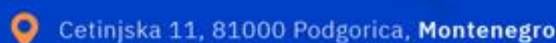
How to Trade with Japanese Candlesticks



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How to Trade with Japanese Candlesticks

Observation is the best friend of the technical analyst. By watching the markets, I noticed something interesting about candlestick charts, which I use extensively. I realized the real bodies used in candlestick charting can be used to determine significant support and resistance points, a strategy I had never seen before. Take a look at how it can be done.

Although they have only recently become popular in the Western Hemisphere, Japanese traders have been using the candlestick charting technique for hundreds of years. Candlestick charts, much like the bar chart equivalent, utilize the open, high, low and close activity to plot a period (usually a day). In candlestick charting, unlike bar charting where the highs and lows tend to be the focus, the opens and closes are the most significant.

A candlestick is composed of two features, as shown in Figure 1. The real body is a rectangle encompassing the area between the open and close and is what gives candlestick graphs their distinctive appearance. The real bodies are blacked in if the open is above the close and white if the close is above the open. A session in which the open and close are the same is commonly referred to as a doji session and is represented by a single horizontal line at that price.

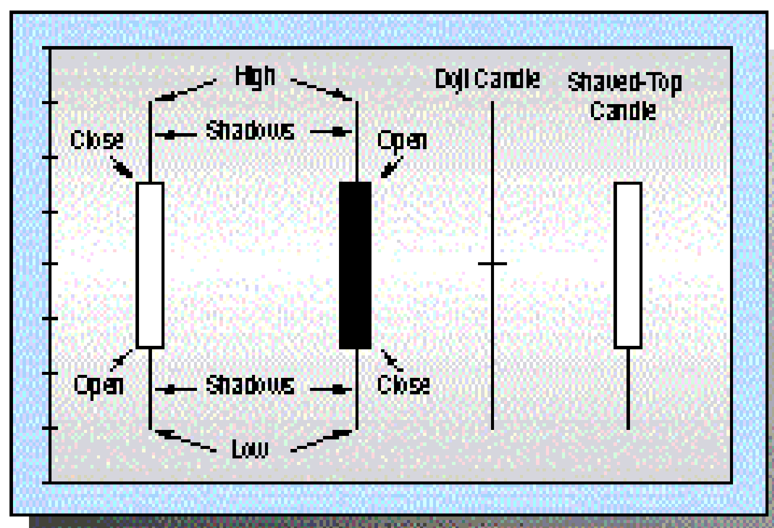

FIGURE 1: CANDLESTICKS. *A candlestick is composed of two features. The first is the real body, which is the rectangle between the open and close and is what gives candlestick graphs their distinctive appearance; this area is blacked in if the open is above the close and white if the close is above the open. A session in which the open and close are the same is commonly referred to as a doji session and is represented by a single horizontal line at that price. The second distinctive feature is the shadows of a candle, which are drawn in the area above and below the real body and the extremes. It is possible to have one, two or no shadows. When a shadow is absent, the result is referred to as a shaved candle.*

The shadows of a candle - which give the appearance of being wicks - are drawn in the area above and below the real body. The upper shadow is the area between the high and the top of the real body, while the lower shadow is the area between the bottom of the real body and the low. It is possible to have one, two or no shadows.

When a shadow is absent, the result is often referred to as a shaved candle.

Much of candlestick analysis revolves around the search for, and identifying, reversal patterns. Many of the distinctive terms associated with candlestick charting come into use with reversal patterns. This is where the real difference between candlestick charting and bar charting comes into play. However, candlestick analysis can offer more than you think. Most technicians use highs and lows for support and resistance points as part of their basic charting techniques. But in keeping with the candlestick emphasis on opens and closes, let's change the way we look at the market. Instead of the usual highs and lows, let's use real-body highs and lows.

DETERMINING SUPPORT AND RESISTANCE

When a chartist looks at a bar graph, accumulations of highs and lows are often seen as key market levels. Breaking through these points signals important changes in the expected direction of prices. Candlestick real bodies, however, may turn out to be better for this task. Much like highs and lows are on bar charts, an accumulation of real-body highs or lows at a given level is significant.

An example of real-body resistance levels can be seen in Figure 2. The real-body high from the first day provides the initial resistance point. Note how the second day's action takes prices above that resistance, even to a new high, but the market ends lower on the day. The situation is similar after the fourth day. Twice the market rallies above real-body resistance, only to fall back. Real-body support levels would work in a similar, but opposite, manner.

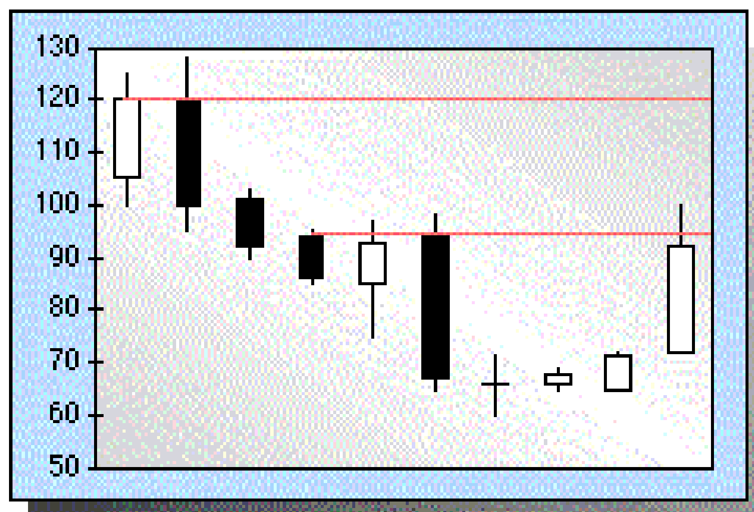

FIGURE 2: CANDLESTICK REAL-BODY RESISTANCE. *Here's an example of real-body resistance levels. The real-body high from the first day provides the initial resistance point. Note how the second day's action takes prices above that resistance, even to a new high, but the market ends lower on the day. The situation is similar after the fourth day. Twice the market rallies above real-body resistance, only to fall back. Real-body support levels would work in a similar, but opposite, manner. The last candlestick is what would be considered a breakout. In effect, there must be a real-body penetration of the support or resistance point before we can consider the action to be significant.*

TRADING APPLICATIONS

One of the first uses that many technicians see for this technique is in terms of breakouts, much like in using bars.

The advantage in using real-body highs and lows for support and resistance is that ranges are tighter, allowing entry into a trading position earlier than might otherwise have been the case. Perhaps the most intriguing part of this new methodology, however, is its usefulness for day trading. Most technicians use candlesticks as a day-end indicator, but this technique gives us a greater degree of depth than is necessary for day trading. Real-body support and resistance allow us to take our analysis into the shorter time frames, which in turn allows us to get better entry points for our longer-term trades.

Longer-term levels require trading against the approach of a level. Often, in such cases, prices have come from a relatively long way off, and just reaching those key levels is a major achievement. Waiting for a break of support or resistance may mean missing a trade. Positions set under these circumstances can be held for longer time frames, perhaps as long as a week.

In candlestick charting, as in bar charting, the more times a level is touched, the more significant the level becomes. This is, however, a double-edged sword; if a resistance point is touched or penetrated slightly several times, it becomes more likely that a real breakout is in the offing. The wrong side of a breakout is not where we want to be. At the same time, however, the more times that a resistance point is touched, the larger the eventual decline is likely to be if the market falls instead of rallying.