

# Spotting early reversal signals by using candle charts

*"A prudent man has more than one string to his bow." — Japanese proverb*

**J**apanese candle chart analysis, so-called because the lines resemble candles, has been refined by generations of use in East Asia. Such charts have been used longer than bar charts and point-and-figure charts but were unknown to the Western world until I introduced them in 1990. These charting techniques are now used internationally by traders, investors, and premier financial institutions here and abroad. Most technical analysis Web sites, real-time trading systems, and technical analysis software have candle charts, attesting to their popularity and usefulness.

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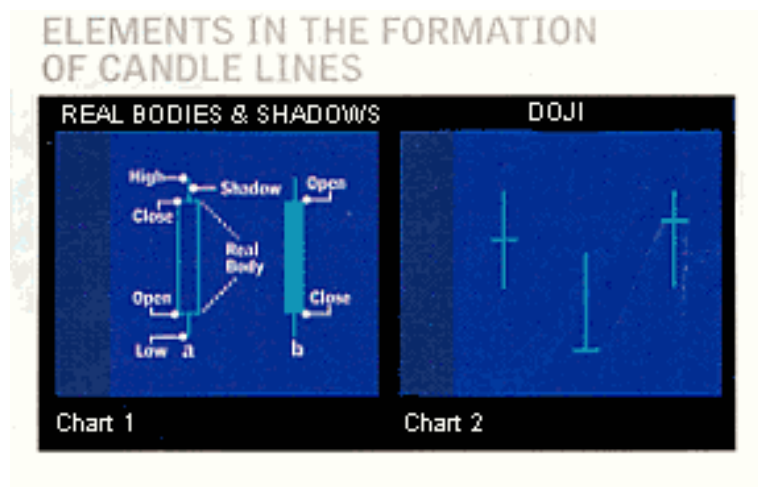
Some of the reasons for the explosive interest in these heretofore secret techniques are:

- Candle chart techniques are easy to understand. Anyone, from the first-time chartist to the seasoned professional, can easily harness the power of candle charts. This is because, as will be shown later, the data required to draw the candlestick chart is the same needed to draw the bar chart (the high, low, open, and close).
- Candle charts provide earlier indications of market turns. Candle charts can send out reversal signals in a few sessions rather than the weeks often needed for a bar chart reversal signal. Thus, market turns ascertained with the aid of candle charts will frequently be in advance of traditional indicators. This should help you enter and exit the market with better timing.
- Candle-charting signals furnish unique market insights. Candle charts not only show the trend of the move, as does a bar chart, but, unlike bar charts, candle charts also show the force underpinning the move.
- Candle-charting tools enhance Western charting analysis. As noted earlier, candle charts use the same data as bar charts: open, high, low, and close. This means that any Western technical tools you now use can also be used on a candle chart. However, candle charts can also give you timing and trading benefits not available with bar charts.

Candle-charting strategies are a tool, not a system, and they are best used in conjunction with those Western technical techniques you are most comfortable with.

As the Oriental proverb states, "A journey of a thousand miles begins with the first step." This chapter is a first step, albeit an important one, on the road to candle chart analysis. You will see how the candles can help make your market analysis more efficient, improve entry and exit timing, and open new, effective, and unique avenues of analysis.

Charts 1 and 2 show samples of candle lines. The broad part of the candle line, called the real body, is the range between the session's open and close. If the close is higher than that session's open, the real body is empty (see a in chart 1). A black real body (see b in chart 1) occurs when the close is lower than the open.



The thin lines over and under the real bodies are, respectively, the upper and lower shadows. The top of the upper shadow is the high of the session; the bottom of the lower shadow is the session's low.

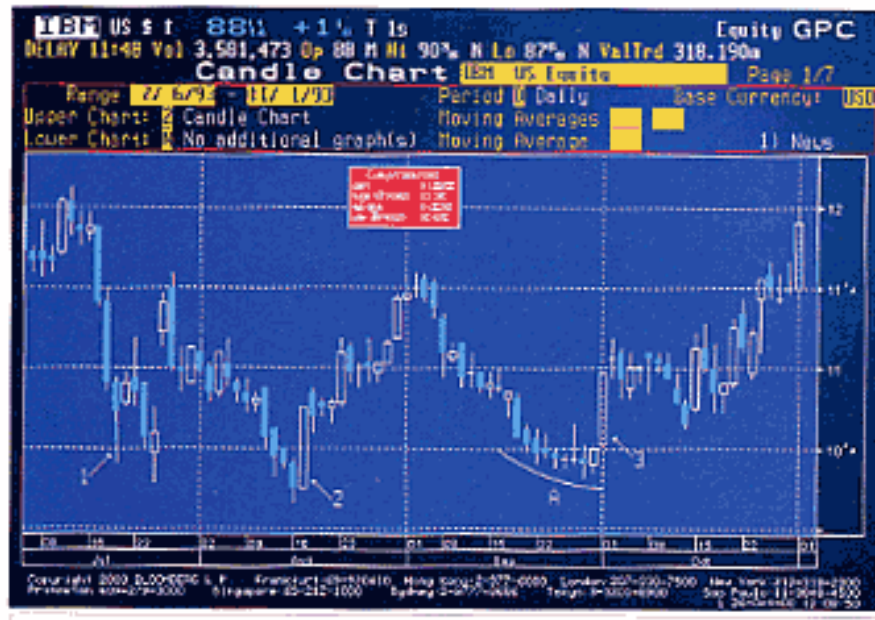


FIGURE 2

Notice how the candle lines in chart 2 do not have a real body. Instead, they have a horizontal line. These lines that look like crosses are called doji. A doji indicates that the open and close are the same (or almost the same). The doji signifies that the market is in balance between the forces of supply and demand. The emergence of a doji in a trending market could be an indication that it is losing its momentum. Doji are discussed in more depth later.



FIGURE 3

Candle-charting techniques can be applied to whatever time frame you now use, from intraday to weekly. Thus, on a 60-minute chart, the real body is the range of the open and close of that

60-minute Japanese, such a session — especially after a sharp advance — indicates that the stock is, as the Japanese say, "separating from its trend."

As previously mentioned, candle charts can be used in any time frame, including small intraday segments. For example, type NDX <Index> IGPC1 5 <Go> for a chart of the Nasdaq 100 Stock Index in which each candle line represents the open, high, low, and close of a five-minute period.

Whether intraday or over several days, the presence of a doji after a forceful rally should hoist a warning flag. The doji can be a valuable warning that as an index or security reaches a peak, it meets enough supply to checkmate all of the demand. If there is a doji after a long white candle, you can use the highest high of the tall white candle or the doji — including their shadows — as signals of resistance.

An example of this technique can be seen in figure 3. Observe how the high of the doji became resistance. This chart shows how resistance can be penetrated intraday, as it was on July 17. But if the bulls cannot maintain enough force to hold the market above resistance into the close, then the resistance area is still valid. A close over that resistance level would mean a bullish breakout. Just as the market is "tired" with a doji after a tall white candle, so it is said to be "refreshed" with a close over the resistance area.

A Japanese proverb states, "His potential is that of the fully drawn bow; his timing is the release of the trigger." The timing of the "release of the trigger" depends on many things beyond those addressed here. For example, there are times when candle signals should be ignored. This is when experience with candle charts comes in. Candlecharts.com analyzes and evaluates candle-charting signals with many other considerations, including the risk/reward of potential trades, candle patterns in relation to current market conditions, and a market's action after a trade is initiated. These and other trading aspects allow for the most fully enhanced power of the candles, and such an integrated approach is recommended for their use. May the candles help enlighten your trading.

*from Bloomberg Markets*