Stock Markets Guides

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Pivot Point Trading Strategy Guide

When trading using technical analysis, what matters more than anything else is that you have the right strategy which will enable you to spot profitable entry and exit opportunities effectively.

There are various indicators that traders use for this, such as trading based on the trends, candlestick patterns, and using statistical indicators such as Bollinger bands. However, the most reliable indicator among these is the support and resistance levels to trade. This is generally done through the use of pivot points trading.

In this post, you will learn about pivot points, how they're calculated, the different types of pivot points, and the trading strategies that you can to profitably trade using pivot points.

What is a Pivot Point?

Before you begin to understand pivot points, you need to understand what support and resistance levels for a stock are. These levels are both different price points that represent the range in which the stock generally fluctuates.

Suppose a given stock has a support level of $5 and a resistance level of $6. This means that when the stock price is at $5, the bulls in the market will begin to buy the stock because they believe it is undervalued. This will create an excess demand in the market, thereby pushing up prices.

The bulls will ride this price wave all the way up to $6, at which point the security becomes overvalued in their eyes, and they begin to sell it off and book their profits.

This then means an excess supply of the stock in the market, and the bears are in power, resulting in the stock price falling.

The prices then fall all the way back down to $5, wherein the bulls start repurchasing the stock. Since the stock price fluctuates between $5 and $6, these are the support and resistance levels for the stock, respectively.

Using the support and resistance levels along with the stock data for the previous day, pivot points can be calculated.

Since they rely on the data from the previous data, each day has its own unique pivot points, making it a very exclusive trading opportunity. These levels that are termed pivot points are then used as frameworks to determine the ideal entry and exit points and the ideal stop-loss and take-profit points for the trades.

Pivot Point Trading Strategy

If you wish to trade equities through pivot point strategies, several steps are involved with this process.

You need to know how to calculate pivot points based on the previous day's data.

Even though most trading platforms and software already have built-in calculators for pivot points, you need to understand how they are calculated so that you can also do them yourself if needed. Then, you need to know how to trade using pivot points optimally.

There are two main strategies that traders use most commonly: the breakout trading strategy and the bounce trading strategy.

Each of these steps has been explained in detail below.

How to Calculate Pivot Points

There are seven main pivot points that traders use on charts.

Each of these pivot points represents something unique, and they're calculated using the previous day's low, high, and closing price.

The first pivot point is the Basic Pivot Level (PP), which is the middle point on the chart, around which all the other points are centered. This point represents balance in the market, at a point where the bullish and bearish forces are in equilibrium. If the price moves above the PP, then this indicates that the bulls dominate the market; if the price falls below the PP, this is an indicator of a bearish market.

In addition to this, there are 3 support levels (S1, S2, and S3) and 3 resistance levels (R1, R2, R3) calculated using the PP and the previous day's data. Each of these represents a different level and helps identify stop-loss and take-profit points for a particular trade.

The different pivot points can be calculated as follows:

Basic Pivot Level (PP) = (Previous Day's High + Previous Day's Low + Previous Day's Close)/3

Resistance 1 (R1) = (2 X PP) – Previous Day's Low

Support 1 (S1) = (2 X PP) – Previous Day's High

Resistance 2 (R2) = PP + (Previous Day's High – Previous Day's Low)

Support 2 (S2) = PP – (Previous Day's High – Previous Day's Low)

Resistance 3 (R3) = Current Day's High + 2 X (PP – Previous Day's Low)

Support 3 (S3) = Current Day's Low – 2 X (Previous Day's High – PP)

When plotted on the price chart, this should give you 7 parallel lines. It is important to note here that each resistance and support level calculation uses the PP value. Therefore the PP is the central value around which all the other values revolve.

An incorrect PP value will also result in your other values being wrong; hence it is important to use the right values while calculating the Basic Pivot Point.

Pivot Point Breakout Trading Strategy

Pivot points enable you to establish the different support and resistance levels for a stock based on its movements on the previous day.

Once you notice a stock approaching either a support or a resistance level, there are two things that the stock could do. It could either reverse its trend at the support/resistance level and start moving in the opposite direction, or it could break through the level and continue moving in the same direction.

If the former happens, you should trade using the bounce strategy. However, in the case of the latter, the breakout trading strategies must be used.

If the stock price breaks through a particular level, say the R1 level, this indicates a strong bullish trend on the stock. In this case, you should then open a trade with a stop-loss at a level just below the R1 price. These breakouts most commonly occur in the morning when the market opens, and the activity is maximum at that point. It is important to note that every trade using pivot point breakout strategies should be made using a stop-loss to avoid running into huge losses.

Once you have opened a trade at the point where a breakout happens, you should then wait for the price to at least touch the next level, R2 in this case, before you close the trade. However, you could even hold out to see if the price touches even higher levels, such as R3 or above.

Once the trade crosses R2, however, you can close the trade at any time. It would help if you had an ideal risk-reward ratio for each trade as a trader that will decide where your stop loss is and where you close the trade and book a profit. Suppose you enter a trade at $5 and your risk-reward ratio is 3:1, then your stop loss would be at $4 (a $1 loss), and you would close the trade to book a profit at a price level of $8 (a $3 profit). Your risk-reward ratio on this trade would be 3:1 as desired.

Pivot Point Bounce Trading Strategy

When the price touches a particular support or resistance level, it might not always break through that level and continue on its trend.

Occasionally, you will see that the stock touches a particular level, reverses its trend, and starts moving in the opposite direction. For example, say a stock price touches the S1 level. It might choose to turn around and begin moving upwards until it reaches R1 when it starts moving down again. If this happens, then this means that the first stage of the support and resistance levels are holding, and you should use the bounce trading strategies to trade.

Say a stock price touches the S1 level and begins moving upwards. In this case, you should buy the stock and set your stop-loss at a level marginally lower than the S1 level. You should then hold the stock until it touches the next level, at least PP in this case.

After this, you can sell the stock at any point when your risk-reward ratio is satisfied. It is important to note here that the price might not always be bouncing between support and resistance levels; it could also choose to bounce between two support or two resistance levels. For example, the stock price might reverse trends and bounce between the R1 and R2 levels, and even in this case, the same strategies must be applied.

Fibonacci Pivot Points

Fibonacci pivot points are another type of pivot point that traders use.

While the strategies used by traders to trade on these points are quite similar to classic pivot point trading strategies, the calculations of the points and levels differ. These points are more commonly used than classic pivot points because they are a better indicator of support and resistance levels; however, they are also a bit more complicated to calculate and understand.

To trade using the Fibonacci pivot points, you will need to understand how Fibonacci indicators are calculated, what Fibonacci levels are, and how you can effectively trade on them.

What is the Fibonacci sequence?

The Fibonacci sequence is a pattern of numbers where every number is the sum of the previous two numbers.

The series goes 1,1,2,3,5,8,13,21. Here, the third term 2 is the sum of the previous two terms (1+1), the fourth term 3 is the sum of the second and third term (1 and 2), and so on.

Fibonacci numbers are also used in stock trading to calculate retracements, indicating how much a stock will bounce back in any given conditions.

The three main Fibonacci intervals are the 23.6%, 38.2%, and 61.8% intervals; however, the 50% interval is also often considered crucial.

This means that suppose a stock is trading at $30 and it goes up to $31, which is the resistance level, the stock has made a gain of $1. It will then bounce back by either 24, 38, 50, or 62 cents. Traders very commonly use these intervals to set target profits and stop losses.

What are the Fibonacci Pivot Points?

The Fibonacci pivot points are calculated based on the intervals discussed earlier.

Of the four intervals, the most crucial ones that traders most often monitor in pivot trading strategies are the 38.2% and the 61.8% levels. The intervals can be calculated as follows:

Basic Pivot Point (PP) = (Previous Day's High + Previous Day's Low + Previous Day's Close)/3

Support 1 (S1) = PP – {.382 * (Previous Day's High – Previous Day's Low)}

Support 2 (S2) = PP – {.618 * (Previous Day's High – Previous Day's Low)}

Support 3 (S3) = PP – {1 * (Previous Day's High – Previous Day's Low)}

Resistance 1 (R1) = PP + {.382 * (Previous Day’s High – Previous Day’s Low)}

Resistance 2 (R2) = PP + {.618 * (Previous Day’s High – Previous Day’s Low)}

Resistance 3 (R3) = PP + {1 * (Previous Day’s High – Previous Day’s Low)}

Weekly Pivot Point Trading Strategy

While carrying out weekly pivot trading, the support and resistance levels used are calculated based on the close, high, and low prices of the previous week.

The week runs from Monday to Friday, so the week’s close price is the stock price on Friday at the time of the closing of the market.

However, pivot trading strategies are also commonly used in forex trading, where trading runs 24 hours. In this case, according to the New York markets, the closing time could be considered, or in some cases, the price at 11:59 pm on Friday when the market closes for the weekend is also considered.

While trading weekly pivot points, you can let your positions stay overnight and transfer them from one day to another, even though that is not something that day traders often do. However, since many candles are needed to spot when a breakout or bounce is happening and to identify and set stop-losses, the normal candle timeframe is 15 or 30 minutes, or an hour at best.

Anything greater than that does not provide enough candles for the strategy to be used effectively.

How to Use Pivot Points in Intraday Trading

For using pivot points in intraday trading, the rules are a bit different.

In the equity markets, the pivot points are calculated based on the previous day's close, high, and low prices. In the forex markets where trading continues 24 hours a day, traders either use midnight as the close or use the price at 4 pm New York time as the closing price for their calculations.

Obviously, this affects the calculations of the pivot points and the consequent support and resistance levels; therefore, you must take care to remember what prices you use and stick to them consistently. This will also make a difference in how long you can hold your positions and what targets you will set for your trades.

In intraday pivot trading, just like with weekly pivot trading, it is important for you to have many candles to spot patterns easily. 1 minute or 5 minute candles work best with pivot trading strategies.

Therefore, intraday pivot trading is quite fast-paced and challenging and should only be done if you’re comfortable with the weekly trading first.

Mastering Pivot Point Trading

If you’re starting in pivot trading, there are several things that you need to keep in mind to become a successful trader and not lose money.

Firstly, presentation matters. When you’re trading using pivot lines, you cannot afford to get confused between the PP line, the support lines, and the resistance lines. To avoid this, you should take care to color-code your lines.

The most commonly used method is to color the PP line a certain color (normally black), the support lines in one color, and the resistance lines in another color. This will enable you to spot patterns easily and keep you from being confused later.

The second thing to keep in mind is always to set a stop-loss for every trade.

This is important for all trades, but it becomes absolutely crucial when trading using pivot points. This is because there is always a good chance of what looks like a breakout to turn out to be just a bounce. If this happens, you will not want to be left holding the bag on a loss making trade; therefore, stop-losses are crucial because they minimize your losses and keep the risk-reward ratio within the required parameters.

Lastly, it is important to stay disciplined.

This means that irrespective of what happens, stick to your rules. Do not move the stop-loss on a trade no matter what happens.

There will always be more opportunities and more ways to profit, and it is not worth compromising your discipline ever.

When you open a trade, wait until it touches the next price line or hits the stop-loss before closing the trade. Do not close the trade before that.

All of these traits are of an experienced and disciplined trader, and that is what you need to profit in the market consistently. It is easy to make money trading, but discipline is key to make money trading over a long period of time.

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