Fibonacci Retracements – Waiting for the Right Moment

By Ng Ee Hwa

It has been 3 years since the Singapore stock market begun its amazing bull run, scaling to new highs and reaching the all time high of more than 3600 points in June 2007. The exponential increase in trading volume in the stock market shows that more and more beginners may be getting involved in stocks. Most are looking for big rewards and are determined to make a killing to profit from this bullish market. However largely unknown to beginners, the lack of a comprehensive trading strategy or technical knowledge in analyzing the behavior of the stock market is leaving them exposed to high risk.

On the other hand, most experienced traders understand the behavior of the stock market well and would know how to anticipate price movements in any given time frame. For example, some stocks would form a chart bottom formation before resuming the uptrend while some stocks with stronger bullish sentiment would resume its uptrend ferociously. Either way, the experienced traders would know how to identify when is the best time to take up positions where there is lesser risk. Therefore, it is crucial for beginners to learn some form of technical analysis so as to time their trades better. No one likes to buy high and sell low, but not many know how to buy low and sell high. This article will introduce an effective tool that will help identify the chart bottoms and the best time to enter the stock market. This tool is well known as the Fibonacci Retracement levels. Last but not least, we will also discuss how Fibonacci Retracement can be used to manage and minimize risk in the stock market.

Figure 1 China Energy rebounded off 38.2% level

Figure 2 Tech Oil & Gas rebounded off 61.8% level

The Fibonacci sequence is a series of numbers that were first derived by Leonardo of Pisa in the fifteenth century after observing the population expansion of a pair of rabbits. Recognising the importance of Fibonacci numbers to real-life application, mathematicians derived the Fibonacci Retracement levels for trading in the stock market; the latter levels being made up of 6 percentage numbers or lines. Depending on the preferred trading period of the trader, the Fibonacci Retracement lines are drawn for an uptrending stock by first identifying the bottom and then the top. After the identification of the bottom and then the top, we start to calculate the retracement levels between the highest price and the lowest price. Nowadays, this can be done by a simple click of the mouse. Most charting software in the market allow you to draw the Fibonacci Retracement levels effortlessly. ChartNexus is one such tool which also comes with free end of day data for download. The fibonacci retracement levels commonly used are 23.6%, 38.2%, 50% and 61.8% with the most significant levels being 38.2%, 50% and 61.8%. As the saying goes, what goes up must come down. In an uptrend, a stock will

Figure 3: Using Fibonacci Retracement lines as support and resistance level

make higher high and higher low. Fibonacci Retracement is used to identify the price level as it retraces to a higher low before testing the higher high. The first possible level of support for a retracement is usually the 38.2% line. The following figure below illustrates how the 38.2% line is effectively tested as support in the chart of China Energy.

In the figure above, China Energy began to pullback after forming a top from May 2007 to early June 2007. On 12th June 2007, the stock tested the 38.2% level and subsequently rebounded off the level. Again, from 24th to 25th June 2007, the stock tested the 38.2% level a second time and rebounded off it. 38.2% in this case served as a very strong support for China Energy.

The following figure shows Tech Oil & Gas rebounding after hitting the 61.8% line.

Figure 4: Using Moving Average with Fibonacci Retracement level

However, the 61.8% line is also known as the last line of defense for the stock price. A break below the 61.8% line usually means that the uptrend of the stock is negated. In Figure 3, Luzhou broke the 61.8% line on 1st March 2007 (in red) and the stock price went down further thereafter.

As observed from Figures 1 & 2, Fibonacci Retracement Levels offer very strong support or resistance to the price movement. In Figure 3, we can see that Luzhou's stock prices were able to find good support at the 50.0% line from Oct 2006 to Jan 2007. However, in the month of March the 50.0% line turned from support to resistance, resisting Luzhou's price from heading higher. Similarly in the month of April, Luzhou's price found resistance at the 61.8% line and went into a downtrend shortly thereafter.

The Fibonacci Retracement levels can also used in conjunction with other indicators to help in analyzing the stock chart. This is known as confluence of signals. The combination of other indicators further enhances and compliments the usage of Fibonacci Retracement levels thus resulting in higher probability of a successful trade. In this article, one of the popular indicators used by many traders, the 100-day moving average is used to analyze the stock chart of Tech Oil & Gas which is shown in Figure 4 below.

Figure 4 clearly shows that the prevailing trend of Tech Oil & Gas is an uptrend and that the price found support on the 100-day moving average from May 2007 to July 2007 . The next observation is that the price was trading near the 61.8% Fibonacci Retracement level. While the 100-day moving average is supporting the price movement, Fibonacci Retracement is also providing support at the 61.8% level which is about the same price level as the moving average line. Hence the price is said to be very well supported because we have the confluence of two types of analysis, namely moving average and Fibonacci levels,

This article has highlighted the importance of understanding the stock market behavior in order to enhance one's timing of the stock market. A powerful tool such as Fibonacci Retracement is widely used to identify possible support and resistance to the price movement. This helps experienced traders to buy low and sell high. In addition, the usage of the Fibonacci Retracement line together with the concept of support and resistance level and the confluence with the 100-day moving average helps to forecast the possible price movement and increases one's confidence to take the trade. **SI**

Ee Hwa is a private trader and Market Strategist for ChartNexus. Witty and concise in his delivery, his unassuming and generous sharing of his insight into Singapore stock market using layman terms makes learning Technical Analysis fun and easily understandable. He is the chief trainer for ChartNexus, conducting trading strategy seminars and coaching programs. He also contributes articles to investment magazines such as SmartInvestor and SGX Pulses on a regular basis.