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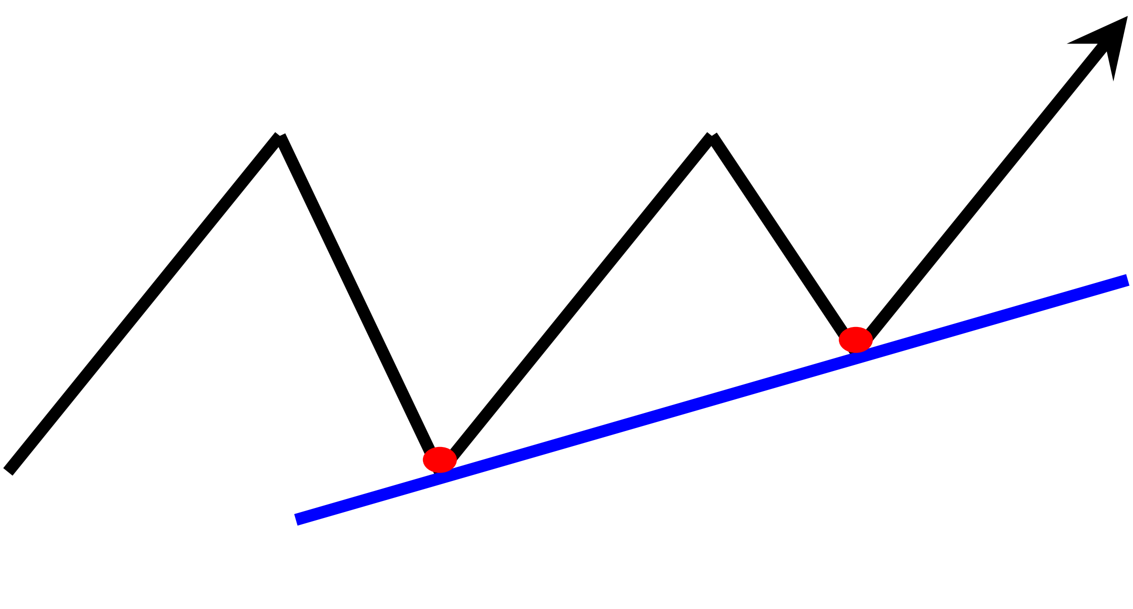
Divergence & Hidden Divergence

Explained

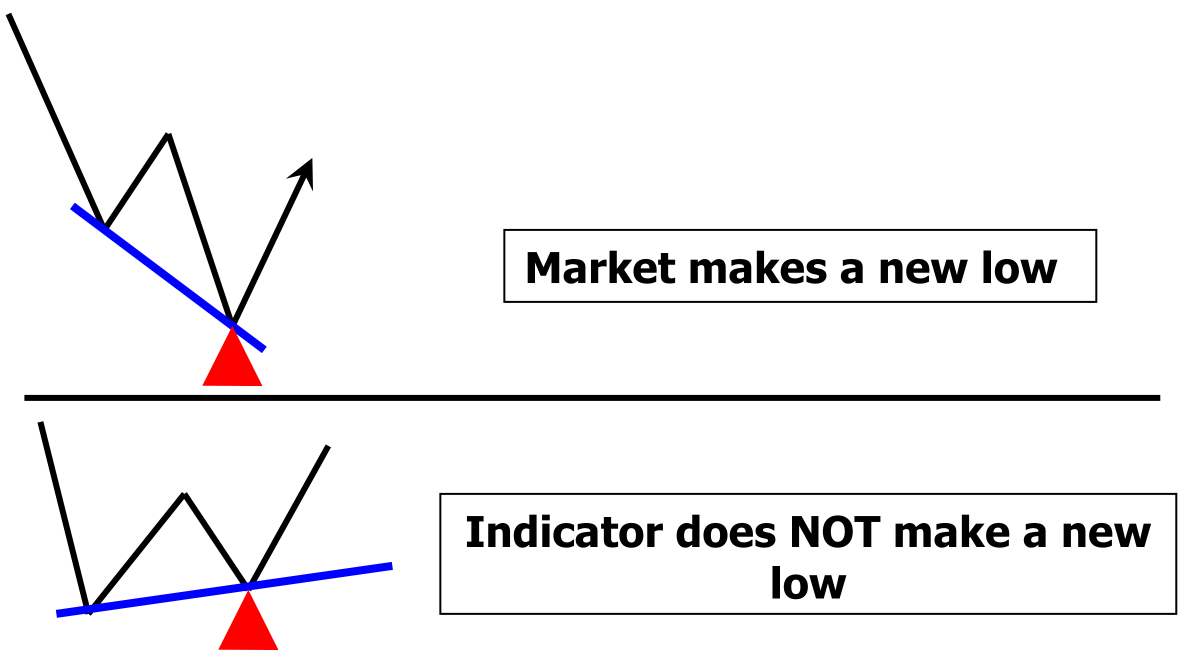


Divergence & Hidden Divergence Explained
Classic Divergence is defined as:

Bullish Classic Divergence occurs when price of the currently traded market makes a low, then pullsback, and makes a new LOWER LOW!

At the same time, the indicator of choice, in following examples we will be using the Stochastic Oscillator, the indicator does NOT make a new lower low but makes a HIGHER LOW indicating the potential for higher prices to come.

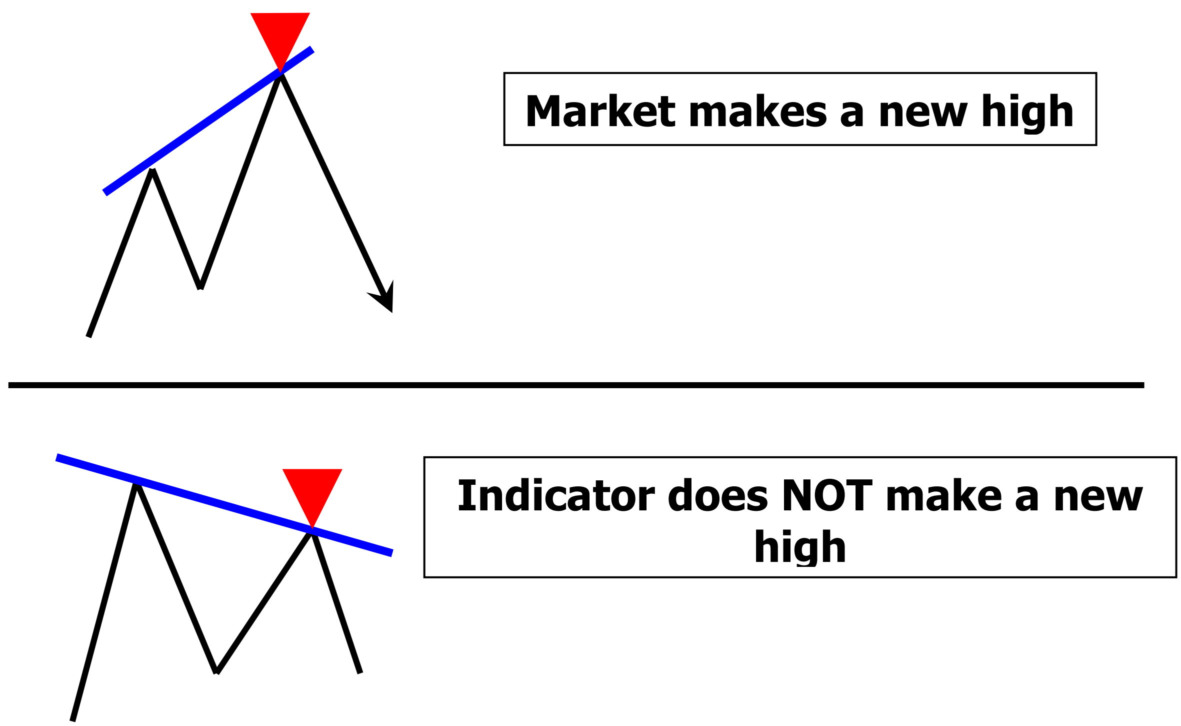
See the Illustration below for **Classic Bullish Divergence**



Bearish Classic Divergence occurs when price of the currently traded market makes a high, then pullsback, and makes a new HIGHER HIGH!

At the same time, the indicator of choice, in following examples we will be using the Stochastic Oscillator, the indicator does NOT make a new HIGHER HIGH but makes a LOWER HIGH.

See the Illustration below for **Classic Bearish Divergence**



Tyipcially these patterns precede a reversal. We do not trade them on their own merits though it can be done and is done by many traders. We look to use this pattern an early warning for a potential trade in the opposite direction of the current market IF all other conditions are met.

See the chart examples on the next page!

<u>Classic Bullish Divergence</u>: Market makes a low, then makes a new "lower low" while at the same time, the Indicator makes a low, then fails to make a new low and puts in a "higher low". Shortly after the market rallies to the 1241.00 area resistance.

<u>Classic Bearish Divergence</u>: Market makes a high, then makes a new "higher high" while at the same time, the Indicator makes a high, then fails to make a new high and puts in a "lower high". Shortly after the market breaks to the 1255.00 support below then lower.

Classic Divergences usually occur at major tops and bottoms after a move of considerable length. They may also happen intra day inside the days range at key areas such as 50% levels or previous swing highs or lows.

There is another kind of Divergence, called "Hidden Divergence". It's called Hidden Divergence because it is not your typical divergence type setup and few traders "see it" when it occurs mistaking it for either strength in a downtrend or weakness in an established uptrend. This is the exact opposite of what Hidden Divergence, or HD is signalling.

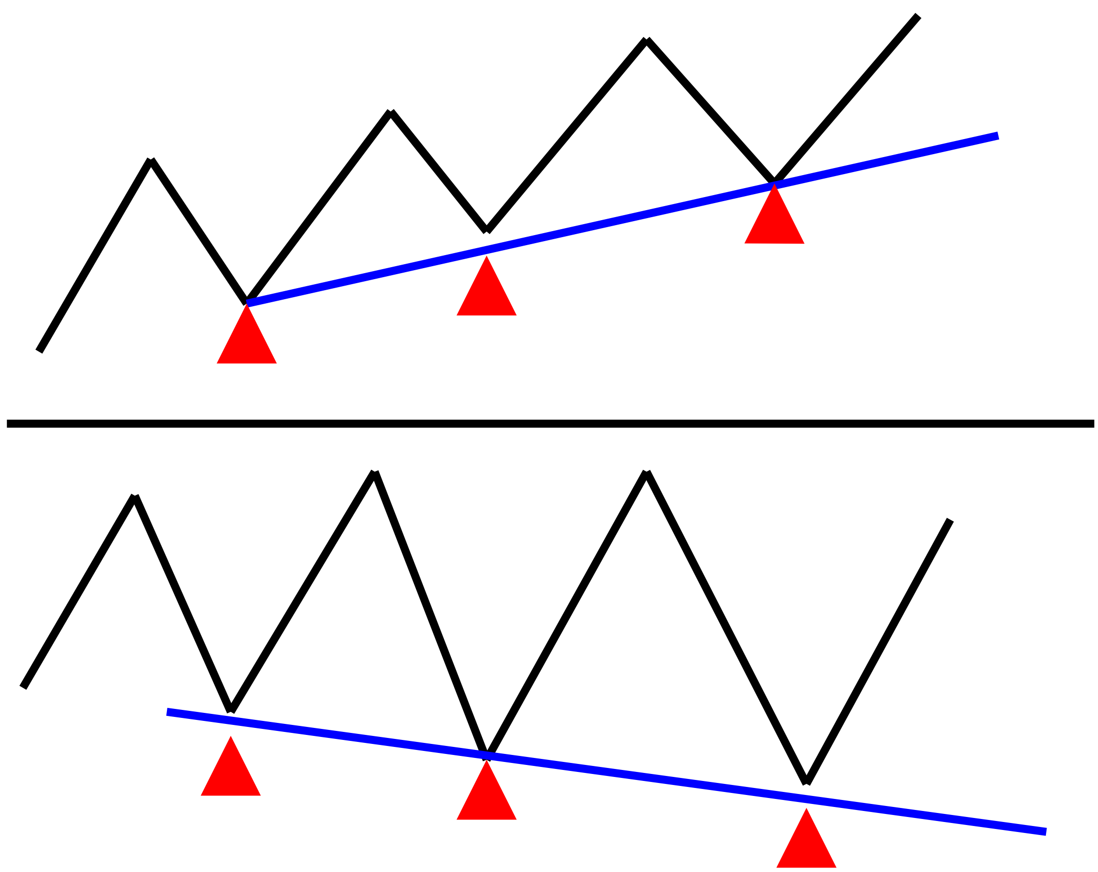
We still use the same indicator, the Stochastic Oscillator to identify this pattern. Unlike the Classic Divergence patter, the Hidden Divergence is NOT a reversal but a "continutation" pattern in the current direction and alerts us to potential buyers pushing the market higher in an uptrend or sellers pushing the market lower in a downtrend.

This adds a note of confidence or confirmation of the trend possibly continuing in the current direction and our standard pullback trades can be used to take additional entries in the same direction or new entries if currently on the sidelines.

Let's take a look at the examples below.

Bullish Hidden Divergence or HD!

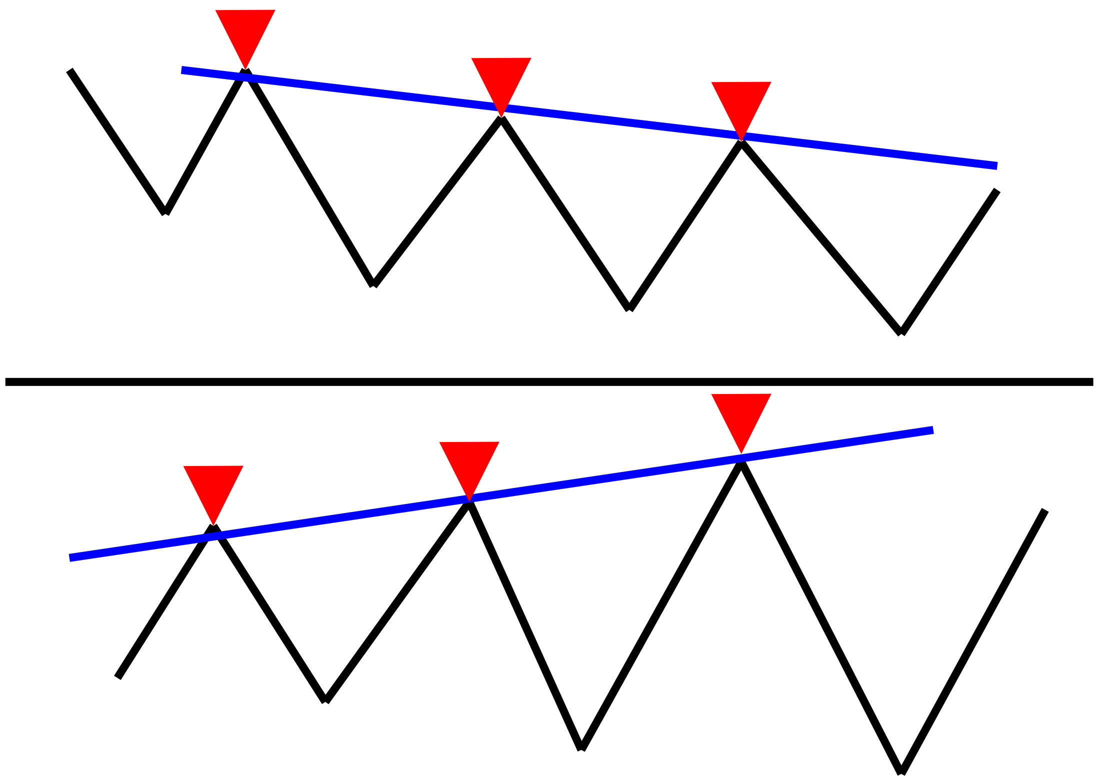
Market in a typical uptrend making a series of higher highs and higher lows



Indicator makes lower lows while the market makes higher lows during the rally

Bearish Hidden Divergence or HD!

Market in a typical downtrend making a series of lower highs and lower lows



Indicator makes higher highs during while the market makes lower highs during the decline

See examples of Bullish and Bearish Hidden Divergence below

Note in the example above during the uptrend the market put in a series of higher highs and higher lows while the indicator put in LOWER LOWS during the pullbacks until Classic Bearish Divergence showed up at the top signalling a potential reversal to the downside which in fact did take place.

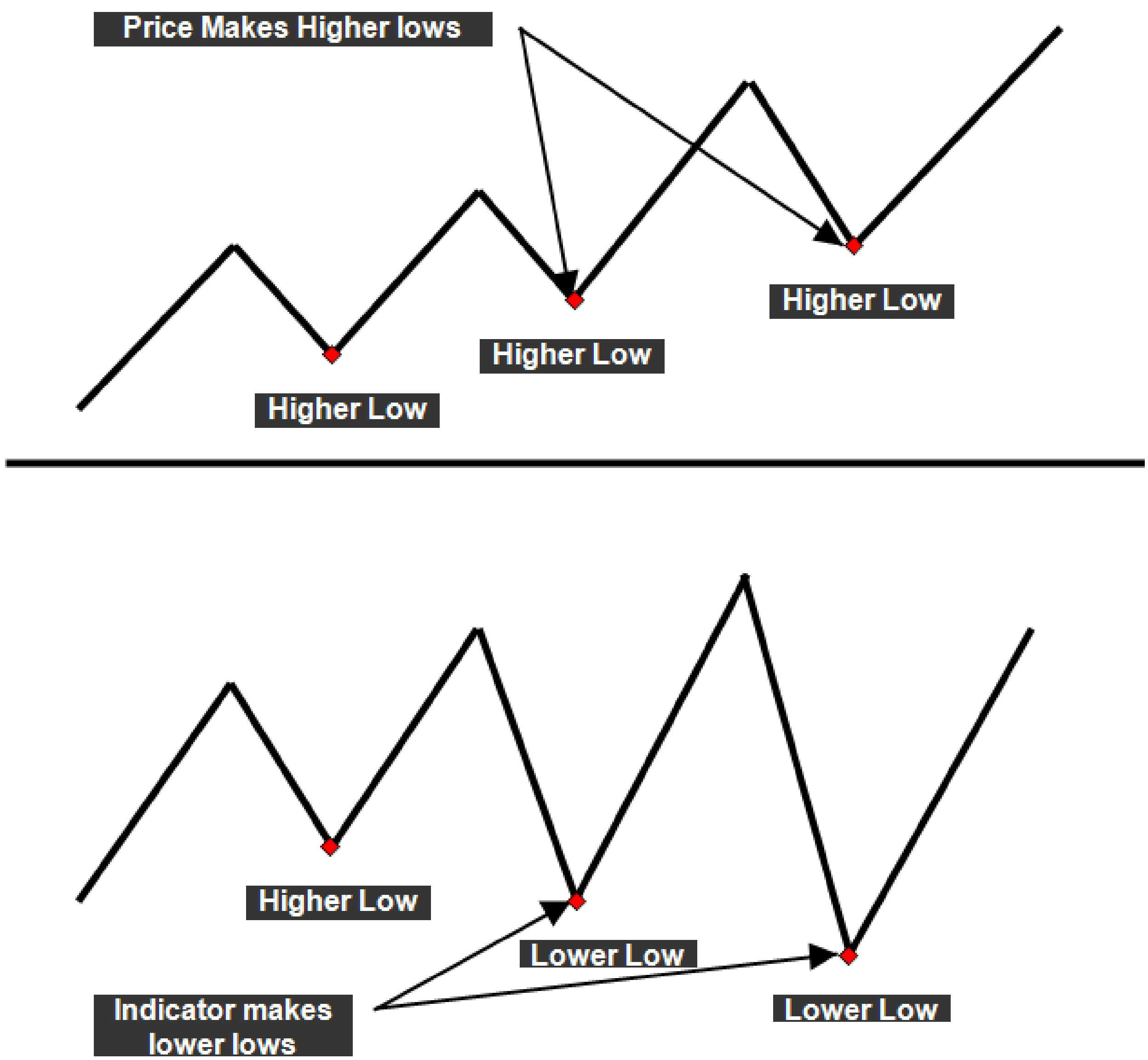
Note in the example above during the downtrend the market was putting in a series of lower highs and lower lows while at the same time the indicators was putting in HIGHER HIGHS during the decline on the pullbacks signalling potential continuation until at the bottom Classic Bullish Divergence occurred signalling a potential reversal to the upside which in fact did take place.

It is important to note that when comparing price to the stochastic that we are comparing swing highs and swing lows of the price, the S&P, with the swing highs and the swing low of the indicator, the stochastic.

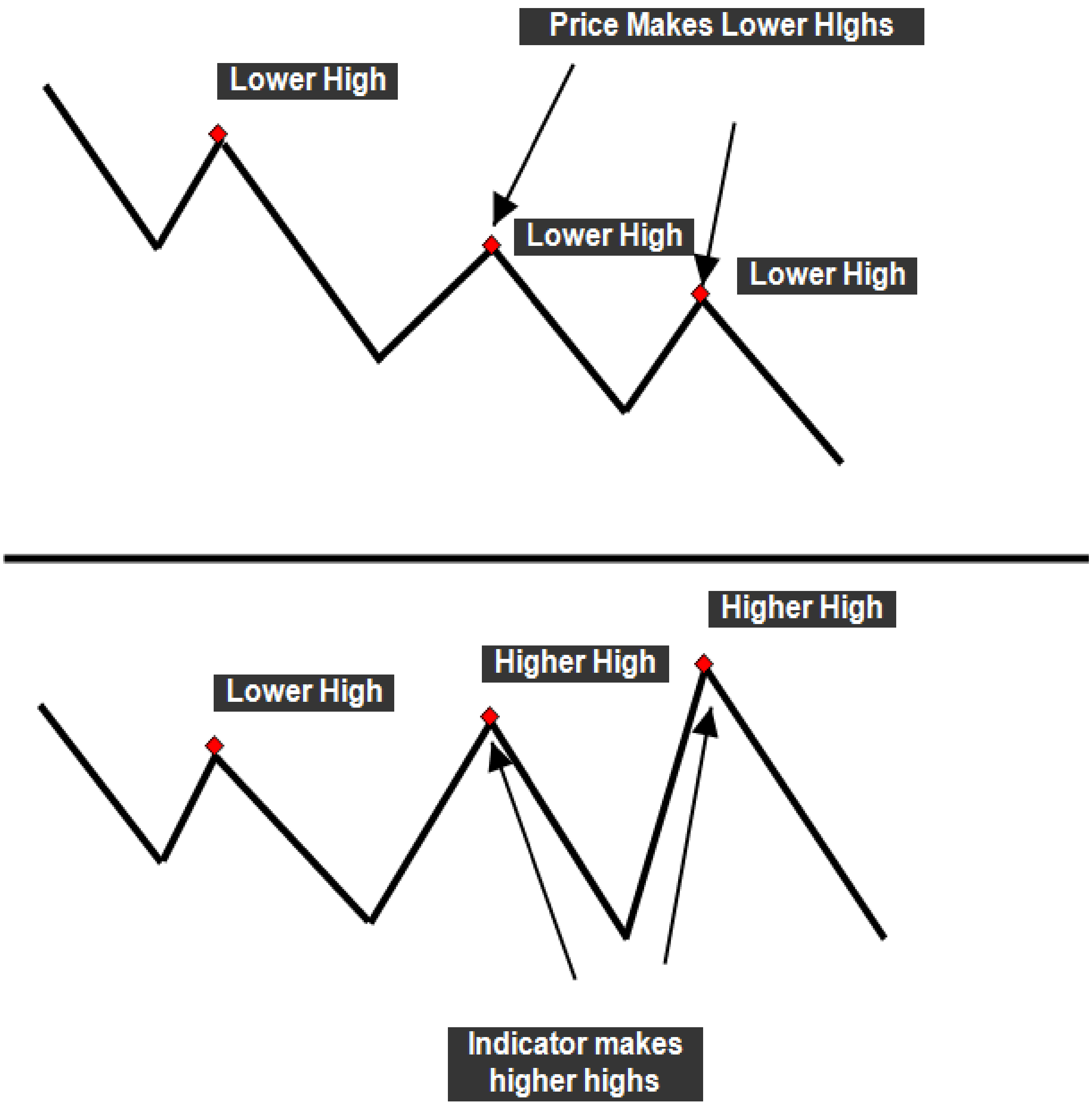
We want to step back and look from a distance rather than up close scrutinizing each candle. Divergence or Hidden Divergence should be blatantly obvious on the chart. Subtle divergences are OK at times but we don’t want to make a habit of zeroing in too close and missing the forest from the trees.

To reinforce the concept even further once again take a look at the 2 diagrams on the following pages.

Bullish Hidden Divergence:



Bearish Hidden Divergence:



Classic Divergence and Hidden Divergence are tools for us to gauge market strength and lend a different perspective of the current market structure.

Like all things you can get carried away by putting too much focus on one thing to the exclusion of others. In trading it's never just "one thing" but a combination of things at any given time based on current market conditions.

We can use Classic divergence as a warning signal for potential reversals telling us we may want to stand aside from continuing to buy in the current uptrend or selling in the current downtrend giving us a higher level of confidence of a potential reversal. At the same time, we can use Hidden Divergence to give us the confidence to take a secondary trade long in an uptrend or in a downtrend as the Hidden Divergence alerts us to potential continuation.

The most important thing to remember when trading and applying specific price patterns or indicator patterns is context. That means where the current market is trading, where it came from, and how it got there all play a part in how we apply our strategies to the in order to determine high probablity trades.

Study the charts on your own so you can become familiar with the patterns and how you might integrate them into your strategies and further your ability to read the chart with a high degree of accuracy!

Good Trading!

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