Secrets of the Orient: An Introduction to Candlestick Charts

The SDR's first educational section is dedicated to an introduction to candle charting techniques by Steve Nison, CMT, the leading authority on candlestick charts and first to introduce candlestick charts to the Western world.

What are Candlestick Charts?

Japanese candlestick (candle) charts, so named because the lines resemble candles with their wicks, are Japan's most popular form of technical analysis. Candle charts are over 100 years old and as such are older than Western bar charts and point and figure charts. Yet, amazingly, these charts were unknown to the Western world until recently. Candle trading techniques have now become one of the most discussed forms of technical analysis around the world. Almost every technical analysis software package and Internet charting service now has candle charts. This attests to their popularity and usefulness.

This article is a very basic introduction to candle charting techniques. But even with the primary candle signals discussed, you will discover how candles open avenues of analysis not available anywhere else. My goal here is to provide a sense of the potential of what the candles can offer.

What are the Benefits of Candle Charts?

Candle charts are easy to understand:

Anyone, from the first-time chartist to the seasoned professional can easily harness the power of candle charts. This is because, as will be shown later, the data that is required to draw the candlestick chart is the same as that needed for the bar chart (the high, low, open and close).

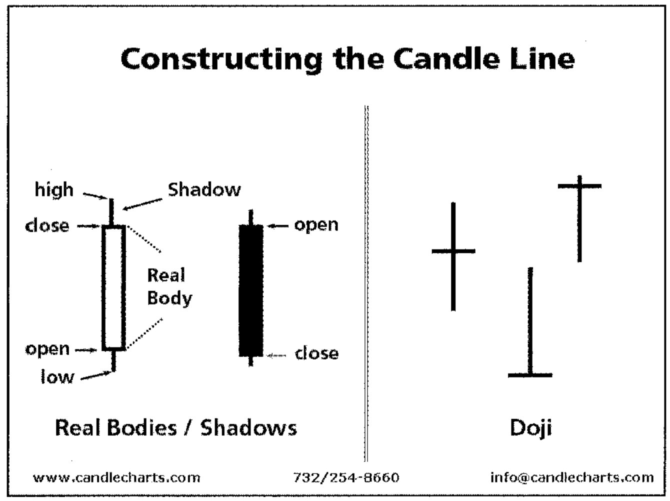
Candlestick charting tools will give you a jump on the competition:

Candle charts not only show the trend of the move, as does a bar chart, but, unlike bar charts, candle charts also show the force underpinning the move. In addition, many of the candle signals are given in a few sessions, rather than the weeks often needed for a bar chart signal. Thus, candle charts will help you enter and exit the market with better timing.

Candlestick charting tools will help preserve capital:

In this volatile environment capital preservation is just as important as capital accumulation. You will discover that the candles shine in helping you preserve capital since they often send out indications that a new high or low may not be sustained.

Candle charting techniques are easily joined with Western charting tools:

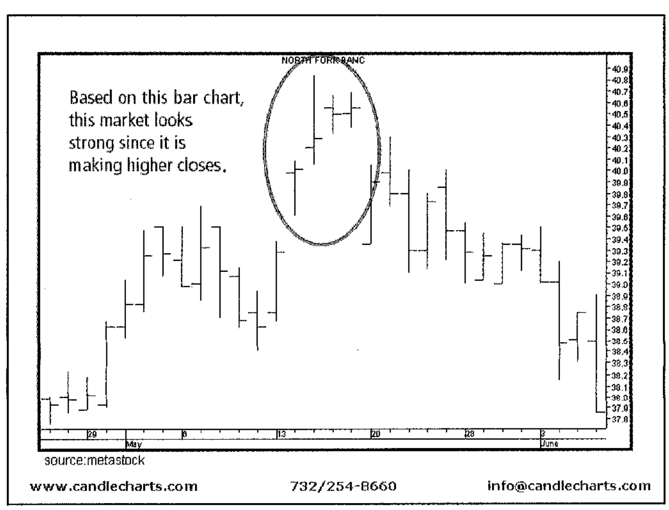


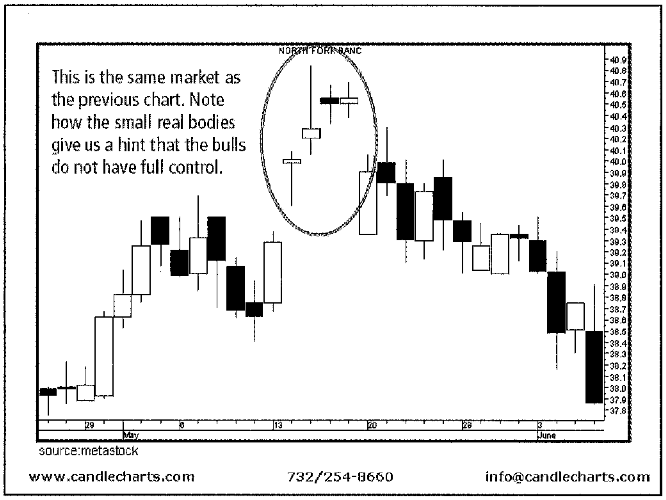
1: Constructing candlestick lines: Real body and Doji

that any of the technical analyses used with bar charts (such as moving averages, trend lines, retracements, Bollinger Bands, etc.) can be employed with candle charts. However, candle charts can send signals not available with bar charts.
Candlestick charts can be used in stocks, futures, and any market that has an open, high, low and close. And they can be used in all time frames—from intraday to weekly.

Constructing the Candlestick Lines

The broad part of the candlestick line in Exhibit 1 is called the **real body.** The real body represents the range between the session's open and close. If the close of the session is above the open then the real body is white. If the real body is black (i.e., red in Neovest), the close of the session is lower than the open.



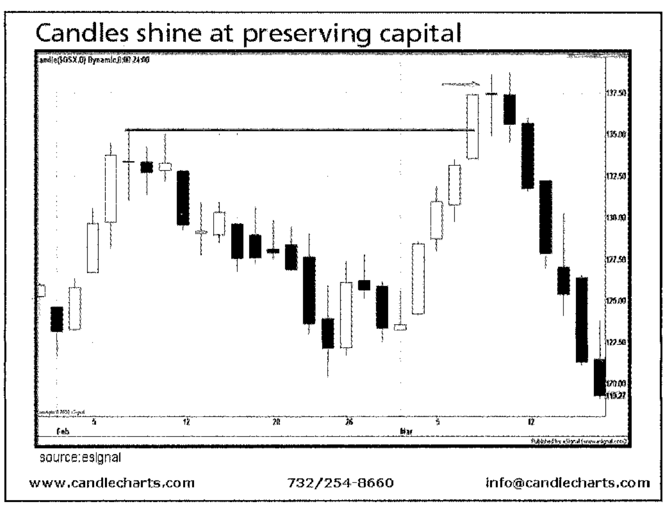


3: Chandle chart: Spinning tops, North Fork Banc

The thin lines above and below the real body are the **shadows.** These are the session's price extremes. The shadow above the real body is called the **upper shadow** and the peak of the upper shadow is the high of the session. The shadow under the real body is the **lower shadow** and the bottom of the lower shadow is the session's low.

Candle lines can be drawn for all time frames, from intraday to monthly charts. For example, a 60-minute candle line uses the open, high, low and close of that 60-minute period; for a daily chart it would be the open, high, low and close for the day. On a weekly chart the candle would be based on Monday's open, the high and low of the week and Friday's close.

Notice that the candles to the right in Exhibit 1 have no real bodies. These are examples of **doji** (pronounced doe-gee). A doji is a candle in which the opening and close are the same. Doji represent a market that is in balance between the forces of supply and demand. We will look more at the doji in one of the chart examples below.



While the candlestick line uses the same data as a bar chart, the color of the candlestick's real body and the length of the candle lines real body and shadows convey an instant x-ray into who's winning the battle between the bulls and the bears. For instance, when the real body is black, that means the stock closed below its opening price. This gives you an instant picture of a positive or negative close. Those of us who stare at charts for hours at a time find candlesticks are not only easy on the eyes, they convey strong visual signals sometimes missed on bar charts.

Spinning Tops

The logo of our firm is "Helping Clients Spot Market Turns Before the Competition". This is because one of the most powerful aspects of candle charts is that they will often provide reversal signals not available with traditional bar charting techniques. Let's take a look at this aspect with a **spinning top.**

As mentioned previously, one of more powerful aspects of candle charts is the quick visual information they relay about the market's heath. For example, a small real body (white or black) indicates a period in which the bulls and bears are more in a tug of war. The Japanese have a nickname for small real bodies—"spinning tops" because of their resemblance to the tops we had as children. Such small real bodies give a warning that the market's trend may be losing momentum. As the Japanese phrase it, the "market is losing its breath".

Let's look at an example of how candle charts will often help you preserve capital, a benefit so important in today's volatile environment. In this scenario I will illustrate how a candle chart can help you avoid a potentially losing trade from the long side.

On Exhibit 3 on the area circled, the stock looks strong since it is making consecutively higher closes. It looks like a stock to buy.

Using the same data as on the bar chart, we now make a candle chart (Exhibit 4). On the candle chart, in the same circled area, there are a series of small real bodies—which the Japanese call spinning tops. Small real bodies hint that the prior trend (i.e. the rally) could be losing its breath.

As such, while the bar chart makes it look attractive to buy, the

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going long – the small real bodies illustrate the bulls are losing force. Thus, by using the candle chart, a trader would likely not buy in the circled area and thus help avoid a losing trade.

This is but one example of how candles shine at helping you preserve capital. Warren Buffet has two rules: Rule 1 - Don't lose money. Rule 2 - Don't forget rule 1. Thus, candles shine at helping you preserve capital.

Doji

As the real body shrinks we ultimately wind up with a doji. As shown on the right side of Exhibit 1, a doji is when the open and close are the same.

The doji indicates a market in complete balance between supply and demand. Since a doji session represents a market at a juncture of indecision, they can often be an early warning that a preceding rally could be losing steam. Indeed, the Japanese say of a doji is that "the market is tired", while a close over the doji would "refresh" the market.

Properly used, candle charts may not only help improve profits, but will assist in preserving capital. They can do this by helping you avoid a potential losing trade or exiting a profitable trade early. Exhibit 4 shows an example of the latter.

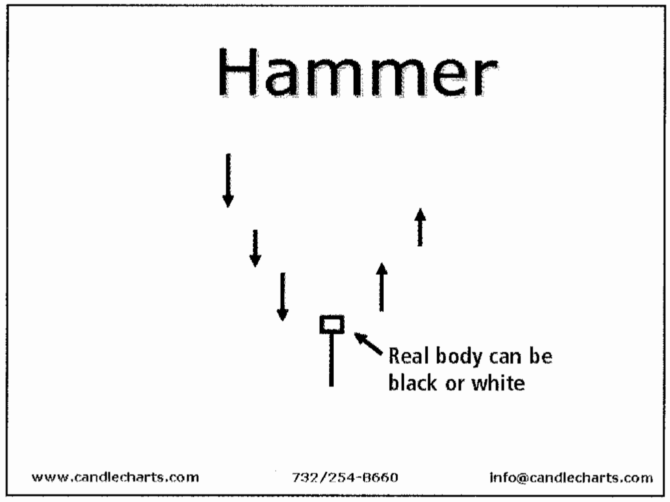
The horizontal line in Exhibit 4 show a resistance area near 135. A tall white candle pierces this resistance in early March. But observe what unfolded the next session—the doji. This doji line hinted the bulls had lost full of the market although it does not mean that the bears have taken control. This is a classic example of the power of candle charting techniques. Specifically, within one session we were able to see a visual clue via the doji that while the market was maintaining its highs, the doji shouted that the bulls were not in complete control. So while the market looked healthy from the outside, the internals (as shown by the doji) were relaying the fact that this stock was not as healthy as one would think.

The Hammer

We now look at a specific type of candle line that has a very long lower shadow called a **hammer** (Exhibit 5). So called because the market is trying to hammer out a base. The criteria for the hammer are:

1. The real body is at the upper end of the trading range.
2. The color of the real body can be black or white.
3. A bullish long lower shadow that is at least twice the height of the real body.
4. It should have no, or a very short, upper shadow.

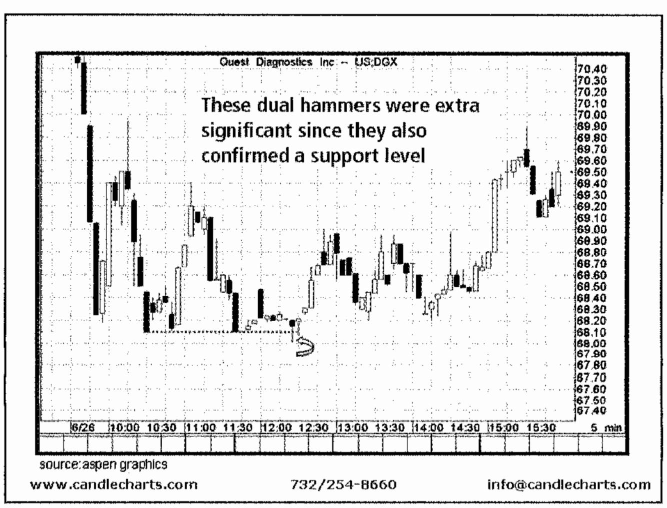
The hammer reflects the market insights obtained from a candle

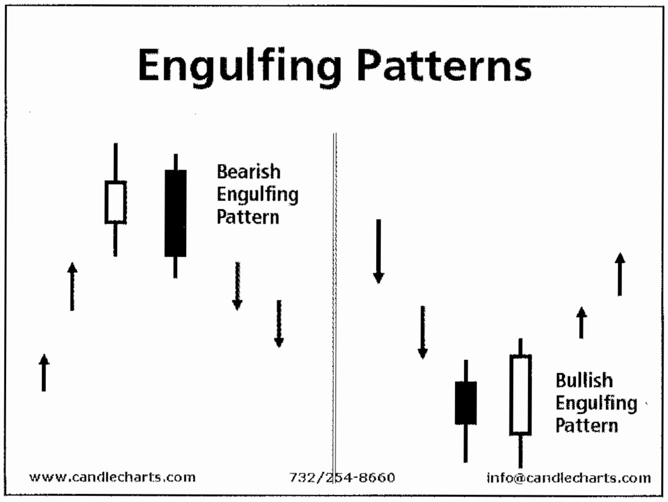


5: The Hammer

that the market rejected lower price levels to close at, or near, the highs of the session. From my experience, most times when there is a hammer, the market may not immediately move up, but may rally slightly, or trade laterally, and then, after expanding on a base, rally. If the market closes under the lows of the hammer, longs should be reconsidered.

Candle charts can be used in all time frames- from intraday to weekly. In the intraday chart (Exhibit 6), there are two back-to-back hammers (denoted by the arrow). These dual hammers took on extra significance since they confirmed a support level shown by the dashed line. This is a classic example of the power and the ease with which one can combine the insights of candle charts (the hammers) with classic western trading signals (the





7: Bearish and bullish engulfing patterns

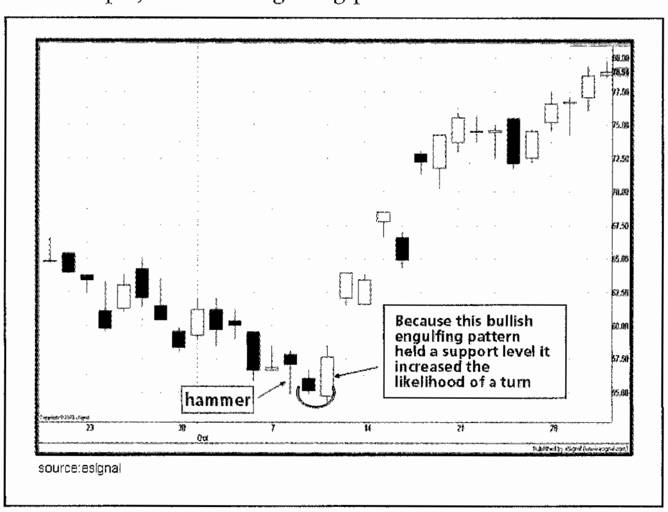
support line) to increase the likelihood of a market turn. This synergy of candle charts and western technical tools should provide a powerful weapon in your trading arsenal..

Engulfing Patterns

An engulfing pattern is a two-candle pattern. A **bearish engulfing pattern** (shown on the left in Exhibit 7) is formed when, during a rally a black real body wraps around a white real body. A **bullish engulfing pattern** (on the right of Exhibit 7) is completed when, during a descent, a white real body envelops the prior black real body.

The engulfing pattern is illustrative of how the candles can help provide greater understanding into the behavior of the markets. For example, a bullish engulfing pattern reflects how the bulls have wrested control of the market from the bears. A bearish engulfing pattern shows how a superior force of supply has overwhelmed the bulls. The Japanese will say, for instance, that with a bearish engulfing pattern that "the bulls are immobilized".

Exhibit 8 shows how a bullish engulfing pattern in early October called a reversal at IBM's lows. This bullish engulfing pattern was especially potent because it reinforced a support area set by a hammer.



Candles and the Overall Technical Picture

Remember a basic principle: candle-charting techniques are a tool and not a system. Effective candle-charting techniques require not only an understanding of the candle patterns, but a policy of using sound, coherent trading strategies and tactics. These include using stops, determining the risk and reward aspect of a potential trade, observing where a candle pattern is in relation to the overall trend, and monitoring the market's action after a trade is placed. By understanding, and using, these trading principles, you will be in a position to most fully enhance the power of the candles.

This is only a basic introduction to candle charts. There are many more patterns, concepts and trading techniques that must first be considered. But even with these basic concepts, you can see how the candles open new and unique doors of analysis.

May the candles light your path to profits!

Steve Nison, CMT, was the very first to introduce candlestick charts to the Western World. He is author of the two international best-selling books, Japanese Candlestick Charting Techniques and Beyond Candlesticks, which have been translated into eight languages.

Steve is founder and President of Candlecharts.com, which provides educational products and advisory services to institutions and private traders. Steve has trained professionals from hundreds of financial firms from around the world, including World Bank and the Federal Reserve, hedge funds, NASDAQ and NYSE market makers and major brokerage firms on how to apply and profit from these methods.

To sign up for Steve Nison's free bi-weekly newsletter and to learn more about Mr. Nison's video workshops, visit www.candlecharts.com or contact Steve at nison@candlecharts.com.