Money & Markets
PRECISION PROFITS

Ichimoku Cloud Crossover Strategy

By Michael Carr

Ichimoku cloud charts are a technical indicator developed by Japanese business writer Goichi Hosoda in the 1930s.

According to the legend, Hosoda was so frustrated with market forecasting tools that he decided to dedicate his time to finding something useful.

He rented space for a team of researchers in a windowless warehouse and got to work. Using price data from old newspapers, they tested countless different methods for forecasting market trends.

Keep in mind this was long before the age of computers and involved a lot of manual calculation.

Then one day, the breakthrough came…

Hosoda's Discovery

A moving average (MA) is an indicator that's commonly used in technical analysis. It smooths out random, short-term price moves to show a clearer long-term trend.

But in that windowless warehouse, Hosoda realized that no single MA provides a full view of the market.

For that, he discovered, it was useful to use several different MAs. He also found it was helpful to calculate the MAs in a different way.

Usually, the MA is calculated with closing prices. If you want to find a 200-day MA, you use the closing price for the past 200 days. Hosoda's team tested different variables including the highest and lowest price of the day. They found that the best results came from using "midpoints."

The midpoint is the average of the day's high and low. Using midpoints along with different lengths of moving averages, Hosoda created charts that show the state of the

market at a glance. Hence the name Ichimoku, which literally translates to “at a glance” in Japanese.

Because Ichimoku clouds offer so much information, they can be intimidating to new traders.

Let’s break one down together…

The red-and green-shaded areas in the chart below are the “clouds.”

The simplest interpretation is to buy when prices are above the clouds and sell when they break below them.

Unfortunately, interpreting Ichimoku clouds isn’t quite that simple.

Trading breaks of the clouds *will* result in big wins — but only when prices are in long-term trends as they are in this example.

When prices move quickly through the clouds, this strategy will result in a number of losing trades.

That’s why it’s important to understand the other components of Hosoda’s cloud system…

Let’s Get Technical

There are four other main components of an Ichimoku Cloud that are illustrated in the chart below:

A “bar” is each period of time plotted on the price chart. In the chart above, candlesticks are used to show the price action.

The gold line in the chart is the turning line, or “Tenkan-sen.” It’s the midpoint of the high and low of the last 9 bars.

The blue line is the standard line, or “Kijun-sen.” It’s the midpoint of the high and low of the last 26 bars.

The red line is the lagging line, or “Chikou Span.” It’s the closing price shifted 26 bars back.

The clouds are formed by two additional lines:

1. Senkou A: The Tenkan-sen + Kijun-sen / 2 (the line is shifted forward 26 bars).
2. Senkou B: The High + Low / 2 using period = 52 (this line is shifted forward 26 bars).

The cloud is green if A is above B. It’s red if A is below B.

When A is rising and above B, the uptrend is strengthening. Likewise, when A is falling and below B, the downtrend is strengthening.

Taking Action Based on the Clouds

There are several ways to interpret the chart. If the price closes above the clouds, the chart is bullish. When prices are in the clouds, the signal is unchanged.

If the price drops into the cloud after a buy signal, the chart remains bullish until prices drop below the clouds, at which point it turns bearish.

Some traders, for example, use the turning line and standard line for signals.

The turning line (Tenken-sen) is faster since it's calculated with 9 bars. When it's above the slower line, or standard line (Kijun-sen), that's a buy signal. When it's *below* the slower line, that's bearish. This is very similar to a moving average strategy.

If both lines are above the cloud, it indicates a positive trend. If both lines are below the cloud, the trend is negative.

More conservative traders, on the other hand, tend to focus on the lagging line.

When this line crosses above the clouds, it's a buy signal. Sell signals occur when it falls below the clouds, while time in the cloud is ignored. Because this line is 26 bars behind the price action, it profits during big trends.

Many traders look for two or even three of the signals before acting. This can help identify the safest trades.

The Ichimoku Cloud is a versatile market forecasting tool. Most people have heard of it before. But then, they try applying them to a chart once, get scared, and quickly revert to a simpler indicator.

In the Trade Room, we use a crossover strategy. The buy rules are simple.

Entry Rules:

- Buy calls when the price of the stock closes above the clouds and RSI(2) is above 50.
- Buy puts when the price of the stock closes below the clouds and RSI(2) is less than 50.

In these rules, the price crossover is the setup for the trade and is confirmed by RSI(2), a short-term momentum indicator.

Once we are in a trade, the sell rules are discretionary, and we'll update you in the Trade Room when it's time to sell.

This strategy has a long record of success and can be combined with multiple other strategies to develop a diversified trading plan.

Join us in the Trade Room each morning at 9:30 a.m. ET to see how we use the Ichimoku Cloud crossover strategy and see its latest signals.

Regards,

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