

USING CANDLESTICK CHARTS TO TRADE FOREX



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INTRODUCTION

Candlestick charts have become an invaluable resource for traders since their invention in Japan in the 1700's. This type of chart has provided Western traders with insight into the future direction of markets since becoming popular in the West in the early 1900's.

Candlestick charts can be an extremely valuable technical analysis resource when engaged in forex trading. Due to their accurate graphical representation, and the different types of patterns formed by just one candlestick or a series of candlesticks, a forex trader that can recognize and correctly interpret candlestick patterns definitely has an edge.

Candlestick charts have unique characteristics that differ from conventional open, high, low and close or OHLC charts. They convey the same OHLC information, in addition to whether the asset or exchange rate had increased or sold off during the period of the candlestick which is shown in color.

Every candlestick on a chart is displayed in one of two colors, which are usually black and white, with black representing a down period and white representing an up period. Red and green are also sometimes used. The Metatrader 4 forex trading platform has an option to display exchange rate movement as a candlestick chart.

CANDLESTICK CHART ORIGINS

Candlestick charts were first devised and used by a legendary Japanese trader named Homma Munehisa of Sakata, Japan in the 1700's. Munehisa was one of the most successful traders of all time. Trading primarily in rice futures, Munehisa was reputed to have made as much as the present day equivalent of \$100 billion during his time trading, making as much as \$10 billion over the course of a single year.

By the early 1900s, this new charting technique was introduced in the West and popularized by Charles Dow, who is a well-known technical analyst, famous for being one of the inventors of the Dow-Jones Industrial Average. The charting technique has been used ever since in the West, mainly by commodity and stock traders. Candlestick charts have more recently become popular in the forex market and are now commonly used instead of the more traditional bar charts.



CANDLESTICK CHART DEFINITION

A candlestick chart uses individual entries called “candles” for specified time periods and they denote the direction of the currency pair’s exchange rate during that time period by color.

The candle consists of two parts. The body of the candle indicates the opening and closing exchange rates. An up move is usually represented by a white candle and a down move is represented by a black candle. The opening price of a white or up candle is on the bottom, and the closing price of a white candle is on top. This is reversed for black candles.

The “shadows” or “wicks” of the candle consist of a line protruding up from the top that visually indicates the high point of the time period, as well as a line protruding down from the bottom of the body that shows the low point of the time period. These shadows show how much the currency pair’s exchange rate moved below the base of the candle body and above the top of the candle’s body.

The wick on the top of the candle represents how high the instrument traded above the opening or closing price, depending on the candle’s color. Similarly, the wick protruding from the bottom of the candle shows how low the instrument traded below the opening or closing price, depending on the candle’s color. Long shadows indicate a wide price fluctuation either up or down.

If the candle is white, then the upper shadow or wick represents how much higher the instrument traded above the closing price for the period represented by the candle, while the lower wick represents how much lower the instrument traded from the opening price for the period represented by the candle.

The same is true but inverted for a black candlestick. The upper wick represents how much higher the instrument traded from the opening price for the period, while the lower wick represents how much lower the instrument traded from the closing price for the period.

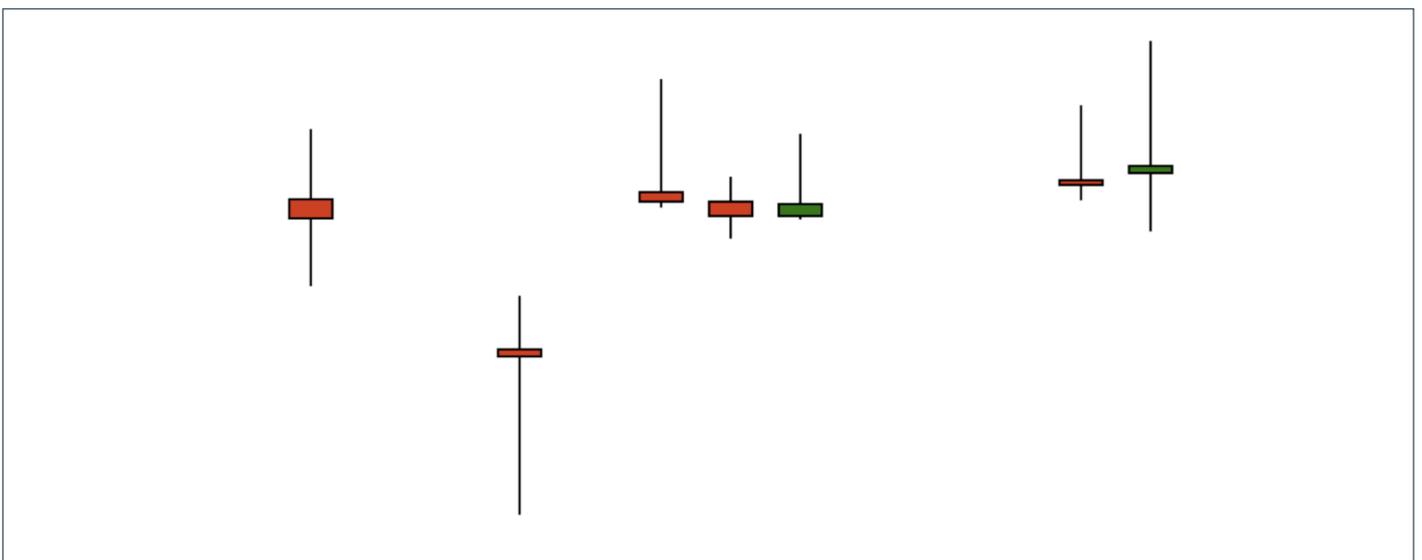
SINGLE CANDLESTICK PATTERNS

Candlestick patterns fall into two categories: continuation patterns and reversal patterns. As their names imply, a continuation pattern shows the prolonging of a trend, while a reversal pattern indicates a turnaround of a previously established trend.

Depending on the number of candles that make up a particular configuration, candlestick patterns also fall into several different types that can convey useful market information to the trader looking to perform technical forex analysis. The simplest type of candlestick pattern consists of only one candlestick, while other patterns are made up of several candles.

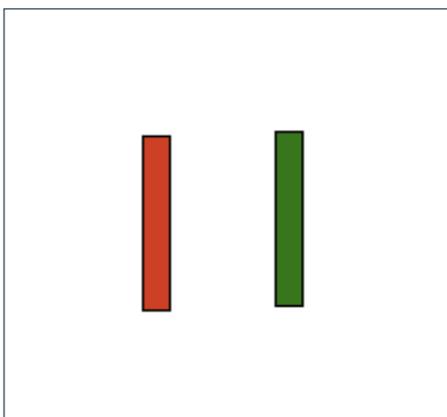
Single candlestick pattern types include:

- Doji - a reversal candlestick pattern that has identical opening and closing prices, with one or two shadows. Because the candle lacks a body, the Doji has the appearance of a cross, a T, or an upside down T. The Doji shaped like a T is known as a Dragonfly Doji, while the upside-down T is called a Tombstone Doji. The cross Doji, with an upper and lower shadow, is called a Star Doji. All of these patterns signal a market reversal is imminent.

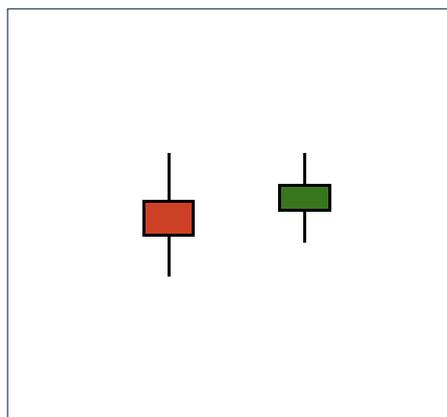


Doji Patterns

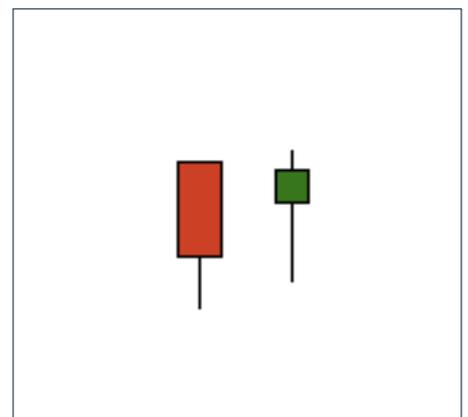
- **Marubozu** - this type of single candlestick pattern can be either a continuation or reversal pattern, depending on the context and the adjacent candlesticks. The Marubozu is made up of a solid body with no shadows. It indicates either strong demand in the market if the pattern is white or abundant supply in the market if the candlestick is black.
- **Spinning Top** - this single candlestick pattern consists of long upper and lower shadows and a small body. A bearish spinning top has a black body, while a bullish spinning top has a white body. This pattern is often indicative of a lack of direction and indecision in the market.
- **Hammer or Hanging Man** - this single candlestick reversal pattern has a small body, either above or below a long shadow. A Hanging Man candle has a black body and a long lower shadow, while a Hammer consists of a small white body with a long lower shadow. Both patterns signal a reversal of the previous trend is forthcoming.



Marubozu Patterns



Spinning Top Patterns



Hammer or Hanging Man
Patterns

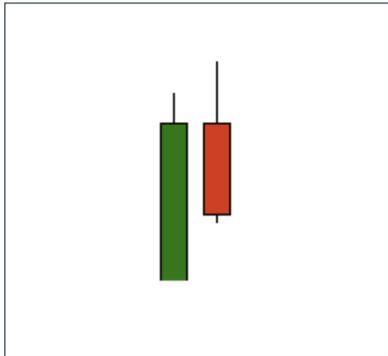
MULTIPLE CANDLESTICK CHART PATTERNS

Candlestick patterns of more than one candlestick offer the trader a unique method of analyzing the market, with many well defined multiple Candlestick patterns having been identified and studied over hundreds of years. These trading signals can be especially useful to forex traders trading the Japanese Yen.

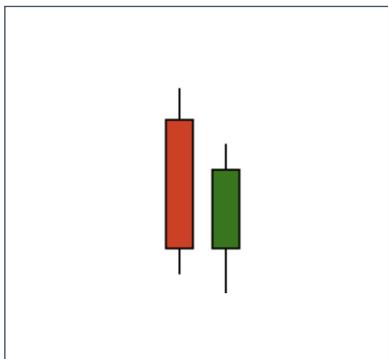
Japanese traders that invented the system gave their patterns colorful names. Each of these patterns incorporates sound trading principles which underline the classic interpretation of each particular candlestick chart pattern.

Having an ability to recognize and understand the interpretation of multiple candlestick patterns is a powerful trading tool for any financial market. Furthermore, for traders in the forex market, knowledge and understanding of Candlestick patterns adds extra depth to their knowledge of technical analysis and their ability to use it effectively while trading currencies.

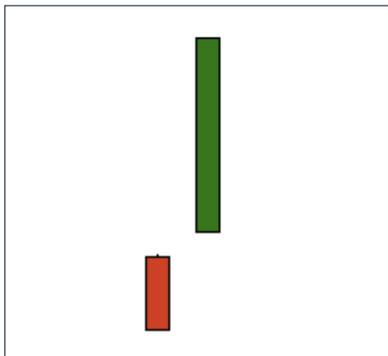
TWO CANDLESTICK PATTERN FORMATIONS



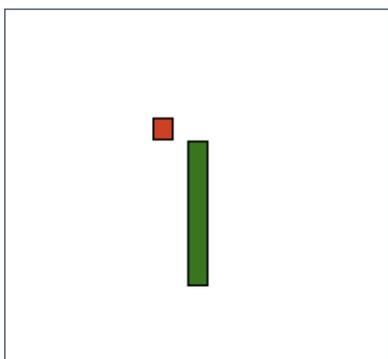
Dark Cloud Cover Pattern



Piercing Pattern



Bullish Kicking Pattern



Bearish Kicking Pattern

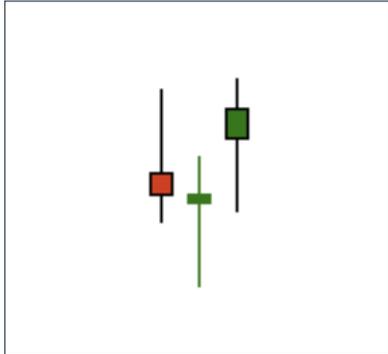
Patterns consisting of two Candlesticks are often bullish or bearish depending on the underlying trend in the market. For example, an Engulfing pattern, which consists of a black candlestick with a small lower shadow being engulfed by a white Marubozu candlestick, is bullish.

Conversely, an Engulfing pattern showing a white candlestick with a small upper shadow being engulfed by a black Marubozu is bearish.

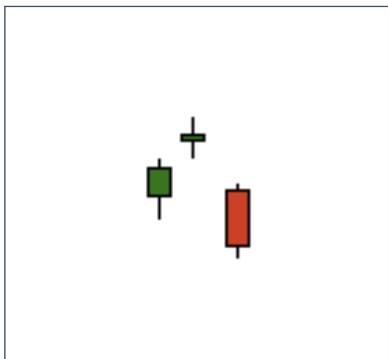
Other Candlestick patterns with two Candlesticks include the:

- **Bearish Harami** - a reversal pattern consisting of a long white candlestick with a large body engulfing a small black candlestick.
- **Bullish Harami** - a reversal pattern consisting of a large black candlestick engulfing a small white candlestick.
- **Dark Cloud Cover** - a bearish top reversal pattern consisting of a white candlestick followed by a black candlestick that opened higher than the previous candlestick's opening.
- **Piercing Pattern** - this bullish bottom reversal pattern is an inverted Dark Cloud Cover and consists of a black Candlestick followed by a white candlestick that opened higher than the previous candle's closing price.
- **Bullish Kicking Pattern** - a two Candlestick reversal pattern consisting of two Marubozu Candlesticks. The first Candlestick is black and closes at the low of the period, while the second Candlestick is a white Marubozu that opens with the market gapping higher than the previous Candlestick's high and then continuing to trade higher.
- **Bearish Kicking Pattern** - a reversal pattern consisting of two Marubozu candlesticks. The first candlestick is white closing at the high of the period, while the second candlestick is a black Marubozu that opens with the market gapping lower than the previous Candlestick's low and then continuing to decline.

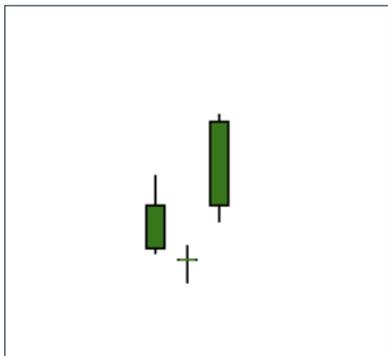
THREE CANDLESTICK PATTERN FORMATIONS



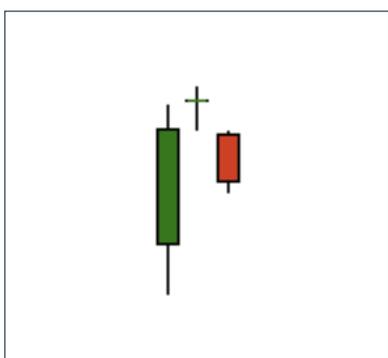
Morning Star Pattern



Evening Star Pattern



Morning Doji Star Pattern

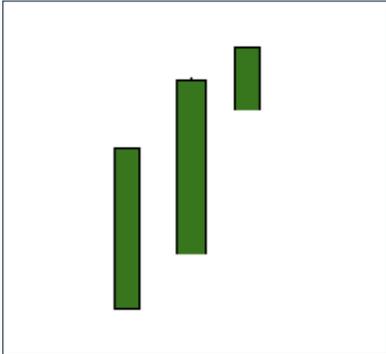


Evening Doji Star Pattern

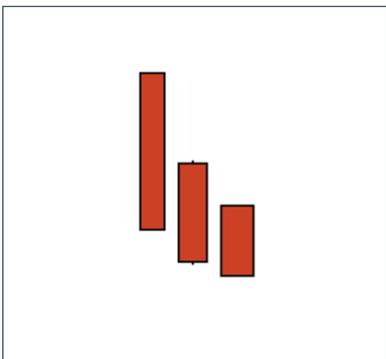
Some Candlestick Patterns containing three Candlesticks include the:

- **Morning Star** - this bullish reversal pattern generally occurs near a market bottom and consists of a long black candlestick, followed by a small white candlestick with an opening below the previous candlestick's close, which is then followed by a white candlestick.
- **Evening Star** - an inverse Morning Star, this bearish reversal pattern generally occurs near a market top and consists of a long white candlestick followed by a small black candlestick with an opening above the previous candlestick's close, which is then followed by a black candlestick.
- **Morning Doji Star** - this bullish reversal pattern generally signals a market low and consists of a long black candlestick followed by a Star Doji with opening and closing prices below the previous candle's opening, which is then followed by a white candlestick.
- **Evening Doji Star** - an inverted Morning Star, this bearish reversal pattern generally signals a market top and consists of a long white candlestick followed by a Star Doji with opening and closing prices above the previous candle's close, which is then followed by a black candlestick.
- **Shooting Star** - a bearish reversal pattern consisting of a candlestick with a long body followed by a Dragonfly Doji with opening and closing prices above the previous candlestick's closing or opening price, followed by a black candlestick, the first candlestick can be either black or white. This pattern is invalidated if the next candlestick after the first three is a black candlestick that gapped lower.
- **Inverted Hammer** - a bullish reversal pattern that generally occurs in a downtrend and consists of a long candlestick followed by a Tombstone Doji with opening and closing prices above the previous candlestick's closing or opening price, followed by a white candlestick. The first candlestick of the pattern can be either black or white, and this pattern is invalidated if the next candlestick after the first three is a white candlestick that gapped higher.

THREE CANDLESTICK PATTERN FORMATIONS



Three White Soldiers Pattern



Three Black Crows Pattern

- Three White Soldiers - a bullish reversal pattern consisting of three ascending Marubozus with higher opening prices.
- Three Black Crows - a bearish reversal pattern consisting of three descending Marubozus with lower opening prices.
- Bullish Three Inside Up - this candlestick reversal pattern begins with a long black candlestick which closes at or near the low for the period. The following candlestick is a short bodied white candlestick that forms the Bullish Harami Pattern. The third candlestick is a white candlestick with a closing price higher than the previous white candlestick.
- Bearish Three Inside Down - this bearish candlestick reversal pattern begins with a long white candlestick which closes at or near the high for the period. The following candlestick is a short bodied black candlestick that forms the Bearish Harami Pattern. The third candlestick is a black candlestick with a closing price lower than the previous black candlestick.

The above chart patterns are just a few of the many potentially useful candlestick chart formations that have been thoroughly researched by Japanese traders over decades, if not centuries, of market observation.

PROS AND CONS OF USING CANDLESTICK CHARTS

The main advantage of using candlestick charts is that levels of accumulation and distribution are illustrated in a clear manner, with ascending shadows showing increasing demand and descending shadows illustrating increasing supply.

Nevertheless, what Japanese candlestick charts do not inform a trader of is the precise sequence of when the instrument or exchange rate rallied and when it sold off. This information can only be gathered by watching the exchange rate's movement on a tick chart, and is one of the few pricing elements not readily apparent in Candlestick charts.

Even though this exact sequence of exchange rate movements does not appear on a candlestick chart, candlestick charting provides a useful visual summary that still gives the forex trader a unique insight into the levels of supply and demand that a line graph or an OHLC graph simply cannot illustrate.

As a result, every trader, regardless of the market they are operating in would be well advised to learn about candlestick charting. For forex traders, this valuable knowledge can make a positive difference to the overall trading results in their forex account.