

Using Divergences to Identify Market Reversals

Using divergences correctly can help spot key market turns

Many traders and analyst use price-momentum divergence to identify trend reversals. For those of you who are not familiar with this term divergences may be defined as follows:

Bullish divergence: When price lows are lower in a trend but momentum lows are higher

Bearish divergence: When price highs are higher in a trend but momentum highs are lower

Basically what this is effectively saying is that momentum, that is the pace of the trend, slows then the underlying momentum indicator will not confirm the new price extremes by making new momentum extremes.

For example, it is easy to see from this chart that there has been a strong uptrend.

Below the price chart is my form of the Relative Strength Index (RSI).

Note how the RSI is showing a bearish divergence. As you can see price highs are still rising but the RSI peaks have begun to fall. This is a feature that often accompanies a stronger reversal in the trend.

Is this a confirmed reversal signal?



Let's see what happened next:



In fact the uptrend continued in spite of the divergence.

While this special version of RSI provides better divergence signals it is vital that price also confirms a reversal. This can be done using several methods.

Firstly, by considering the definition of an uptrend: Price is making higher highs and higher lows.

To confirm price reversal then we should wait for it to decline below the last significant low. In the first chart price had declined very little and therefore the risk of price continuing its uptrend remains.

Secondly, by looking for break of a trend support:

In this case no break of the support line was seen until after the 2.1160 peak. This was also accompanied by a bearish divergence and therefore confirmed the reversal of the trend.

Note that after breach of the trend support how price later moves back to retest the line. This often provides excellent trade opportunities.

It is a common error that traders anticipate a trend reversal merely because there is sign of a divergence. However, this is not a 100% safe strategy. Unless there are other indications to confirm it is safer to wait for confirmation of the reversal.

Good luck

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