Combining Japanese Candlesticks with Western Technical Analysis for a High-Probability Forex Trading Combination...

James Chen discusses Candlestick patterns and how to combine their interpretation with Western technical analysis methods to foster high probability trading.
lust Forex traders are familiar with candlestick charts, as this method of depicting prices has become the standard format on many Forex charting platforms. What many Forex traders may not be aware of is how well candlestick patterns function when combined with elements of Western technical analysis, such as support and resistance, bar chart patterns and the like.

To provide a brief introduction to candlestick charting as a financial analysis tool, it was introduced relatively recently to the Western world from its origins in the historic rice trading markets of Osaka, Japan. Steve Nison, a prominent U.S. technical analyst, was responsible for bringing this ancient, yet innovative, Japanese chart-reading technique to Western investors. He translated esoteric Japanese financial texts into English and published several works on this ancient charting approach. Nison has been so successful in propagating the Japanese method of candlestick charting that it has now superseded the popularity of bar charts in many financial markets, including Forex.

The structure of a candlestick chart is significantly different from a bar chart. Candlestick charts contain all of the same vital price elements that are contained in bar charts. The difference lies in the visual representation of these elements. Included with the simple representation of price in candlesticks is an entire repertoire of colorfully named candlestick patterns that provide potential indications and confirmations of possible future price behavior.

To start with the bare basics, the physical structure of a candlestick appears much like a candlestick in the non-financial context. There is the candle body that represents the prices between the candle’s open and close, and then there are the wicks (or shadows) that represent the high and low extremes where price traveled during the duration of the candle. Figure 1 shows a basic candlestick illustration.

**Figure 1: Candlestick Structure**

Candles work for all financial markets, but are slightly different for the Forex market because of its unique 24-hour trading characteristic with the lack of gaps. As a result of the uniqueness of Forex, there is a subset of candle patterns that many Forex traders focus on. These patterns include doji, spinning tops, hammers, shooting stars, hanging men, inverted hammers, engulfing patterns, and harami.

Virtually all candlestick proponents, including Nison himself, advocate the use of candles to confirm or be confirmed by Western technical analysis, rather than being used as the primary means for making trading decisions. Candlestick patterns are best at confirming or warning of potential reversals, when used in conjunction with Western technical indicators.

One of the key elements of candlesticks that make them useful in warning of potential reversals is the phenomenon of long wicks (or shadows). Long wicks suggest indecision, price rejection, and a potential failure of the market to continue in the same direction. When used with Western technicals, these candlestick patterns can be extremely effective signals.

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Elements of Western technical analysis that are most effectively used with candlesticks center on support and resistance identifiers. These include horizontal support and resistance lines where price has turned or reversed in the past; uptrend support lines and downtrend resistance lines; Western bar chart patterns; Fibonacci retracements and extensions; pivot points; and volatility bands like Bollinger bands.

Candlestick patterns contribute to an overall high-probability approach to trading Forex because they provide strong additional rationale for getting into a given trade setup. In other words, candlestick patterns help establish confluence. The vitally important concept of confluence within the realm of technical trading may mean different things to different traders. The basic idea is that multiple technical confirmations make for a stronger trade rationale, and a higher-probability trade.

Confluence simply means more than one technical indication providing a basis for any given trading action. This could be any combination of two or more technical factors pointing in the same direction. Some examples of these technical factors include: support/resistance levels, trendlines, Fibonacci levels, pivot points, Western bar patterns, Japanese candlestick patterns, moving averages, volatility bands, and many more.
As previously mentioned, there are several candlestick patterns that are especially well suited to confirming Western technical analysis methods in the Forex market. These include doji, spinning tops, hammers, shooting stars, hanging men, inverted hammers, engulfing patterns, and harami. Figures 2 and 3 show illustrations of these candlestick patterns.

**The Doji**

Of all candlestick patterns, perhaps the “doji” is the simplest of all. Representing supreme indecision in the market, a doji is formed when a candle’s open and close are either equal or very close to equal. After the doji opens, price may go up and/or down substantially, creating candle shadows in the process, but should close at or very near the opening price. Again, this pattern represents indecision, or a tug-of-war, between buyers (bulls) and sellers (bears). With additional technical confirmation, a doji is often considered a trend reversal indication.

**Spinning Top**

Another sign of indecision similar to the doji is the “spinning top.” A spinning top has a very small real body (though not as small as the single line of a doji) with upper and lower shadows that are longer than the vertical length of the real body. Spinning tops can also indicate potential trend reversals with additional technical confirmation.

The spinning top and doji both send the primary message that price closed the trading period (candle) at or around the same price at which it opened. Between the open and close, price may have moved significantly in either direction, or in both directions. This signifies that the market is undecided as to which direction to take. It can also signify a potential neutralizing of any previous trend that might have been in place, as countertrend forces may be slowing down the progress of trend forces in a hotly contested tug-of-war.

**Hammers**

“Hammers” can be strong confirming indicators of potential trend reversals to the upside. A hammer candle occurs after a downtrend. Its appearance is top-heavy with the real body being either color, (bullish or bearish). Very importantly, a hammer has a long lower shadow – this is the most important aspect of this candle. It signifies that the previously prevailing bears attempted to push price lower, but failed. While failures of this nature can often be the catalyst for reversing a downtrend, a hammer candle pattern, like other candle patterns, should only be used as a confirmation tool.

**Shooting Star**

What a hammer candle is to a down-
trend, a “shooting star” candle is to an uptrend. Essentially the opposite of a hammer, a shooting star is bottom-heavy with a long upper shadow. The color of the real body (whether bullish or bearish) is unimportant. Shooting stars follow uptrends, much like hammers follow downtrends, and indicate potential uptrend reversals.

The long upper shadow of a shooting star is the most important aspect of the pattern, as it signifies that the previously prevailing bulls attempted to push price higher, but failed. Much like hammers, while failures of this nature can often be the catalyst for reversing an uptrend, a shooting star candle pattern should only be used as a confirmation tool, and not as a primary decision tool.

**Hanging Man**

A “hanging man” candle looks identical to a hammer candle, but occurs after an uptrend, instead of a downtrend. Just like the hammer, a hanging man is top-heavy with the real body and has a long lower shadow. The color of the real body is also irrelevant. As a hanging man should follow an uptrend, it can be considered a confirmation of a potential uptrend reversal. However, its signal arguably carries less weight than a hammer or a shooting star in its ability to signify a reversal confirmation, as a hanging man opens and closes near the top of its range after an uptrend. Therefore, the element of failure is not nearly as strong as with hammers and shooting stars.

**Inverted Hammer**

Similarly, an “inverted hammer” looks identical to the appearance of a shooting star candle, but occurs after a downtrend, instead of after an uptrend. Just like the shooting star, a hanging man is bottom-heavy with the real body and has a long upper shadow. The color of the real body is also irrelevant. As an inverted hammer should follow a downtrend, it can be considered a confirmation of a potential downtrend reversal.

However, like the hanging man, its signal arguably carries less weight than a hammer or a shooting star in its ability to signify a reversal confirmation, as an inverted hammer opens and closes near the bottom of its range after a downtrend. Therefore, as with hanging man patterns, the element of failure in inverted hammers is not nearly as strong as with hammers and shooting stars.

**Bullish Engulfing Pattern**

The “bullish engulfing pattern” is a bullish reversal pattern that usually occurs after a downtrend. It is a two-candle pattern that is most often considered a reversal indicator. The first candle has a small bearish real body and the second candle has a large bullish real body that completely encompasses the first candle’s real body range. The concept behind this two-candle pattern is that the small body of the first candle represents hesitancy to continue a downtrend, while the large body of the second candle represents the bulls overpowering the previously prevailing bears, potentially reversing the downtrend.

**Bearish Engulfing Pattern**

In an opposite fashion, the “bearish engulfing pattern” is a bearish reversal pattern that usually occurs after an uptrend. It is a two-candle pattern that is most often considered a reversal indicator. The first candle has a small bullish real body, and the second candle has a large bearish real body that completely encompasses the first candle’s real body range. The concept behind this two-candle pattern is that the small body of the first candle represents hesitancy to continue an uptrend, while the large body of the second candle represents the bears overpowering the previously prevailing bulls, potentially reversing the uptrend.

**Harami**

The opposite of an engulfing pattern is a “harami” pattern. It is a two-candle pattern that consists of a large body followed by a smaller, encompassed body of the opposite color. Therefore, a harami pattern can either be a large bullish candle followed by a small bearish candle, or a large bearish candle followed by a small bullish candle. Like engulfing patterns, harami patterns are also considered potential reversal indicators.
Harami patterns represent indecision after strong trends, as is evidenced by the small body of the second candle in the pattern.

When combining Japanese candlesticks with Western technical analysis, the key is to identify candlestick patterns right at or near significant price areas as defined by elements of Western technical analysis.

One of the strongest of such instances occurs when a hammer or shooting star candlestick pattern occurs at support or resistance, respectively. This is due to the fact that hammers and shooting stars represent price rejection – a failure of price to continue in the previously prevailing direction.

When a hammer occurs right at or near a strong support level (where price has turned up at least once in the past) after a defined downtrend, there is a significant chance that a bullish reversal is in the making. Likewise, when a shooting star occurs right at or near a strong resistance level (where price has turned down at least once in the past) after a defined uptrend, there is a significant chance that a bearish reversal is in the making. An example of this is shown in Figure 4 (left).

The same can be said for hammers and shooting stars showing price being rejected, or failing, at significant Fibonacci levels (as shown in Figure 5, above), pivot points, and Bollinger Band extremes.

Other potential reversal candlestick patterns like doji, spinning tops, hanging men, inverted hammers, engulfing patterns and harami that occur at significant support or resistance levels, Fibonacci levels, pivot points or Bollinger Bands also raise the probability of an impending reversal.

When utilizing Japanese candlestick patterns in conjunction with Western technical analysis elements, one of the key concepts to keep in mind is that the stronger and greater number of signals pointing to a significant price event like a trend reversal or turn, the better the chance that a turn will actually occur. This is the ideal of confluence, and it fosters a high-probability Forex trading environment.