Candlesticks and Traditional Chart Analysis

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Introduction: East Meets West

Japanese candlesticks have the potential of giving confirmation to signals generated by traditional (Western) technical analysis techniques. Candlesticks are a complete approach to chart analysis that is sufficiently independent of Western techniques that value is added when they are combined. Moreover, since candlestick charts are created using the same information as Western bar charts (i.e., open, high, low, close), they can be smoothly related one to the other.

Candlesticks and Moving Averages

An example of the added power to chart interpretation is candlestick patterns confirming moving average signals. In the following chart, the two highlighted areas show two separate candlestick patterns, *spinning top* and *doji*, followed by a long white (hollow) candlestick.

The interpretation of these candlestick patterns add bullish confirmation of the 200-day moving average at support levels around October 10 and February 5. Moreover, those same Japanese candlestick patterns confirmed the 30 level on the RSI as an oversold condition.

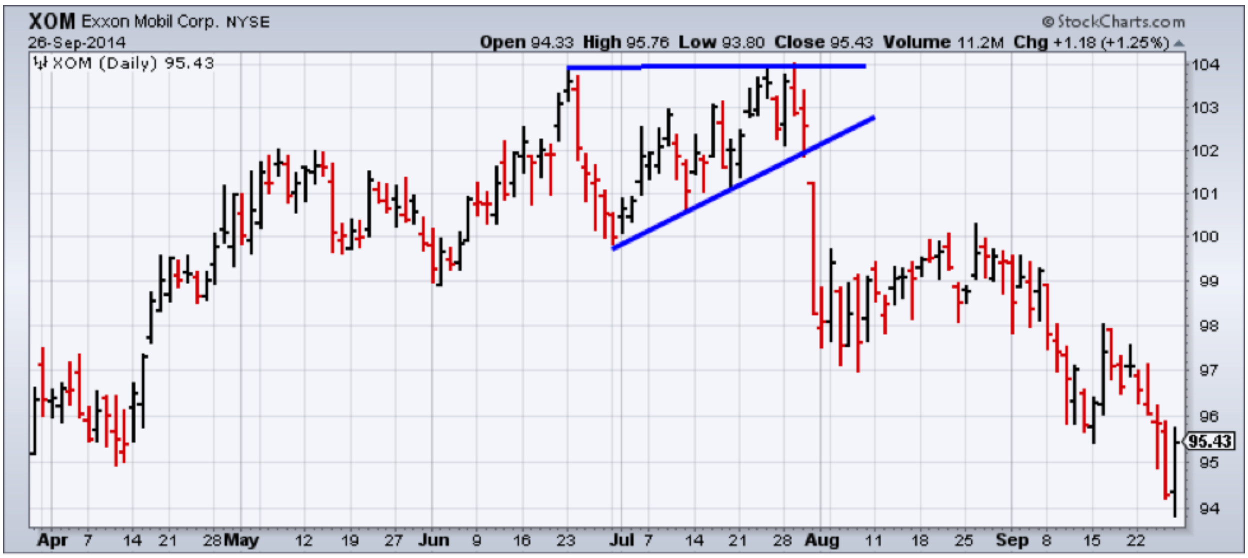
Candlesticks and Breakouts

Candlesticks can also add confirmation to breakouts from traditional chart patterns that are found within congestion zones. When a bullish or bearish Candlestick Pattern occurs within the vicinity of a traditional breakout, it adds validity to the direction of that breakout. An example is shown in the chart below where the eventual breakout is to the downside.

At first, the top line of the triangle is touched twice by *spinning-top* candlesticks, which indicates indecision. Then, just prior to the downward breakout from the triangle, there appears a *bearish harami* candlestick pattern, followed by another down day to provide confirmation. Once the price action gaps down below the ascending triangle, it does so with a long filled candlestick. All of this information taken together adds up to an overall bearish picture.

An ascending triangle is traditionally recognized as a bullish chart pattern. But, in this case, the evolving bearish behavior was identified using candlestick pattern analysis. The chart below contains the same information. However, it is now displayed as a traditional OHLC bar chart.

As you can see, the ascending triangle is easily recognizable. However, without the use of candlestick analysis, it is more difficult to assess the potential direction of the breakout before it occurs.



Candlesticks and the Head & Shoulders Pattern

One limitation of using candlestick patterns by themselves is that they do not provide potential price targets. Applying traditional technical analysis in conjunction with candlestick pattern analysis can provide estimated price targets. The following chart shows a *head & shoulders* pattern with an eventual breakout to the down side. During the development of the right shoulder, there is a bearish harami pattern followed by two long bearish candles. These add confirmation to the breakout when it occurs. However, without identification of the *head & shoulders* pattern, the *bearish harami* would not give any inclination of a potential price target. Using the traditional price target calculation of a *head & shoulders* pattern, a price target can be calculated by taking the distance from the top of the head to the neckline and subtracting that from the breakout of the neckline.

Using both types of analysis together gives a potentially clearer picture than using either type in isolation. After all, technical analysis is not an exact science, you need to look for confirming signals to build evidence to support a likely outcome. A good corroborating signal gives you more confidence in your trading decisions.

Candlesticks with Volume

Volume can be used to confirm candlestick patterns. The following chart is the same XOM chart shown previously. The only difference is that now volume is added below the price chart. Volume begins to increase and crosses above the 200-day moving average during the formation of the *bearish harami* pattern. Volume increases dramatically at the breakout of the ascending triangle and slowly decreases throughout the gradual bullish correction following the downside breakout. As the price action turns down again, volume also increases. After a second brief correction, a *doji* is formed on huge volume (green arrows), and the sell-off in Exxon Mobil continued.

Conclusion

As the previous examples demonstrated, candlestick patterns can be very useful in identifying potential changes in market direction. When used in conjunction with traditional technical analysis, candlestick patterns can add confirmation to those signals. In general, the more supporting information you can add to your analysis of chart patterns the more conviction you will have in your trading decisions.

The other advantage to using candlestick pattern analysis, along with other technical analysis tools, is when they provide conflicting signals. When you get conflicting signals, it gives you the opportunity to decide if the weight of the evidence is strong enough to proceed with your trading decision or if you should skip the trade altogether and look for better opportunities.

Technical Analysis techniques work best when they are not used in isolation. The more evidence you can gather to support your analysis the more likely you are to make informed decisions – and the more likely you are to know when you are wrong and should get out of a losing position. Candlestick analysis is an excellent tool to help provide this extra evidence to your trading and investing decisions. Together, Japanese Candlesticks combined with traditional (Western) technical analysis create a mutually beneficial combination.