Retracement Or Reversal

Kennsei Trading, Inc.
Chief Trader Dinger
dinger@kennseitrading.com
www.HotStocksforIncome.com

Retracement Or Reversal

Most of us have wondered, at some point, whether a decline in the price of a stock we're holding is long term or a mere market hiccup. Some of us have sold our stock in such a situation, only to see it rise to new highs just days later. This is a frustrating and all too common scenario, but it can be avoided if you know how to identify and trade retracements properly.

What Are Retracements?

Retracements are temporary price reversals that take place within a larger trend. The key here is that these price reversals are temporary, and do not indicate a change in the larger trend.

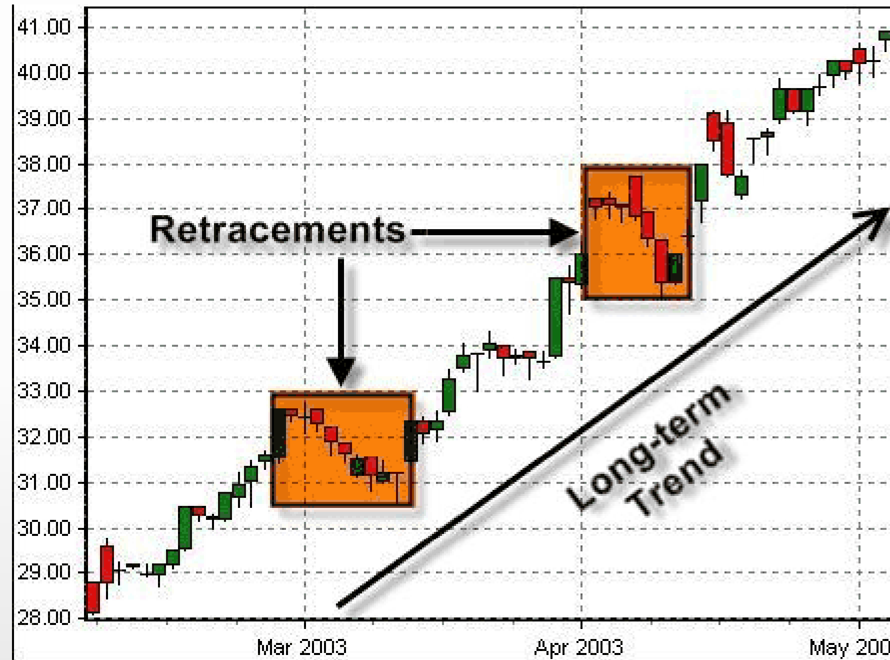

Figure 1: An example of retracements in the price action of a particular stock.

Notice that despite the retracements, the long-term trend shown in this chart is still intact - that is, the price of the stock is still going up.

The Importance of Recognizing Retracements

It is important to know how to distinguish a retracement from a reversal. There are several key differences between the two that you should take into account when classifying a price movement:

Factor	Retracement	Reversal
Volume	Profit taking by retail traders (small block trades)	Institutional selling (large block trades)
Money Flow	Buying interest during decline	Very little buying interest
Chart Patterns	Few, if any, reversal patterns - usually limited to candles	Several reversal patterns - usually chart patterns (double top, etc.)
Short Interest*	No change in short interest	Increasing short interest
Time Frame	Short-term reversal, lasting no longer than one to two weeks	Long-term reversal, lasting longer than a couple of weeks
Fundamentals	No change in fundamentals	Change or speculation of change in fundamentals
Recent Activity	Usually occurs right after large gains	Can happen at any time, even during otherwise regular trading
Candlesticks	"Indecision" candles - these typically have long tops and bottoms (spinning tops, etc.)	Reversal candles - these include engulfings, soldiers and other similar patterns

Figure 2 - *Note that short interest is delayed when reported, so it can be difficult to tell for certain depending on your time frame.

So, why is recognizing retracements so important? Whenever a price reverses, most traders and investors are faced with a tough decision. They have three options:

1. Hold throughout the sell-off, which could result in large losses if the retracement turns out to be a larger trend reversal.

2. Sell and re-buy if the price recovers, which will definitely result in money wasted on commissions and spreads. This may also result in a missed opportunity if the price recovers sharply.

3. Sell permanently, which could result in a missed opportunity if the price recovers.

By properly identifying the movement as either a retracement or a reversal, you can reduce cost, limit loss and preserve gains.

Determining Scope
Once you know how to identify retracements, you can learn how to determine their scope. The following are the most popular tools used to do this:

Fibonacci retracements
Pivot point support and resistance levels
Trendline support and resistance levels

Fibonacci Retracements
Fibonacci retracements are excellent tools for calculating the scope of a retracement. They are most widely used in the foreign exchange market, but are also used in the stock market. To use them, simply use the Fibonacci retracement tool (available in most charting software) to draw a line from the top to the bottom of the latest impulse wave.

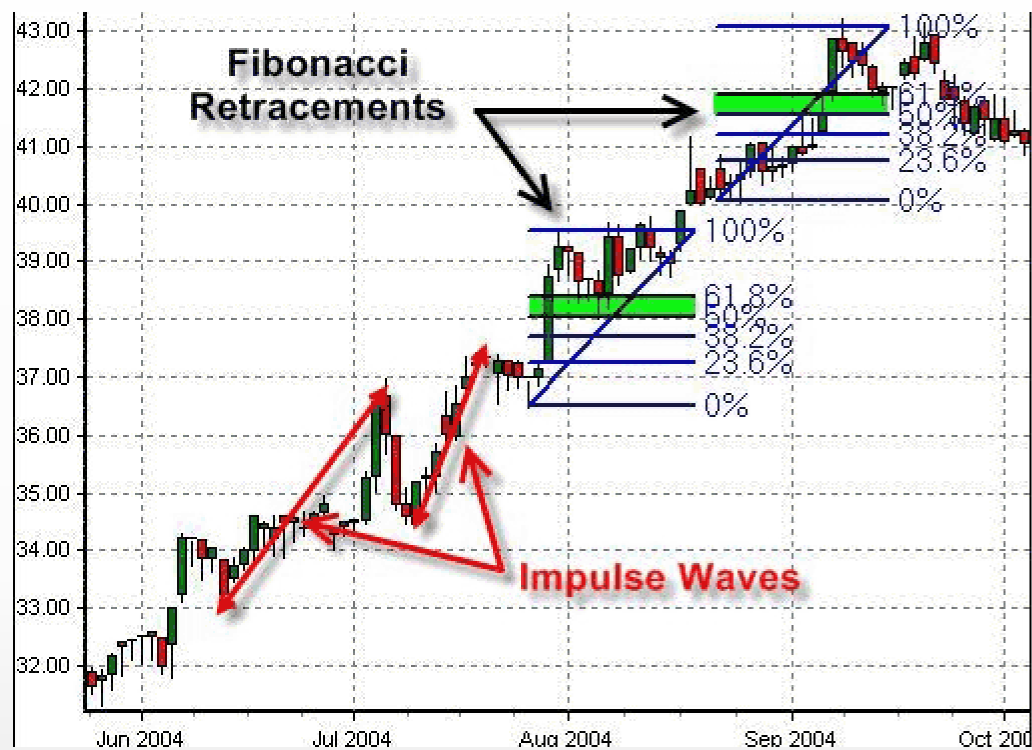

Figure 3: An example of the Fibonacci retracement tool.

In most cases, retracements will stay around 38.5% (daily) or 50% (intraday). If the price moves below these levels, then a reversal may be forming.

Pivot Points
Pivot point levels are also commonly used when determining the scope of a retracement. Most traders look at the lower supports (R1, R2 and R3) - if these are broken, then a reversal may be forming.

Trendline Supports
Finally, if major trendlines supporting the larger trend are broken on high volume, then a reversal is most likely in effect. Chart patterns and candlesticks are often used in conjunction with these trendlines to confirm reversals.

Dealing with False Signals
Even a retracement that meets all the criteria outlined in our table in Figure 2 may turn into a reversal with very little warning. The best way to protect yourself against such a reversal is to use stop-loss points. Here is how you can do this:

1. You can estimate retracement levels using technical analysis and place your stop-loss point just below these levels.

2. Alternatively, you can place the stop-loss just below the long-term support trendline or moving average.

Ideally, what you want to do is lower your risk of exiting during a retracement, while still being able to exit a reversal in a timely manner.

The Bottom Line
As a trader, you need to be able to differentiate between retracements and reversals. Without this knowledge, you risk many things such as exiting too soon and missing opportunities, holding onto losing positions and losing money and wasting money on commissions/spreads. By combining technical analysis with some basic identification measures, you can protect yourself from these risks and put your trading capital to better use.

Don’t forget to visit

www.hotstocksforincome.com

Your One Stop Stock Resource Team