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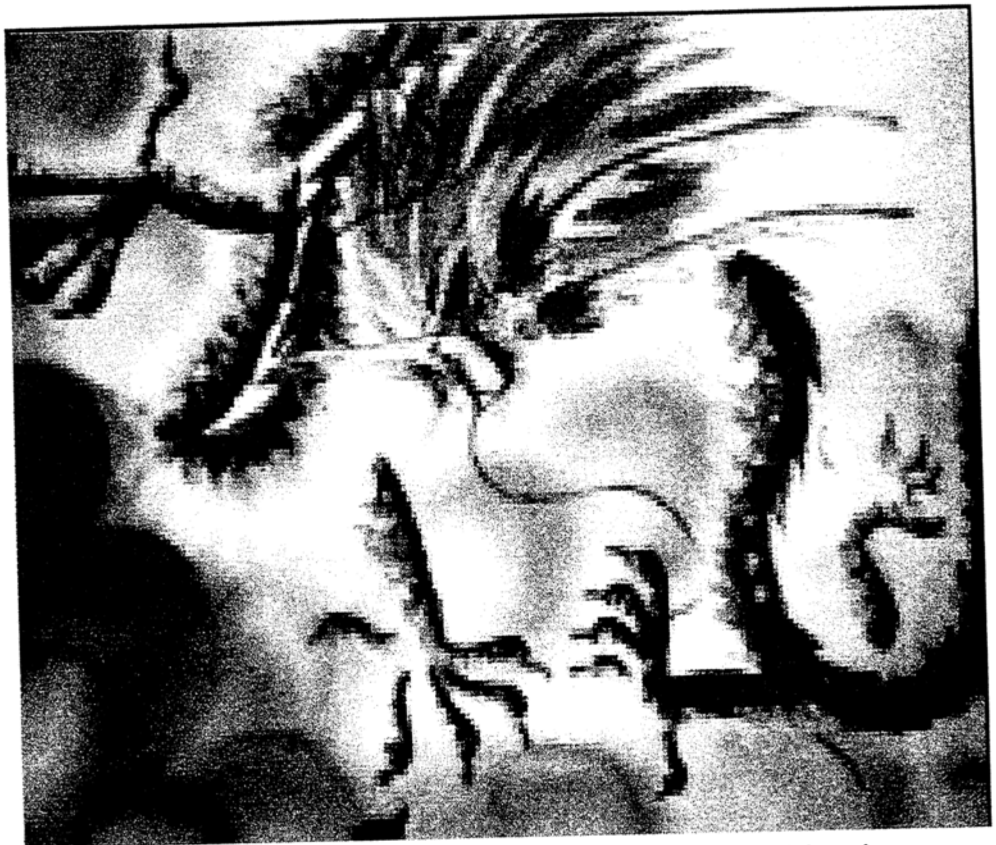
Practical Applications Of Japanese Candlestick Charts: Incorporating The Art Of Candlestick Charts Into Your Current Trading Method

Developed over 300 years ago, this method of technical analysis is still relevant and an exceptional addition to Western technical analysis. By combining both approaches to market forecasting one is able to take the best from both schools. Gary's belief is that the outcome from this combination is capable of extending the benefits of any methodology. This lecture will cover and discuss practical trading approaches including stop placement and trailing levels, risk parameters, money management and the psychology of trading any market with Japanese candlesticks.

The information derived by using this approach can directly influence the day-to-day decision process which can enhance your awareness of the markets. You will learn the basics of Japanese candlestick charting, as well as how to combine them with Western technical tools such as trend lines, DeMark Sequential, moving averages, stochastics and many other standard technical tools.

Gary S. Wagner, C.T.A., is president of International Pacific Trading Company. He is also the codeveloper of the "Candlestick Forecaster," a highly acclaimed software based trading application. His book Trading Applications of Japanese Candlestick Charting, *offers an in-depth look at candlestick charts and explains how traders can integrate these charts with the power and precision of Western technical tools. A veteran technician, Gary frequently contributes articles to several different publication for traders. By combining Western technical indicators with Eastern technical charts, Gary has created a whole new way of looking at the markets. As one of the newest additions to the "All-Star Trader's Hotline," Gary looks forward to sharing his powerful insights with you.*■



Japanese Candlestick Patterns. Use the power of the dragon.

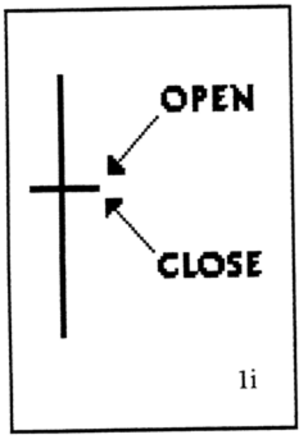
By Gary S. Wagner

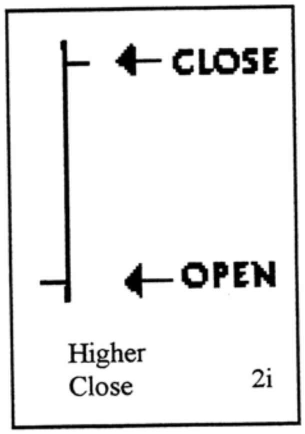
Over three centuries ago, one Japanese man began developing a technical analysis tool that was directly related to the actual price movement of any commodity or stock issue. He was not a mathematician or a statistical genius, he was simply observing the types of patterns that are created during each trading session to identify and establish traits or tendencies that occurred after individual patterns had formed. His name is Sokyu Honma.

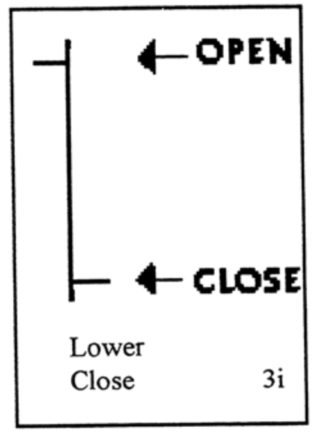
Although it is still unclear as to who is responsible for inventing the candlestick chart, much of the development and maturing process was completed by Honma. It is rumored that the chart was first introduced near the beginning of the Meiji era (around 1870) by an English man and was used primarily for the silver market in Yokohama. The most widely accepted theory as to how candlesticks were introduced into Japanese culture is that the chart originated at the beginning of the rice market (around 1750). After both Western Europe (1561) and Japan (1654) established exchanges, the increase in the complexity and diversity of the economic conditions, and the continuing technological advances provided an ideal environment for the development of the candlestick chart.

The Japanese first used the candlestick chart in the commodity market (primarily the rice market), then integrated these techniques into their stock market. After World War II, the chart became very popular in Japan due to an increase in the number of active speculative investors. Prior to this last 50 or so years, the candlestick technique was known to only a few Japanese investors.

How to draw a bar ch

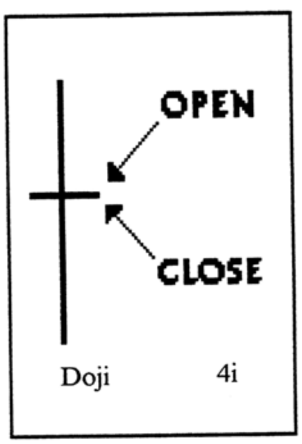


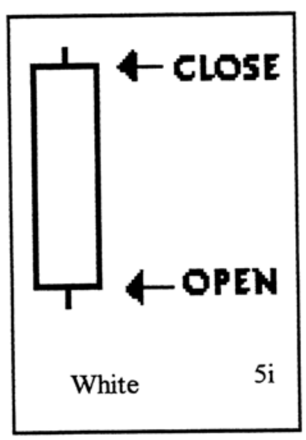


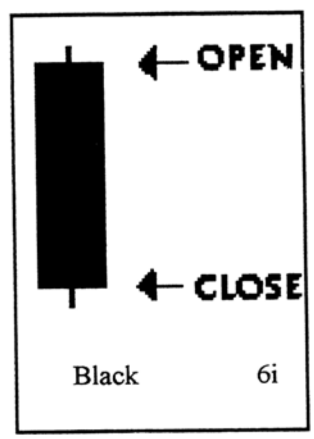


In the Japanese candlestick, one of the major elements is the body of the candlestick. The difference between the open and close prices makes a box which we call real body. A black body means the close is lower than the open, and a white body means the close is higher than the open. Usually there are extension lines come out from the ends of the real bodies, they are called shadows. Those lines represent the high and low prices for the trading days.

How to draw a Japanese Candlestick





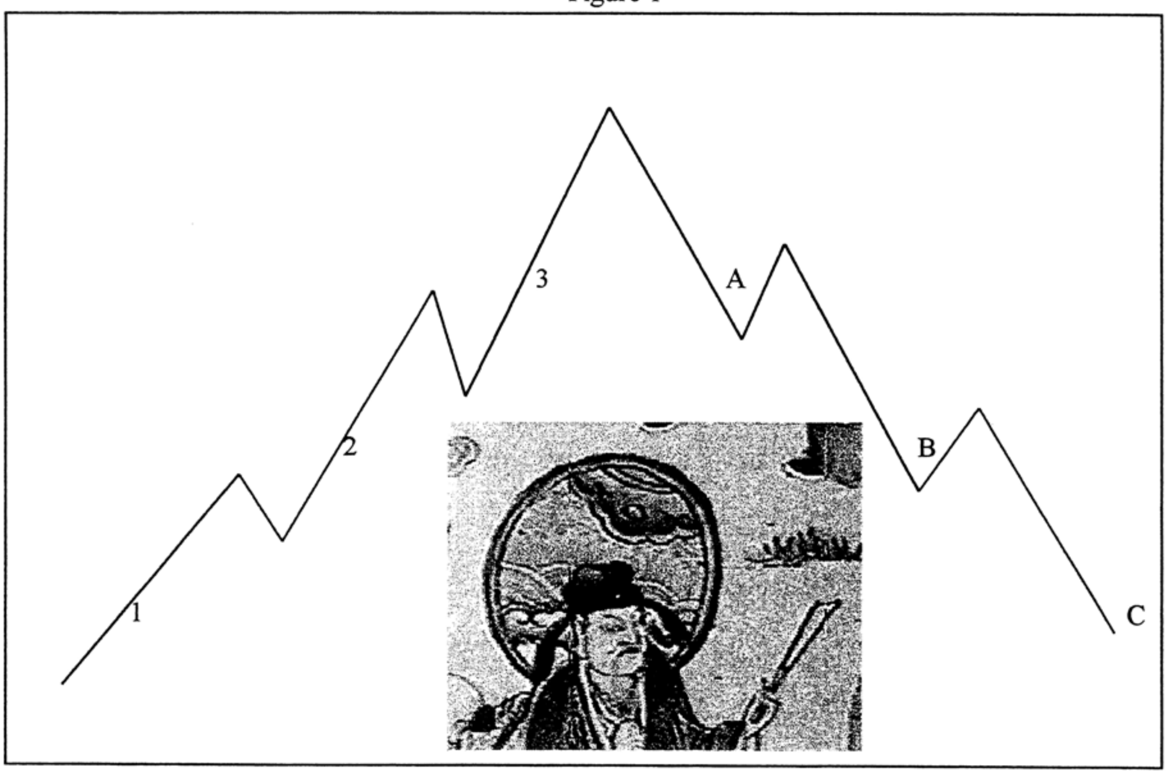


The Japanese Method of Three:

There is a Japanese saying "consult the market about the market." which means when observing the market, we should pay close attention to the market movement itself rather than observing the international affairs and economic policies that may or may no effect the market. The chart is a recording of market price movements in a picture form. By studying the chart, one is able to identify the path the market has taken in the past and is able to attempt to predict the future course of the market price.

As divulged by Seiki Shimizu in his book "The Japanese Chart of Charts", the natural law of market price is the "Three Level Fluctuation". This method teaches us that market prices move in three levels, moving up three levels, then, always moving down three levels to form a zigzag pattern. This "Three Level Fluctuation" greatly corresponds to the "Elliot Wave Theory" (see figure 1). There are many unforeseen circumstances that can alter or cause a breakdown in this pattern, such as recent news items which may cause erratic price movements. We need to be able to adjust to the realities of the future by sorting through the various shapes and patterns that have formed and using only those with the highest probabilities. This is what the candlestick chart is all about. The chart's task is not to predict exact tops or bottoms, but to instantly assist in confirming market tops or bottoms when they form.

Figure 1



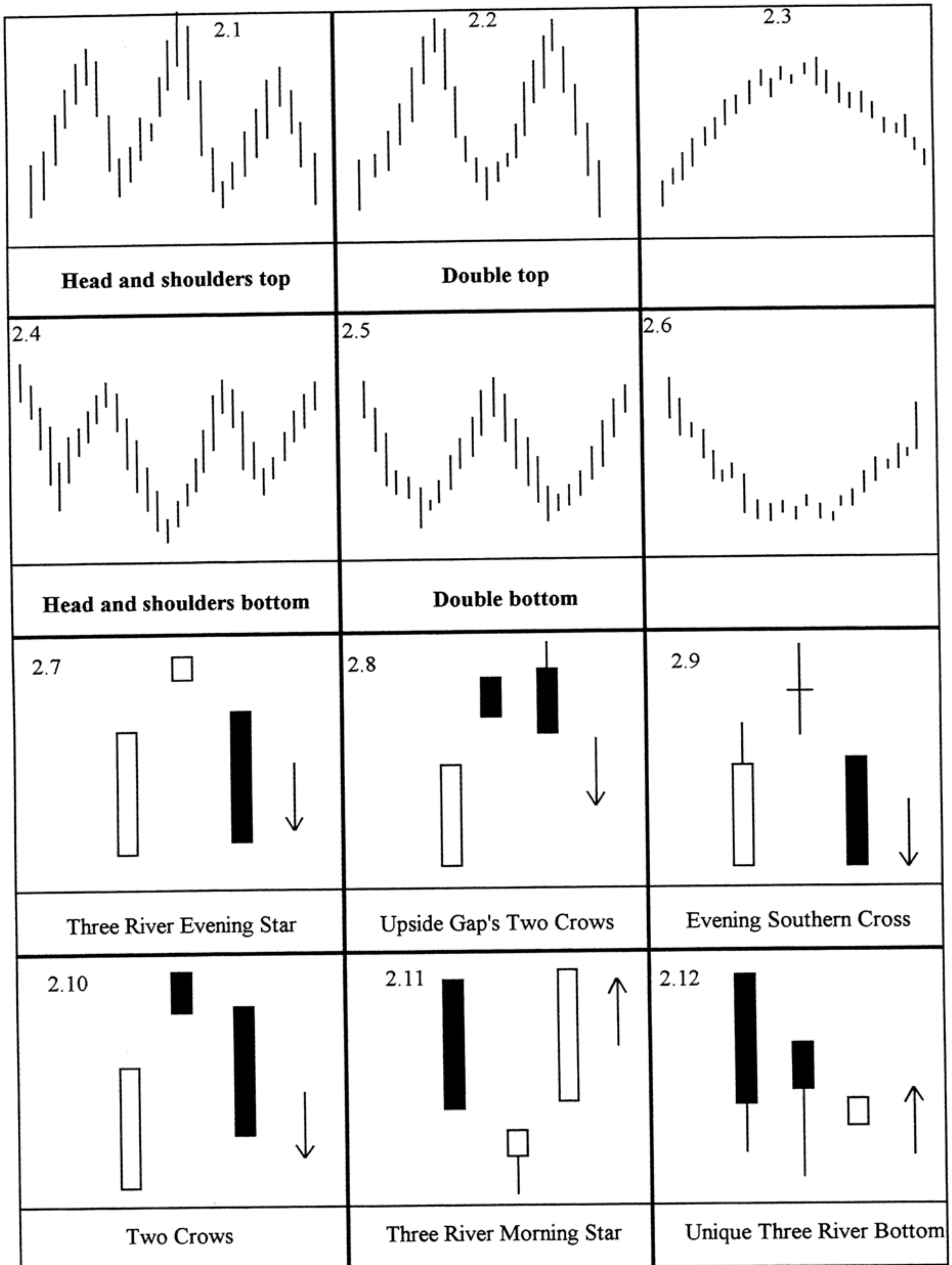

2.1
2.2
2.3
Head and shoulders top
Double top
2.4
2.5
2.6
Head and shoulders bottom
Double bottom
2.7
2.8
2.9
Three River Evening Star
Upside Gap's Two Crows
Evening Southern Cross
2.10
2.11
2.12
Two Crows
Three River Morning Star
Unique Three River Bottom

Figure 2

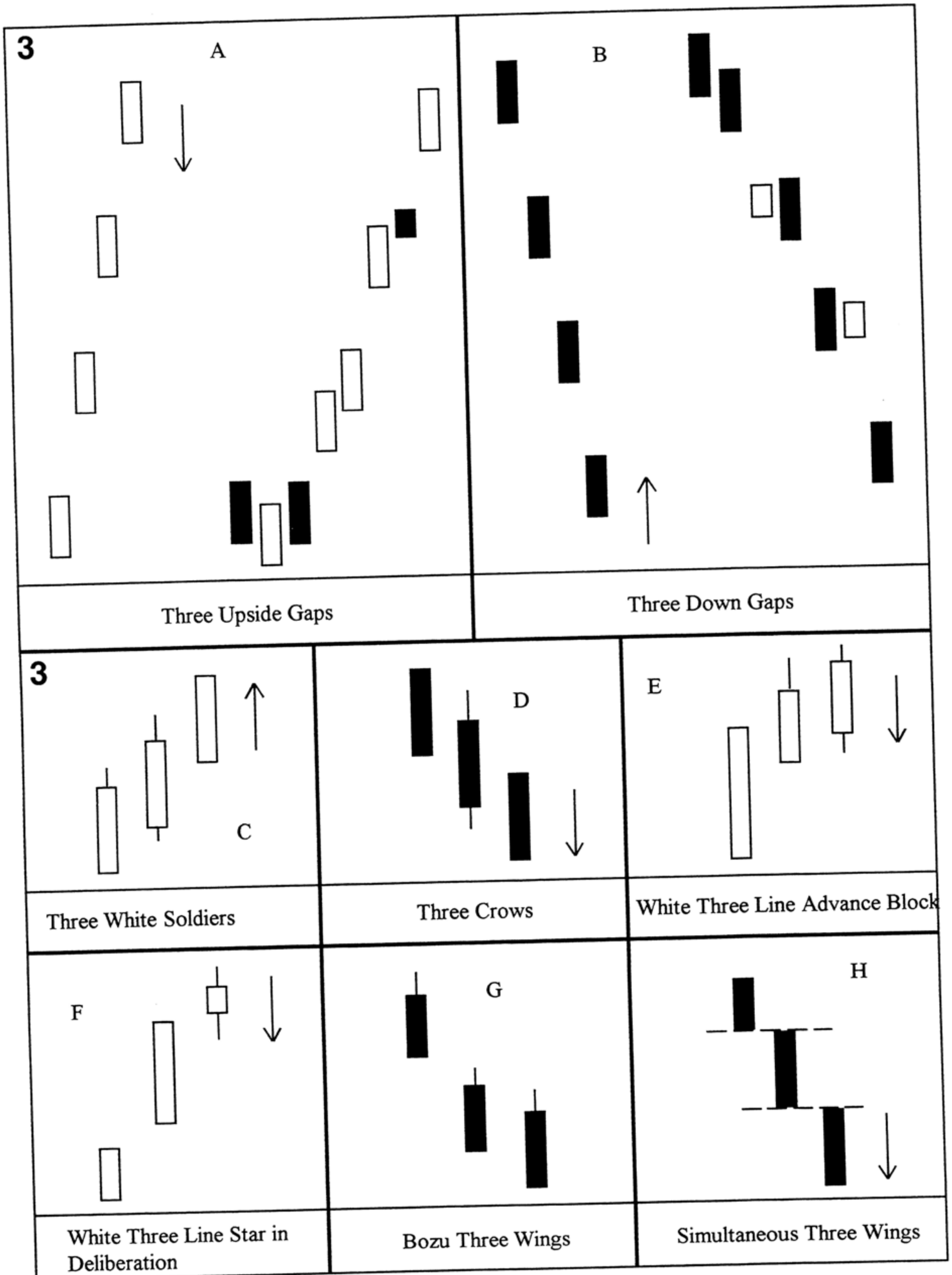

3
A
Three Upside Gaps
B
Three Down Gaps
3
C
Three White Soldiers
D
Three Crows
E
White Three Line Advance Block
F
White Three Line Star in Deliberation
G
Bozu Three Wings
H
Simultaneous Three Wings

Figure 3

1. Confirmation

"Confirmation" patterns are created after an initial candlestick pattern has formed. The "confirmation" pattern is considered a conservative traders entry point. They identify that the initial candlestick pattern now has a higher likelihood of prompting a market price move in the directing predicted. "Confirmation" patterns are an essential part of trading with candlesticks and have been taught to generating after generation of Japanese.

2. Continuation

"Continuation" patterns are created after an initial candlestick pattern has formed, and normally appears after a "confirmation" pattern. The "continuation" patterns are used to identify a trending market and to maintain an awareness of the trend strength. Many times, the "continuation" patterns will form during the individual "Three Level Fluctuations" as described earlier. These "continuation" patterns are generally helpful to keep you long or short during a defined market trend after the initial candlestick buy or sell pattern.

3. Combination

"Combination" patterns are fairly simple to understand. They are created when two or more individual candlesticks, or two or more individual multi candlestick patterns, or any combination thereof, appear side by side and issue similar signals. An example would be a "Hanging man and Doji Line" found at or near a ceiling. This is a strong indication of a potential bearish price move. "Combinations" patterns are not rare, they appear in generally all stocks and commodities. The key to these unique patterns is to be able to identify them as a stronger influence to a possible future price move and to help identify the direction of the future move.

4. Confluence

"Confluence" patterns are composed of a number of other technical oscillators or patterns that assist in confirming or denying the potential for any candlestick pattern probability of success. For example, one might choose to use Moving Averages, Stochastics, Momentum and Elliot Wave Theory as "confluence" indicators to assist in determining the current conditions of any market and to assist in confirming the possibilities of the current candlestick pattern(s). Generally all Western technical oscillators can be used as "Confluence" patterns. The key is to understand the relationships between the price movement of the chart, the relative change in the Western technical oscillators, and the candlestick pattern(s) that have formed. This could be considered part of the "Sakata's Constitution", as it is an underlying concept. Although, this is more a fundamental reality of profitable trading than a concept.

The "Sakata's Constitution" and "Sakata's Five Methods"

Sokyu Honma was actually born Kosaku Kato (1716-1803) in the city of Sakata, Yamagata Perfecture, Japan during the Tokugawa period (Eighth Shogunate). Later in life, he was adopted by the Honma family. At that time, the port of Sakata was a distribution center for "shonai" (rice). Honma concentrated his attention on the rice cash market and later on the popular fixed rice market. His detailed attention to the markets and his understanding of candlesticks propelled him to become a very wealthy man. He was considered an elusive and feared individual trader because of his diligent and effective understanding of candlesticks and the psychology of the rice markets. Through his very charismatic personality and highly effective trading methods he gained the nick-name "Dewa's long nosed goblin".

The "Sakata's Five Methods" originated from the rules and methods that Honma first developed to trade with called "Sakata's Constitution". At this time the candlestick chart had not evolved yet and was not incorporated into Honma's technique. Later, after Honma began using the candlestick chart, the "Sakata's Five Methods" was developed by fusing the "Sakata's Constitution" with the advanced techniques of the candlestick chart. Honma's secret methods were divided into two groups and have been passed down through many generations of Japanese. The two methods are the "Markets Sanmi no den" and "Sakata's Strategies".

The "Market's Sanmi no den" or "Sakata's Constitution":

1. Without being greedy, think about the time and price ratio by looking at past price movements.

2. Attempt to sell at the top and buy at the bottom.

3. One should increase one's positions after a rise of 100 bags from the bottom or a fall of 100 bags from the top. This technique can be related to scaling into existing positions.

4. If one forecasts the market incorrectly, one should attempt to identify the error as soon as possible. As soon as the error is discovered, one should liquidate one's positions and rest on the side for 40-50 days.

5. One should liquidate 70 to 80 percent of one's profitable positions, liquidating the remainder a changing directions once the price has reached it's ceiling or bottom.

Upon execution, all of these methods can be considered "Sakata's Strategies". Methods 4. and 5. are primarily trading principles used to limit loss and increase profits. Methods 1., 2. and 3. require the use of a chart and are techniques designed to realistically enhance one's trading ability over time.

Very early in Japans cultural history, the number "three" has been considered a mysterious number and it is thought that a divine power lives within it. This is more than likely where the "Sakata's Constitution" and the "Sakata's Five Methods" attained its mysticism. The "Sakata's Five Methods" consists of ***"Sanzan"*** (Three Mountains), ***"Sansen"*** (Three Rivers), ***"Sanku"*** (Three Gaps), ***"Sanpei"*** (Three Parallel Lines) and ***"Sanpo"*** (Three Methods). To preface all five terms of the "Sakata's Five Methods", the Japanese term ***"San"*** translates to the number "three".

"Sanzan" (Three Mountains)

The "Three Mountains" consist of two groups, each with three individual shapes of market topping and bottoming formations (see figure 2). These two groups directly correlate to the "three level fluctuations" theory we have already discussed. The "Three Mountains" pattern is very similar to the Western "Head and Shoulders Top". They both consist of the very same price movement characteristics. The Japanese also consider the "Double Top" and "Rounded Top" as variations to the "Three Mountains" group.

The reverse of the three individual market top formations detailed above create the second group of patterns that complete the "Three Mountains". This group identifies a market bottom. They are the "Head and Shoulders Bottom", the "Double Bottom" and the "Rounded Bottom".

The Japanese view these patterns from a broader perspective. These patterns are attuned to identifying major reversals of trend over a longer time frame. Often times, we see these patterns as smaller pieces to a much larger puzzle. When we begin to piece together the puzzle, we can only then begin to predict its outcome.

"Sansen" (Three Rivers)

The "Three Rivers" patterns reflect a complete reversal of price direction. They form in either "Morning" or "Evening" positions with many variations. The "Three River Morning Star" pattern reflects a bullish reversal of trend or a possible market bottom. Whereas the "Three River Evening Star" pattern reflects a bearish reversal of trend or a possible market top.

The common formations, as shown in figure 3, often consist of very strong single candle types (such as Doji's, Bozu or Marubozu lines). These individual candle types represent some of the strongest single candle types to identify price direction or lack of it. For example, the "Doji Line" that separates the other two candles within this pattern identifies that the market is unable to continue its current trend. The third candle that completes this pattern confirms the fact that the market trend has reversed.

The variations of the "Three Rivers" include the "Upside Gap's Two Crows", the "Evening Southern Cross", the "Two Crows" and the "Unique Three River Bottom". Although these variations may appear visually completely different, they reflect the same intention of the market - to reverse.

“Sanku” (Three Gaps)

The “Three Gaps” pattern consists of three individual gaps in price that occur during a defined trend. The gaps do not need to be consecutive, they may form throughout many days of trading. This pattern signifies that the market has continued in its defined trend and current trend may soon end. The “Three Gaps” pattern can form during either a bullish or bearish trend to identify specific trend reversals. Remember that this pattern has a specific correlation to the “Three Level Fluctuation” theory. The gaps may form during the three individual price advances or declines that support the “Three Level Fluctuation” theory.

When a “Bullish Three Gaps” is formed, the Japanese call this “Sanku Fumiage”. It represents a price ceiling and one should start selling. When a “Bearish Three Gaps” is formed, the Japanese call this the “Sanku Nage Owari” or the “Sanku Tatakikomi” and one should start ordering long positions. In either condition, once the market price begins to reverse and the third gap is filled, one should increase one’s current long or short positions.

“Sanpei” (Three Parallel Lines)

The classic formation of the “Three Parallel Lines” occurs when three of the same color candles appear with no price gaps between them. If they are all bullish candles (white), they create the “Three White Soldiers” pattern. If they are all bearish candles (black), they create the “Three Crows” pattern. These common types of “Parallel Lines” are viewed as a continuation of the current market trend.

The variations of the bullish (white) “Three Parallel Lines” are different in shape and meaning from the classic formations. The “White Three Line Advance Block” (Sakizumari) differs slightly from the “Three White Soldiers”, yet it represents the possible end a current bullish price move. It depicts a continuing bullish price move that is diminishing in strength and likely to reverse. Another variation is the bullish (white) “Three Line Star in Deliberation” (Akasansen Shianboshi). It represents that the current price move is indecisive and is likely to reverse. Often, this pattern may form into an “Engulfing Bearish” or a “Three River Evening Star” indicating strong selling in the market now.

The bearish variations of the “Three Parallel Lines” are a little more complicated. The first is the “Bozu Three Wings”. It varies from the “Three Crows” because of a gap between the first and second candles and the requirement that all three candles be of the “Bozu” or “Marubozu” type. This pattern represents strong bearish price action. The second variation occurs when the second candles opening price is equal to the first candles closing price and the third candles opening price is equal to the second candles closing price. So to say, each new candle opens on the previous candles close. This is called the “Simultaneous Three Wings”, and is an indication of continued bearish price action.

"Sanpo" (Three Methods)

The "Three Methods" patterns are related to one's position in the market (buy, sell, or wait). So to say, one shouldn't continually buy and sell positions all year, it is often wise to wait and not enter any position in the market until the timing is right. These pattern groups indicate a congestion period within the market and one should wait for confirmation of the current of new trend.

These two patterns are the "Rising Three Methods" and the "Falling Three Methods". If the "Rising Three Methods" appears in a rising market, one should expect a short rest before a further climb in price. The opposite is true for the "Falling Three Methods". If it appears is a declining market, one should expect a short break before a further fall.

These patterns also relate to a candlestick trading technique called "The Trending Candle/Body Reversal" system developed by Mr. Geert Strubbe of Belgium. This technique is disclosed later within this reference guide.

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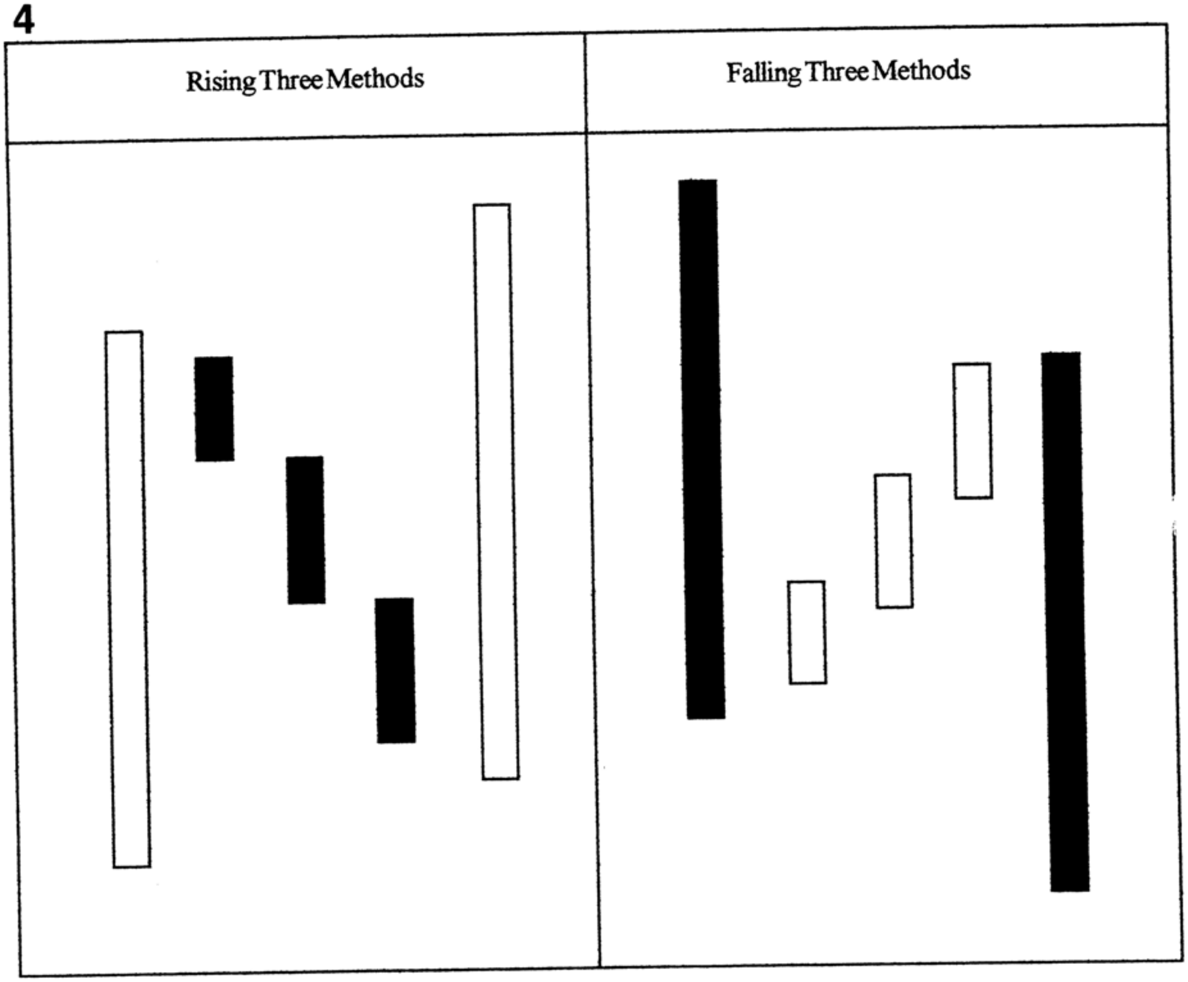
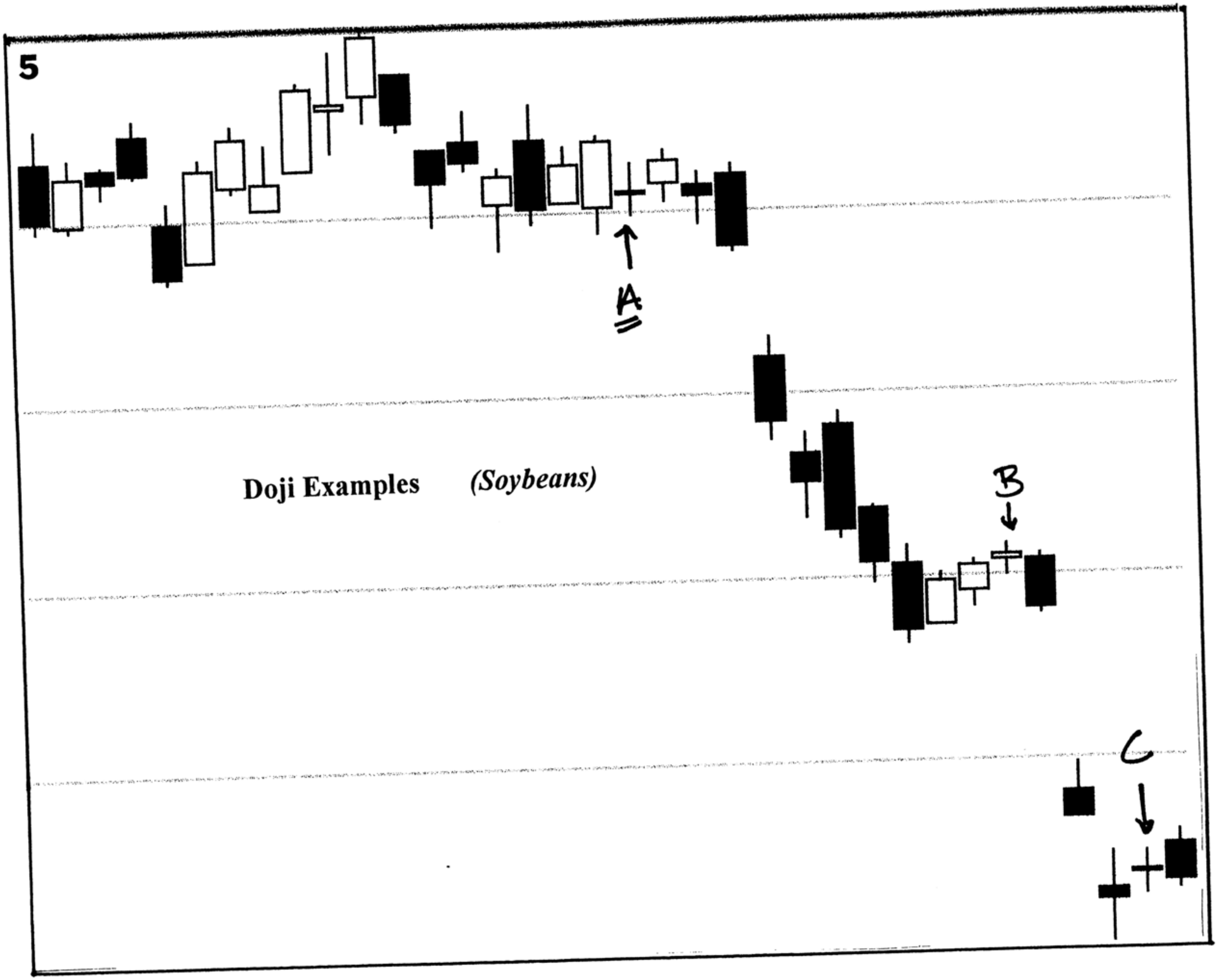
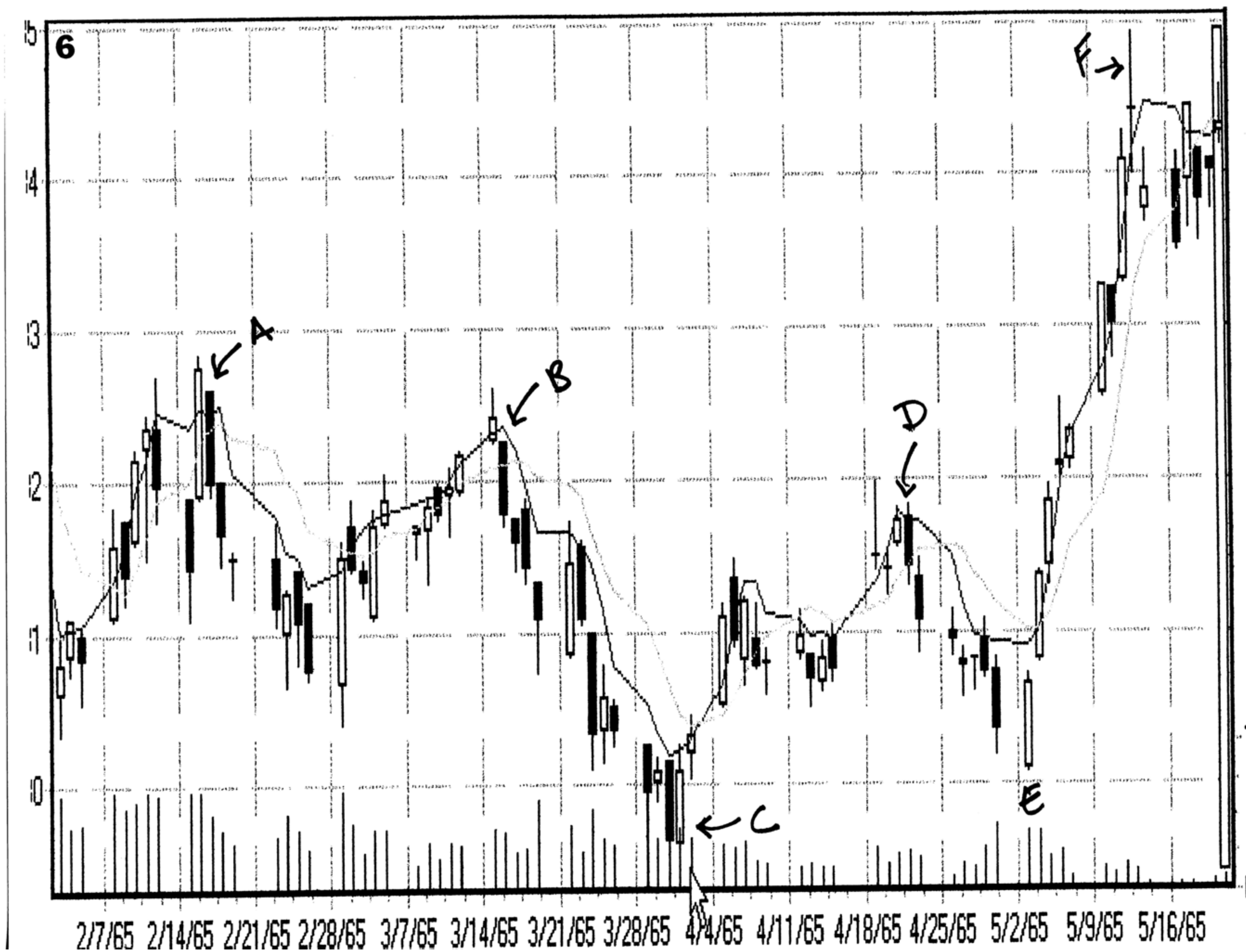



5
Doji Examples (Soybeans)
A
B
C


6
5
4
3
2
1
0
2/7/65
2/14/65
2/21/65
2/28/65
3/7/65
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3/21/65
3/28/65
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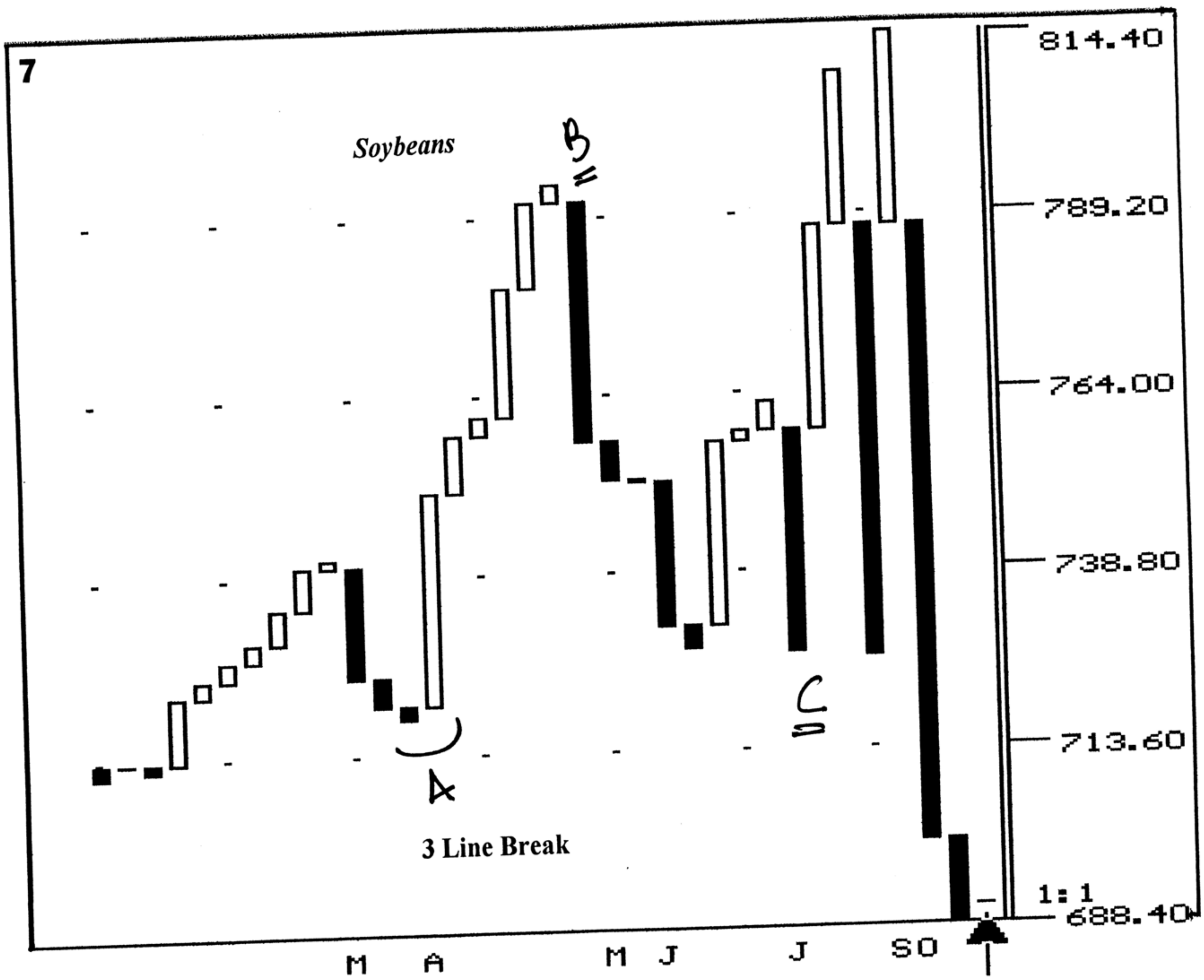
7
Soybeans
B
A
C
3 Line Break
814.40
789.20
764.00
738.80
713.60
1:1
688.40
M
A
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J
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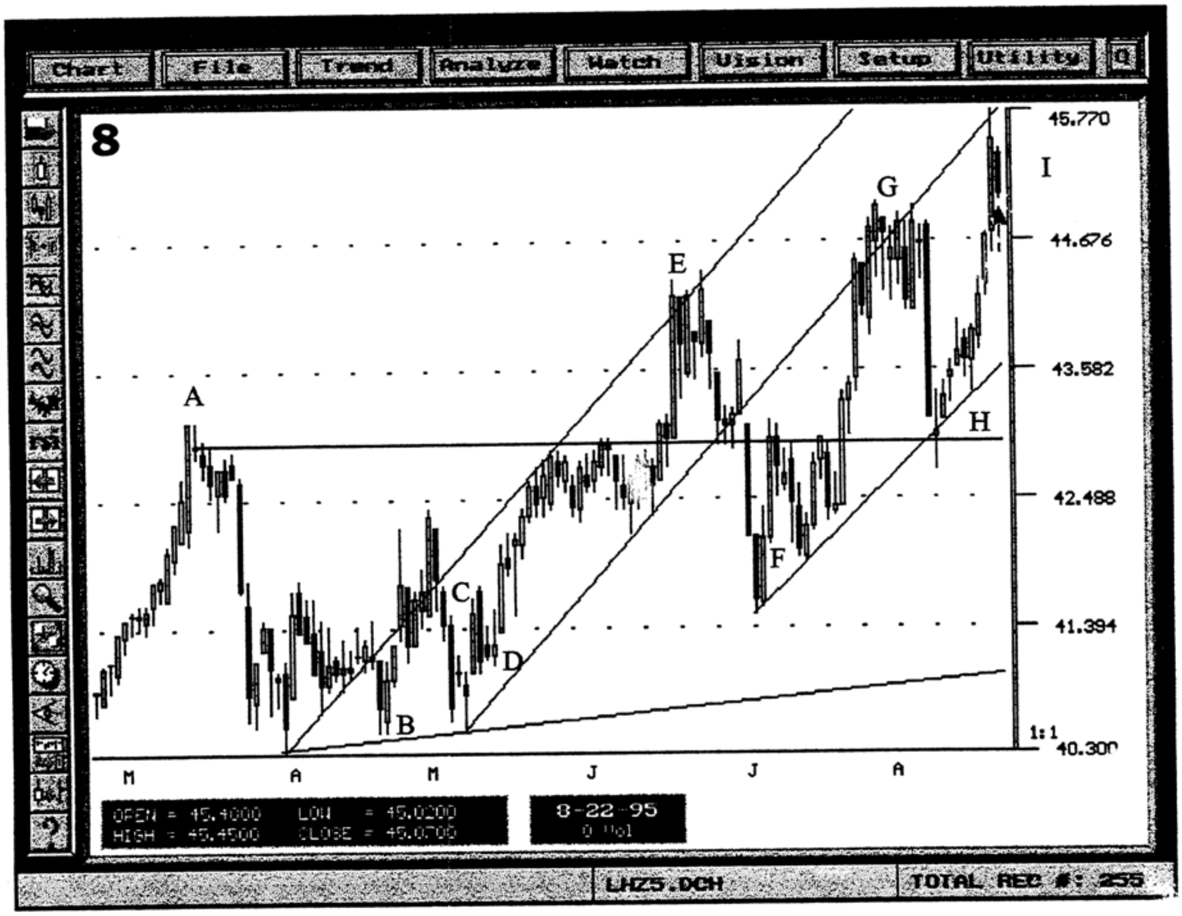
O

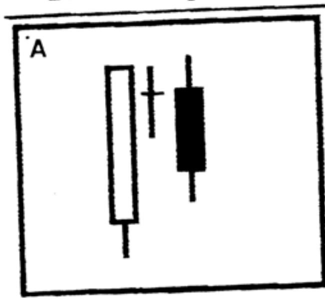
Live Hogs December 1995



This example illustrates the continuity of individual candlestick patterns as well as Tom DeMark's Sequential theory. Live Hogs can sometimes be a very volatile market with large price swings. This type of price activity is ideal for trading with Japanese candlesticks.

As we begin to cover the material within this section, we will discuss practical trading approaches including Stop placement and Trailing levels, Risk parameters, Money Management and the Psychology of trading any market with Japanese Candlesticks. All of these factors pertain to your success or failure as a trader.

9 **Tweezers Tops Confirmation**



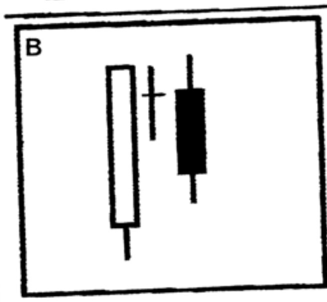
Possible top: short term sell signal. Place stop above trend resistance at 43.15, the current candles high.

Proper Action:

It might be wise to enter a short market postion.

Sell Signal

Harami White Cross Confirmation



The harami white cross seems to be correct. It might be wise to enter the market from the short side.

Proper Action:

Place stop above 42.95, the previous candle's close.

Sell Signal

This example illustrates one of the primary benefits of the Japanese candlestick approach - patterns that form in combinations. For example, when two or more individual candlestick patterns form at the same time, it is showing us that the market is ready to move in the predicted direction. In this case, we find a Tweezers Tops Confirmation and a Harami White Cross Confirmation pattern that inform us to SELL this market.

Both of these candlestick signals are unique patterns. It just happened that they formed on the same trading day. The Tweezers Tops pattern is created when two candles have the exact same high price. If the following trading day is lower than those highs, we would receive Confirmation. The Harami White Cross pattern is similar to an "Inside day" (Western Term) and in Japanese means "Pregnant". It is a common reversal signal and one should always wait for Confirmation before trading this signal.

The term "Confirmation" will become very familiar to you be the end of this session. Confirmation signals were developed to assist traders in identifying when candlestick patterns are correct and when they are false. All traders should learn to use confirmation within their trading approach as a means of finding more probable trading opportunities.

The definition of "Confirmation" is as follows:

Bearish Confirmation = a BLACK candle with a lower HIGH, LOW and CLOSE price (as seen above).

Bullish Confirmation = a WHITE candle with a higher HIGH, LOW and CLOSE price.

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IPTC is the developer of one of the most highly acclaimed trading applications on the market today. The "Candlestick Forecaster® for DOS is a comprehensive application designed to track and analyse the markets using a the largest candlestick pattern recognition library in existence. The Master edition uses a library of over 1300 candlestick patterns in conjunction with 6 western oscillators (Moving Averages, Stochastics, RSI, RMI, Williams %R, and Trading Bands) to provide one of the most accurate trading systems available anywhere. Features of the Master Edition include...

- The "Candle Watch" which allows the user screen for buy/sell signals on over 600 markets at a time.
- Draw up to 10 different trend lines on a single chart and utilize the western oscillators for more detailed analysis.
- Historically scan and backtest a chart for patterns to generate reports, profitability studies, or statistical analysis
- Read over 20 different data formats to easily integrate with the user's existing software.

The Candlestick Forcaster® Samurai for Windows (either 3.1 or Windows 95) has all the same features as the Master edition, along with several new features... specifically;

- Two new western oscillators... The MACD and the CCI;
- A Trader's Log that will allow you to keep track of your profit/loss statements;
- An "Autopilot" feature that allows you to automate your candlewatch;
- The "Report Smith" which allows you to customize how your reports print
- A Downloading function which will allow you to access your downloading software from within the Samurai;

We also offer a Daily Fax Service, available over either E-Mail or Fax, giving timely recommendations for the futures markets based on Candlestick analysis, along with commentary by Gary S. Wagner.

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