



Harriman Trading

# Ichimoku Charts

An introduction to  
Ichimoku Kinko Clouds

Nicole Elliott

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An Introduction to  
Ichimoku Kinko Clouds

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without Yuichiro Harada's help I would not have got this far



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# Preface

## Who this book is for

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The book has been written for existing users of candlestick charts who want to extend their knowledge and techniques to include Ichimoku Cloud charts. As such, some knowledge of technical analysis is assumed, especially a knowledge of candlesticks (although a brief primer on candlesticks is also included in the book's appendix).

## What this book covers

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The book covers the history of candlestick charts - explaining the context in which they developed. It then moves on to explain how in the 1940s and 1950s a journalist, with the pseudonym Ichimoku Sanjin, started refining candlestick analysis by adding a series of moving averages. The book explains in detail how to construct Cloud charts and how to interpret them. A chapter is devoted to the advanced analysis of Cloud charts, with an in-depth study of the Three Principles: Wave Principle, Price Target and Timespan Principle. The book is illustrated throughout with numerous examples of Cloud chart analysis.

## How the book is structured

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The book comprises six main chapters:

### **1. History**

A brief history of candlesticks and the development of Ichimoku Kinko Hyo.

### **2. Constructing the Cloud Charts**

First, a quick introduction to candlestick charts - the foundation of Ichimoku - and then a detailed explanation of how Ichimoku charts are constructed.

### **3. Interpretation of the Clouds**

How to interpret the Cloud charts, including: identifying support and resistance levels; the significance of cloud thickness and the distance between price and cloud; and how to finesse trading positions.

### **4. The Three Principles**

A discussion of the three principles of Ichimoku charts: the Wave Principle, Price Targets and the Timespan Principle.

## **5. Case Studies**

Several case studies are included that work through in detail the interpretation of Ichimoku chart examples.

## **6. Option Trading with Clouds**

How the unique combination of timing and price levels that is possible with Ichimoku analysis is particularly relevant for option trading strategies.

## Supporting web site

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The web site supporting this book can be found at [www.harriman-house.com/ichimoku](http://www.harriman-house.com/ichimoku).

# Introduction

A long time ago, and more years than I would care to admit to, I started my first City job as a junior dealer at the then small Bank of Scotland. Working in the money market section, with what at that time were cutting edge interest rate futures, my two bosses (there were only three of us) said:

“You will be our expert on charts. All the futures dealers in Chicago use these, so off you go and learn.”

And so I did. Later, armed with a pencil, graph paper, a couple of brief lessons under my belt and bare-faced cheek, I wormed my way in to the offices of the few jobbers and brokers who knew about Technical Analysis.

I immediately knew I had found my niche, and still today I often think my job is such fun. Everyday I have a jigsaw puzzle where I have all of the pieces, but there is no image to fit them to. You have to work the big picture out by yourself. It is also a little like dancing. Sometimes it is pure hard slog: tiring, tedious, repetitive, constant discipline, and my partner has two left feet. Then the other times (which more than make up for everything else) it's truly fantastic, intuitive, creative, and I have Fred Astaire to lead me round the dance floor.

Over the years the pencil and paper were replaced with computer programs. Then one day I noticed a new technical study had been added to the vast array I already had to choose from. Called *Ichimoku Kinko Hyo*, I had never heard of it, despite having practised as a full-time Technical Analyst for almost twenty years. My initial reaction was one of shock-horror, when I looked at a chart and saw something that looked like a writhing mass of knotted, multi-coloured noodles.

I left the noodles alone for a while; but then ten years ago I went to work for a Japanese bank, and recognised the charts many of my Japanese colleagues were using: Spaghetti Junction! Curiosity got the better of me and - at the risk of losing my street cred as sole full-time chartist in a very macho dealing room - I asked them what these were.

“Oh, cloud charts,” they said. “We all use them.”

They did, and still do. And now I do too.

When the markets were quiet, I asked our very busy dollar/yen dealer, Harada-san, if he could explain them to me. Slowly (as he was very busy), and despite some language problems, I began to understand. Setting them up on my files, I started to use them every day. Questions arose as I went along, which then allowed me to progress to the next level with his explanations.

I now realise how much I owe Harada-san, because all the books on the subject are in Japanese and, quite frankly, I am too old to start learning a language in order to learn a new charting method.

This book distils what I've learnt about Ichimoku Kinko Hyo over the last few years of working in a Japanese dealing room. I like the method and now use it every day - because it works. I hope you too find the clouds fascinating and profitable.

# 1

History





In this short chapter I thought it would be interesting to briefly describe the political and economic background that prevailed at the time that candlesticks were first thought of, and how Ichimoku Cloud charts evolved from these. The chapter ends with a calligraphic diversion that analyses the Chinese characters for Ichimoku Kinko Hyo.

## Edo, candlesticks and Ichimoku Kinko Hyo

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### Political and economic background

The use of charting increased as Japan emerged from a feudal period of constant war, where the emperor in Kyoto and his military deputy, the shogun, had lost all control (1500 to 1600). A process of unification began, known as the Edo period, which lasted from 1600 until the Meiji Restoration in 1868. During this time, Japan was cut off from the outside world and developed a highly individual society and set of values. Missionaries were expelled in 1587, and in 1633 a decree was passed prohibiting Japanese from trading with foreigners or living abroad. These measures reinforced the power of central government. Many see this as a time when every aspect of life was uniquely Japanese.

One of the generals responsible for restoring order in Japan at the beginning of the Edo period was Tokugawa Ieyasu. He took the title of shogun in 1603 and his family went on to rule until 1868. He governed from Edo (now called Tokyo) and his government, known as the *bakufu*, administered his lands. The bakufu oversaw the samurai officials, who in turn were responsible for collecting taxes and maintaining order. He realised that the key to holding on to power was separating out roles and legitimising landholdings in order to assess crop yields.

The nobility were isolated from politics in Kyoto and had little contact with the outside world, devoting themselves to scholarship, classical culture and religion. Far-flung provinces were allowed to keep their feudal lords, the *daimyo*. To keep a close eye on the daimyo they were expected to spend half the year in Edo, at their own considerable expense - swelling the population of the city to one million by 1700 and making it one of the largest cities in the world.

After careful surveys all land was recorded and assessed for crop yields. This was the basis of taxation and was measured as to how many *koku* of rice it would yield (one koku being about five bushels). Peasants paid 40% to the governing bodies, usually in rice but later also in cash. Their weapons had been confiscated in 1588, so their role was completely different from that of the samurais. Land under cultivation doubled in this period and yields increased significantly with better tools and the pooling of resources. Clustering around castles,

craftsmen and merchants supplied the goods and services needed by peasants, warriors and government officials. Known as *chonin*, meaning townspeople, they formed the basis of an increasingly important class and were what we would call merchants.

The bakufu supervised land routes, primarily for military purposes, but these were not especially suitable for transporting goods. Sea routes and rivers were successfully adopted as an alternative, the route between the northeast and Osaka being especially busy as it linked the major cities. Increased stability also meant that local markets declined in importance as centralized government gained control. Trade between regions grew steadily with Osaka dominating finance and commerce. It had large warehouses in which raw materials were stored, which in turn allowed for the stabilization of the prices of goods.

The Dojima Rice Exchange, set up in the late 1600s, was the first of its kind and by 1710 was trading in warehouse receipts as well as the physical commodity. Rice coupons, a precursor to futures contracts, could be re-sold and when the coinage became debased were the most accepted and useful medium of exchange.

At about this time the merchants became especially powerful because the samurai and lords were deeply indebted to them. Luxurious city living and long periods away from home had taken their toll. By 1800, merchants were able to marry into the feudal and political classes (which previously had been prohibited), resulting in them wielding greater political power.

In this climate of change, villages in the country began to suffer from peasant revolts, because of the deteriorating economic situation and as a protest against the class divide. Inflation was a persistent problem, exacerbating difficult policy choices, so that in 1859 the bakufu were forced to open up ports to foreigners. A few years later, in 1868, Tokugawa power ended and imperial rule was restored.

## Candlesticks

The man widely credited with perfecting candlesticks, and making a fortune in the process, was Munehisa Homma (1724-1803), who lived in the Edo period described above. Nicknamed 'Sakata', because he first worked at Shonai Sakata - a commercial town in northern Japan - he was the youngest son who, unusually, took over the family trading business, before moving to Edo (Tokyo).

Sakata postulated five rules for successful trading. Using carefully chosen alliterative words, he used the prefix of 'san' meaning three, which for the Japanese is a sort of 'magical' number (like lucky 7 or unlucky 13 to some Westerners). The number three is believed to mark the start or turning point of a series of events. Sakata's five rules are:

1. Sanzan - three mountains,
2. Sanpei - three soldiers,
3. Sansen - three rivers,
4. Sankoo - three spaces, and
5. Sanpo - three laws.

Using these rules he aimed and managed to separate out ‘value’ from the ‘price’ of rice contracts - the fear and the greed of his counterparties, supply and demand. Using his methods, Sakata was rumoured to have had the longest ever winning streak of 100 consecutive profitable trades.

Some say that because of all the upheaval during its evolution, and the dominant role of the army, many candlestick patterns have military connotations. However, ‘three white/black soldiers’ is the only one that immediately springs to my mind. Many of the others are just as likely to be linked with stars, animals or people. Some, like ‘Doji’ (which means ‘simultaneously’), convey whether buyers or sellers are the dominant force (neither in the case of a *doji* candlestick).

We can note, in passing, that the evolution in Japan of price charts in the 17<sup>th</sup> century, and candlesticks in the 18<sup>th</sup> century, easily pre-dates the first American bar charts of the 1880s.

### Ichimoku Kinko – a refinement of candlesticks

Moving swiftly on to just before the outbreak of World War II, a journalist called Goichi Hosoda started adapting and refining candlestick analysis by adding a series of moving averages. He used the pseudonym ‘Ichimoku Sanjin’, where the first Chinese character of his name means ‘at a glance’. The other characters mean ‘of a man standing on a mountain’, harking back to Homma’s three mountains, but also to give a sense of the perspective and clarity this type of charting brings. Starting in the 1940s he analysed share prices and eventually published a book outlining his method in 1968 - after forcing many students to crunch thousands of numbers for him. This was, of course, before the advent of affordable computers, so it was a very laborious process. I believe that the use of pseudonyms has been common in Japan for a great many years. Perhaps this is why my esteemed colleague, Harada-san, was happy with his nickname ‘Richie’ (as in Richie Rich with the glasses). The famous artist Hokusai changed his pseudonym up to 36 times, possibly each time he changed the style of his work but maybe just to match his mood.

More recently, the method was revived by Hidenobu Sasaki of Nikko Citigroup Securities, who published *Ichimoku Kinko Studies* in 1996. Now in its 18<sup>th</sup> edition, this is the book

most Japanese use, and it has been voted the best technical analysis book by the Nikkei newspaper for nine consecutive years.

Be aware that candlesticks are not the only charts used in Japan. As well as acknowledging Western methods, my Japanese colleagues are equally happy using Renko, Three-Line-Break charts and Kagi charts. As many charting packages do not offer these, they are religiously drawn by hand every day. This is really for purists and those who only follow one or two main instruments. Being so laborious it does not lend itself to cross-market analysis. **However, walk into any Japanese dealing room today and the most common charts you'll see will be Ichimoku Kinko Clouds.**

## Calligraphy

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The Chinese character for 'bar charts'



comes from the word 'foot', alluding to the idea that markets leave footprints, which can then be followed, read and interpreted.

In Japan three alphabets are used for writing. *Kanji*, the most ancient script, was introduced in the 5th century from China via Korea. In kanji each little pattern sums up an entire concept and corresponds to a word. Hence, the patterns are ideograms and are what are known as 'Chinese characters'.

Two other scripts were developed in 9<sup>th</sup> century Japan and are the first truly Japanese writing. They are phonetic and have 46 syllables of which 5 are vowels. *Hiragana* is more cursive, while *Katakana* is more angular and mainly used for foreign words.

All three scripts are either written across the page from left to right, or vertically from top to bottom and right to left. Japanese newspapers are read 'back to front'.

Back to the Chinese character for 'bar chart', known as 'Hyo'. Look at this next set of characters-

# 一目均衡表

Once again you can see the one for ‘chart’ at the end on the right. The second character, the one that looks like a ladder means ‘look’ and, together with the first one, resembling a minus sign, stand for ‘at one glance’. (It is not really a ladder, but the picture of an eyeball turned on its side - you need a little imagination here!) The others are too complicated to be worth going into, but character three spells out ‘Kinko’ meaning ‘balance’.

## Terminology

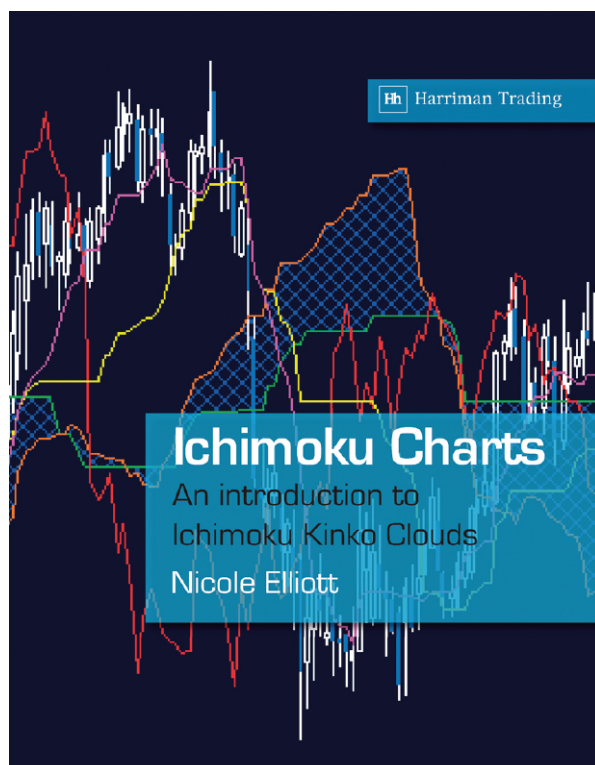
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The correct name of these charts is: *Ichimoku Kinko Hyo*. But this is something of a mouthful, so the charts are often referred to as *Ichimoku charts* or *cloud charts*. Occasionally one might come across *Ichimoku Kinko Clouds*, which again is the same thing. All these terms are used interchangeably in this book.

# Ichimoku Charts

## An introduction to Ichimoku Kinko Clouds

Nicole Elliott



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