Module 5 – Chapter 6 – Fibonacci Retracement

Fibonacci retracement is a popular tool among technical traders, utilized to identify potential support and resistance levels. Based on the Fibonacci sequence—a series of numbers where each number is the sum of the two preceding ones—this tool draws horizontal lines to indicate where potential price reversals could occur.

What it is and what it shows

Fibonacci retracement levels are horizontal lines that indicate potential support or resistance levels based on the Fibonacci sequence. By drawing a line from a significant peak to a trough (or vice versa), these levels are generated at key Fibonacci levels, commonly 23.6%, 38.2%, 50%, 61.8%, and sometimes 78.6%.

The foundational idea behind Fibonacci retracement is that markets will retrace a predictable portion of a move before continuing in the original direction. These retracements provide traders with potential levels to enter trades or place stops.

To understand why these particular percentages matter, it's worth noting that the Fibonacci sequence has certain mathematical properties. For instance, the ratio of a number to the next higher number is approximately 0.618, hence the 61.8% retracement level. Similarly, the inverse of 0.618 is 1.618, which gives rise to other levels.

How to trade it

Trading with Fibonacci retracement involves several strategies:

1) **Identifying Potential Support and Resistance**: One primary use is to identify potential support and resistance levels. When a price decline is expected to end, it might do so near a Fibonacci retracement level (e.g., 61.8%). Conversely, during an uptrend, the price might find resistance near one of these levels.

Example: If a stock rises from Rs.100/- to Rs.150/- and then starts to decrease, the 50% retracement level of that move is Rs.125/-. Some traders might see this as a potential support level.

2) **Setting Stop Loss Orders**: Traders can set their stop loss orders at or near Fibonacci retracement levels. If a trader believes the price will find support at a retracement level, they might place their stop loss just below that level.

Example: If a trader enters a long position near the 38.2% retracement level, they might set a stop loss just below the 50% retracement to protect their position.

3) **Target Setting:** Retracement levels can also be used to set price targets. For instance, if a price bounces off a retracement level, the next higher retracement can be used as a potential target.

Example: If price finds support at the 50% retracement level and starts moving up, the 38.2% level above might serve as a potential short-term target.

4) **Combination with Other Tools**: It's always a good idea to combine Fibonacci retracement with other technical analysis tools such as trendlines, moving averages, and other indicators to increase the likelihood of making successful trades.

Traders should remember that while Fibonacci retracement can provide valuable insights, no tool guarantees success in the markets. It's always essential to apply risk management practices and continuous research when making trading decisions.

An example of the Fibonacci Retracement

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