Getting Started with Fibonacci Retracements

By

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This is a quick guide to using Fibonacci Retracements for day trading gap stocks. A thorough treatment of the subject would require an entire book. So, my intent is not to cover every scenario and the dozens of uses I find for this tool. Rather, it is meant to get you started.

Leonardo Pisano Fibonacci was an Italian mathematician who lived in the 12th century. The number sequence that bears his name was actually used by Indian mathematicians as early as the 6th century. But, Fibonacci was the one who imported the idea to the West and used it in his writings to explain various occurrences in the natural world. Fibonacci Retracements are chart tools based upon this sequential order. They are usually found as a drawing tool on most chart software programs.

In this "Getting Started" guide", I will cover (1) how to draw Fibonacci Retracements, (2) when to redraw the lines, and (3) how to use them in your trading. You will find that I use Fibonacci extensively in my trading. It is not the only indicator I look at. So, let me offer a word of warning. Some traders are looking for one tool that will make trading easy. In their search for the "Holy Grail" of trading, they want to find something that is easy and works in every situation. But that is not the nature of trading. Fibonacci lines are not a simple tool by which you draw a line on a chart and state "every time it crosses this line then I'll buy the stock". It doesn't work that way. As with most technical indicators, they are most powerful when used in conjunction with other indicators that measure different things. What makes Fibonacci useful is the fact that it measures things not measured by other indicators. It has nothing to do with RSI and Stochastics. Yet, it is very powerful when used in conjunction with these other indicators.

In one sense, Fibonacci Retracement lines are just lines on a chart, representing possible levels of support and resistance. Yet, it is uncanny how often stocks move in concert with these lines.

By nature, the gap stocks are some of the most profitable and volatile stocks that you will trade each day. The Fibonacci lines are a means of lessening that risk. By using the Fibonacci tool, we are not trying to capture the highest or lowest point of the day as our

entry. That is risky and has a low probability of success. However, using the Fibonacci tool as outlined in this document, you will discover a more conservative entry point and therefore a trade that has a higher probability of success.

After reading this guide, you should be able to use the Fibonacci Retracement tool in your own trading. You can begin by reviewing your trades each day in the light of Fibonacci. Draw the Fibonacci lines on your charts and see if it adds clarity to your trading. Drawing the lines is the simple part. Knowing how to interpret the movement of price, as it meets these lines, takes experience. You have to look at a lot of charts. But this guide will help you get started.

(1) How to draw Fibonacci Retracements.

If a stock gaps down, then you pull the Fibonacci tool from the previous day's closing price to the current day's LOD (low of day).

Let's look at a chart.

Chart 1

In Chart 1, since CNX gapped down on the morning of June 4, 2010, we started with the previous day's closing price (blue arrow) and pulled the Fibonacci tool down to the current day's LOD. This sets up a series of lines on your chart. Some draw programs show the 23.6% Fibonacci line and some do not. But this is the most critical line for me. For the charts in this document, I have drawn a long line to show the 23.6% line.

If a stock gaps up, then you pull the Fibonacci tool from the previous day's closing price to the current day's HOD (high of day).

Let's look at a chart.

Chart 2

In Chart 2, since RTP gapped up on the morning of June 3, 2010, we pull from the previous day's close (blue arrow) to the current day's HOD (green arrow). (Note: the Fibonacci %'s vary depending on the direction of your drawing. If you started the drawing at the HOD and pulled to the previous day's closing price, then the lines would be the same, but they would be classified differently…23.6% would become 76.4%.)

(2) When to redraw the lines.

If either extreme of the drawing is violated, then a new drawing must be made. One example of this is when a gap down stock goes to a new intraday low. The opposite is also true. If a gap up stock goes to a new intraday high, then the Fibonacci lines have to be redrawn.

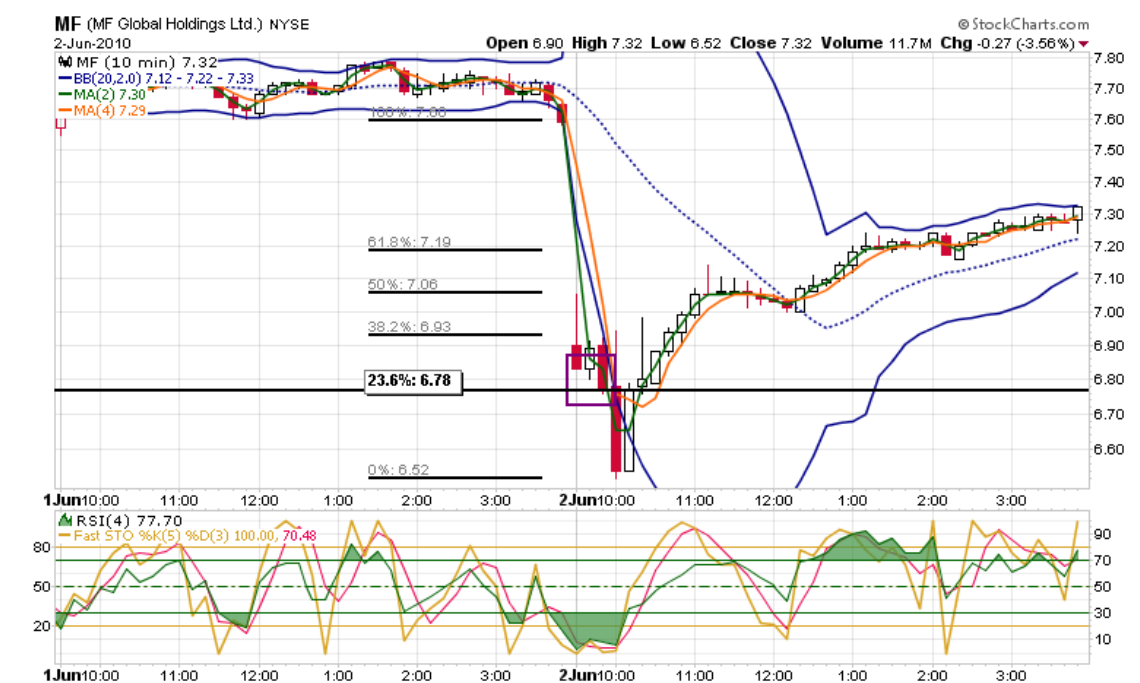Let's look at an example of a gap down stock that had to be redrawn.

Chart 3

In Chart 3, each of the first three 10-minute candles falls lower than the previous candle (purple box). It isn't until after 10:00 that we get the LOD for this stock. So, if you had drawn Fibonacci lines based on any of the first three candle lows, then you would have to redraw those lines. This brings up an important point. How do you know when you've reached the LOD? Answer: you'll know it when price moves above the 23.6% line and is accompanied by the appropriate RSI levels. If price is struggling at your previously drawn 23% line, then you wouldn't be entering the trade anyway. So, you wait, redraw the lines if necessary, and enter the trade when the perfect combination of RSI and Fibonacci exits.

The other instance in which the Fibonacci lines must be redrawn: when the price of a stock moves past its previous day's closing price. So, for example, if a gap down stock retraces 100% of its gap and "fills the gap", and then subsequently goes higher so that its current day's price is higher than the previous day's closing price, then the lines must be redrawn.

Let's look at an example of a gap down stock that did this.

Chart 4

In Chart 4, AIG "filled the gap" when it hit the previous day's closing price of 35.41. If you played the gap down reversal as a long trade, then this is a time to be cautious since many gap fills will stall or reverse at this point. But AIG continued to go higher and violated the previous Fibonacci drawing that was based on the previous day's closing price. (The purple box shows where the previous day's closing price was violated.) So, the Fibonacci had to redrawn. Chart 4 shows the revised Fibonacci drawing. For a gap down stock such as the one in Chart 4, I pull from the intraday low to the intraday high.

That gives me a new 23.6% line at 35.53. You can see how price bounced off the top line of the Bollinger Band, RSI weakened, and you have a perfect new short set-up based on that 23.6% Fibonacci line.

When a gap up stock fills the gap, then the Fibonacci must be redrawn by pulling from the HOD and ending at the new LOD.

(3) How to use them in your trading.

As I often say, the Fibonacci lines are just lines. The line is not important. What is important is how price moves in relation to that line. There are three things that can help you understand how price will be affected once it touches a Fibonacci line. They are: (a) the context of the larger market (is the market going up or down?), (b) the size, color, and movement of the candles as they touch the Fibonacci line, and (c) the strength (angle and measurement) of RSI and Stochastics on the 5 and 10-minute charts.

As I said earlier, it is not a simple matter of just drawing a line on a chart. You have to learn how to interpret the movement of price as it touches these lines. You learn how to do this by looking at a lot of charts. But let's look at three charts as examples.

In our first example, we look at the gap up of DCTH.

Chart 5

Chart 5 shows the standard 23.6% Fibonacci Retracement reversal. It is most often seen with gap downs, but you will also see it in the gap ups, as shown here with DCTH. You can see how price fails to get back to the 23.6% line. As RSI and Stochastics weaken,

price continues to drop until it finds support at the 76.4% Fibonacci line of 14.67 (not drawn on this chart).

So, a gap up that weakens beneath the 23.6% Fibonacci line becomes a good short candidate. A gap down that strengthens above the 23.6% Fibonacci line becomes a good long candidate.

In our second example, we look at the gap down of BP.

Chart 6

In Chart 6, we look at a stock that struggled at the 23.6% Fibonacci line. You can see how price pushed through just a little bit, but look at the other indicators. RSI barely gets to the 50 line while Stochastics are maxed out. While this may be a risky short set-up, it is definitely a warning sign against going long at the Fibonacci line.

In our third example, we look at the gap down of TCK.

Chart 7

In Chart 7, we see how price met double-lined resistance. We see price resisting the mid-line of the Bollinger Band and then falling below the 61.8% Fibonacci line. This 61.8% Fib line is often a line of resistance for stocks that have recovered from their gap down - especially if the market is showing weakness at the same time.

I hope this Quick Guide will help you get started using Fibonacci Retracements in your own trading. It takes time and study to become comfortable using this tool. So, as always, invest in plenty of study time before you try to use this tool with live trades.