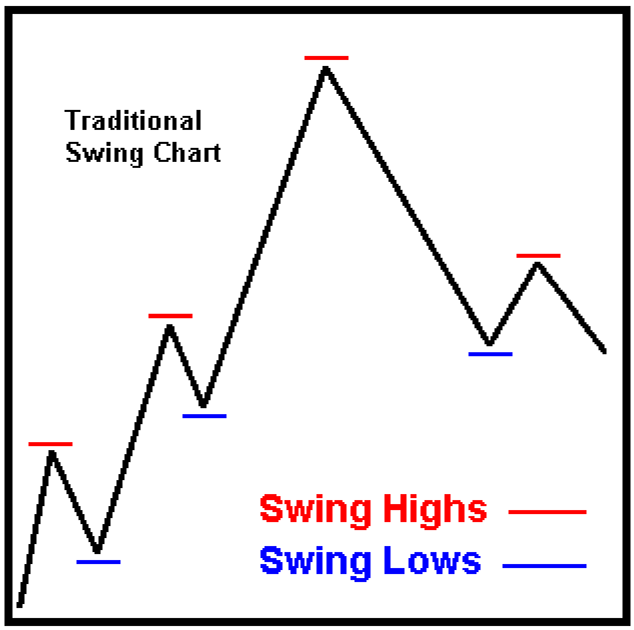
How to Trade Support and Resistance Levels

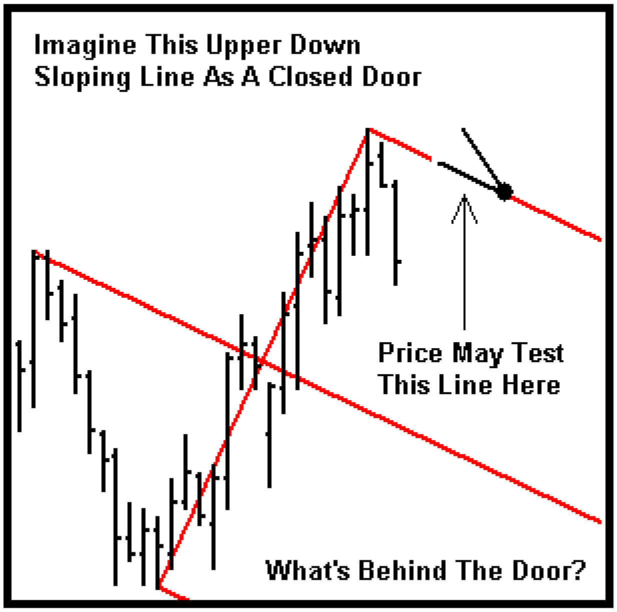
Many traders count themselves amongst the legions of “swing traders,” entering long or short positions as price approaches potential swing highs or swing lows. Other traders are intraday scalpers and use swing highs or swing lows as formations to hide stop loss orders above or below, taking advantage of the build up of entry orders from swing traders at these regional extremes. But the question to both groups of traders is always the same: Are we there yet? Have we reached the buying zone or selling zone?



By definition, swing traders are always trying to sell rallies in a down trend and buy dips in an up trend. Then they can try to ride the “swing” or swings higher, running trailing stops that “box” in their profits as price moves in their favor.

But the peril is always the same: Has a recent rally within an established down trend finally reached an area where a top will form and price will then return to the major down trend—OR—Has price violated the down trend and a new up trend had begun? As a swing trader, you always run the risk of being “hit by the train” of a change in trend. Is there a way to better gauge whether price is running out of energy and is about to turn OR is likely to continue, running right through its likely stopping area?

I’ve done a tremendous amount of charting and statistical analysis over the past five years developing tools to keep me from “stepping in front of the train” of newly emerging trends. And one of the most useful ways I have found is to analyze the qualities of the price bars as they approach these likely turning points. The quality I am looking for I have named “Separation” and hopefully these charts and this description will help you successfully identify turning points and keep you from stepping in front of the trains!
Let’s look at a chart:

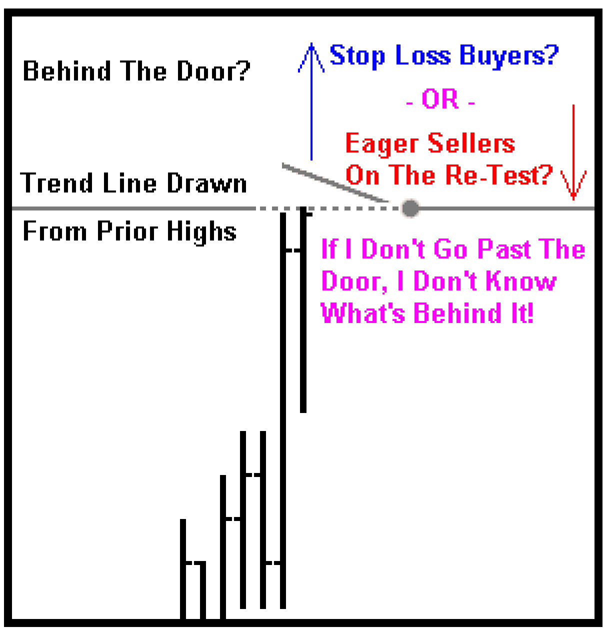


In this example, price has climbed higher and I added in a down sloping pitchfork, or Median Line, to show me the potential path of price IF I have identified a swing high. But note that this upper red line has not been “tested” by price. To relate this term “tested” to trend lines, trend lines are generally drawn by connecting two prior highs or two prior lows. If you choose a prior high and then randomly pick a point in space, rather than draw the trend line by connecting it to another prior high, you get a line in space that has a slope that may or may not have meaning—you won’t know until it is tested. An untested Median Line has a bit more validity because of the mathematical relationship of the three alternating pivots used to draw it, but it becomes much more valid once it has been tested.

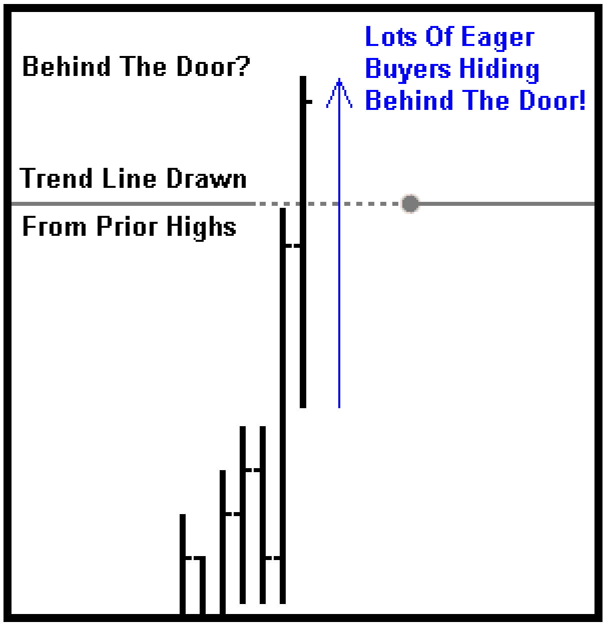
To make the analogy easier to understand, let's turn the down sloping line into a simple trend line. And we'll state up front that this trend line is drawn from two prior high pivots. Now we have an area where we think price MAY stop at, but WILL IT stop at this trend line?

Let's think about what would make it stop at the trend line: Price has topped out twice at this area. This leads traders to feel it's likely to follow the same pattern. So there may indeed be good orders to sell at or above this trend line, because price has stopped here before. One famous trading motto is: "Beat on a line that is working until it beats you". If there are a good deal of traders waiting to sell at or above this trend line, price will test it and price will fail to go higher—and probably run a good bit lower in a short period of time as traders try to get short as it becomes obvious that a top is forming.

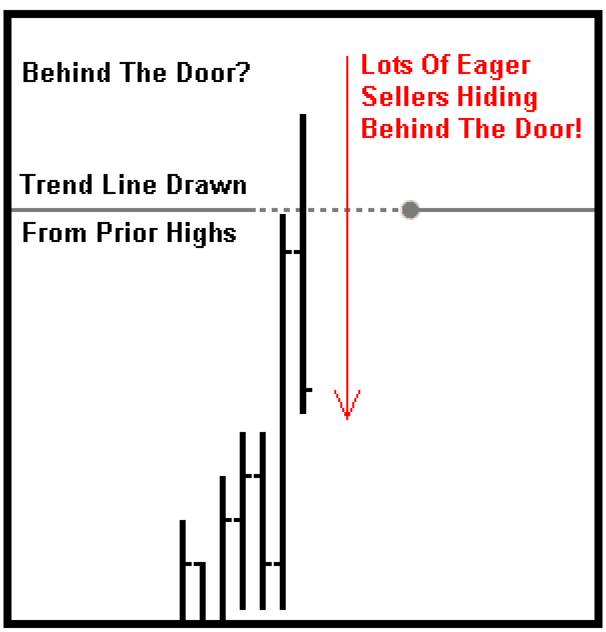
Now what would make price run higher through this line? If most traders are already short this market, either from the prior test of this trend line or from other areas, they may have a great deal of stops being worked in the market just above this trend line. If this is the case, once price tests and begins to violate this trend line, price will accelerate through this trend line very quickly and move higher.



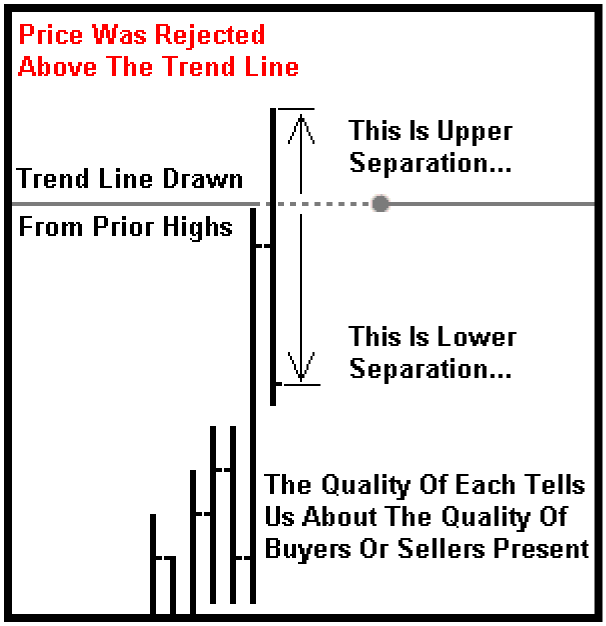
If price approaches the trend line but does not test or violate it at all, I still won't know if a top is in, because I won't know if there are sell orders or stop buy orders above the trend line. Because price hasn't yet "peeked" beyond the doorway, I don't what is beyond it.



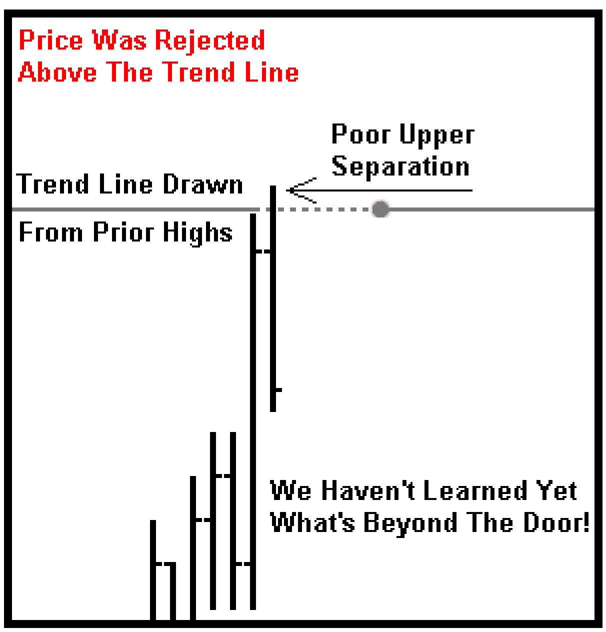
Here you can see that once price ran up above the trend line formed by prior highs, there were lots of stop loss buyers and these orders pushed prices much higher—and price closed well above the trend line that I originally wanted to get short against. The distance above the trend line that price moved is our first look at “Separation”. In this case, price closed with good separation above the trend line, which shows good buying interest. There is NO sign of weakness on this chart and no reason to attempt to pick a swing top.



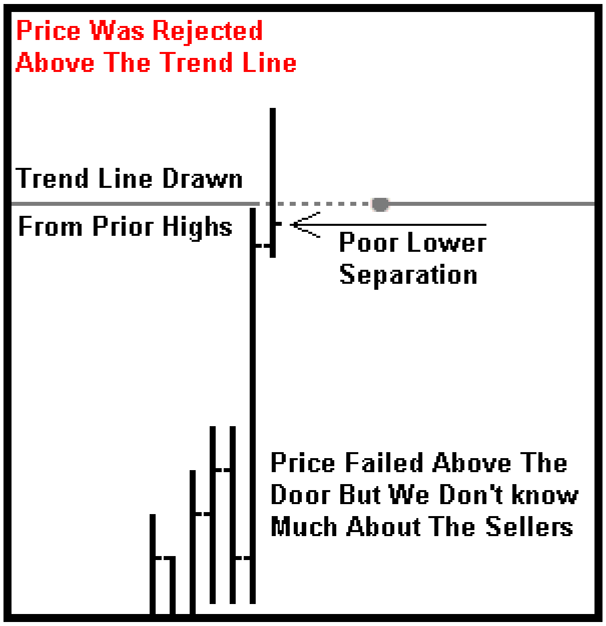
In this example, price tested the trend line, ran a bit higher when some buy stops were hit and then suddenly found nothing but eager sellers waiting to get short as the buy stop orders disappeared. Note that price went well above the trend line but closed well below the trend line, which is also great “Separation,” but in this case it is down side separation and is a major sign of weakness.



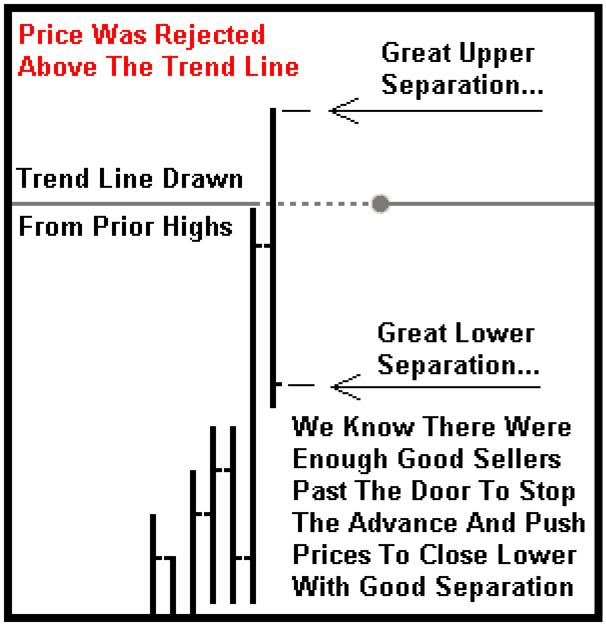
Having the upper separation, even though the lower separation gives me the sign of weakness I wanted to see before trying to enter a short position, is important because it tells me price gave the buyers all the chance in the world to take control of this market and they failed to take control. And once the sellers took control, they ran price back down through the trend line and quite a bit more—Again, a sign a major weakness.



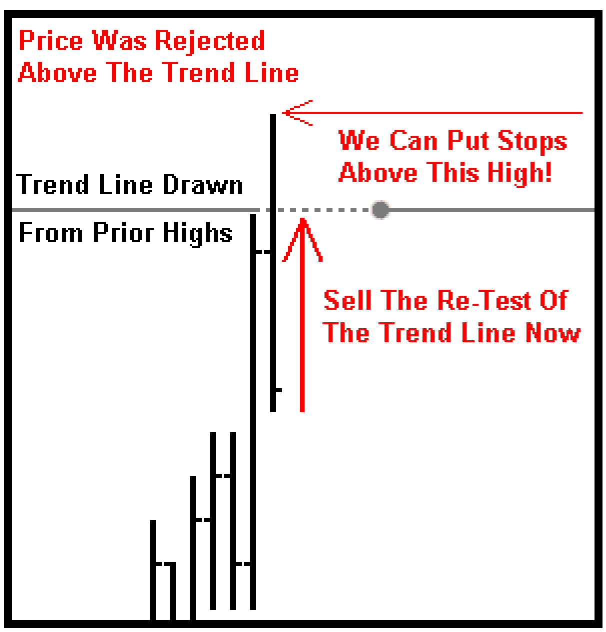
In this case, price barely peeked above the trend line, giving me no up side separation. Although price then traded quite a bit lower, I am not as confident about the test of the trend line, because there may still be nothing but buy stops waiting above the trend line. And as price turned lower, new short positions were probably added. But these new short positions do not have much profit in them and any turn back up to re-test the trend line may run into not only the original stop loss buy orders that have accumulated there, but may also run into additional stop loss orders because of the fresh new short positions from this recent move down.



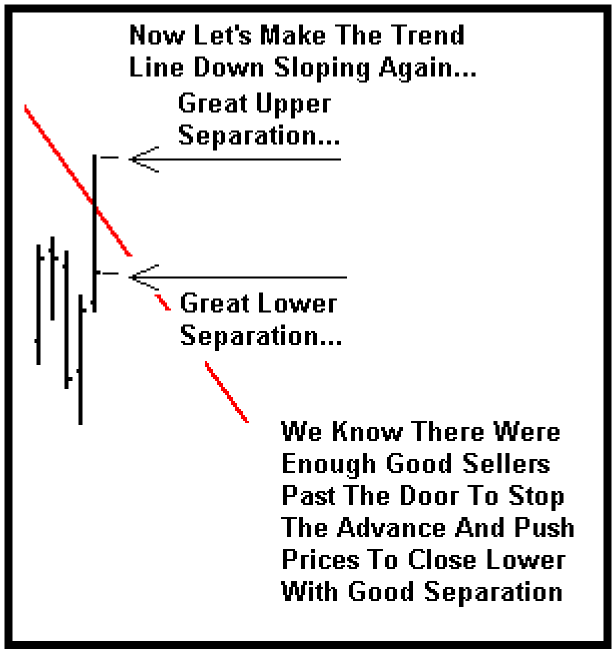
Here you can see price climbed well above the trend line and did find enough sellers to push price back down to just below the trend line. So there is good up side separation but poor down side separation. This means that even though we found solid sellers once all the buy stops were run above the trend line, we did not find enough aggressive sellers to push price a good amount below the trend line—which would have been a sign of weakness. In this case, I am afraid of the old saying: “What was resistance is now support.” The new short positions established at or above the trend line do not have much profit in them and any move back above the trend line is likely to again provoke a fresh round of stop loss buying, pushing prices to new highs.



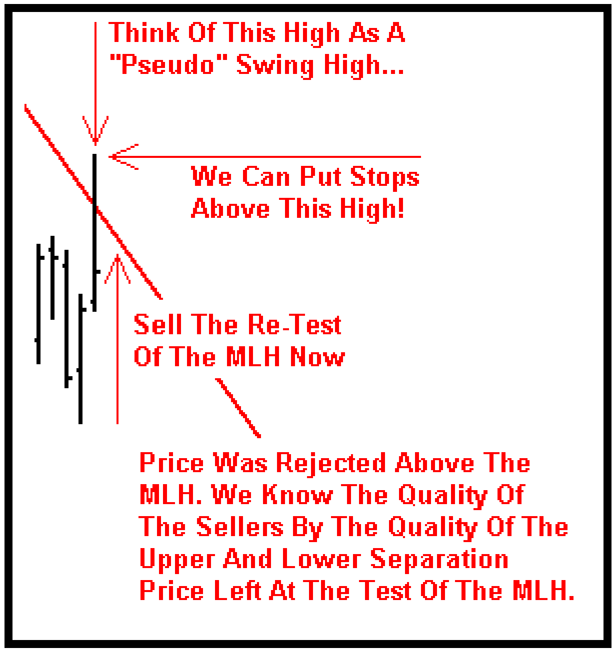
Let's look again at an example with good upper separation and good lower separation. When both are present, we know price gave the buyers every chance to take control of the situation. But once the market ran out of buyers, fresh sellers came into the market and took control, pushing price back down through trend line and forcing it much lower, leaving good down side separation. Having separation above and below the market tells me that the area has been "well scouted" and the close of the bar tells me whether buyers or sellers were in control. In this case, the area was "well scouted" and the sellers were clearly in control when the bar closed. This is a sign of major weakness.



Once we have good upper and lower separation and price closes on an extreme, how can we enter the market? In this case, price closed near its lows and gave me a major sign of weakness after leaving good upper and lower separation. IF price re-approaches the trend line, I will get short as it approaches that area and my stop loss orders will go above the high that marks the upper separation. I expect to find sellers above the trend line because they so convincingly took control the last time price was above the trend line. So I expect the sell orders will act as a buffer, or protection, and I purposely hide my stop loss order above this recently made price formation. These orders should effectively keep me from being run over “by the train”.



Now let me simply put the slope back into the trend line. Again, we see great up side separation and great down side separation. And price closed near its lows. The sign of weakness is obvious and if price comes back up to the down sloping line, I would initiate a short position and my stop loss order would go above the top of the recently made high—just above the upper separation. I expect fresh sellers will emerge to help buffer any rise above this trend line, which will help protect my short position.



Other traders often ask me how to identify swing highs or lows "as they occur" and if my analysis is correct, at the end of the day, I'll be able to look back at this peek above the trend line as swing high. And so as it unfolds, I refer to these potential extreme bars as "Pseudo" swing highs or lows. As you get more practice watching price action unfold in "real time" and learn to think several steps ahead as price tests these areas, you'll begin to see more "Pseudo Swings" in real-time and that's when you'll begin to catch swing highs and swing lows and still do a good job missing being hit by the run away trains!