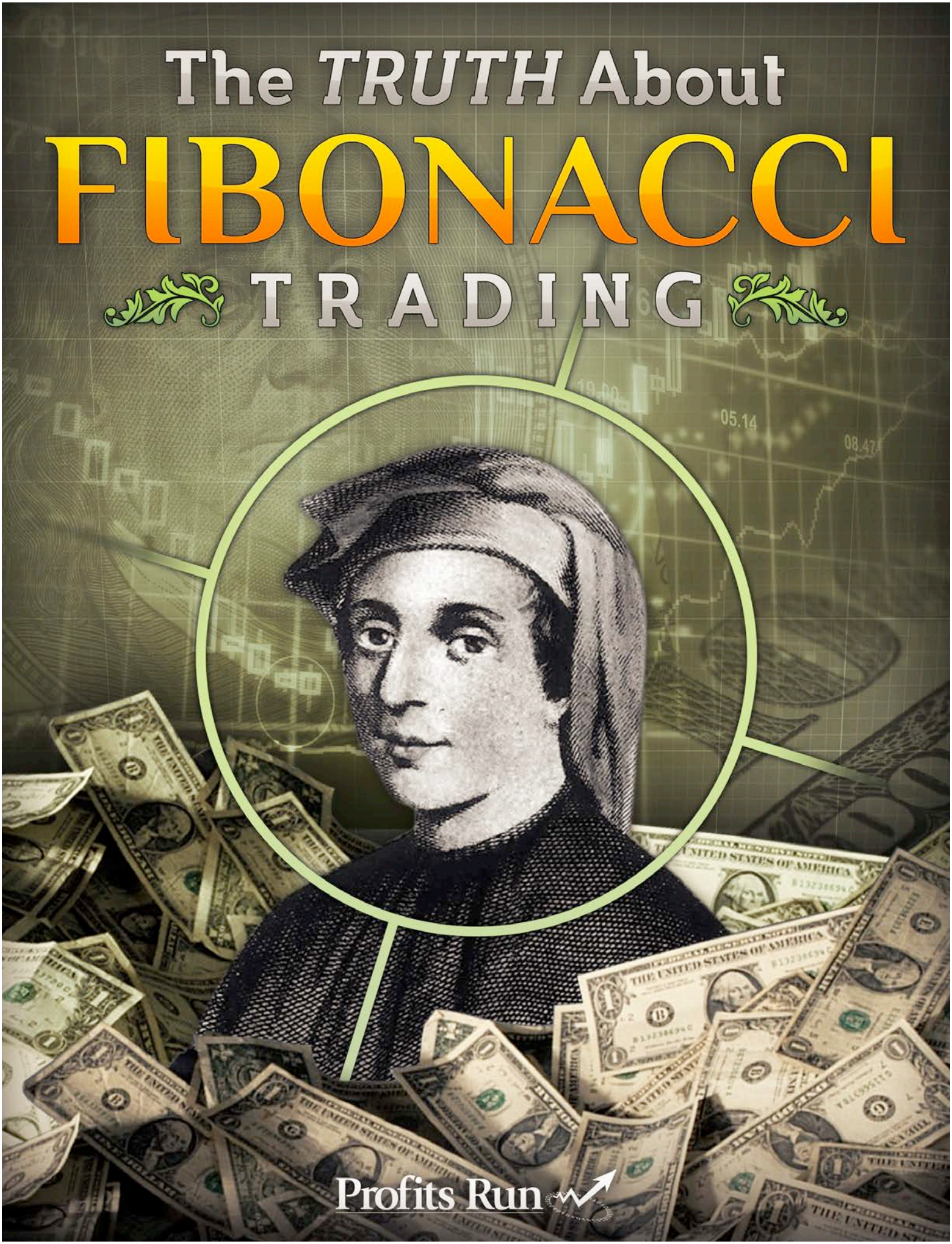
The *TRUTH* About FIBONACCI TRADING



Profits Run

Disclaimer: Forex, stock, futures, and options trading is not appropriate for everyone. There is a substantial risk of loss associated with trading these markets. Losses can and will occur. No system or methodology has ever been developed that can guarantee profits or ensure freedom from losses. No representation or implication is being made that using the information in this special report will generate profits or ensure freedom from losses.

Published by:

Profits Run, Inc.

28339 Beck Rd Unit F1

Wixom, MI 48393

www.profitsrun.com

The Truth About Fibonacci Trading

The truth about Fibonacci levels is that they are useful (like all trading indicators). They do not work as a standalone system of trading and they are certainly not the "holy grail", but can be a very effective component of your trading strategy to help predict market direction.

But who is Fibonacci and how can he help you with your trading?


Leonardo Fibonacci

Leonardo Fibonacci was a great Italian mathematician who lived in the thirteenth century who first observed certain ratios of a number series that are regarded as describing the natural proportions of things in the universe, including price data. The ratios arise from the following number series: 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144 ……

This series of numbers is derived by starting with 1 followed by 2 and then adding 1 + 2 to get 3, the third number. Then, adding 2 + 3 to get 5, the fourth number, and so on.

The ratios are derived by dividing any number in the series by the next higher number, after 3 the ratio is always 0.625. After 89, it is always 0.618. If you divide any Fibonacci number by the preceding number, after 2 the number is always 1.6 and after 144 the number is always 1.618. These

ratios are referred to as the "golden mean." Additional ratios were then derived to create ratio sets as follows:

Price Retracement Levels
0.236, 0.382, 0.500, 0.618, 0.764

Price Extension Levels
0, 0.382, 0.618, 1.000, 1.382, 1.618

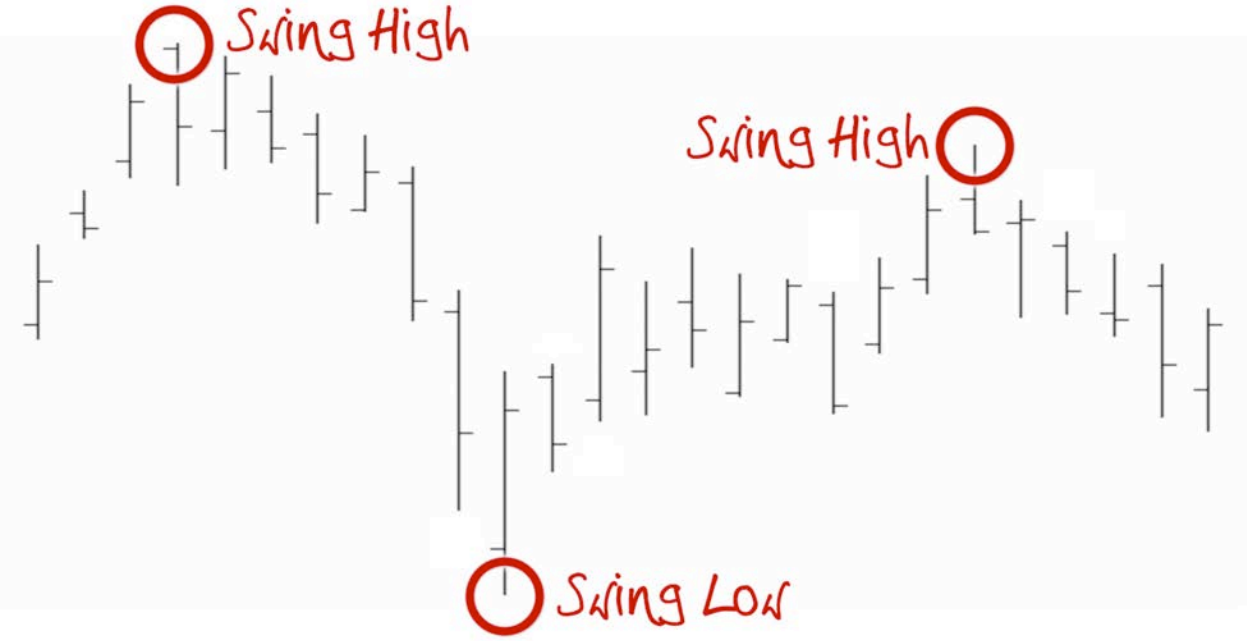
The first set of ratios is used as price retracement levels and is used in trading as possible support and resistance levels. One reason we have this expectation is that traders all over the world are watching these levels and placing buy and sell orders at these levels which becomes a self-fulfilling expectation.

The second set is used as price extension levels and is used in trading as possible profit taking levels. Again, some degree of self-fulfillment comes into play here as traders all over the world watch these levels and place buy and sell orders based on them.

Most good trading software packages include both Fibonacci Retracement Levels and Price Extension Levels. In order to apply Fibonacci levels to price charts, it is necessary to identify Swing Highs and Swing Lows.

A Swing High is a short term high bar with at least two lower highs and lower lows on both the left and right of the high bar. A Swing Low is a short

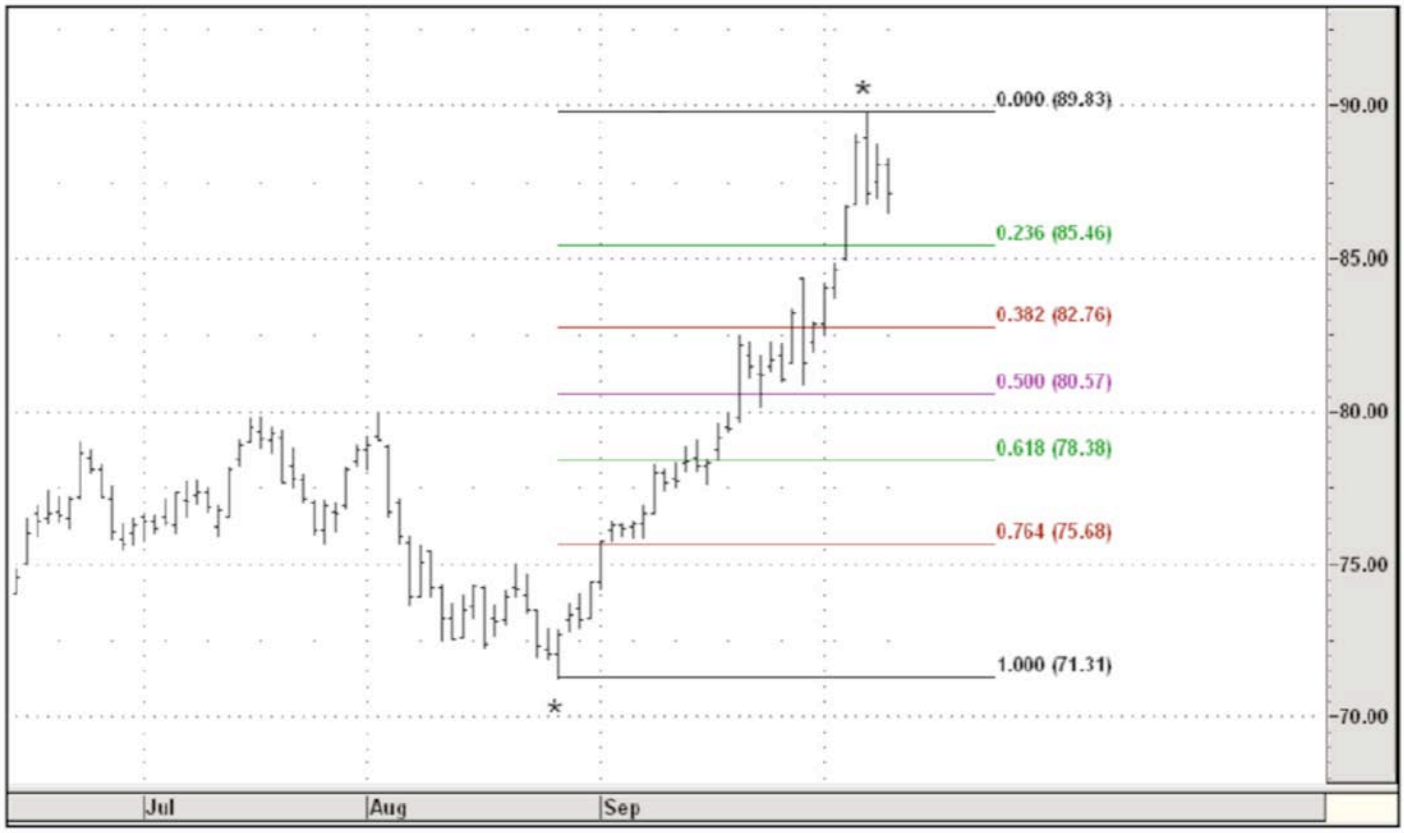
term low bar with at least two higher lows and higher highs on both the left and right of the low bar.



Fibonacci Retracement Levels

In an uptrend, the general idea is to look for an opportunity to go long the market on a retracement to a Fibonacci support level. The price retracement levels can be applied to the price bar chart of any market by clicking on a significant Swing Low and dragging the cursor to the most recent potential Swing High and clicking there. Of course, the exact technique for plotting Fibonacci levels may differ slightly depending on what software you use. This will display each of the Retracement Levels showing both the ratio and corresponding price level. Let's take a look at some examples of markets in an uptrend. The same points made by these examples are equally applicable to markets in a downtrend.

Example 1: Here we plotted the Fibonacci Retracement Levels by clicking on the Swing Low at about $71.31 and dragging the cursor to the Swing High at about $89.83. You can see the resultant levels plotted by the software. Now the expectation is that if the market retraces from this high it will find support at one of the Fibonacci Levels, because some traders will be placing buy orders at these levels as the market pulls back.



Example 1

Example 1.1

Example 1.1: Now let's look at what actually happened after the Swing High occurred. The market pulled back right through the 0.236 level and continued the next day through the 0.382 level before finding support. After a few days, the market resumed its upward move. Clearly buying at the 0.382 level would have been a good short term trade.

Example 2: Again, the Fibonacci Retracement Levels were plotted on the chart in the same manner as described in Example 1. Again, we are looking for the market to retrace from the Swing High and find support at one of the Fibonacci levels.

Example 2.1: Now let's look at what actually happened. The market again pulled back right through the 0.236 level and continued to pull back until it found temporary support at the 0.50 level (a lot of buyers at this level). However, once the buying power was exhausted, the market continued to retrace all the way down to the 0.764 level before resuming its upward trend. In this case, buying at the 0.764 level would have been a good short term trade.

Example 2

Example 2.1

Example 3: Here's another example. If the market retraces from the Swing High, where will it find support?

Example 3

Example 3.1: Well, in this case the market found support at the 0.50 level. Buying at this level would have been a great trade as the market gapped up a few days later.

Example 3.1

Example 4: Here's one more example.

Example 4

Example 4.1: Whoops! The market gapped down through all levels of support and never looked back. A long trade here would have been a loser or at least an open losing position.

Example 4.1

You can see from these examples that the market often finds at least temporary support at the Fibonacci Retracement Levels – not always, but often. It should be apparent that there are a few problems to deal with here.

First, there is no way of knowing which level will provide support. The 0.236 level seems to provide the weakest support, while the other levels provide support with approximately the same frequency.

Second, the market will not always resume its uptrend after finding temporary support, but instead continue to decline below the last Swing Low.

Thirdly, placement of stops is a challenge – it is probably best to place stops below the last Swing Low, but this requires accepting a high level of risk in proportion to the likely profit potential in the trade. Another problem is determining which Swing Low to start from in creating the Fibonacci Retracement Levels. One way is from the last Swing Low as we did in the examples. Another is from the lowest Swing Low of the past 30 days.

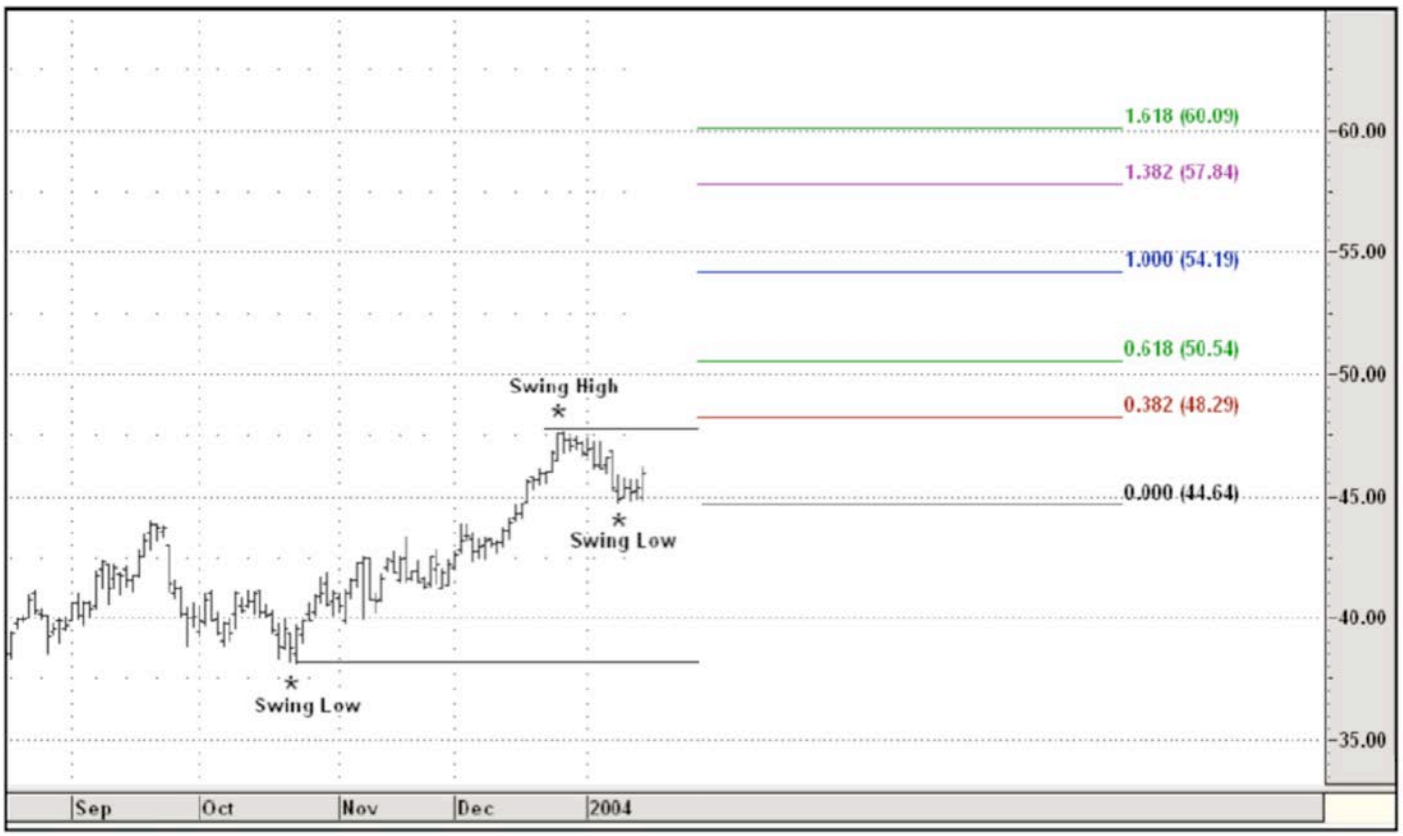
The point is, there is no one right way to do it, and that's why it's important to use Fibonacci levels as a confirming indicator in combination with your other strategies.

Fibonacci Price Extension Levels

In an uptrend, the general idea is to take profits on a long trade at a Fibonacci Price Extension Resistance Level. The Price Extension Levels can be applied to the price bar chart of any market by clicking on a significant Swing Low and dragging the cursor to the most recent Swing High. Then by clicking on the Swing High and back down to the retracement Swing Low and clicking there. This will display each of the Extension Levels showing both the ratio and corresponding price level. Let's take a look at some examples of markets in an uptrend. The same points made by these examples are equally applicable to markets in a downtrend.

Example 5: Here we plotted the Fibonacci Price Extension Levels by clicking on the Swing Low at about $38.20 and dragged the cursor to the Swing High at about $47.67 and then down to the retracement Swing Low. You can see the resultant levels plotted by the software. Now the expectation is that if the market continues higher it will find resistance at one of the Fibonacci Levels, because some traders will be placing sell orders at these levels to take profits on their long trades.

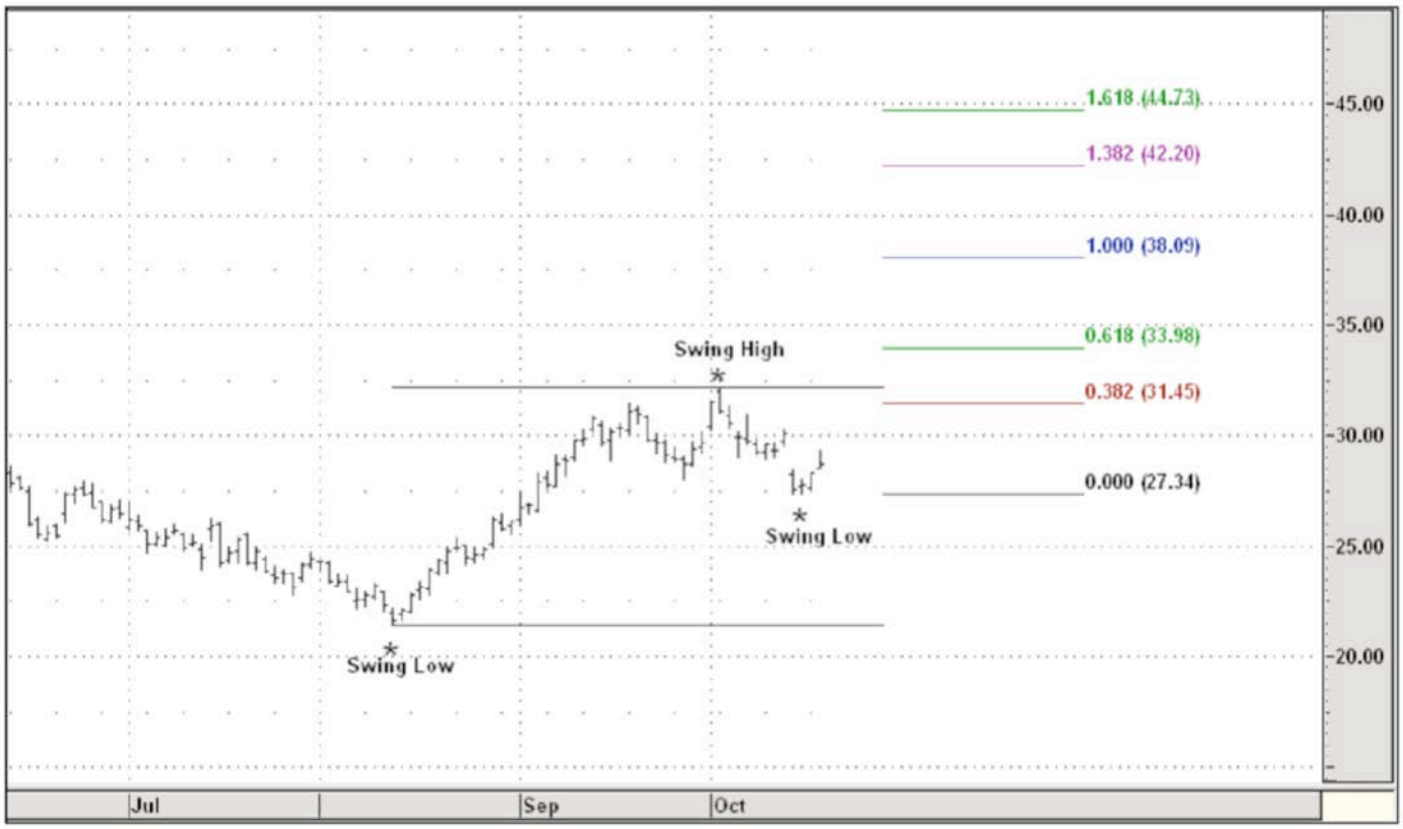
Example 5.1: Now let's look at what actually happened after the retracement Swing Low occurred. The market rallied making new highs pausing at the 0.382 level and again at the 1.000 level after a retracement down it rallied again going right through the 1.382 and 1.618 levels. Taking profits at the 0.382 level would have been premature, but taking profits at the 1.000 level would have made a nice trade.



Example 5

Example 5.1

Example 6: Again, the Fibonacci Price Extension Levels were plotted on the chart in the same manner as described in Example 5. Again, we are looking for the market to continue higher before finding resistance at the Fibonacci Levels.



Example 6

Example 6.1: Now let's look at what actually happened. The market rallied, making new highs and pausing between the 0.382 level and the 0.618 level, and then continued higher. This up move could well continue up to at least the 1.000 level. Taking profits at the 0.382 level would have been premature and only time will tell if taking profits at the 0.618 level was the optimal place to exit the long trade.

Example 6.1

Example 7: Here's another example. Will the market continue higher to one of the Fibonacci Price Extension Levels?

Example 7

Example 7.1: Well in this case the market found resistance at the 0.382 level which would have been the place to take profits on any long trades.

Example 7.1

Example 8: Here's one more example.

Example 8

Example 8.1: Like the last example, the market found resistance at the 0.382 level which would have been the place to take profits on any long trades.

Example 8.1

You can see from these examples that the market often finds at least temporary resistance at the Fibonacci Extension Levels - not always, but often. As in the examples of the Retracement Levels, it should be apparent that there are a few problems to deal with here as well. First, there is no way of knowing which level will provide resistance.

The 0.382 level was a good level to cover any long trades in two of the examples, but in the other examples taking profits at that level would have been premature. Another problem is determining which Swing

Low to start from in creating the Fibonacci Extension Levels. One way is from the last Swing Low as we did in the examples; another is from the lowest Swing Low of the past 30 days.

Again, the point is that there is no one right way to do it, and so you want to use these techniques as confirmation to support your other trading strategies.

When used as part of an effective trading method, Fibonacci levels have the potential to help predict market direction. And the key to an effective trading method is to integrate a few indicators (not too many) that are applied in a way that is not obvious to most observers.

All successful traders know it's how you use and integrate the indicators (including Fibonacci) that makes the difference. The lesson learned here is that Fibonacci levels can be a useful tool, but never enter or exit a trade based on Fibonacci levels (nor any other indicator) alone.

Good Trading,