TRADING MARKETS.COM Trading Strategies

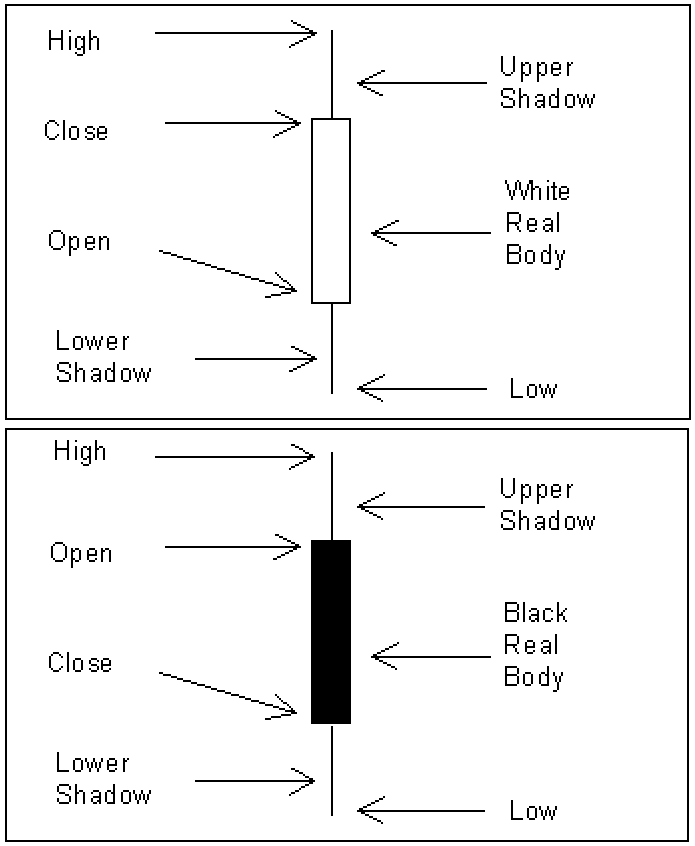
A Realistic And Effective Strategy For Using Candlestick Charts

By Tsutae Kamada

Pick up any stock or futures chart book in Japan and more than 90% of the time you'll find candlestick charts. It's rare to see *bar* charts like those used in U.S. When I ask friends who work at stock brokerages in Japan why they use candlesticks rather than bars, interestingly, nobody says candlesticks are better, just that they are *clearer*.

What they mean by *clearer* is that with candlestick charts, we can distinguish down-days from up-days quickly and easily. On an up-day, we see a white real body candlestick. On a down-day, the real body of the candlestick is black. (See examples below.) On the other hand, with the bar chart, according my friends, it is not so easy to tell if the day is up or down by a quick glace.

As we know, this problem can be solved easily. We have many charting-software packages today which can give us different colors for up-days and down-days -- we simply make the down-day bar black and the up-day bar white.

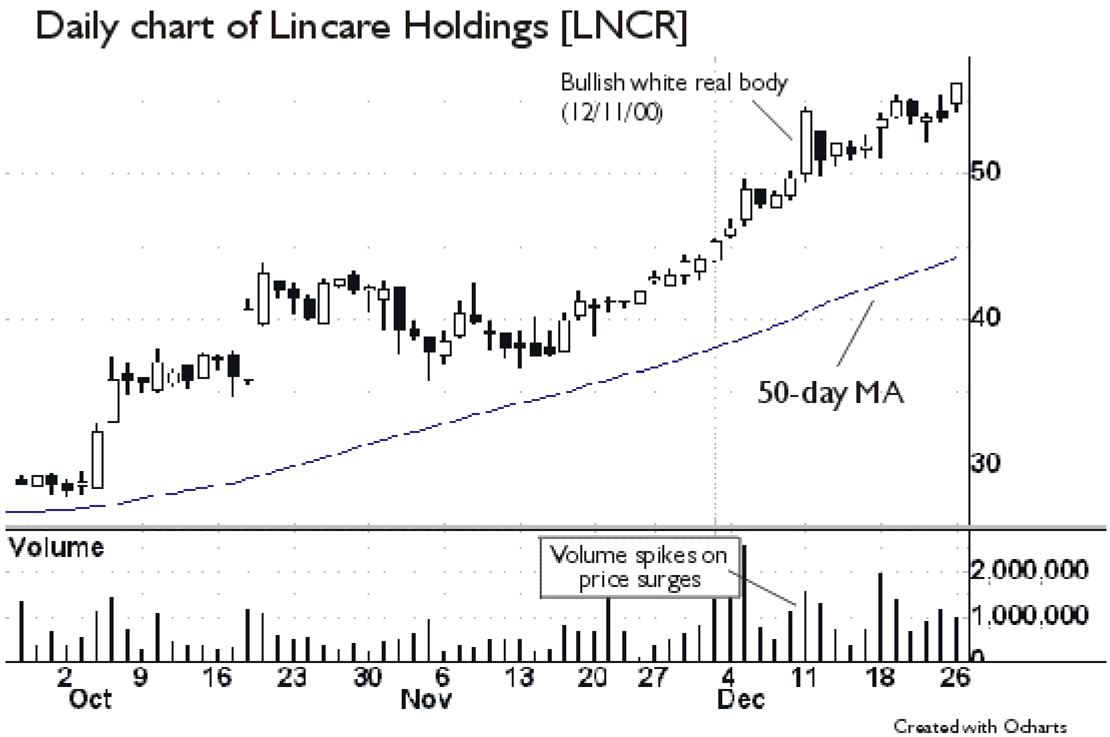


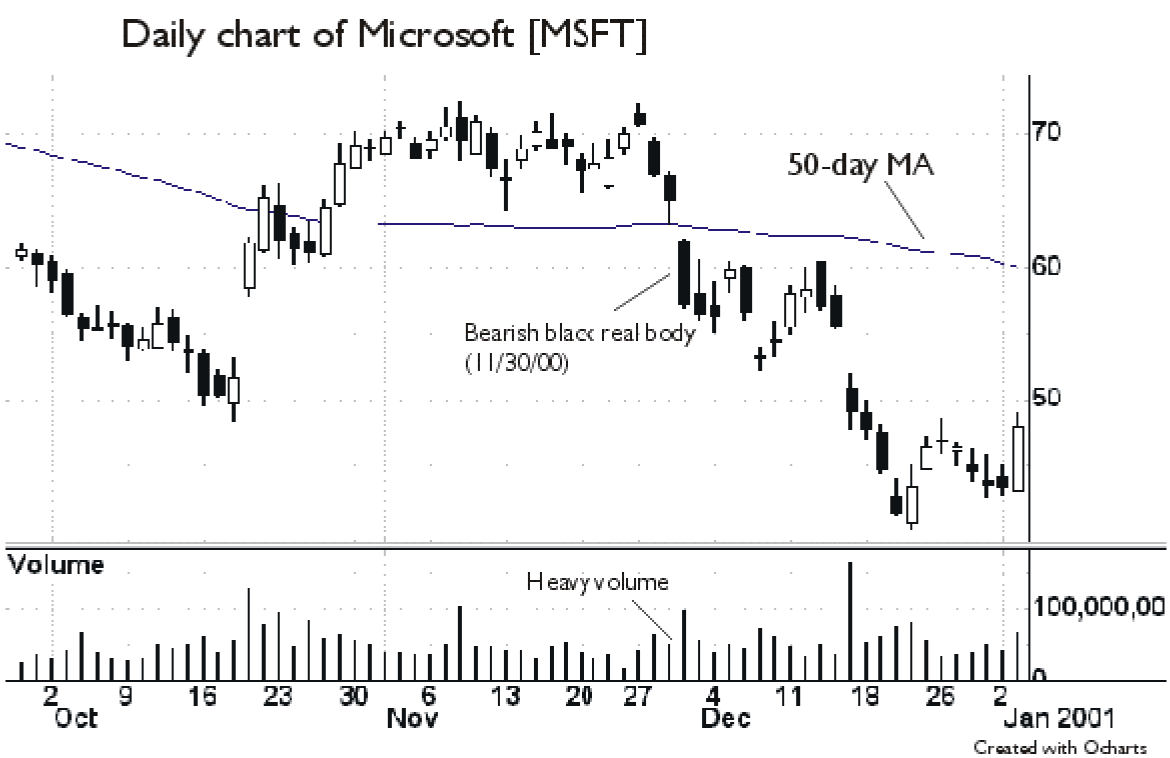
What else? Is there any reason why we should be using candlestick charts instead of bar charts? How about price reversals? Isn't it true that candlestick charts indicate price reversals better than bar charts? For example, a shooting star at the high price level foretells coming price decline. That may be so, but isn't it the same as a price bar with an upper long tail? How about a bullish Engulfing candlestick at the low price level? That is an excellent buy signal, right? Again, that may be so, but that is the same as a bullish outside bar at the low price level. How about a Hammer? It signals a good buy point. True, but that is also same as a price bar with a long tail on the bottom.

I have no intention of discrediting candlestick charts in this lesson. I am a long-time user of candlestick charts, and I believe candlestick charts are more visually oriented than bar charts. In this lesson I would like to point out how effective candlestick charts are when they are used with other technical tools such as trend lines and moving averages. It is impossible to cover all candlestick chart patterns and definitions in this lesson, so if you are interested, you might want to read *Japanese Candlestick Charting Techniques* by Steve Nison.

The most important thing about the candlestick to me is the size of its real body. As you know, a candlestick is made up of a real body, an upper leg (upper shadow) and a lower leg (lower shadow). When the price is up, the candlestick has a white (empty) real body. On a down day, the real body of the candlestick is black, as I mentioned earlier.

Black real body and white real body -- it is like a battle between good and evil. Let me explain why the size of the real body is important. I want you to picture the real body of the candlestick as a window. If the real body is white, the window is open. If you see a black real body, it means the window is closed. A long white candlestick is a bullish signal. The window is wide open, and it is shouting at all investors and traders to come inside. On the other hand, a long black candlestick is bearish. The window is shut. It trapped investors and traders inside the body, and it is ready to go down. (See examples below.)



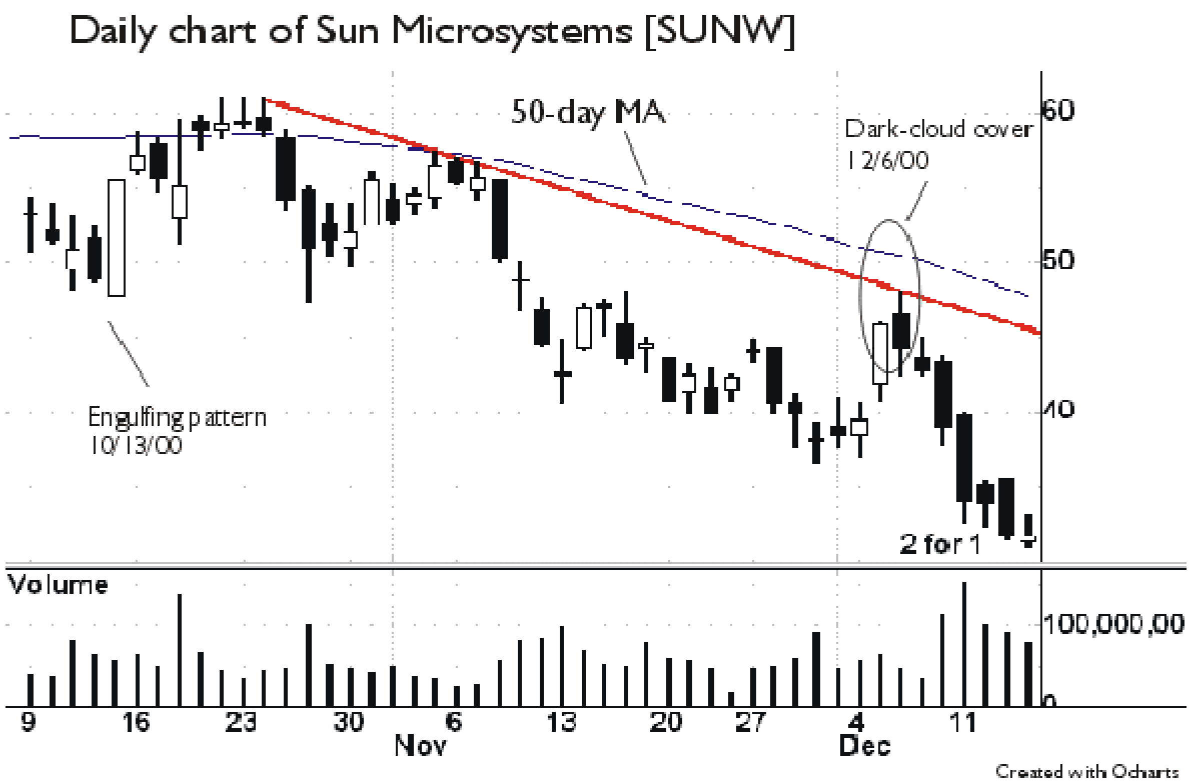


Many traders have told me how disappointed they are with candlestick charts, even complaining that candlesticks gave them winning trades less than 40% of the time. But I discovered common mistakes among these traders: They were so busy learning new names and patterns of candlestick charts (Doji, Morning Star, Hammer, Piercing Line, etc.) that they forgot to combine them with moving averages, trend lines, and other technical tools to improve their trading skills. As you know, no single tool works for all situations in stock trading. You have to get as many confirmations as possible before you commit yourself to trading.

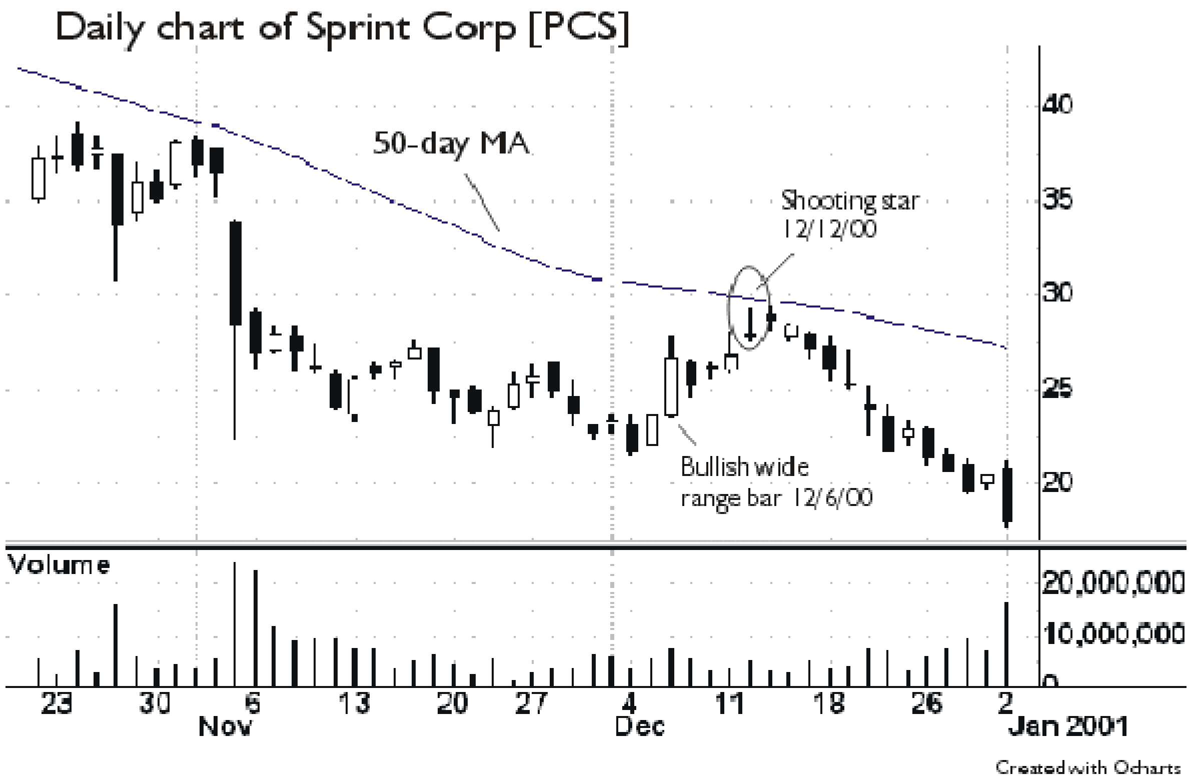
Let's see some examples.

Sun Microsystems (SUNW) teaches us the importance of trading in the direction of the trend. If the trend of a stock is down, you should be looking for opportunities to sell, even though you get bullish signals from candlesticks. Sun Microsystems has been in a downtrend since September. On Oct. 13, the stock signaled a strong buy. It formed a bullish Engulfing Pattern (wide-range outside bar). As you can see the chart below, it really does look bullish. But, if you bought the stock next day, you would have been quickly disappointed.

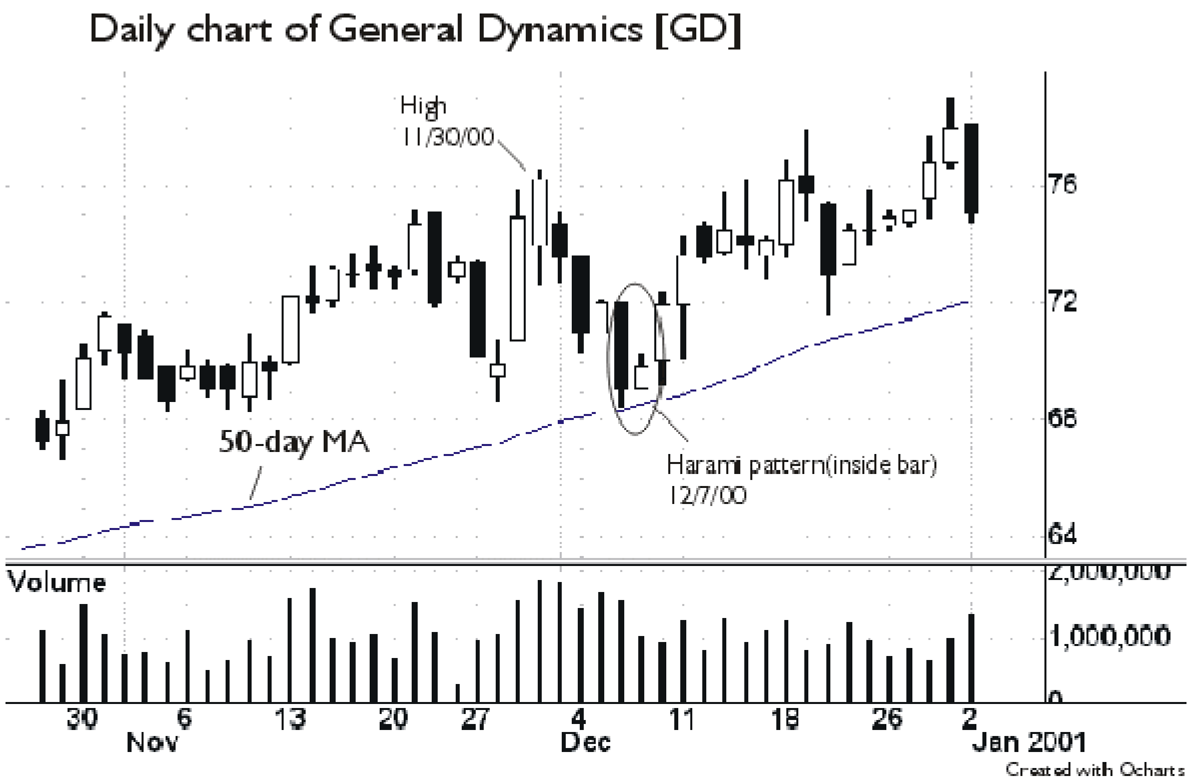
Sun Microsystems ran into its 50-day moving average, and this average line proved to be strong resistance. The same thing happened on Dec. 5. The stock gapped up on the open and formed a bullish bar. Trading volume was also active. After seeing this bullish candlestick, some traders bought the stock next day. But again, Sun Microsystems quickly met up with its declining trendline and resumed its downtrend. By the way, this candlestick pattern is called the Dark-Cloud Cover (a strong gap-up open that reverses to the downside and fills the gap) .



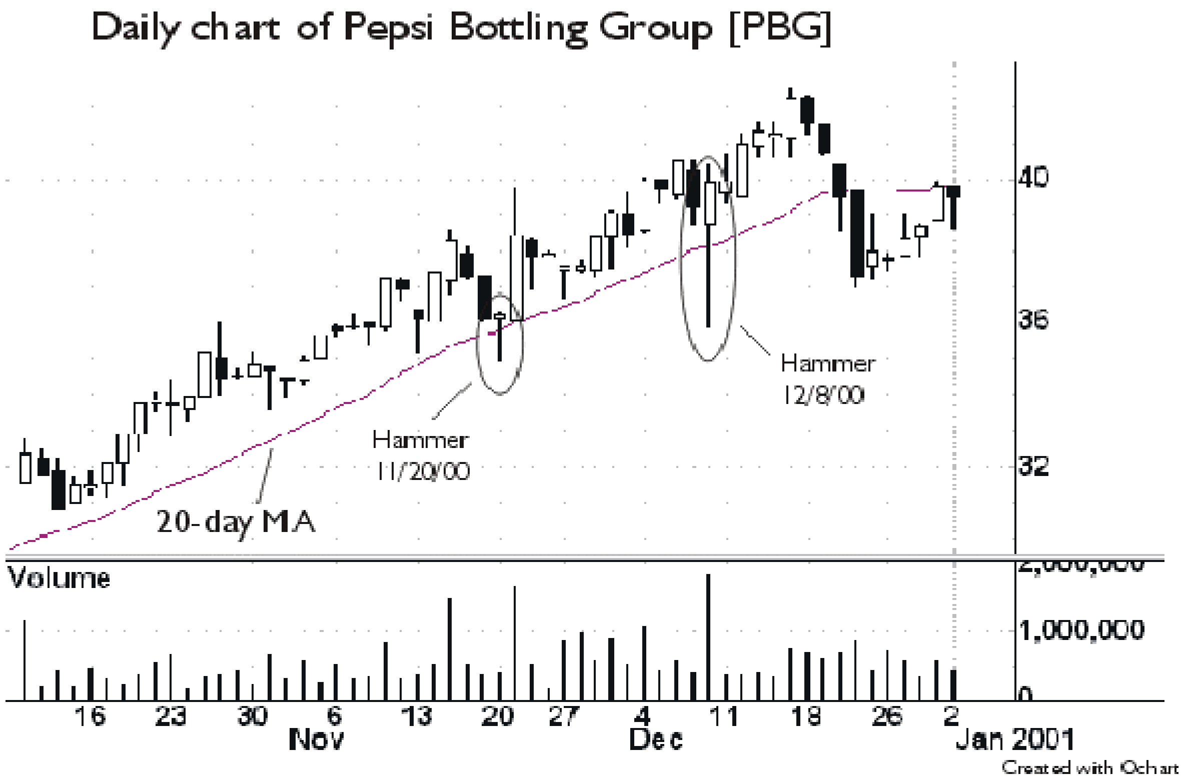
Another good example is Sprint Corp (PCS). As you can see from the chart below, the stock has been downtrending for more than six months. On Dec. 6, Sprint formed a bullish wide-range bar. Four trading days later (Dec. 12), the stock bumped its 50-day moving average and formed a bearish Shooting Star (a bar with a long tail on top). The stock never succeeded in breaking above the average line, but resumed its downtrend. Don't fight the trend of the stock and pay attention to candlestick patterns which confirm the trend of the stock.



Strong uptrending stocks often pull back from their highs for a few days, and candlesticks can provide you interesting buy signals when stocks are ready to resume their uptrend. General Dynamics (GD) hit its high on November 30 and began to pull back. On December 7, near the 50-day moving average, the stock formed a bullish Harami bar (an inside bar). The next trading day, December 8, General Dynamics successfully took out the high of the Harami bar and resumed its uptrend.

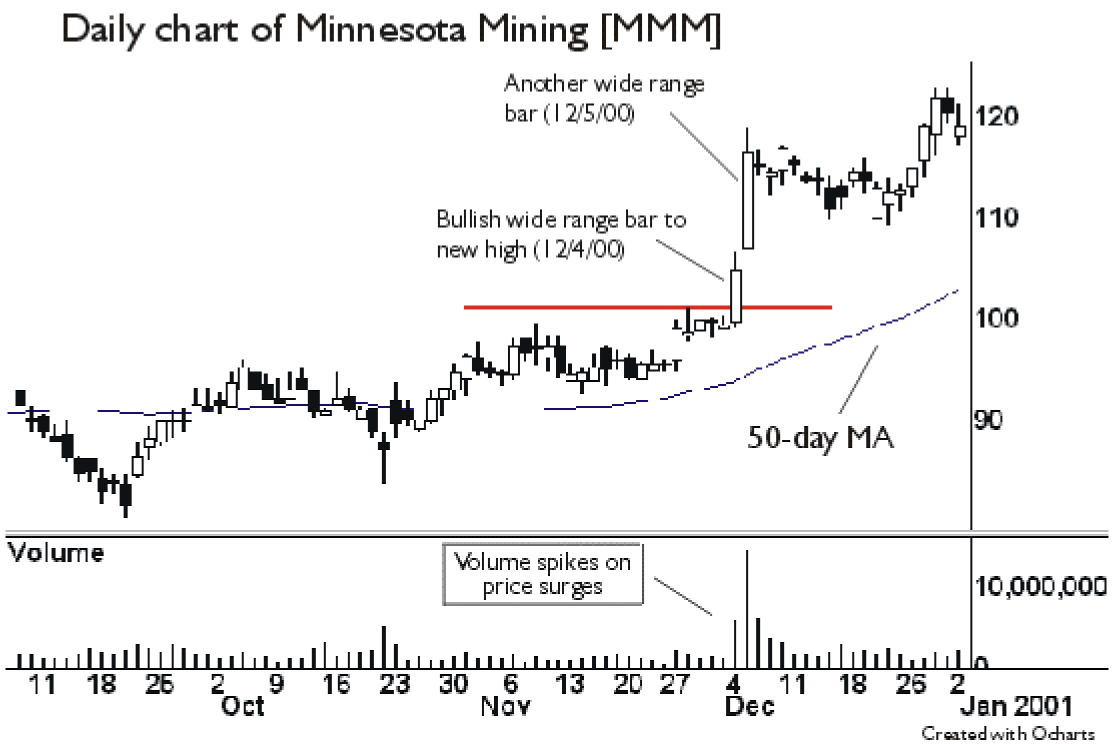


After pulling back from its high, Pepsi Bottling Group (PBG), on Nov. 20, tested the 20-day moving average and formed a bullish Hammer (a bar with a long lower tail). The next trading day, the stock took out the high of the Hammer and resumed its uptrend. Also on Dec. 8, the stock formed another Hammer after pulling back from its Dec. 6 high. On Dec. 11, the stock moved above the high of the Hammer and began to resume the uptrend.

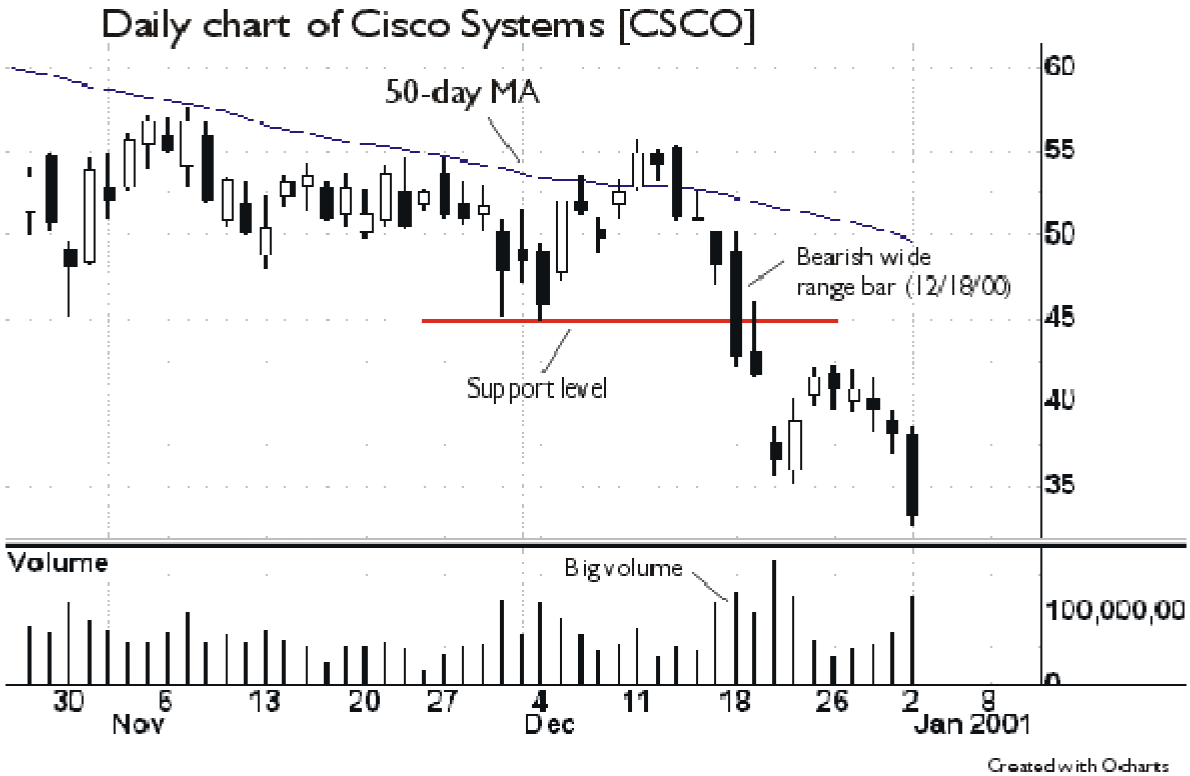


Breakouts and breakdowns are popular methods used by many traders. You can utilize candlesticks to verify the validity of breakouts/breakdowns. One point to remember: Breakout methods work better when the market is uptrending. Recently, we have been experiencing many breakout failures because the market is in a bear phase. Make sure that you understand not only the trend of your stock but also the trend of the sector your stock is in.

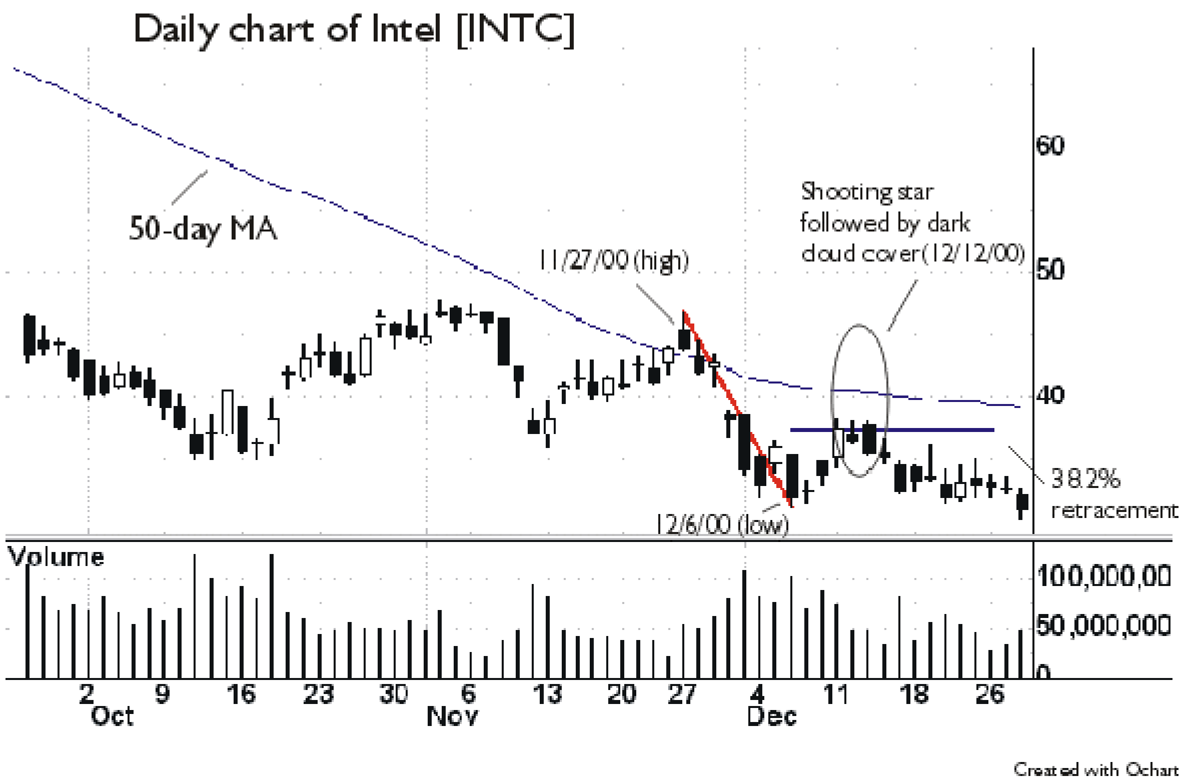
Minnesota Mining (MMM), with heavy volume, broke out to a new high on Dec. 4. See the bullish long candlestick (wide-range bar) on the chart below. Also notice that the candlestick has very short tails on both upper and lower sides. It adds more bullishness, and remember what I said earlier: The window is wide open, and the stock is screaming at traders to come inside. Anyway, the very next day, the stock made another strong breakout to a new high.



We can find a successful breakdown play in Cisco Systems (CSCO). On Dec. 18, Cisco Systems fell below its support level and closed at a new low. We also saw extremely heavy transaction volume. Look how long the candlestick is. This is so bearish; the candlestick has very short tails on both lower and upper sides. The window is shut down, and all traders are trapped inside. It sure looks ready to go down more.

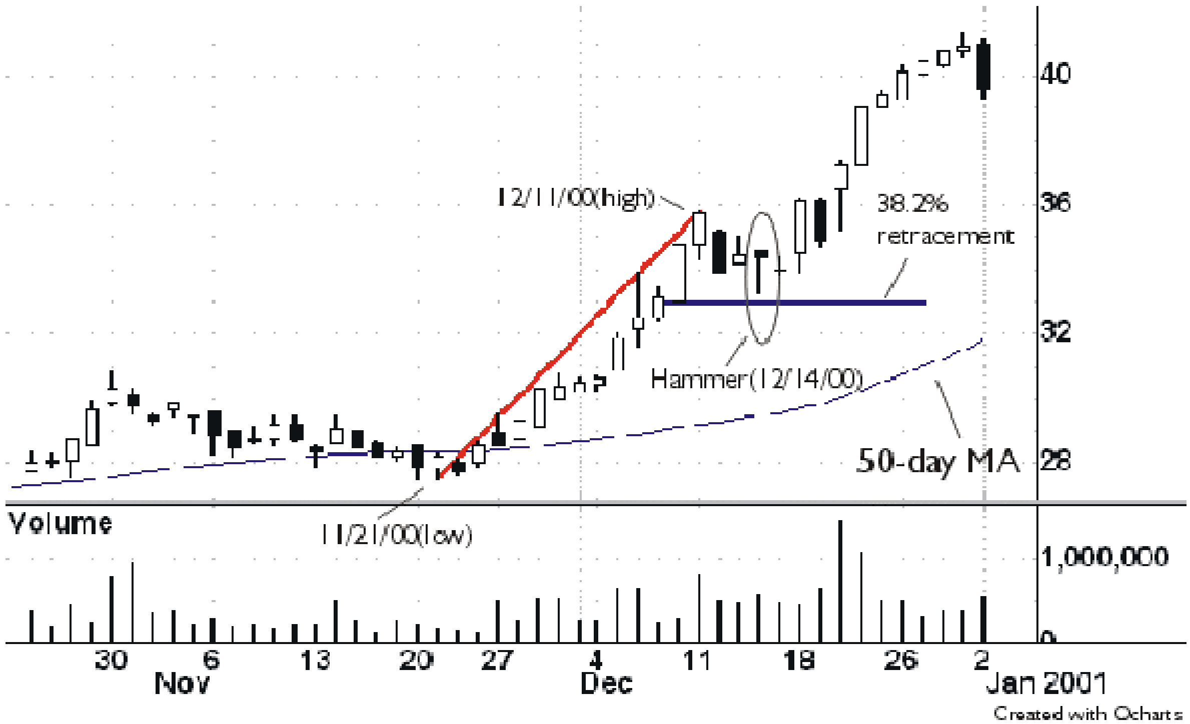


Candlestick charts can be also combined with Fibonacci retracement levels. Three important retracement levels are: 38.2%, 50%, and 61.8%. (See Carolyn Boroden's excellent lesson on Fibonacci Retracements.) Let's look at Intel (INTC). Remember, the stock is downtrending, so I am interested in an entry for short sell. On Dec. 11, Intel closed slightly above its 38.2% retracement level (a swing from the Nov. 27 high to the Dec. 6 low). It looked like this upward momentum would carry over to the next trading session, but Intel formed a bearish Shooting Star (a bar with a long upper tail) and resumed its downtrend.



Greenpoint Financial (GPT) generated an excellent buy signal from a combination of the Fibonacci retracement level and the candlestick. On Dec. 14, Greenpoint Financial successfully tested its 38.2% retracement of a swing from the Nov. 21 low to Dec.11 high. The stock also formed a bullish Hammer. Two trading days later, Greenpoint Financial took out the high of the Hammer and resumed its uptrend.

Daily chart of Greenpoint Financial [GPT]



The candlestick chart is a powerful tool to improve your trading results. Don't forget it is just another tool you can use. It is not *the tool*. Remember to use candlestick charts with other technical tools, and try to get multiple confirmations before you commit to trade.

I would like to conclude this lesson with a quotation from Steve Nison: "I do not use bar charts any more, I only use candlestick charts. But that does not mean I only use candlestick indicators. While the candlesticks are a vital medium of market analysis, I use all the technical tools at my disposal. This is the advantage of candlestick charts. With them you can use candlestick techniques, Western techniques, or a combination of both."

Good luck, and happy trading.