

Bullish and Bearish Divergences and Momentum Indicators

Tips to ensure you don't trade too early on divergences

One of the common uses of momentum indicators is the identification of trend completion when price and momentum begin to diverge. It is very common at times where price is making new highs for momentum to fail to make new high and in fact makes lower highs. (In a downtrend this will mean that price is making new lows while momentum is making higher lows.) This is a sign that the trend is decelerating. Look at the following chart:



Very clearly USDJPY saw a sustained rally towards the 121.38 high, both key highs and lows both moving higher.

Look at the RSI which has been plotted below. After pushing higher during the uptrend, towards the end RSI made a lower high on the final peak in price. This is a bearish divergence and following this price made a sharp reversal lower. This was a great signal which could have generated significant profit potential.

Great, we'll be on the look out for these from now on... and it looks as if we have subsequently seen another bearish divergence:



Here's another great example. Price has rallied and made new highs but RSI has failed and seen a lower high on the second price peak. We saw a trend line in the initial rally break and come very close to be retested at the second peak.

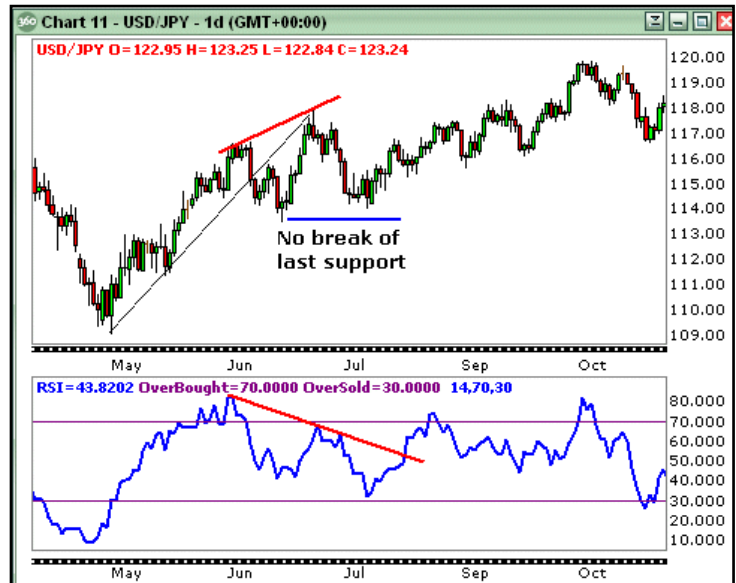
Surely this means we can sell...

Well actually, we haven't thought about what we're doing... Let's take a look at what subsequently happened:

Well it looked good for a while and if you had run a good trailing stop there would have been room for some profit. However, as far as a trend reversal is concerned, it failed completely.

One of the issues with divergences is that it is often better to wait for confirmation from price that it has reversed. If we consider the basic definition of an uptrend it is that highs are moving higher and lows are also moving higher.

In the example we would have had to have waited for the break below the previous swing low – which was a long way lower and this never occurred. Thus price retained the sequence of higher highs and higher lows. On the break of the line across the RSI peaks it would have confirmed a reversal higher and resumption of the trend.



The lesson to be learned here is that while divergences can provide excellent reversal signals, they do require confirmation. This can come from different analysis, possibly the break of a trend line (as in the first example) or possibly a reversal pattern such as a double top or head and shoulder break. In addition, if the divergence is in the daily chart then look at the intraday signals. You may be able to find a reversal pattern in the 4-hour chart, or perhaps an intermediate trend line break and retest.

However, what this does highlight is that whatever analysis you utilize it is vital that you do not trade on one signal alone and ensure the signal is confirmed by other analysis.

Good luck
Ian Copsy
www.fx-forecaster.com

© Ian Copsy 2009