A MARKETPLACE BOOK

The Candlestick Course

STEVE NISON

WILEY

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Foreword

When I was a brand-new trader, I purchased Steve Nison's first book, *Japanese Candlestick Charting Techniques*. As I began to turn the pages, I mused, "Ah, here is a book that talks about charts in a way I can understand and enjoy!"

I'd become overwhelmed by other books on technical analysis—books that threw me into mazes of indicators and oscillators and parabolic trailing stops. Immersing myself in these tomes inevitably brought on one result . . . a nap.

Steve's book was different. In its pages, I discovered the world of candlestick charting, a technique created centuries ago by a Japanese rice trader. The history of candlesticks fascinated me, as did the picturesque names of many of the formations, names such as morning star, hanging man, and dark cloud cover. I soon learned that these patterns revealed much more than their symbolic names. They displayed the trader's most important signal—that of a price trend reversal, or change.

After having stared at cold and stoic bar charts for months, I welcomed the chance to replace them with candlesticks. I quickly adopted the popular method of assigning green and red colors to the positive and negative candles, respectively.

I soon found that these storytellers helped me assess a stock's price pattern rapidly. With the help of other indicators, candlesticks aided me in gauging a stock's possible future movement with a high degree of accuracy. I felt a debt of gratitude to Steve Nison for bringing this powerful information to the Western world.

Please realize that before *Japanese Candlestick Charting Techniques* (often referred to as the "bible of candle charting") was published in 1991, candlestick charting techniques remained deeply hidden in the East. We are fortunate that Steve Nison researched this unique charting system and brought it to Europe and the United States. His efforts literally revolutionized technical analysis of the financial markets.

As a trader or investor, your interest in candle charts will present you with many benefits. First, even if you are relatively new to technical analysis, candlestick patterns are easy and enjoyable to learn. Second, as mentioned earlier, they give you an edge on spotting possible price reversals. Next, combined with other Western indicators, they become a potent decision-support tool that can confirm or enhance buy/sell signals. Finally, the ability to read candle formations adds to your efficiency and effectiveness in reading overall markets and trends. These benefits should have a positive affect on your trading or investing account's bottom line.

Some years after I became a student of candlesticks, I attended a large trading conference held in Ontario, California. By this time, I had written my own book, *A Beginner's Guide to Day Trading Online*, and had another in process, *A Beginner's Guide to Short-Term Trading*. A glance at the conference program told me Steve Nison was speaking that afternoon. I immediately decided to attend his workshop and introduce myself to him.

I enjoyed Steve's lecture, and afterward, elbowed my way through the crowd to the podium. When I introduced myself, he shook my hand, and smiled. "Toni Turner?" he said. "Oh, yes, I know who you are. I bought your book on day trading. It's great." I returned his smile and I glowed for the remainder of the conference.

I am now honored and gratified to say that Steve Nison and I have become good friends. Among the leaders in the financial field, this wise and savvy *gentle*man is held in the highest regard. Whether he is presenting a seminar, writing a book, or teaching an online course, he is the consummate professional. I especially enjoy his jabs of dry humor, which make learning the intricacies of technical analysis pleasurable and downright fun.

This course book has been designed as an interactive study guide. A supplement to Steve Nison's books, video, and online courses, it gives you the framework in which to study and apply candlestick charting techniques. Each chapter includes learning objectives, key terms, content to study, and thought-provoking questions. You'll find the answers to the questions located at the end of each section. Please read those answers in their entirety. They contain additional information you will find useful.

I'm confident you'll find *The Candlestick Course* an enjoyable, hands-on tool you will refer to often, even after you've finished working through its contents.

As a trader or investor, acquiring knowledge and applying it properly is one of the most important steps you can take. The time you invest learning about candle charts will serve you well, and should add to your success in the financial markets.

Good luck and good trading!

Toni Turner, author of *A Beginner's Guide to Day Trading On Line*
and *A Beginner's Guide to Short-Term Trading*
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About the Author

Steve Nison, Chartered Market Technician (CMT), is President of Candlecharts.com. Mr. Nison, the very first to reveal the startling strength of candle charts to the Western world, is the leading authority on the subject. His books, *Japanese Candlestick Charting Techniques* and *Beyond Candlesticks* are known as the bibles of candlestick charts.

Mr. Nison has presented his trading strategies in 18 countries to traders from almost every financial firm, including the World Bank and the Federal Reserve. His work has been highlighted in financial media around the world, including the *Wall Street Journal*, *Worth* magazine, and *Barron's*. He was previously a senior technical analyst at Merrill Lynch and senior vice president at Daiwa securities. He holds an MBA in Finance and Investments.

Candlecharts.com offers a wide array of services and products that complement this workbook, including on-site and Web-based seminars, candlestick software, advisory services, and video workshops.

You are invited to sign up for Mr. Nison's free biweekly educational e-newsletter. Each newsletter details a specific trading tool or technique using real-world examples. To subscribe, please go to www.candlecharts.com.

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Introduction

As the first to reveal Japanese candlesticks to the West, I am pleased and proud that they have now become an important analytical tool for many traders and investors. Candlestick charts, also called candle charts, are especially potent for helping to spot early reversal signals and, when utilized correctly, can help preserve capital while increasing the percentage of successful trades. Candle charts display a more detailed and accurate map of the market than bar charts do. This is because candle charts open new avenues of analysis and offer many advantages over bar charts:

1. Candle charts pictorially display the supply-demand situation by showing who is winning the battle between the bulls and the bears.
2. Like the bar chart, the candle chart shows the trend of the market, but candles add another dimension of analysis by also revealing the force (or lack of force) behind the move.
3. Bar chart techniques often take weeks to transmit a reversal signal. However, candle charts often send out clues of imminent reversals in one to three sessions. The result is that candle charts often provide the opportunity for more timely trades.
4. Because candle charts use the same data a bar chart does (that is, the open, high, low, and close), all Western technical signals used on a bar chart can easily be applied to a candle chart. Since candles offer many advantages over bar charts, using candle charts instead of bar charts is a win-win situation because you get all the trading signals used in bar charts with the earlier reversal signals generated by the candles.

For example, say you have a long stock position. A candle pattern known as dark cloud cover takes shape. In the course of only two sessions, it completes its reversal signal. At that point you'd be wise to take your gains off the table, especially if there are other confirmatory bearish signals. Others, who don't recognize the pattern, are not so fortunate. They may hold their position and eventually lose some—or all—of their profits.

Another advantage of candles relates to their effectiveness on charts on a wide spectrum of markets. Futures, bonds, currencies and equities, and any chart in which sessions include a high, low, open, and close can display candlesticks.

Candle lines and patterns also apply to any time frame. Individual and institutional investors utilize them on weekly charts, swing and intermediate-term traders study them on daily charts, and short-term and day traders examine them on intraday charts.

In addition, candles give instant pictures of market psychology. Early Japanese traders placed great faith in interpreting the emotions of market participants. In today's volatile markets, driven to extremes by the impact of sudden news and events, it's easy to see why awareness of market sentiment and collective opinion is so important.

Unlike bar charts, in which opinion is not so easily spotted, one glance at a candle chart tells you instantly how people feel about a stock or market. A candle's extended real body demonstrates definite bullish or bearish control. Conversely, a small real body indicates indecision or a tug-of-war between the bulls and bears with no apparent winner. (We discuss these aspects in Chapter Two). Both strong opinion and indecision are extremely important signals to market players, and candlesticks broadcast them quickly and efficiently.

ABOUT THE BOOK

A Japanese proverb says, "Like both wheels of a cart." This is an apt way to describe this book. The first wheel of this book provides a basic foundation for those new to candle charts or for those who want to reinforce their understanding. The second wheel consists of the many questions interspersed throughout the book. These provide a quick way to gauge the depth of your understanding and will help solidify the concepts addressed. It is the questions and interactive sections that separate this book from my others.

The Candlestick Course has two main audiences: those who are novices to candle charts and those who are knowledgeable and want to gauge their depth of understanding. It focuses on the critical aspects of candle charts that are so important for successfully harnessing their power. The goal is not to educate you on all the candle patterns and techniques but to show you how to recognize and use the more important and widely used candle signals. Most important, the book offers a way to quantify your understanding of the basic concepts and principles.

Keep in mind that the tools addressed in the course should be only a part of your analysis. If you have favorite Western tools, such as volume or moving averages, stay with them, and add the candle charting techniques to your analysis.

Each chapter contains sections that include learning goals, key terms, discussions for hands-on application, and questions. Please use the questions at the end of each section to check your understanding of the material presented. To maximize the effectiveness of this workbook, I've used a spectrum of questions, from multiple-choice to exhibits and real-world chart examples. While the questions may be short, many of the answers are lengthy so as to aid understanding. Don't skim through the answers; they are designed to be another avenue of education. The more time you spend absorbing the discussions and applying what you've learned by answering the questions, the more effective (think *profitable*) your decisions will be in the real financial world.

Chapters One, Two, and Three describe how to recognize the candle signals, how to use them to gauge if the trend is changing, and questions and answers are given at the end of each section.

Chapter Four has practical applications of the principles discussed in the earlier chapters, as well as trading guidelines.

Chapter Five is unique: We take a five-month daily chart and dissect that chart a day, or a few days, at a time.

In Chapter Six we bring it all together, with charts and related questions to provide real-world, hands-on practice.

A visual glossary of candlestick terms appears at the end of the book.

Chapters One to Three include Side Lights and Key Points. The Side Lights detail interesting facts or added information. The Key Points are answers to the questions I am most frequently asked at my seminars.

A Japanese proverb states, "The depth of the foundation determines the height of the wall." *The Candlestick Course* provides a foundation of knowledge for immediately harnessing the power of candle charts and will serve as a solid foundation for all your future work with candle charts.

CHAPTER ONE

The Essentials

SECTION ONE

Candlestick Overview: Origins and Basic Applications

The financial markets represent some of the most exciting and challenging arenas on earth. Those who participate in these markets conduct research by utilizing two basic types of analysis: fundamental and technical. Fundamental analysts pore over fiscal statements and company reports, and technical analysts scan charts to assess a market, stock, or any other financial instrument.

Though the fundamentals are important, the shorter the time frame, the more important the psychological component of the market becomes. And the only way to measure the emotional aspect of the markets is through technical analysis. Indeed, there are many times when the emotional conditions of the market overwhelm the fundamentals. For example, how many times have we seen the appearance of a positive fundamental only to have that market descend? Even if we have a strong stock based on the fundamentals, what is likely to happen to that stock if the overall market is down sharply? Of course, the negative psychology of the overall market will influence that stock even if its fundamentals didn't change. As Bernard Baruch cogently put it, "What is important in market fluctuations are not the events themselves, but the human reactions to these events." The most potent way you can gauge the emotional state of the market is through candlestick charts.

In the pages that follow, you'll learn how Japanese candlestick techniques promote efficient and effective analysis. As your proficiency in interpreting candle charts evolves, the knowledge absorbed and its application should add to your success in the financial markets. Since the terms *candlestick charts* and *candle charts* are used interchangeably in the trading community, that is how they are used throughout the book.

In this section you will learn . . .

- Background of candlestick charting techniques
- Markets and time frames in which candles are utilized
- Limitations of candle charts
- Importance of risk/reward
- Significance of using other technical tools with candle charts

Key terms to watch for:

- Reversal signals
- Candle lines
- Price targets
- Risk/reward

The use of candlestick charts originated in Japan. Since little or no currency standard existed during those times, rice represented a medium of exchange. Feudal lords would deposit it in warehouses in Osaka and sell or trade the coupon receipts whenever they chose. Therefore, rice became the first futures market.

In the 1700s, Munehisa Homma, a rice trader from a wealthy family, studied all aspects of rice trading from fundamentals, such as weather, to market

SIDE LIGHT

Centuries ago, Japanese merchants were at the bottom of that country's social system, below soldiers, farmers, and artisans. By the 1700s, though, merchants moved up in prominence. Even today, the traditional greeting in Osaka is "Mokarimakka?" which translates to, "Are you making a profit?"

psychology. He subsequently dominated the rice markets and amassed a huge fortune. Homma's trading techniques and principles eventually evolved into the candlestick methodology used by Japanese technical analysts with the start of the Japanese stock market in the 1870s.

The greatest advantage to using candles on your charts, instead of bars, is that single candle lines and multiple candle patterns offer more reliable, earlier, and more effective reversal signals.

Reversal signals are the meat and potatoes of traders and investors. Major trend reversals represent the territory where the most gains are pocketed (and lost). In addition, the ability to identify possible reversal signals on the markets is invaluable for applying money-management strategies to improve profits and, equally important, preserve profits.

No single technical indicator, however, represents the holy grail. Like other indicators, candlesticks have limitations.

As will be detailed later, the candle line is constructed from the open, high, low, and close, which is the same data used in bar charts. Therefore, for a candle line or pattern to offer a proper signal, you must wait for the session's close to confirm it. To hasten the reading, however, rather than waiting for the end of a daily session (for a daily chart), you can look at a shorter time frame (i.e., an intraday chart) and obtain an earlier signal.

Let's say it's midday and you are focusing on a daily chart. Your view of the market is that it may be ready to rally. Rather than waiting for the end of the daily session to see if a bullish candle signal is confirming your outlook, you can switch to an hourly chart and see if any bullish candle patterns formed in the morning on the hourly chart.

Be aware that although candle signals can demarcate areas of support and resistance, they do not offer price targets. This is why it is so important to use classic Western techniques, such as pivot highs and lows, or trend lines, since these can be used to obtain a potential target. Before initiating a trade with a candle signal, always consider the risk versus the reward (risk/reward) of that trade. I repeat: NEVER PLACE A TRADE WITH A CANDLE SIGNAL UNTIL YOU HAVE CONSIDERED THE RISK/REWARD OF THE POTENTIAL TRADE. For example, if there is a bullish candle signal, such as a hammer, the risk (stop-out level) should be under the low of that hammer. Now that we have defined the risk, the next step is defining the potential target. Defining a target can be done in many ways, including a prior high or a falling resistance line. Now we have the risk/reward parameters defined, only then should you decide whether or not to place a trade. Bullish hammer or not, if the risk is $2 and the target is also $2 from the hammer's buy signal (which comes on the close of that session), this is not a trade that warrants action.

As a Japanese proverb says, "His potential is that of the fully drawn bow, his timing the release of the trigger." The timing of the release of the trigger depends on the risk/reward aspect of the trade.

Although candle lines and patterns may offer excellent signals, I advise using them in combination with other technical indicators. Just as several strands wound together are stronger than a single fiber, so is the combined power of several indicators all giving the same buy or sell signal.

Proceed by answering the following questions. Check your answers against the answers at the end of each section. Even if you know the answer to a question without hesitation, take time to read my explanation. You'll find additional information in my answers that will add to your knowledge of candles.

In the next section of this chapter, we'll cover the construction of single candle lines. The basic formations are easy to learn. We'll start by placing emphasis on the length of real bodies, whether short or long, as well as the lengths of their accompanying shadows. With a little practice, you'll soon be able to decipher the important signals candles present.

CHECK YOUR UNDERSTANDING

Questions for Chapter One, Section One: Candle Chart Overview

1. The candlestick chart was invented by
   a. the Chinese.
   b. the Japanese.
   c. no one knows.
   d. the Koreans.
2. Candle charts are believed to have started
   a. in the 1600s, in the rice futures markets.
   b. in the 1870s, with the opening of the Japanese stock market.
   c. in the U.S stock market, in the 1920s.
   d. in China, in the seventeenth century.

3. Candlestick charts can be used for which markets?
  a. Japanese stock market
  b. U.S. stock market
  c. Futures markets
  d. All of the above
4. What time frames *cannot* be used to construct a candle chart?
  a. Daily
  b. Weekly
  c. Five-minute chart
  d. Tick chart
5. A limitation of candle charts is that
  a. they only work with daily or longer-term charts.
  b. they can't be merged with Western technical analysis.
  c. they need a close to confirm a candle signal.
  d. they only work with stocks.
6. Another limitation of candle charts is that they
  a. don't give reversal signals.
  b. don't give price targets.
  c. can only be used on daily charts.
  d. can only be used on equities.
7. Why can you use Western technical analysis techniques on a candle chart?
  a. Because candlestick charts and Western technical analysis evolved at the same time.
  b. Because they both have closing prices.
  c. You can't use Western technical analysis on candle charts.
  d. Because candlestick charts and bar charts use the same data.
8. Before placing a trade based on a candle signal, one should
  a. consider the weight of other technical signals.
  b. consider the risk/reward of the trade.
  c. always look at a 5-minute chart.
  d. Both (a) and (b).

Answers for Chapter One, Section One: Candle Chart Overview

1. **b.** The candlestick chart was invented by the Japanese. The name "candlestick" or candle chart is derived from the fact that the lines look like candles with wicks.
2. **b.** According to my research, the first candlestick charts were used when the Japanese stock market started in the 1870s. However, candlestick techniques likely evolved from earlier technical methodology that started with the Japanese rice futures market in the 1600s. Back then, traders dealt with the psychology of the market rather than specific price patterns. One author, writing in 1755, said, "When all are bearish, there is cause for concern." This is very similar to contrary opinion used today in the trading community. Even in those days, the Japanese understood the psychological aspect of the market.
3. **d.** Candle charts can be used in all markets that have an open, high, low, and close.
4. **d.** Candle charts can be used throughout the trading spectrum, from weekly to daily and intraday charting. For a weekly chart, the candle would be composed of Monday's open, the high and low of the week, and Friday's close. For a daily chart, you would use the open, high, low, and close of the session. On an intraday basis, it would be the open, high, low, and close for the chosen (i.e., hourly) time period. Since tick charts only have closes, we can't use candlesticks on them.
5. **c.** Because candle charts use the open, high, low, and close, we need to wait for the closing price to confirm the candle signal. However, a valuable technique is to look at a shorter time frame to obtain an earlier signal. For example, on a daily chart, we would have to wait for the close of the day to complete the candle line, or signal. If you shift to an intraday candle chart, you need only wait for the close of that intraday session to get the candle signal.
6. **b.** Candle charts cannot give price targets (although they can provide potential support and resistance levels). This is why it is best to combine them with Western technical signals that help provide a target. For example, a pivot high or a falling resistance line may be an upside target once a bullish candlestick signal is given.
7. **d.** Because candle charts and bar charts use the same open, low, high, and low prices, all Western technical analysis techniques can be com-