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THE POWER OF JAPANESE CANDLESTICK CHARTS

ADVANCED FILTERING TECHNIQUES FOR TRADING STOCKS, FUTURES AND FOREX

FRED K.H. TAM

The Power of Japanese Candlestick Charts

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The Power of Japanese Candlestick Charts

Advanced Filtering Techniques for Trading Stocks, Futures, and Forex

Revised Edition

Fred K. H. Tam

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CONTENTS

INDEX OF REVERSAL PATTERNS

Single Candlestick Patterns

Double Candlestick Patterns

(continued)

Triple Candlestick Patterns

Multiple Candlestick Patterns

INDEX OF CONTINUATION PATTERNS

PREFACE

This book is about applying the popular time-tested Japanese candlestick technique to spot market turning points. After all, making money from the markets is all about predicting correctly when the market is about to turn, and the Japanese candlestick technique does this job superbly.

I find the candlestick technique very applicable for trading actively traded financial instruments such as stock indices, foreign exchange (forex), commodities futures, and stocks. This is because most, if not all, financial instruments tend to exhibit short-term rallies only to be followed by short-term corrections regardless of their time frames. Their trading cycle ranges from 5 to 15 candles (see Figure P.1 and Figure P.2).

It is fun to be on the right side of the market, buying at or near market bottoms and selling at or near market tops. But the question is, "How do I know if today's market action constitutes a market bottom?" Conversely, after a sharp rally of a few sessions, what signals are there to tell you that your stocks have topped out and are due for a correction?

Questions like "Is this the right time to buy?" or "Is this the right time to sell?" have always been a talking point amongst traders and investors. The objective of this book is to provide an answer to these questions.

There are many techniques out there, mainly from the West, like the moving average, relative strength index, moving average convergence divergence (MACD), stochastic, momentum, Bollinger bands, Elliott waves, and so on, that can help you time your entry and exit. I strongly believe that these Western techniques should be part of a trader's arsenal.

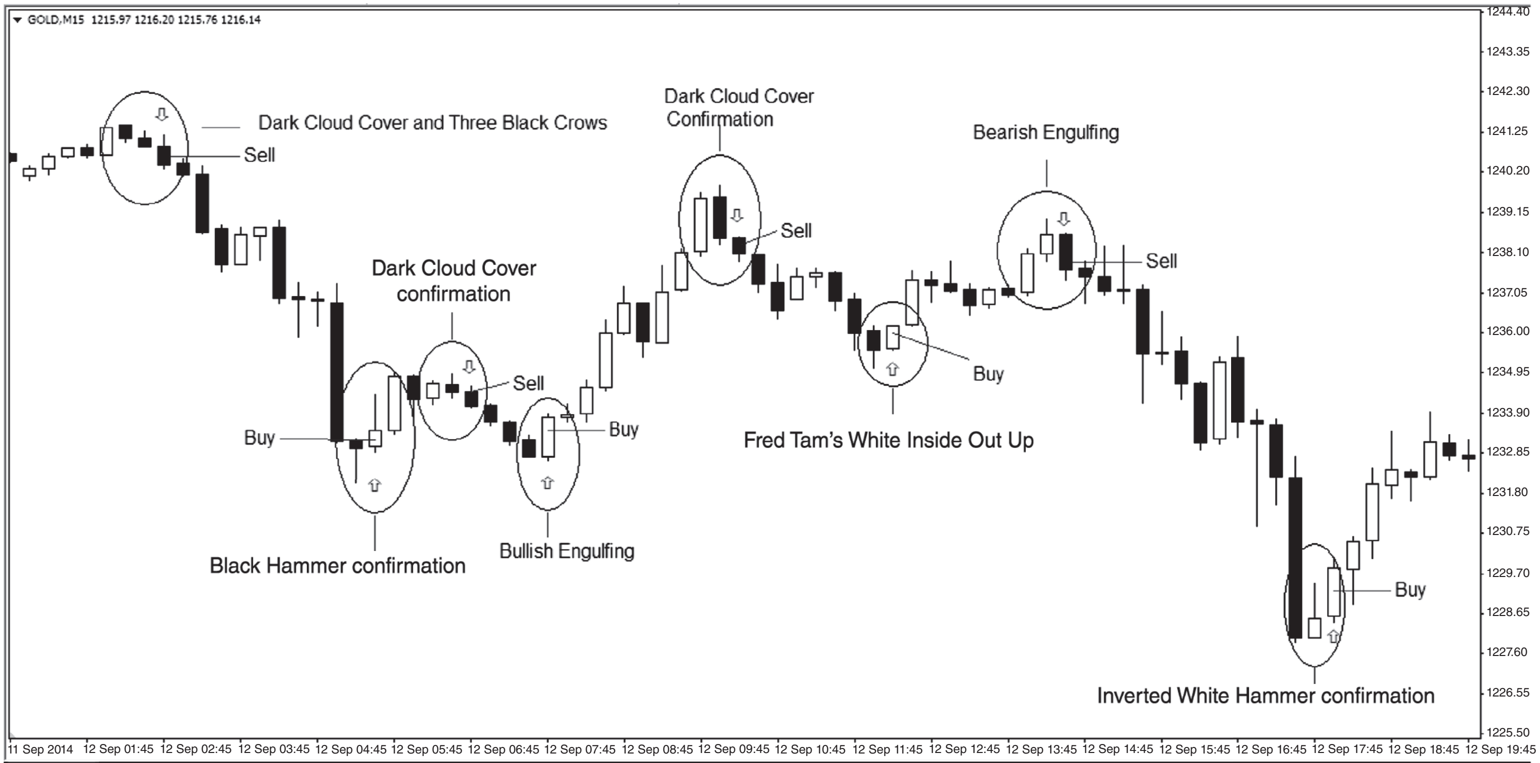

FIGURE P.1 Gold 15-Minute (2014)—Trading cycles range from 5 to 15 candles

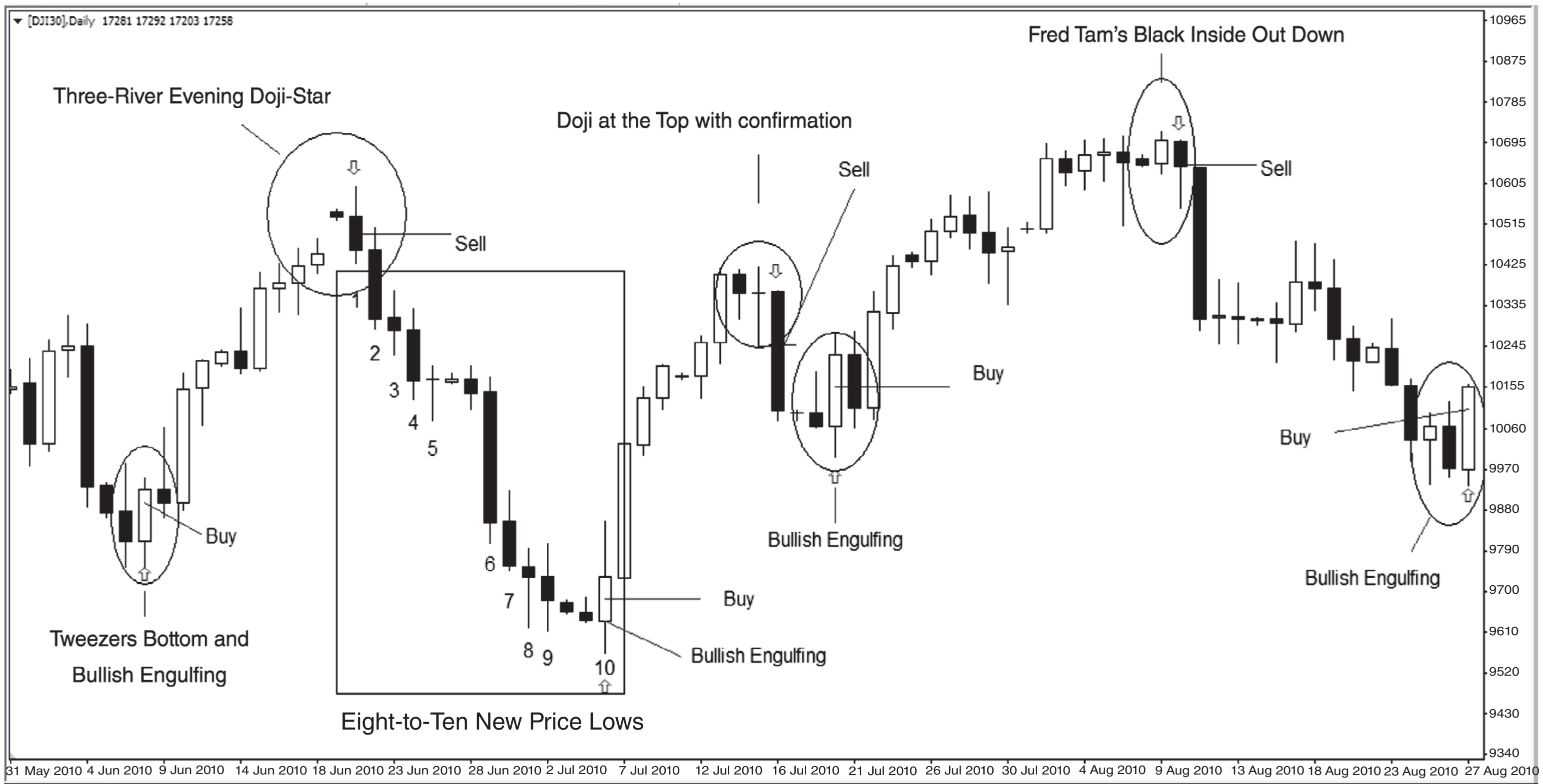

FIGURE P.2 Dow Jones Industrial Average Daily (2010)—Trading cycles range from 5 to 15 candles regardless of the periodicity of the chart

But complementing Western techniques with that of Japanese candlesticks will give you that extra edge in getting a much better price—a lower price if you are buying and a higher price if you are selling. You will be convinced from the hundreds of charts illustrated in this book that Japanese candlestick signals lead the Western technical indicators in timing market entry and exit.

The candlestick technique is the most leading of all technical indicators that I have come across. The reason why the Japanese candlestick technique triggers buy or sell signals at least 2 periods and sometimes up to 10 periods earlier than Western indicators is that candlestick signals are based on an analysis of price itself.

When you are analysing the candle chart, you are in effect analysing the psychology of the market participants that is reflected in its price. No indicators can beat a technique that analyses price in itself.

This passage taken from the Sakata Goho sums up the candlesticks' raison d'être:

> The psychology of the market participant, the supply and demand equation and the relative strength of the buyers and sellers are all reflected in the one candlestick or in a combination of candlesticks.

Western indicators, on the other hand, use formulas that take into account prices of several periods. The MACD, for example, uses a 12-day, 26-day, and 9-day exponential moving average as its parameter. Once parameters are used more than two periods, the resultant signal, when it is triggered, tends to lag behind price (see Figure P.3). This is the reason Western indicators tend to call a buy or sell between 3 and 10 periods (and sometimes more) from the market's bottom or top. The longer the parameters used, the more distant is the signal.

This book is written for the beginner as well as for the advanced trader. Part I takes you through, from the technique's historical background, to the construction of the candle chart to defining and interpreting single to multiple candles. It not only explains the psychology behind each pattern, but also offers suggestions on the proper action to take as well as a stop-loss point to exit if the signal fails.

As the candlestick technique prides itself on spotting market U-turns, I have devoted many pages in this book to describe popular reversal patterns and how to apply them to enter and exit the markets. Continuation patterns are also covered to alert the trader when a trend is only pausing momentarily but will continue with its run after a rest.

Part II of this book covers the more advanced aspects of trading with candlesticks. It emphasizes the importance of using candlesticks together with Western technical indicators to improve the accuracy of candle signals. Several popular Western technical indicators are covered in this book with examples drawn from widely traded financial instruments like forex; U.S., European, Japanese, Singapore, and Malaysian stocks; and stock indices, as well as from the futures markets to illustrate that this technique works for all markets. This technique, however, will not work if the instrument traded is controlled by a small group of players in a thinly traded environment.

The Japanese candlestick technique is a very powerful short-term trading technique if it is used on 1-minute, 5-minute, 15-minute, or 1-hour charts, as markets exhibit rallies and declines between 5 and 15 cycles on every time frame. It is therefore very suitable for use by remisiers, stockists, scalpers, day traders, and short-term position traders.

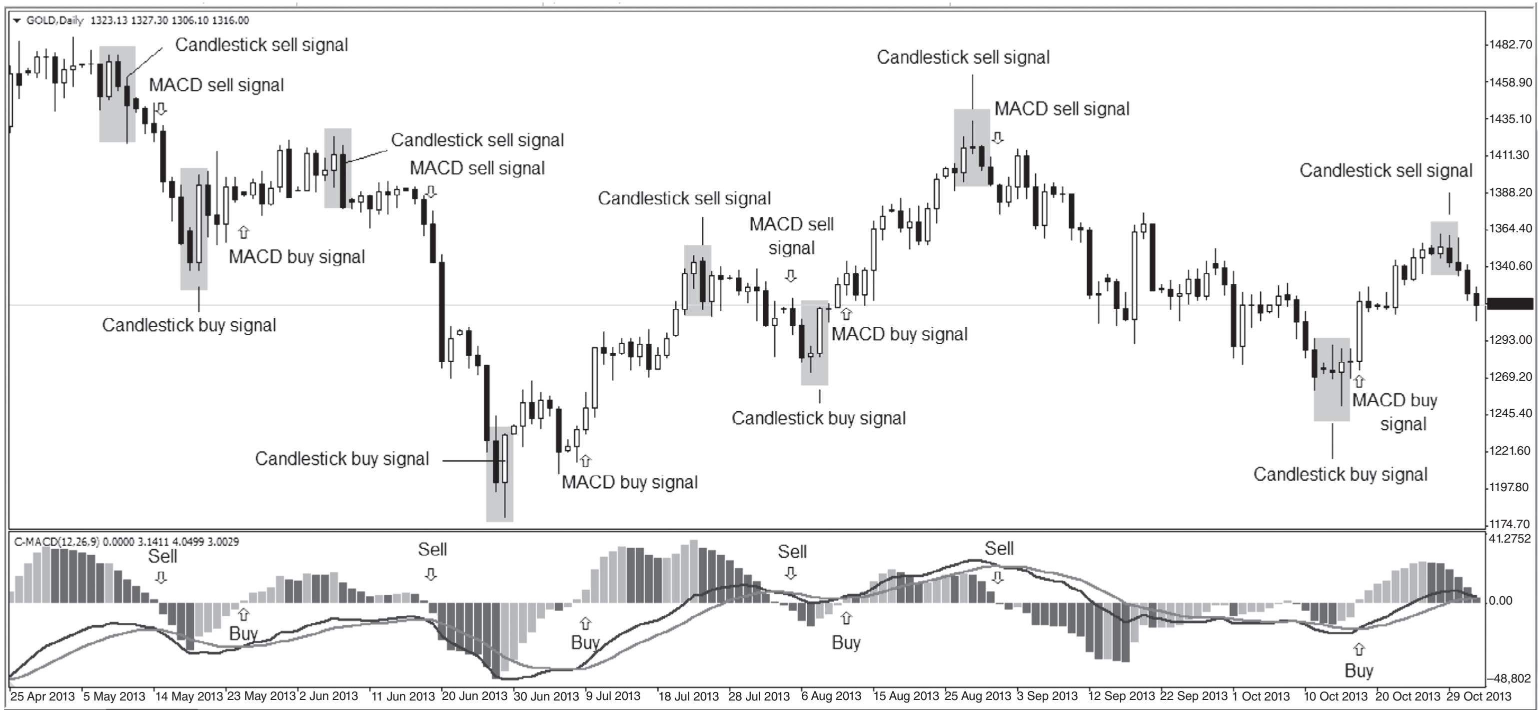

FIGURE P.3 Gold Daily (2013)—Western indicators (e.g., MACD) tend to lag behind candlesticks

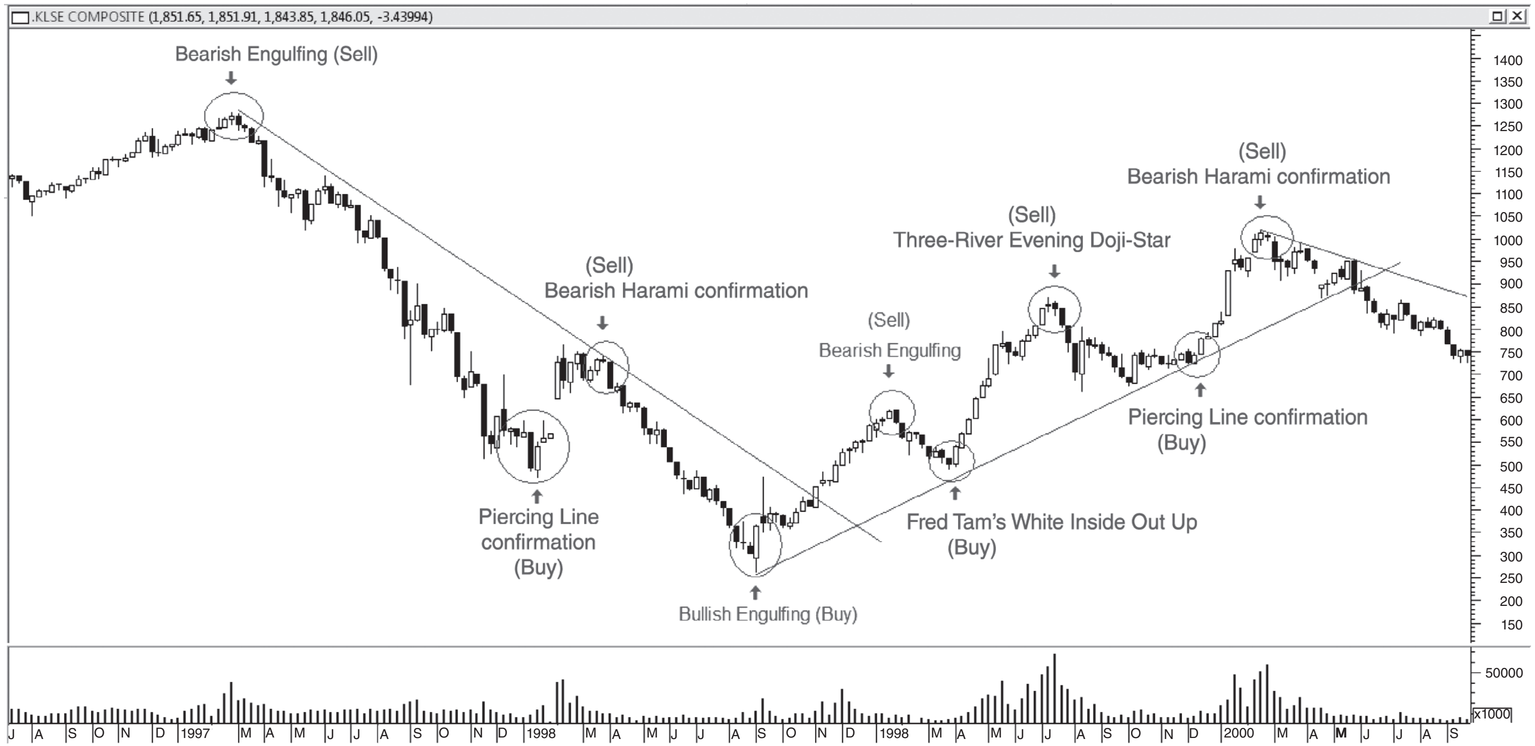

FIGURE P.4 Kuala Lumpur Composite Index Weekly (1999)—Weekly candle charts are best for long-term investors

This technique is equally useful for medium-term and long-term forecasting through the use of 4-hour, daily, weekly, and monthly candlestick charts in combination with longer-term Western technical indicators (see Figure P.4).

Herein lies the adaptability of technical analysis in that it works irrespective of the time frame used. You can apply this technique for intra-day trading through the use of a 1-minute chart, a 5-minute chart, a 15-minute chart, a 30-minute chart, or an hourly chart.

For longer-term investors like fund managers who tend to hold stocks for a period of more than a month, I have found that the weekly candle charts provide the most consistent buy and sell signals.

Winning from the market requires two ingredients. The first is that you must have a proven trading technique. The second is that you must practice sound money management. This book will provide you with the first ingredient.

Knowing when to exit the market when you are wrong is part of money management. To that extent, this book will also cover the second ingredient.

Good luck and happy trading.

ACKNOWLEDGMENTS

A book on Japanese candlesticks is not easy to write, mainly because of the lack of literature on the subject until 1991 when an American analyst by the name of Steve Nison revealed this ancient technique to the Western world through his classic book, *Japanese Candlestick Charting Techniques: A Contemporary Guide to the Ancient Investment Techniques of the Far East*.

This book was my first contact with candlesticks. Nison's second, *Beyond Candles*, is another masterpiece. After putting his research into practice, I am convinced of the candlesticks' usefulness in forecasting market U-turns as well as trend continuations and am now a faithful disciple of this age-old technique. Nison has my utmost respect for introducing candlesticks to the Western world and to me. He is, to me, the "granddaddy" of candlesticks.

I would also like to thank Gary S. Wagner and Brad L. Matheny for furthering my knowledge on candles. We met when I attended a U.S. International Trading and Markets Conference called "Futures West '94" in Los Angeles. Wagner and Matheny's book, *Trading Applications of Japanese Candlestick Charting,* taught me, besides additional candlestick techniques, the importance of computerization of candle patterns.

Though I have never had a chance to meet Greg Morris, I give him credit for his well-formatted book, *Candlepower*. He had obviously done extensive research to produce this book, including painstakingly giving each pattern a Japanese name. His interview with renowned Japanese technician Takehiro Hikita is recommended reading.

Last but not least, I want to acknowledge the guidance, support, and patience of the editors and management team at John Wiley & Sons Singapore Pte. Ltd., namely, Nick Wallwork, Chris Gage, Emilie Herman, Jeremy Chia, and Gladys Ganaden, who patiently helped me bring this book to fruition.

PART I

Basic Candlestick Techniques

Introduction

The Japanese candlestick charting technique dates back to the 1700s when bar charting and point-and-figure charting were not even discovered. Japanese traders, on the other hand, were already using this technique to trade their rice markets. Yet this technique of charting was confined strictly to Japan until the Americans discovered this technique from Japanese traders who traded the U.S. financial markets in the 1980s.

What fascinated the U.S. traders in the late 1980s was its uncanny trading accuracy in the purchase and sale of stocks, stock index and commodity futures, currency and treasury bonds on the New York and Chicago exchanges. Yet, the Americans were unaware of the techniques used by the Japanese. Strong interest emerged amongst the U.S. traders as to how the Japanese arrived at their buy and sell decisions.

They reasoned that if they were going to beat the Japanese at their game, the American traders would have to fully understand how the Japanese traders' minds worked. That entails knowing their charting technique. Understanding how

Japanese traders use their charts would help the American traders answer the question "What are the Japanese going to do next?" This accounts for the resurgence of interest in the West into this previously obscure technique of technical analysis.

More information is now available on candlestick charting after extensive research by an American analyst, Steve Nison. His two books, *Japanese Candlestick Charting Techniques* and *Beyond Candles*, offered the outside world a first glimpse into this ancient methodology of the Japanese traders.

As Nison's research into this mystically obscure charting technique became available through his two books, traders in the United States and the rest of the world began to realise its forecasting value. When combined with Western technical concepts, forecasting and trading the markets can be—in the words of Steve Nison—exciting, powerful, fun, and much more rewarding.

Even as recently as the late 1980s, real-time quote and chart services offered to investors in the United States, Europe, and the rest of the world did not feature candlestick charts—only bar charts. Yet within two years after Nison's first book, published in 1991, almost every real-time technical service and end-of-day technical analysis software package offered candlestick charts to their clients. In Malaysia, every major real-time technical chart service provider such as Thomson-Reuters, Bloomberg, Updata, Meta-Trader, and Bursa Station supports real-time candlestick charts. The inclusion candlestick charts into these companies' services underscores their popularity and usefulness.

Historical Background

After the unification of Japan under the Tokugawa Shogunate (Eighth Shogunate) from 1615 to 1867, its agrarian economy grew. By the seventeenth century, Osaka was regarded as Japan's capital and commercial centre. Osaka's easy access to the sea made it a national port for the shipping of supplies, including rice. Strategically located, Osaka soon became the centre for the rice trade, and rice brokerage became the foundation of Osaka's prosperity. The Dojima Rice Exchange became the centre of rice trade for physical delivery.

Into this background, Munehisa Homma (1716–1803) was born in the city of Sakata, Yamagata Prefecture, Japan. His real name was Kosaku Kato, but he took up the name Munehisa Homma later in his life after his adoption by the wealthy Homma family. At that time, the port of Sakata was a distribution centre for *shonai* (rice). Homma concentrated his attention on the rice market and later on the popular fixed rice market. By 1750 he was trading at his local rice exchange in Sakata. After the death of his father, he was placed in charge of managing his family's assets. With this money he went to the Dojima Rice Exchange in Osaka and began to trade rice futures.

His detailed attention to the markets and his understanding of candlesticks propelled him to become a very wealthy man. He was considered an elusive and feared trader because of his effective understanding of candlesticks and the psychology of the rice markets. He would keep records of yearly weather conditions. To analyse the psychology of investors, Homma analysed rice prices going back to the time when the rice exchange started. Using his own network of communication links he made a killing in the Osaka Rice Exchange and later in the Edo (now Tokyo) exchange.

It was believed that Homma even achieved the feat of 100 consecutive winning trades. Munehisa Homma was perhaps the first person in recorded Japanese history to have used past prices to predict futures price movements—and he did it successfully.

His charismatic personality and highly effective trading methods gained him the nickname "Dewa's long-nosed goblin" and an honour as the "god of the markets." He was such a legend that a folk song from Edo was composed to honour his feats. "When it is sunny in Sakata [Homma's hometown], it is cloudy in Dojima [the Dojima Rice Exchange in Osaka] and rainy in Kuramae [the Kuramae Exchange in Edo]." Interpreted, it means: When there is a good rice harvest in Sakata, rice prices fall on the Dojima Rice Exchange and collapse in Edo. This song underscores Homma's control over the rice markets during his time.

In later years, Homma became the financial consultant to the Japanese government and was given the title of "Samurai." He died in 1803, but his books about the markets (*Sakata Senho* and *Soba Sani No Den*), which revealed his trading principles, evolved into the candlestick charting technique that we know today.

Reasons Candlestick Charts Are So Popular Today

Here are six reasons that candlestick charts are so popular amongst professional traders today:

1. **Leading indicator:** Candlestick charts have the ability to show reversal signals earlier than Western charting techniques. As such, candlestick charts are a true leading indicator of market action. They regularly identify potential moves before they become apparent with Western technical tools. Many Japanese candlestick patterns are not found in Western chart techniques. Figure 1.1 shows an example of how candlesticks lead moving average convergence divergence (MACD) in timing entry and exit.
2. **Pictorial:** Candlestick charts are very pictorial and describe the state of players' psychology at a particular moment, which can be utilised to make meaningful trading decisions. Terminology like the "hangman," "shooting star," "dark cloud cover," "hammer," and "abandoned baby" paints indelible word pictures that can assist the trader to remember the pattern through recalling its name. The candlestick technique consists of hundreds of different pattern groups that accurately identify specific traits and tendencies.
3. **Versatile:** Candlestick charts are versatile in that they can be used alone or in combination with Western technical tools. They are unlike point-and-figure charts, which cannot be used alongside other Western technical indicators. Candlesticks use the same price data as bar charts, yet the candlestick technique better promotes the ability to recognise complex pattern groups and predict the next possible outcome based on them.
4. **Can be applied to any time dimension:** Candlestick charting techniques can be adapted for either short- or long-term trading. Candlestick charts are excellent for short-term

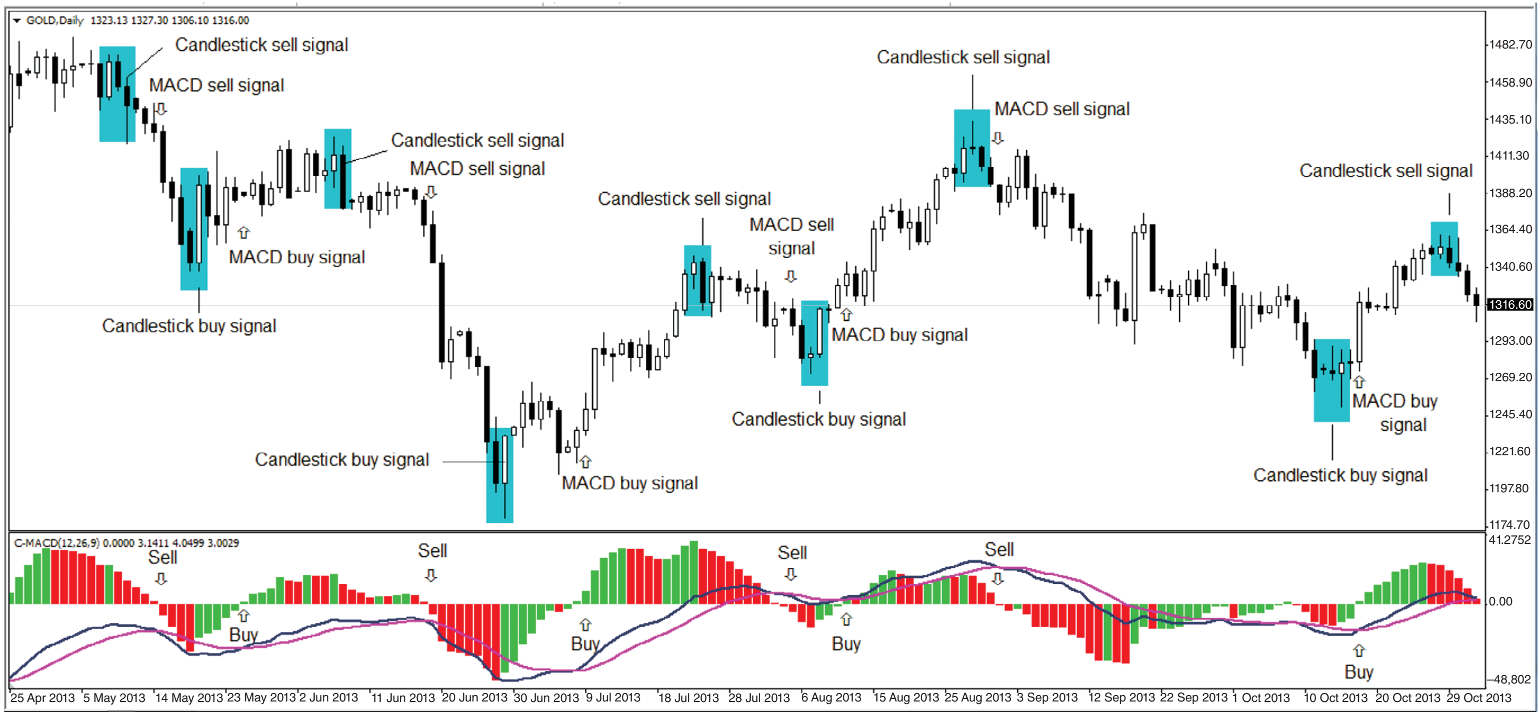

FIGURE 1.1 Gold Daily (2013)—An example of how candlesticks lead MACD in timing entry and exit