Technical Analysis - 6 - Divergence

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Divergence:

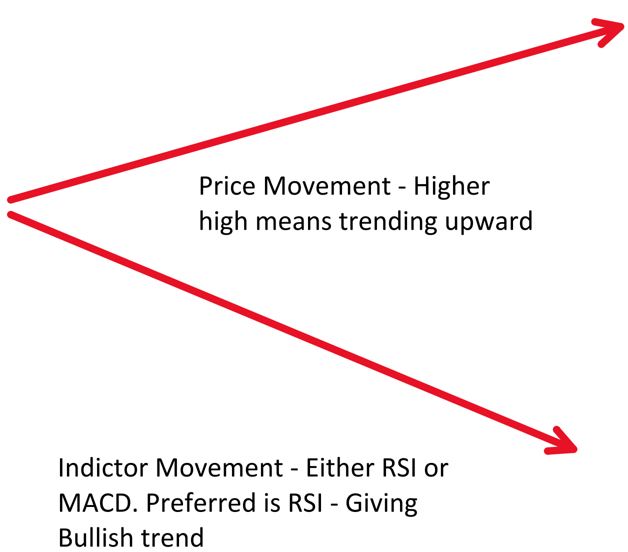
Early signal to exit the trade. Using other indicator like RSI or MACD it can take decision.

Divergence in technical analysis occurs when the price of an asset moves in the opposite direction of a related technical indicator or oscillator. It signals that the momentum underlying the price trend is changing, which may foreshadow a potential shift in the trend's direction.

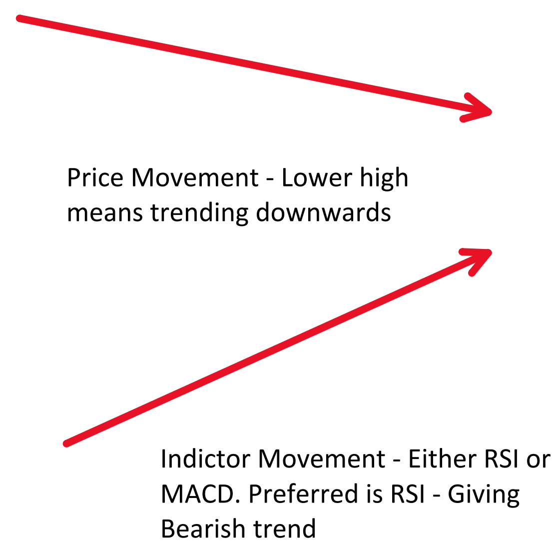
Traders monitor divergences because they can provide early warnings that market momentum is weakening or strengthening, even before it is reflected in price action.

https://www.investopedia.com/terms/d/divergence.asp

Positive Divergence:



Negative Divergence:



Bullish Divergence

Bearish Divergence

Divergence vs. Confirmation

Confirmation in technical analysis occurs when a price trend aligns clearly with signals from momentum indicators, validating the strength and direction of a trend. In contrast, divergence signals a disagreement between price movements and indicator momentum, highlighting potential weakening or reversals of trends. In practice, traders often wait for confirming events (such as a support break, resistance rejection, or indicator crossover) before acting on a divergence, thereby filtering out false signals.

Limitations and Risks of Relying on Divergence

Like all trading signals, divergence has its limitations. Here are some reasons why divergence can make traders prematurely exit or enter positions, misinterpreting these signals:

- **False signals**: Not every divergence results in a trend change. In choppy or highly volatile markets, indicators can show divergences that lead to no meaningful price move. Also, during strong trends, an oscillator may diverge for a long time while price continues to rise or fall, causing traders to misjudge the trend's endurance.
- **Uncertain timing**: Divergence tells you a trend is weakening, but it doesn't pinpoint when a reversal will occur (if at all). A divergence can persist over many price bars before the market finally turns. Traders who act too early on divergence alone may endure a drawdown if the price keeps moving in the original trend for a time.
- **Subjectivity in identification**: Determining what counts as a significant high or low on an indicator can be subjective. Different analysts might identify different points for comparison, especially if the price swings are minor. Small differences in how divergence is measured can lead to different conclusions.
- **Indicator lag**: Momentum indicators are derived from price, so they inherently lag to some degree. A divergence often becomes evident only after several periods of data. By the time it's confirmed, the price might have already started to reverse or could be on the move, potentially giving late signals.

Because of these limitations, traders should confirm any divergence with evidence on the price chart itself before acting.