

HOW TO TRADE WITH JAPANESE CANDLESTICKS



«Beginners focus on analysis, but professionals operate in a three dimensional space. They are aware of trading psychology, their own feelings and the mass psychology of the markets.»

Dr. Alexander Elder

Professional trader
and teacher

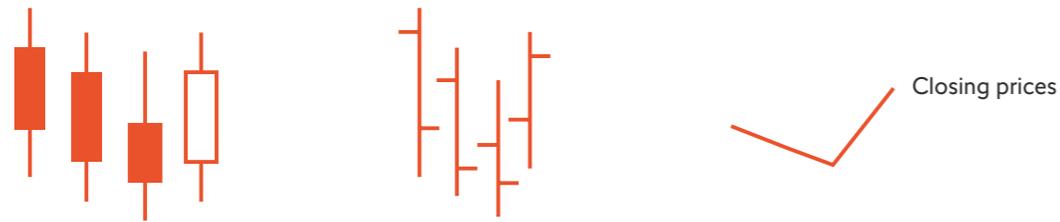
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INTRODUCTION

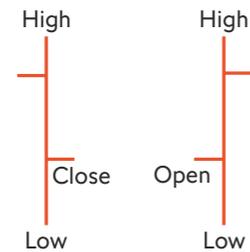
Japanese candlestick charting, legend has it, was invented by rice traders in western Japan in the 1700s. Trading platforms contain line charts and bar charts and candlestick charts, which contain more information than line charts and are easier to read than bar charts.

Here are the same price movements shown in these three ways:

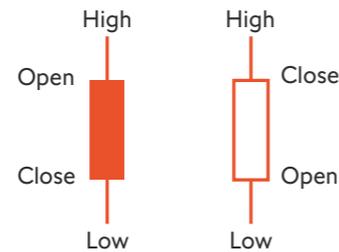


Once the eye becomes used to candlesticks, the chart becomes much richer with information. Line charts show either the opening price or the closing price. Bar charts and candlestick charts both show the opening price, closing price, highest traded price of the period and lowest traded price of the period. In addition to this, the color of the body of the candle makes it easy to grasp the direction of the price movement.

Bar chart



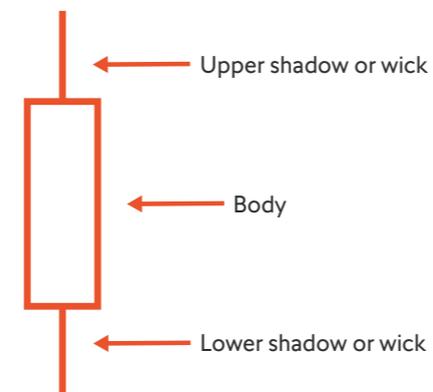
Candlestick



Rising prices are generally shown using hollow bodies, and falling prices with filled-in bodies. Other color combinations exist.

Candlestick patterns that might inspire trades can consist of a single candle, but usually contain two or even three candles. **Candlesticks can be applied to any timeframe, but are particularly useful to analyzing the short-term direction of the market.**

In the following, a number of common patterns are described in detail using the terms shown here:



The existence and length of candlestick body and shadow contain information about market psychology. The strength of a price change is shown by the size of the body of the candle in relation to the length of the shadow: long bodies and short shadows imply consensus about the price, while the indecisive markets often have small bodies and long shadows of price exploration. Some traders enjoy focusing on analyzing candlestick bodies, while others find trade opportunities in the choppy charts of candlestick shadows.

In the following, we will look at candlestick patterns that often precede trend reversals. The patterns are divided into bullish reversals and bearish reversals.

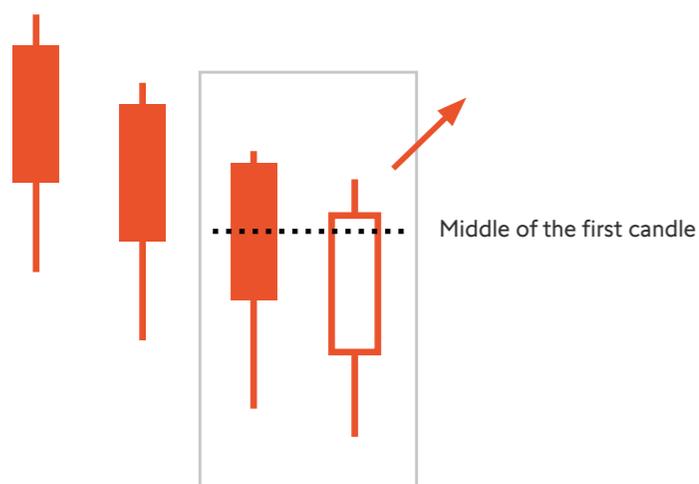
BULLISH TREND REVERSAL PATTERNS

Bullish piercing line

Following a downtrend are two candles, the first closing lower than opening, the second opening below the price range of the first period and closing higher than the middle of the first candle.

Trend reversal

This pattern shows a close that is much higher than the preceding period's. This may mean a reversal of the prevailing trend, especially when the close of the second candle is well above the middle of the body of the first candle. If the price moves above the close of the second candle, it is worth confirming the buy signal by other means, such as other chart patterns. If the price moves below the low of the second period, the signal is not confirmed – this is the stop loss level unless a new bearish price move is anticipated.



Related candlestick patterns:

- Dark cloud cover is the exact opposite.
- Bullish engulfing, where the second candle closes higher than the first. Bearish engulfing is the exact opposite.

Bullish engulfing

Following a downtrend are two candles, the first closing lower than opening, the second opening at the same level or even lower than the first, and closing at the same level or higher than the first candle. In short, the body of the second candle should be longer than the body of the first.

Trend reversal

This pattern shows a close that is much higher than the preceding period's. The indecision indicated by the small candle body – which may even be a cross - might mean a reversal of the prevailing trend. If the price moves above the close of the second candle, it is worth confirming the buy signal by other means, such as price change momentum or trade volume. If the price moves below the low of the second period, the signal is not confirmed – this is the stop loss level unless a new bearish price move is anticipated.



Related candlestick patterns:

- Bearish engulfing is the exact opposite.
- Bullish piercing line, where the second candle closes above the middle of the first, but within the body of it. Dark cloud cover is the exact opposite.

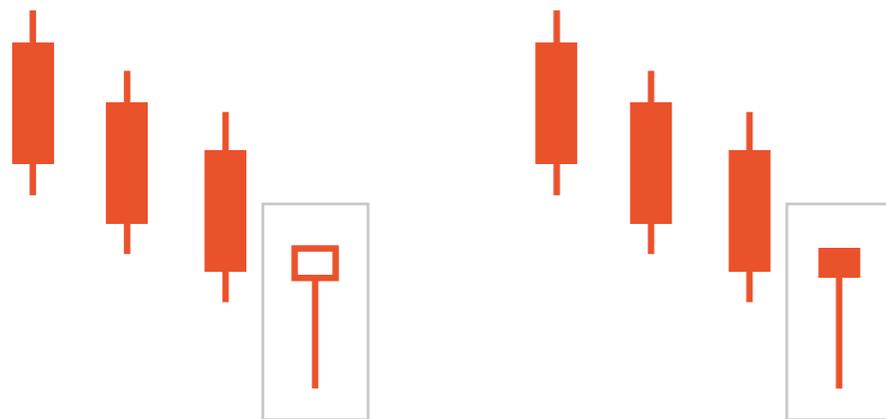
Upward hammer and downward hammer

Following a downtrend, there is a box on a stick, that is, a hammer. There is no or very little upper shadow. The direction of the price movement of the period is unimportant, but the bottom of the candle's body is below the bodies of the two previous down-trending candles. The bottom shadow is at least twice the length of the body of the candle. The candle as a whole is of normal length.

When opening a position, always consider at which level you wish to take profit or stop loss. It is possible to create orders to trade automatically at these price levels. Take profit orders should be further away from the entry level than the stop loss order, so that profits can cover a few bad trades. As a rule of thumb, the potential profit should be three times the potential loss.

Trend reversal

Since both the open and close are far above the lowest price of the period, this candle often indicates that the next movement of the market will be higher. This observation rests on the buyers bringing the price so far up in spite of sellers' efforts during the trading period. In other words, at closing, the buyers' efforts outweigh the sellers'. If the price moves above the close of the Hammer candle, it is worth confirming the buy signal by other means, such as trade volume. Set stop loss at the lowest price of the Hammer's shadow unless a new bearish price move is anticipated.



Related candlestick patterns:

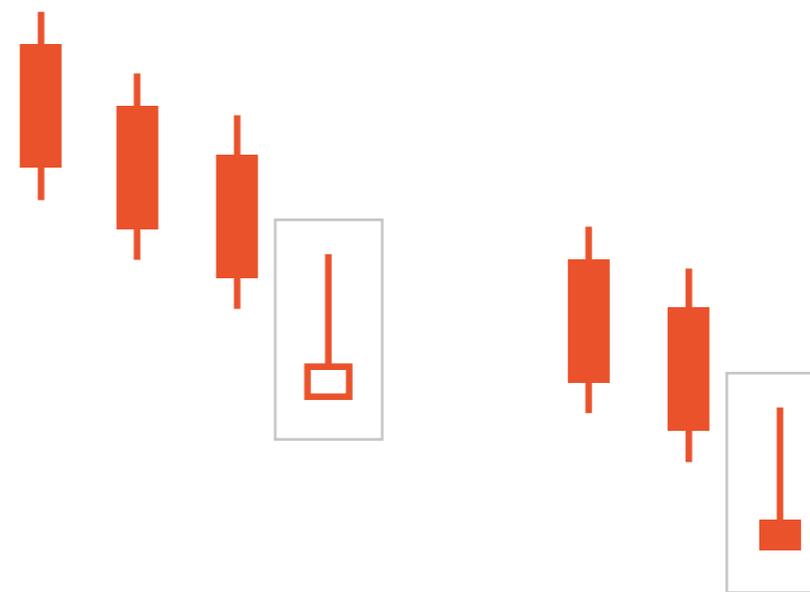
- Inverted Hammer

Inverted Hammer

Following a downtrend, there is a box with a stick on top, that is, an upside-down hammer. There is no or very little lower shadow. The direction of the price movement of the period is unimportant, but the top of the candle's body is below the body of the previous down-trending candle's. The upper shadow is at least twice the length of the body of the candle. The candle as a whole is of normal length.

Trend reversal

Since the price exploration of this period was mostly upwards, this candle often indicates that the next movement of the market will be higher. If the price opens above the body of the Hammer candle for the next trading period, it is worth conning the buy signal by other means, and perhaps entering the market at a level at least halfway up the upper shadow. Set stop loss at the lowest price of the Hammer's candle body or shadow unless a new bearish price move is anticipated.



Related candlestick patterns:

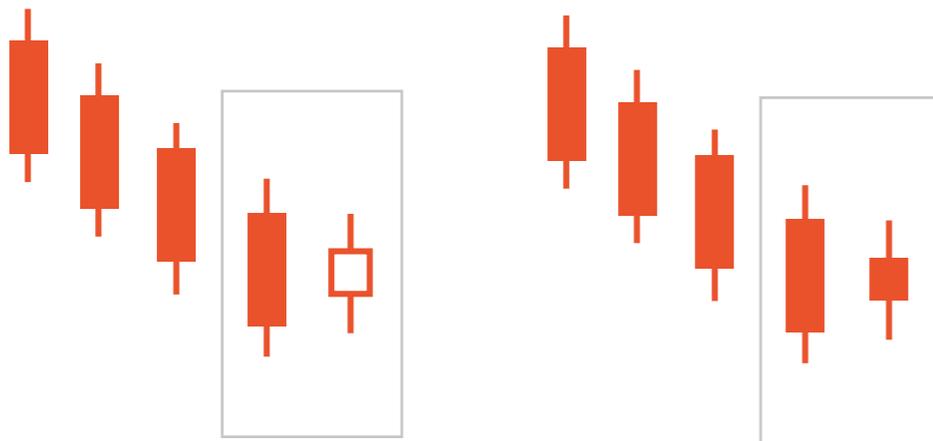
- Hammer

Bullish Harami

Following a downtrend, a normal candle that closes below opening price. The body of the candle of the next period is shorter than this candle's. In fact, the opening or closing prices of the two candles may be the same, but the price range of the second candle body should be completely within the first candle body. The direction of the price movement does not matter – the short candle can be either color.

Trend reversal

Since the opening and closing prices of the second period are above the closing price of the first candle, these two candles may be a sign that the downtrend is about to reverse. If the price moves above the middle of the first candle, or the close of the second candle (whichever is higher), it is worth confirming the buy signal by other means. If the price moves below the lowest price of the two periods, the signal is not confirmed – this is the stop loss level unless a new bearish price move is anticipated.



Related candlestick patterns:

- Bearish Harami
- Bullish/bearish Harami cross

The Japanese word "harami" is an old expression for pregnant woman, literally «body in the stomach». The shape of the pattern is similar to a pregnant woman's belly if you draw a line around the two candles: the first candle is the «mother», the second is the «baby».

Bullish Harami cross

Following a downtrend are two candles, the first closing lower than opening, the second opening below the price range of the first period, and closing higher than the middle of the first candle.

Trend reversal

Since the opening and closing prices of the second period are above the closing price of the first one, these two candles may be a sign that the downtrend is about to reverse. The entry level depends on the size of the first candle. If the first candle is of normal size, the opening trade can be at a level above the middle of the first candle. However, if the first candle is short, the opening trade should be at or above its opening price. Trade opportunities should always be confirmed by several different analyses, for example chart, momentum and volume. If the price moves below the lowest price of the two periods, the signal is not confirmed – this is the stop loss level unless a new bearish price move is anticipated.



The Japanese word "doji" means "ten". In Japanese writing, the character for "ten" resembles a cross. If a candle is not quite a Doji but has a small body, it is called a Star. The market that leads to a Doji is indecisive, with buyers and sellers balancing each other. Note the length and direction of the shadows – the greater their length, the greater the importance of the reversal because it is hard-won.

Related candlestick patterns:

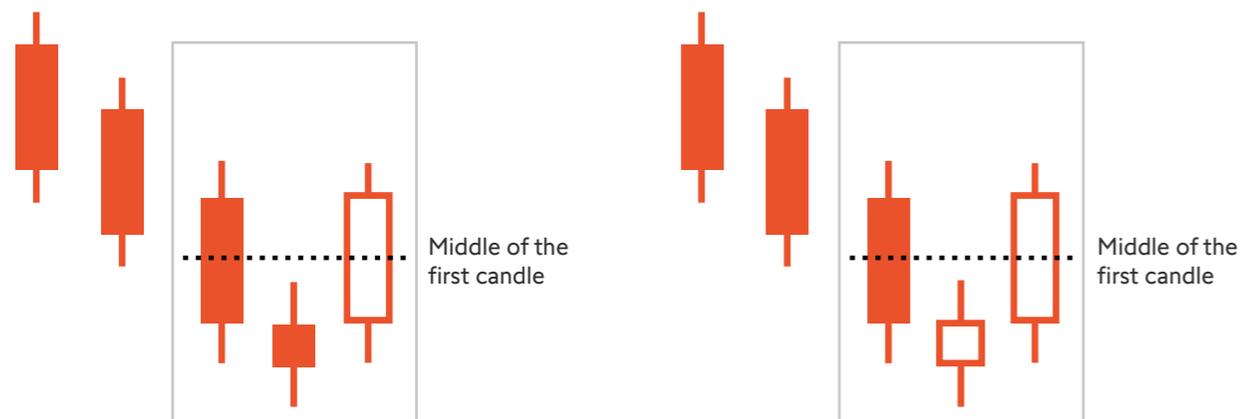
- Bearish Harami cross
- Bullish/bearish Harami

Morning star

Following a downtrend, there is a normal candle that closes below opening price. It is followed by one short candle that opens at or below the level of the closing price of the first candle and forms a small body (the direction of the price move is unimportant). The third part of this pattern is a normal candle that opens at or above the lowest price of the body of the second candle, and that should close well above its opening price, preferably above the middle of the body of the first candle.

Trend reversal

If the price moves above the close of the third candle, it is worth confirming the buy signal by other means, such as other chart patterns. If the price moves below the lowest price of the last two periods, the signal is not confirmed – this is the stop loss level unless a new bearish price move is anticipated.



Related candlestick patterns:

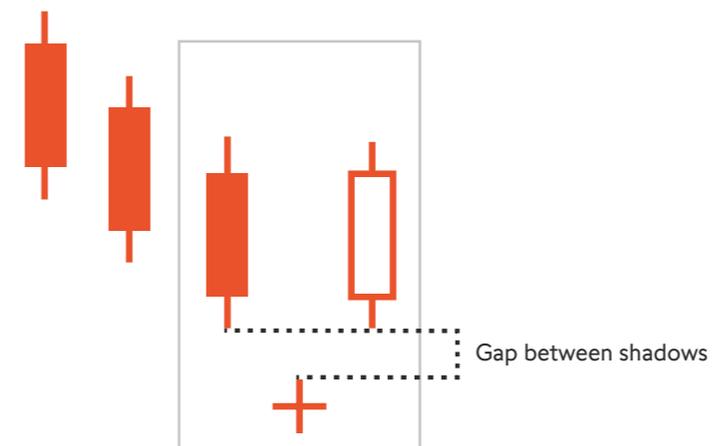
- Evening star
- Abandoned baby

Abandoned baby (bullish)

Following a downtrend, there is one normal candle that continues the downtrend, followed first by a gap to a cross, and then by a normal candle that closes well above the closing price of the first candle. The strength of this indication is shown by the fact that not even the shadow of the cross overlaps with the shadows of the two other candles of the pattern.

Trend reversal

The great indecision of the market indicated by the two gaps in opposite directions serves as a reminder to keep a close eye on the security in question. If the price moves above the close of the third candle, it is worth confirming the buy signal using other patterns or indicators. If the price moves below the low of the last two periods, the signal is not confirmed – this is the stop loss level unless a new bearish price move is anticipated.



Related candlestick patterns:

- Abandoned baby (bearish)
- Morning star/evening star

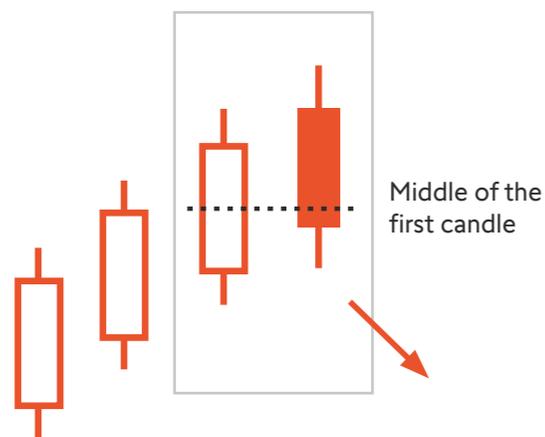
BEARISH TREND REVERSAL PATTERNS

Dark cloud cover

Following an uptrend are two candles, the first closing higher than opening, the second opening above the price range of the first day, and closing lower than the middle of the first candle.

Trend reversal

This pattern shows a close that is much lower than the preceding period's. This may mean a reversal of the prevailing trend, especially when the close of the second candle is well below the middle of the body of the first candle. If the price moves below the close of the second candle, it is worth confirming the sell signal by other means, such as other chart patterns. If the price moves above the high of the second period, the signal is not confirmed – this is the stop loss level unless a new bullish price move is anticipated.



Related candlestick patterns:

- Bullish piercing line
- Bullish engulfing, where the second candle closes higher than the first. Bearish engulfing is the opposite.

Bearish engulfing

Following an upwards trend are two candles, the first closing higher than opening, the second opening at the same level or even higher than the first, and closing at the same level or lower than the first candle. In short, the body of the second candle should be longer than the body of the first.

Trend reversal

This pattern shows a close that is much lower than the preceding period's. The indecision indicated by the small candle body – which may even be a cross - might mean a reversal of the prevailing trend. If the price moves below the close of the second candle, it is worth confirming the sell signal by other means, such as price change momentum or trade volume. If the price moves above the high of the second period, the signal is not confirmed – this is the stop loss level unless a new bullish price move is anticipated.



Related candlestick patterns:

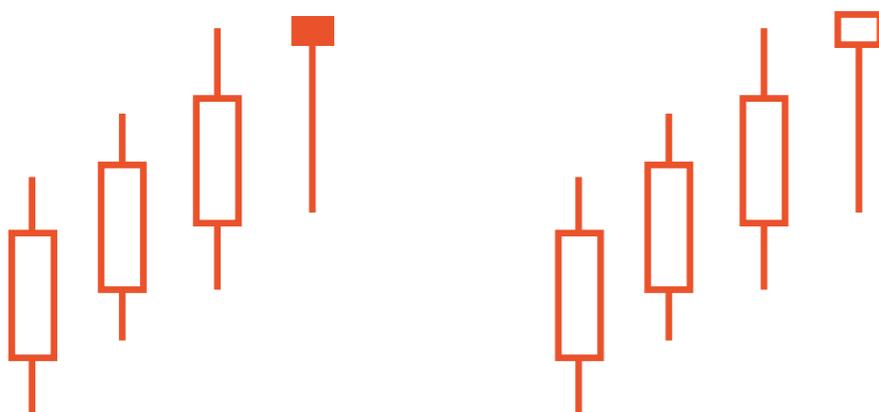
- Bearish engulfing is the exact opposite.
- Bullish piercing line, where the second candle closes above the middle of the first, but within the body of it. Dark cloud cover is the exact opposite

Hanging man

Following an upward trend, there is a box on a stick, that is, a hammer. There is no or very little upper shadow. The direction of the price movement of the period is unimportant, but the bottom of the candle's body is above the bodies of the two previous up-trending candles. The bottom shadow is at least twice the length of the body of the candle. The candle as a whole is of normal length.

Trend reversal

Since this small body is seen after a generally rising trend, but explored lower prices, this candle often indicates that the next movement of the market will be lower. If the close is below the open, the buyers did not completely outweigh the downward price pressure of the trading period. If the price moves below the close of the Hammer candle, it is worth confirming the buy signal by other analyses. Set stop loss at the higher of the last two trading periods, unless a new bullish price move is anticipated.



Related candlestick patterns:

- Shooting star
- Bullish Hammer

Shooting star

Following an upward trend, there is a box with a stick on top, that is, an upside-down hammer. There is no or very little lower shadow. The direction of the price movement of the period is unimportant, but the bottom of the candle's body is below the body of the previous up-trending candle's. The upper shadow is at least twice the length of body of the candle. The candle as a whole is of normal length.

Trend reversal

Since the price exploration of this period was mostly upwards but ended near the opening price, this candle shows that at the end of trading, the sellers were outweighing the buyers. This often indicates that the next movement of the market will be lower – particularly if the closing price is below the opening. If the price moves below the body of the Hammer candle in the next trading period, it is worth confirming the sell signal by other means. Set stop loss at the highest price of the Shooting Star's upper shadow unless a new bullish price move is anticipated.



Related candlestick patterns:

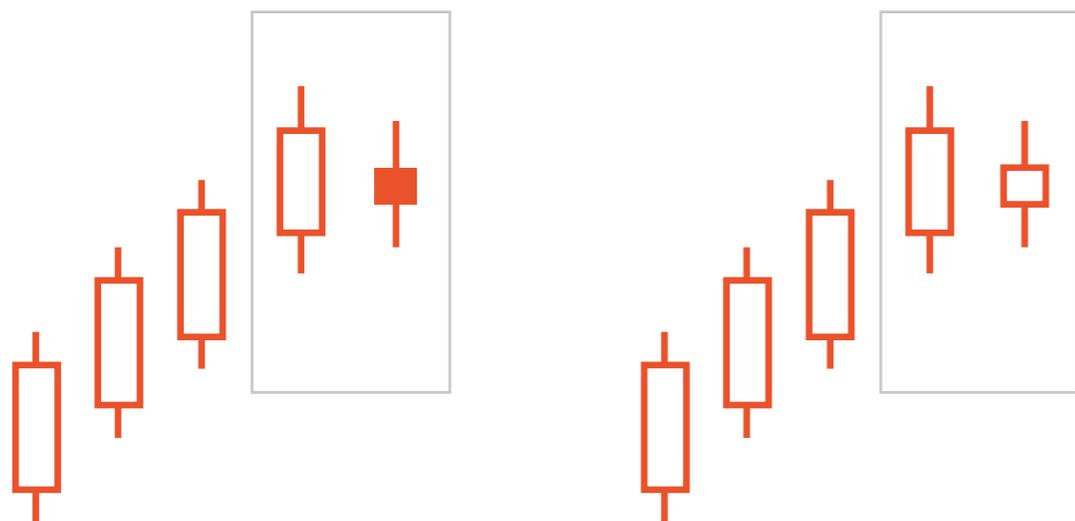
- Hanging man
- Bullish inverted hammer

Bearish Harami

Following an upwards trend, a normal candle that closes above opening price. The body of the candle of the next period is shorter than this candle's, and should be completely within the first candle body's price range. The opening or closing prices of the two candles may be the same. The direction of the price movement does not matter – the short candle can be either color.

Trend reversal

Since the opening and closing prices of the second period are below the closing price of the first candle, these two candles may be a sign that the upwards trend is about to reverse. If the price moves below the middle of the first candle, or the close of the second candle (whichever is lower), it is worth confirming the sell signal by other means. If the price moves above the highest price of the two periods, the signal is not confirmed – this is the stop loss level unless a new bullish price move is anticipated.



Related candlestick patterns:

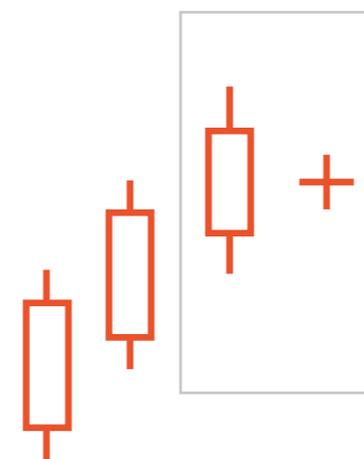
- Bullish Harami
- Bullish/bearish Harami cross

Bearish Harami cross

Following an uptrend, a normal or short candle that closes above its opening price. The candle of the next period closes at almost the same price as it opens, i.e. has virtually no body. The price range of the second candle is entirely within the body of the first candle.

Trend reversal

Because the cross indicates even more indecision than the star of the classic Harami pattern, the Harami cross can be taken as a stronger signal. Given that the opening and closing prices of the second period are below the closing price of the first candle, these two candles may be a sign that the upwards price trend is about to reverse. The entry level depends on the size of the first candle. If the first candle is of normal size, the opening trade can be at a level below the middle of the first candle. However, if the first candle is short, the opening trade should be at or below its opening price. Trade opportunities should always be confirmed by several different analyses, for example chart, momentum and volume. If the price moves above the highest price of the two periods, the signal is not confirmed – this is the stop loss level unless a new bullish price move is anticipated.



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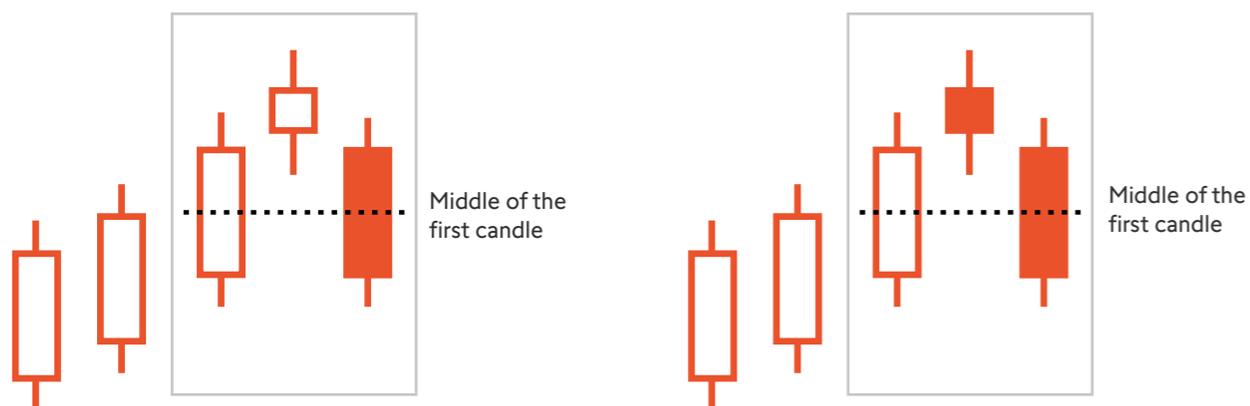
- Bullish Harami cross
- Bullish/bearish Harami

Evening star

Following an uptrend, there is a normal candle that closes above its opening price. It is followed by one short candle that opens at or above the closing price of the first candle and forms a small body (the direction of the price move is unimportant). The third part of this pattern is a normal candle that opens at or below the highest price of the body of the second candle, and that should close well below its opening price, preferably below the middle of the body of the first candle.

Trend reversal

If the price moves below the close of the third candle, it is worth confirming the sell signal by other means, such as other chart patterns. If the price moves above the highest price of the last two periods, the signal is not confirmed – this is the stop loss level unless a new bullish price move is anticipated.



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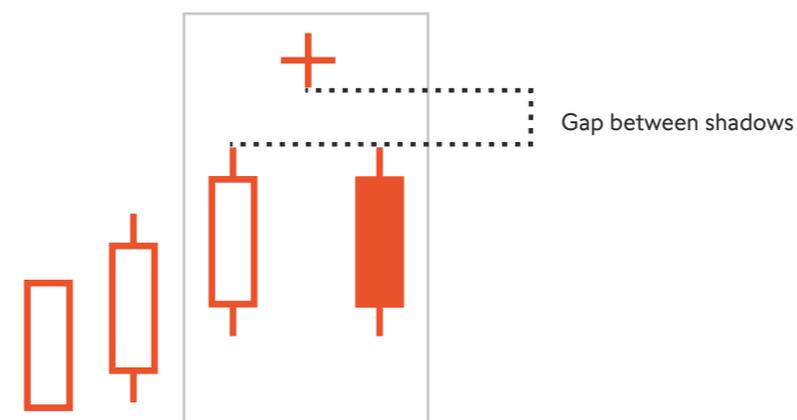
- Morning star
- Abandoned baby

Abandoned baby (bearish)

Following an upwards trend, there is one normal candle that continues the trend, followed first by a gap to a cross, and then by a normal candle that closes well below the closing price of the first candle. The strength of this indication is shown by the fact that not even the shadow of the cross overlaps with the shadows of the two other candles of the pattern.

Trend reversal

The great indecision of the market indicated by the two gaps in opposite directions serves as a reminder to keep a close eye on the security in question. If the price moves below the close of the third candle, it is worth confirming the sell signal using other patterns or indicators. If the price moves above the high of the last two periods, the signal is not confirmed – this is the stop loss level unless a new bullish price move is anticipated.

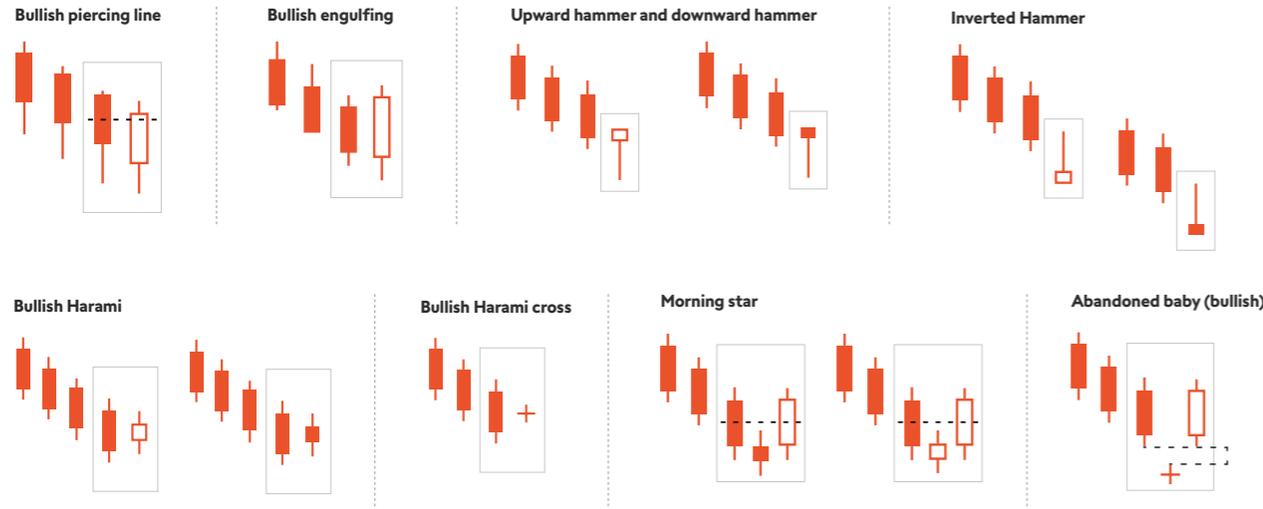


Related candlestick patterns:

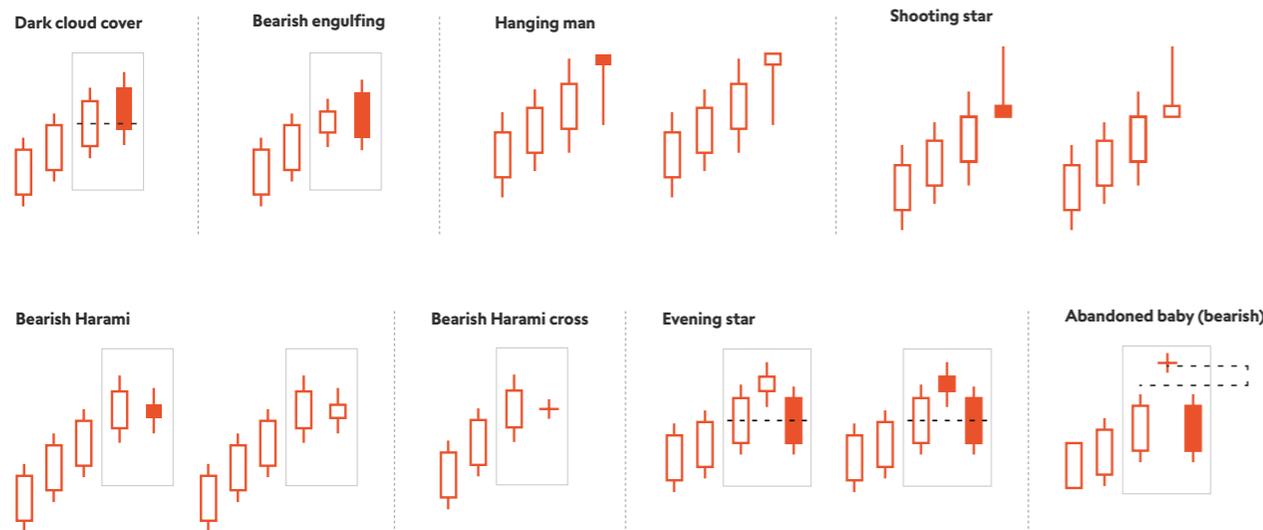
- Abandoned baby (bullish)
- Morning star/evening star

SUMMARY

Bullish trend reversal patterns



Bearish trend reversal patterns



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