

Technical Analysis III: Support and Resistance

Contributed by Administrator
Friday, 12 September 2008
Last Updated Friday, 12 September 2008

What are support and resistance?

Support levels are prices where buyers have shown or are likely to show strength.

Resistance levels are prices where sellers are likely to be strong.

Support

Support levels essentially give the market a 'floor', since they are areas where buyers tend to be strong. If the price falls to a strong support level, traders should expect buyers to step in and drive the price up, or at least keep it from moving any lower.

Because support levels are prices where buyers are supposed to be strong, if the price falls below a support level, this is a signal for the market. It shows that there is more selling pressure (or less buying) pressure than previously thought, and it often leads more traders to exit long positions and take short positions.

Resistance

Resistance levels perform the opposite function of support, which provide a 'ceiling' to the market. If the price rises to a strong resistance level, short sellers should be expected to enter the market and traders in long positions may cover their positions to take profits. This combination of selling pressure will often drive the price lower.

Resistance functions in the same manner as a safety net for short positions and an entry point for traders looking to buy on a breakout.

When a price breaks through a resistant level, it often triggers a large number of stop orders and makes for even greater buying power. Often the stronger the resistant level, greater the number of stops that are triggered and the larger the move above resistance.

Unfortunately, not every breakout is valid. Because they know that many traders place stops to sell just above resistant levels, some large institutional traders attempt to drive the price higher in the short term just to trigger these stops. Without any real force behind the move higher, the price can fall back to resistance. The same dangers of false breakouts apply to support levels as well.