Anatomy Of A Trade Using Fibonacci Price Analysis

By Carolyn Boroden

Fibonacci price analysis can be an extremely powerful trading tool, if used correctly.

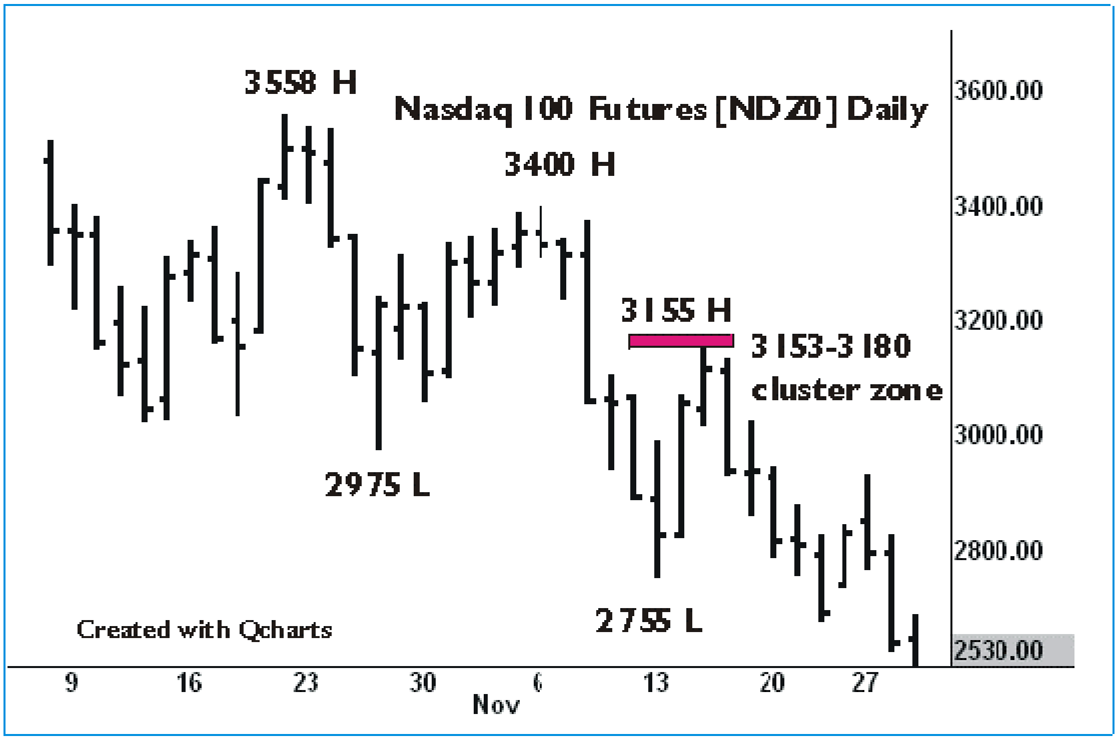
The typical argument against using Fibonacci price relationships to trade is that levels can be projected all over the place -- confusing traders as to which level or area to execute the trade against. In this lesson, we are going to focus on how we choose the appropriate levels to execute a trade against.

The first example walks through a relatively recent trade setup against a **price cluster zone.**

Price clusters are the first and most powerful way to use this type of price analysis. The definition of a price cluster zone is when the coincidence of three or more Fibonacci price relationships come together within a relative tight range.

Let's start with an example in the December Nasdaq futures contract **(NDZ0).** We are looking at the high that was made on **Nov. 15** at the **3155** level. First, if we go back in time to this price cluster setup, we saw a healthy confluence of price relationships between the **3153-3180** area. This zone included the *.618 retracement* of the 3400 high to the 2755 low, the *50% retracement* of the 3558 high to the 2755 low, along with the *100% price projection* of the 2975 low to the 3400 high projected from the 2755 low.

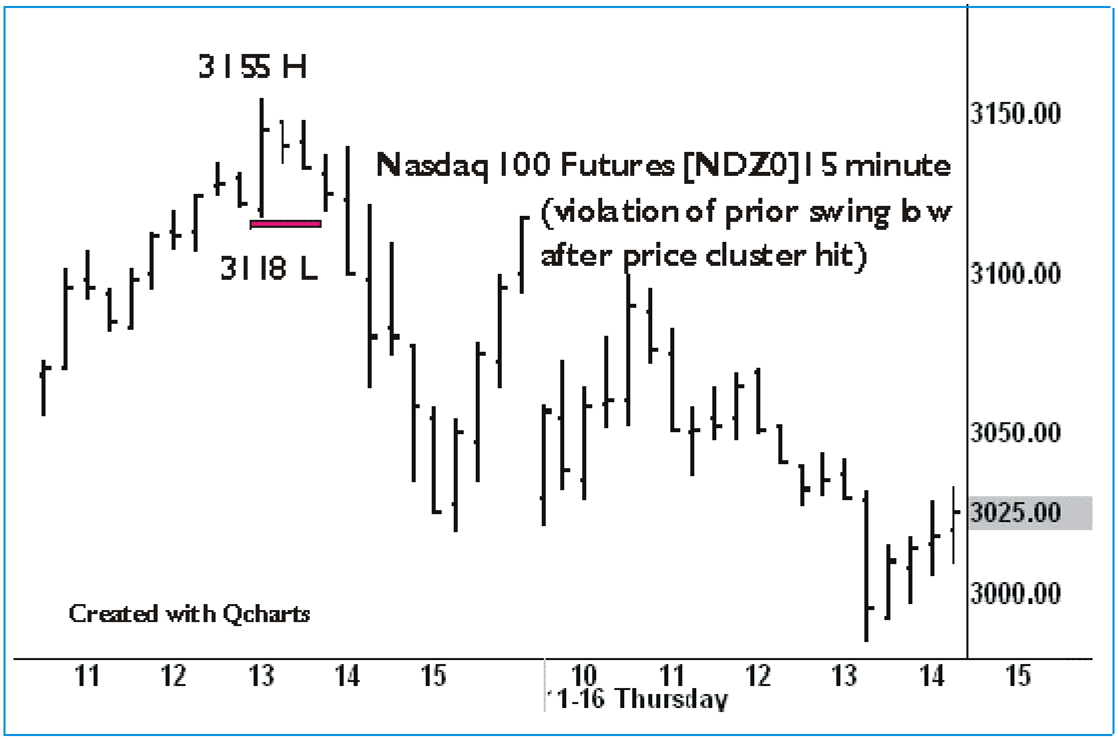
At that time, the Nasdaq 100 contract was trading straight up into the 3153-3180 area. Did we just want to sell into this zone and **HOPE** the market stalled? Probably not. It would have worked in this case, but there are of course times when a cluster will be violated, so it is worth waiting for **confirmation** of a price reversal before entering a trade against one of these *price cluster zones.*



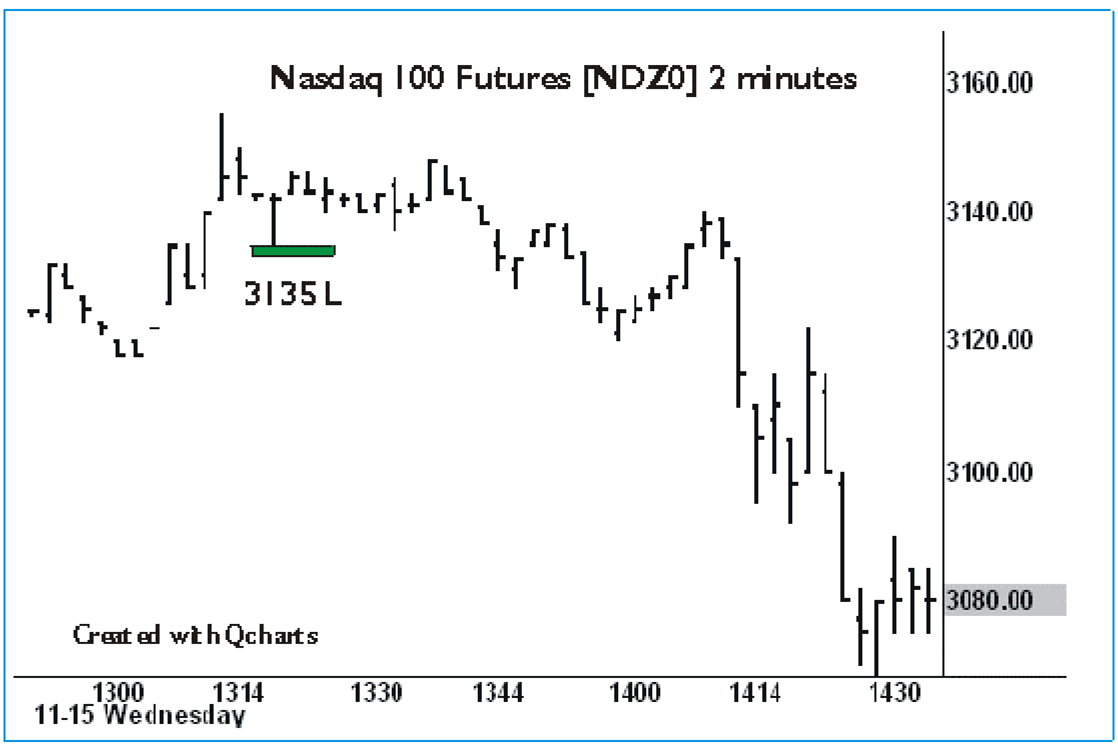
Let's take a look at what might have **confirmed** a reversal and told us to execute a trade against the 3155-3180 zone. First note that this coincidence of price relationships was defined projecting from key highs and lows obvious on the **daily** chart. If you used the daily data to confirm a change in trend and just waited for the low of the previous day to be taken out, you would not have seen a sell trigger until the 3020 level was violated. Now that's a long time to wait for confirmation, though this type of entry is still valuable if you are a longer-term trader.

Most of us have no patience, however, so we would want to take it down to a lower time frame than the one that we projected the *Fibonacci price relationships* from. For example: Since we ran the projections from a daily chart, we would want to go down to a 60-minute or even a 15-minute chart to confirm a sale against this key resistance area.

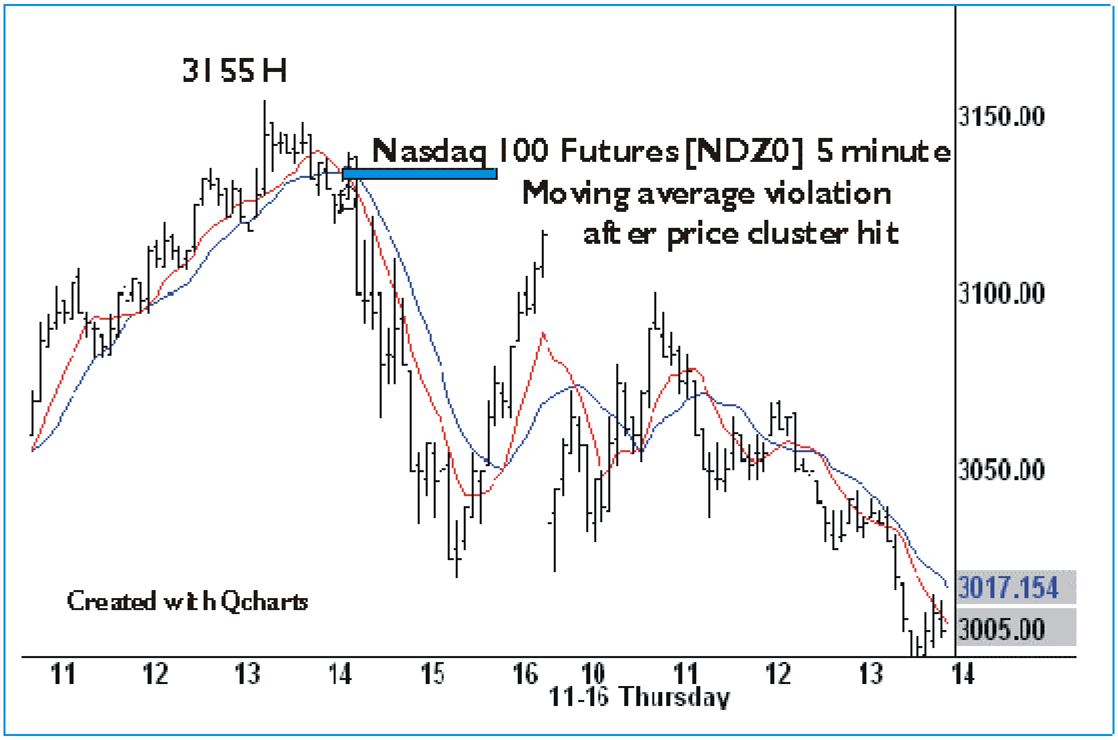
If you look at a 15-minute chart back around Nov. 15, you can see where a prior swing low was taken out at the **3118** level. This would have been considered a sell *"trigger"* against the **3153-3180** price cluster zone.



If you went down even further to a two-minute chart, the violation of the **3135** swing low could have been taken as a sell trigger.



Now let's look at **moving averages.** If you are short-term oriented, you want to get a trading signal as soon as possible. Therefore, you would probably want to use a five-minute chart for trade entry using these averages. In this example, the averages were violated after the high was made within the **3153-3180** price cluster zone **(3155 actual high)**. As soon as these averages were violated (eight- and 13-bar in this example), we would consider a sale with the risk defined just above the top of the price cluster zone, **or** just above the high made before the reversal signal via the averages. If you are longer-term oriented, you may want to use the 60-minute chart and moving averages for your trade signals.



For those of you that have a favorite indicator of a change in trend (MACD, stochastics, buy or sell patterns, etc.), I invite you to combine your trigger/indicators with these key price relationships and check the results. I think you will be pleased with the combination of methods. Personally, I will either buy or sell directly against a cluster **IF** and **ONLY IF** it is in the direction of the main trend. Otherwise, attempting to pick a bottom or pick the top can be very costly. Alternately, I use the violation of a prior swing high or low as confirmation, typically on a shorter-term chart (five- to 15-minute) similar to the example described above.

What about stops and money management?

Initial risk against a cluster trade is always defined as just marginally above or below the actual price cluster zone. Once you enter a trade against this zone, if it starts to move in your favor, you should move to a breakeven stop ASAP and then trail the stop.

What about exiting the trade?

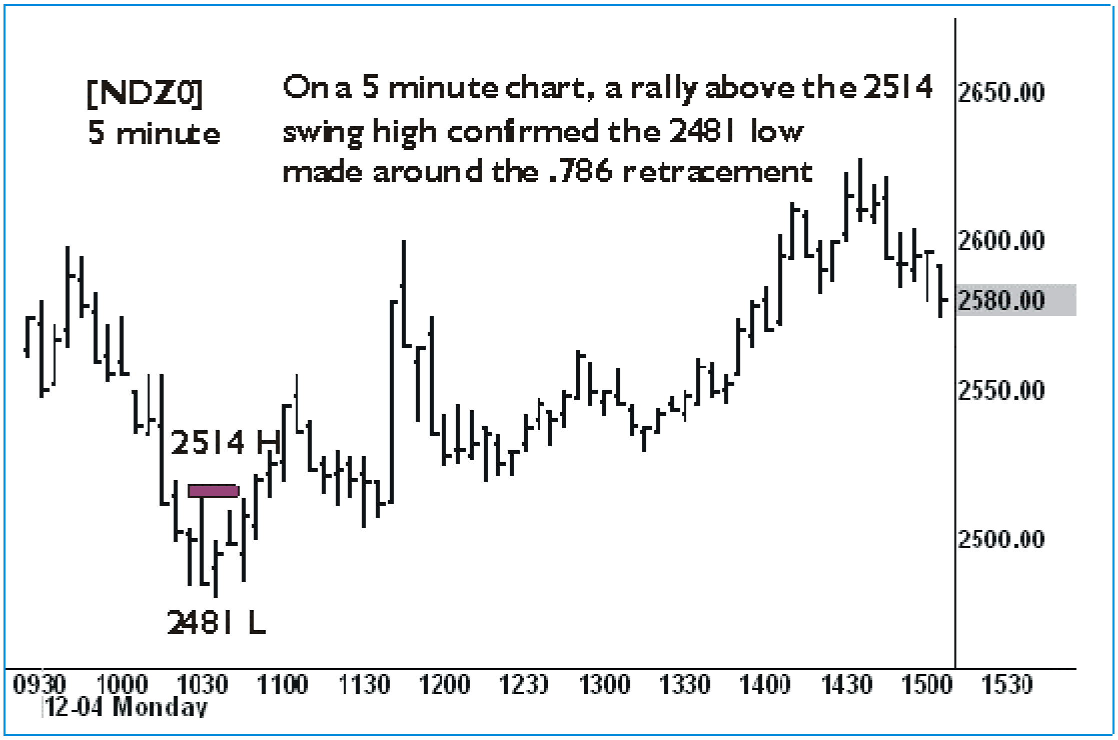
There are two ways to exit a price cluster trade. Either allow a trailing stop take you out (as long as the initial stop does not), or you could exit if the price objectives via this same analysis are met. For a trailing stop, I recommend placing these stops just ticks below a prior swing low or high as the market moves in your favor.

What about trading against single Fibonacci levels?

Although we **prefer to see a confluence** of levels before stepping up to the plate on a trade, there are instances when a single retracement, price-extension or price-projection level will produce a "turn" or change in trend in the market. In the case when we only see one of these price relationships , we would **definitely** wait for confirmation of a change in trend against the level as the **odds** for a change in trend are lower than when we have a confluence of relationships come together.

In the example below on a 30-minute chart in the Nasdaq 100 futures, we had a single *.786 price retracement* of the 2436 swing low to the 2683 swing high come in at 2488. A low was made just a touch below this key retracement level at 2481. How would we have known not to take a trade against the .382, .50, or .618 retracement of this same prior swing and to take a trade against the .786 price retracement zone instead? If you waited for **confirmation** of a reversal or change in trend, you would not have entered a trade until the fourth (or .786 retracement) essentially held and was then followed by a reversal trigger. What is the reversal trigger? Check out the next chart example.

If you went down to a five-minute chart after this contract held right around the .786 price retracement, a rally above the prior minor swing high at the **2514** level would have been considered a "buy trigger" against the .786 retracement. The risk at that point was defined below the 2481 low. Personally, I rarely use a single retracement to trade against, unless it is of a major daily range since price "clustering" is so much more powerful.



There is one more way we qualify Fibonacci levels to trade against. That is with **TIMING.** If we see an important time relationship, or a confluence of time relationships at the same time Fib levels are hitting on the price axis of the market, the odds for a change in trend increase dramatically. This however, will be discussed in a future lesson, perhaps the next one.