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Introduction to Japanese Candlesticks

The History of Japanese Candlesticks

Throughout Candlestick Analysis you are going to find many war-like references. Between 1500 and 1600 the territories of today's Japan were at constant war. Each daimyo (feudal lord) was in constant contention to take over their neighbor. This one hundred year period is known as Sengoku Jidai or the "Age of Country at War". This was a definite period of turmoil.

It slowly came to order in the early 1600's through three dynamic generals - Nobunaga Oda, Hideyoshi Toyotomi, and Leyasu Tokugawa. Their combined leadership prowess has become legendary folklore in Japan's history. Their achievements are described as: "Nobunaga piled the rice, Hideyoshi kneaded the dough, and Tokugawa ate the cake." All the contributions from these great generals unified Japan into one nation. Tokugawa's family ruled the country from 1615 to 1867. This becomes known as the Tokugawa Shogunate Era.

While the Candlestick methodology was being developed, a military environment persisted in Japan. Understandably, the Candlestick technique employs extensive military terminology for its explanations. Investing is correlated to battle. It requires the same tactical abilities to win.

The investor has to prepare for winning trades as a general prepares for battle. A strategy is required, the psychology of coming events have to be thought through. Competition comes into play. Aggressive maneuvers and strategic withdrawals are required to eventually win the war - to achieve financial success.

As stability settled over the Japanese culture during the early 17th century, new opportunities became apparent also. The centralized government lead by Tokugawa diminished the feudal system. Local markets began to expand to a national scale. The demise of local markets created the growth of technical analysis in Japan.

Osaka became regarded as Japan's capital during the Toyotomi reign. Its location near the sea made it a commercial center. Land travel was slow and dangerous, not to mention costly. It became a natural location for the development of the national depot system, assembling and disbursing supplies and market products. It rapidly evolved into Japan's largest city of finance and commerce.

Osaka, the "Kitchen of Japan" with its vast system of warehouses, eventually established an atmosphere of price stability by reducing regional imbalances of supply. Osaka became the profit center of all Japan, completely altering the normal social standards. In all other cities the quest for profits was despised. Japan was composed of four classes, the Soldier, the Farmer, the Artisan, and the Merchant. It was not until the 1700's that the merchants broke down the social barrier. "Mokarimakka" which means "Are you making a profit?" is still the common greeting in Osaka today.

Under Hideyoshi's reign, a man named Yodoya Keian become a successful war merchant. He had exceptional abilities to transport, distribute and set the price of rice. His reputation become so well known, his front yard become the first rice exchange.

Unfortunately, he became very wealthy. Unfortunate because the Bakufu (the military government lead by the Shogun) relieved him of all his fortune. This was done based upon the charge that he was living a life of luxury beyond his social rank. This was during a period in the mid 1600's when the Bakufu was becoming very weary of the merchant class.

A number of merchants tried to corner the rice market. They were punished by having their children executed. They were exiled and their wealth was confiscated.

The Dojima Rice Exchange, the institutionalized market that developed in Yodoya's front yard, was established in the late 1600's. Merchants were now capable of grading the rice, and negotiated setting the market price. After 1710, actual rice trading expanding into issuance and negotiating for rice warehouse receipts. These become known as rice coupons, and were the first forms of futures. The Osaka rice brokerage became the foundation for the city's wealth. 1,300 rice dealers occupied the Exchange. Due to the debasing of coinage, rice became the medium of exchange. A daimyo in need of money could send his surplus rice to Osaka and get a receipt from a warehouse. This receipt (coupon) could then be sold. As with many daimyo, cashflow problems could be eliminated through this method. Sometimes many future years of crops were mortgaged to take care of current expenses.

With the rice coupon becoming an actively traded entity, the Dojima Rice exchange became the world's first futures exchange. Rice coupons were also called "empty rice" coupons, rice that was not in physical possession. Rice futures trading became so established in the Japanese marketplace, that in 1749, 110,000 bales (rice traded in bales) were freely traded while there were only 30,000 bales in existence throughout Japan.

It was during this time period that Candlestick trading became more refined. Candlestick analysis had been developed over the years simply due to the tracking of rice price movements.

However, in the mid 1700's they were really fully utilized. "The god of the markets" Homna came into the picture. Munehisa Homna, the youngest son of the Homna family, inherited the family's business due to his extraordinary trading savvy. This at a time when the Japanese culture, as well as many other cultures, thought it common that the eldest son should inherit the family business.

The trading firm was moved from their city, Sakata, to Edo (Tokyo). Homna's research into historic price moves and weather conditions established more concrete interpretations into what became known as Candlesticks. His research and findings, known as "Sakata Rules" became the framework for Japanese investment philosophy.

After dominating the Osaka rice markets, Homna eventually went on to amass greater fortunes in the Tokyo exchanges. It was said that he had over one hundred winning trades in a row. His abilities became legendary and were the basis of Candlestick analysis.

Japanese Candlestick analysis was never a hidden or secretive trading system. It was successfully used in

Japan for hundreds of years. It has been only recently, about 25 years ago, that it first made its way into the U.S. trading community. Until then, there just wasn't any interest from Western cultures to investigate the Candlestick Technique. Even then, it was not noticed all that much.

The perception has been that it was difficult to learn and very time consuming. That may have been true until recently. The first books introducing it into the U.S. trading arena would describe how to make wooden boxes that were backlit. Then the chart graphs could be better viewed. Fortunately, the advent of computers and computer programming has taken Candlestick analysis ahead by leaps and bounds.

Until recently, the investment community knew about Candlesticks, they just didn't know how to use them effectively. Interest has been increasing dramatically now that the roaring markets have collapsed. Investors, new and old, are now trying to investigate methods that protect them from the severe losses that occurred from March 2000 until now.

Hundreds of years of analysis and interpretation can be much more easily extracted through computer programming. Huge fortunes were amassed with simple charting techniques. The same will be true with all the benefits that computer software provides the investor today.

The interest in candlestick signal analysis in the United States has to be credited to Steve Nison. Over three years of extensive research produced Steve Nison's initial publication "Japanese Candlestick Charting Techniques", published in 1991. Much of the background and historical information about candlesticks, found in this site and many other sites, was probably the results of Steve Nison's excellent research.

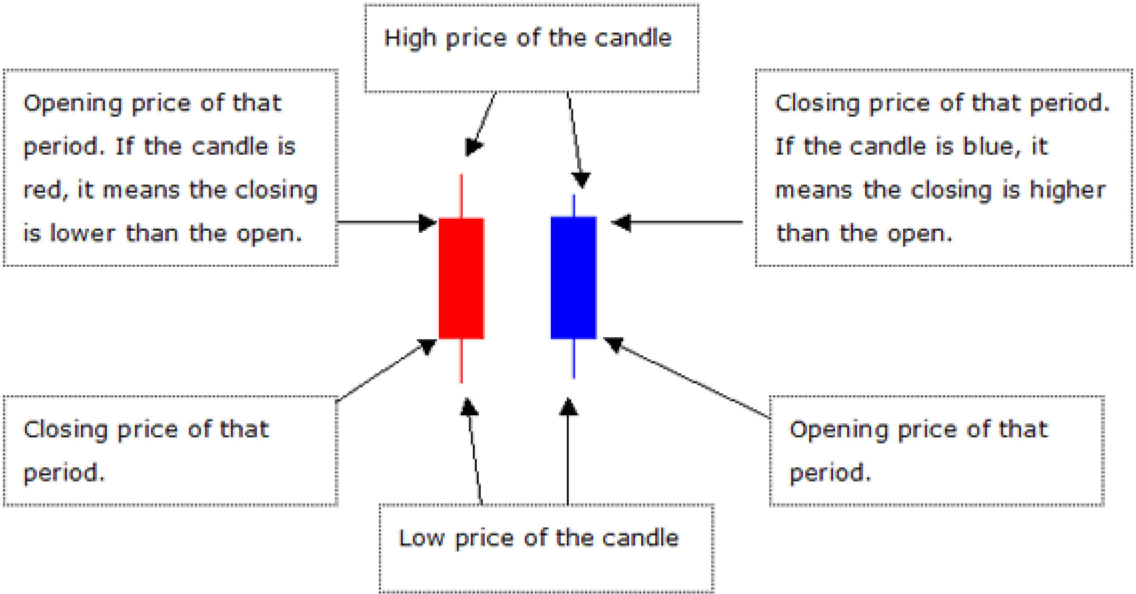
Acknowledgement: Sourced from http://candlesticks.forum.com

What is a candlestick chart?

Candlestick charts shows information about the price action and the movement of the currency price over a specified period of time. It contains the market's open, closing, low and high of that specific time frame.

Below is an analysis of a candlestick chart and its components.

Note: that the Blue Candle is an up day and the red candle is a down day.



What are candlestick patterns?

Technical analysts found that, by observing the candlesticks, there are recurring patterns on the candlestick charts. Such patterns are like recurring pictures on the candlestick charts and they tend to occur when a trend is about to end or reverse its direction. The patterns are very good visual representation of the price movements and give traders a good grasp of what is going on in the market.

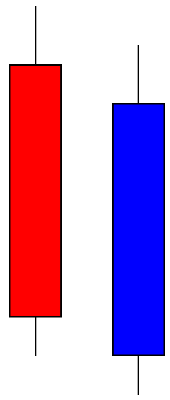
Why are candlestick patterns so important?

Why are candlesticks so important? It is because they are the best gauge of what is going on in the market at the present time. If a candlestick is very short, it implies that the range for the trading day was very tight. If this candle appears after a strong up-trend, it may suggest that sellers have now begun to enter the market more aggressively, and thus the price may be on its way back down.

Eventually, candlesticks patterns can easily be used to identify potential reversals of trends in the market - especially when used in conjunction with other indicators. By observing the candlestick patterns, traders can speculate potential reversals of trends and entering the market with strong reference to the patterns. The following are key patterns to watch out for:

Piercing Line

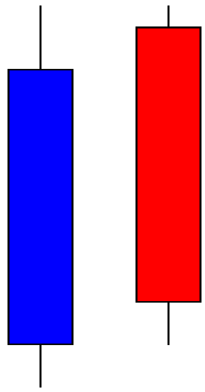
- Every action has an equal and opposite,
- Found at the bottom of a move,
- 2 consecutive candles,
- The first is bearish,
- The second is a bullish down day
- Much Stronger signal when 2nd body pierces 1st by at least 50% - check volume



Bullish reversal patterns that shows sellers are losing their dominance.

Dark Cloud Cover

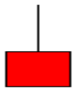
- Variation of the bearish Engulfing pattern,
- Slightly different makeup, although the outcome is usually the same – southerly,
- Found at the top of a move,
- 2 consecutive candles, first is bullish,
- The second is a bearish up day
- Check volume



Bearish pattern showing slower buying momentum.

Shooting Star

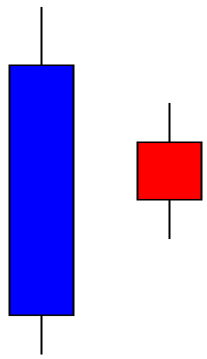
- Found at the top of a move and can signal the end of that move,
- Small 'real' body and long 'wick'
- Opens near low, rallies, then falls back,
- Can be a great indicator to 'short' calls, thus the 'shooting star'



Reversal patterns that occurs after gaps. Buyers make new high but are fail to sustain then.

Harami

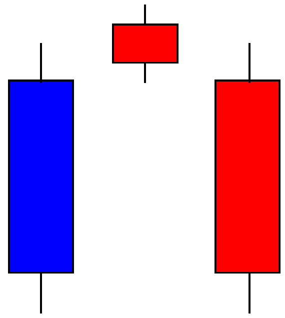
For a true 'Harami Cross' the open and close must be inside that of the previous day.



Harami shows a trend that is losing its momentum and may reverse. Bullish or bearish depends on the existing trend.

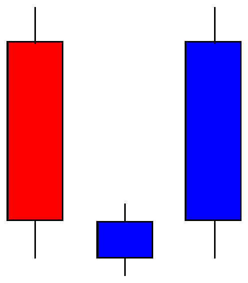
Evening Star

- The evening star is formed over three trading periods.
- The first day is a long clear/green body, this could be seen as the last hoorah for the bulls
- The Second is a smaller body of any colour could be an island/spinning top
- The Third, or confirmation day is bearish and signals the arrival of the Bears



Reversal pattern shows trend has changed direction after making new highs.

Morning Star



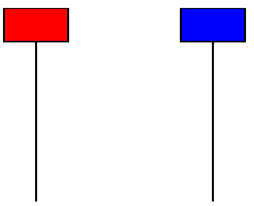
Similar to evening star, reversal pattern shows trend has changed direction after making new lows.

Hammer

- Has a long lower 'wick'
- Small 'Real Body'
- Said to Hammer out the bottom of a trend,
- Occurs after a downward move
- Bulls close the stock near its high

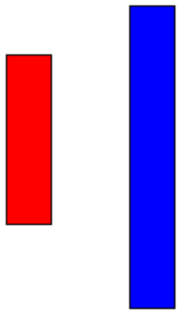
Hanging Man

- Occurs at the top of a move, as well as during an upward move,
- Bearish Signal
- Rallies to close near its high, leaving it vulnerable to a sell off,
- Can be a strong indicator of a 'counter' trend or reversal,



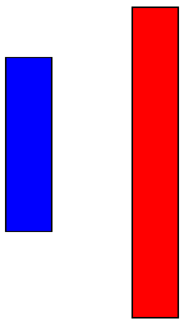
Good reversal pattern after a severe trend. Signifies weakening market sentiment. Pattern is considered a hammer after a down trend and a hanging man after an up trend.

Bullish Engulfing



Usually occurs after dramatic down trends. Good indication that downside momentum is lost as a large candle is completely reversed at next time frame.

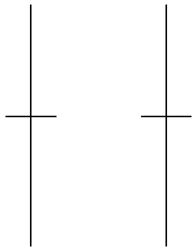
Bearish Engulfing



Common pattern after strong up trends. Signifies that buyers are losing control.

Doji/ Double Doji

All Doji patterns indicate a temporary agreement between buyers and sellers each one is a warning. **WAIT for confirmation**



Pattern implies indecision in the marketplace as the price has a big range but does not go anywhere.