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STRATEGIES *for*

PROFITING

with

**JAPANESE
CANDLESTICK
CHARTS**

STEVE NISON

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Resources

Strategies for
Profiting
With Japanese
Candlestick Charts



STEVE NISON



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Publisher's Preface

What you have in your hands is more than just a book. A map is simply a picture of a journey, but the value of this book extends well beyond its pages. The beauty of today's technology is that when you own a book like this one, you own a full educational experience. Along with this book's author and all of our partners, we are constantly seeking new information on how to apply these techniques to the real world. The fruit of this labor is what you have in this educational package; usable information for today's markets. Watch the video, take the tests, and access the charts—FREE. Use this book with the online resources to take full advantage of what you have before you.

If you are serious about learning the ins and outs of trading, you've probably spent a lot of money attending lectures and trade shows. After all the travel, effort, expense, and jet lag, you then have to assimilate a host of often complex theories and strategies. After thinking back on what you heard at your last lecture, perhaps you find yourself wishing you had the opportunity to ask a question about some terminology, or dig deeper into a concept.

You're not alone. Most attendees get bits and pieces out of a long and expensive lineage of lectures, with critical details hopefully sketched out in pages of scribbled notes. For those gifted with photographic memories, the visual lecture may be fine; but for most of us, the combination of the written word and a visual demonstration that can be accessed at will is the golden ticket to the mastery of any subject.

Marketplace Books wants to give you that golden ticket. For over 15 years, our ultimate goal has been to present traders with the most straightforward, practical information they can use for success in the marketplace.

Let's face it, mastering trading takes time and dedication. Learning to read charts, pick out indicators, and recognize patterns is just the beginning. The truth is, the depth of your skills and your comprehension of this profession will determine the outcome of your financial future in the marketplace.

This interactive educational package is specifically designed to give you the edge you need to master this particular strategy and, ultimately, to create the financial future you desire.

To discover more profitable strategies and tools presented in this series, visit www.traderslibrary.com/TLEcorner.

As always, we wish you the greatest success.

Chris Myers

President & Owner

Marketplace Books

How to Use This Book

The material presented in this guide book and video presentation will teach you profitable trading strategies personally presented by Steve Nison. The whole, in this case, is truly much greater than the sum of the parts. You will reap the most benefit from this multimedia learning experience if you do the following.

WATCH THE VIDEO

The video brings you right into Nison's session, which has helped traders all over the world apply his powerful information to their portfolios. The great thing about the video is that you can watch the instructor again and again to absorb his every concept.

ACCESSING THE VIDEO

To access the streaming video that comes with this book, please register at www.wiley.com/go/wileytradingvideo.

READ THE GUIDE BOOK

Dig deeper into Steve Nison's tactics and tools as this guide book expands upon Nison's video session. Self-test questions, a glossary, and key points help ground you in this knowledge for real-world application.

TAKE THE ONLINE EXAMS

After watching the video and reading the book, test your knowledge with FREE online exams. Track your exam results and access supplemental materials for this and other guide books at www.traderslibrary.com/TLEcorner. If this is your first time at the Education Corner, you may be asked to create a username and password. But, it is all free and will be used when you take the self-tests at the end of each chapter.

GO MAKE MONEY

Now that you have identified the concepts and strategies that work best with your trading style, your personality, and your current portfolio, you know what to do—go make money!

Meet Steve Nison



Steve Nison was one of the first experts to reveal the secrets of Japanese candlestick charting analysis in the world outside of Japan. He is acknowledged as the Western Hemisphere's leading authority on the subject. He is also the author of two internationally acclaimed and best-selling books: *Japanese Candlestick Charting Techniques* and *Beyond Candlesticks*.

Mr. Nison's work has been published in financial media around the world, including the *Wall Street Journal*, *Barron's*, *Worth* magazine and *Institutional Investor*. He is also a popular speaker and has presented his trading strategies internationally to market makers, analysts, institutional traders, and active online traders. In 1997, the author founded Nison Research International, which provides customized technical advisory and onsite and web-based seminar services. Prior to that, Mr. Nison was a senior vice president at Daiwa Securities and senior technical analyst at Merrill Lynch.

The charts used in this book were provided by Aspen Graphics (www.aspenres.com) and Quicken Quotes Live. To find out more about Quicken Quotes Live and its charting service, visit their website at www.quicken.com/quickenquoteslive.

Introduction

A Japanese proverb says, “A clever hawk hides its claws.” For over 100 years, the claws of Japanese technical analysis and candlestick charts have been hidden from the Western world. I’m pleased to be able to help you uncover and unlock these secrets of the Orient. Simply put: candlestick charts have revolutionized technical analysis. They are now one of the most discussed forms of charting in the world. *The Wall Street Journal* said, “Japan’s candlesticks light traders’ paths.” *Investors’ Library* agreed: “Whether you day trade or hold positions, candlesticks are a must.”

By the way, it’s not just the media that loves candlestick-based analysis. My book sales have zoomed over the past several years because thousands of traders have discovered candlesticks. Hundreds of financial publications and websites have also found candlestick charts. I was using a Quicken Quote’s log one day, when my ten-year-old son asked, “Do they have candlesticks?” I said, “Yes.” Then he said, “If it wasn’t for you, Daddy, there’d be no candlestick charts.”

That is not entirely true because the Japanese developed candlestick chart analysis hundreds of years before my time. But I appreciated my son’s compliment and it is true that before I began writing about these incredible analytical tools, they were virtually unknown in the West. Consider this: since around 1900, the traditional charts used in the West have been limited to bar charts and point and figure charts. It was only in the late 1990s that I revealed candlesticks to this side of the world. Today, candlesticks are becoming a basic and popular charting technique. I think this demonstrates their usefulness.

I predict that candlestick charts are going to become an integral part of your technical analysis arsenal. And

everyone can agree about the importance of technicals. Technical analysis is the only way to gauge the emotional health of the market. Price is made of two components: rational and emotional. How many times have you seen a market move without any change in fundamentals? The longer the time frame of investing, the more important the fundamentals are. But as you move into shorter time frames, the technicals take on added significance. The only way to factor in the emotional influence on price is through the study of price movement—in other words, studying charts for price patterns and signals.

The fundamentals gauge the rational part of your investing decisions, but they don't account for the emotional or psychological reasons that prices change in the short term. Jesse Livermore, the famous trader from the early 1900s, said that human nature never changes; the pockets change and the technology changes, but the market never changes. How can it? Human emotion drives the market—not reason, not economics, and certainly not logic.

To demonstrate, on the floor of the Chicago Board of Trade back in the '90s, the price of soybeans was rallying due to a drought. Because of a drought in the soybean area, the price of soybeans was rallying. Then a few drops of water slid down a window. "Look," someone shouted, "rain." Then came a steady trickle, and then a downpour. It was raining in downtown Chicago. The price of soybeans began to slowly move down, then collapsed. It was raining in Chicago all right, but nobody grows soybeans in Chicago. In the heart of the soybean belt, some 300 miles south, the sky was blue, sunny, and very, very dry. And this is the important part. Even if it wasn't raining on soybean fields, it was in the heads of the traders, and that's all that counts. To traders, nothing matters unless the market reacts to it. The game is

played with emotions; and the only way to gauge the emotionalism of the market is through technicals.

Candlestick charts give you insight into the psychology of the market. Another application of technicals, even if you are fundamentally oriented, is found when you seek value investments. With several companies available, which one do you buy? If you wanted to lighten up on a position, what do you sell? You sell those stocks that are in your resistance areas. So I like to look at it as the right hand helping the left. The technicals complement the fundamentals. And because so many traders and investors use charts now, charting itself has become a major market moving influence. Anything that moves the market is worth monitoring.

This concept is nothing new. I had a book translated called *The Fountain of Gold, A Free Monkey Record of Money*. Crazy title, don't you think? The book observed, "When all are bearish, there is cause for prices to rise. When everyone is bullish, there is cause for the price to fall." What does that sound like? Contrarian investing. The book was written in 1755. And just to put it in historical perspective, before America was a nation, the Japanese were using contrarian opinion. In fact, the Japanese were trading what they called "empty" rice contracts, which were the first futures contracts. This is where charting really began. These contracts were traded in Osaka, which was such an important trading area that to this day the traditional greeting in Osaka is, "Are you making a profit?"

An article about my work that appeared in the *Japanese Economic Journal* said, "To know the Japanese chart method is not enough, one must absorb the best parts of Western technicals." The Japanese have the candles, but they know all the Western technical methods, too. So Japanese analysts and traders use their candlesticks—Eastern technicals—and they use Western technicals at the same

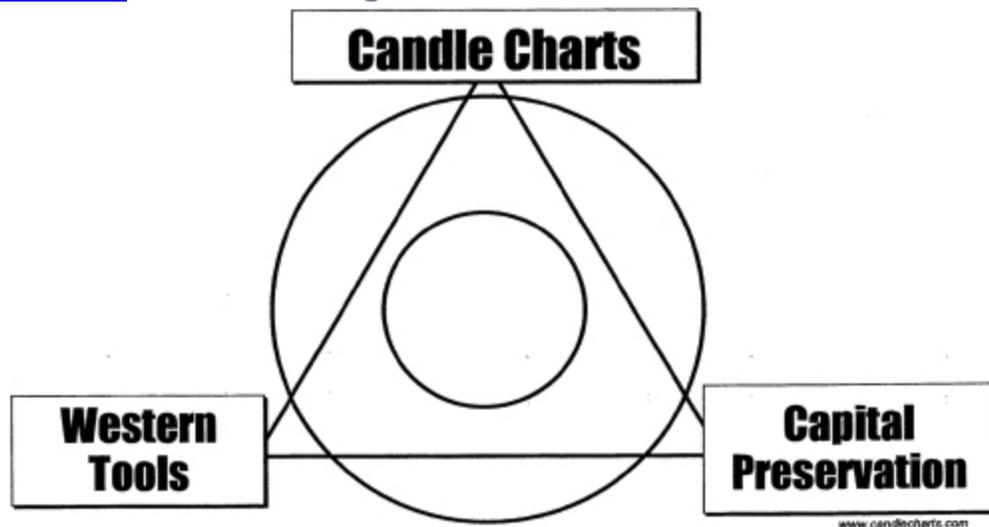
time. Now it's our turn to learn from them, to combine what I call the best of the East and the West.

Chapter 1

The Basics: Candlestick Construction

My firm has an exclusive strategy called the *trading triad*. I like to make the analogy that trading is like a three-legged stool. What happens if you take away one leg of the stool? It's going to fall over. So it is with the trading triad, as illustrated in [Figure 1.1](#).

Figure 1.1: The Trading Triad



The first leg is the basics of candlesticks. Construction of the chart with individual price lines, development of recognizable patterns and trends, and how these reveal market momentum. The second leg is a study of Western technicals. I do not believe that candlestick charts replace technicals or even traditional Western-style bar charts. You still need four price factors: open, high, low, and close, which become even more valuable when studied as part of

trend lines and moving averages. The third leg is the study of how this information works to reduce risk and to promote preservation of your investment capital.

You might have heard the expression, “Water can both sink and raise a ship” This wisdom applies in so many places, including how you use candlestick charts. These are timing tools, of course, but they can provide so much more. You can also use candlesticks to manage and reduce risk, and to make more informed decisions involving your portfolio. That is where the real value to candlestick charting is going to be found.

Candlestick patterns give you very specific turning points, or reversals. These appear in several ways: as single candlesticks, two-part patterns, or three-part patterns. On a bar chart, you look for reversals by tracking a long-term trend line or picking up on popular technical signals like the well-known head and shoulders. Candlestick patterns will certainly provide a clearer signal in the moment of a pending reversal. However, you also need to remember that the overall technical pattern and trend is more significant than any single candlestick.

For example, you might notice a clearly defined candlestick pattern, but by the time it forms, it may be too late to act. What is important to keep in mind is that whatever market you are looking at, you can use candlestick charts to improve the timing of your trades. This works in any time frame and in any market condition.

[Figure 1.2](#) is a typical bar chart. Review this keeping an important point in mind: the candlestick chart is constructed using exactly the same data as that used for the bar chart. So I have taken the same data displayed in this bar chart and converted it into a candlestick chart in [Figure 1.3](#).

[Figure 1.2](#): Bar Chart



Figure 1.3: Candlestick Chart



A **bar chart** is also called an OHLC chart, a simple price chart showing the day's trading range in a vertical line or stick; the opening price, a smaller extension out to the left; and the closing price, a small extension to the right.

THE CANDLE LINE

The candlestick takes the information found on the bar chart and adds a third dimension to it. The bar chart's vertical stick is replaced by a rectangle topped and bottomed by the borders of the trading range, plus an extension above and below the rectangle; so it is the same up-and-down size as the bar chart's stick. The new dimension is that some candlestick rectangles are white and others are black. The white rectangles appear on days that the price moves upward (closing price is higher than opening price). Black rectangles show up on downward-moving days (when closing price is lower than the opening price).

A **candlestick chart** is a formation reporting the day's trading range in a rectangular white formation for upward-moving days, or in a rectangular black formation for downward-moving days. The upper and lower borders of the rectangle are the opening and closing prices.

The name "candlestick" comes from the fact that "wicks" are seen either above or below the rectangles (or both above and below). Each segment of the candlestick chart has a descriptive name. The rectangular body (white or black) is called the "real body" because its upper and lower borders represent opening and closing price.

A **real body** is the candlestick's rectangle, bordered by opening and closing prices and excluding any price points above or below those levels.

Any extension above the rectangle is called the upper shadow; and any extension below the rectangle is called the lower shadow. For example, if the opening price is \$32.10 and the closing price is \$34.00, there was a real body change of \$1.90. However, during the day, the price range might have moved up as far as \$35 per share and down as low as \$32 per share. In this case, you would see both an upper shadow and a lower shadow.

The **upper shadow** represents a session's price range above the range between opening and closing price, extending to the day's highest price.

The **lower shadow** represents a session's price range below the range between opening and closing price, extending to the day's lowest price.

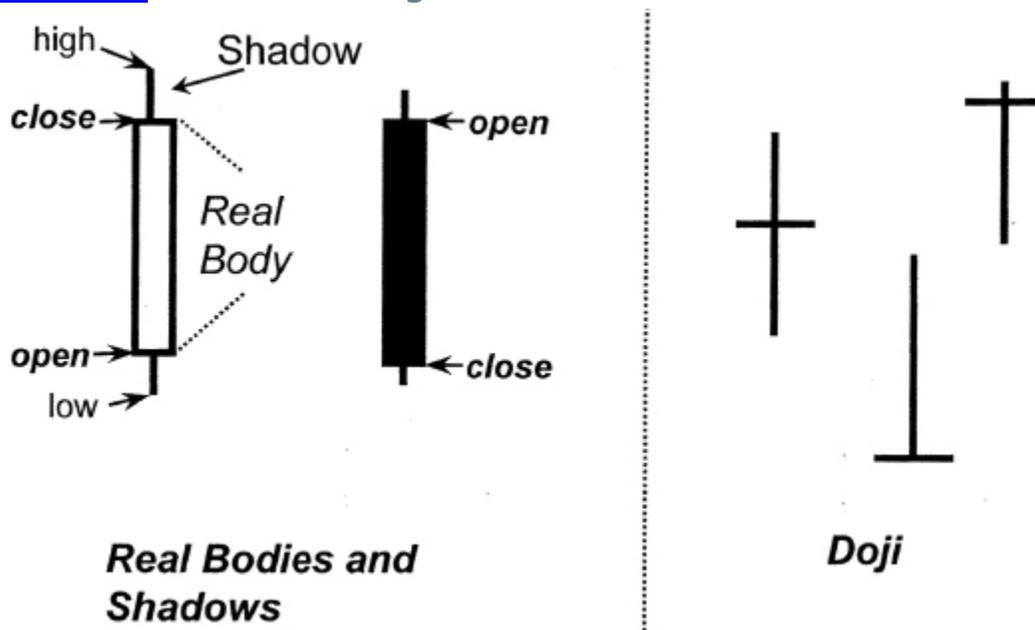
John Murphy, former CNBC talk show host, once told me that a viewer called in and asked the question, "What are those charts that look like hot dogs?" I briefly considered calling them "hot dog charts" to make them appealing to Americans, but thought better. But it makes the point that these charts are still relatively new in the West.

No matter whether you think of these as candlesticks or hot dogs, they involve a lot of new terminology. It is going to be important to master this terminology before you can effectively use candlesticks. For example, what is it called when the opening and closing price are the same level or very close? This is a *doji* formation. The word "doji" is Japanese for "mistake."

Doji, meaning “mistake” in Japanese, is a candlestick with opening and closing prices at the same price level or very close; rather than a rectangle, the real body is a horizontal line.

When a doji also has both upper and lower shadows, it resembles a cross. The real body is the horizontal line and the shadows are the vertical lines. Of all of the single candlestick formations, the doji is one of the most important. I will explain why a bit later; for now I am only trying to introduce some of the important basic concepts and definitions. The formation of the candlestick (including the doji) is summarized in [Figure 1.4](#).

Figure 1.4: Constructing the Candle Line



 For full comprehension of the doji candle, watch Steve explain on the DVDs included with this book.

The “candle line” refers to all of the features you find in candlesticks: the real body, upper and lower shadows, open and close, and the direction of price movement. This is

summarized on the left portion of the illustration. On the right side, I have summarized the appearance of the doji. Notice that there are three possible doji formations: the cross (with upper and lower shadows), as well as those with a shadow only on one side.

The candlestick is so valuable because it gives you such a wealth of information in a relatively simple design. This includes everything at a glance:

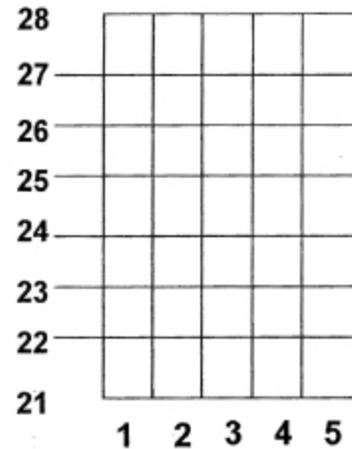
- the day's complete trading range
- opening and closing prices
- direction of price movement

Even more to the point, when you look at a chart with many sessions included, you can see the overall trend immediately. Even with a bar chart, you can easily tell whether price trends are moving upward or downward; but candlestick charts make it easier to judge relative strength or weakness of upward and downward sessions, the *size* of daily trading ranges, and—when combined with daily volume—the volatility in trading action.

At this point, you already have enough information to build your own candlestick chart. [Figure 1.5](#) gives you a grid as a starting point, along with five trading sessions and each one's open, high, low, and close.

[Figure 1.5](#): Drawing Candle Lines

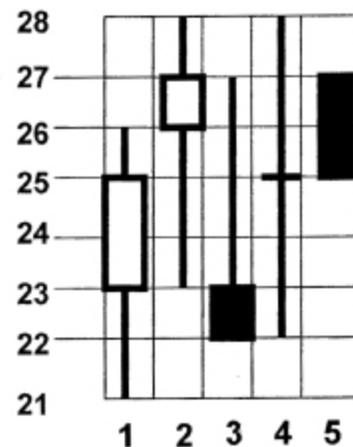
<u>session</u>	<u>open</u>	<u>high</u>	<u>low</u>	<u>close</u>
1	23	26	21	25
2	26	28	23	27
3	23	27	22	22
4	25	28	22	25
5	27	27	25	25



This information is easily moved onto a candlestick chart by transferring the price information, as demonstrated in [Figure 1.6](#). The decision about whether the real body should be white or black relies on whether price for the day moved upward between open and close (requiring a white real body) or downward (requiring a black body). The range of trading defines the extent of upper and lower shadows. These rules apply whether your charts cover daily sessions or five-minute sessions. Incidentally, the technical patterns you find using candlesticks apply to all durations of charts. Day traders like to use very short-term charts, and swing traders—those trading in two- to five-day time frames, usually prefer daily charts.

Figure 1.6: Drawing Candle Lines

<u>session</u>	<u>open</u>	<u>high</u>	<u>low</u>	<u>close</u>
1	23	26	21	25
2	26	28	23	27
3	23	27	22	22
4	25	28	22	25
5	27	27	25	25



When I first began using candlesticks back in the 1980s, I had to draw the charts by hand. At that time, there was no Internet and even if there had been, no one really knew anything about candlesticks. Today, you are more fortunate. Many sites provide free and instant candlestick charting with a lot of flexibility, including the duration of the chart and additional technical features like moving averages, for example. Even though you do not need to draw charts by hand, it is a good idea to go through the exercise just to make sure you have grasped the basics. As for me, I am still waiting for an even more advanced system, one in which I can press a button and get tomorrow's prices!

GAPS

One point that often confuses people about candlesticks: the formation is strictly limited to the current trading price action. The opening price is not the previous session's closing price. If you start with this premise, then the candlesticks will *not* make much sense. So when you see a space between one session's close and the next session's open, it can be significant, especially if the gap is quite large.