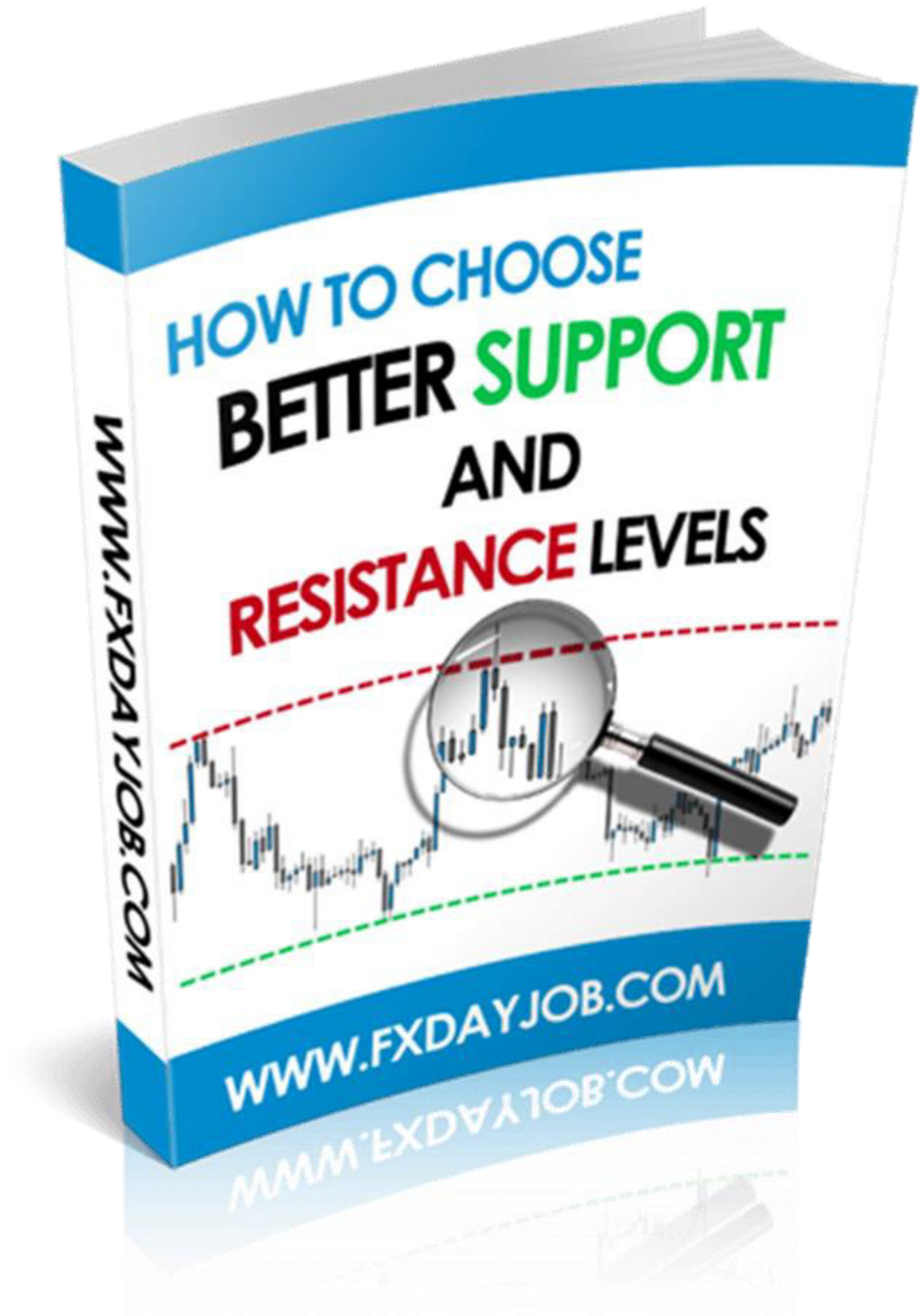
How to Choose Better Support and Resistance Levels

by Chris Padgett



First, a personal note:

I want to thank you for signing up to my free newsletter, and for downloading this free eBook. Since starting my website in 2011, it's been my great pleasure to help many traders become profitable or more profitable.

My goal has always been to have my readers leave my site with real information that they can use in their own trading to make a difference. I've thought about stopping the site or selling it a few times, but every time I've considered it, I remember the many comments from readers, on my site, Facebook page, twitter DM, etc..., thanking me for making a difference in their trading or for steering them in the right direction.

I have a vision for the future of my site, FXDayJob.com. Since I thought of the idea of the 100-Trade Test, I've wanted to buy new Forex trading systems on a regular basis (or test good free systems, if I can find them), and put them to the test.

I also recently started a Youtube channel! I'm planning to add new videos regularly. Check it out and subscribe to help me get it off the ground.

Of course this takes money, but more importantly, it takes a lot of time. The 100-Trade Tests for Infinite Prosperity and Top Dog Trading each took nearly 5 months. I'm testing a new trading system now that only gives about 10 trading opportunities per month (sometimes less), so it would take nearly a year to complete.

The bottom line is that I'm spending a lot of my free time to improve the website, and striving to add value to it on a weekly basis for you guys. This is time I could, and probably should, be spending elsewhere.

That being said, if you find any of the articles on my website useful, please share them. Link to them in forums that you visit. Like and share my Facebook page. Subscribe to my new Youtube channel. Follow me on Twitter. Get involved in the comments on the site, Facebook page, etc.... All of these things show your appreciation, and they help me build a larger audience too.

You guys are the reason I do this. I would like to continue doing what I'm doing, and much more. I hope I can count on your support. Thanks again, and happy trading!

The Importance of Support and Resistance Levels

Support and resistance is so important in trading. Its reliability varies a bit from market to market. In the Forex market, support and resistance levels are very important, but not as reliable as they are in the stock market.

The reason for this is because retail traders only make up an estimated 15% of the Forex market. When a big bank or international company need to buy a bunch of Euros, for instance, they couldn't care less whether or not the Euro is at a good technical level for a buy. They're going to get their Euros.

If enough Euros are bought, the supply drops significantly, and demand goes up, causing the price of the Euro to go up in relation to any other currency that it is paired with. This type of transaction can cause the Euro, or any other currency, to spike right through what may have seemed to be an important structural point in the market.

That being said, support and resistance is still one of the most important leading technical indicators in the Forex market, or any other market, so you'd better learn how to use it correctly.

Rookie Mistakes with Support and Resistance

New traders rarely bother plotting out significant support and resistance levels. I can attest to that, because I used to hate doing it. Then I tried a few trading systems that relied heavily on support and resistance, and realized how much money I had been needlessly loosing over the years because of my laziness.

I understand. It can be a little daunting to learn something so subjective in nature. As traders, especially after we've gained some experience, we like to use easy to follow, step-by-step mechanical processes. That way, we cut out as much human error as possible.

The problem is that not everything in trading can be done so mechanically. Choosing good support and resistance levels is a mixture of mechanical rules, knowledge of how the market works, experience, and common sense.

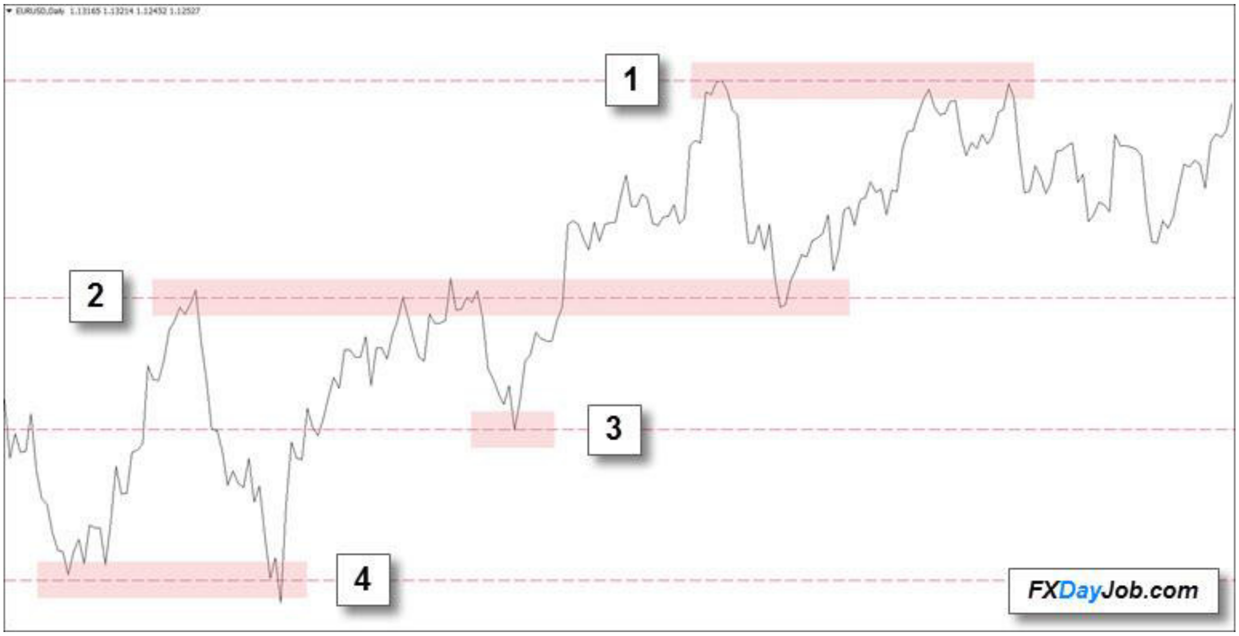
Another problem new traders, or traders that are new to using support and resistance, have is that, when they first start plotting support and resistance, they tend to see everything as potential support or resistance. Luckily, this is easy to fix.

In fact, by the time you finish reading this eBook, you should have a pretty good understanding of what makes one level stand out more than another, what makes a very significant level, how the market makers use these levels, and how you can use them in your own trading.

The Basics of Choosing Support and Resistance

The first thing you should know about horizontal support and resistance is that, although you may represent it with a line on your charts, support and resistance levels are actually zones. You have to keep in mind that you're not picking a precise point, but a zone where price may find support or resistance.

With that in mind, when you first start trying to spot good support and resistance levels, one technique that can help you is to switch to line charts in your trading platform. This can help to reveal more significant levels to you.



The line graph chart doesn't show absolute highs and lows, because the line charts are based off of the closing price of each period. However, as you can see from the image above, this technique can be very helpful in revealing significant support and resistance zones.

What you are looking for are zones that have supported or resisted price on multiple occasions (like in examples **1**, **2**, and **4**). You're also looking for zones that mark the absolute highs and lows in recent price history (like in examples **1** and **4**).

Zones that have, for instance, resisted price and then, once they have been broken, supported price are can be particularly significant (see example **2**). Of course, the opposite of this particular scenario is also true.

> **Note:** Each time a support or resistance zone rejects price, it becomes less likely to do so the next time. Eventually, even very significant levels will be broken. However, once price breaks through, if it finds support or resistance one the other side, it's like starting over.

You're also looking for single bounces that are significant (like in example **3**). What makes any bounce significant? How far price bounces from the support or resistance zone is important, but so is the surge into that level before the bounce.

The surge into the level must always be taken into account. As you can see in the image above, all of the zones that I selected had a good surge of price into them, and then a good bounce away from them.

What Makes One Level Better Than Another?

To understand the answer to this question, you need to know how "smart money" uses support and resistance zones. By smart money, I mean the "big boys," the market makers, the financial institutions that actually move the markets on a daily basis.

Smart money is what generally makes certain structure in the market significant. The reason these areas become significant is because they represent areas of liquidity in the market.

Smart money trades with so much volume that it isn't easy for them to get into and out of the market. That's one disadvantage that they have over retail traders. They go after areas of concentrated liquidity because they need traders taking the opposite of their position.

The main advantage that they have over retail traders is that they use their ability to buy and sell large positions in the market to manipulate supply and demand. They can literally make the market to move to their will.

Often the market makers or other large players in the market will seek liquidity in the form of "stop runs." Have you ever had your stop loss taken out, but shortly afterward, the market ends up going in the direction you had chosen (you were right at the wrong time)? I'm sorry to tell you this, but you were likely the victim of a stop run.

Putting This Information to Good Use

So how can you use this information to your advantage? If you learn where these stop runs are likely to happen, you can use these significant liquidity zones to increase your odds of being on the same side of the market as smart money.

In the image below, I've marked the significant support and resistance levels (and likely areas of liquidity), and I've numbered some things that I want to talk about. I did this to show you the levels that I would have picked and the thought process behind my decisions.

First off, the two most significant levels on this chart are the overall high and the overall low. Any long-term investors that are short during this period have likely placed or moved their stop losses above the overall high.

Likewise, any investors that were long or went long during this period have likely placed or moved their stop losses below the overall low. Both of these levels will be significant zones to look out for when price eventually returns to them.

Originally, I would have had the support line below **1**, **3**, and **5** sitting right underneath the candlestick bodies at **1**. However, since the bounce at **3** respected this zone while making lower candle bodies, I would have adjusted my support level slightly lower to sit underneath the candle bodies of **3** (as shown in the image).

> **Note:** Some traders draw their support and resistance off of the candlestick wicks. I draw my support and resistance right above or below the candlestick bodies, because a closed candle body better represents the price that the market actually accepted - as opposed to a spike in price that was rejected.

Why did I not mark **4** and **6** as resistance zones? **4** is too close to the, even at the time, more significant level of **2**. If I'm not going to mark **4** as an important level, why would I mark 6 as one. The last thing I want to do is take a short from **4** or **6**, only to find out that the market makers are doing a stop run on the level above **2**.

The level originally below **1** would have provided you with potential long trades at **3** and **5**, before finally breaking through support.

Why did I not use **7** and **8** as support and resistance zones? The bounce out of **7** was not strong enough for me to have considered using it as support when price came back into that level. Consequently, the surge into **8** was not strong enough to establish it as a significant resistance level, although the bounce away from it was nice.

Then we have a situation similar to one that we've already discussed. **11** was too close to **9**, and **12** was too close to **10**. In each case, I would have preferred the deeper, more conservative levels.

When price came into **13** (which is the same resistance level used above **10**), I would have been looking for a possible reversal, but there was no bounce. Similarly, as price came into **14** (which is the backside of the support zone below **1**, **3**, and **5**), I would have also been looking for a reversal.

The resistance level above **15** seems to be the same level as **14**, only adjusted over time (which often happens when price returns to a level that it hasn't been back to in a while). The same can be said for the bounce at **16** and the old level at **13**.

Over time these levels can be skewed slightly. It's similar to what I did at **1** when **3** formed lower candle bodies, but on a larger scale.

In any case, **15** and **16** both had nice surges into and out of their levels, which is enough to establish them as significant support and resistance levels on their own. Both of those levels would have provided trading opportunities as price came back into them.

Finally, I would be hesitant to mark any level above **15** as significant, unless price makes it to the overall high. I would consider anything between those levels as a sort of "no man's land." Keep in mind that the overall high is also likely to be slightly skewed, if you are planning to trade similar levels.

Note: By now you can probably see what I mean when I say that choosing support and resistance can be a little subjective at times.

For instance, if you wanted to be a little more aggressive, you could take a short setup that occurred when price came back into the overall high from our example chart. However, you can't know for sure exactly where liquidity is going to be sitting after all that time has passed.

A more conservative approach would be to wait for price to have a significant bounce down near the area, revealing the new, adjusted level (if there is one). The problem is that the bounce may just continue downward, starting a new downtrend, and leaving you without a second chance at it.

As you can see, there are positives and negatives to each approach. I tend to be more conservative, as I have learned over time that a conservative approach is easier for me to deal with, psychologically speaking.

How Are You Using Support and Resistance?

What you are using support and resistance for should determine how selective you are when choosing your levels. If you are taking your entry triggers at support and resistance levels, you should be more selective. Only mark significant support and resistance zones that are likely holding liquidity.

The idea is that you want to take fewer quality trades - as opposed to more low quality trades. One excellent way to qualify high quality trades is to only take setups that occur at significant support and resistance zones.

If, however, you're using support and resistance as a means to determine possible take profit levels for your trade, or levels where you might take some money off of the table (scale out), you could be better off applying a looser interpretation of what levels are significant enough to use.

You might simply, for instance, use an area near the last high or low as your take profit level - regardless of whether or not that level would be good enough for taking trade entries.

See the image below for a better understanding of what I'm talking about. I've marked the significant support levels (**green**) and the significant resistance level (**red**). I've also marked some less significant levels (**gray**) that could be use to scale out or take profit.

As you can see from the image above, when choosing levels to scale out or take profit, it's actually conservative to be less picky. In such instances, you're trying to anticipate any area where price could possibly reverse.

Whereas, when taking entry triggers, you only want to choose the most significant levels to ensure a high probability trade, and to limit the chances of the market makers doing a stop run on a deeper level after you've entered the market.

> **Note:** Of course, you can always use significant levels to scale out or take profit as well.

Why Is This a Great Trade Setup?

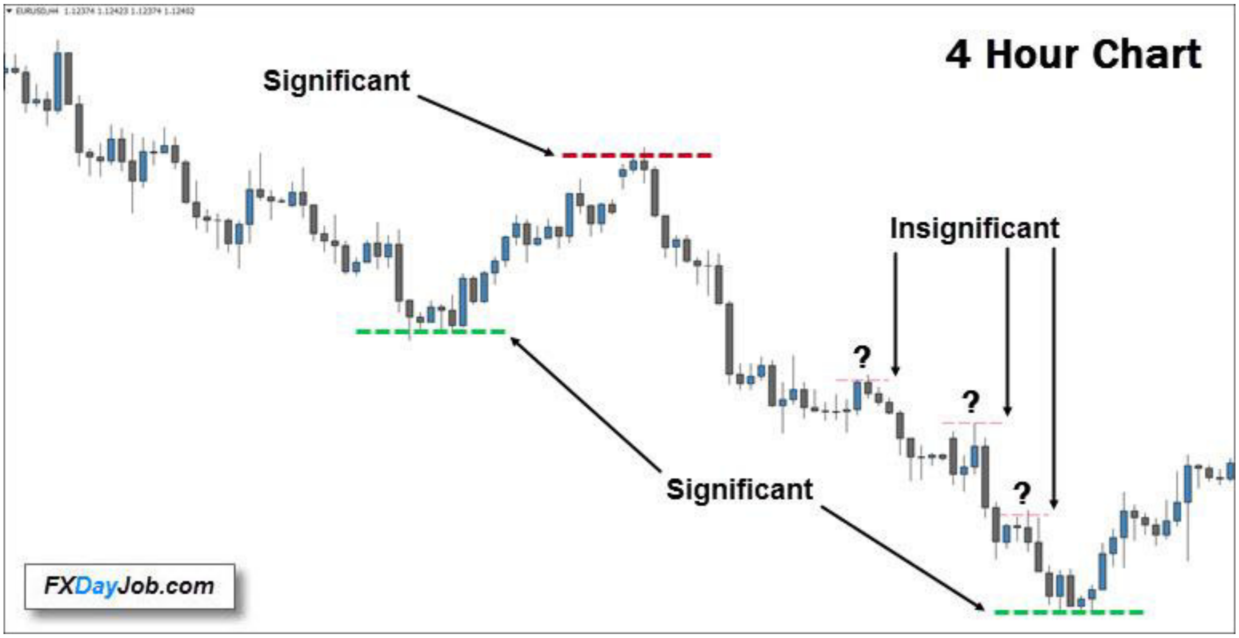
The sell setup, in the image above, has several things going for it:

1. The trade setup occurred at a significant resistance level.
2. The level appears to have been used as a stop run by the market makers.
    a. Notice how price pierced well above the level and then closed below it again.
    b. Anyone short from that level likely had their stop losses taken out.
3. A strong bearish candlestick pattern, the bearish engulfing pattern, formed at this level, and closed below the resistance line as well.

Significant Support and Resistance Levels Scale Up

If you are having trouble determining whether or not a particular level is significant enough to use for trade entries, it is often helpful to see if the level scales up (holds up on a higher time frame).

In the image above, you can see a few resistance levels, on the 1 Hour chart, that look like they could be significant. However, when you switch to the same period on the 4 Hour chart, those levels practically disappear, as you can see in the image below.



Moving up to a higher time frame smoothes out the noise of the lower time frames. If a level still sticks out to you on a higher time frame than the one you're trading from, it is likely a significant level.

Similarly, you could mark obvious levels, for instance, on the 4 Hour chart, and then move down to the 1 Hour chart to trade those levels (scaling down).

> **Note:** If you were to use the "scaling down" technique on the 4 Hour and 1 Hour charts, you would adjust your levels to the candle body highs and/or lows on the 1 Hour chart - not the 4 Hour chart. In other words, you get the rough levels from the 4 Hour chart, and then move down to the 1 Hour chart to fine tune them.

The sweet spot for this technique (either scaling up or scaling down) is 3 - 4 times the period your trading from, in my experience. In other words, if you're using the 5 Minute chart to trade from, scale up to the 15 Minute chart (3x) to check the significance of your levels. If you're using the 1 Hour chart, scale up to the 4 Hour (4x).

Some popular time frames don't scale up quite as well, i.e., 1 Minute to 5 Minute, 30 Minute to 1 Hour, 4 Hour to Daily, Daily to Weekly. This is because the 5 Minute chart is 5 times longer per period than the 1 Minute chart, the 1 Hour chart is only twice as long as the 30 Minute chart, etc....

That being said, if you're trading the 4 Hour chart, for instance, and one of your levels still looks significant on the Daily chart (which is 6 times longer than the 4 Hour chart), it should be a very significant level to trade from.

You can also create custom time frames to use for this exact purpose. Some trading platforms like Trade Station and Ninja trader allow you to create custom time frames by default. On my site, I show you how you can create custom time frames for the free Metatrader 4 platform as well.

Backside Levels and Clean Breaks

The last subject that I want to go over is trading the backside of support and resistance levels. When there is a breakout of a significant support or resistance level, often price will retrace back to that level, and will give you an opportunity for a high probability trade.

For instance, say you had marked a significant resistance level on your chart, but price had recently broken through that level and continued upward. If price retraces back to your former resistance level, that same level will often become support.

In the image below, you can see a couple of examples where former resistance levels became support. You can also see a some examples of clean breakouts of the previous resistance, and some buy signals that occurred after price retraced back to the new support level (previous resistance).

You could wait for a significant bounce in price to confirm that the new support or resistance level will hold price, or you could take a more aggressive approach and trade your reversal setup (if you get one) in anticipation of a bounce off of the backside of the previous area of support or resistance, as shown in the image above.

If you take the second, more aggressive approach, you definitely need to take into consideration how cleanly price breaks through previous support or resistance. The reason is that an ugly, choppy break of a previous level can skew the position of that level or nullify its significance altogether.

In the image below, you can see a couple of examples that show messy breakouts of a previous resistance zone. Notice how price did not break, and then leave, the zone cleanly. Rather, in both examples, price chopped back and forth across the previous resistance zone.

The candlestick wicks are not important, as far as a clean break goes. What is important is what the candlestick bodies do. A clean break, regardless of what the candlestick wicks do, will have a candlestick body that breaks through, and then subsequent candlestick bodies will continue in the same direction (see the image on the previous page for examples). The bodies will not chop back and forth, and they will not hang around a previous support or resistance zone, moving sideways.

In the two examples of messy breaks above, I would not be looking for a buy entry if price retraced back to these levels at a later time, because I would not be sure were the level is sitting anymore. I also would not be sure if the market was going to respect these areas as support at all, after such messy breaks.

Instead, I would wait for a significant bounce in the area (if there was a bounce at all), which would reveal to me where the new support level is. In my opinion, this is the only way to trade the backside of a level that did not breakout cleanly.

Hopefully, I've demonstrated to you that choosing good support and resistance levels is not as hard as you may have thought. I hope you learned some things that you can use to immediately increase your success in trading.

If you found this information useful, please share my site with other traders. If you have any questions or suggestions, please feel free to leave me a comment on my site, Facebook page, or Twitter. I'll do my best to get back to you in a timely manner.

Some Helpful Resources

Forex Trading Lessons - FXDayJob.com

The 100-Trade Test

Trading System Reviews

Free Price Action Course

Bearish Engulfing Candlestick Pattern

Create Custom Time Frames in Metatrader 4

A Handy Candlestick Timer for Metatrader 4

A Cool Break Even Expert Advisor for Metatrader 4

Recommended Trading Systems

Day Trading Forex Live

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Top Dog Trading

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