

Support and Resistance - What Is It?

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A brief analysis of what support and resistance levels are and why knowing about them is useful. The next article in this series will cover why they occur.

What are they?

In a market, support and resistance levels are those which the price has trouble crossing; at support the price has trouble crossing from above and at resistance the price has trouble crossing from below. The red line on the image below is an example of a support level, on multiple occasions the price has moved down until it reaches it and then moved up again.

Such levels can be found on multiple time frames (the above is taken from EURCHF on the hourly). As a general rule (the why's are examined in the next article) the longer the timeframe the levels show up on, the more significant they are and the more the price is likely to react to them. From a practical perspective, if these levels are marked on a chart, then as the price approaches them we can conclude that there is a higher than usual probability that it will reverse when it reaches them.

Why are they important

Whilst these levels are not absolutes, as can be seen on the above chart - the price sometimes breaks them, they do provide a point at which we have better than average odds of 'predicting' what the market will do. If, without any additional information we make a call as to the direction it will move, we have a roughly 50/50 chance of being right. If, at these points we have say a 60/40 chance of being right because the price in our experience acts as we expect at these points sixty percent of the time then we should, if this continues to be true, be right more than we are wrong.

Too much shouldn't be read into 'being right more than you're wrong'; it is perfectly possible to make money being wrong much more often than you are right as long as the profit from your few wins more than cancels out your cumulative losses. What's important is the extra information; at these points we have a better chance of making correct predictions, which gives us a useful building block for constructing a system which will make more than it loses in the long run; a system with an edge.

Firstly they can be used as tools to signal a potential trade entry; if a sign which often signals a reversal in the direction of price movement (more on these later in this series) occurs at one of these levels then the combination of these two factors, known as confluence, gives greater confidence that the reversal will actually occur.

They are also useful for defining potential 'problem areas' once a trade is open. If you are in a long trade (betting on the market going up) and you know that there is a resistance level at a given point above where you opened the trade, you know to watch the trade carefully at this level and potentially take your profits if it looks like it's reversing.

In the next few articles: why these support and resistance zones exist at all, pivot zones and trend lines.

