HOW TO MAKE MONEY TRADING THE ICHIMOKU SYSTEM
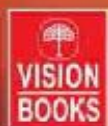
Guide to Candlestick Cloud Charts

Packed with in-depth analysis of high-probability trading strategies and numerous real-market examples of stocks, derivatives, commodities and currency trades

Balkrishna M. Sadekar

Author of the Bestseller
How to Make Money Trading with Candlestick Charts

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About the Book

How to Make Money Trading Ichimoku Cloud Charts

Ichimoku Kinko Hyu, commonly referred to as Ichimoku indicator, is one of today's most powerful trading systems.

A Japanese innovation, like the candlesticks, it can be used with equal success to trade stocks, commodities, futures, currencies and bonds — in fact, to anything that can be charted! Ichimoku also works very well on all time frames, from the weekly all the way down to the one-minute chart.

Loosely translated, Ichimoku chart means a 'one glance equilibrium' chart. Due to the unique construction of the Ichimoku cloud, which is the heart of this system, a trader can visually determine in an instant whether a chart is bullish or bearish! Not just that:

- Ichimoku clearly defines support and resistance, identifies trend direction, gauges momentum, and provides trading signals.

- It is the only system with a built-in forward looking indicator.

- Looking at Ichimoku charts on multiple time frames can offer a tell-all x-ray into the dynamics of any market.

- It shows how to correctly time their entry and exit trades.

- Most charting platforms today offer Ichimoku as an indicator.

Packed with in-depth analysis of high-probability trading strategies and numerous real-market examples of stocks, derivatives, commodities and currency trades, this book reveals how you can make money using the powerful Ichimoku system, the candlestick cloud charts.

About the Author

BALKRISHNA M. SADEKAR is the founder of Profitable Candlestick Charting LLC., an educational company providing training to stock traders in the proper use of candlestick charting and technical analysis. He is also a member of Technical Securities Analyst Association (TSAASF.org), a leading authority for technical analysis in the United States.

With a Masters degree in Engineering, Sadekar has passionately blended technology with investor psychology analysis *via* candlestick charts. A trader for more than a decade, he has trained and continues training novice and experienced traders in correctly applying trading systems for profiting from equity markets.

Sadekar resides in Richmond, VA in the US and can be reached *via* his website, www.ProfitableCandlestickCharting.com. His first book, *How to Make Money with Candlestick Charts*, also published by Vision Books, is a bestseller.

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Contents

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Lastly, a special thanks to the two amazing individuals in my life, my wife and daughter. They continue to push me to achieve the best.

1

Introduction

Ichimoku Kinko Hyu, commonly referred to as Ichimoku, is one of the best systems available for trading the markets. The Ichimoku indicator can be applied to stocks, commodities, futures, currencies and bonds. If you can chart it, you can apply Ichimoku to it. It works very well on all time frames, from the weekly all the way down to one minute chart. For those familiar with candlestick charts, Ichimoku charts are a default extension of Japanese innovation.

Loosely translated, Ichimoku chart means a 'one glance equilibrium' chart. **Once a trader is familiar with the components of an Ichimoku system, it should take no more than a glance to decide if the chart is bullish or bearish.** This was the purpose with which Goichi Hosoda invented this system. Goichi was a Japanese reporter who wanted to create an all-in-one indicator to visually depict the market's sentiment in the chart. After fine tuning it for many years, he finally published his findings in Japan in the late 1960s. This was the first publication on Ichimoku system and it got rapidly adopted by the Japanese traders and across Asia. Ichimoku started getting a following in the Western world in the 1990s as computers became widespread. The computation involved in developing and displaying the indicator got a lot easier with the help of computers. Most charting platforms today offer Ichimoku as an indicator.

The Important Numbers

The Ichimoku system is based on three numbers: 9, 26 and 52.

There are a few theories about why these numbers were used by Goichi when he developed the system.

In Japan, there were 26 trading days in a month in those days. So 52 days would account for two months of trading activity. The number 9 was about a week-and-a-half of trading. Another theory proposes that the number 26 was based on a lunar cycle. The fact is that it really does not matter. The Ichimoku system works with amazing accuracy with these original numbers. Traders often try to change and experiment with the number settings. There's nothing wrong with that and you might want to do so as well. Please make sure, however, that you are not curve-fitting the settings. You might find some settings working flawlessly on a 5-minute chart, but when you try to use them on the daily chart, they fail dramatically. So keep that in mind if you want to play with different numbers on your Ichimoku chart. **I would strongly suggest using the original numbers as they have stood the test of time on all time frames and across all asset classes.**

As mentioned earlier, Ichimoku charts are meant to show investor sentiment at a glance. Another huge advantage of this system is that there is no need for other indicators and oscillators. One of the big dilemmas traders face is what indicators or oscillators to use. Choosing between hundreds of them and experimenting with their individual settings is a daunting task. Most times traders will use an indicator for a few trades and if the trades don't work, move on to the next indicator. This way, they never really get to experience the indicator in all situations. They keep moving from indicator to indicator and from one trading system to another, finally blowing out their account. There is no indicator, oscillator or trading system out there which will work 100% of the time. So is Ichimoku the holy grail for traders? Obviously not! The holy grail in trading is a myth. Each system has its flaws. It is how a trader uses the system that makes the system profitable. Remember that the goal of trading is to make more profits than losses. It is not to make only profitable trades. That is impossible. In fact, research has shown that successful traders have a higher number of losing trades than winning ones. They are successful because of one simple reason. The profits in their profitable trades are far higher than the losses in their losing trades. Most inexperienced traders have exactly the opposite situation. They go for quick profits, but let the losers run. This mindset needs to change! The Ichimoku system, with its dynamic support / resistance components is well suited to help the trader in adhering to strict rules.

Price Equilibrium

The core of the Ichimoku system is built around the relationship between price and its equilibrium. In the Western world, equilibrium is based on closing prices of an asset. An example of this would be a 50- or 200-period simple moving average. Technical analysts will often refer to these as equilibrium for price; namely, the price cannot stray too far from them and has to revert back sooner or later. In the Japanese world, the high and low of the trading period is considered equally important as the price open and close. The high is the point where demand was overwhelmed by supply. The low is where buyers provided enough demand to absorb supply. These two price extremes give the range of trading activity for that period. This range changes every period and is dynamic. If prices do not make new highs and new lows within a certain amount of time, the equilibrium will be maintained and price could gravitate towards it. In bullish trends, this equilibrium keeps moving higher as the price achieves new highs. In bearish markets, on the other hand, the equilibrium moves lower as the lows keep falling. These trends continue so long as the demand / supply relationship doesn't revert. When it does, price breaks out through the equilibrium and starts moving in the opposite direction.

In Ichimoku, equilibrium is calculated as the average of the highest high and the lowest low in three different periods. Any guesses which three periods?

Yes, 9, 26 and 52!

Ichimoku is a Trend Following System

Most successful traders make their money trading trends. It is extremely difficult to derive profits from a non-trending market. Ichimoku helps mitigate this issue to a certain extent. It helps the trader in identifying non-trending markets, so that they can be avoided. As you will read in the next chapter, **the Ichimoku system has a built-in zone, called the Kumo cloud, which signifies consolidation**. Traders need to be extra cautious initiating trades when the price is within the Kumo, as it is then in a non-trending phase.

The individual components of Ichimoku are designed to provide the following information:

- Is the chart bullish or bearish?
- Is the chart displaying consolidation of price?
- If the chart is bullish, is there momentum in the trend?
- If the chart is bearish, is there momentum in the trend?
- If a chart is consolidating, how long would it be before the consolidation might get over?
- Where is the price equilibrium? For bullish markets, this would be support; and for bearish markets this would be resistance.

Future Projection and Past Influence

Another in-built feature of Ichimoku is the projection of future price action. Goichi firmly believed that current price action has repercussions in the future. Demand and supply available in the present will create support and resistance in the future. Based on this assumption, the Ichimoku system is designed to project dynamic support and resistance values 26 periods ahead in time. No other indicator has such a future predicting feature.

Just as the present affects the future, the past also influences the present. Accordingly, prices from 26 periods ago are given great importance in the Ichimoku system. As Chapter 2 describes, traders need to be particularly aware of this phenomenon.

I would urge the reader to read and re-read Chapters 2 and 3 until the Ichimoku components and their significance is clear and well understood. Chapters 4 and 5 constitute a practical guide to Ichimoku trading.

Welcome to the world of Ichimoku! You will profit from it.

2

Ichimoku Components

The Ichimoku system has five components to it:

- Tenkan;
- Kijun;
- Senkou A;
- Senkou B; and
- Chikou.

The Senkou A and Senkou B together form a structure commonly known as the Kumo cloud.

We will explain the five components in this chapter. Keep in mind that these components are highly effective when used as a system. Chapter 3 will deal in detail about integrating the five components together to form a trading system.

Tenkan

Tenkan, also known as 'the Conversion Line,' is calculated by averaging the highest high and the lowest low of the previous 9 periods. Keep in mind that the Japanese place a lot of importance on how the price behaves during the entire trading period. The high and the low of the day are as important as the open and close of the candle on the candlestick chart. The high point of the candle is where demand was overcome by supply and the low point of the candle is where supply was absorbed by the demand. This is the crucial point of candlestick charts and is carried over in the Ichimoku as well. In other words, **the average of the high and low will give the equilibrium of price for that period.** So the average of highest high and lowest low of the last 9 periods will provide an equilibrium point for price over the previous 9 periods.

Tenkan = (Highest high of 9 periods + Lowest low of 9 periods) ÷ 2

Please note that the Tenkan differs from the 9-period exponential moving average (EMA) and the 9-period simple moving average (SMA). Both SMA and EMA are based on closing prices and are much smoother than Tenkan. Tenkan, by its very nature, will exhibit periods of flattening as can be seen in

Figure 2.1: **Tenkan *versus* EMA and SMA; notice the flattening of Tenkan in the right hand part of the chart**

If a stock jumps up and then starts moving sideways without making any new 9-period highs, then the Tenkan will go flat thus visually indicating that price is consolidating. At that point, either the price will come down to the Tenkan to find equilibrium or, after 9 periods, the Tenkan will start to rise to support the price.

One can think of Tenkan as a short term "magnetic" guide for the price. Price cannot stray too far from the equilibrium that Tenkan represents. For stocks in an uptrend, Tenkan acts as a minor support level. On the other hand, for stocks in a downtrend, Tenkan provides minor resistance.

You can see how Tenkan keeps providing support for the price in the chart of Axis Bank in Figure 2.2. Price often times breaks the Tenkan intraday, but closes back above it indicating bulls coming in to defend the equilibrium.
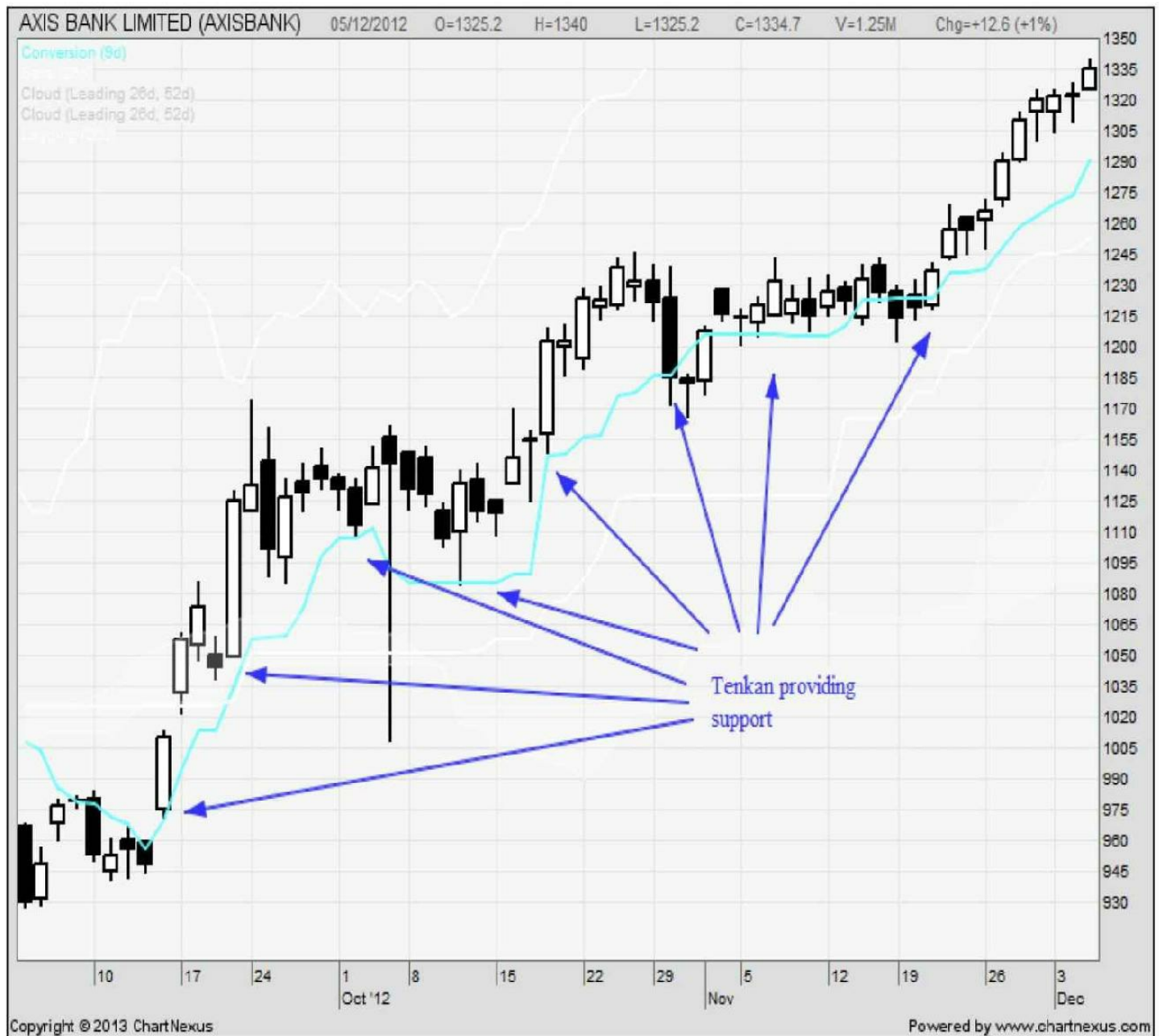

Figure 2.2: **Tenkan provides minor support for the price in an uptrend**

The five components of Ichimoku System — the Tenkan, Kijun, the Kumo made up of Senkou A and Senkou B, and the Chikou

Correspondingly, chart of Bajaj Hindustan in shows the various times that Tenkan provided resistance to any potential reversal in price.

Figure 2.3: **Tenkan provides minor resistance to price in Bajaj Hindustan's downtrend**

Kijun

The Kijun, also called the 'Base Line' is primarily a trend container. It is calculated by averaging the highest high and the lowest low of the previous 26 periods. Just like the Tenkan, the period can mean a 1-minute, 5-minute or any other time frame. So the formula for Kijun is as follows:

Kijun = (Highest high of 26 periods + Lowest low of 26 periods) ÷ 2

Traders should not compare Kijun to a regular 26-period simple moving average or exponential moving average. As the chart in Figure 2.4 shows, the Kijun is more sensitive to price highs and lows and does not care about prices moving within the 26-period high / low areas. In the chart in Figure 2.4, you would notice that while the 26-period SMA and EMA keep moving up, the Kijun goes flat. **The Kijun denotes equilibrium between the buyers and sellers.** If prices over the last 26 periods are fluctuating in a range, the equilibrium will be at the mid-point of this range. This point will attract prices back to it like a magnet. As Figure 2.4 shows, the EMA and SMA are lagging indicators. Even though prices started going lower, these moving averages kept going higher. The Kijun will be horizontal as soon as the stock stops making new highs and consolidates.

Figure 2.4: **Kijun *versus* EMA and SMA; note how the Kijun is more sensitive to price highs and lows**

- If prices are above the Kijun, it is considered bullish.

- If prices are below the Kijun, it is considered bearish.

Can the price move below the Kijun intra-time period? Sure it can. The key is that it should not close decisively below it. As long as prices close above the Kijun, the stock is considered in an uptrend. Once the price closes below it, the uptrend is considered broken. This does not mean a downtrend has started. As you will see in the later chapters, all the Ichimoku components together alone tell the whole story.

Notice how the Tata Power stock in Figure 2.5 occasionally dipped below the Kijun during the uptrend until it finally broke down and closed below it.

Figure 2.5: **Kijun provides major support to the price in an uptrend. Equally, it provides resistance to the price in a downtrend**

The Kijun provides strong support for the price in an uptrend. It also offers a strong resistance to the price in a downtrend

Prices cannot get too far away from the Kijun. Again, keep in mind that the Kijun represents equilibrium. Prices need to always be in sync with the equilibrium. That is where demand and supply are balanced. Consider the chart in Figure 2.6 to understand how the Kijun acts as a magnet for prices.

Figure 2.6: **Kijun acting as a magnet for the price, attracting it back to itself time and again when it moves too far away**

After the downtrend, some event occurs to trigger exuberant buying in the stock. This can be seem in the middle of the chart. This surge in demand leads to an exponential price increase in a short period of time. Prices cannot keep rising that fast for too long, however. This leads to the Kijun initially reacting to the price, from about 27 June till about 11 July, but then going flat as the stock could not make new highs. The flat Kijun now starts attracting the price back to it.

Scenarios of exiting a trade when the price has considerably extended from Kijun, will often lead to losses. They are best avoided for swing trading.

Figure 2.7 shows such a quick move to the upside. Anyone would want to take profits off the table if presented with a 28% gain in a couple of weeks. Now, if enough traders decide to take profits, then guess where the stock is heading? Down to its equilibrium!

Figure 2.7: **A flat Kijun is a powerful magnet that pulls the price back towards itself**

Ichimoku allows the trader to visually anticipate when the equilibrium is going to shift up or down. Since we know that the Kijun is the average price of the highest high and lowest low of the previous 26 periods, one can notice from the chart if any of those two parameters are due for a change. Study the chart of Axis Bank in Figure 2.8. Can you predict what Kijun will do the next day?
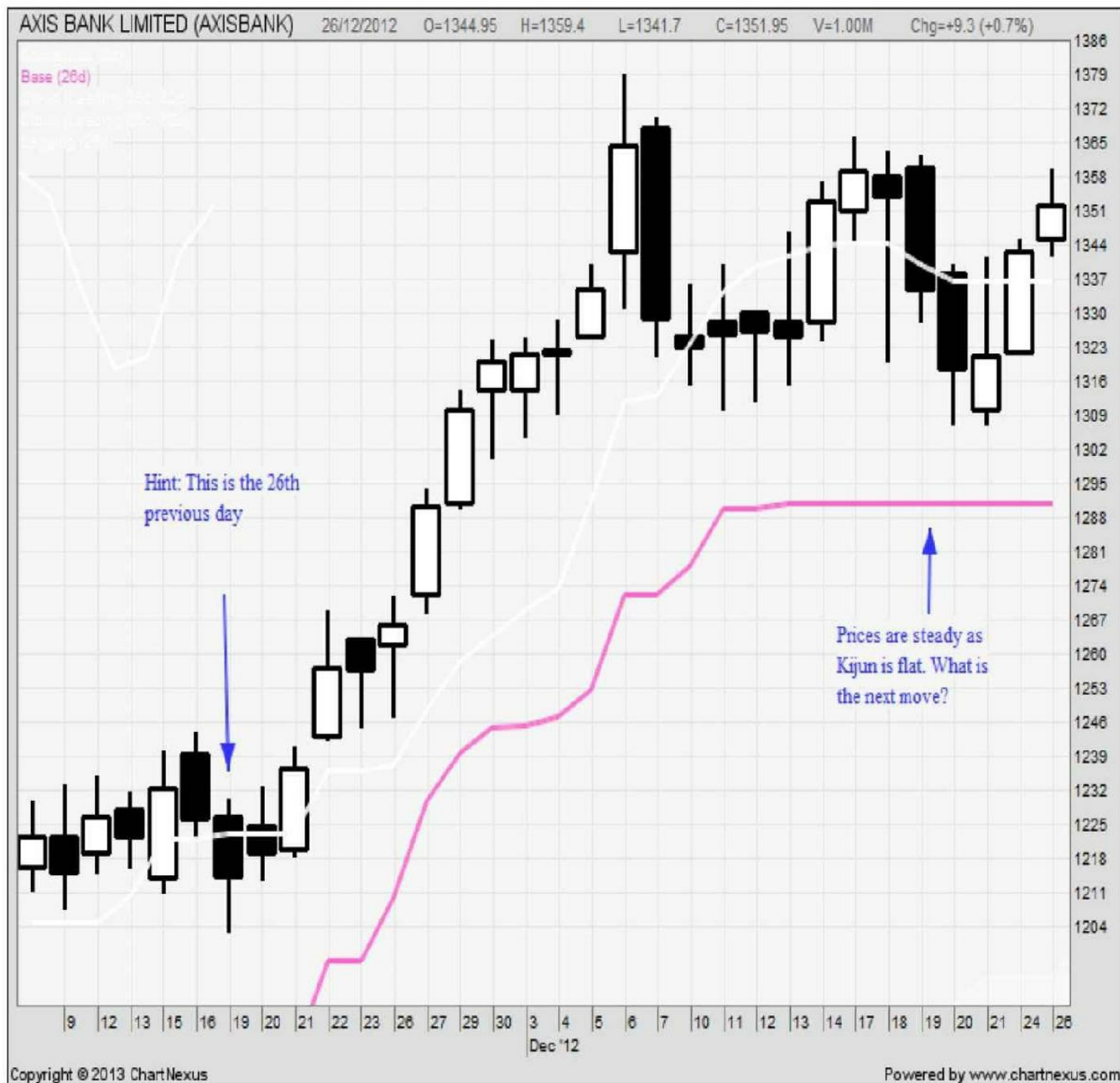
Figure 2.8: **Price consolidation waiting for Kijun**

Since the low of 25 days back was higher than the low 26 days ago in the case of Axis Bank (*see* Figure 2.9), the Kijun will move up. As the lows keep getting higher, one can expect the Kijun to trend up nicely to support the stock.

Figure 2.9: **Price breaks out as the Kijun starts trending**

The same analysis holds true for a stock in a downtrend. Notice how in Figure 2.10, the Kijun is flat at this point.

Figure 2.10: **The Flat Kijun will start heading down soon**

Now continuing the story from Figure 2.10, the 26-period highs will keep dropping from 5 December. This will turn the Kijun down and it will offer resistance to the stock as can be seen in the chart in Figure 2.11.

Figure 2.11: **Price heads south as the Kijun trends down**

Kijun as a Stop Loss Point

The Kijun is often used as the stop loss point in a trade. A small buffer allowing for intraday movement (assuming a daily chart) should be used below the Kijun for setting the stop loss. In an uptrend, as the stock makes new 26-period highs, the Kijun will start moving up. This allows the trader to move up the stop loss setting as well. This helps in two ways.

1. It reduces any potential loss until the trade reaches breakeven.

2. Once the trade reaches breakeven, it allows the trader to lock in more profits as the equilibrium moves up.

Notice how in Figure 2.12, the stop out setting for the stock keeps moving higher allowing the trader to lock in bigger profits as the trade progresses.

Figure 2.12: **Kijun used as a stop out signal**

There could be an occasional instance when the stock gaps against you and below the stop out level. There is not much a trader can do about that, but to close out the trade and move on to the next one.

Kumo

The Kumo is the heart of the Ichimoku system and is commonly referred to as the cloud. It is made up of two individual components, the Senkou A and Senkou B. We will first look at each of these components and then discuss their aggregation into the Kumo cloud.

Senkou A

Now that you are familiar with the Tenkan and Kijun, it is easy to understand the Senkou A, also referred to as 'Span A.'

Senkou A is the average of the two components, namely Tenkan and Kijun, and is projected 26 days in the future on the chart.

Senkou A = (Tenkan + Kijun) ÷ 2

Figure 2.13 shows the relationship between Tenkan, Kijun and Senkou A.

Figure 2.13: **Senkou A — and its relationship with Tenkan and Kijun**

To make it clearer, today's Senkou A would be formed by averaging the Tenkan and Kijun values of 26 days ago. On the same note, today's Tenkan and Kijun values, when averaged, will create the Senkou A point 26 days in the future.

If the Senkou A (26 days in the future) is rising, it is considered bullish for the stock.

If it is declining, then the stock would be considered to be in a bearish mode.

The current Senkou A can provide support for a rising stock (*see* Figure 2.14).

Figure 2.14: **Senkou A providing support to rising price**

Correspondingly, it can provide resistance for a declining stock (*see* Figure 2.15). This is especially important if the indicator is flat.
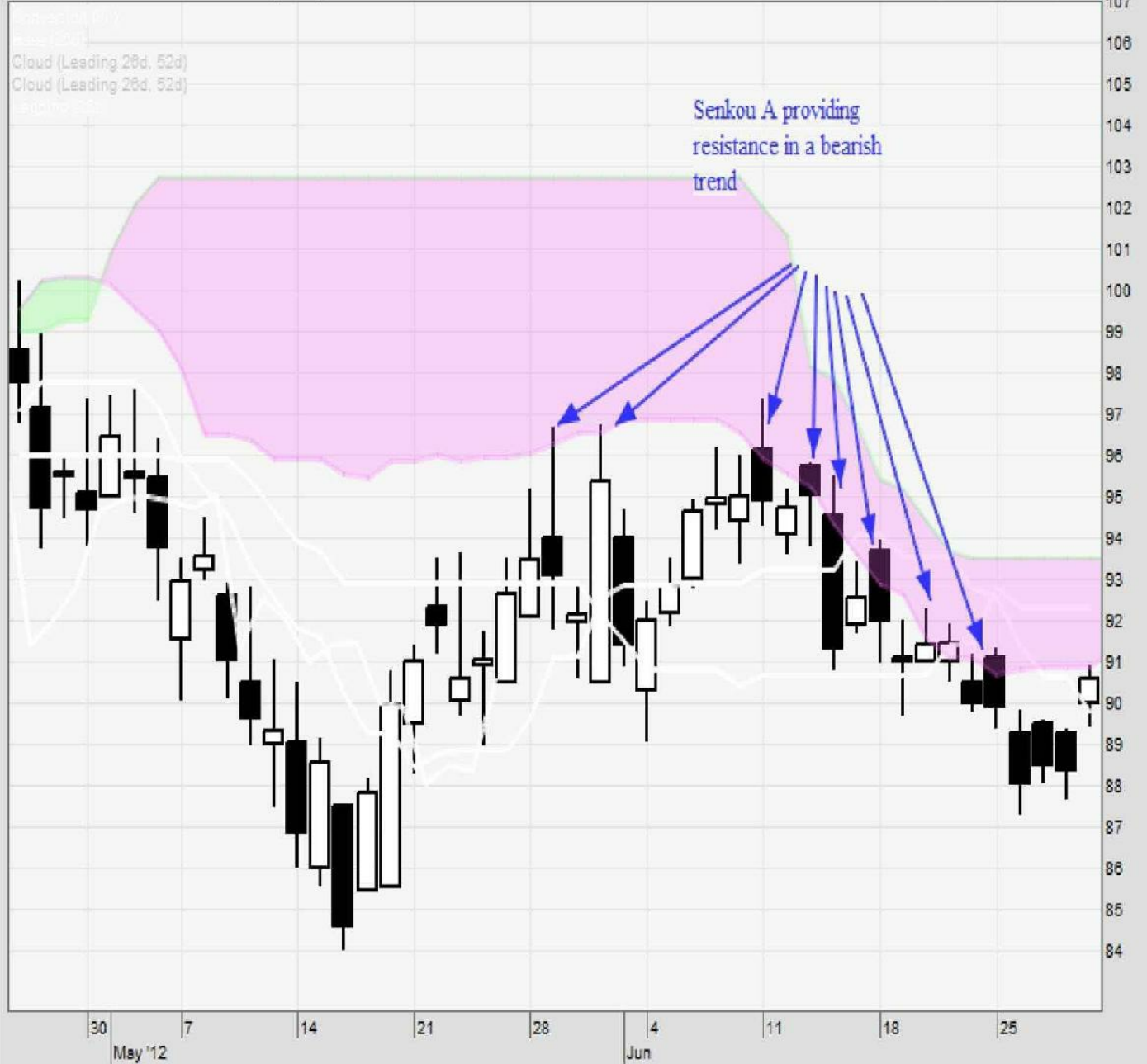
Figure 2.15: **Senkou A resistance to falling price**

Senkou B

This component of the Kumo is calculated by averaging the highest high and lowest low of the prior 52 periods and projecting it 26 periods into the future. It is essentially the equilibrium for prices over the past 52 periods, plotted 26 days in the future on the chart.

Senkou B = (Highest high of prior 52 periods + Lowest low of prior 52 periods) ÷ 2

Again, to make it clearer, today's Senkou B value was formed 26 days back. The value that one sees on the chart in [Figure 2.16](#), 26 days in the future was arrived at by averaging the highest high and the lowest low period by the price over the past 52 periods, starting from today.
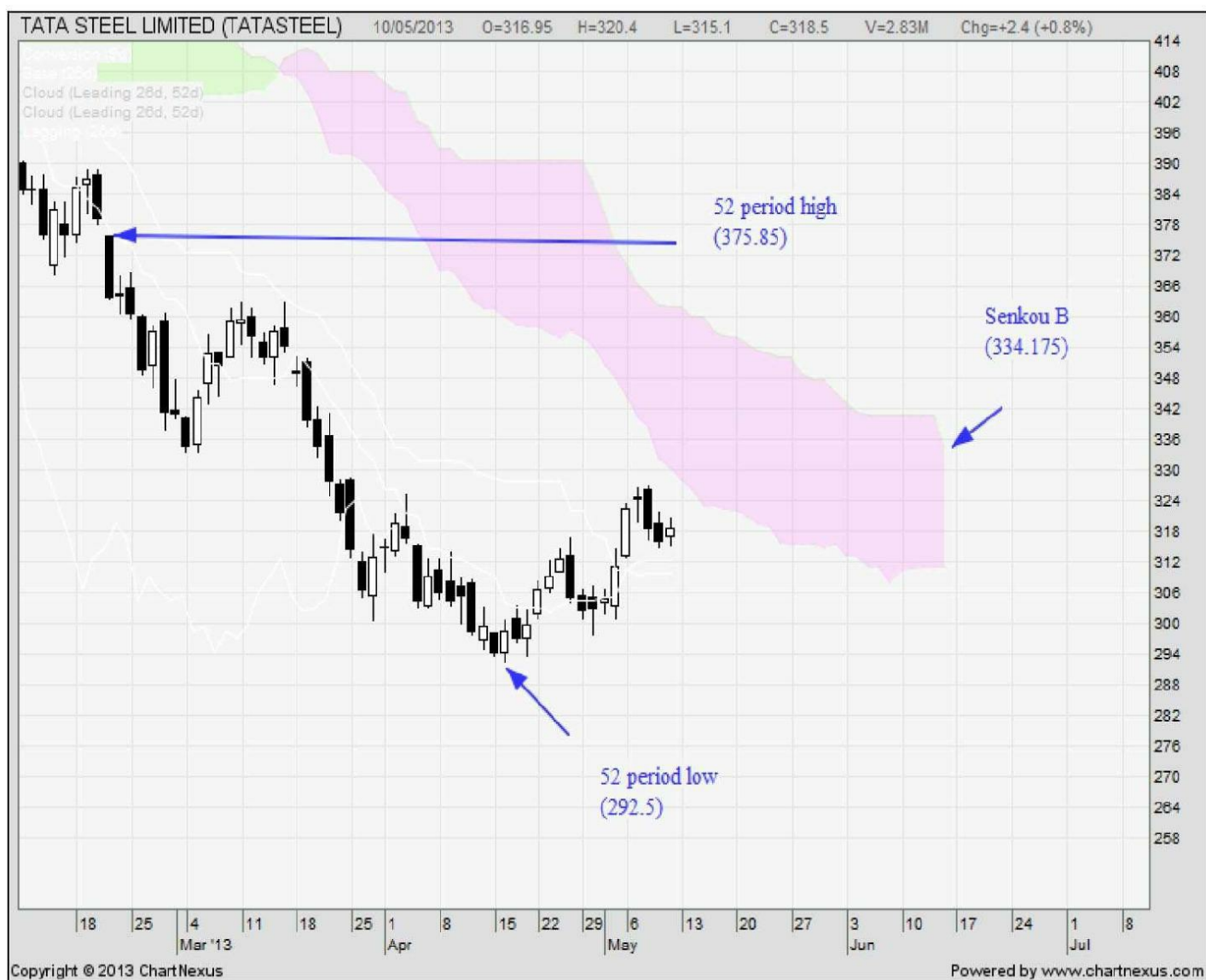

Figure 2.16: **Senkou B's value of 334.175 for 26 periods (in this case, days) in the future is the average of the highest high (375.85) and the lowest low (292.5) of the past 52 periods**

Now, this is what Senkou B tells us:

- If Senkou B is rising in the future, the stock is considered bullish.

- If, on the other hand, Senkou B is declining in the future, then the chart is considered bearish.

Like Senkou A, the current Senkou B can also provide support and resistance to the stock price (*see* Figure 2.17 and Figure 2.18). This support or resistance is especially strong if Senkou B is trending horizontal. Keep in mind that it is a longer term equilibrium point.

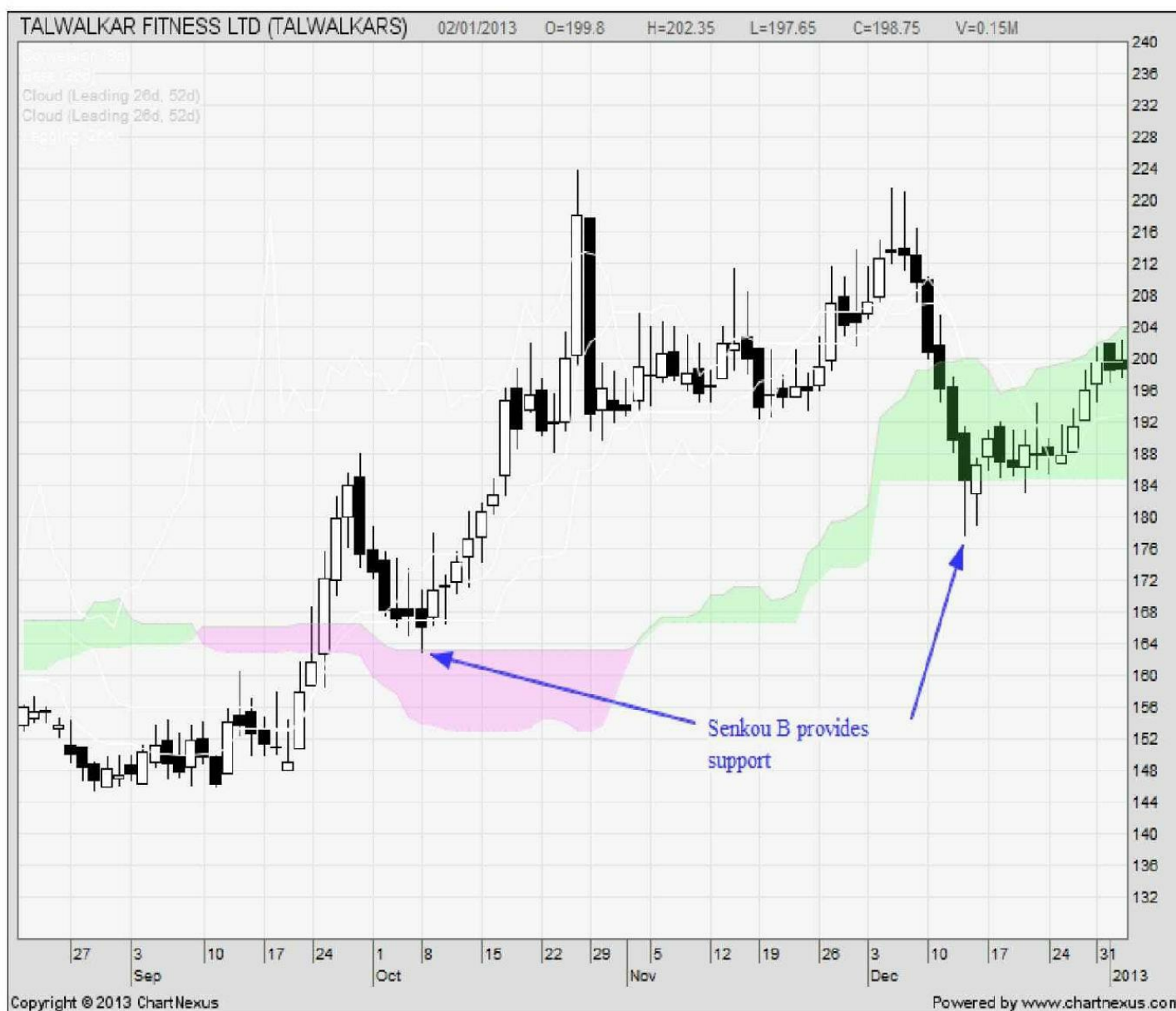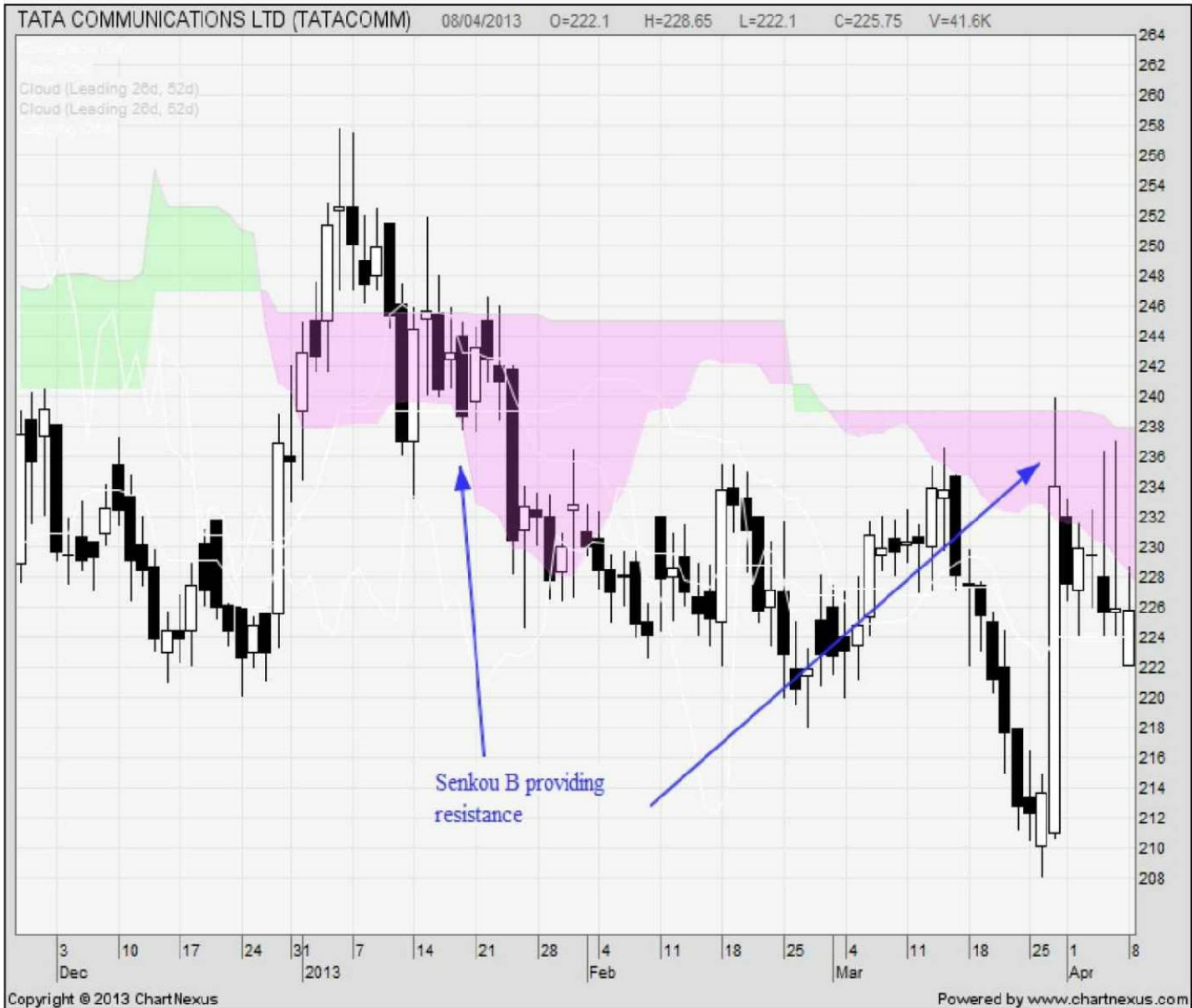*Figure 2.17:* **Senkou B providing support to the price**

Figure 2.18: **Senkou B offering resistance to the price**

What Senkou A and Senkou B Tell Us About the Trend

- **If Senkou A is above Senkou B, it is considered bullish.**
- **If Senkou A is below Senkou B, it is considered bearish.**

The reason for this is simple. The Senkou A is a faster averaging indicator compared to Senkou B. Thus, when a stock is rising, Senkou A will have higher values than would Senkou B. Conversely, when prices are declining, Senkou A by definition will move faster and decline before Senkou B does.

How Senkou A and Senkou B Form the Kumo

Together, Senkou A and Senkou B form the Kumo cloud. The area between the two lines is shaded and represents either a zone of possible support or resistance, for the stock, as the case may be.

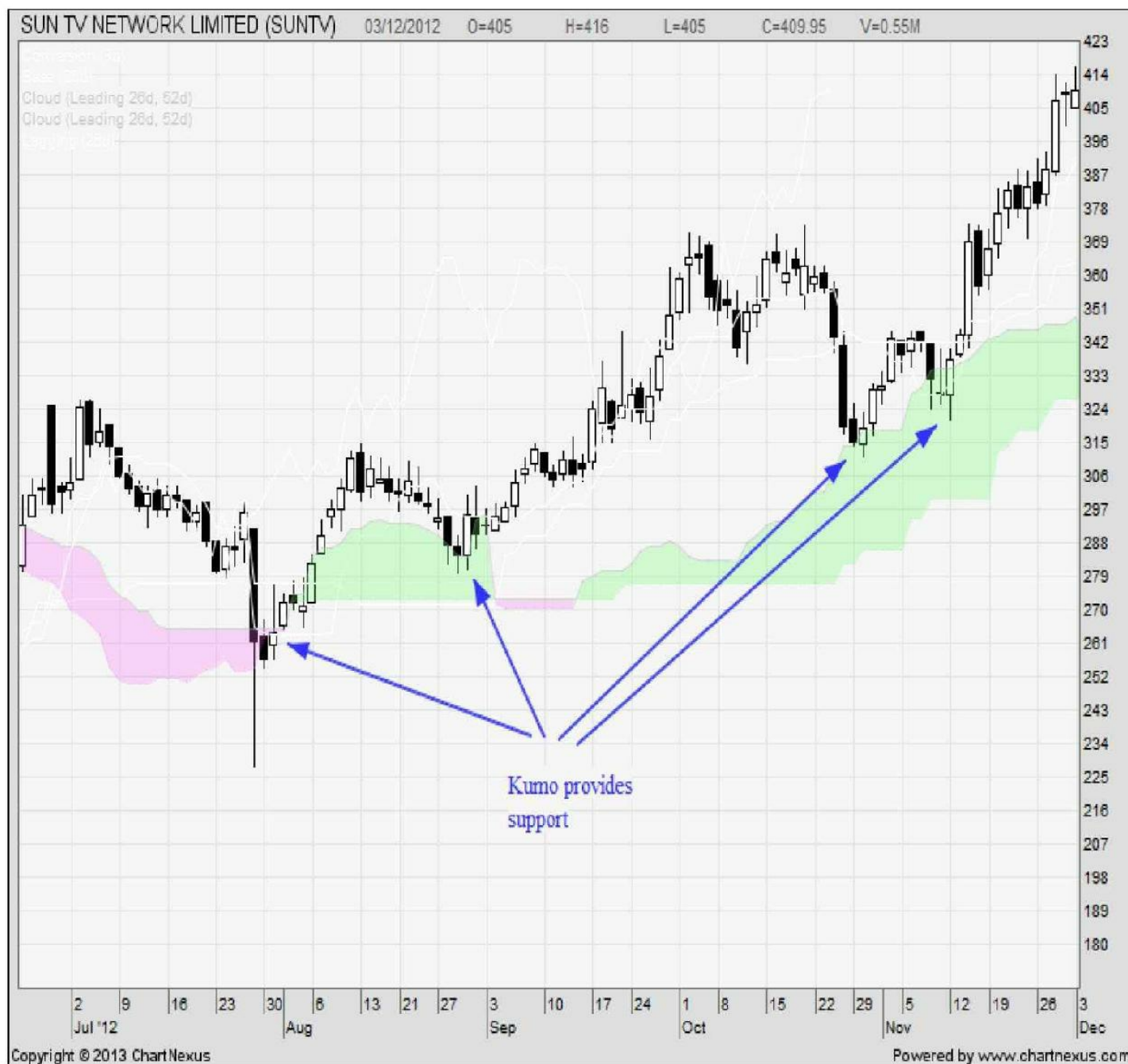Figure 2.19 shows the chart of Sun TV. Notice how the Kumo provides support for the price.

Figure 2.19: **Kumo is the shaded are in the chart, formed by Senkou A and Senkou B**

Figure 2.20 depicts the chart of Subex. In this case, the downtrending Kumo offers resistance to every price rally.