

 Wiley Trading

Profitable CANDLESTICK TRADING

Pinpointing Market Opportunities to Maximize Profits

SECOND EDITION



Stephen W. Bigalow

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PREFACE TO THE NEW EDITION

Japanese Candlestick charting and analysis is one of the most effective technical methodologies in the universe of technical analysis. This has proven to be truer with more research and investigation since the first publication of this book 10 years ago. The same problems that appeared to keep the Candlestick method out of the limelight back then have persisted to make Candlesticks still a fairly underused method today. Through the years, the number of people who have become proficient users of Candlestick analysis had been minimal, but now there is a small core of Candlestick investors that consistently improve techniques that make Candlestick signals work better. Nearly three decades of using the signals have produced two basic revelations: the signals are extremely accurate, and it is unusual that more people have not become advocates of the technique.

The Candlestick Trading Forum web site has been instrumental in educating investors and showing them how to use the candlestick signals correctly. A decade ago it was evident that one of the most powerful investment techniques has been sitting in front of the U.S. investment community, yet it has not exploded in popularity as one would expect. There is a definite perception about Candlestick trading. It is seen as requiring a long time to learn and become proficient. That is the major reason the majority of investors have stayed away from Candlesticks. That misconception is what spurred the original writing of this book. The Candlestick Trading Forum has become one of the leading web sites in teaching investors how to quickly learn the common-sense aspects of Candlestick analysis. The past decade has shown great improvements in the accuracy of Candlestick signals. The original publication of this book developed a community of investors who have worked well and continue to work well in researching and identifying confirming indicators that improve the results from Candlestick analysis. Other books on the topic were written nearly two decades ago. Those books were informational and well written, but they were published in a vacuum. Once the books were read, each investor was out there on her own. The number of people to confer with after first becoming exposed to the Candlestick method was

minimal. The ideas were new in the United States, and there were few places to turn to for guidance.

For the past three decades, most investors have been aware of Candlesticks. The most common statement is "They know about Candlesticks; they just don't know how they work." An extremely high percentage of chart followers have the Candlestick formations on their charts versus the standard bar charts. This is due to the favorable visual impact. The illustrative properties of the Candlestick chart make viewing much easier.

Four hundred years of research by successful Japanese rice traders constituted the inception of statistical analysis. What may take computers one afternoon to perform, the Japanese rice traders assembled over centuries of time. However, there is a definite benefit involved with human interpretation of these signals. The Japanese traders were able to describe the investor sentiment behind the formation of the signals. This becomes an extremely powerful asset for exploiting profits from markets that involve human emotions.

Being thoroughly convinced that Candlestick analysis surpasses all other technical analysis induced me to eliminate the misperceptions. Japanese Candlestick analysis is definitely not a passing fad. It is here to stay and effectively extracts profits from the trading markets—profits for those who take the little time required to become acquainted with the Candlestick thinking process.

Not only does the knowledge of what a signal looks like benefit the Candlestick-educated investor, but learning the common-sense psychology that formed the signal provides the investor with a whole new perspective into successful investing. Somebody is making huge profits in the markets. It is not what the conventional wisdom advocates: Buy and hold. The big winners are those who have developed successful methods for interpreting when to buy and sell. Candlestick analysis is that method. Read this book, and your investment abilities will be forever improved, improved to the point of not just constantly exceeding market averages, but being able to exploit the indications of the signals to amass extraordinary profits.

Once you learn the Japanese Candlestick technique, your understanding of how investment markets work will dramatically alter your investment psychology. The probabilities of producing magnificent profits will always be in your favor. Learn Candlesticks and reap the knowledge that has led to centuries of successful trading.

Learning how to use any trading technique does not stop when you finish reading a book. The information in this book should be convincing enough for readers to want to improve their investment capabilities. The common-sense aspects built into Candlestick analysis makes learning this technique very easy. The Candlestick Trading Forum web site was established when this book was originally published. The online continuing training allows investors to

gain complete clarity about the profitable aspects the signals produce. Each Thursday night, a free training session reinforces the information learned in this book.

The past 10 years have seen some very relevant improvements in candlestick trading techniques. Whether trading stocks, options, currencies, or commodities, the simple visual depiction of investor sentiment will improve your investment capabilities dramatically.

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This book was made possible through the influences and inspiration of many people. It is hard to decide who to mention first due to the integral input of all during the process of writing this book.

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Although Steve Nison is credited with introducing Candlesticks to the U.S. markets, Greg Morris wrote a couple of books that were instrumental in making Candlestick analysis interesting. His writings and research made for a compelling reason to investigate Candlestick analysis further. He has since become a gracious and generous friend.

Many thanks go to my friends and associates at Enron Corporation in Houston, Texas. Mike Roberts has my heartfelt thanks for the work he did way above the call of duty. His many hours of editing and format suggestions will never be forgotten. I don't know what I would have done without his gracious assistance. Vince Kaminski and Gary Hickerson contributed invaluable access to functional trading concepts and research integration along with intellectual encouragement. Consulting with the experts at Enron Corporation, a high-class, well-run operation, was a fantastic experience while writing the book. And it produced a great number of strong friendships.

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To keep from possibly blemishing any reputations associated with those acknowledged as contributing to the completion of this book, it should be noted that any factual errors or omissions found within this book are solely my responsibility.

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Chapter 1

INTRODUCTION

The learning of books, that you do not make your own wisdom, is money in the hands of another in time of need. Japanese Proverb

Japanese Candlestick analysis is a highly effective but underused investment decision-making technique. Most people in the U.S. investment community are aware of Candlestick analysis, but few understand how or why it actually works. Candlestick charts reveal many insights using well-recognized Japanese Candlestick formations, yet few people understand the ramifications or significance of the signals that are clearly and reliably displayed.

This book was written to educate investors on how to use the Japanese Candlestick technique profitably. The easy-to-follow procedures detailed in this book provide the reader with profit-making techniques that can be learned quickly. More importantly, learning the principles of market psychology underlying the Candlestick methodology will revolutionize the reader's overall investment psyche forever. While this may sound bold and far-fetched, fortunes have been made using the Japanese Candlestick techniques. Knowing how to use the Candlesticks and why they work will immediately improve the reader's investment profitability and permanently alter overall investment perceptions. This newly acquired perception will produce consistent profits along with an associated mental reprogramming designed to maximize investment returns. Once investors become convinced of the reliability of the Candlestick methodology, they also acquire a preprogrammed investment discipline. As a result, Candlesticks add a whole new dimension to enhancing the investor's profit-making abilities.

Most readers will be surprised at how the knowledge gained from a close reading of this book dramatically enhances investment abilities across all investment vehicles and overall trading time frames. More than 400 years of refined reversal-identification and trend continuity projection is now at the reader's disposal. Mastering the Candlestick methodology will be the next major step for maximizing investment returns. Ten years of additional trading research has added valuable revisions to this book. Candlestick signals

have one consistent aspect. They visually identify what is occurring in investor sentiment. Investor sentiment has not changed and will not change over the next 500 years. The addition of computer-generated technical indicators greatly enhances the information provided by Candlestick signals.

Why aren't the Candlestick signals used more? Why, if the signals demonstrate such a high degree of accuracy, are there not many more investors, whether institutional or individual, using these signals? The answer is that the Candlestick technique in the past has been too labor-intensive and required a long and steep learning curve before the investor gained proficiency. This book was written to provide the reader with an easy and fast training program to circumvent those obstacles.

The Benefits of the Candlestick System

Japanese Candlestick signals possess one major attribute that is not present in other technical systems: The signals are created by the change in investor sentiment. This point is the crux of the success of Candlestick analysis. Again, to emphasize the importance of what you have just read: *The signals are created by the change in investor sentiment.* Understanding this truism will make it easier to adapt your investment psychology to this successful trading discipline.

This information can be utilized for successfully trading the S&P 500 e-minis as well as long-term holds. The improved computer programs have greatly enhanced the correct rate ratio associated with Candlestick analysis. Just from the year 2000 to 2010, computer scanning capabilities and execution programs have dramatically improved an investor's capabilities for producing profits. Applying computer-generated trend analysis techniques to the Candlestick signals has greatly improved the signals' effectiveness.

The secrets of the effectiveness of the signals can be learned in a fast and easy process. An investor does not need to be knowledgeable about technical charting to take immediate advantage of the signals. The graphical formation of a signal makes reversals immediately visible. A Candlestick formation provides a visual graphic of investor psychology during a specific time period. For the purpose of illustration in this book, the standard time frame is one day, and the trading entity is stock—equity as opposed to commodity. Investment strategies can be structured, of course, for whatever time period is suited to your trading style: minute-to-minute or monthly. Applicable trading instruments include any vehicle that has the key elements of investor fear and greed.

The graphics of a Candlestick chart have greater appeal than Western charts (commonly known as *bar charts*). The amount of data displayed is exactly the same, but the ease of visual interpretation is dramatically different. The immediate representative depiction of price movement as the result

of investor sentiment is visually in front of you. Recognizing the change in investor sentiment is made easier when the graphics are clear and easy to understand.

Once you become accustomed to the Candlestick charts, all other charting will seem diminished in terms of effectiveness. That is not to say that other charting techniques cannot be used as "alert" functions. Candlestick signals, incorporated with other types of charts, fine-tune the reversal identification process. Watch your profits soar by simply combining Candlesticks with basic technical charting methods.

Candlestick analysis is the process for putting all the probabilities in alignment. The signals and patterns can make analyzing the market indexes very easy. If you know which direction the market should be moving, then you can establish your portfolio positions in that direction. Obviously, all boats are going to rise in a rising tide. The Candlestick signals and patterns help identify which stocks have the better upside potential. If it has been determined that the market indexes are moving positive, the next step for improving the probabilities is starting to see which of these sectors have the strongest reversal signals. From that point, each sector can be broken down into the individual stocks. Simple scanning techniques will identify which stocks have the best and most forceful reversal signals.

When you are able to identify the direction of the market, identify which sectors are moving best with the direction of the market, and finally scan for the strongest stocks in that sector, the probabilities are now greatly in your favor. These capabilities allowed the Candlestick investors to make an immense amount of money in the market decline from 2007 to March of 2009. Upon witnessing the market bottom in March of 2009, strong returns were made during the uptrend going into 2010. Fortunately, utilizing Candlestick analysis is not rocket science. It is merely utilizing the graphic depiction of investor sentiment.

A Successful History

Knowing the history of the formations inevitably imparts confidence in the Japanese Candlestick technique. Since Japanese rice traders developed the system long ago, it must have credible features. The history of the rice traders who developed the signals reinforces that assumption. With its 400 years of development, the Candlestick methodology got its major refinement in the mid-1700s.

Kosaku Kato (1716–1803) was born in the city of Sakata (now Tamagata Prefecture) during the Tokugawa Period (Eighth Shogunate). Adopted by the Honma family, he became known as Sokuta Honma. His successful interpretation of the Candlestick formations made him the most feared and respected rice trader in Japan, and the wealth he produced for his family became legendary.

Success is a ladder that cannot be climbed with your hands in your pockets. Japanese Proverb

Songs were written about the Honma family's untouchable wealth, as reflected in the lyric "Nobody could ever be a Honma, but everybody would like to be at least a lord." Their mastery of the rice market price movements was popularized in verses such as "When it shines in Sakata, it's cloudy in Dojima. And in Edo (Tokyo), it rains." In other words, when there is good weather in Sakata (the growing region), the prices fall on the Dojima exchange and rice prices plummet in Tokyo.

Honma's methods are divided into two categories: the Market Sanmi No Den and Sakata's Method. The Market Sanmi No Den rules can be summarized as:

- A. Without being too greedy, analyze the time and price ratio by reviewing its past movements.
- B. Aim at selling at the ceiling and purchasing at the bottom.
- C. Increase the position after a rise of 100 bags from the bottom or 100 bags from the top. (The price stayed the same; the volume measured in bags changed in those days.)
- D. If a trade is not working, analyze it as fast as possible. Once it is discovered to be a bad trade, liquidate it immediately and rest before putting on the next trade.
- E. Liquidate 70 to 80 percent of a profitable trade, liquidating the remainder after the price has indicated a top or bottom.

The Market Sanmi No Den rules A, B, and C require that the investor study charts. Rules D and E represent investing philosophies.

Sakata's Method is the first verifiable beginning of pattern recognition.

Although Honma did not originate Candlestick analysis, his rules and philosophies gave the technique credibility. In his early fifties, Honma wrote 160 rules that became the cornerstone of Japanese Candlestick analysis, as well as the basis for Japanese investment disciplines.

Through Candlestick recognition, the name Sokyū Honma is associated with successful investing in Japan, in the same way that the name Bill Gates is associated with successful computer program marketing in the United States. Learning to "consult" the market, as Honma did a few hundred years ago, will greatly enhance your investing probabilities in the markets today.

Consult the Market about the Market

When analyzing the market, pay attention to the market movement itself—in other words, *consult the market about the market*. The would-be investor has to follow the market movement like a cat that wants to catch the mouse.

Charts reflect the past. Theoretically, it is not possible to predict the market's future; yet, analyzing identifiable patterns as a prelude to a high probability result is as close as an investor can get. Repeating patterns are not 100 percent accurate, but visually verifiable probabilities can adjust the odds immensely in your favor. Identification of certain events provides a basis for predicting an occurrence. Otherwise, admonitions such as "Red sky at night, sailor's delight" would not be in existence. Hundreds of years of weather observations produced a high probability for a reliable prediction about tomorrow's weather. The same historical observations have made Candlestick signals highly accurate.

Commodities and currencies are much easier to evaluate with Candlestick signals. Both have the benefit of not having multiple influences to affect their price move. But stocks have confirming indicators that allow an investor to be in the correct trades at the correct time. The combination of Candlestick signals and confirming indicators allowed investors to make very good profits during the market decline from the fourth quarter of 2007 to the bottom during the first quarter of 2009. Even for investors who do not like to short, the introduction of the short funds, especially the leveraged short funds, made for very good profitability during that time frame.

"Let the markets tell you what the market is going to do"—the Japanese rice traders have made this very possible. The revisions of this book will demonstrate how to take advantage of the accurate trend analysis capabilities built into Candlestick signals.

Candlestick Charts versus Bar Charts

After using the Candlestick charts, you will find that bar charts do not provide the same clarity. Despite the fact that the same information is being conveyed, the Candlestick charts, through greater visual appeal, provide information that is more communicative than bar charts. Candlestick patterns allow the investor to identify pertinent information in a relatively fast and unencumbered manner.

Bar Charts

A vertical line, seen here in Figure 1.1, represents the daily price movement on a bar chart. The top of the line is the high of the daily trading range; the bottom is the low of the day. A notch to the right side of the line represents the closing price. In more recent years, a notch has been added to the left side of the line to designate the opening price. Opening prices did not become readily available in stock transactions until the early 1990s. Futures and commodity charts have had access to this information for a longer period of time.

Internet charting services and software vendors provide a large number of additional technical indicators along with the charts. Fortunately, we are

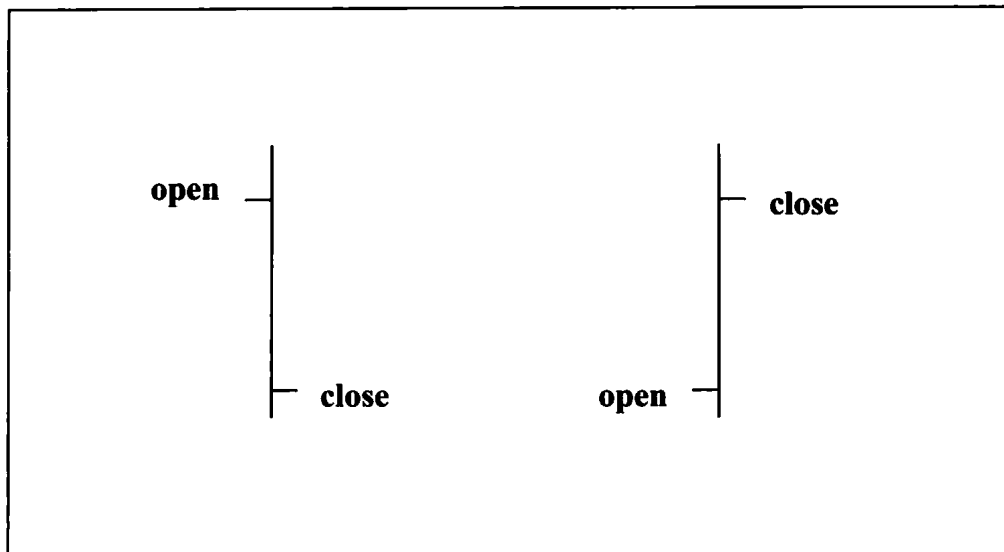


Figure 1.1 Daily price movement.

living in a time when software packages are constantly being developed to provide more and more technical information. This is mentioned to illustrate the benefits of technology that can be applied to better enhance the investor's evaluations. Upon becoming accustomed to the Candlestick charts, an individual can fine-tune the probabilities of successful trades many times greater than what the capabilities would have been just a few short years ago.

Candlestick Charts

Using the same information provided in a bar chart, Japanese Candlestick charts provide immensely more illustrative graphics. As in bar charts, the open, close, high, and low are all that is required. Yet, the manner in which they are depicted provides a great amount of information to the Candlestick analyst.

Forming the Candlesticks

Horizontal lines represent the open and the close. (See Figure 1.2.) Once both lines are added to the chart, they are boxed. This box is called the BODY. If the close is higher than the open, the body is white or empty. If the close is lower than the open, the body is black or filled. Keep in mind, this does not necessarily mean that a white body represents that the price was up for the day or that a black body represents that the price was down for the day. The body color only illustrates where the close was compared to the open.

The contrasting colors of the bodies provide for rapid visual interpretations. If a declining column of dark candles is interrupted by the appearance

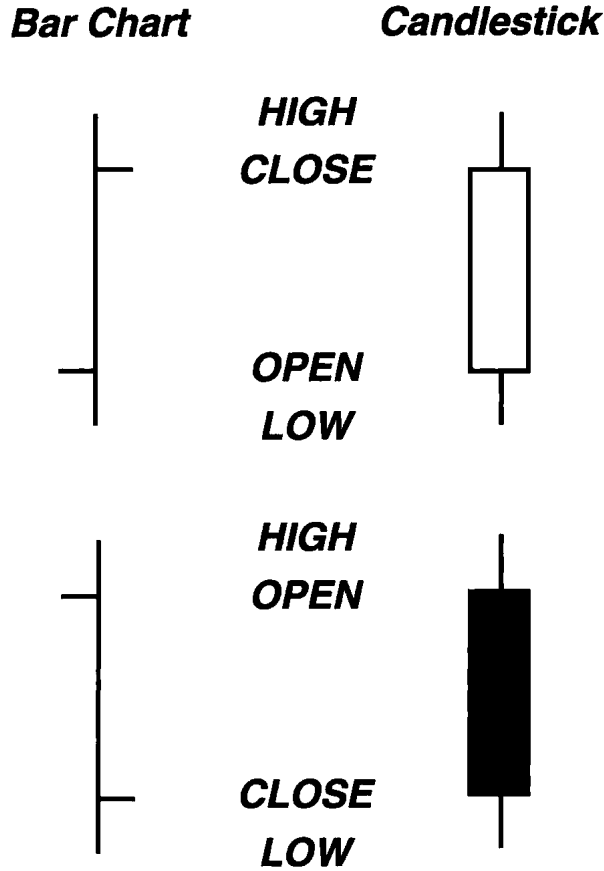


Figure 1.2 Forming the Candlesticks.

of a white candle, this attracts the eye immediately. This is something that would not occur when viewing conventional bar charts.

The lines extending from the body represent the extremes of the price movement during the day. These are known as the *shadows*. The shadow above the body is known as the *upper shadow*. In some Japanese analytical circles, the upper shadow is also described as the *hair*. The shadow below the body is known as the *lower shadow* or the *tail*. The length of the shadows has important implications for the strength of reversal moves.

The bodies with shadows look much like candles—thus the name Candlesticks. But don't let the unsophisticated name throw you. The information provided by the formations puts the Candlestick analyst giant leaps ahead of other technical analysts. The colors of the boxes are not important. For visual clarity, white and black easily show contrast. Some computer software uses green for up and red for down. The purpose of the chart is to provide a clear indication of what signals are being formed.

Figures 1.3 and 1.4 are included for comparison purposes. Once you have become accustomed to the Candlestick charts, the visual aspects of the Candlestick charts will make all other charting techniques seem obsolete.



Figure 1.3 Bar Chart.



Figure 1.4 Candlestick Chart.