

# **The Power And Finesse of Japanese Candlestick Charting**

Presented by:

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Over three centuries ago, one Japanese man began developing a technical analysis tool that was directly related to the actual price movement of any commodity or stock issue. He was not a mathematician or a statistical genius, he was simply observing the types of patterns that are created during each trading session to identify and establish traits or tendencies that occurred after individual patterns had formed. His name is Sokyū Honma.

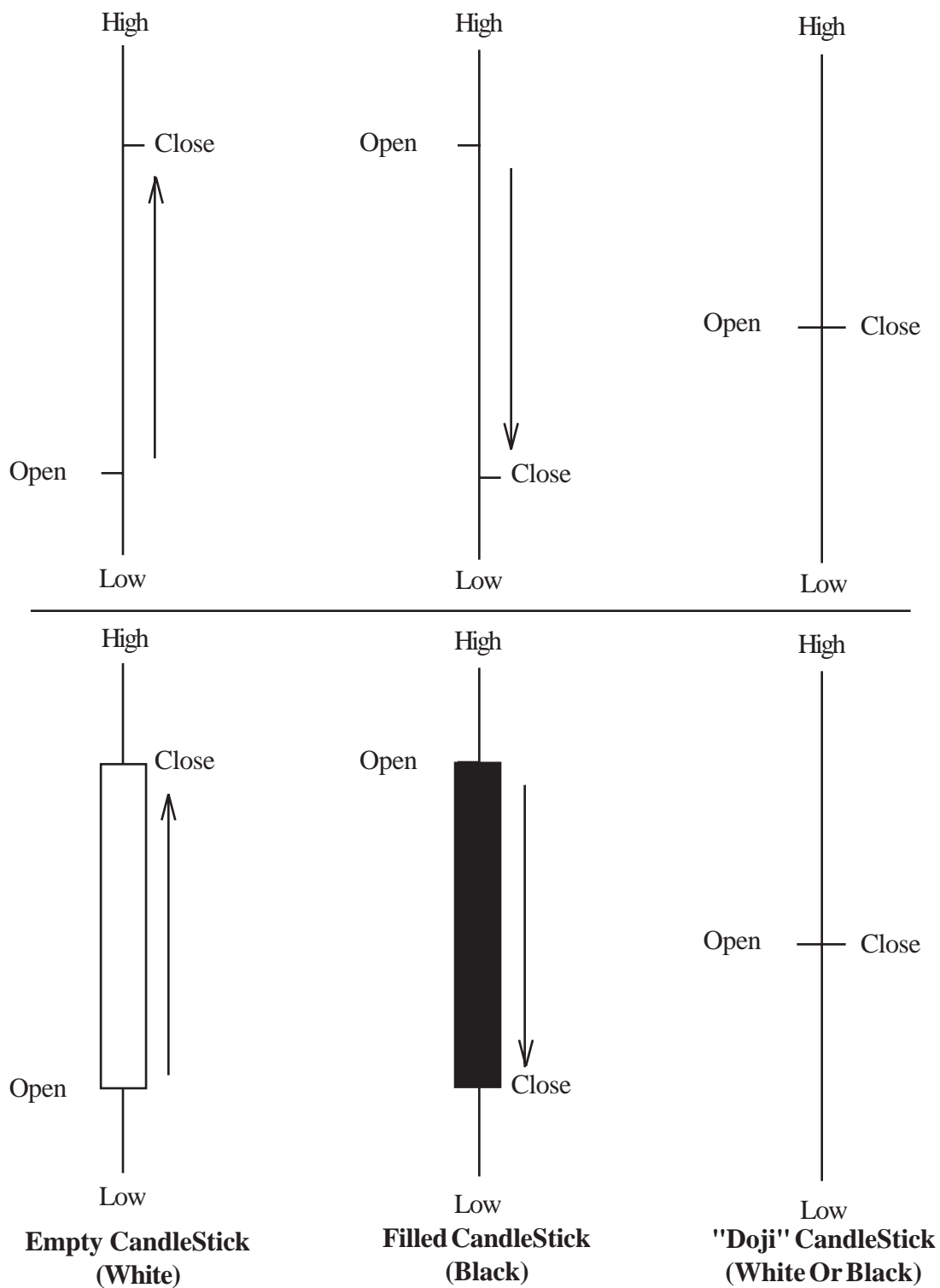
Although it is still unclear as to who is responsible for inventing the candlestick chart, much of the development and maturing process was completed by Honma. It is rumored that the chart was first introduced near the beginning of the Meiji era (around 1870) by an English man and was used primarily for the silver market in Yokohama. The most widely accepted theory as to how candlesticks were introduced into Japanese culture is that the chart originated at the beginning of the rice market (around 1750). After both Western Europe (1561) and Japan (1654) established exchanges, the increase in the complexity and diversity of the economic conditions, and the continuing technological advances provided an ideal environment for the development of the candlestick chart.

The Japanese first used the candlestick chart in the commodity market (primarily the rice market), then integrated these techniques into their stock market. After World War II, the chart became very popular in Japan due to an increase in the number of active speculative investors. Prior to this last 50 or so years, the candlestick technique was known to only a few Japanese investors.

Japan's most elusive technical trading methodology has now entered the twentieth century and traders world wide are interested in sharing the wealth of knowledge that is only available with this technique. Japanese candlesticks blend perfectly with nearly all of the common Western technical analysis methods and will increase your understanding of any commodity or stock issue as well as provide an incredible insight into any market's future price moves. The technologically advanced era that we have evolved to provides the necessary tools (computers and software) to simplify the candlestick technique and makes it available to anyone interested in using this enhanced technical analysis method.

## Constructing Candlesticks

The construction of Japanese Candlesticks is really quite simple. Because the emphasis is placed on the Open~Close range, Candlesticks are drawn with a "rectangle" around the Open~Close range. If the close is higher than the open, then the rectangle is left "Empty" - which appears as a "White" candle. If the close is below the open, then the rectangle is drawn in, or "Filled" - which appears as a "Black" candle. Lastly, if the Open and Close are "Very Close" or "Equal", a small rectangle (or horizontal line) is drawn - creating a "Doji" shaped candle.



## The “Sakata’s Constitution” and “Sakata’s Five Methods”

Sokyu Honma was actually born Kosaku Kato (1716-1803) in the city of Sakata, Yamagata Prefecture, Japan during the Tokugawa period (Eighth Shogunate). Later in life, he was adopted by the Honma family. At that time, the port of Sakata was a distribution center for “shonai” (rice). Honma concentrated his attention on the rice cash market and later on the popular fixed rice market. 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 individual trader because of his diligent and effective understanding of candlesticks and the psychology of the rice markets. Through his very charismatic personality and highly effective trading methods gained him the nick-name “Dewa’s long nosed goblin”.

The “Sakata’s Five Methods” originated from the rules and methods that Honma first developed to trade with called “Sakata’s Constitution”. At this time the candlestick chart had not evolved yet and was not incorporated into Honma’s technique. Later, after Honma began using the candlestick chart, the “Sakata’s Five Methods” was developed by fusing the “Sakata’s Constitution” with the advanced techniques of the candlestick chart. Honma’s secret methods were divided into two groups and have been passed down through many generations of Japanese. The two methods are the “Markets Sanmi no den” and “Sakata’s Strategies”.

### The “Market’s Sanmi no den” or “Sakata’s Constitution”:

1. Without being greedy, think about the time and price ratio by looking at past price movements.
2. Attempt to sell at the top and buy at the bottom.
3. One should increase one’s positions after a rise of 100 bags from the bottom or a fall of 100 bags from the top.
4. If one forecasts the market incorrectly, one should attempt to identify the error as soon as possible. As soon as the error is discovered, one should liquidate one’s positions and rest on the side for 40-50 days.
5. One should liquidate 70 to 80 percent of one’s profitable positions, liquidating the remainder a changing directions once the price has reached it’s ceiling or bottom.

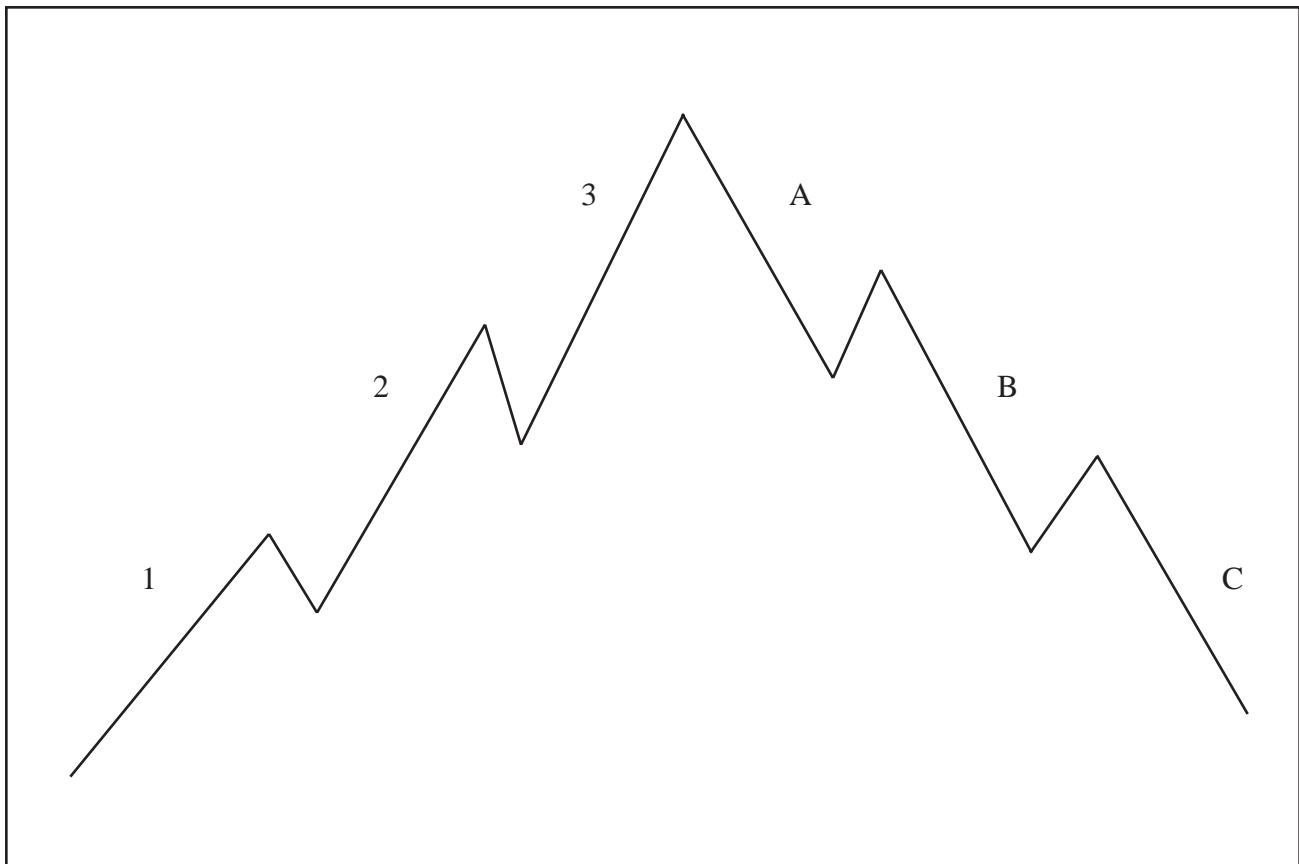
Upon execution, all of these methods can be considered “Sakata’s Strategies”. Methods 4. and 5. are primarily trading principles used to limit loss and increase profits. Methods 1., 2. and 3. require the use of a chart and are techniques designed to realistically enhance one’s trading ability over time.

## The Japanese Method of Three:

There is a Japanese saying “consult the market about the market.” which means when observing the market, we should pay close attention to the market movement itself rather than observing the international affairs and economic policies that may or may not effect the market. The chart is a recording of market price movements in a picture form. By studying the chart, one is able to identify the path the market has taken in the past and is able to attempt to predict the future course of the market price.

As divulged by Seiki Shimizu in his book “The Japanese Chart of Charts”, the natural law of market price is the “Three Level Fluctuation”. This method teaches us that market prices move in three levels, moving up three levels, then, always moving down three levels to form a zigzag pattern. This “Three Level Fluctuation” greatly corresponds to the “Elliot Wave Theory” (see figure 1). There are many unforeseen circumstances that can alter or cause a breakdown in this pattern, such as recent news items which may cause erratic price movements. We need to be able to adjust to the realities of the future by sorting through the various shapes and patterns that have formed and using only those with the highest probabilities. This is what the candlestick chart is all about. The chart’s task is not to predict exact tops or bottoms, but to instantly assist in confirming market tops or bottoms when they form.

Figure 1



Very early in Japan's cultural history, the number "three" has been considered a mysterious number and it is thought that a divine power lives within it. This is more than likely where the "Sakata's Constitution" and the "Sakata's Five Methods" attained its mysticism. The "Sakata's Five Methods" consists of "Sanzan" (Three Mountains), "Sansen" (Three Rivers), "Sanku" (Three Gaps), "Sanpei" (Three Parallel Lines) and "Sanpo" (Three Methods). To preface all five terms of the "Sakata's Five Methods", the Japanese term "San" translates to the number "three".

## "Sanzan" (Three Mountains)

The "Three Mountains" consist of two groups, each with three individual shapes of market topping and bottoming formations (see figure 2). These two groups directly correlate to the "three level fluctuations" theory we have already discussed. The "Three Mountains" pattern is very similar to the Western "Head and Shoulders Top". They both consist of the very same price movement characteristics. The Japanese also consider the "Double Top" and "Rounded Top" as variations to the "Three Mountains" group.

The reverse of the three individual market top formations detailed above create the second group of patterns that complete the "Three Mountains". This group identifies a market bottom. They are the "Head and Shoulders Bottom", the "Double Bottom" and the "Rounded Bottom".



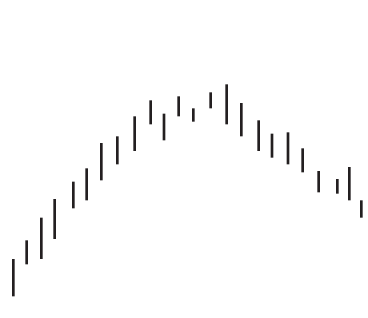



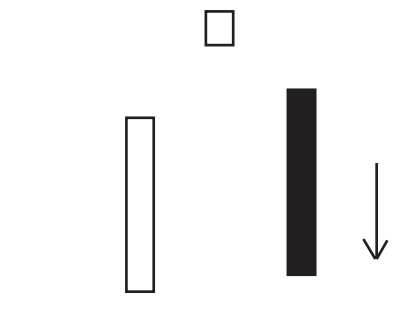
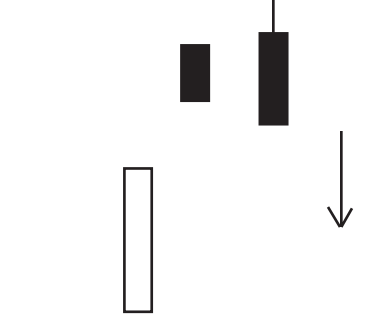
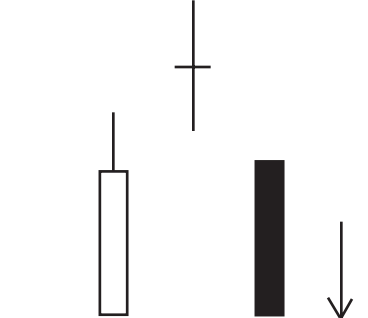
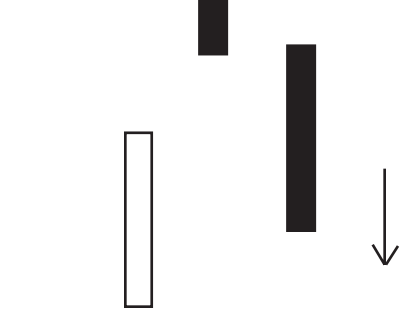
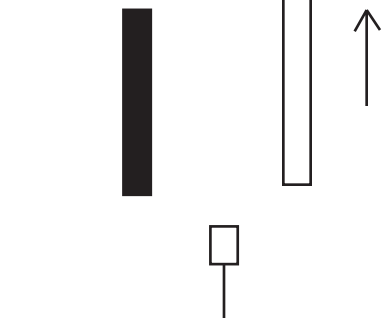
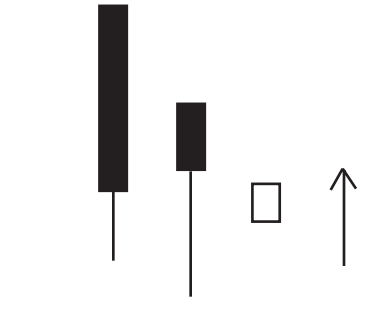
The Japanese view these patterns from a broader perspective. These patterns are attuned to identifying major reversals of trend over a longer time frame. Often times, we see these patterns as smaller pieces to a much larger puzzle. When we begin to piece together the puzzle, we can only then begin to predict its outcome.

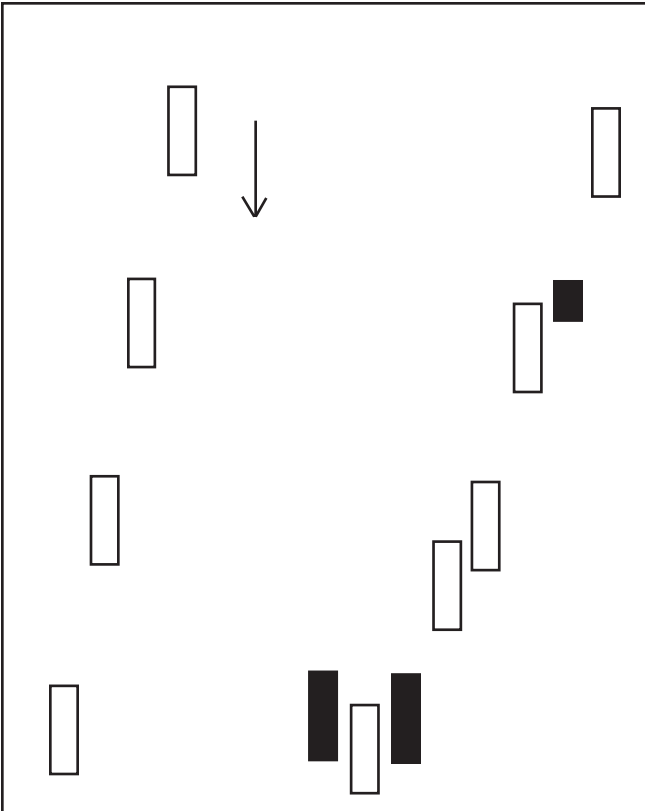
## "Sansen" (Three Rivers)

The "Three Rivers" patterns reflect a complete reversal of price direction. They form in either "Morning" or "Evening" positions with many variations. The "Three River Morning Star" pattern reflects a bullish reversal of trend or a possible market bottom. Whereas the "Three River Evening Star" pattern reflects a bearish reversal of trend or a possible market top.

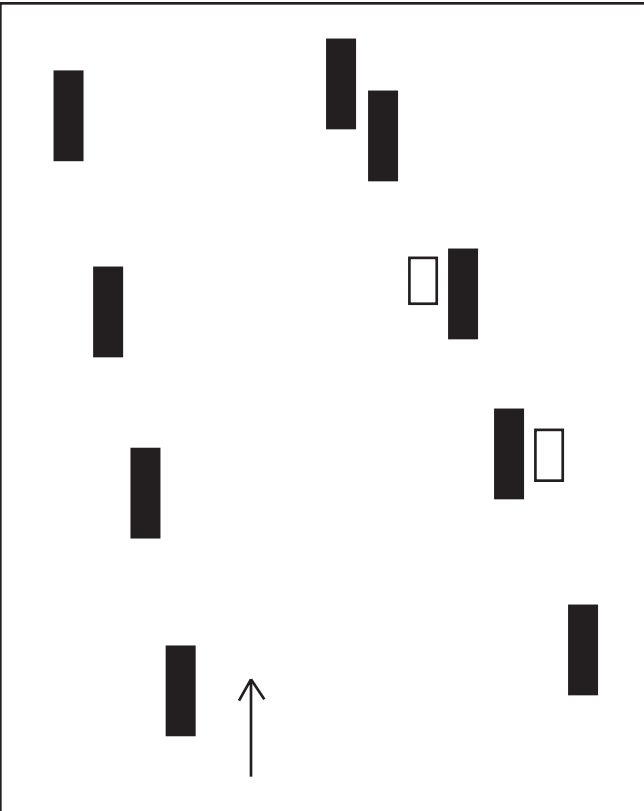
The common formations, as shown in figure 3, often consist of very strong single candle types (such as Doji's, Bozu or Marubozu lines). These individual candle types represent some of the strongest single candle types to identify price direction or lack of it. For example, the "Doji Line" that separates the other two candles within this pattern identifies that the market is unable to continue its current trend. The third candle that completes this pattern confirms the fact that the market trend has reversed.

The variations of the "Three Rivers" include the "Upside Gap's Two Crows", the "Evening Southern Cross", the "Two Crows" and the "Unique Three River Bottom". Although these variations may appear visually completely different, they reflect the same intention of the market - to reverse.

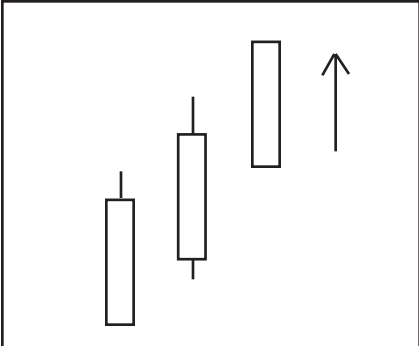
|  |   |  |
|--|---|--|
| 1<br> | 2<br> | 3<br> |
| <b>Head and shoulders top</b>  | <b>Double top</b>   | <b>Rounded top</b>   |
| A<br> | B<br> | C<br> |
| <b>Head and shoulders bottom</b>   | <b>Double bottom</b>  | <b>Rounded bottom</b>  |
|     |     |     |
| <b>Three River Evening Star</b>  | <b>Upside Gap's Two Crows</b>   | <b>Evening Southern Cross</b>  |
|     |     |     |
| <b>Two Crows</b>   | <b>Three River Morning Star</b>   | <b>Unique Three River Bottom</b>   |



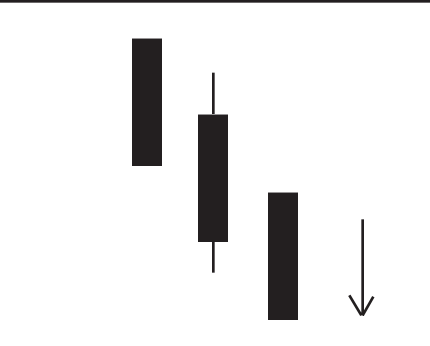
Three Upside Gaps



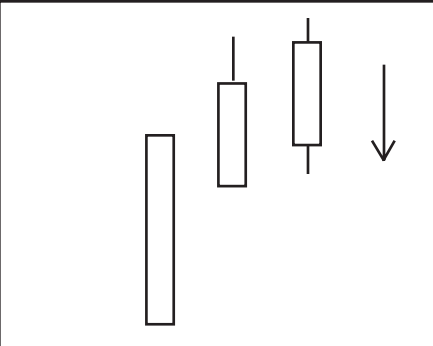
Three Down Gaps



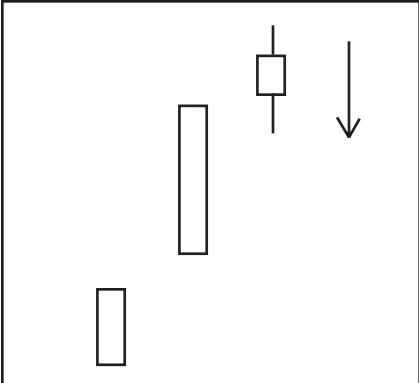
Three White Soldiers



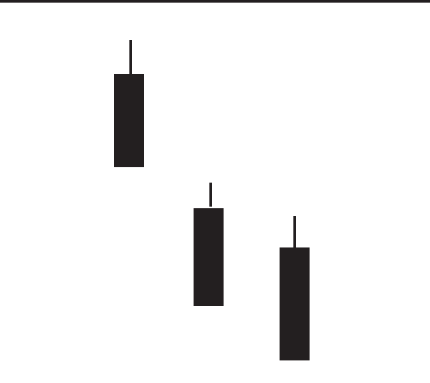
Three Crows



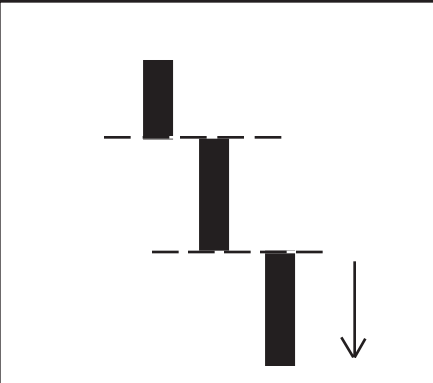
White Three Line Advance Block



White Three Line Star in Deliberation



Bozu Three Wings



Simultaneous Three Wings

## “Sanku” (Three Gaps)

The “Three Gaps” pattern consists of three individual gaps in price that occur during a defined trend. The gaps do not need to be consecutive, they may form throughout many days of trading. This pattern signifies that the market has continued in its defined trend and current trend may soon end. The “Three Gaps” pattern can form during either a bullish or bearish trend to identify specific trend reversals. Remember that this pattern has a specific correlation to the “Three Level Fluctuation” theory. The gaps may form during the three individual price advances or declines that support the “Three Level Fluctuation” theory.

When a “Bullish Three Gaps” is formed, the Japanese call this “Sanku Fumiage”. It represents a price ceiling and one should start selling. When a “Bearish Three Gaps” is formed, the Japanese call this the “Sanku Nage Owari” or the “Sanku Tatakikomi” and one should start ordering long positions. In either condition, once the market price begins to reverse and the third gap is filled, one should increase one’s current long or short positions.

## “Sanpei” (Three Parallel Lines)

The classic formation of the “Three Parallel Lines” occurs when three of the same color candles appear with no price gaps between them. If they are all bullish candles (white), they create the “Three White Soldiers” pattern. If they are all bearish candles (black), they create the “Three Crows” pattern. These common types of “Parallel Lines” are viewed as a continuation of the current market trend.

The variations of the bullish (white) “Three Parallel Lines” are different in shape and meaning from the classic formations. The “White Three Line Advance Block” (Sakizumari) differs slightly from the “Three White Soldiers”, yet it represents the possible end a current bullish price move. It depicts a continuing bullish price move that is diminishing in strength and likely to reverse. Another variation is the bullish (white) “Three Line Star in Deliberation” (Akasansen Shianboshi). It represents that the current price move is indecisive and is likely to reverse. Often, this pattern may form into an “Engulfing Bearish” or a “Three River Evening Star” indicating strong selling in the market now.

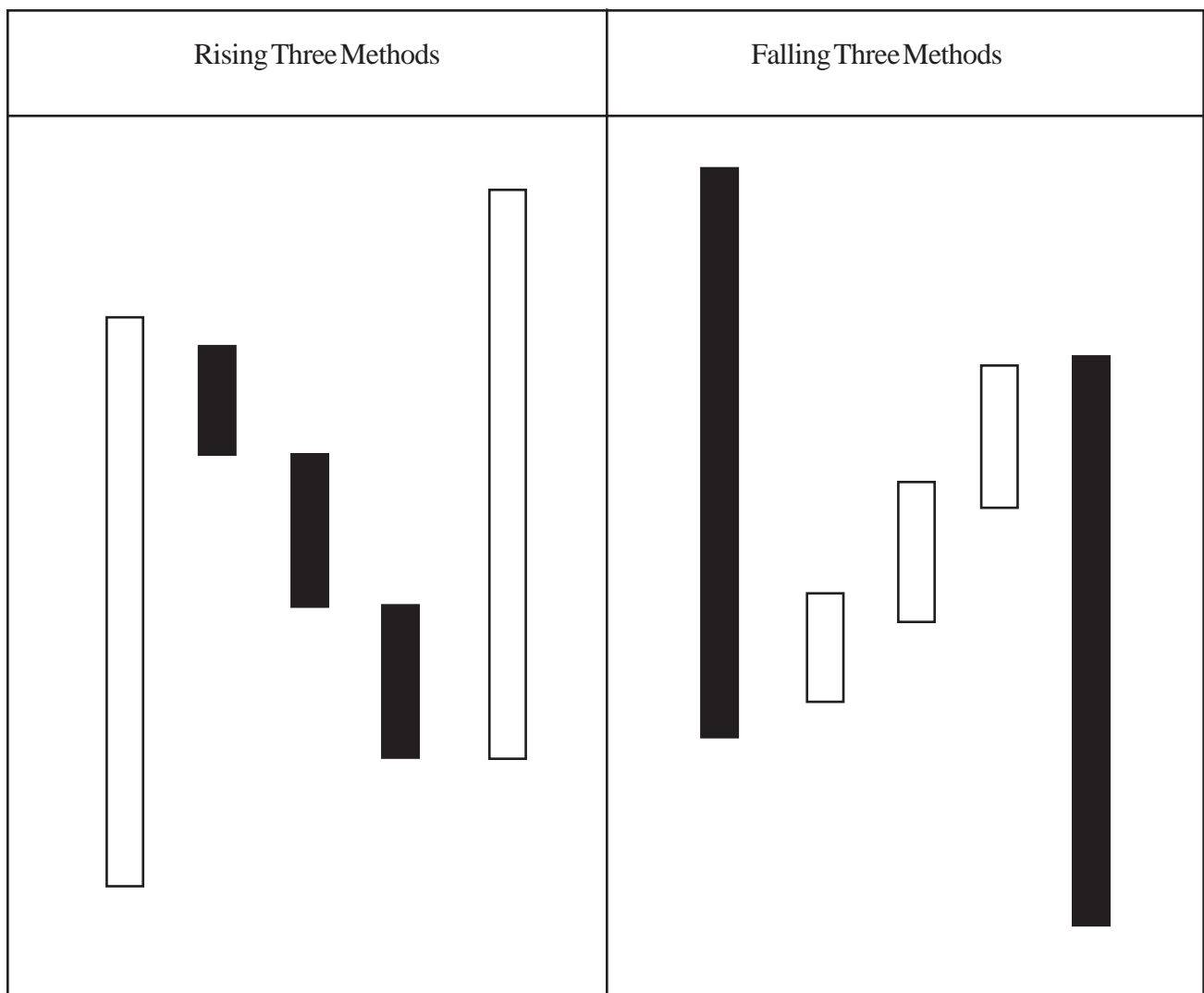
The bearish variations of the “Three Parallel Lines” are a little more complicated. The first is the “Bozu Three Wings”. It varies from the “Three Crows” because of a gap between the first and second candles and the requirement that all three candles be of the “Bozu” or “Marubozu” type. This pattern represents strong bearish price action. The second variation occurs when the second candles opening price is equal to the first candles closing price and the third candles opening price is equal to the second candles closing price. So to say, each new candle opens on the previous candles close. This is called the “Simultaneous Three Wings”, and is an indication of continued bearish price action.



## “Sanpo” (Three Methods)

The “Three Methods” patterns are related to one’s position in the market (buy, sell, or wait). So to say, one shouldn’t buy and sell all year, it is often wise to wait and not enter any position in the market. These pattern groups indicate a congestion period within the market and one should wait for confirmation of new trend.

These two patterns are the “Rising Three Methods” and the “Falling Three Methods”. If the “Rising Three Methods” appears in a rising market, one should expect a short rest before a further climb in price. The opposite is true for the “Falling Three Methods”. If it appears in a declining market, one should expect a short break before a further fall.



## Facts about Japanese Candlesticks

Candlesticks are a true leading indicator. They regularly identify potential market price moves before they begin to happen.

Candlesticks are attuned to the short term trend (3 to 15 trading sessions) when charted on a Daily basis. To apply candlestick to longer term trending markets, one must use a Weekly or Monthly chart.

Candlesticks can be applied to any other Western technical oscillators to produce a synergistic trading approach.

Candlesticks are the only technical analysis tool that generates intuitive text messages (results) about the inner psychology of any market.

Candlesticks have been relatively unknown, except in Japan, for the last three centuries.

Candlesticks use the same price data as bar charts, yet the candlestick technique better promotes the ability to recognize complex patterns and to identify what these patterns mean.

The Japanese candlestick technique consists of hundreds of different patterns that accurately identify specific market traits or tendencies.

# Extended pattern groups used with candlesticks

## 1. Confirmation

“Confirmation” patterns are created after an initial candlestick pattern has formed. The “confirmation” pattern is considered a conservative traders entry point. They identify that the initial candlestick pattern now has a higher likelihood of prompting a market price move in the direction predicted. “Confirmation” patterns are an essential part of trading with candlesticks and have been taught to generations of Japanese.

## 2. Continuation

“Continuation” patterns are created after an initial candlestick pattern has formed, and normally appears after a “confirmation” pattern. The “continuation” patterns are used to identify a trending market and to maintain an awareness of the trend strength. Many times, the “continuation” patterns will form during the individual “Three Level Fluctuations” as described earlier. These “continuation” patterns are generally helpful to keep you long or short during a defined market trend after the initial candlestick buy or sell pattern.

## 3. Combination

“Combination” patterns are fairly simple to understand. They are created when two or more individual candlesticks, or two or more individual multi candlestick patterns, or any combination thereof, appear side by side and issue similar signals. An example would be a “Hanging man and Doji Line” found at or near a ceiling. This is a strong indication of a potential bearish price move. “Combinations” patterns are not rare, they appear in generally all stocks and commodities. The key to these unique patterns is to be able to identify them as a stronger influence to a possible future price move and to help identify the direction of the future move.

## 4. Confluence

“Confluence” patterns are composed of a number of other technical oscillators or patterns that assist in confirming or denying the potential for any candlestick pattern probability of success. For example, one might choose to use Moving Averages, Stochastics, Momentum and Elliot Wave Theory as “confluence” indicators to assist in determining the current conditions of any market and to assist in confirming the possibilities of the current candlestick pattern(s). Generally all Western technical oscillators can be used as “Confluence” patterns. The key is to understand the relationships between the price movement of the chart, the relative change in the Western technical oscillators, and the candlestick pattern(s) that have formed. This could be considered part of the “Sakata’s Constitution”, as it is an underlying concept. Although, this is more a fundamental reality of profitable trading than a concept.

## Candlestick Pattern Table

### .. *Bullish Patterns*



*Engulfing Bullish* - is a common bullish, or buy, pattern. An engulfing bullish pattern after a defined down trend normally signals a bullish reversal. It is normally wise to wait for confirmation.



*Piercing Line* - may indicate the end of a bearish trend. With confirmation, this pattern is indicating a bullish, or buy, signal.



*Bullish Harami Line* - is indicating a potential market reversal. The harami line is a sign of market consolidation. With confirmation, this pattern is indicating a bullish, or buy, signal.



*Inverted Hammer with Confirmation* - is indicating the potential for a bottom reversal if found after a down trend. This is a very common bottom reversal indicator - buy with confirmation.



*Hammer with Confirmation* - is the inverse of the Inverted Hammer. Refer to the Inverted Hammer.

### .. *Bearish Patterns*

*Confirmation* (conservative) - used to confirm candlestick patterns. Waiting for confirmation will help reduce any premature, or incorrect candlestick signals.



*Engulfing Bearish* - is a common bearish, or sell, pattern. An engulfing bearish pattern after a defined up trend normally signals a bearish reversal. It is normally wise to wait for confirmation.



*Dark Cloud Cover* - may indicate the end, or correction, of a bullish trend. With confirmation, this pattern is indicating a bearish, or sell, signal. It's normally wise to wait for confirmation.



*Bearish Harami Line* - is indicating a potential market reversal. The harami line is a sign of market consolidation. With confirmation, this pattern is indicating a bearish, or sell, signal.



*Shooting Star or Inverted Hammer* - is indicating the potential of a top reversal if found after an up trend. This is a very common top reversal, or consolidation indicator - sell with confirmation.

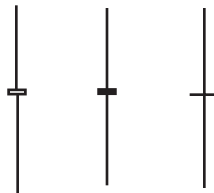


*Hangman with Confirmation* - is the inverse of the Inverted Hammer. Refer to the Inverted Hammer.

## .. *Doji's*

Think of any doji as a tightening of price activity. As price activity tightens, the potential for a reversal or breakout becomes more probable. When dojis form in groups, more pressure is created thus we have a high probability of a major reversal or breakout. When the price trend establishes direction, the pressure is released.

Single, high volume dojis that gap above or below previous price levels are strong indications of a potential major top or bottom.

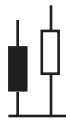


A *doji* is an indication of extreme market consolidation and shows signs of a potential reversal.. One with high volume is showing the intense pressure of the trading session. Large volume dojis after a large price move are strong indicators of major tops and bottoms. In a defined, longer term trend, it is not uncommon to see four or 5 dojis in a group that form near correction points.

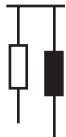
*Double Doji* - is indicating tightening pressure with the inability of price movement.

.. ***Tweezers Patterns:***

Tweezers patterns show levels of support and resistance.



*Tweezers bottoms* indicates a support level at, or below the lows of the pattern. If the support level is broken with a large black candle or includes a price gap, proper action is to sell.



*Tweezers tops* indicates a resistance level at, or above the highs of the pattern.



*Tweezers tops and bottoms* indicates a very tight support and resistance level near the highs and lows of the pattern with a strong potential for an accelerated price move.

## Candlestick Analysis Rules & Suggestions

As one learns to interpret the different candlestick patterns, one should always keep in mind the following rules to assist in the proper identification and possible actions taken from the patterns. There are three simple rules to interpreting candlestick patterns:

### 1. Size

Larger candles play an important role when identifying patterns. They represent accumulation or distribution within the market or stock. When you begin to see an increase in size of the candles, the trend is accelerating and accumulation is occurring. When you begin to see a decrease in the size of the candles, the trend is decelerating and distribution is occurring.

### 2. Shape

The shape of the candlestick, or pattern, determines the type of pattern generated, the possible trading signal and the potential direction of trend. Shape and size work hand-in-hand. A very small Engulfing Bullish pattern would indicate the potential for a market rally, yet the small size indicates that the trend has not yet begun to accelerate.

### 3. Location

The location of a candlestick pattern will assist in determining the possible trading signal. For example, a Shooting Star found after a defined up trend strongly indicates a potential bearish correction or top. A Piercing Line found after a defined down trend indicates a potential for a bullish reversal. Either of these two patterns found within a consolidated, sideways trend, do not indicate as strong a potential for a trend reversal, and one should wait for confirmation of the candlestick pattern before taking action.