Bullish and Bearish Divergence Signals

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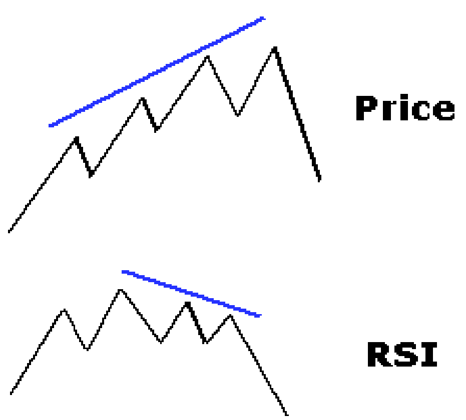
Momentum indicators are normally used more as overbought/oversold indicators with levels above an upper level between 70 and 80 suggesting potential for a reversal lower and a lower level between 20 and 30 suggesting potential for a reversal higher.

When used carefully with strong reference to price these signals can be quite accurate. However, it is also possible to utilize momentum indicators to warn of a deceleration of a trend and subsequent risk of and end to the trend.

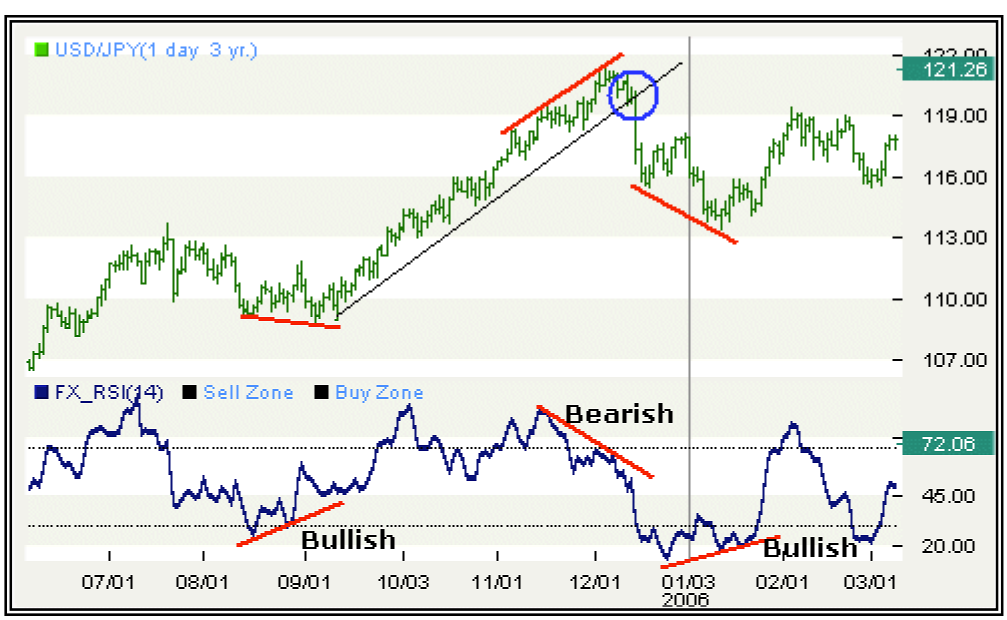
The latter signals are normally highlighted by what are known as "divergences." These can be defined as:

Bullish divergence:	Rising price highs in an uptrend while corresponding highs in the momentum indicator are declining
Bearish divergence:	Declining price lows in a downtrend while corresponding lows in the momentum indicator are rising



When price and momentum direction begin to diverge in this manner it is basically identifying that the speed of the trend is beginning to lose momentum and as such there is greater risk for the trend to reverse.

Note how in this diagram that price has been rising in a sequence of higher highs and lower lows (an uptrend) but over the last three price peaks the corresponding RSI has marked lower peaks in the indicator.



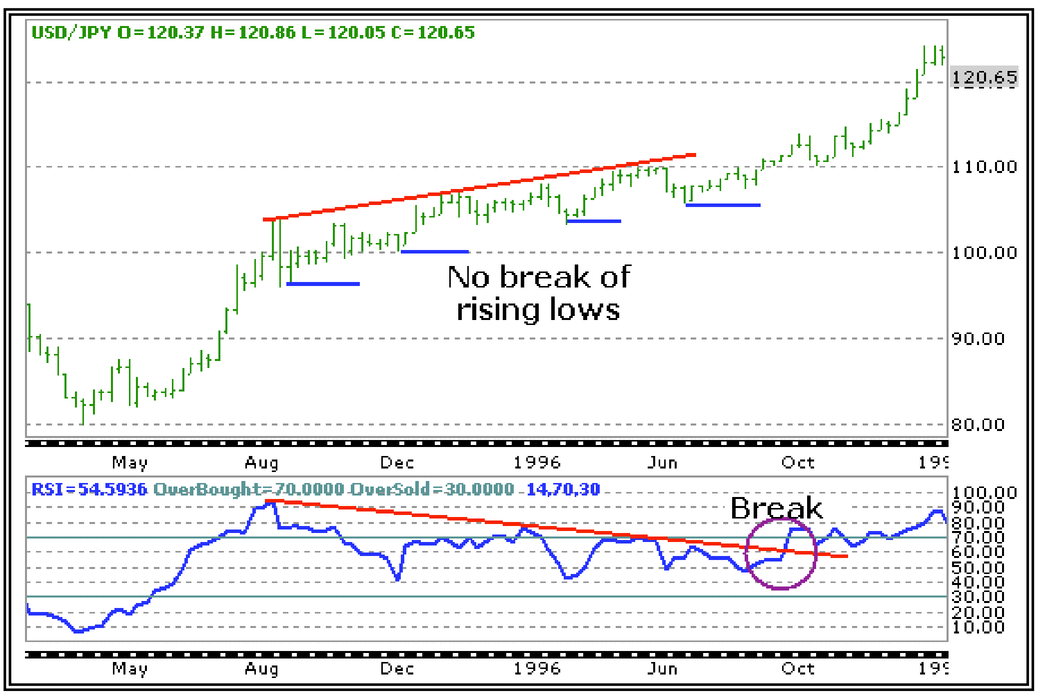
The chart above shows three examples of divergences. The first towards the left of the chart is a bullish divergence where price has been declining with lower highs and lower lows but over the final two lows the RSI (Rapid RSI) has seen a higher low.

This signals a reversal higher in price which then sees an strong uptrend develop until towards the right center of the chart at the top of the trend we note that while the two last price highs are still rising, the Rapid RSI below has seen a lower high on the second price peak. The break of the trend support line confirms reversal.

Finally, from the peak at the right center of the chart we see a downward correction develop within which the price lows move lower but the Rapid RSI lows fail to confirm the downward momentum and this bullish divergence signals a reversal higher once again.

Does this mean that every time we note a divergence forming in this way that we should enter a trade? Most definitely not. It is always vital that such signals are confirmed by price. Remember the definition of an uptrend is a series of higher highs and higher lows, and vice versa for a downtrend. Until the prior low (in an uptrend) is broken, there is no reversal of the uptrend. The opposite is true for the downtrend.

Look at the chart below:



You can see here that price is rising very consistently in an uptrend while an apparent bearish divergence develops in this weekly chart over a period of nearly one year. However, no downward reversal occurs. There are two features to note here. The first is that at no time does the prior low point in the uptrend ever get broken and the second is that towards the right of the chart the break above the divergence line (effectively a trend resistance in Rapid RSI) price then accelerates higher once again.

However, divergences when used in conjunction with signals generated from price are an exceptionally strong indicator of a reversal and can provide you with excellent trading opportunities.

Good luck
Ian Copsey