Support and resistance

In addition to prices moving in trends, Technical Analysts also look for support and resistance levels. Support occurs at a level at which the market participants believe the price will rise and, consequently, where the demand is. Resistance occurs at a level at which the market participants believe that price cannot rise further and, consequently, where the supply is. Technical Analysts don't look for fundamental reasons why certain areas are support and resistance areas, they simply observe that they are. In fact, they occur mostly for psychological reasons. Let's have a look at how it might work: Figure 1 shows a hypothetical price on the decline.

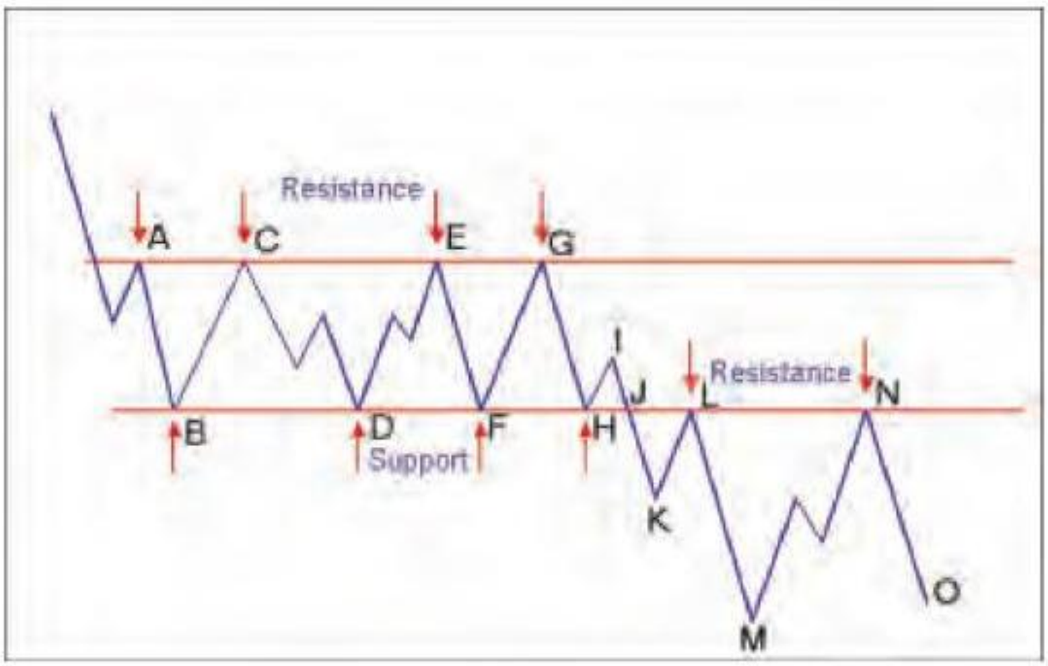

Figure 1: Support and resistance

The price is in a downtrend. It pauses, reacts back up to point A, and then falls to point B. Technical Analysts do not reason why it did this; it is simply understood that supply and demand caused the price to move in this way. At point A, buyers were not prepared to pay any more and so the price declined to B, where the buyers were prepared to start buying again.

You have to remember that the market is made up of lots of participants with differing views and objectives. Buyers who bought at point B may take profits at point C. However, there is another group who bought at point A, are pleased that the price has risen back to the same level at point C, and are pleased to get out of their position. This collective view causes a resistance level at point C and causes the price to move down from point C.

Remember, buyers at point B made a good gain when they sold at point C, and so when it gets down to point D they start buying again. This creates a support level, where buyers are prepared to take an interest again. This demand pushes the price back up again. Once again, at point E, they start selling, reinforcing the resistance level at that level. This causes the price to decline again until it reaches support at point F, where the same short-term traders, who have bought at B and D before, start buying again.

Point G is as far as the price gets again because the short-term traders have become confident that it will not go higher, and so the resistance at that level gets stronger. It declines again to point H and, once again, the buyers come back again, creating support for the price. The price bounces to point I and then falls back to point J. The same buyers who bought at point H are pleased that they now have a second chance to buy at the same price at point J, but this time, the sellers are in charge and force the price below point J. It is important to consider how the participants feel about this. Buyers had become confident buying at the same level and making a profit, so much so, that they probably were buying increasingly more each time. For the first time, they are in a losing position.

Some will sell their positions immediately, creating a selling frenzy that pushes the price down. Others will, however, hope and pray that the price will rise back to the price they paid. Point K is the point where the price has become oversold. That is, it has fallen too far too quickly, and short-term traders looking for a quick profit start buying. This forces the price back up to point L briefly, where the new buyers take a quick profit and some of the B, D, F, H and J buyers sell to break even. The move to point L is short-lived as so many sellers appear. So, the level at point L, which was a support level, now becomes a resistance level. The price falls to point M.

There is no reason why the price stops at point M. It could be at any level. It is simply a point where demand exceeds supply and the price is driven back up again. It is important to pause and consider the psychological make-up of the participants. There will be a large group who bought at the B, D, F, H and J levels and are still holding their positions. What is going through their minds is 'if only the price can reach the price I paid, I will sell out and never buy another thing again'! This creates even more resistance at the L level, which is the same level as the previous support. So, when the price does eventually rise back to that level, those who have been praying start selling at point N, reinforcing the resistance level and forcing the price down again to point O or lower. The level at points L and N will remain a strong resistance until there are no sellers left at that level.

The important point about this scenario is to understand that levels of support and resistance do occur on charts and that they occur for psychological, not fundamental reasons. When support is broken, it is important to recognise and understand that support becomes resistance to any up movement and that this is also caused by psychological reasons. Although not shown in the diagram, resistance, once broken becomes support to any down movement. So support and resistance alternate. This is not just a theory, it actually happens in real life, as the chart of Whitbread plc (a FTSE 100 company) below will testify.

Notice how resistance areas become support areas once the price breaks above the resistance, and support areas become resistance areas once support is broken. As explained, these are created by the emotions of fear and greed that influence market players. There are thousands of private scenarios being played out. There is no point in trying to analyse each and every one. Simply observe and predict where the price will be supported and where it will be resisted. You can see that there is support for the price around the 780 mark and resistance around the 850 mark. Should the resistance break, then the next resistance is at around 1130, a price tested twice several years ago.

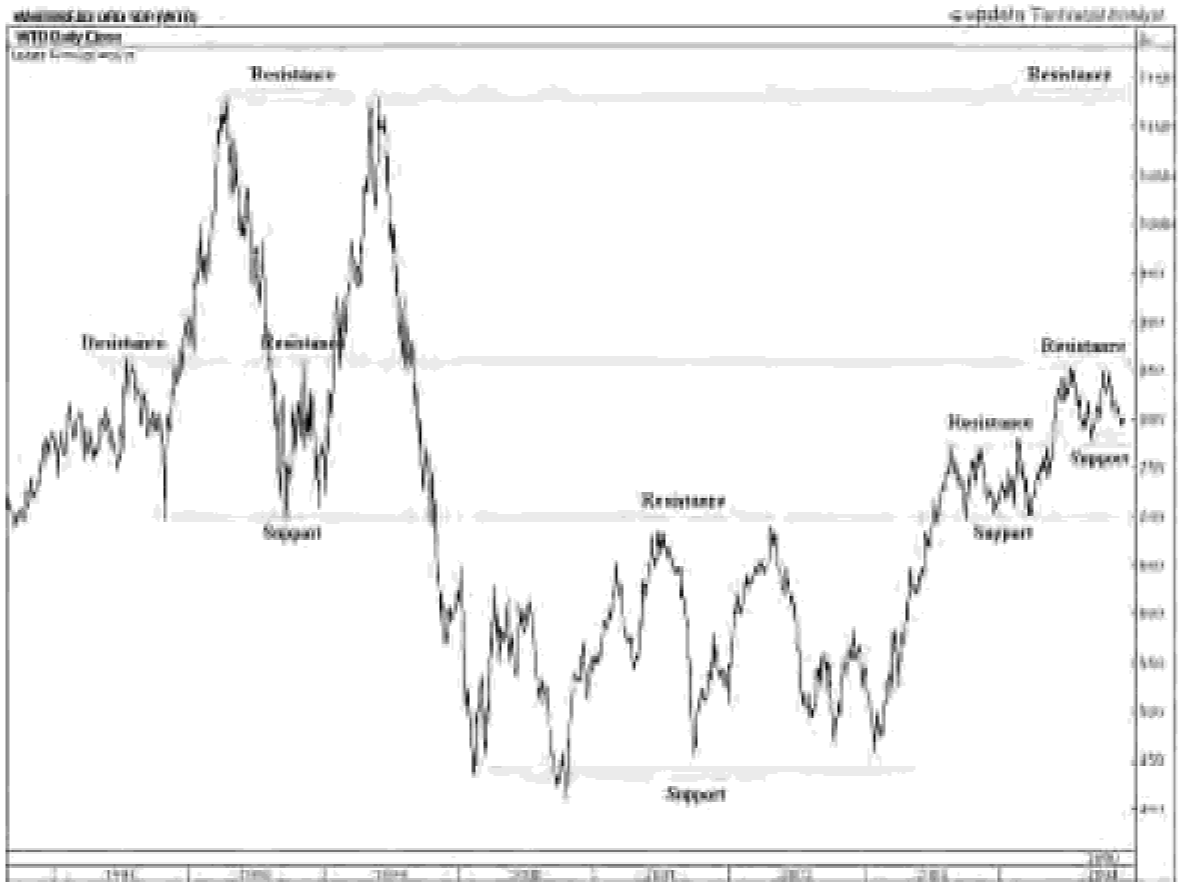

Chart 1: Whitbread plc showing support and resistance levels

Price patterns

In addition to looking at trends, support and resistance, Technical Analysts also look for price patterns. These patterns help us to predict whether a trend has reversed or whether it will continue. They are not rigid patterns, and perhaps Technical Analysts made a mistake when they decided to give them names, like double-tops and head and shoulders, because then the uninformed take hold of them and recite them without understanding how and why they are created. These patterns are created by crowd psychology as well.

Let's see how it happens, referring to Figure 2.

Figure 2: How price patterns are formed

The price finds a level where it starts to move up. Very few people get on the first leg up. After the first move up, profit-taking forces the price back and Group A buys. The point where Group A buys allows a trend line to be drawn from the bottom to this point. The price runs up and Group A, who are then showing a good profit, sell, causing the price to fall back again. When they think the price is at bargain levels, Group B, who missed out before, buys. The price runs back up again and Group B eventually sells for a profit and are pleased with themselves.

The price falls back to the psychological trend – the red trend line – in Figure 3. Group C, the largest group, usually small players, who have missed the whole move from the bottom, buy in the circled area. Instead of rising, however, the price continues down, breaking the uptrend line. Remember, however, that none of these participants are consciously aware that *the trend line exists. Consider the psychological state that members of Group C are in. Their first foray into the market has left them holding a paper loss. Many will be praying that the price gets back to the level they paid so they can get out at break-even. The 'cheapness' of the price however attracts the attention of Group B, who notice that the price is in the same area that they had made a profit from before. Group B therefore buys as well and the price moves up again allowing a new trend line to be drawn. It is the line where there is currently demand. As the price reaches the level paid by Group C, it is held back by selling from Group C, who have just suffered the trauma of the price falling below the level they bought at. So, Group C sells to break even, placing resistance on any further up move, and the price falls back again. This allows a downtrend line to be drawn from the top. It is the line where there is currently supply. Look at Figure 3. The price is trapped in a triangular pattern bounded by the neckline and the downtrend line. It is a point of resolve, where either the demand from buyers or supply by sellers must take the upper hand. Also notice that a head and shoulders pattern has been traced out by the antics of the various groups. There is a head and two clear shoulders supported by a neckline.*

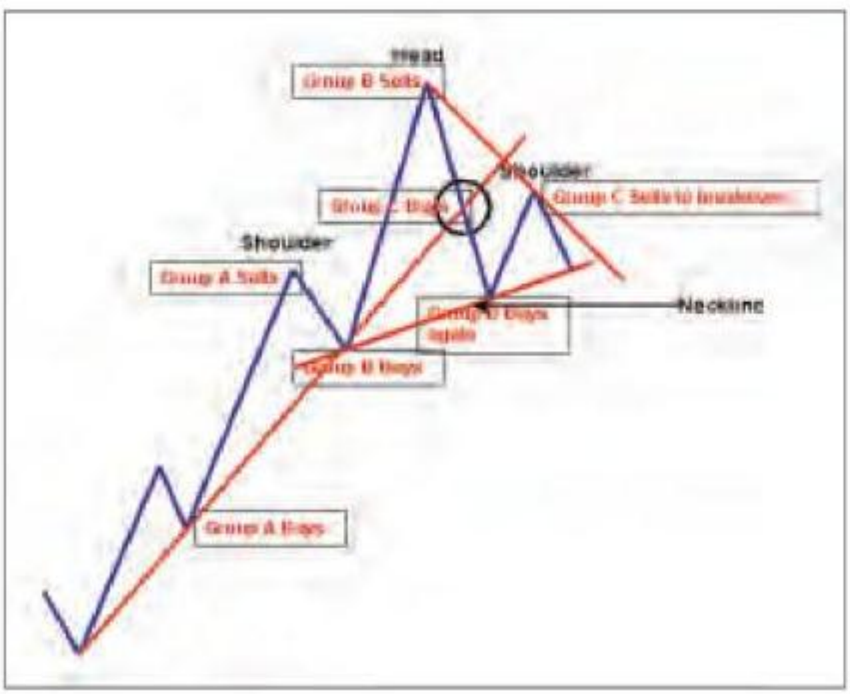

Figure 3: How price patterns are formed