Fibonacci Analysis for Forex Beginners

Retracements and Projections

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About ActionForex.com

ActionForex.com was set up back in 2004 with the aim to provide insightful analysis to forex traders, serving the trading community over a decade. We started providing only a daily and a mid-day report, now known as Action Insights. Gradually, we added a lot more in-house contents to the site. Techinical Outlook section was expanded to cover more pairs. Central Bank Views, China Watch and Special Topics are added to cover fundmental developments that affect the markets. In addition to that, Top Movers, Heat Map, Pivot Point Charts and Pivot Meters, Action Bias and Volatility Charts, are tools used by traders from all over the world.

"Empowering the individual traders" was, is, and will always be our motto going forward.

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I. Introduction

Leonardo Fibonacci was an Italian mathematician who first observed certain ratios of a number series which can describe the natural proportions of things in the universe.

The Fibonacci numbers are the following sequence of numbers: 0, 1, 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144, 233, 377, 610, 987 ......

The first two Fibonacci numbers are 0 and 1, then the Fibonacci sequence is formed by getting the sum of the two previous numbers to obtain the next number.

The number sequence generates some mathematical relationship and the most well known and widely used is the ratio of any number to its next higher number which approaches a constant value of 0.618, e.g.:

- 13/21 is 0.619, 55/89 is 0.6179
- 377/610 is 0.61803, and,
- the higher pair of number you get, you will have a result closer to 0.618

Another percentage is the ratios of alternate numbers which approaches a constant value of 0.382, e.g.:

- 13/34 is 0.3823
- 55/144 is 0.3819
- 377/987 is 0.382
- again the higher pair of number you use, you will get a result closer to 0.382

In addition, 0.382 is also the inverse of 0.618 (1-0.618=0.382). Finally is the ratio of 0.5, which only occurs between the relation of the 2 numbers 1 and 2, nevertheless, this ratio is also considered as one of the very important Fibonacci ratio especially in technical analysis.

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II. Fibonacci Retracements

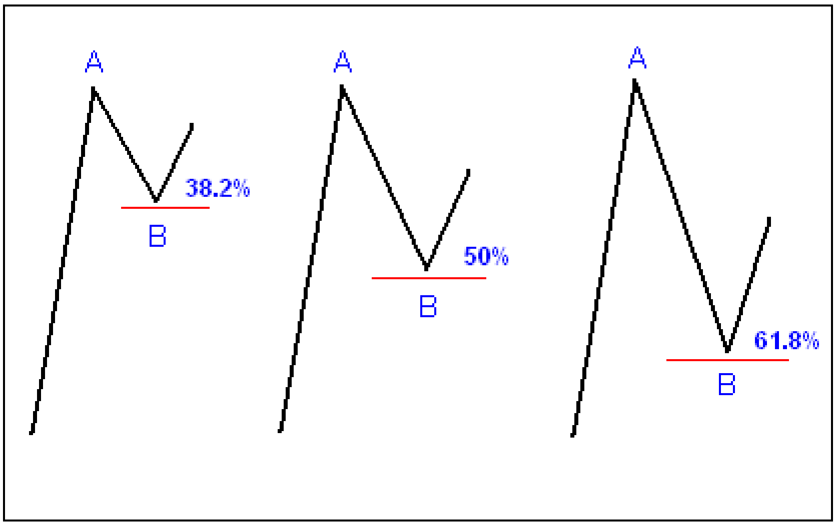
Even in a trending market, either up or down, price does not move in a straight line, there will be numbers of short-term countertrend price movement known as pullbacks and corrections in different magnitude before the prevailing trend resumes.

Experienced traders know that in order to enhance profitability and make a trade less risky, the best way is to enter a position at the end of the correction. Therefore, technique in predicting the retracement level becomes extremely useful in formulating a trading strategy

Technical analysts considers Fibonacci percentages very effective ways to locate the possible retracement level especially when the actual chart support and resistance levels are too far away.

These Fibonacci percentages / ratios, 0.382, 0.5 and 0.618 can be very useful especially for swing traders in order to identify the pivot points on the chart.

In an uptrend, whenever a pullback takes place, which should be treated as golden opportunity to enter long position and these percentages can be applied to predict the retracement level (i.e. where you can set your entry point) or identify Fibonacci support level which should contain the correction (i.e. where you can put your stop-loss). The following diagram explains the retracement patterns of 3 major Fibonacci percentages and same principle also applies to downtrend.



In a rising market, after meeting certain resistance level, point (A), when correction unfolds, it is quite common for price to find support at these three Fibonacci retracement levels.

In a fast market, pullback tends to be shallow and normally only reaches **38.2%** of the nearest upmove before turning north again. Some people consider this as the first line of defense, once this level is penetrated, this implies a deeper correction of the underlying trend has commenced.

Another well known percentage is the **50%** retracement. In a primary, secondary or intermediate trend, correction against a major uptrend often retraces approximately 50% of the prior uptrend as it is quite common for half of the participants to take profit after certain temporary top is formed.

Last but surely not least, is the **61.8%** Fibonacci percentage. In a weak trend, it is not uncommon to see this percentage of correction, this point is also considered as the maximum retracement level which is allowed if the prior trend is going to resume. Once this level is broken firmly, a break of 61.8% retracement, it usually warns of a reversal rather than a retracement is taking place.

Guidelines on using Fibonacci retracements

Whilst there are no fixed rules in applying Fibonacci retracement, we do have some useful guidelines which should help enhancing the accuracy in predicting the pullback or correction levels.

Guideline 1: To identify the High and Low first

Before you could start calculating Fibonacci retracements, you must first identify the market high and low prices. Generally many people consider using the longer term historical high and low may help identifying significant support and resistance levels.

However, for short term trading, using the major high and low might not have too much help as even you take the smallest percentage (e.g. 23.6% or 38.2%) could still be too far to reach, so it is not practical to use these levels as an entry point.

In an uptrend, when ever pullback takes place, there is only one temporary top (high) but there are numbers of reaction low, therefore, picking the appropriate intermediate low would greatly improve the chance to predict the pivot point.

It is more like an art than science in choosing this so-called appropriate intermediate low, we believe the Elliott Wave Theory can do the job pretty well.

Guideline 2: Plotting the Fibonacci retracement levels

After selecting the relative high and low points, this is the time to draw the Fibonacci percentage retracement levels on the chart. In a rising market, the measurement should start from the low point (i.e. 0%) to the high point (i.e. 100%). Then the drawn 38.2%, 50% and 61.8% and 38.2% retracement levels should be the lines of correction target, and vice versa for a falling market.

Guideline 3: Take reference of Historical Behavior

In addition to normal Fibonacci percentage expectation, e.g. 38.2% for fast market, one should also observe what had happened before and take it into consideration. If all along the uptrend, most previous pullback took place reached 50% before finding renewed buying interest, then one shall reasonably adjust the chosen Fibonacci level accordingly.

Guideline 4: Always have a Plan B

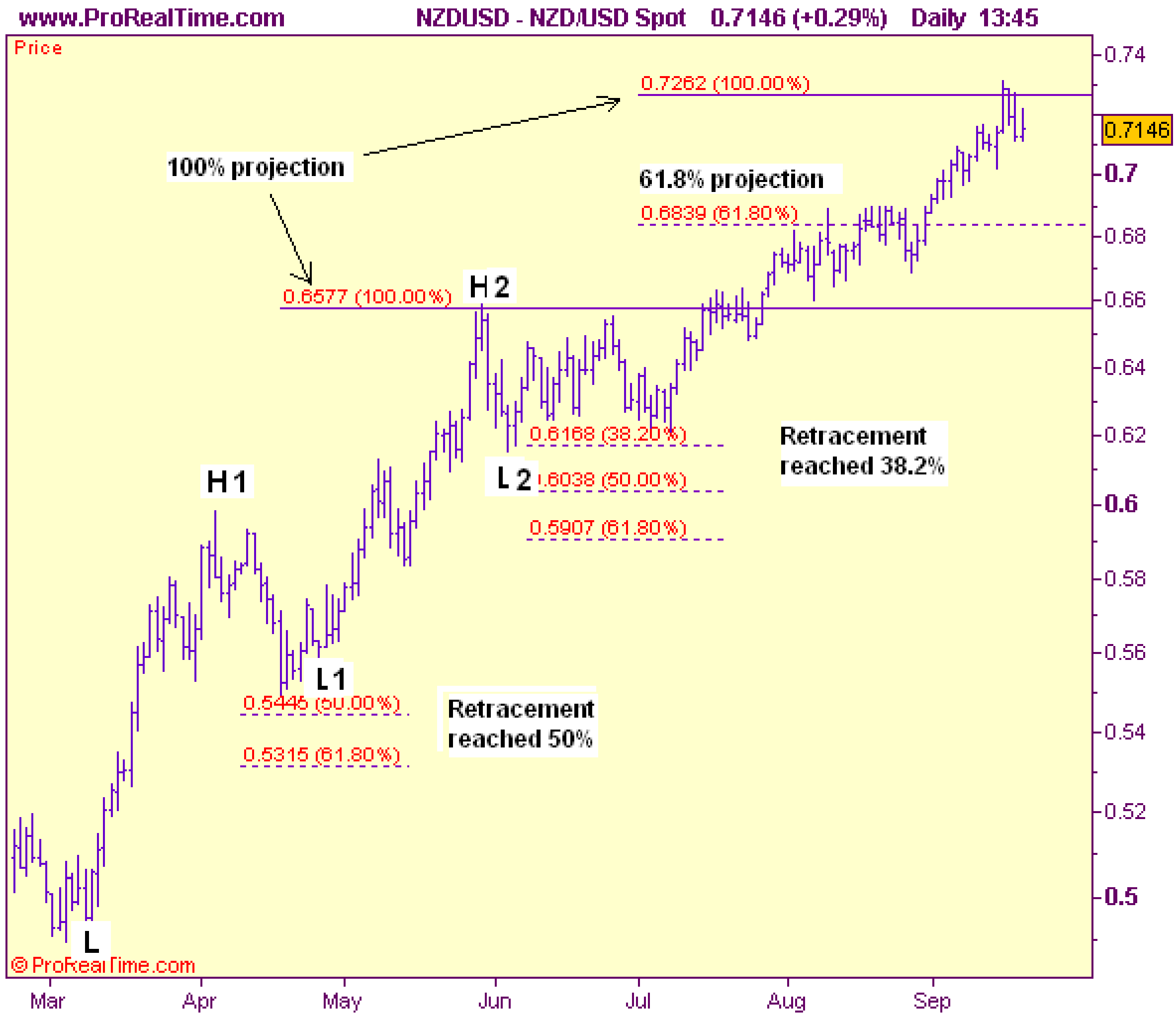
Once a temporary top is formed, we normally expect 38.2% retracement before upmove resumes, however, one should also set a percentage (e.g. 50%) which would abort this scenario and suggest either a deeper correction is going to take place or a reversal is in progress, then at which point would signal price is heading for another direction.

III. Fibonacci Projections

Once the pull back or correction is over and price is starting to resume previous move, this is the time to apply projection technique in order to predict the next upside or downside target.

Fibonacci projection (extension) takes into account three points, in an uptrend, they are the starting low point (A), the swing high (B), then the reaction low (C), measures the vertical distance from (A) to (B) and get the Fibonacci percentage (e.g. 50% or 61.8%), then project it from point (C).

The following chart displays an actual example in NZD/USD daily chart of the application of Fibonacci retracement and projection.



On the left hand side of the chart, after forming a temporary high (H1), kiwi retreated almost 50% (of L to H1) and renewed buying interest emerged at L1.

Then it started to move higher from there, then one can use these 3 points L, H1 and L1 to project the upside target. The currency pair rose to as high as H2, slightly exceeded 100% of L-H1 measuring from L1.

Similar process occured after forming another temporary top at H2, one can calculate the Fibonacci retracement level by using L1 and H2 and get the three percentage (38.2%, 50% and 61.8%) levels ready.

Price reached 38.2% retracement level and headed north again from there, as the retracement was shallow (only 38.2%), initial upside target should be 61.8% of L1 to H2 measuring from L2 and when this level is exceeded, get 100% projection level ready for the next upside objective.

In general, the simplest way in picking which ratio to use is if previous move has retraced between 0.236-0.382, then apply 50% projection, and if correction was near 50%, use 61.8%. When retracements exceeded 61.8%, use 100%, 123.6% or 161.8%.

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IV: Conclusions

Fibonacci ratios are common used in forex trading for predicting depth of correction. They're also used for predicting how far a trend could go on resumption.

This ebook explained the basis of calculating the ratio. Also, various ways and guidelines on applying the ratios are discussed.

These Fibonacci techniques can be part of a larger technical analysis framework for any Forex traders.

When you're ready, let's move on to other ebooks of the series for building your skill as a successful trader.

Trading is a journey, not a destination.

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