The Japanese Candlestick

Traders often use technical analysis to beat the market. Technical analysis refers to the study of the action of the market itself and analysing the history of trading of a specific stock and making predictions of future trends based on the past data. Technical analysis uses different models and rules for trading, often based on the principles of price movement and volume traded. This includes moving averages, business cycles, regressions and price correlations.

Technical analysis as a method of investing opposes to that of the fundamental analysis approach. Technical analysis focuses on price movements and volume, understanding the psychology of the traders while fundamental analysis looks at the facts of the stock itself. Technical analysis is used mostly among the traders, especially the day traders. One specific tool of technical analysis that often comes to mind of every trader is the Japanese Candlestick.

While Japanese Candlesticks are highly effective, many do not understand the full potential of it. Candlestick charts provide much insight to the stock, yet only a small number of people understand the significance of these signals. One major attribute of the Candlestick is that the signals shown are created by the change in the sentiment of the investor. The candlestick offers a glance into the psychology of the investor, which will shine light onto why investors sell or buy a specific stock and allow you to exploit this for your own benefit. Let us take a look at the characteristics of a candlestick.
The box that makes up the difference between the close and open is called the real body of the candlestick. The open price is the price at which the first share was traded for the current trading day and the close price is the price at which the last share was traded for that current trading day. The height of the body from the open to the close is the range between the day’s open price and the day’s close price. When the body is white, it means that the opening price was lower than the closing price. When the opening price is higher than the closing price, the body is black. The candlestick line may have small thin lines above or below the body and these lines are called shadows, which represent the low and high prices reach for that particular day. The lower shadow represents the low price while the upper shadow represents the high price. The contrasting colours of the bodies provide for instant visual interpretations and the shadows also provide an insight about the volatility on that day.

The signals from Japanese Candlesticks are a reflection of the investor’s fear and greed. With this knowledge, it will help to create a mindset to anticipate how formations may develop. One simple illustration is when a stock has been going down steadily for the past ten trading days. Each day the prices gets lower and lower which ultimately makes traders uneasy and fear starts to set in. Once a certain threshold is reached, majority of traders would want out. Candlestick analysis will allow investors to understand who is buying while others are selling and prepares you to anticipate these events and profit from them.

It is also very important to note that each candlestick tells its own story. Depending on the size of the body and the length of either shadow, it can convey a lot of important information, which will greatly affect your decision-making. Take for example a pin bar, as shown here. This pin bar is an excellent indicator and is what most traders want to see. Using the bearish pin bar as an example, the upper shadow is much longer than then the lower shadow. This indicates that initially there were many buyers who tried to push the price up as shown from the high of the shadow. However, the sellers came in and push the price all the way back down and even below the opening price. This shows that the sellers won and they are the ones who are in control. This is an excellent indicator of an upcoming bearish trend. This is alike for the bullish pin bar.
One of the most valuable attributes of candlestick is the recognition of reversal points. The ability to identify technical hints that put the probabilities of your prediction in favour is the main purpose of technical analysis. Candlestick analysis enhances an investor’s ability to prepare for trend changes and to be able to profit from it. Understanding the psychology behind the candlestick formations will give you a great advantage. Candlestick signals have the ability to identify a trend reversal or the potential reversal. A major trend will probably not have a one-day reversal. It may take a few days or weeks for the direction of the price movement to expend itself and reverse. The development of the reversal signals warns the investor that a change is occurring and the investor has to decide on what steps to take to minimize his loss or maximize his gain.

Although there are also many other strong attributes of the candlesticks to aid in making of investing decisions, there are certain rules that should be adhered to. One main rule is “When in doubt, get out”. Eliminating emotions when making investing decisions is the hardest thing to do. Rational decision-making is done before money is placed on the line and disappears completely afterwards. The candlestick signals have high probabilities of being accurate but not all signals are going to meet expectations. There are events that are out of anyone’s control such as a terrorist attack or a natural disaster. These events cannot be predicted and hence can occur at any time. Another rule is to “Don’t look back”. Investment decisions have to be made with the best information available at any time. Even if the price increases after you closed the trade, you still made the best decisions with the information available at the point of time. Discipline is very much needed when investing which allows you to make the best decisions based on the parameters laid out.

Once an investment has been made, the mental process that occurs in the mind of the investor undergoes a whole new way of disciplines. These are often not applied in our daily lives; hence there is no way to practice them regularly. Investors need to build on the mental discipline and the processes undertaken. This involves mental conditioning and constant practice, which is difficult to do without putting your money at risk. This is the only way to condition the mind for future decision-making. For beginners, there is often a phase of virtual trading to practice the necessary skills. However, at some point of them he or she would have to actually put some money at risk as when money is involved, everything changes. There is no course or no school that can teach someone to condition their mind for a specific discipline. The only real practice can be done by that individual and only works when money is on the line. The Japanese Candlestick does facilitate some of these mental conditioning practices. The candlesticks signals are read by the investor and the investor will undergo certain psychological thought process. Understanding the rationale behind each candlestick signal gives the investor an advantage. Learning the market action and the way
signals are created gives the investor an insight into the minds of others investors and allow them to make a pre-emptive move.

Successful analysis of the stock market is a very difficult task. Most investors often prepare themselves as though they were preparing to go for grocery shopping. One must first have a basic understanding of how the market forces interact and then learn about the different technical indicators that explain these forces. It has been shown that the Japanese Candlestick analysis can greatly enhance the efficacy of ones trades. Once the candlestick is understood well with all its signals, it can be a great tool for any trader. Being able to recognize reversal signals is only a portion of the beneficial aspects. There are a multitude of other signals and patterns that candlesticks provide for. Being able to use them effectively will have a strong effect on the investor’s psychology. The Japanese candlesticks are very effective investment tools and can easily be used alone, but more benefits can be reaped when used along with other technical methods.

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