

Protected: Divergences Ebook

[PimpMyEA.com](http://www.pimpmyea.com) a blog about automatic trading on MetaTrader 4, Multicharts/Tradestation and JForex

Foreword

Divergences can be identified comparing price action on a chart (e.g. a EURUSD chart) with an indicator applied to the same chart. Usually the indicator is an “oscillator” (its values are always included in a fixed range, as an example from 0 to 100), but this is not always the case. The tools we suggest for spotting divergences are **DuettoFX** (an oscillator) and **SintesiFX** (an indicator which is not an oscillator). A common oscillator included in all trading platforms is **RSI** (Relative Strength Index) and it can be used for identifying divergences, however we think that DuettoFX and SintesiFX are far superior in this regard.

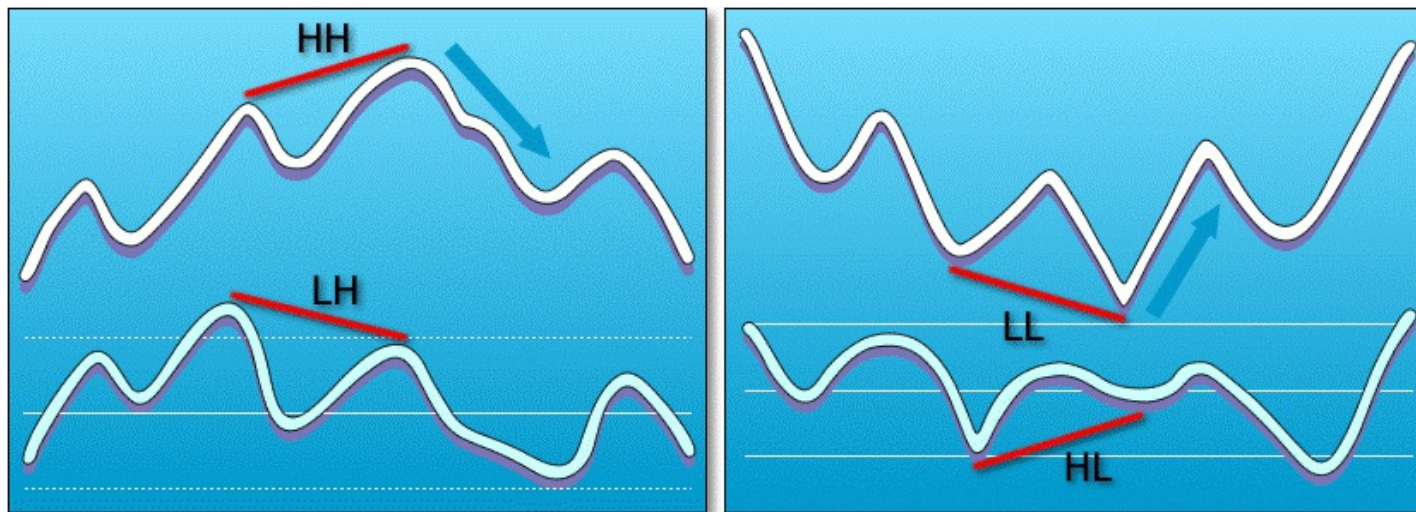
Any time the price chart shows a local “high” or “low” which does correspond to a similar “high” or “low” on the indicator we have a possible divergence, meaning that price is going to reverse soon. As an example an “higher high” on price matching with a “lower high” on the indicator is a classic “regular bearish divergence” pattern, meaning that price is probably going to reverse after its last high.

Classification of Divergences

Divergences can be classified as “regular” vs “hidden” and as “bullish” vs “bearish”.

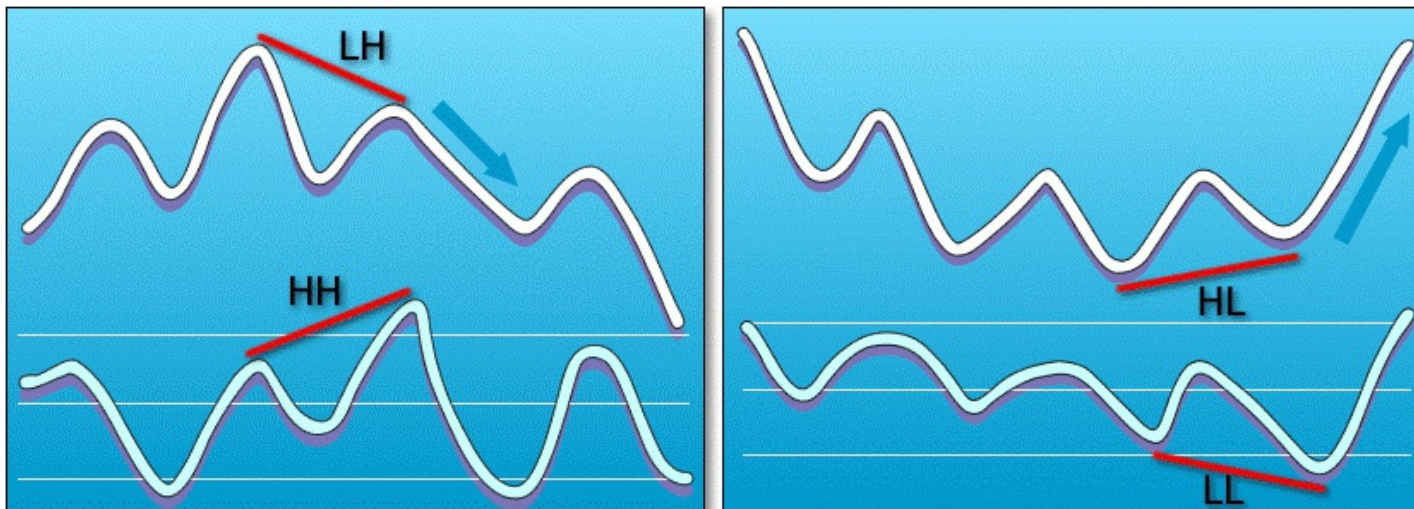
The “**regular**” divergence is a “**reversal pattern**”:

- Higher Highs (HH) on price and Lower Highs (LH) on the oscillator anticipate a bearish reversal (**Regular Bearish Divergence**)
- Lower Lows (LL) on price and Higher Lows (HL) on the oscillator anticipate a bullish reversal (**Regular Bullish Divergence**)

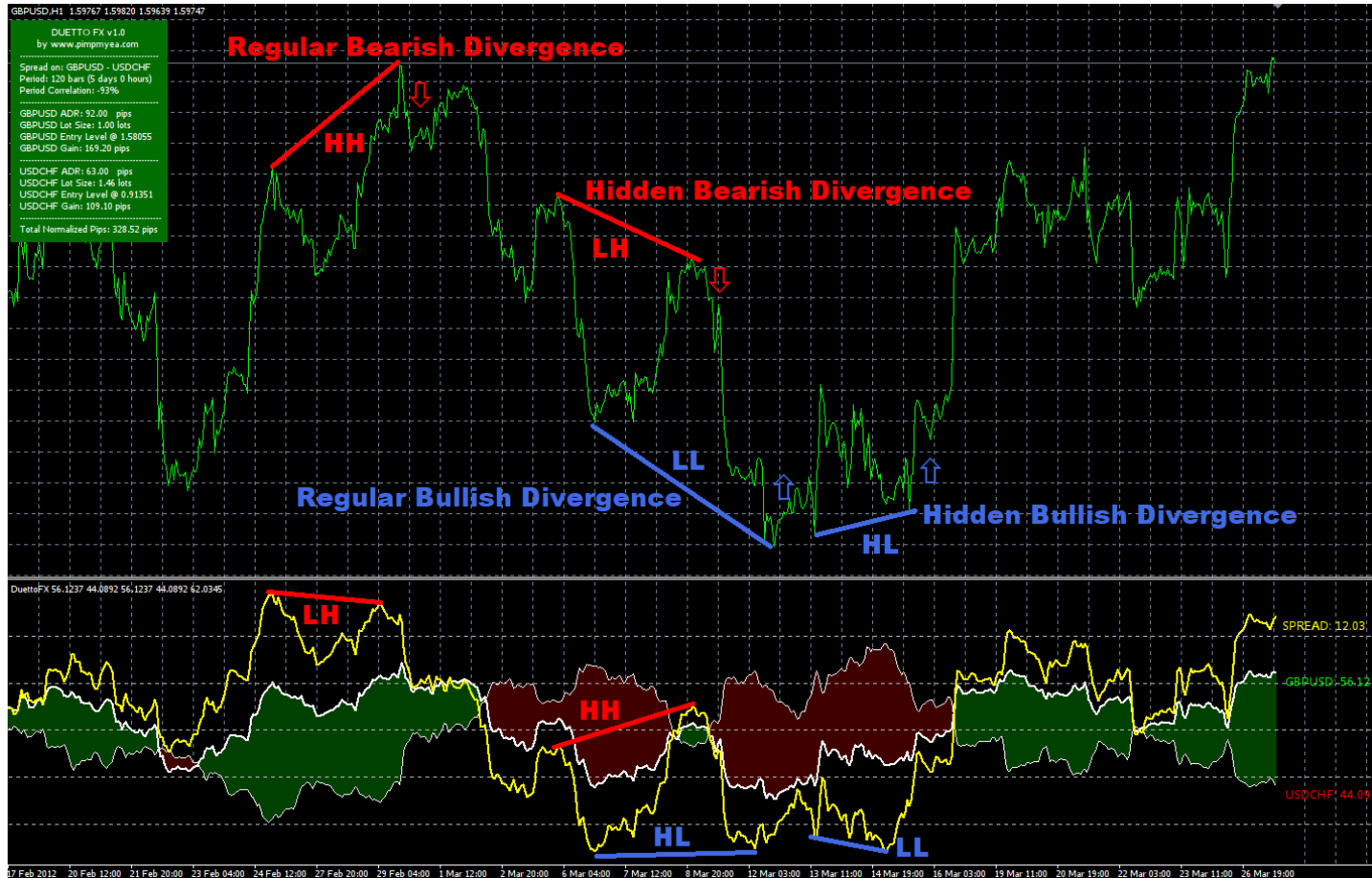


On the contrary “**hidden**” divergence is a “**continuation pattern**”:

- Lower Highs (LH) on price and Higher Highs (HH) on the oscillator anticipate a bearish continuation (**Hidden Bearish Divergence**)
- Higher Lows (HL) on price and Lower Lows (LL) on the oscillator anticipate a bullish continuation (**Hidden Bullish Divergence**)



The following picture of a GBPUSD hourly chart with DuettoFX gives a clear “real life” example of each type of divergence (click on it for a larger view):



Tips for Identifying a Divergence

Usually the oscillator used for spotting divergences is calculated exclusively on the “Close” price of each candle (**DuettoFX** and **SintesiFX** make no exception). For this reason it is important to understand that “High” and “Low” prices of each candle on your chart are totally irrelevant to divergences. You cannot draw Higher Highs based on the Highs and Lower Lows based on the Lows, but you should only connect the “Close” prices of your candles. Therefore **the best thing to do is to visualize a “Line Chart” on your MT4 platform**, while Candlesticks and Bar Chart may be misleading (at least if you are a beginner in the field of “divergences”).

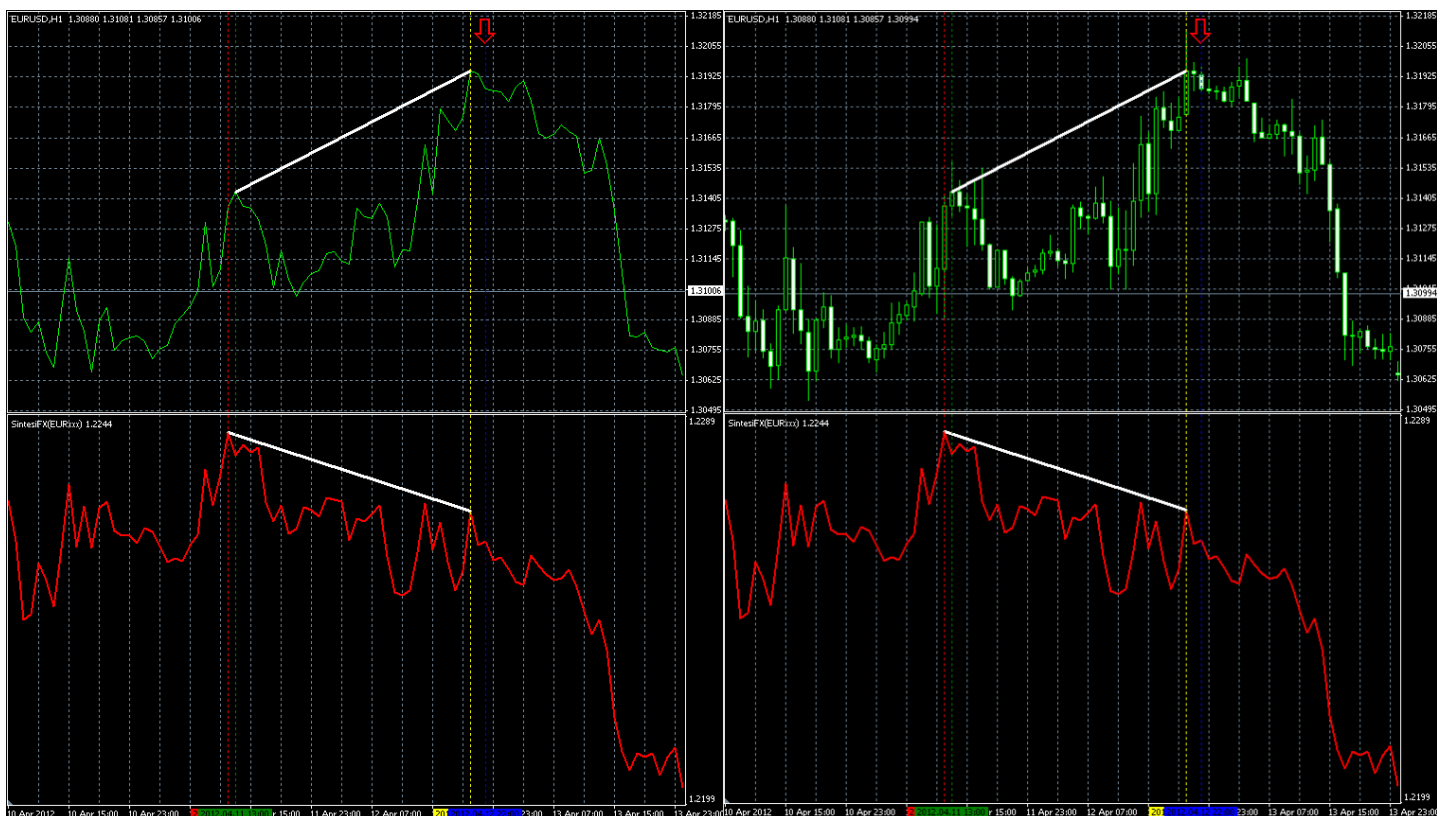
If you use an oscillator like **DuettoFX** or **RSI** you must keep in mind that the local high/low displayed on the indicator can lag 1 or two bars behind the corresponding local high/low on the price. On the contrary if you use **SintesiFX** then you can expect the indicator to both anticipate or lag behind the price for 1/2 bars. Since you are trying to match highs and lows this is an important aspect to bear in mind.

Another important tip is the “fractal” aspect of highs and lows, in other words you should understand how to identify “good” local highs and lows. Let’s say a local high on price has 10 bars before showing a lower price and 7 bars after showing a lower price (remember we always refer to the “Close” price). In this case the “fractal score” of this local high is $N = 7$. The bigger N the better, meaning that local high is really meaningful. The same rule – just reversed – can be used to identify the fractal score of a local low. As an example if you have a local low with 8 bars before showing a higher price and 11 bar after showing a higher price then the fractal score of this local low is $N = 8$. You can use our “HyperFractal” MT4 indicator in order to identify more easily the most meaningful local highs and lows. The suggested settings are `bars_for_fractal = 19` and `bars_to_wait = 1`.

How to Time the Entry of a Divergence Trade

It is important that a reversal is “confirmed” both on price and on the indicator before we can actually enter a divergence trade. If the indicator lags behind the price, then we should wait for the confirmed reversal on the indicator. If the price lags behind the indicator (this scenario can happen with **SintesiFX**) then we should wait the confirmed reversal on the price.

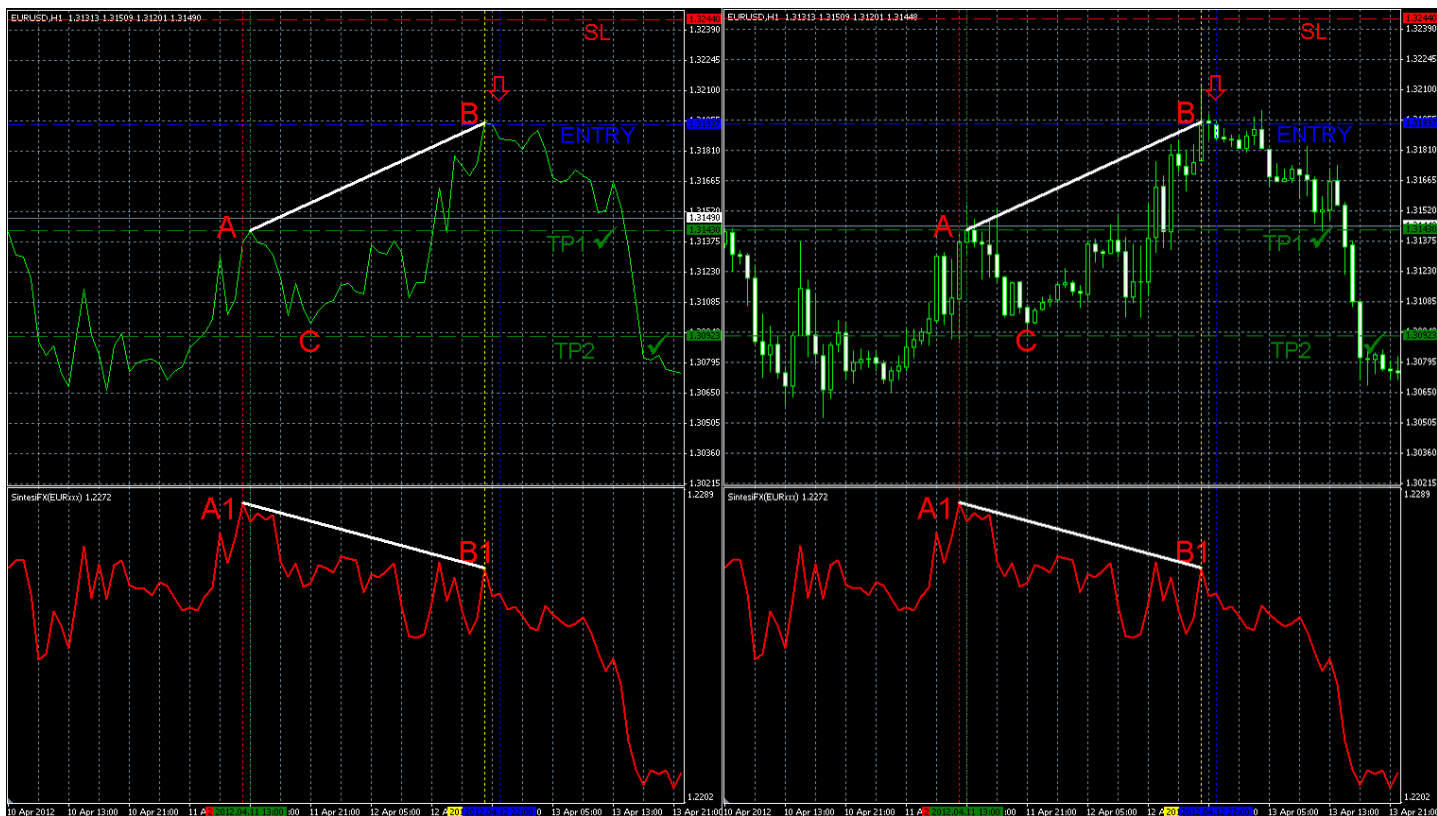
Let’s clarify this point with a EURUSD chart (click on it for a larger view):



In the picture above I've put side by side a line chart and a candlestick chart, just to make things clearer. In this regular bearish divergence pattern the first local high comes first on the indicator (red dotted line) and then on the price (red green line). The second local high comes exactly on the same bar for the indicator and the price (yellow dotted line). At this point we wait at least 1 bar after the last local high to make sure we see a reversal both on price and on SintesiFX. Finally we can enter a short trade on the opening of the next candle (blu dotted line).

Trade Setup for a Regular Bearish Divergence

In this section I'm showing an example of a EURUSD short trade on a "Regular Bearish Divergence" pattern. Through the example you can learn the rules of the short trade setup. Of course the rules for a long trade setup with a "Regular Bullish Divergence" are just inverted (read the section below).



A is the first local high on price and A1 the first local high on SintesiFX. B is the second local high on price and B1 the second local high on SintesiFX. C is the lowest low on price between A and B. This is our main target for this short trade.

TP2 is placed on the lowest low at C. TP1 is half way between the entry price and TP2. SL must be placed so that the entry price is half way between SL and TP1.

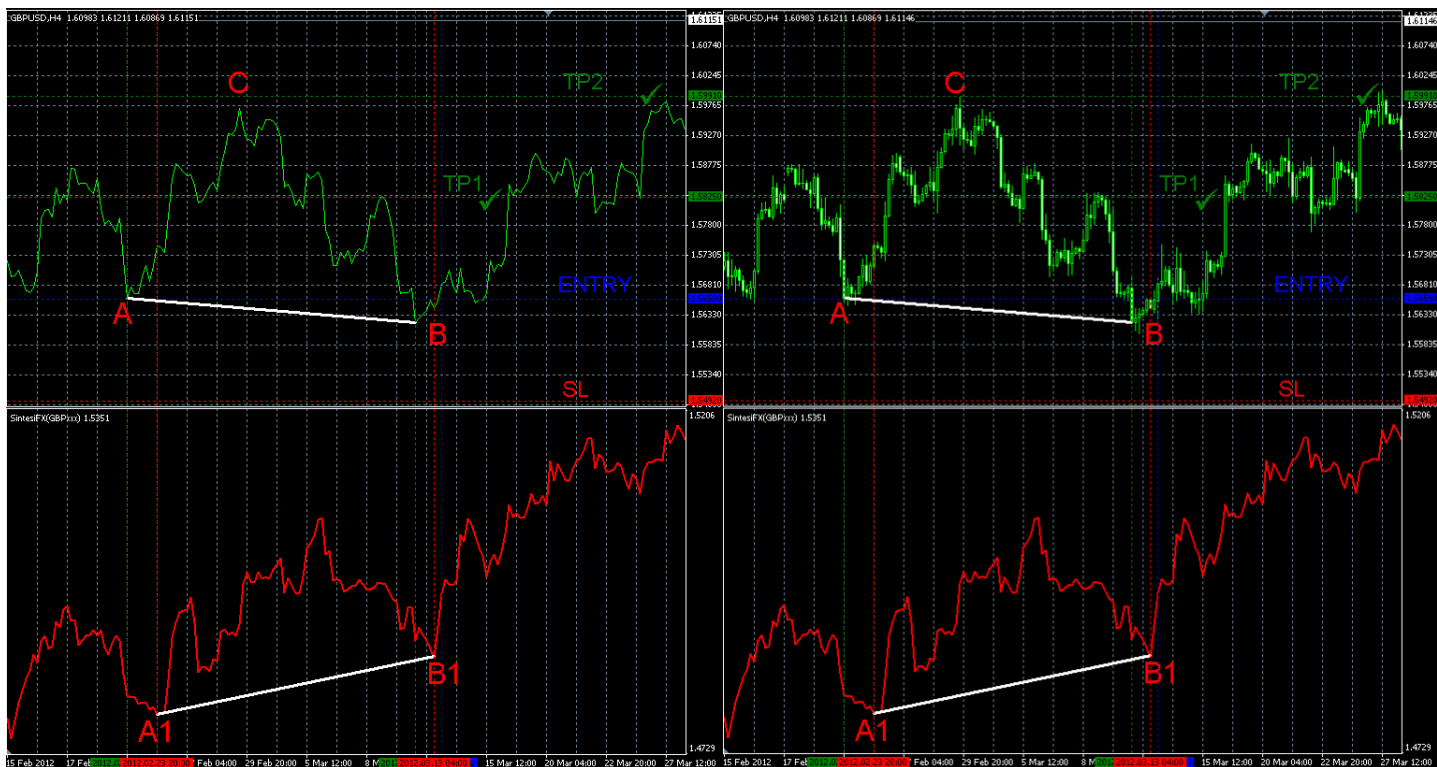
We enter the trade with double lot size and we close first half at TP1 and second half at TP2. When price gets near TP1 it can be a good time to put the stop loss at breakeven.

Take also in mind that the divergence is “invalidated” if B1 gets above A1 on the indicator window. In this case you’d better close the trade even if the SL has not been hit yet.

The trade setup that I’ve described is “safe” in the sense it allows the trader to survive other possible minor divergences that could appear on your way. As an example there are other two minor regular bearish divergences on the chart above before price reaches B. Another way to play this game is to use always a very tight stop loss (as an example the high of the bar before the entry bar). In this case we are stopped out more often, but in the end we enter the big winning trade which largely recoups previous losses.

Trade Setup for a Regular Bullish Divergence

In this section I’m showing an example of a GBPUSD long trade on a “Regular Bullish Divergence” pattern. Through the example you can learn the rules of the long trade setup. Of course the rules for a short trade setup with a “Regular Bearish Divergence” are just inverted (read the section above).



A is the first local low on price and A1 the first local low on SintesiFX. B is the second local low on price and B1 the second local low on SintesiFX. C is the highest high on price between A and B. This is our main target for this long trade.

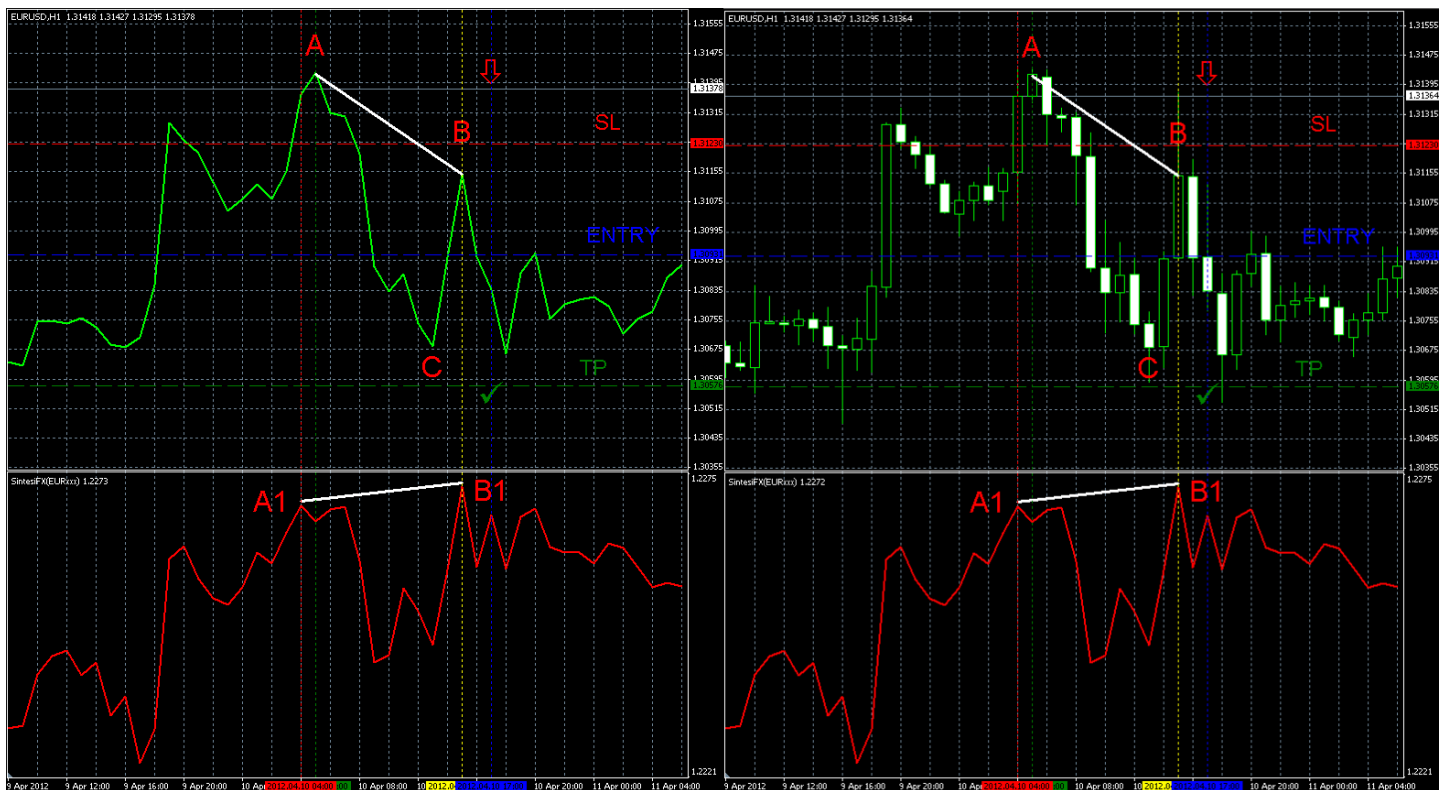
TP2 is placed on the highest high at C. TP1 is half way between the entry price and TP2. SL must be placed so that the entry price is half way between SL and TP1.

We enter the trade with double lot size and we close first half at TP1 and second half at TP2. When price gets near TP1 it can be a good time to put the stop loss at breakeven.

Take also in mind that the divergence is “invalidated” if B1 gets below A1 on the indicator window. In this case you’d better close the trade even if the SL has not been hit yet.

Trade Setup for a Hidden Bearish Divergence

In this section I’m showing an example of a EURUSD short trade on a “Hidden Bearish Divergence” pattern. Through the example you can learn the rules of the short trade setup. Of course the rules for a long trade setup with a “Hidden Bullish Divergence” are just inverted (read the section below).



A is the first local high on price and A1 the first local high on SintesiFX. B is the second local high on price and B1 the second local high on SintesiFX. C is the lowest low on price between A and B. This is our main target for this short trade.

In this case the entry price is too near to our target, so it is better to have only one take profit. TP is placed on the lowest low at C. SL must be placed so that the entry price is half way between SL and TP.

The divergence is “invalidated” if B gets above A on the price window (bear in mind that B is the close price of a closed bar). In this case you’d better close the trade even if the SL has not been hit yet.

Trade Setup for a Hidden Bullish Divergence

In this section I’m showing an example of a GBPUSD long trade on a “Hidden Bullish Divergence” pattern. Through the example you can learn the rules of the long trade setup. Of course the rules for a short trade setup with a “Hidden Bearish Divergence” are just inverted (read the section above).



A is the first local low on price and A1 the first local low on SintesiFX. B is the second local low on price and B1 the second local low on SintesiFX. C is the highest high on price between A and B. This is our main target for this long trade.

TP2 is placed on the Highest high at C. TP1 is half way between the entry price and TP2. SL must be placed so that the entry price is half way between SL and TP1.

We enter the trade with double lot size and we close first half at TP1 and second half at TP2. When price gets near TP1 it can be a good time to put the stop loss at breakeven.

The divergence is "invalidated" if B gets below A on the price window (bear in mind that B is the close price of a closed bar). In this case you'd better close the trade even if the SL has not been hit yet.

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