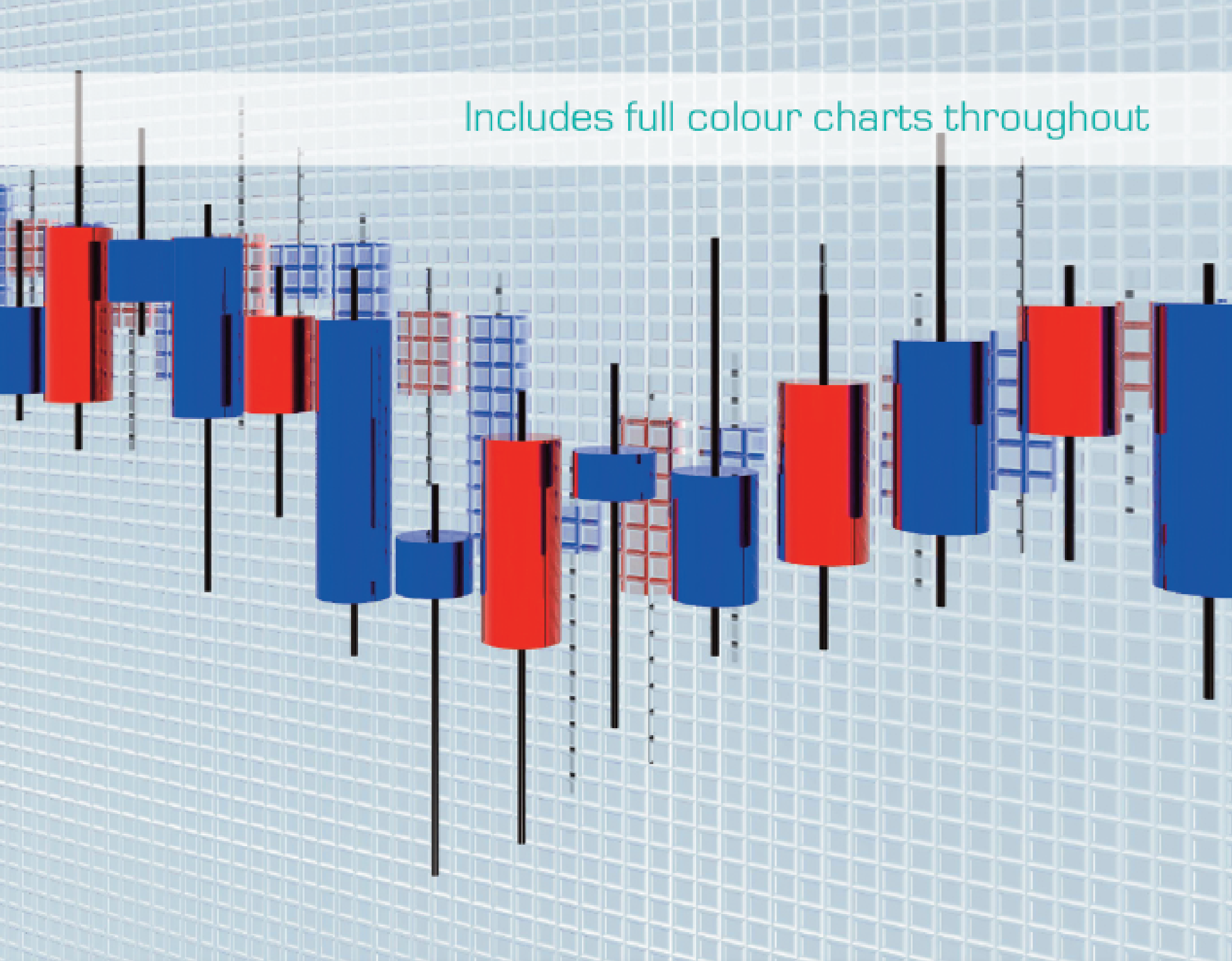
Includes full colour charts throughout



CANDLESTICK CHARTS

An introduction to using candlestick charts

Clive Lambert

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Preface

Who this book is for

In this book I aim to introduce candlestick analysis to anyone from an absolute beginner to an experienced market professional who has a working knowledge of charting. The language should be simple enough for a novice, but shouldn't exclude those with more experience, as my aim is to change your viewing of a candlestick chart into a search for the answer to the perennial question "Who's controlling the market: the bulls or the bears?" Ideally, you will have some knowledge of the markets, and even more ideally you will be a cynic about technical analysis, and this book will convert you!

What the book covers

After a brief introduction I will spend a good deal of time looking at three very different basic shapes of candlestick to get a firm grip on the principles involved.

Then I will take a more broad-brush approach to cover several other patterns that can signify reversals or continuations of trend, focusing particularly on the powerful reversal patterns.

In later chapters I will expand on several aspects of candlestick analysis and their uses in practical trading situations. Candlesticks can be used over different time frames and we will look at their application whether you are a short-term trader or a long-term money manager. I will end by explaining how candles can be used for entering and exiting trades when used in conjunction with support and resistance levels as well as with other basic forms of technical analysis such as momentum indicators.

The book does not go into the more esoteric forms of candlestick charting – there are a wide variety of advanced candlestick patterns that can take years to learn – nor does it cover hybrid methods such as Ichimoku charting, which is a subject in itself. However, close study of this book should enable anyone to use candlesticks in their analysis of the markets, and improve their trading and decision-making.

Foreword

The human mind is not as good at processing large amounts of information as we might like. Psychologists have shown that human beings are only able to juggle small numbers of related and often conflicting pieces of information without making judgement errors. As a result, individuals faced with the vast amounts of information available to support investment decisions often find themselves swamped by the enormity of the task; unable to see the wood from the trees.

Technical analysis is a field of financial markets research that works to address the above problem by focusing on a single, universally available, data source that reflects all known information and activity relating to all financial securities. Price history.

Technical analysts argue that as markets are efficient, prices reflect all known information and that they move over time as participants react to new information and changing needs. As a result, the technical analysis of these price changes can provide real insight into the market dynamics and be used to develop trading strategies that exhibit superior risk/reward characteristics.

Technical analysts use price history to show them what market participants are doing with their money. By tracking prices they can develop an understanding of the market's own psychology and identify patterns of behaviour that are frequently repeated. Technical analysis is used to create trading strategies that are both objective and efficient. Entry and exit prices can be identified in advance and subsequent price data can be employed as an instantaneous feedback mechanism for trade management and strategy refinement. In this way, technical analysis greatly assists in distilling the vast amounts of conflicting and complex information available to develop winning investment strategies.

While technical analysis approaches have developed significantly over the past few decades, some techniques are far more ancient. While their real origins are unknown, Japanese candlestick charts have been recorded as being employed in the rice markets as far back as the 1600s. What is particularly interesting is that many of these ancient approaches continue to provide highly effective trading signals when applied to modern markets and securities. For this reason, it's no surprise perhaps that candlestick charting techniques are so extensively employed by the world's most professional investors.

Clive Lambert is one of the UK's leading experts in the use and application of Japanese candlestick chart analysis. I have known him for many years and have learnt to greatly respect his depth of knowledge and the objectiveness it brings to his market strategies.

In this book, Clive has combined his love of the subject with his experience as a professional trader, to demystify candlestick charting and make it accessible and effective for the reader. His writing style is conversational and his explanations clear and practical. As a result, the book is a refreshing departure from the dry and complex writing often associated with financial markets. With insight and clarity, the book unravels the psychology behind price patterns and provides a powerful collection of simple and effective methods to trade for profit and control risk.

For all the above reasons, I am happy to recommend this book and proud to have been asked to write this foreword. Investing in financial markets is notoriously hazardous and no technique, however clever, is infallible. However, candlestick charts provide a powerful set of analytical tools designed to maximise profits and minimise losses in the business of financial markets trading. These tools are invaluable for all those seeking to make their fortune in the markets and this book is an excellent way to learn about many of them.

Adam Sorab
Chairman – Society of Technical Analysts (STA) 1998-2008
Director – International Federation of Technical Analysis Societies (IFTA)

Introduction

My personal journey with technical analysis and candles

Stock Exchange Floor to LIFFE Floor (via Sydney)

My first experience of technical analysis was at my very first job in the City, fresh out of school, listening to Robin Griffiths on the fifth floor of the offices of the stockbrokers James Capel as a wide-eyed 16-year-old kid. I remember thinking that he seemed to make a lot more sense than many of the "fundamentalists" who took the microphone. His longevity and continued high standing in the industry is proof of the pudding.

My next experience came four years later, on my first day in the 90-Day Bank Bills booth for the brokers Tullett and Tokyo on the Sydney Futures Exchange. I was given the point & figure chart to keep up to date: a collection of pieces of graph paper, taped together, which in its unfolded state stretched across several metres. Many a fellow (older!) technician that I come across these days had a similar first experience. Ah, those were the days!

Soon after that I had the privilege of working on the LIFFE Floor for a total of ten years, both at the Royal Exchange (now the site of a few rather swanky shops and restaurants) and at Cannon Bridge (where LIFFE still reside, despite the coloured jackets having long been hung up for the last time, or framed as a memento in the case of a few, mine included). I say it was a privilege because it's truly something to tell the grandchildren, even though we didn't know it at the time. It was just such great fun. It was 100% "work hard, play hard". When there was work to be done, orders to be filled, clients to please, we knuckled down and did a great job. I was there for several major events: Black Wednesday, LTCM, and the fall of Barings, the last of which was very close to home for some floor operatives.

But there was something else that working on the LIFFE Floor did for me personally, something that I didn't even realise at the time would stand me in such good stead for my future career as a technical analyst: it got me into watching price action unfold live.

After leaving LIFFE and starting work in an office, which is when I first started looking at candlestick charts, I realised that I was doing exactly the same thing with technical charts as I used to do on the floor: watching the price action, and making assumptions on the back of what I was seeing. It was an almost seamless transition. I remember my boss mocking me the first time I asked if I could send out some support and resistance levels on the Bloomberg to the client base: 'Ah, so you think you're a technical analyst, do you? Ha ha ha!' Within six months he was dragging me round hedge fund companies getting me to show them the latest Bund chart – how quickly it changed! This was obviously a huge result for me personally, as only months before my attempts to talk about the technicals were merely based on trying to keep my job. My previous floor broking skills – hand signals and shouting loudly – were largely redundant.

I lasted a year or so in the office. Working in a sterile office with just a handful of people was a bit of a culture shock after the Floor. I was also rather tired of the negative tag that was attached to ex-Floor operatives at that time. So my family and I decided to up sticks, move to Australia, and at the same time I set up my own company to sell my technical analysis commentary.

The Australian dream lasted just 16 months before the Lamberts packed up and came back home to England. The company is still going though, and I'm still, eight years on, happily jumping out of bed at the crack of dawn to write about the markets, based mainly on observations from the candlestick charts.

Before I stop talking about myself I'd like to thank my wife Rachael for all her support over the years, and particularly in the months that I spent writing this book. She has been a solid rock and a true friend.

Thank you my love.

Financials to commodities

In recent years my team have been asked to diversify our product base – to look at commodities, metals, equities, and all sorts of other weird and wonderful things. When starting to look at a new market we've done the same thing each and every time. We use the same templates that we've used previously, most of which use a basic canvas of candlestick charts over a range of different time frames. We've always said that if after a few weeks or months this methodology clearly isn't working, we'll have a rethink. So far we've never had to have a rethink, and now have many readers for our daily ramblings across many different markets, all using the markets for different reasons, and all finding a use for our analysis of the candlestick charts.

The Society of Technical Analysts

At the same time as building up the business I have also become heavily involved in the UK Society of Technical Analysts, and I joined the Board of the Society in 2003. I have found this to be an invaluable experience and I feel both privileged and fortunate to have become friends with some of this country's leading analysts. I would like to take this opportunity to thank these people for taking me seriously and giving me the confidence to grow as an analyst to the point where my thoughts are now being put down in print. I would particularly like to thank Adam Sorab, Chairman of the Society from 1998 to 2008, for his enthusiastic support of my work, and for writing the foreword to this book.

1

What Are Candlesticks?

A potted history

Candlesticks have been around a lot longer than anything similar in the Western world. The Japanese were looking at charts as far back as the 17th century, whereas the earliest known charts in the US appeared in the late 19th century. Rice trading had been established in Japan in 1654, with gold, silver and rape seed oil following soon after. Rice markets dominated Japan at this time and the commodity became, it seems, more important than hard currency.

Munehisa Homma (aka Sokyu Honma), a Japanese rice trader born in the early 1700s, is widely credited as being one of the early exponents of tracking price action. He understood basic supply and demand dynamics, but also identified the fact that emotion played a part in the setting of price. He wanted to track the emotion of the market players, and this work became the basis of candlestick analysis. He was extremely well respected, to the point of being promoted to Samurai status.

The Japanese did an extremely good job of keeping candlesticks quiet from the Western world, right up until the 1980s, when suddenly there was a large cross-pollination of banks and financial institutions around the world. This is when Westerners suddenly got wind of these mystical charts. Obviously this was also about the time that charting in general suddenly became a lot easier, due to the widespread use of the PC.

In the late 1980s several Western analysts became interested in candlesticks. In the UK Michael Feeny, who was then head of TA in London for Sumitomo, began using candlesticks in his daily work, and started introducing the ideas to London professionals. In the December 1989 edition of *Futures* magazine Steve Nison, who was a technical analyst at Merrill Lynch in New York, produced a paper that showed a series of candlestick reversal patterns and explained their predictive powers. He went on to write a book on the subject, and a fine book it is too. Thank you Messrs Feeny and Nison.

Since then candlesticks have gained in popularity by the year, and these days they seem to be the standard template that most analysts work from.

I'm going to leave the history lesson there, because unlike other esteemed experts on Japanese charting methods I've never had the privilege of either sitting down with a Japanese expert, nor even going to Japan. So this book, if you like, can be classed as a Westerner's take on an ancient Japanese method.

Because of this I've deliberately avoided spending too much time referring to the Japanese phraseology or the translations.

Construction of candlestick charts

Candlesticks versus traditional bar charts

Until the late 1980s the Western world used bar charts as the standard method for charting the markets. A bar chart displays price on the vertical axis and time along the horizontal axis; each bar represents a set time period (eg, a day or a week or a month). For the moment we'll stick to daily charts. The four pieces of data used in a bar chart are: the day's open, high, low and close. Figure 1-1 shows how these four levels are displayed.

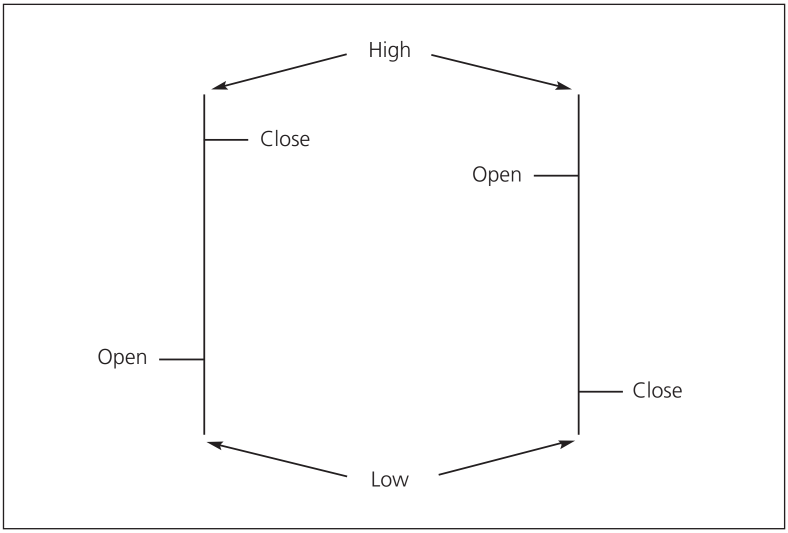


Figure 1-1: Bar chart construction

Candlestick charts use the same price levels as bar charts (ie, open, high, low, close), but they display the data in a different way – as can be seen in the following figure.

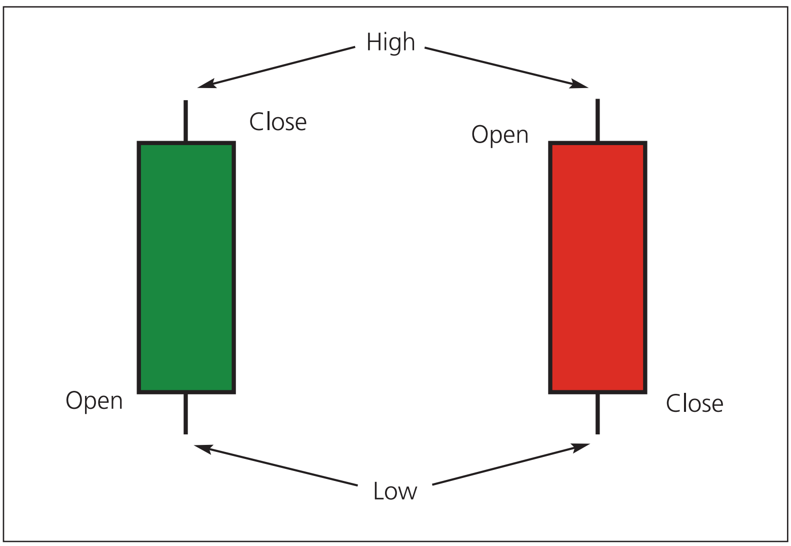
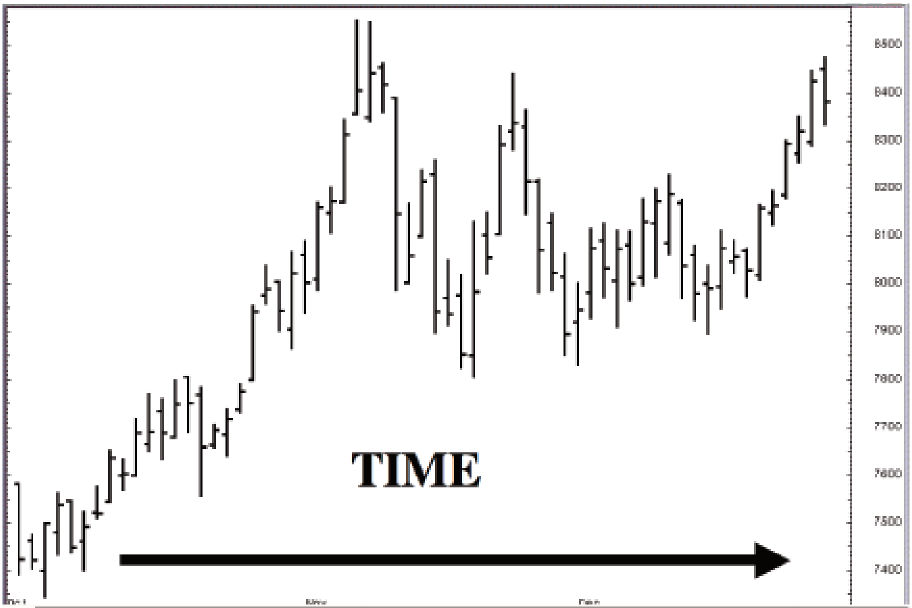


Figure 1-2: Candlestick chart construction

By comparing the bar charts and candlesticks you can see that the principles are similar – they both present in a graphical format the essential price data (open, high, low, close) for a given period.

Let's look at an actual example.

The figure below shows a standard bar chart, while the following figure is the same chart but this time using candlesticks instead of bars.



Source: CQG, Inc. © 2008 All rights reserved worldwide.

Figure 1-3: Bar chart (factual, but uninspiring)

Source: CQG, Inc. © 2008 All rights reserved worldwide.

Figure 1-4: Candlestick chart (factual, and emotive)

By comparing the preceding two charts, you can see that the shape of the charts is the same. (The two charts actually show the price behaviour of gold at the end of 2007 – but it is not important to know that at this stage.)

Although the overall shape of the charts is the same, the candlestick chart is easier to read because the candles do a much better job of clearly distinguishing the exact relationship between the four prices for each period. For example, it is easy to see whether a period was bullish or bearish (by the colour).

Summary

The information carried in bar and candlestick charts is the same, but the design of the latter makes it easier to spot patterns that can be significant to a trader or analyst.

The anatomy of the candles

Let's have a closer look at the colour scheme used in the candlestick charts. A closer inspection of Figure 1-4 shows that the candlesticks are different colours depending on whether the market closed above or below the open. The fat bit in the middle is the difference between the open and the close, and is called the real body of the candlestick.

A candlestick with a green real body is created on a day when the market closed higher than where it opened. In other words price moved higher over the course of the day. This means, if you use the basic principles of supply and demand, there were more buyers than sellers. To put it into the market parlance that I will use from now on, the bulls won the day.

A candlestick with a red real body is the result of a day where the market closed below the level at which it opened. This means the sellers outweighed the buyers, or there was more supply than demand, resulting in price moving lower. In market terms it was a bearish day.

So we now know that the difference between the open and the close is called the real body, and that its colour depends on whether it was a bullish or bearish day, from open to close.

I would stress at this point that the colour of a candlestick is nothing to do with where a market closes in relation to the previous day's close. This is a common mistake that many people make because on quote boards prices are often displayed either as red or green depending on whether the market is higher or lower compared to the previous close.

If, for example, a stock closed at £1.00 yesterday, then opened today at £1.10, but by afternoon trade had sold off to close at £1.03, it would still be up 3 pence on the day. However, the candlestick's real body would be big and red because the stock opened at £1.10 then closed at £1.03.

I have illustrated this in Figure 1-5 below.

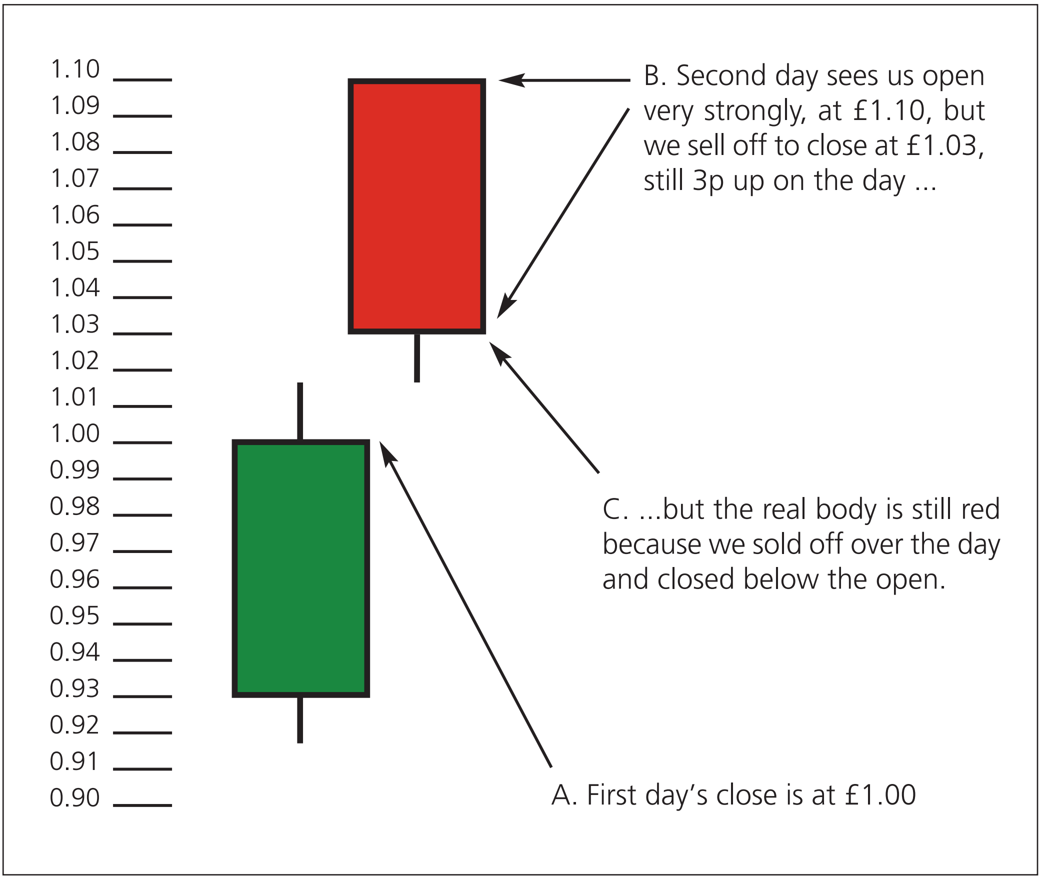


Figure 1-5: Example of a higher close than the previous day's, but still a red candle

Let's finish off this walk through the construction by adding some terminology into the equation.

The figure below shows the other terminology you need to be aware of with respect to the different elements of an individual candlestick.

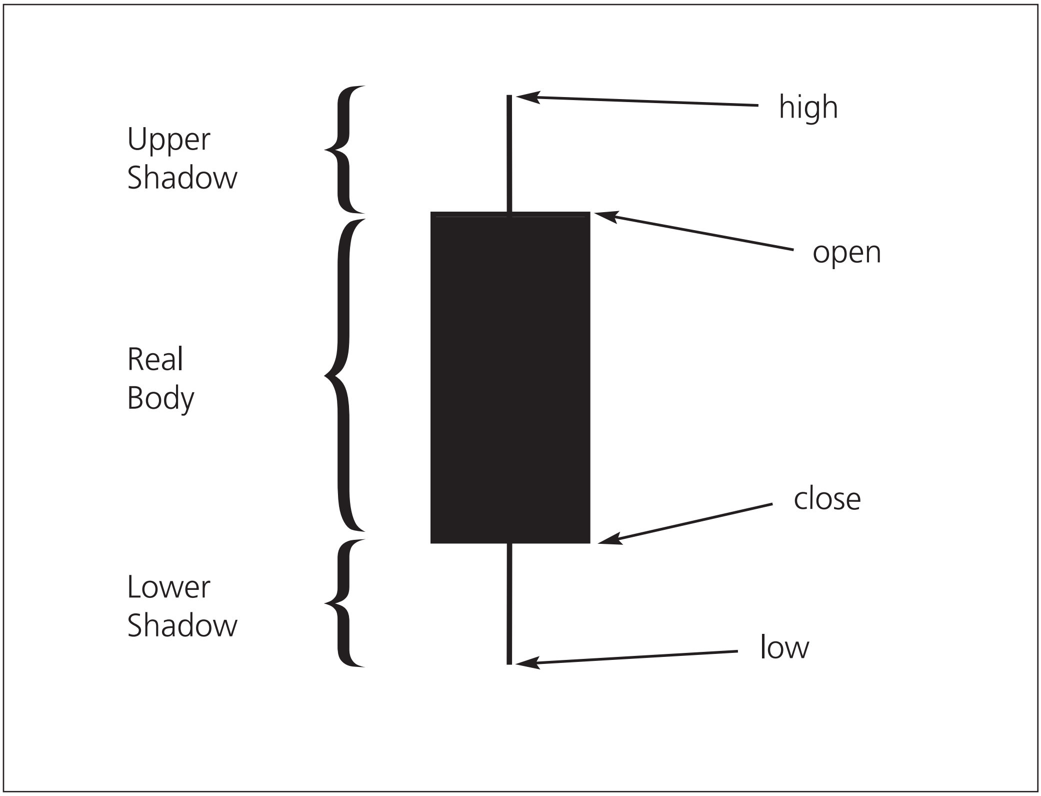


Figure 1-6: Terminology

The difference between the top of the real body and the high of the day is the upper shadow (sometimes called the upper wick).

The difference between the bottom of the real body and the low of the day is the lower shadow (or lower wick).

Another way to think about it is that there's a line all the way down the middle of a candlestick representing the day's range. The Japanese call this the *kage* or the shadow line.

It is important to be happy with these terms as I will continually use them throughout the rest of the book.

The charts I will use throughout this book, for the sake of continuity, are all taken from a charting system called CQG. Their favoured colour scheme, and the one I've grown used to using in my daily routine, is green (for bullish) and red (for bearish) candles, as illustrated so far in this book.

Different charting systems have different default settings, although with most half decent systems you can change the candles to whatever suits you. Just make sure you know which way round they are!

In fact – and confusingly – the Japanese traditionally used red candles for up days and black candles for down days, red being a lucky colour in Japan.

A general rule of thumb that will usually see you right is that solid blocks are down days, whereas real bodies that are light of colour are bullish candles.

This may also help you in case you come across candlestick charts in black and white only.

Again there is a custom that is generally accepted in candlestick analysis, and I will use this for the rest of the book, just to try and keep things standardised:

Open < Close = bullish = light in colour = open real body

Open > Close = bearish = dark in colour = filled real body

The psychology of charts and trading

The idea of a chart in the first place is to illustrate where the price of a security has been. Supply and demand sets the price of something, and the chart is a graphical representation of the historical changes in supply and demand, ie, the historical changes in overall thinking towards the product being viewed, as set by buyers and sellers.

Technical analysis concerns itself with looking for trends in price, and also looking for signs that these trends are ending or reversing. This is something that candlesticks can do much more quickly and much more clearly than most other technical methods.

There are advantages and disadvantages with all types of market analysis, and within technical analysis there are methods that react slowly to changes and therefore don't suit certain types of trader or analyst, whereas there are other methods that give many more signals but tend not to be so robust. Some prefer this. Candlesticks are often put into the latter category.

Later on I will explore how you can add other things to your candlestick analysis to come up with more robust trading ideas.

Overall, the answer is to combine a few things with your candlestick charts so that you come up with a trading strategy that suits your needs and your personality. Some may even decide that they don't need to use candlesticks for a specific strategy, but instead just to give a snapshot view of the market minute-by-minute, day by day, or week by week.

> For now the key thing to understand is that candlesticks are a graphical representation of price movement, and therefore show the market's thinking and sentiment, and any changes in this thinking and sentiment that may be unfolding.

So, technical analysis shows what the market thinks of a stock or security. Obviously the market is the collective mass of people who are trading or investing in any particular instrument. Therefore the price is the definitive proxy of what the market – every type of trader involved, all bundled together into one mass – thinks about that instrument.

> It is people that set price, and people who form the chart. In other words technical analysis is quite simply a study of human behaviour – or psychology to you and me.

And this is what I do with candlesticks: I dig into the psychology of each of the patterns that make up candlestick analysis. There are many different patterns, all with different shapes. In the coming chapters we're going to go through the different patterns, work out what movement in price formed these shapes, and then translate that into the psychology of the market at each step of the formation of the pattern. What was the market thinking that resulted in these particular patterns? And why does this often translate into a reversal or continuation of the trend?

An easy way to think about the market is as if it's a battle between the buyers and the sellers. Just split it into two distinct groups of traders: the bulls and the bears. Obviously this is quite a generalisation, but it can be a very effective way of analysing market movements – maybe because it personalises it.

This is the crux of the whole book, in my opinion. I have tried to help you understand the construction of the different patterns that appear in candlestick charts in order that you can deduce what is happening in the market for yourself. While reading this book, hopefully you will have "a light-bulb moment" and realise what candlesticks can do for you, no matter what you're trying to gain from your charts. I am hoping you will see how candlesticks can help you to answer some of the rather confusing questions I have already posed about market psychology and the minute-by-minute changes in sentiment. Market psychology underpins candlestick analysis, and I have thrown it in at this early stage to get you thinking in this way!

Chapter summary

- You should now be comfortable with the construction of candlesticks, know the names of the component parts, and understand the difference between open and filled real bodies.
- A candlestick with an open (green) real body is the result of a day where the market closes above its opening price, and the open real body is the difference between the open and close.
- A filled (red) real body on a daily candlestick means the market closed below the opening price, and the filled real body is the difference between these two values.
- The line down the middle of any candlestick pattern defines the day's range – the high to low.
- Candlesticks are designed to give you a graphical representation of the market psychology at any given moment.

Candlestick Charts

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