Lesson 4 by Madiba Malebo

Divergences

Momentum
Oscillators
(Indicators)

Oscillators or Indicators

Now we will talk about momentum indicators

- The term "momentum" refers to the velocity of a price trend.

- This indicator measures whether a rising trend is accelerating or decelerating or whether prices are declining at a faster or slower pace.

Oscillator (Indicator) Analysis

Analyze in three – Dimensions

TREND - Bullish or Bearish

AREA - Overbought or Oversold

DIVERGENCES - Bullish or Bearish

Oscillator

Direction

Direction – Up & Down

Momentum, like prices, move in trends.

This means that the techniques used for analysing price trends like using moving averages can be used for appraising momentum trends.

We must keep in mind that a trend reversal in momentum is not always associated with a similar reversal in the price.

PRICE IS THE BOSS.

Oscillator

Extremes

Area – Overbought & Oversold

All momentum oscillators move from one extreme to another.

Some oscillators, like RSI and IMI are calculated in such a way that they fluctuate between 0% and 100%. In these cases there is an established level for the Overbought and Oversold lines in the above cases 70% and 30%.

Other oscillators, like ROC or Momentum do not have maximum or minimum levels, so in this case we must calculate the Overbought and Oversold lines ourselves.

Classic
Divergences

Divergences– Bullish & Bearish

In a nutshell, divergence can be seen by comparing price action and the movement of an indicator. It doesn't really matter what indicator you use. You can use RSI, MACD, ROC, IMI, etc. Just think "higher highs" and "lower lows".

If price is making higher highs, the oscillator should also be making higher highs. If price is making lower lows, the oscillator should also be making lower lows.

If they are NOT, that means price and the oscillator are diverging from each other. And that's why it's called "divergence."

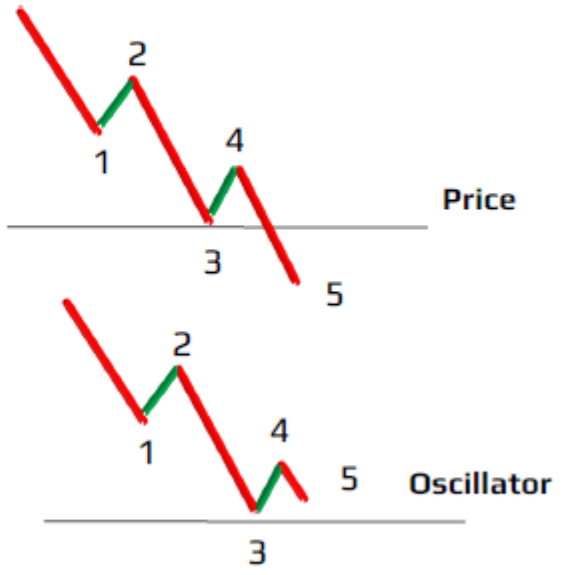
A divergence is used as a possible sign for a trend reversal

Divergences– Bullish

If price is making lower lows, but the oscillator is not, this is considered to be positive (bullish) divergence.

This normally occurs at the end of a down trend. After establishing a second bottom, if the oscillator fails to make a new low, it is likely that the price will rise, as price and momentum are normally expected to move in line with each other.

It is also called Positive Divergence because even though the price is declining, it is declining at a slower and slower rate. In this instance the technical position is said to be improving or getting stronger



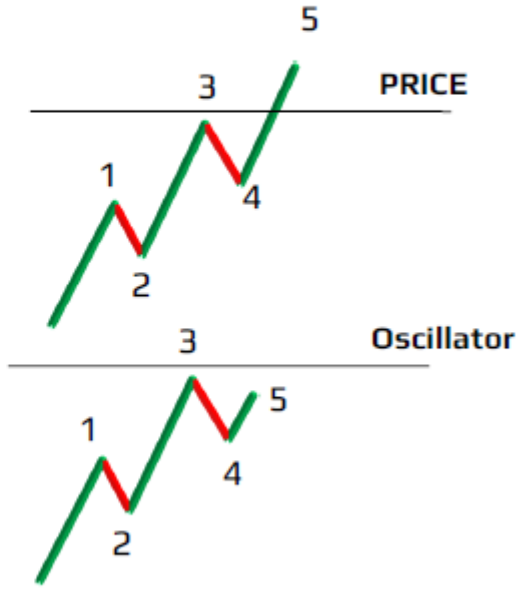
Bullish Divergence

Divergences– Bearish

If the price is making a higher high, but the oscillator is NOT, then you have negative (bearish) divergence.

This type of divergence can be found in an uptrend. After price makes that second high, if the oscillator makes a lower high, then you can probably expect price to reverse and drop.

It is also called Negative Divergence because rising prices are supported by weaker and weaker underlying momentum. The deteriorating momentum represents an early warning sign of some underlying weakness in the uptrend.



Bearish Divergence

Divergences– Bullish & Bearish

As you can see from the images above, the divergence is best used when trying to pick tops and bottoms. You are looking for an area where price will stop and reverse.

The oscillators signal to us that momentum is starting to shift and even though price has made a higher high (or lower low), chances are that it won't be sustained.

A divergence is used as a possible sign for a trend reversal

Divergence Trap – Bullish & Bearish

Most of the time, divergences proceed in a fairly orderly way. They get progressively lower or higher as per the direction of the trend.

Then, just as you expect the price to drop, a final rally develops and this advance will push the momentum indicator back above at least one or two previous peaks.

Typically, this latest rally will prove to be a "divergence trap" after which the price will then fall in the manner previously expected.

This Final move is usually because of some unexpected news even that causes short covering. When the short-covering ends, there is very little to support the price and down it goes.

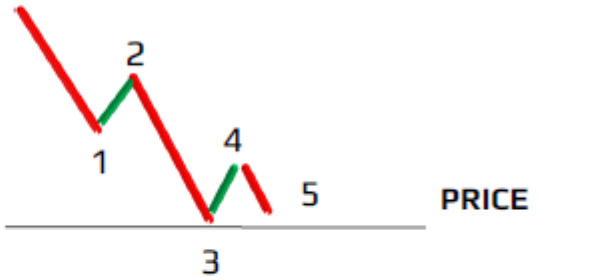
Hidden
Divergences

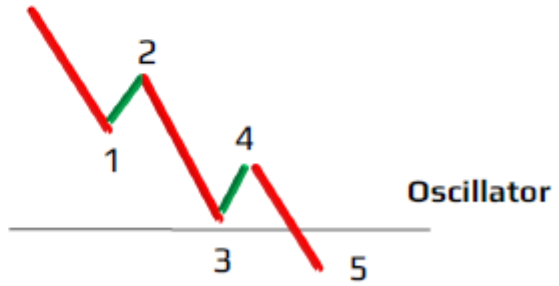
Hidden Divergences– Bullish

If price is NOT making lower lows, but the oscillator is making lower lows, this is considered to be hidden positive (bullish) divergence.

This normally occurs at the end of a down trend. After establishing a second bottom, if the oscillator fails to make a new low, it is likely that the price will rise.

A divergence is used as a possible sign for a trend reversal.





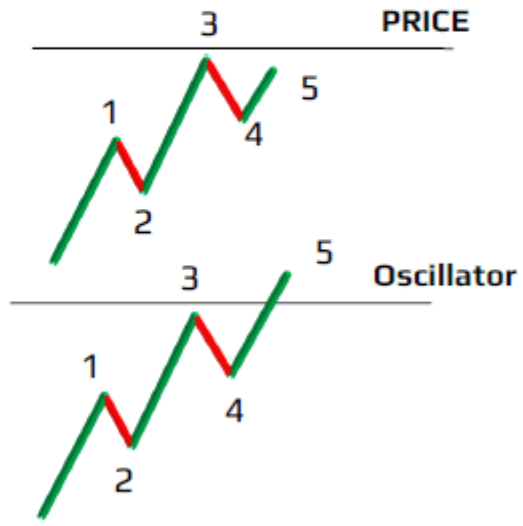
Bullish Divergence

Hidden Divergences– Bearish

If the price is NOT making a higher high, but the oscillator is making a Higher high, then you have hidden negative (bearish) divergence.

This type of divergence can be found in an uptrend After price does not make a second high, if the oscillator makes a higher high, then you can probably expect price to reverse and drop.

A divergence is used as a possible sign for a trend reversal.



Bearish Divergence

Complex
Divergences

Complex Divergence – Bullish & Bearish

Price Trends are determined by the interaction of many different time cycles. However most momentum oscillators, reflect only one cycle, since they are constructed using a specific time period.

One way to solve this problem is to overlay two momentum indicators – like ROC, RSI or IMI constructed from two different time periods and compare them.

Complex Divergence – Bullish & Bearish

Most of the time, both series are moving in the same direction.

When the shorter of the two reaches a peak and then falls toward the zero level while the series with the longer time span continues to rally to a new high, this indicates that the two cycles reflected by the oscillators are "out of synch" with each other.

This is what we call Complex Divergence. It's a divergence between two oscillators instead of an oscillator and price.

Complex Divergence – Bullish & Bearish

It is important to compare two time spans that are separated by a long interval.

For example, it makes sense to compare two oscillators based on a 10 and 20 time period for a short-term trend because the indicators are separated by a substantial time span. As a result, they will reflect two totally different time cycles.

If we compare a 20 and 22 time period, this would not be the case because the two are so close that they would reflect price trends caused by more or less the same cycle.

Strength of Divergences

Divergence – Strength

1. Their number

The more divergences that occur, the greater their significance.

The initial divergence indicates a need for corrective action in the market, but the failure of the price to respond indicates that fewer and fewer informed investors are Buying/Shorting the instrument as more and more uninformed traders move in.

This means that the corrective process, when it finally does begin, is likely to be much more sever.

Divergence – Strength

2. The time span separating them

The time period separating the divergence is also very important.

Usually, the greater the time span between divergences the more important they are.

Also Divergences in a longer period oscillator are more important than divergences in a shorter period oscillator.

Divergence – Strength

3. The closeness of the momentum reading to the equilibrium level at the final turning point in price.

For example if the prices is making a New High but the oscillator is not and is actually very near the equilibrium level then be on guard for a larger than normal sell-off.

Divergence – Summary

Normal Divergences occur when price IS making a new High/Low and the oscillator is NOT making a new High/Low

Hidden Divergences occur when the price is NOT making a new High/Low and the oscillator IS making a new High/Low

Complex Divergences occur when the Longer period oscillator IS making a new High/Low and the Shorter period oscillator is NOT making a new High/Low AND is moving towards its equilibrium level

Perhaps most important of all, divergences must be confirmed by a reversal in price.

Divergence – Summary

A prerequisite to look for Divergences is the existence of a prior TREND. In a range signals are not clear.

You only look for Bearish Divergences in an Uptrend.
You only look for Bullish Divergences in a Downtrend.

Divergences do not by themselves represent actual BUY or SELL signals. They act however as an early warning signal

Buy and Sell signals can come only from a reversal in the price itself. Momentum characteristics do, however, emphasize the significance of price signals when they are given.

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