# Trading the Hidden Divergence

Presented by Sunil Mangwani
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# Indicators in technical analysis.

Indicators along with chart patterns, trend lines, resistance / support levels etc., are an essential part of technical analysis.

But there is a common misconception, that the use of indicators can predict the future price action.

Logically, if one looks at the calculations of the technical indicators, they are based on the price movement, so they would obviously mirror the price movement.

When price rallies, the underlying momentum in the price causes the indicator to rally as well, and the same applies when price starts falling.

So why would one expect the indicator to predict the subsequent price moves, when it would mirror the price?

Hence, very few indicators have characteristics which can be defined as leading.

# Divergence

One such characteristic is the “Divergence” set-up which is often considered to be an effective and leading indicator of price movement.

Divergences occur when there is a discrepancy between the price and a technical indicator.

We can define it as the failure of the indicator to confirm the higher high or lower low of the price. This discrepancy or divergence is usually observed on the oscillator type of indicators, such as the RSI, MACD, CCI, Slow Stochastic etc.

(In fact, these oscillators give their most valid signals when their readings diverge from the price.)

Hence an early indication of the change in momentum is given by the divergence set-up, and a change in momentum is often the primary indication for a shift in trend.

# Regular Divergence

The most common type is the Classic or Regular Divergence which is a reversal pattern.

It can be defined as –

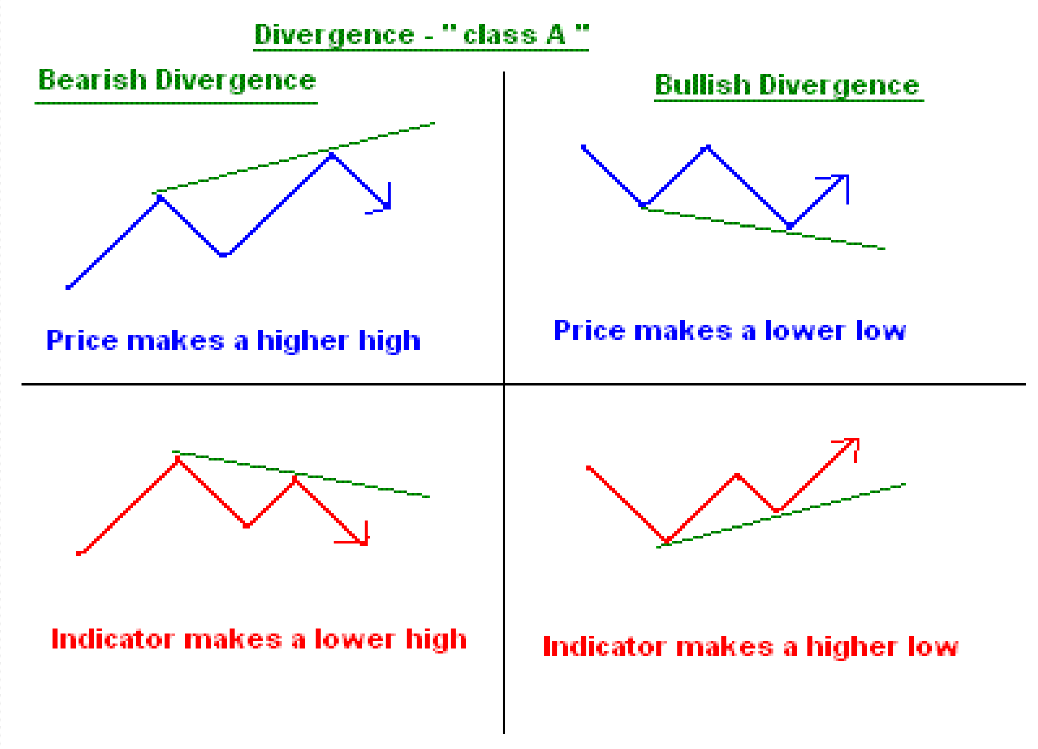
Higher highs in price and lower highs in the oscillator which indicates a trend reversal from up to down. This is known as the Bearish Divergence.

Lower lows in price and higher lows in the oscillator which indicates a trend reversal from down to up. This is known as the Bullish Divergence.

The Regular Divergence indicates that the underlying momentum in the price may be decreasing and that a bottom or top could be near.

# Regular Divergence

Chart image of regular divergence



# Regular Divergence

Chart of regular divergence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# Hidden Divergence

While the Regular Divergence is more commonly used, there is another type of divergence which is not used as regularly, but is far more effective.

It is called a Hidden Divergence, which is also a discrepancy between the price and an indicator, except that this is a continuation pattern.

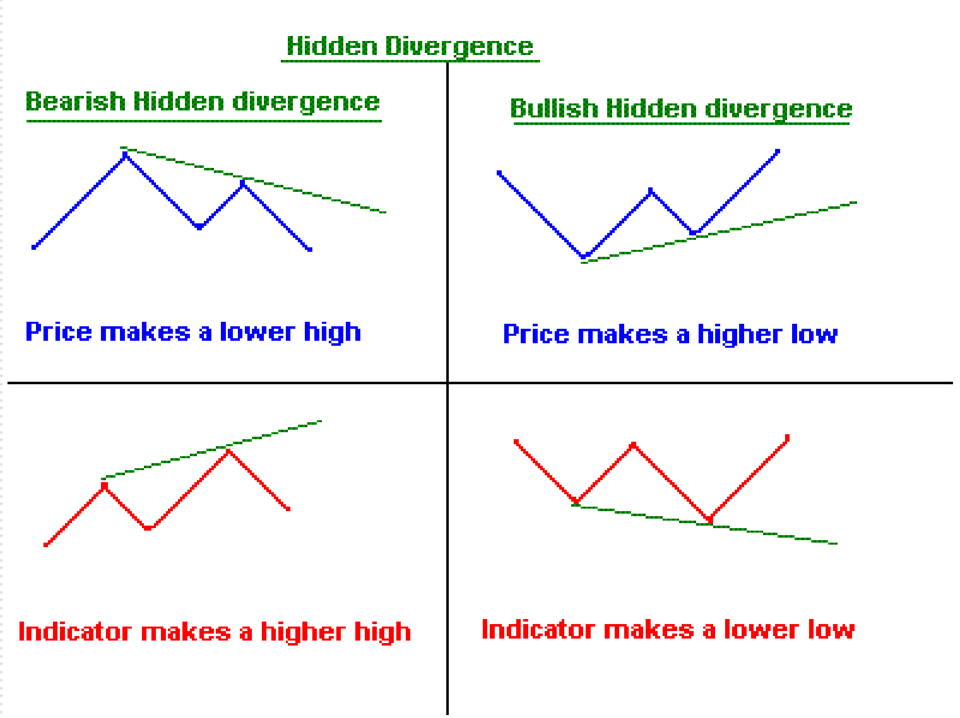
It can be defined as –

Bearish Hidden Divergence - Lower highs in price and higher highs in the oscillator which indicate a confirmation of the price trend which is down.

Bullish Hidden Divergence - Higher lows in price and lower lows in the oscillator which indicates a confirmation of the price trend which is up.

# Hidden Divergence

Chart image of hidden divergence





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# Hidden Divergence

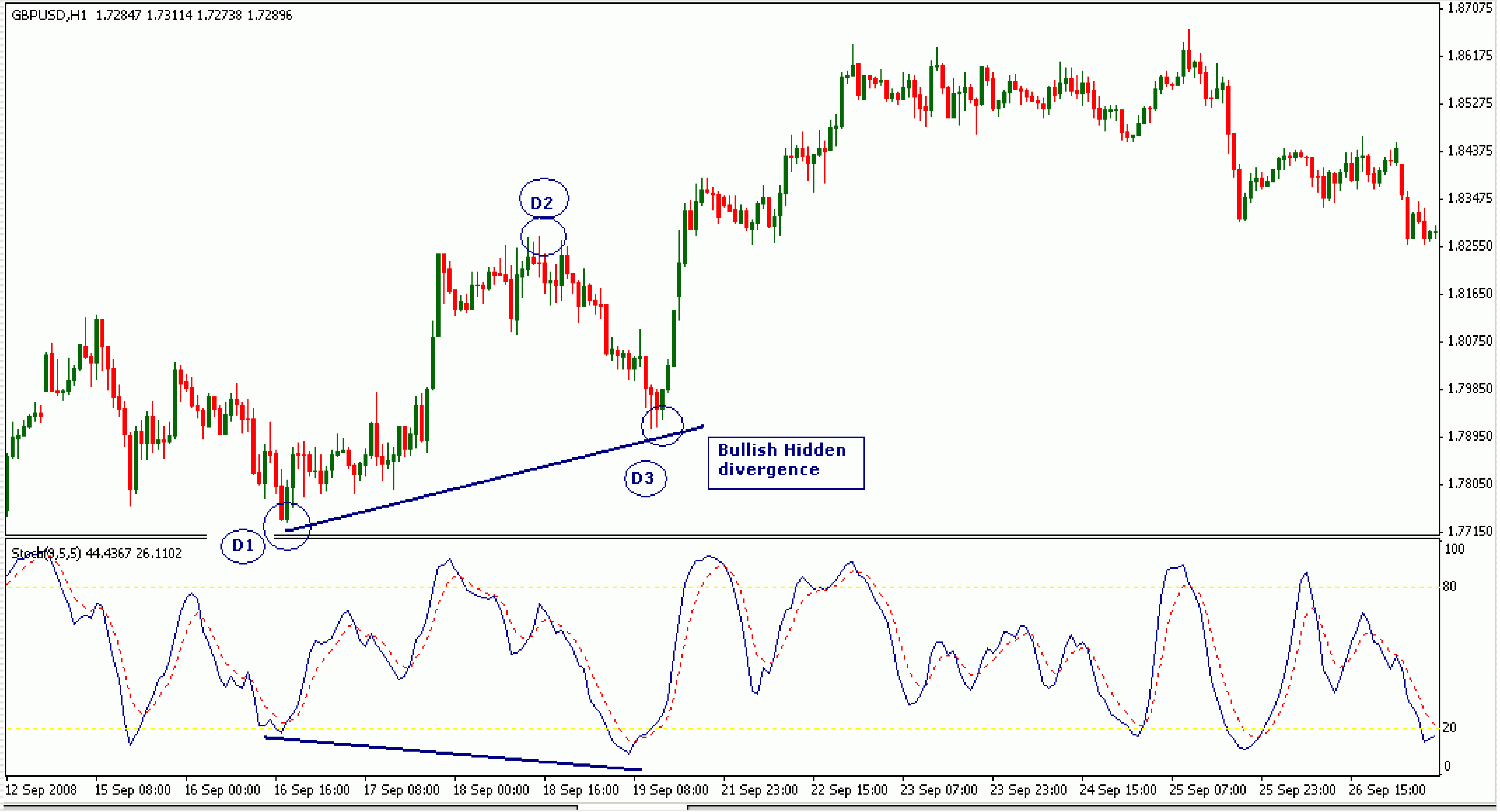
Hidden Divergences are the opposite of Regular Divergences, but offer a greater trade potential, since they pinpoint entries which are in the direction of the trend.

Since this is a pattern which gets a trader into a prevailing trend, it has a higher probability of success.

The advantage of this set-up is that it gives the trader the precise entry, stop and exit levels within a continuing trend, which is a far better proposition than “catching a falling knife”.

And the trader is following the Golden Rule – “The trend is your friend.”

# Hidden Divergence

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# Hidden Divergence

Hidden divergences are often found in a trend, and one can call it the "Rubber band" or the "Catapult" effect of the indicator.

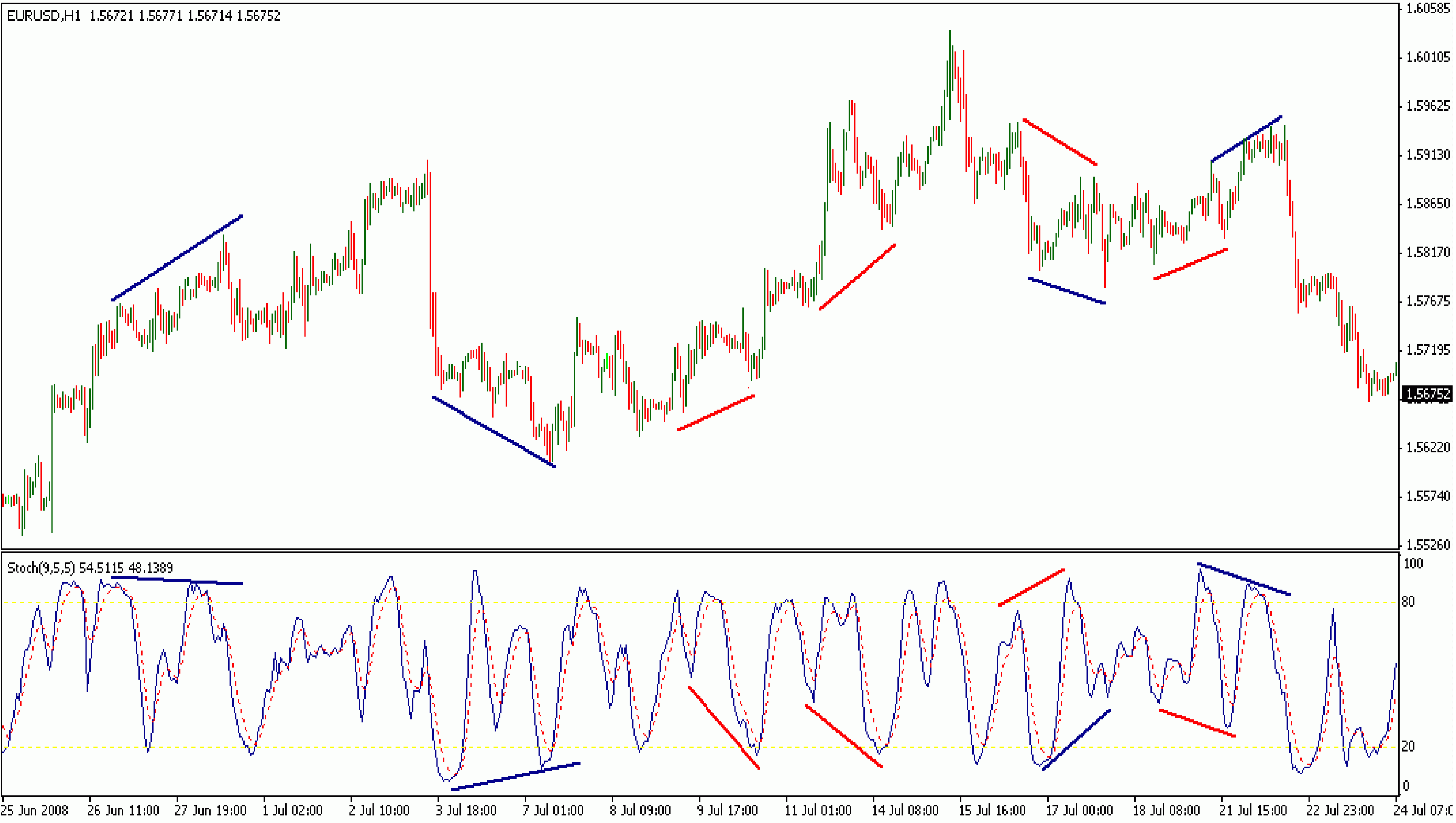
In an existing trend, price makes a pull-back, but the indicator makes a larger pull-back, thus stretching beyond the mean. We would expect the indicator to revert back to its mean, which it does with strong momentum.

In the process, price snaps back to its original trend, which give way to strong moves.

Getting a proper entry into such moves can give excellent profit targets.

We can say that we have the wind in our sails, for such trades.

# The effectiveness of divergences

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# Trading the hidden divergence

Identifying a valid divergence pattern is one thing, but trading the set-ups is another.

The trader has to have a proper entry, manage the trade and identify a correct exit point.

The only way to survive in the business of trading is to have an iron clad trade plan, with precisely defined entries, exits and stops.

Further one must have pre-defined money management rules, the patience to wait for the set-up, and the discipline to follow it to the “T”.

Let us use some other tools to effectively trade this set-up

# Fibonacci ratios

Fibonacci ratios are a very popular tool among technical traders and are based on a particular series of numbers identified by mathematician Leonardo Fibonacci in the thirteenth century.

The Fibonacci sequence of numbers is as follows:

0, 1, 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144, etc.

Each term in this sequence is simply the sum of the two preceding terms and sequence continues infinitely.

The remarkable characteristic of this numerical sequence is that each number is approximately 1.618 times greater than the preceding number.

This common relationship between every number in the series is the foundation of the common ratios used in the Fibonacci studies.

# Applying the Fibonacci ratios

For some reason, these ratios seem to play an important role in the financial markets, just as they do in nature, and can be used to determine critical points that cause price to reverse.

Price has an uncanny way of respecting Fibonacci ratio's, often quite precisely. Hence one can use the Fib ratios to ascertain the correct technical levels.

<u>Price action is never random, and every wave leaves behind the clues for the next move. We can thus, use the previous price action to determine the anticipated price movement.</u>

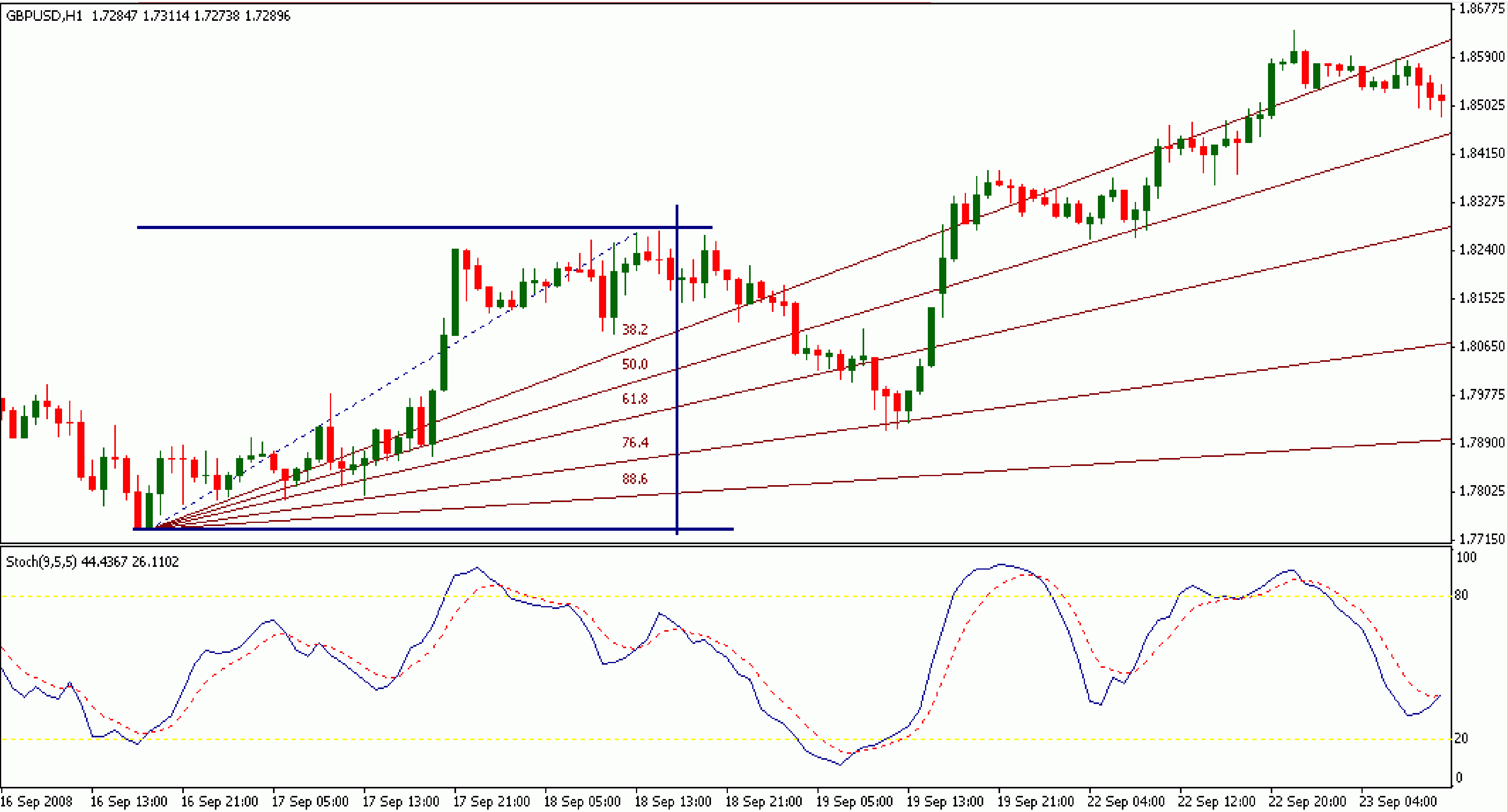
# Fibonacci Fans

The Fibonacci fans are a charting technique consisting of diagonal lines that use Fibonacci ratios to help identify key levels of support and resistance.

Fibonacci fans are created by first drawing a trend line through two points (usually the high and low), and then by dividing the vertical distance between the two points by the key Fibonacci ratios.

The result of these divisions each represents a point within the vertical distance. The 'fan' lines are then created by drawing a line from the leftmost point to each of the numbers representing a Fibonacci ratio.

# Fibonacci Fans

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# Applying Fibonacci Fans

The fan ratios that we use have 5 Fibonacci levels – 38.2%; 50.0%; 61.8%; 76.4% and 88.6%.

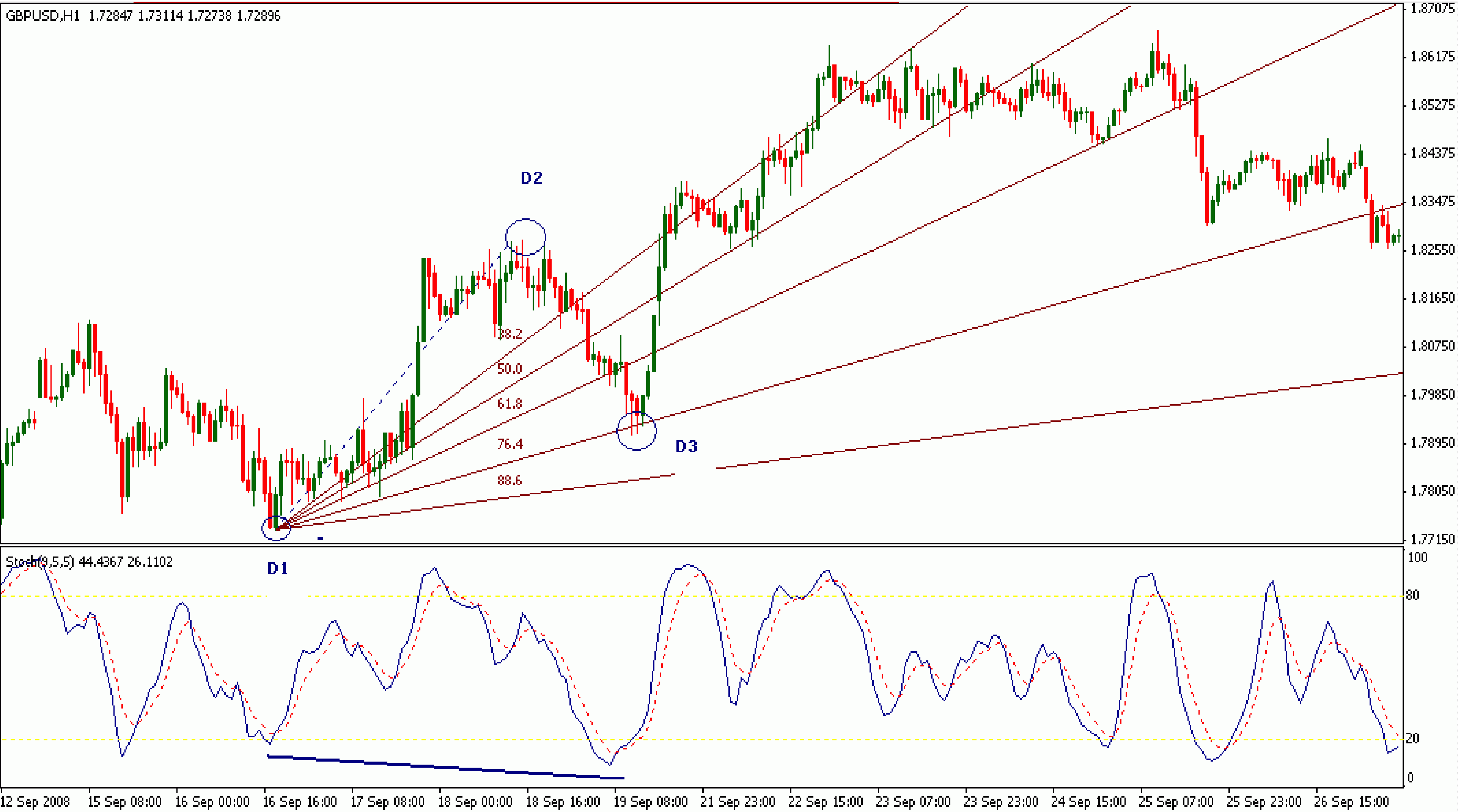
Of all the ratios, the 88.6 level holds a lot of importance. This is the level, from where price has a very high probability of retracement.

We can thus call the 88.6 fan fib level as **"The Barrier Level of the Fib Fans."**

In case of an up trend, we plot the Fib fans on the existing up trend from the swing low to the swing high (from where price started the pull-back down)

If the pull-back is held within the Fib fans - and specifically as mentioned before - if price does not break the 88.6 fan level or finds support at that level, then the indication is that price should resume the up move again.

# Applying Fibonacci Fans

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# Applying the fans to the hidden divg.

In case of a hidden divergence, we first confirm the maximum level of retracement.

In an ideal set-up, the fans offer strong support levels, from where price should continue with the existing up trend.

The maximum level of the pull-back should be contained within the 88.6 fan level.

In case of a strong trend, the 76.4 or the 61.8 level would also hold the price move.

But the 88.6 level becomes an important level.

<u>If price breaks this level to the downside, then the hidden divergence is negated</u>

# Trading the hidden divergence setup.

The first and the most important point is to determine if the pull-back has been completed.

Here the support levels of the Fibonacci fans become important, and we can also use candlestick charts to see if we get some reversal signs.

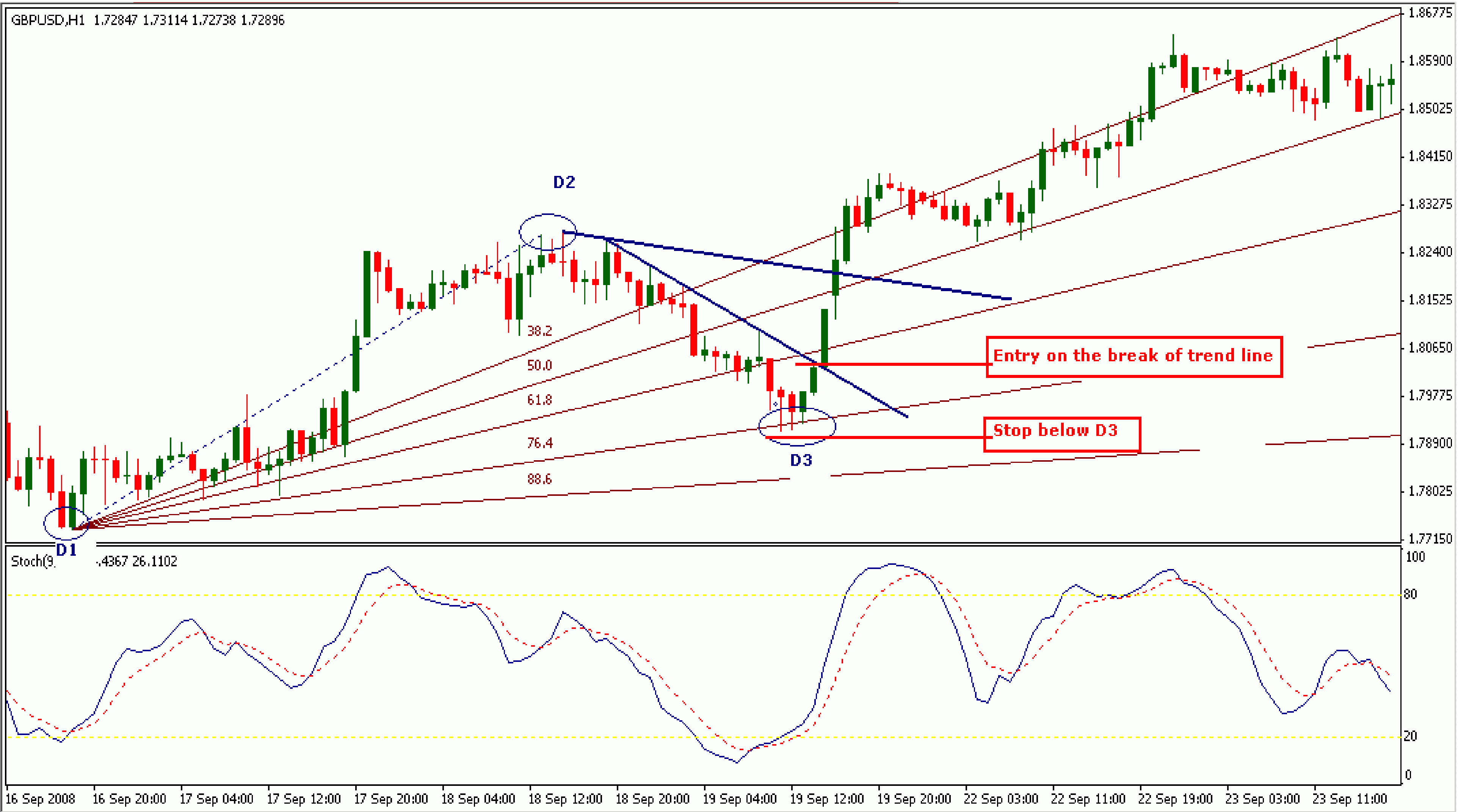
As we can see in this chart example, price found support at the 76.4 fan level, which gave us a strong indication of the resumption of the trend.

We then apply the following rules for the trade set-up

Entry into a long trade – On the break of the trend line, or on the high of the reversal bar.

Stop to be placed – below the D3 level, which is a strong support zone.

# Trading the hidden divergence setup.

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# Price targets

While an entry into a trade is the initial step of a trade, it is the exit which is more important.

One must have the exit levels pre-defined, to avoid the situation of a winning trade turn into a losing one.

The most effective way is to determine a target zone, which can be derived by a confluence of different factors.

Let us have a look at two different ways to determine the price objectives –

1.) Measured moves.

2.) Fibonacci Expansions.

# Measured moves

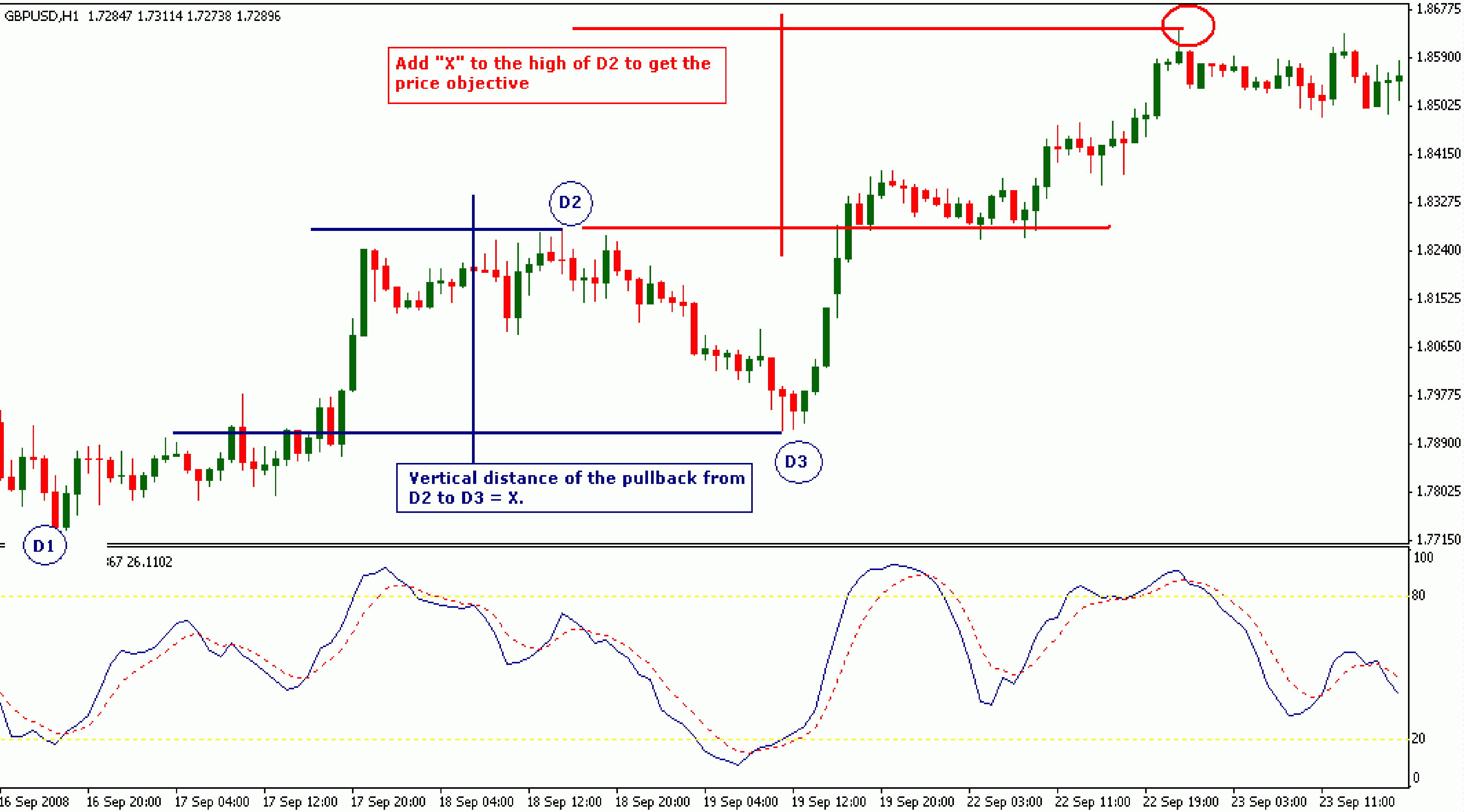
As we mentioned earlier, price moves are never random and price does have a definite pattern in its movement. There is always a method behind the madness.

Measured moves are a very simple yet effective way to determine further price movements.

In this case, we measure the vertical distance of the pull-back (from D2 to D3) and add this distance to the high of D2.

Price has a very probability of achieving this objective, which becomes our minimum target level.

# Measured moves

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# Fibonacci Expansions

Fibonacci levels can be used effectively to determine the target objectives.

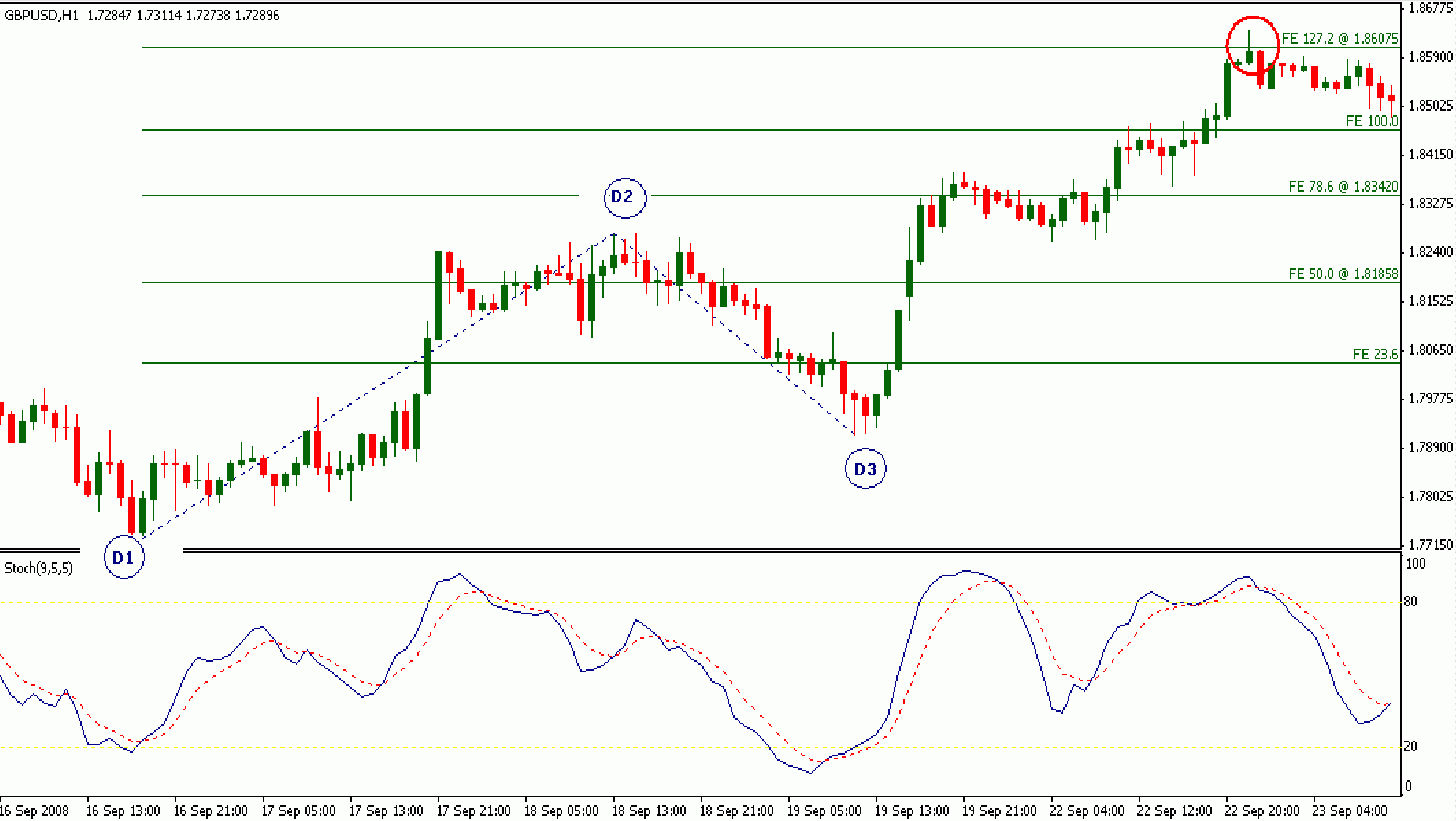
But a trader must know which ratio to use for which particular situation.

Just like the different tools in a carpenter's tool box, where every instrument has a specific purpose, the fib ratios too have a specific use for different situations.

For Hidden divergences, the Fibonacci expansions are ideal for calculating the price targets, since the pull-back gives us 3 points to plot the Fibonacci ratios on.

As we can see in the chart, the Fib Expansion level of 127.2 coincided precisely with the earlier 'measured move' target.

# Fibonacci Expansions

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# Trade Plan

“Plan Your Trade and Trade Your Plan.“

There are absolutely no guarantees in trading, and you will never be correct all of the time.

But you must have a Trading plan, which is often the dividing line between success and failure.

Traders who carefully plan each trade, have a much better chance of making money than those who don't.

In fact, the simple act of drafting a plan can significantly increase the odds that your trade will be profitable.

An ideal Trading Plan must incorporate the concept of 3M’s

# The 3 M's – Money, Mind & Method

These are the holy trinity of trading, and it's important that traders recognize all three before they can achieve consistent success.

If one were to distribute the 3M's on a scale of 1 to 10, then

Money - The Money Management would account for 50%;

Mind - Psychology of trading would account for 30%;

Method - Technical analysis would account for only 20%.

Hence it is imperative, that besides the Method, one must give more importance to Money & Mind.

# Money Management

The first priority of a trader is the preservation of capital, which is the trader’s bloodline.

*<u>Traders Golden Rule No.1 - “No capital, no trading”.</u>*

*<u>Preservation of capital comes from controlling the losses and letting the profits run.</u>*

Secondly one must accept the fact, that one cannot predict or control the market. Once you have entered a trade, you have absolutely no control over it.

But you can control what is within your limits – the amount of capital that you risk on a trade.

*<u>Traders Golden Rule No.2 – “Take care of your losses, and the profits will take care of themselves”.</u>*

*<u>Always maintain the correct position size and the do not risk higher amounts of capital and keep a proper Risk to Reward ratio.</u>*

# Money Management

A trader is in this profession to make money, so one must have some compensation for putting in the time and effort.

If one takes a small amount of profit from every trade, not only does it increase your capital, but it also reduces the psychological pressure.

Hence one must take initial profits from a trade as soon as it goes in your favour

*Traders Golden Rule No.3 - "Never let a winning trade turn into a losing trade"*

# Mind

Define the exact conditions that you will get you in a trade.

If price does not fulfil those conditions, do not trade.
Don’t enter a trade only because price is moving.

You must ask yourself whether it satisfies the conditions in your trade plan.

Have the patience to wait for your set-up to occur, and once it does, have the discipline to follow your trading plan to the “T”

# Conclusion

Finally, if you don’t have a plan, it simply means that you are gambling & not treating this as a business.

And if you do have a plan, this factor alone puts you in the top 20% of the profitable traders

I hope this presentation can help you gain that extra ‘Edge’ over the market.

Visit my website for more educational and practical information on the correct use of technical analysis.

We don’t just teach, but also implement the knowledge in the live market.

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