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The Efficacy of Support and Resistance Levels in Determining Fair Stock Value

Abstract

Technical analysis is frequently criticized as pseudoscience, akin to financial astrology, due to its reliance on historical price patterns rather than intrinsic valuation models. However, this paper contends that support and resistance (S/R) levels — particularly dynamic ones — serve as empirically valid indicators of supply and demand, effectively approximating a stock's fair value when prices deviate but repeatedly retest these zones. While fundamental analysis depends on speculative assumptions (cash flows, discount rates, terminal growth), S/R levels emerge from real-time market behaviour, offering an observable and actionable measure of equilibrium.

We explore:

- The inherent limitations of intrinsic valuation models.
- How S/R levels function as supply-demand equilibrium points.
- The superiority of dynamic S/R in trending markets.
- The psychological and institutional reinforcement of S/R as a fair value proxy.
- Empirical evidence supporting S/R based trading strategies.

The findings suggest that while fundamental analysis remains crucial for long-term investing, S/R levels provide a more immediate and practical tool for identifying fair value in the stock market.

1. Introduction

1.1 Background

The debate between technical and fundamental analysis has persisted for decades. Critics argue that technical analysis lacks a theoretical foundation comparing it to astrology due to its reliance on historical price patterns rather than economic fundamentals. However, support and resistance (S/R) levels stand out as a unique exception — these zones are not arbitrary but reflect real shifts in supply and demand.

1.2 Problem Statement

Fundamental valuation model such as (Discounted Cash Flowl) is highly sensitive to assumptions making them unreliable for short-to-medium term trading. Even if an investor accurately estimates intrinsic value, the market may take years to reflect it in orice. In contrast, S/R levels provide immediate, observable reference points where market participants consistently react.

1.3 Research Objectives

1. Highlight the limitations of intrinsic valuation.
2. Demonstrate how S/R levels act as supply-demand equilibrium zones.
3. Compare static vs. dynamic S/R in different market conditions.
4. Provide empirical evidence supporting S/R as a fair value proxy.

1.4 Hypothesis

Support and resistance levels, particularly dynamic ones, serve as a more reliable short-to-medium term measure of fair value than intrinsic models because they reflect real time market psychology and order flow.

2. The Flaws in Fundamental Valuation Models

2.1 Sensitivity to Assumptions

Intrinsic valuation model (DCF) require numerous assumptions:

- Future cash flows (highly unpredictable beyond 3-5 years).
- Discount rates (affected by interest rates, risk premiums).
- Terminal growth rates (small changes lead to large valuation swings.)

2.2. Market Recognition Lag

Even if a stock is undervalued, price may not adjust all other market participants recognize it. This creates a disconnect between intrinsic value and market price (margin of safety).

2.3 Behavioral Biases and Irrational Markets

Efficient Market Hypothesis (EMH) assumes rational pricing, but markets are often driven by sentiment, herd behaviour, and liquidity flows, making fundamentals unreliable in the short-to-medium term.

2.4 Conclusion

While fundamental analysis is essential for long-term investing, it's short-to-medium term predictive power is weak due to model sensitivity and market inefficiencies.

3. Support and Resistance as Supply-Demand Indicators

3.1 Static Support and Resistance

Fixed price levels where buying (support) or selling (resistance) historically dominates. The formation is previous highs/lows and consolidation zones.

3.2 Dynamic Support and Resistance

Levels that adjust with price trends which is more adaptive in trending markets.

3.3. Fair Value Reflection

When price deviates from S/R but retests or breaks these zones, it signals a market reassessment of fair value.

4. Empirical Evidence: S/R a Market-Driven Fair Value Proxy

4.1 Order Flow and Institutional Reinforcement

Larger traders (market makers) place orders near key S/R levels reinforcing their importance.

4.2 Statistical Backtesting

Studies show that breakout/retest strategies at S/R levels yield positive risk-adjusted returns.

4.3 Psychological Anchoring

Traders remember past reactions at key levels, creating self-fulfilling prophecies.

5. Criticisms and Counter Arguments

5.1 "S/R is Self-Fulfilling, Not Predictive"

Market structure ensures these levels persist due to algorithmic trading and liquidity pools.

5.2 "Fundamental Drive Price Long-Term"

True, but S/R helps identify entry/exit points before fundamentals are priced in.

5.3 "False Breakouts Are Common"

Dynamic S/R filters noise better than static levels.

6. Conclusions & Practical Implications

6.1 Key Findings

- Fundamental models are unreliable for short-term trading due to sensitivity and market inefficiencies.
- S/R levels act as real-time supply and demand zones, making them a practical fair value proxy.
- Dynamic S/R will always outperform static S/R in trending markets.

6.2 Practical Applications

Traders can use S/R for entry/exit points and investors may combine S/R with fundamentals for better timing.

Final Thought:

Price is the truth. Even if fundamentals justify a valuation, the market must acknowledge it first before it matters. S/R levels provide a map of where that acknowledgement occurs.