How To Use

Fibonacci Retracements: The Ultimate Guide

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By PriceActionNinja.com

Fibonacci Retracements In Trading

If there's one thing that's true about forex it's that price never moves up or down in a straight line.

Most of the time price will advance, correct a certain distance, advance again, then correct a bit more before continuing to advance… and so and so forth.

This is the natural behaviour of the market.

Price is 'breathing', expanding, and contracting as money from different parties flows in and out.

When price moves in one direction and then starts to correct (move in the opposite direction), it's called a retracement, or pullback as some people know.

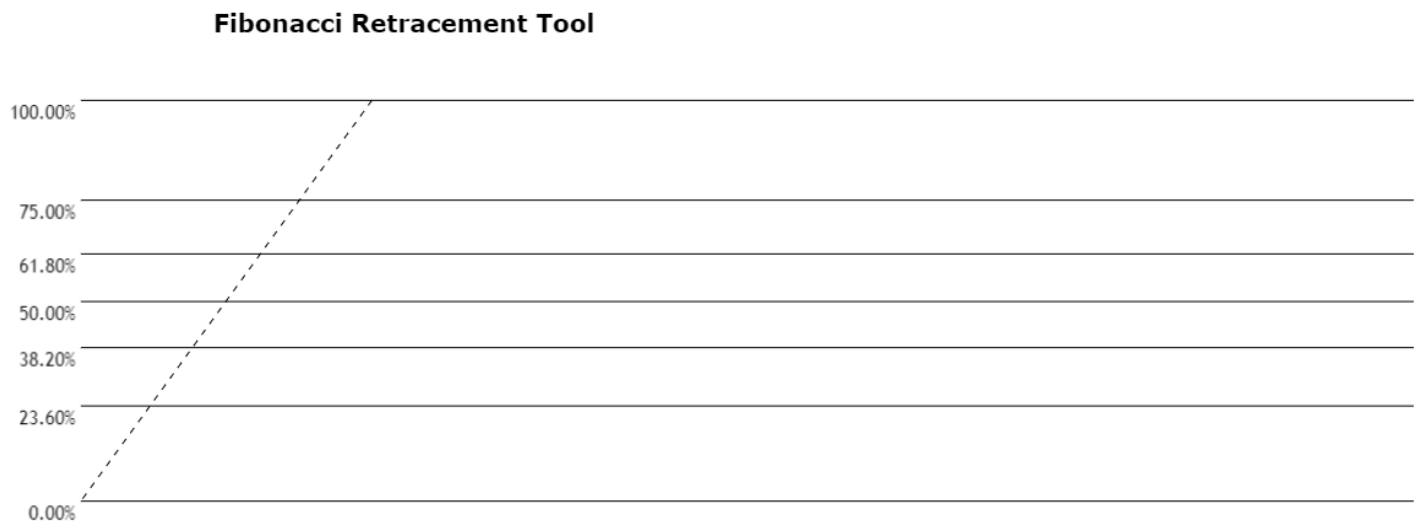
I'm sure you've heard of these before.

Retracements offer a low-risk way to get into an existing trend or strong movement. The fact price moves counter to the main direction gives you an opportunity to buy low and sell high (or sell high and buy low if you short), which we all know is the key to making money in trading.

The fibonacci retracement is a tool that allows you to gauge when and where these retracements may end.

Using some complex calculations, which I won't bother explaining here, the tool marks 5 horizontal lines on the chart.

These lines, which can be thought of as support and resistance levels but marked automatically rather than manually, show the points where a retracement has a high probability of ending.



And here's what the tool looks like.

As you can see, it's just 7 horizontal lines – 5 if you count the 0 and 100 levels, which we don't use in trading.

These lines are the retracement levels.

They're the points the fibonacci tool has calculated where a retracement has a high probability of ending.

See how each level has a little percentage attached?

This shows how far price has retraced into the prior swing when it reaches that level.

The reason the percentages are a bit off e.g 38.20%, 61.80%, etc is because of the calculation the tool uses.

The fib tool uses the fibonacci number sequence – basically a complex maths calculation – to find the levels and mark them on the chart. It calculates the levels in numbers e.g., 38.20% is 0.382 and then converts them into percentages to show how far price has retraced into the previous swing.

So that's what the tool looks like, but how does it work?

Well, let me show you some examples…

Here's the beginning of a retracement on Eur/Usd.

Normally, you might use support and resistance levels or, if you have a bit more experience, supply and demand zones to find where this retracement may end.

These methods work well; they often coincide with where retracements terminate.

The problem is, they're not specifically made for finding the end of retracements. They're techniques for predicting reversals applied to retracements.

As a result of this, they don't work that well. They do often fall in line with where retracements end, as I said, but they don't predict them very accurately or map out how they'll develop.

The fibonacci retracement tool, however, does do this.

The fact it's created just for retracements – though it has other uses as well – means it much more accurate at predicting where they'll end and how they'll develop.

This is what the retracement looks like with the fib tool marked.

See how the tool mapped out the fall?

When the retracement started, price fell for a while before finding support at the 23.60% level.

After stalling for a few hours, it then fell again before rising back to the source of the drop. Another, much bigger, drop followed until price hit the 38.20% level, at which point it reversed, and the retracement ended.

Let's look at another one…

Here's another retracement, this time on Aud/Usd.

Again, normally we wouldn't know where this retracement might end or how it could unfold. With the fibonacci tool, though, we have a good idea of both.

And here's how it panned out.

Just like the other example, the tool predicted how the retracement would develop and where it might end. We didn't see price stall at any of the levels like in the previous example, but it did reverse at the 38.20% level, which the tool marked for us on the chart.

Which Retracement Level Is The Price Going To Reverse At?

The fibonacci tool makes it easy to see where a retracement could end and how it might develop. What it doesn't do, however, is tell you which level price will ultimately reverse at.

It's not all bad, though…

Even though the tool can't tell you which retracement level price will reverse at, there are times when it's more likely to reverse at one level over the other.

For example:

A correction after a sharp price movement is much more likely to end at the 38.20% or 23.60% retracement levels than the others.

The reason why is because traders and investors set greater profit targets after a sharp movement, (due to the price covering a big distance in a short amount of time). This means they take less profit off their trades, which in turn, means price doesn't correct as much during retracements.

For more gradual movements, the opposite is true.

Instead of being more likely to reverse at the upper levels (23.60% – 38.20%), the price instead has a much higher chance of reversing at the lower levels (61.80% – 78.60%).

This is because investors and traders take a lot more profit off their trades during gradual movements, causing much deeper retracements to take place.

Keep in mind:

Even though the price is more likely to reverse at these ratios under differing conditions, it's not guaranteed.

There will still be times when price reverses at the lower levels after sharp movements, and times when it reverses at the upper levels after gradual movements.

These aren't cold hard rules, more just guidelines.

Another point is when you see the price hit a retracement level, you can't just assume it's going to reverse and place a trade.

The levels, while they all have a high probability of causing price to reverse, aren't guaranteed. You must wait until the price has given a signal that confirms the correction is likely to be over before you enter.

How To Draw Fibonacci Retracements Correctly

So, now you know what the fibonacci tool looks like and have some idea of how to use it, it's time for me to explain the most important part of this whole guide:

How to draw the retracements correctly.

Because the fibonacci tool doesn't mark the levels automatically, you must manually place the tool on the swing the retracement is taking place on.

For the most part, this is easy.

You find the swing, select the tool, and then place it on the chart.

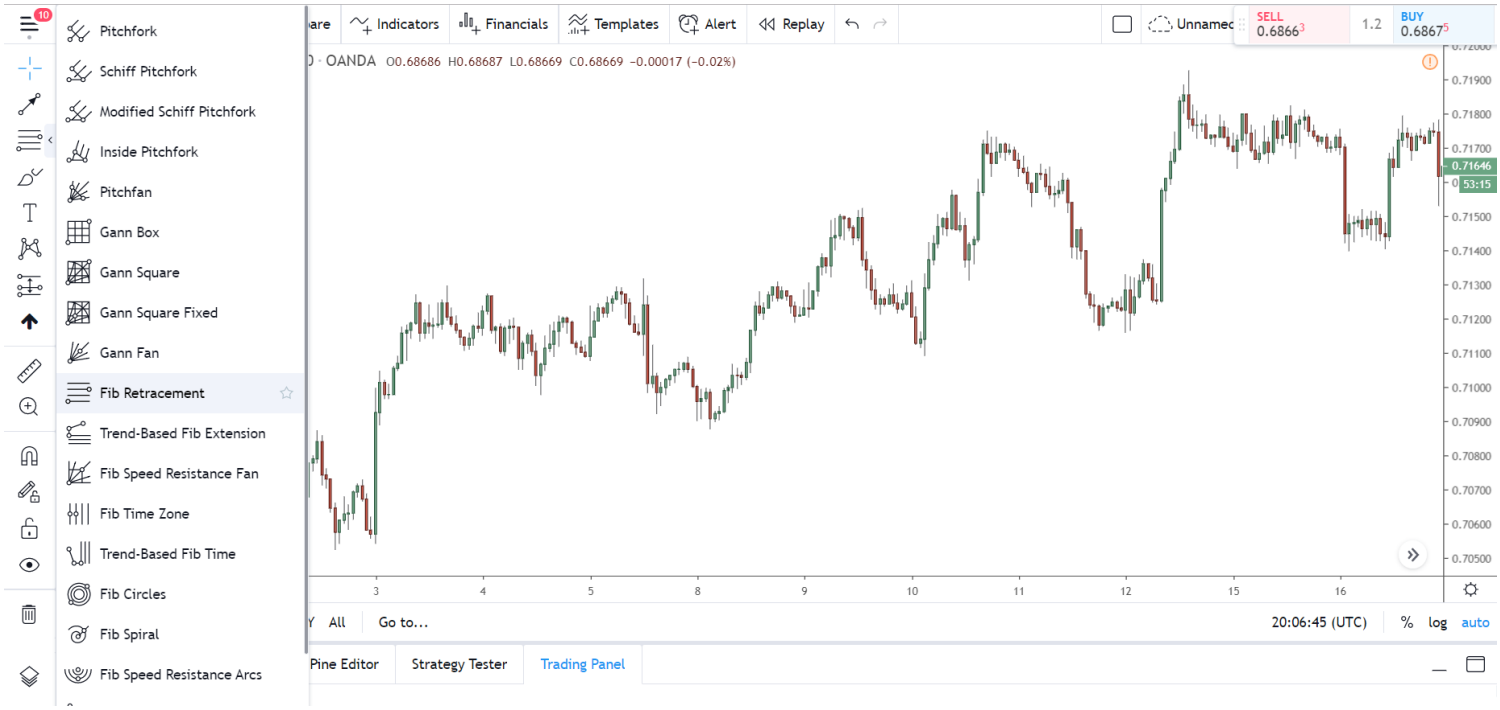
However, there are a couple of important things you need to know to make sure the tool is placed correctly so that the levels show up in the right location.

Here's what you need to do:

Step 1) Select The Fibonacci Retracement Tool

While you may not have heard of it, the fibonacci retracement is one of the most popular tools in forex, which means it's available on pretty much every trading or charting website out there.

To select the tool on Tradingview – the site I use – click the 3rd icon down in the tool window…



And then click the “Fib Retracement” from the drop-down list.

Step 2) Locate The Beginning And End Of The Current Price Swing.

Okay, now here’s where things get a bit tricky…

The retracement tool calculates where the levels should be based on the prior price swing. So, to mark the retracement levels correctly, you must find the beginning and end of the swing the retracement is taking place on.

A swing is what’s created when the price rises or falls for a while before moving in the opposite direction.

There are two types:

Upswings – Swings that occur when price increases for an extended period after previously falling.

Downswings – Swings that occur when price decreases for an extended period after previously rising.

All price movement in forex is made up of upswings followed by downswings followed by upswings and vice versa.

This is obvious if I put a zig-zag indicator on the chart.

Now to find where the current swing begins and ends, you need to first locate the source of the swing and then the point where it ends, and the retracement begins.

Here's how to do this for upswings:

Upswings

So, for upswings, the beginning of the swing is the point where the overall rise began.

The easiest way to find it is to look for the last major decline that took place (by major, I mean a decline that lasted a while, not just a few candles that caused a small drop like at points 1 and 2) and then where it ended.

In this case, the decline ended where I've marked the outlined circle, so that's the beginning of the upswing.

Finding the end of the swing is much, much easier.

You just look at where the retracement started. The retracement itself is a downswing. As I said, downswings always follow upswings and vice versa, so the beginning of the retracement is the end of the previous upswing.

Now let's look at downswings…

Downswings

For downswings, the beginning of the swing is the point where the overall decline originated from.

To find it, just look at where the last major rise ended – again, major meaning a rise that lasted a while, not just a couple of candles that caused a small retracement like at points 1, 2, and 3.

In our case, it's the outlined circle.

As with upswings, the easiest way to find the end of a downswing is to locate the beginning of the retracement since that's the start of a new swing.

With that out of the way, let me show how to place the tool.

Step 3) Drag The Tool From The Beginning Of The Swing To The End

So, you've found where the current swing begins and ends.

The next step is to place the tool at the beginning of the swing and then drag it either down or up (depending on the swing) to the end.

The way you do this is easy: you just drag and hold from the beginning of the swing to the end. There are a couple of nuances to it, however, so let's do a quick walk-through now.

Upswings

First off, find the lowest low created at the beginning of the current upswing.

In our case, this is the low marked with an arrow.

Now click and drag the tool up to the highest high created at the end of the swing. As you drag upwards, you'll see the retracement levels appear next to the swing.

And with that, the tool is placed.

You can now start watching the levels for where the retracement may end.

Let's look at downswings now…

Downswings

First: find the highest high that formed at the beginning of the downswing.

This is the high marked with an arrow in our case.

Next: place the tool on the high and drag down until it sits on the lowest low found at the end of the downswing.

With the tool placed, you can start watching the retracement levels for a reversal.

Pretty easy, huh?

3 Effective Ways To Use Retracements In Your Trading

The retracement tool is great for understanding where a retracement may end and how it'll develop over time.

But how is that useful in real trading situations?

Well, in a few ways actually…

For one, it makes it much easier to get low a risk entry into a strong trend or movement, which, of course, helps us make more money. Additionally, the tool is great for finding confluence with other technical points, like support and resistance levels and supply and demand zones, so it enhances existing strategies too.

I haven't got time to detail all the ways you can use the tool today, but here's 3 I think are most effective.

#1 To Get Into Strong Moves

Getting a low-risk entry into a trend or strong movement is not easy. Price often moves so violently during these moves that either no entry appears or is over so fast it was impossible to get in.

Retracements are one of the only times you can get into moves like these, and this is something the fib tool makes very easy.

Do you know how to trade support and resistance levels?

To trade support and resistance, you mark the levels on the chart, wait for price to return, and then see if an entry trigger, like a candlestick pattern, appears to get into a trade. Well, get this…

You use the retracement tool to enter trades in the same way.

By waiting for price to return to each level and then seeing if a candlestick pattern or some other entry signal appears, you can get a low-risk high reward entry into a strong trend or movement.

A good example of this is seen below…

See how a big bearish engulfing pattern appeared at the 50.00% level?

Just like trading supply and demand or support and resistance, this engulf forming at a re-tracement level signals price might be about to reverse, therefore is a good signal to go short.

What happens later?

Price reverses, causing the retracement to end and the prior trend to continue

Candlestick patterns like pins and engulfs work best as entry signals at retracement levels, but sharp rises or declines away also work really well, and it's always better to see if the levels have confluence with other technical tools to confirm price has a high probability of reversing.

Speaking of confluence…

#2 Confirming Other Technical Points Of Interest

Looking for confluence is one of the best ways to find where price will turn, and it's something else the fibonacci tool also comes in handy for.

Finding confluence with the tool is simple:

You mark whatever technical levels or points you want to find confluence for on the chart and then place the tool on the most recent swing, as I've done in the image below.

If one of the levels lines up with a technical point as the 50% level does with this demand zone, it has confluence with it, which means price has a better chance of reversing if it reaches the zone.

Retracements almost always end at a technical point, usually a support or resistance level or supply and demand zone.

Often, multiple levels or zones will have formed during the prior swing, so the retracement tool will also help you find which of these is the one price is most likely to reverse at.

#3 Predicting Where Swings Will End

The fibonacci tool's main use is to map out and predict where and when retracements could end.

That's what it was designed for, and that's how it's best used.

What a lot of traders don't know, however, it that not only can the tool map out where retracements may end, but also normal swings.

Did you see the a level below the 100% level in the previous image?

Look again…

Below the 100% level there's the 123.60% level.

This isn't a retracement level – because price can't retrace more than 100% of a swing. Rather, it's what's known as a fibonacci extension.

Extensions are fib levels that go beyond the 100% level.

They function the same as retracement levels, only they're used for mapping out how future swings may unfold rather than retracements. The levels also follow the same number sequence; 23.60%, 38.20%, 50%, etc… but they all have a 1 in front.

So 23.60% is 123.60% – because they appear past 100% of the swing rather than inside.

You can use extensions in lots of ways, but they're best used for understanding how future swing may develop and where they might end.

Take the image below, for example…

Price is rising again after a retracement caused it to fall.

By applying the extensions, we can get a sense of how this new upswing might develop and where it may end.

As you can see, the extensions mapped out the new swing nicely.

The upswing that began after the retracement continued until it reached the 123.60% level, at which point a new retracement began (black arrow). Once that was over, price rose to the 150.00% level (green arrow), and another, much deeper retracement started.

Eventually, that also came to an end, and price began rising again.

This rise stalled first at the 161.80% level, then the 200% level before finally ending at the 241.00% level, where price reversed, and the entire upswing came to an end.

Now, I haven't got time today to detail how extensions work – they really need their own in-depth post to be explained correctly.

But I have got a couple of pointers just in case you want to use them…

1. Like retracement levels, extensions are always placed at the beginning and end of a swing, but the opposite way around. So rather than place the 0% level at the end of the swing, as you do with retracements, you instead place it at the beginning, with the 100% level taking its place.

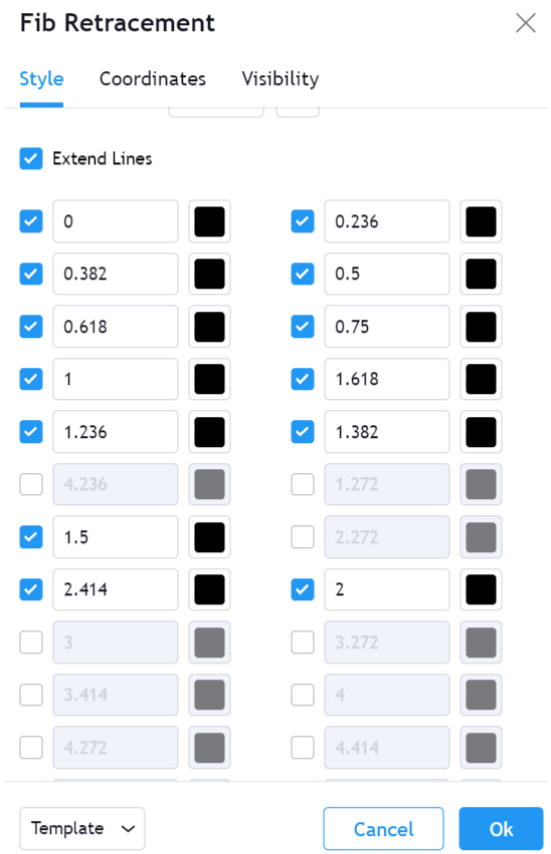
2. By default, the fib tool doesn't show the extensions. It's not a well-known or well-used technique, so the tool won't show the levels when you place it on the chart.

This means to use the levels; you must enter their values yourself through the settings menu of the fibonacci tool.

This isn't difficult to do, but it does differ depending on your charting platform.

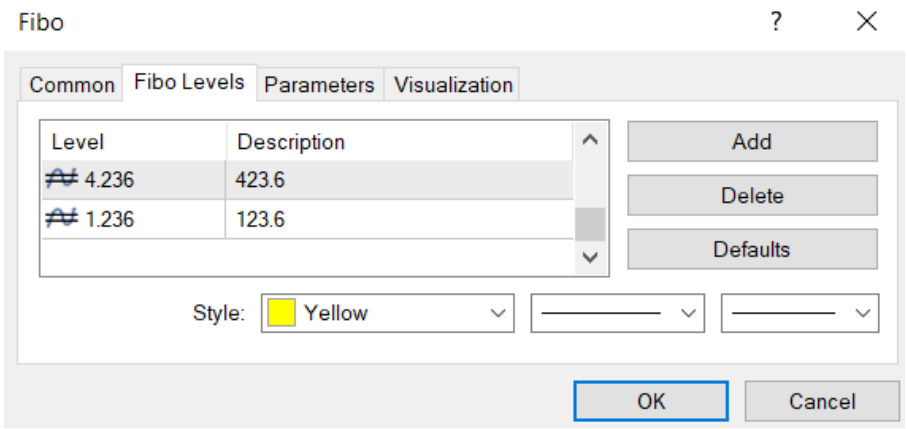
On Tradingview, just enter each number below 1 into a box.

Important Note: Right click one of the retracement levels and click "settings" to open the menu below.



On MT4, open the settings menu by right-clicking one of the retracement lines and selecting “Fibo Properties”. When the menu opens, head over to the Fibo Levels tab and click the Add button.

Now, enter one of the levels in the level tab. Then put it corresponding percentage in the description box.



Repeat this until the following levels are entered.

1.236 – 123.6

1.382 – 138.2

1.5 – 150

1.618 – 161.8

2 – 200

2.414 – 241.4

And with that, the tool is ready to go.

Summary

So, that's the fibonacci retracement tool for ya. It's not the easiest tool to understand, at least not at first, but it's easily one of the most useful. And one I think all traders should consider adding to their arsenal of price action tools.

More posts on retracements will be available shortly.