Action Forex

ADVANCED CANDLESTICKS AND ICHIMOKU

STRATEGIES FOREX TRADING

Part 2

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INTRODUCTION

In the first part of our e-book, Advanced Candlesticks and Ichimoku Strategies for Forex Trading, we covered area including basic chart analysis (trend analysis, pattern recognition), Fibonacci retracements and projection, major candlestick patterns as well as Ichimoku Kinko Hyo charting. In this second part of the e-book, we will extend our coverage of both Candlestick and Ichimoku Kinko Hyo charting. More focus would be put on other bullish and bearish candlestick patterns such as 'Dark Cloud Cover', 'Three White Soldiers' and 'Piercing Line' etc. Besides, we will have more in depth studies on the Ichimoku Kinko Hyo charting, introducing more trading signals, the use of Chikou Span and more advance application of the Ichimoku Kumo.

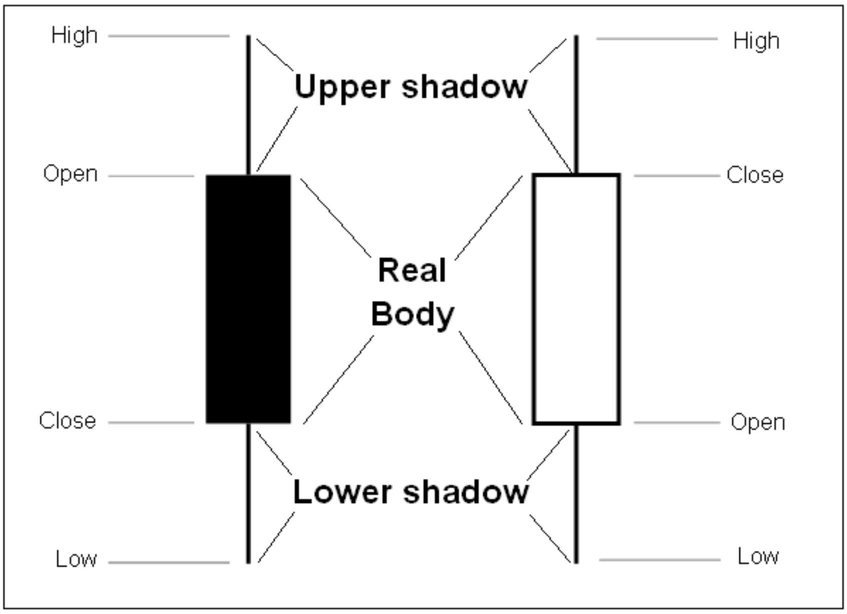
Once again, we will use recent examples in describing how to apply these tools to help formulating day to day trading strategies. We have been publishing Ichimoku and Candlesticks trade ideas in Actionforex.com since early 2009, providing intra-day and weekly trading strategies updates on USD/JPY, EUR/USD, GBP/USD, AUD/USD and EUR/JPY (4 times a day for intra-day and once a week for weekly recommendations) with clear entry levels, profit objectives (from 100 points to 150 points) and stop-loss (30-35 points).

Chapter 1 - Use of Candlestick charts

Candlestick chart was developed in 1700s in Japan by a man named Munehisa Homma, originally designed to trade rice futures in the 17^{th} century, he invented a method to analyze the price with an overview of the open, high, low and close prices of each trading day over a certain period of time.

A line, known as shadow, was drawn to show the day's price range and a broader part of the candlestick represents the area between the session's opening price and the closing price, known as real body. If the opening price is lower than the closing price (i.e. a rising day), then the body is white; if the opening price is higher than the closing price (i.e. a falling day), then the body is black.

As the style of charting is relatively easier to read and understand, it became very popular and analysts relate the chart patterns to various bullish or bearish signals, which were considered quite reliable in predicting future market directions.

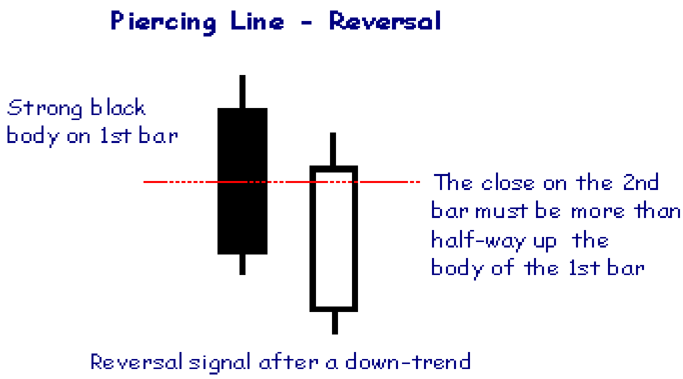


The colour (white or black) and the length of the real body exhibits the market forces, whether bulls / demand or bears / supply are winning. Generally speaking, the long the body indicates the more intense in buying or selling pressure (e.g. long white candlesticks reveal strong buying interest, i.e. buyers are very aggressive) whilst short real body normally suggests indecisive market situation and further sideways consolidation would take place. According to different combinations of candlesticks, various bullish and bearish patterns were found and we are going to discuss some of the patterns we did not cover in the part 1 of this book here.

1.1 – More Bullish Patterns

Piercing Line

This is a bullish reversal double candlestick pattern in a falling market, it consists of a black candlestick followed by a white candlestick that opens lower than the low of preceding or below the close of the previous candlestick (i.e. gap down opening), then price closes above the middle of the previous black body candlestick.



Characteristics:

In a falling market;

1. A long black candlestick preferably closes near the low;
2. Followed by a long white candlestick which opens lower than the close of the first bar;
3. The high of second white candlestick is contained within the first black candlestick and it must close higher than the middle of the body of the first candlestick;
4. The second bar should not close above the first candlestick body.

Explanation:

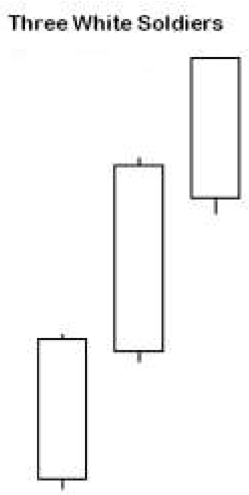
The formation basically suggests market participants are reevaluating the underlying security with potential buying starting to consider it is undervalued and is at a good price to build long positions.

Confirmation:

In order to confirm a low formation or reversal, one needs to see another long white candlestick or a large gap up on the next trading day

Three White Soldiers

The bullish Three White Soldiers (also known as Sanpei) is one of the triple candlestick patterns which consists of three white candlesticks (preferably to be long) with consecutively higher closes. Each candlestick opening below previous close and the closing prices are near to or at their highs. When this pattern appears after market has been staying at a low price for too long, it will be considered as a bullish reversal signal which treated as an indication of the end of a downward trend.



Characteristics:

1. In a falling market;
2. Three consecutive white candlesticks, preferably long ones;
3. Each candlestick forms new high;
4. The opening price of each candlestick is within the body of the prior bar;
5. Each candlestick closes near or at its highs

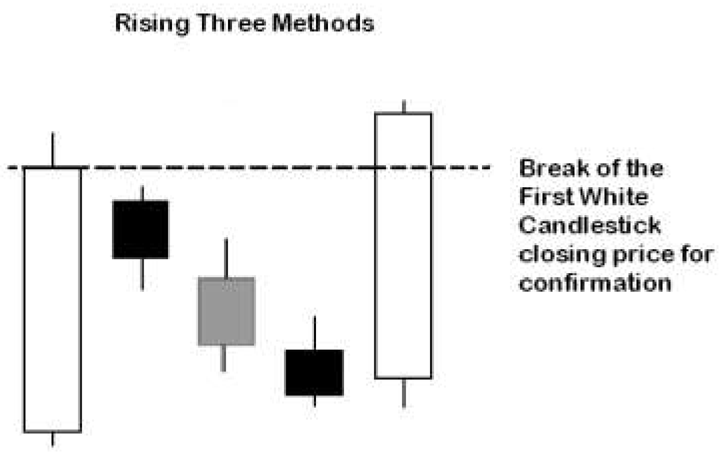
Explanation:
This pattern normally appears after a prolonged period of downward trend or low price. Market is still near the low or bottom has already been formed, upward attempt by the bulls and the three consecutive white candlesticks indicate they are winning with higher highs and closing prices near the highs. This forces the bears to cover their short positions which also help pushing price further north.

Confirmation:

Since after the completion of this patterns, price will already be quite far from the bottom and the pattern itself consists of 3 long white candlesticks, one should see oscillators e.g. RSI to rise above 50 and gap-up or addition long white candlesticks should also serve as a confirmation.

Rising Three Methods

In Candlestick charting analysis, most patterns are reversal patterns no matter is bullish or bearish, with only a few continuation pattern and here is one which considered quite reliable by traders. The pattern begins with a long white body candlestick followed by three small body candlesticks (mostly black but the one in the middle could be white) and ended with another long white body candlestick. The three small body candlesticks are confined within the range of first white candlestick, indicating the market is taking a pause due to uncertainty after a strong rise (to consolidate) and the fifth candlestick brings resumption of the uptrend with a closing price well above the high of the first white candlestick.



Characteristics:

1. In a rising market;
2. Start with a long white candlestick;
3. Followed by 3 small body candlesticks, could be in both colour but the pattern tend to be stronger if they are all black, all three bars should stay within the range of the first white candlestick (including the shadows;
4. Price holds above the low of the first bar and the fifth bar is another long white candlestick, opening above the close of the fourth candlestick and closing at a new high above the top of the first bar.
5. Although this pattern mostly consists of five candlesticks, some leeway can be given with the middle three small bodies could go up to four or even five.

Explanation:

A typical consolidating pattern after a sharp move, market is taking a pause, bulls are building up new long positions with bears giving their last attempt to fight back. When price couldn't drop below the low of the first bar, bulls take over again whilst bears give up.

Confirmation:

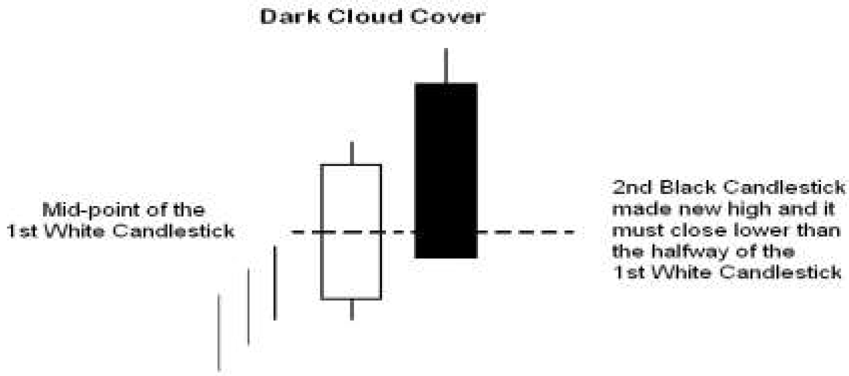
1. Low of the first white candlestick must remain intact

2. The break of the closing price of the first white candlestick should be treated as the first confirmation and with the fifth bar closes well above the top of the first bar, that is final.

1.2 – More Bearish Patterns

Dark Cloud Cover

This is one of the double candlestick bearish reversal patterns, it consists of a long white candlestick followed by a black candlestick which opens above the close of the white candlestick or more ideally opens at a new high, i.e. gap-up, and then closes below the mid-point of the body of the first white candlestick. It is considered as a bearish reversal signal during an uptrend.



Characteristics:

1. In a rising market;
2. A long white candlestick preferably closes near the high;
3. Followed by a long black candlestick which opens higher than the close of the first bar, preferably opens at new high;
4. The low of the second black candlestick is contained within the first white candlestick and it must close lower than the middle of the body of the first candlestick;
5. The second bar should not close below the first candlestick body

Explanation:

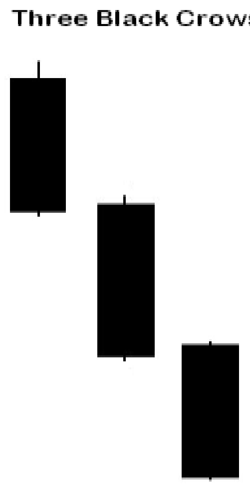
In a rising market, it seems like the bulls are taking control and after a rising day, price opens higher or gap up but upmove does not continue and price quickly turn around to close near the low. In a way, the pattern suggests the market is rejecting that high but in a less dramatic way like the shooting star which finishes the whole process within 1 day.

Confirmation:

In order to confirm a top formation or reversal, one needs to see another long black candlestick or a large gap down on the next trading day

Three Black Crows

The bearish Three Black Crows is one of the triple candlestick patterns which consists of three black candlesticks (preferably to be long) with consecutively lower closes. Each candlestick opening above previous close and the closing prices are near to or at their lows. When this pattern appears after a prolonged period of high price, it will be considered as a bearish reversal signal which used as an indication of the end of an uptrend.



Characteristics:

1. In a rising market;
2. Three consecutive black candlesticks, preferably long ones;
3. Each candlestick forms new lows;
4. The opening price of each candlestick is within the body of the prior bar.
5. Each candlestick closes near or at its low.

Explanation:

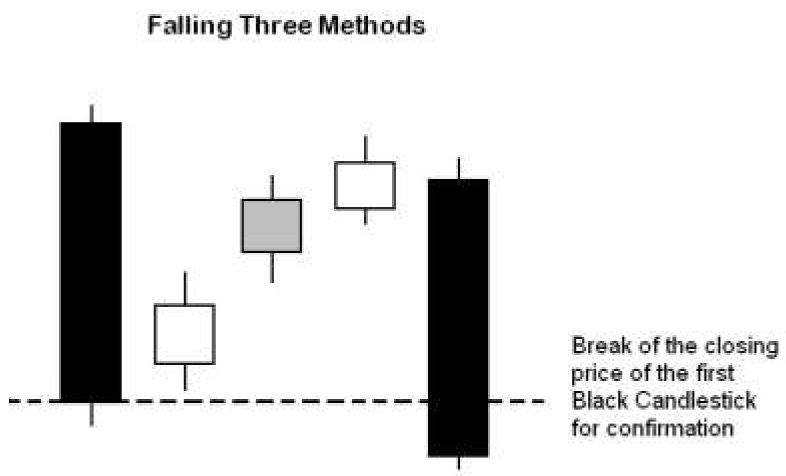
This pattern mostly happens after the market has been hanging at a high price for long time. Market is still near the high or top has already been formed, Bears are testing the supports and the three consecutive black candlesticks indicate they are having the edge with series of lower lows and closing price near the lows. Normally bulls will rush covering their longs which put extra pressure on price.

Confirmation:

Normally after the three consecutive black candlesticks, price will already be quite far from the top and the pattern itself consists of 3 long black candlesticks, one should see oscillators e.g. RSI to drop below 50 and gap-down or addition long black candlesticks should also serve as a confirmation.

Falling Three Methods

This is another continuation pattern which begins with a long black body candlestick followed by three small body candlesticks (mostly white but the one in the middle could be black) and ended with another long black body candlestick. The three small body candlesticks are confined within the range of first black candlestick, indicating the market is taking a pause due to uncertainty after a sharp fall (to consolidate) and the fifth candlestick brings resumption of the decline with a closing price well below the low of the first black candlestick.



Characteristics:

1. In a falling market;
2. Start with a long black candlestick;
3. Followed by 3 small body candlesticks, could be in both colour but the pattern tend to be stronger if they are all white, all three bars should stay within the range of the first black candlestick (including the shadows);
4. Price holds below the high of the first bar and the fifth bar is another long black candlestick, opening below the close of the fourth candlestick and closing at a new low below the bottom of the first bar.
5. Although this pattern mostly consists of five candlesticks, some leeway can be given with the middle three small bodies could go up to four or even five.

Explanation:

A typical consolidating pattern after a sharp move, market is taking a pause, bears are building up new short positions with bulls giving their last attempt to gain ground. When price couldn't rise above the high of the first bar, bears take control again whilst bulls give up.

Confirmation:

1. High of the first black candlestick must remain intact

2. The break of the closing price of the first black candlestick should be treated as the first confirmation and with the fifth bar closes well below the bottom of the first bar, that is final.

To sum up, applying the candlestick chart patterns analysis allows the investor an added advantage especially with the reversal signals. Candlestick chart should be used in conjunction with other traditional technical analysis tools such as oscillators in order to confirm top and bottom formation.

Chapter 2 - Ichimoku Analysis

In the first part of this E-book we covered the basic use of the Tenkan-Sen, Kijun-Sen, Senkou Span A and Senkou Span B (which create the Ichimoku cloud). In this second part of the Ichimoku Kinko Hyo analysis, we will talk about the Chikou Span, some more trading signals and more in depth applications of the Ichimoku cloud or Kumo.

2.1 – Chikou Span

Chikou Span is also known as lagging line is plot by shifting current closing price backwards into the past 26 periods on the chart. This is one of the unique features of Ichimoku Kinko Hyo analysis by time-shifting current price backwards in order to get a clearer perspective of the price action. This line allows us to have a quick comparison of present level and the price of 26 periods ago.

With a quick glance of this line, one shall be able to identify if there is a change in trend and see if any support or resistance is being penetrated.

There are several way to utilize the Chilkou Span:

i) To do a quick comparison of current price to the price back in 26 periods ago, if current price is lower, then one can assume the bearish direction to continue and vice versa.

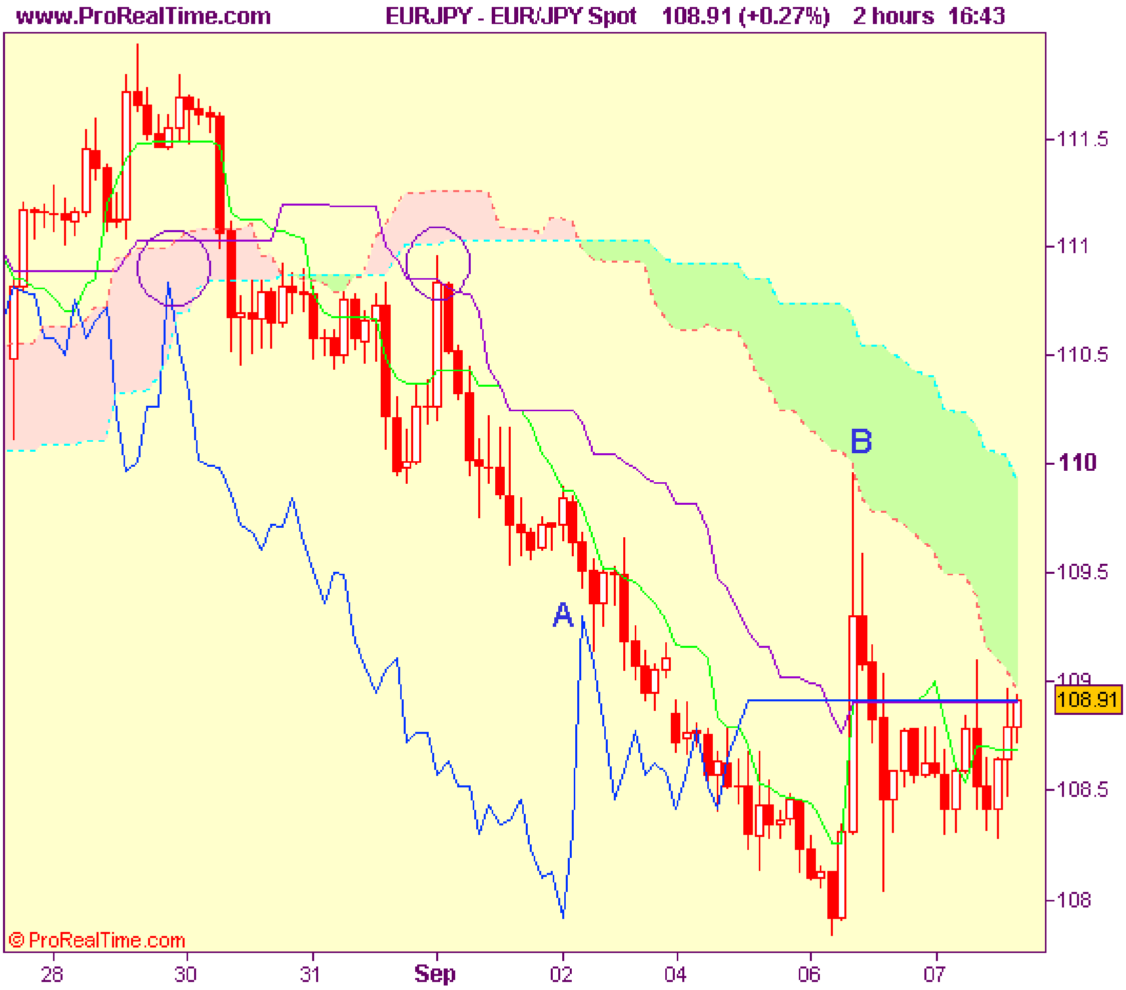
ii) In a falling market, if the Chikou Span rebounds and touch previous price level, one can assume that certain resistance would appear there. Therefore, if the Chikou Span is able to rise through previous price level, this normal represents a change in trend from bearish to bullish.

iii) In a rising market, if the Chikou Span retreats and touch previous price level, one can assume that certain support would appear there. Therefore, if the Chikou Span is able to drop through previous price level, this normal represents a change in trend from bullish to bearish.

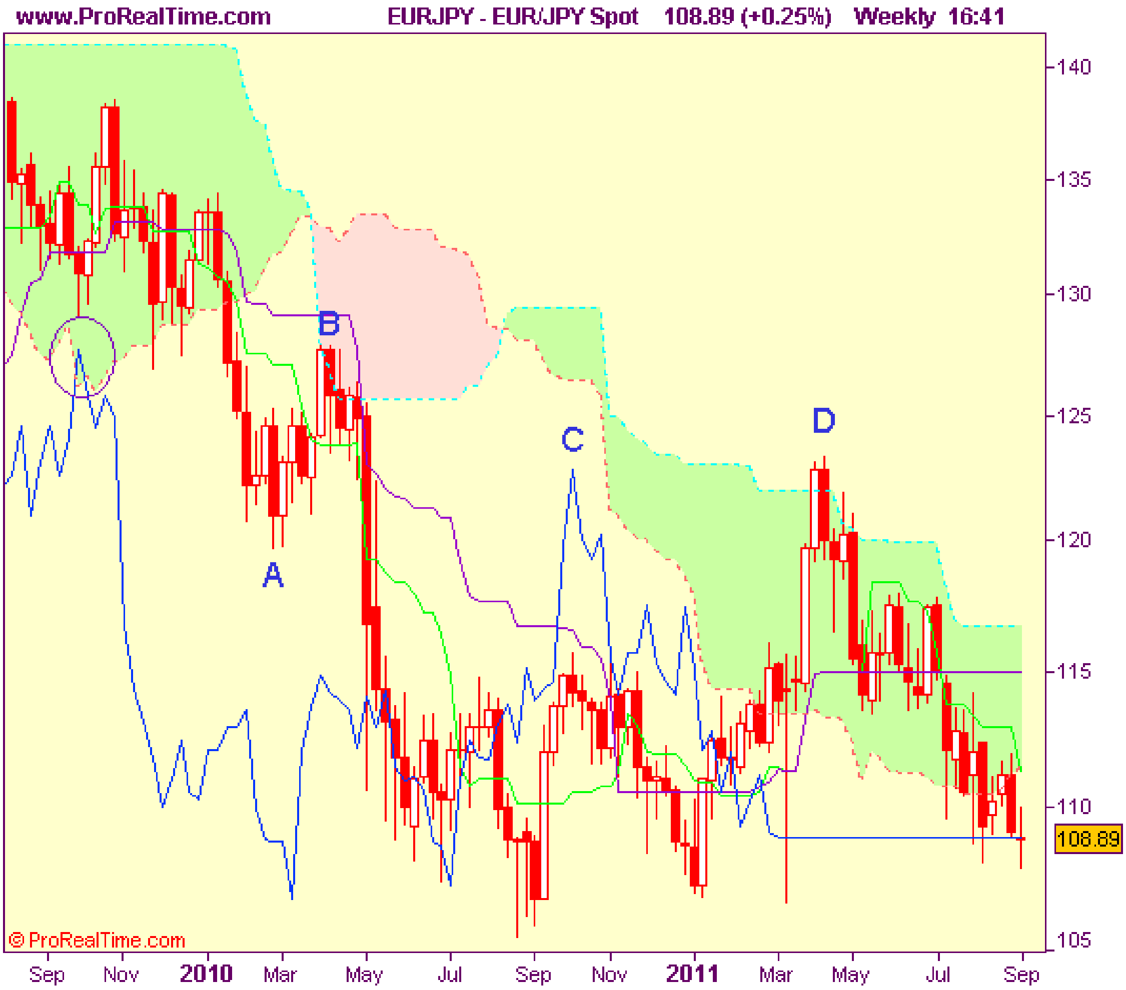
iv) When the Chikou Span touch back the level of the Tenkan-Sen, Kijun-Sen or Kumo back in 26 periods ago, one can expect current price to meet resistance or support.

Here are some recent examples:

a) Meeting resistance at the Kumo and previous price level

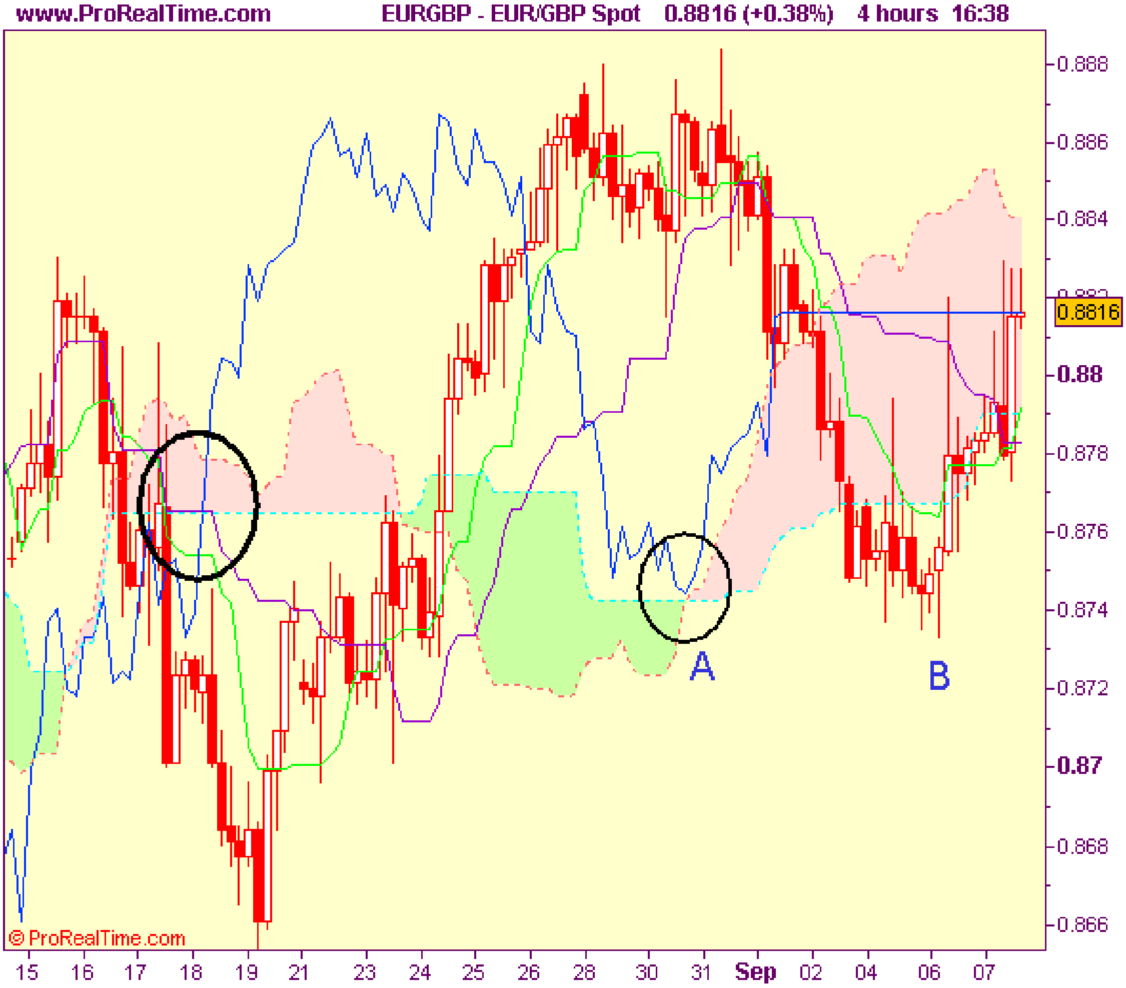


In the above chart, since price started to fall from 111.93, although the first rebound from 109.90 broke above the Tenkan-Sen and Kijun-Sen, it faltered below the Ichimoku cloud bottom and the Chikou Span also met renewed at the Ichimoku cloud. The single currency then rebounded again from 107.80, even this bounce was quite sharp, price met strong resistance right at the Ichimoku cloud bottom (at point B) and you can see the Chikou Span also met resistance right at the previous price level back in 26 periods ago (at point A). Since the single currency failed to break through previous price level, suggesting the bearish trend remained intact and price then turned back down again.



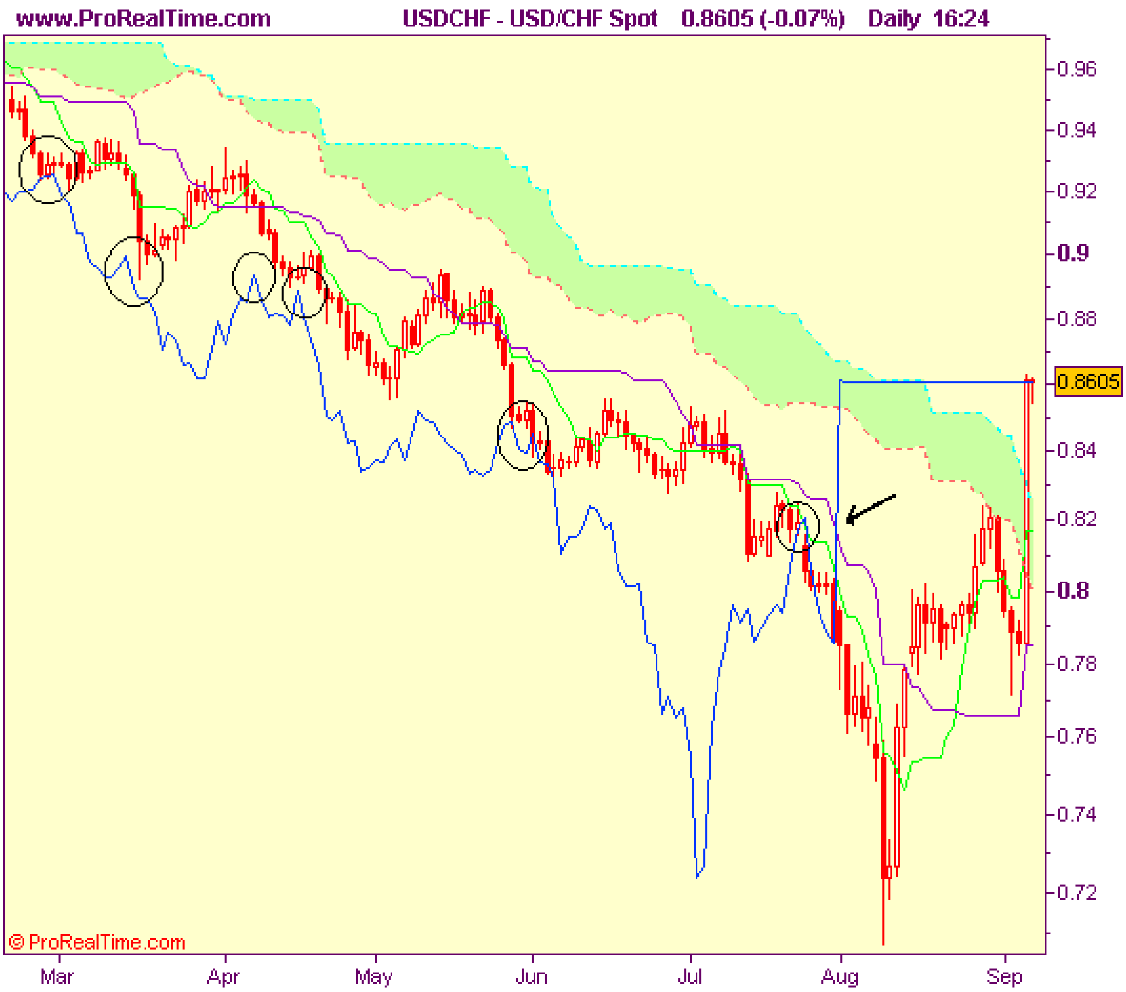
In the above chart, after falling for several months, euro rebounded from point A to point B, price did not reach resistance the Kijun-Sen but the Chikou Span already met resistance at the Ichimoku cloud bottom, price then tumbled again from there to as low as 105.44 before rebounding again. Although euro continued to find good support above this level and broke above Tenkan-Sen, Kijun-Sen and even Ichimoku cloud top (at point D), the Chikou Span met strong resistance below the Ichimoku cloud bottom (at point C), suggesting trend is still bearish and euro turned south again from point D back below 110.00 level.

b) Use Chikou Span to confirm change in direction



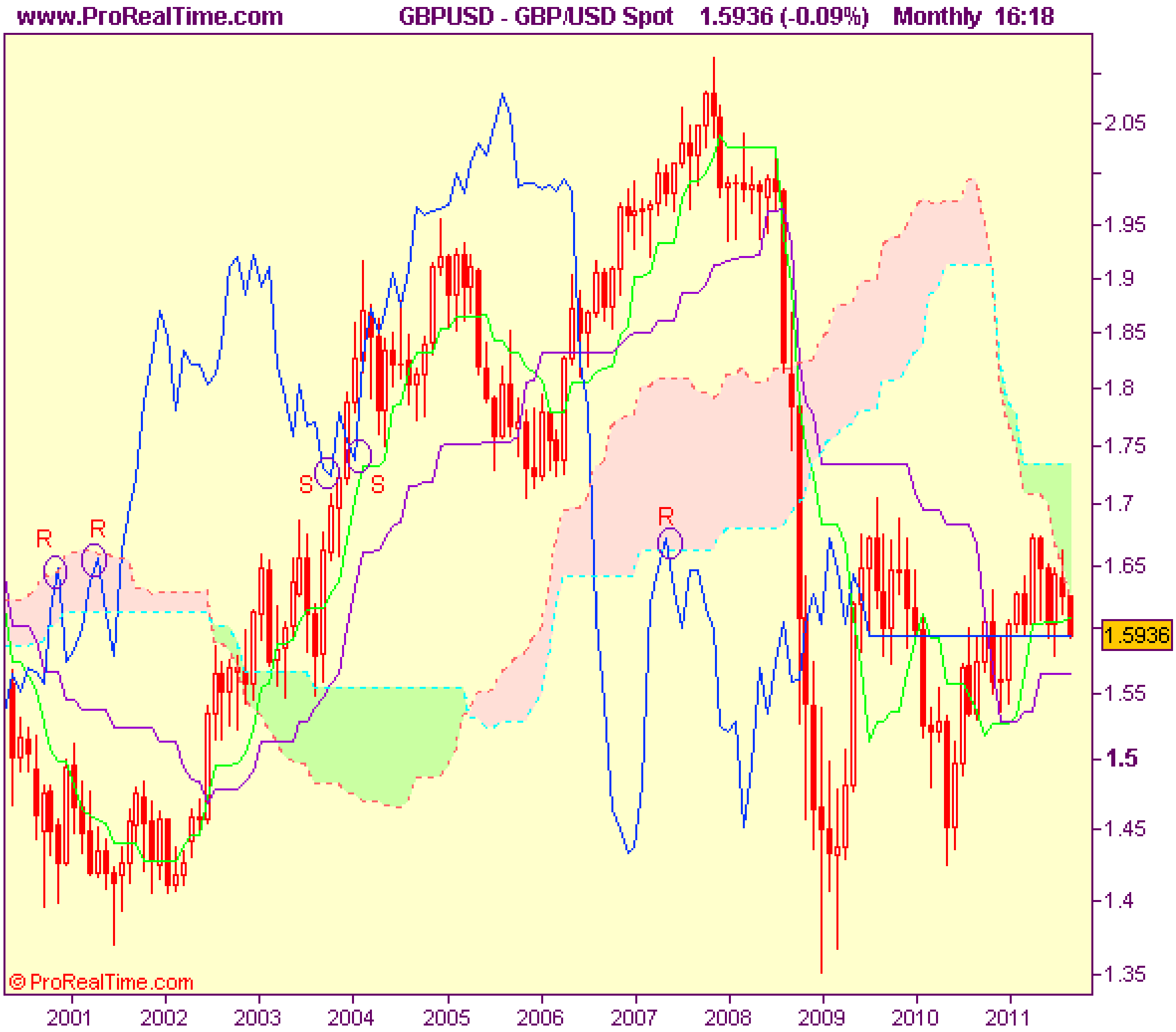
In the above chart, euro rebounded from 0.8654 and the big circle on the left indicate the point where Chikou Span broke through price, then Tenkan-Sen, Kijun-Sen and finally the Ichimoku cloud, confirming the change in direction. The currency pair surged to as high as 0.8884 before retreating, Chikou Span broke below price which provided confirmation of top formation, price then continued to fall to point B. Without the Chikou Span, as the decline from 0.8886 already penetrated Tenkan-Sen, Kijun-Sen and even the Ichimoku cloud bottom, it looked pretty bearish and seemed like further decline would be seen. However, if we take Chikou Span into consideration, once can see in point A, the Chikou Span just held above the Ichimoku cloud and euro found support at the corresponding point B, then staged a strong rebound from there.

On the left side of the above chart, the previous price level continue to cap the Chikou Span and although the strong rebound from 0.8734 to point B broke above the Ichimoku cloud top and Tenkan-Sen also penetrated the Kijun-Sen, as the Chikou Span faltered just below the Ichimoku cloud bottom, price retreated quite sharply from point B. Despite price dropping below the lower Kumo from point B, as Chikou Span found support just above previous price level and then broke above the Ichimoku cloud, price then rebounded again and broke above point B eventually.

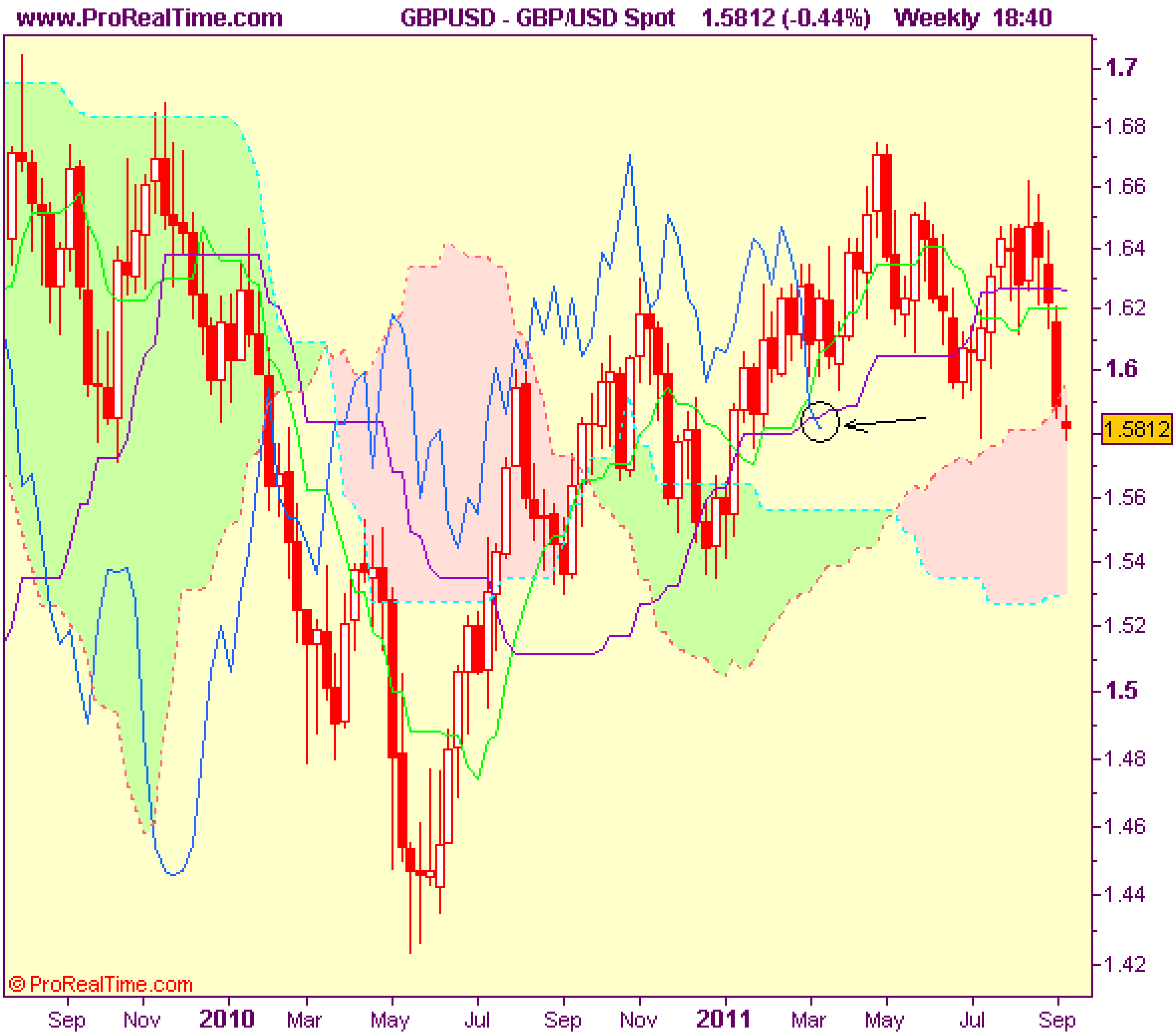


Another similar example here, one can see all the circles representing how previous price levels acting as resistance to the Chikou Span in a downtrend. Until the Chikou Span broke above price, Tenkan-Sen and Kijun-Sen on the right hand side of the above chart (with the pointer), this is where the Chikou Span provided confirmation of the change in trend.

c) Using Chikou Span to identify support and resistance.



In a ranging market, previous level of the Ichimoku cloud and price level could act as both support and resistance to the Chikou Span, so one can also take into account of these levels for corresponding support and resistance at current price. On left side of the chart, the 2 'R' represent the two resistance levels, however, without referring to the Chikou Span it would be almost impossible to identify these two resistances. When the Chikou Span successfully penetrated the Ichimoku cloud which confirmed the change in trend, then the previous price level turned to become support level for Chikou Span, marked as 'S'. In early 2009, cable rebounded strongly from 1.3500 and broke above the Tenkan-Sen, as you can see the previous level of the Ichimoku cloud bottom capped the corresponding rebound in Chikou Span at the middle point 'R' which capped the move from 1.3500.



Above is a recent example, after rising from 2010 low of 1.4228, cable continued to move high since May 2010 to complete a one year uptrend to as high as 1.6747 and then retreated from there to 1.5781 before bouncing again to 1.6618. On recent drop from 1.6618, the Chikou Span finally broke below previous price level as well as the Tenkan-Sen and Kijun-Sen, suggesting a change in direction. If we solely consider the Ichimoku cloud, as price already fell inside the Kumo area, next support would be apparently the lower Kumo around 1.5288, however, if we took the Chikou Span into account, the first support would come in at the previous Ichimoku cloud top level (which is 1.5555), so one can expect to see good level of support to appear there ahead of the lower Kumo. Once the Chikou Span breaks through the previous Kumo area, this would provide final confirmation for a top formation and since there isn't any obvious support (price, Tenkan-Sen or Kijun-Sen) after the break, so one can expect after the break-out, the decline is going to be quite sharp.

Conclusion

To sum up, the Chikou Span not only provide a quick comparison of current price with the past price level 26 periods ago, it could also help identifying support and resistance by using previous price, Tenkan-Sen, Kijun-Sen or Kumo levels. Finally it could also serve as a confirmation of a change in direction when Chikou Span breaks through previous price, Tenkan-Sen, Kijun-Sen and finally the Ichimoku cloud levels.

2.2 – Trading Signals

In part 1 of this E-book, we only covered the most basic and traditional trading signal within the Ichimoku Kinko Hyo analysis – Tenkan-Sen/Kijun-Sen cross signal. In this second part of the Ichimoku analysis, we are going to talk about several more trading signals, including Kijun-Sen cross, Senkou Span cross and Chikou Span cross signals.

In this section, when explaining each signal, we will also discuss where to put entry level, exit level and stop-loss placement. Then we will put recent real life examples to elaborate individual signal.

a) Kijun-Sen cross

We believe the Kijun-Sen cross trading signal is one of the most reliable trading signals among the others, though the signal may normally comes a little late. This signal can be used in different time frame but its reliability will decrease in shorter time frames due to the increase in volatility.

Let us first recap what is the Kijun-Sen, which is also known as base line, it is calculated as :

(Highest High + Lowest Low) / 2, for the past y periods (Traditionally y=26)

Kijun-Sen got a similar formula as the Tenkan-Sen but with a longer time frame, i.e. 26.

The Kijun-Sen cross signal comes in when price breaks above or below the Kijun-Sen. A buy signal is generated when price rises above the Kijun-Sen from below whilst a sell signal is generated when price crosses below the Kijun-Sen from above. According to different location of where the cross-over takes place, the signal can be classified in <u>Strong</u>, <u>Neutral</u> and <u>Weak</u>.

Strong signal:

- A strong buy signal occurs when a bullish cross-over takes place above the Ichimoku cloud;
- A strong sell signal occurs when a bearish cross-over takes place below the Ichimoku cloud.

Neutral signal:

- A neutral buy signal occurs when a bullish cross-over takes place within the Ichimoku cloud area;
- A neutral sell signal occurs when a bearish cross-over takes place within the Ichimoku cloud area.

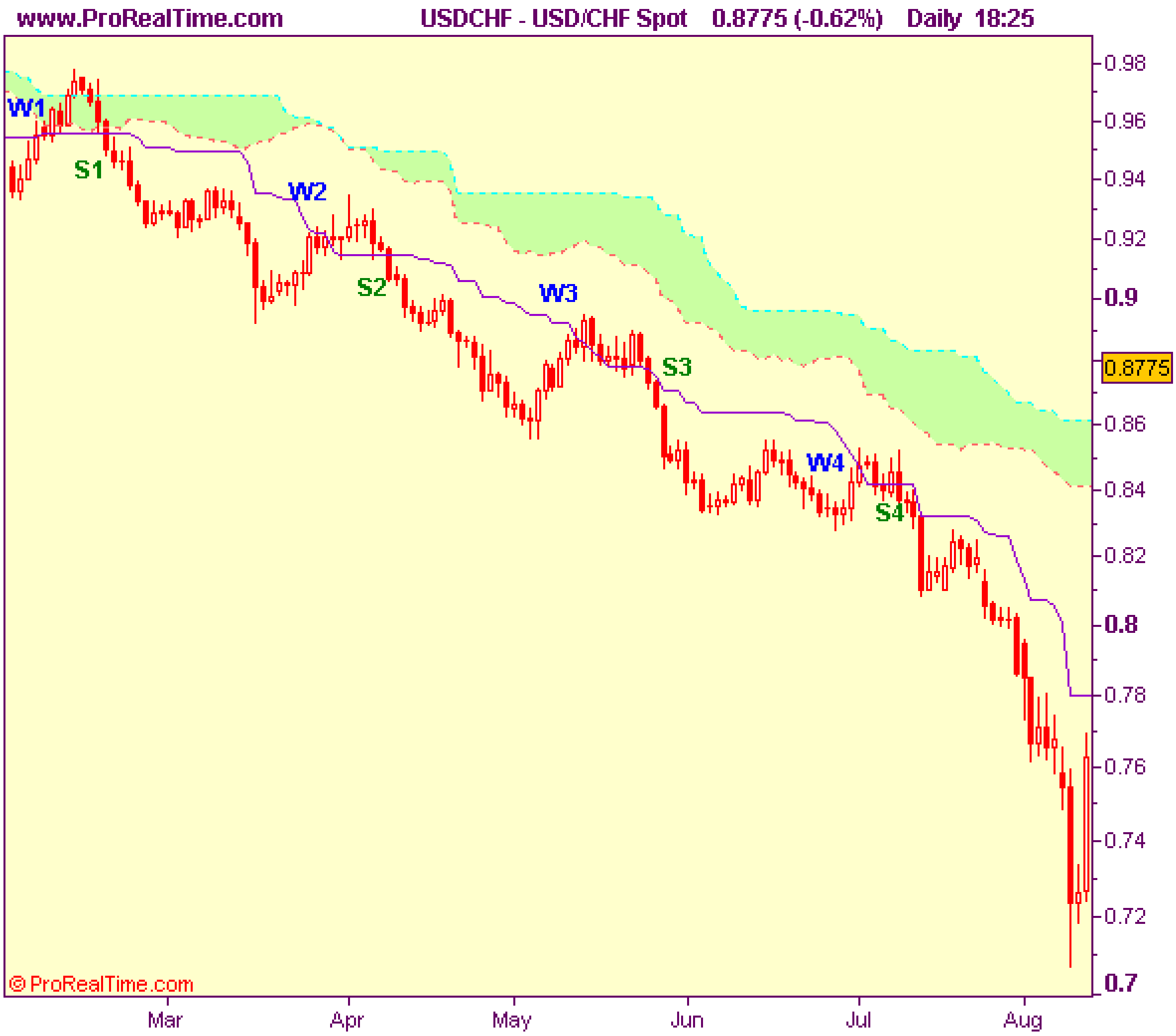
Weak signal:

- A weak buy signal occurs when a bullish cross-over takes place below the Ichimoku cloud;
- A weak sell signal occurs when a bearish cross-over takes place above the Ichimoku cloud.

In the above chart, the first sell signal generated when price dropped below the Kijun-Sen, however, this cross-over occurred above the Kumo, suggesting the signal was only a relatively weak one, price tested the lower Kumo and started to recover. Thereafter price crossed below the Kijun-Sen for the second time, forming another sell signal which happened below the Ichimoku cloud, indicating a strong sell signal was formed, price tumbled all the way to a 2009 low of 1.3500.

On the rebound from 1.3500, price crossed above the Kijun-Sen and generated a buy signal, however, as this cross-over took place below the Kumo, it was treated as a weak buy signal. The rebound faltered right at the Ichimoku cloud top and price started a 2 years long consolidation. In this sideways period, several buy and sell signals were generated which mostly happened within the Ichimoku cloud area, suggesting they were all neutral strength buy/sell signals.

In the above chart of GBP/JPY, the first sell signal generated on the far left was a strong sell signal as the cross-over took place well below the Ichimoku cloud, price fell sharply from around 200.00 to as low as 118.85 (over 8000 points decline) before rebounding. A buy signal was formed thereafter on the bounce from 118.85, however, as price broke above Kijun-Sen well below the Ichimoku cloud, it should be treated as a weak signal. Price then dropped again after faltering below the upper Kumo and a sell signal was formed as price dropped below the Kijun-Sen, this cross-over happened within the Ichimoku cloud area, indicating it was a medium strength or neutral strength sell signal, no sharp decline was followed but price still fell steadily for rest of 2010.



In the above chart, it was a major downtrend on a daily chart of CHF, as marked by W1, W2, W3 and W4, price rose above the Kijun-Sen and supposedly generated several buy signals, however, as all these so-called buy signals were formed below the Ichimoku cloud, they should be treated as weak buy signals. On the other hand, series of sell signals were generated, marked by S1, S2, S3 and S4, with price dropped below the Kijun-Sen and as all these cross-over happened below the Kumo, there were all strong sell signals and as you can see the results after these sell signals were quite significant. (620 points after S1, 590 points after S2, 495 points after S3 and hefty 1330 after S4)

In order to utilize a buy/sell signal, it is important to identify entry level, exit level, stop-loss placement and profit target, in Kijun-Sen cross signal, these levels are set as follows:

Entry: After seeing the break-out (either bullish cross-over or bearish cross-over), one should get ready to place the order and once the bar closes above the Kijun-Sen (for buy signal) or below the Kijun-Sen (for sell signal), this would confirm the signal and one can just enter the market at this point.

Exit: One should exit their position whenever the price crosses back in the opposite direction of the trade. For example, if a short position was entered on a bearish cross-over of the price below the Kijun-Sen, one should get out when the price rises back above the Kijun-Sen. This could also be used as a profit protection measure.

Stop-loss: As indicated above, once the signal is confirmed, price should not crossed back to the Kijun-Sen in the opposite direction, so one can simply place the stops 10-20 points above the Kijun-Sen for a short position and 10-20 points below the Kijun-Sen for a long position. The set up of this 10-20 points buffer depends on the volatility and traders' own judgment.

Profit target: As Kijun-Sen is a trending indicator, it is not possible to set profit target solely by the Kijun-Sen, one should apply other projection technique or oscillators to help setting profit objectives. However, the Kijun-Sen can act as a very good tool in order to set a profit-protecting level as price should not touch back the Kijun-Sen if the trend is going to continue. Therefore, once the trending move unfolds, one can use the Kijun-Sen to set trailing stop in order to protect profit.

b) Senkou Span cross

Although this signal is not as well known as the previously introduced trading signals, if this signal is being used correctly, it could also provide reliable and reasonably good results.

First of all, let us recap on what is Senkou Span, there are Senkou Span A and Senkou Span B, which create the famous Ichimoku cloud area or Kumo. These two lines are derived from the Tenkan Sen and Kijun Sen;

The Senkou Span A is calculated as:

(Tenkan-Sen + Kijun-Sen) / 2, shifted forwards y periods (Traditionally y=26)

The line is basically the mid-point between the Tenkan Sen and Kijun Sen but being plotted 26 periods ahead.

The Senkou Span B is calculated as:

(Highest High + Lowest Low) / 2 for the past z periods, shifted forwards y periods (Traditionally y=26 and z=52)

This line is always drawn alongside the Senkou Span A and is another component of the Ichimoku Kinko Hyo to create the Kumo / cloud. This line represents a relatively longer term view of the market equilibrium in the charting system, instead of calculating the past 26 periods data, the Senkou Span B measures the average of the highest high price and lowest low price for the past 52 periods (2 months data on daily chart) but again shifts forwards by 26 periods. Due to the use of long time variable, it is quite common to see the Senkou Span B to move horizontally.

The Senkou Span cross signal is given when the Senkou Span A (the shorter variable line) crosses over the Senkou Span B (the long variable line). If the Senkou Span A crosses above the Senkou Span B from below, this is treated as a bullish signal. If the Senkou Span A crosses below the Senkou Span B from above, this would be a bearish signal. Similar to other trading signal in Ichimoku Kinko Hyo system, according to different location of the cross compared to the current price level, the signals can be classified into three categories of strong, neutral and weak.

Strong signal:

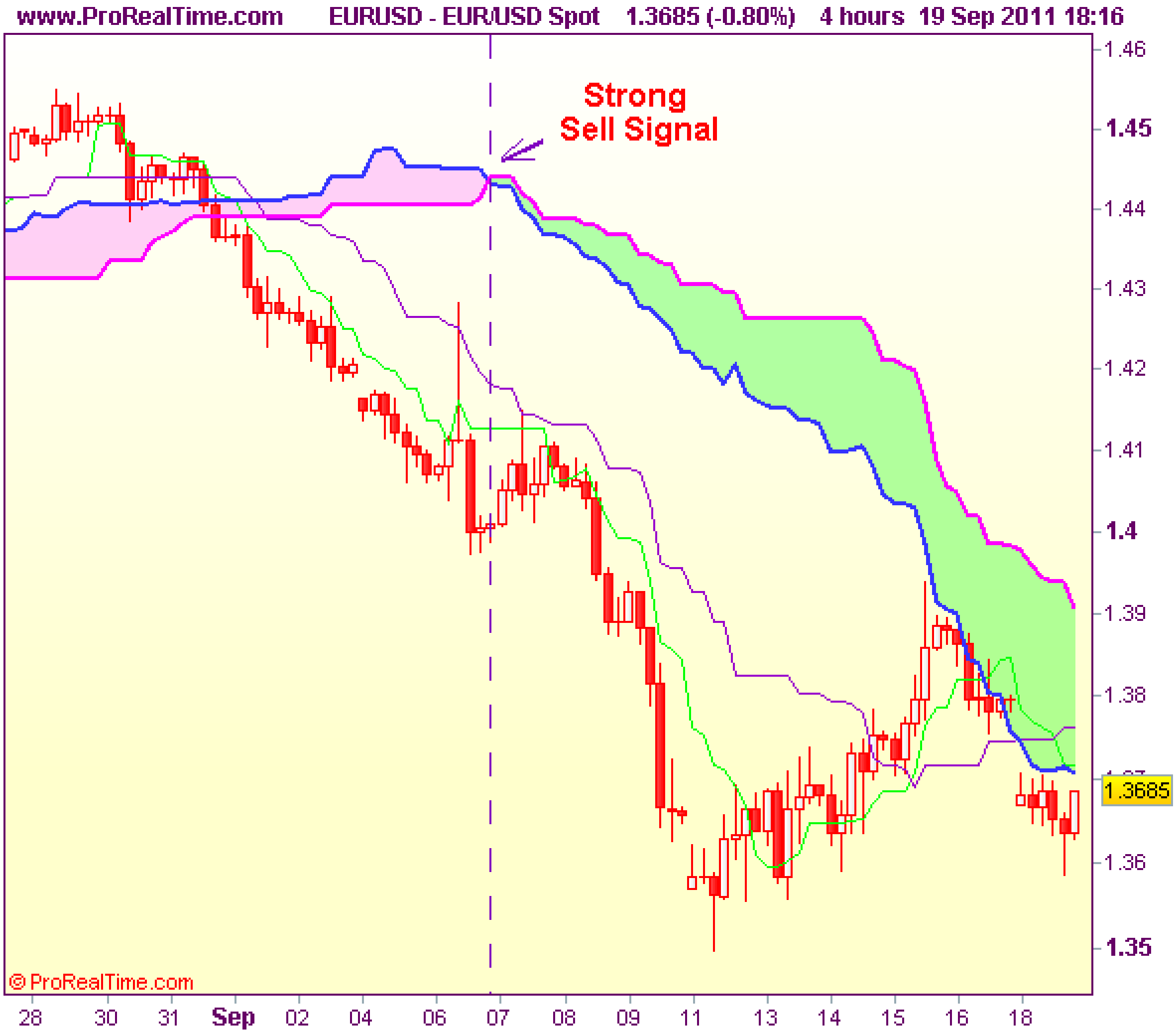
- A strong buy signal occurs when a bullish cross-over takes place below current price level, i.e. current price location matches with the signal direction.
- A strong sell signal occurs when a bearish cross-over takes place above current price level, i.e. current price location matches with the signal direction.

Neutral signal:

- A neutral signal, no matter is buy or sell, occurs when the cross-over takes place and current price level is locating within the Kumo area.

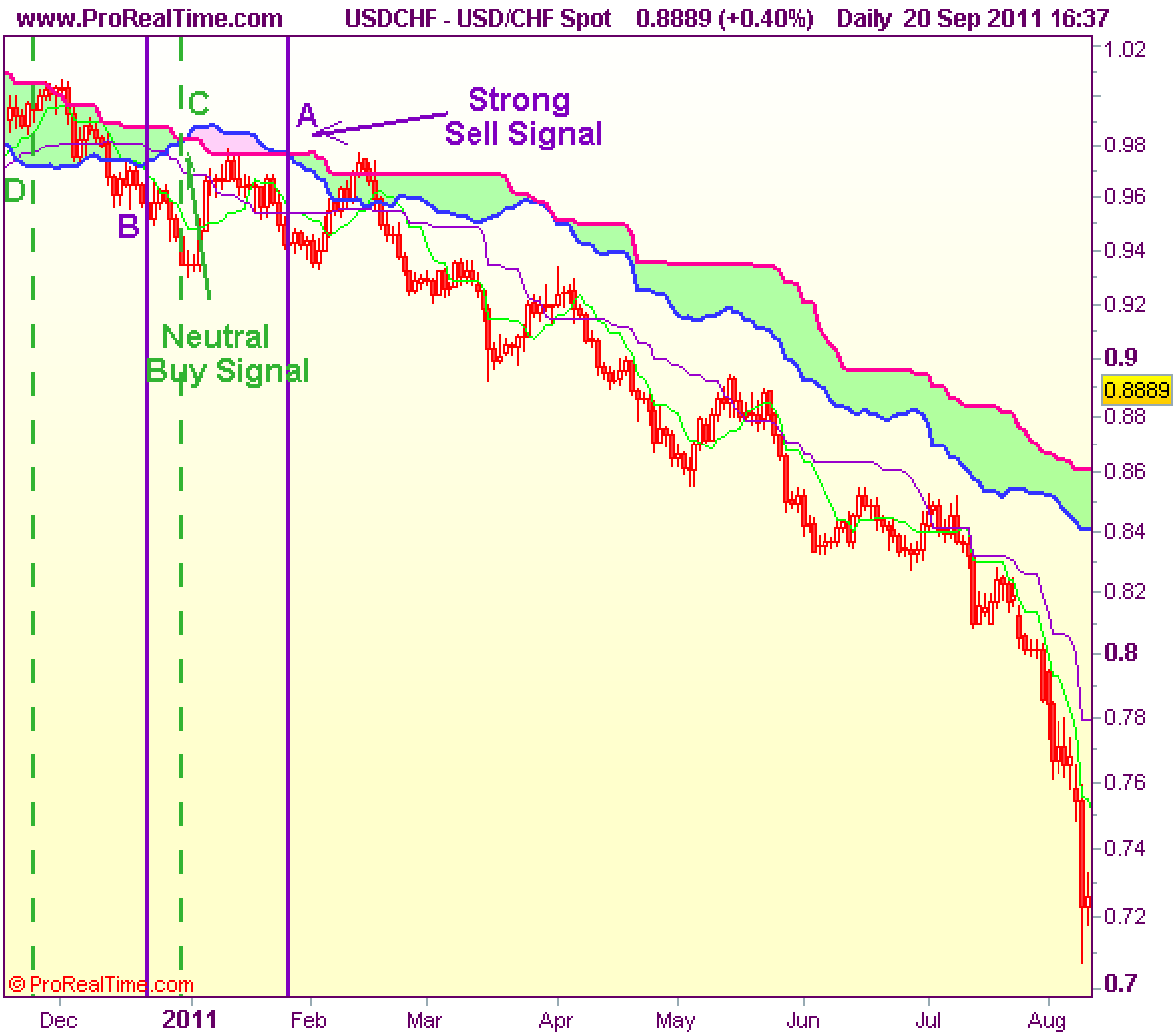
Weak signal:

- A weak buy signal occurs when a bullish cross-over takes place above the current price level, i.e. current price location is on the opposite side of the signal direction;
- A weak sell signal occurs when a bearish cross-over takes place below the current price level, i.e. current price location is on the opposite side of the signal direction.



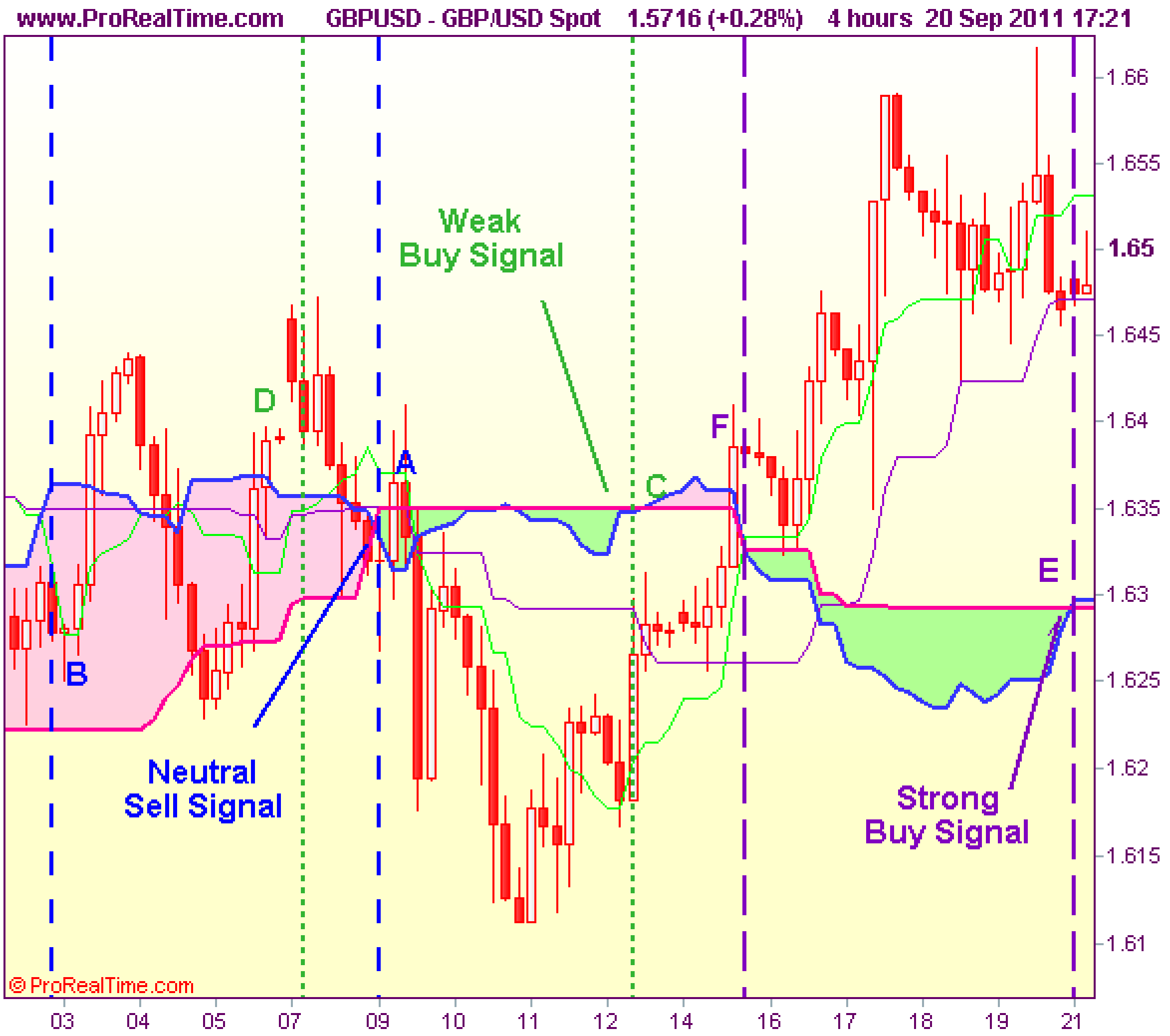
On the above chart, the Senkou Span A crosses below the Senkou Span B at point A, generated a sell signal and when comparing it to the corresponding current price level - point B, this point B is lower than point A, therefore this is a strong sell signal. As one can see price continued to decline from around high 1.43 all the way down to 1.3495.

It is worth noting that this point B is also where the Tenkan-Sen crosses below the Kijun-Sen from above, i.e. another bearish signal and when this kind of situation happens, this would add credence to the Senkou Span cross sell signal or one can treat it as a double confirmation.



On the above USD/CHF daily chart, the Senkou Span A crossed the Senkou Span B for the first time from bottom up at point C, providing a buy signal, however, when comparing to the corresponding price level at point D, the price was hovering within the Ichimoku cloud. This suggests the buy signal is only a neutral one and price only rose marginally higher before running into resistance at the Ichimoku cloud top and then retreated.

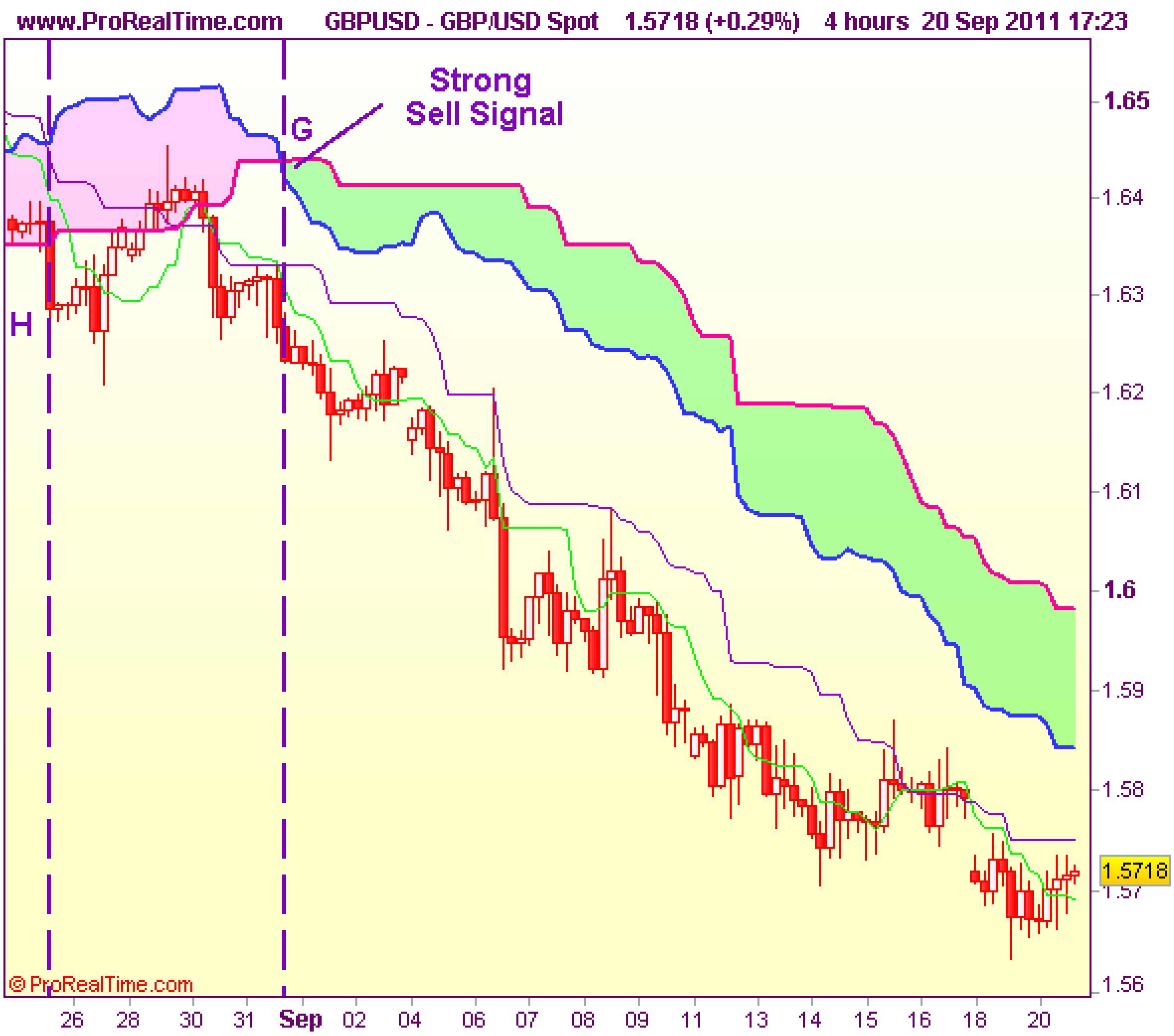
Then the Senkou Span A crossed the Senkou Span B again at point A but this time from top down, providing a sell signal. Unlike the previous one, when comparing the cross-over point A to the corresponding price level point B, the price was below the point A, so this is a strong sell signal and price tumbled since from around 0.95 level all the way to record low of 0.7068.



Here is another example from GBP/USD 4 hour chart, the Senkou Span A first crossed below the Senkou Span B from above, provided a sell signal at point A but as the corresponding price level at point B was within the Kumo area, this was only a neutral sell signal. Price then continued to gyrate since point B.

The Senkou Span A then crossed above the Senkou Span B from below, provided a buy signal at point C, however, as the corresponding price at point D was higher than point C, indicating this was only a weak buy signal. Price only rose marginally higher and then fell quite sharply from there down to low 1.61 level.

On the right hand side, the Senkou Span A crossed above the Senkou Span B from below at point E and as the corresponding price at point F was higher than the point E, suggesting this buy signal was a strong one and price did rally from point F to as high as 1.6618 before retreating.



Price then turned lower from 1.6618 and at point G, Senkou Span A crossed below Senkou Span B from above and as the corresponding price level at point H was clearly below the cross-over point G, a strong sell signal was created and cable tumbled from around 1.6300 all the way down to 1.56 level.

Here are some guidelines on how to set entry, exit, stop-loss and profit target levels.

Entry: The entry is relatively simple as once the cross-over is confirmed with a closing price on that particular time frame, one can just enter at the market level. Having said that, it is more important to filter out those signals are not in line with the major direction, one should refer to a higher time frame chart to identify the major trend first.

Exit: The exit point in Senkou Span cross signal comes in when the Senkou Span crosses in the opposite direction, however, one can refer to the Tenkan-Sen or Kijun-Sen in order to have a earlier sign.

Stop-loss: In general, the stop-loss should be placed on the opposite side of the Ichimoku cloud, i.e. stop-loss for a sell signal should put the stop above upper Kumo and vice versa. If the Kumo is too close, then one can put a 10-20 points buffer.

Profit target: Similar to the case of Kijun-Sen cross, one should use other projection technique or oscillators to help setting profit objectives.

c) Chikou Span cross

As explained in our previous section introducing the Chikou Span, when Chikou Span crosses through the price curve, this could be used as a signal of a change in trend. Hence if we look at it from another perspective, this cross can also be utilized as a signal generator. If the Chikou Span crosses above the price curve from below, this is a buy signal whilst a cross of Chikou Span below the price curve from above, this is treated as a sell signal.

Once again according to the relative positions of the price and the Ichimoku cloud, these signals can be classified into strong, neutral and weak as follows:

Strong signal:

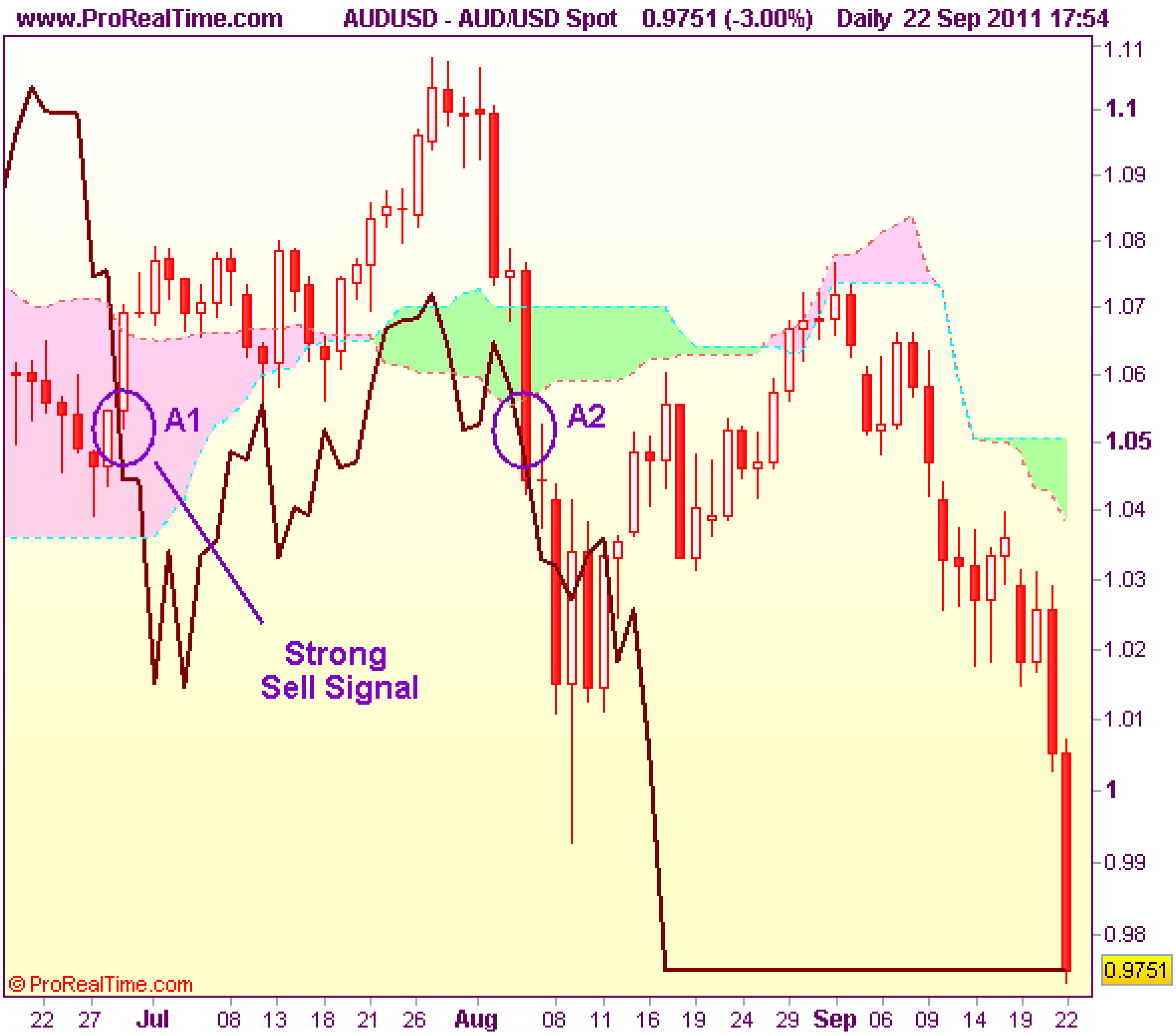
- A strong buy signal occurs when a bullish cross-over takes place where the current price is above the Ichimoku cloud;
- A strong sell signal occurs when a bearish cross-over takes place where the current price is below the Ichimoku cloud.

Neutral signal:

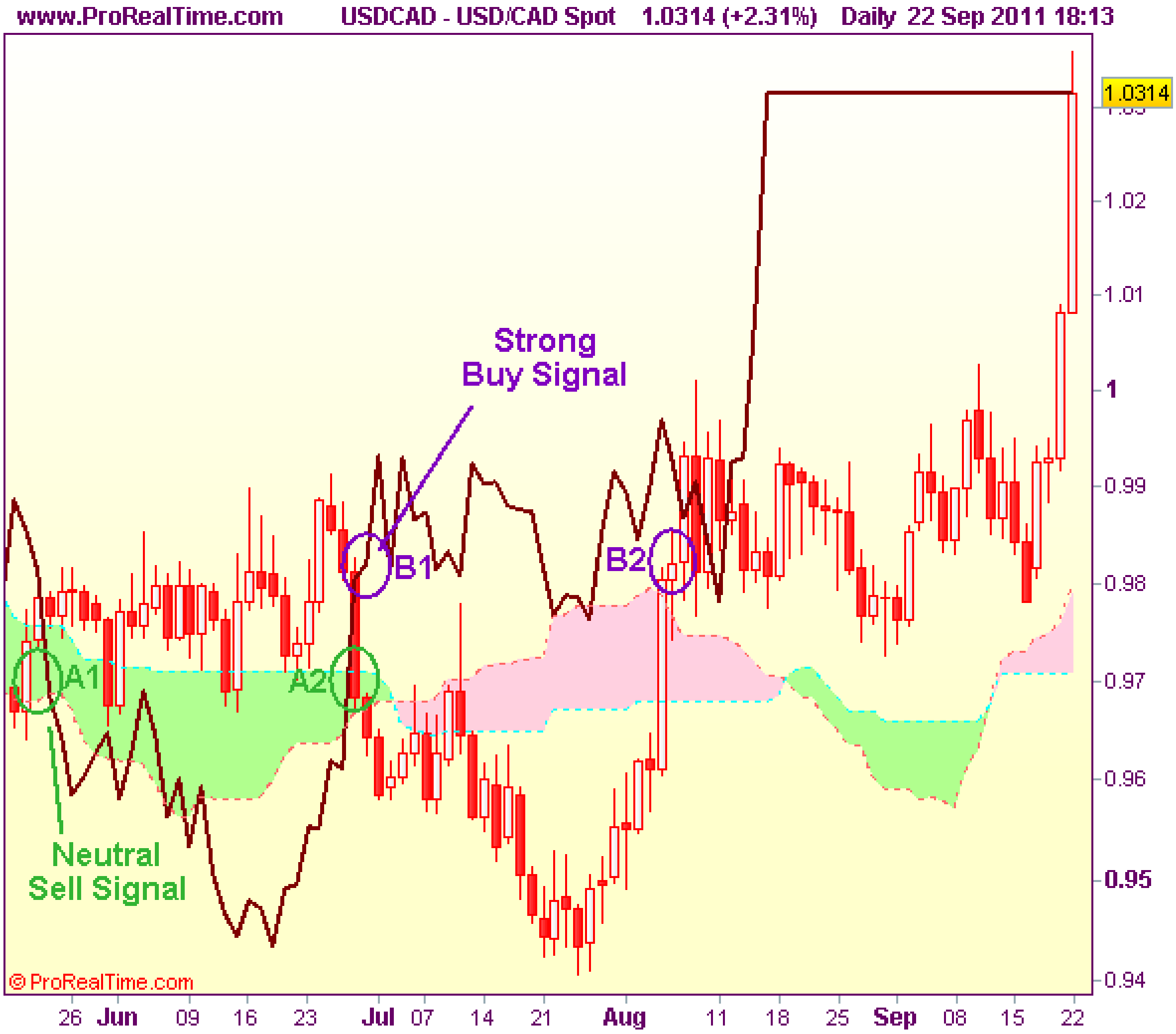
- A neutral buy signal occurs when a bullish cross-over takes place whilst the current price is trading within the Ichimoku cloud area;
- A neutral sell signal occurs when a bearish cross-over takes place whilst the current price is trading within the Ichimoku cloud area.

Weak signal:

- A weak buy signal occurs when a bullish cross-over takes place but the corresponding current price level is below the Ichimoku cloud;
- A weak sell signal occurs when a bearish cross-over takes place but the corresponding current price level is above the Ichimoku cloud.

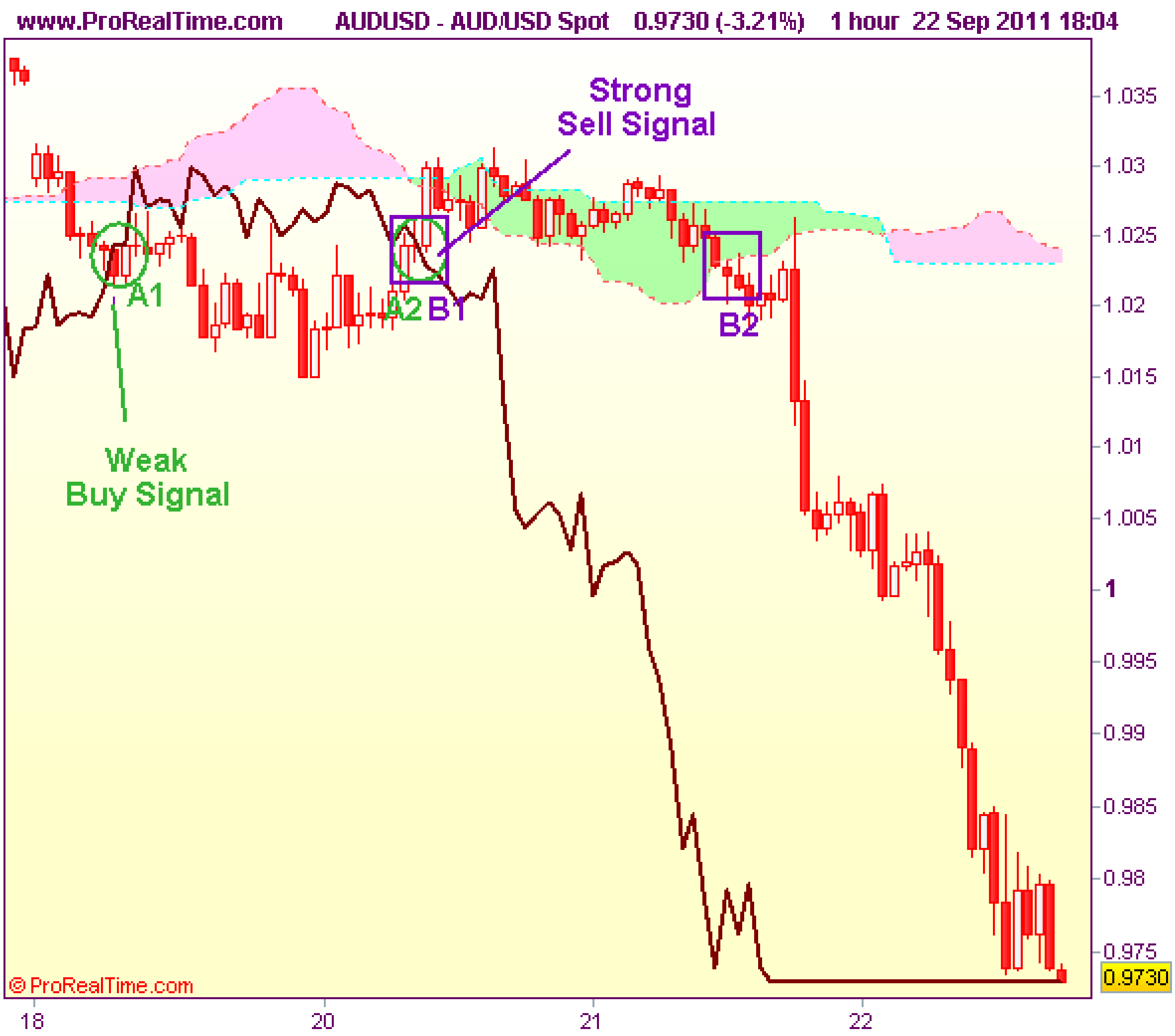


On the above daily chart of AUD/USD, the Chikou Span crosses below the price curve at A1 and as the corresponding current price level A2 was just below the Ichimoku cloud, therefore this is a strong sell signal and aussie quickly slipped to 0.9927. Although price then rebounded from there to as high as 1.0765, price faltered at the Ichimoku cloud top and more importantly the Chikou Span never crosses back above the price curve, aussie then tumbled again from there and broke below 0.9927.



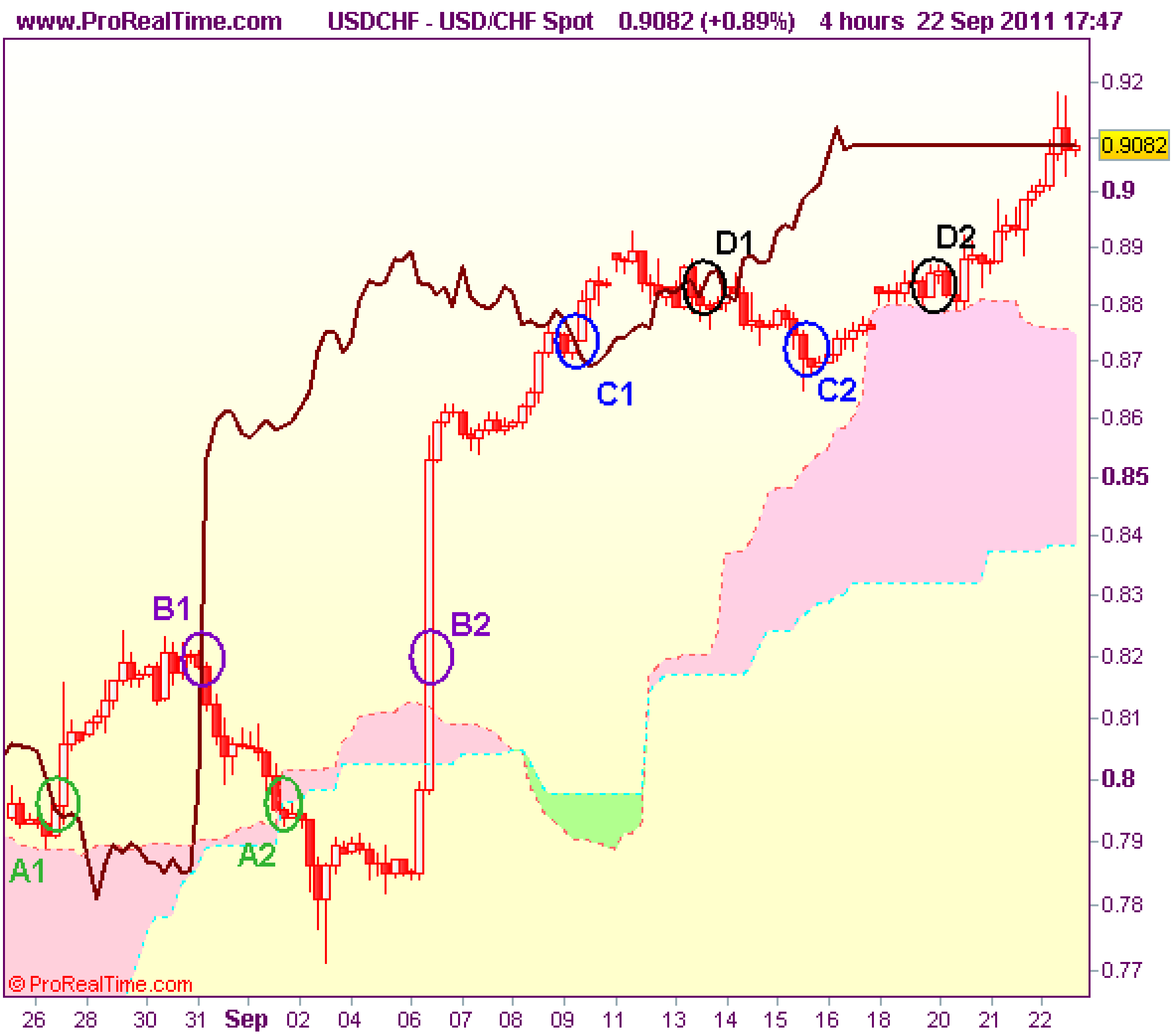
On the above daily chart of USD/CAD, the Chikou Span crossed the price curve on the far left at A1, the corresponding price level at A2 was trading within the Ichimoku cloud area, indicating this is a neutral strength sell signal. The currency pair slipped to as low as 0.9407 before staging a strong rebound.

On the subsequent rebound from 0.9407, the Chikou Span crossed above the price curve again at B1 whilst the corresponding price level at B2 was clearly trading above the Ichimoku cloud top, so this is a strong buy signal. Although the greenback did not surge immediately from B2, price and Chikou Span continued to stay above the Ichimoku cloud and rallied eventually to above 1.0300 level.



On the above hourly chart of AUD/USD, the Chikou Span crossed above the price curve from below for the first time at A1, generated a buy signal, however, as the corresponding price level at A2 was clearly below the Ichimoku cloud area, suggesting this was only a weak buy signal and aussie only rose briefly above the Ichimoku cloud top and turned down again from 1.0313.

Thereafter, the Chikou Span crossed back below the price curve from above at B1 (also at the same point of A2, looked like a cycle of 26 period is working on aussie) whilst the corresponding price at B2 was just below the Ichimoku cloud bottom, indicating this was a strong sell signal and one can see aussie tumbled from around 1.0200 all the way for over 400 points to as low as 0.9730.



Although the above 4-hour chart of USD/CHF may look a bit messy with all the markings, this can illustrate how one can utilize the Chikou Span cross signals to ride along with the major trend and filter out those weak signals.

The first time that Chikou Span crossed the price curve at A1 was a sell signal as Chikou Span broke through price from up down, however, as the corresponding price level at A2 was right within the Kumo, so this was merely a neutral sell signal. Although price did extend the retreat to 0.7711, the greenback rebounded quickly from there. Thereafter the Chikou Span crossed above the price curve from below at B1, formed a buy signal but as this time the corresponding price level at B2 was clearly above the Ichimoku cloud top, this was a strong buy signal and one can see buy rallied from there all to way to 0.8927 before retreating (from the break-out point of B1-B2 around 0.8210, it was an over 700 points rally).

When price retreated from 0.8927, the Chikou Span also retraced and broke below the price curve from above at C1, however, as the corresponding price level at C2 was well above the Ichimoku cloud, indicating this was only a weak sell signal and price only fell to 0.8647 before renewed buying interest emerging again.

Finally, the Chikou Span crossed above the price curve the forth time in this chart at D1, when checking with the corresponding price level at D2, as price was still trading above the Ichimoku cloud top, hence this buy signal was a strong one and price did surge again from around 0.8850/55 to as high as 0.9183 (over 300 points rise).

Here are some guidelines on how to set entry, exit, stop-loss and profit target levels.

Entry: The entry is quite straightforward, once the Chikou Span crosses above or below the price curve (where the signal is generated), the trader can enter a position accordingly but one should wait for the closing price for the confirmation of the Chikou Span break-through of price curve.

Exit: Similar to the previous signals, the exit point in Chikou Span cross signal comes in when the Chikou Span crosses back the price curve in the opposite direction. Having said that, after a strong trending move, the Chikou Span will most likely to quite far away and if one have to wait for a cross back in the opposite direction, that could be a bit late, so traders can take other indicators, such as the Tenkan-Sen or Kijun-Sen into consideration.

Stop-loss: In Chikou Span cross signal, the placement of stop-loss isn't that clear when comparing to other Ichimoku signals, however, as indicated above that if Chikou Span crosses back price curve in opposite direction, one shall exit the position, so one can use the previous price level (26 period backward) to set the stop-loss. The most obvious way would be to place stop-loss above that particular bar high (or with 10-30 points buffer depending on the time frame).

Profit target: This is quite subjective, as indicated in previous chapter that the Chikou Span tends to meet support or resistance at the level of Tenkan-Sen, Kijun-Sen and Kumo 26 periods backward, therefore one can set target at these levels. Whilst in major trending move, all those lines will all be far behind the Chikou Span, then one can only apply other projection technique or oscillators to help setting profit objectives.

2.3 – Trading with the cloud / Kumo

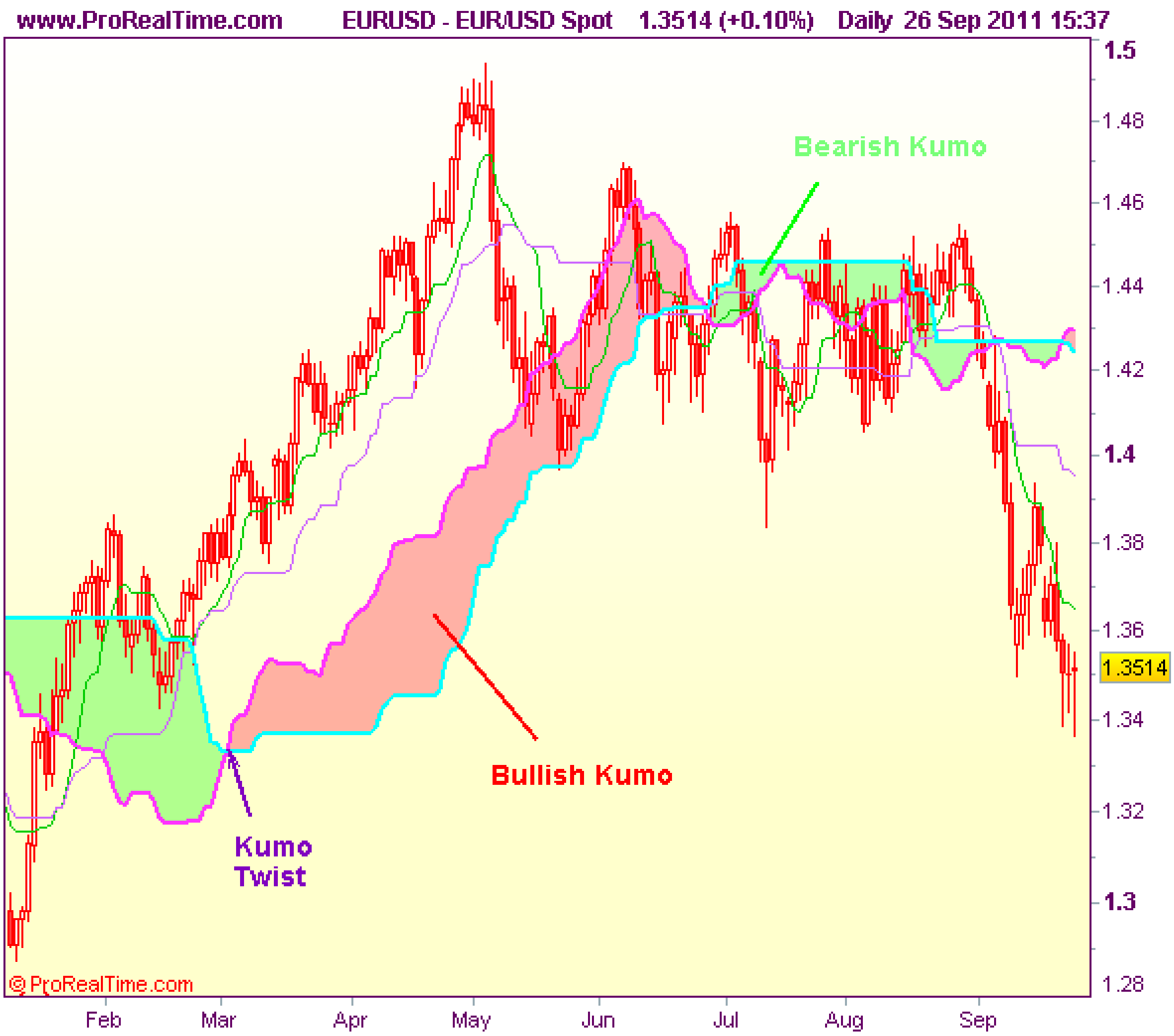
In the first part of this E-book, we illustrated how the Ichimoku cloud / Kumo is created (i.e. the area between the Senkou Span A and Senkou Span B) and how the Kumo is able to provide a different perspective of the concept of support and resistance.

In this second part, we would go a little deeper and introduce how to identify Kumo sentiment, what does flat ground cloud top / bottom represent and finally how Ichimoku cloud / Kumo can be used to provide trading signal.

Kumo sentiment

First of all, lets talk about the Kumo sentiment, since the Kumo/Ichimoku cloud is composed with the Senkou Span A and Senkou Span B, with the shorter variables in the calculation of Senkou Span A (i.e. is a faster line compare to Senkou Span B), this line will move along on top of the Senkou Span B in a rising market. In other words, when Senkou Span A is above Senkou Span B, the sentiment of this Kumo area is bullish.

On the other hand, when Senkou Span A is below the Senkou Span B, the sentiment of this Kumo/cloud area is bearish.



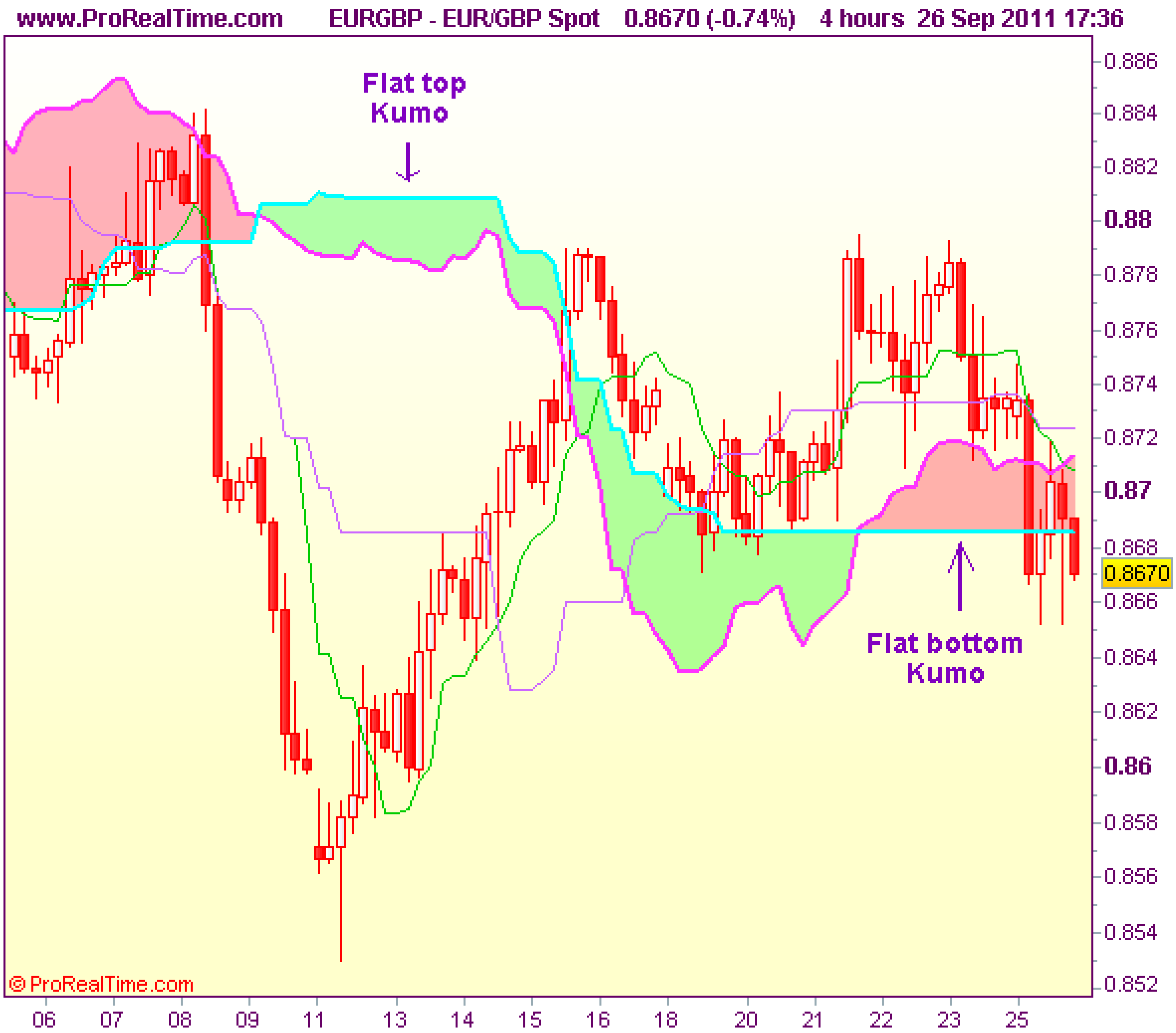
In the above chart, the shading area in red represents Kumo with a bullish sentiment with the Senkou Span A (the pink line) moving above the Senkou Span B (the blue line). When the Senkou Span A crosses below the Senkou Span B, i.e. the green area, this represents a bearish Kumo.

One should note that the change in Kumo colour takes place when the two lines cross-over, which is called *Kumo Twist*.

Flat top / bottom Kumo

In first part of this E-book, when we talked about the Kijun-Sen, due to the long variable in the formula, some times the line move horizontally (or we call it the flat ground Kijun-Sen). Normally the flat ground Kijun-Sen tend to have a pullback effect or rubber band effect to the price, this happens when the price moved too far away from the Kijun-Sen or in other words the move was over-extended, then price tend to move back towards the flat ground Kijun-Sen.

As the Senkou Span B is also using a long variable of 52 periods, when the Senkou Span B moves horizontally that means the range of the past 52 periods remains the same and the location of the Senkou Span B represents the mid-point of this range, some consider it as the price equilibrium. Since price has a tendency to return back to equilibrium, therefore the flat ground Senkou Span B (when it is located above the Senkou Span A, this is called the flat top, when it is located below the Senkou Span A, this is called the flat bottom), the Senkou Span B will also have the similar kind of pullback or rubber band effect exerting on price.



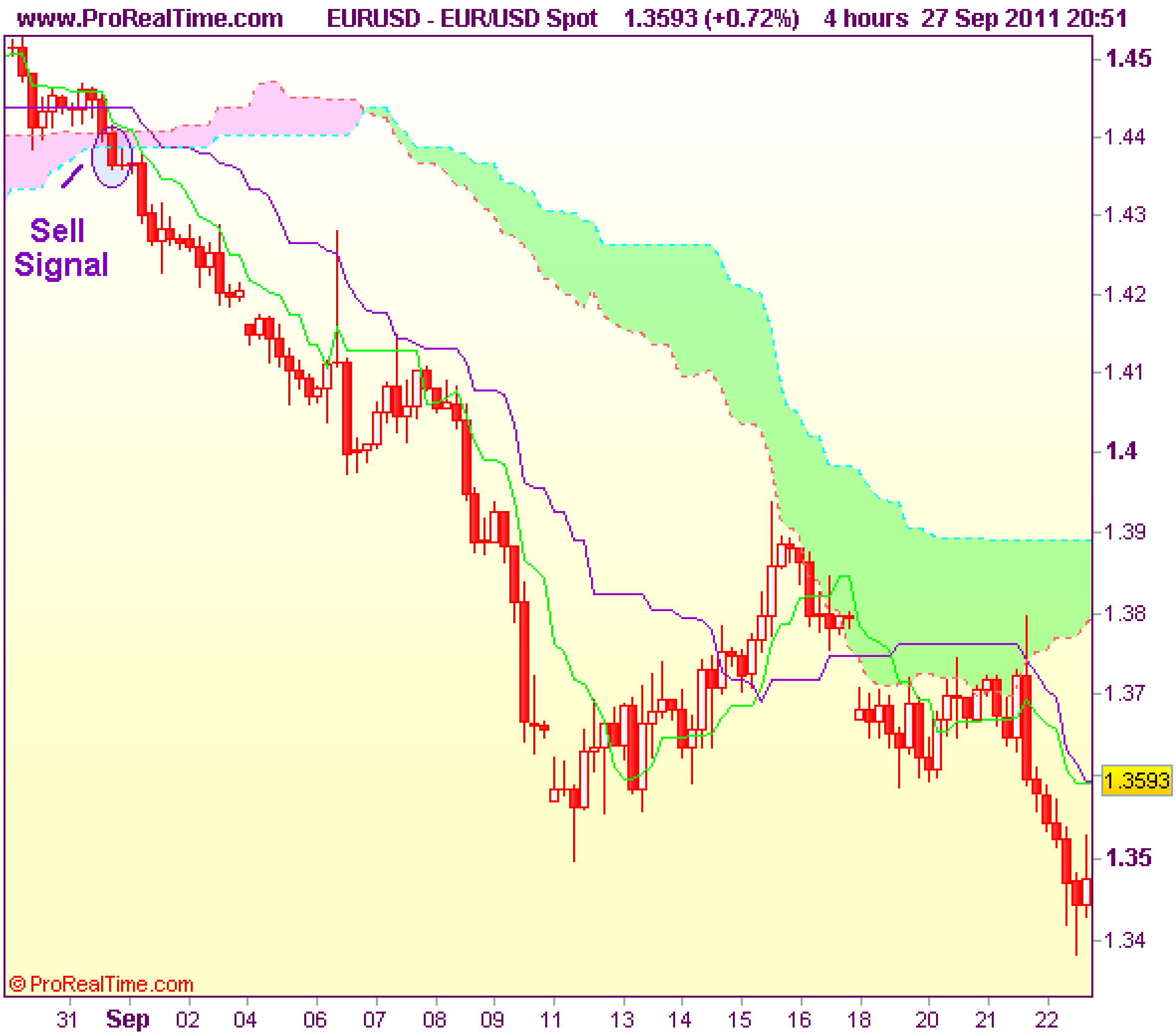
In the above chart, after the sharp selloff from 0.8842, the move was very much over-extended as supported by the flat top Kumo, price rebounded in part due to the pullback or rubber band effect from the flat Senkou Span B.

After the strong rebound from 0.8531, the Senkou Span B moved horizontally again and a flat bottom Kumo was formed on the right hand side of the chart, once again price retreated on the pullback effect from the flat ground Senkou Span B.

The Kumo (or most people call it cloud and actually it means cloud in Japanese) is probably the most famous part of Ichimoku Kinko Hyo analysis and is getting more popular among chartists to identify support and resistance area. Some people even consider the Kumo as the core or key of this charting system and in fact the cloud itself is the most instantly visible component among the other lines in Ichimoku.

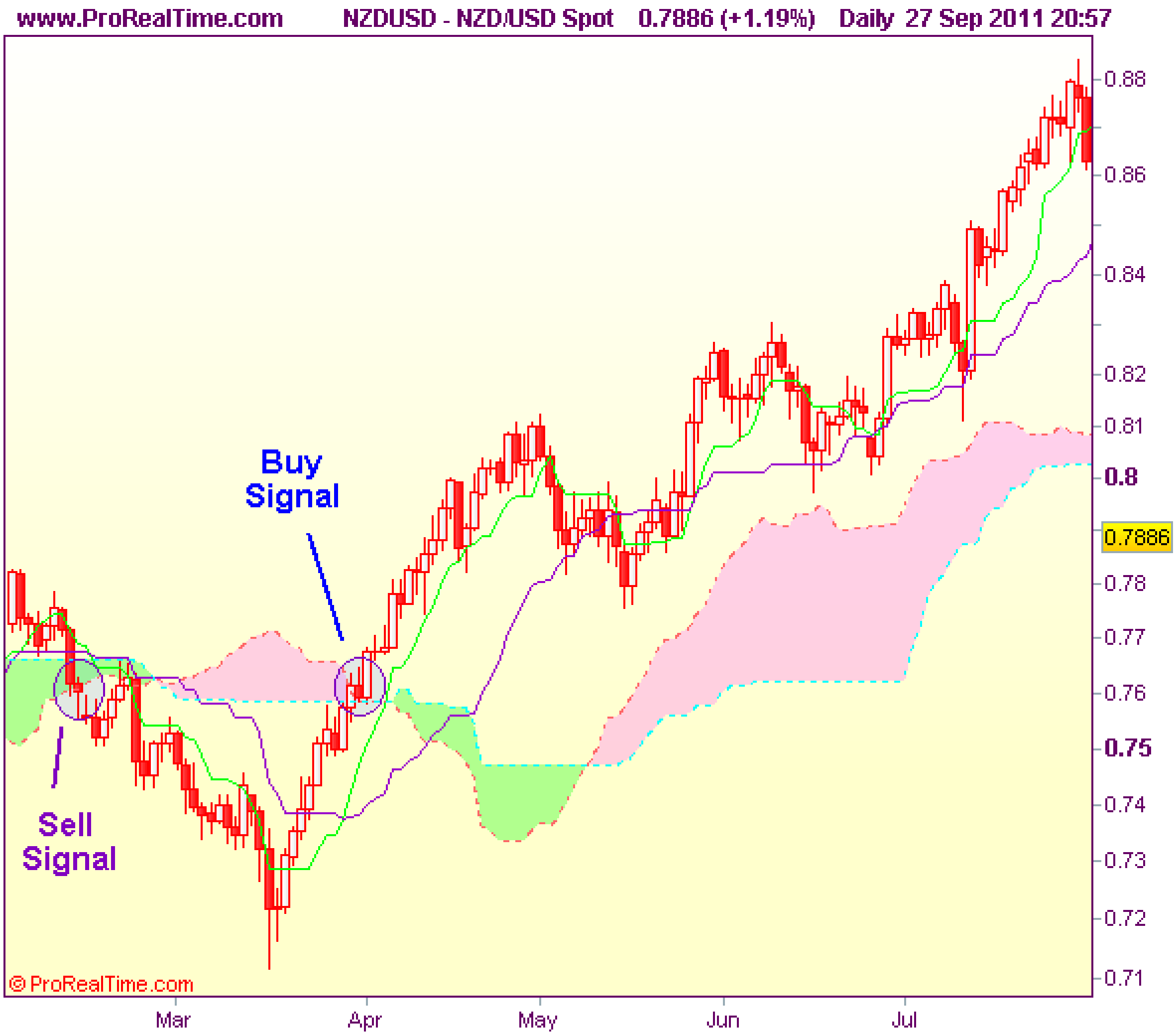
Kumo Break-out trading signal

A Kumo Break-out trading signal is generated when price breaks through the Kumo area, once price closes above the Ichimoku cloud top / upper Kumo, this confirms a buy signal. Likewise, when price closes below the Ichimoku cloud bottom / lower Kumo, this confirms a sell signal is generated.



In the above 4-hour chart of EUR/USD, when price broke through the Ichimoku cloud, a sell signal was generated, once price closes below the lower Kumo (in this case a 4-hourly closing), this provided confirmation. Price then continued to fall for major part of September from around high 1.43 all the way down to 1.3400.

As long as price stays below the Ichimoku cloud area, the bearish sentiment remains and one can hold on to the short position entered on the break-out of Kumo.



In the above daily chart of NZD/USD, a sell signal was generated on the far left as price broke below the Ichimoku cloud bottom, kiwi then slipped to as low as 0.7120.

Thereafter, price reversed and turned upward from 0.7120 and once kiwi broke above the Kumo with a daily close above Ichimoku cloud top, a buy signal was confirmed. The currency pair then surged from around 0.76 for several months to as high as 0.8800.

From this chart, one can notice that the break-out signal comes in a little bit late from the actual reversal, however, if price is able to stay on the right side of the signal, i.e. above the Kumo after a buy signal and below the cloud after a sell signal, one can ride along all the way with the trend.

Here are some guidelines on how to set entry, exit, stop-loss and profit target levels for Kumo break-out signal.

Entry: The entry point is quite simple, after the break-out of the Ichimoku cloud, one can wait for the price closes above (for buy signal) or below (for sell signal) and enter the market right away in the direction of the breakout. However, one needs to be careful when the break-out takes place at the flat top or flat bottom Kumo area as price may touch back the Ichimoku cloud due to the pullback effect.

Exit: As indicated at the above examples, as long as price stays on the corresponding side according to the break-out signal, one can hold on to the position, so naturally the exit point would be when price breaks away from the opposite side of the Kumo. In other words, after a buy signals, if price breaks back below the Ichimoku cloud bottom, one should exit the position right away and vice versa for sell signal. Having said that, aggressive traders may consider this exit point will be too late as price normally moved pretty far away from the turning when price breaks on the opposite side of the Kumo. Therefore, one can also use other indicators such as the Tenkan-Sen / Kijun-Sen cross-over as other sign for exiting the position.

Stop-loss: Likewise, stop-loss should be placed on the opposite side of the Kumo of the signal, i.e. for a buy signal, stop-loss should be placed below the lower Kumo; for a sell signal, stop-loss should be placed above the upper Kumo.

Profit target: This really depends on the traders, since this is a trending signal, aggressive players may think the break of the opposite side of the Kumo too late, so one needs to take other indicators or technical techniques into consideration in order to set profit objective.

Chapter 3 - Summary and conclusion

In this second part of Candlestick and Ichimoku Kinko Hyo analysis E-book, we further discussed the two analysis methods with several more bullish and bearish reversal candlestick patterns, plus introducing some continuation candlestick patterns. In the part of Ichimoku Kinko Hyo analysis, we introduced the use of the Chikou Span and several more Ichimoku trading signals (in addition to Tenkan-Sen / Kijun-Sen cross signal) which we consider quite reliable trending signal and can be applied to different time frames.

Finally we talked about the most important component of the Ichimoku Kinko Hyo analysis, the Kumo, also known as the cloud, in more details, covering the Kumo sentiment, flat top / bottom Kumo and how to trade with the Kumo.

We believe the Ichimoku Kinko Hyo is a very power technical analysis tool in day to day trading activities, however, as this is basically a trending analysis, it has a slight disadvantage when it comes to the market turning points, signals will normally kick in a bit late when comparing to other technical analysis methods, e.g. Elliott Wave Theory, MACD, RSI. This is the reason why we prefer to use Ichimoku together with Candlestick charting as all the reversal patterns in Candlestick analysis are the keys to fill in the missing puzzles in Ichimoku analysis.

We hope to hear your feedback on how you like or dislike about this book and what other topics you find them interesting and would like to know more, please let us know and more E-book will come from your favorite FX portal ActionForex.com.