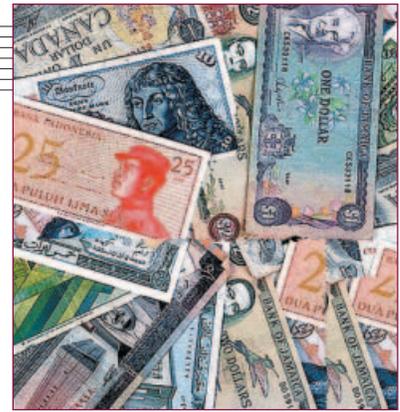


FOREX FOCUS

*Access to foreign exchange trading has opened up exciting trading options for the retail trader. You can now trade alongside corporations and institutions in a highly liquid market that is global, traded around the clock, and highly leveraged. Before jumping into this market, however, we must understand the factors that affect the forex market. With that in mind, STOCKS & COMMODITIES has introduced **Forex Focus** to better prepare the retail trader to participate in the currency market.*



Support & Resistance Precision In Forex

Currency markets tend to follow support & resistance levels. Use those levels to identify entries and exits, and to apply risk management.

Many foreign exchange traders rely on the accuracy of support & resistance levels so evident on currency price charts. Some of these traders will eschew the use of mathematically derived indicators or back-tested systems as primary trade decision tools, preferring instead to allow their manually drawn lines to dictate entries and exits.

BACK TO BASICS

There is much to be said for this back-to-the-basics brand of technical analysis. Even a glance at a long-term currency chart will substantiate that key price levels appear to be remarkably well-respected time and again. This applies to both diagonally drawn uptrend and downtrend lines, as well as to horizontal support & resistance lines.

Central to these principles of support/resistance (S/R) within the greater context of technical analysis is the premise that a truly valid S/R level will eventually be tested on both sides; support will become resistance and resistance will become support. A line that is tested on both sides often proves to be strong and stable and will frequently sustain its validity for an extended period of time, as support or as resistance.

Of course, in order for a resistance line to become a support line there needs to be a breakout of the original resistance line, and conversely, for a support line to become a resistance line there needs to be a breakdown of the original support line. An S/R level would, by necessity, have to be breached before that same line could be established as a continuing S/R level on the opposite side. The irony lies in the fact that one side of the S/R needs to be invalidated in order to create the framework for the other side of the S/R. But this can create a variety of possible trading opportunities.

Practically speaking, trading off support or resistance, whether it is in an uptrend, a downtrend, or a horizontal level, comprises two chief options. One option is to assume that the price level will be respected, and consequently trade bounces off the line. The other option is to assume that the level will be breached and consequently trade breakouts of the line. These two trading strategies are diametrically opposed in both trade direction and philosophy. Most often, a technical trader will allow actual price action at or near the critical S/R level to determine which of the two paths, if any, to take.

Whichever path you choose, keep in mind that support & resistance has never claimed to be an exact science. At the same time, however, the charts presented in this article will demonstrate that at least in the realm of forex, it comes surprisingly close.

DRAWING SUPPORT & RESISTANCE

Before a discussion of specific chart attributes can take place, the ground rules for drawing support & resistance must first be established. Although there are almost as many rules for these drawings as there are traders trading off them, for our purposes here we can stick to the basics.

An uptrend support line connects at least two lows, with the second low higher than the first. A downtrend resistance line connects at least two highs, with the second high lower than the first. Two points are the absolute minimum, but any S/R line becomes much more valid with three or more touches that occur in a straight line. After a breakout of a given S/R line, uptrend support should ideally become resistance, and downtrend resistance should ideally become support.

As for horizontal S/R levels, these lines are drawn to connect double/triple highs or lows. And just like for the diagonal uptrend and downtrend lines, horizontal support often becomes horizontal resistance and vice versa.

With some fine-tuning, the method of drawing support & resistance can be utilized by traders as a comprehensive trading model for the forex market.

FOREX FOCUS



SUPPORT/RESISTANCE IN ACTION

As the recent EUR/USD chart in Figure 1 illustrates, a single chart can often display multiple instances of price action adhering closely to the principles of support & resistance.

The line at 1A is a textbook case in point. This line approximately bisects the chart. But more important, the line began its life as a bona fide downtrend resistance line with three precise touch-points. After the breakout at the red circle, which was an excellent trading opportunity in itself, this resistance line eventually transformed itself into reliable support for a huge subsequent bull run in the euro. And at the point where line 1A provided this support (at the last blue circle on line 1A), price literally turned on a dime, lending some credence to support/resistance theory. From a practical perspective, a trader could hardly have asked for a more precise trade entry opportunity.

Line 1B is another good example of downtrend resistance becoming uptrend support. Shortly after this steep downtrend line was broken, this same line served as stable support for a sudden and drastic rally in the EUR/USD pair that produced phenomenal pip gains for a full month.

The uptrend support line at 1C shows a slightly different utilization of support/resistance principles. The first two examples discussed were marked by a change of direction after breakout. In contrast, the uptrend at line 1C began as an uptrend and continued to be an uptrend even after the line was broken. But the key point is that after the uptrend support line was broken down, line 1C transformed into a resistance line for the continuing uptrend.

Line 1D shows another directional trend change after breakout, much like the first two examples. After two resistance touchpoints in the downtrend, a breakout occurred. The price then bounced back down to hit precisely the same S/R line, but this time the line served as support instead of resistance. After this touch, the currency pair then shot up and hardly looked back.

And finally for the EUR/USD pair, we have the horizontal line at 1E. Here, we have a common occurrence of a horizontal S/R level serving as support, then as resistance after a break-

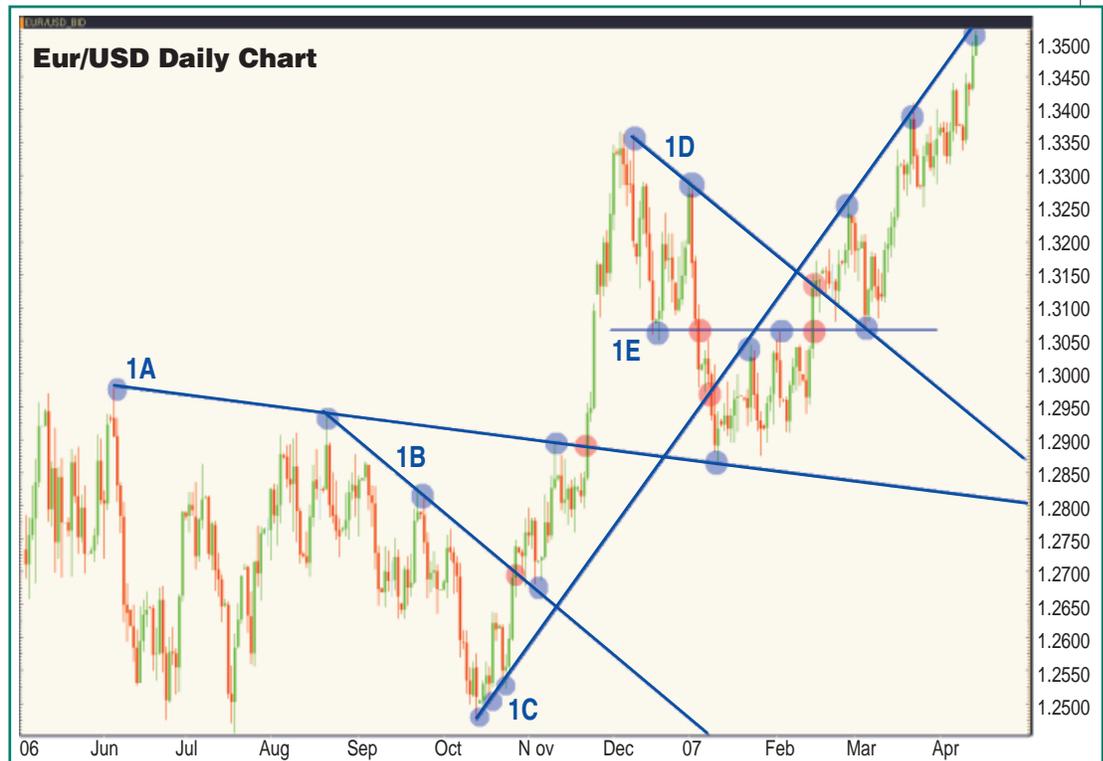


FIGURE 1: EUR/USD DAILY CHART WITH SUPPORT & RESISTANCE LINES. Blue circles are support and resistance touch-points. Red circles are breakout/breakdown points.

down, then as support again after a breakout. This particular line was tested multiple times in a precise manner, validating its worth as a particularly significant horizontal price level.

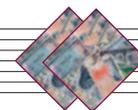
This same phenomenon of significant horizontal S/R price levels can readily be seen on the GBP/USD daily chart displayed in Figure 2 as well.

The horizontal line at 2A had an accurate double-high test before breakout, as shown. And well after the breakout of this double high, when price eventually fell back to the same level as before the breakout, the GBP/USD tested almost exactly the same double-high level, but this time as support instead of resistance. And sure enough, a clear-cut bounce off this support occurred.

On line 2B, the very evident intermediate uptrend managed at least five support touches of the line before breakdown, then retouched the line as resistance, then finally dropped precipitously shortly after that resistance was hit. This, like many of the other S/R setups mentioned, was an especially apparent and tradable support/resistance play.

Moving on to the USD/JPY daily chart, as is evident in Figure 3, price action for this currency pair has, until recently, been characterized by a relatively long uptrend bisected by a stable S/R uptrend line.

This can be seen at line 3A. Four accurate touches of the uptrend support line turn into a breakdown roughly in the middle of the chart (at the red circle), and then subsequent use of the same line as an uptrend resistance line with approximately four more subsequent touches from the underside. This line served as an extremely significant S/R line for



can be fully utilized by these traders as a comprehensive trading model for the forex market, complete with optimal entries, exits, and even risk management. This powerful tool in the technician's toolbox may lack some of the flashiness of newer and more complex technical methodologies, but forex traders can be assured that its simple effectiveness in interpreting a currency chart is truly unmatched.

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FIGURE 2: GBP/USD DAILY CHART WITH SUPPORT & RESISTANCE LINES. Blue circles are support and resistance touch-points. Red circles are breakout/breakdown points.

nearly a year of recent price action in the USD/JPY currency pair and is still considered valid to this day.

Finally, the line at 3B shows a breakout of the downtrend, followed by a considerable rally up for the dollar, and then an even more drastic drop back down to the same original downtrend resistance line, which, of course, by then became support. Once price hit this new support line, it performed a U-turn and shot back up. And again, that is exactly what price should have done according to the essential principles of support & resistance.

TRENDS IN FOREX

As the major currency charts all demonstrate, price action in foreign exchange tends to follow the tenets of technical analysis, and especially the vital sub-discipline of support & resistance. Perhaps more so than some other major financial markets, forex lends itself well to technical traders who wish to get back to the basics, to the core of technical analysis. With some fine-tuning, the method of drawing support & resistance

‡FX AccuCharts (FX Solutions)

‡See Editorial Resource Index



FIGURE 3: USD/JPY DAILY CHART WITH SUPPORT & RESISTANCE LINES. Blue circles are support and resistance touch-points. Red circles are breakout/breakdown points.