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# The Secrets of Candlestick Charts Unveiled

By GFT



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## INTRODUCTION

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Over the last few decades, traders have begun to use candlestick charts far more frequently than any other technical analysis tool.

Candlestick charts have a simple, easy to analyze appearance. Unlike bar or line charts, candlestick charts provide more detailed information about the market at a glance. With this information, you can use candlestick charts, one of the seven types of charts available within DealBook® 360, to make decisions about the market quickly and with more confidence.

## THE FIRST LIGHT: A BRIEF HISTORY OF CANDLESTICK CHARTS

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The principles behind candlestick charting were first developed over 250 years ago by Munehisa Homma\*, a Japanese businessman who traded rice futures.

Homma realized that the rice futures market was strongly influenced by the emotions of the traders. He knew that traders tended to hold on to their positions for as long as the market moved their way. If something happened in the market and the traders lost confidence, they would reverse their positions quickly.

Homma understood that what happened between the open and the close of rice futures was essential to technical interpretation, so he developed a process to reliably track trader confidence and identify trends in the market.

These principles, which form the basis of modern candlestick charting, were so successful that Homma became very wealthy and the number of people who used his principles to trade grew. Over time, Japanese traders found Homma's principles so useful that he received the title of honorary Samurai.

## BE NIMBLE: THE BENEFITS OF CANDLESTICK CHARTS

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Today, candlestick charts are one of the most common tools traders use for technical analysis. Most traders prefer to use the candlestick chart because it can help them to:

- **Determine the current state of the market at a glance.** Just by looking at the color and length of a candlestick, traders can determine instantly if the market is strengthening (becoming bullish) or weakening (becoming bearish).
- **See the direction of the market more easily.** On a candlestick chart, the color and shape of the candlestick can help traders determine if an uptrend is part of bullish momentum or simply a bearish spike.
- **Identify market patterns quickly.** Candlestick charts display specific bullish and bearish reversal patterns that cannot be seen on other charts.

\*Many histories of candlestick charting refer to Munehisa Homma as Munehisa Honma. Some texts even state his name as Sokyū Homma or Sokyū Honma. We refer to him throughout the document as Munehisa Homma.

## FLAME ON: CANDLESTICK FEATURES

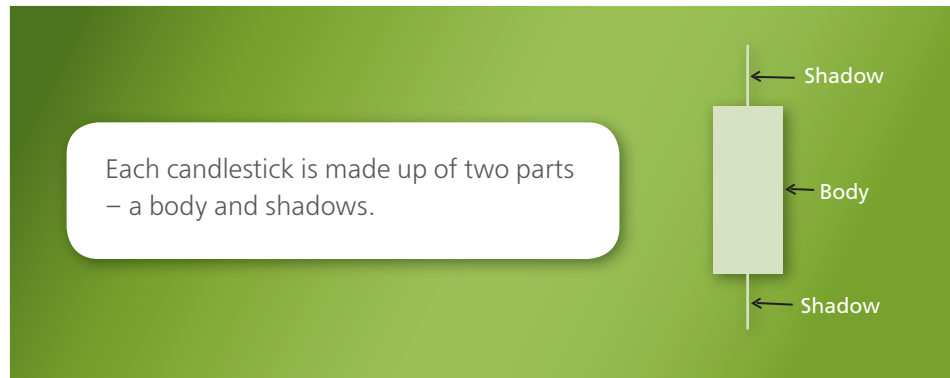
When you open a candlestick chart, you may notice that it looks similar to a bar chart.



At this point, you may be wondering, “So, how can candlestick charts tell me more about the state of the market?” We’ll discuss this in a moment. First, let’s take a closer look at candlesticks.

## ANATOMY OF A CANDLESTICK

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The candlestick body is a rectangle that represents the level of trading activity for a specified period. For example, on a chart with a ten minute time scale, a candlestick would represent all of the trading activity in a ten minute period on the market.

Candlestick shadows (also called tails or wicks) are the thin lines above and below the body. An upper shadow displays how high trading went while a lower shadow shows how low it went.

## READING CANDLESTICKS

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The appearance of the candlestick body and its shadows provide a lot of information about the state of the market and where it's going.

The length of the candlestick body shows where the majority of the trading took place. A long body suggests that the market is trading heavily in one direction, while a small body indicates lighter trading.

In our examples, you'll notice that green candlesticks appear in an "up" candle; in other words, the currency closed higher than the previous candle's close. Red candlesticks show a "down" candle or that the currency closed below the previous candle's open.



Figure 3. Candlesticks of up trends are colored green and those of down trends are red.

Traditionally, up trends were represented by white candlesticks, while down trends were depicted by black candlesticks. Today, traders using DealBook® 360 can select any color combination they want. For our purposes, we'll continue to use the green and red colors to show ups and downs.



Figure 4. Examples of long and short bodies and shadows on the daily euro/dollar chart.

The appearance of shadows can also tell you which way the market is heading. Long shadows show that trading went far past the open and close values while short shadows indicate that most of the trading happened near the open and close. Typically, short shadows mean that there is little change in the market direction, but a long shadow can signify a big change.

## IDENTIFYING CANDLESTICK PATTERNS

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Being able to read the candlesticks in a candlestick chart can help you see the current state and direction of the market. This can help you make decisions about the market now, but how about what the market will do in the future?

Candlestick charts can also display specific bullish (strengthening) and bearish (weakening) patterns that cannot be seen on other charts. These can help you find potential market opportunities and make decisions about what to do in the future. Let's look at a few patterns that may help you.

## ONE-DAY REVERSAL PATTERNS

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One pattern that traders frequently look for is a **candlestick reversal pattern**. You may already know that a reversal indicates a sudden change in the market direction. For example, a bullish reversal means that the market may move up from a down trend while a bearish reversal indicates that the market is shifting down from an up trend.

A one-day reversal is usually a signal that the general direction of the market for that day is changing. While one-day reversals are significant to traders for short-term trading, they know this pattern can also be the starting point of a more long-term market reversal.

One of the most recognized one-day reversal patterns is the doji. On a candlestick chart, a doji resembles a cross because it has little to no body.



When a doji appears on a chart, it usually means the opening and closing prices of the candlestick were identical. This means that the market reached the end of the trend and temporarily balanced. Usually, the markets tend to reverse after a doji appears, although significant market pressure on one side may postpone the reversal briefly.

There are many variations of the doji. For example, the **long-legged doji** has long upper and lower shadows that show the level of trader indecision in the market.

When a doji appears midway through an up or down trend, the pattern is called a **rickshaw man**. Often, the appearance of this doji means that the trend is about to reverse suddenly.

A **paper umbrella** is a doji candlestick with a small body and a long lower shadow. When this type of doji appears at the top of an uptrend, it is called a **hangman**. When a paper umbrella appears at the bottom of a downtrend, it is called a **hammer**.



Figure 5. Example of a hangman in dollar/yen.

A doji may also appear with other patterns that indicate reversal trends in the market. Whenever a doji appears, traders should watch the market and prepare for a reversal.



## TWO-DAY CANDLESTICK REVERSAL PATTERNS

Another type of candlestick reversal pattern is the **two-day reversal pattern**. Again, this kind of reversal signals that the general direction of the market is changing, but the change occurs over two days. These patterns appear at an extreme up or down trend in the market, so many traders watch for these patterns so that they can manage their own position in the market.

Like one-day reversal patterns, a two-day reversal pattern can be either bullish or bearish. In this section, we'll look first at bullish and then bearish reversal patterns.

The most common bullish reversal patterns are the **bullish engulfing pattern** and the **piercing line pattern**.



Figure 6. Example of a bullish engulfing pattern on the daily dollar/yen chart.

The **bullish engulfing pattern** occurs at the end of a down trend and consists of a bullish candlestick with a body longer than the previous day's bearish body. Bar chart users may recognize this as a bullish key reversal. Note that the bullish engulfing candlestick doesn't have to reverse the entire previous bearish candlestick – only its body.

The **piercing line** is a miniature version of a bullish engulfing pattern. Following a bearish movement in the markets, the currency opens at the same level as the previous low and closes at or above the 50 percent level of the previous candlestick's range.



Figure 7. Example of the piercing line seen on the Australian dollar/Japanese yen chart.

In contrast, the two most common bearish reversal patterns are the **bearish engulfing pattern** and the **dark cloud cover pattern**.



Figure 8. A market example of the bearish engulfing pattern in sterling/dollar.

The **bearish engulfing pattern** appears at the high of an uptrend and is formed by a bearish candlestick with a body longer than the previous day's bearish body. It closes below the low of the previous candle.

The **dark cloud cover pattern** occurs at the top of an up trend and consists of one long bullish candlestick followed by two bearish candlesticks, the first long and the second short. The long bearish candlestick, which is considered the “dark cloud,” must have a closing price within the price range of the bullish candlestick, but is also below the midpoint of bullish candlestick’s open and close prices.



Figure 9. An example of a dark cloud cover pattern on the euro/Norway kroner daily chart.

Again, recognizing these reversal patterns in a trend helps traders make decisions about their position and prepare for movement in the market.

## THE “WAIT AND SEE” PATTERNS

While most patterns on the candlestick chart can show you possible up or down trends, certain patterns can also indicate when traders should slow or stop trading and wait for clearer market signals. These are called **wait and see patterns**; two of the best known are the **inside range** and **tweezers**.



Figure 10. Three inside ranges in euro/dollar before the pair broke higher.

An **inside range** is a pattern where the open and close of one candlestick happen within the body of the previous candlestick. This pattern can appear over two or more days and often the consecutive ranges face in opposite directions.

When an inside range occurs, the market movement is slight and provides little indication of its direction. For traders, this pattern usually means securing their positions and waiting until a new pattern in the market emerges.

The **tweezers** refers to two consecutive candlesticks that have matching highs or lows. When the consecutive candlesticks have matching highs, the pattern is called a **tweezers top**. When candlesticks have matching lows, the pattern is a **tweezers low**.

The tweezers pattern indicates that a currency is rising to a specific price, falling to a lower price, and then repeating the rise and fall. As with the inside range pattern, traders who can see a tweezers pattern in the charts should slow and even possibly stop their trading until a clearer trend in the market emerges.

## SAKATA'S FIVE METHODS

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Before Homma developed candlestick charting, traders in his hometown of Sakata, Japan followed a set of rules and methods called Sakata's Constitution. Homma later used a set of patterns in this constitution, called **Sakata's Five Methods**, as the basis of his candlestick charting principles. Today, these patterns still help traders identify simple trends in the market.

Sakata's Five Methods consist of five specific patterns: **three mountains, three rivers, three gaps, three parallel lines**, and **three methods**. What's the significance of three? Japanese culture at the time believed three to be a significant, even divine number. Homma also believed that when traders found a promising trade, they should wait for three days. If the trade still looked good after three days, it would then be profitable.

As you read the description of these patterns, some may already sound familiar to you. Nonetheless, these candlestick formations can help you predict simple trends in the market.

The **three mountains pattern** shows three candlesticks moving up or down in a trend. Usually, this pattern indicates that the trend is about to end. If the middle candlestick is higher than the other two, the formation becomes a **three Buddha** formation or a head-and-shoulders pattern. Traders should plan for the market to reverse its direction.

The **three river method** also indicates a reversal pattern. This pattern looks different depending on if the reversal is bullish or bearish. The bearish version of this pattern, called a three river evening star, shows a long bullish candlestick, a short, bullish candlestick (also called an island or a star), and a bearish candlestick where the low is below the midpoint of the candlestick body on the first day. The bullish version, called a **three river morning star**, shows a long bearish candlestick, a short, bearish candlestick, and a bullish candlestick where the low is below the midpoint of the candlestick body on the first day.

The **three gaps pattern** appears when the trading is high. A gap happens when the opening price moves significantly higher or lower than the close of the last candlestick and creates an empty spot on the chart. The three gaps pattern usually means a trend is over and is about to change. After the third gap of this pattern appears and the market reverses, the market moves enough to close the length of the second gap.

The **three parallel candlestick pattern** refers to three consecutive candlesticks that are going the same way and have a similar height. This means the ongoing direction is expected to continue and traders should plan accordingly. When the three candlesticks are bullish, the formation is known as the **three soldiers**; when bearish, the pattern is called the **three crows**.

The **rising three method** is a pattern that shows a long candlestick followed by three short candlesticks moving in the opposite direction. These are followed by another long candlestick that continues the original trend.



Figure 11. A market example of the three rising method in the dollar/yen.



In Figure 11, you can see a bearish rising three: a bearish candlestick is followed by three bullish candlesticks and then another bearish candlestick. This pattern usually means there is inactivity in the market and that a lot of tight trading is happening.

## SUMMARY AND CONCLUSION

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While candlestick charting may seem like a lot to learn, don't worry. As you read candlestick charts, these common patterns will become more familiar to you. Over time, you'll learn about other patterns and combinations of patterns that you can use to determine the state of the market, anticipate its possible direction, and identify market patterns.

One of the best ways to analyze candlestick charts and test your knowledge of patterns is by opening a GFT practice trading account. If you already have a live account with GFT, you can also view candlestick charting on historical data. DealBook<sup>®</sup> 360 enables you to view candlestick charts in a range of time scales and even compare other charting types. In no time at all, you'll see why candlestick charts are one of the most popular and truly useful technical analysis tools.

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