DIVERGENCE BETWEEN PRICE AND AN INDICATOR

Chartists use the concept of “divergence” as one tool for determining if a trend may be weakening. For newcomers to chart analysis, at first the concept of divergence may seem difficult to understand. The illustrations below should make the concept easier to grasp; and with a little practice analyzing trends, novices should learn to quickly and easily determine if there is a divergence between price and an indicator.

A divergence is *not a guarantee* that a change in the direction of the trend will occur. It is simply a *warning*. A divergence may get shrugged off as price continues to move in the direction of the existing trend. However, a divergence may encourage a trader to take a defensive posture to protect profits built up in a trade. For instance, say he has held a core (long-term) long position in an uptrending stock and notices a negative divergence. He may choose to take some profits on the trade and/or tighten the stop. He should also be on the alert for additional signals of weakness, such as the break of a strong rising support trendline or a strong moving average. Additionally, a divergence may be used to anticipate a change in trend direction so a trader is prepared to trade in the new direction should a reversal occur following the divergence.

NEGATIVE DIVERGENCE

A negative divergence occurs when the peaks in the price of a stock (or index) are still rising (labeled P1 and P2 in Figure 1.1), but the peaks of an indicator that measures the momentum of price start declining (labeled A and B on the MACD histogram). For rising stocks, think “peak-peak.” That is, compare the **peaks** in price to the **corresponding peaks** in the indicator.

Note: The upward sloping line drawn on the chart connecting the peaks in price is to illustrate the divergence only; it should not be confused with a trendline.

POSITIVE DIVERGENCE

A positive divergence occurs when the bottoms in the price of a stock (or index) are still falling (labeled B1, B2 and B3 in Figure 1.2), but the bottoms of an indicator that measures the momentum of price start rising (labeled A, B and C on the MACD histogram). For declining stocks, think “bottom-bottom.” That is, compare the **bottoms** in price to the **corresponding bottoms** in the indicator.

Note: The downward sloping line drawn on the chart connecting the bottoms in price is to illustrate the divergence only; it should not be confused with a trendline.

This information is an excerpt from Lesson 5-Technical Indicators in Course 1 on Charting. Click here to purchase this lesson and/or to see a list of all the available lessons.

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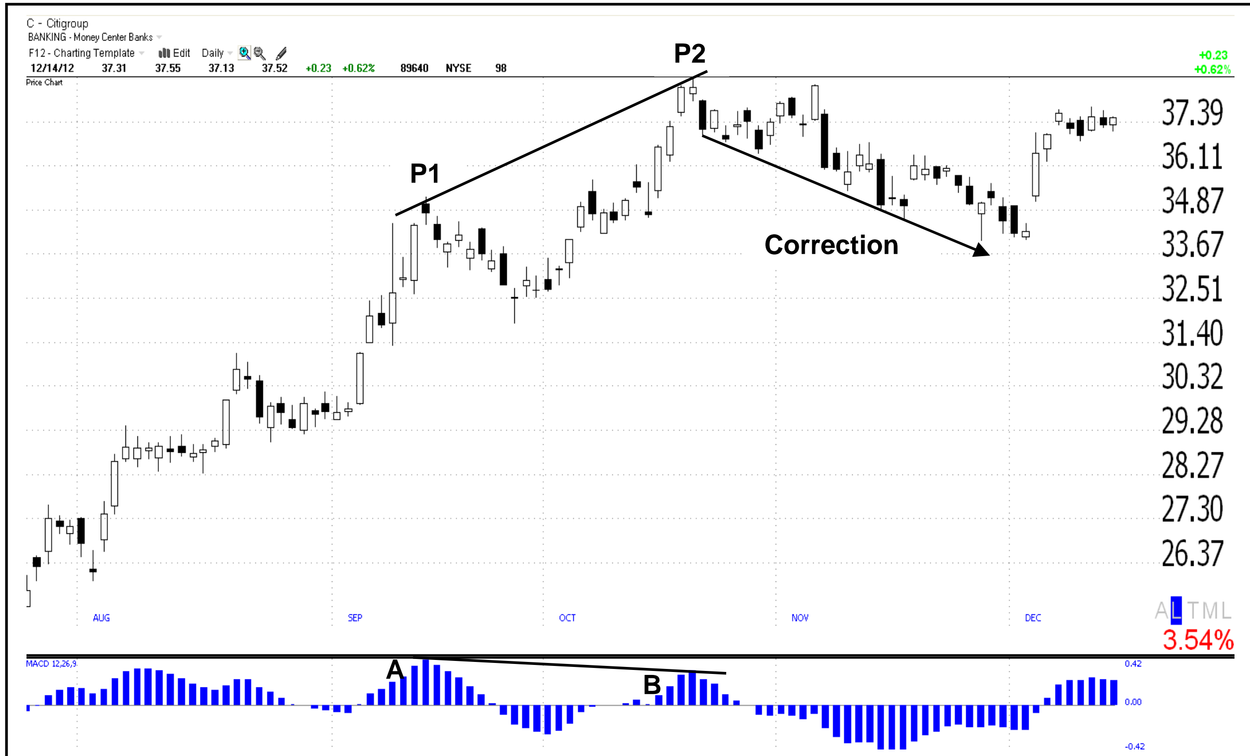

TeleChart

Figure 1.1
A negative divergence between price and the MACD histogram preceded a correction.

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Figure 1.2
A positive divergence is setting up between price and the MACD histogram.

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