1
Candlesticks = Signals

INTRODUCTION

Traders and investors have been looking at charts for well over 85 years as Edwin Lefèvre wrote (1994, p. 61), "I should say that a chart helps those who can read it or rather who can assimilate what they read". The problem today, however, arises not only from the interpretation of the chart but also how best to apply the mass of indicators and what indicators are best applied.

This book and the techniques that are discussed set out to demonstrate how to use a chart in the context of the market price action, that is, what to look for on a financial chart and then to place the signal into some form of technical context that will make it possible to gain insight very quickly into a particular currency market, thus saving many hours of fundamental research. This book demonstrates chart analysis that can give you, as a technical trader, an edge for entering a position in the financial markets, allowing the position to be monitored on a daily basis for signs of change or weakness.

The purpose of this book is not to teach you how to trade the markets, but instead how to find opportunities in the markets that present themselves as trade and investment opportunities. The signals, the warnings about market sentiment become apparent once you understand how to apply some of the familiar chart techniques that have stood the test of time, examples made available in such a way that it will not take long to understand how to apply these techniques to your own charts and find trade and investment opportunities.

Regardless of whether you are a part-time trader or full-time trader, your only concern is to find important signals that represent opportunities that will lead you to a profit. The daily market price action that appears on charts in the form of Japanese candlesticks or patterns are, for whatever reason, the result of the actions of market participants, but a technical trader is not interested in the crowd's reasons for doing what they do, but instead the result of their buying and selling.

P1: OTA/XYZ P2: ABC
c01 JWBK363/Burgess June 10, 2009 17:5 Printer Name: Yet to Come

It is, however, during the buying and selling that the emotional responses of many market participants are heightened and these emotionally loaded responses to the market occur time and time again and are categorised as FEAR, HOPE and GREED. In light of the vast amount of information that is available via the internet or news channels, these emotions are quite often heightened to such an extent that it is almost impossible to make a clear decision leading in many cases to badly executed trades. The opinion of some expert somehow gets the message across that undermines your objective thinking, and it is ultimately the recommendation that is the technical trader's worst enemy. To invest in the financial markets it is absolutely necessary to create your own plan based on your own analysis. A trade should be executed from a position of power and confidence not from uncertainty or based on feelings.

In this book the techniques are applied in a relatively straightforward manner so as to create a technical picture on which to base an investment decision that does not rely on any outside recommendations but instead on your own visual analysis of the markets. A chart should be used to identify the opportunities that are ever present in the financial markets, monitor long-term investments and help to plan an investment decisively. Charts should also be used to find the appropriate level at which to enter or exit a position.

Chart analysis is a cold hard study of the markets, it is a study of the price action and nothing more. If the closing price of the Euro continues to move higher in the week then foreign exchange traders and investors will be buying that currency, which is a fact, in spite of what the fundamental and economical reasons may be.

Interpreting a chart is about recognising and understanding the sentiment of the market. If the market was bullish, is it still bullish, if not, why not? Is the market correcting or is it a reversal?

In this book, the more obvious techniques have been taken and applied as ideas for expressing the technical picture. The techniques have been arranged in order of importance and are readily and quickly understandable and bring those searching for a method of interpreting the financial markets to their objective.

Each subject relates to the phenomenon of chart technical analysis with the issue of the investment and trading strategy being part of the plan. Six primary chapters cover the subject matter.

Chapter 1 looks at the categories and ideas behind signals produced by Japanese candlesticks with a focus on the market sentiment. The candles are reduced to eight types in order to comprehend the ideas derived from them, covering the more general standard type signal representing both extreme and normal market conditions with the more abstract representing uncertainty and imminent change.

Chapter 2 relates to the patterns that appear in the financial markets and the various relationships to market sentiment including how to find possible measured targets upon a breakout of the pattern, a pause in the market trend and a change in market sentiment. Patterns are important signals and many market participants trade them.

Chapter 3 looks at the idea of support and resistance levels focusing on trend line support and resistance and the phenomena of polarity and pivot lines that give rise

P1: OTA/XYZ P2: ABC
c01 JWBK363/Burgess June 10, 2009 17:5 Printer Name: Yet to Come

to a simple price observation at levels considered as bullish or bearish, allowing the technical trader to determine market direction and monitor positions.

Chapter 4 introduces the moving averages and the momentum indicators, both of which are based on the underlying price action. The averages supply information about the conditions of the market such as trending environment and support and resistance, the momentum indicators monitor the close in relation to the highs and lows over a set period of time and reflect this as the rate of change within the market. The momentum indicator is used for confirmation of market price action, displaying over-bought and over-sold conditions and divergence.

Chapter 5 applies certain techniques to the charts for finding optimal entry levels as confirmed by the techniques in the previous chapters. The obvious consequences of finding optimal market entry, covered by such themes as volume, pivot lines and interpretation of short-term charts, are very important for the technical trader.

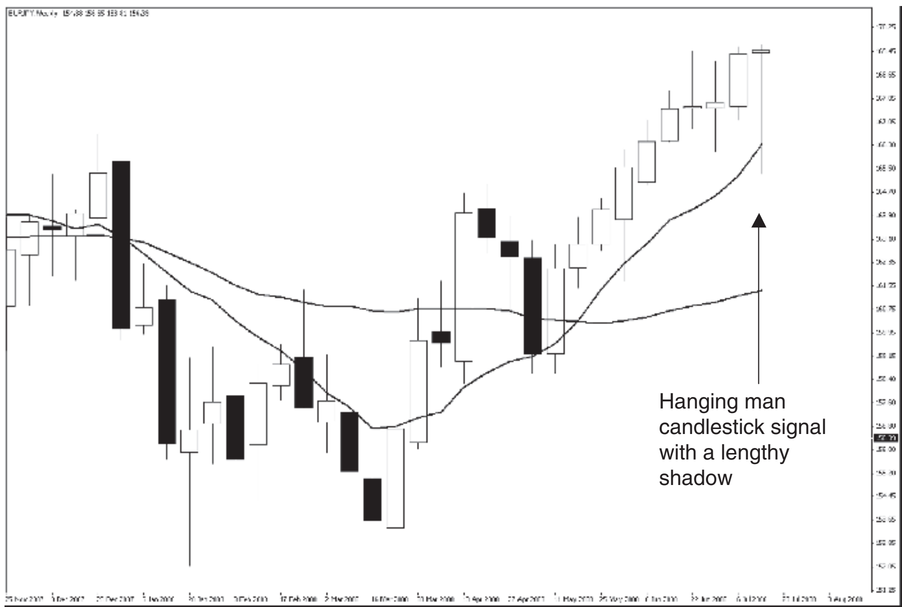
Chapter 6, the final chapter, draws on all the methods and techniques discussed previously in order to create a plan not only for watching the markets for signals but also for developing a strategy to be used for investing and monitoring a position.

All of the methods and ideas covered here come under a form of classification in the world of technical analysis. There will be the view that the ideas contained here must include also the ideas relating to their class. This is not necessarily the case as there has to be an element of will in trading and investing. The operations that involve placing wealth at risk involve emotions, therefore all that can be achieved technically is to arrange those technical tools in accordance with the dominant ideas behind them and convey them in such a manner that the primary task of creating a consistent yet simple technical picture of the financial markets is achieved.

In studying these techniques the reader will undoubtedly try to adopt and produce slight variations. This should be encouraged, however, these techniques, especially those indicators used for the purpose of demonstrating a change in momentum, have stood the test of time, that is, they are universally accepted as being sufficient and do not require change or modification. Applying the same parameters and back testing will prove this argument. It is with these techniques that you will master the basics necessary to understand your own charts and thus read the underlying market sentiment.

JAPANESE CANDLESTICK SIGNALS

On Friday 13 July 2008, the foreign exchange cross EUR/JPY closed the week leaving a large bearish signal on the weekly candlestick chart. This signal, known as a "hanging man" in Japanese candlestick terms, is bearish if seen at certain levels on a chart especially after an advance in recent price action. It is considered by chartists and technical traders to be a warning that the market is reaching a top and may falter on attempts higher. This simple candlestick signal offered traders of the foreign exchange market (Forex or FX) a great opportunity to enter a short position in the EUR against the JPY, see Figure 1.1 overleaf.

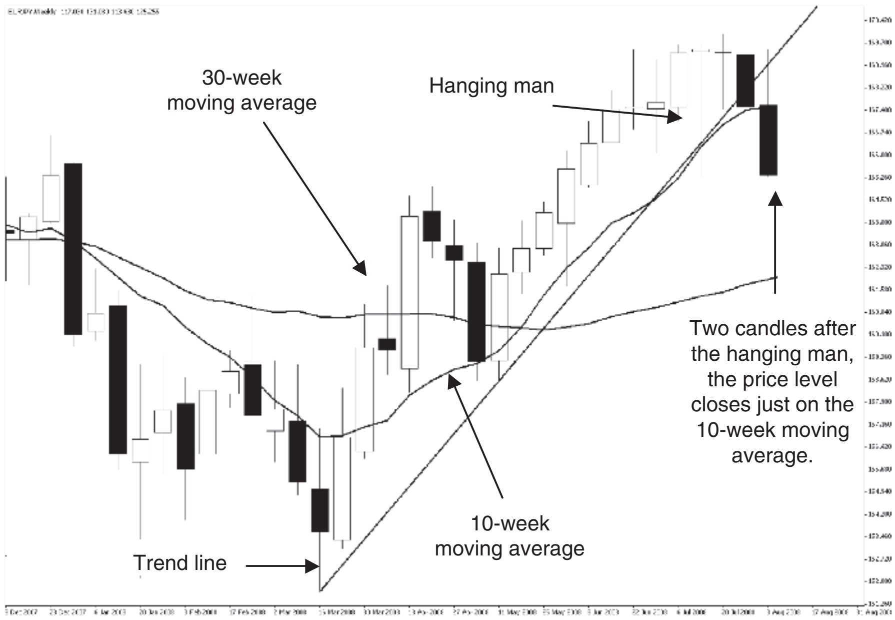


(source MetaQuotes Software Corp)

Figure 1.1 EUR/JPY weekly chart with large hanging man candlestick.

The hanging man candlestick signal appeared on the chart because during the early part of the week the market had sold off sharply only to see buyers re-enter the market and push the price back towards the opening levels thus creating the "hanging man" with a lengthy "shadow".

At the close of that week there would have been many traders in the market, including fresh buyers, all of whom were anticipating higher levels to come and yet were nervous at the slightest decline in price action. The following week a similar candlestick appeared at the weekly close, another warning signal which left many forex traders that weekend concerned about their positions in the market. Two weeks after the first hanging man appeared, clues begin to unfold which confirmed that there is a change taking place in the market, a change which the initial bearish candlestick had signalled previously. For example, there was a close below the current trend line that week, the first since the trend began on 16 March 2008, that is 19 weeks had passed before the trend line had been violated! Another very important clue was the close of that weekly candlestick on Friday 25 July 2008, this was the first weekly close at the 10-week moving average level since the two averages crossed positive on 18 May 2008. In fact, prices dipped below the 10-week moving average before closing just above it but still below the trend line, see Figure 1.2 opposite.



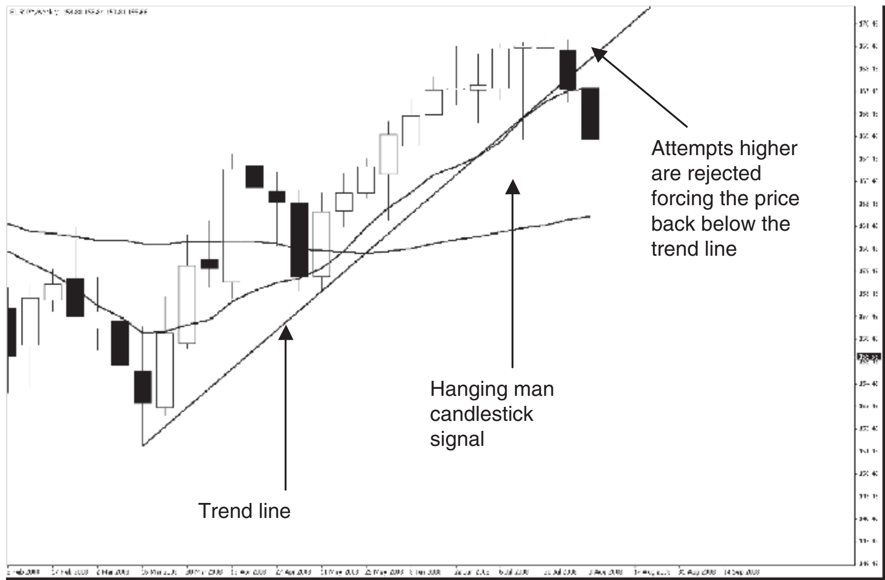
(source MetaQuotes Software Corp)

Figure 1.2 EUR/JPY weekly chart demonstrating a break of a trend line and a close below the 10-week moving average, the market sentiment is changing.

At this point those traders that had entered the market pushing the market back up would have been left holding losing positions but still hanging on in hope that the market would move off higher from the current level. Although the EUR/JPY cross did attempt to move higher from the 10-week moving average it was rejected, not only from the highs, but also from the trend line where technical traders had been waiting to sell, see Figure 1.3 overleaf.

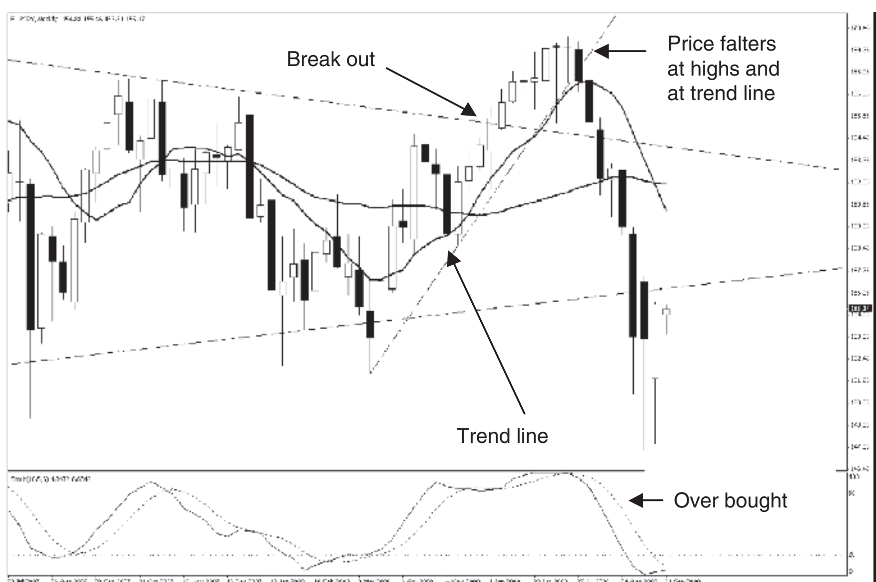
The hanging man candlestick signal now began to take effect. At some point, those traders, either working in banks or large corporate organisations that were still long began to reduce their exposure in the market by cutting the size of their positions. The result of all of this is that the EUR/JPY cross accelerates lower as traders cut their positions. As you can see from the chart in Figure 1.4 overleaf, the price pauses at the 30-week moving average before continuing much lower. Originally, all of this price action was based on a very powerful and yet very visual signal.

There were also two other very important clues that the EURO would struggle to move higher against the Japanese Yen. The stochastic indicator was in the over-bought zone and was beginning to cross negative, there was also a large triangle pattern from which the EUR/JPY had broken out too soon, suggesting that prices would falter and find their way back inside the triangle.



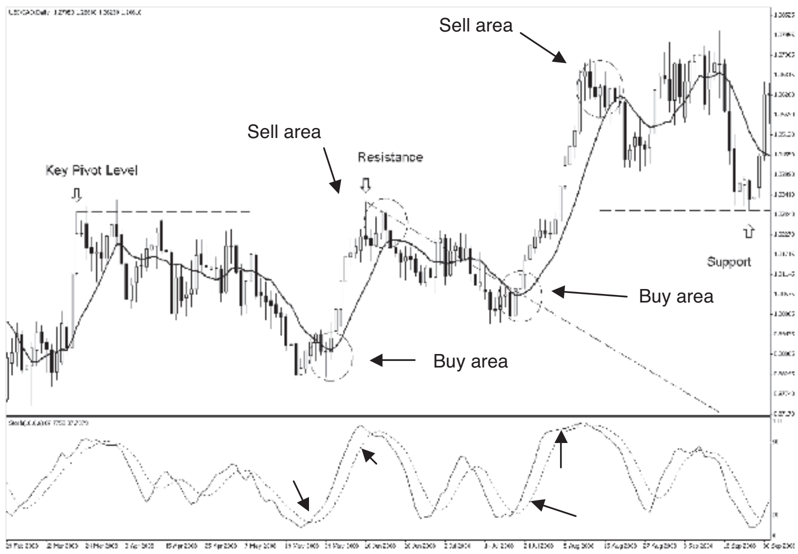
(source MetaQuotes Software Corp)

Figure 1.3 EUR/JPY weekly chart showing the beginning of break down in market price action.



(source MetaQuotes Software Corp)

Figure 1.4 EUR/JPY weekly chart after the break down in market price action has occurred.



(source MetaQuotes Software Corp)

Figure 1.5 USD/CAD daily chart showing buy and sell areas.

Having seen the hanging man candlestick signal, you as a technical trader of the foreign exchange market would have been prepared for a change in market sentiment. You would have expected the change to happen and would have been watching the chart for further technical evidence to confirm the signal, gathering information and creating a strategy from your chart that would enable you technically to follow the market. What is probably more important, however, is the trade which you would have seen as a low risk trade in your favour. A stop-loss order placed some points above the hanging man, at the level where you would have been wrong and wanted to protect your money, was easily positioned in the market, ensuring absolute risk/reward.

A chart should be technically easy to interpret. If the technical picture is difficult to understand then something is wrong with your analysis or some technical indicator has not been placed correctly on the chart. It is the signals together with indicators as well as support and resistance and trend lines that make up the technical picture that helps to dissect the market price action and display the market sentiment in such a way that a conclusion may be reached, see Figure 1.5. These techniques must be consistent and concise in their application. Consistency will help to avoid uncertainty in finding and confirming the opportunities as and when they appear on the chart.

THE SINGLE SIGNALS

Beginning with Japanese candlesticks, these signals originate with a Japanese rice merchant named Munehisa Homma (also known as Sokyu Honma) (1724–1803),

P1: OTA/XYZ P2: ABC
c01 JWBK363/Burgess June 10, 2009 17:5 Printer Name: Yet to Come

who developed a graphical set of rules to use for trading rice. It is from this period in Japan that candlesticks as we understand them today are derived. A candlestick is a graphical representation of the OPEN, HIGH, LOW and CLOSE of the market price action and for this reason it is very important to have accurate data. Candlesticks that have a 22:00 GMT close on the foreign exchange market (after the New York close) may have slightly different graphical implications compared to a candle that has a 23:00 GMT close or a midnight (GMT) close. Graphically, candlesticks display market sentiment in such a way that makes the task of sifting through charts easier. They are usually coloured to represent the direction, for example, a higher close relative to the open might be white, a lower close relative to the open may be black. This has the advantage of recognising the day's trading at a glance, i.e., a negative day or a positive day, see Exhibit 1.1.

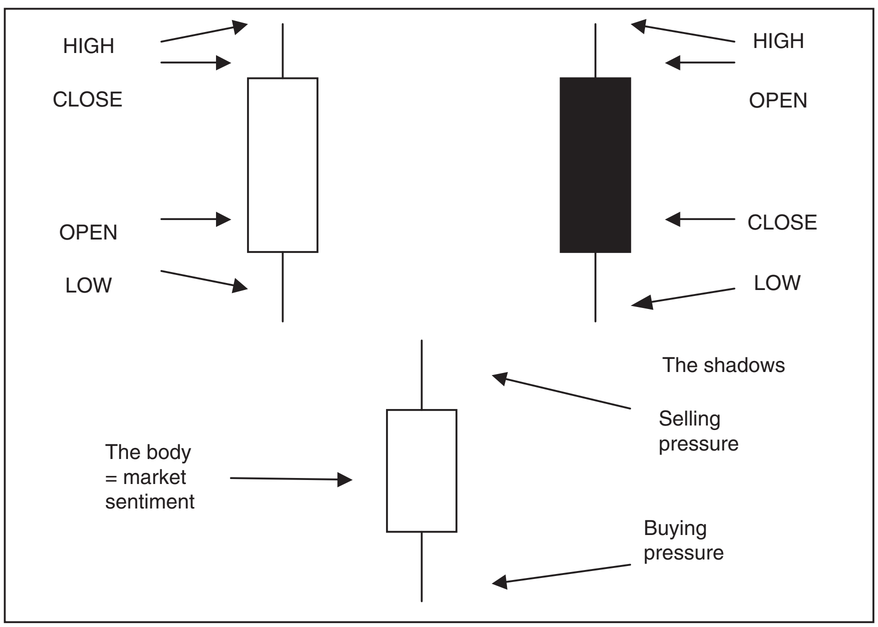
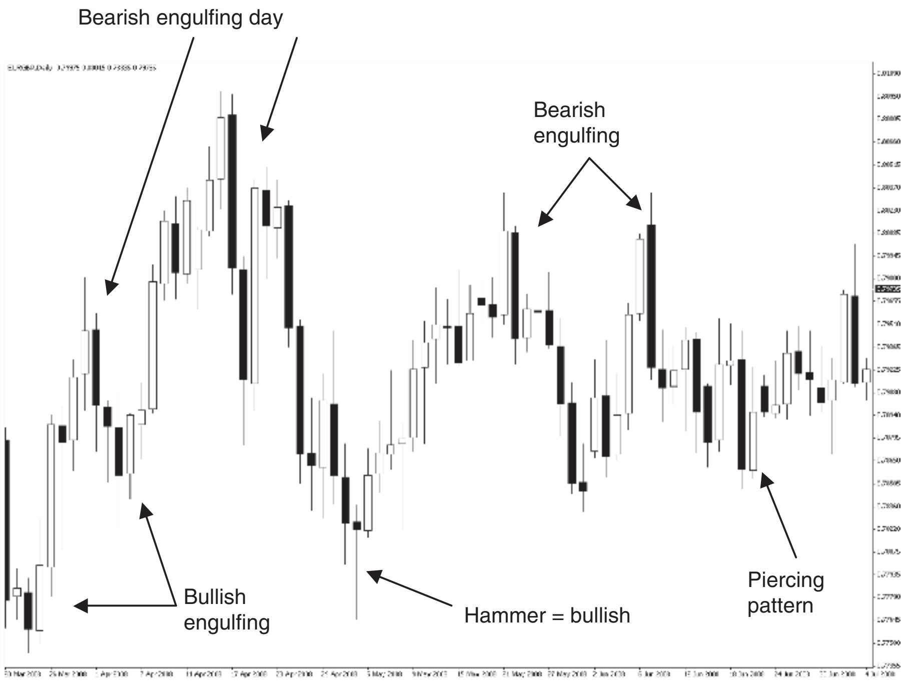


Exhibit 1.1 White candle is a positive, the market price action moved up throughout the day; the black candle is a negative day, here the market price moved down.

The candlestick chart is a visual representation of the inner workings of a market. The selling pressure or the buying pressure is displayed visually allowing for immediate insight into the market. The candlestick shadows are useful as indicators of resistance and support, allowing lines to be drawn on the chart with relative ease at these levels. It is, however, the market sentiment and change in market sentiment that candlesticks charts demonstrate best. Simply compare a bar chart to a candlestick chart and this becomes apparent.



(source MetaQuotes Software Corp)

Figure 1.6 EUR/GBP daily chart with some examples of Japanese candlestick signals displaying the market sentiment as bullish or bearish.

The daily candlestick chart shown in Figure 1.6 displays the same price information as the daily bar chart in Figure 1.7 overleaf. Where the candlestick chart displays the sentiment of the market the bar chart says very little until the market breaks out of its range or channel or makes a new high or low.

A bar chart, as compared to a candlestick chart, can display patterns and channels more clearly than a candlestick chart and this is probably a bar chart's greatest advantage. However, the visual clues about daily market sentiment are not so easy to discern. Where as a candlestick that opened at the lows and moved higher, closing at the highs, is demonstrating that the market has been positive, a candlestick that has opened, found support and closed only slightly higher during the course of the session is demonstrating uncertainty in the market. These variations are displayed very well visually on a candlestick chart but not on bar charts.

Applying candlesticks to the chart it is not only possible to establish the day's range as with a bar chart, but also establish the sentiment of that range by looking at the body of the candlestick that forms between the open and the close. A positive day has seen more buying than selling, perhaps large orders going through the market,

(source MetaQuotes Software Corp)

Figure 1.7 Example of a EUR/GBP daily bar chart with very little to see about what the market sentiment is in this market.

and many short-term traders decide on a direction. A negative day is just the opposite; the session has seen more sellers than buyers with many buyers just sitting on the sidelines. An uncertain day, however, is a sign that the market has seen many buyers or sellers quickly finding resistance or support and those buyers or sellers that did enter that session may have exited the market very quickly thereafter. These are days where the market consolidates.

Japanese candlesticks applied to a chart on their own are not the solution to understanding the financial markets. Candlesticks can often be interpreted falsely especially as many of them look like reversal signals. Many investors and technical traders do not apply them on charts for exactly this reason. Another reason that many professional investors find candlesticks difficult is that the daily session may trade at the same level for 90 % of the day; the market can trade around a certain price level for most of the session only to move higher towards the close of the session, the real body is arguably not representative of the real trading session. It is, therefore, necessary to look at the short-term time frame in order to confirm that this has happened and find the bulk of the trading on the 60 min. chart so as to clear up any uncertainty, see Exhibit 1.2 opposite.

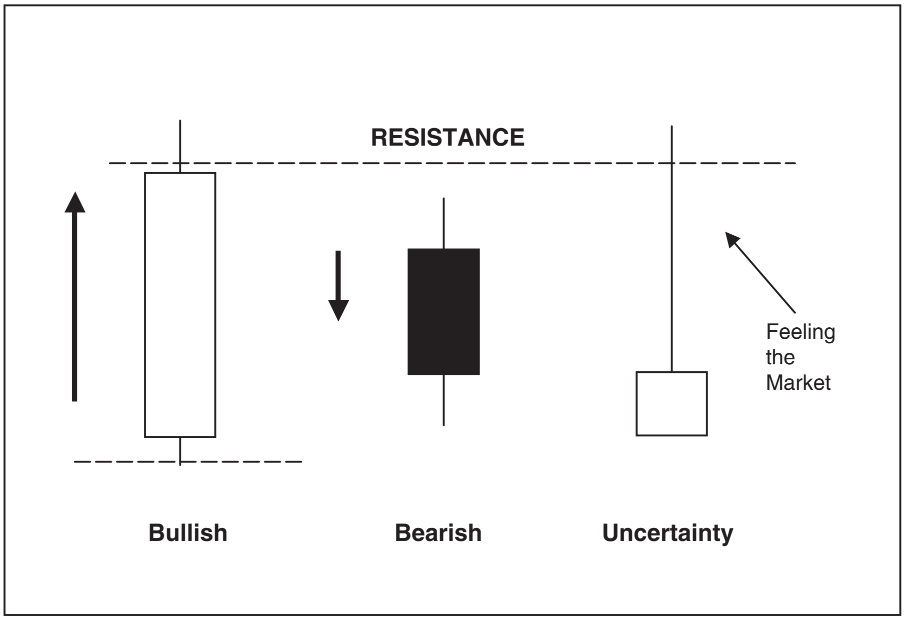
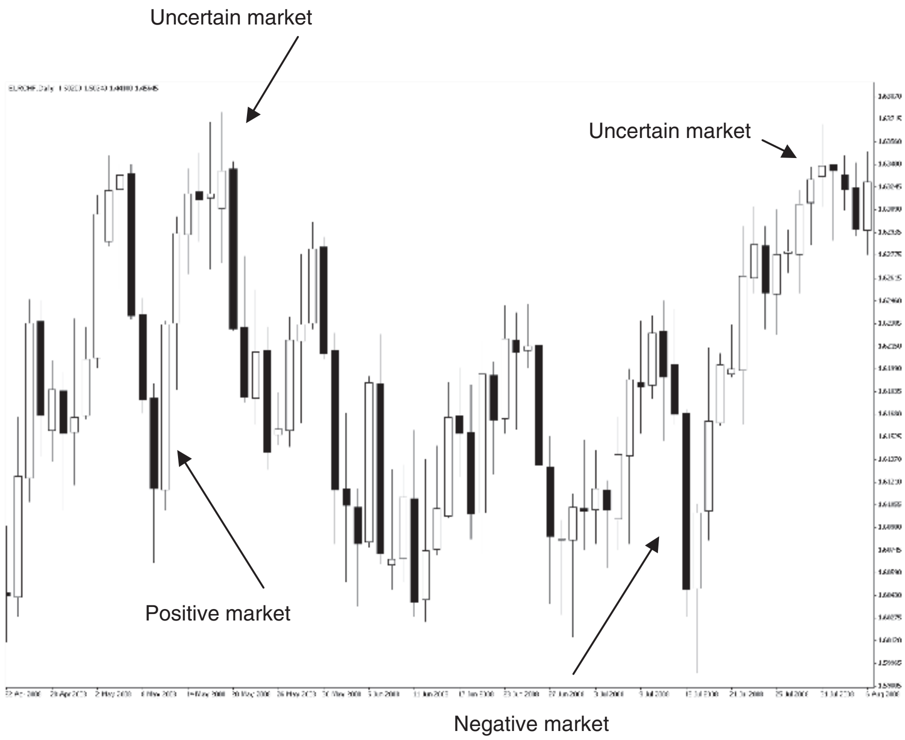


Exhibit 1.2 White candle is positive, black candle is negative, long shadow found strong selling pressure.

The close of the session is important and for this reason, as will be demonstrated later in this book, it is necessary to place candlesticks within the context of other indicators and in particular to find a significant level on the chart and then watch to see if the market is closing at, above or below the level of importance. This is a useful indication of a truly bullish, bearish or uncertain market. Put simply, to watch how the market reacts at certain pre-defined levels and observe what type of candlestick forms at these levels.

For the purpose of this book the candlesticks in Exhibit 1.3, on page 13, are constructed to follow a system of classification of signals that is expressible by the open, close, high and low of the market session. The main aim is to obtain the greatest amount of visual utility. Therefore the arrangement has been adapted accordingly to the simplest and most visual form that appears on daily charts, one that will not require a deep comprehension of Japanese candlesticks. These candlestick signals are the more obvious signals which best reflect market sentiment at a glance. The objective is to learn to recognise the signals that candlesticks produce with regard to the sentiment of the market and the change in market sentiment, which is what you as a technical trader and investor should be concerned with because where there is change, there is opportunity!

As a guide, it is useful to see the white candles as positive and the black candles as negative, as well as the size and frequency which should be noted on the chart.



(source MetaQuotes Software Corp)

Figure 1.8 EUR/GBP weekly chart with positive days, negative days and uncertain days.

A white positive candle may still have bearish implications and a black negative candle with a long shadow may only be a pause in market price action before the market continues higher, and is thus positive overall. A negative closing hammer that appears at support only to see a positive session thereafter could be seen as having even stronger bullish implications. It is therefore necessary to apply confirmation as much as possible. Where the real body of the candle can show market sentiment, the highs and lows are just as important. Higher lows suggest greater buying interest and lower highs just the opposite.

Candlestick signals form the basis of chart reading in this book and are discussed as signals in the light of other techniques that confirm the signal. More often than not candlestick signals provide a very early warning about a possible change in market sentiment. Occasionally, however, a candlestick may take a few days before the change in market sentiment actually begins to unfold.

This is particularly important when reading charts with candlesticks. Learn to see how often a harami actually unfolds in the next session and how often it requires a

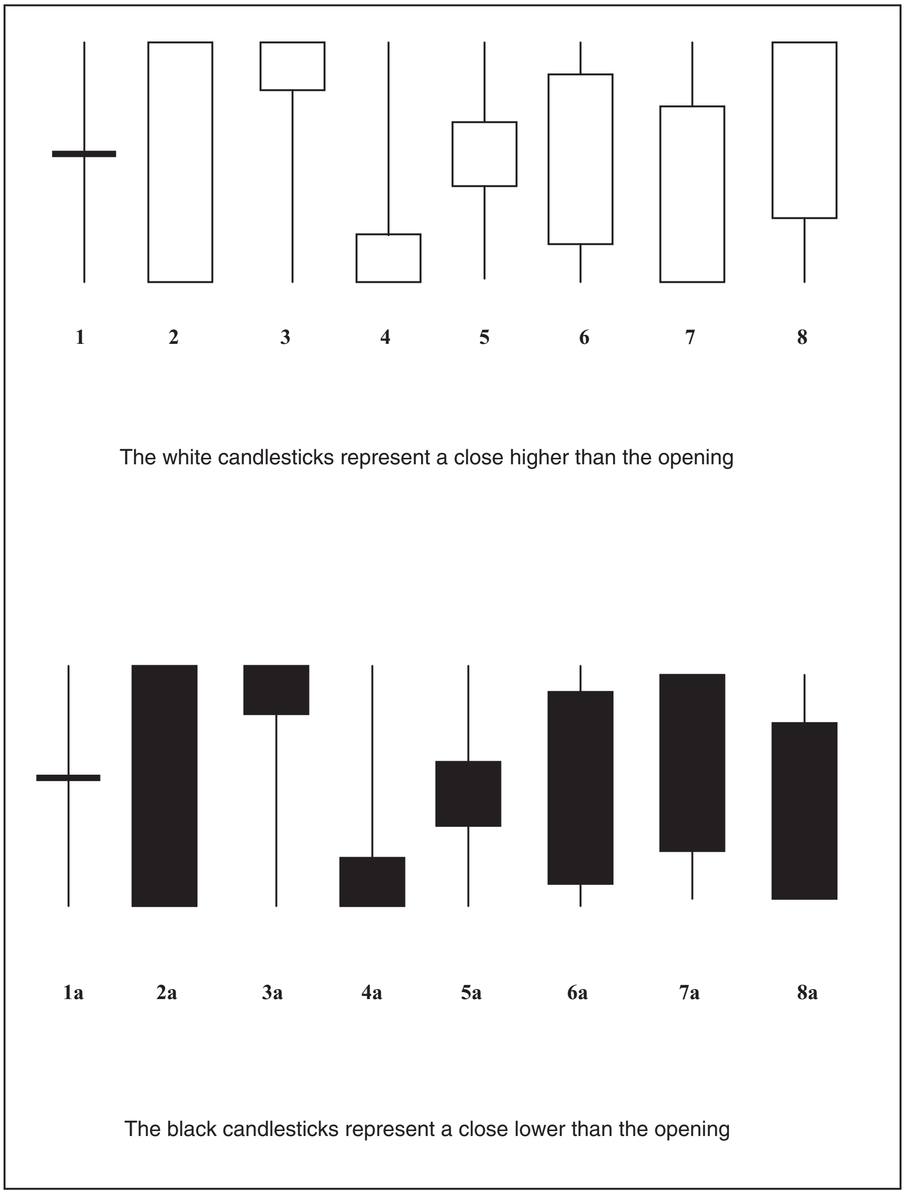


Exhibit 1.3 Eight candlestick types.

P1: OTA/XYZ P2: ABC
c01 JWBK363/Burgess June 10, 2009 17:5 Printer Name: Yet to Come

few days before that signal begins to unfold. Together with other important technical aspects these signals will prove to be very valuable. Finally, rather than back test candlestick patterns simply take a chart and look for these candlesticks, see how the market reacts to them.

1. Doji Cross – Opens and closes at same level = warning uncertain market.
2. Marabozu – Opens at the lows, closes at the highs = positive market.
3. Hammer – Opens, finds buying pressure, closes higher = positive market.
4. Inverted Hammer – Opens at the lows, moves higher, finds sellers, closes near open = warning (can be black or white in colour).
5. Spinning Top – Opens, finds support and resistance, closes higher = uncertainty
6. Standard day – Opens, moves lower, finds support, closes near highs = positive market.
7. Bullish Belt-Hold Line – Opens at support, moves higher, finds resistance, closes near to highs = continuation.
8. Bullish Closing Bozu – Opens, moves lower, finds good support, closes at the highs = positive.

1a. Doji Cross – Open and closed at same level = warning uncertain market.
2a. Marabozu – Opens at high, closes at the low = negative market.
3a. Hanging Man – Selling pressure with a close lower than the opening.
4a. Shooting Star – Buyers found support, pressure causes lower close (can be black or white in colour).
5a. Spinning Top – Opens, moves lower, finds support, moves higher, finds resistance, closes lower than open = uncertainty
6a. Standard Line – Opens, moves higher, finds resistance, moves lower, finds support, closes near to the lows.
7a. Bearish Belt-Hold Line – Opens at resistance and immediately moves lower closing near the lows.
8a. Bearish Closing Bozu – Opens, moves higher, finds good resistance, closes at the low of the day = Negative.

Candlestick 1 and 1a, the Doji Candlestick

This candlestick is very well known amongst technical traders and is a very important signal. Should this be seen after a recent advance in price action it is a warning that the market may have reached a turning point, that there is a possible change in market sentiment, a pause at the very least. This type of candle can have very long shadows with no body or very short shadows with no body. The trading session has seen very little progress with many short-term traders becoming confused, leading to uncertainty in the market.

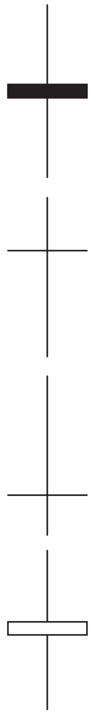
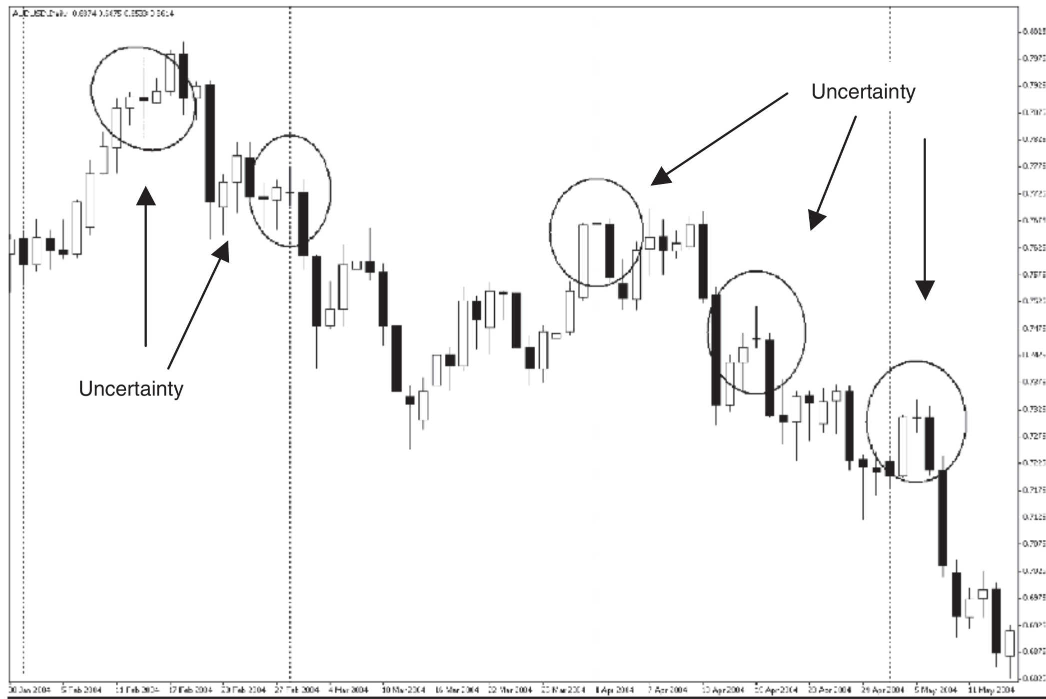


Exhibit 1.4 Doji type candles.



(source MetaQuotes Software Corp)

Figure 1.9 AUS/USD daily chart with Doji candlesticks signalling a possible change in market direction.

The doji candlestick has variations. The shadow can be longer or shorter and the open and close may be at one end of the shadow, which is known as a gravestone doji (bearish) or dragonfly doji (bullish). It is the warning signal which these candlesticks display visually that signals opportunities for the technical trader.

Candlestick 2 and 2a, the Marabozu Candlestick

The long candle that is known as a marabozu candlestick which opens at the low and closes at the high signals a very positive market session. This candlestick has no upper and lower shadow and although not crucial in the FX markets, is often characteristic of this type of candlestick. The candlestick can also stand out as being abnormally large in comparison to a normal daily session and can be two to three times the length. The market has experienced a large move and is likely to retrace due to profit taking. This candlestick can appear in the opposite direction to the main trend but the mid point becomes an area to watch for support or resistance (which is useful as a point of reference for future price action as these levels can often be important for long periods).

The example in Figure 1.11 on page 18 demonstrates how useful these candlesticks can be as a point of reference for future price levels that are likely to see some sort of reaction around the mid point of the body. These levels on charts are known as support and resistance levels that become pivotal, that is, these levels indicate price zones that are support or resistance until broken at which point an area that has seen resistance will become support or support then becomes resistance. Figure 1.11 demonstrates quite well how the mid-point can be applied as an area of future support or resistance. The candlestick in Figure 1.11 is an excellent example of a resistance level in progress; tested and validated on various occasions the line of resistance becomes an important level for the technical trader. In this example, the level is generated from the mid point of the candlestick, but pivot lines can be found and generated in different ways. These methods are discussed in Chapter 3 and form an important aspect of charting.

Candlestick 3, the Hammer

The hammer candlestick as a signal appears after a decline in price action. It is discernible by the large shadow that appears below the small body. The price action has been in decline, perhaps for weeks, until it becomes exhaustive culminating in one final sell off. For the most part, a significant area of support has been found that should already be on the chart. The market touches the point where buyers see the market as an opportunity, together with those market participants who are buying back their short positions. The price is forced back towards and finally above the opening level. This can happen relatively quickly.

The hammer signal may not always be as conclusive as in Figure 1.12 on page 19, but its appearance suggests that the selling pressure is over and that the market

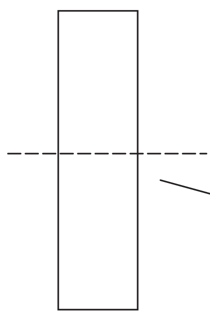


Exhibit 1.5 Marabozu candle can have a pivot line at the 50% level

(source MetaQuotes Software Corp)

Figure 1.10 USD/CHF Weekly chart showing a candle three times the length of a typical daily candle. There is often some retracement during the following sessions as profit is removed. The approximate centre of the candle usually provides a good level of support and resistance.

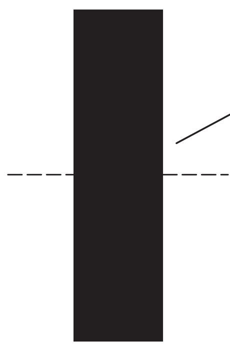
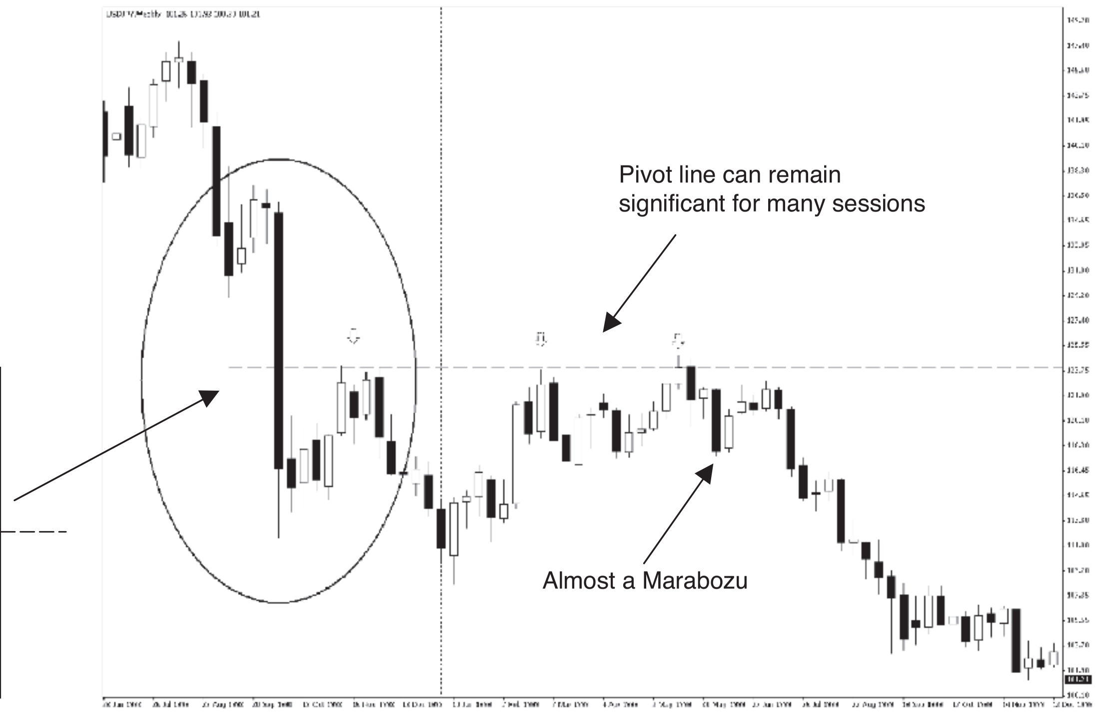


Exhibit 1.6 Marabozu negative day.



(source MetaQuotes Software Corp)

Figure 1.11 USD/JPY daily chart with a long bearish candlestick.

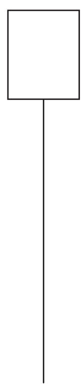


Exhibit 1.7 The hammer.

(source MetaQuotes Software Corp)

Figure 1.12 USD/CAD weekly chart displaying the end of a bearish trend with the appearance of bullish hammer signalling a possible change.

is turning bullish. The colour of the body can also be black, signalling a weaker close, but discrimination should be applied in order to determine the importance of the level that the market price action has reached. A white body has a higher close and would suggest a more bullish sentiment.

Candlestick 3a, the Hanging Man

This type of signal, known as the hanging man, is like the hammer signal unique in that a lengthy shadow appears under the real body of the candle, but unlike the hammer candlestick the hanging man is seen after a recent advance in price action. The market experiences a sell off only to see buyers re-enter the market and push the price back towards the opening levels. This candlestick has bearish implications. As with all candlestick signals that imply a top or bottom, confirmation techniques should be used to determine the significance of the level that the price has reached.

Candlestick 4, the Shooting Star

This signal appears at market tops. The shooting star is signalling a potential loss of momentum as the market finds selling pressure. Those buyers that have been in the market for the medium term together with the short-term buyers begin to take profits resulting in a sharp sell off that leaves many intra-day buyers exiting their positions quickly. The body can be black or white but whereas the inverted hammer is a signal that appears at market bottoms this signal is seen at market tops. Caution should be applied to this signal as it can imply continuation; interestingly this signal at fresh highs can be informative in as much as it suggests that there is bullish sentiment in the market, but that first attempts into uncharted territory resulted in selling pressure. Again, finding and waiting for confirmation is important with this signal. The example in Figure 1.14 on page 22 shows that the following session resulted in a negative day that confirms the shooting star signal.

Candlestick 4a, the Inverted Hammer

The inverted hammer found at market bottoms is similar to the hanging man found at market tops. The body of the candlestick is small and there is a large shadow above the real body. The market has found support and turned bullish. Many market participants who were short on previous sessions will have quickly had their positions stopped out, thereby forcing the market higher. The movement, however, is flawed as no fresh buyers enter at this level and many of those who stepped in forcing the price up during the intra day move quickly take profits and sit on the sidelines. The signal is, however, a useful indication of a possible change in market direction. As with the example in Figure 1.15 on page 23, it takes three further sessions before the market becomes confidently bullish. Unlike the hammer at market tops, this signal at market bottoms often requires more buying pressure to push prices higher than the hammer requires selling pressure to move a market lower.

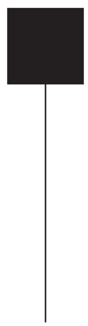


Exhibit 1.8 Hanging man candlestick.

(source MetaQuotes Software Corp)

Figure 1.13 USD/CHF weekly chart with two hammers appearing after an advance in price action and warning of a change in market sentiment.

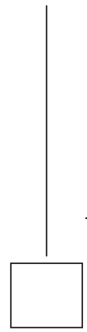
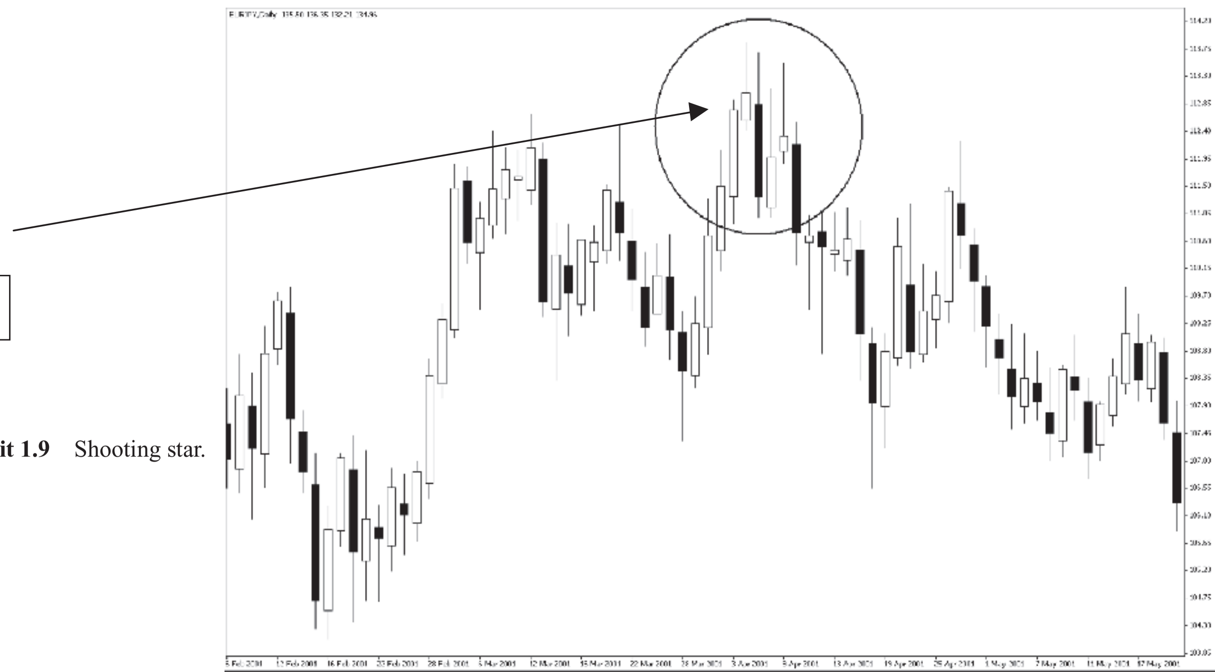


Exhibit 1.9 Shooting star.



(source MetaQuotes Software Corp)

Figure 1.14 EUR/JPY daily chart showing that a shooting star selling pressure has been found but which can also imply a continuation in bullish price action.

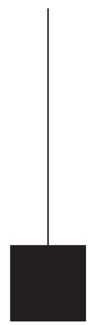
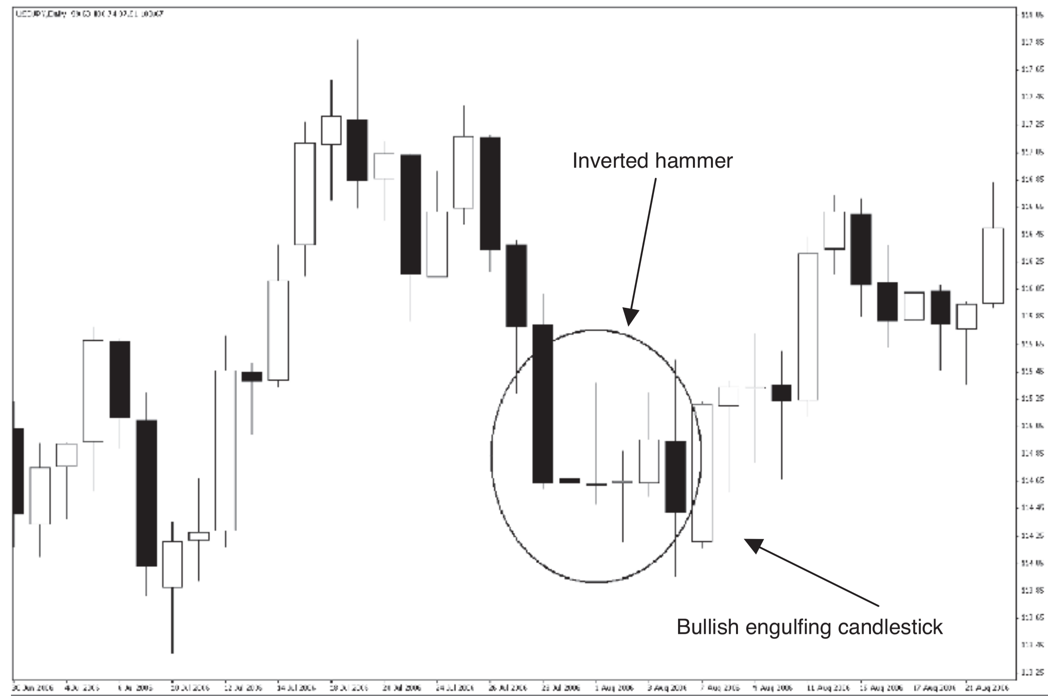


Exhibit 1.10 Inverted hammer candlestick.



(source MetaQuotes Software Corp)

Figure 1.15 USD/JPY daily chart with inverted hammer as an early warning about a possible change in market direction. Four sessions later a bullish engulfing session finally produces the key day but the inverted hammer warns of a possible change in direction, at the least you would not want to be thinking about being short.

Candlestick 5 and 5a, the Spinning Top

This candlestick usually signifies a pause in market direction. The market has moved higher and lower throughout the day's session, but the real body of the candlestick is small. This suggests that the market session has been range bound with no real commitment in either direction. The small body with shadows suggests that the short-term market participants are uncertain, their positions are quickly stopped out during the session. Typically many traders will sit on the sidelines and wait for a clearer signal.

A market that is experiencing a pause or consolidation will display this in the form of a row of spinning tops. Eventually a break out will occur and the move thereafter can be quite substantial. Find a chart with four or five spinning tops in a row and it might be worth watching intently for the break out rather than trying to categorise or figure out what the Japanese pattern might be. The trend will tend to dominate so a row of spinning tops in an up trend would suggest that the break out will be in the direction of the trend.

Candlestick 6 and 6a, Standard Candlestick

This candlestick is seen as a standard positive session. The market found support and then moved higher throughout the session closing near the highs. It is an important candle in a trending market as it signifies and confirms a healthy market. In a trending market buyers will be watching the high of these sessions for confirmation that the market will continue higher. Small body candlesticks follow the standard candlestick in the example chart below, suggesting that traders are cautious but remain bullish as seen by the fact that there are more white candlestick bodies than black candlestick bodies, that is, more positive than negative daily closes.

Candlestick 7, Bullish Belt-Hold Line

The bullish belt-hold line signal suggests support. This signal appearing at a base or towards the end of a range suggests that the market is turning bullish going forward. From the opening the market moves higher but does not close at the highs. The support level on this type of candle is quite strong and could be sufficient enough to place a support line or pivot line on the chart for future reference. If the opening area is already at a support level from the previous market action then this type of candle will confirm the level.

Such candles, if seen at levels of support, add confidence to your strategy. As long as the support level remains valid the bullish belt-hold line suggests that the market sentiment is holding. This may require watching for further signals to support this but, as in Figure 1.18 on page 27, a hammer candlestick appears after which the market does not touch the support level again and only moves higher.

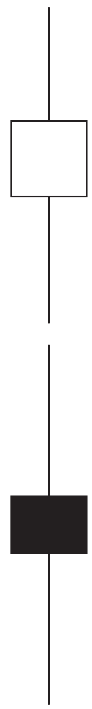
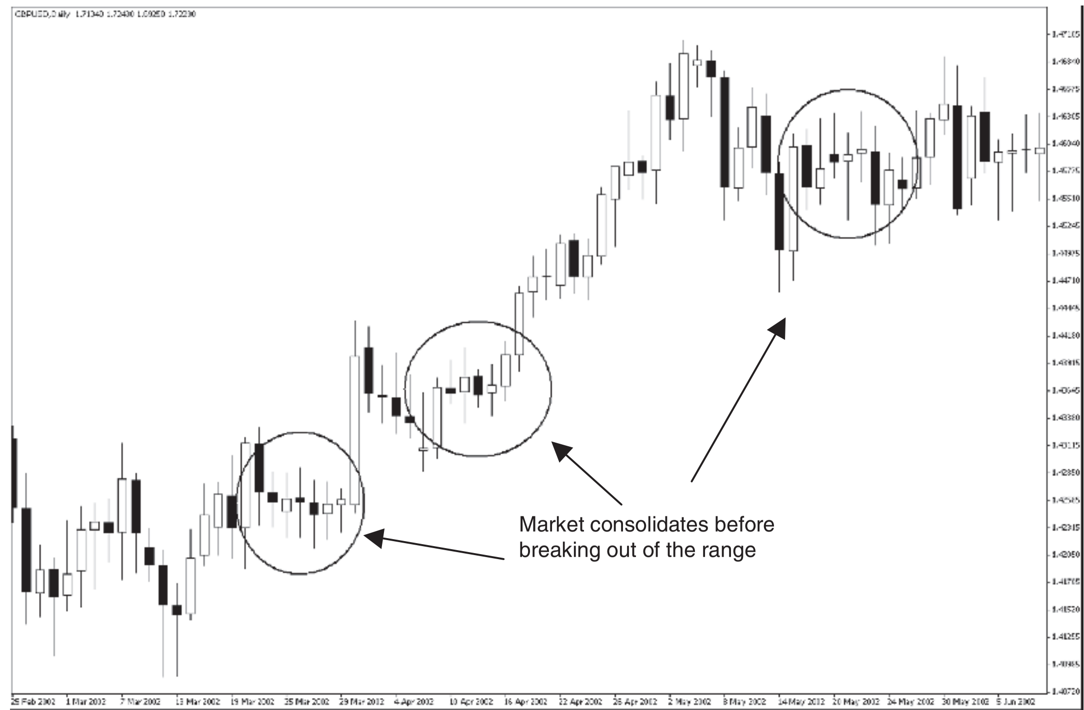


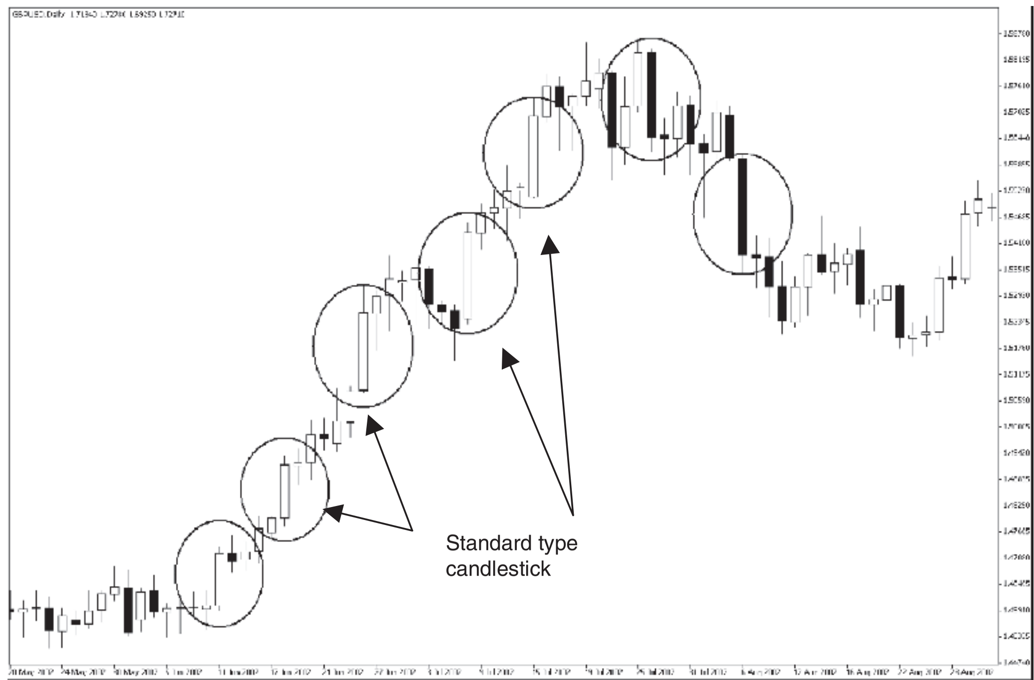
Exhibit 1.11
Spinning Top.



(source MetaQuotes Software Corp)

Figure 1.16 GBP/USD daily chart with clustered spinning tops displaying a market that has no real conviction and is pausing.

Exhibit 1.12 Standard day type candle, can also be 2/3 times the normal daily size.



(source MetaQuotes Software Corp)

Figure 1.17 GBP/USD daily chart showing a trending market that has the standard type candlestick demonstrating confidence in the trend. In this example, the smaller candles are a pause in the trend. The move up will have seen positive market sentiment but this slows and short-term traders become uncertain. In this type of scenario it is preferable to remain with the direction of the trend in anticipation of a move higher to come.

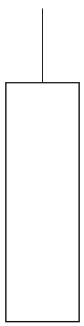


Exhibit 1.13 Bullish belt-hold lin candlestick.

(source MetaQuotes Software Corp)

Figure 1.18 GBP/USD daily chart with a bullish belt-holdline. Sometimes the initial signal can take a few more sessions before it has the desired effect.

P1: OTA/XYZ P2: ABC
c01 JWBK363/Burgess June 10, 2009 17:5 Printer Name: Yet to Come

Candlestick 7a, Bearish Belt-Hold Line

This signal appears at tops and bottoms. The appearance at market tops is useful for indicating that the resistance level is valid. The open is at or very close to a resistance level from which the price actions move away. As in the example shown in Figure 1.19 opposite, the bearish belt-hold line opens just below the close of the previous sessions, down past the opening and into the shadow of the previous session, suggesting that support is waning!

The opening is at a level which may have seen resistance for many previous sessions, it may also require that the level be found by searching the price history for some technical aspect that occurred and which still has some significance. Support and resistance levels can have an important role on charts for many days, weeks, months and even years.

In the example in Figure 1.19, the candle opened at the resistance level and moved away thus confirming the level as resistance. Another particularly good signal that is generated by this type of candle is when it appears at market highs. The signal then suggests the complete opposite to its standard usage. The chart in Figure 1.20 demonstrates this quite well. The session has a positive start evidenced by the fact that it moves higher from the session. The support is confirmed and many traders will be bullish especially as the market has been trending. However, the shooting star (inverted hammer), two sessions earlier, contains the bullish activity within its shadows. The belt-hold candlestick has pushed up into an area of resistance as it moves towards the high of the shooting star!

Another example of combining candles and finding confirmation is shown by the bearish belt-hold line in Figure 1.20 on page 30. The belt-hold candle opens at a marabozu pivot line which confirms the belt-hold candle. If you were short-term trading and you saw the price moving down from the opening and you already had the resistance level marked on your chart you would be cautious about buying the market at that level!

Candlestick 8, Bullish Closing Bozu

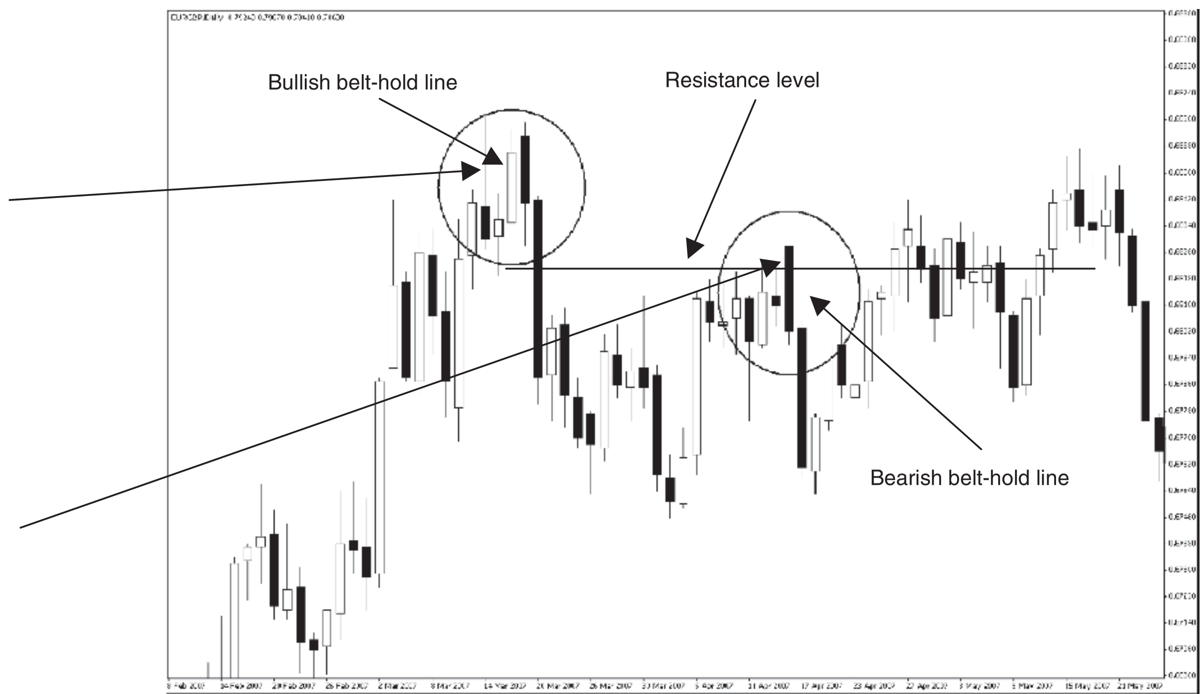
The bullish closing bozu is a signal that should be seen as an opportunity to monitor the strength of the market. Closing at the highs is considered to be positive going forward; this signal, however, can often be the beginning of a reversal! The most useful way to utilise this signal is when it appears in a trending environment, then monitor the opening of the next session. If the market has been moving higher and this candle appears the chances are that the market price action will continue. If, however, the same candle signal appears during a down trend but there is no reason to believe that a base has been found, then it suggests that the market will continue to move lower. At which point the base, i.e., the support level will become resistance once broken. The price action of the following session should have little or no activity below the close. It is very important to watch the price level for the following session. Likewise, for a base confirmed by other techniques – as in Figure 1.21 on page 31 – which has

Exhibit 1.14 Bearish belt-hold line candlestick.

(source MetaQuotes Software Corp)

Figure 1.19 GBP/USD daily chart with a bearish belt-hold line at resistance.

Exhibit 1.15 Belt-hold line candles.



(source MetaQuotes Software Corp)

Figure 1.20 EUR/GBP daily chart with bearish and bullish belt-hold line examples.

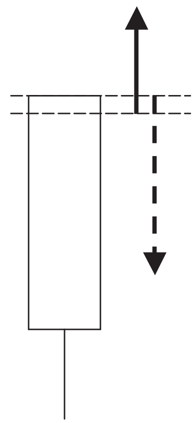


Exhibit 1.16 Bullish closing Bozu.

(source MetaQuotes Software Corp)

Figure 1.21 USD/CAD daily chart with a bullish closing bozu.

seen a bullish engulfing day and then a pause which sees a bullish closing bozu that helps confirm the base.

Candlestick 8a, Bearish Closing Bozu

The same applies to the bearish closing bozu in that this candlestick helps to confirm the market sentiment as being a continuation of the ongoing or immediate trend. This signal requires confirmation in order to continue having confidence in the continuation of a trend. One simple method, as with the bullish closing bozu, is to monitor the opening of the next session. Too much time above the middle of the bozu candlestick body suggests that the price action will reverse. It is a sign that the market might need more time before it has the expected impact on market price action.

There are other techniques which are discussed later in this book that could be applied to the chart in Figure 1.22 on page 33, and that would enable the technical trader to confirm the sentiment of the market generated by the closing bozu candlestick signal.

JAPANESE CANDLESTICKS – DOUBLE CANDLE SIGNALS

There are also candlestick patterns that require a previous candle for comparison. The candlesticks are the same as the eight single candlesticks at the beginning of this chapter, but are interpreted by looking at the impact of the opening of the new candle against the range of the previous candle, especially the closing price of the previous candle. This is useful for observing any change in market sentiment that might be occurring. One technique for an early sign of a reversal is to look at the close of the present candle against the opening of the previous candle.

The Bullish Engulfing Pattern

Candlestick signals require confirmation in order to support the initial signals that are generated and the methods and techniques of doing this are discussed later in this book. However, comparing candlesticks to the previous candlestick can be very useful in observing change in market sentiment and confirming the current price level as supportive or as resistance. The bullish engulfing pattern, for example, is a strong reversal signal. When these two candles appear it suggests that a significant support level has been found. The signal is produced when the previous candlestick body is engulfed. The criterion is for an opening to be below the previous candlestick's close and the closing of the current session to be above the previous candlestick's open. As with the bullish closing bozu candle in Figure 1.23 on page 35, not only is that candle itself bullish but together with the previous candles it also forms an engulfing session. A close at the highs is positive going forward.

Exhibit 1.17 Bearish closing Bozu.

(source MetaQuotes Software Corp)
Figure 1.22 AUS/USD daily chart with a bearish closing bozu.

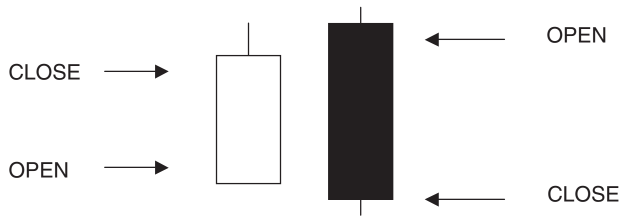


Exhibit 1.18 The current range against the previous range.

The Bearish Engulfing Pattern

This is the opposite of the bullish engulfing pattern. Again, this signal forms at areas of strong resistance. The opening should be above the previous close and the close should end the session below the previous open. The candlestick type that engulfs the previous session is equally important. Shown in the example below, the single candle in Figure 1.24 on page 36 is a bearish belt-hold line candle! The session has opened at the highs and moved lower right through the previous session's trading. This candle can confirm that there is now strong resistance at that level. The belt-hold line engulfs the previous session thus confirming a bearish engulfing pattern. This candle not only confirms resistance at the opening but engulfs the entire body of the previous session. This represents quite a strong change in market sentiment.

The Piercing Pattern

This is a similar pattern to the engulfing pattern but does not have the same strength of signalling of a correction as the engulfing pattern. The appearance of the piercing pattern is a warning that support has been found but that confirmation is necessary with this pattern. This signal is generated when the price action retraces to at least 50 % of the previous session. This candlestick signal forms at the lows, finds support and then moves back through the opening and higher into the body of the previous session. The candlestick should pierce the previous session by at least 50 %. The further the penetration the stronger the signal!

Dark Cloud Cover

The opposite candlestick to the piercing pattern is the dark cloud cover pattern. This candlestick forms at the highs of a move and is often seen after a recent advance in price action. The deeper this candle penetrates the previous body the greater the significance the pattern has as a turning signal.

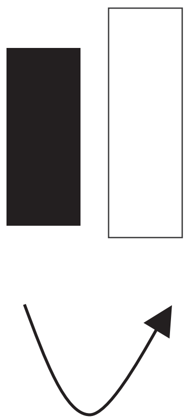
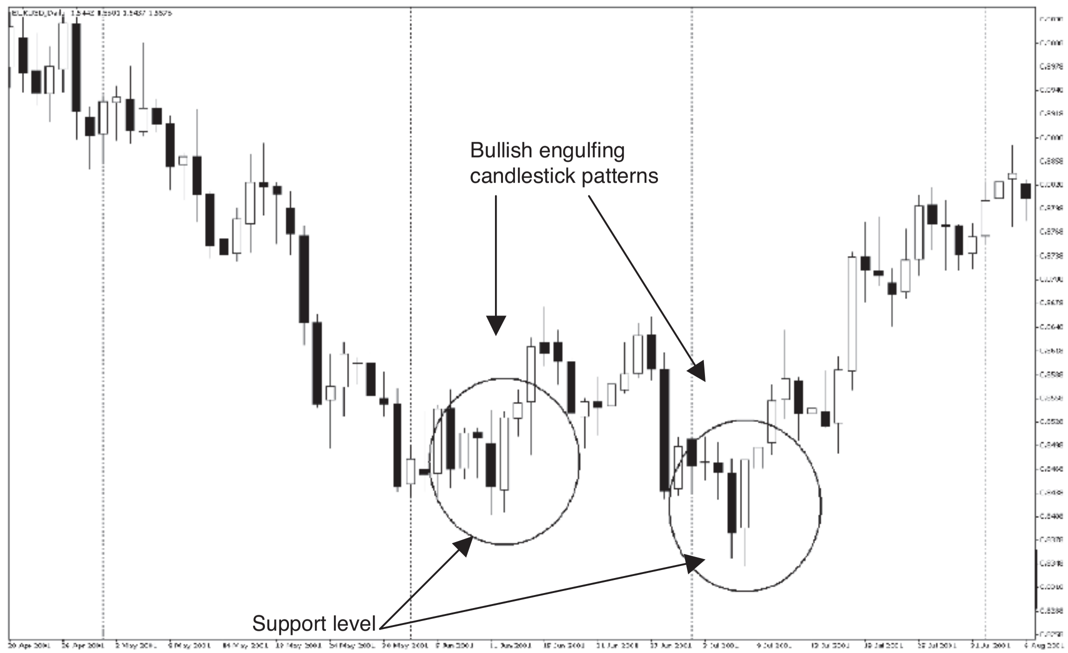


Exhibit 1.19 Bullish engulfing.



(source MetaQuotesSoftware Corp)

Figure 1.23 GBP/USD daily chart showing a bullish engulfing candlestick that opens below the previous close and finishes the session above the previous open.

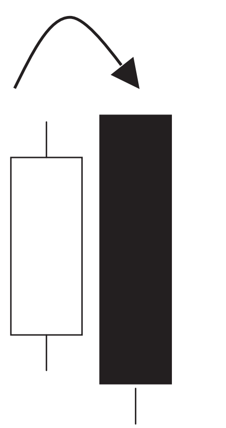


Exhibit 1.20 Bearish engulfing.

(source MetaQuotes Software Corp)

Figure 1.24 GBP/USD daily chart showing a bearish engulfing pattern created by a belt-hold line candlestick. There is a similar pattern known as an outside day on the bar chart. The market has been trending before encountering resistance. The price makes a new high and quickly retraces the previous session closing below the previous session's opening level.

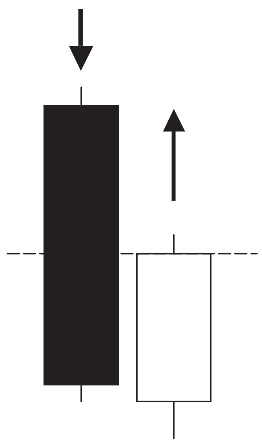
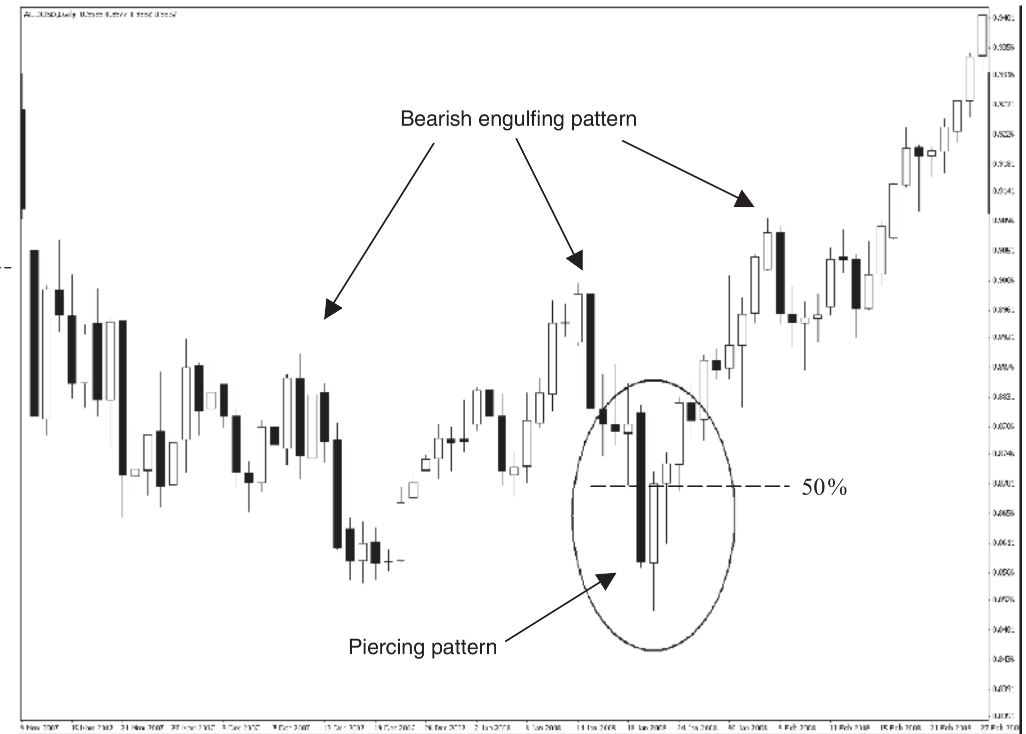


Exhibit 1.21 Bullish piercing pattern.



(source MetaQuotes Software Corp)

Figure 1.25 AUS/USD daily chart showing bearish engulfing pattern and a (bullish) piercing pattern.

This is not quite as bearish as an engulfing pattern but with the forex market the close and open are not as definable as a market that has a 10-hour gap between the close and the open. Many forex traders will simply be trading from what they have seen earlier on in the day regardless of what the time is.

Figure 1.26 opposite demonstrates quite well the significance of the dark cloud cover candlestick.

The Tweezer Top

This signal forms when the price action finds resistance for two consecutive sessions. The tweezer top signal is bearish and using this candlestick formation together with an engulfing pattern it is a very useful technique that has great visual advantages for finding resistance levels on charts at a glance. The second session does not have to engulf the body of the previous session but if it does it is very strong. Those traders and investors who were long from the previous session will now be on the wrong side of the market. The market may not have been trending and can be a range bound market when this occurs, but either way the highs of both candles must falter at or almost at the same level of resistance.

The tweezer pattern can have many variations, for example a tweezer harami, a tweezer dark cloud cover or a tweezer engulfing. The level at which the two candles form is important.

The Tweezer Bottom

As with the tweezer top signalling a strong resistance level, the tweezer bottom signifies an important support level. The low from the previous session remains supportive and the price action therefore moves higher. A tweezer candlestick set up can be made up of various candlestick types as long as the lows or highs are at the same level and usually with both showing the shadows at the same level. Those traders who went short on the previous session are now forced out of their positions and are likely to sit at the side. An engulfing session, for example, would be a powerful tweezer combination, as shown in the example in Figure 1.28 on page 41.

The tweezer pattern is a very distinctive signal and stands out on the chart especially if there are long shadows on both candles.

The Harami Top

The harami signal appears as a warning that the market sentiment of the prior trend may be changing. This candle signal is quite powerful in displaying the uncertainty of the market; confirmation is required with this pattern as the harami can often be a pause before the market continues higher. If the market is trending very strongly then common sense will dictate that the harami may simply be a pause in the market rather than a turning signal.

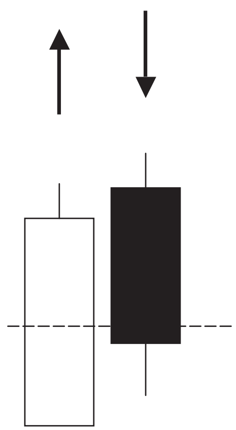


Exhibit 1.22 Bearish piercing pattern.

(source MetaQuotes Software Corp)

Figure 1.26 AUS/USD daily chart showing a dark cloud cover candlestick pattern.

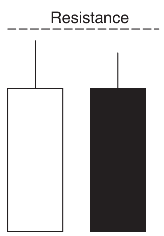


Exhibit 1.23 Tweezer pattern.

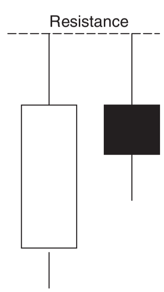
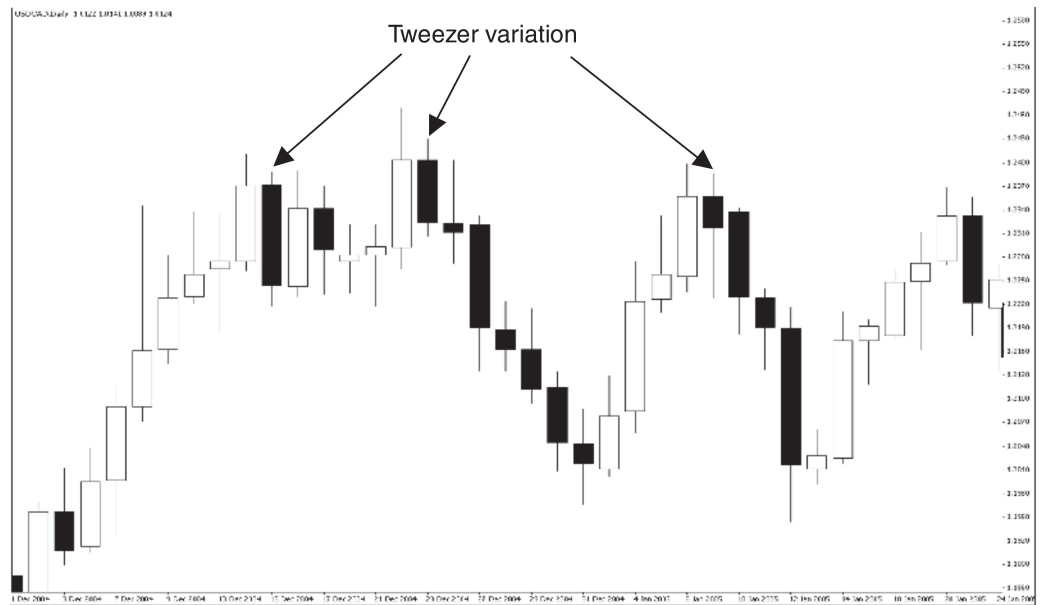


Exhibit 1.24 Tweezer pattern.



(source MetaQuotes Software Corp)

Figure 1.27 USD/CAD daily chart demonstrating variations of the tweezer top pattern.

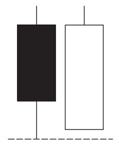


Exhibit 1.25 Bullish belt-hold tweezer.

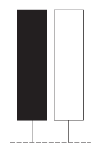


Exhibit 1.26 Engulfing Bozu tweezer.

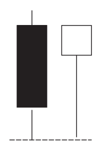


Exhibit 1.27 Hammer tweezer.

(source MetaQuotes Software Corp)

Figure 1.28 USD/JPY daily chart showing a bullish engulfing tweezer pattern.

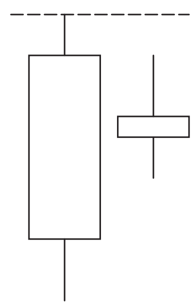


Exhibit 1.28 Harami pattern.

(source MetaQuotes Software Corp)

Figure 1.29 USD/JPY daily chart showing a classic harami signal after a rise in price action.

The Harami Bottom

This signal is found at turning points. It may, however, need a few sessions before it takes effect in the desired direction. It is the opposite of the engulfing pattern. Again, with most of these double candles the signals point to a threat to the previous market sentiment either as uncertainty or confirmation of support or resistance levels. The harami signal points out that there is uncertainty. A stronger version is the harami cross. The colour of both candles is not important, they can be the same. The body, however, must be contained within the previous session.

The Doji Evening Star

The final candlestick signal in this section is the doji evening star and doji morning star scenario. It is a popular set up amongst candlestick traders. This combination is a warning that the market sentiment has changed. The third candle is important and more significant if it becomes an engulfing candle as in the example in Figure 1.31 on page 45.

The Doji Morning Star

The opposite applies at support levels. As in Exhibit 1.31 on page 46 the third candle is an engulfing candle that places greater emphasis on the power of that signal. The importance of finding confirmation remains the same as for all candlestick signals but this particular scenario stands out quite well as a basing scenario.

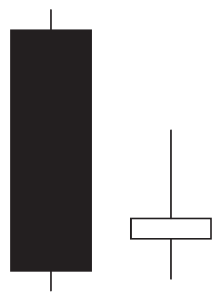


Exhibit 1.29 Harami cross.

(source MetaQuotes Software Corp)
Figure 1.30 USD/JPY weekly chart with two harami type signals.

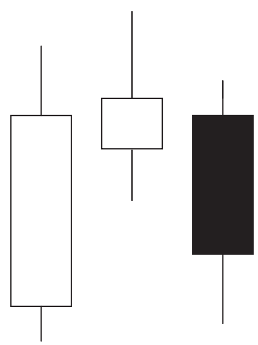


Exhibit 1.30 Evening doji star.

(source MetaQuotes Software Corp)

Figure 1.31 EUR/USD weekly chart with a good example of an engulfing pattern.

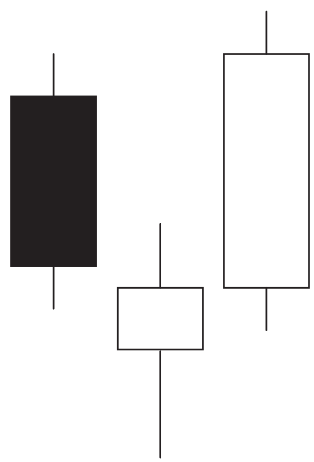


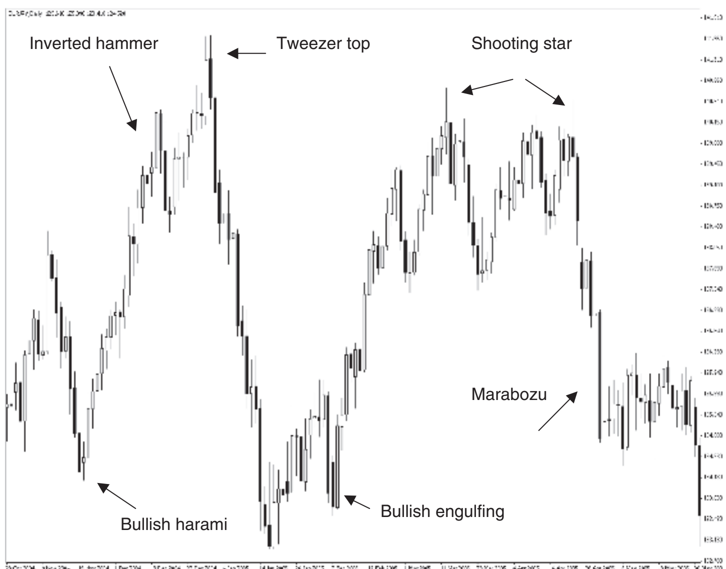
Exhibit 1.31 Morning doji star.

(source MetaQuotes Software Corp)

Figure 1.32 GBP/JPY weekly chart showing a morning star scenario.

SOME CANDLESTICK EXAMPLES

- Bullish harami;
- Inverted hammer;
- Tweezer top;
- Bullish engulfing;
- Shooting star;
- Marabozu candlestick.

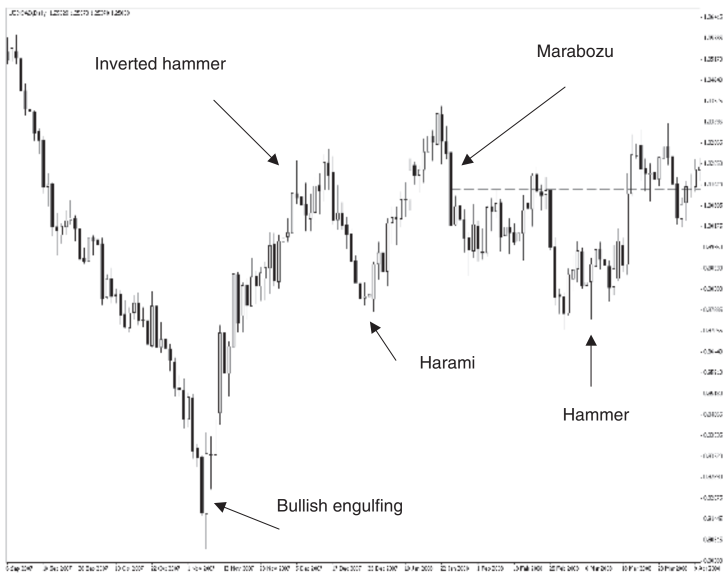


(source MetaQuotes Software Corp)

Figure 1.33 EUR/JPY daily chart showing candlestick examples.

SOME FURTHER CANDLESTICK EXAMPLES

- Bullish engulfing;
- Harami;
- Marabozu with mid-point resistance and later support level;
- Hammer.



(source MetaQuotes Software Corp)

Figure 1.34 USD/CAD daily chart with candlestick examples.

CHART ANALYSIS EXERCISE 1

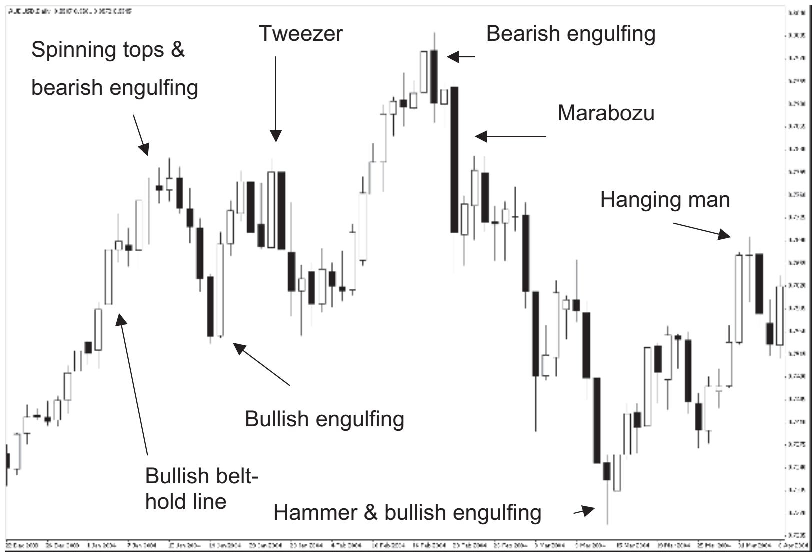
Find the following candlestick signals on Figure 1.35:

- Doji (spinning tops);
- Bullish belt-hold line;
- Tweezer top;
- Bearish engulfing;
- Marabozu;
- Hanging man;
- Hammer;
- Bullish engulfing.

(source MetaQuotes Software Corp)

Figure 1.35 AUS/USD daily chart showing various candlestick types.

CHART ANALYSIS EXERCISE 1 – ANSWERS



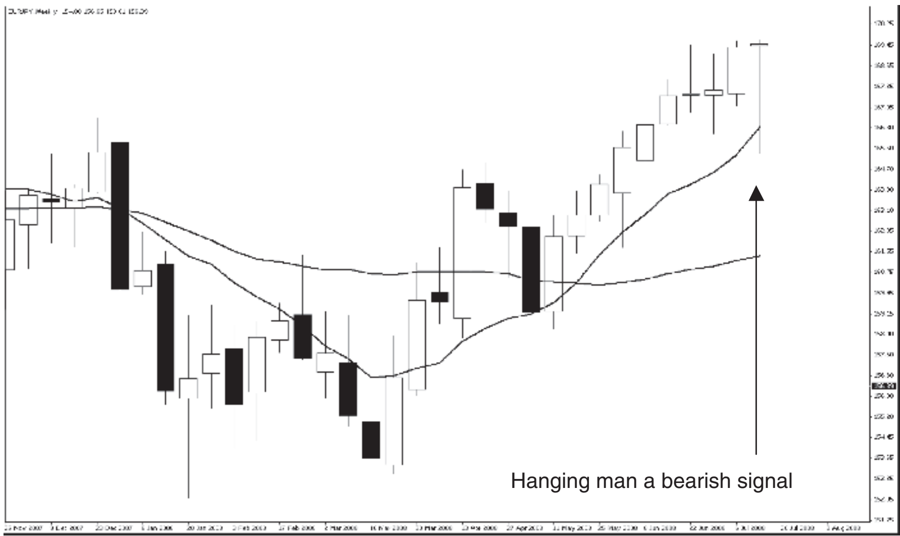
(source MetaQuotes Software Corp)

Figure 1.36 AUS/USD daily chart showing candlestick patterns.

SUMMARY

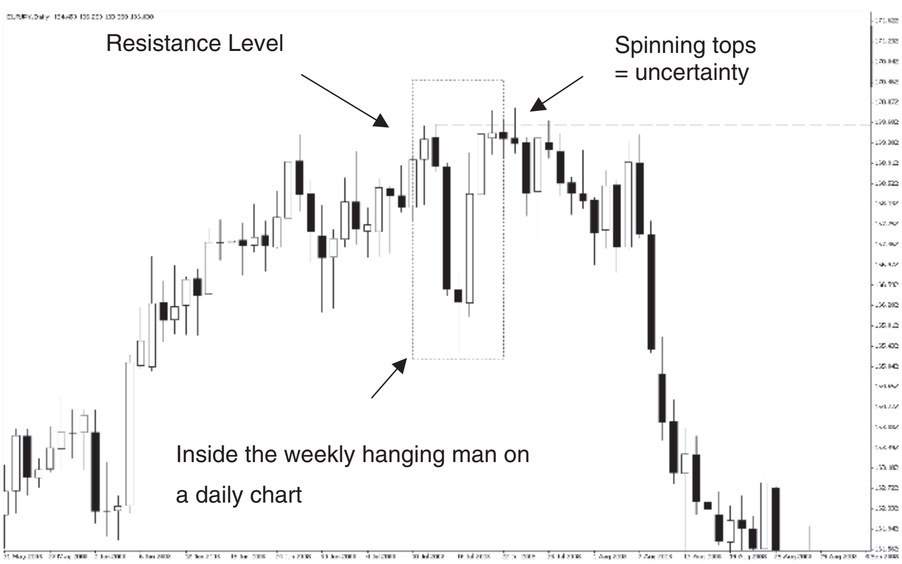
This chapter has outlined an abridged version of Japanese candlesticks and demonstrated that by applying these patterns it is possible to gain insight very quickly into a market that would otherwise be difficult to decipher. Weekly candlesticks charts and monthly candlesticks are more reliable than daily and hourly candlesticks, and it is vital, as discussed later in this book, that the bigger long-term market be applied to any daily charts. It is also important to ask yourself when looking at candlestick patterns the same question: “where is this candlestick?, is it in the context of other technical aspects that are at the same price level?”

Switching from weekly to daily candlesticks can help enormously in deciphering the market. For example, a weekly candlestick scenario, such as the hanging man in Figure 1.37 opposite, will help to confirm the daily chart technical picture. In this scenario the top of the hanging man on the weekly chart is a resistance level. A line taken from the top of the weekly hanging man and placed on the daily chart, as in Figure 1.38 opposite, demonstrates the resistance level at work. Spinning top candlestick types form during the early part of the trading week and suggest uncertainty in the market at that level.



(source MetaQuotes Software Corp)

Figure 1.37 EUR/JPY weekly chart with a large hanging man candlestick finding support at the 10-week moving average.



(source MetaQuotes Software Corp)

Figure 1.38 EUR/JPY daily chart demonstrating the inner workings of the weekly hanging man.

Each attempt beyond the high of the hanging man candlestick level is clearly rejected on the daily chart. There are shadows or wicks above the candlesticks' real body that form at that level and which are clearly showing that the price action is finding selling pressure. Each of the spinning tops, likewise, never produced a daily close beyond that resistance level and eventually, as the market begins to move away, the daily candlesticks that appear over the following sessions produce lower highs. This is another very valuable clue that the market has come under selling pressure. Eventually, a harami type candlestick signals the decline in the EUR/JPY. Although a brief attempt higher results in a tweezer that might have shaken some investors out of their positions, the hanging man candle from the weekly chart proved to be a very powerful signal!

Japanese candlesticks provide clear market signals but they need to be placed in context and together with other techniques in order to confirm the candlestick signal. Candlesticks can give warning of change and sometimes imminent change in market direction.

Candlesticks are equally useful for showing areas of market support and resistance and are very good for creating pivot lines (pivot lines are discussed in Chapter 3). Candlesticks, however, can be complicated and at times lead to the wrong conclusion. For this reason it is always important to confirm the signal using other candles and other chart techniques. Try to keep the basic outline as discussed in this chapter when looking for candlestick signals and be patient when you find them. A bullish harami, for example, may take another one or two sessions before the signal begins to unfold. It may take you many years of practice to become fluent in their application, and there are many set ups and scenarios that require intensive study before basing an investment decision on candlesticks alone.

The signals that have been presented in this chapter should be seen as a visual representation of market sentiment and, as will be discussed later in this book, are used in ways that help to make a decision about market direction. Looking for signals should be a straightforward process. Always begin by looking at the high and the low and then the open and the close in order to determine the strength of market sentiment.

The open and the close helps to determine the main area of trading that has taken place as does the open and close in relation to the previous candle. The shadows, remember, are signs of selling pressure or buying pressure. A series of lower lows suggests weakness whereas a series of higher highs suggests strength.

In this chapter, candlesticks have been presented in a very basic manner in order to show how the process of monitoring the market can become easier when these signals stand out as visual clues about change in market sentiment that may present opportunities worth exploiting.