RUSS HORN
Forex Master Method

Presents

Japanese Candlestick

Patterns

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JAPANESE CANDLESTICK PATTERNS

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JAPANESE CANDLESTICK PATTERNS

Introduction

Japanese Candlestick Charting is definitely one of the most common ways of charting used today. This can be attributed to the fact that throughout history, candlestick charting has provided an easy, practical and simple means of interpreting price.

This kind of charting is so-called because it was first used by the Japanese to trade rice since the 18th century. Munehisa Homma, the "Father of Japanese Candlestick Charting", is the Japanese rice trader who first used this charting technique to predict price movement based on historical data. It was Steve Nison who discovered how the Japanese used this charting method and from his work, the whole world came to know about candlestick charting.

Although Homma's technique has evolved over time, candlestick charting has been used throughout the world. There are many reasons that this form of charting gained popularity since its discovery and remains widely used today.

Japanese candlestick charting is applicable to any tradable market, and it allows analyzing the markets with other technical analysis tools, such as technical indicators and studies that can be drawn on the chart.

Not only that, it also allows traders, investors and financial institutions to analyze price behavior at an artistic point of view, and that is the candlestick chart patterns, in conjunction with other forms of technical analysis to make better decisions in trading.

It's quite remarkable that one or a set of candlesticks with a particular appearance and arranged in a specific manner can reveal the market sentiment of the given timeframe. Not only that, it can also show which direction the market will most likely move in accordance to the timeframe it is found.

Definition of Terms & Related Concepts

In this section, we will come to terms with the concepts on Japanese Candlesticks and Charting. I'm sure you're quite familiar with them, but it's always good to review the basics before we talk about more complicated stuff.

Let's start with a candlestick. A **Candlestick** is a visual representation of a set of data concerning price movement. This data includes the open, high, low and close prices of the day. A complete candlestick is composed of a "real body" and a "shadow" on both ends (also known as wicks or tails).

The image below shows the parts of a Japanese Candlestick.
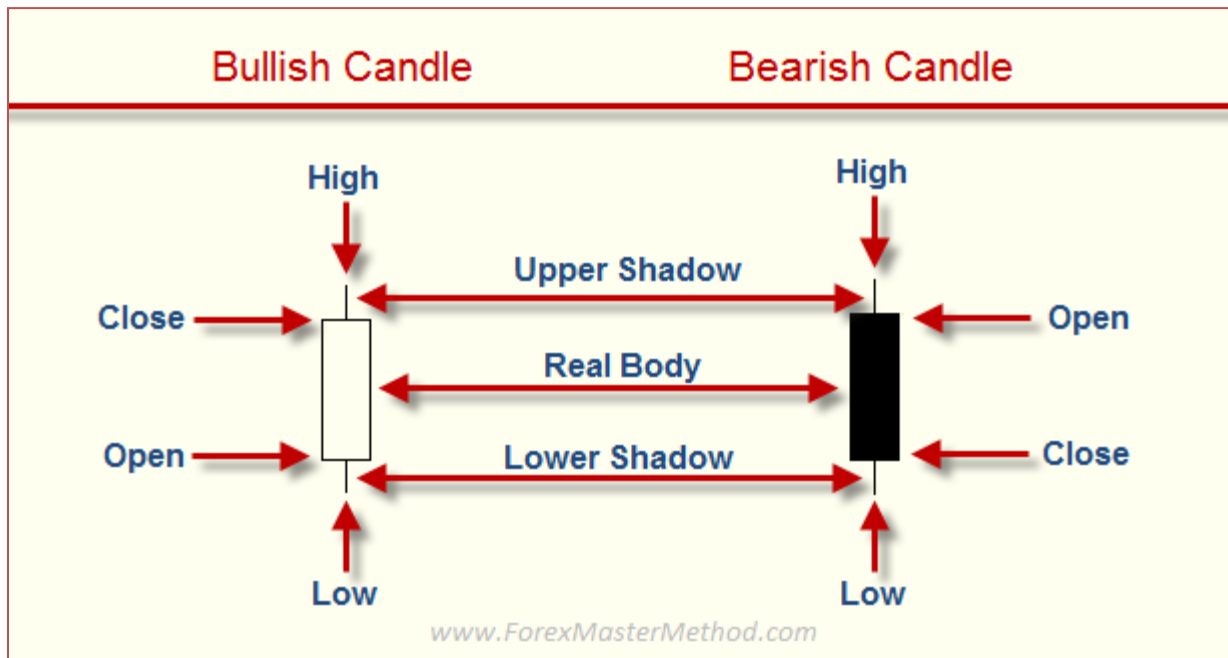
The **Real Body** is rectangular in shape and starts from the open price and ends with the close price. The upper shadow indicates the high prices while the lower shadow indicates the low prices reached during the specific time frame. Some types of candles don't have a real body, a wick or both, but we'll come to that later.

The color of a candlestick's body displays the direction at which the price is going. Traditionally, a white (a.k.a. hallow) candlestick is bullish, while a black (a.k.a. filled) candlestick is bearish. Because of modern charting software, we can now customize our charts according to our preferences. Usually, a lighter color is used for bullish candles (e.g. green or blue) while a darker color is used for bearish candle (e.g. red).
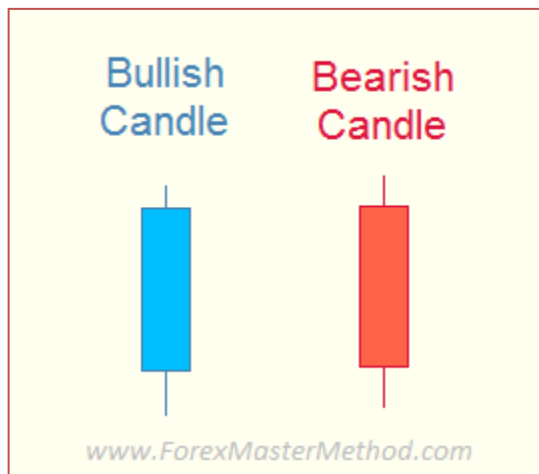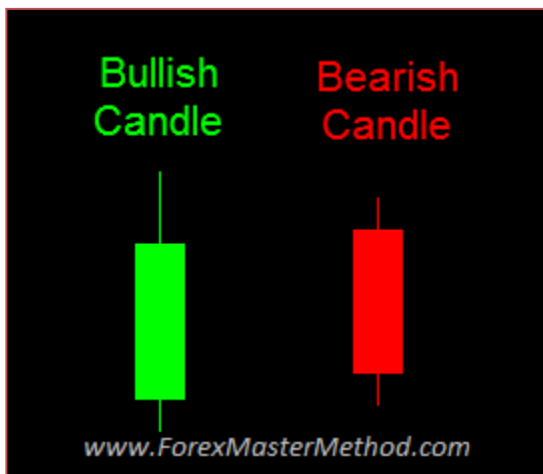
The length of a candlestick's body also indicates the strength of price movement. Long bodies indicate that there is strong buying or selling pressure. In the image below, the long white candle indicates that there is strong buying pressure while the long black candle indicates strong selling pressure. The candles with short bodies indicate little buying or selling movement, indicative of consolidation.
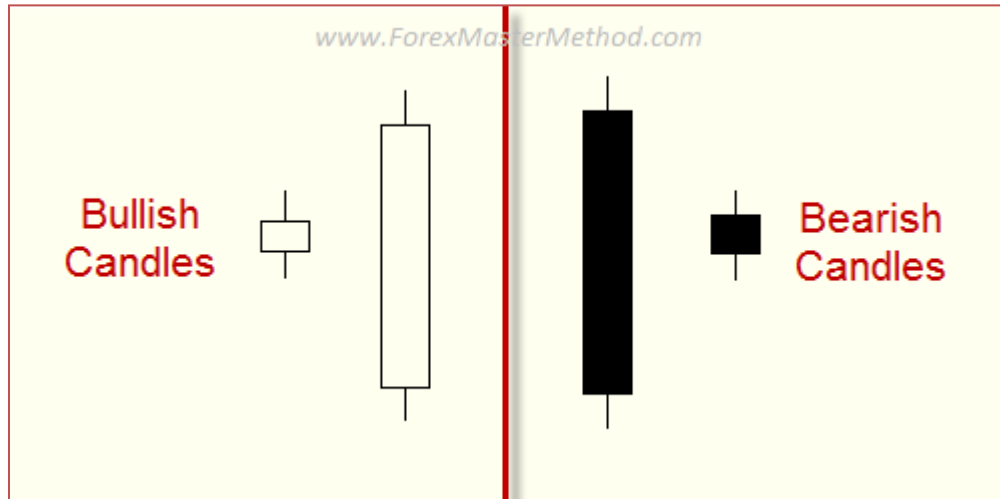
The **Shadows** of the candlestick also indicates some information depending on its presence and length. A bullish candle without an upper shadow indicates that the highest price reached is equal to its close. Conversely, a bearish candle without an upper shadow indicates that the highest price is equal to its open price. Short shadows indicate that price movement occurred near the open or close of the candle.

Long upper shadows indicate that the price has moved higher than the close (bullish) or open (bearish) of a candle. If a candle has a longer upper shadow, it means that the buyers pushed the price up but the sellers were able to close the candle at a much lower price. These types of candles are usually found when the price was going upward and is about to reverse (or retrace).
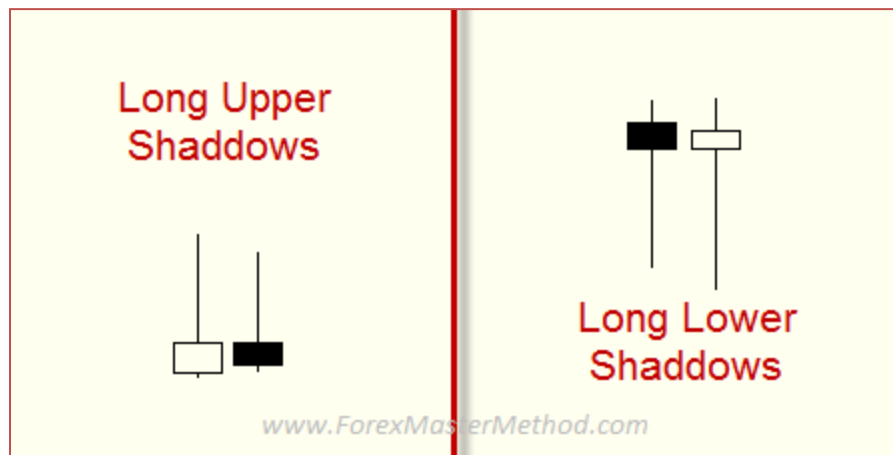
On the other hand, long lower shadows indicate that price has moved lower than the open (bullish) or close (bearish) of a candle. A candle with a longer lower shadow indicates that the sellers pulled price to a much lower level but the buyers managed to close at a higher price. Candles with longer lower shadows usually appear when the price was going down and it's about to reverse (or retrace).

A candle's body may be more significant than its shadow, but the information you get from both parts must be taken into consideration. It is also important to consider a candle's position relative to the candles surrounding it in the chart when analyzing market behavior. The reoccurring patterns on the charts help traders identify where the price will most likely go. This is what forms candlestick patterns.

How long a candlestick is formed depends on the timeframe. For example, a candle on a 1 Minute chart takes 1 minute to complete before a new candle forms. A candle on a 5 Minute chart takes 5 minutes to form, while a candle on a 15 Minute chart takes 15 minutes to form... and so on and so forth.

If you look at a chart, each candle represents the price moved in the duration of the timeframe.
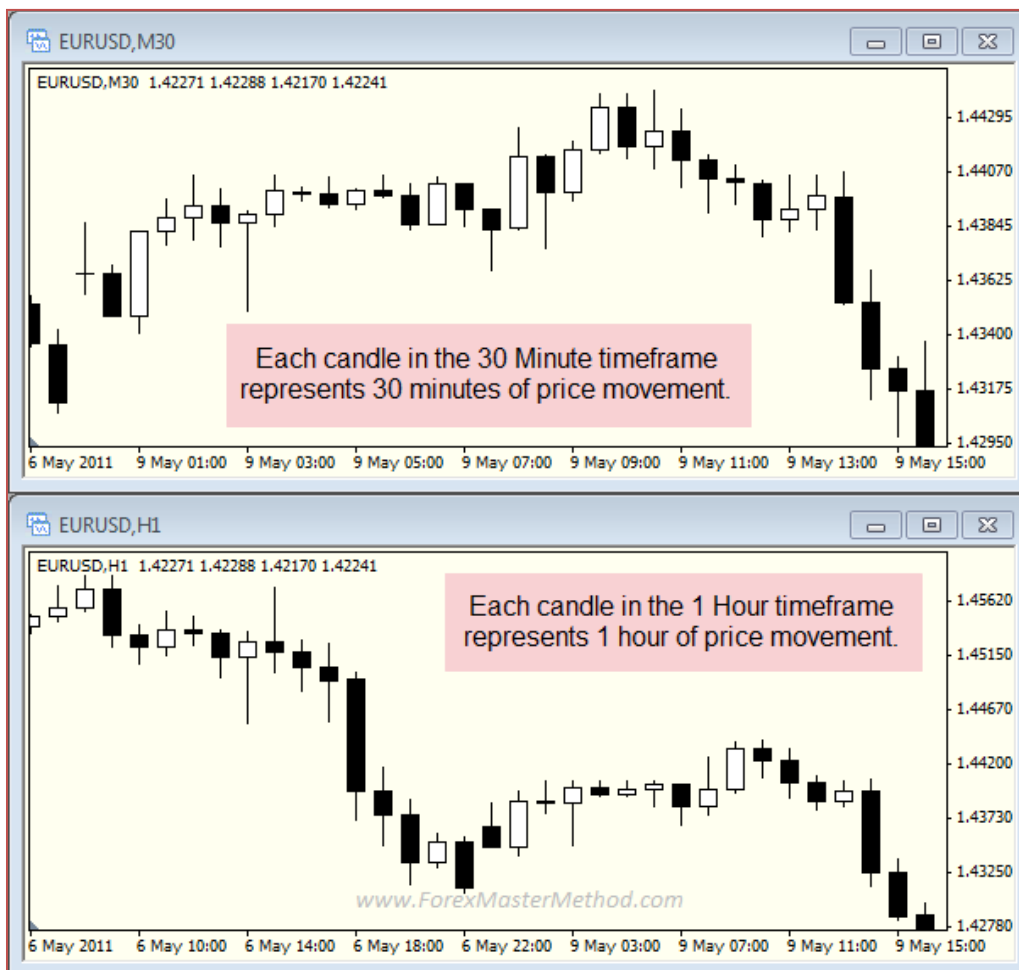
Advantages

The candles on a chart indicate the prices that represent how investors feel toward the market. The patterns that are formed usually serve as an effective tool in identifying market sentiment. This technique has been proven to be successful throughout history, which is why candlestick patterns are still widely used.

Because candlestick patterns are easy to identify once you look at your chart, this provides traders a quick and simple way to analyze the markets, forecast price direction and/or confirm the signals according to their system and works just like a 2nd opinion. You become more confident in taking action.

Traders who are familiar with candlestick patterns definitely have an edge over those who are unfamiliar with them.

It is important to note that though the use of candlestick patterns is a powerful tool in predicting price movement, it is not a perfect tool. There are many factors that affect its effectiveness, such as the types of candles involved, the timeframe used, the trend of the market and the overall characteristic of the financial instrument. However, some candlestick patterns tend to be more effective than others.

Kinds of Candlesticks

Every candlestick you see on the chart falls into a specific type of classification. Here are the different kinds of candlesticks:

Regular Candles

I classify these candles regular because they are characterized by having complete parts with regular lengths. In other words, those candles that have no peculiar attribute. These candles will also serve as our baseline for identifying other types of candlesticks.
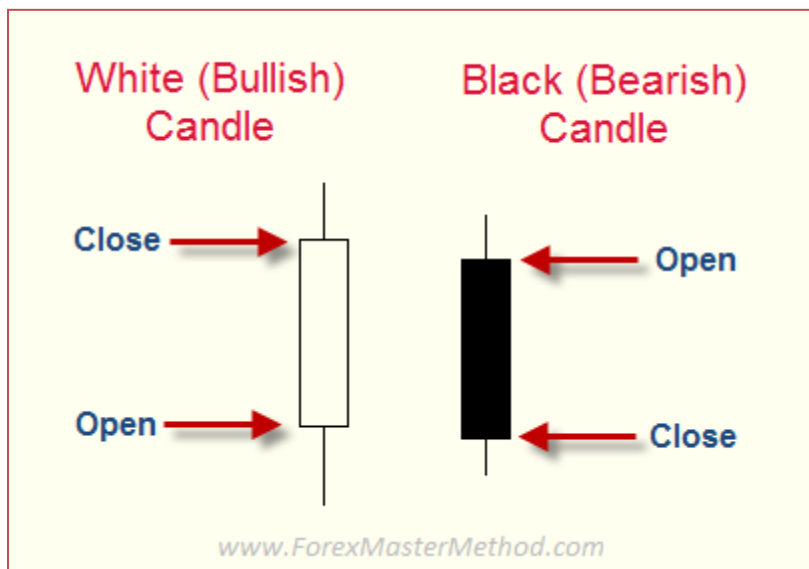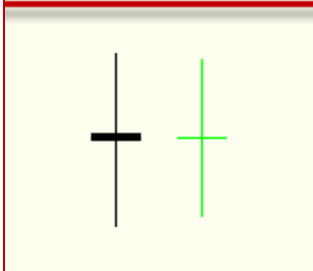

Doji

A **Doji** is a candlestick with equal open and close prices, or if they are very close to each other. Doji candles represent indecision and indicate possible price reversal.

They can be further classified as Long-Legged Doji, Dragonfly Doji, Gravestone Doji and Four Price Doji.
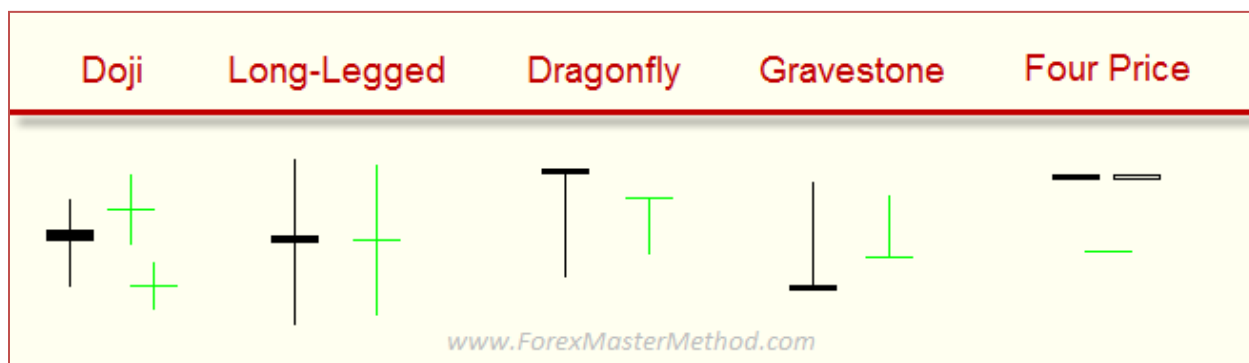
Long-Legged

A **Long-Legged Doji** has long shadows on either side of equal (or almost equal) length. This indicates that although the open and close prices are equal, price moved high above and way below the open price, which generally indicates a great indecision on the market.

This usually indicates an imminent change in the trend especially when found following a previously quiet market.
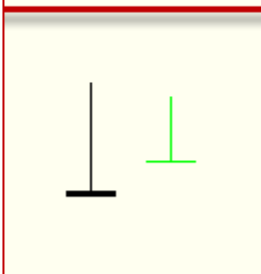
Dragonfly
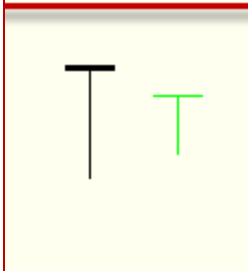
A **Dragonfly Doji** only has a long lower shadow, indicating that the price activity occurred below the open price and ended when price moved back to the open price. It opened at a high price in the market before price began to go down but later on managed to close at the price at which it opened. This usually indicates a forthcoming reversal.

If the market was in a downtrend, the price may go up but it's important to wait for bullish confirmation to ensure that price will indeed reverse. A bullish engulfing candle may suffice.

Gravestone

A **Gravestone Doji** is opposite to the Dragonfly. As you can see, it only has one long shadow at the upper end of the candle. This signifies that market action occurred above the open price and ended when price moved back down to the open price.

From an uptrend, this can indicate that a bearish reversal is imminent, so wait for a bearish confirmation to ensure that price is reversing before placing a sell trade.

Four Price
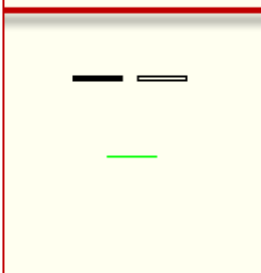
Unlike the previous types of doji candles, a **Four Price Doji** has no shadows. This is because the open, high, low and close prices are all the same. It's quite rare but can be found when the market is trading at very low volumes, especially when it's not within market hours/session.

This indicates that there isn't enough price movement and one should not take any trades.

Hammer

A **Hammer** is a candlestick with a long lower shadow, which is 2-3 times the length of its body (the body is short) and has no or little upper shadow. This usually happens because price action occurred way below the open price but ended at a high closing price. The candle can have a white or black body, but the latter is definitely more bearish.

The sellers pulled price very low, but the buyers managed to close the session at a level above the open price. This is usually appears in a downtrend and indicates a possible bullish reversal. However, a bullish confirmation is necessary before entering a buy trade.

Here are examples of hammers.
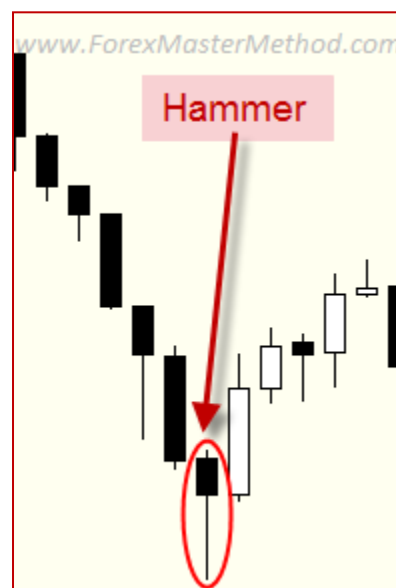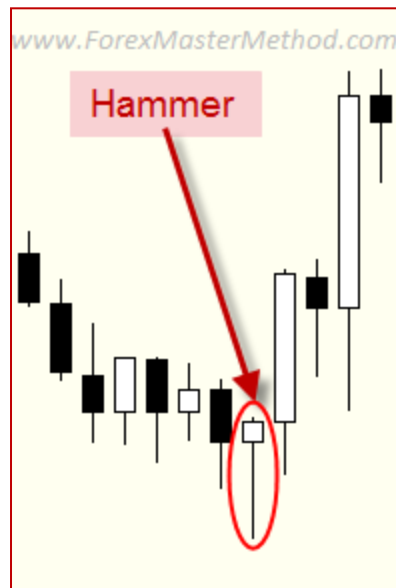
Hanging Man

Although usually confused with the hammer, the **Hanging Man** is different and may indicate that price has reached the top or a resistance level and a bearish reversal is underway. It looks like the hammer but it is found during an uptrend when the price begins to go down and reverse. The candle can have a white or black body, but the latter is definitely more bearish.

The long lower shadow indicates that the sellers were able to lower the price during the session but the buyers managed to bring it back up near the open. This could indicate that price may reverse to the down side because the sellers are now beginning to gain more strength than the buyers.

Below is an example of a hanging man pattern.

Shooting Star

A **Shooting Star** is a candle with a small body, a very long upper shadow and absent or short lower shadow. It appears when price has been increasing and is considered a bearish reversal candle and is the exact opposite of a hammer.

Once the candle opened, the price moved upwards and fell back to close near the open price. As usual, wait for bearish confirmation before taking a short trade.
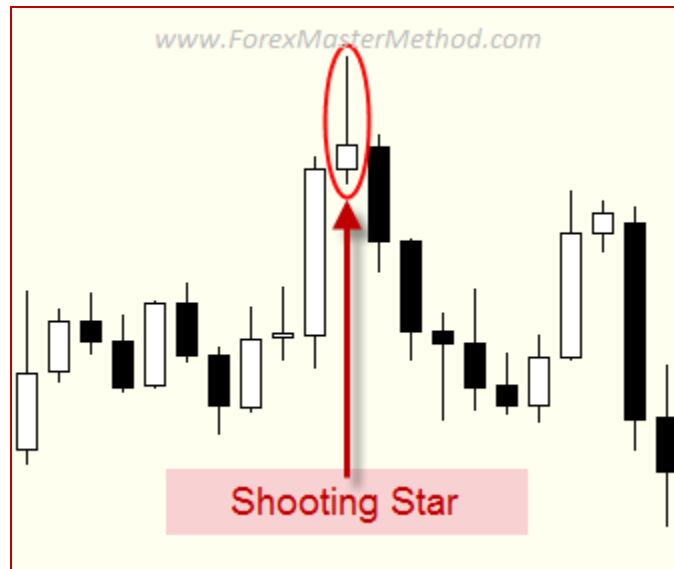
Inverted Hammer

An **Inverted Hammer** looks just like a shooting star, but it appears when the price has been declining and is indicative of a bullish reversal.

The long upper shadow of the inverted hammer indicates that the buyers have attempted to raise the price before the candle closed near the open price. The sellers are running out and so the buyers are picking up strength. This indicates that price will soon go upwards.

Spinning Top

A **Spinning Top** is a candle with upper and lower shadows that are longer than its body and usually represents indecision. Price has been moving well above and below the open price but closed near the open price. This indicates the market's indecision and neither of the buyers or sellers are winning.

However, if a spinning top follows a long bullish candle, it may indicate that there are no more buyers and the price will go down. Conversely, if it follows a strong downward move, it may mean that there are no more sellers and price will go up.
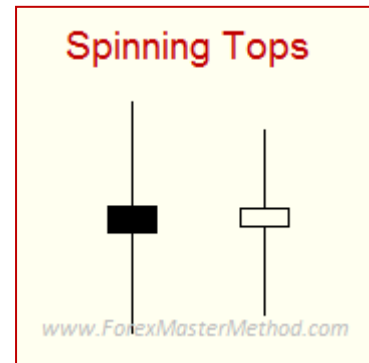

Below is an example of a spinning top following a strong downward move. Price began to increase.

Long Lower Shadow

A candle with a **Long Lower Shadow** (or equivalent to the length of the body) and a short upper shadow is considered a bullish reversal candle. It indicates that as soon as the candle opened, the sellers were able to dominate the market at the beginning of the session but were later overpowered by the buyers, who moved the price up and closed the session higher than it opened.

Because the buyers have successfully increased the price and dominated the market, price will most likely go up.
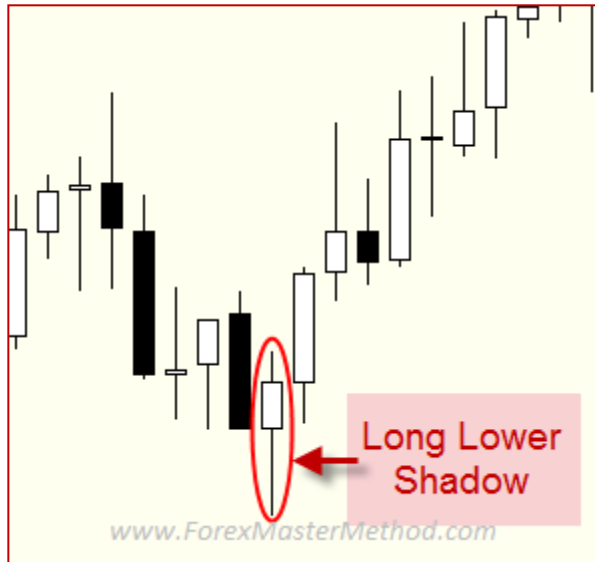
Long Upper Shadow

On the other hand, a candle with a **Long Upper Shadow** (or equivalent to the length of the body) and a short lower shadow is considered a bearish reversal candle. Right after price opened, the buyers increased the price higher, but the sellers managed to decrease the price and close the candle below the opening price.

This candle indicates that the sellers are now dominating the market and the price will soon go down.
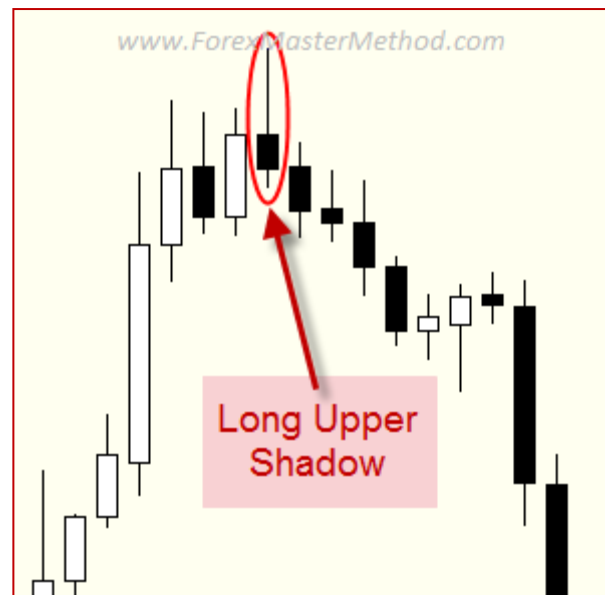
Marubozu

Unlike the other types of candles, the **Marubozu** candle has no shadow on both sides of a long body. This is because the high is equal to the close price (bullish candle) or the open price (bearish candle). It can be found in both bullish and bearish trends.
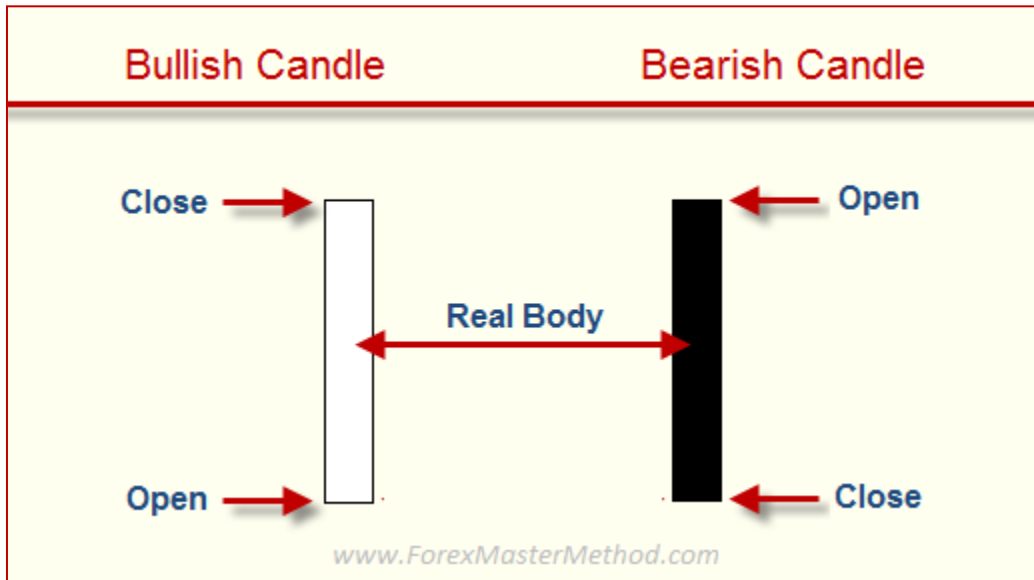
A white marubozu is a strong bullish candle which usually indicates the beginning of, or the continuation of, an uptrend. Conversely, a black marubozu is a strong bearish candle that can indicate the beginning of or the continuation of a downtrend.
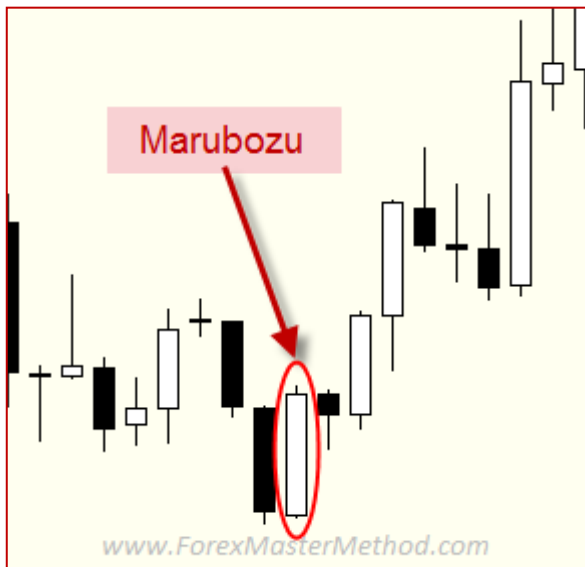
Kinds of Candlestick Patterns

There are a number of candlestick patterns that are quite effective in forecasting possible price movement. Below are the most common types of candlestick patterns.
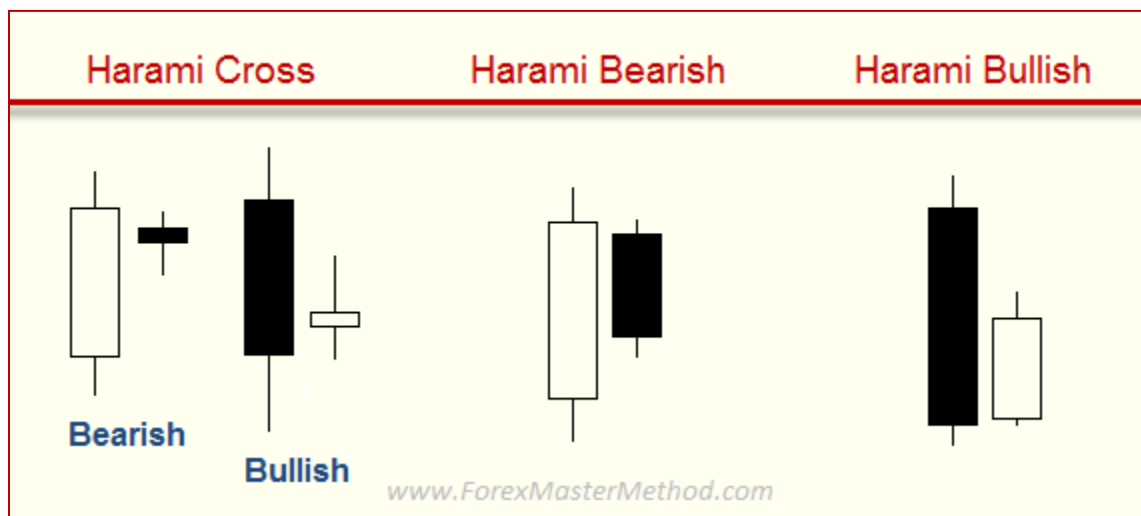
Harami

A **Harami** is a simple pattern composed of two candlesticks, wherein the first candle exceeds both ends of the second candle. Both candles are opposite in color (thus opposite in direction). This pattern usually appears during a trend's normal retracement and indicates that the current direction is temporary. The price will soon switch direction to follow the main trend.

A **Harami Cross** is so-called because the second candle is a Doji which is located within the range of the first candle. In the image above, the long white candle is followed by a black doji, which may indicate that price will go down. The long black candle is followed by a white doji, and it indicates that price will go up. This type of harami pattern is the most effective.

A **Bearish Harami** consists of a long white (bullish) candle followed by a shorter black (bearish) candle that is located within the open and close range of the white candle. This means that buying pressure was high during the first candle, but selling pressure took over during the second candle. This indicates that price may continue going down.
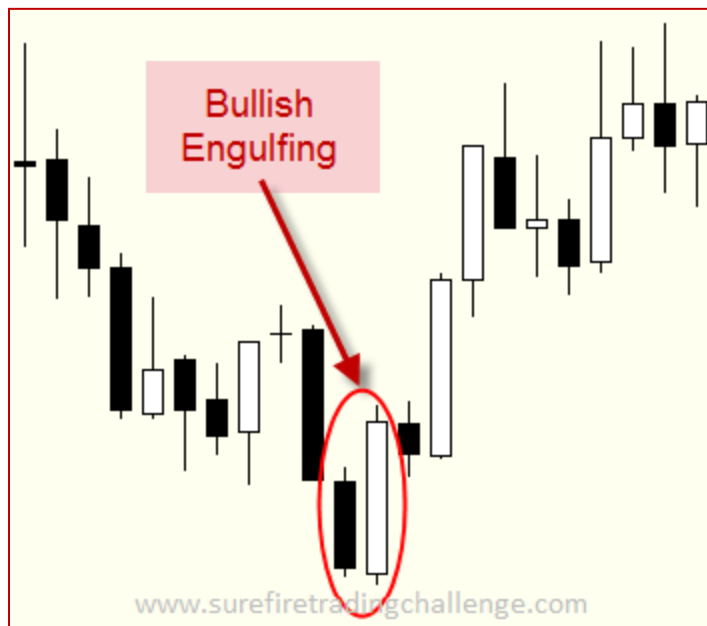
On the other hand, a **Bullish Harami** has a long black (bearish) candle followed by a shorter white (bullish) candle. On the first candle, the sellers dominated the market but on the second candle, the buyers completely took over. This means that price may continue going up.

Engulfing Pattern

An **Engulfing Pattern** is also composed of two candles and is the opposite of a Harami. Here, the first candle is smaller and is within the range of the second candle. They are opposite in colors. Because the first candle is within the range of the second candle, it appears as though the second candle is "engulfing" the first candle.

A **Bearish Engulfing Pattern** appears at the end of an uptrend and is considered a bearish reversal pattern. In the image to the right, you can see that the white (bullish) candle is within the range of the black (bearish) candle. It is "engulfed" by the black candle.

This means that during the first candle, the buyers were in control of the market but were completely overthrown by the sellers. The black long candle signifies a strong move downwards and may indicate the beginning of a downtrend.

On the other hand, a **Bullish Engulfing Pattern** can be found at the end of a downtrend and is considered a bullish reversal pattern. In this image, notice how the black (bearish) candle is completely engulfed by the long white (bullish) candle.

This shows that while the sellers were dominating during the first candle, the buyers took over during the second candle and pushed price to close very high. The long white candle indicates strong buying power, and so the trend is now reversing into an uptrend.

Piercing Line

The **Piercing Line Pattern** consists of two candles, both with long bodies and absent or small shadows. The first candle is a long black (bearish) candle followed by a long white (bullish) candle that opened below the close of the bearish candle. This occurs during a downtrend and is considered to be a bullish reversal pattern.
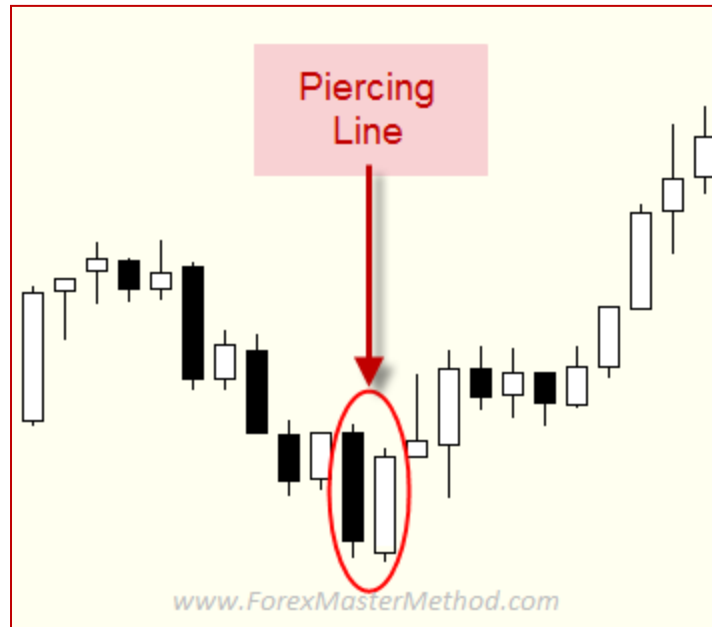
In the image above, the long black candle shows a strong downward move, and the white candle opens below the previous close and closes above the midpoint of the previous candle, so it looks like it is "piercing" the previous candle.

The sellers are pulling price lower continuing the downtrend during the first candle and the open of the next candle, but the buyers are gaining strength moving price upward and closing it above the midpoint of the previous candle. This may indicate a possible bullish reversal.

Dark Cloud Cover

Opposite to the piercing pattern, the **Dark Cloud Cover Pattern** occurs during an uptrend and is a bearish reversal pattern. It consists of two candles, where the first candle is a long white (bullish) candle followed by a long black (bearish) candle that opened above the close of the bullish candle.
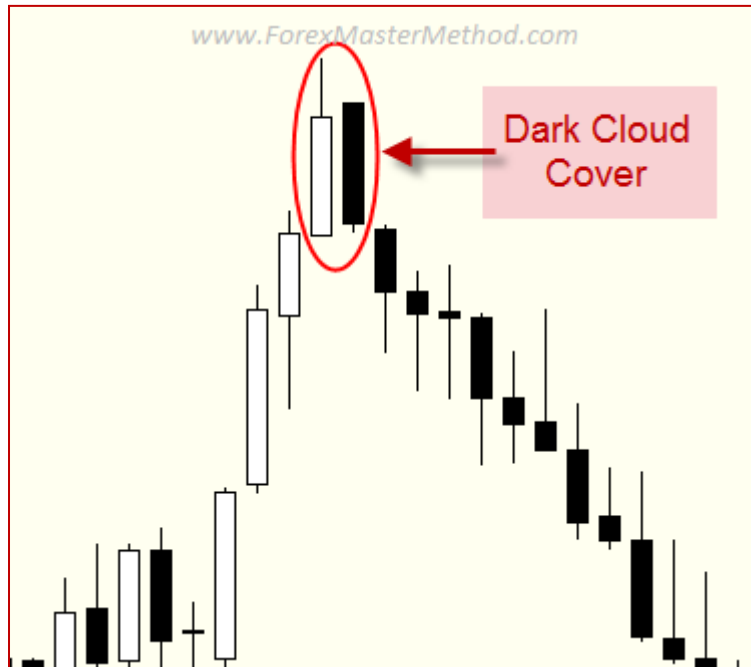
In the image above, you can see that the black (bearish) candle opened above the close of the previous candle and closed at a price below the midpoint of the previous candle.

This pattern means that the buyers were initially controlling the market during the first candle up to the open of the second candle. The sellers immediately gained strength after this open and pulled price so low that the candle closed below the previous candle's midpoint. This indicates that price may continue going down.

Abandoned Baby

The Abandoned Baby is composed of 3 candles and is quite a rare reversal pattern. A unique characteristic of this pattern is the presence of a gap before and after a doji that is located between two long candles of opposite directions.
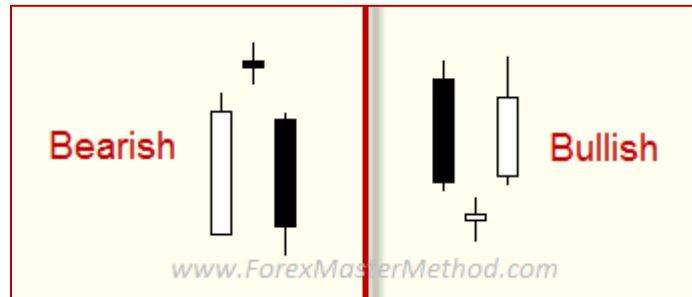
Evening Star & Morning Star

The star patterns are similar to the abandoned baby patterns, composed of 3 candles. The middle candle can be a short candle or a doji, and the gap before and after it is either absent or very small.

An **Evening Star** is a bearish reversal pattern while the **Morning Star** may indicate a bullish reversal.
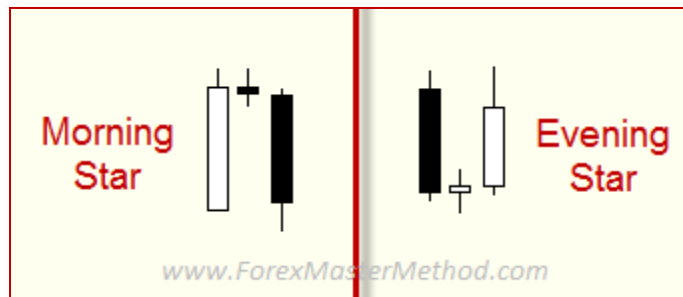
Three White Soldiers & Black Crows

These patterns consist of three candles following the same direction wherein the first candle is considered the reversal candle, the second candle is longer than the first and the third candle is at least the same length as the second. This is a very potent reversal pattern.

Three White Soldiers is comprised of 3 white (bullish) candles and appear after a downtrend. Even if the downtrend is followed by a short consolidation, when followed by three white soldiers, this indicates a bullish reversal.

The same goes with the **Three Black Crows**, which has 3 black (bearish) candles found after an uptrend (or a consolidation following an uptrend) and indicates a bearish reversal.

Candlestick Recognition Indicator

The Candlestick Recognition Indicator is a custom indicator designed to identify the different types of candlesticks and common types of candlestick patterns. It highlights these patterns on the chart and also indicates the percentage of its relevance to the pattern that is formed. Please note that the indicator is only compatible to MetaTrader4 platforms.

Installation

After downloading the Candlestick Recognition Indicator, just follow the steps bellow to install:

1. Copy the Candlestick Recognition Indicator file (Candles.ex4).

2. Open the following folders:
   My Computer
   Program Files
   Metatrader4 (This is your MT4 platform. If unable to locate this, please contact your broker's support team, and they will give you this information in no time.)
   Experts
   Indicators

3. Once you reach the Indicators folder, all you have to do is to paste the indicator file (Candles.ex4).

4. If you have your MetaTrader4 platform open, close and restart it.

5. You can now locate the indicator among your custom indicators. To apply, simply drag and drop onto your chart.

Settings & Types of Candlestick Patterns

There are so many types of candlestick patterns out there, but the most common and important patterns can be identified by the Candlestick Recognition Indicator.

The settings of the indicator can be changed. If already applied on your chart, all you need to do to open it is to click on "Ctrl" + "I" and double-click on Candles to edit the settings. In the Inputs tab of your indicator, you can find the following information:

TextDistance (10)
 – This is the distance between the candles and the name of the pattern.

TextColor (Goldenrod)
– This is the color of your text. It is set to Goldenrod by default as it is best for dark background, but you may change it to a darker color for a light background.

HighlightColor (SkyBlue)
– The candlestick pattern will be highlighted with this color. Feel free to select the color that suits your chart.

Output Settings
– These are the types of candlestick patterns that can be revealed by the indicator. It can show you 14 patterns, but by default, only the following is set to "true":

1. H – Hammer
2. Hbe – Harami Bearish
3. Hbu – Harami Bullish

If you would like to see the other patterns on your chart, just double-click on the parameter and change it to "true". Below is a list of all the patterns that you can set your indicator to identify.

1. D – Doji
2. H – Hammer
3. HC – Harami Cross
4. Hbe – Harami Bearish
5. Hbu – Harami Bullish
6. SS – Shooting Star
7. ST – Spinning Top
8. Ma – Marubozu
9. LL – Long Lower Shadow
10. LU – Long Upper Shadow
11. Ebe – Engulfing Bearish
12. Ebu – Engulfing Bullish
13. PL – Piercing Line
14. DC – Dark Cloud Cover

Video

This video will show you how the Candlestick Recognition Indicator is used and how you can apply candlestick patterns in your trading.

Comments/Notes

Although candlesticks serve as excellent tools to forecast short-term reversals, they are not perfect and should not be used as a standalone system.

The best thing about candlestick patterns is that it can be used with any method/system, indicators and technical analysis techniques. When applied in conjunction with other technical analysis tools and/or a developed system of trading, it can definitely improve your trading performance by serving as a confirmation to the signals, or a warning sign that entering a trade might be a bad idea.

Another note to consider when using candlestick reversal patterns is that most of them, especially single candlestick patterns, require confirmation that the trend is indeed reversing.

For example, if you see a long upper shadow following an uptrend, it does not necessarily mean that the price will reverse because it may still regain its upward strength. The only way to be sure that price is now reversing is if the candle is followed by a strong bearish candle. Just like cases like this, a bearish confirmation is necessary.

Conclusion

To become a successful trader, one needs to gain a good understanding on the different types of candlesticks and the patterns that they form. It is important to know what these patterns imply when you see them on the chart because they reflect the market's sentiment.

The reason that Japanese candlestick charting is the most commonly used type of charting is that it helps traders gather a lot of information about the market. Candlestick patterns provide traders with so much information that most technical indicators can't.

Indeed, candlestick patterns have survived the test of time and remained widely used worldwide, not despite of, but because of advancement in technology and technical analysis. This only proves that this technique of analyzing and forecasting the market has worked throughout the centuries and still remains relevant up to today.

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