

Hidden divergence trading

Chamane's Guidelines

Divergence patterns work in trading. I have read several comments claiming the opposite on discussion forums, but I prefer views of experts such as Barbara Starr (1996), Alexander Elder (2014) or George Lane (in Smith, 2010) on the subject. The best way to be convinced about it is to backtest using momentum indicators (RSI, Stochastic, MACD, CCI, etc.). The regular divergence is more known, but I prefer the hidden divergence. In the vast majority of cases, it is followed by a movement in the direction of the trend. That's why I was first interested in this technique.

The way I use hidden divergence puts emphasis on convergence of different signals. One indicator is not enough and it is important to ensure that all probabilities work in our favour. The analysis steps I use are numerous, and I don't use them all every time. The more I identify signs of convergence, the more I consider that a trade has a chance of success. Without further ado, here are the main guidelines of the way I trade.

1.0 Indicators

My favorite one is the MACD. I use both the histogram and the MACD line. The settings I use are **Fast MA=8, Slow MA=17, Signal MA=9**, as suggested by Gerard Appel for Daily timeframes (Walker, 2010).

I also use the Stochastic indicator (**%K=8, %D=5, Slowing=3**). Other configurations are valid and are at the trader's discretion.

The hidden divergence pattern is stronger when it is detected on more than one indicator at the same time, as in the example below:



2.0 The hidden divergence pattern.

It is easy to distinguish divergence patterns on a diagram showing past data, but doing it in real time is more complicated. In the following example, a hidden divergence is identified by the yellow lines. A Doji candle and an Engulfing candle (yellow circle) can be considered as short signals in a hidden divergence pattern, but we see that in this case it is a losing situation because the price continues to rise. However, the hidden divergence pattern is still valid (pink lines) and only the trade entry signals that will minimize losses and maximize profits are missing. We will see them later on.



2.1 Pattern detection

The hidden divergence pattern is under development when the indicator starts behaving differently from the price. In the following figure, the red vertical line indicates the moment when price starts to deviate from the indicator. That moment is only an alarm signal and the trader must decide whether he has enough converging signals to take a position. At the vertical line, no signal has yet appeared.



2.2 Convergence signals

I will describe the main convergence signals I use before entering a trade.

2.2.1 Trend

Hidden divergence is known to be a pattern of continuity (trendwise), but it can also appear at the beginning of a trend reversal, as shown in the following example. While the trend has been downward for some time, a pattern of hidden divergence indicates a possible upward reversal, supported by a higher low (after a series of lower lows).



One should not look for a pattern in the direction of the trend at all costs, but doing so is a converging signal that increases the probability of success. There are several ways to evaluate the trend, the one I use is the crossing of Donchian's 26 and 130 middle lines. They usually indicate the trend direction of the upper time window.



In the above example, the crossing of the Donchian midlines indicates a downward trend. A first hidden divergence indicates price continuity in the direction of the trend, while the second hidden divergence indicates the beginning of an upward trend. The first hidden divergence is more reliable, which does not mean not trading the second, as other signs of convergence will be used.

2.2.2 Fibonacci retracement

An entry signal is stronger at a major Fibonacci level (0.618, 0.500, 0.382). Then there is a better chance that the development of the hidden divergence has reached maturity.



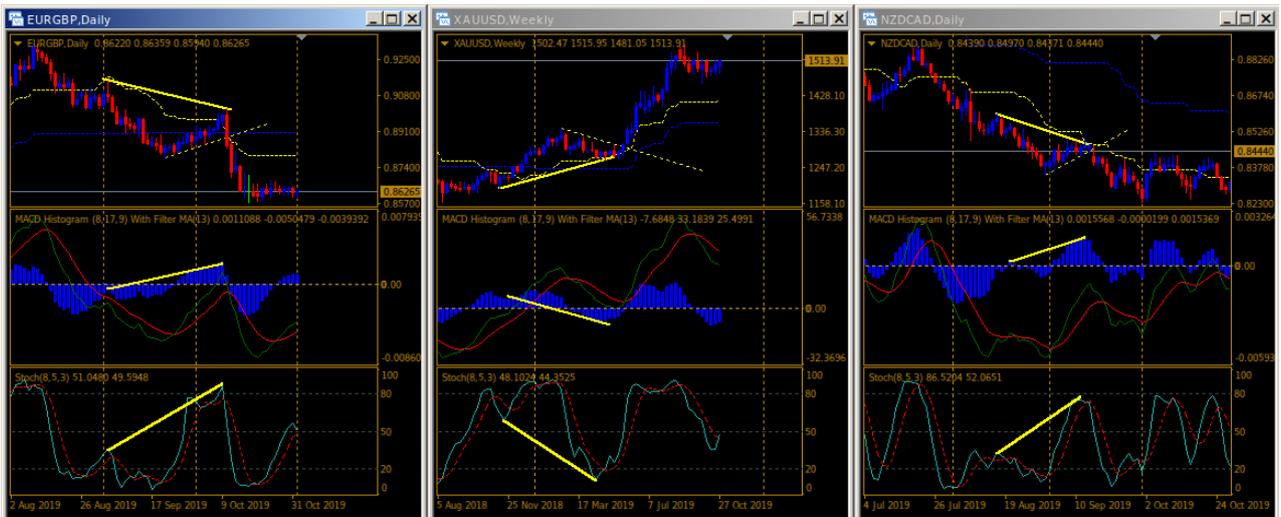
In the above example, price breaks a (dashed) trend line after reaching the 0.618 Fibonacci level during the development of a hidden divergence pattern.

2.2.3 Price action

"Doji" or "Engulfing" candles increase the probability that price will follow a given direction. In the previous example, after price reached the Fibonacci 0.618 number, an "Engulfing" candle started a strong downward movement. Other candlestick patterns can be used as well.

2.2.4 Trend lines

It is best to wait until price breaks a trend line following the identification of a hidden divergence. The following figure illustrates 3 different cases.



2.2.5 Divergence detection on more than one indicator

As mentioned above, the choice of the momentum indicators is at the discretion of the trader, but when hidden divergences are detected by two indicators at the same time, they are usually more reliable (see the previous image).

2.2.6 MACD in the lower timeframe

This is the entry signal I prefer. When I detect a start of hidden divergence pattern in the main window, I look at the lower timeframe for an entry signal when the MACD line crosses the 0 level. The following figure shows that a hidden divergence is developing in the weekly chart. In the daily timeframe, the price has just broken a dotted trend line downward and the MACD has crossed the level 0, which is the point of entry for sell. The break of the trend line alone may be enough, but I prefer to enter following the signal of the MACD.



Main window (hidden divergence)	Lower timeframe (MACD crossing the 0 level)
• Monthly	• Weekly
• Weekly	• Daily
• Daily	• 4 Hours
• 4 hours	• 1 Hour
• 1 hour	• 15 minutes
• 15 minutes	• 5 minutes
• 5 minutes	• 1 minute

2.2.7 Regular Divergence in the Lower Timeframe

A regular divergence in the lower timeframe following a hidden divergence in the main timeframe increases the chances of success. In the following figure, there is a hidden divergence (yellow lines at the red vertical line) in the weekly chart and, in the daily chart, a regular divergence followed by a trend line break and an entry signal when MACD crosses the 0 level. Note that the Donchian median lines indicate a downward trend in the Weekly chart.



2.3 Money Management

Money management is one of the most important aspects of any trading system. I will not go into details, there are several resources on the web about it¹. I will summarize the few options I consider when I am about to enter a trade. In any case, I risk only 2% of my capital².

2.3.1 Stop loss

I place my stop loss level at the last swing reversal: the lowest point in a buying position and the highest point in a sell position. The distance between this point and the entry position is the **risk** (see figure below).



2.3.2 Number of units (lots)

Taking into account the value of the smallest available unit, the number must give a risk that does not exceed 2% of your capital. If the smallest unit (e.g. 0.01 lot, 0.1 lot or 1 lot) is worth 1% of your capital, it is then possible to trade 2 units.

2.3.3 Trade follow-ups

When the price reaches 50% of the risk value in gain, I move my stop loss to the entry point + 2 to 3 pips. I prefer to secure the trade as soon as possible, even if the trade closes with only a small gain, than to suffer a bigger loss at the original risk level.

¹ For example: <https://admiralmarkets.com/education/articles/forex-strategy/top-10-forex-money-management-tips>.

² I rarely go up to 5%.

2.3.4 Profit

When taking my position, I put my Take profit at the distance that equals my risk (see image below - Take profit (1)). I am aiming for a $RR^3 = 1: 1$.

If I have two units in play summing up a risk of 2% or less, I close one unit in Take profit (1) and move the stop loss of my second unit to the entry point + 2 to 3 pips. I let the price run for this second unit and can aim for a gain of 2 or 3 times higher (Take profit (2) or Take profit (3)).



2.3.5 Cost averaging method

This method is suggested by Gerald E. Greene in his book *Turning losing Forex trades into winners*. It consists in taking all the entry signals of an indicator on a timeframe 8 to 12 times smaller than the main window where a signal is observed. For example, if the MACD line crosses the 0 level upwards in a daily window, I consider that price is entering a **Trading Zone**⁴ until MACD reaches again the 0 level. In the Trading Zone, we then check in a 2 hour chart (12 times lower in that case) all MACD signals crossing the 0 level upwards. Each trade is handled in the same way as previously described (maximum risk of 2%, $RR = 1: 1$, etc.). According to Greene, there is a high probability that the summing up of gains and losses in the Trading Zone will give a positive result. To better illustrate this method, I will describe a complete trading process in the next chapter.

³ Risk to Reward ratio.

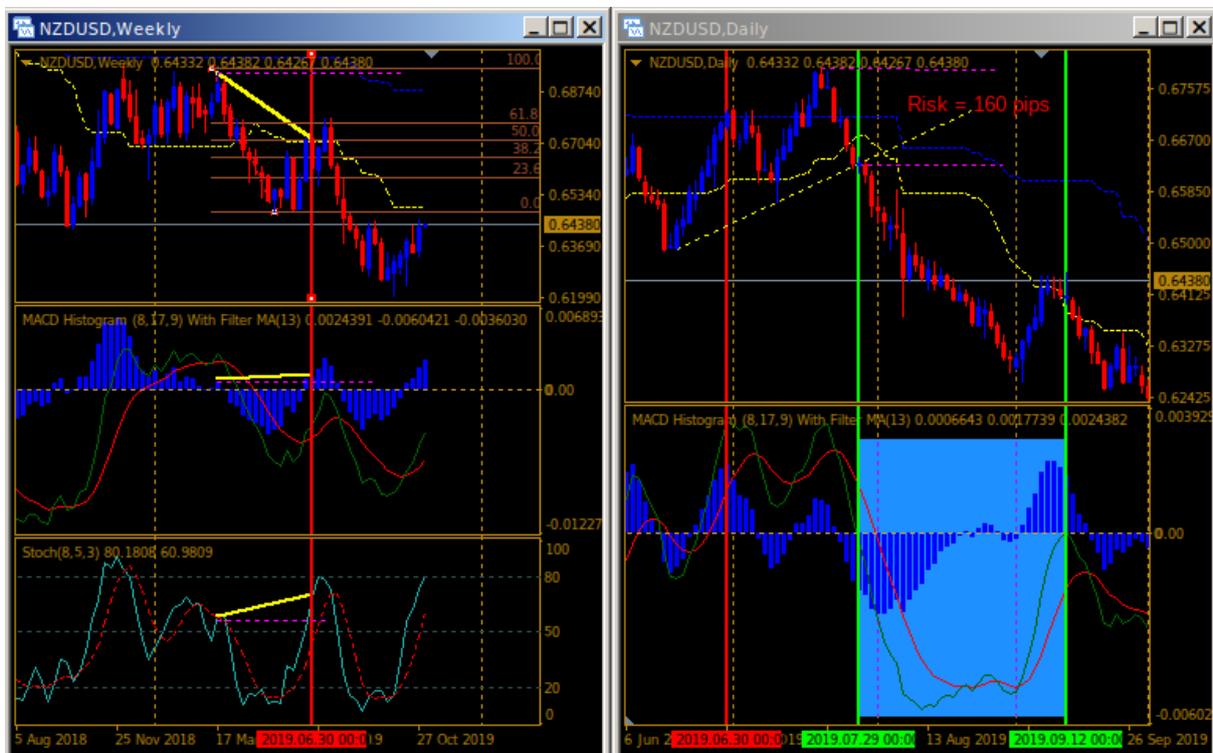
⁴ Greene doesn't use that expression, I created it.

3.0 Summary

Here is a complete example of a trade situation when a hidden divergence pattern is identified (see image below) :

1. **Identification of a hidden divergence.** In the weekly chart, the two indicators are diverging from the price (red vertical line and pink dashed horizontal lines). At that point, the Fibonacci tool indicates the 0.500 level. From the moment the hidden divergence develops, we can watch for an entry signal in the Daily chart (lower timeframe).

2. In the Daily chart, price broke a trend line down and MACD crossed its 0 level down too. Note that at the red vertical line, the MACD did not immediately cross its 0 level. It returned up to the 0.618 Fibonacci level in the Weekly chart. The **crossing of the 0 level by MACD** signaled the start of a **Trading Zone** (blue rectangle) to the down side. It is possible to enter a sell trade at the crossing of the MACD, insofar as the risk is less than 2% of the capital. For a risk of 160 pips, it is likely to be greater than 2%. It is therefore better to adopt a cost averaging approach at an even lower timeframe.



3. **Cost averaging approach.** From the Daily chart at the start of the Trading Zone, we switch to the 2-hour chart. In the Trading Zone, all signals of MACD crossing the 0 line to the down side are entry points. In our case, 6 entries out of 8 (yellow circles) are winners with a RR = 1:1, the last two being small losers.



Good trading!

Chamane

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