

Forex – Market Reversals

For the astute investor, reversal patterns can alert them to changes in the markets underlying trend, giving them earlier entry into a new trend or a hasty exit from one that is about to end. These patterns are made with bar charts, candlestick charts, and swing charts.

These various reversal patterns are very predictable and portray the market sentiment – the ‘thinking’ of the crowd. The movement of price for the particular trading session clearly shouts out how the masses are reacting to their perception of current events.

Reversal patterns are much more effective if they are preceded by strong trend. The reversal candle is called the ‘signal candle’. Before you act upon a signal candle, you need to have a confirmation candle (a strong black candle in a reversal from up to down, or a strong white candle in a reversal from down to up).

Let’s look at some of the common candle reversals ...

Common Candle Reversals

Hanging Man



The Hanging man is found at market tops and is quite a powerful reversal. The reason it is so powerful is that people react to fear much greater than they do to good news.

This candle has a small body at the top of a long wick that needs to be at least two times the size of the body. There is either a really small top wick or none at all.

It also looks just like a Shooting Star reversal, but just upside down.

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The Shooting Star

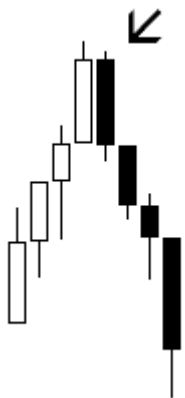


This is similar to the Hanging Man and also the Hammer reversals where the wick needs to be at least 2 times the size of the body, and in this case it needs to be the 'upper' wick.

The psychology behind this candle is that the bulls were quite strong, continuing with the previous trend, but at some stage the bears came in with a significant sell off, so much that it closed near the open.

Gaps between the lead up candle and the signal candle, and even between the signal and the confirming candle, give more significance to the likely reversal.

Engulfing



The Engulfing Pattern, whether it be a Bullish Engulfing pattern or a Bearish engulfing pattern, works off the same principles.

The market must be trending strongly into the reversal.

The signal bar is a strong bar, where the open and the close are in opposite ends of the bar, and its body totally engulfs the body of the previous lead up bar.

The emphasis is on the bodies of the two bars, not the 'total ranges' (distance between the high and lows of each bar).

Some people make a mistake in thinking that the signal bar must have its range outside of the previous bar, eg; its High is higher than the previous bars high, and its Low is lower than the previous bars low. But as you can see in the image above, the black reversal candle actually is a DOWN bar (a lower high and a lower low), but it fits the 'engulfing' rules where the body of the black bar exceeds the body of the previous bar. What these people are doing, is misinterpreting the reversal for an 'Outside Bar' reversal.

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If they were to miss the comparison of the two bodies here – they would miss the reversal indicator. However, it is preferable if the body of the signal candle actually engulfs the entire range of the previous candle.

The 'Bullish Engulfing' pattern is simply the opposite of the above – a white candle body fully engulfs the previous candles body.

The Hammer



The Hammer is the opposite of the Shooting Star – it has a small body with a wick below that is at least two times larger.

The psychology is also opposite – there was initially lots of selling, then the buyers came in with force and the session closed up near the open.

It doesn't really matter if the body is black or white, however a white candle is preferable as it shows higher favour towards the bulls. But in saying this, it is always better to wait for the following candle to confirm, (a strong white candle).

The Doji



The Doji is another very powerful and common reversal pattern found at tops and bottoms around 60% - 80% of the time – but is actually stronger at the top of markets.

The candle has no body, or at most a very small one – the open and close are the same price or very similar. What it represents is either indecision in direction between the Bulls and the Bears or otherwise described as agreement in price.

Like all other reversals the market needs to be strongly trending. There are many variations of the Doji which vary depending on the placement of the open and the close.

It is important to understand that not all appearances of reversal patterns will reverse the trend, they may just create a top or bottom of a peak or trough in the overall trend.

Reversals are more likely to happen when they are grouped with some other significant indicators. When you see these reversal patterns appear at significant time or price influences, it contributes a higher probability to turn the market with greater force and change the trend rather than a small pull back.

High Probability Indicators

Time Cycles:

–a reversal pattern that appears within a Cycle ‘Time Band’ (when a time cycle is due to end) is significant.

Price Cycles:

- are price levels where the market finds support or resistance at previous price highs and lows, natural numbers, or percentages of previous ranges (look in to studies by W.D.Gann and Fibonacci numbers –some of which will be discussed later in this topic).

Volume:

Volume of moderate to high volume should accompany the reversal bar or candle.

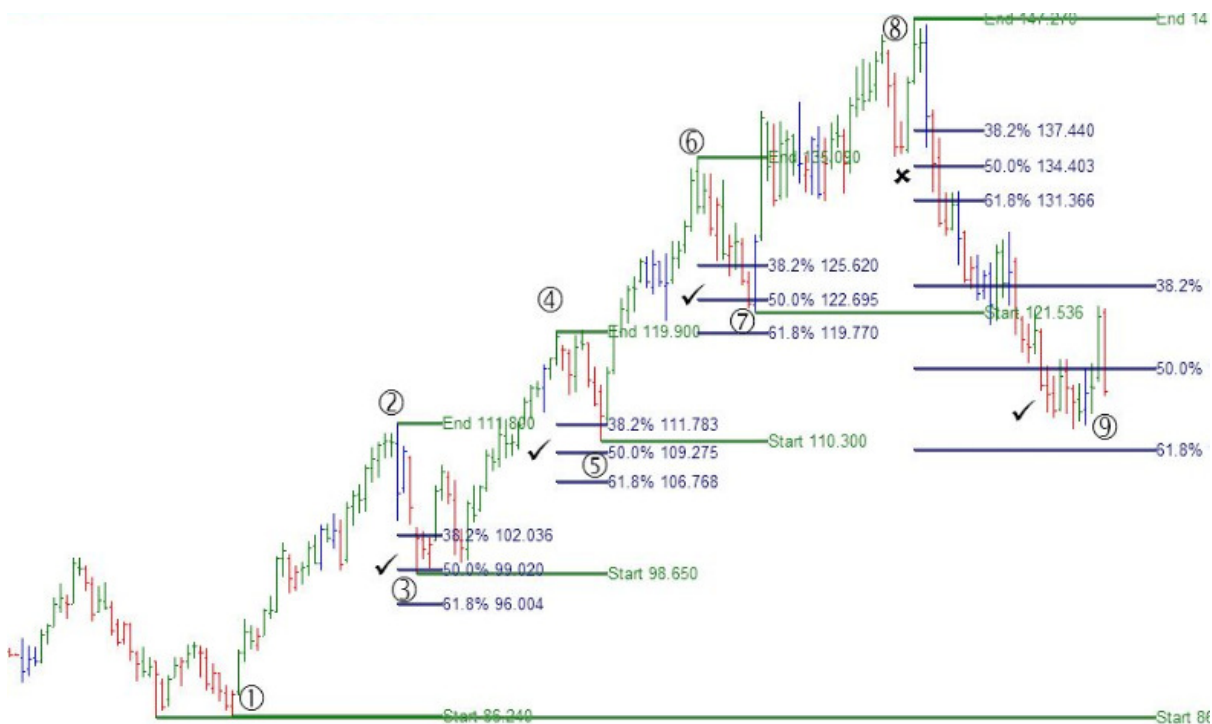
Fibonacci Numbers

On the daily chart below you can see I have added some numbers to all the 'peaks & troughs', starting with the number 1 at the first low.

- From number 1 to 2 is the first large movement upward, then the market falls down with a fairly significant pull back—as the market falls down (to number 3) you can see it has fallen down between the 38.2% and the 61.8% levels drawn onto the screen. These are Fibonacci levels. They are created by a Fibonacci tool that calculates the distance ('range') between the numbers 1 & 2 and then projects the percentages of that 'range' downward.
- 50% of that range would be 50% of the movement upward—so as you can see the movement upward was from 86.2 points up to 111.8 points, the total range is 25.6 points (111.8 minus 86.2). If you then divide the total range (25.6) by 2 (or 50%) you get the number 12.8. Then subtract 12.8 from the high of 111.8 and you get 99.0. (You can see the 99.0 level is projected down by the Fibonacci Retracement tool (and quoted as the 50% retracement).
- The interesting phenomenon is, markets move in 'trends' either upward or downward, and as it trends you will find it has its natural 'pull backs' or retracements against the trend, and when it does it will come back to a price in between the 38.2% and the 61.8% Fibonacci levels—quite often smack bang onto the exact prices of these levels (38.2%, 50% or 61.8%), before reversing and carrying on into the trend direction it was travelling in.
- Looking back at the chart you can see that once the market fell down from the range made between 1 to 2 down to 3 it then reversed between the Fibonacci levels and then continued on its way. Once we see the market again start to fall we can put Fibonacci levels on to the new 'range' just created (range 3 to 4).
- The market continues in this same sequence—rising for a period of time and when it falls it does so into a predictable price 'area', which is simply a calculation of the previous rise up. Quite amazing. It also does this from the rise of 5 up to 6 then down to 7.

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- Then after the move from 7 to 8 the market starts to fall, however this time when it falls it does quite quickly right through the Fibonacci retracement price 'area'. What we can do now is take the range of the larger movement which is from number 1 up to number 8 and project down the Fibonacci levels. And in doing so we can see that the market is now currently within this price 'area'. There are larger and smaller 'ranges' which are really just cycles of 'time' as referred to in the previous lesson on Market Cycles, but quite an in depth study that cannot be justified on this one page.
- These Fibonacci retracements can be used quite successfully with Cycle Analysis and 'bar or candlestick' reversal patterns to give powerful insight into the potential change in direction.
- Although we are currently within the larger 'range' price 'area' it has come down below the 50% retracement which is showing 'weakness' in the market, so it may fall further and in that case we would look for a larger 'range' to project the Fibonacci points from as the longer term time cycles are more dominant than the shorter time cycles.
- Each new bar that presents tells a little more of the story, insight into what may unfold.



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Q&A – Questions

QUESTION & ANSWER SECTION

		Answers
Question 1:	Reversal patterns alert the trader to the end of a current trend and the start of a new one. True or False?	
Question 2:	Reversals also show the s_____ of the crowds thinking.	
Question 3:	The market should be trending strongly into the reversal pattern for it to be more effective. True or False?	
Question 4:	The Shooting Stars wick needs to be at least _____ times the size of its body.	
Question 5:	The Doji is found around ___% to ___% of the time at market tops and bottoms.	
Question 6:	The market psychology behind the Doji is that there is agreement in P_____.	
Question 7:	The Fibonacci levels discussed in this paper are?	
Question 8:	These Fibonacci levels, 38.2%, 50% and 61.8%, are calculations of the previous 'range'. True or False?	
Question 9:	The Fibonacci levels are like time cycles – they appear or form accurately 100% of the time. True or False?	
Question 10:	The Fibonacci levels combined with reversal patterns can give traders a higher probability of a potential change of trend.	

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Q&A – Answers

QUESTION & ANSWER SECTION

		Answers
Question 1:	Reversal patterns alert the trader to the end of a current trend and the start of a new one. True or False?	True
Question 2:	Reversals also show the s_____ of the crowds thinking.	Sentiment
Question 3:	The market should be trending strongly into the reversal pattern for it to be more effective. True or False?	True
Question 4:	The Shooting Stars wick needs to be at least _____ times the size of its body.	2.5 Times
Question 5:	The Doji is found around ___% to ___% of the time at market tops and bottoms.	60% to 80%
Question 6:	The market psychology behind the Doji is that there is agreement in P_____.	Price
Question 7:	The Fibonacci levels discussed in this paper are?	38.2%, 50% and 61.8%
Question 8:	These Fibonacci levels, 38.2%, 50% and 61.8%, are calculations of the previous 'range'. True or False?	True
Question 9:	The Fibonacci levels are like time cycles – they appear or form accurately 100% of the time. True or False?	False
Question 10:	The Fibonacci levels combined with reversal patterns can give traders a higher probability of a potential change of trend.	True