MASTER ONE SETUP THEN MASTER MANY THE MARKET IS YOUR ATM

DIVERGENCE

&

HIDDEN DIVERGENCE

MAY THE GODS GUIDE BE WITH YOU

DIVERGENCE.

It's about higher highs and lower lows. If you find them in price, but not in the oscillator, you have regular divergence. If you find them in the oscillator, but not in price, then it's hidden divergence.

Higher Highs => Short

Lower Lows => Long

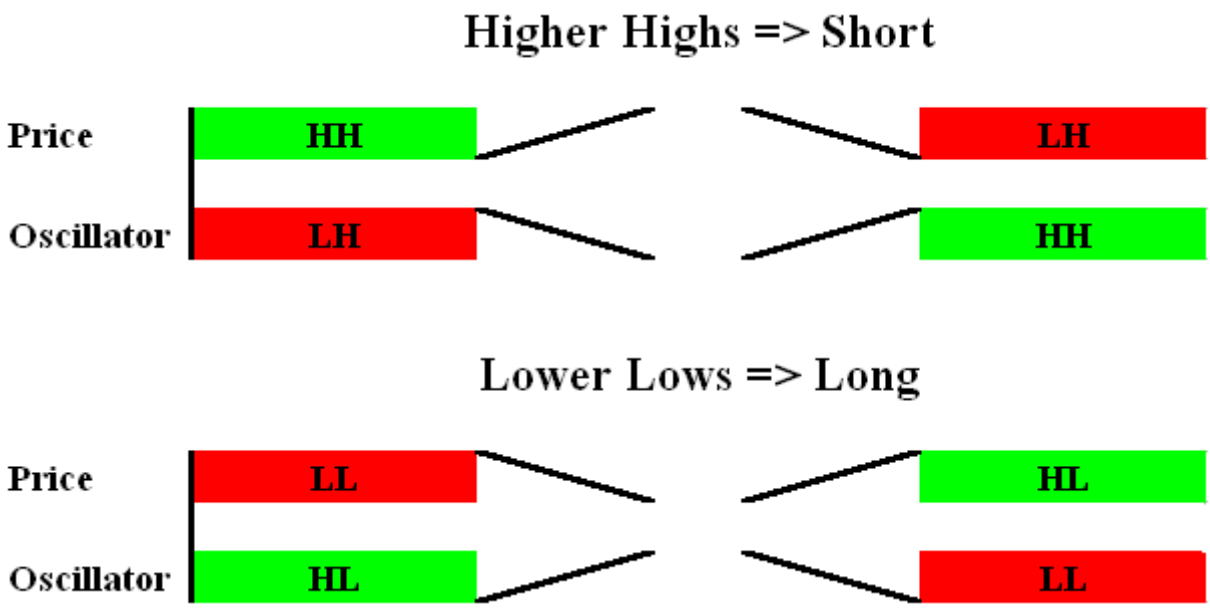
At first this seemed to me like the opposite of common sense, so I had to think about it for a while. I finally got it that it means when higher highs or lower lows in either price or an oscillator aren't confirmed by the other, then the direction indicated by the extremes, meaning the higher highs or lower lows, is weak and is likely to change.

If the higher highs or lower lows are in **price** but not the oscillator, then the direction of price is likely to reverse. This is **regular, or classic divergence** and can be used as a confirming indicator for a **reversal entry**.

Regular divergence describes a price trend change that will probably happen in the future, albeit shortly. On the other hand, hidden divergence is a confirming indicator of past price direction.

We have hidden divergence when we have higher highs or lower lows in the **oscillator** but not in price. In this case the direction indicated by higher highs or lower lows in the oscillator is contradicted by the price trend. Unlike regular divergence, where the weakness in price trend is about to lead to a reversal; here the weakness has already led to a little reversal against the trend. The **hidden divergence** implies that this recent little reversal in price direction will be short-lived and that price will resume moving in the direction of the trend. This is exciting because it can confirm a **continuation entry**, which is generally much less risky than a reversal entry. What you have here is the opportunity to enter on a pullback of the current trend, which you expect to continue based on this and whatever other indicators you choose. This is trading with the trend, nice and friendly; however, please heed the following warning.

Warning: I consider divergence to be an indicator, not a signal to enter a trade. It would be unwise to enter a trade basely solely on this indicator as too many false signals are given; however, on the other hand, I consider it even more unwise to trade against this indicator.



SUMMARY OF FOUR TYPES OF DIVERGENCE

Regular Divergence:

- Higher highs in price and lower highs in the oscillator which indicate a trend reversal from up to down.
- Lower lows in price and higher lows in the oscillator which indicate a trend reversal from down to up.

Hidden Divergence:

- Lower highs in price and higher highs in the oscillator which indicate a confirmation of the price trend which is down.
- Higher lows in price and lower lows in the oscillator which indicate a confirmation of the price trend which is up.

On the diagram, the diagonal lines represent the trend lines drawn on a chart showing how each of the four patterns look with price above and the oscillator below. On the two price lines, going either from right to left or left to right, the reversal of the diagonal lines shows the direction to be expected by each instance of divergence. In each of the four instances of divergence, when price is headed up, green, chances are good it will turn down, red, and vice versa.

Divergence Trading

Regular Divergence. Hidden Divergence. "What a great tool, it really works!" "I see divergences all over the place and would get chopped to pieces if I traded all the signals. Just doesn't work for me!" These are comments and other variations of them that are heard all the time. Hopefully, we can clear up some of the confusion so you will be able to add regular and hidden divergence successfully to your trading toolbox.

Divergence is a comparison of price to technical indicators. It can also be a comparison to another symbol or spread between two symbols. Divergence occurs when what you are comparing is moving in opposite directions. Divergence can signal an up coming change in trend, a change of trend in progress or that a trend should continue. A divergence signal suggests watching for a trading opportunity in the direction of the signal. Divergences may continue over many swing highs/lows so price action should confirm your trade. This can be done in many ways, some of which are: price making a higher high/low or lower high/low or price testing the last swing high/low, price trading past high or low of previous bar, many of which will correspond with the MACD histogram crossing zero.

Divergence trading can be used on many indicators -- Stochastic, MACD, RSI and CCI to name a few. As with most indicators, divergence signals in a higher time frame (TF) are going to indicate a larger move in price. The chart examples are going to be comparing price with the Stochastic and MACD indicators. Each chart has the 50EMA (Blue), 200EMA (Red), 9/3/3 Stochastic and the 7/10/5 MACD histogram on it. There are many other Stochastic and MACD settings that also work for divergence signals.

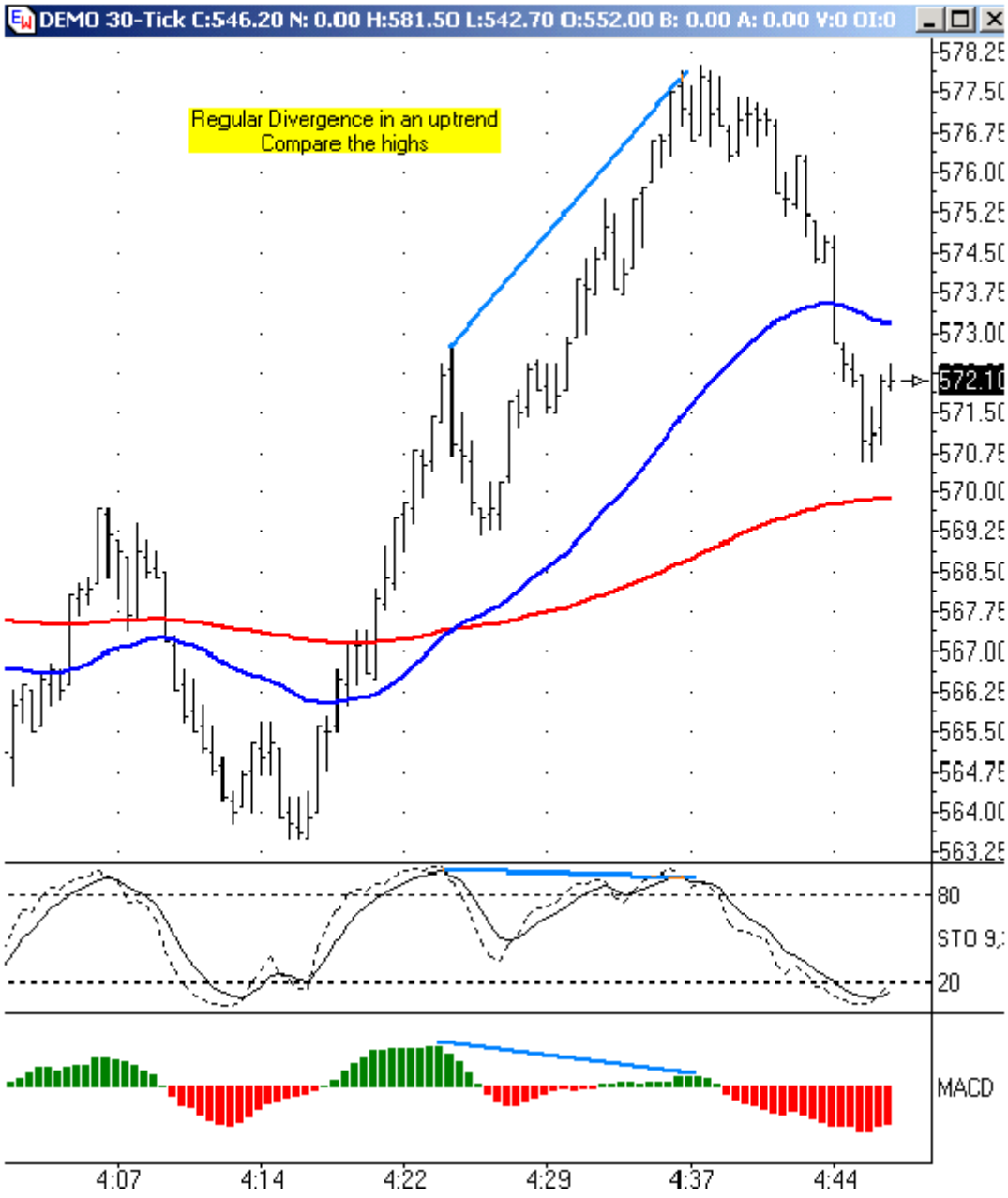
Regular divergence (RD) is best used at the test of a previous high or low, what most traders call a double or triple top/bottom. It is not uncommon to see 3 or 4 higher highs in price in an up trend with 3 or 4 lower highs in the indicator or 3 or 4 lower lows in price in a downtrend with 3 or 4 higher lows in the indicator. This is called 3pt RD or 4 pt RD. This is the indicator telling you with regular divergence that the trend is getting weak and the potential for a change of trend is there and to trade accordingly. To some traders, it might mean to tighten stops, while others might prepare to exit the trade.

Hidden divergence (HD) is best used in trends for continuation trades with the trend. A high percentage of hidden divergence trades will move at least to the last swing high/low, thereby giving you a way to calculate your risk/reward for the trade. If there isn't enough points between the signal and the last swing high/low, then many traders will usually pass on the trade. Another warning to pass on the trade signaled by HD is having RD present for the last 3 highs in an up trend or last 3 lows in a downtrend which is thereby signaling a possible change of trend (COT).

As long as price is making higher highs and higher lows, that time frame is considered to be in an up trend. When price is making lower highs and lower lows, that time frame is considered to be in a downtrend.

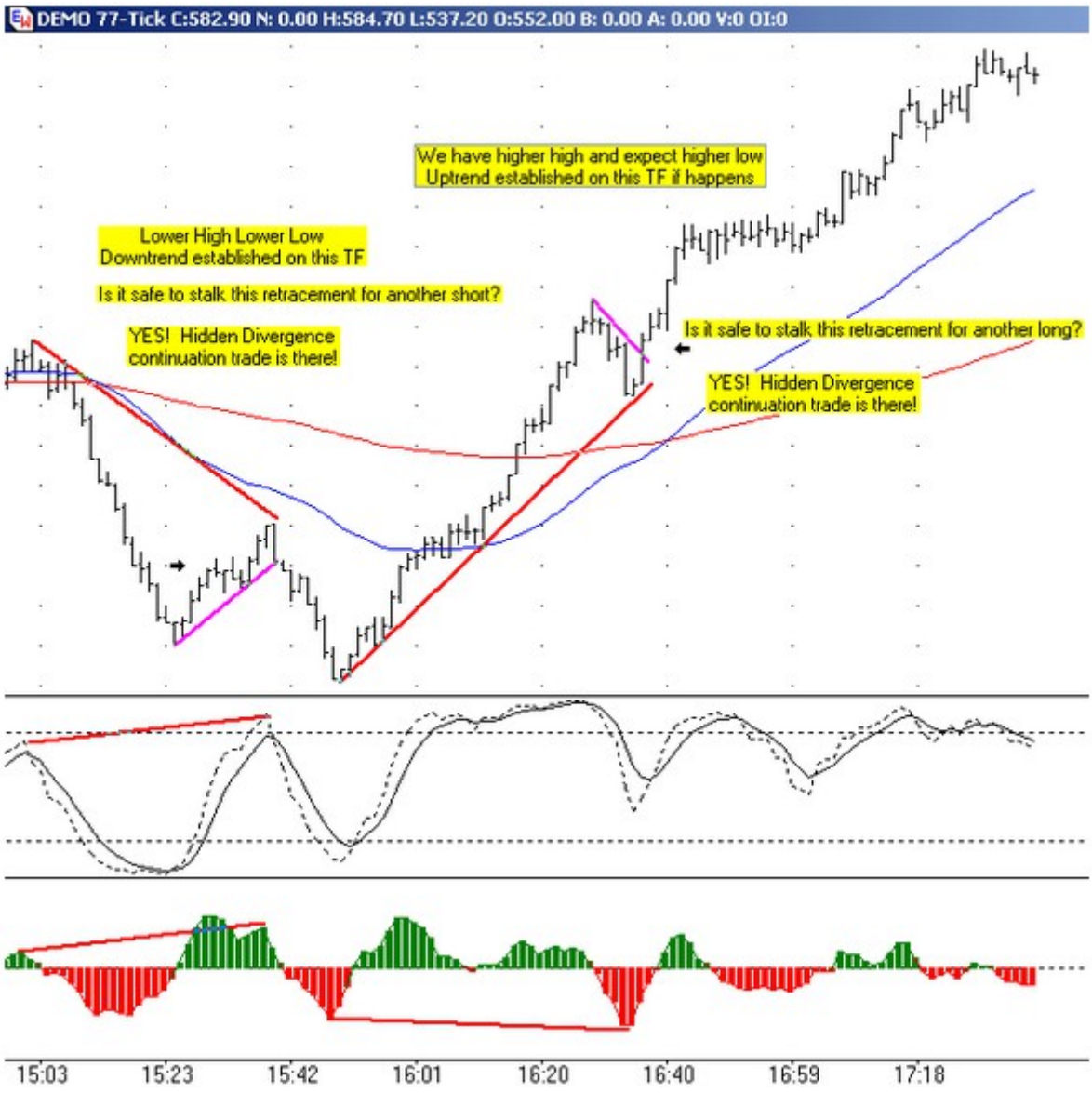
The following two charts are an example of regular divergence. Just because we see regular divergence when comparing two highs in an up trend or on a comparison of two lows in a downtrend, it is not an automatic trade. If the trend is strong enough, you may only get sideways price action or a one or two bar retracement before the trend resumes. Regular divergence can be a tool to answer the question of whether the trend is gaining or losing momentum.

Regular divergence in an up trend (higher highs/higher lows) compares the higher highs in price with the highs in the indicator. Note that both Stochastic and MACD have a lower high while price has a higher high...a signal the trend is getting weak.



Regular divergence in a downtrend (lower highs/lower lows) compares the lower lows in price with the lows of the indicator. Note that both the Stochastic and MACD have higher lows while the price has lower lows....a signal the trend is getting weak. This chart also shows an example of 3pt RD -- each lower low in price has a higher low in the MACD. RD can also have 4pt and 5pt divergence before the trend actually changes.

Hidden divergence compares the higher lows (HL) of price in an up trend with the lower lows (LL) in the indicator and the lower highs (LH) of price in a downtrend with the higher highs (HH) of the indicator. Hidden divergence helps to answer the question of whether the trend is going to continue. The following chart shows how HD can confirm which flags/retracements are the high percentage continuation trades to take. When you draw a trend line (TL) on the indicator you are using, you want the length to match the TL drawn on price on the chart. Note the price action entry for many traders corresponds with MACD crossing zero.

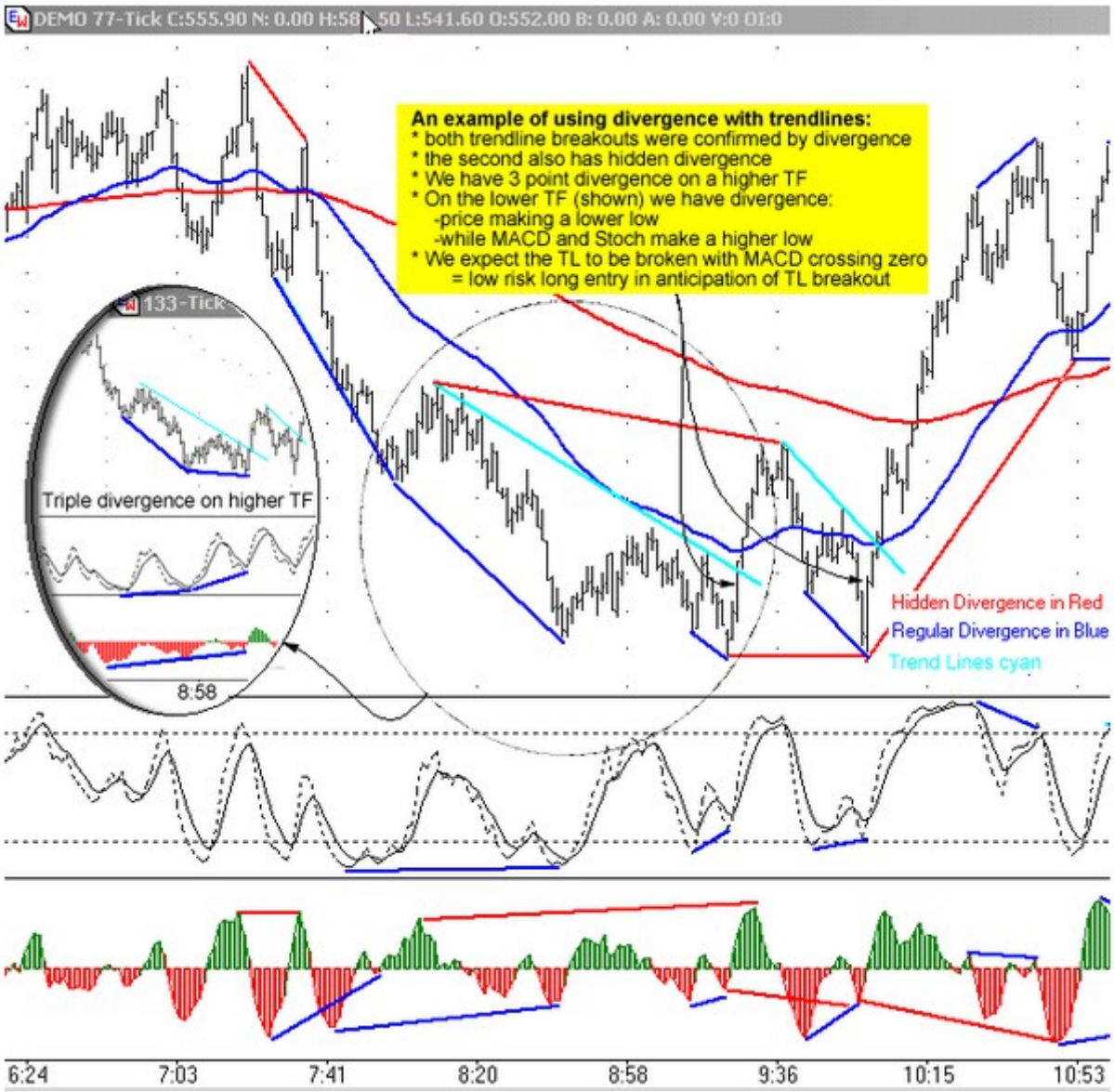


Another time to look for a divergence is after a period of consolidation or sideways movement in the market that also has a test of a previous high or low in the consolidation range. The following chart shows the benefit of drawing trend lines (TL) as soon as you have the two points to do so (the red arrows on left). Each touch of the TL by price is a place to check to see what HD is saying. The test of TL by price about 1:30, shows an example of how RD can be a warning that the HD signal, if taken, will not reach the target of the last swing low.

The following chart shows how to use divergences with trend lines and anticipated MACD cross of zero at the same time the TL is being broken. Divergence is implying that price will have the strength behind it to take out the trend line resistance. Notice the setup started in the higher time frame inserted chart. Dropping down to a lower time frame enabled us to have a better entry point with less risk.

The chart shows how divergence signaled two identical setups for low risk longs on a trend line (TL) break of the light blue TLs also coinciding with the MACD crossing zero. The second low risk long also has HD divergence with the previous low in its favor also. Note that the 3pt regular divergence shown in the higher time chart in the oval is usually worth paying attention to.

Also, on this chart many other regular and hidden divergences have been marked. The divergence trades combined with trend lines, Fibonacci levels, support, resistance and/or patterns are higher percentage trades.



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