

Divergence Trading

What if there was a low risk way to sell near the top or buy near the bottom of a trend?

What if you were already in a long position and you could know ahead of time the perfect place to exit instead of watching all your unrealized gains vanish before your eyes because your trade reverses direction?

What if you believe a currency pair will continue to fall but would like to go short at a better price or a less risky entry?

Well there is a way. It's called divergence trading.

Divergence is basically price action measured in relationship to an oscillator indicator. It doesn't really matter what type of oscillator you use. You can use RSI, Stochastic, MACD, CCI, etc. etc. The great thing about divergences is that you can use them as a leading indicator and after some practice, it's not too difficult to spot.

When traded properly, you can be consistently profitable with divergences. The best thing about divergences is that since you're usually buying near the bottom or selling near the top, your risk on your trades are very small relative to your potential reward. Cha ching!

Higher Highs and Lower Lows

Just think "higher highs" and "lower lows". If price is making highs, the oscillator should also be making higher highs. If price is making lower lows, the oscillator should also be making lower lows.

If they are NOT, that means price and the oscillator are diverging from each other. Hence the term, divergence.

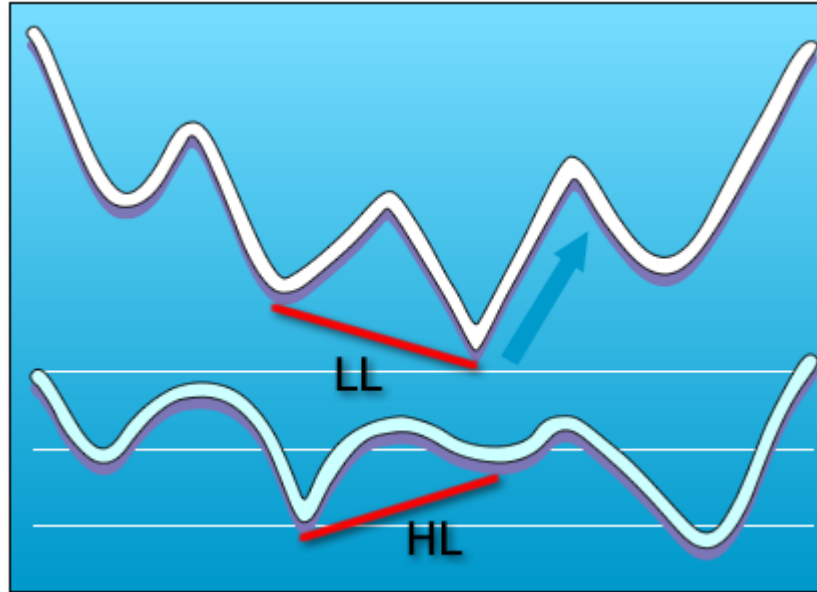
There are TWO types of divergence:

Regular

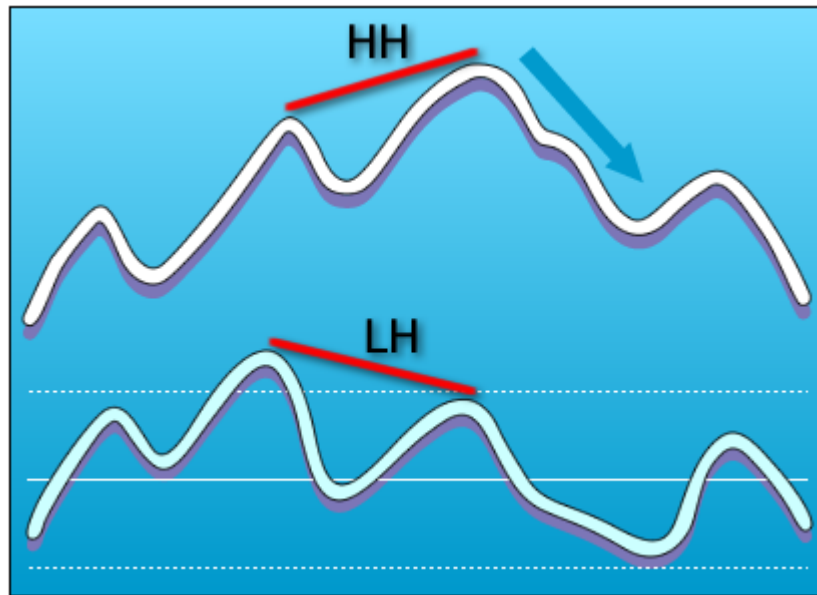
Hidden

A **regular divergence** is used as a possible sign for a **trend reversal**.

If the **price is making lower lows (LL)**, but the **oscillator is making higher lows (HL)**, this is considered **regular bullish divergence**.

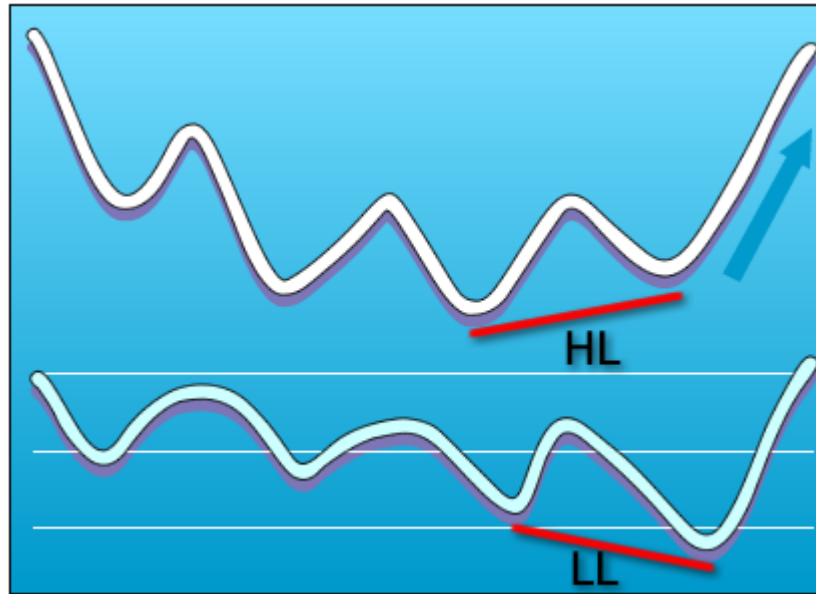


If the **price is making a higher high (HH)**, but the **oscillator is lower high (LH)**, then you have **regular bearish divergence**.

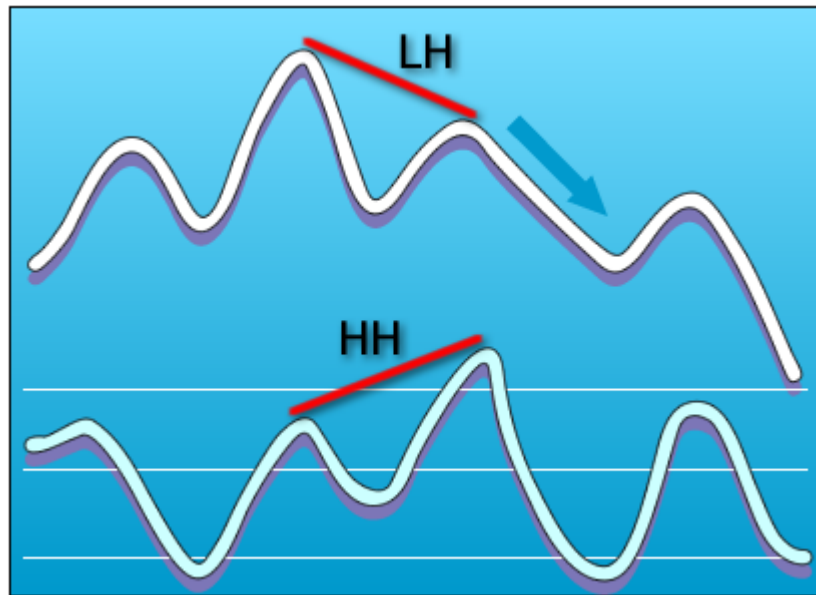


A **hidden divergence** is used as a possible sign for a **trend continuation**.

If **price is making a higher low (HL)**, but the **oscillator is making a lower low (LL)**, this is considered **hidden bullish divergence**.



If **price is making a lower high (LH)**, but the **oscillator is making a higher high (HH)**, then you have **hidden bearish divergence**.



Here's how you could trade divergences:

Divergence Type	Price	Oscillator	Trade
Regular	Higher High	Lower High	SELL
Regular	Lower Low	Higher Low	BUY
Hidden	Higher Low	Lower Low	BUY
Hidden	Lower High	Higher High	SELL

Divergences act as an early warning system alerting you when the market could reverse. For example, if bulls have steadily pushed EUR/USD higher, the appearance of divergence between price and indicator could mean that bulls are running out of gas and price will soon fall

Please keep in mind that I use divergence as an indicator, not a signal to enter a trade! It wouldn't be smart to trade basely solely on divergences as too many false signals are given. It's not 100% foolproof, but when used as a setup condition and combined with additional confirmation tools, your trades have a high probability of winning with relatively low risk.

On the flip side, I think it is just as dangerous trade against this indicator. If you're unsure about which direction to trade, chill out on the sidelines.

Divergences don't appear that often, but when they do appear, it'd behoove you to pay attention. Regular divergences can help you collect a big chunk of profit because you're able to get in right when the trend changes. Hidden divergences can help you ride a trade longer resulting in bigger-than-expected profits by keeping you on the correct side of a trend.

The trick is to train your eye to spot divergences when they appear AND choose the proper divergences to trade. Just because you see a divergence, it doesn't necessarily mean you should automatically jump in with a position. Cherry pick your setups and you'll do well.

There are nine cool rules for trading divergences. Learn 'em, apply 'em, and make money. Ignore them and go broke.

1. In order for divergence to exist, price must have either formed one of the following:

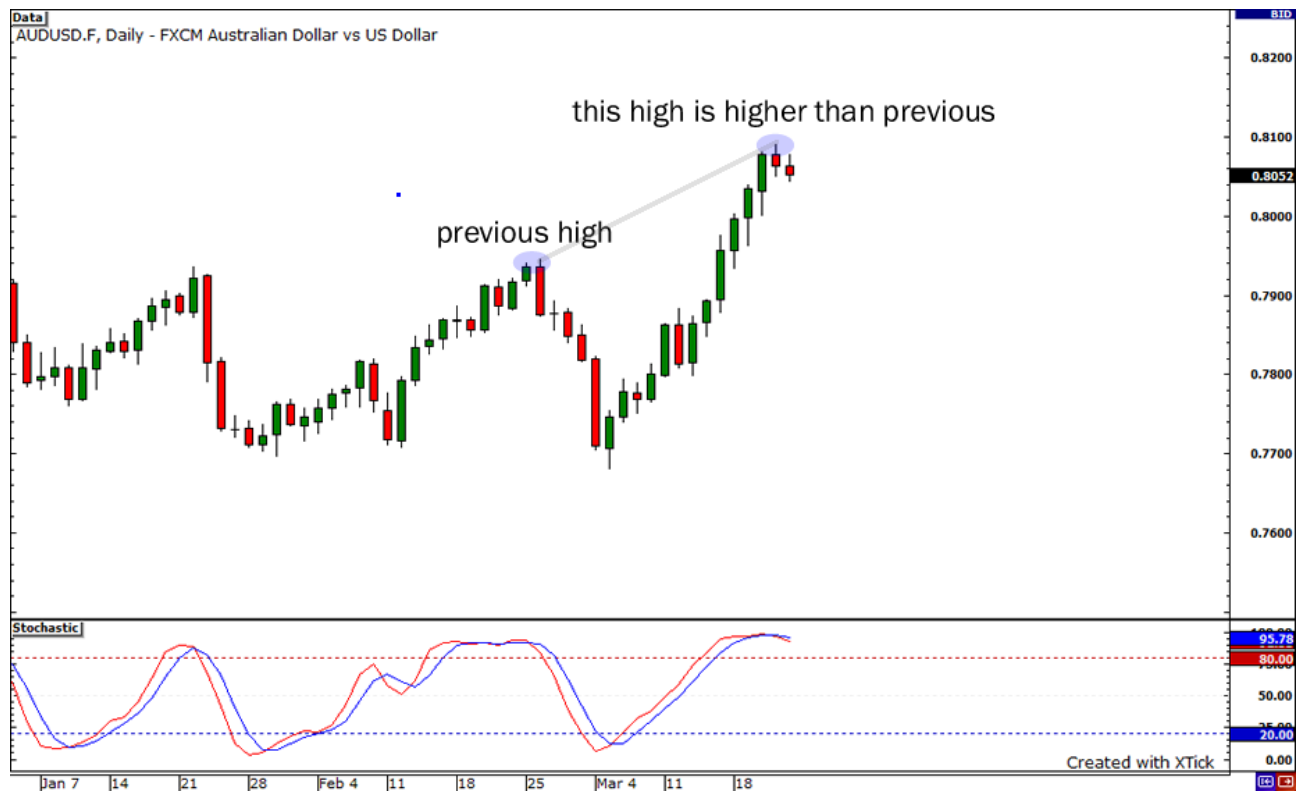
Higher high than the previous high

Lower low than the previous low

Double top

Double bottom

Don't even bother looking at an indicator unless ONE of these four price scenarios have occurred. If not, you ain't trading divergence buddy. You just imagining things. Immediately go see your optometrist and get some new glasses.



2. Okay now that you got some action (recent price action that is), look at it. Remember, you'll only see one of four things: a higher high, a flat high, a lower low, or a flat low. Now draw a line backward from that high or low to the previous high or low. It HAS to be on successive major tops/bottom. If you see any little bumps or dips between the two major highs/lows, do what you do when your significant other shouts at you - ignore it.

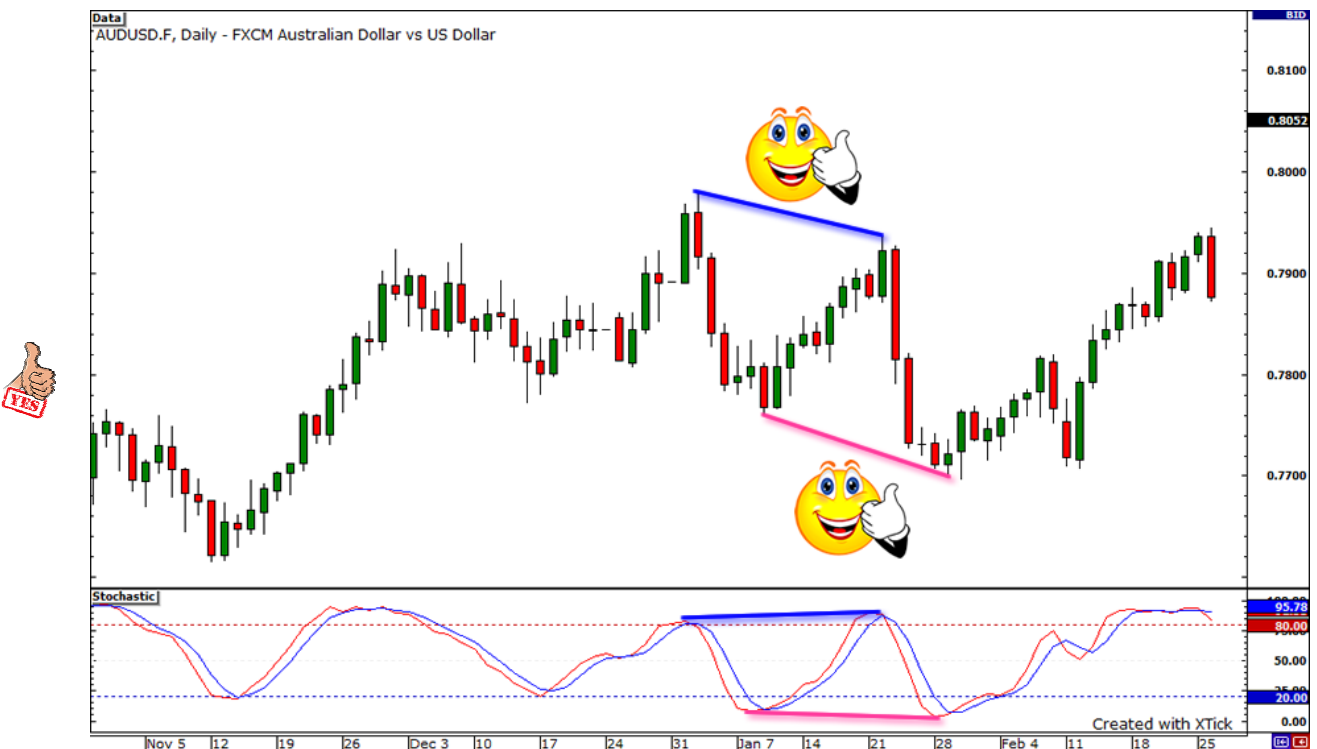
3. Once you see two swing highs are established, you connect the TOPS. If two lows are made, you connect the BOTTOMS. Don't make the mistake of trying to draw a line at the bottom when you see two higher highs. It sounds dumb but peeps regularly get confused.

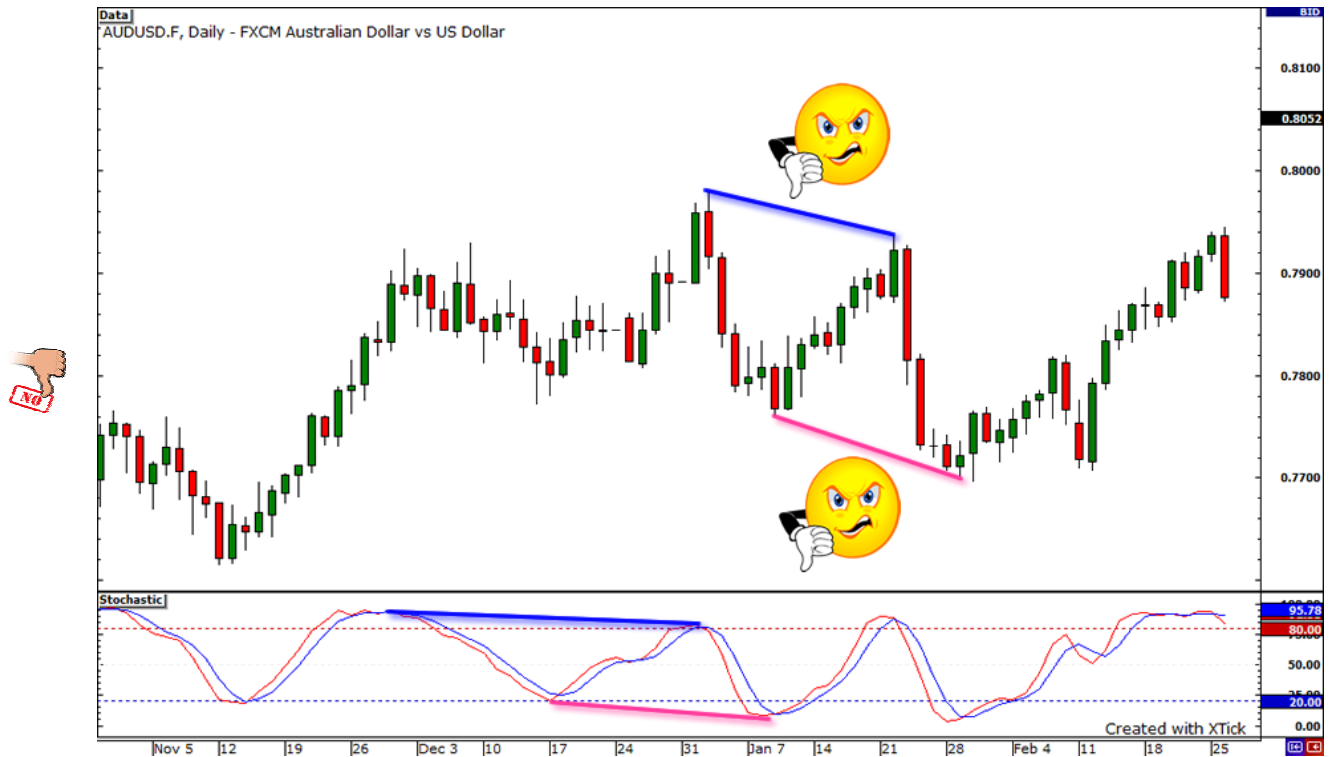


4. So you've connected either two tops or two bottoms with a trendline. Now look at your preferred indicator and compare it to price action. Whichever indicator you use, remember you are comparing its TOPS or BOTTOMS. Some indicators such as MACD or Stochastic have multiple lines all up on each other like teenagers with raging hormones. Don't worry about what these kids are doing.

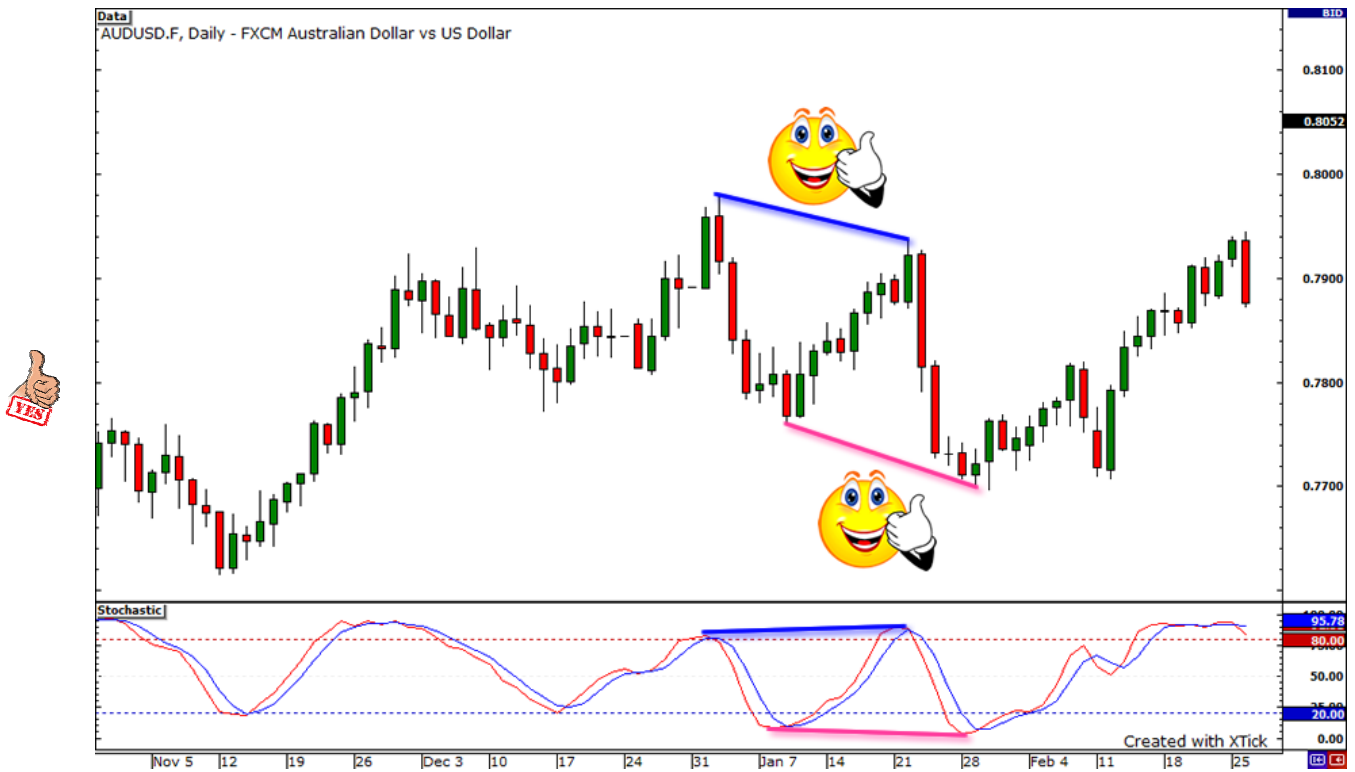


5. If you drew line connecting two highs on price, you MUST draw a line connecting the two highs on the indicator as well. Ditto for lows also. If you drew a line connecting two lows on price, you MUST draw a line connecting two lows on the indicator. They have to match!

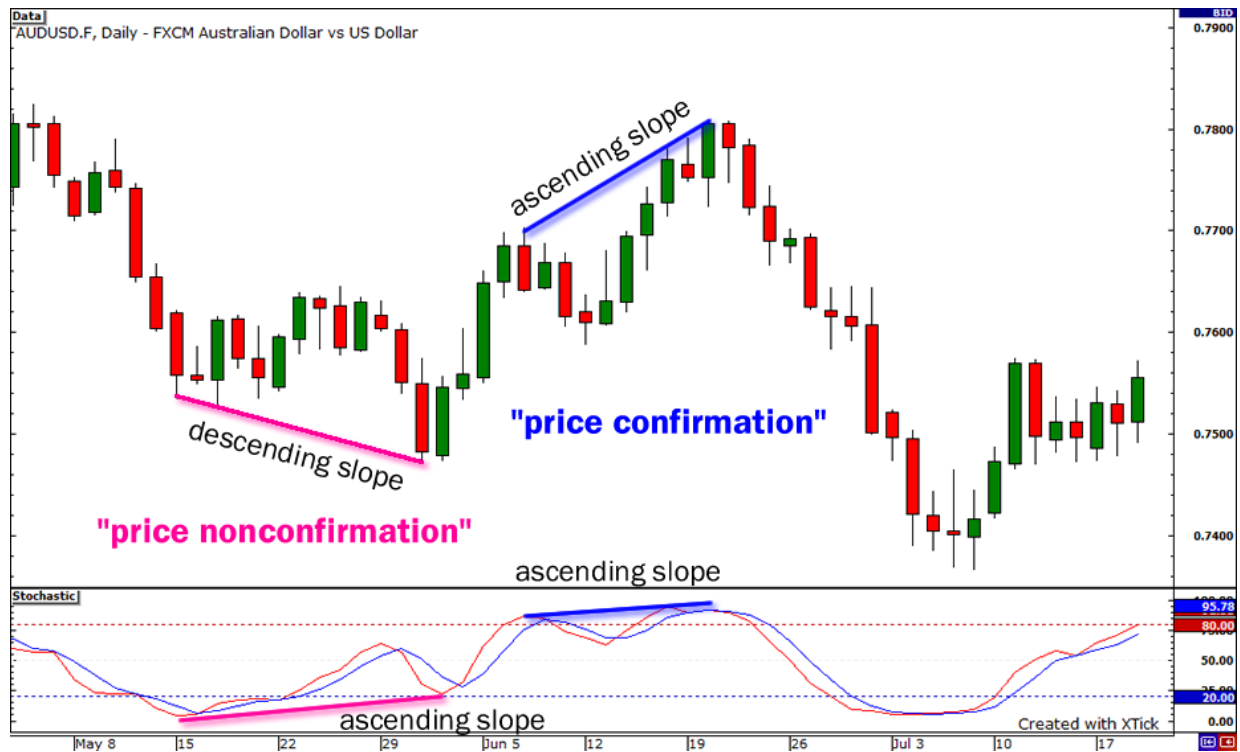




6. The highs or lows you identify on the indicator MUST be the ones that line up VERTICALLY with the price highs or lows.




7. Divergence only exists if the SLOPE of the line connecting the indicator tops/bottoms DIFFERS from the SLOPE of the line connection price tops/bottoms. The slope must either be: Ascending (rising) Descending (falling) Flat (flat).



8. If you spot divergence but price has already reversed and moved in one direction for some time, the divergence should be considered played out. You missed the boat this time. All you can do now is wait for another swing high/low to form and start your divergence search over.



9. Divergences on longer timeframes are more accurate. You get less false signals. You will also get less trades but your profit potential is huge. Divergences on shorter timeframes will occur more frequently but are less reliable. I personally only look for divergences on 1-hour charts or longer. Other traders use 15-minute charts or even faster. On those timeframes, there's just too much noise for my taste so I just stay away.

Type	Bias	Price	Oscillator	Description	Example
REGULAR	Bullish	Lower Low	Higher Low	Indicates underlying strength. Bears are exhausted. Warning of possible trend direction change from down to up.	
	Bearish	Higher High	Lower High	Indicates underlying weakness. Bulls are exhausted. Warning of possible trend direction change from up to down.	
HIDDEN	Bullish	Higher Low	Lower Low	Indicates underlying strength. Good entry or re-entry. Occurs during retracements in an uptrend. Nice to see during price retest of previous lows. "Buy the dips"	
	Bearish	Lower High	Higher High	Indicates underlying weakness. Found during retracements in a downtrend. Nice to see during price retests of previous highs. "Sell the rallies"	

http://www.babypips.com/school/divergence_trading.html