment techniques. Candlestick signals obviously have a statistical basis to them or they would not still be in existence after all these centuries. Gaps have very powerful implications. Combining the information of the two produces investment returns that very few investors take the time to exploit.

Dissecting the implications of a gap/window makes its appearance easy to understand. Once you understand why a gap occurs at different points in a trend, taking advantage of what the gaps reveal becomes highly profitable. Where a gap occurs is important. The ramification of a gap in a chart pattern is an important aspect to Japanese Candlestick analysis. ***Some traders make a living trading strictly off of gaps***.

Consider what a window or gap represents. In a rising market, it illustrates a price opening higher than any of the previous day’s trading range. (For illustration in this book, the “day” will be the representative time frame.) What does this mean in reality? During the non-market hours, something made owning this stock tremendously desirable. So desirable that the order imbalance opens the price well above the prior day’s body as well as the high of the previous day's trading range. As seen in Figure 1, note the space between the high of the previous day and the low of the following day.

Figure 1 – Illustration of a gap.



Witnessing a gap or window at the beginning of a new trend produces profitable opportunities. Seeing the gap formed at the beginning of the trend reveals that upon a reversal of direction, the buyers have stepped in with a great amount of zeal. A common scenario is witnessing a prolonged downtrend. A Candlestick signal appears, a Doji or Harami, Hammer, or any other signal that would indicate that the selling has stopped. What is required to verify that the downtrend has stopped is more buying the next day. This can be more solidly verified if the next day has a gap up move.

Many investors are apprehensive about buying a stock that has popped up from the previous days close. A risky situation! Yet a Candlestick investor has been forewarned that the trend is going to change, using a signal as that alert. A gap up illustrates that the force of buying in the new upward trend is going to be strong. The enthusiasm shown by the buyers trying to get into the stock demonstrates that the new trend should have a strong move to it. Use that gap as a strength indicator.

Gaps occur in many different places and forms. Some are easy to see, some are harder to recognize. This book will take you through the different situations where a gap has appeared. Each situation will be explained in detail, (1) to give you a full understanding of what is occurring during the move and (2) to provide a visual illustration to become familiar with the formation, making it easy to recognize. This allows the Candlestick investor to spot an investment situation as it is developing.

Gaps at the Bottom

Knowing that a gap represents an enthusiasm for getting into or out of a stock position creates the forewarning that a strong profit potential has occurred. Where is the best place to see rampant enthusiasm? At that point you are buying near the bottom. Obviously, seeing a potential Candlestick "buy" signal at the bottom of an extended downtrend is a great place to buy. In keeping with the concepts taught in Candlestick analysis, we want to be buying stocks that are already oversold to reduce the downside risk. What is better to see is the evidence that buyers are very anxious to get into the stock.

Reiterating the basics of finding the perfect trades, as found in Mr. Bigalow's book "Profitable Candlestick Trading", having all the stars in alignment makes for better probabilities of producing a profit. Consider the Housing construction industry mid-September 2001. The indexes were bottoming out after the 9/11 debacle.

The Housing stocks indicated the best evidence of capital inflow. The initial move to the upside was evident with a large number of good signals found in those stocks after doing a scan of the charts. Investors were really liking the residential home builders. This is clearly seen in Figure 2 - CTX, Centex Corp. It gapped up the same day, illustrating that buyers were coming into this stock with a vengeance. The initial gap is very important. It will indicate how strong the new move will be.

Figure 2 - Centex Corp.

Upon witnessing a gap up, an individual signal, such as the dark candle in the above chart after the gap up, has less relevance. When a large gap occurs, it is not unusual to see immediate selling as the traders take their quick profits. The overall message is that the bulls are in strong. The next few days demonstrated that the price was not going to back off, the new trend had started.

The long-term investor, after analyzing the monthly chart, could have established a position, with the knowledge that funds were flowing into this sector with much more enthusiasm than other sectors, which could have been just rising with the overall tide. A great indication for where to position your funds!

Figure 3 - TOL, Toll Brothers Inc. is another example of the gap up after a Candlestick buy signal, indicating that the investors were coming into this stock with vigor. The result was eventually returns of 80 - 100% in a four or five month time frame.

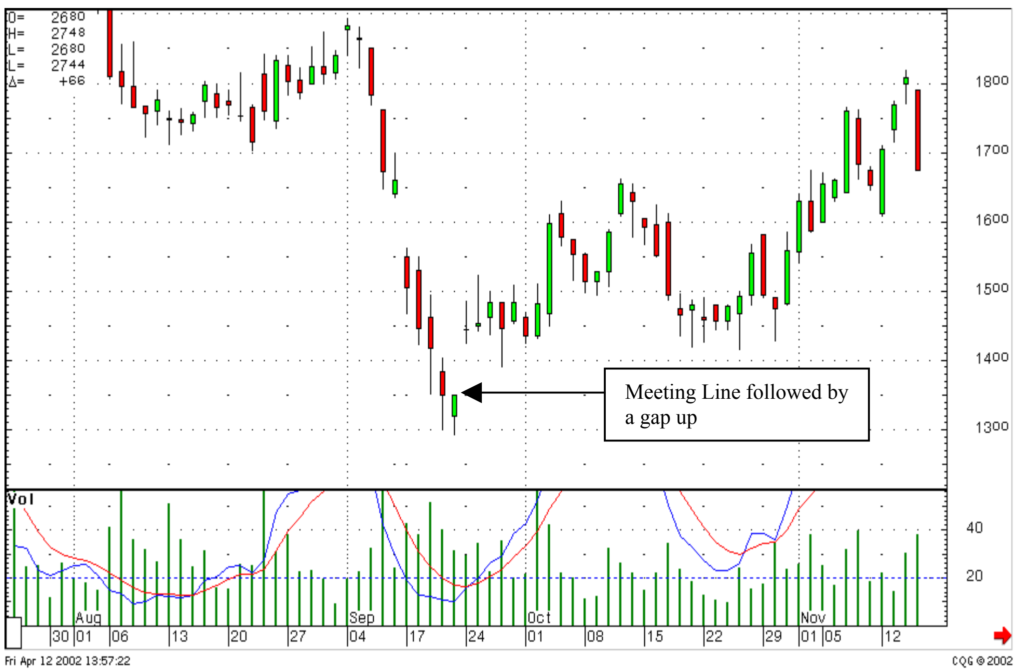
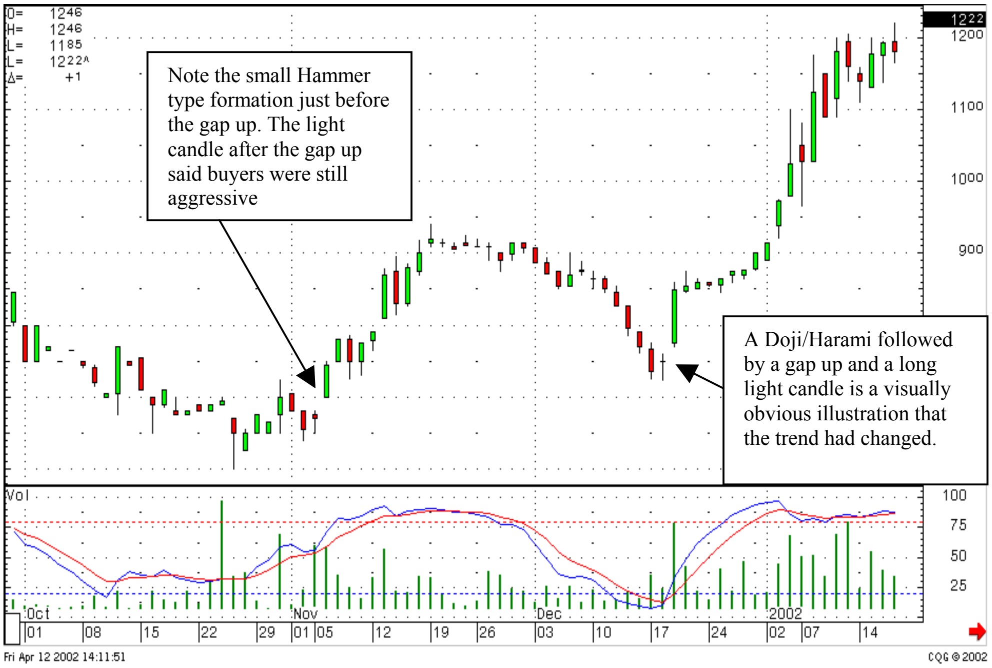


Figure 3 - Toll Brothers Inc.

For the trader, seeing a Candlestick "buy" signal followed by a gap up, when the stochastics are in the oversold range, makes for an extremely attractive trade. Notice the Doji formed on the day of the gap up. Logic tells you that the bulls are buying. The bears, who were happy to be selling at lower prices a couple of days ago, are more happier to be selling at these levels. Thus a Doji. The major indication is that the trend has changed vigorously.

Figure 4 - Cross Media Marketing



Note in Figure 4 - XMM, Cross Media Marketing, after Doji/Haramis, one on November 5th, another on December 18, 2001, that the gap up the next day clearly indicated the trend had stopped. The resulting trades produced 28.5% and 49.3% respectively. Probabilities demonstrate that a gap up is going to preclude an advance in price under these circumstances.

Unofficially, statistics illustrate an 80% and better probability that a trade will be successful when stochastics are oversold, a Candlestick "buy" signal appears, and the price gaps up. (The Candlestick Forum will offer our years of statistical figures as "unofficial." Even though over fifteen years of observations and studies have been involved, no formal data gathering programs have been fully operated. However, currently the Candlestick Forum is involved with two university studies to quantify signal results. This is an extensive program endeavor. Results of these studies will be released to Candlestick Forum subscribers upon completion.)

Having this statistic as part of an investor's arsenal of knowledge creates opportunities to extract large gains out of the markets. The risk factor remains extremely low when participating in these trade set-ups.

Note in Figure 5 - SPF, Standard Pacific Corp., gaps up the day after a Harami stops the current downtrend, 4/25/01. The gap initiates a move that sends this price to a higher level to stay. The following day gaps up significantly, consolidates for a few days and then gaps up again. The second and third gaps are considered "measuring gaps". These types of gaps will be explained later in this book. The important aspect from this chart is the initial gap up, revealing that the buying was overwhelming the selling.

Figure 5 – Standard Pacific Corp.

Many investors are afraid to buy after a gap up. The rationale being that they don't like paying up for a stock that may have already moved 3%, 5%, 10% already that day. Witnessing a Candlestick "buy" signal prior to the gap up provides a basis for aggressively buying the stock. If it is at the bottom of a trend, that 3%, 5%, 10% initial move may just be the beginning of a 25% move or a major trend that can last for months.

Huge gains can be made by finding and knowing the significance of a candlestick signal. Figure 6 - XMSR, XM Satellite, has signs of bottoming in early April, 2001. The Homing Pigeon, a form of Harami, shows the selling has stopped. A small Hammer, then a Doji/Hammer should be evidence that the sellers are losing strength. The Doji/Hammer should produce an alert that there is major indecision going on at this point. Watch for a strong open the next day.

Figure 6 – XM Satellite

The bigger the gap up, the more powerful the new trend will be. This was evidenced by another small gap up a few days later. Traders may have gotten out at the $8.00 range, still a good return. The longer-term investor should have gotten out at the $16.00 area. The $12.00 area could have been scary, but notice that after a gap up at $12.25, the lower close still didn't come into the last white body's range. The next black candle also didn't close in the white candle's range. Profit taking. The bears could not move the price back to the big white candle's trading range. The bulls took note of this and came back strong after their confidence was built back up. This moved prices to the next level. When prices gapped higher at the $16.00 range, then gapped down from that level, the selling was picking up strength. If the position was not liquidated then, it would have been logical to do so a few days later when a new high was not reached and an Evening Star formation was seen. Getting out at $15.50 around 5/23 would have produced a very nice 300% plus profit for a little under two months time.

That is what you use Candlestick analysis for. Getting rid of the losing trades quickly. Finding and exploiting the maximum gains from the good trades. Finding! An important element. The gaps produce the opportunities.

Coach Inc., Figure 7, illustrates when a trend is starting out strong. Late April, 2001 shows bottoming, a couple of Dojis appearing. If investors had been observing these signals, they would want to see bullish signals confirming the reversal. The gap open to $26.00 would have the Candlestick investor getting in on the open. Over the next 7 trading days, the trader could have realized a 27% gain. The long-term investor would have more than doubled those gains over the next few months.

Figure 7 - Coach Inc.

The Morning Star signal is an obvious visual reversal signal. A more potent signal is the Abandoned Baby signal. This is formed by the sellers gapping down a price at the bottom of a trend, trading through a day of indecision with the bulls, then the bulls taking over the next day, gapping prices back up and moving them higher. The bigger that gap, the more powerful the next up move.

As seen in Figure 8 - MERQ, Mercury Interactive Corp. during the early days of April, 2001, had a day where prices gapped down at the end of the downtrend. The weak sellers finally give up and get out at the bottom. They are met with bargain hunting bulls. The trading that day forms a Spinning Top, a day of indecision, almost like that of a Doji.

Figure 8 – Mercury Interactive Corp.

Quite often you will witness a big volume day during this three-day period. It is most effective if it occurs on the indecision day, showing an inordinate amount of stock moving from the weak traders to the strong traders. The big volume day can still occur on any of those days. What is most important is to see this big amount of stock change hands at this bottom period.

When the stock price gaps back up after the indecision day, this illustrates the sellers are now finished and the bulls have taken control. Again, measuring gaps are seen in this example, creating the opportunity for the trader to make 73% in about two weeks.

Example after example can be given on how a gap up at the bottom can produce big profit opportunities. But just as gaps tell you something as they occur at the bottom moving back to the upside, they are just as informative for preparing the investor to see when a downtrend is ready to reverse.

Reviewing some of the observations that Candlestick analysis reveals, as found in "Profitable Candlestick Trading", the Japanese could not only identify when a reversal was occurring, they could describe the trading environment that would anticipate the reversal. For example, using candlestick formations, it was clearly obvious that after an extended downtrend, the fear and panic would start to exaggerate. The daily trading range would expand as more investors panicked and liquidated their positions. This series of events would forewarn the Candlestick investor that the bottom was getting near, and to be vigilant for a buy signal. The most informative signal at the bottom of one of these declines is the gap.

For example, a stock has been in a downtrend for weeks. The talking heads on the financial stations are all expressing their opinions about how this company/industry is in the trash can. There is no reason to own this stock. Finally the last holdouts cannot stand the pain of owning that stock anymore. They get out at any cost. The price gaps down the next morning. Once this gap is spotted, a variety of profitable trading procedures can be put in place.

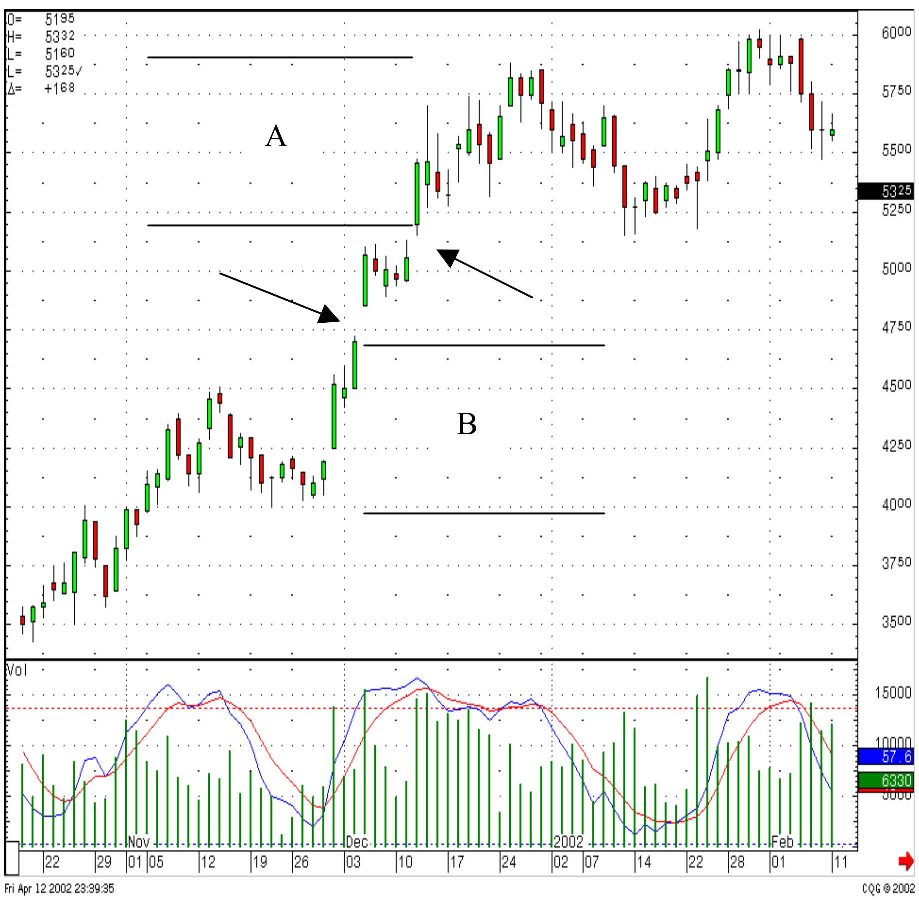
What can happen from this point? The price has gapped down after weeks of a lengthy decline. If it is a mild gap down, the price may keep declining. You may start seeing a dramatic increase in volume. The price is showing another big down day. However, the aggressive Candlestick investor realizes that the gap down was a blow-off signal. Upon seeing the price decline finally hit bottom and appear to stabilize, the aggressive investor can start to accumulate stock. Knowing that the gap was part of the panic selling gives the candlestick investor the confidence to step in when there is still panic in the air.

If the gap down is severe, the panic may all be built into the opening price. A severe gap down open after an extended downtrend may be a good opportunity time to buy. Watch how the stock price reacts after the open. If it appears to be stabilizing at the open level, with a little downside move that seems to be immediately bought up, it is time to start establishing a position. At the end of that day, you want to see a white candle, a close much higher than the open. This illustrates that all the sellers have been washed out. The buyers have taken over. This is the advantage that Candlesticks have over other charting techniques. It is much easier to see what is happening in a stock price when the color of the bodies can be viewed. A stock price that opens down and continues to go lower has a completely different strategy. The purchase of that position may be a few days or weeks down the road.

Measuring Gaps

A gap that occurs well after the beginning of a trend reversal, where stochastics are still in the midrange of an uptrend, has different implications. How do you distinguish whether a gap is a potential measuring gap? Evaluate where the stochastics are in the trend. If they are still relatively low, the trend has more room to create another gap before getting to the overbought area. Note in the CTX chart, Figure 9 - Centex, how the trend started with a small gap up. The next few days, another gap forms, in the midrange of this trend. The bears could not push prices back down through that gap over the next few days.

Figure 9 – Centex



Eventually the bulls gapped up the price again. Notice that the beginning of the trend up to the first gap [B] is about the same price movement as the move after the second gap to the top of the trend [A]. This simple measurement gives the gaps their name. The telling ingredient is the fact that the bears could not push prices back down through the first measuring gap. That factor gives the bulls renewed confidence and they step back in. The next day they gap it up again due to not being afraid of the bear camp.

Gaps At The Top

The gap that appears at the top of a trend is the one that provides the ominous information. Remembering the mental state of most investors, the enthusiasm builds as the trend continues over a period of time. Each day the price continues up, the more investors become convinced that the price is going to go through the roof. The "talking heads" on the financial stations start to show their prowess. They come up with a multitude of reasons why the price had already moved and will continue to move into the rosy future.

With all this enthusiasm around, the stock price gaps up. Unfortunately, this is usually the top. Fortunately, Candlestick investors recognize that. They can put on exit strategies that will capture a good portion of the price move at the top. Consider the different possibilities that can happen when witnessing the gap up at the top of a sustained uptrend. Most of the time the gap will represent the exhaustion of the trend, thus called an Exhaustion Gap. Or it could be the start of a Three Rising Windows formation. Or big news, a buyout or a huge contract is about to be announced.

What are the best ways to participate in the new potential, if there is any, at the same time knowing that the probabilities are that the top is in? A few simple stop-loss procedures can allow you to comfortably let the price move and benefit from the maximum potential. Hopefully, in the description of the gaps occurring at the exuberance of an extended trend, you have already experienced a substantial gain in the position. Any gap up is adding to an already big gain. Probabilities dictate that this is the top. Possibilities could include more upside gains.

Upon a slight to medium gap up, the Candlestick investor should put their stop at the close of the previous day. The thinking being that if the price gapped up, indicating that the top is in, and the price came back down through the close of the previous day, the buying was not sustained. If so, the stop closed the position at the level of the highest close in that trend.

Look at Figure 10 - NXTP, Nextel Partners Inc. If you had bought the stock the day after the Harami signal, showing that the selling had stopped, the open may not have been the strength wanted to show that the buyers were stepping in. After the price opened lower the next day, not showing resumed buying, a good spot to put the "buy stop" would be at the closing price of the previous day. The thinking being that if the price, after opening lower, came up through the closing price of the previous day, then the buyers were still around. Buying price = $4.50.

After a few weeks, the price starts to accelerate and finally they gap it up. News was probably looking very rosy at this point. Now the Candlestick investor is prepared. Knowing that a gap up at the top indicates that the top is near, they can implement strategies to maximize profits. Most investors will know that their position is up almost

100% in three weeks. That is not the type of move that will be missed by most. Upon seeing the bigger price days and volume picking up, the Candlestick investor will be ready for any sell signals that appear.

When the gap open appears, a number of strategies can be put in place. First, a stop loss can be put at the closing price of the previous day. If prices start falling off immediately and come down through the previous day's close, then the bears have taken control. You are out at the high close of the uptrend. In this case, as the price moves up, it would be safe to put a stop at the open price.

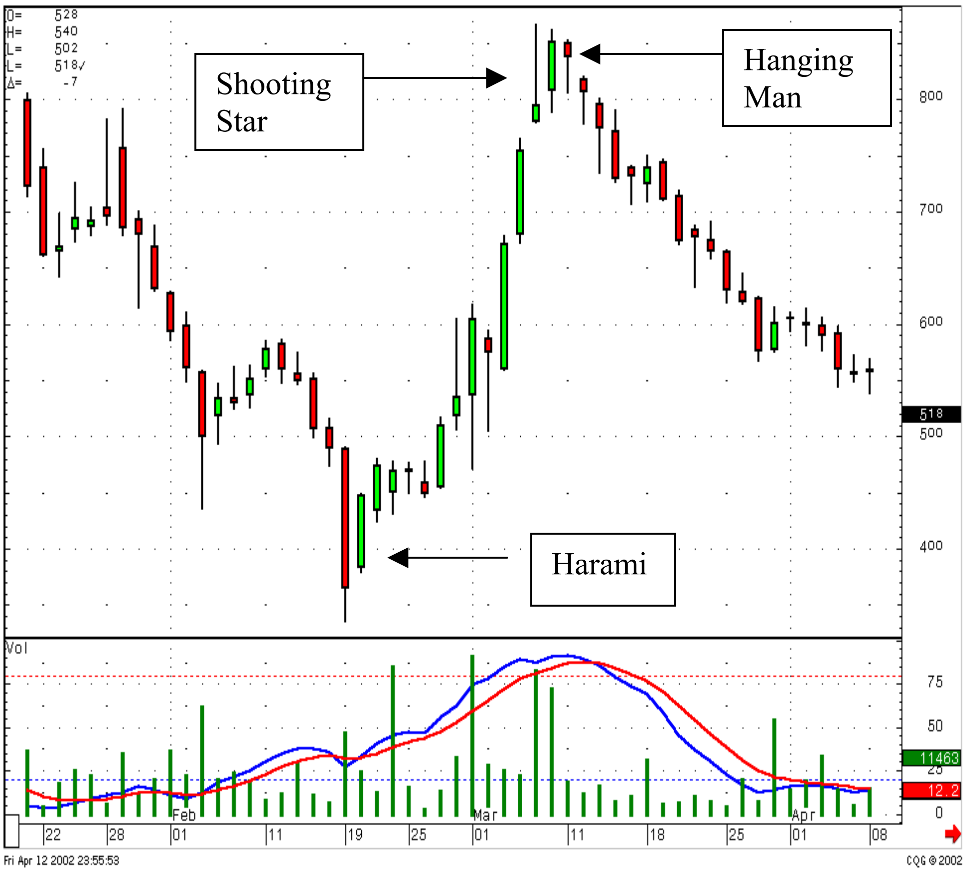


Figure 10 – Nextel Partners Inc.

A fundamental change might be in progress. The same rationale as putting a stop loss at the previous day's open, if the price comes back down to and/or through that level, the sellers probably have taken over control. Otherwise, if the stock price continues higher, it may stay in a strong spike move for the next few days. Knowing that the stochastics are now well into the overbought area, and the price was running up after a gap, selling one half of the position would be a prudent move. Probabilities say that this is near the top. There is always the low percentage possibility that new dynamics are coming into the stock price, an announcement of a new huge contract or a possible buyout offer, something new and different from the dynamic that ran the price up to these levels in the first place. A surge of buying may create a "Three Rising Windows" pattern, moving prices to much higher levels. The probabilities of this occurring at the top of a trend are very small but feasible. Moving the stop losses up to each close or next day's open price maximizes the potential profits from that trade.

As seen in NXTP, a Shooting Star formed, definitely a sell signal. If the price opened lower the next day, the position should be liquidated immediately. That is what the Shooting Star is telling you, that the sellers are showing up. The next day opened higher and stayed up all day. Things still look good. However a Hanging Man formation appears the next day. This is where the Candlestick investor should be thinking, "a Shooting Star, a sell signal, now a Hanging Man, another sell signal, be ready to get out." The next day after the Hanging Man, a lower open should have instigated the liquidation of any remaining position. At worst, the average selling price should have been in the $8.10 area. The gap was the alert signal that positions should be liquidated. This trade produced an 80% return over three weeks. Now go find another bottom signal.

Figure 11 – Omnivision Technologies Inc.

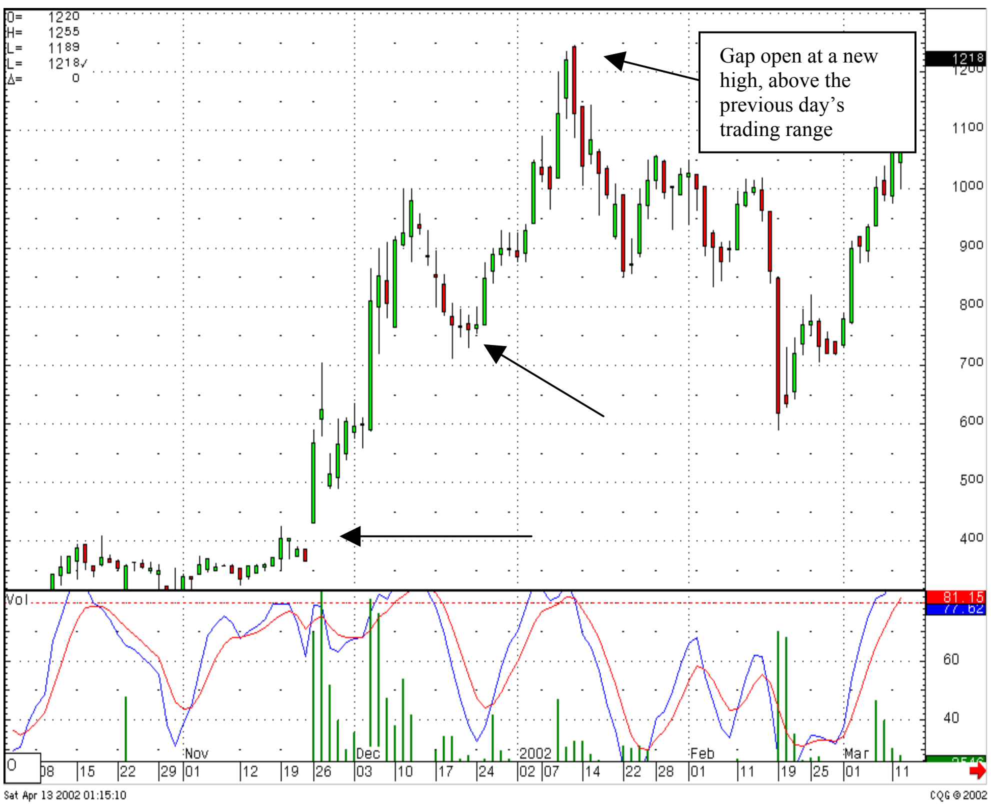


Figure 11 - OMVI, Omnivision Technologies Inc. demonstrates a gap open at the top with absolutely no follow through. This is when having a stop at the previous day's close will be the best exit. Whether the position was established at the breakout gap or the Tri-Star pattern, the profits were substantial. Being prepared for the gap up was the profit maximization technique.

If the gap up is substantial, after a long uptrend, it might be prudent to liquidate one half of the position immediately. The remaining position would have a stop placed at the previous day's close. If the price pulled back to the previous close, again it would be apparent that the sellers had stepped in after the gap up. The method locked in a price above the highest closing price of the trend.

Illustrated in Figure 12 – MGAM, Multimedia Games Inc., the end of the up move was foretold by a large green candle forming after a run up, then a gap up follows. This should have alerted Candlestick investors to start profit taking. It produced a good 33% profit in a just over a week. Now go find a low risk bottoming trade again.

Figure 12 – Multimedia Games Inc.

If the gap is up substantially, and it continues higher, put the stop at the open price level. On any of the scenarios described, the price moving back to the stops would more than likely create signals that warranted liquidating the trade, forming Shooting Stars, Dark Clouds, Meeting Lines or Bearish Engulfing patterns. In any case, sellers were making themselves known. It is time to take profits in a high-risk area and find low-risk buy signals at the bottom of a trend.

Selling Gaps

Now turn the tables over**.** The same enthusiasm demonstrated by a gap to the upside is just as pertinent for sellers on the downside. A gap down illustrates the desire for investors to get out of a stock very quickly. Identifying clear Candlestick "sell" signals prepares the investor for potential reversals. The Doji at the top, Dark Clouds, Bearish Engulfing patterns are obvious signals to be prepared for further downmoves. The Doji is the best signal to witness a trend reversal.

The Doji should stand out at the top of a trend just like a blinking billboard. Note the Doji at the top of the ISSI, Integrated Silicon Solution chart, Figure 13. The Candlestick investor would have already been prepared upon seeing that a Doji was forming that day as the close was getting near. At worst, the position should have been liquidated when the pre-market indications showed a weak open.

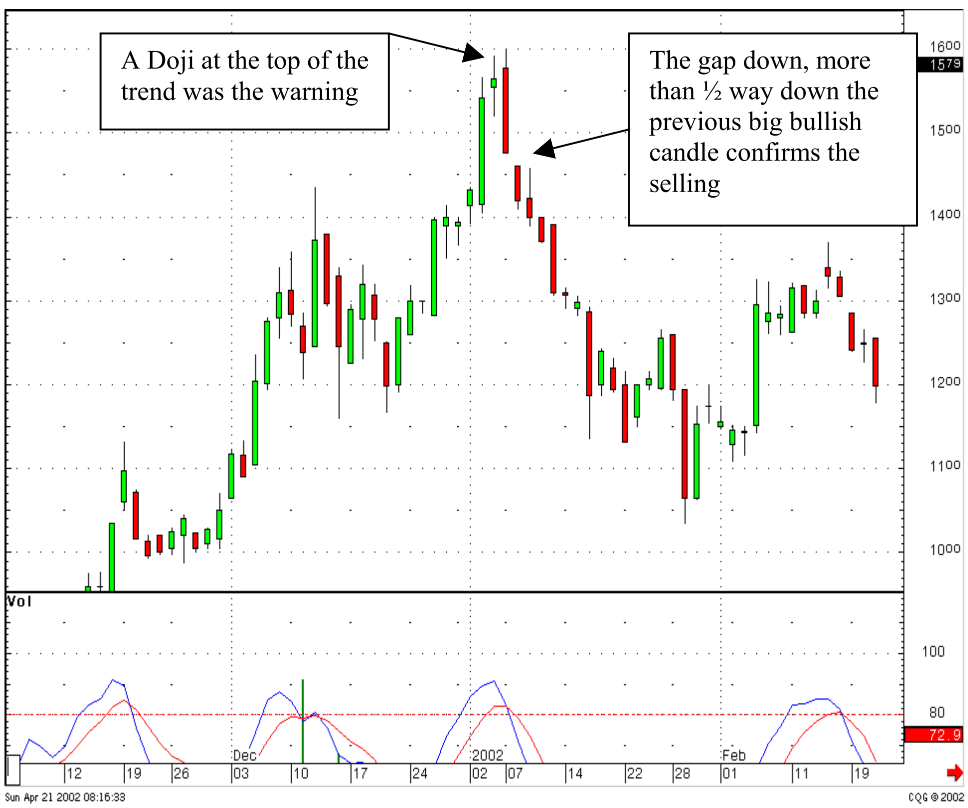
Figure 13 – Integrated Silicon Solutions

The existence of the gap down demonstrates an urgency to get out of this position. Being prepared for this event prevented giving back a major portion of profits.

Illustrated in the ASTSF chart, Ase Test Limited Ord Shr, Figure 14, the gap down confirms the downtrend a day later after the appearance of the Doji. A clear Evening Star signal requires the black candle after the Doji to close more than half-way down the previous large white candle. In this case, it closed right at the midpoint, still leaving some doubt as to whether the uptrend is truly over. The gap down the following day confirms that the sellers are now in control.

Knowing the simple description of the signals gives the candlestick investor that extra head start in preparing to take profits or go short. Utilizing the statistical probabilities of what the signals convey allows the mental, as well as the actual preparedness. The ease of identifying a gap, and knowing what messages a gap conveys, instigates the investor to change the position status immediately.

Figure 14 - Ace Test Limited Ord. Shrs.



These are examples that demonstrate the obvious benefits of what the windows /gaps portray. However, there are many more situations where they provide important investment decision-making aspects.

For example, review the Toll Brothers chart, Figure 15, April of 1999. Notice how the initial gap acted as a support level. In the weeks after the gap up the price would come back to the top of the gap but would not close lower. As long as the gap was not filled, the uptrend stayed intact. This is a good rule of thumb. If a gap cannot be filled, the predominant trend will continue. The Japanese term for filling a gap is ***anaume.***

Knowing that a gap will act as a support or resistance level gives the Candlestick investor time to prepare when one of these levels is approached. The condition of the Stochastics and the potential set up of another reversal signal informs the investor as to whether that gap is going to act as a support or if the gap will be filled. This may be occurring at a time when no other technical indicators are present in that price area. Note how the gap acts as a support level in the Toll Brothers chart. Each time price dipped to this level, the buyers stepped in and would not let the price fill the gap. This should obviously become a support consideration.

Figure 15 - Toll Brothers Inc.

Gapping Plays

As always, there are exceptions to all rules. The Gapping Plays are those exceptions. As previously discussed, the gap at the top of a trend is the exhaustion gap. The same is said for the gap at the bottom of a trend. The appearance of those gaps is either the last gasp exhilaration (at the top) or the last gasp panic (at the bottom). However, the Gapping Plays represent a different set of circumstances at the top or bottom.

After a strong run up, it is not unusual to see a price back off and consolidate before the next leg up in a rally. This could be in the form of a back off in price or a backing off from further advance. The latter is a period of the price trading flat at the high end of the previous uptrend. After the flat trading period, a new burst of buying, causing a gap up, illustrates that the buyers have not been discouraged. This new buying is evident by the gap up. As a gap expresses enthusiasm, this is usually the reinstatement of the previous move, taking prices up to a new level.

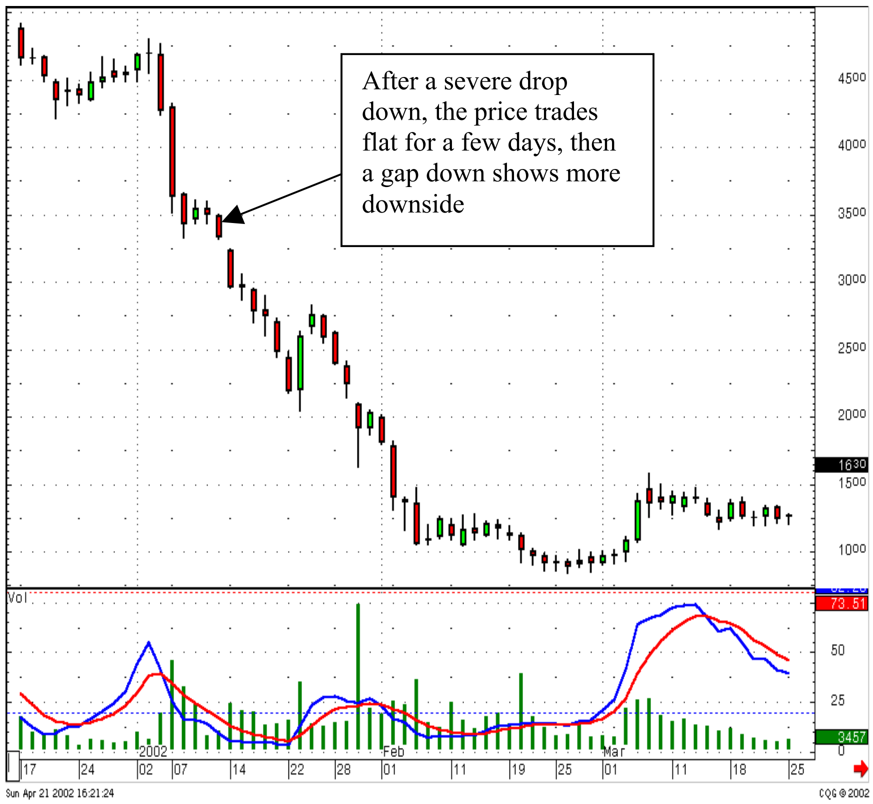
As seen in Figure 16 - ITG, Investment Technology, the gap up after prices had stayed flat and at the top end of the last large white candle, for about a month and a half, finally convinced buyers that the sellers were not around. The gap up should have alerted the Candlestick investor that prices should be moving up to a new level. This becomes a High Level Gapping Play.

Figure 16 - Investment Technology

The same is true for a declining trend. After a significant downtrend, prices level out. Once the sellers are convinced that there are no buyers around to move the price up, they can sell again with confidence. This confidence is seen in the gapping down of price. At that point, much lower prices can be expected.

As seen in Figure 17 - PCSA, Airgate PCS, after the price dropped dramatically, the buyers and sellers have a few days of indecision. The prices remain flat for three or four days. But after the sellers realize that the buyers are not strong enough to get the prices to move back up, they get out with force. This is known as a Low Price Gapping Play.

Figure 17 - Airgate PCS



Dumpling Tops and Fry Pan Bottoms

Sometimes a gap or window is required to demonstrate that the price move is picking up steam. Otherwise, the move may not create any signs that a move is forming. The best illustration is the Dumpling Top. The slow curvature of the top would not attract any attention. However, being prepared for a gap down allows the investor to make profits that otherwise would just blend into the trend with no great expediency needed.

Figure 18 illustrates the Dumpling Top. The Gap is the crucial sign in this pattern. Once the gap occurs, the downtrend should prevail for a number of days. Prior to the gap, there is so little price volatility, nobody would be interested in what was occurring in this stock. The Candlestick investor gets a forewarning of a profitable trade.

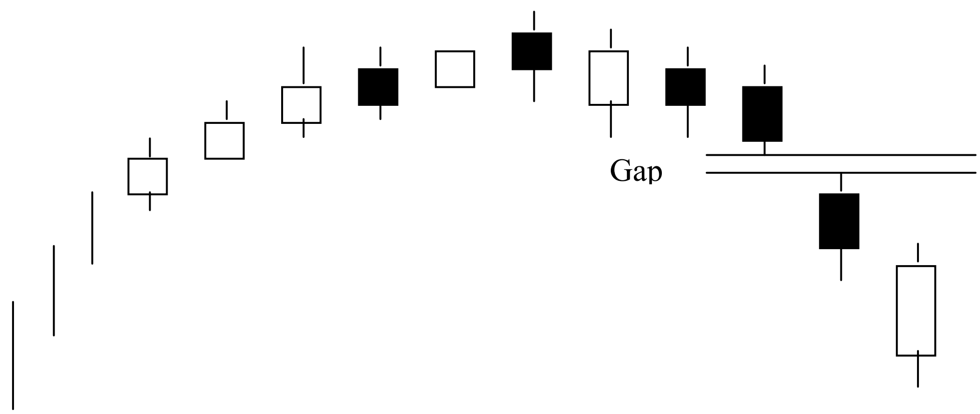
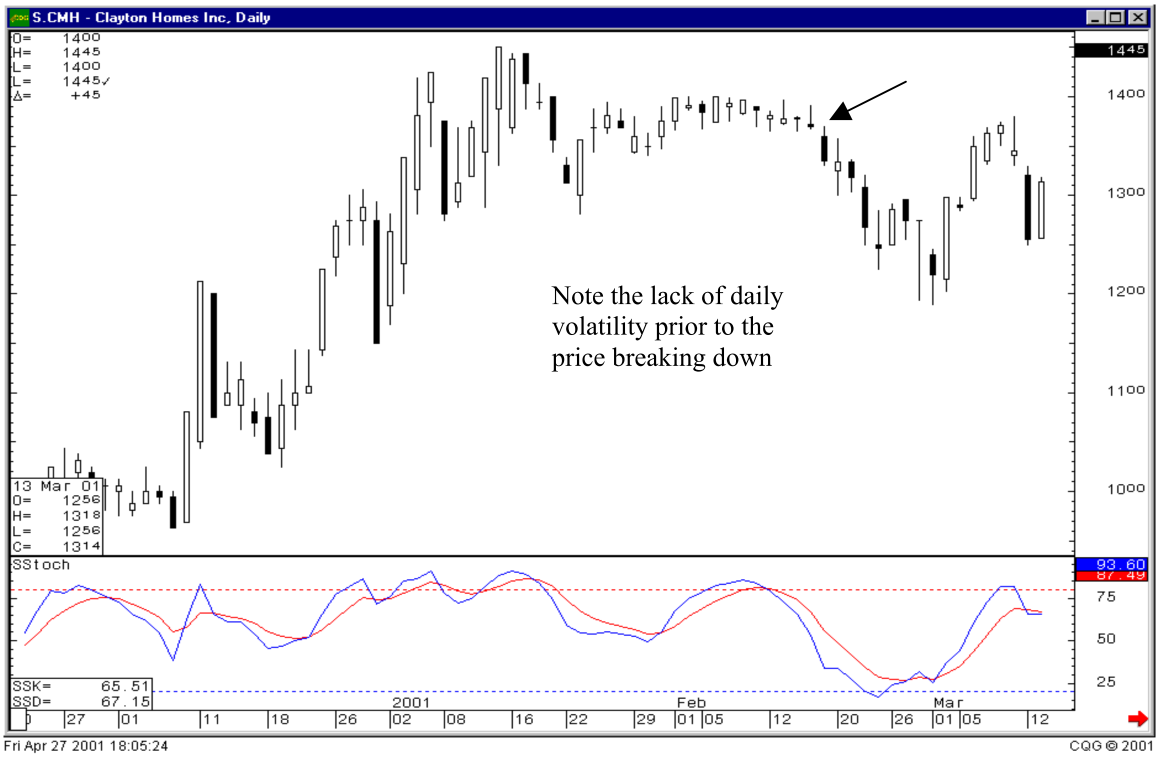


Figure 18 - Dumpling Top.

Note in Figure 19 - CMH, Clayton Homes, Inc., that the trading became listless until the gap down instigated a sell off.

Figure 19 - Clayton Homes, Inc.



Just as the gap down is the main initiative for expecting the downtrend after the Dumpling Top, the same is true for expecting an up-move after a Fry Pan Bottom. The Fry Pan Bottom gets its name from the slow gradual curve made at the bottom of a trend. This provides a lot of time for the sentiment to change from bearish back to bullish.