BEYOND CANDLESTICKS

学問に近道なし

"Learning is Like Rowing Upstream; Not to Advance is to Fall Back"

BEYOND CANDLESTICKS

New Japanese Charting Techniques Revealed

STEVE NISON

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ACKNOWLEDGMENTS

三人寄れば文珠の知恵

"You Cannot Clap With One Hand"

A Japanese book that I had translated said that: "Japanese charts are frequently considered secretive. The number of people who know the essentials of these charts are few and reference material is scarce."[1] This paucity of material was particularly true with some of the new techniques revealed in the second part of this book. However, thanks to the help of some important individuals, I was able to uncover many previously hidden aspects of Japanese technical analysis.

Without the assistance of the translating done by Richard Solberg, it would have been almost impossible to write this book—or my first one! Not only did Richard ably do the translating, but equally important was his tenacity in finding and obtaining the Japanese books I needed for my basic research. Richard has been one of my most vital resources.

As with my first book, I had the help of knowledgeable Japanese traders who helped refine my knowledge by sharing valuable insights obtained from their years of experience.

Mr. Hiroshi Okamoto, Director at Nomura Investment Trust, Mr. Yasuhi Hayashi, Senior Trader at Sumitomo Life Insurance, Mr. Nori Hayashi, Investment Manager at Barclays Trust, and other members from the Nippon Technical Analysts Association (NTAA) in Japan were all very gracious. I am sure many of my questions may have seemed very rudimentary to them, but they were patient and open about sharing their knowledge. Without their insights, this book would be much less detailed.

Mr. Kiyohiko Yoshizawa, vice president at Paine Webber, provided

valuable new facts and insights about the candles during our numerous meetings.

One of my most important contacts was Mr. Yoji Inata, a correspondent for Reuters. Mr. Inata's assistance was critical for the new tools addressed in this book; we spent many hours together. Not only did he take his valuable time to review some of the new techniques to make sure I correctly understood the ideas, but he also took the extra step of conferring with his Japanese colleagues on points about which he was not 100% sure. Mr. Inata said that he enjoyed our studying together. I think he was being polite. Although I may have contributed to his knowledge in some respects, for the most part I was the student. I was fortunate to have had a gracious, knowledgeable, and friendly teacher.

Thanks again goes to my friend, Bruce Kamich. A true professional, he continues to provide me with a stream of insightful and helpful ideas.

The editor of this book, Susan Barry, was also the editor of my first book. Susan had the foresight to see how brightly the interest in the candles would burn. She was a major factor in my choice of John Wiley & Sons to publish this book. I hope Susan does not decide to move to a publishing firm in the Antarctic. If I ever do a third book, I would have to follow her.

As an English poet said: "Where ignorance is bliss, wisdom is folly." Before writing my first book, I was blissfully ignorant of all the time and effort that goes into such a project. That book, made me aware of how difficult the process is. Because of this, I had no desire to go through it all again. However, Dodge Dorland, Chief Investment Officer of Landor Investment Management (New York, NY), gave me the push to do this second book. Dodge uses candles to trade stocks on an intra-day basis and has been one of the earliest proponents of candles. Anyone who has dealt with Dodge can vouch for his amiability and for his knowledge.

Many of the charts in this book are from the MetaStock software by EQUIS International (Salt Lake City, UT). Without their assistance in providing me with the new software to draw the kagi, three-line break, and renko charts, this book would be much less detailed. Their excellent software, and helpful and knowledgeable staff makes MetaStock a pleasure to use. For those interested in finding out more about the MetaStock software, there is a coupon included at the back of this book. The data used for the Metastock charts was from Dial-Data (Brooklyn, NY). I found their data accurate and easily accessible.

I would like to thank Shahrokh Nikkhah whose early appreciation of my work and desire to make available the many advantages of candlestick analysis to his clients brought about my joining his team where we offer advisory and brokerage services at Daiwa Securities America. I would also thank my colleague, Mark Tunkel for taking the time to help proof-

read this book.

In this, as in my first book, you will see many CQG charts (Glenwood Springs, CO). They are a real-time graphics charting service. CQG was among the first services in the West to offer candle charts to their clients. I have used their service for many years. The accuracy of their data and their support personnel, such as Steve Onstad in New York, make this a premier real-time charting service. Their excellent worldwide reputation is well justified.

Reuters Ltd. (New York, London, and Tokyo) have also provided charts for this project. Their RTA technical analysis real-time charting product offers some unique capabilities. I have had the pleasure of giving a series of seminars for them throughout Europe. The fact that Reuters has gone through the time, effort, and expense to send me to Europe for these seminars shows how committed they are in meeting the educational needs of their clients.

My first book, *Japanese Candlestick Charting Techniques,* was written around the same time as the birth of my son, Evan. (At the time of Evan's birth, I frightened my wife, Bonnie, when I said I was going to name him "Candlesticks Nison.") Evan is now four, and he enjoys "typing" on my keyboard. I tell you this so that if there are typos, I now have an excuse. My daughter, Rebecca, is eight and very bright. I have jokingly said that I wanted this book easy enough for a child to understand, so I think I'll ask her to proofread these pages (yet another excuse if you find any mistakes!). Finally, there is my loving and patient wife, Bonnie, who understands that it is great to have written, but most difficult to write.

Final thanks go to those who provided another incentive for writing this book—the credit card companies and the bank that has my mortgage.

Note

[1]Oyama, Kenji, p. 51.

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PART 1

CANDLES

十人十色

"Let Every Bird Sing its Own Song"

INTRODUCTION

A chart is like a map, the more information each one provides, the better the chance of reaching your destination safely. Candle charts display a more detailed and accurate map of the market than do bar charts. A Japanese book that I had translated stated, "It is not an exaggeration to say that candlesticks are the best in the world and a very exquisite creation for charts."[1] This is because, as detailed below, candle charts open new avenues of analysis and offer many advantages over bar charts:

1. Candle charts will pictorially display the supply–demand situation by showing who is winning the battle between the bulls and the bears. Bar charts do not.
2. Like bar charts, candle charts will show the trend of the market, but candle charts add another dimension of analysis by revealing the force behind the move.
3. Bar chart techniques can often take weeks to transmit a reversal signal. However, candle charts will often send out clues of imminent reversals in one to three sessions. The result is that candle charts often provide the opportunity for more timely trades.

These are just some reasons why the flames of interest in candle charts grow ever brighter. In just a few years, candle charts have joined bar charts and point and figure charts as a basic charting technique.

Candle charts are drawn using the same data as bar charts (the open, high, low, and close), so they send all the same signals that can be found on bar charts. Yet, as just discussed, the candles offer many advantages over bar charts, so using candle charts instead of bar charts is a win–win situation. When you use bar charts you only get bar chart signals. But, with candle charts you get all the bar chart signals, plus you gain the

unique and powerful insights provided by the candles. So, why use a bar chart?

Because the Japanese are major players in most of the world's markets, there is strong interest in how the Japanese use their technicals to trade. Candles are the most popular form of technical analysis in Japan. The importance of the candles for the Japanese trading community is illustrated in the following quote from the European magazine, *Euroweek*. This article quotes an English trader who works at a Japanese bank. He states: "All the Japanese traders here—and that's in the foreign exchange, futures and equities markets—use the candles. It might be difficult to work out the billions of dollars traded in London on interpretations of these charts each day, but the number would be significant."[2]

Think about it: Although billions are traded every day based on the candle chart signals, until recently we had no knowledge of how the Japanese viewed the market with their technicals. This is hard to believe. Knowing the candles and their other technical tools discussed in this book may help answer the question, "What are the Japanese going to do next?."

Years ago, I met with the head of technical analysis for one of Japan's largest life insurance companies (this Japanese trader wanted to meet with me to learn how I used western technicals to trade). When he walked into my office, he saw I had candle charts on my desk. In a surprised voice, he asked: "You know about the candles?." I responded that I did. I then asked if he used them. He told me that his company's top management would meet each Monday to discuss the world markets. At these meetings, he would bring his candle charts to offer his technical views. Then he pointed to my candle charts and asked: "How many other Americans know about this?." I said no one (this was before the publication of my first book). He looked relieved. I then continued, "But I will soon have a book out about it." "So, many others will know about this?," he asked in a disappointed tone. The point of the story is that the Japanese trader came to me to learn about how we, in the West, use technicals. The Japanese have learned from us and they know almost all of our technical methods. In most of the candlestick books and articles I have had translated from Japanese to English, there was at least some reference to western technical techniques. A quote from one of the books I had translated stated, "To understand stocks it is not enough to know the Japanese chart methods . . . one must absorb the best parts of western technicals: and on top of that using the best parts of Japanese charts to make for a progressive outlook which is necessary for stock analysis."[3] We can see from this statement how the Japanese have used our methods to enhance their own. One of the purposes of this book is to do the same

for Western traders—to show how to use the techniques implemented by the Japanese to enhance our market knowledge.

An article about my work appeared in the *Japan Economic Journal*. In it, the reporter states: "Japan, which has been in the position to learn many things from the West in the investments area, may be in the position to teach something."[4] We now have access to a wealth of technical information refined by generations to use; we are learning from the Japanese.

Chapter 2 shows how to draw the basic candle line, and delves into some history of the candle charts. Later in that chapter, I show how a single candle line can provide important market insights. Chapter 3 discusses the basic candle patterns. With the detailed descriptions of these patterns, those new to candles *and* candle experts can discover new market perspectives. The last chapter in this section, Chapter 4 focuses on how the overall technical picture is more important than a single candle pattern.

Notes

[1]Hoshii, Kazutaka, p. 18.
[2]*Euroweek*, August 30, 1991.
[3]Yasui, Taichi, p. 95.
[4]*The Japan Economic Journal*, July 23, 1991.

CHAPTER 1

OVERVIEW

仏作って魂入れず

"The Buddha is Complete, But the Eyes Are Not in Yet"
(The Job is Not Yet Done)

THE EXPLOSIVE INTEREST IN THE CANDLES

There is a Japanese saying, "A clever hawk hides its claws." For over a century, the claws of Japanese technical analysis, that is candlestick charts, were a secret hidden from the western world.

For those new to the exciting field of candlestick charts, *candlestick* is the term used for Japan's most popular and oldest form of technical analysis. They are older than Western point and figure and bar charts. Amazingly, candlestick charting techniques, used for generations in the Far East, were virtually unknown to the West until I revealed them in my first book, *Japanese Candlestick Charting Techniques.*

I am pleased and proud that my first book has been credited with revolutionizing technical analysis by igniting the flames of interest in the candles. Before its publication, few people in the West had ever heard of a candle chart. Now, candle charting techniques are among the most discussed form of technical analysis in the world!

Interest in candle charts has become so intense that the World Bank in Washington, DC asked me to address them on the subject. The world-wide interest in these previously secret techniques are reflected in the financial headlines below:

Institutional Investor—"Revealed! Ancient Japanese Trading System"

Wall Street Journal—"Japan's Candlesticks Light Traders' Path"

Euroweek—"Candlestick Charting Comes of Age"

Equity International—"Candlestick Charting—A New Language for the West"

Reuters—"Candlesticks Light New Path for Western Chartists"

For over 70 years, the standard charting tools in the West have been bar charts and point and figure charts. Yet, within a short time, candle charts have now joined these as a basic charting tool. The rapidity with which this has happened is a direct reflection of the candle's popularity and value.

The groundswell of interest in the candlestick charting has become a topic in the media. A TV show, *Tech Talk*, on the business news cable station CNBC is hosted by the famous technician, John Murphy. John told me that a viewer once called and asked him, "What are those charts that look like hot dogs?" What an interesting and amusing idea, I thought, to Americanize these charts by referring to them as hot dog charts. But I guess the term "candle chart," thankfully, is here to stay.

I have had many wonderful compliments from famous traders and analysts. However, the most endearing compliment came from a woman who wrote, "If you ever have a down day, just remember there's a nice little grandmother in Missouri who's in awe of your accomplishments." This letter, besides being so gracious, illustrates the universal appeal of candles—from traders at the World Bank to a grandmother in Missouri.

The reason for the popularity of candlestick analysis is easy to understand. They can be melded with any other form of technical analysis, they are applicable to any of the markets to which technical analysis is applied, and they provide market insights not available anywhere else.

Why this book? A renowned 16th-century samurai swordsman stated that "learning is the gate, not the house. You first have to go through the gate to get to the house."

My other book, *Japanese Candlestick Charting Techniques*, took you to the gate. This book takes you to the house and has many new, exciting, and effective techniques to improve your trading, investing, or hedging.

Japanese charting was considered a secret. However, I have managed to pry open the "secrets of the Orient" by exchanging ideas with many Japanese traders who use candles and by having many hundreds of pages translated from Japanese into English. Lin Yutang, a noted Chinese philosopher, sagely noted that one gets a different flavor from reading the same book at different stages in life. Therefore, he says, all great books can be read with profit and pleasure a second time; I have found this to be true.

In the time since the publication of my first book, I have reread my original candlestick documents and have gleaned new insights. In addition, I have obtained and translated new Japanese material, have ex-

panded my dialogue with more Japanese technicians and, of course, have continued to learn from my use of candles. I reveal these new and valuable insights in this book.

My first book focused on the futures markets. The candles have now become so important that their popularity has spilled over from futures into stock, bond, and foreign exchange markets from around the world. As a result, this book will have many more of the charts than did my other book.

At times, a single candle line can be important. The Japanese have a saying, "With the fall of one leaf we know that autumn has come to the world." In this sense, a single candle line may be the first sign of a market turn. In this book, I will show how to use individual candle lines to obtain clues about the market's health.

It has been very exciting to see the intense interest sparked by the candles. However, it is often forgotten that the emergence of a candle pattern is but one aspect of trading. Other aspects, such as the risk and reward ratio of a potential trade and monitoring where the candle pattern appears in the overall technical picture, must also be considered. This is so important that I have devoted a chapter to these aspects.

In my continuing studies of Japanese trading techniques, I have uncovered three charting methods that are very popular in Japan, yet are unknown to the West. These charting techniques are called three-line break charts, kagi charts, and renko charts. They are revealed in Part 2 of this book.

In the days of fur trading in the United States, there was a company called the Hudson Bay Trading Company. They were known for taking risks and for careful preparation. Trading journeys were undertaken with much excitement, but in case the fur traders forgot anything, they would camp out the first night just a few miles away from the company's headquarters. In other words, careful preparation spared the travelers potential difficulties.

In Chapters 2 and 3, I too provide careful preparation by providing a primer on basic candle theory and patterns. For those new to candle charts, these chapters will provide the groundwork for your candle chart analysis.

Many of you are probably already familiar with the basics of candle charts. With this in mind, Chapters 2 and 3 will also offer a deeper knowledge of the candles by revealing new candle theories, techniques, and tools. As a result, even those knowledgeable about candles will gain new insights and perspectives into the power of the candle charts. For example, when I describe the candle patterns in Chapter 3, I will provide a unique visual glossary of candle patterns. This method of drawing the patterns will provide a dimension of candle pattern analysis that was

never before available. After you explore with me the beauty and power of the candle charts, you will never be able to go back to a bar chart.

This book will be a self-contained unit. I will not go over all the candle patterns; that is done in my first book. However, I will sometimes make references to the more obscure or rare patterns discussed in my first book. This is for the benefit of those who are familiar with all the candle patterns. Do not worry if you have not heard of the pattern before; it will not detract from the discussion of the chart.

Numerous charts and exhibits will quickly and clearly make evident how candles can enhance your trading, timing, and investing. As shown throughout the book, candles can be merged with any other form of technical analysis. Consequently, I have included charts that show how to fully utilize the candles' power alone, or when joined with other technical tools.

Just as important as the recognition of candle patterns is an understanding of the relationship of the candle patterns to the overall technical picture. Chapter 4 focuses on this vital, but often neglected, aspect. In this chapter, I will address how trading with the candles must take into account the risk and reward of a potential trade, the stop-out level, and the overall trend. I will also address the value of adapting to changing market conditions.

Before I discuss trading with candles, I want to clarify a few points. In the futures market, selling short is as common as buying long. This is not true in the stock market; most equity traders look to buy. Consequently, throughout this book when I use the term "bearish" or "selling" when discussing a stock, you should not think of necessarily going short. Instead, view it as an area to protect existing longs by such means as selling covered calls, moving up protective stops, or offsetting all or some longs.

But this book is about more than candles. In Part II I reveal the disparity index, the three-line break, renko charts, and kagi. These techniques, popular in Japan, are virtually unknown in the West and, unlike candle charting, little has been written about these techniques, even in Japan.

The disparity index compares the close to a moving average. It is used in the same manner as dual moving averages, but it has an interesting wrinkle to it. The three-line break, kagi charts, and renko charts are popular among Japanese traders. They are excellent technical tools for determining the trend of the market.

Whether you use the techniques discussed in this book individually or in combination with one another, you will discover that they provide dynamic advantages for those who make use of their tremendous potential.

Note to Reader: Many charts in this book, especially in Part II, were drawn using technical analysis software from Metastock by EQUIS International (Salt Lake City, UT). A coupon for Metastock Software is included at the end of the book.

CHAPTER 2

THE BASICS

小事が大事

"Inattention is Fatal"

HISTORY OF THE CANDLE CHARTS

THE Japanese were the first to use technical analysis to trade one of the world's first futures markets—rice futures. The Japanese started trading in this market in the 1600s. Interestingly, the birth of the Japanese rice futures market was a consequence of the country's military history.

After a century of internal warfare among the daimyo (Japanese feudal lords), General Tokugawa Ieyasu, who ruled from Edo (the ancient name of Tokyo), won the famous battle at Sekigahara in 1600. This was the battle that helped unify Japan. Tokugawa thereafter became Shogun of all Japan. After his victory over the daimyo, General Tokugawa cleverly required that all the feudal lords live in Edo with their families. When the lords returned to their respective provinces, the entire family stayed at Edo as hostage. The feudal lord's main source of income was rice that was collected as tax from the peasants who worked their land. Since this rice could not be transported from the daimyo's provinces all the way to Edo, they set up warehouses in the port city of Osaka to store their rice.

Because all these powerful daimyo lived so close to each other in Edo, they attempted to outdo one another in lavish dress, mansions, and other luxuries. This was reflected by a popular saying at the time, "The Edoite will not keep his earnings overnight." This showed that the daimyo in Edo were seen as spendthrifts with an expensive lifestyle. To maintain this lifestyle, the daimyo sold rice from their warehouse in Osaka; sometimes they even sold rice from future harvests. The warehouse would

issue receipts for this future rice. These were called empty rice contracts ("empty rice" since the rice was not in anyone's physical possession) and they were sold in the secondary market. This was the beginning of one of the world's first futures market.

Trading in rice futures engendered much speculation, and it was from this speculation that Japanese technical analysis was born. The most famous trader in the rice futures market was Homma. Homma traded in the rice futures markets in the 1700s. He discovered that although there was a link between the supply and demand of rice, the markets were also strongly influenced by the emotions of the traders. Because of this, there were times when the market perceived a harvest as different from the actual. He reasoned that studying the emotions of the market could help in predicting prices. In other words, he understood that there was a difference between the value and the price of rice. This difference between price and value is as valid today with stocks, bonds, and currencies, as it was with rice centuries ago.

In the material I had translated, candle charts are often called Sakata charts in reference to the port city of Sakata, where Homma lived. However, based on my research, it is unlikely that Homma used candle charts. As will be seen later, when I discuss the evolution of the candle charts, it was more likely that candle charts were developed in the early part of the Meiji period in Japan (in the late 1800s).

Whether or not Homma invented charting is open to question. But determining whether one person, in this case Homma, created charts or used them to trade is not too important. There is a tendency in the West to be preoccupied with imposing authorship to one person. It is more likely that the candle charts we know today and all the techniques associated with them tended to be a process of cumulative authorship by several people over many generations. Even if he did not invent candle charts, Homma understood that the psychological aspect of the market was critical to his trading success. And it appears that the earliest forms of technical analysis in Japan dealt more with the psychology of the market rather than charts.

In the book, *The Fountain of Gold—The Three Monkey Record of Money,* purportedly written by Homma, the author states: "After 60 years of working day and night I have gradually acquired a deep understanding of the movements of the rice market." The book then goes on to say: "When all are bearish, there is cause for prices to rise. When everyone is bullish there is cause for the price to fall." This phrase echos what is now called contrarian opinion, a tool important to so many traders. Yet, *The Fountain of Gold—The Three Monkey Record of Money,* was written in 1755. It is amazing that before America was a nation, the Japanese were trading with contrarian opinion! The title had me perplexed for some

time. I did not understand the reference to the "three monkeys" in the title. Then in some of my translated material, it said something about comparing successful trading to being like the three monkeys we all knew as children—see, hear, and speak no evil. Then it dawned on me; the title of the book, *The Fountain of Gold—The Three Monkey Record of Money,* means that for traders to get to their "fountains of gold," they should have the characteristics of these three monkeys. Specifically:

1. "See no evil"—when you *see* a bullish (bearish) trend, do not get caught up in it; consider it an opportunity to sell (buy).

In the *Fountain of Gold,* it states that there is always a rotation of Yang (bullishness) and Yin (bearishness). This means that within each bull market, there is a bear market, and within a bear market, there is a bull market. This view may explain why Japanese candlestick techniques place so much emphasis on reversal, rather than continuation, patterns.

2. "Hear no evil"—when you *hear* bullish or bearish news, don't trade on it.

It may be safer to take a position after you determine how the market reacts to a news item rather than initiating a trade when the news is released. Bernard Baruch, the millionaire stock speculator and presidential advisor, stated that what is important in market fluctuations "are not the events themselves, but the human reactions to these events." Exhibit 2.1 shows that how the market reacts to the news may be just as important as the news itself.

The Iraqi War started in the first few days of August 1990. Yet, Exhibit 2.1 shows that gold stalled at $425. This $425 level was gold's high earlier in 1990. This failure to take out the prior high was in spite of the fact that there was a Mideast War. Gold's failure to rally on supposedly bullish news sent out volumes of information about the state of the market. To wit, be careful of a market that fails to rally on bullish news. Note that after this failure at $425, gold lost its luster as prices returned to their pre-Mideast crisis price near $360 within two months.

Also be aware of what the Japanese refer to as "whispering tactics." This is what they call the spreading of false news to trick others in the market. Try to keep out of rumor buffeted markets. Isaac Newton once said, "I can calculate the motion of heavenly bodies but not the madness of people." Why get involved with the madness of people?

3. "Speak no evil"—don't *speak* to others about what you are going to do in the market.

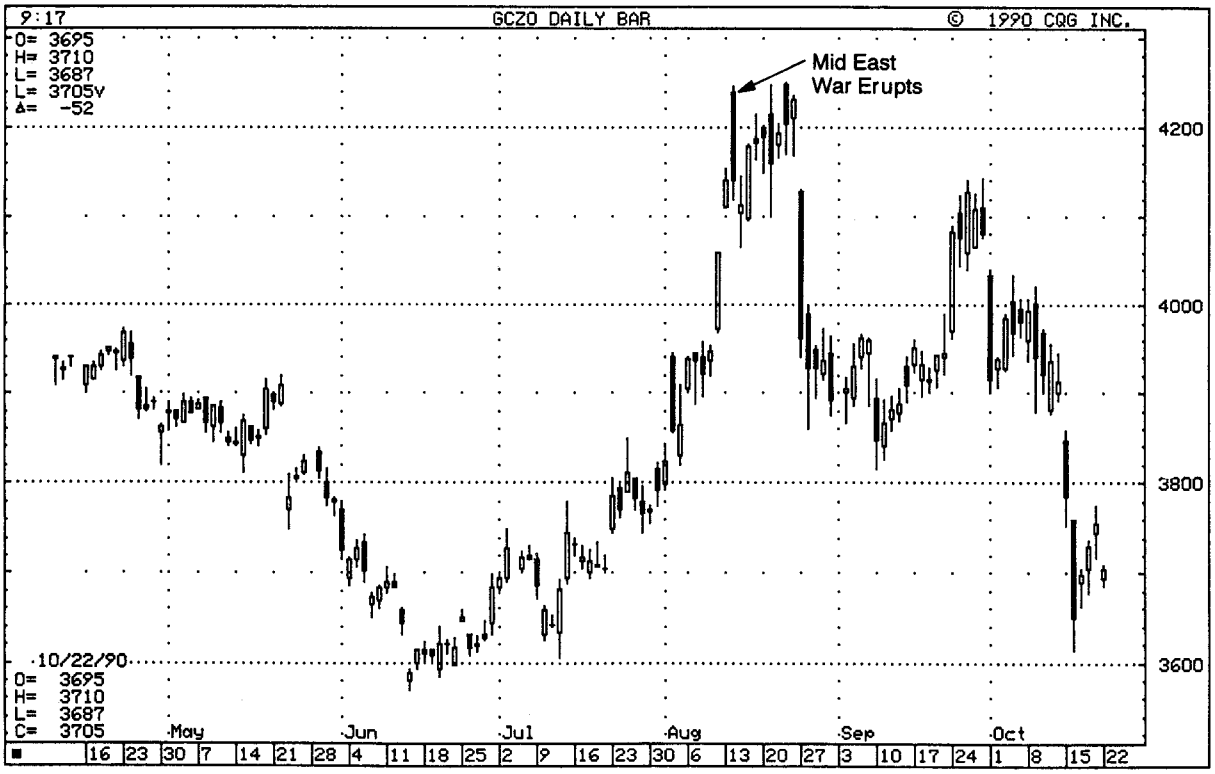


EXHIBIT 2.1. Observing the Market's Reaction to Fundamental News, Gold—December 1990, Daily

Has the following happened to you? Based on your analysis, you decide to buy into a market. You tell someone else of this decision, but they say something negative about that market. Because there is always a degree of uncertainty, you get nervous and decide not to buy. Then, of course, the market rallies.

If you have carefully studied the market, it is safer not to speak to anyone about what you plan on doing unless you believe they have better insight than you. Look only to the market to give you direction. In one of my favorite passages in *The Fountain of Gold,* it says that ". . . to learn about the market ask the market—only then can you become a detestable market demon." Isn't that a wonderful phrase? Wouldn't you love to become a *detestable market demon?* The colorful language used by the Japanese is just one reason their technical techniques are so exciting.

Let us turn our attention to Exhibit 2.2, which illustrates the path that ultimately led to the candle charts.

Evolution of the Candle Charts

A. Stopping chart—Also referred to as a point, line, or star chart. This was the earliest type of chart and was drawn by joining only closing

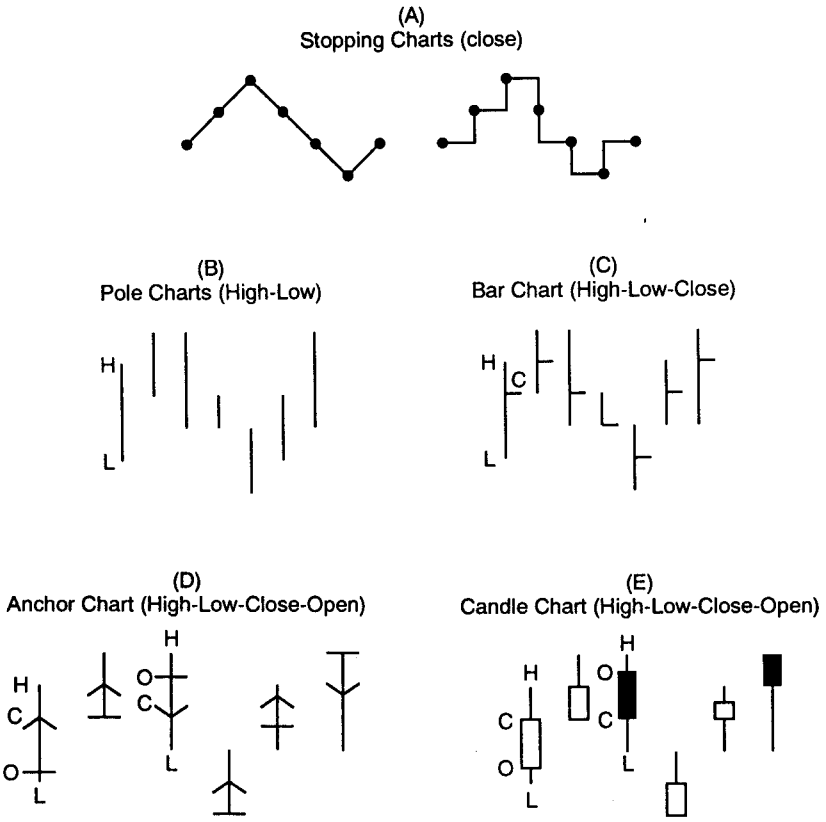


EXHIBIT 2.2. The Evolutionary Path to the Candlestick Charts

prices. They were named stopping charts because that was where the prices stopped by the end of the session. Stopping charts were drawn with either diagonal lines or horizontal lines connecting the closes.

B. Pole chart—Its name is derived from the fact that the lines resemble poles. This chart added the extra information imparted by showing the range between the high and the low of the session. These lines show not only the direction of the move, but the extent of the move for each session.

C. Bar chart—This is a combination of the stopping and pole charts.

D. Anchor chart—Named as such because it looks like an anchor. Based on legend, these charts originated in the Kyoho Era (from 1716) from the fact that the usual meeting place for rice traders was port cities.

The anchor chart was an important event in the evolution of charting. With this chart, the opening price was now added and created a chart with an open, high, low, and close. Just as important, and something unique to Japanese charts, was that the relationship between the open and close was pictorially displayed. The top and bottom of the anchor's vertical line are the high and low of that session. The horizontal line of the anchor line is the open. The arrow of the anchor line is the close. If the close is higher than the open, the arrow points up; if the close is lower, the arrow points down.

E. Candle chart—The next improvement from the anchor charts was the candle chart. Although they are shrouded in mystery, the candles probably started in the early part of the Meiji period (from 1868). As can be seen in Exhibit 2.2E, candle lines were a refinement of the anchor chart. The use of black and white real bodies made analyzing the underlying supply and demand situation visually easier to determine than with the anchor charts.

With the arrival of the candle charts, Japanese technical analysis flowered as people started thinking in terms of signals and trading strategies. Patterns were developed and market prediction became more important. Trying to forecast the market took on extra importance in the 1870s when the Japanese stock market opened.

As can be seen from Exhibit 2.2, bar charts were one of the ancestors of the more evolved and productive candle charts. In essence, this means that since most of the West is still using bar charts, it is also using a less evolved form of charting than the Japanese are with candle charts.

CONSTRUCTION OF THE CANDLE LINE

The first step in using the power of candles is learning how to construct the basic candle line. Exhibits 2.3. and 2.4 show that the candle line consists of a rectangular section and two thin lines above or below this section. We see why these are named candlestick charts; the individual lines often look like candles with their wicks. The rectangular part of the candlestick line is called the *real body*. It represents the range between the session's open and close. When the real body is black (e.g., filled in), it shows that the close of the session was lower than the open. If the real body is white (that is, empty), it means the close was higher than the open.

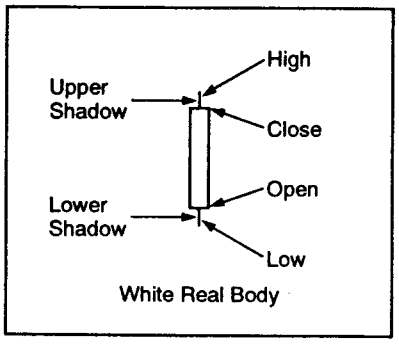


EXHIBIT 2.3. White Real Body

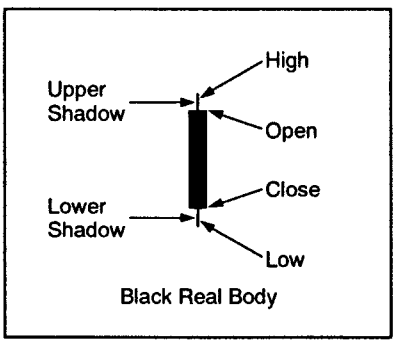


EXHIBIT 2.4. Black Real Body

The thin lines above and below the real body are the *shadows*. The shadows represent the session's price extremes. The shadow above the real body is referred to as the upper shadow and the shadow under the real body is the lower shadow. Accordingly, the peak of the upper shadow is the high of the session and the bottom of the lower shadow is the low of the session.

Candle charts can be used throughout the trading spectrum, from daily, to weekly, and intra-day charting. For a daily chart, one would use the open, high, low, and close of the session. For a weekly chart, the candle would be composed of Monday's open, then the high and low of the week, and Friday's close. On an intra-day basis, it would be the open, high, low, and close for the chosen time period (i.e., hourly).

Exhibit 2.3 shows a strong session in which the market opened near the low and closed near its high. We know that the close is higher than the open because of the white real body. Exhibit 2.4 illustrates a long black candlestick. This is a bearish session in which the market opened near its high and closed near its low.

The Japanese focus on the relationship between the open and close. This makes sense; probably the two most important prices of the day are the open and close. It is therefore surprising that American newspapers have openings for futures prices, but not for stocks. A member of the Nippon Technical Analysts Association told me that he found it unusual that U.S. newspapers do not have opening stock prices; the Japanese have the openings in their papers. He said that he did not know why the Americans disregard the openings.

I would expect that just as almost all technical software vendors now carry candle charts, so it may be that as candles become more popular in the equity market, newspapers may, by popular request, carry stock openings. Until then, in order to obtain the data needed to draw the candles (the open, high, low, and close) you need to use a data vendor service. These services furnish prices on disks or through modems. The data supplied from a data vendor are then transferred into a technical analysis software package that will draw the candles based on these data.

A note of caution: Some data vendors who do not have the actual opening price of a stock default to the prior session's close as today's open. This, in my opinion, is not valid. You must have the true open to draw an accurate candle line. Although an open on a stock will usually not be much different from the prior close, there are some candle patterns in which a higher or lower opening (compared to the prior close) gives valuable information. A data vendor that includes actual opens on stocks is Dial Data (Brooklyn, NY).

REAL BODY AND SHADOWS

While an individual candle usually should not be used alone to place a trade, the size and color of its real body and the length of its shadows can provide a wealth of information. Specifically, looking at a line's real body and shadows gives a sense of the supply and demand situation. This section will discuss this basic idea, and explain how to use real bodies and shadows to get clues about the market's underlying strength or weakness. By using the candle lines discussed below, you may be able to get an early and tentative indication of market direction.

THE REAL BODY

In Japanese charts, even an individual candle line has meaning, and one of the first clues about the vitality of the market is to look at the size and color of the real body. To the Japanese, the real body is the essence of the price movement. This is a critical and powerful aspect of candle charts; through the height and color of the real body, candle charts clearly and quickly display the relative posture of the bulls and the bears.

This section will be segmented according to the decreasing size of the real bodies. The first part of this section will consequently focus on long white and then long black real bodies. After these, attention is turned to candles with small real bodies called spinning tops. These diminutive real bodies display a market where the bulls and bears are in a tug of war.

This section will conclude with candles that have no real bodies. These candles have the same (or nearly the same) opening and closing. Such candles, called doji (pronounced dō-gee), reflect a market in a state of transition. Doji, as you will see later, can be an important market signal.

Long White Real Bodies

A long white real body is defined as a session that opens at or near the low of session, and then closes at or near the session's high. The close should be much higher than the open. For example, if a stock opens at $40 and closes at $40⅝, it would not be a long white candle since the opening and closing range were relatively close. For a long white candle to have meaning, some Japanese candlestick traders believe that the real body should be at least three times as long as the previous day's real body.

EXHIBIT 2.5. Long White at a Low Price Level

Long White at a Low Price Level

A single candle by itself is rarely sufficient reason to forecast an immediate reversal. It could, however, be one clue that the prior trend may be changing. For instance, as shown in Exhibit 2.5, a long white real body at a low price range may be the first sign of a market bottom. A long white candle shows that the ability to rise is virtually unimpeded by the bears. The closer the close is to the high of the session, and the longer the white real body, the more important the candle line.

Exhibit 2.6 shows that in late 1991, this stock was stabilizing near $5. The first sign that the bulls were attempting to take control was the unusually long white real body at 1. Note how this real body was extended compared to the prior real bodies. However, an almost equally long, but black real body (for information on black real bodies, see page 29), on the week after candle 1 showed that the bears still had enough force to offset the bulls' advance. In early 1992, another unusually long white candle, shown at 2, appeared. This white candle opened on its low (since it does not have a lower shadow) and closed on its high (since it does not have an upper shadow). Such a candle is exceptionally strong, notably when it is so elongated as in candle 2. Candle 3 was another strong white candle that propelled prices to new multi-month highs. With the tall white candles 1 and 2 both appearing near $5, we can see the significance of that $5 support area. Consequently, when prices corrected back to this level in July and August 1992, it is not surprising that the selloff stopped near $5.

Long White Candle Confirms Support

As shown in Exhibit 2.7, the tall white candle that rebounds from support underscores the aggressiveness of the bulls. A long white candle that bounces off a support area such as a trendline, a moving average, or a retracement level gives extra confirmation of that support.

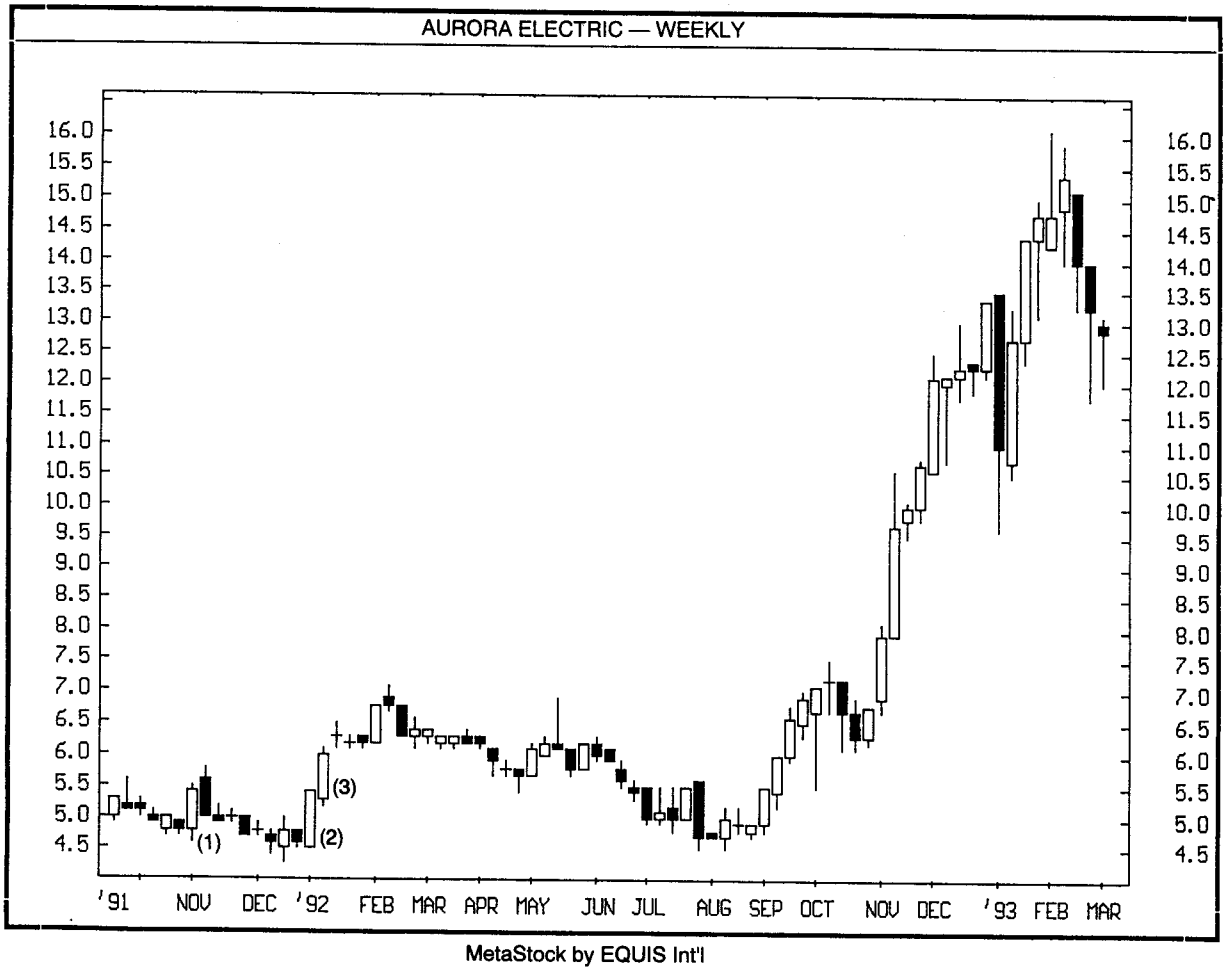


EXHIBIT 2.6. Long White Candle at Low Price, Aurora Electric—Weekly

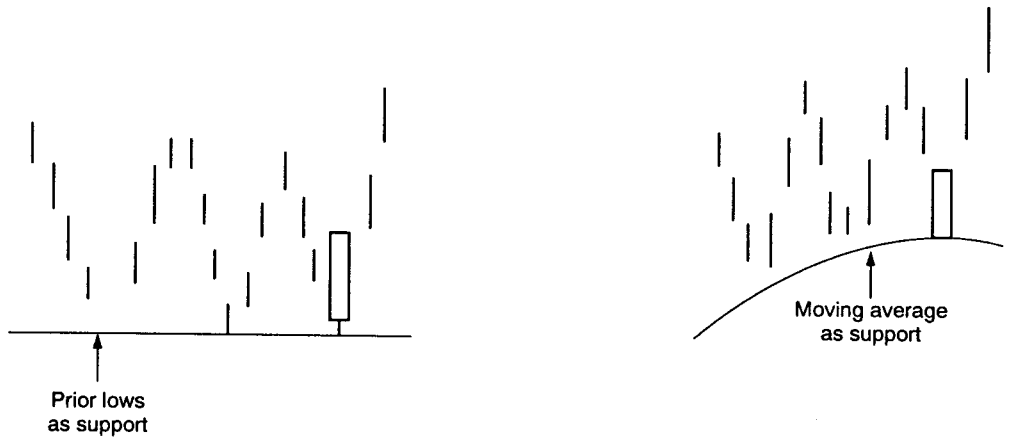


EXHIBIT 2.7. Long White Candle Confirms Support

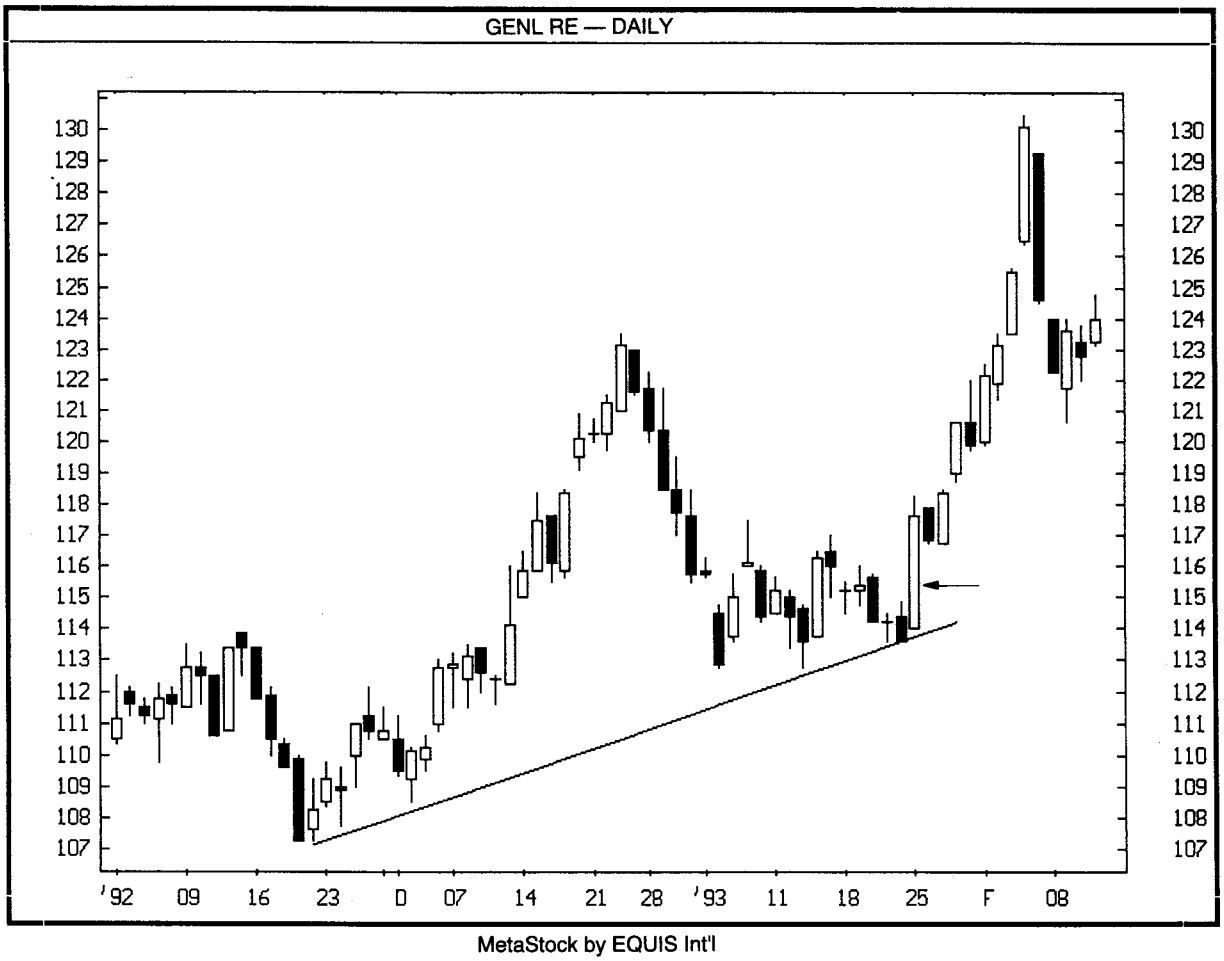


EXHIBIT 2.8. Long White Candle Confirms Support, General Re—Daily

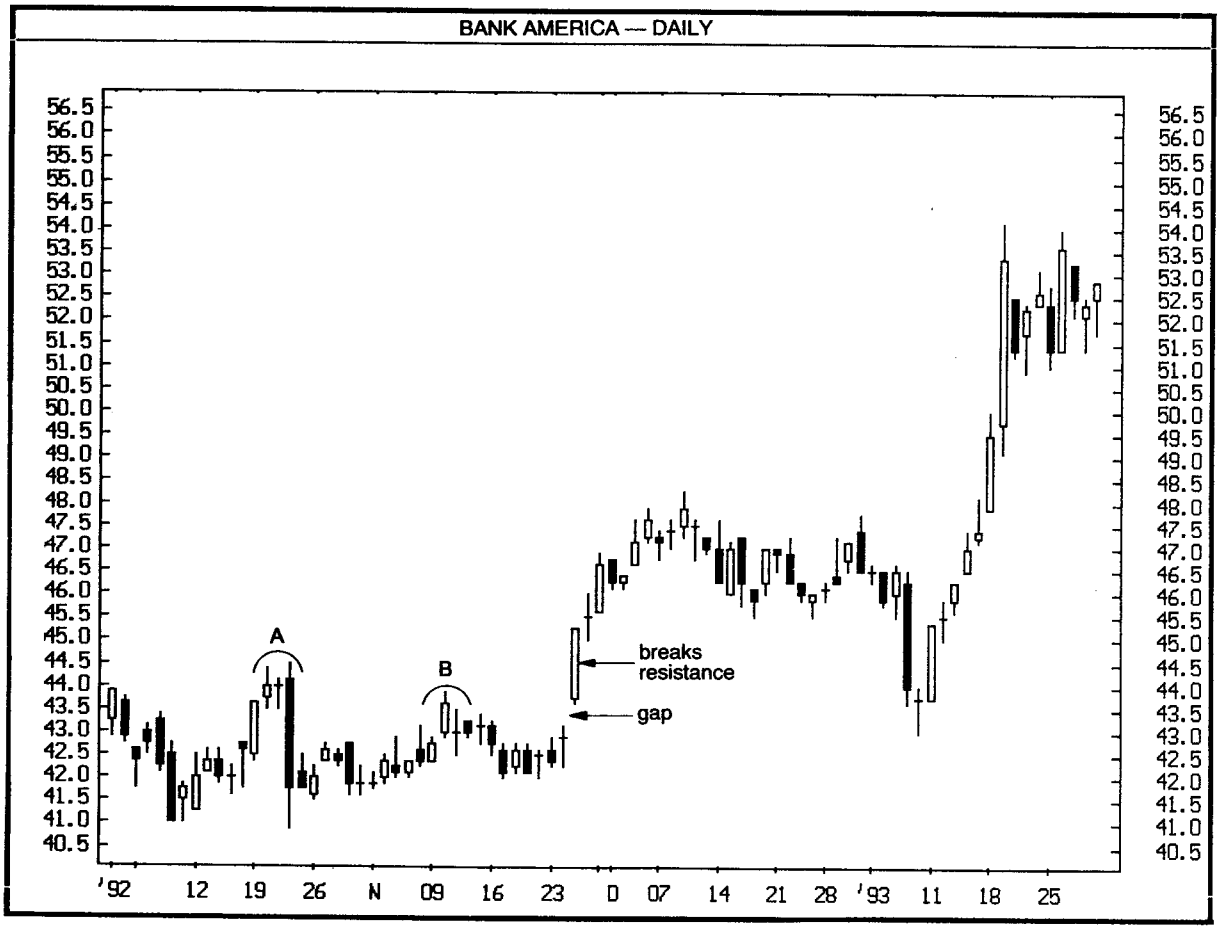
In Exhibit 2.8, we see how drawing a support line with a candle chart is done the same way as with a bar chart. In this case, we are looking at a support line that is obtained by connecting the lows of the session (that is, by connecting the bottom of the lower shadows). This upward sloping trendline was tested numerous times. In late January, a bounce from this support via a long white real body showed the eagerness of the bulls to buy near that support.

Long White Body Breaks Resistance

Exhibit 2.9 displays how the market can prove its mettle by piercing a resistance area with a tall white real body. As shown in Exhibit 2.10, the highs at areas A and B disclosed a resistance area near $44 and $45. In late November, an extended white real body gapped higher on the open-

EXHIBIT 2.9. Long White Candle Breaks Resistance

ing and closed at the session's high. This tall white candle confirmed an important breakout from the aforementioned resistance band. Note how in early 1993 the gap before this white candle became a support area. We will look at the importance of gaps as support when windows are discussed in the next chapter.



Long White Real Bodies as Support

Exhibit 2.11 brings out one of the more exciting uses of long white candles, specifically, that long white candles can become support areas. I have found this to be an excellent tool since it serves to alert traders to support zones that are not available with bar charts. The depth of the reaction should find support at either the middle of the long white real body or the bottom of the entire white candle, including the lower shadow. The Japanese literature says that a long white real body should be support in a rising market. However, based on my experience, it can also be used as support in a falling market. The reason the market may fall back after an exceptionally tall white real body is that prices may become short-term overbought (that is, they rallied too far too fast). In this scenario, the market may have to retrace some of the prior rally to relieve this overbought condition.

In Exhibit 2.12, the huge white candle in early 1992 propelled prices from $10½ to about $15. Almost a 50% rise in one week! After such a move, it was not surprising that the market had to consolidate its gains. Based on the precept that a long white candle is support, the middle of the white real body (at the arrow), near $12½, should then be monitored as support. The power of the market is well reflected by the fact that for the rest of 1992, the market held above this support area.

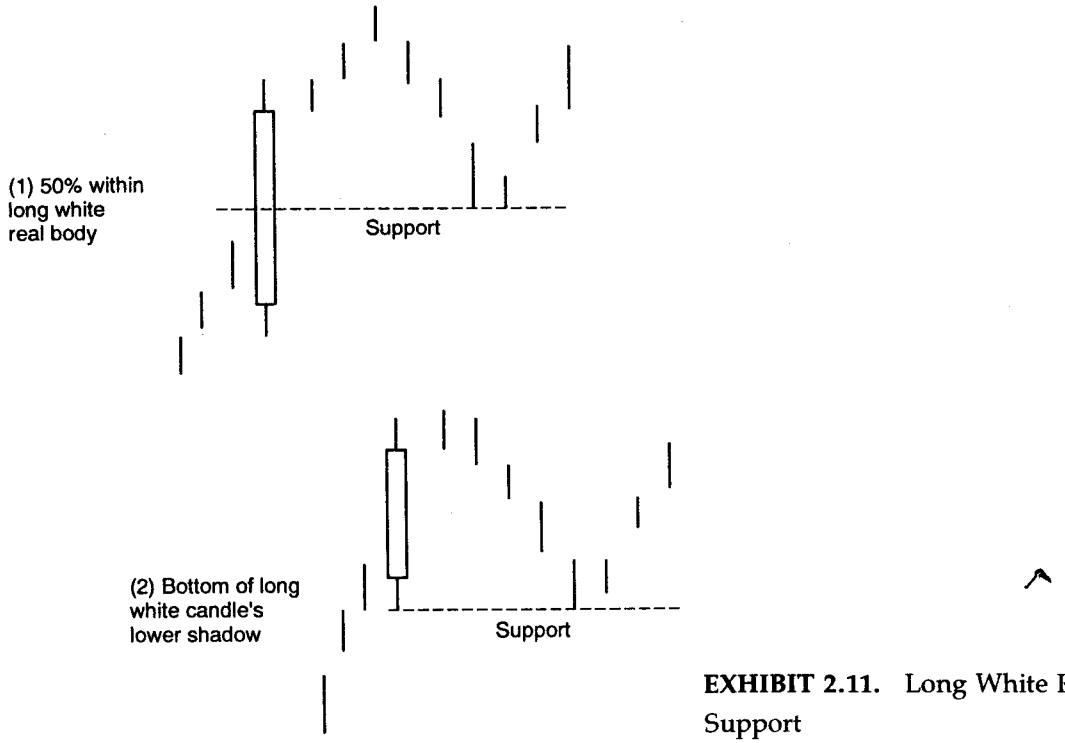


EXHIBIT 2.11. Long White Real Bodies as Support

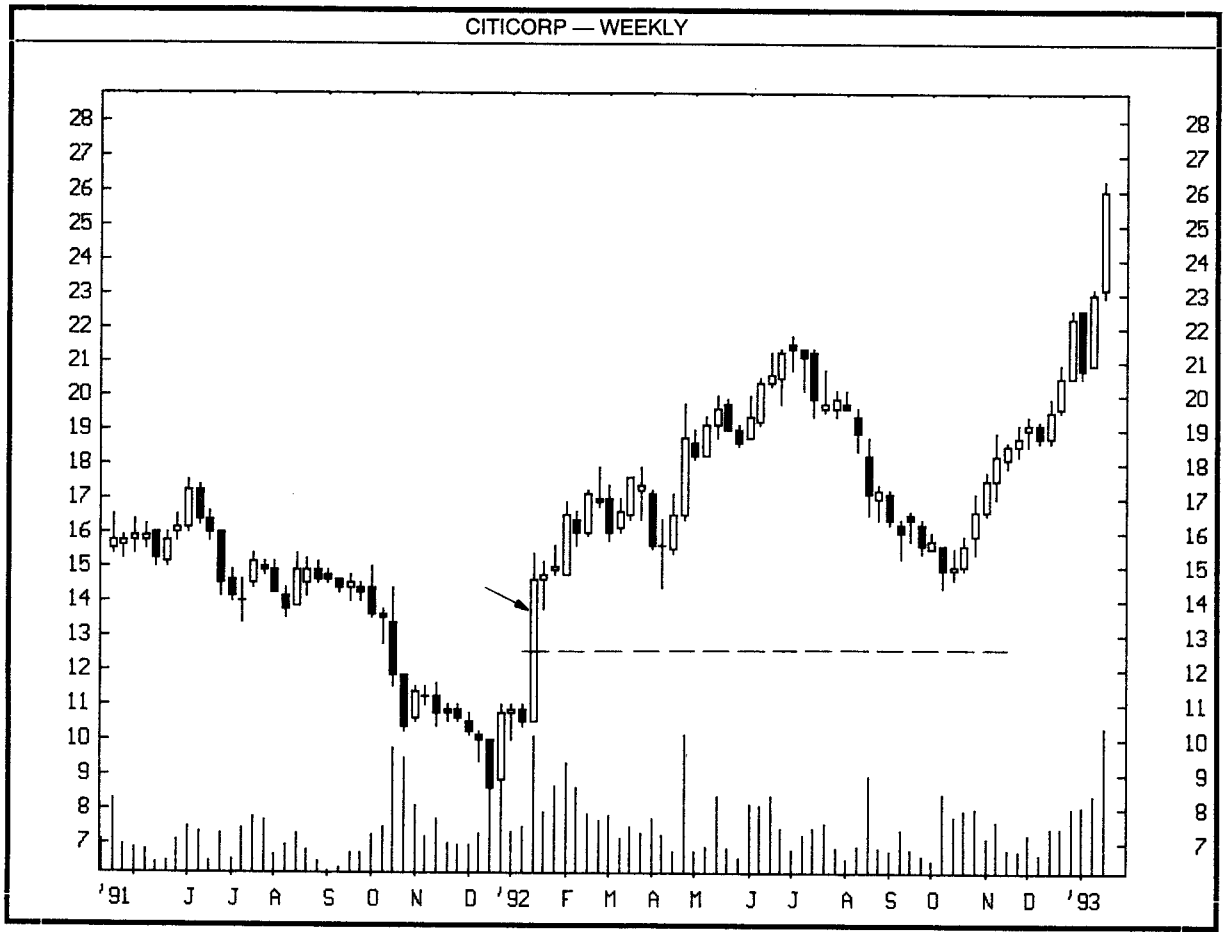


EXHIBIT 2.12. The Middle of a Long White Candle as Support, Citicorp—Weekly

Exhibit 2.13 illustrates how the lower end of tall white bodies 1–4 became support on corrections. Of interest is that the support line obtained by extending the low of candle 3 was broken in September 1992. Observe, however, that the sell-off stopped near the support area from the low of candle 2. This chart also illustrates an important point. Candlestick traders should wait, if possible, for the market to close under support to confirm a break. In this example, we see in mid-1992 that the support level from the bottom of candle 3 was broken intra-weekly (see X on the chart), as was the support by the bottom of candle 4 (see Y). Because the weekly (i.e., the Friday) close held above these support areas, the support line was still in force.

Notice in Exhibit 2.14 how the low of the long white real body in early April (at the arrow) was 109–22. This means that area should provide a base on sell-offs. In this exhibit we see the importance of waiting for a close under a support area to confirm the breaking of support.

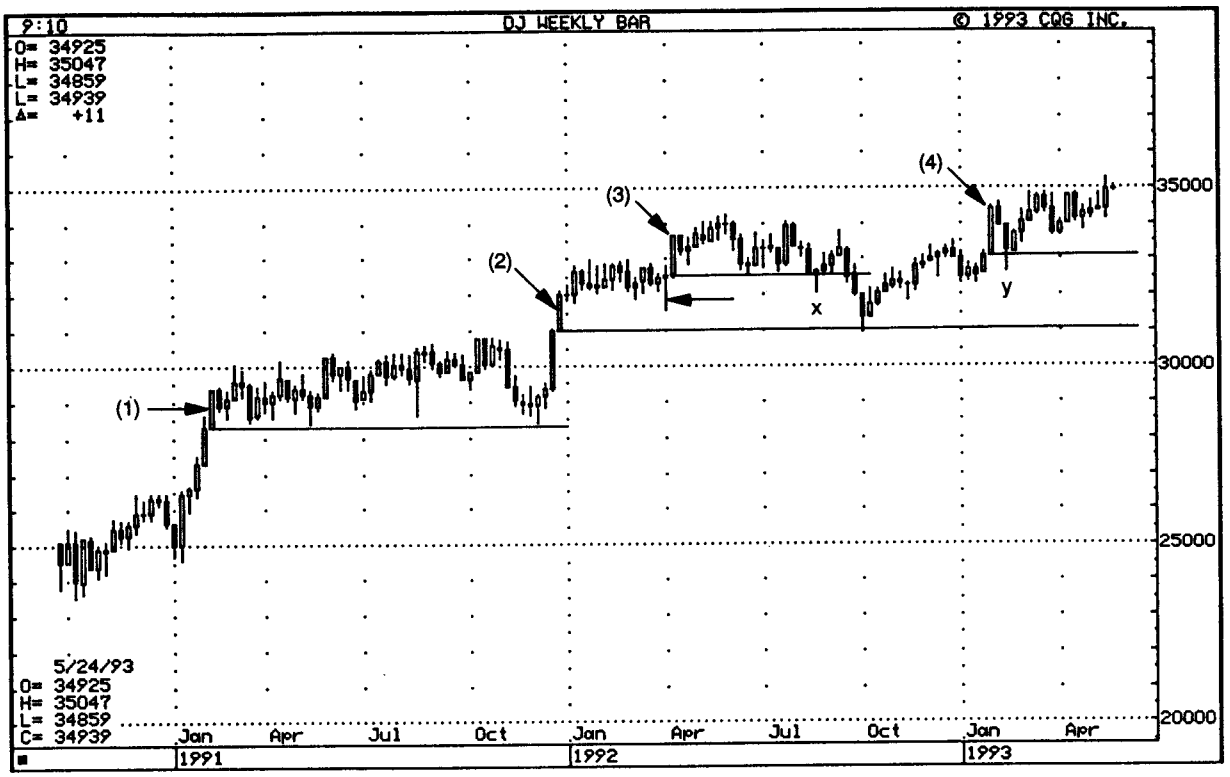


EXHIBIT 2.13. Bottom of Tall White as Support, Dow Jones—Weekly

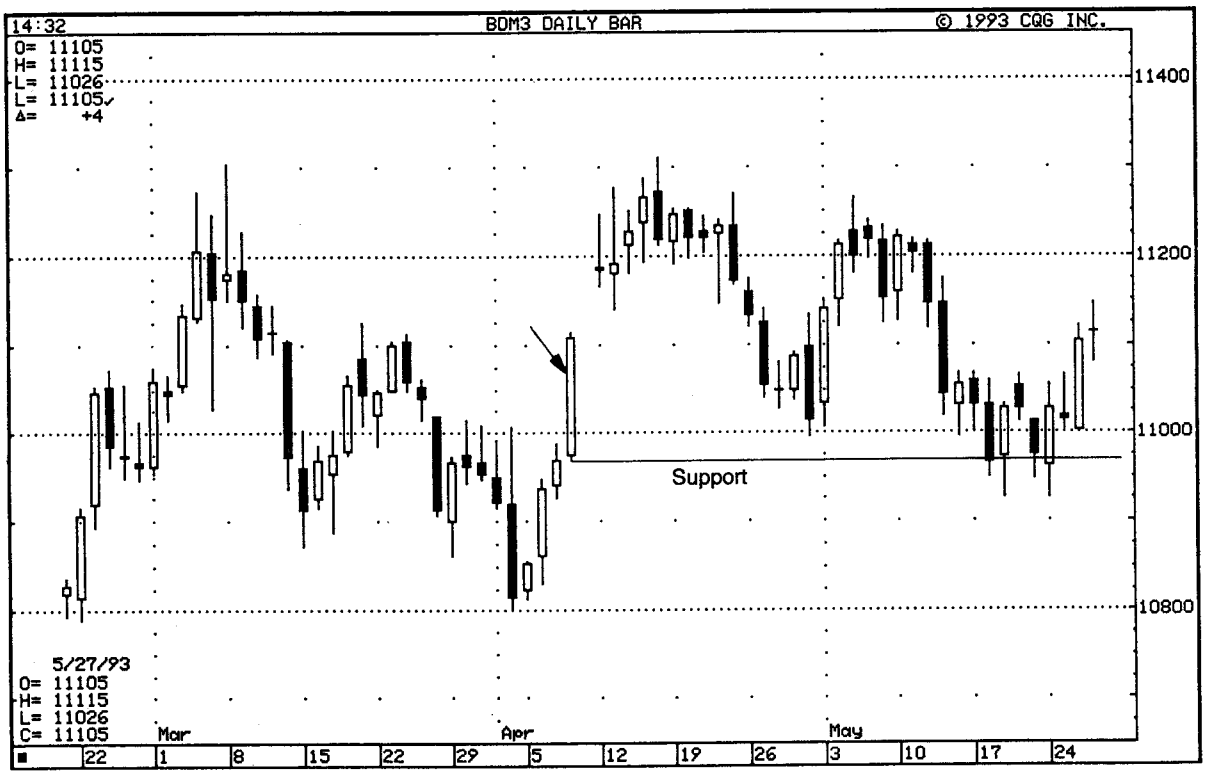


EXHIBIT 2.14. Bottom of Tall White Candle as Support with Bond Futures—Daily

A method you could use with this concept of tall white candles as support is to buy on a correction near the midpoint of the white candle. From that level down to the bottom of the long white candle (this includes the bottom of the lower shadow) should be support. If the bottom end of the support zone (that is, the lows of the tall white candle) is penetrated on a close, then you should reconsider your long position. At times, these support areas are broken on an intra-session basis, but as long as the support holds on the close, I still view it as valid support.

One of our institutional clients told me he found that, at times, after a tall white candle, the market corrects. I advised him that such action is not surprising since after such a candle, the market may be overbought and hence vulnerable to a setback. I then suggested the use of a long while candle as a support area in which he could buy on a correction. Coincidentally, on November 23, at the time the trader and I were talking about this, the bond's first hour of trading had just ended. This first hour, as shown in area 2 in Exhibit 2.15, completed a tall white candle. Since he traded bonds, I informed the client that support should be from the halfway point of this white candle down to the bottom of the candle, including the lower shadow. I then pointed out that there was another long while candle from the preceding day's first hour of trading (see

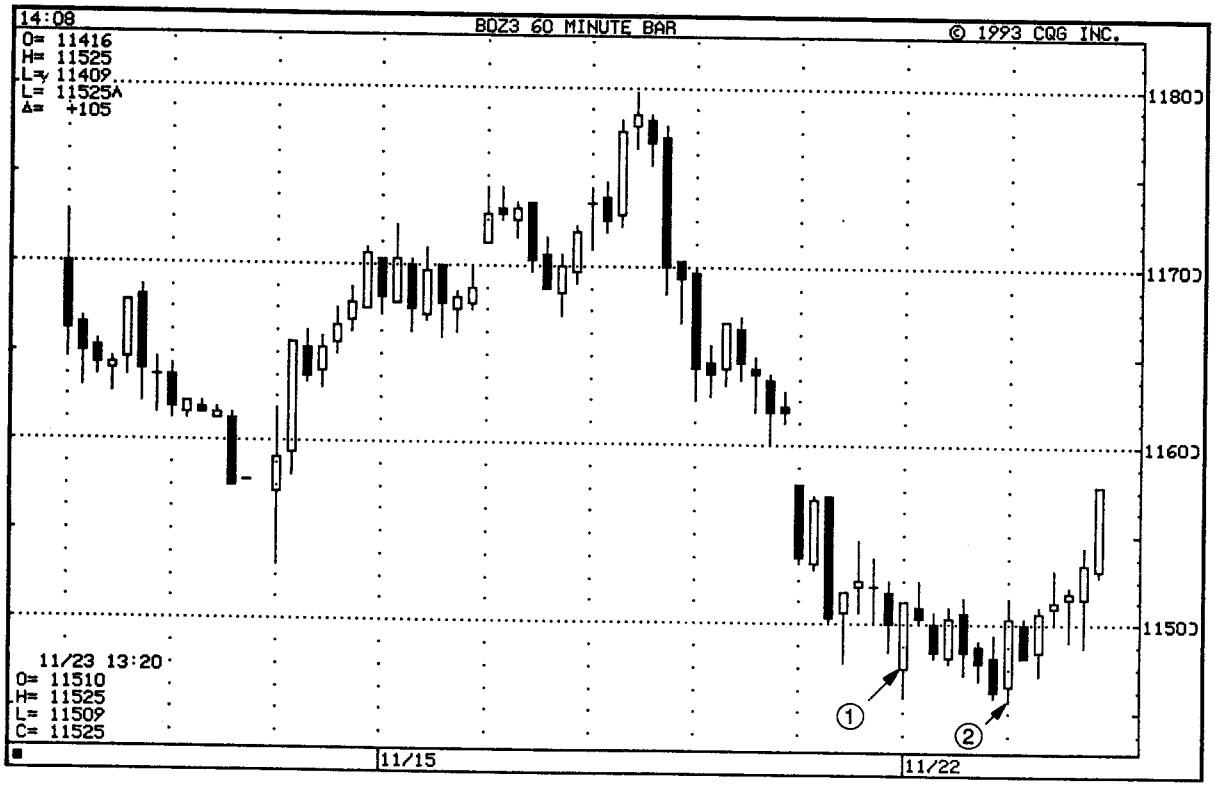


EXHIBIT 2.15. Using the Support Zone in a Tall White Candle December 1993 Bond Futures—Intra-Day

candle 1). The bottom of that tall white candle (including the shadow) was successfully defended as support with candle 2. Thus, there were two white candles (at 1 and 2) that reinforced the support near 114–16. Note how, after white real body 2, the market retraced about halfway into it before rallying.

Long Black Real Body at High Price Area

Just as a long white candle could be an early signal that the market may be trying to build a bottom, so it is that a distinctively long black real body at a high price may be a tentative warning of a top. The long black real body should be significantly longer than the candles preceding it. This is illustrated in Exhibit 2.16. Such a long black real body displays that the bears had grabbed control of the market. The longer the rally continued and the more overbought the market, the more reliable the cautionary signal of this long black real body becomes.

The long white candle (1) in Exhibit 2.17 echoes a vibrant market. However, there were a few warnings that Home Depot was overheating. The first was that the relative strength index (RSI) was above 70%. Such a high RSI figure is a clue that the market is overbought. Another sign that the bulls were losing their upside push was the series of small real bodies following the tall white candle at 1. These small real bodies showed that the supply-demand situation was more in balance as compared to tall white candle 1 (candle 1 showed that demand was overwhelming supply). Small real bodies are discussed in more detail later in this chapter.

Falling black real body at 2 showed that the bears had wrested control of this stock. Note how black real body 2 was the longest black real body since at least November 1992. This shouts out a warning that there is now something very different about the market, and that appropriate defensive action—such as selling covered calls, or offsetting some longs—should be undertaken. For those who are familiar with all the candle patterns, note how the tall white candle at 1 and the black real body at

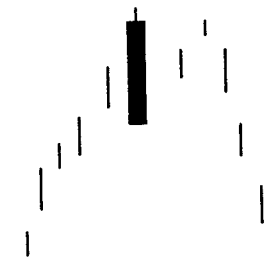


EXHIBIT 2.16. Long Black Real Body at High Price Area

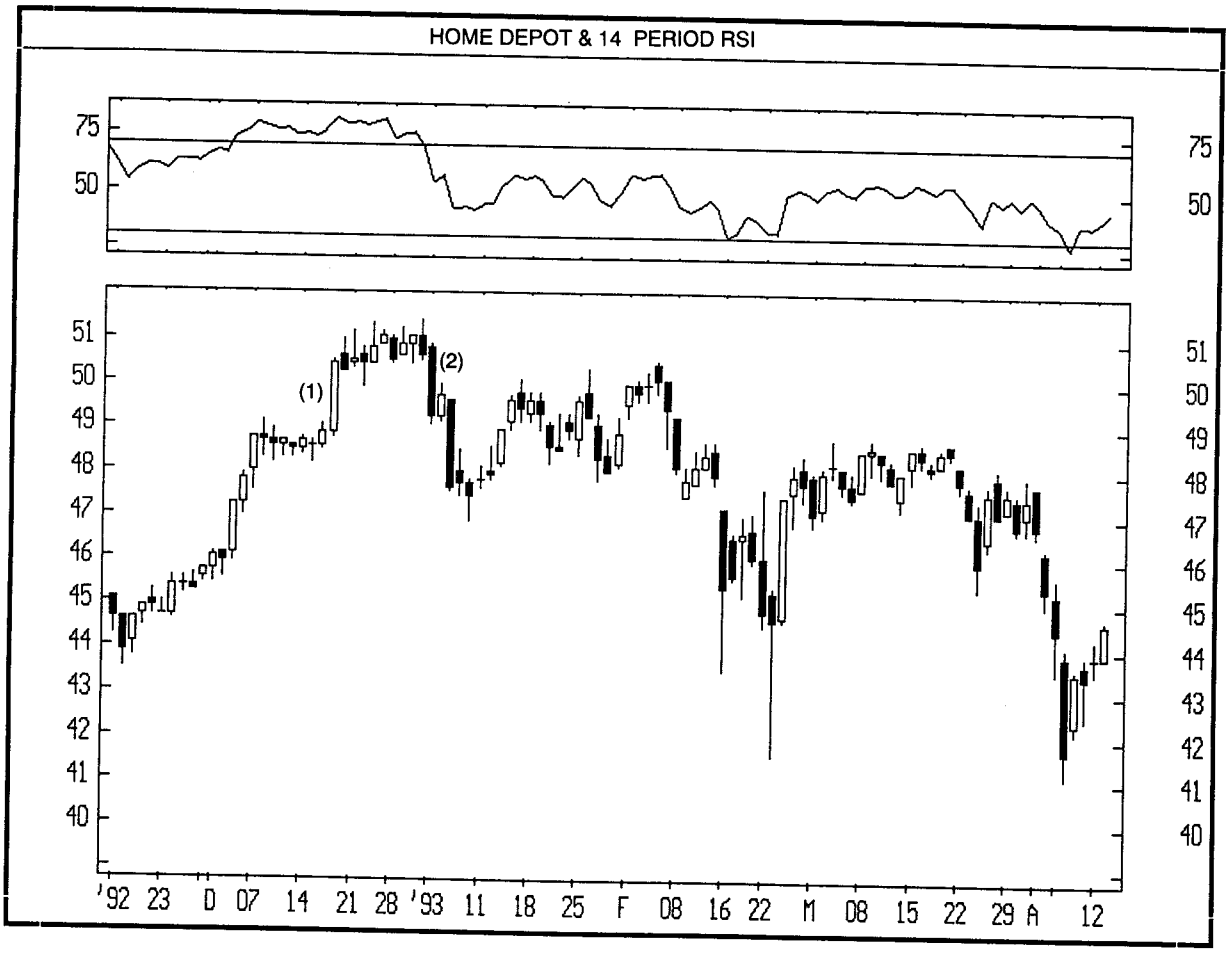


EXHIBIT 2.17. Large Black Candle at High Price and the Relative Strength Index, Home Depot—Daily

2 formed a bearish tower top, so named because the two long candles at 1 and 2 look like towers.

Long Black Confirms Resistance

If, as shown in Exhibit 2.18, the market backs off sharply from resistance through a long black candle, it is extra confirmation of the resistance area. This is because such a candle means that either the bulls have

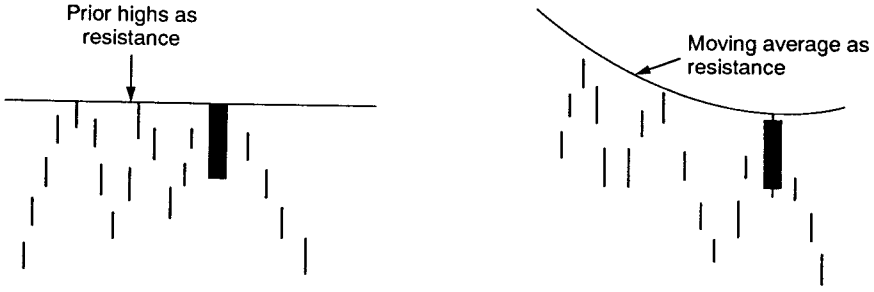


EXHIBIT 2.18. Long Black Candle Confirms Resistance

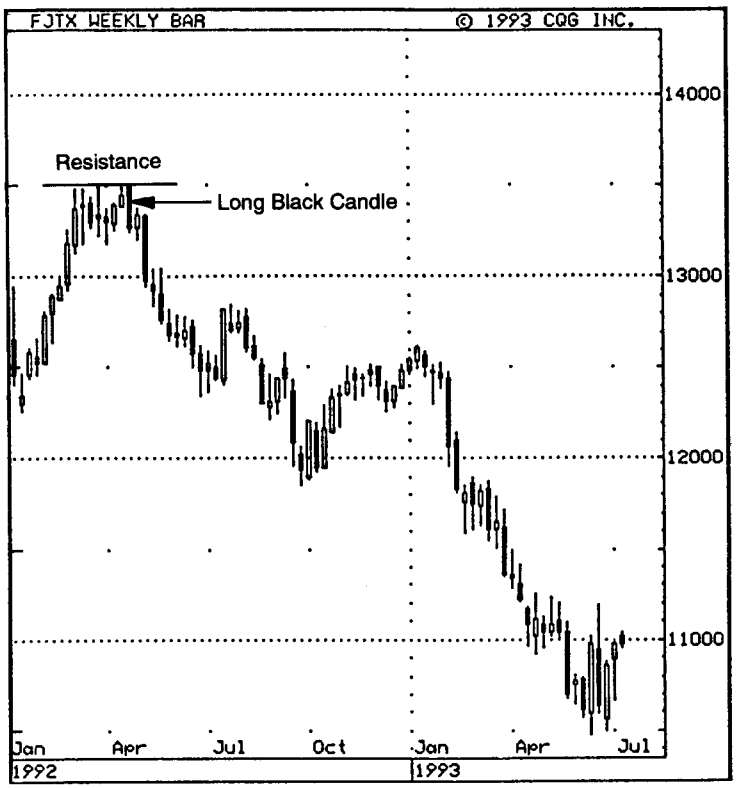


EXHIBIT 2.19. Long Black Candle at Resistance, Cash Yen—Weekly

retreated or that the bears have become aggressive enough to overwhelm the bulls. Either of these scenarios is potentially bearish. In Exhibit 2.19, there is an evident resistance area near 135 yen. This is shown by the horizontal trendline. The first long black candle at the arrow stalled at this resistance. With the retreat from this resistance through this unusually long black real body, there was a cause for caution. Two weeks later, the second, even longer black real body signified the capacity of the bears to drag prices lower.

Long Black Breaks Support

As shown in Exhibit 2.20, the way the market breaks a support area may indicate the seriousness of the break. For instance, a move under a support area by way of a long black candle should be viewed as a potentially more bearish scenario than if the market closes under a support area with a short black candle or a white candle.

A popular longer term moving average monitored by both Japanese and American stock market participants is the 200 day moving average. Exhibit 2.21 shows how this moving average was support throughout

EXHIBIT 2.20. Long Black Candle Breaks Support

late 1992 into January 1993. However, the first sign of a break of this support came by way of long black real body 1. Although this only broke the 200 day moving average line by a few cents, it was an early, but provisional, sign of trouble. Final proof of a decisive break of the support area came with long black candlestick 2.

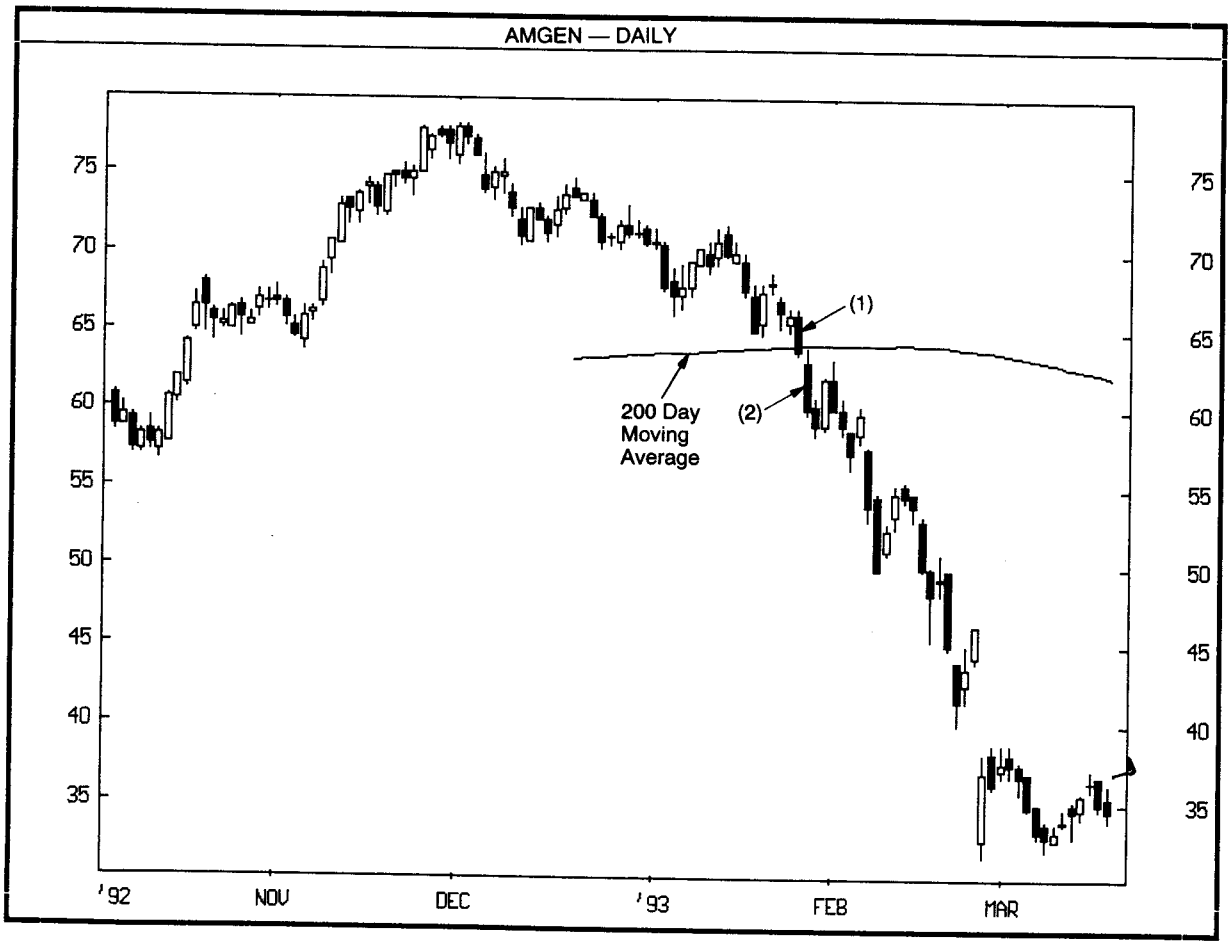


EXHIBIT 2.21. Long Black Real Body Breaks Moving Average Support, Amgen—Daily

EXHIBIT 2.22. Long Black Candle as Resistance

Long Black as Resistance

As a long white real body acts as a support area, so a long black real body should act as resistance (see Exhibit 2.22). In Exhibit 2.23, long black real body 1 penetrated an uptrending support line. With the long black candle at 1 and the long black real body six weeks earlier (at X), there

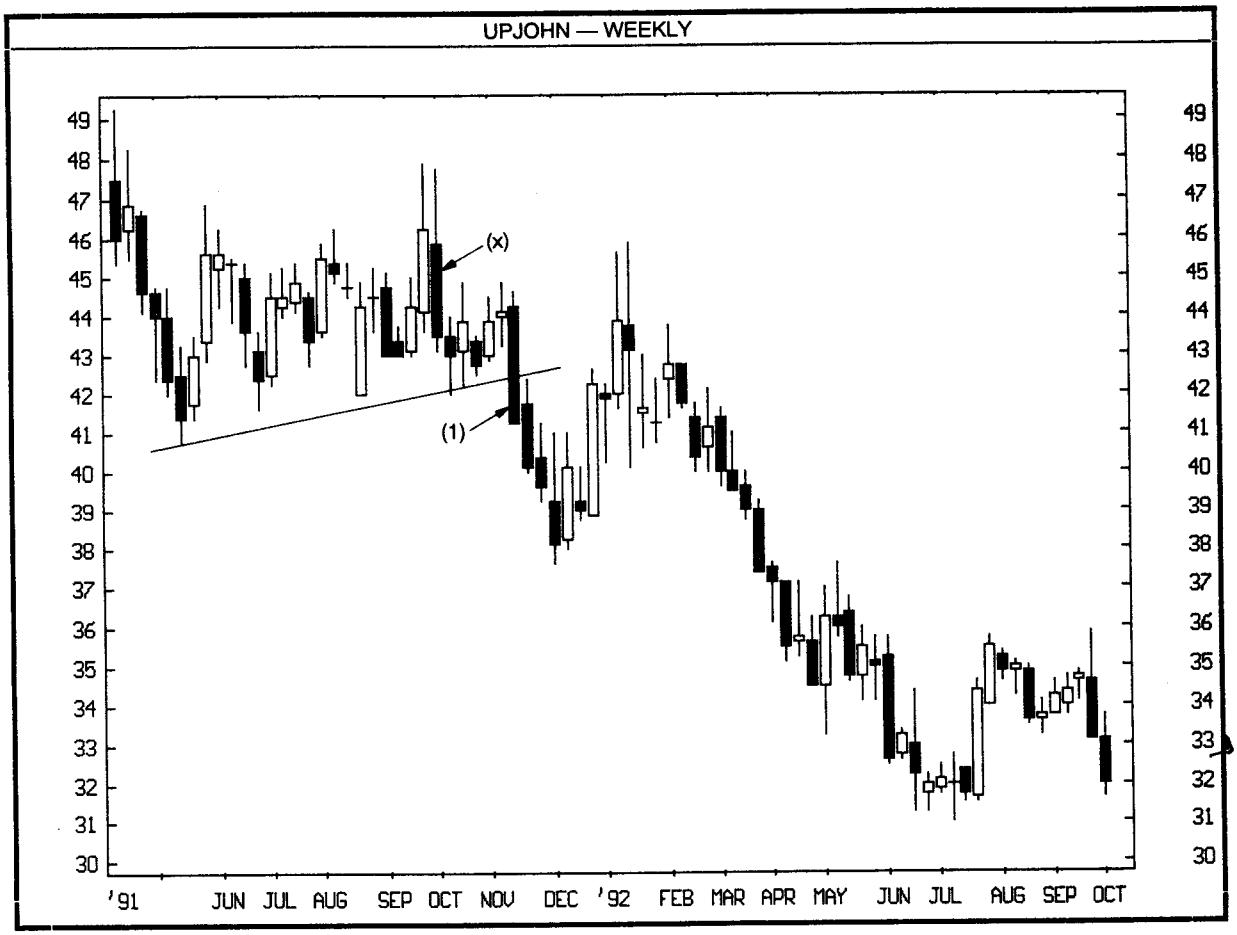


EXHIBIT 2.23. Long Black Candle as Resistance, Upjohn—Weekly

was now a resistance zone that could be used to exit longs or to go short, on a bounce to that resistance.

Exhibit 2.24 displays a price explosion via a long white candle in late 1991. Using the theory of long candles, let us see how one could have traded this market. A long white candle gives us a support area at 50% within its real body. Consequently, a pullback to near the 50% retracement of the long white could be used as an early buying zone. This could have been at areas 1 through 4. Now, we turn our attention to a price target. Notice the exceptionally bearish long black real body from September 1991 (at the arrow). As discussed above, we would expect a rally to stall as it approaches the top of this black candle. Although the bulls were finally able to gather enough force to breach this resistance of the long black candle, it took them over a year to accomplish this. Thus, buying on a pullback into the long white with a minimum target to September's long black real body could have been an effective trading strategy.

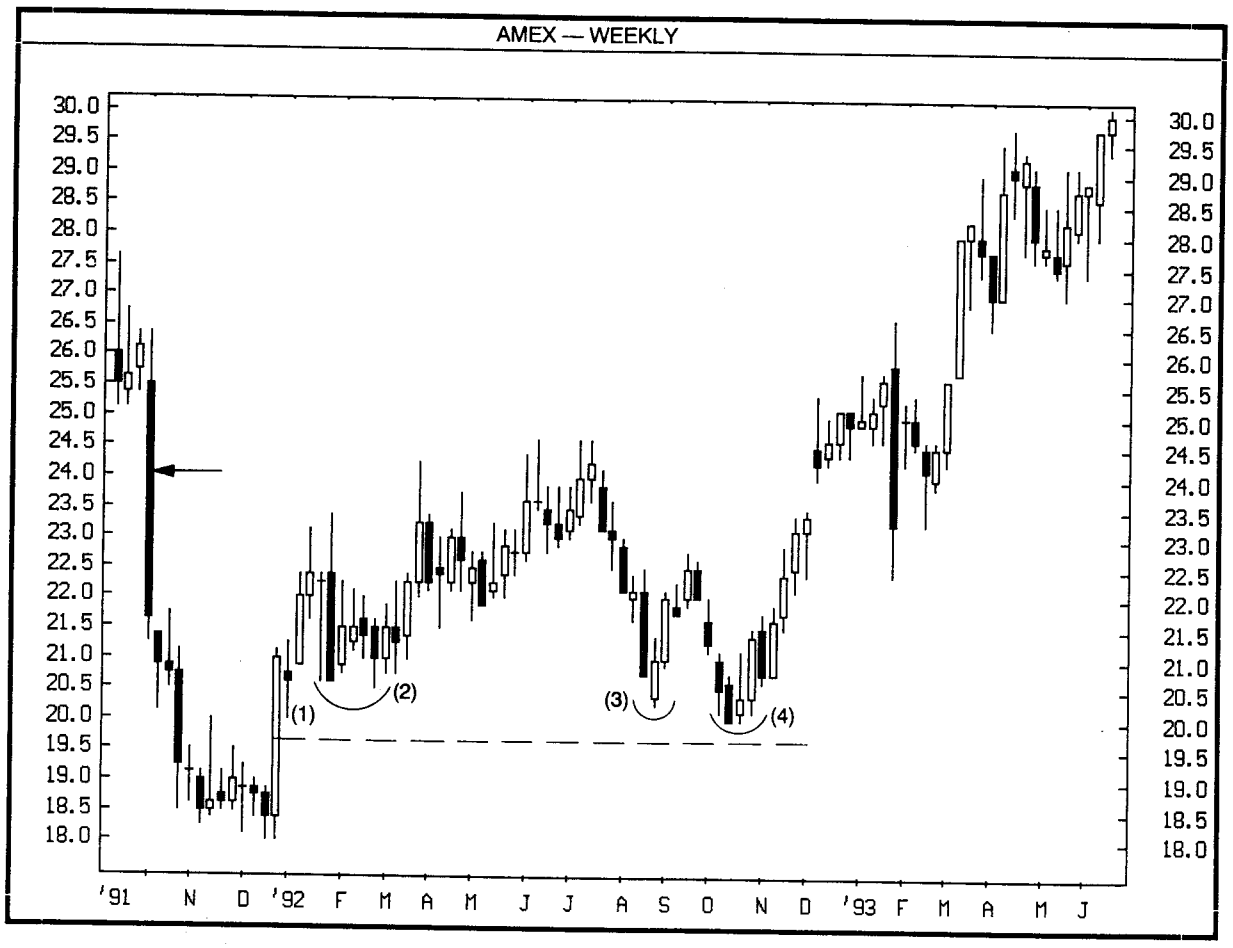


EXHIBIT 2.24. Long Black Candle as Resistance, Amex—Weekly

Size, Frequency, and Color of Real Bodies

The tone of the market can be gauged by comparing the relative height, frequency, and color of a group of candle lines. The first sign of trouble in Exhibit 2.25 came with the long black candle at 1. Note how this is the longest black candle in some time. Then, an appearance of an elongated black candle at 2 was an evident warning sign of trouble. The price descent continued until February's tall white candle at 3 arose. This was the loftiest white real body in many months, and relayed that the bulls had entered the market in force. Observe how the midpoint of February's white real body became a base for a minor rally.

In the boxed section in Exhibit 2.26, we see a period in which the market was trading laterally. With a bar chart, it would be difficult to glean information about the relative strength of the bulls or the bears in such an environment. With the candles, however, we can do this. In this trading range environment, we can see that there were eight black real

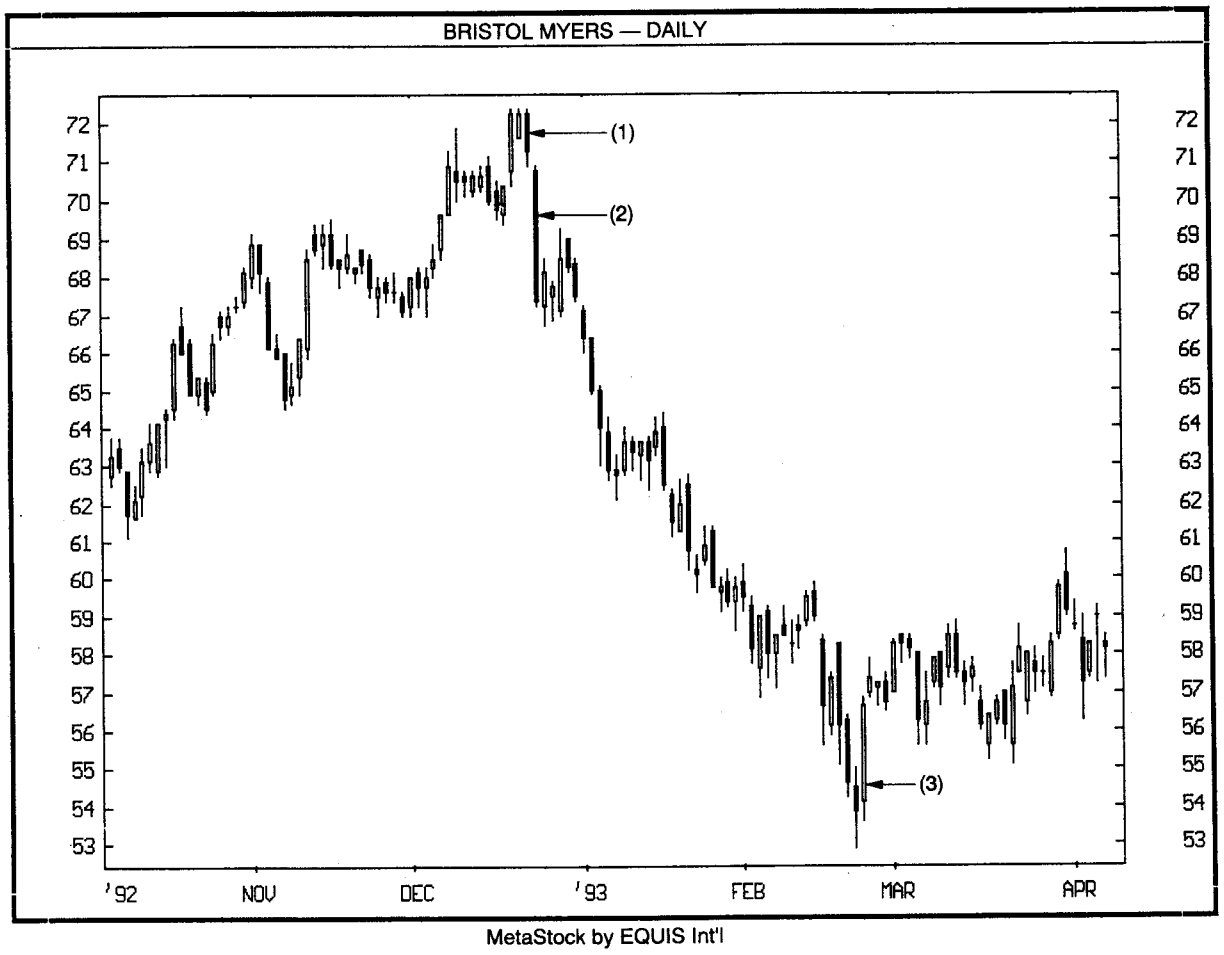


EXHIBIT 2.25. Size and Color of Real Bodies, Bristol Myers—Daily

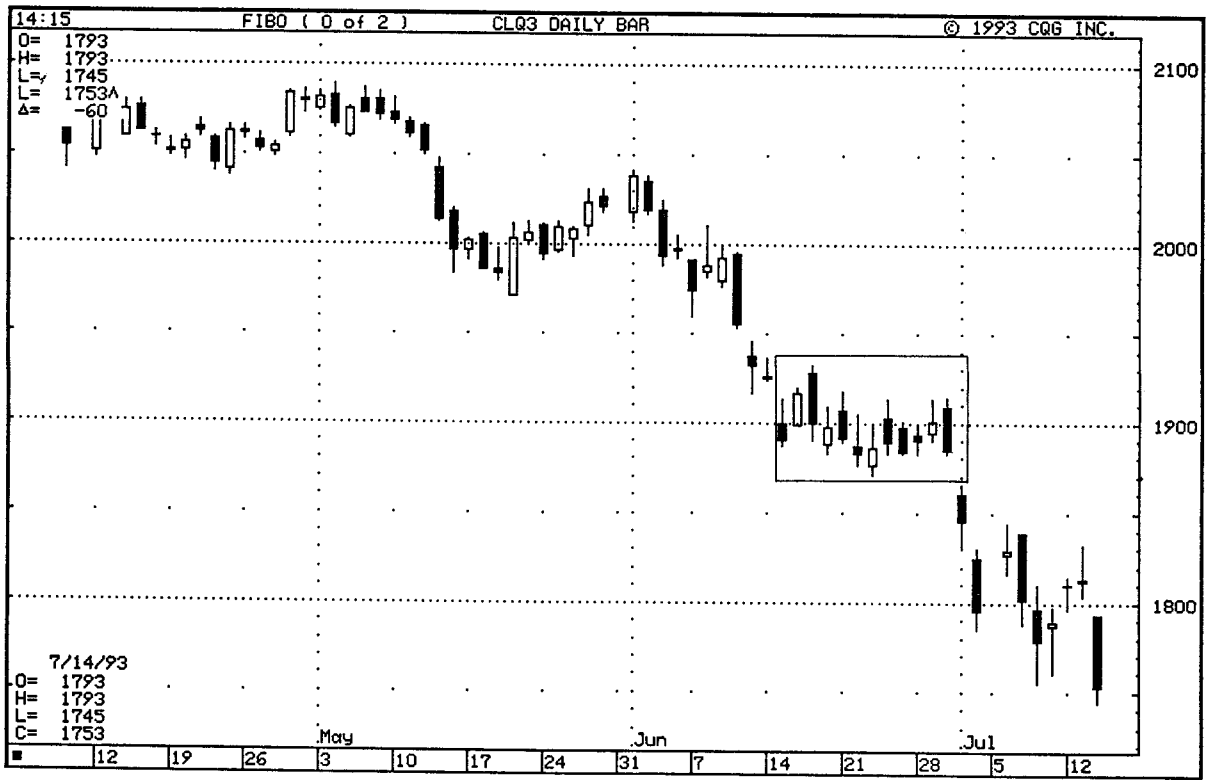


EXHIBIT 2.26. Relative Size, Frequency, and Color of Real Bodies, August 1993 Crude Oil

bodies and only four white candles. Also, the black real bodies were taller than the white ones. With more and larger black real bodies than white real bodies, the candles tell us that the bears were taking a more aggressive stance than were the bulls. Classic Western technical theory stated that after a congestion band, the market's trend should have resumed in the same direction that it had before the congestion band. In this example, the preceding trend was down. Thus, the bearish candle action during the lateral range reinforced the classic Western theory and increased the odds of a continuation of the preceding downtrend.

In the next section, using information on how the open compares to the close will be discussed. But before that, I will discuss new ways of interpreting candle patterns. This methodology will help illuminate the theory and market action behind each candle pattern. Each candle pattern in this book will be illustrated four ways (refer to Exhibit 2.27).

Exhibit 2.27 (B) The blended candle—If the candle pattern has more than one candle line, you can combine them to make a single candle line, which I call a *blended candle*. This method is sometimes used in the Japanese candlestick literature to help clarify whether a pattern is bullish or bearish. The blended candle is an individual line that is a combination of the open, high, low, and close of all the candle lines in the pattern.

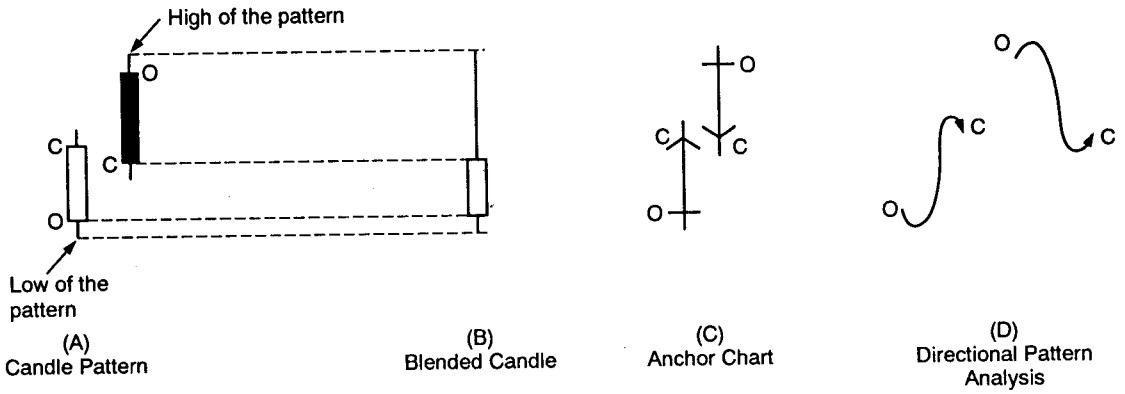


EXHIBIT 2.27. Candle Pattern Analysis

As shown in Exhibit 2.27 (B), the blended candle is drawn using a four-step process:

1. Use the open of the first session of the candle pattern as the open of the blended candle.
2. Use the high of the candle pattern (in other words, the top of the highest upper shadow) as the high of the blended candle.
3. Use the low of all the sessions of that pattern (i.e., the bottom of the lowest lower shadow) as the low of the blended candle.
4. Use the close of the last session of the candle pattern as the close of the blended candle.

Based on the insight offered by the blended candle line in Exhibit 2.27, we can deduce that the two-candle combination in Exhibit 2.27 (A) is a bearish combination. This is because the blended candle shows the bearish aspects of a long upper shadow and small real body near the bottom of the range.

Exhibit 2.27 (C) Anchor charts—Those who draw the candle charts by hand and are tracking many markets or are restricted in time may find this task to be burdensome. One way to circumvent this (besides buying software) is to consider using anchor lines instead of candle lines. The anchor chart as previously discussed, is composed of the open, high, low, and close. If the anchor is pointing up, it means that the close is higher than the open (with the arrow part of the anchor representing the close). An anchor pointing down means that the close is lower than the open.

Although the anchor chart is less visual than the candle chart, it provides the same information and is faster to draw. The disadvantage to the anchor chart is that you don't have the quick color clue, as you do

with the candle's white and black real bodies. But you can draw up sessions in red and down sessions in black (remember, however, that unless you have a color printer, all the anchor lines will be black when a hard copy is printed).

Exhibit 2.27 (D) Directional Pattern Analysis—To clarify the market's path that unfolds during the candle pattern, I will draw arrows reflecting the market's basic intra-session action. I call this *directional pattern analysis.* The path shown by the market's action in the directional pattern analysis can be used as a rough method to gauge the overall price action during the session. Although the arrow in the directional pattern analysis will show the path taken by the market during the session, it will not show the order of when these prices where touched.

For example, based on the relationship of the real body and shadows of the first white candle in Exhibit 2.27 (A), we know that, at some time during the session, prices moved under the opening price. However, we do not know when the price moved under the open. While the arrow in Exhibit 2.27 (D) may make it appear that the market immediately moved lower after the opening, it may not have unfolded that way. The market instead may have rallied after the open and later in the session fell under the opening price. Thus, it is important to keep in mind that the directional pattern analysis should be thought of as a visual clue about the relative price action of the open, high, low, and close compared to one another. However, it does not tell us the sequence of that price action.

Opening Compared to Prior Real Body

A disadvantage of candle charts is that they require the close to complete the candle line. There are some ways around this limitation. One method is to go to a shorter time. In other words, if you are looking at a daily chart, you can sometimes get a signal on the hourly chart before the close of the daily session. Another mechanism to bypass waiting for the close, and the one I will focus on here, is comparing the opening to the prior real body.

Exhibit 2.28 (A) illustrates that if the opening is under the midpoint of the previous white real body, it could be a bearish scenario. Conversely, if the next day's opening is above the black body's midpoint, as shown in Exhibit 2.28 (B), it could be viewed as a positive sign. This concept might be useful for those who are more aggressive and risk-oriented and would want to buy or sell on an opening rather than waiting for a close.

This technique is more important for stocks than for futures. This is because the futures market's higher volatility makes it more likely for the

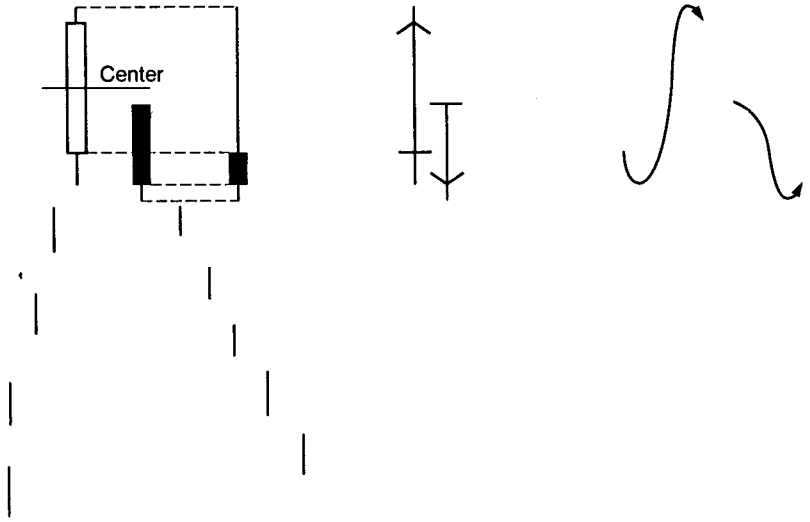


EXHIBIT 2.28. (A) The Traditional Candle Line or Pattern

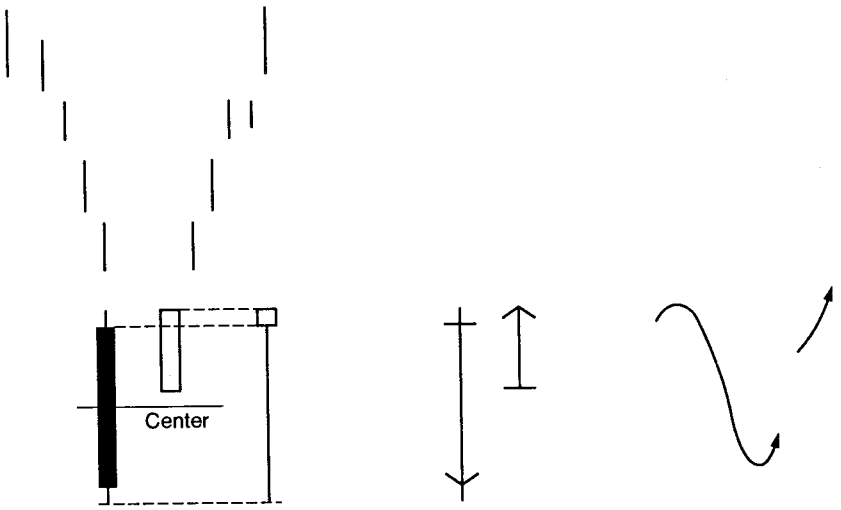


EXHIBIT 2.28. (B) Opening Compared to Prior Real Body

price to open away from the prior close (remember that for prices to open above or below the prior real body's midpoint, it has to open away from the prior close). However, for a stock, such an occurrence is rarer, and as a consequence more significant.

The chart of Manville (Exhibit 2.29) gave three signals that it was in trouble in mid-1992. First was the long upper shadow candle at the arrow (shadows are discussed in detail in the next section of this chapter). This showed the market rejected the $11 zone. The next signal was when Manville opened under the center of the prior white real body. Final bearish confirmation came the following week when the market gapped lower.

In Exhibit 2.30, in the session marked by the arrow, the market opened above the midpoint of the prior black real body. This positive develop-

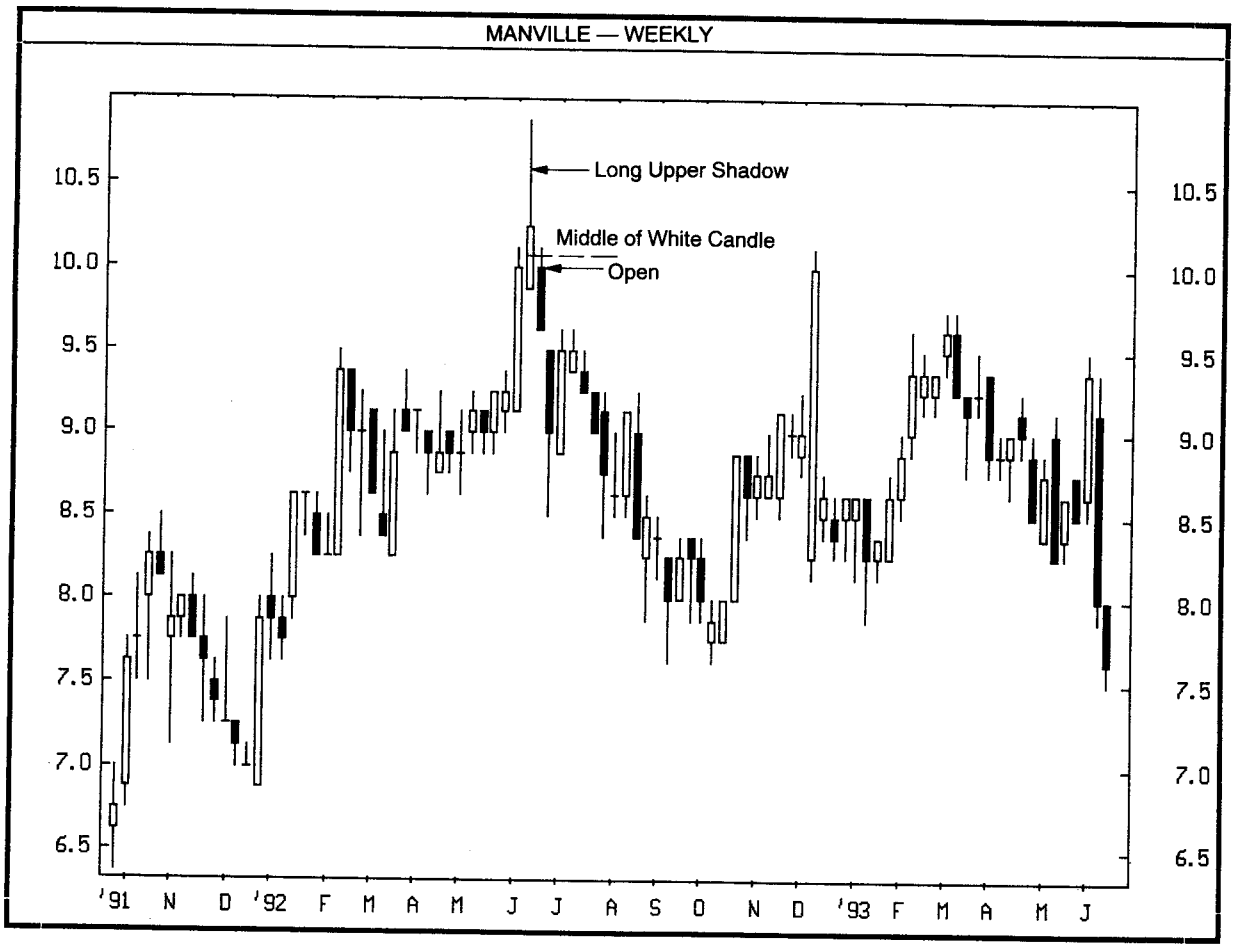


EXHIBIT 2.29. Open Under the Center of Prior White Real Body, Manville—Weekly

ment was reinforced by the white candle's high volume activity. This volume showed the pressure of the buying force.

Spinning Tops

We have seen the power inherent in tall white or black real bodies. A tall white body reflects a strong session in which the bulls are in control, whereas a long black real body means that the bears are in charge. Now, what would it mean if, instead of tall real bodies, there were small real bodies? This would tell us that the bulls and bears are in a tug of war and that there is more of a balance between supply and demand. Such small real bodies, called spinning tops, tell us that the power to move up or down is lacking, or as the Japanese phrase it, the "market is losing its breath."

As shown in Exhibit 2.31, these are spinning tops even if the lower and/or upper shadows are large. It is the diminutive size of the real body

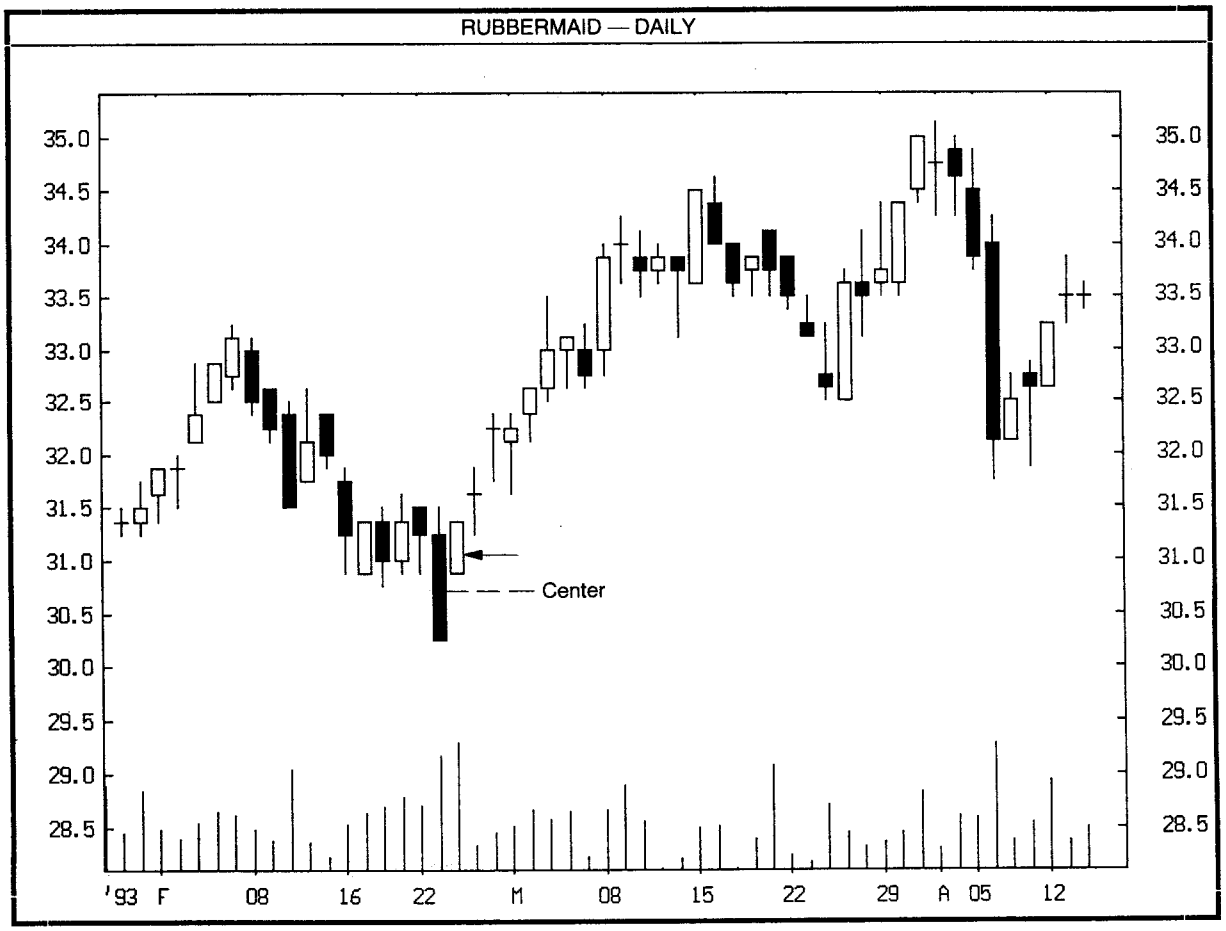


EXHIBIT 2.30. Open Above the Center of a Black Real Body, Rubbermaid—Daily

that defines a spinning top. A spinning top is a warning sign that the market is losing its momentum. For instance, if the market is at or near a new high—especially after a steep advance—the emergence of a spinning top could be a signal that the bulls are having trouble in continuing their ascent. This could be a cautionary signal that the prior move is stalling.

In Exhibit 2.32, the strong, long white real bodies at the end of July left no doubt about who had control of this market—the bulls. But the two spinning tops after these long white real bodies sent out a warning

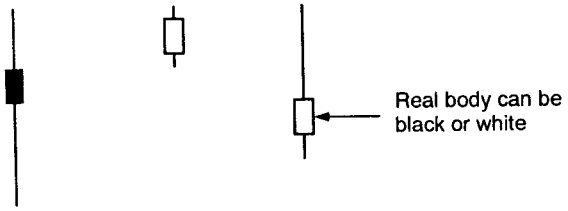


EXHIBIT 2.31. Spinning Tops

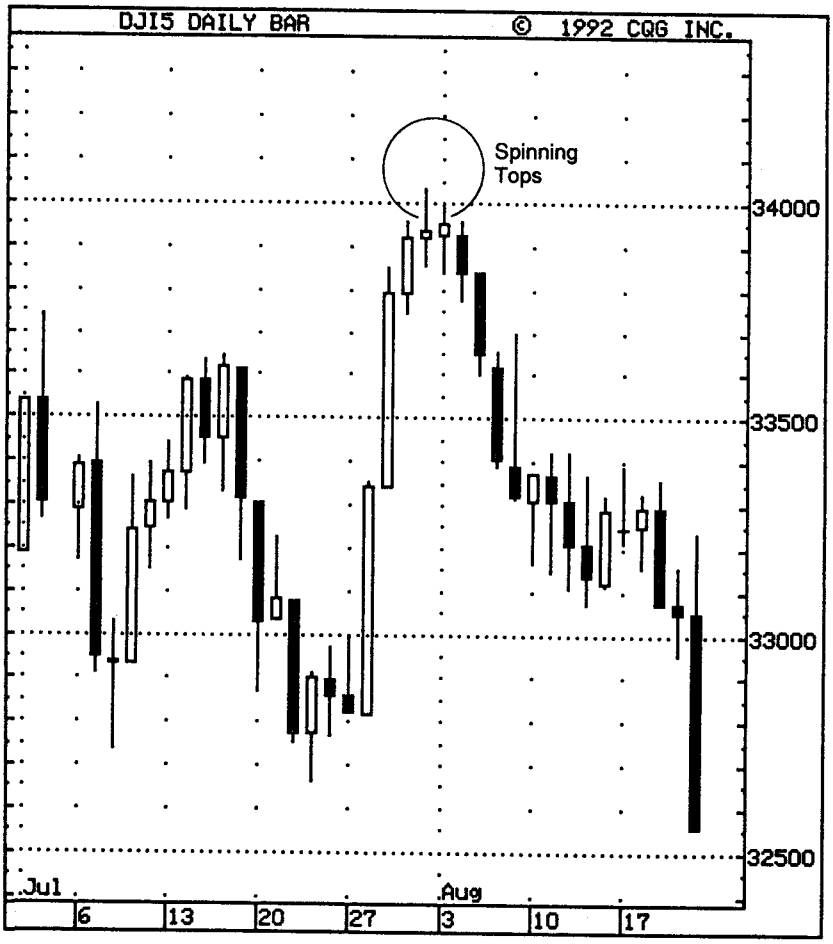


EXHIBIT 2.32. Spinning Tops, Dow Jones—Daily

that the bulls were unable to maintain the momentum of their advance. The arrival of the spinning tops showed that the market was losing its vitality. The black candles after the spinning top added more reason to suspect a turn.

Accumulation and Distribution

One of the most powerful and important aspects of candle charts is their ability to meld themselves with any other form of technical analysis. Let us, for example, uncover how one candle (the spinning top), combined with volume, can provide critical information about the inner workings of the market.

Two key concepts relating volume to price action are those of accumulation and distribution. Accumulation occurs when, at a low price level, there is a high volume session with stagnant prices. The high volume relays that the bears are attacking full force, throwing all their re-

sources and ammunition into the fray. But the stagnant prices during the session show that the bears are unable to drag down prices. All that the bears have tried to sell has been accumulated by the bulls. After such a scenario, the bears may either run out of ammunition or just give up. The consequence of either of these is a rally.

Distribution is the opposite of accumulation. Distribution occurs when, at a high price level, there is heavy volume but virtually frozen prices. What is happening in such an environment is that the "smart" money is thought to be distributing their supply to meet all the buying that is entering the market. With distribution, the sellers are offering enough supply to meet all the buyer's demand, thus keeping prices in check. Distribution should therefore be viewed as a topping scenario.

Note that as part of the definition for either accumulation or distribution, there must be little price movement. A spinning top reflects a session in which there is little price action (as defined by the difference between the open and the close). So, by combining volume with spinning tops, we can determine when there is accumulation or distribution.

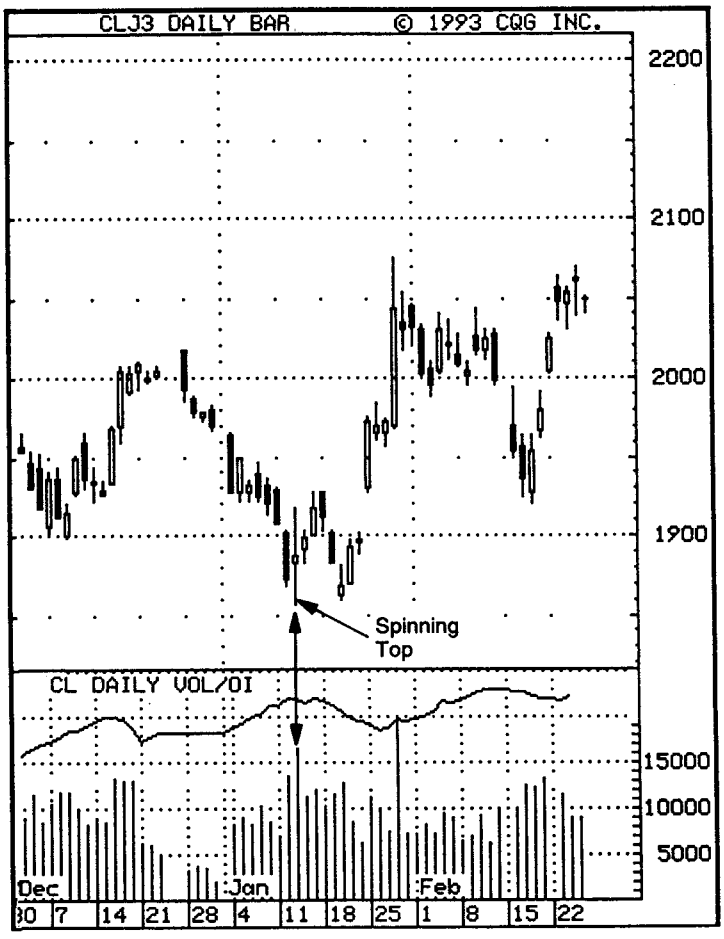


EXHIBIT 2.33. Spinning Tops and Accumulation, April 1993 Crude Oil—Daily

Exhibit 2.33 shows that a spinning top candlestick emerged on January 12. Note also the heavy volume of that session. As describe above, stagnant prices and high volume at a low price level are classic signs of accumulation. The high-volume spinning top in this example shows that the selling pressure was easily absorbed. This positive sign was further reinforced by the fact that this spinning top session made a new low for the move, yet the bears were unable to maintain these new lows.

In Exhibit 2.34, June's tall white candle session was also a high-volume session. This was a very bullish development insofar as the market moved up sharply with strong buying interest (as gauged by the high volume). However, what occurred in the next session was cause for concern. In that session, a small real body (i.e., a spinning top) emerged. The volume on the spinning top session (circled on the chart) was not as extreme as it was the prior day. Yet, looking back at the volume at the bottom of the chart, we see that it was nonetheless a very high-volume session compared to the prior periods. Consequently, there was a high-volume spinning top session. What does that tell us? The high volume reflects a market in which the bulls came out in force, but the small real body—the spinning top—means that the bears were aggressive enough to almost stalemate the bull's advance. This action was a classic sign of distribution. The small real bodies over the next few sessions

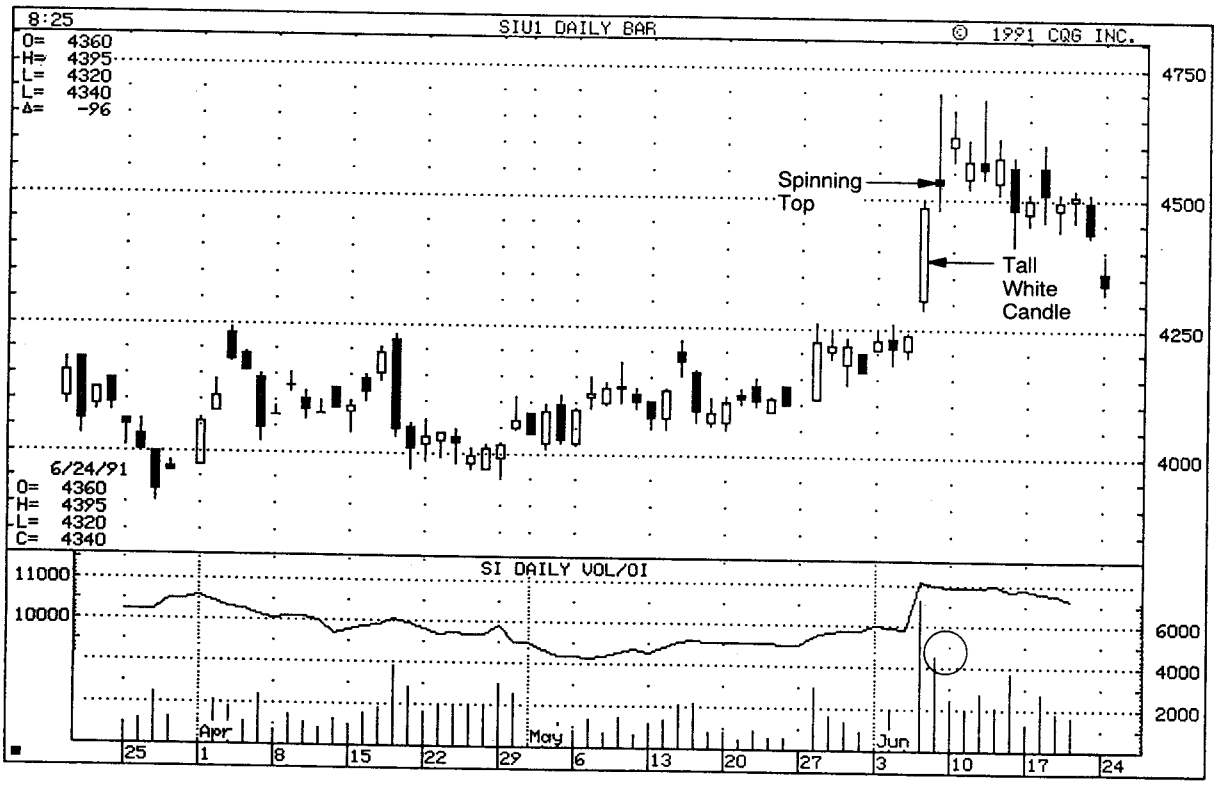


EXHIBIT 2.34. Spinning Top and Distribution September 1991 Silver—Daily

continued to echo the inability of the bulls to propel this market. Note how the longest real bodies following the spinning top were black. This showed that the bears had gained a foothold on the market.

Doji

One of the more important individual candlestick lines is the doji. As shown in Exhibit 2.35, a doji session has a horizontal line instead of a real body. This is because a doji is formed when the session's open and close are the same (or almost the same). If the market is trading laterally, a doji is neutral. In essence the doji is echoing, on a micro scale, the indecision reflected on a more macro scale by the market's sideways action. However, a doji that emerges after the mature part of an uptrend or sell-off has a greater chance of a market turn. At such a time, the Japanese say that a doji provides "a hint of tops and bottoms."

One should be especially cautious about a doji that arises after a tall white candle which in turn appears after a significant uptrend. This is true whether the doji is within the prior long white real body or above it. Such action represents a disparity about the state of the market. Specifically, the rally and tall white candles during such a rally tell us that the bulls are still in charge. But a doji means that the bulls are failing to sustain the upside drive. This is shown in Exhibit 2.36.

How do you decide whether a near doji day (i.e., where the open and close are very close, but not exact) should be considered a doji? One method is to look at a near doji day and compare it to recent action. If there is a series of very small real bodies, I would not view the near doji day as significant since so many other recent periods had small real bodies or doji. (Other methods are covered in my first book).

As mentioned before, a doji is meaningful when it arises after a tall white candle during an uptrend. In this scenario, the market is consid-

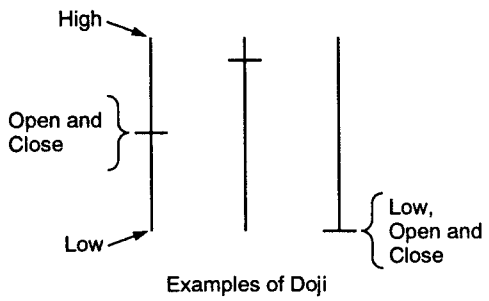


EXHIBIT 2.35. Doji

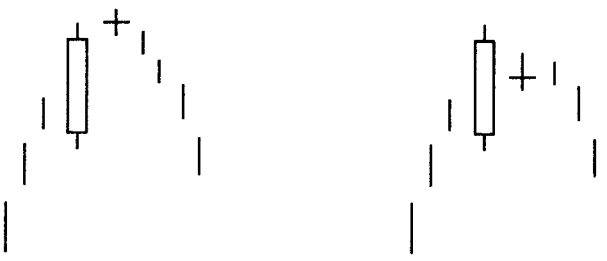


EXHIBIT 2.36. Doji After a Tall White Real Body

EXHIBIT 2.37. Doji as Resistance

ered by the Japanese to be "tired." Also, as shown in Exhibit 2.37, the top of a doji session (that is, the top of the upper shadow) often represents resistance. However, if the highs of the doji session are exceeded, then the market's uptrend should continue. This is discussed in more detail below.

A common mistake among those who use candles is to use a doji as an outright buy or sell signal. This is not correct. The doji indicates, as the Japanese say, "a crossroads between the bulls and the bears." While the doji can mean the market may reverse its prior trend, traders should view the doji as echoing a market in transition rather than being an outright reversal pattern. Based on this, traders should wait until the next session or two after the doji to show them which way the market will move.

If there is a doji during a rally, and if the market continues strong after this doji, it is a bullish indication since the market has resolved itself from the state of transition (as shown by the doji) to its new trend—up. Thus, while a doji that appears after a rally could be an indication of a reversal (since the market is at a crossroads), it is best to wait for bearish confirmation over the next day or two to get a top reversal confirmation. For those who sell on a doji, the doji should act as resistance (see Exhibit 2.37). If the market closes above the high of the doji, the Japanese say the market has become "refreshed." Based on this, a buy stop should be placed above the high of the doji. The opposite would be true with a doji in a downtrend. To wit, a doji in a downtrend shows that the market is at a point of indecision, and a white candle after such a doji shows that the market has resolved itself to the bull side. A buy based on the doji after a downtrend should have a sell stop under the doji's low (including the lower shadow). This is because such a scenario is viewed as a bearish continuation signal.

One of the most fascinating aspects about candle charts is that, in spite of their underlying simplicity, they provide so much valuable information about the state of the market. For example, what is more il-

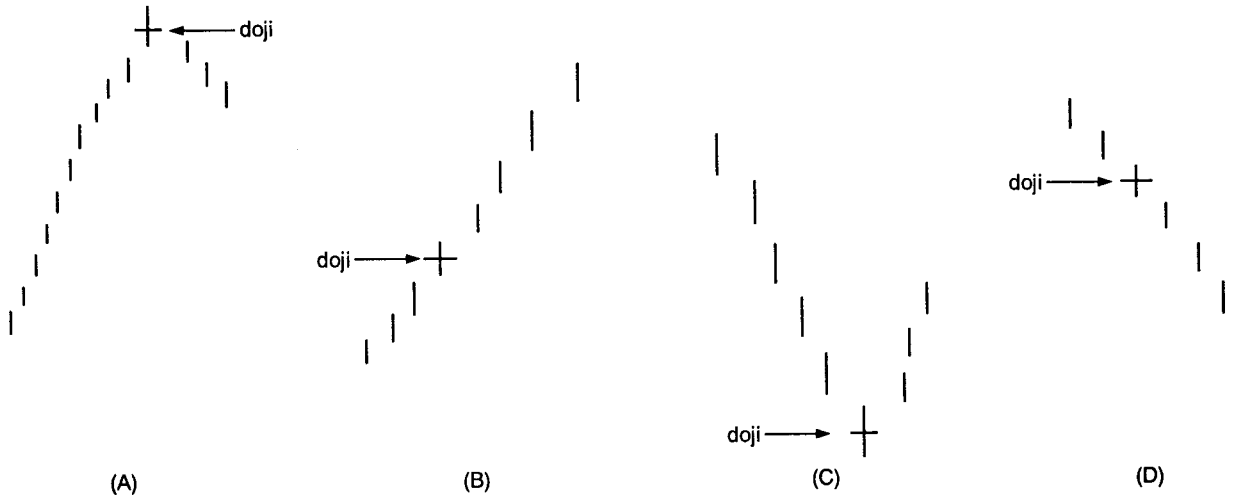


EXHIBIT 2.38. Doji After Extended Move

lustrative of a market in balance than a doji? That simple, individual candle line relays how a market is in a state of balance between the bulls and bears. As a result, the market may be at a transition point. All this information in one candle line!

An important aspect about doji (the plural of doji is also doji) is that traders should look at where the doji appears in a trend. Exhibit 2.38 shows a doji in relation to the trend. As in Exhibit 2.38(A), the appearance of a doji after a steep advance or in an overbought market could be a top. However, as shown in Exhibit 2.38(B), if the market just started to rise, it indicates there is less of a chance that the market is at a top. In Exhibit 2.38(C) we see how the emergence of a doji after a precipitous decline could mean a bottom. Exhibit 2.38(D) displays a market that has just begun to fall. In this scenario, prices may continue their descent even after a doji. The main concept behind Exhibit 2.38 is that doji become more important as a reversal signal the more overbought or oversold the market.

In Exhibit 2.39, we notice a rally that started in early November stalled after two doji following a tall white candle. The appearance of these doji told of a market in which the bulls and bears were in equilibrium. This was very different from the prior session when the tall white candle displayed a vibrant and healthy market in which the bulls were in control. These doji were showing, as the Japanese would phrase it, that "the market is separating from its trend."

As discussed before, doji become resistance. In this chart, there is also a long black real body candle (at the arrow) a few days after the doji. This black real body should also be resistance. With this in mind, the doji sessions and the long black real body provided a resistance zone in

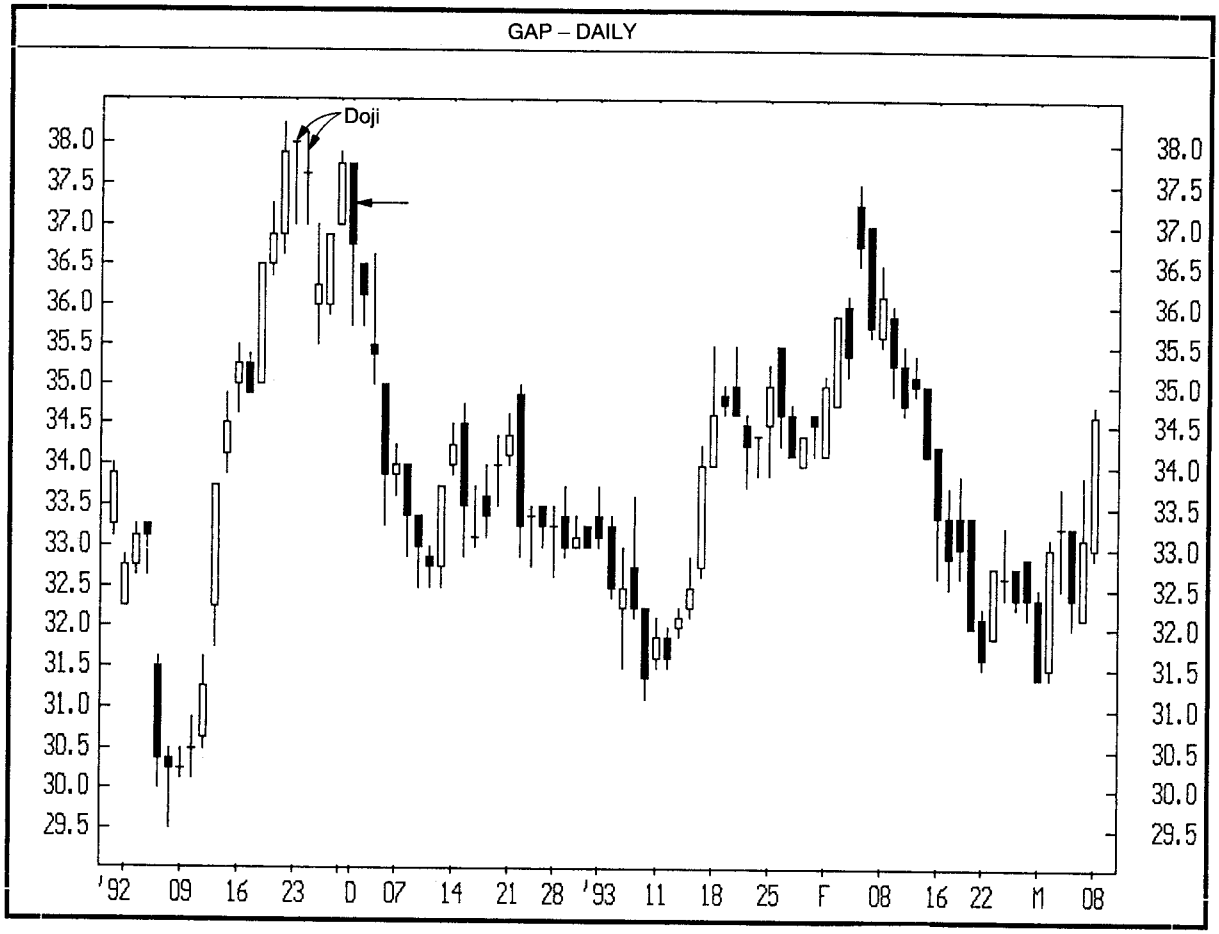


EXHIBIT 2.39. Doji After a Tall White Candle, Gap—Daily

the $37 to $38 area. It was within here that the market failed during the early 1993 rally.

The arrow in Exhibit 2.40 points to a doji session in which the open, low, and close are at the bottom end of the session's range. This doji is known as a gravestone doji. A gravestone doji looks like a wooden memorial used in Buddhist funerals that is placed at a gravestone. It is said that those who buy at a high price level after this doji will die and become ghosts. (Those familiar with candle patterns will note how this doji was part of a classic evening doji star pattern [this pattern is discussed in Chapter 3]).

Exhibit 2.41 shows how the small real bodies at 1 and the doji at 2 warned that the market was losing its upside drive. After trading in a lateral range for a few weeks, prices ascended to new highs in late January. However, there were two clues that the rally might not be sustainable. The first was the doji at 3. This showed that, although the market had reached new highs, the upside drive had stalled. Another clue was

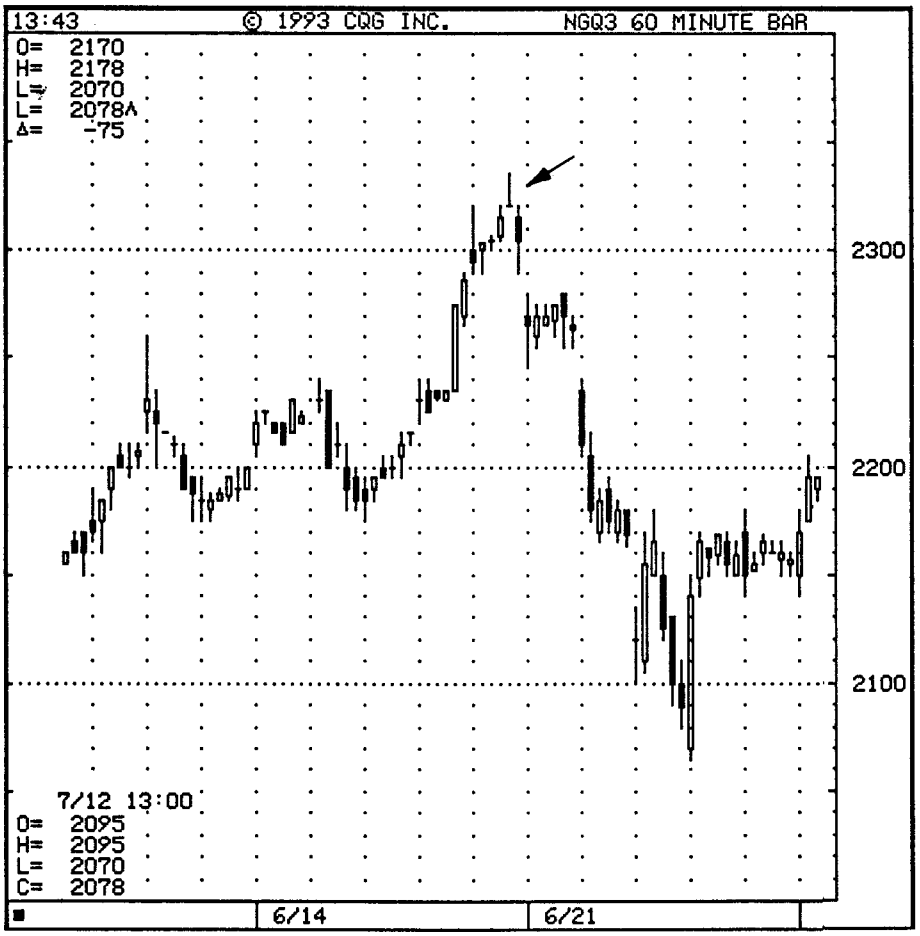


EXHIBIT 2.40. Gravestone Doji August 1993 Natural Gas—Intra-Day

provided by the rate of change (ROC) oscillator. This oscillator compares today's closing price to that of ten sessions ago.

For this example, I show the ten day ROC. This compares today's close to that of ten days ago. With a healthy market, traders would like to see an increasing ROC oscillator. This reflects that the market's upside momentum is growing as prices are ascending. However, note how at doji 2, Dell touched a new high, yet the ROC oscillator was at a lower reading than it was at the prior highs in December. This underscores a slackening of the upside drive.

Thus, the ROC oscillator helped reinforce the bearish implication of doji 2. As further confirmation of a top, there was the long black candle on the day after doji 3. A few days after this black candle, the ROC oscillator fell under 0 (some technicians view that as a time to sell). This chart is an example of how easy it is to combine the candles with Western technical tools.

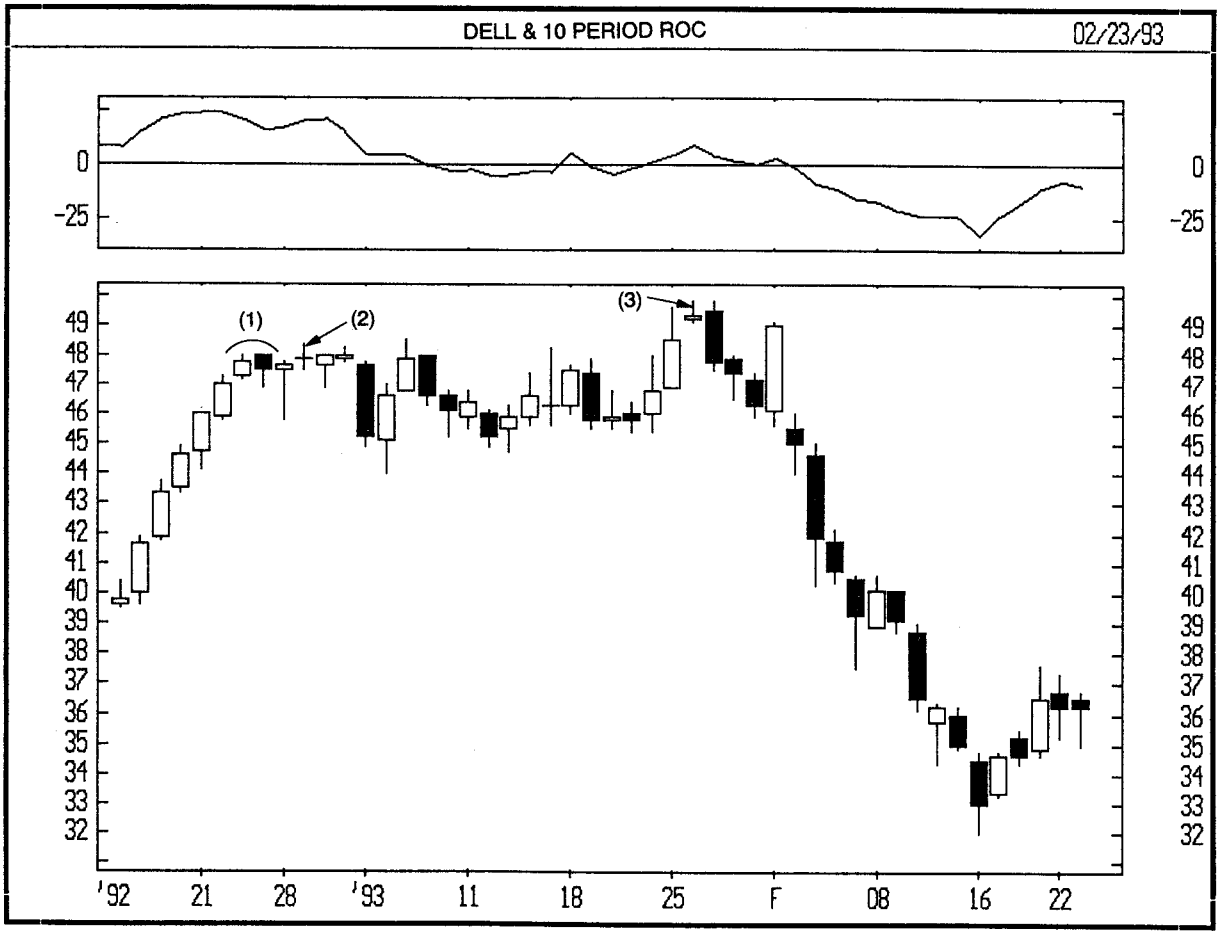


EXHIBIT 2.41. Doji and Momentum, Dell—Daily

SHADOWS

While the real body is often considered the most important segment of the candle, there is also substantial information to be gleaned from the length and position of the shadows. Thus, the location and the size of the shadow should also be considered when analyzing the psychology behind the market.

A tall upper shadow is especially important when it appears at a high price level, at a resistance area, or when the market is overbought. This is because such a candle line would hint that there is either heavy supply entering at higher prices or an evaporation of buying. In either case (see Exhibit 2.42), a long upper shadow could be a bearish development. A long lower shadow candle that bounces from a support area, or appears in an oversold market, could be an important clue that the bears are losing control.

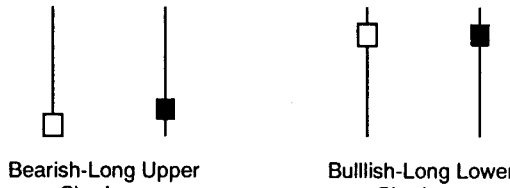


EXHIBIT 2.42. Long Shadows

In Exhibit 2.43, in early 1992 there was a hint of trouble with the doji following the tall white candle. Remembering the concept that the doji session should be resistance, the market stalled at the doji's high over the next two weeks. The two candles after the doji had long upper shadows. These shadows displayed that there was either very aggressive selling near the 109 level, or that buying quickly evaporated near these highs. In either case, these long lower shadows showed a dampening of the rallying strength. Further evidence of the importance of this resistance was the failure there in mid-1992.

Exhibit 2.44 displays that candles 1, 2, and 3 rebounded from near 59¢ via long lower shadows. These long lower shadows reflected the solidity of the support and the eagerness of the buying. Also important was the length of the base that had been built. For almost two months,

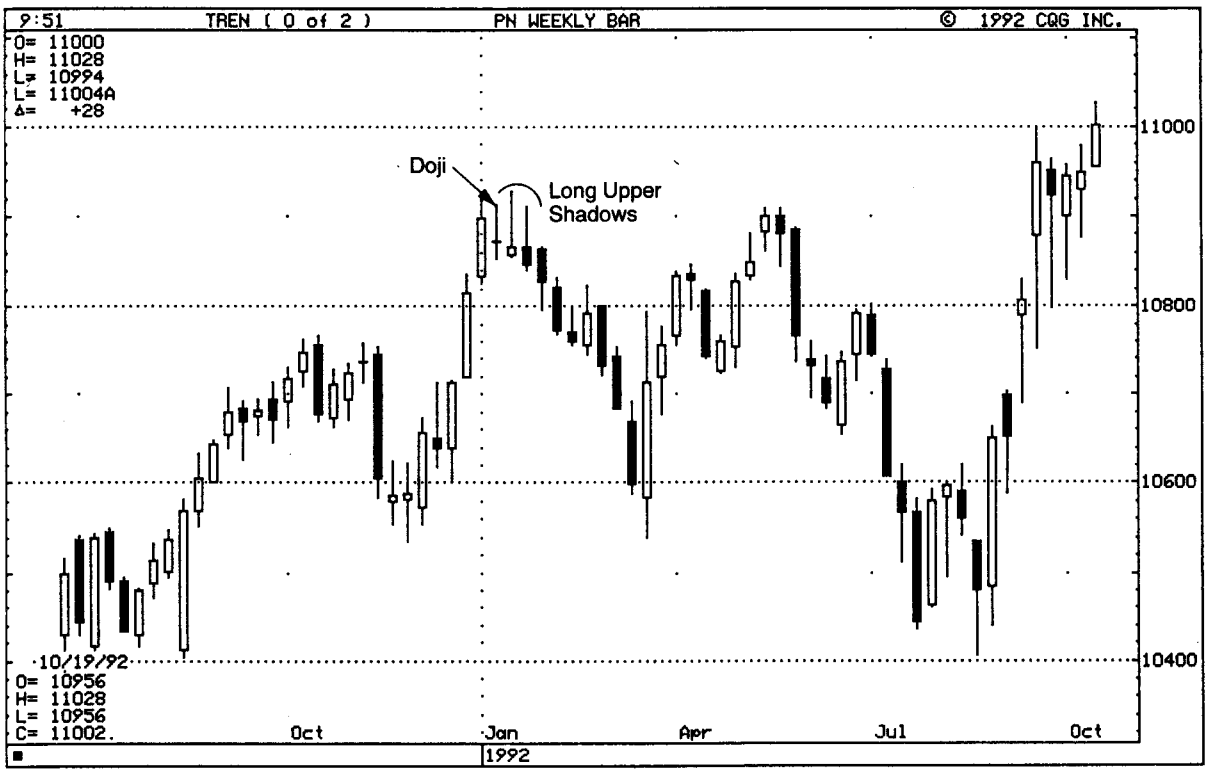


EXHIBIT 2.43. Long Upper Shadows Confirm Resistance, Notionnel Bond—Weekly

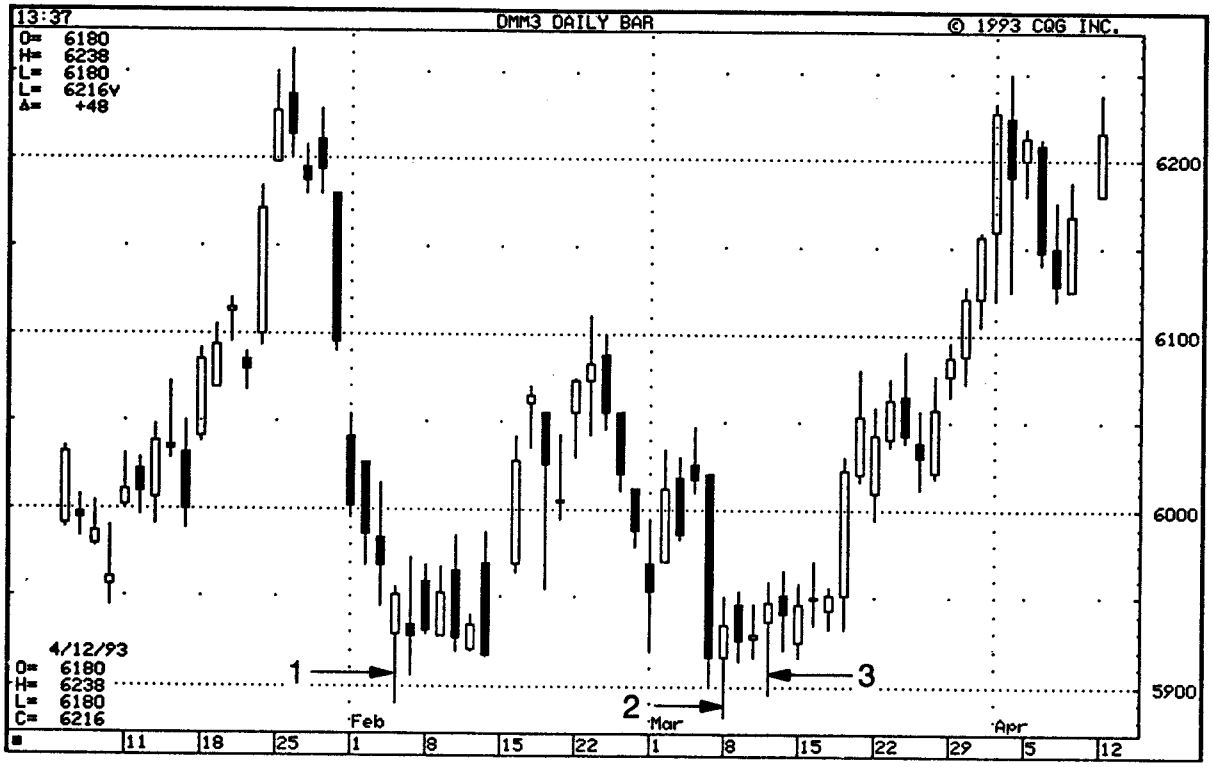


EXHIBIT 2.44. Long Lower Shadows Confirm Support, June 1993 Deutsche Mark—Daily

the bears tried to break prices under 59¢ and they failed. In general, the longer the base, the more solid the scaffolding on which a rally can be built.

A popular moving average among futures traders is the 65-day moving average. This line often swerves as support or resistance. For example, note how in Exhibit 2.45 that it was support in early November and again in early January. The test of this support in early January via long lower shadows, shows how strongly and quickly the market sprang from there. For those who are familiar with candles, the first long lower shadow candle is a hammer. Hammers will be explained in the next chapter.

High-Wave Candles

A candle with a long upper and lower shadows is called a *high-wave candle* (shown in Exhibit 2.46). It shows that the market is in a standoff between the bulls and bears. When a high-wave emerges after a downtrend or uptrend, the Japanese say that the market has lost its sense of direction. This lack of market orientation means that the prior trend is in jeopardy.

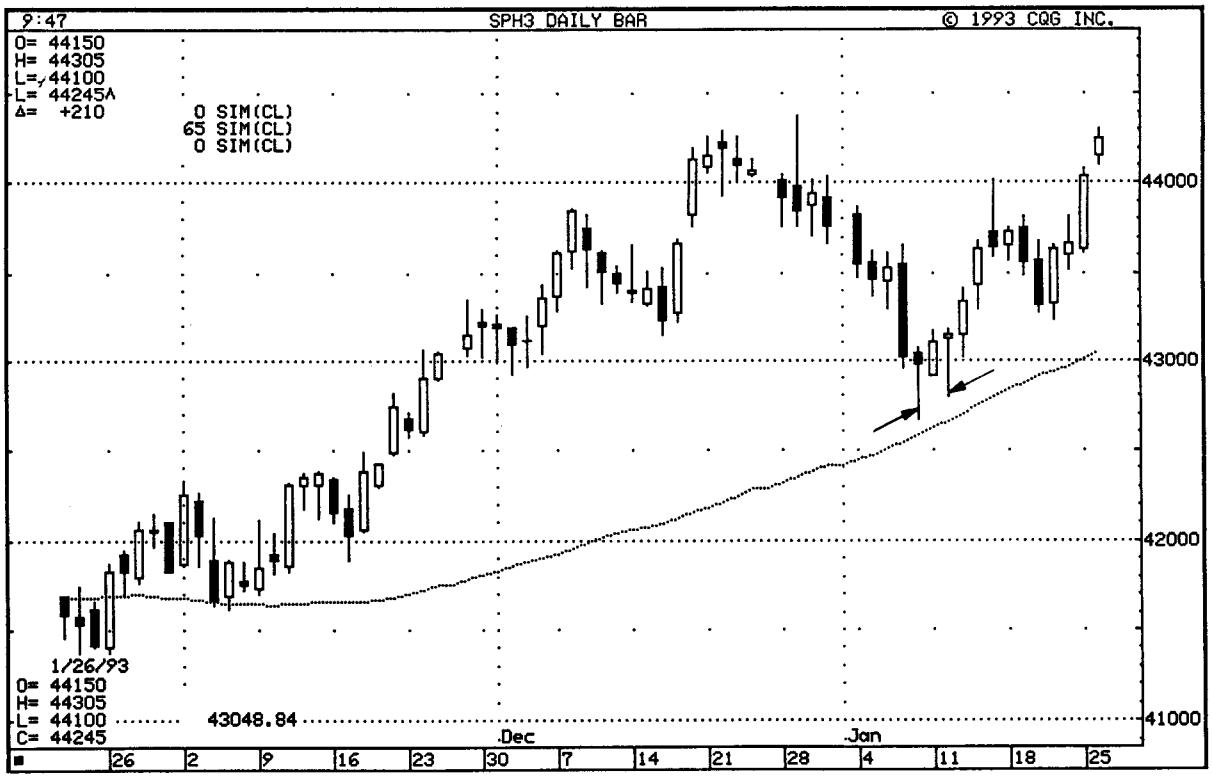


EXHIBIT 2.45. Long Lower Shadows Confirm Support, March 1993 S & P Futures—Daily

A doji that has long upper and lower shadows is either called a high-wave doji or a long-legged doji.

In Exhibit 2.47, a series of high-wave candles are displayed at 1, 2, and 3. The high-wave candle at 1 hinted that the bulls and bears were at a standoff. The action that preceded candle 1 had a bearish bias. Thus, with the appearance of high-wave candle 1, the market had sent out a clue that the trend was probably in the process of change. This outlook was reinforced by the dual white candles after high-wave candle 1. The market ascended from candle 1 until it got to another high-wave candle (at 2). From there, prices declined sharply in the next session via a long black real body. However, at the session after this long black real body, a candle with an extended lower shadow (at X) showed that the lows

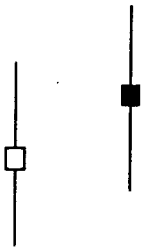


EXHIBIT 2.46. High-Wave Candles

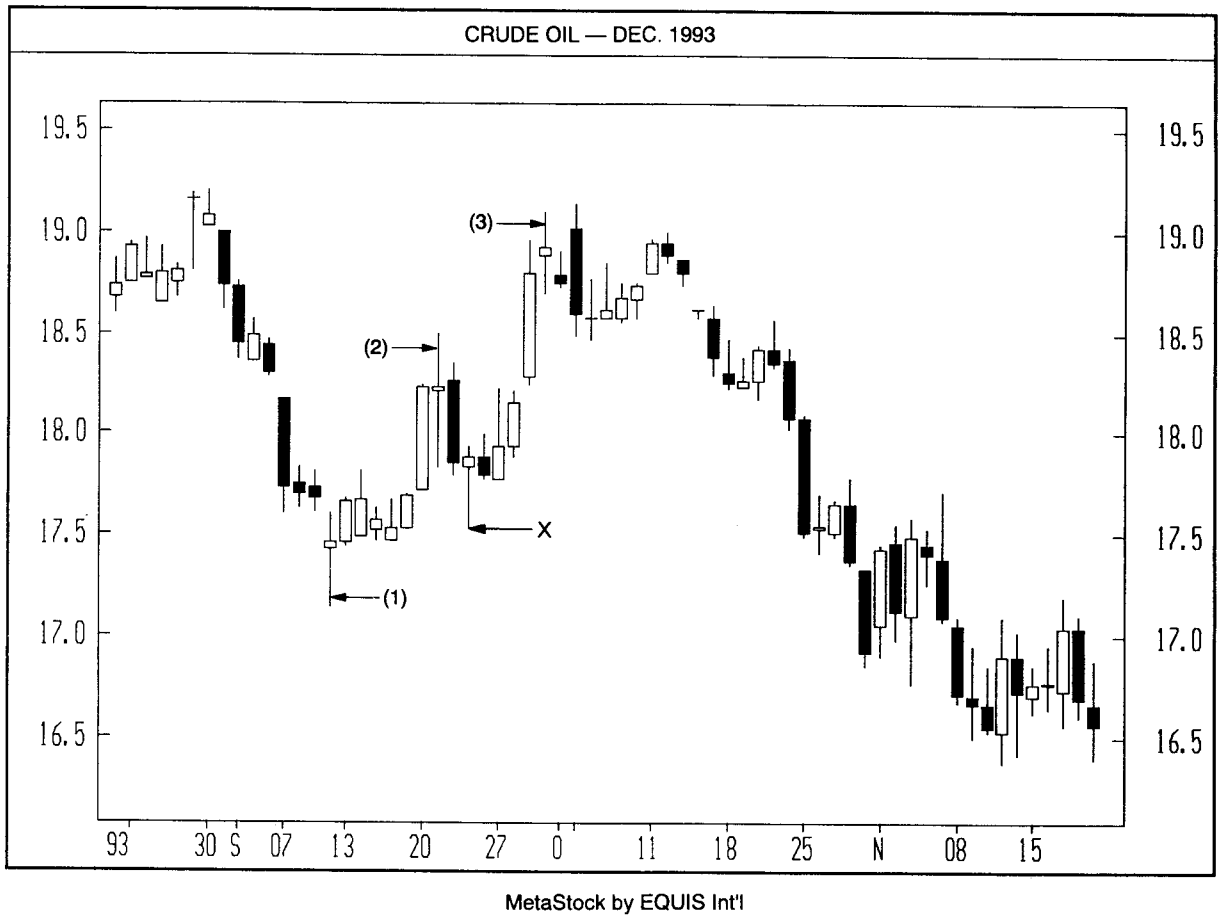


EXHIBIT 2.47. High-Wave Candles, December 1993 Crude Oil

from the prior week had become an attractive buying area. As prices ascended from candle X, a whisper of trouble emerged via the high-wave candle at 3. Two days later the long black candle showed that the bears had entered the market in force, and as a result, increased the likelihood that the high-wave candle at 3 was a top reversal.

CHAPTER 3

THE PATTERNS

意思あるところに道あり

"He Whose Ranks are United in Purpose Will Be Victorious"

Since the publication of my first book, I have had new Japanese material translated, have met new Japanese traders, and have continued my dialogues with those Japanese traders who have previously helped me. In addition, I have also had another three years of hands-on experience. As a result, I have gleaned new insights and concepts that will be conveyed to you in this chapter.

This chapter will not be a reference to all the patterns that are in my first book. Instead, my aim here is twofold. For those new to candles, this chapter will reveal how some of the more common and important candle patterns can provide powerful insights into your market analysis. For those already knowledgeable about the candles, you will discover new refinements and trading techniques. It is especially important to read the detailed descriptions of the charts. It is in these that you will most easily see some of the new refinements of candle theory, as well as some new concepts.

As one of the Japanese books I had translated stated, "the psychology of the market participant, the supply and demand equation, and the relative strengths of the buyers and sellers are all reflected in the one candlestick or in a combination of candlesticks."[1] In this chapter, I will describe the many uses and trading insights provided by individual candle lines and candle patterns based on two or more candle lines. The organization of this chapter is based on the number of lines that form the pattern. Consequently, this chapter's first section will focus on individual candle lines, such as the hammer and shooting star. The next section will delve into candle patterns comprised of two candle lines.

These include the dark cloud cover and two gapping black candles. The final section in this chapter will address those candle patterns, such as the evening star and record sessions, which have three or more candle lines.

SINGLE CANDLE LINES

In Chapter 2, I detailed how the length of the shadows can relay information about the resiliency of the bulls or the bears. For example, a long upper shadow echoes the ability of the bears to regain control of the market during a rally. A long lower shadow pictorially reflects the bulls' ability to rally the market after the market's new session lows have been made.

In this section, the single candle lines I will be describing (the hammer, hanging man line, and the shooting star) either have a long upper or lower shadow. But, because they also possess the important aspect of having a small real body near the top or bottom of the trading range, these candles lines take on increased importance when using candle charts.

The Hammer

As shown by Exhibit 3.1, the hammer, with its long lower shadow and a close near or at the high, is easily understood to be a bullish signal. The term "hammer" derives from the fact that the market is "hammering out a base," or that a bottom is so solid that it does not break, even when a hammer knocks away at it.

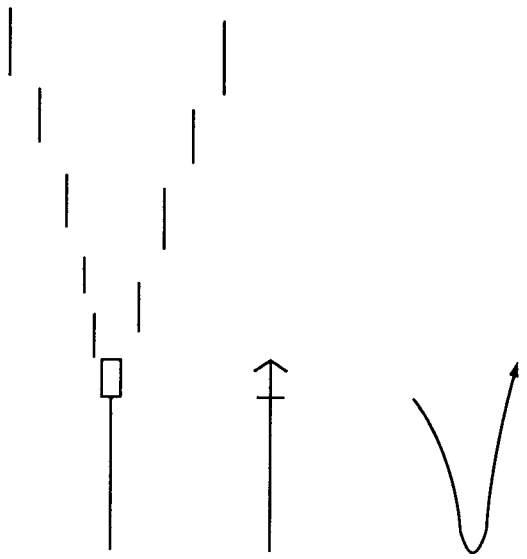


EXHIBIT 3.1. The Hammer

An aspect of the hammer is that it must appear after a significant downturn or in an oversold market to have significance. The hammer is a reversal indicator, and as such, should have a downtrend to reverse. A hammer that appears after a fall of, say, two or three days is usually not important. Since the hammer is most useful after a significant downturn, it should be noted that there may be selling on a rally from the hammer. As such, the first bounce from the hammer may fail and the market may return to test the hammer's support.

Consequently, trading with the appearance of a hammer depends on a trader's aggressiveness and risk adversity. Some traders may decide to buy immediately after the hammer appears in case the market does not pull back to retest the hammer. Some traders may decide to wait to see if the market returns to the hammer, and if so, will buy on that return move. If the market successfully tests the hammer's support area, there is then a more solid support area and a better chance for a rally. A method that I sometimes recommend to our clients is to lightly test the waters from the long side after a hammer, and then add the remainder of the long position after (and if) there is a successful test of the hammer. Whichever methodology is used, a stop (based on the close) could be placed under the lows of the hammer.

Exhibit 3.2 displays a classic hammer in that the extreme length of the lower shadow reflects how aggressively the bulls were able to propel prices off the lows of the session. The bounce from this hammer stalled during the next few sessions. But the pullback held the hammer's support. This action helped enlarge the base upon which to build a more substantial rally.

A trading tool that I find useful with candles is a Western technique called a *spring*. As shown in Exhibit 3.3, a spring occurs when the bears are unable to hold prices under a broken support area. Because such action proves that the bears were unable to grab control of the market when they had their chance, it should be viewed as a bullish development. The opposite of a spring is an *upthrust*. An upthrust occurs when the market makes a new high, but then fails to hold that high. Upthrusts will be addressed in the section titled "The Shooting Star" later in this chapter. (Springs and upthrusts are described in detail in my first book.)

An ancient oriental book on military tactics referred to gaining an advantage over the enemy by acting as a "moving shadow." This term, as used by the warrior who wrote that book, means that when you cannot see the state of your opponent, you pretend to make a powerful attack to uncover the intention of the enemy. This concept, as related to trading, is one of the reasons a spring is so important.

Probes of support or resistance areas are attempted throughout the markets by large-scale traders. They want to discover how the market

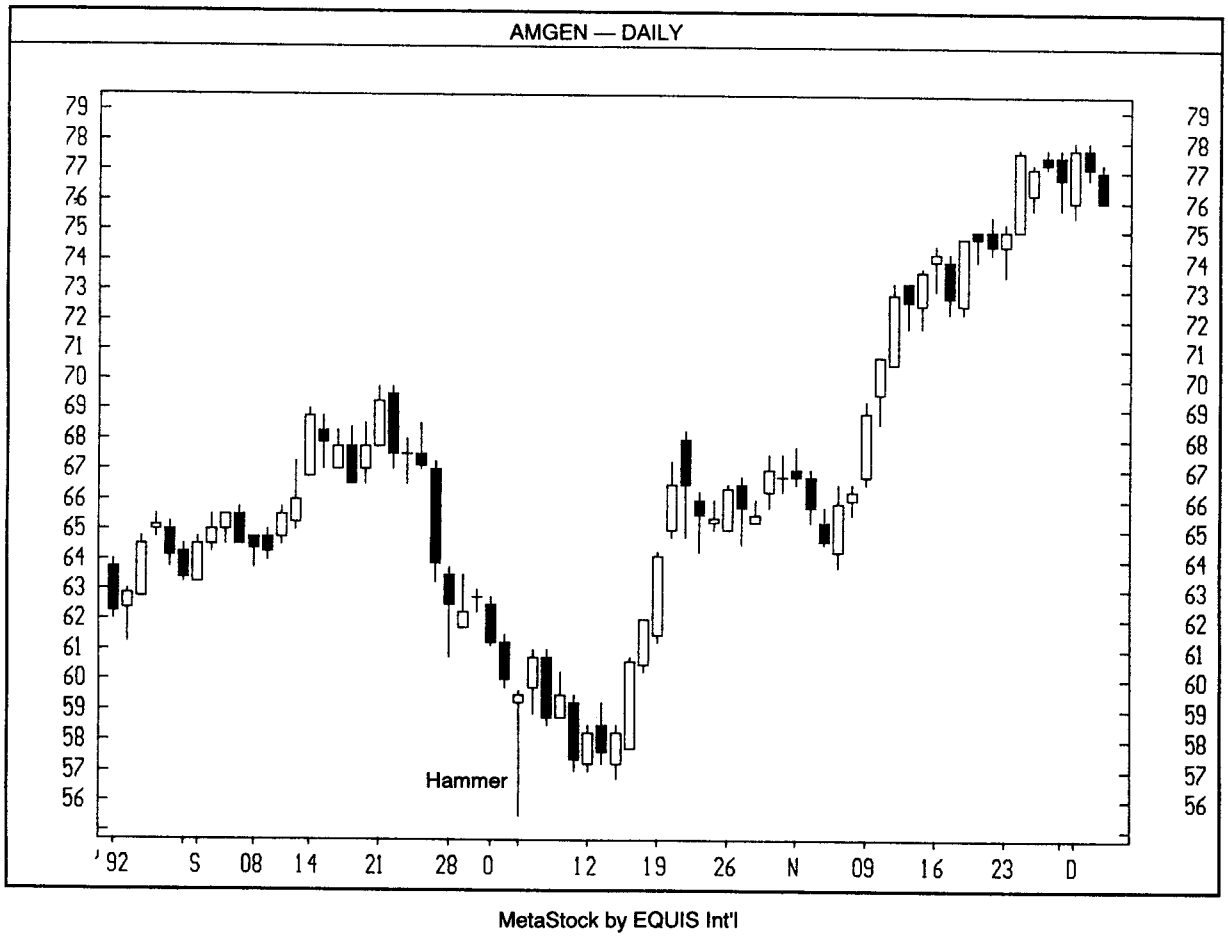


EXHIBIT 3.2. Hammer as Support, Amgen—Daily

will react once a support or resistance area is pierced. In effect, these traders act like the aforementioned "moving shadow," testing the battlefield by entering a large order to try and break support (or resistance). For example, if a large-scale trader places a sell order as the market gets near support, their sell order may be enough to drag prices under the support area. Now, this trader, as a "moving shadow," will now learn about the underlying strength of the market. If the market fails to hold under a broken support area and forms a spring, these "moving shadows," (i.e., the sellers who were attempting to probe the market), now have learned about the tenacity of the bulls and as a result may decide to cover their shorts.

EXHIBIT 3.3. Spring

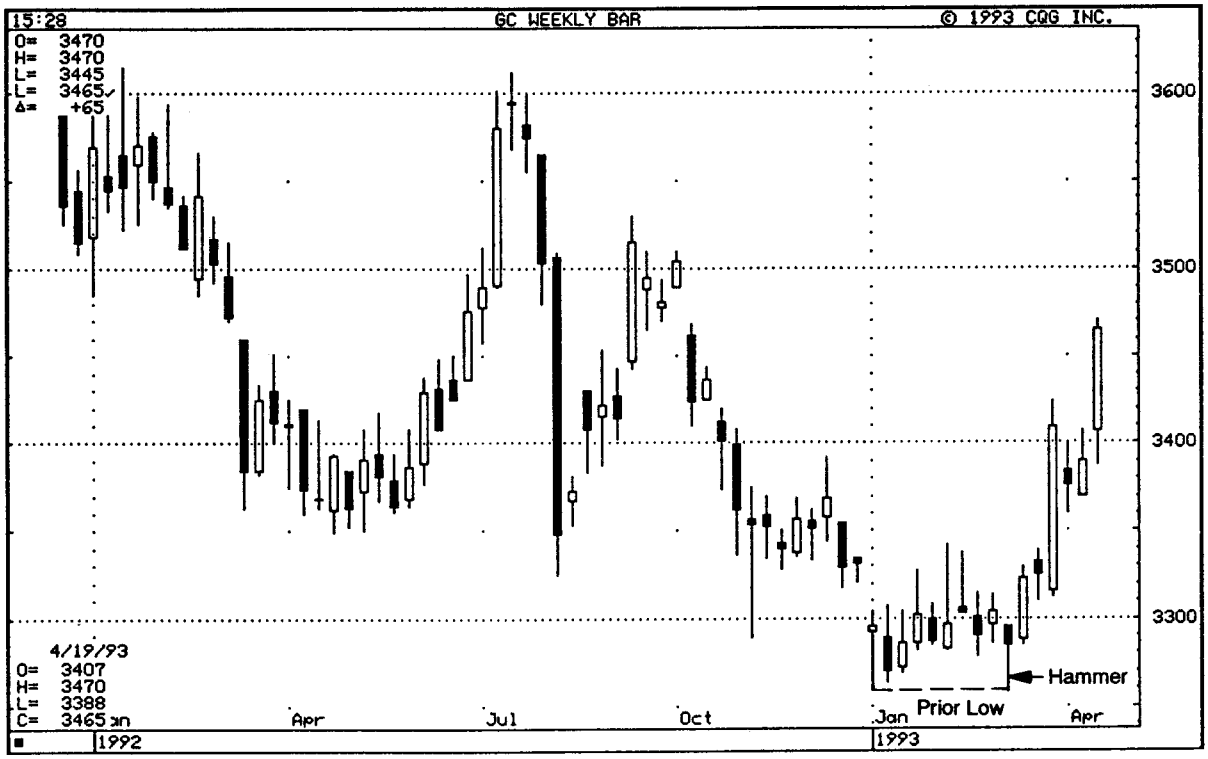


EXHIBIT 3.4. Hammer and a Spring, Gold—Weekly

In Exhibit 3.4, we see one of the more powerful combinations of Eastern and Western technicals—a hammer and a spring. The 1993 low was formed by a hammer. This hammer was also a spring since the low of the hammer's lower shadow slightly punctured a support zone, but sprang back above this broken support line. Also of interest in this chart is that the high made near $360 in mid-1992 was formed by a doji following a tall white candle.

The Hanging Man

As shown in Exhibit 3.5, a hanging man has a very long lower shadow, a small real body (white or black) near the upper end of the trading range and little or no upper shadow. This is the same shape as the hammer line. However, as expressed in the Japanese literature, "If it appears from below, buy, and if appears from above, sell."

This phrase means that the same shape line can be bullish or bearish, depending on where it appears in a trend. If this line appears "from below," that is, during a decline, it is a bullish hammer. However, if this same shape line appears "from above," that is, during an uptrend, it is a sell signal and is referred to as a hanging man line.

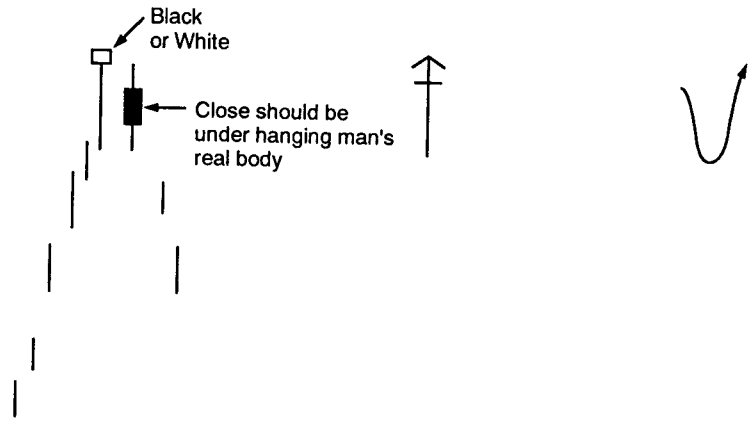


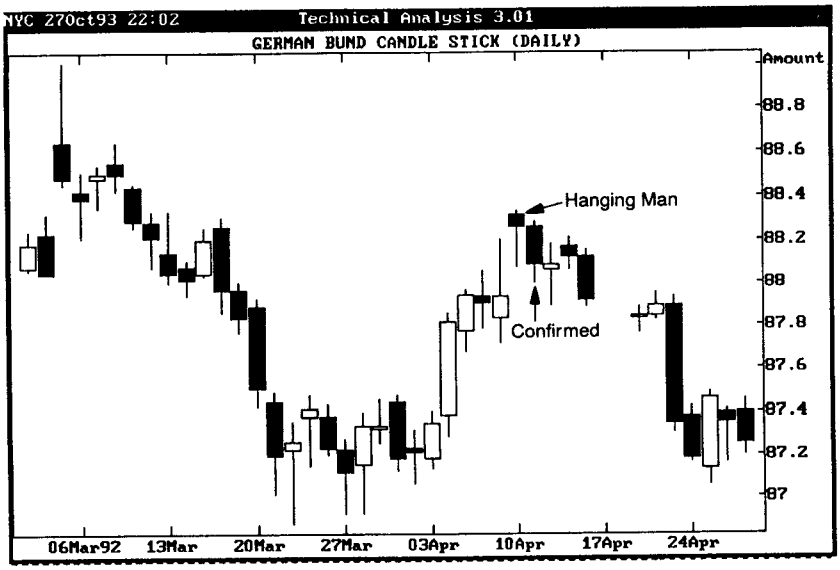
EXHIBIT 3.5. The Hanging Man

Thus, the hanging man line is a top reversal signal that must arrive during a rally, while the hammer is a bottom reversal line that must appear during a decline; the same line can be bullish or bearish, depending on the trend preceding it. In this context, it is interesting that the Japanese have two words for rice. They call it either "raisu" or "gohan." Raisu is the Japanese term for rice when it is prepared Western style. The term "raisu" even sounds like the Western word "rice." Gohan also means rice, but it is rice prepared Japanese style. In other words, the Japanese refer to the exact same product—rice—by different names. What surrounds the rice determines whether the rice is referred to as raisu or gohan. So it is with the hammer and hanging man. Whether the candle line is a bullish pattern (the hammer) or a bearish pattern (the hanging man) is dependent on what precedes the line.

With the hanging man's long lower shadow reflecting buying interest, it may seem that the hanging man is a bullish signal. However, the hangman's action shows that once the market has fallen, it has become very fragile. The small real body of the hanging man also shows that the prior uptrend may be in the process of changing. Because of the bullish action of the hanging man session (during the session the market sells off and then rallies by the close), an important aspect of the hanging man lines is that there should be bearish confirmation. A common method of bearish confirmation of a hangman is to wait to see if the next session's close is under the hanging man's real body. This is shown in Exhibit 3.5.

The reason for the importance of this confirmation has to do with the fact that the hanging man's long lower shadow shows that there is still rising power left in the market. However, if prices fall under the hanging man's real body, it translates into the fact that everyone who bought at the open or close of the hanging man session is now losing money. In such a scenario, these longs may decide to liquidate, and by doing so, may engender a further weakening of prices.

Since my seminar on the candles at the World Bank in Washington,



Reuters Graphics

EXHIBIT 3.6. Confirmation of a Hanging Man, German Bund—Daily

DC, some of their traders have asked my opinion on candle patterns on various markets. One of their traders asked what I thought about the chart of the German Bund shown in Exhibit 3.6. She asked my opinion on April 10 after the hanging man was formed. I explained to her that if the hanging man were confirmed by a weaker session the next day, the outlook would be bearish. In this case, the market confirmed the bearish hanging man during the next session.

Exhibit 3.7 shows how important it is to wait for confirmation of a hanging man session. In that chart, we see a hanging man. However, note how the following week the bulls pushed prices above the high of the hanging man. This means that those who bought during the hanging man session now have a profit. Consequently, there is little reason for them to liquidate their longs. The result is that a higher close than the hanging man session voids any of the bearish potential of the hanging man. That is what happened here as the market exceeded the hanging man session. Also of interest in this chart is that in April 1992, there was a hammer that was also a bullish spring, since the hammer made a new low which failed to hold.

An article about my work with candles in *The Wall Street Journal* displayed the chart shown in Exhibit 3.8. In this article, I discussed how the hanging man at $40 helped confirm a top. I explained that before the 1990 Mid-east crisis, the highest crude oil futures reached was around $32 (crude oil futures began trading in 1983). Once the market exceeded that level, I had a target at around $40. That was a resistance area in the cash market back in 1979. Note that at the $40 area, there was a bearish candle signal via the hanging man line. The market retreated from this $40 level and tested a support line. It then rallied and, with sort of a last

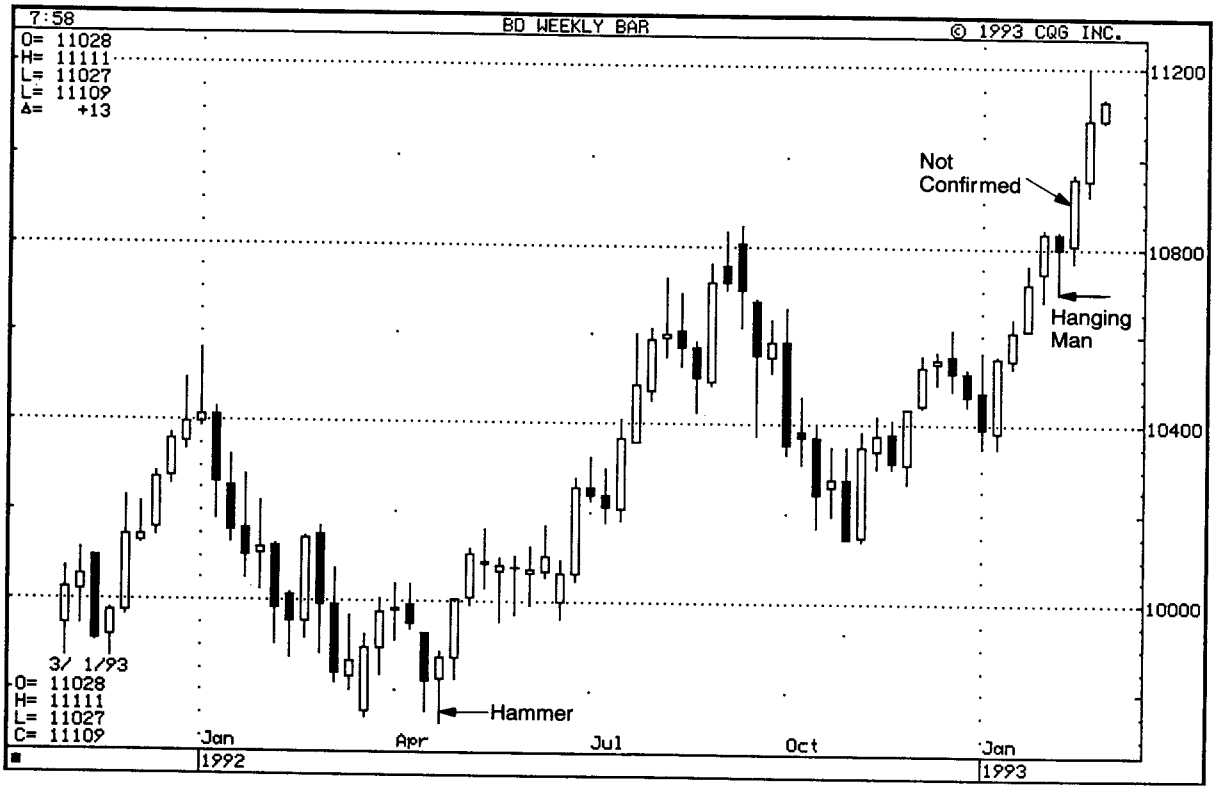


EXHIBIT 3.7. Waiting for Confirmation of a Hanging Man, Bonds—Weekly

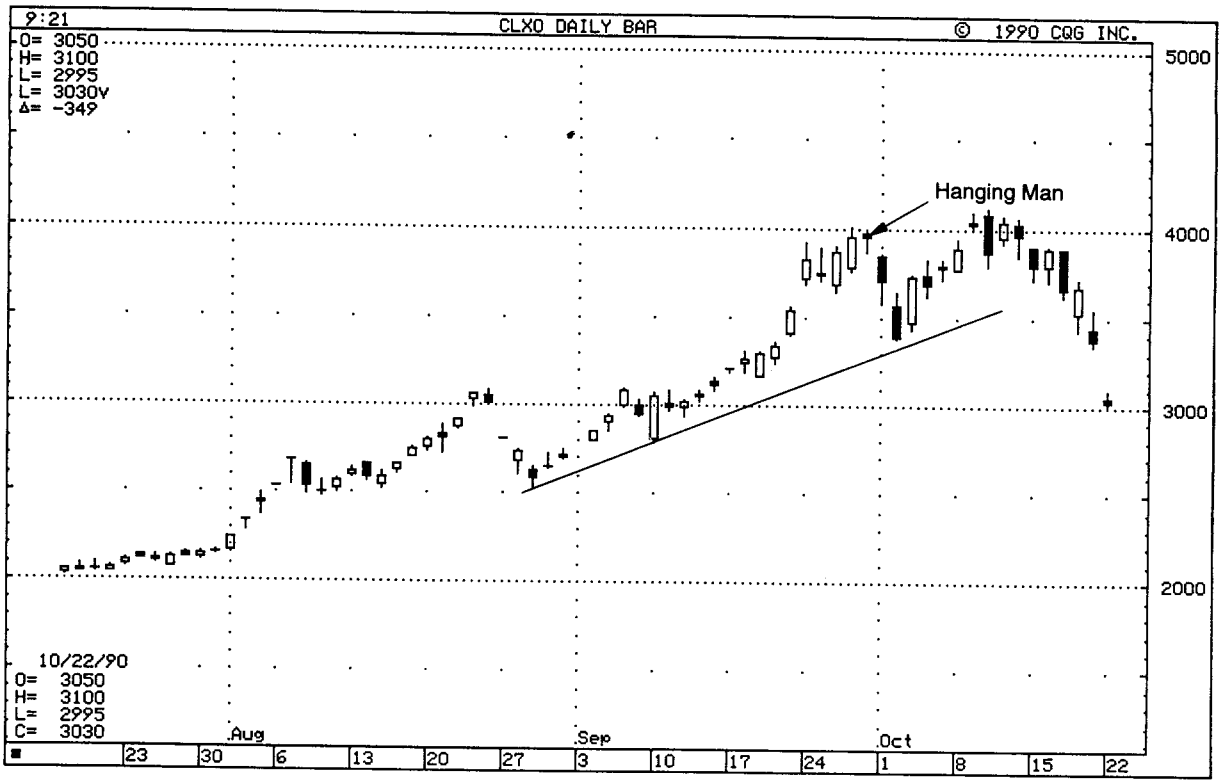


EXHIBIT 3.8. Hanging Man Confirms Resistance, November 1990 Crude Oil—Daily

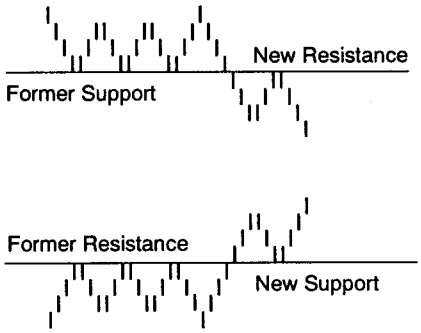


EXHIBIT 3.9. Change of Polarity Principle

gasp, the bulls temporarily nudged the market above $40 before the floor fell out of the market.

There is a basic Western technical concept that states that a penetrated resistance area should then be converted to support and a broken support area should be resistance. I call this concept the *change of polarity principle* (it is discussed in detail in my first book). This concept is shown in Exhibit 3.9. I find the change of polarity a very useful tool, especially when joined with candles. You should find that the more often a support or resistance area is tested before prices break them, the better the change of polarity principle should work.

In Exhibit 3.10 we see that an evident support area from mid- to late

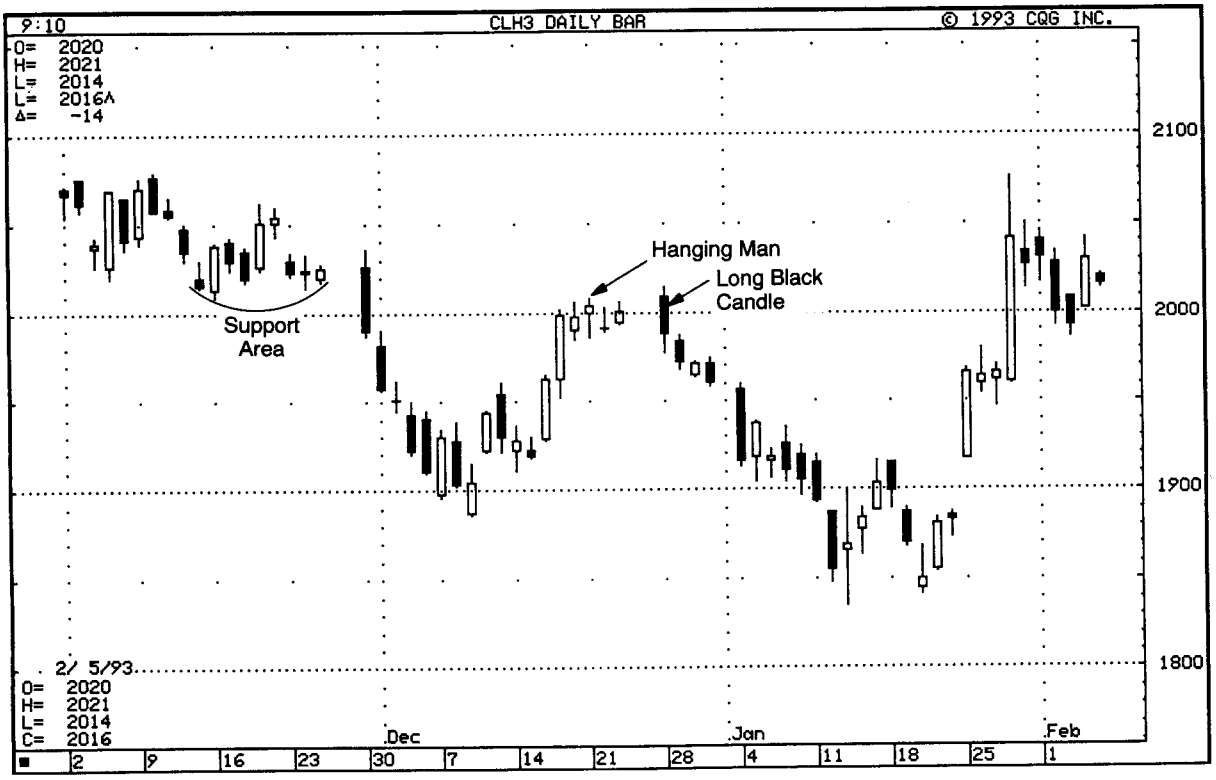


EXHIBIT 3.10. Hanging Man and the Change of Polarity Principle, March 1993 Crude Oil

November was slightly above $20. Once this important support was broken, the change of polarity rule implied that this $20 support should then become resistance. This is what unfolded as this $20 resistance area was confirmed with the mid-December hanging man session. The long black real body, also near $20, on December 28, showed that the bears had taken control.

The Shooting Star

A session with a long upper shadow and a small real body near the bottom end of the trading range is called a *shooting star* (see Exhibit 3.11). Just as the long lower shadow of a hammer is bullish, so the long upper shadow of the shooting star is bearish. The long upper shadow means that the bears have been able to sharply drag prices back from their highs.

In Exhibit 3.12, we see how the mid-August shooting star's long upper shadow reflected the aggressiveness of the bears. Following this shooting star, another symptom of market uncertainty came with the high-wave candle. The fact that the shooting star and the high-wave candle both appeared near the psychologically important 100 area reinforced the importance of those signals.

In Exhibit 3.13, I show how a support area from late August (marked S) changed to resistance through September and into October. The October failure of this resistance area was via a shooting star. The long upper shadow of this line reflected the heaviness of supply towards the 1.66 level. Another attempt to breach 1.66 failed in early October with a long black real body.

In the section on hammers, I discussed the concept of springs (when the price springs back above a broken support area) and that the opposite of a spring is an upthrust. As shown in Exhibit 3.14, an upthrust is created when prices break above a resistance area, but then retreat back under the previously broken resistance. This scenario has bearish impli-

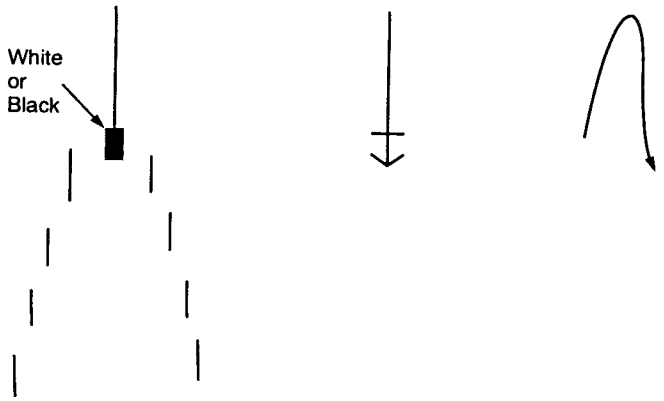


EXHIBIT 3.11. The Shooting Star

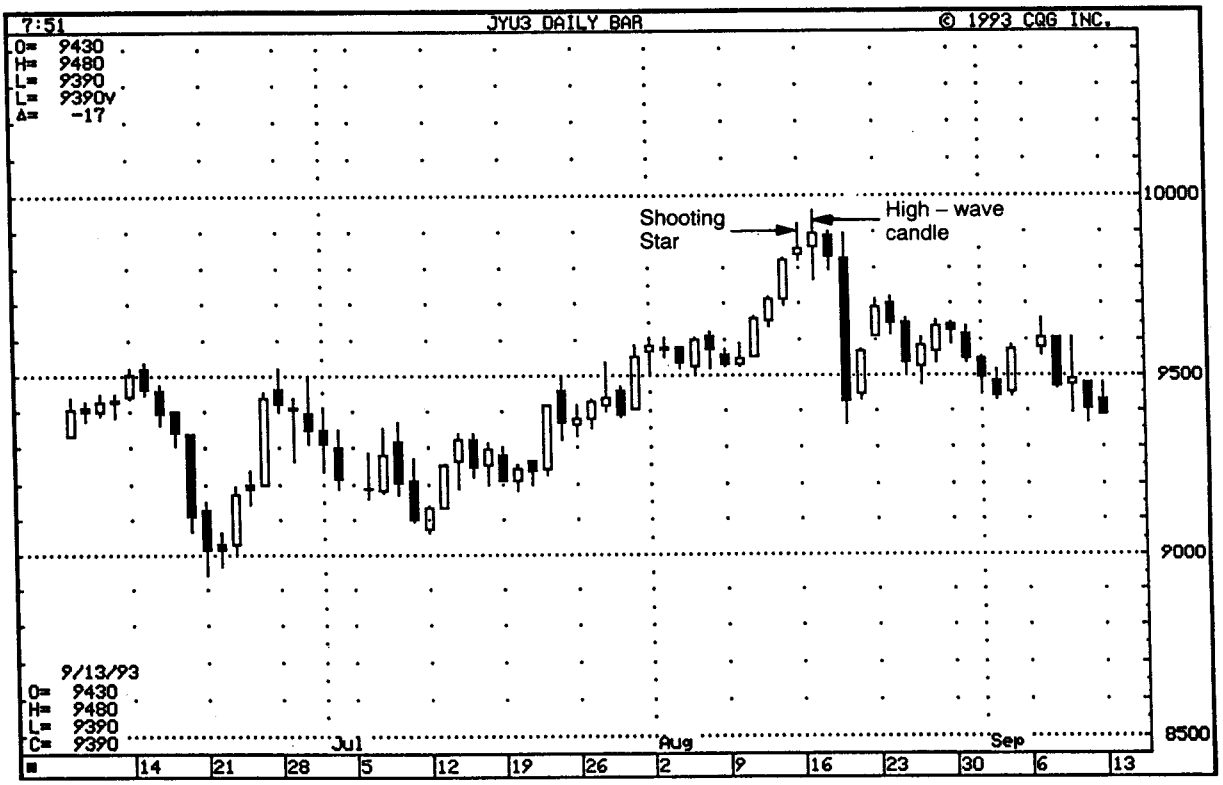


EXHIBIT 3.12. Shooting Star with a High-Wave Candle, September 1993 Japanese Yen

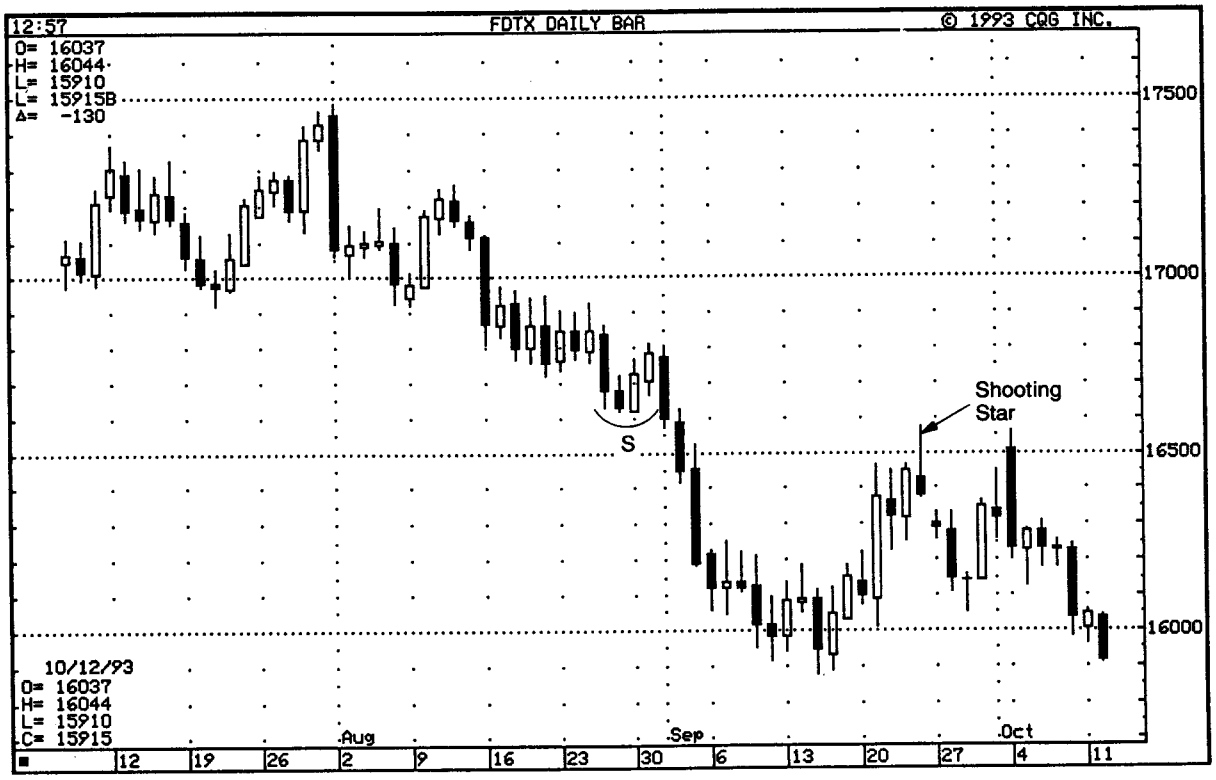


EXHIBIT 3.13. Shooting Star and the Change of Polarity, Cash Deutsche Mark

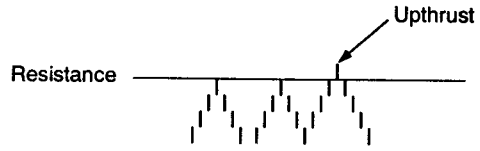


EXHIBIT 3.14. An Upthrust

cations. At times, the upper shadow of a shooting star can also be part of an upthrust.

In Exhibit 3.15, there is a shooting star that pierced the January 7 and 8 resistance area with its long upper shadow. The failure of the bulls to keep prices in the new territory created a bearish upthrust.

To help clarify the difference between the hammer, hanging man, and shooting star lines, I have annotated Exhibit 3.16 with an example of each candle line. Note that for each signal the market must be in a clearly defined trend.

1. Shooting star—We can see how the shooting star must appear after an uptrend. The shooting star's long upper shadow reflects market rejection of higher prices.

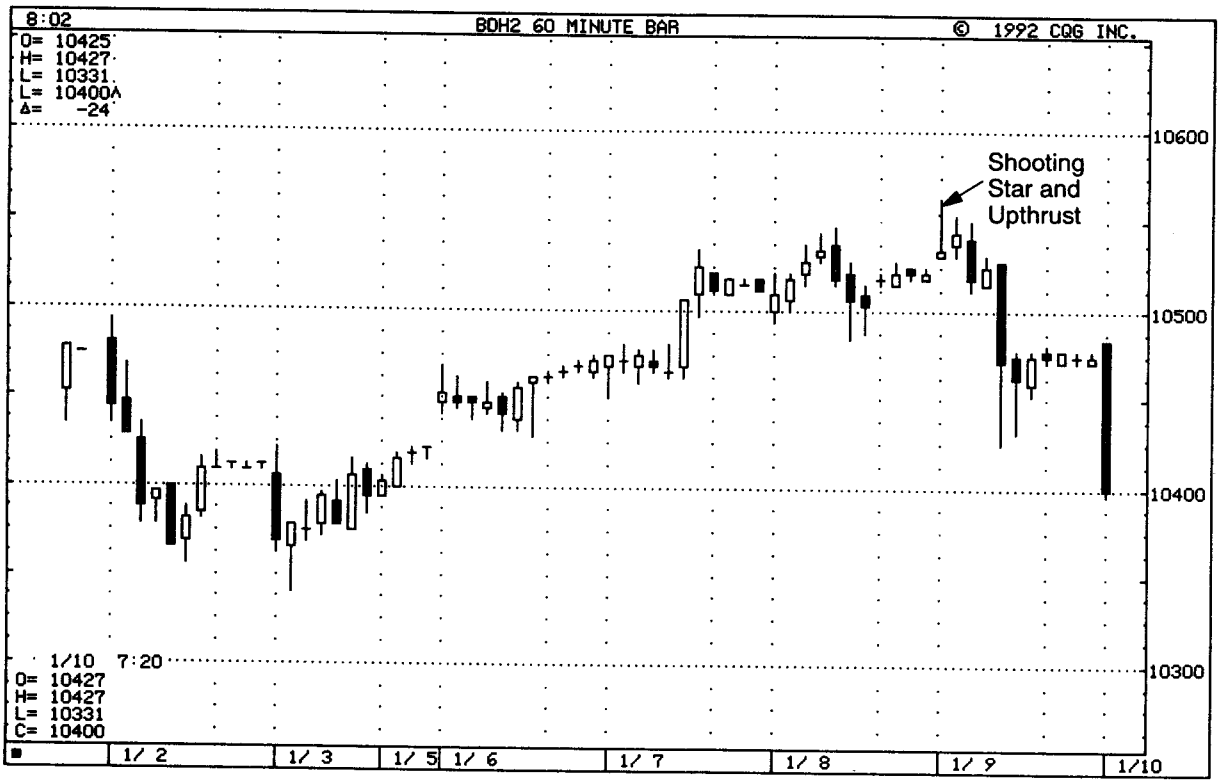


EXHIBIT 3.15. Shooting Star and Upthrust, March 1992 Bonds—Intra-Day

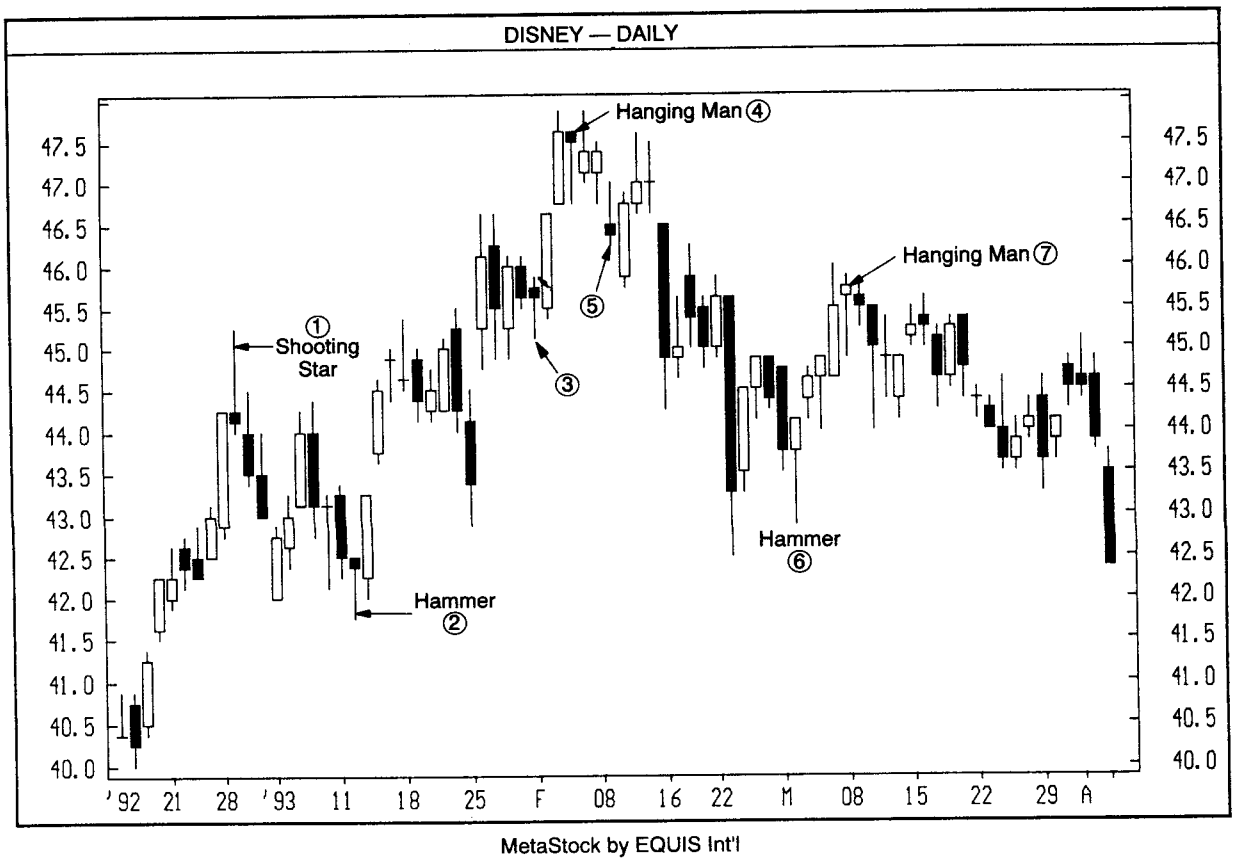


EXHIBIT 3.16. Hammer, Hanging Man, and Shooting Star Lines, Disney—Daily

2. Hammer—A long lower shadow candle that must appear during a downtrend.
3. Although this has the correct shape of a hammer or hanging man line (a long lower shadow with a small real body near the highs of the session), candle 3 is neither a hammer nor a hanging man. This is because this line did not appear during an uptrend or a downtrend, but was in the middle of a trading range. Thus, line 3 is not a hammer (although the long, lower shadow could be viewed as a positive signal).
4., 7. Rallies preceded these hanging man lines, which were confirmed during the next session by a close under the hanging man's real body. In line 7, we can see a small upper shadow. If the upper shadow is relatively small, it is still considered a hanging man. (A small upper shadow is also allowable with a hammer.) Note how the real body of the hanging man can be white or black.
5. This line has the correct shape of a shooting star (a tall upper shadow and a small real body at the lower end of the session's range). However, since it does not appear after an uptread, it does not have the bearish implications as would a traditional shooting star.

6. This particular hammer should be viewed as being relatively unimportant since it appeared only after a minor downtrend. It did, however, show, via its long lower shadow, a successful test of a support area near $43 from the late January and early February lows.

To summerize, always look at the preceding trend to determine if the hammer, shooting star, or hanging man lines should be acted upon. Remember that as reversal signals; they need a prior trend to reverse.

DUAL CANDLE LINES

In the preceding section, I looked at individual candle lines. In the remainder of this chapter, I will review some of the more important or common candle patterns that are comprised of two or more candle lines.

Dark Cloud Cover

A dark cloud (shown in Exhibit 3.17) shows, as the Japanese express it, that the market has a poor chance of rising. The dark cloud cover's first candle is a strong white session. During the next session, there is buying pressure left over and the market opens higher, but later in that session, prices decline as the market closes under the center of the previous session. This pattern reflects a period in the market when the upward power of the tall white candle has been dissipated by next session's weak black candle. Note how the blended candle line in Exhibit 3.17 has a longer

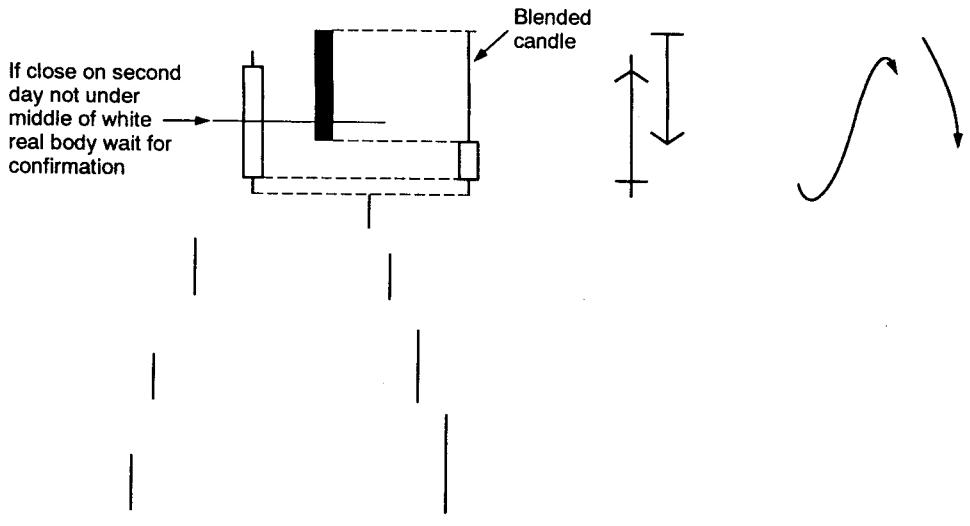


EXHIBIT 3.17. Dark Cloud Cover

upper shadow. In other words, the dark cloud cover displays pictorially a time in the market in which selling pressure is exceeding the buying pressure.

An ideal dark cloud cover's second session should close under the midpoint of the prior white candle. If the black candle does not close below the halfway point, it is considered by some Japanese traders to be an incomplete dark cloud cover. In such cases, it is best to wait for confirmation during the next session in the form of a weaker close. As a general rule, the deeper the close of the dark cloud cover's second session pushes into the white candle, the more bearish the signal.

A dark cloud that fails to move under the center of the prior candle is shown in Exhibit 3.18. Looking at the blended candle in Exhibit 3.18, we see how there is less of an upper shadow than in the case of the more classic dark cloud cover's blended candle shown in Exhibit 3.17. This means the dark cloud cover in Exhibit 3.18 may be less bearish than a standard dark cloud cover. This is why there should be confirmation by further weakness after the type of dark cloud cover shown in Exhibit 3.18.

There is a difference in how I would view the dark cloud cover in stocks and futures. The ideal dark cloud cover has the second session's open above the high of the prior session. Since there is generally higher price volatility in the futures market as compared to stocks, it means that I am more flexible about the definition of a dark cloud cover with stocks than with futures. Specifically, with stocks I still view it as a dark cloud cover if the second session opens above the prior session's *close*, rather than its high. This is shown in Exhibit 3.19.

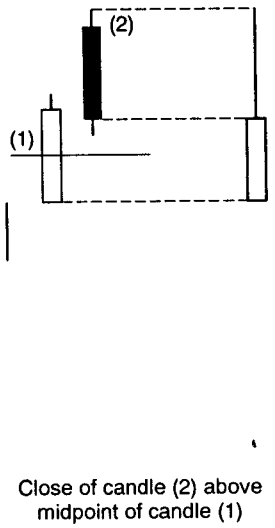


EXHIBIT 3.18. Dark Cloud Variation 1

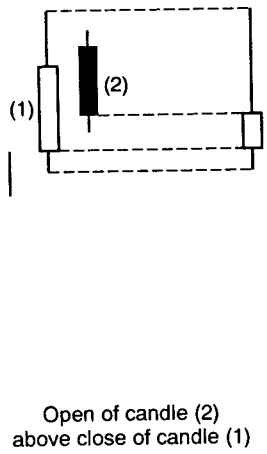


EXHIBIT 3.19. Dark Cloud Variation 2

However, if the second session of the dark cover of a stock does open above the prior session's high (instead of its close), it would be more of a potential reversal signal. This is because it is more bearish if the market reverses after failing from a new high than it is if the market fails from an area that was not a new high.

A dark cloud cover often becomes resistance. In Exhibit 3.20, we see a dark cloud cover in late January near $75.50. The market retreated from there until a hammer (that was also a spring) formed near $69 in February. The rally from this hammer stalled in March at the resistance set by the dark cloud. However, as with any form of technical analysis, there should be a price at which you should reconsider your original outlook. For a pattern like the dark cloud cover, if the market closes above the high of the dark cloud cover, the chances are that the market will continue its upward path. In this example, observe how the market not only closed above the high of the dark cloud cover in late March, but did so via a bullish rising gap. Another interesting aspect of this gap is that the ses-

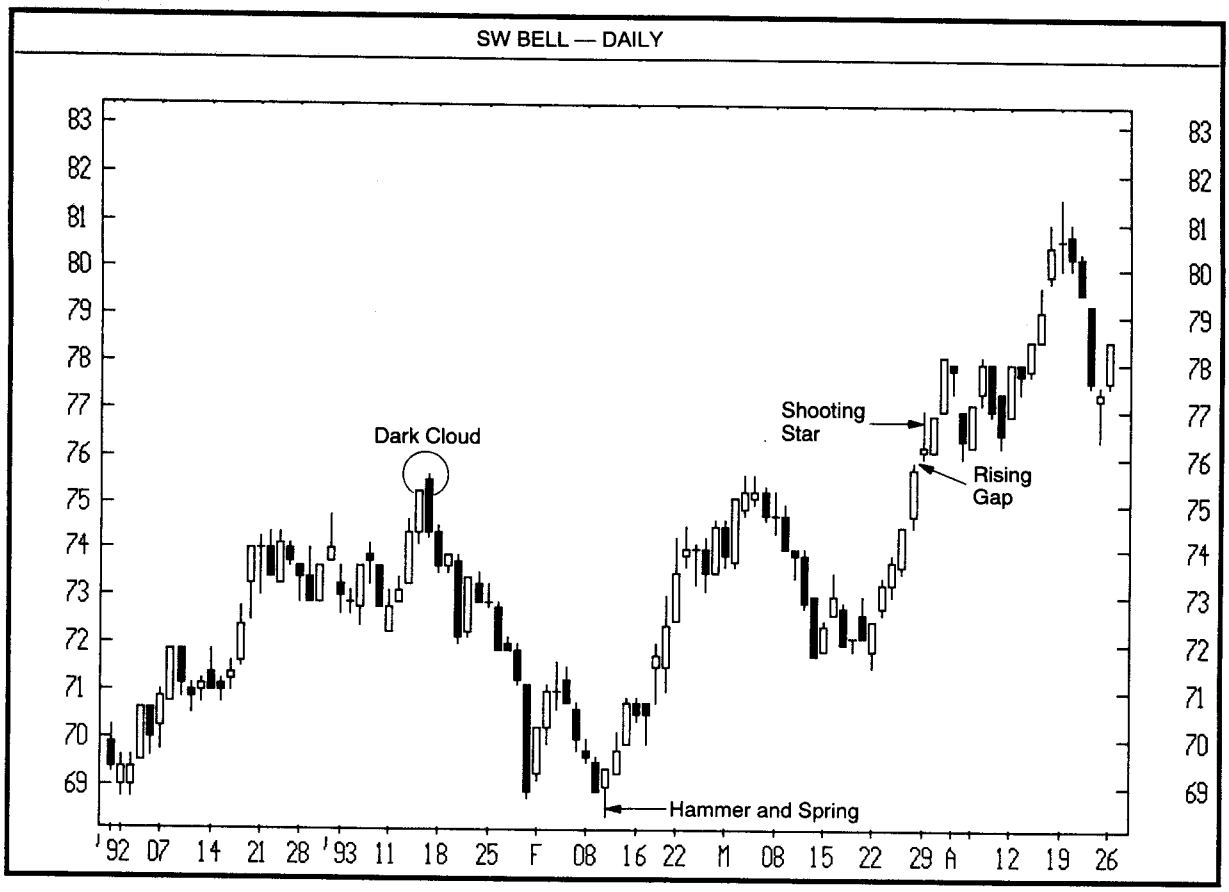


EXHIBIT 3.20. Dark Cloud Cover as Resistance, Southwest Bell—Daily

sion after the gap created a shooting star. Yet the bearish implications of the shooting star was not confirmed since the market failed to close under the rising gap (this will be discussed in detail later in this chapter under the section on "windows"). Thus, when selling short based on a dark cloud cover, consider a stop on a close above the highs of that pattern. For those who are looking to buy, you should consider it when on the close, prices pierce the high of the dark cloud cover.

Exhibit 3.21 is an example of two less than ideal dark cloud covers at 1 and 2. Dark cloud cover 1 was not ideal since the second session (the black candle) failed to close under the mid-point of the prior session. Dark cloud cover 2 lost some of its bearish importance because the second session of the pattern opened just above the prior close instead of the prior high. Yet, since both of these non-classic dark cloud covers emerged so close to one another, they served to reinforce each other. In other words, both dark cloud covers reflected the fact that as prices made new highs near $45, the bears were able to drag prices back down under the

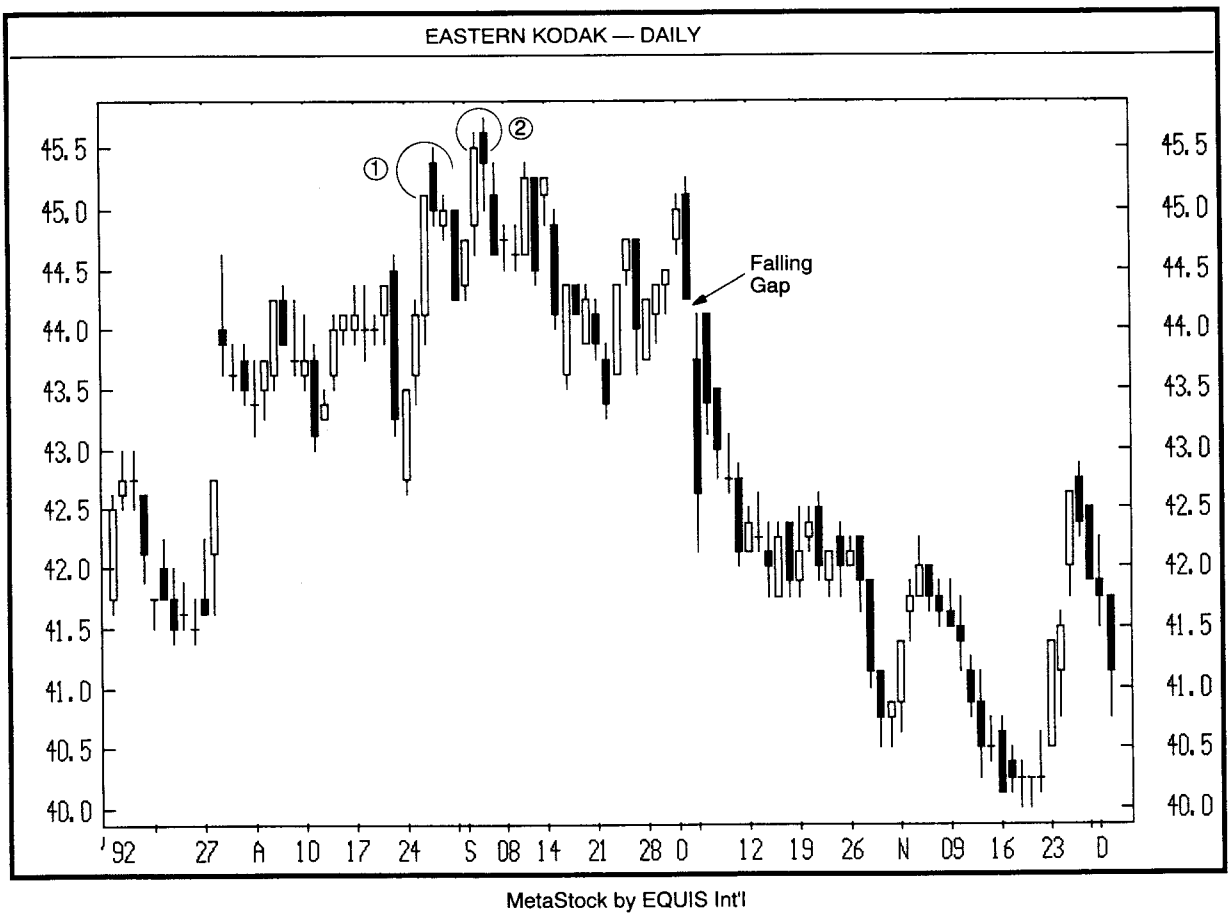
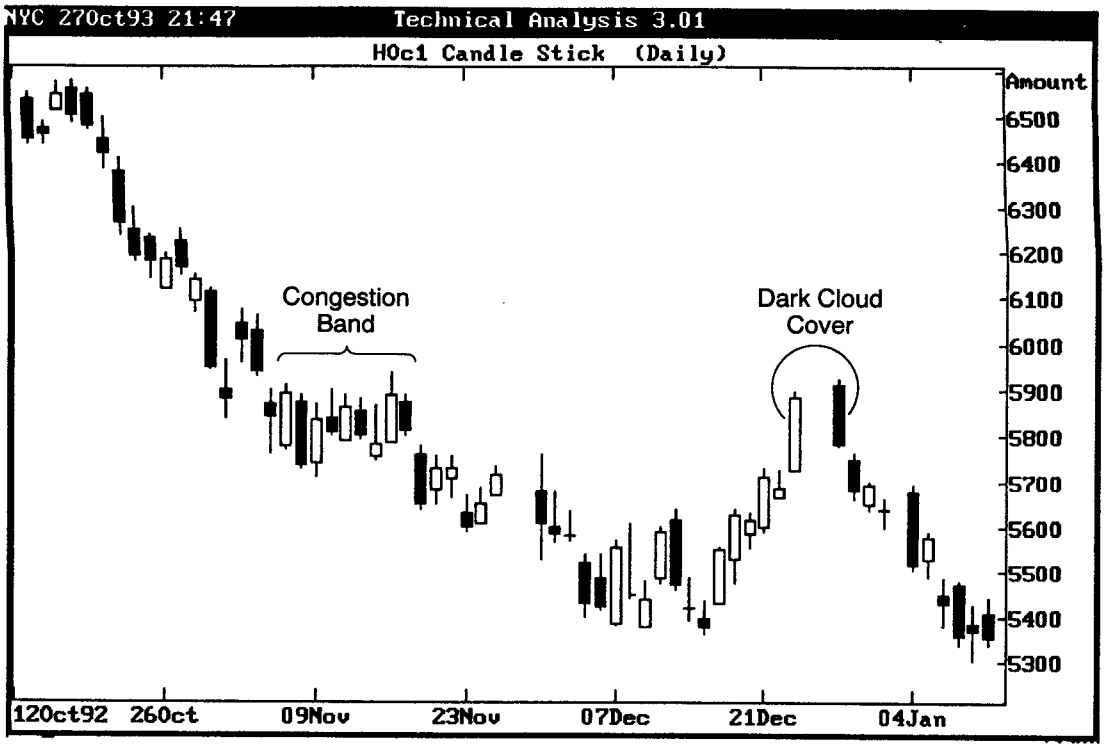


EXHIBIT 3.21. Dark Cloud Covers in Close Proximity, Eastman Kodak—Daily



Reuters Graphics

EXHIBIT 3.22. Dark Cloud Cover Confirms Resistance, February 1993 Heating Oil

prior closes. This is not a healthy scenario. The gap lower was final proof of a break to the downside.

Exhibit 3.22 shows a congestion band between 59 and 60¢ during the first half of November. When the market trends laterally for an extended period, the congestion zone often becomes a resistance or support area once prices break out of that range. This is because the longer the market trades sideways, the more traders get involved in the market as either buyers or sellers. In this example, once prices broke under the bottom end of the early November congestion band, those who went short while the market was within the lateral band were making a profit on the downside breakout. However, those who went long while the market was within that early November trading band were in a losing trade when prices broke under the bottom end of the congestion band. This means that if the market rallies back up to the congestion band, those longs may use that rally to try to get out of their losing trade. In other words, the existing longs should be new sellers on rebounds to the congestion band. In Exhibit 3.22, once the early November congestion area was broken, it then became resistance. The December failure at that resistance area came with the dark cloud cover (the empty area between the two candles of the pattern was due to a holiday).

The Piercing Pattern

As shown in Exhibit 3.23, the piercing pattern is the opposite of the dark cloud cover. The dark cloud cover appears after an uptrend, and is comprised of a black real body that closes well into the prior white body. The piercing pattern is a white real body that closes within the prior black real body. This pattern shows that there is fierce buying at lower levels.

The following is an interesting and graphic explanation used in a Japanese book to describe what happens during the formation of the piercing pattern

> the last of the bulls that were backed into a corner and came out fighting in a heroic fight. Kamikaze fights are always frightening, so the bears seeing this take to the sidelines for the moment. In this quiet period, the bulls may get reinforcements, or after all the selling that has occurred, the supply road for the bears may be already broken."[1]

In other words, the downward energy of the market has been dissipated.

There are various names for the two candle patterns that have the second white candle close less than halfway into the prior black candle. These are discussed in detail in my other book. For the purposes of the discussion here, these names are unimportant. What is important is the general concept that the more the white candle pierces the black candle, the more constructive the signal. If the white candle fails to move deeply into the black candle, it reflects a weak counterattack by the bulls and

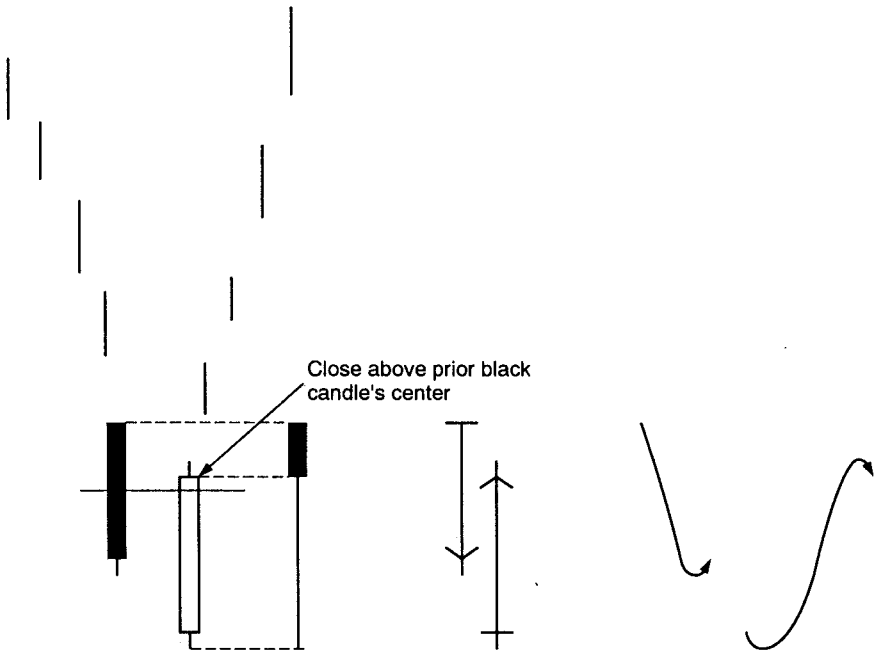


EXHIBIT 3.23. The Piercing Pattern

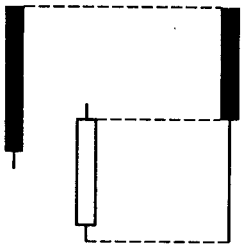


EXHIBIT 3.24. White Candle Under Center of Prior Black Candle

selling could resume. As illustrated in Exhibit 3.24, you can see that a pattern that has the second session below the midpoint of the prior black candle creates a blended candle with a short lower shadow. Note, by comparison, the long lower shadow of the blended candle in Exhibit 3.23. This shows the bulls successfully mounted a strong counterattack. Also consider that the lower the second candle's opening, the longer the lower shadow of the blended candle will be. This means that a piercing pattern that has a low opening second session and then closes well into the prior candle would be an optimum example of that pattern.

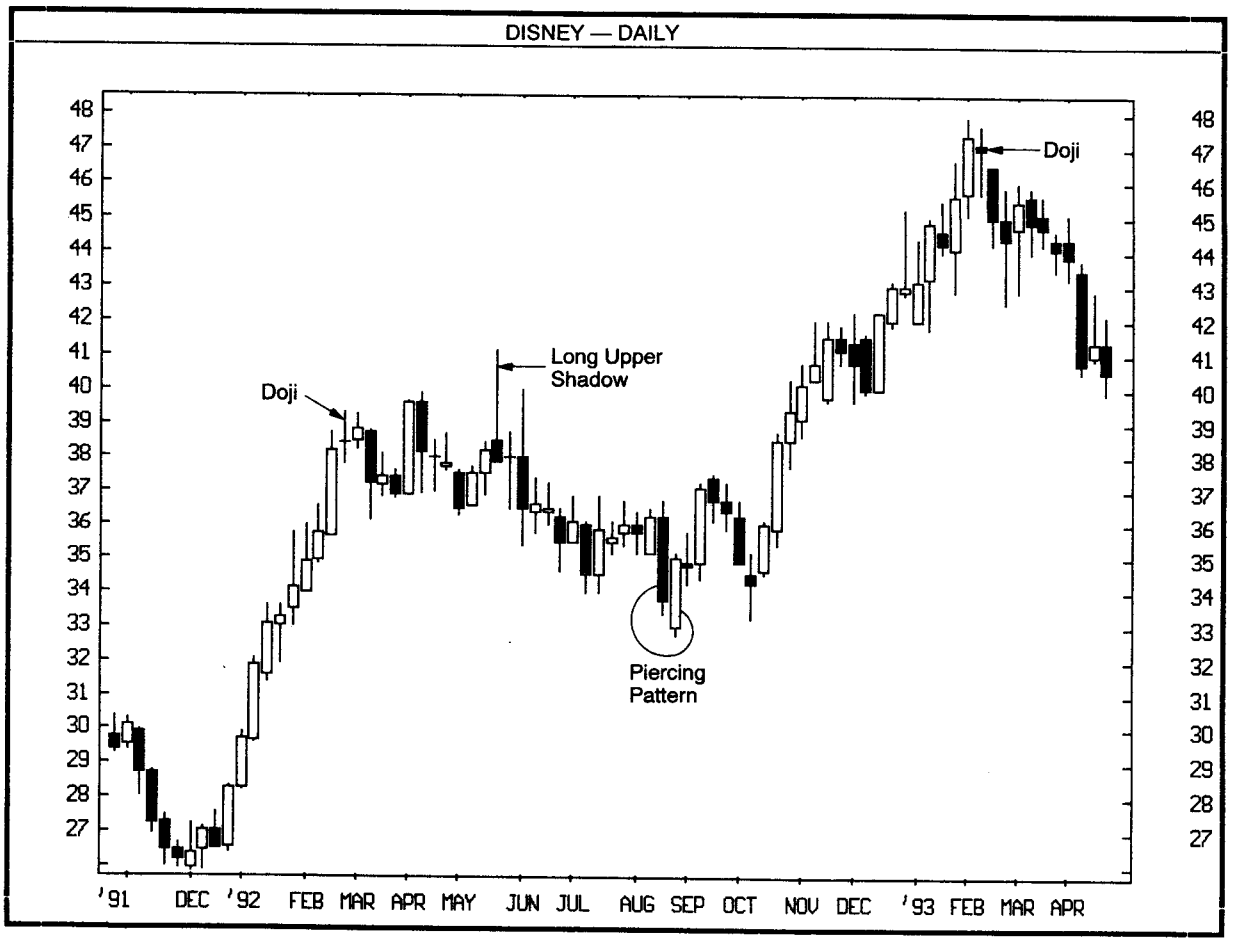


EXHIBIT 3.25. Piercing Pattern and Retracement, Disney—Weekly

It has been my experience that dark cloud covers are more prevalent than are piercing patterns. Part of the reason may have to do with an old Wall Street saying, "In on greed, out on fear." Although both greed and fear are strong emotions, I think many would agree that of the two, fear is the one that could cause the most volatile markets. During market bottoms, traders or investors usually have the opportunity to wait for an opportunity to enter the market. They may bide their time and wait for a pullback or for the market to build a base, or to see how the market reacts to news. Fear is more prevalent at tops. Fear is saying, "I want out—now!"

In Exhibit 3.25 we see that an advance that started in late 1991 stalled at the doji following the tall white candle. The extended upper shadow in May echoed the importance of the resistance area set by this doji. The market then retreated until August's piercing pattern. The piercing pattern was also at a support area based on a 50% retracement of the rally from the December low to the May high. The 50% retracement area should be closely monitored by traders because such retracements are widely watched by technicians. This pattern became support that was held in October with a high-wave candle. The rally from this base near $33 stalled at another doji following a tall white candle in early 1993.

Exhibit 3.26 displays that April's piercing pattern confirmed a support

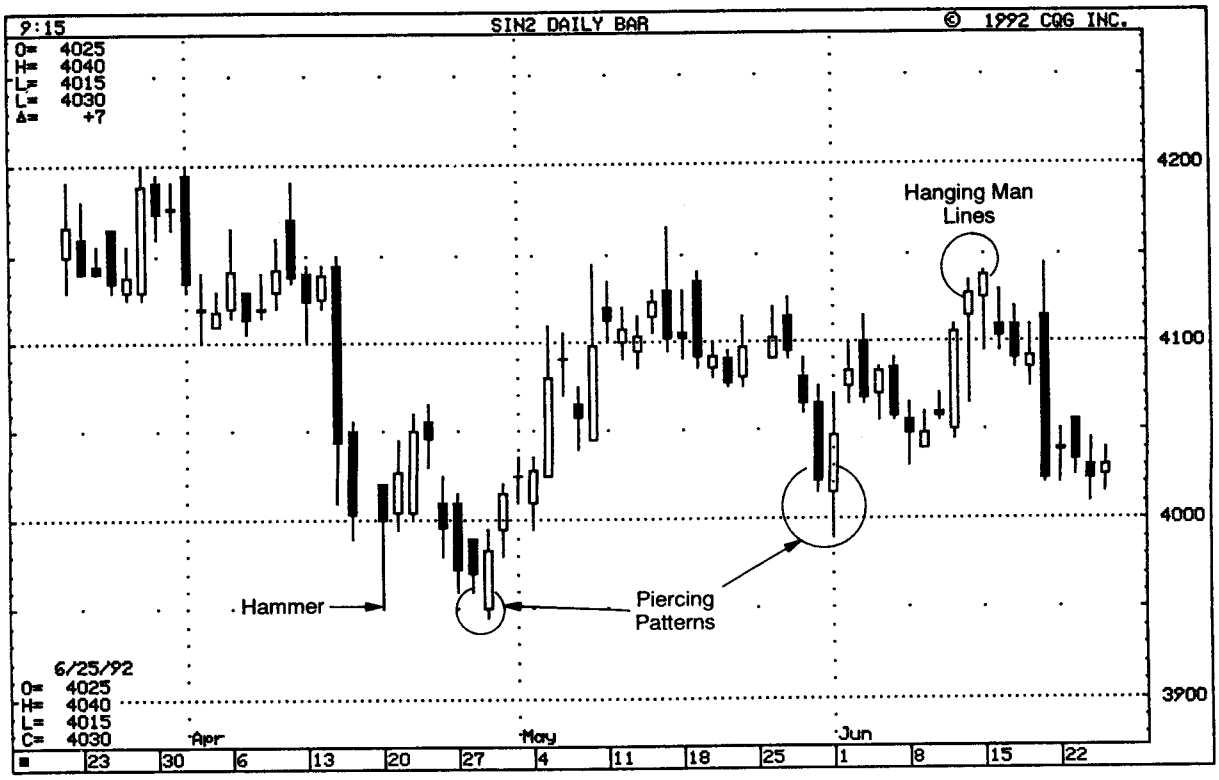


EXHIBIT 3.26. Piercing Pattern Confirms Support, Silver—July 1992

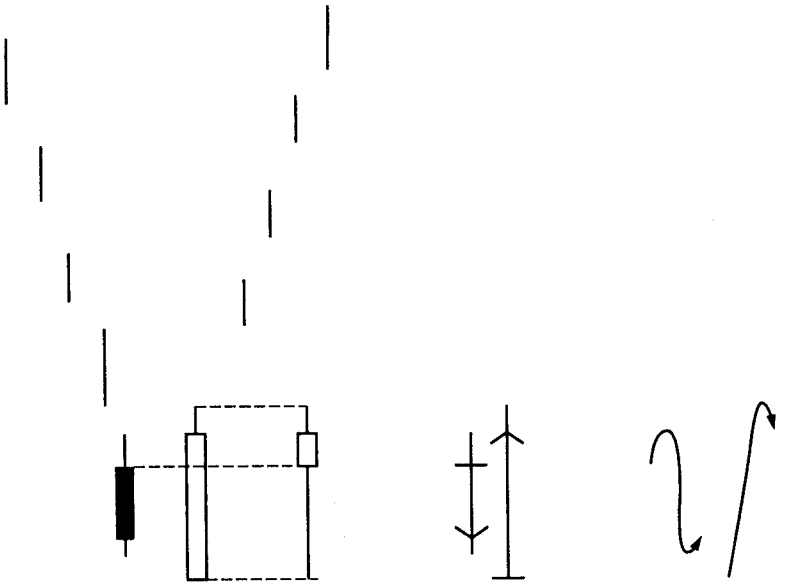
area provided by the prior week's hammer. Another piercing pattern in late May and early June signaled a temporary base for another assault at May's resistance area near $4.15. A series of two hanging man lines appeared at that resistance. Note how the first hanging man was not confirmed (since the next session did not have a lower case). Only on the day after the second hanging man session, with its close under the second hanging man's real body, was the hanging man line confirmed.

The Engulfing Patterns

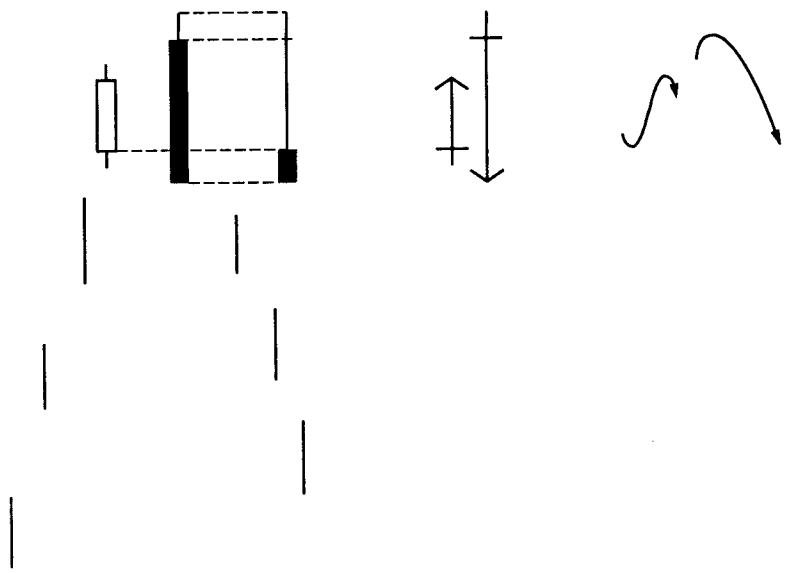
An engulfing pattern is a two candle pattern. A bullish engulfing pattern (shown in Exhibit 3.27A) is formed when, during a downtrend, a white real body wraps around a black real body. A bearish engulfing pattern (Exhibit 3.27B) is completed when, during a rally, a black real body envelops a white real body.

The engulfing pattern visually shows how the opposing forces had gained control of the market. For example, a bullish engulfing pattern reflects how the bulls have wrested control of the market from the bears. A bearish engulfing pattern shows how a superior force of supply has overwhelmed the bulls. The Japanese say that with a bearish engulfing pattern, "the bulls are immobilized." We previously saw how with the dark cloud cover, the bears were able to move prices into the prior white real body, but with the bearish engulfing patterns, the power of the bears was such that they were able to pull the close under the entire prior white real body. The same concept can be used to compare a piercing pattern to a bullish engulfing pattern. With the piercing pattern, the bulls counterattack strongly enough to push the close of the second white real body well into the prior black real body. However, with the bullish engulfing pattern, the bulls' strength is that much greater since the close of the white candle session is above the top of the prior black real body. Although this generally means that the bearish engulfing pattern is more bearish than a dark cloud cover, and a bullish engulfing pattern more bullish than a piercing pattern, it is equally important to see where these patterns emerge before deciding which is more important. For instance, a piercing pattern that confirms a major support area should be viewed more likely as a bottom reversal signal than a bullish engulfing pattern that does not confirm support. This vital aspect of viewing the candle patterns in conjunction with the overall technical picture will be discussed in depth in the next chapter.

The basic definition of an engulfing pattern is that the second real body must engulf an opposite color real body. However, not all engulfing patterns are equally important. The importance of the engulfing pattern



(A) Bullish Engulfing Pattern



(B) Bearish Engulfing Pattern

EXHIBIT 3.27. Bullish and Bearish Engulfing Patterns

is dependent on the relative size of the real bodies, the relationship of the shadows to one another, and other factors. For example, the strictest definition of an engulfing pattern would be if the first candle is small and the second candle very large, and the second real body wraps around the entire first candle—including its shadows. The next strictest definition would be if the shadows of the second candle exceeded the shadows of the first candle (in other words, on the second day of the engulfing pattern, the market made a higher high and a lower low).

As with a dark cloud cover, if the market surpasses an engulfing pattern, it is said to go opposite to the pattern. This means that if prices close above the top of the bearish engulfing pattern (including the upper shadows), the outlook turns from bearish to bullish.

Aspects addressed in this section's charts include:

1. how engulfing patterns become support and resistance;
2. how an engulfing pattern can be combined with Western technical tools;
3. why traders should be more flexible in defining an engulfing pattern with stocks compared to futures;
4. the importance of comparing the size of the two real bodies of the engulfing pattern;
5. the danger signal of a bearish engulfing pattern after a doji.

In Exhibit 3.28, the first sign of trouble was with the high-wave candle in late August. During the first two sessions of September, more trouble arose with a bearish engulfing pattern. The market backed off from there, and found support at the mid-August rising gap. (We will look at how gaps become support or resistance later in this chapter.) The rally from

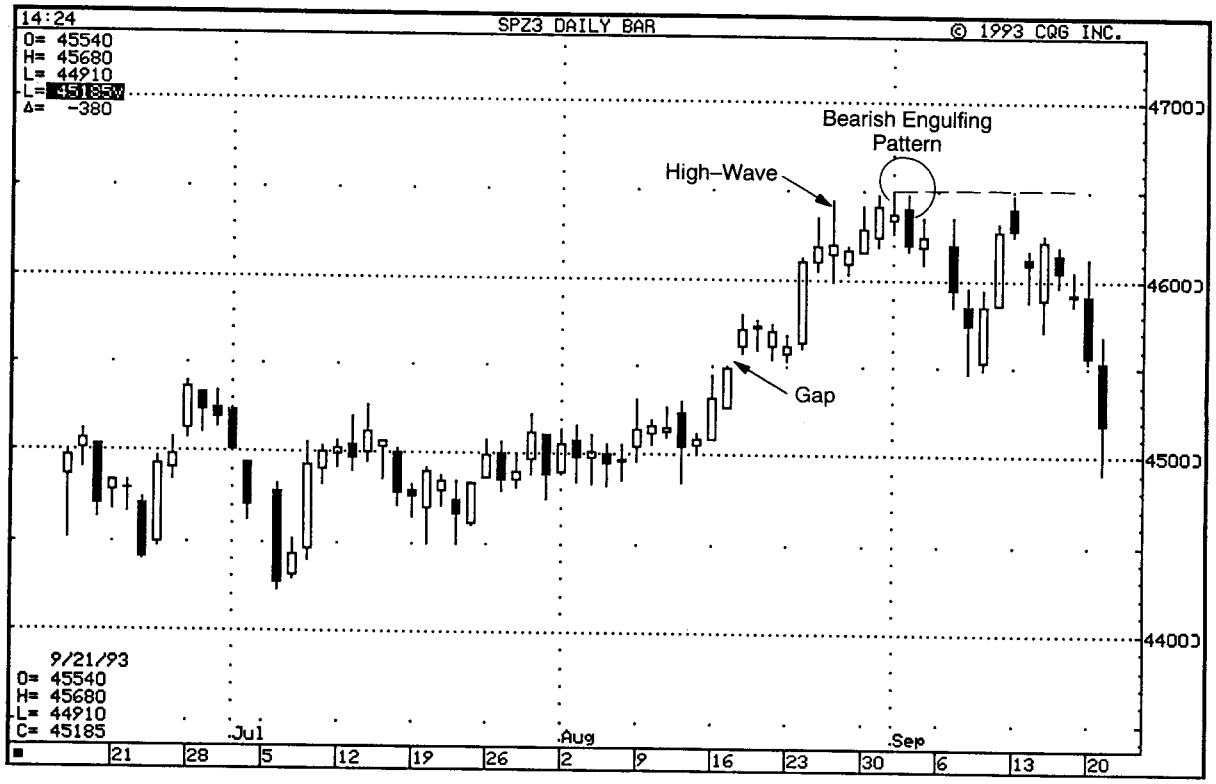


EXHIBIT 3.28. Bearish Engulfing Pattern as Resistance, December 1993 S&P

this gap stalled at the resistance area set up by the bearish engulfing pattern.

Exhibit 3.28 also displays how the candles can offer reversal signals not available to those using Western technical tools. With Western technicals, there is a reversal signal called a top outside reversal session, sometimes also known as a key reversal. This occurs when prices make a new high for the move and then close lower than the previous session's close. Note how in the bearish engulfing pattern highlighted in the S & P was not a reversal session since the second session of this bearish engulfing pattern (i.e., the black candle) failed to make a new high for the move. Yet, because the black candle enveloped the white candle, it was a bearish engulfing pattern. Consequently, while no reversal pattern was revealed with western technicals, there was a reversal with candle charts.

In Exhibit 3.29, we see how a selloff in December commenced with the doji following the tall white candle. This area's resistance was con-

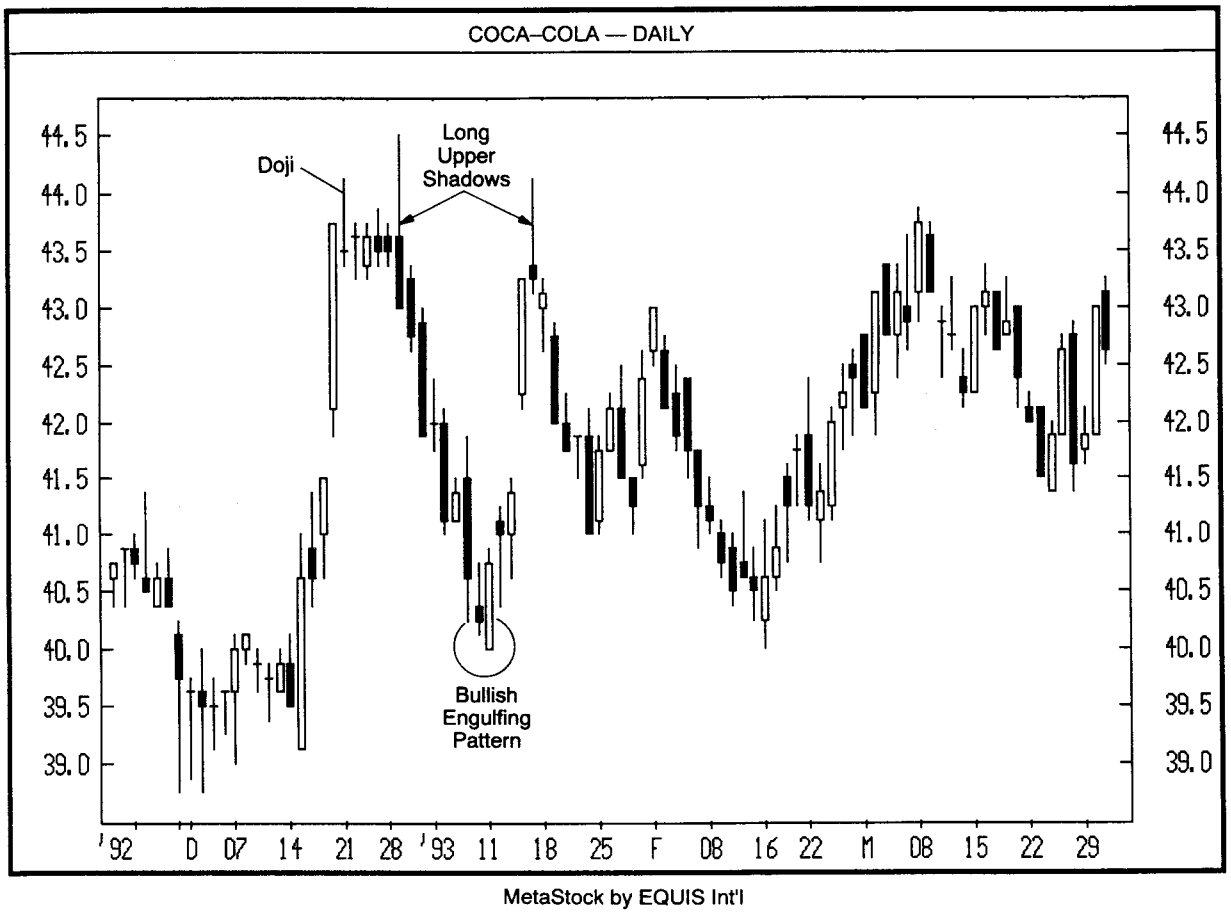


EXHIBIT 3.29. Bullish Engulfing Pattern as Support, Coca Cola—Daily

firmed by the long upper shadow candle near $44 a few sessions later. The selloff found a base in January 1993 near $40 via a bullish engulfing pattern. From there, the market rallied, and again stalled via a long upper shadow candle near the previously discussed resistance area of $44.

Based on the action described thus far, we know that $44 is resistance and the bullish engulfing pattern near $40 is support. Thus, for traders looking for a buying zone, it could be done on corrections to the bullish engulfing pattern (near $40) with a target towards $44 and a stop on a close under the lows of the bullish engulfing pattern. This scenario unfolded in February. The concept of risk-reward is very important. Before placing a trade with candles or any other form of technical analysis, risk-reward must always be considered (in Chapter 4, I will discuss this critical subject in more depth).

Exhibit 3.30 displays a classic bearish engulfing pattern near $50. It was classic since a very tall black real body enveloped a very short white real body. In March, there was another bearish engulfing pattern. This

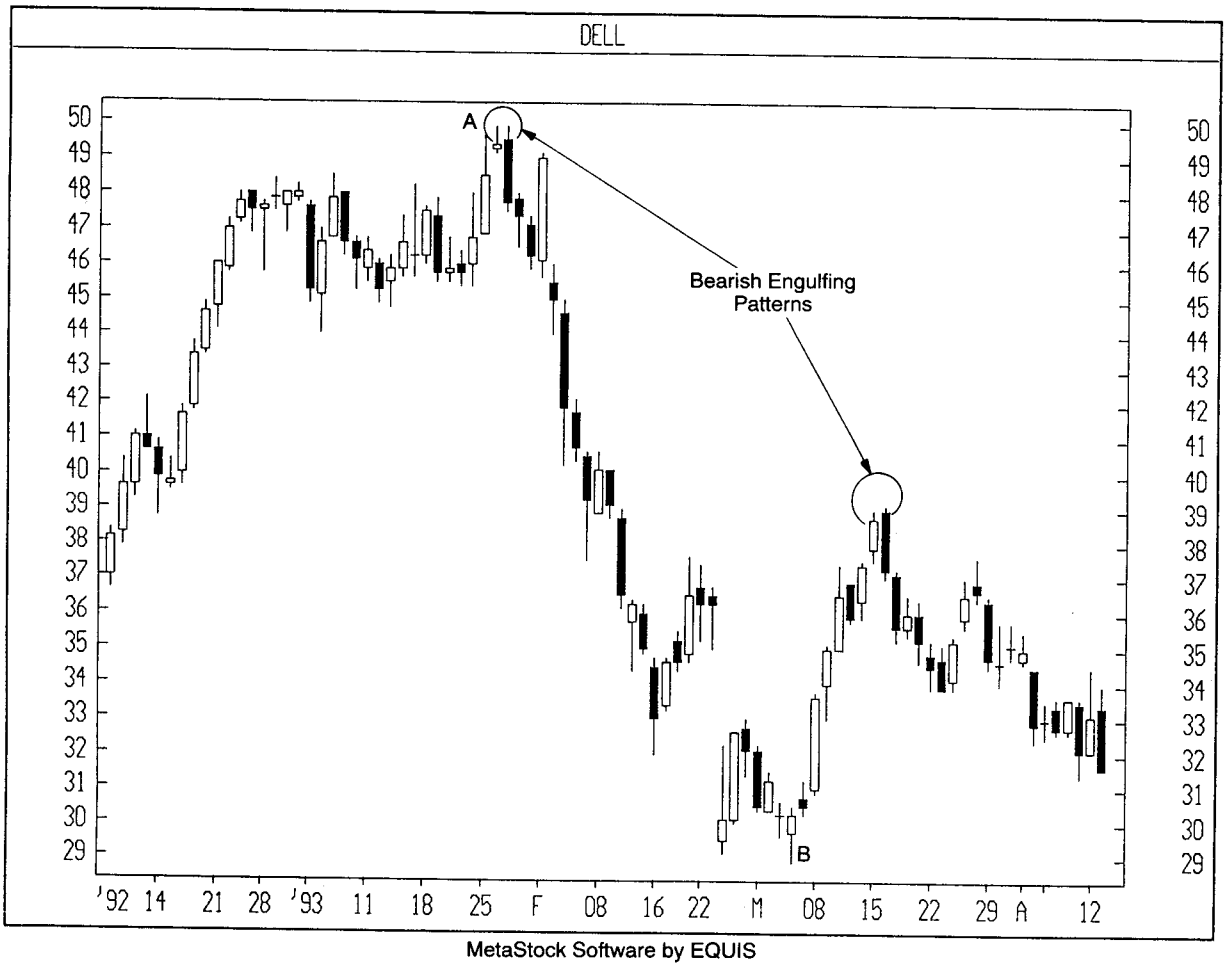


EXHIBIT 3.30. Engulfing Pattern Confirms Retracement, Dell—Daily

one confirmed a resistance area defined by a 50% retracement of the selloff from A to B.

Because stocks often open relatively unchanged from the prior close (as compared to the futures market), there should be more flexibility in defining an engulfing pattern with stocks than with the more volatile futures markets. Specifically, I still view it as an engulfing pattern if the open of the second session of the candle pattern is the same as the close of the first candle. This is shown in Exhibit 3.31.

Exhibit 3.32 shows an example of a bullish engulfing pattern in which the open and the close were about the same. The importance of this pattern was reinforced by the fact that it became support during the April 1993 pullback.

When looking at an engulfing pattern, you should consider the relative sizes of the real bodies that form the pattern. An ideal bearish engulfing pattern has a very large real body enveloping a small white real body. The diminutive size of the first small body of a bearish engulfing pattern shows that the momentum of the prior rally is slackening. The large black real body after this small candle then proves that the bears have overwhelmed the bulls.

However, if there are two almost equal size candles that comprise the engulfing pattern, the market may move into a lateral band, rather than reverse (this concept may be useful for options traders who are looking to sell volatility). I will use Exhibit 3.33 to illustrate this important concept. In this deutsche mark chart, there was a bearish engulfing pattern in July 1992 (1 on the chart). Note how the white and black candles were about equal in height. The fact that they are about equal means that the bears and the bulls are about equally strong. With no clear-cut victory of the bears over the bulls, it should not have been unexpected to see prices move sideways for a few weeks. On a breakout from this engulfing pat-

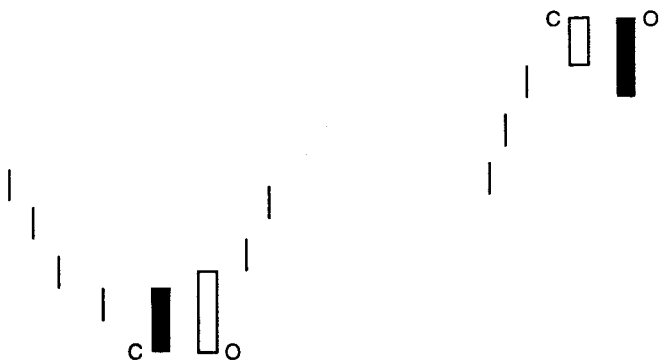


EXHIBIT 3.31. Engulfing Patterns Where Open and Close are the Same

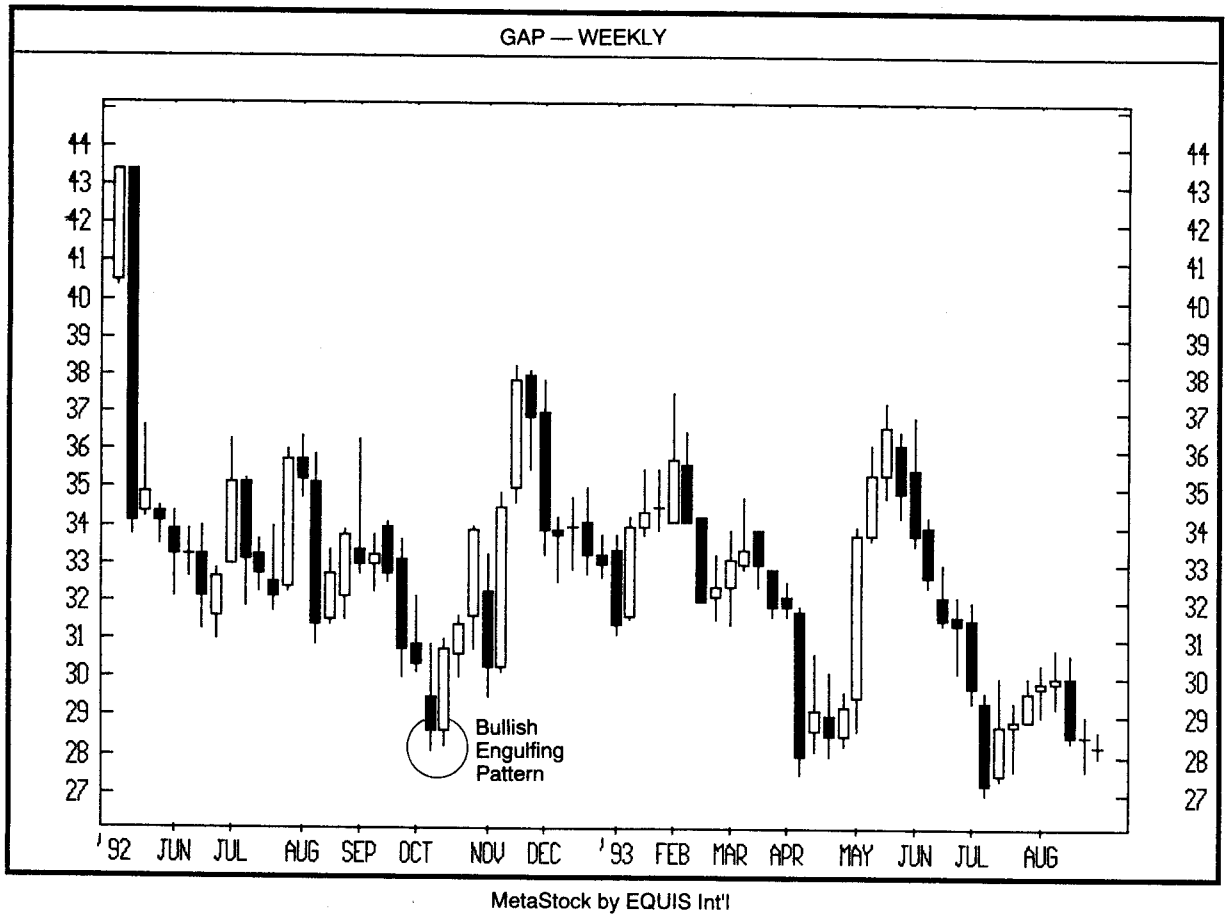


EXHIBIT 3.32. Engulfing Pattern and Stocks, Gap—Weekly

tern's resistance band, the market stalled at another bearish engulfing pattern at 2.

The bearish engulfing pattern at 2 was more significant with its small white real body and massive black real body. It was thus more likely to presage a price turn rather than a move into a lateral environment. This engulfing pattern then became a resistance area.

Exhibit 3.34 displays a bearish engulfing pattern in early 1991. Note how the white and black candles were about equal. As just discussed, this could mean a period of consolidation; this is what unfolded as prices moved into a lateral trading band. The highs of this bearish engulfing pattern set up a resistance area that was confirmed by a long upper shadow. Another bearish engulfing pattern appeared in October 1992. Because the October bearish engulfing pattern had a very large black real body and a small white one, it was more important than the prior engulfing pattern. Even more portentous with the October engulfing pattern was that it followed a doji. Specifically, if there is a bearish engulfing pattern that follows a doji, it is viewed as being a particularly bearish combination.

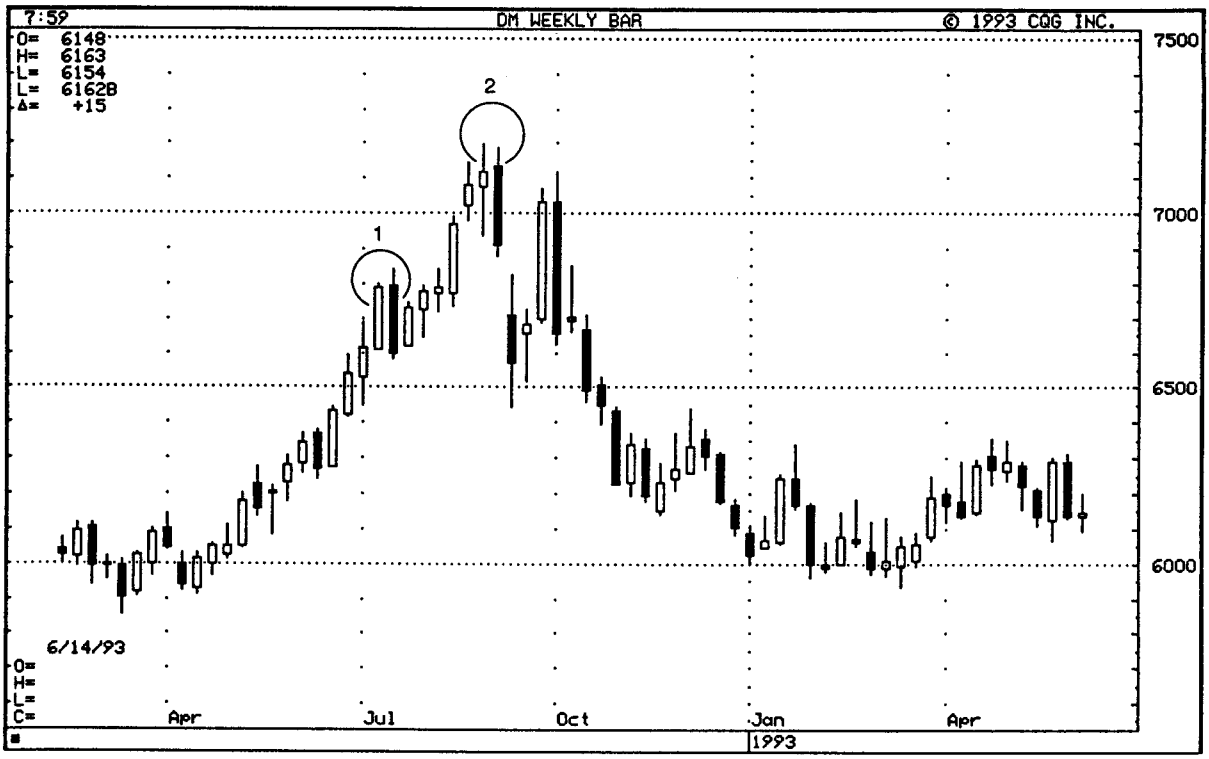


EXHIBIT 3.33. Engulfing Patterns and Size of the Real Bodies, Deutsche Mark—Weekly

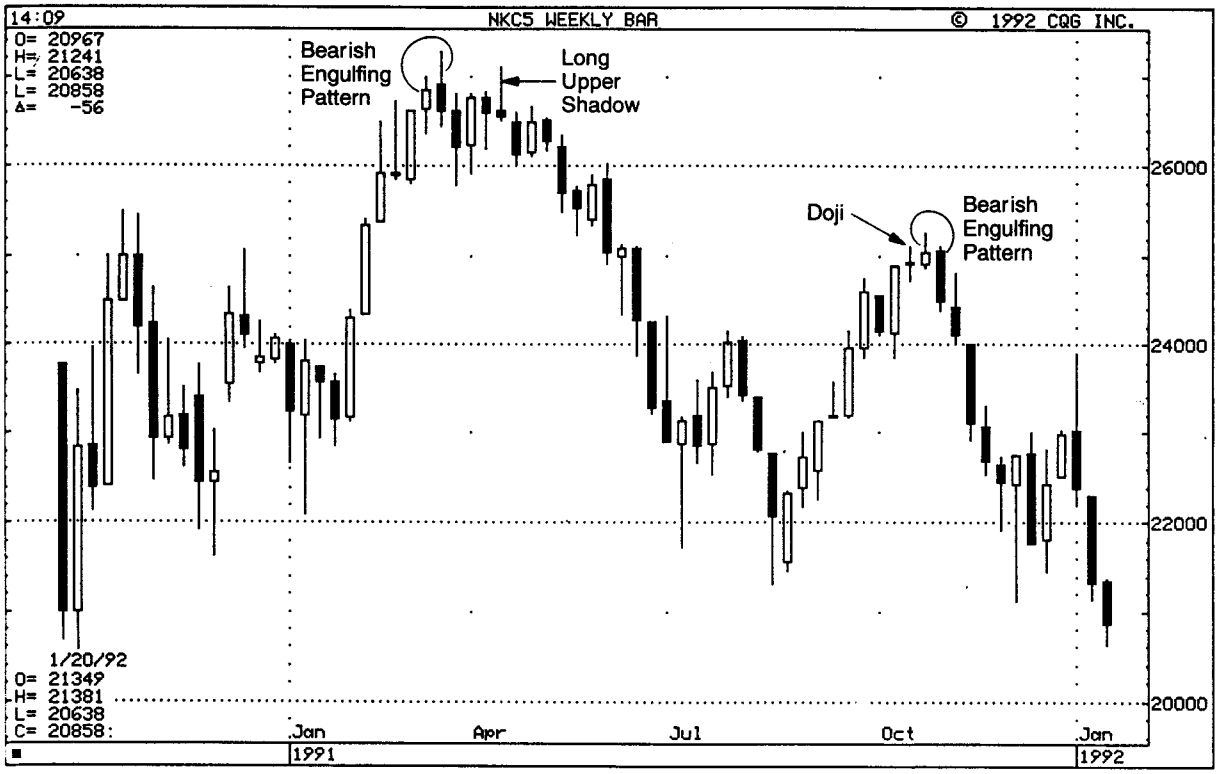


EXHIBIT 3.34. Bearish Engulfing Pattern Following a Doji, Nikkei—Weekly

Last Engulfing Patterns

A bearish engulfing pattern is a large black candle that envelops a small white real body *after an uptrend*. However, if a bearish engulfing pattern appears *during a price decline*, it has the potential of being a bullish bottom reversal signal. This pattern is known as a *last engulfing bottom* (see Exhibit 3.35(A)). The last engulfing pattern is viewed as a turning point for the bulls if prices can close above the black candle's close.

A bullish engulfing pattern is a two-candlestick pattern in which, *during a downtrend*, a large white candle wraps around a prior small black real body. However, if, during a *rising market*, a large white candle engulfs the previous day's black candle, it is a potentially bearish pattern, referred to as a *last engulfing top* (Exhibit 3.35(B)). In candle theory, the bearishness of this pattern is confirmed if the next day the market closes under the prior white candle's close.

In Exhibit 3.35(B), the merged candle of the last engulfing top looks bullish with its long upper shadow. However, remember that the last engulfing top appears in an uptrend, so the merged candle line can be compared to a potentially bearish hanging man line.

The Japanese colorfully compare the last engulfing pattern top to dou-

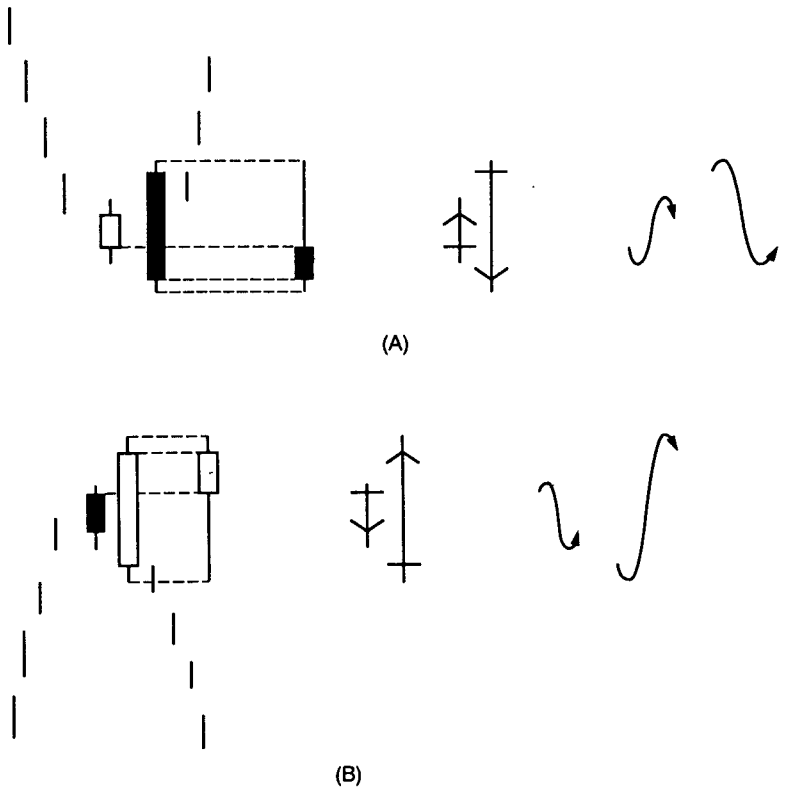


EXHIBIT 3.35. Last Engulfing Bottom and Top

ble lovers' suicide. This is because you fall in love with the market (because of the last engulfing pattern's long white candle), but both you and the market perish together. These words might be a little strong, but they convey the cautionary approach traders should take after the emergence of a last engulfing pattern.

In April 1992, in Exhibit 3.36, there was a bullish engulfing pattern (note how, because this was a stock, I still viewed it as a bullish engulfing pattern although the second session's open was the same as the prior close). The rally from that pattern stalled at the last engulfing top. Note how both of these patterns just discussed had a white candle enveloping a black real body. But what was the difference? In the regular bullish engulfing pattern in April 1992, the combination of the white enveloping the black candles surfaced during a downtrend. In August 1992, the same combination of candles appeared after an uptrend, thus becoming a last engulfing pattern top. The fact that the next day's session closed under the long white real body's close was confirmation of the last engulfing top.

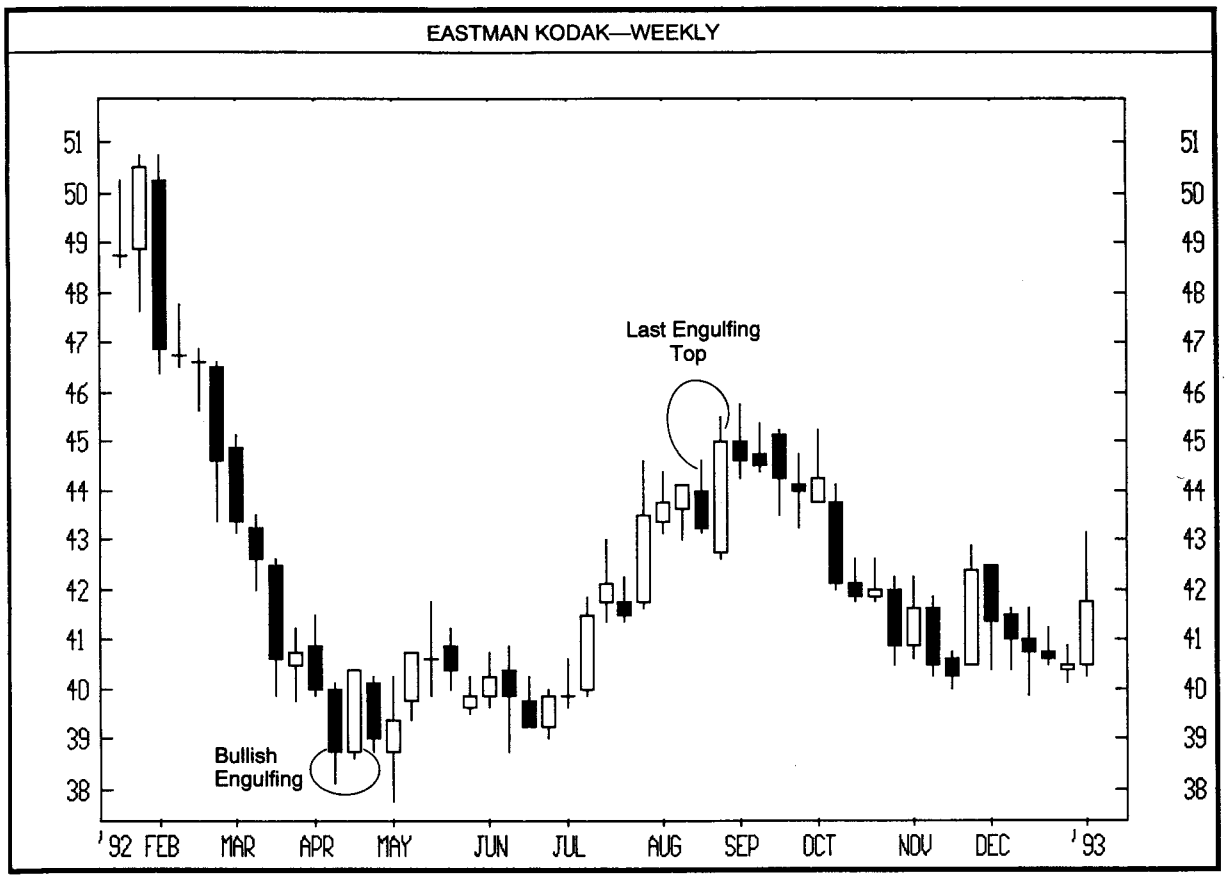


EXHIBIT 3.36. Last Engulfing Top, Eastman Kodak—Weekly

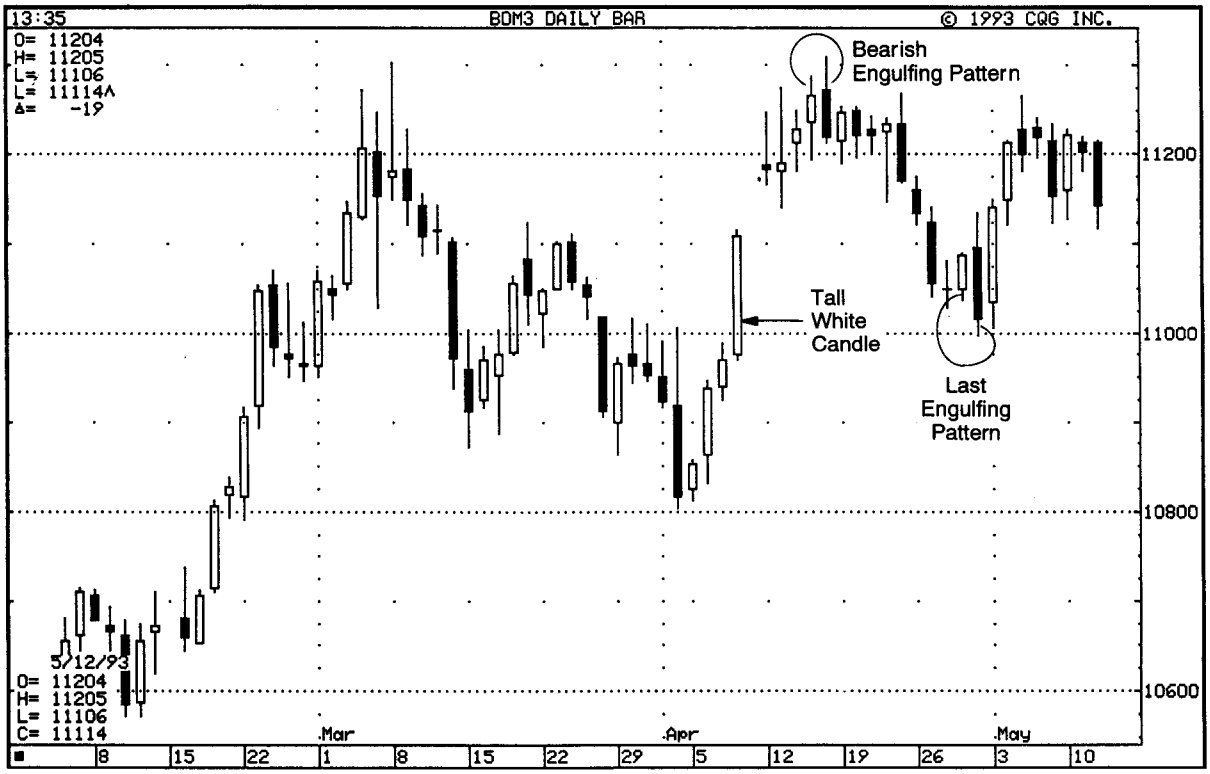


EXHIBIT 3.37. Last Engulfing Bottom, June 1993 Bonds—Daily

In Exhibit 3.37, a bearish engulfing pattern arose at April's price peak. Prices then descended, finding support at the bottom of the tall white candle. This support was tested in late April with a black candle wrapping around a white real body. This had the shape of a bearish engulfing pattern, but it appeared during a downtrend. As such, it became a bullish last engulfing bottom.

In Exhibit 3.38, at the September lows, there was a last engulfing bottom. One of the more interesting aspects of this chart is that the volume on the long black candle session was unusually high. This could be viewed as a selling climax. This increased the chance that the last engulfing pattern was a bottom reversal.

Harami

The harami is comprised of a long real body and a small real body within its range. The harami is the reverse of an engulfing line. Whereas in an engulfing pattern there is a long candle engulfing the previous real body, a harami is an unusually long real body followed by a very small real body.

After a downtrend, the emergence of a harami shows, as expressed in Japan, that "the decline is exhausting itself." A harami, after an ad-

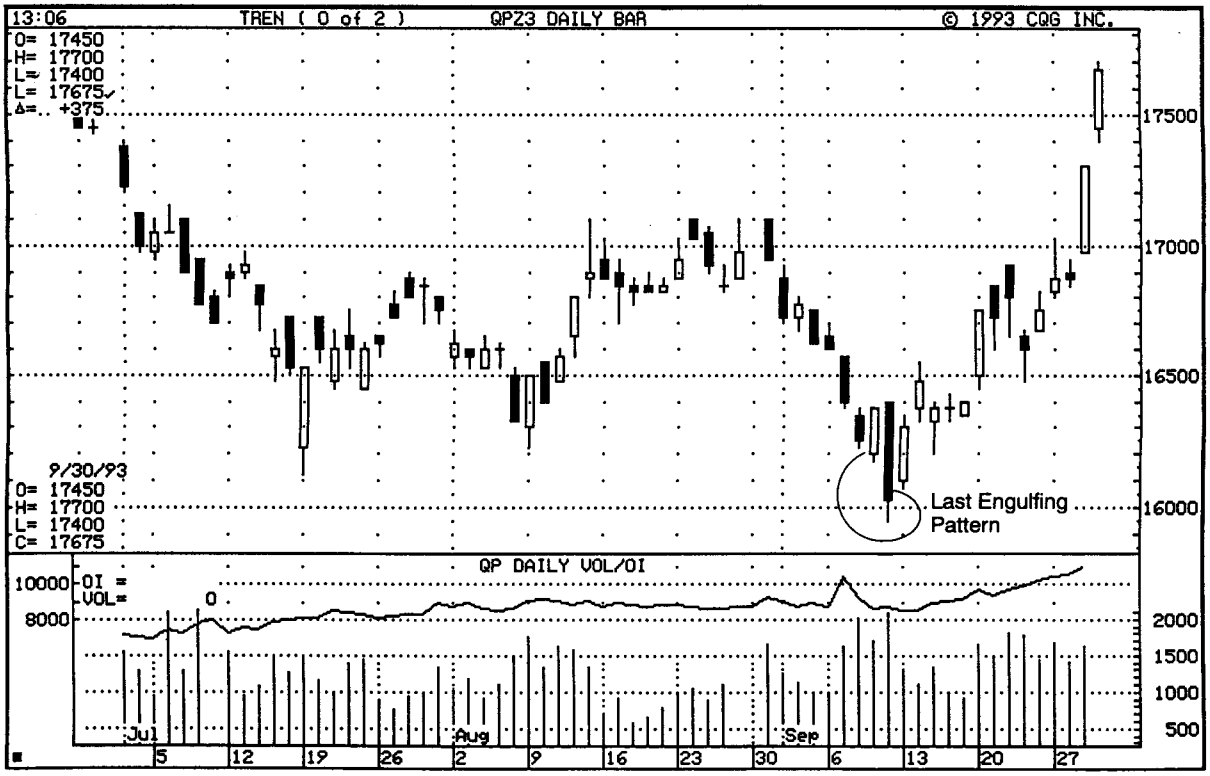


EXHIBIT 3.38. Last Engulfing Pattern and Volume, December 1993 Gas Oil

vance, shows that the market must have failed to maintain higher prices.

As shown in Exhibit 3.39(A), either candle of the harami can be white or black; all combinations are called harami. However, after a downtrend, a white–black (meaning the first candle is white and the second is black) or a white–white harami is viewed more bullishly than a black–white or a black–black harami. This is because a long white candle is by itself viewed as bullish, so its appearance in a harami increases the chance that the falling power of the market will come to an end.

The same rationale applies to a harami after an uptrend. As displayed in Exhibit 3.39(B), a harami with a long black real body can be viewed as more bearish than a harami in an uptrend that has a long white real body. This is because a long black real body after a rally is construed as bearish, so when it is the first part of the harami pattern, the degree of pessimism is increased.

Other aspects that will increase the importance of a harami include the following.

1. If the second real body is in the middle of the trading range of the first real body. If, after a rally, the second real body of the harami is near the upper end of the first real body, the odds increase that the

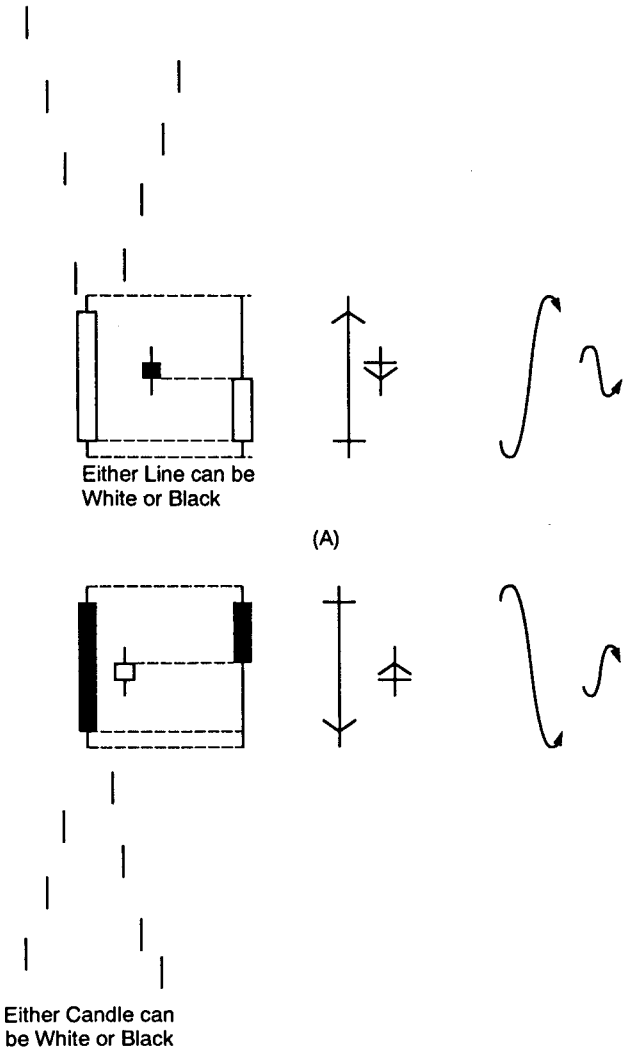


EXHIBIT 3.39. Harami

market will consolidate rather than reverse. I refer to such a harami as a *high-price harami* since the second session's price is in the upper end of the prior range. In a downtrend, if there is a harami with the second small real body near the bottom end of the trading range of the prior long real body, then the outlook is more likely for a market lull rather than for a price reversal. I call this type of harami pattern a *low-price harami*.

2. If the entire range, that is, the open, high, low, and close, are within the prior real body, the chances increase for a price reversal.
3. The smaller the shadows and the shorter the real body of the second candle, the better the signal. If the second candle is a doji instead of a small real body, it increases the probability of a reversal. This combination of a long candle followed by a doji in the first candle's real body is called a *harami cross*.

Some Japanese literature refers to harami as transition periods in the market. This means that if a harami in an uptrend is exceeded, it is viewed as a bullish continuation signal. If the price closes under the low of the harami session in a downtrend, then expect more selling pressure.

Exhibit 3.40 illustrates how a rally that started with November's bullish engulfing pattern hesitated at a harami in December. This harami had two aspects that increased its reliability: the second day's small real body was almost in the middle of the first real body, and the entire range of the second session (including the shadows) was within the real body of the first session. It is interesting how the same scenario unfolded in February. Again, a rally began from a bullish engulfing pattern, and then again stalled with a classic harami. With the harami, as the Japanese would say, "a crack has entered the market." A shooting star a few sessions after the February harami was also a bearish upthrust in which the market made a new high, but the bulls failed to hold these highs. (Although the shooting star session had a real body within the prior long

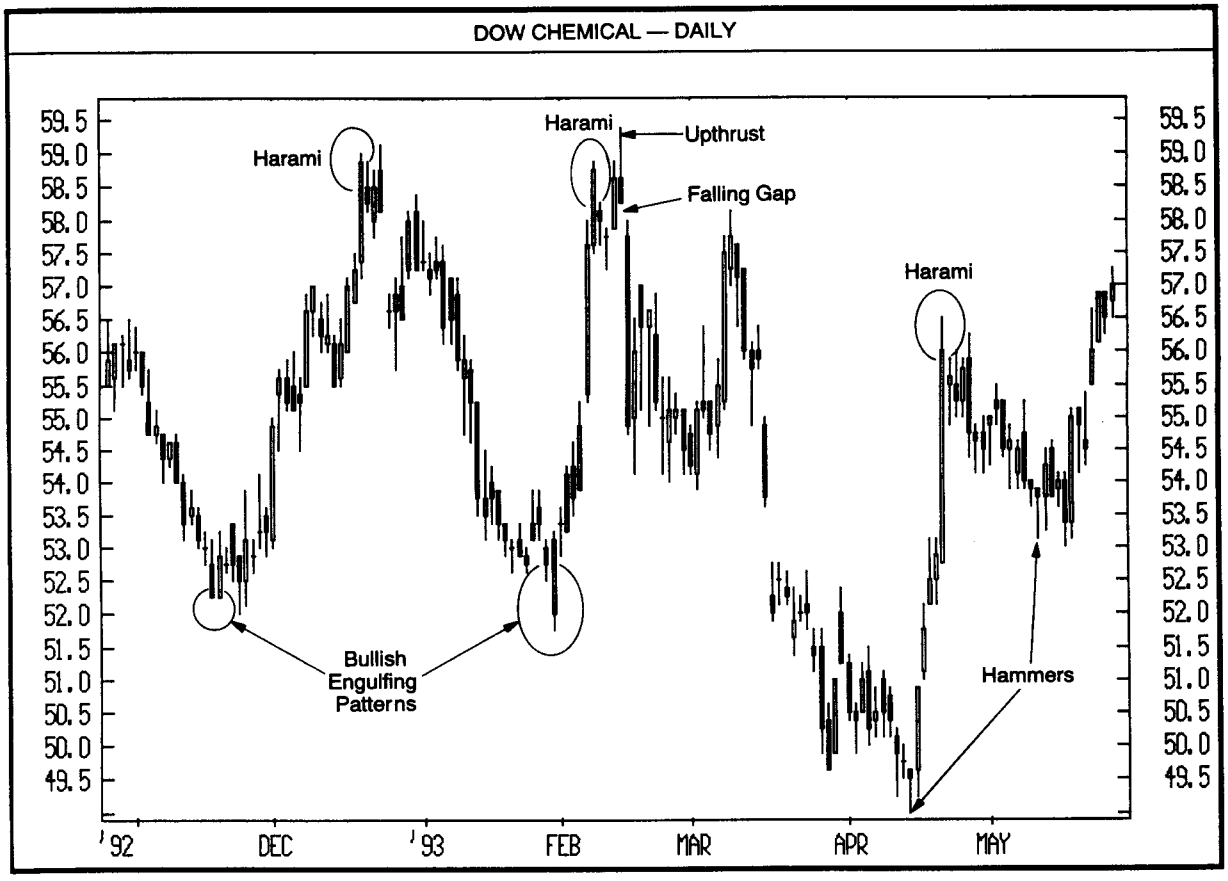


EXHIBIT 3.40. Harami, Dow Chemical—Daily

white candle, these two candles did not form a harami because the upper shadow of the shooting star was too far outside the prior session's range.)

If there was any doubt about the serious trouble this market was in, the falling gap at the arrow should have been the final proof. Note how the harami sessions in December and February became a ceiling. The low in this market was made via a hammer in April. Later that month, a violently long white real body was immediately followed by a diminutive real body. This formed a harami that precipitated a decline until the emergence of another hammer.

In the chart shown by Exhibit 3.41, the selloff from a bearish engulfing pattern found a foundation with May's harami. This second candle of the harami hovered near the bottom of the prior long black real body. As a result, there was more likelihood that prices would move sideways near the lower end of the tall black candle's real body. Note that the long lower shadows after this harami reflected healthy buying interest as prices

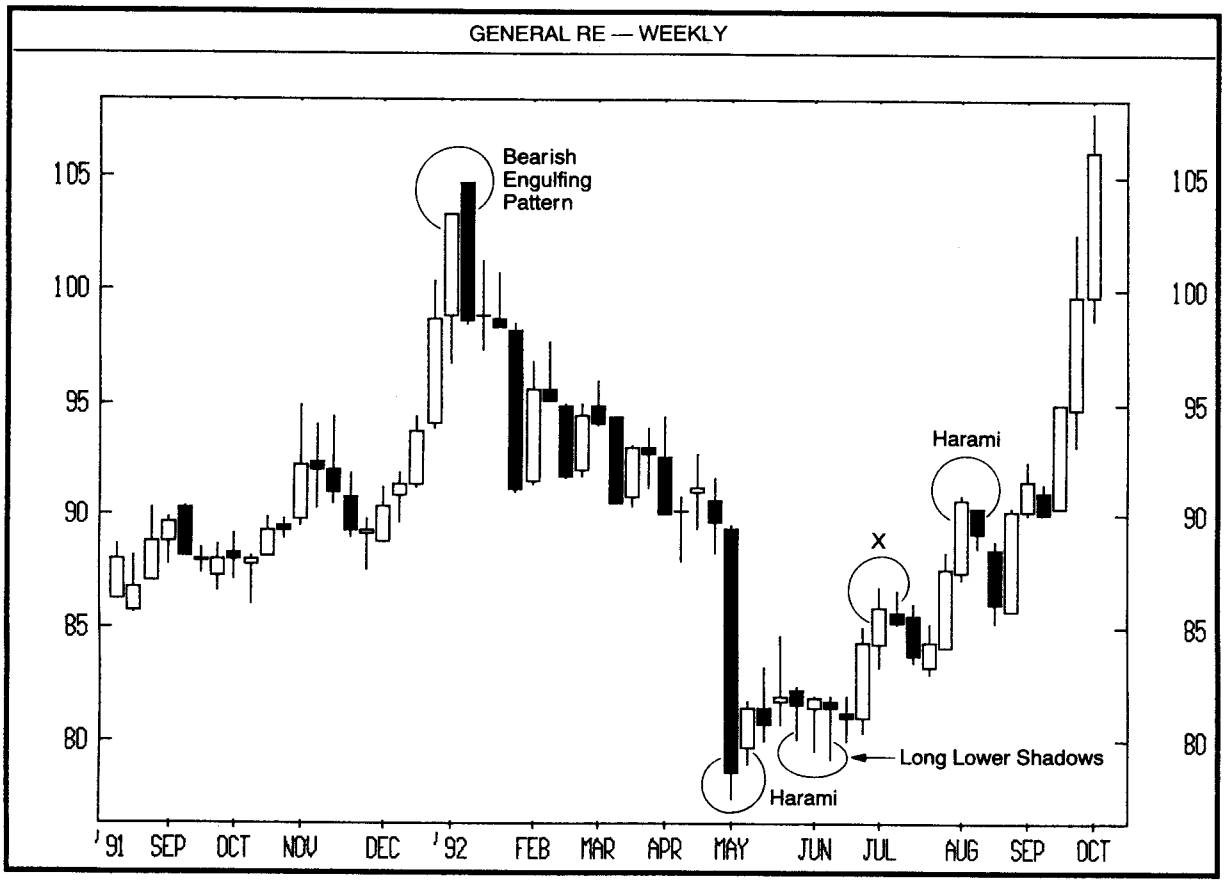


EXHIBIT 3.41. Harami, General Re—Weekly

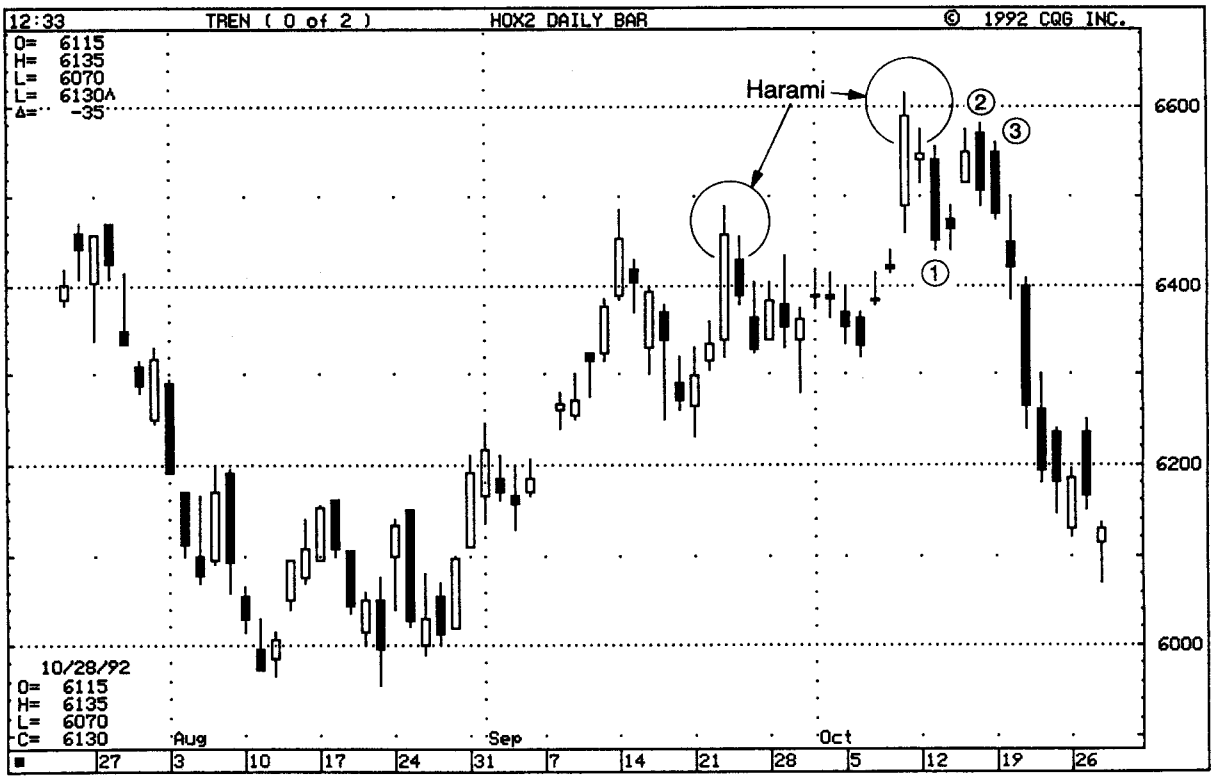


EXHIBIT 3.42. Harami and the Size of the Second Real Body, November 1992
Heating Oil

got near $80. The pattern marked X was not a harami because the white real body was not unusually long. For a harami, the first real body has to be very long relative to the preceding bodies. Another harami appeared in early August, but after an initial setback, prices exceeded the harami so the trend resumed higher.

Exhibit 3.42 shows two examples of harami in which the open, high, low, and close of the second real body are within the first real body. The October harami pattern was more important because of the extremely short real body. Its small size made it like a doji session. Thus, October's harami could be viewed as a harami cross. The series of three long black real bodies (labeled 1, 2, and 3) following October's harami underscored the inherent weakness of the market.

In Exhibit 3.43, in February 1992, we see how a support area (which included a hammer) formed within a $19.00–$19.50 area. Based on the axiom that old support becomes resistance (the change of polarity principle), we would expect $19.00–$19.50 to become resistance. That is what developed as this resistance was first confirmed by a shooting star. From there, the market descended until the piercing pattern occurred. Another assault at the $19.00–$19.50 resistance area materialized in May. At that time, a harami pattern was followed by a dark cloud cover. Another failed

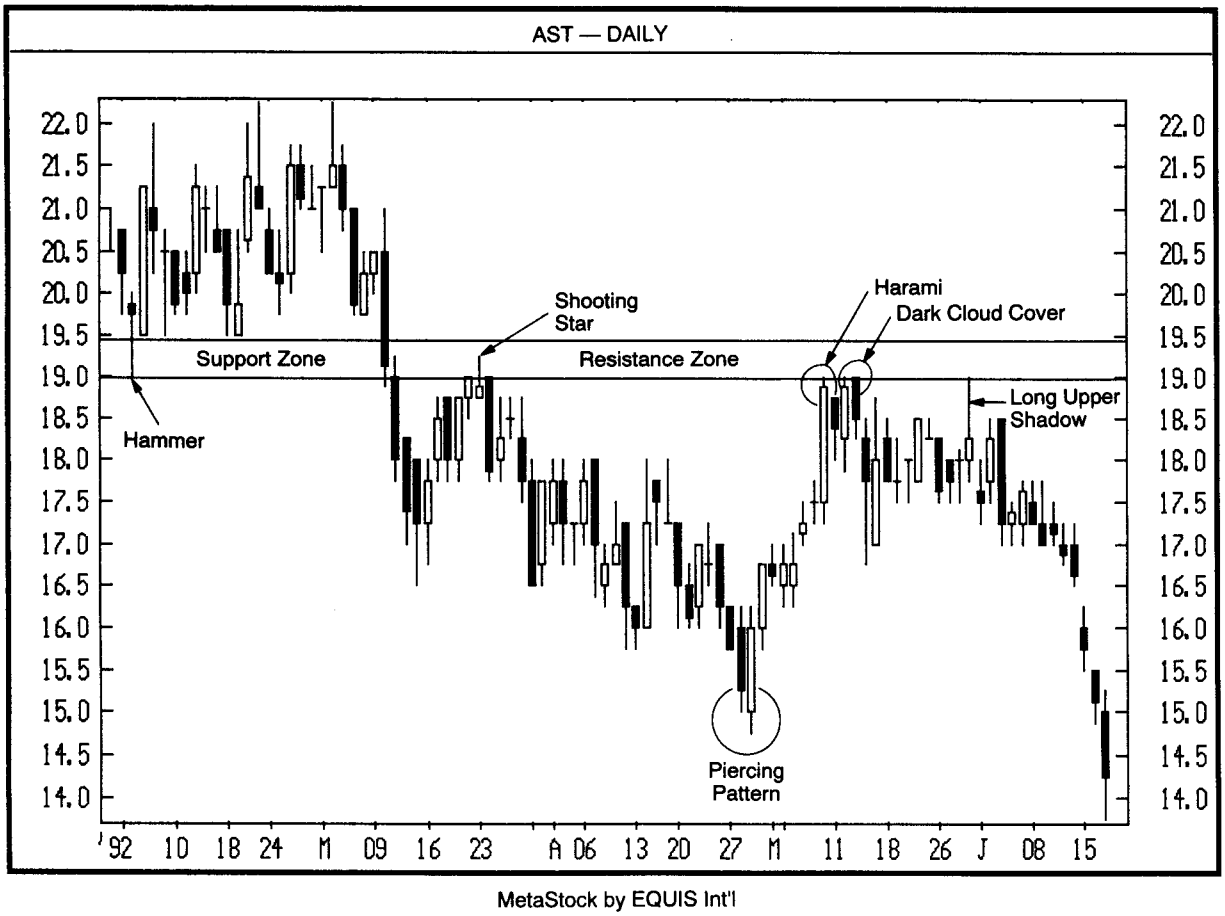


EXHIBIT 3.43. Harami Confirming a Resistance Zone, AST—Daily

attack at the resistance in late May occurred via a long upper shadow candle (this candle was not a shooting star because it did not appear after a rally).

As discussed before, the ideal harami pattern has the second session's real body in the middle part of the first candle. However, if during an uptrend the second candle hovers near the top of the prior candle (i.e., a high-price harami), the chances increase for a consolidation rather than a price reversal. In Exhibit 3.44, we see how several high-price harami (marked 1 through 3) developed from early June through late July. After each of these, the market consolidated for at least a week before moving out of the trading range. This chart brings out another use of a high-price harami (or a low-price harami in a downtrend)—option traders can consider selling volatility. This is because after a high-price harami in an uptrend or a low-price harami in a downtrend, a trader could expect that the market posture may temporarily settle into a lateral band from a previously strong trend. This could mean a decline in volatility.

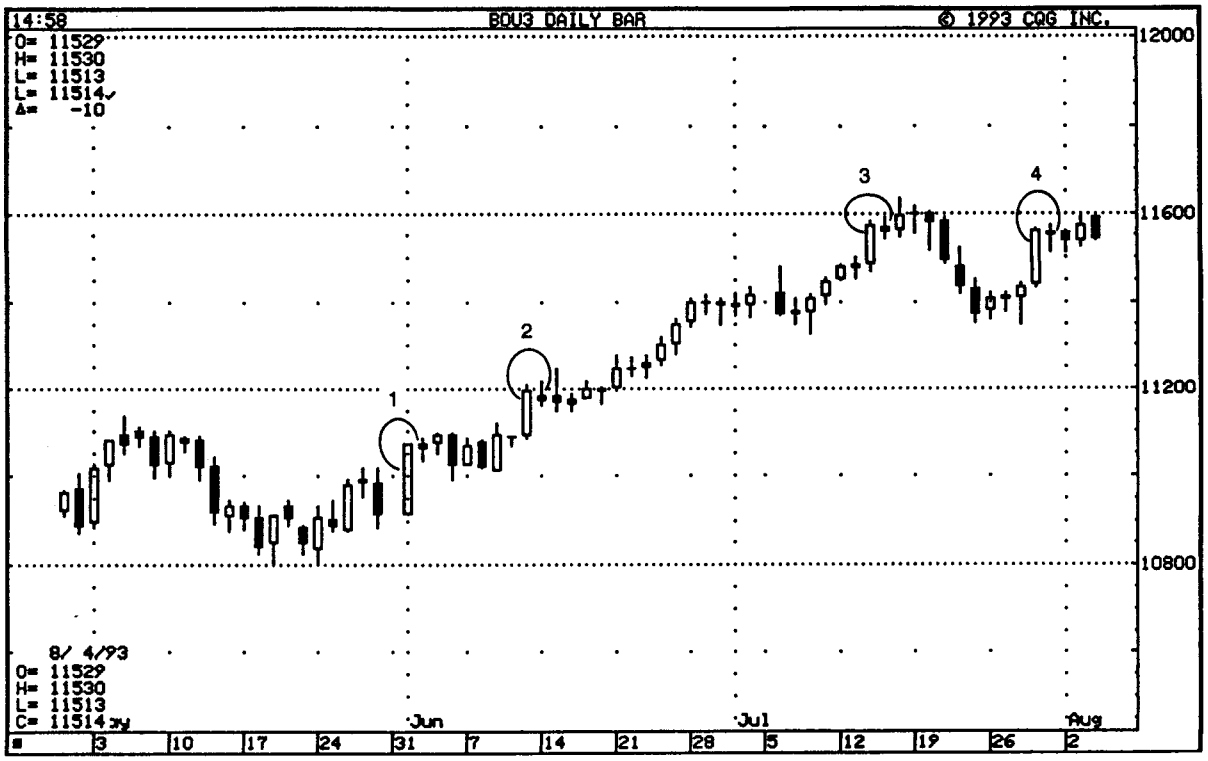


EXHIBIT 3.44. Harami with Second Candle Near Top of Prior Candle, September 1993 Bonds

THE WINDOW

The window, also known as disjointed candles, is one of the more powerful candlestick patterns. As shown in Exhibit 3.45(A) and (B), a window is the same as a gap in the West. That is, for a rising window, the top of yesterday's upper shadow should be under the low of the today's lower shadow. A falling window means that the low of yesterday's session (i.e., the bottom of the lower shadow) is above the top of today's upper shadow. Windows are a good visual clue because they clearly display that the action and market sentiment is so one-sided.

In a talk I gave before a group of traders, I mentioned how, based on my experiences, the window was a candle tool that I have found to work well. After I mentioned this, a trader in the audience told me that he used to work at a Japanese bank. After my explanation of the importance of windows, he said that he then understood why the Japanese traders at the bank would routinely go to the charts looking for gaps—sometimes even going back years to find one. This comment reinforced what I have found to be true about the windows—it is a candle technique not to be ignored.

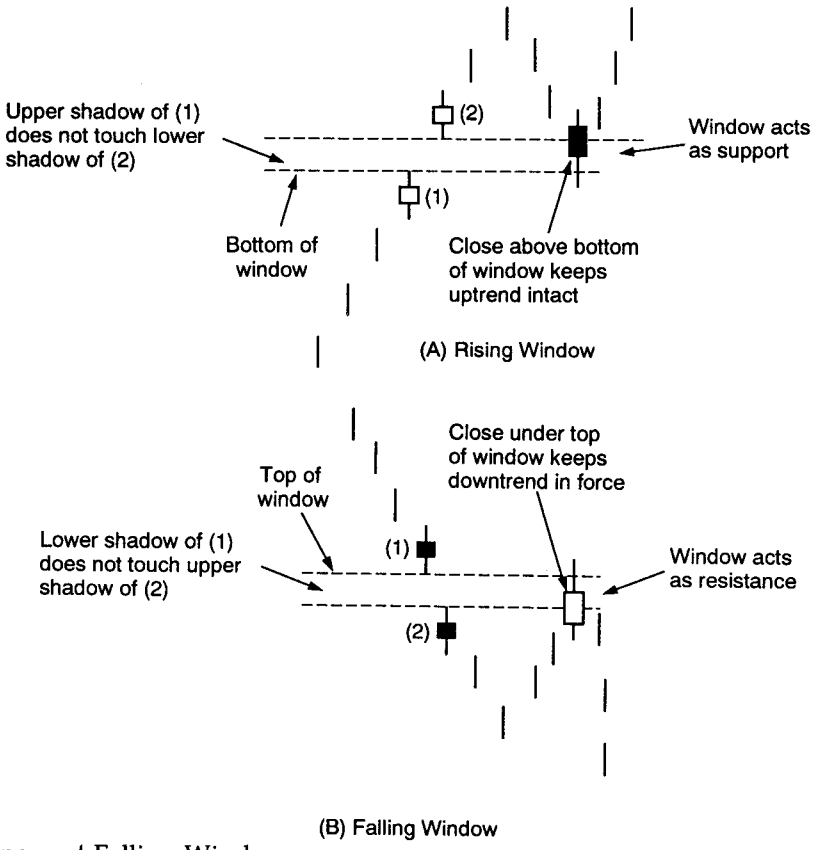


EXHIBIT 3.45. Rising and Falling Windows

Windows are continuation patterns in which the market resumes the trend taken before the continuation pattern emerged. Thus, after a rising window, which is a bullish continuation pattern, the prior uptrend should continue. A falling window has bearish implications since it means the prior trend, in that case down, should resume.

There is a saying used in Japan about windows, "The reaction will go until the window." In other words, the window should be the limit on a reaction. Thus, for a rising window, reactions (i.e., selloffs) should stop within the window. For a falling window, rebounds (i.e., rallies) should stop within the window.

When using windows as support and resistance, it should be noted that the price may fall below the bottom of a rising window or above the top of a falling window temporarily before prices move back in the direction of the window. This is illustrated in Exhibit 3.45(A) and (B).

A general rule that I have found useful based on my experience is that if the price *closes* through the window, I then view the prior trend as being voided. For example, if there is a rising window between $83 and $85 and then the market closes under the bottom of the window (i.e., under $83), the uptrend can be considered as over. Conversely, if there is a falling window between $62 and $60, once the bulls close the

market above the top of this window (at $62), then the bulls have broken the back of the bear market.

Based on the discussion above, an intra-session move under a rising window (or above a falling window) is not proof of a break. The consequence of this is that you should wait for the market to close under the bottom of a rising window (or above the top of a falling window) to confirm that the uptrend is over (or that the downtrend has been voided). On a weekly chart, you should wait for a weekly (that is, a Friday) close under the bottom of the window to say that a window's support had been broken. The risk in waiting for a close to confirm the break of a window is that, by the time this happens, the market may be sharply higher or lower than you may have wanted to risk.

In this section, I will discuss:

1. waiting for a closing price to confirm the break of a window's support or resistance area;
2. how volume can influence the importance of a window;
3. using windows to confirm a trend reversal;
4. how windows can provide a quick clue to the market's health;
5. waiting for three sessions for confirmation of a window;

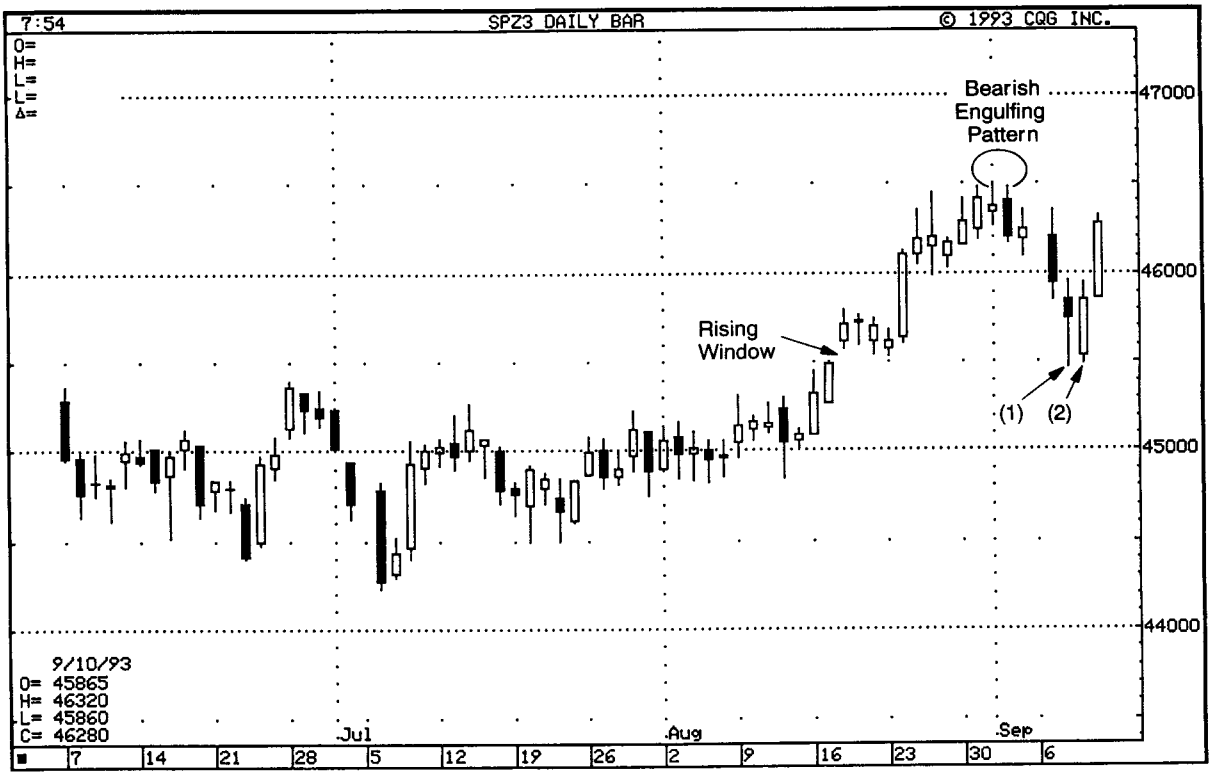


EXHIBIT 3.46. Intra-Session Break of a Window, December 1993 S&P

6. three windows and confirmation of a trend reversal;
7. two black gapping candles;
8. gapping doji.

Exhibit 3.46 shows that a selloff from a bearish engulfing pattern held August's rising window as support. The long lower shadow of candle 1 and the tall white real body of candle 2 echoed the importance of this support area. Candle 1 pulled under the window on an intra-day basis, but by the close, the bulls had managed to push prices above the bottom of the window. This left the uptrend intact.

Exhibit 3.47 shows that there was a rally that started with the October 5 hammer. The force behind the bulls' move was echoed later that month by the rising window and its accompanying high volume (see the arrow). When a window opens via a tall white real body, it has the nickname of a *running* window (based on the fact that the market is "running" in the direction of the window). The rally from this window hesitated via a doji

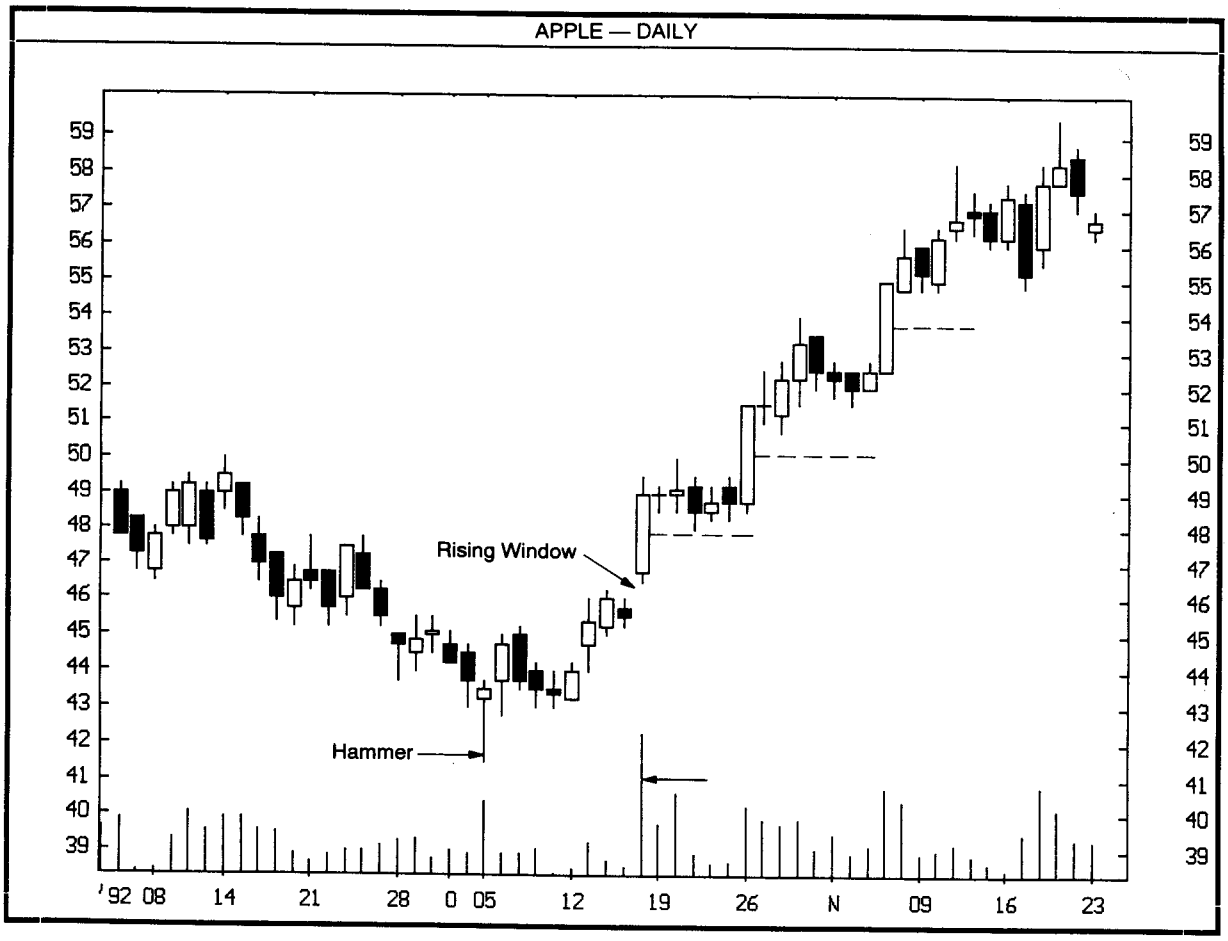


EXHIBIT 3.47. Windows and Volume, Apple—Daily

after the tall white candle. The fact that the pullback from this doji held support at 50% of the white body (see the dashed line) showed the power of the bulls to support the market. Note how, as the market ascended, the midpoint of the tall white candles became support.

Exhibit 3.48 illustrates how June's dark cloud cover short-circuited the prior rally. The sell-off from this pattern found a floor at April's window. Other aspects of this chart are interesting. The low of June's price decline was a harami. This harami appeared within the support band, as predicted by the window. This same combination of a harami within the window also emerged in May. Notice how the June rebound from the window stalled at the resistance area set up by the dark cloud cover.

A shooting star is potentially bearish, but what if the shooting star session also forms a rising window—which is bullish? In Exhibit 3.49, we see that such a scenario unfolded as in mid-January. After the shooting star line appeared, I was asked by a client whether this was a sell signal (the client knew that a shooting star was normally a bearish signal). I pointed out that while this was indeed a bearish shooting star, there was another aspect that was perhaps even more important—the rising window. I suggested to this client that if he wanted to sell short, he should wait for the market to close under the bottom of the window to confirm that the uptrend was over. Since the bears could not pull prices under

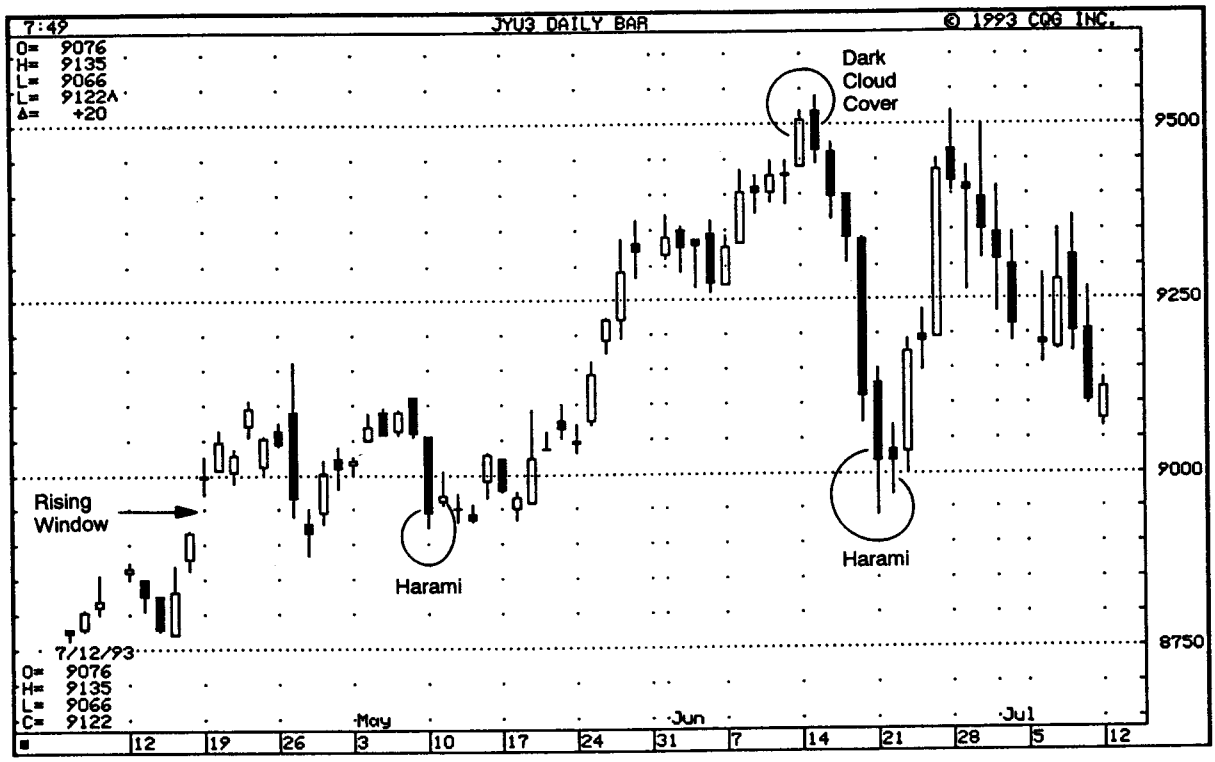


EXHIBIT 3.48. Window as Support, September 1993 Japanese Yen

EXHIBIT 3.49. Shooting Star and a Rising Window, March 1992 Silver

the window, a short sale was unwarranted. After the next session's rally, the client, who did not go short, ordered ten copies of my first book to give to his friends!

Exhibit 3.49 demonstrates a critical concept sometimes forgotten, even by practitioners of the candle charts. Namely, that an individual candle pattern should be viewed in the context of the surrounding technical picture. In this example, a shooting star viewed in isolation (that is, by not looking at the window preceding it) could have caused a poorly positioned trade.

When I show Exhibit 3.50 at my seminar, I title it, "Saved by the Light of the Candles!." This is because the chart is an example of how candles can help avoid a bad trade. In mid-March, the market closed above a major resistance line that went back to December 1991 (only the last part of this resistance line is shown on the chart). This breakout action could have been viewed as potentially bullish. However, there was still a lack of confirmation based on the candles. Specifically, there was an open window in early March that was yet unclosed. Based on candle principles, until the market closes above the top of the window (in this case at $1088), the trend was still down. Observe that, in spite of the breakout from the resistance line, the bulls could not push the market high enough to close above the top of the window. So although a resis-

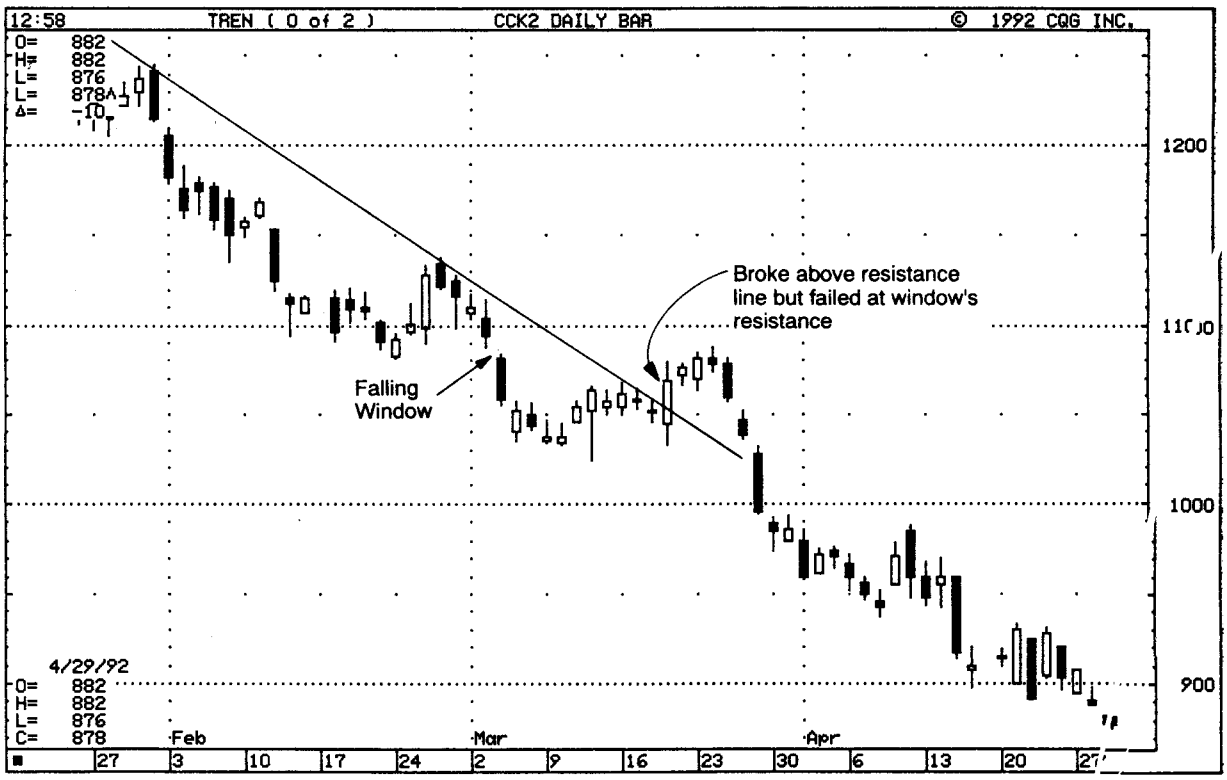


EXHIBIT 3.50. Window as Extra Confirmation, May 1992 Cocoa

tance line was pierced, those who knew about the candles were kept from going prematurely long.

The window can be used as a potent confirmatory mechanism. If there is a reversal signal followed by a window in the same direction, traders should be more confident of a price reversal. Exhibit 3.51 is an example of this aspect. There was a bearish engulfing pattern in May. Prices descended slightly, and then moved up to reach new highs in early July. As this time, another bearish engulfing pattern appeared. However, unlike May's bearish engulfing pattern, July's was followed by a falling window. This window served to reinforce that a top had been put in place.

Exhibit 3.52 shows how candles can help give a quick understanding of the market's health (or illness). In this case, there was a stock that one of my friends had bought. Some very bullish news came out, and immediately after this news, the stock soared to a new high (see the arrow). There were a few ominous signs that appeared in spite of this bullish news. First was the fact that the day the market moved to a new high, it finished the session by closing under the prior day's close. This formed a dark cloud cover.

The other problem was more significant. As I explained to my friend, a market that fails to hold new highs on supposedly bullish news is a

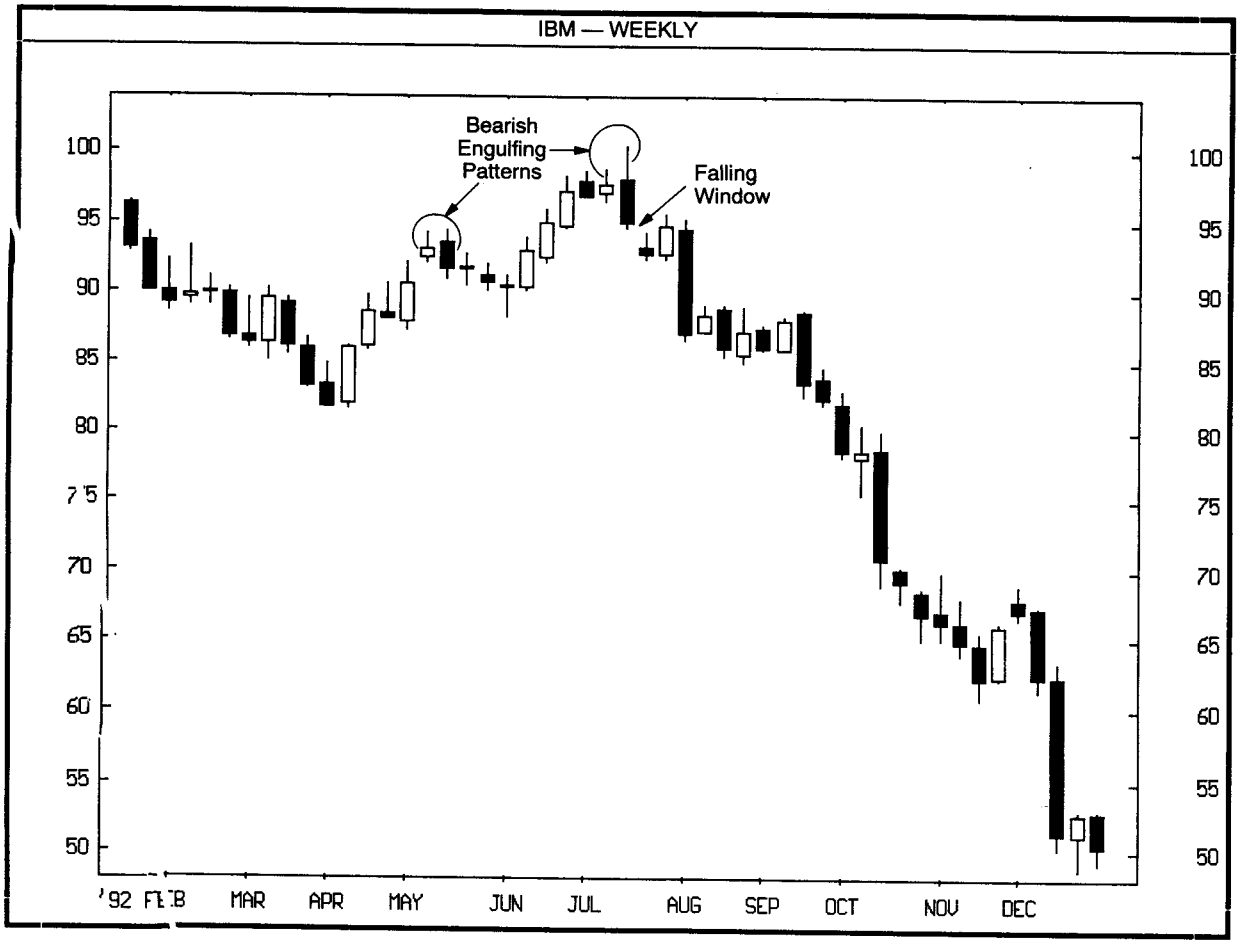


EXHIBIT 3.51. Windows as Confirmation, IBM–Weekly

dangerous market to be long. A stock's price is composed of the total of all information, whether the information is known by the general public or by a select few. Many shares of this stock were held by relatively few people. The failure to hold the new highs probably meant that they knew something the general public did not. They may have taken the opportunity to sell into the rally. Of course, there was always a chance for recovery to the new highs. But, after I saw the falling window, I mentioned to my friend that until the market closed above the top of the window, the market was in a downtrend. This window became resistance as shown by the dual shooting stars. Notice that in August, another falling window opened.

Some Japanese traders believe that if a window is not filled within three sessions, it is confirmation that the market should move in the direction of the window. That is, if there is a falling window that is not filled within three sessions, the market action is viewed as confirming that prices should move lower. In one of the books I had translated, it said that if a window is not filled within three sessions, then there is

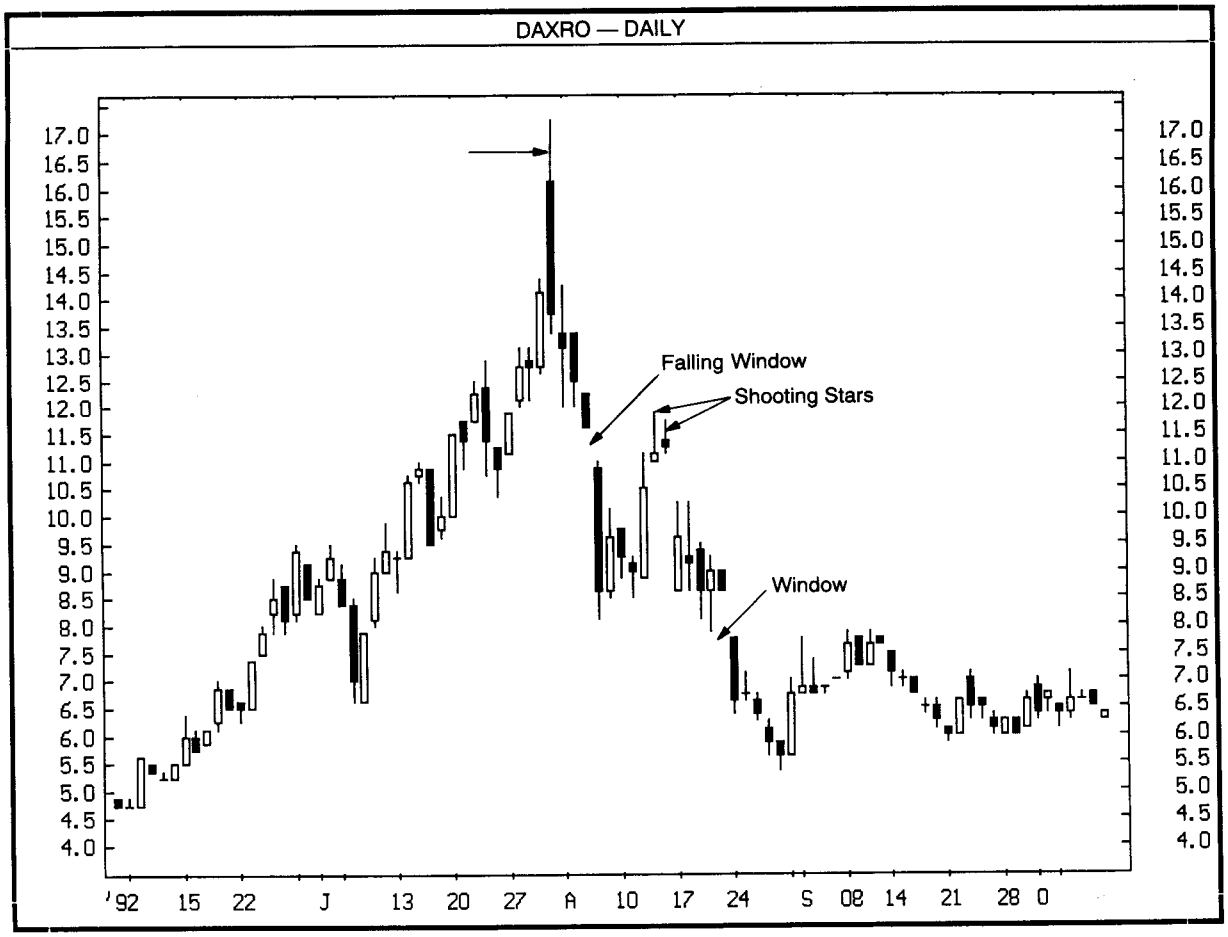


EXHIBIT 3.52. Windows as a Mechanism for Quickly Analyzing the Market, Daxro—Daily

power to go thirteen more sessions in the direction of the gap. I do not agree with the preciseness of the last part of that statement, but this technique of waiting three sessions for confirmation may provide a method to confirm a window's support or resistance.

In Exhibit 3.53, there was a falling window that opened in early March. Based on the above discussion, a method to trade with this window could be to wait three sessions and see if within that time the market can close above the top of the window. If the bulls cannot push prices (on a close) above the top of the window, candle theory states that this should increase the chance that the downtrend will continue. After all, the bulls had three sessions to move prices through the window and failed to do so. In this example, we see how the falling window acted as resistance as the bulls tried in the third session to unsuccessfully push prices above the window. Attempts in May at this window's resistance level at 62¢ stalled via a dark cloud cover and then a long upper shadow candle (at the arrow) a few sessions later.

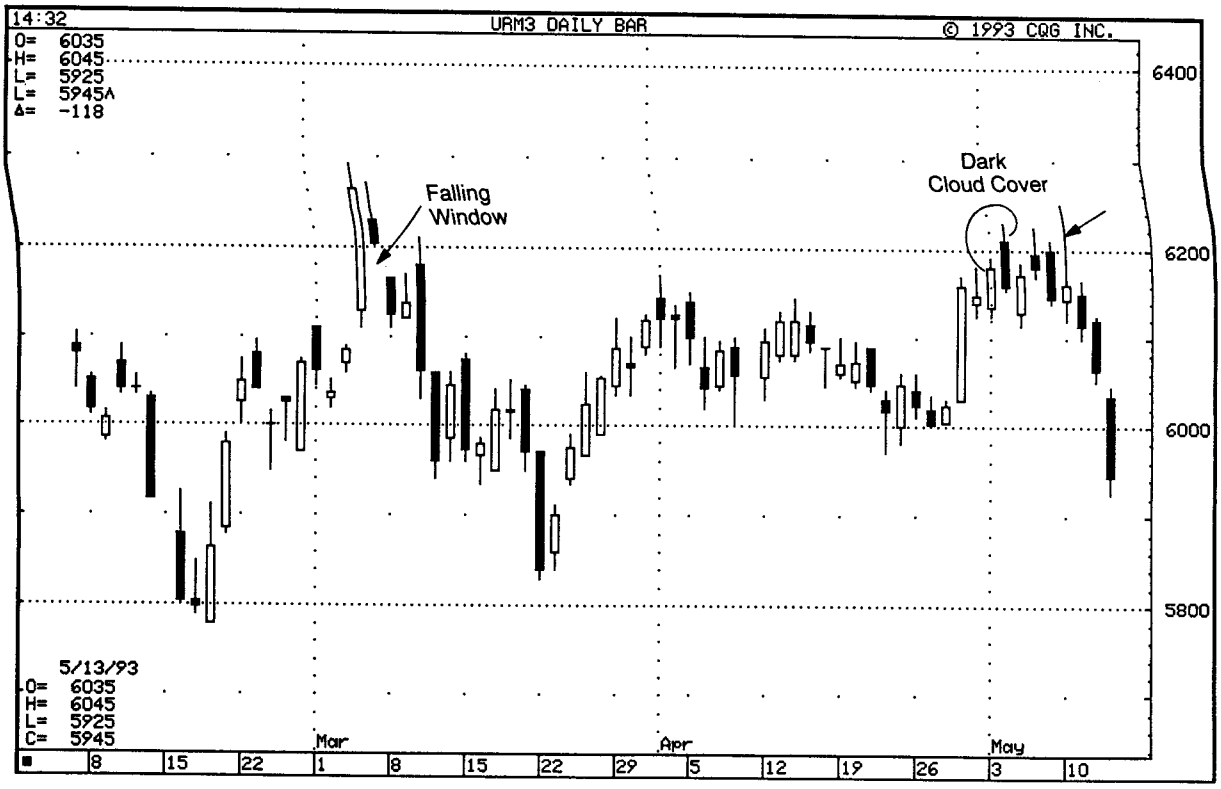


EXHIBIT 3.53. Windows and Waiting Three Sessions, June 1993 Unleaded Gas

I would be careful about putting too much emphasis on three sessions. The Japanese place much importance on the number three in their culture, and this has spilled into their technical analysis. Thus, look closely at what happens when you get a window in your market. You may find that if the window is not filled in within two, four, or even five sessions, rather than the more traditional three sessions, it could be proof of continuation of the trend predicted by the window.

Three Windows

As discussed above, the Japanese emphasize the number three. In this context, the Japanese view a market that has had three rising or falling windows in a row as a market that has reached maturity. The market in such a scenario is viewed as being overextended and correction is likely. Three windows are shown in Exhibit 3.54.

Besides the windows, Exhibit 3.55 is of interest because it shows examples of many candle patterns. After a series of bottoming patterns in January that included a high-wave candle and the morning star, the market gave final bullish confirmation with a rising window. The market ascended strongly from there until a harami pattern was formed. The

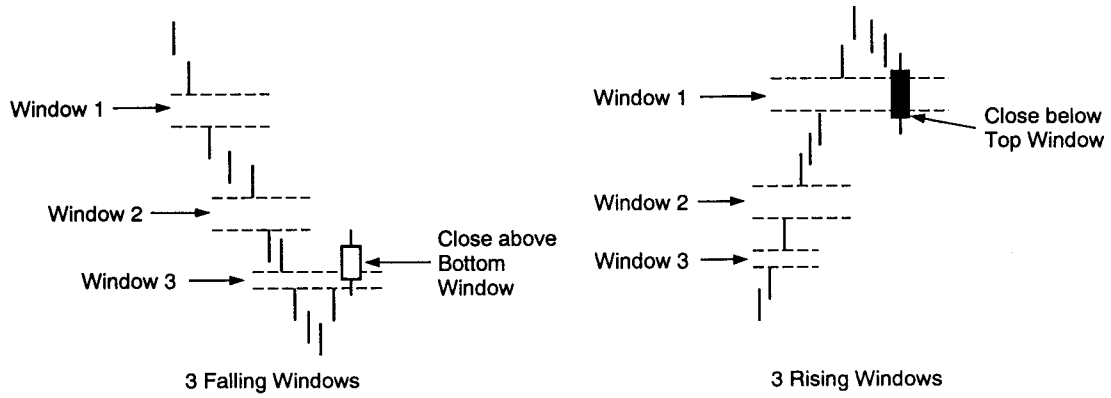


EXHIBIT 3.54. Three Windows

correction from this harami stopped in mid-February with a successful test of January's window. From the February lows until the dark cloud cover in early March, there were three rising windows (numbered 1, 2, and 3). The market then broke lower via a falling window. Note how that falling window became resistance over the next few days.

As shown in the example above, if there is a bearish candle signal after three windows, one should offset long positions. However, the

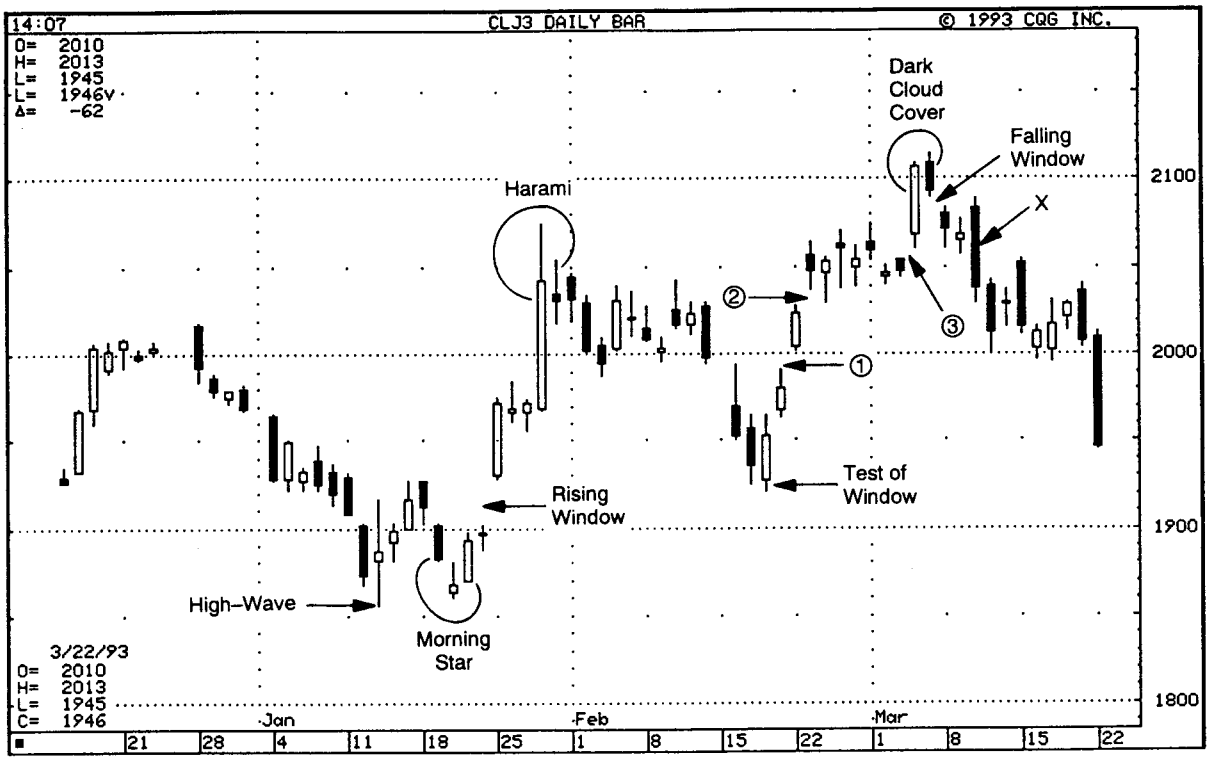


EXHIBIT 3.55. A Dark Cloud Cover After Three Windows, June 1993 Crude Oil

more aggressive may be willing to, as the Japanese say, "take a leap of faith" and they can go short without a bearish candle clue of a turn.

It is my opinion, based on experience, that even if there are three windows in the same direction, I would not trade against the direction of these windows until I see more proof of a trend reversal. To me, this would require that the market moves through the last window on a close (as shown in Exhibit 3.54). Based on this, bearish confirmation in Exhibit 3.55 came with the candle at x (in March), which closed under rising window 3.

Exhibit 3.56 highlights how important it can be to wait for the top window to be filled in before going short after three rising windows. This gold chart shows a rising window in April that is labeled "window 2." This is because prior to this date, and not shown here, there was another rising window. This made April's window the second rising window. Another window followed this, forming the third rising window. A few sessions after window 3, there was a dark cloud cover that was completed on May 3. This pattern signaled a change in the trend as the market went from vertical to sideways. However, although the trend did change, there was not yet confirmation that prices would descend because the bears had yet to close the market under the top window (window 3). This

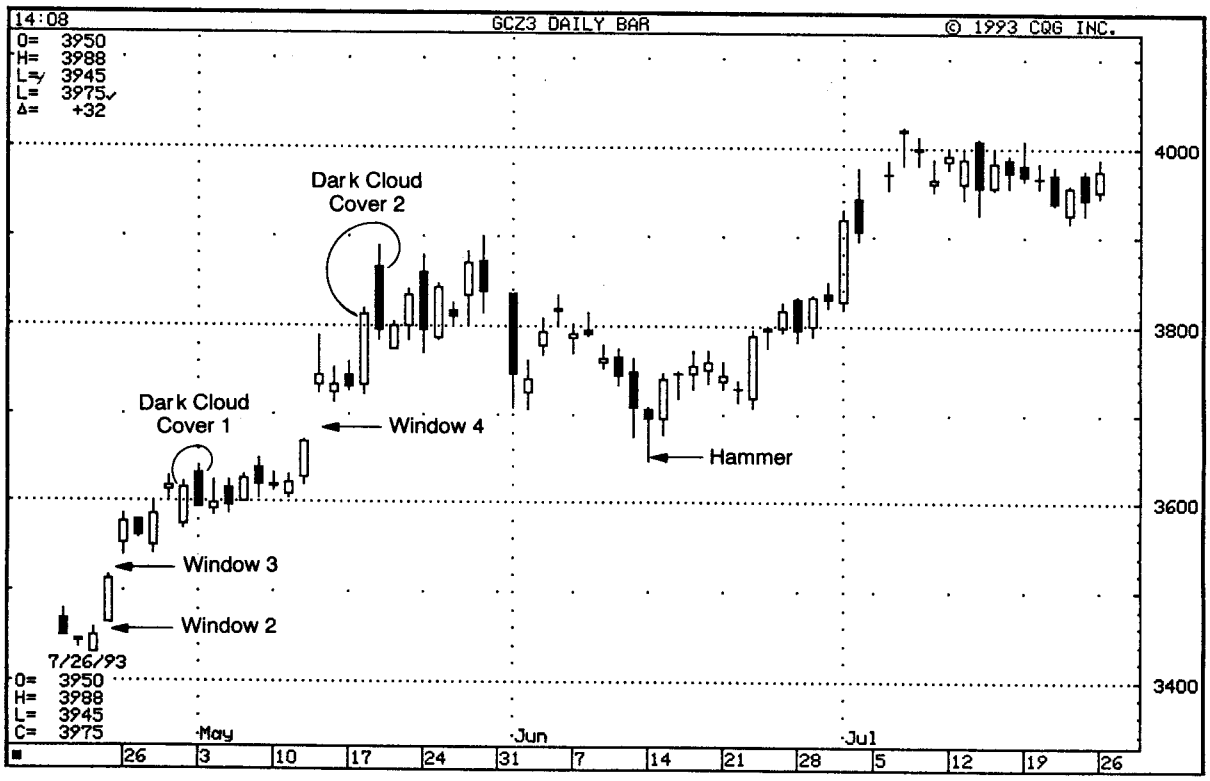


EXHIBIT 3.56. Waiting for Confirmation of a Trend Reversal After Three Rising Windows, December 1993 Gold—Daily

window stayed open, and the market then continued on its upward course. Interestingly, the same scenario as just discussed unfolded as another dark cloud cover (dark cloud cover 2) formed after window 4. After dark cloud cover 2, prices again went from an uptrend into a lateral band. But the widow (number 4) remained unfilled on a close as it was successfully defended by the bulls via a hammer. Note how the window was filled on an intra-day basis, but prices did not close under the bottom of window 4. This meant that the major uptrend was still in effect. Consequently, I usually recommend our clients to use three or more rising (or falling windows) at a time to offset or protect existing positions, but not to go countertrend until the last window is filled in on a close.

Two Black Gapping Candles

While a falling window is bearish, it is even more portentous if the two candles immediately following the window have black real bodies. Such a combination is called *two black gapping candles* (Exhibit 3.57). The dual black candles reinforce the fact that the trend has turned from up to down. This pattern is a sign, as the Japanese express it, of the "rout of the bulls."

The chart of Delta in Exhibit 3.58 gave a plethora of signals that it was experiencing trouble as it got in the $50 to $60 area. The topping signals included:

1. a bearish engulfing pattern;
2. a harami pattern;
3. an evening star;
4. a bearish engulfing pattern;
5. a bearish engulfing pattern;
6. long upper shadows, with the black candle following the white candle, forming a dark cloud cover, and for those knowledgeable about the

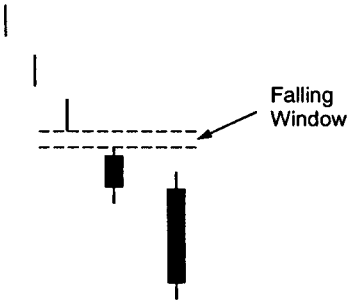


EXHIBIT 3.57. Two Black Gapping Candles

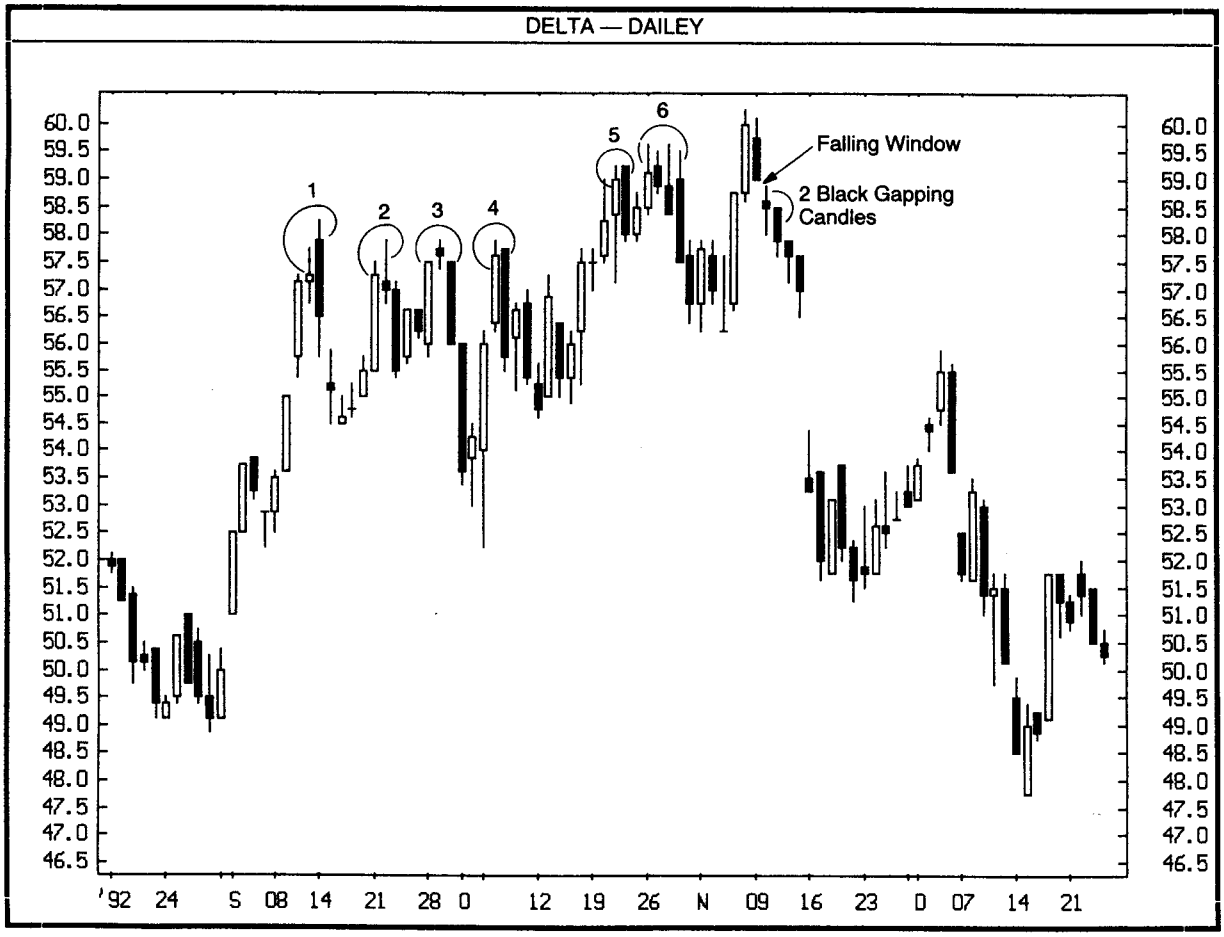


EXHIBIT 3.58. Two Gapping Black Candles Confirm Resistance, Delta—Daily

candle patterns, the three black candles following the white candle, forming a three-crow pattern.

The coup de grâce came with two black gapping candles in mid-November.

In Exhibit 3.59, December's harami followed by a long black real body was an important warning. Also note how those three candles (that is, the two candles of the harami and the next candle) all had long upper shadows. After this group of bearish signals, there was a falling window with two black candles. This completed the two black gapping candles.

Gapping Doji

Exhibit 3.60 shows a doji session that gaps lower during a decline. It is said this is a time where selling meets more selling and thus is a bearish

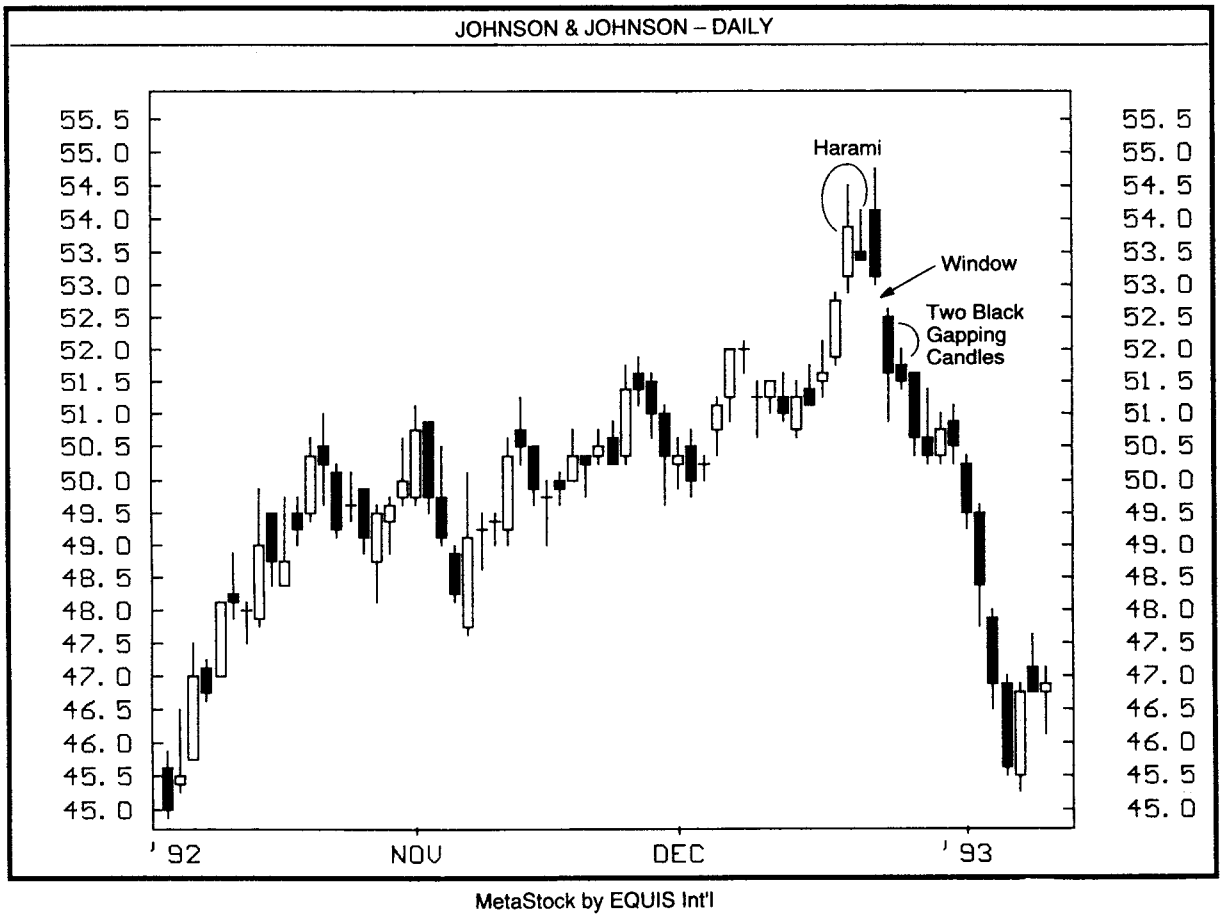


EXHIBIT 3.59. Two Black Gapping Candles, Johnson and Johnson—Daily

signal. I would recommend waiting for confirmation for this pattern on the session after the doji. The reason for waiting is that if the session after the doji is a long white candle that trades higher, it would turn out to be bullish morning star pattern.

In my studies, I have seen reference to this gapping doji only in a falling market, not to a gapping doji in a rising market. However, I see no reason not to view such a pattern as being bullish since it has the

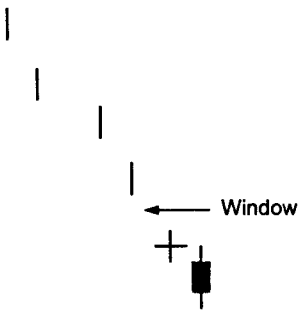


EXHIBIT 3.60. Gapping Doji

requisite rising window. In such a scenario, I would also prefer to wait for a higher session on the day following the doji. This is because the doji could be a sign of a tired market and if a white candle followed this doji it would show that the market would then be refreshed.

As discussed in the section on doji, a doji after an uptrend or a tall white candle could be potentially bearish. However, I would view the fact that if a doji gaps higher, some of the potentially bearish implications of the doji are negated because the rising window shows the underlying strength of the market.

As shown in Exhibit 3.61, the doji at session 1 did not gap lower (that is, the high of doji session 1 was above the low of the prior session). Because of this, doji 1 is not a classic gapping doji, although the market came so close to opening a falling window with doji 1 that I still viewed it as a gapping doji. Interestingly, the next session (at doji 2) the market did form a gapping doji. A sign of further weakness arose when the hammer and bullish engulfing pattern at 3 failed to hold as support when prices closed under the support area set up by the bullish engulfing pattern. At 4 the market gave an important bearish signal via the falling window.

The gapping doji is a rare pattern, but in Exhibit 3.62 there is a falling candle line with a small real body. While not a doji session, it could be

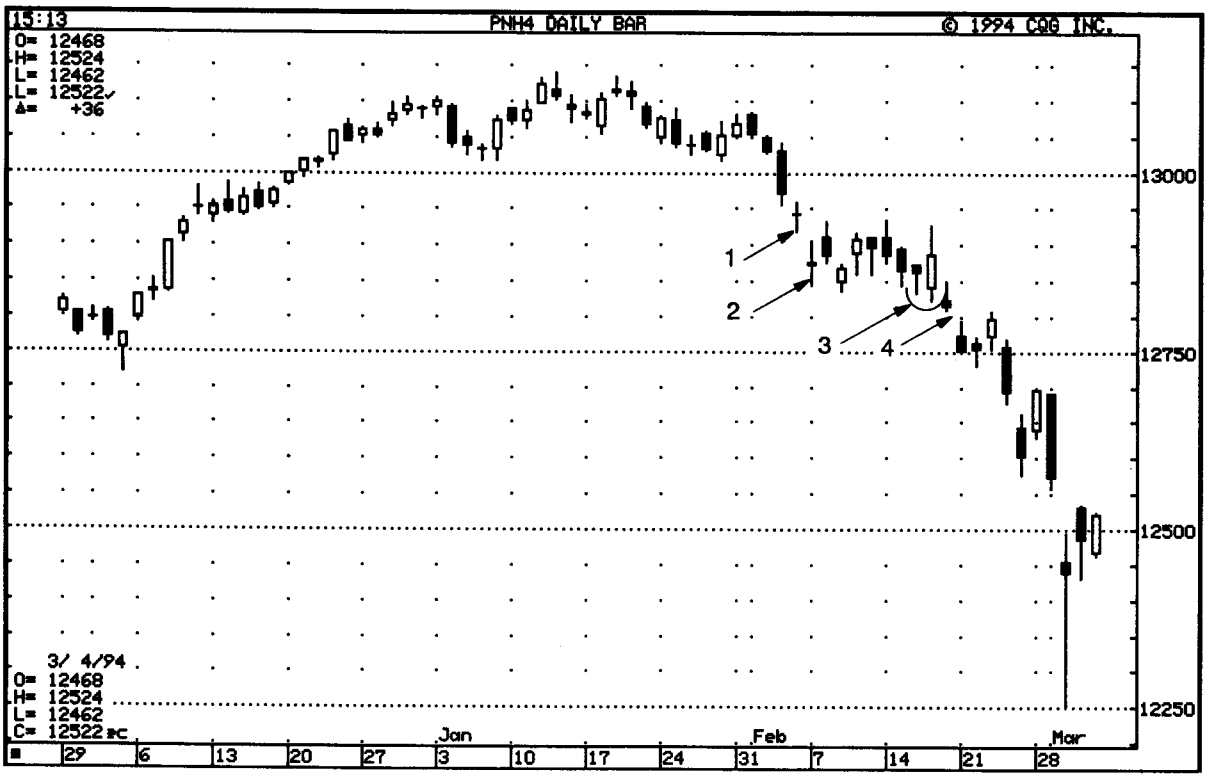


EXHIBIT 3.61. Gapping Doji, March 1994 Notionnel Bond

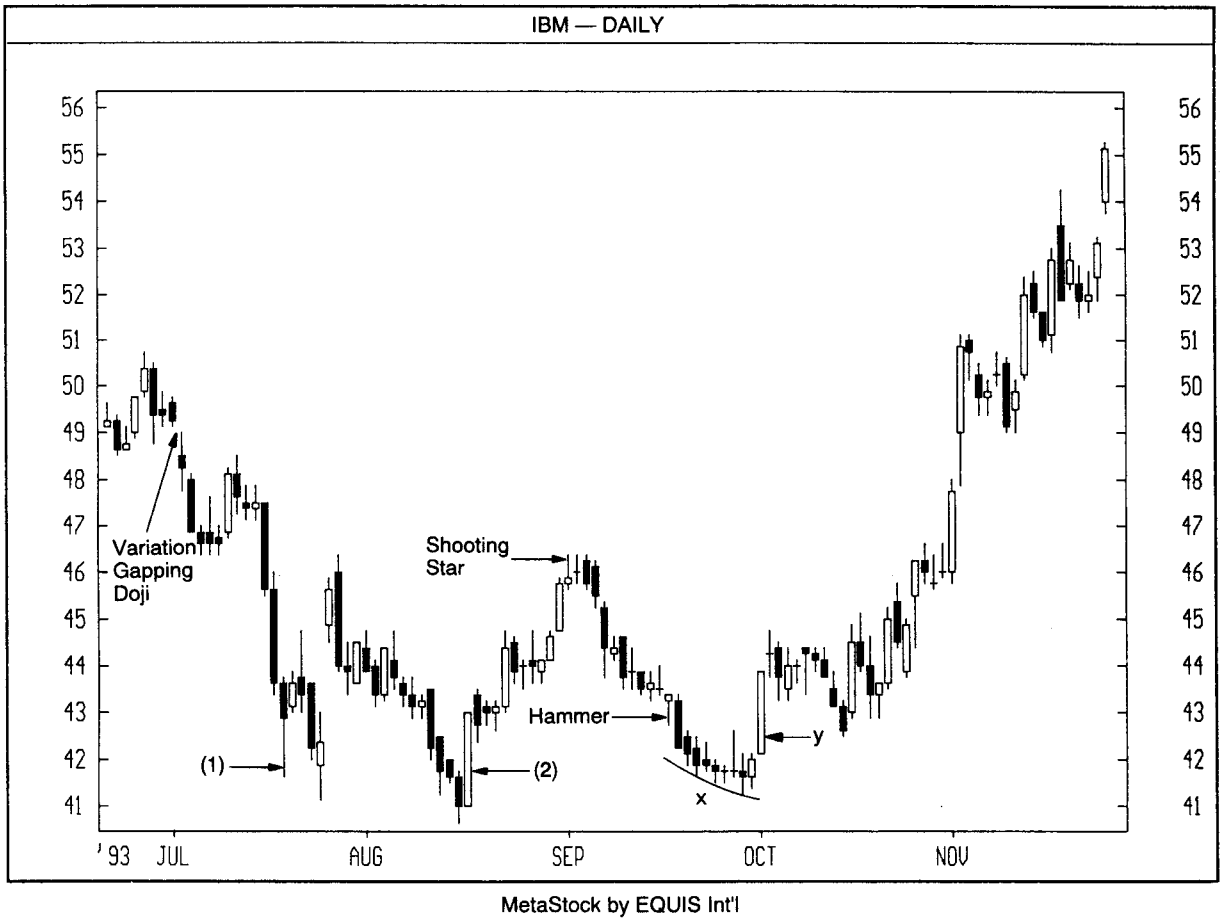


EXHIBIT 3.62. Gapping Doji, IBM—Daily

viewed as similar to a gapping doji in that the small real body is almost a doji and it gapped under the prior lows. (Even if a trader did not view this as a gapping doji, it could also be viewed as two black gapping candles.) This chart has some interesting candle signals that illustrate how IBM was basing out near $40. These include the long lower shadow at candle 1 and a tall white real body at candle 2. A shooting star in late August created problems on the rally from candle 2. The market broke under the lows of the mid-September hammer, but it is interesting how easily we can see the selling pressure evaporating during this sell off (at X) by a series of gradually shrinking black real bodies. The long white candle at Y showed that the bulls had taken control.

THREE OR MORE CANDLE LINES

The Evening Star

As shown in Exhibit 3.63, the evening star is a three-candlestick pattern. The criteria for this pattern include an uptrending market in which a long

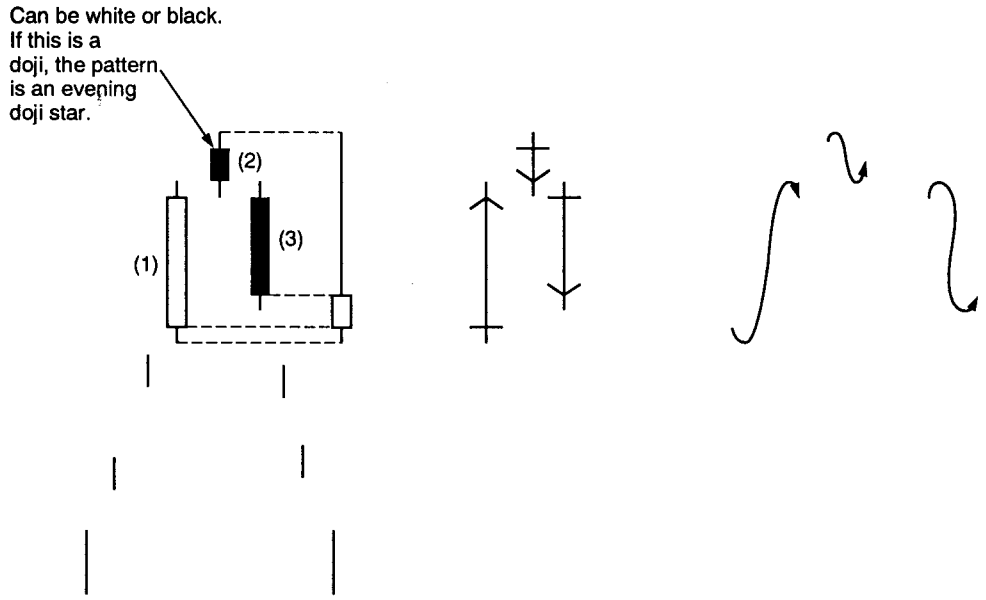


EXHIBIT 3.63. The Evening Star

white candle (candle 1 in the Exhibit) is followed by a small real body (candle 2). The small real body of the second candle line can be black or white and should not touch the real body of candle 1. The third candle of this pattern is a black real body that does not usually touch real body 2, and then closes well into the white candle line that make up the first candle of this pattern. If the second candle of the evening star is a doji instead of a small real body, then the pattern is an *evening doji star.*

In the Introduction to this book, I referred to the book written in the mid-1700s entitled, *The Fountain of Gold—The Three Monkey Record of Money.* In that book, reference is made to Yin and Yang markets. Yang is another term for bullish (for example, a white candle is sometimes referred to as a yang line). A Yin move is a downturn. For instance, a black candle line can be called a yin line. The *Fountain of Gold* has a section that reads, "When movement reaches an extreme, there is stillness. This stillness gives rise to Yin." This is a verbal description of the evening star. To wit!

1. "When yang movement reaches an extreme"—the appearance of the long white candle of the evening star pattern
2. "There is stillness"—describes the small real body. The small real body reflects a market at a transition phase in which the trend goes from up to a period of "stillness."
3. "This stillness gives rise to Yin"—aptly describes how the Yin (the black candle) follows the stillness of the second candle line.

It is important to wait for the third line to get the bearish confirmation of this pattern. This is because, after the second candle line, all we known about the market is that it went from an uptrend to period in which the bulls and bears were in a stalemate as gauged by the small real body of this second candle. It is only after the long black candle moves into the first session's white body that we get the proof that the bears have taken control of the market.

Exhibit 3.64 is an example of how an evening star confirmed a resistance area set up by a bearish engulfing pattern. Because this bearish engulfing pattern and evening star arose near the same area, both patterns formed a potential double top near $45. In Western technicals, a double top is confirmed by a move under the low between the two price peaks that make up the double top. In this chart, this low was made in February at $40½. A double top gives a measure derived on the range from the highs to the low of the pattern. In this case, there was about a $5 range that is subtracted from the February low of $40½. This gave a target to about $35½. Thus, for those wanting to buy on price dips, a

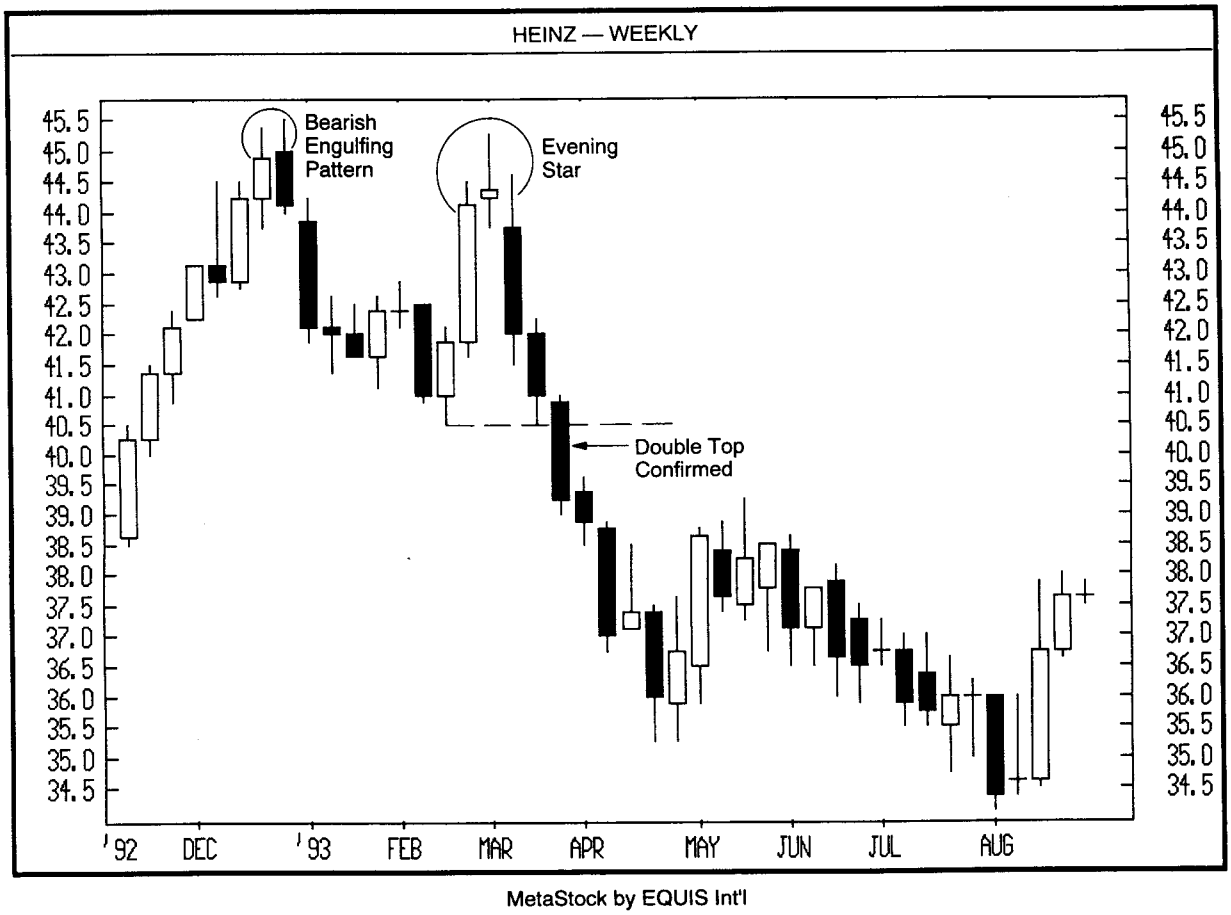


EXHIBIT 3.64. Evening Star Confirms Resistance, Heinz—Weekly

measured move target towards $\$35\frac{1}{2}$ should be the area. We can see from this example how smoothly candle charts can be merged with classic Western charting methods (e.g., the double top).

In Exhibit 3.65, I illustrate that the evening star can become resistance. As shown on this chart, November's evening star stopped the December rally. I use the highest point of the three candles, that form the evening star—that is, the top of the highest upper shadows, as my resistance. If you can withstand the risk, I would recommend using a close (rather than an intra-session move) above the evening star's high as a buy stop. In this case, it would require a weekly (that is, a Friday close) above the dashed line to confirm a breakout from the evening star's resistance area.

As previously discussed, there should be more flexibility in using candles in the stock market than in some of the other markets, such as futures. As shown in Exhibit 3.63, the classic evening star's three real bodies should not be touching. However, because in the stock market the open price is usually near the prior session's close, the real bodies may touch. In Exhibit 3.66, we see how the opening of the middle candle

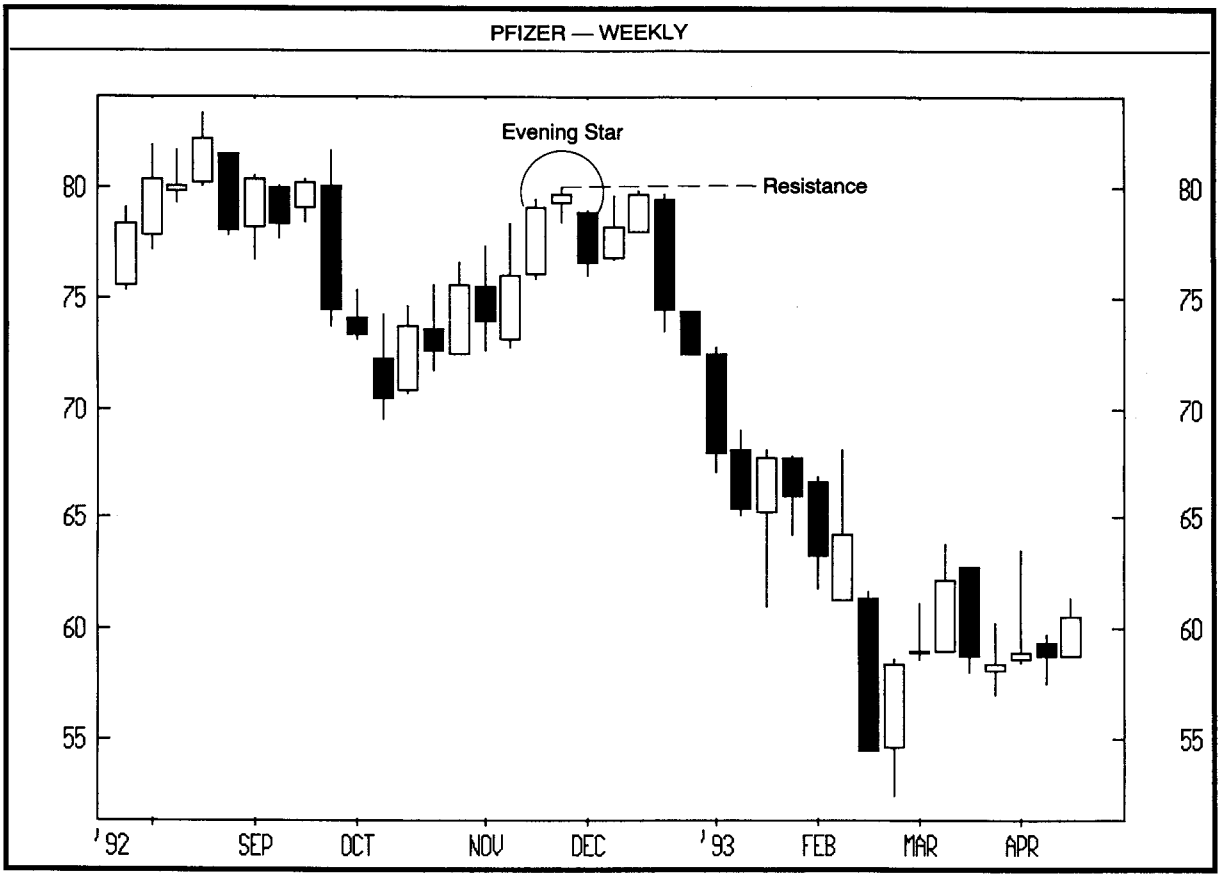


EXHIBIT 3.65. Evening Star as Resistance, Pfizer—Weekly

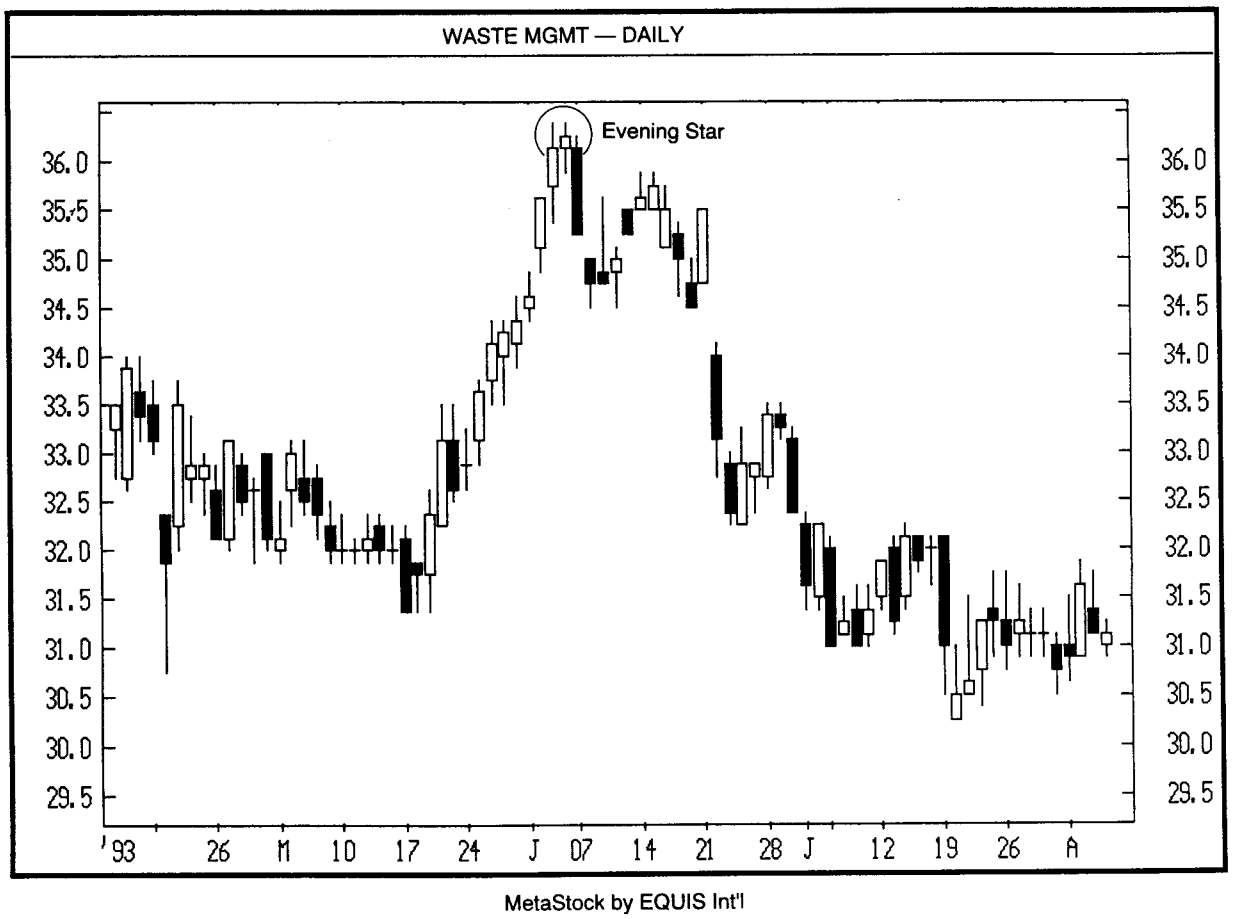


EXHIBIT 3.66. Evening Star and Flexibility, Waste Management—Daily

of the pattern was about the same price as the prior session's close. While some flexibility may be allowed with stocks in regard to the relation of the real bodies, it should be remembered that the more ideal the pattern, the greater the likelihood of a top.

The evening star from late August illustrated in Exhibit 3.67 is different from the more traditional evening star in that the third real body of this one is a small black real body rather than a long black one. However, I viewed this as an evening star variation with all the bearish implications of the more traditional evening star for a few reasons, which I will now address:

1. The third candle of this evening star, although not a tall black candle, nonetheless reflected the potency of the bears by the fact that they were able to drag prices well into the white real body of this pattern.
2. This evening star variation verified a resistance area. In mid-August, there was a group of bearish candle signals that included a shooting

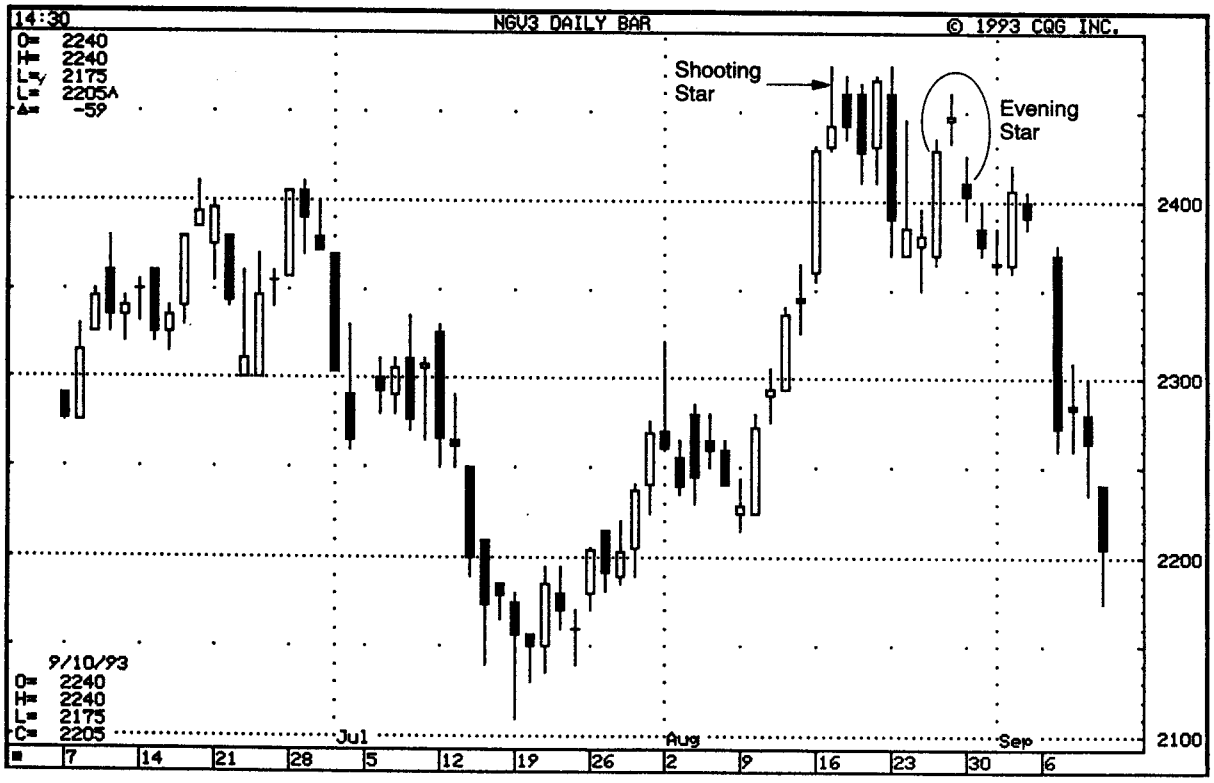


EXHIBIT 3.67. Evening Star and Flexibility, Natural Gas—September 1993

star, then three tall black real bodies after this shooting star, and then a long upper shadow of the candle of August 24. Note how all these bearish candles emerged near $2.50 This is the level where the variation of the evening star appeared.

Exhibit 3.68 shows a collapsing doji star. At a high-price level, the market moves higher. After this, the market gaps lower via a falling doji. This is a point where selling overwhelms buying. If the next session is a

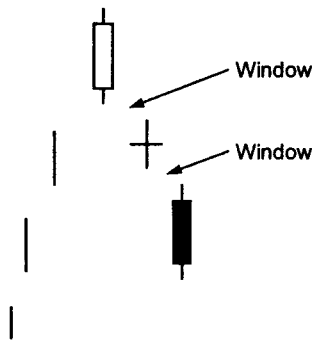


EXHIBIT 3.68. The Collapsing Doji Star

black candle that gaps lower, it is called a *collapsing doji star*. The three candles that make up this pattern are the same three as those needed for the evening doji star. The difference is that the evening doji star has the doji above the tall white real body, while the collapsing doji star has the doji gapping under, instead of above, the first white candle. This pattern is said to be an "omen of a large decline."

While not an ideal version, candle lines A, B, and C in Exhibit 3.69 could be viewed as the collapsing doji star pattern. This chart shows the three main conditions needed for the collapsing doji star pattern: 1) an uptrend to reverse (at the white candle at A), 2) a doji session that gaps under the prior session (at B), and 3) another black candle that moves under the doji session (at C).

Candle lines D and E show a gapping doji pattern (discussed in the section on windows). While similar in appearance to the collapsing doji star, the gapping doji is a bearish continuation pattern. This means that it occurs during a downtrend, while the collapsing doji star is a top reversal pattern that occurs after an uptrend.

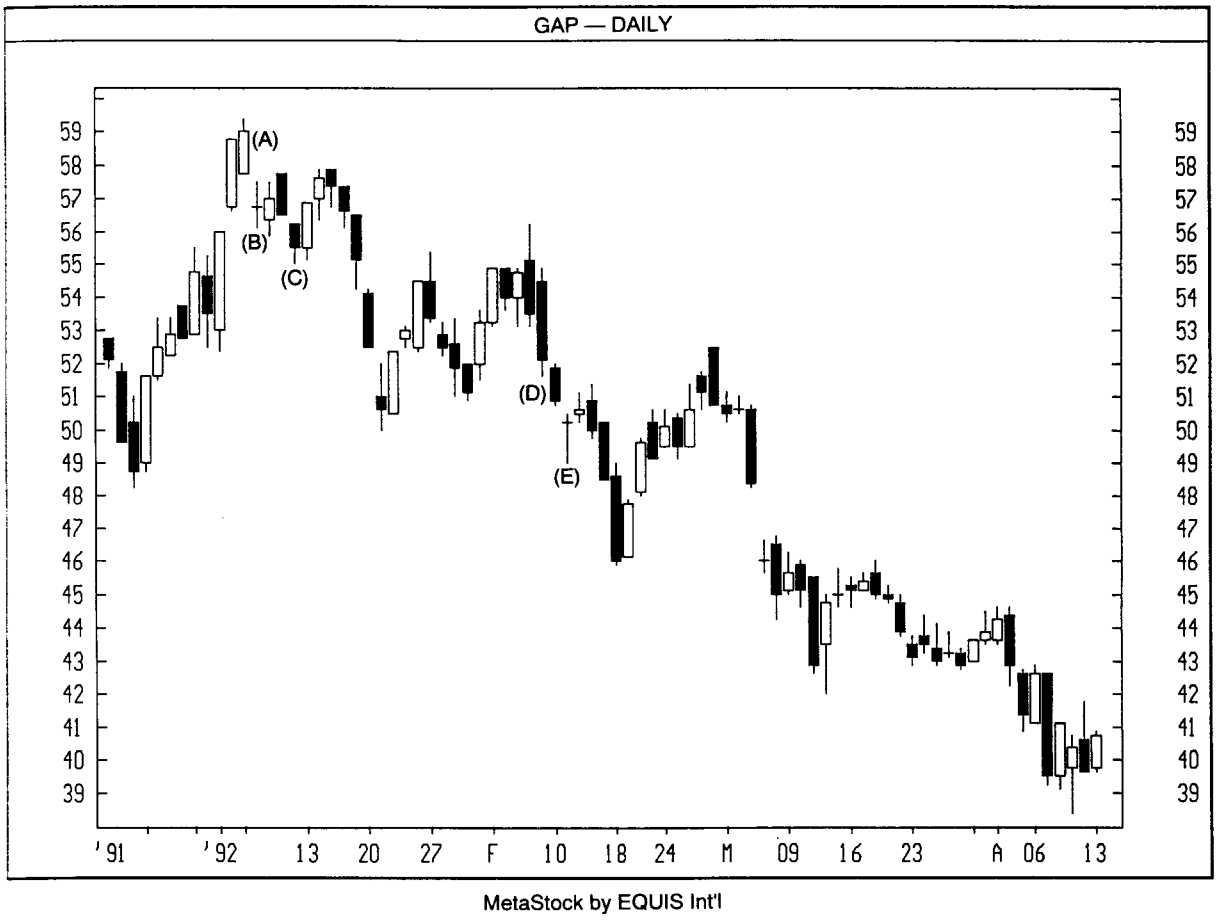


EXHIBIT 3.69. Collapsing Doji Star, Gap—Daily

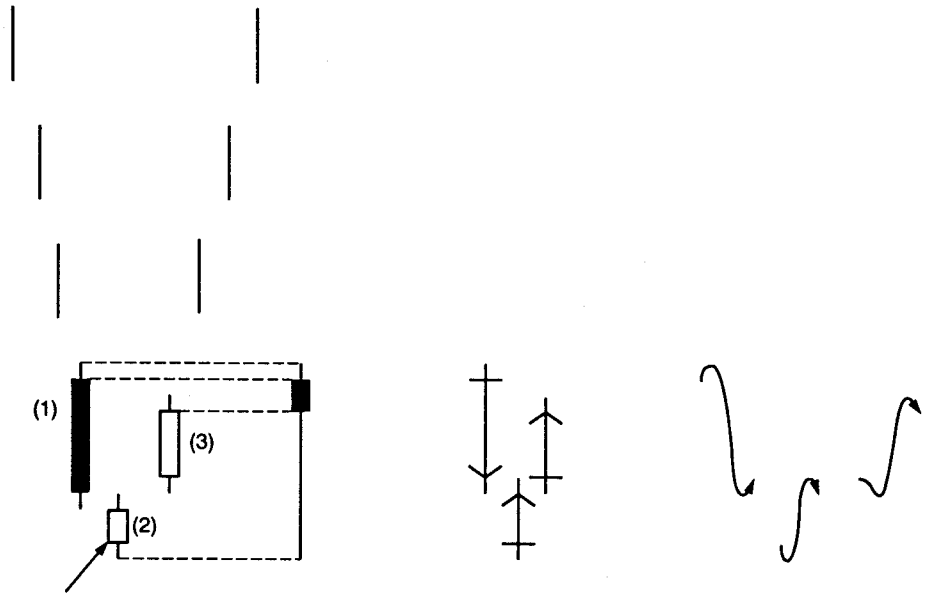


EXHIBIT 3.70. The Morning Star

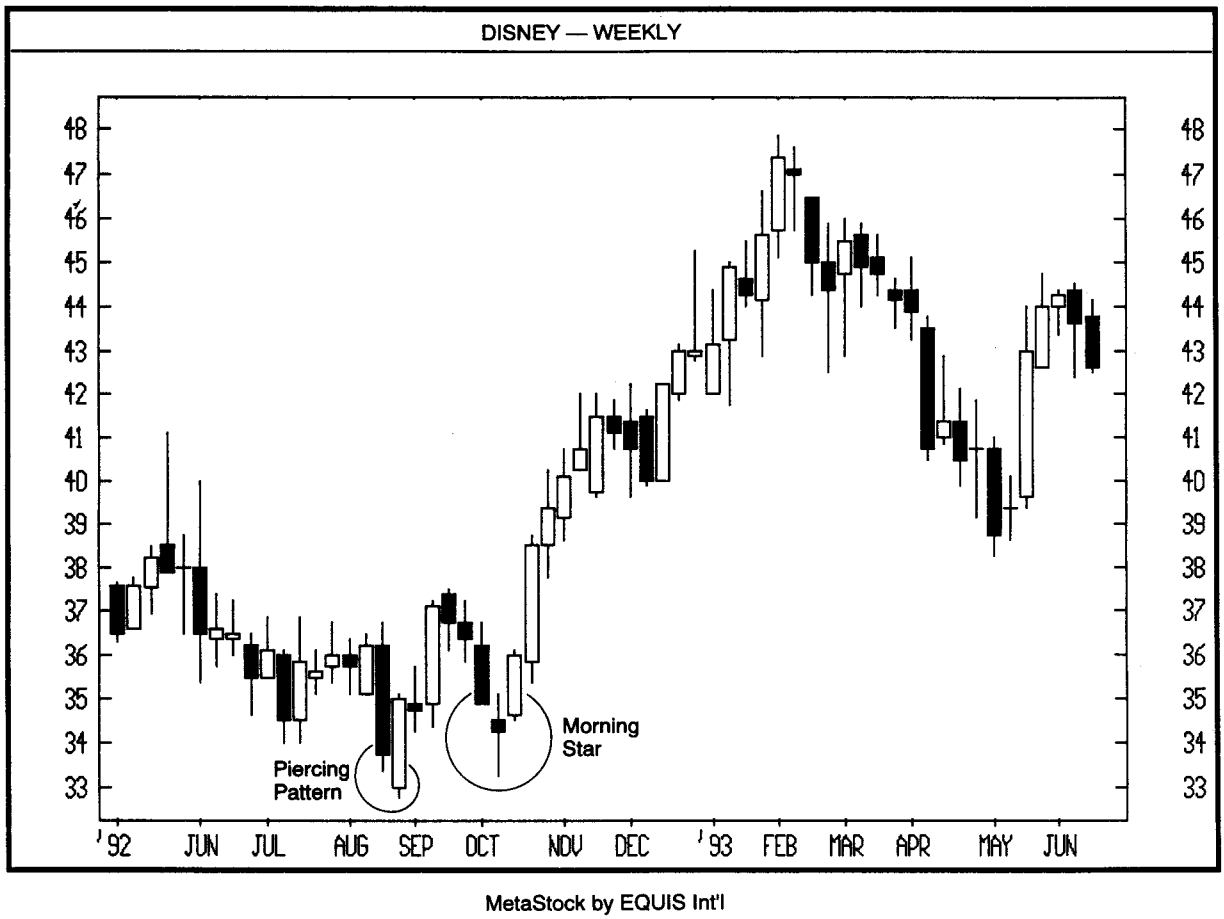


EXHIBIT 3.71. Morning Star Confirms Support, Disney—Weekly

The Morning Star

Exhibit 3.70 shows that the classic morning star has none of the three real bodies that make up the pattern touching. We can see from the blended candle in Exhibit 3.70 that the more that real body 3 pushes into real body 1, the longer the blended candle's lower shadow, and hence the more bullish the pattern.

As shown in Exhibit 3.71, the area in which August's piercing pattern appeared became support again in October via a classic morning star. Also, the middle candle of this morning star was a high-wave candle.

The three candles highlighted in Exhibit 3.72 at the August lows created a morning star. When, as in this case, the star portion of this pattern is a doji, the pattern is referred to as a morning doji star. There is another interesting aspect about this morning star. If there is a doji session that has a gap before and after it, is called an *abandoned baby*. In this chart of Penney, note how there was a gap between sessions 2 and 3 of the morning star and almost a gap between the first two sessions. Thus, this

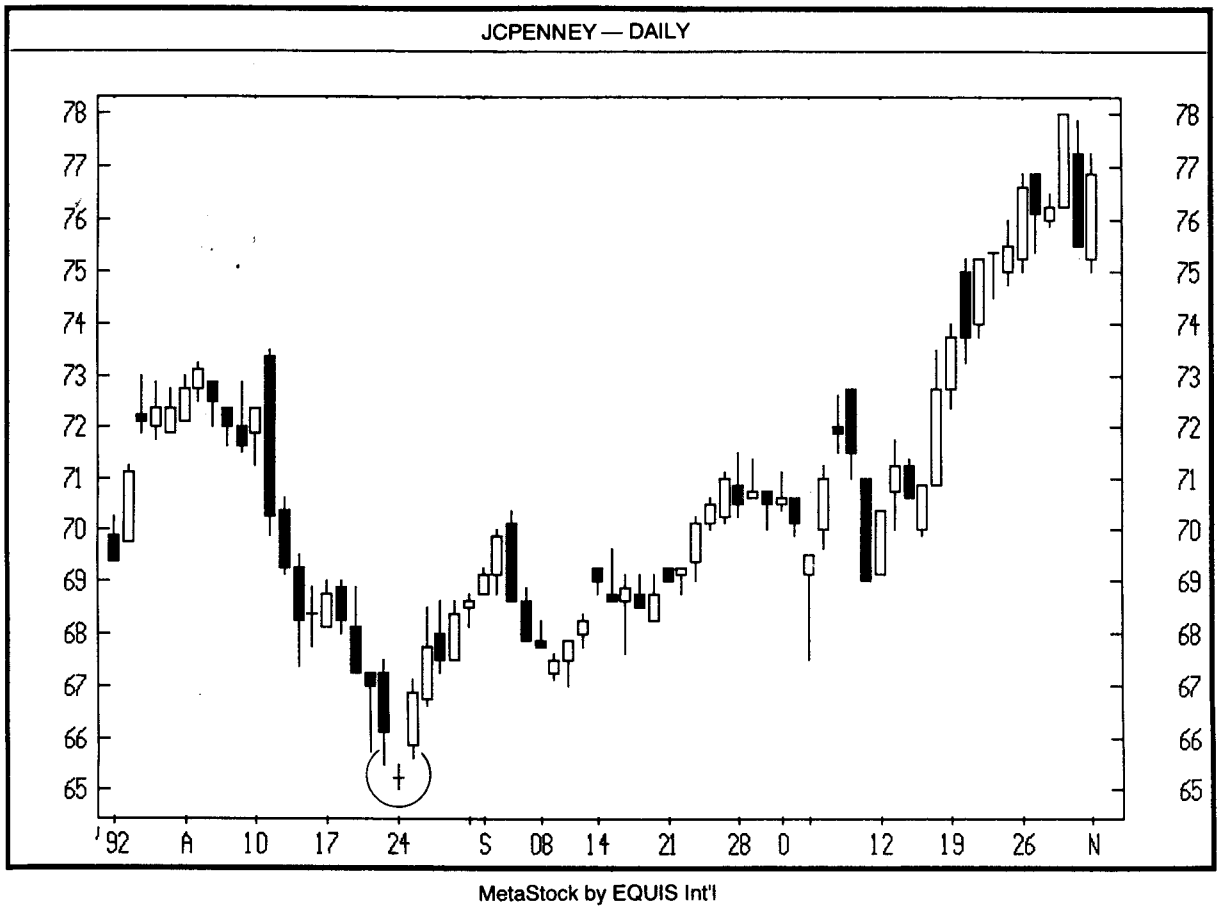


EXHIBIT 3.72. Morning Star, JCPenney—Daily

was almost a very rare abandoned baby pattern. The abandoned baby bottom is, in terms of a bar chart, an island bottom that is also a doji. You can image how rare this combination is.

In the next chapter, I will focus on weighing the overall technical picture in relation to an individual candle pattern. In Exhibit 3.73, I will briefly address this issue. The hammer is September (at hammer 1) was a potentially bullish signal. However, this bullishness was mitigated by the fact that on the day of the hammer, the market opened a falling window. Note how this window then became a resistance area. A few sessions later, another hammer formed (shown at hammer 2). The session after hammer 2 completed the third line needed for the morning star pattern. So, although there were two hammers in this chart, the overall technical picture for hammer 2 was more consecutive than it was for hammer 1 because of hammer 2's longer lower shadow and because hammer 2 was part of a morning star pattern. As a result, for those looking to buy, the area to have considered would be after the completion of the morning star. Traders who needed more bullish confirmation could

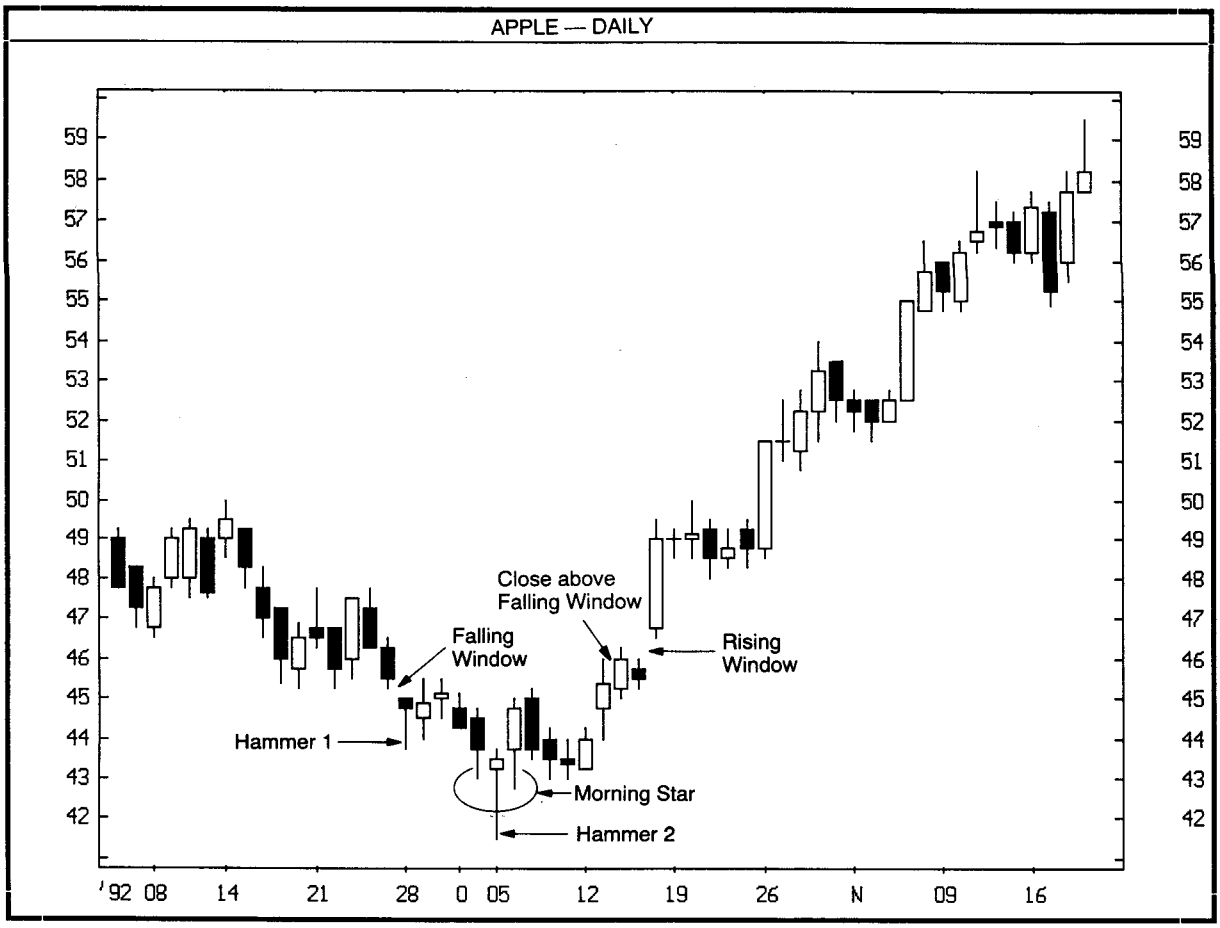


EXHIBIT 3.73. Morning Star and Overall Technical Picture, Apple—Daily

have waited until a close above the falling window's resistance area from mid-October. The rising window in mid-October gave even more bullish proof.

In Exhibit 3.74, there was a hint of a bottom near $12 based on the June 1992 bullish engulfing pattern. In late July, the support area of this pattern (i.e., the lows of the bullish engulfing pattern at $12) was successfully defended. However, in August, these lows were breached, but only temporarily as the bulls were able to regain control of the market by pulling prices back up over $12 again. In doing so, the market formed a morning star pattern and a spring.

As shown in Exhibit 3.75, the first candle of a classic morning star has a large black real body. The third candle of the pattern is a tall white real body that pushes well into the first candle of the pattern. In the morning star pattern M1, the first candle had a small white real body instead of a long lack real body. At patterns M2, the third candle (at the arrow) was a small white real body instead of the more traditional long white real body.

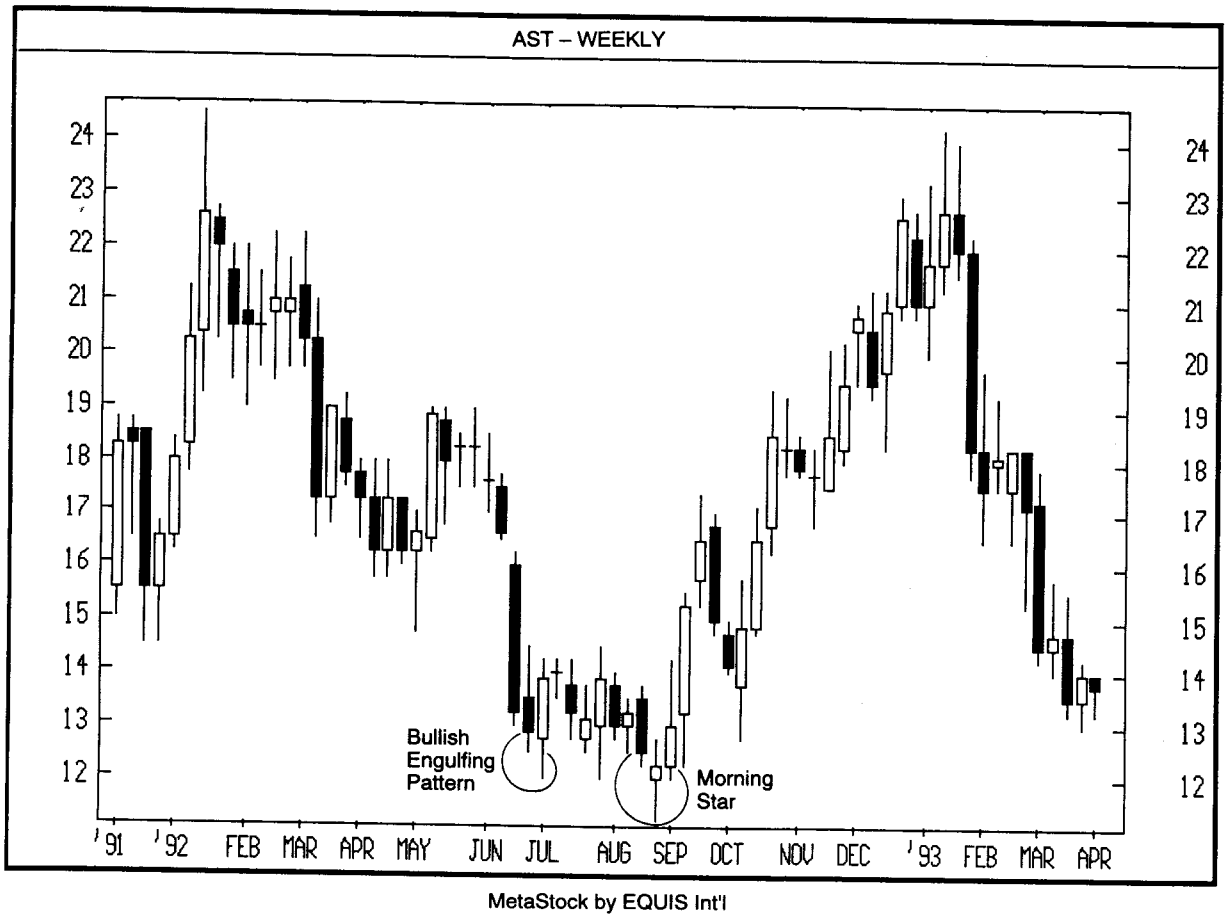


EXHIBIT 3.74. Morning Star and a Spring, AST—Weekly

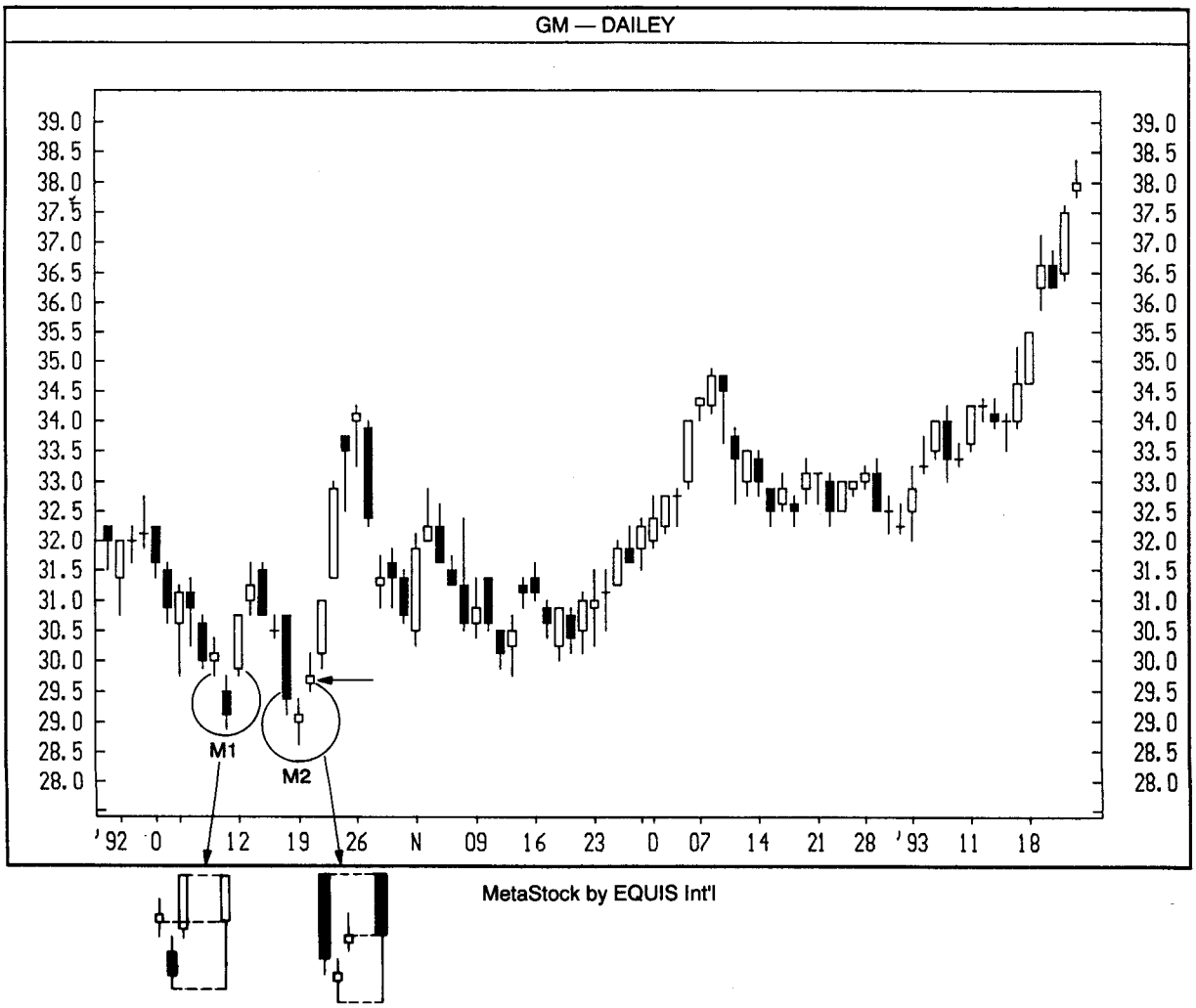


EXHIBIT 3.75. Morning Star and Subjectivity, GM—Daily

The fact that both of these morning star variations appeared near the same support area meant that while both M1 and M2 were not classic morning star patterns, they should be viewed nonetheless as bullish clues. This chart underscores an important point—candles are a form of pattern analysis, and as such, there is a subjectivity that goes with candlestick analysis.

In this regard, I once wrote to the Nippon Technical Analysts Association to see how they viewed candle chart patterns that were less than ideal versions of a pattern. This was their response: "We have found our discussions very interesting in the sense that you try to be very specific in determining definitions of Japanese exhibit readings while we try to keep them flexible so as not to exclude all possibilities. This . . . may be traced to differences in the way of thinking of Westerners who prefer being precise and definite and Orientals who like to be flexible."

This highlights an important point in that the exhibits I have illustrated are mostly ideal versions of the patterns, but in the real world, one should not exclude the possibility that a less than ideal version of that pattern is valid. How do you determine if you should trade from a less than ideal pattern? Based on the Japanese literature, may conversations with Japanese candle traders, and my experience, here are a few suggestions:

1. Wait for more confirmation of that pattern's prediction. For example, an ideal dark cloud cover should have the second session's close more than halfway into the first candle's white real body. If the close is less than halfway into the white real body, then wait until the next session to see if the market remains weak.
2. If the less than ideal pattern confirms a support or resistance area, or if it appears in a very oversold or overbought market, the greater the odds that the pattern will be a reversal. For example, if there is a hammer in which the lower shadow is not very long, but if this "hammer-like" line confirmed a 50% retracement area, I would view such action as having all the bullish import as would a more traditional hammer.
3. A method you may find useful in helping to determine the significance of a less than ideal pattern is to make a blended candle from that pattern. Then see if the blended candle confirms the pattern's forecast. For example, look at Exhibit 3.75 (GM) previously discussed. I used this chart to draw the blended candles from morning star variations M_1 and M_2. Notice how each of these blended candles had long lower shadows. The long lower shadows of both of the blended candles and the fact that both M_1 and M_2 emerged near the same support with the long white candle following M_2 gave clues that the bears were losing control of this market.

RECORD SESSIONS

Most candle patterns are composed of one, two, or three candles. This aspect shows one of the major advantages of the candle charts—they can often send a reversal signal in only a few sessions, whereas bar charts can take much longer. Although some candle patterns do take longer to unfold, they are nonetheless extremely valuable. One of these longer term pattern techniques is the *eight to ten record sessions.*

When a candle session makes a higher high, the Japanese call it a

record session high. A lower low is called a record session low. In candle theory, when there are eight to ten record sessions (that is, eight to ten almost consecutive higher highs or lower), it increases the possibility that the preceding trend will change. Exhibit 3.76(A) shows ten record highs and ten records lows.

Eight to ten record sessions are so important in Japan that they have been described as being "the bones of Sakata's body." The meaning of this expression is that just as the bones, or skeleton, of a person's body are its foundation, so are record sessions the foundation or essence of the Sakata charts. (Sakata charts are another name for candle charts. Sakata was the port city in which Homma traded. In recognition of this, there are many references throughout the Japanese literature to candle charts being called Sakata charts.)

I will now discuss how to count record session highs, but the theory will be the same for record session lows. First, confirm that a low price for the move has occurred. The top of Exhibit 3.76(A) displays how, after a new low, the next session made a higher high. This session became record session 1. Record session 2 occurs when another new high is made (this includes the upper shadow). Note how the session after record session high 1 was not a record session. This was because a new high

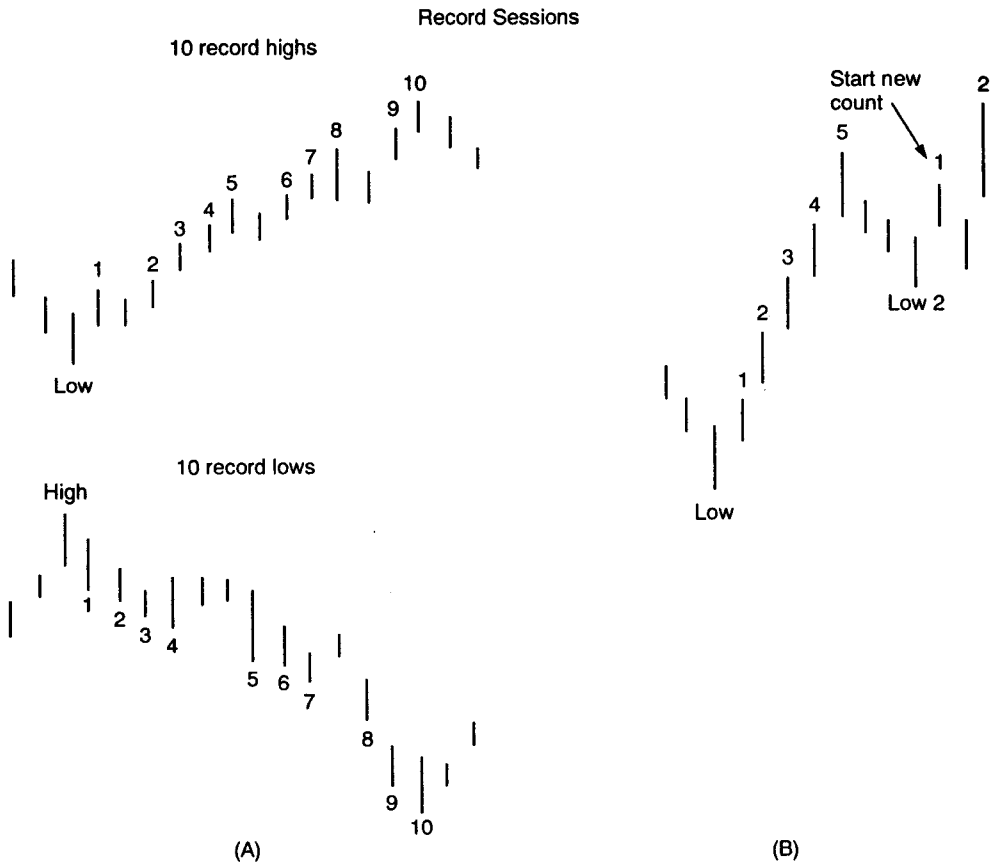


EXHIBIT 3.76.
Record Sessions

was not created. Only when a new high was touched was it counted as record session 2.

To count record sessions in a downturn, first confirm that a new high has been set. The session that makes a lower low then becomes record session 1. The next lower low then becomes record session 2.

The theory of record high sessions is that during a rally, a trader should stop buying after eight to ten record session highs (or liquidate longs, or sell short with the appearance of a bearish candle signal after these record session highs). The same philosophy, but in reverse, should be considered after a decline with eight to ten record session lows. To wit, a trader should stop selling after about eight record session lows (or cover shorts, or buy looking for a bounce with a bullish candle signal after eight or more record session lows).

The record session count need not be consecutive. A few sessions of consolidation can be ignored when counting the new highs or lows. Generally, there should not be more than two or three sessions of sideways action between the record sessions, nor should there be a sharp move counter to the record session trend.

The reason that record sessions should be almost consecutive has to do with the underlying concept of record sessions. In the case of eight-ten record session highs (lows), the market becomes overbought (oversold). In an overbought (oversold) situation, the market becomes vulnerable to a price dip (rally) as those who are currently long (short) may decide to take their profits.

The market can relieve an overbought or oversold situation in one of two ways—by trading laterally or by experiencing a sharp price correction. If the market corrects the overbought or oversold situation by either of these methods, the record session count is no longer valid since the market is no longer overextended, and thus is less vulnerable to a correction. For example, in Exhibit 3.76(B), observe how the market got to record session high 5, then quickly sold off for three sessions. Because of the extent of the selloff during these three sessions, the market relieved its overbought condition. As shown, a new count is then started after low 2.

Do not be too concerned with the specific number of record sessions. The eight to ten record session rule is a guidepost. Each market has its own personality. Just as those who follow cycles may find that different markets have different cycles, so some markets may correct after six or twelve record session instead of the more normal eight-ten sessions.

In Exhibit 3.77, from the low at X, we start the record session high count at the next candle since it made a higher high. After record session 8, the market formed two doji. These doji reflected a market that is tiring. For those who were looking for a reason to exit longs, these doji and the

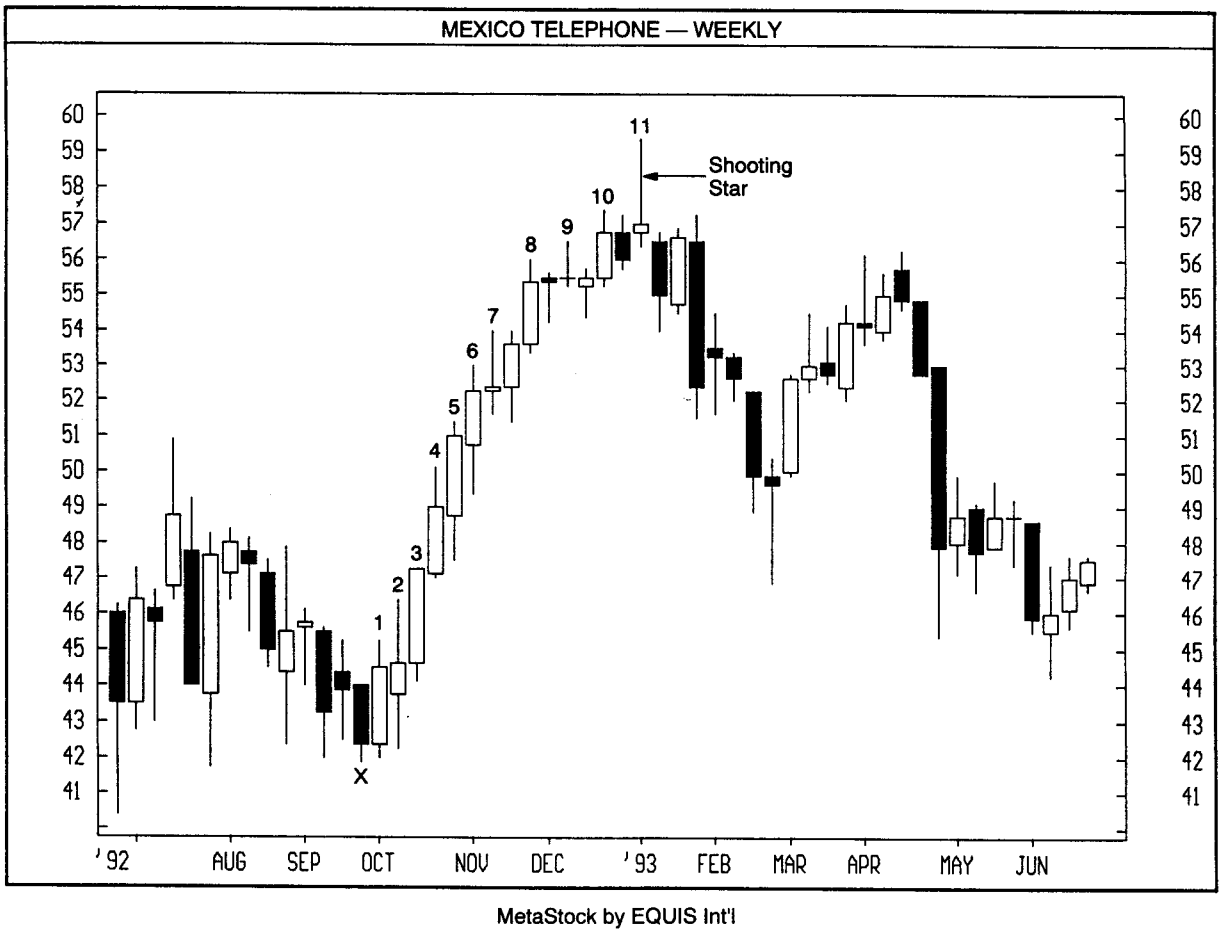


EXHIBIT 3.77. Record Session Highs, Mexico Telephone—Weekly

high number of record sessions were valid reasons. A final push occurred in late 1992 as the extended upper shadow candle—the shooting star—in record session 11 denoted a last gasp for the bulls.

Exhibit 3.78 illustrates how a steep price decline that started with a bearish engulfing pattern dragged the market down over 50% from its highs within a few months. After nine record session lows, the market started to stabilize. Exhibit 3.78 is an example of how the candles not only show the trend of the market, but also can give more insight into the market's health by the color of the candles. The Japanese have a saying, "as different as snow from coal." The short term rally from October (from the bullish engulfing pattern) showed that the bulls were in charge based on the series of white real bodies (the "snow"). The post November selloff pictorially displays the market's weakness with an almost consecutive series of black real bodies (the "coal").

In Exhibit 3.79, a gravestone doji appeared in early September. Inter-

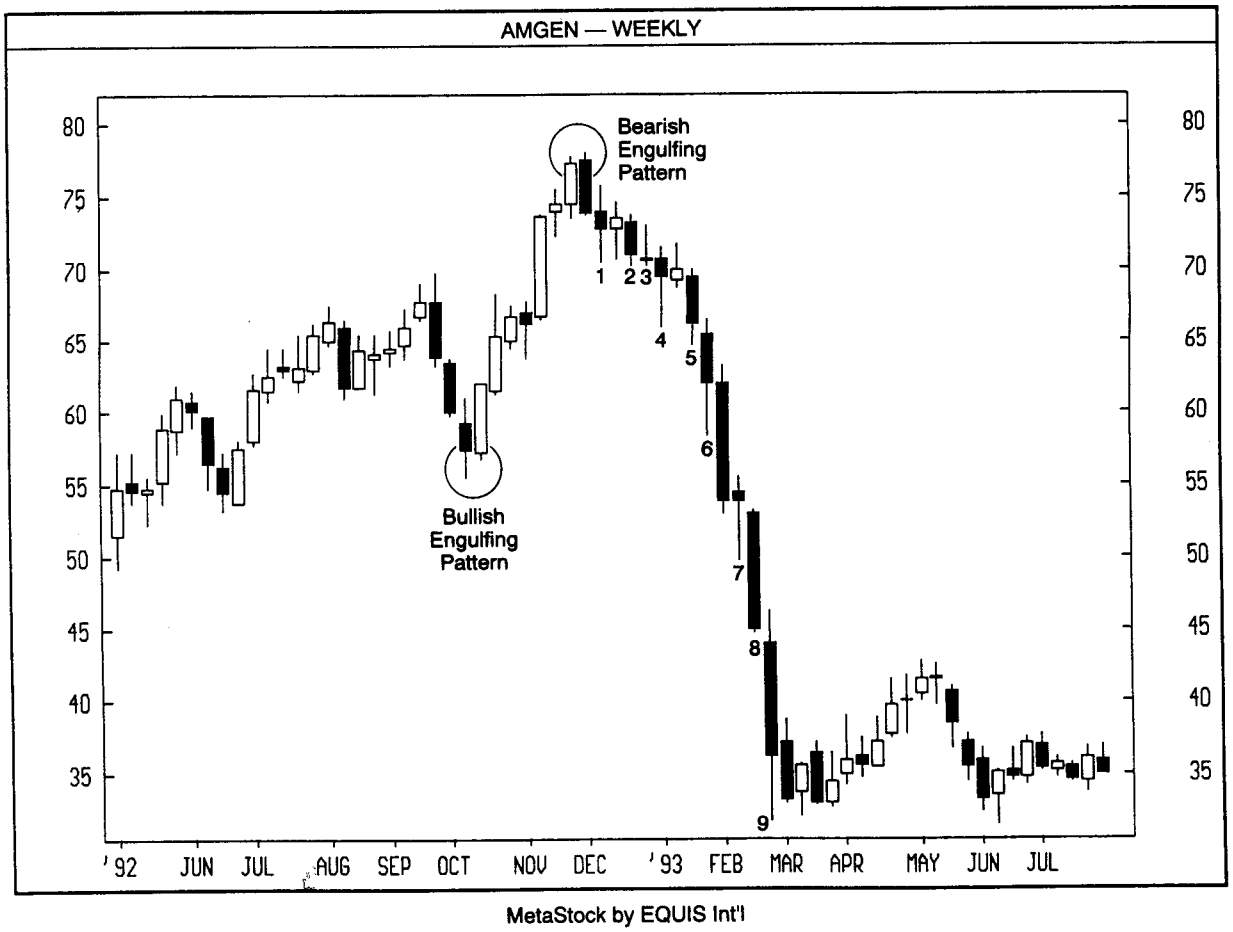


EXHIBIT 3.78. Record Session Lows, Amgen—Weekly

estingly, this gravestone also confirmed that there was a potential top based on the record session concept. After making a new low at L, the market on the next day made a higher high. This was record session 1. After record session 3, the market took a breather for a few days before going on to a fresh new high, and then formed record session 4. As we can see, between record sessions 3 and 4, the market can trade laterally for a few sessions without interrupting the count for record sessions. (However, if these sessions after record session 5 were sharp selloffs, then the record session count would have to start again). By the time the Nikkei gets to record sessions 7 and 8 (which are shooting stars), the market is already in trouble, with the gravestone doji at record session 9 becoming a top.

In Exhibit 3.80, a piercing pattern emerged after a nine-count record session. As a result, a rebound could be expected. From the 1993 high near $21 to the low of the piercing pattern, we get a 50% retracement

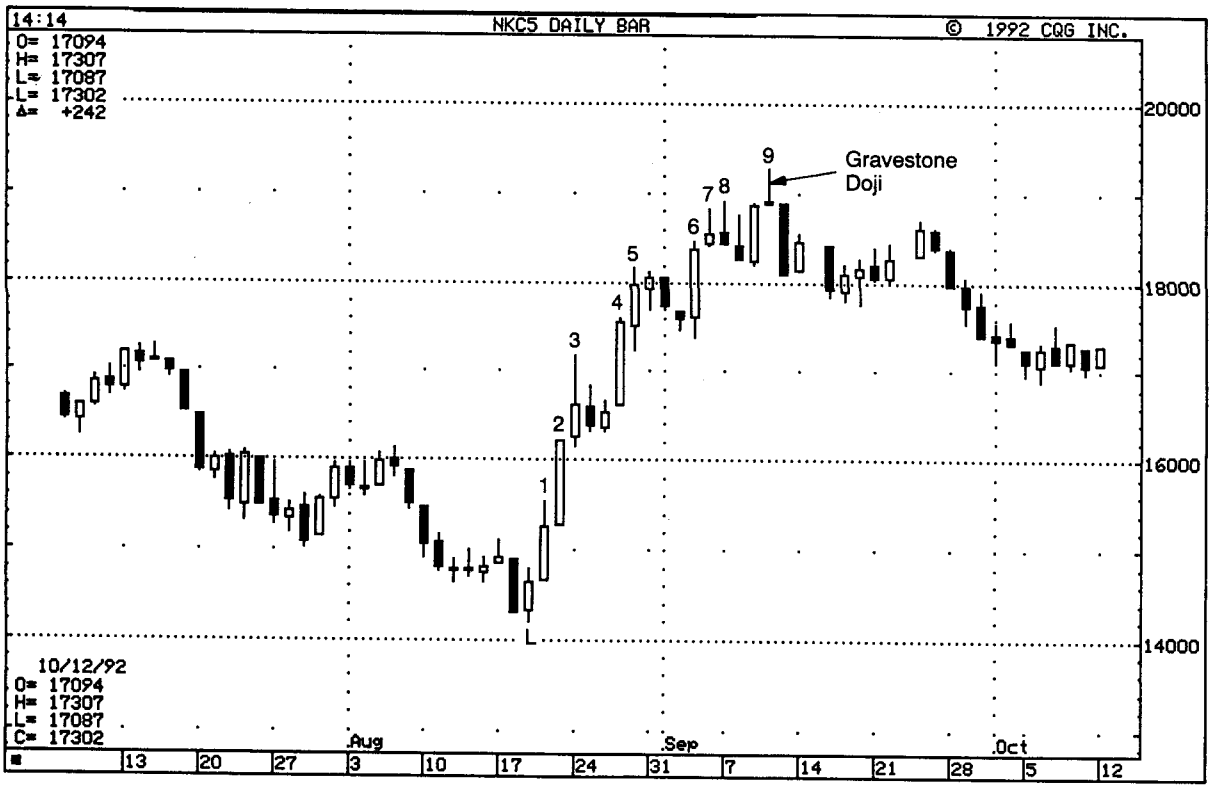


EXHIBIT 3.79. Record Session High and Bearish Confirmation, Nikkei—Daily

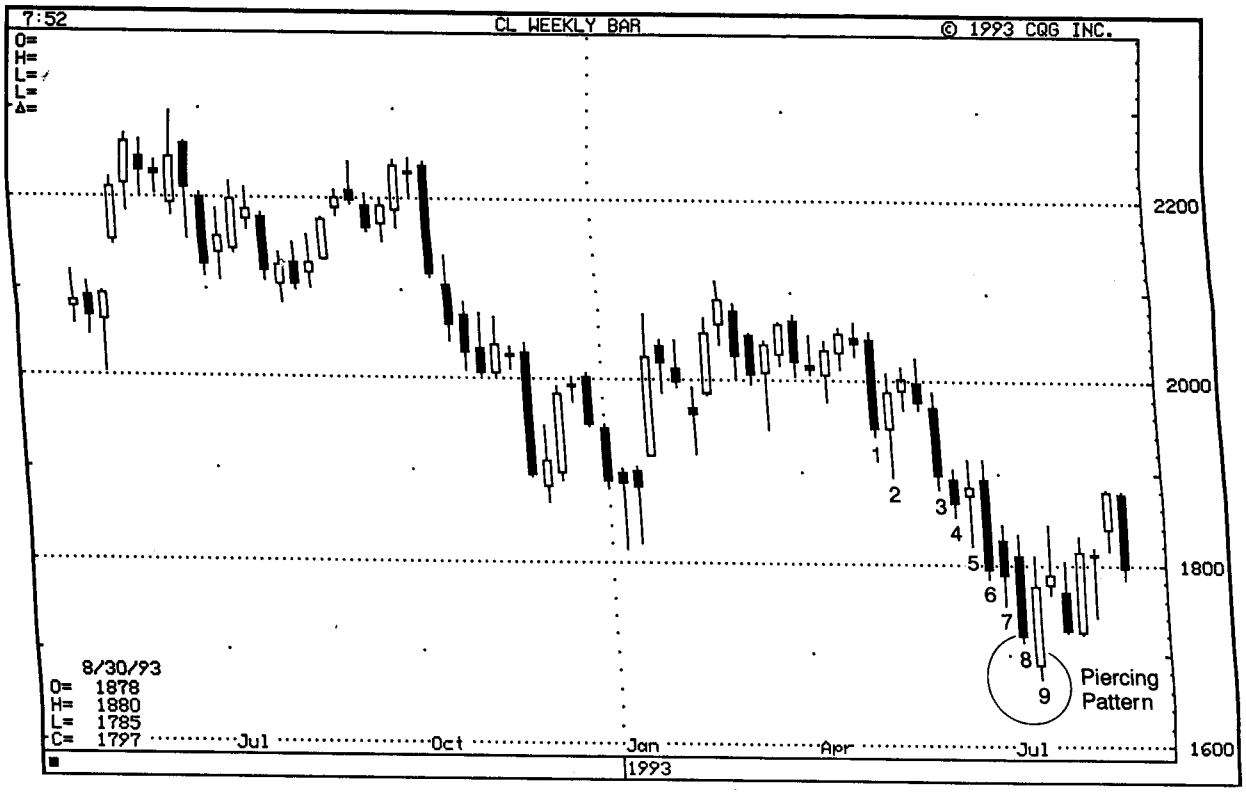


EXHIBIT 3.80. Record Session Lows and Retracement Levels, Crude Oil—Weekly

level near $19. This is where the market stalled after the rebound from the piercing pattern.

Note

[1]Sakata, Goho, p. 92.