Hidden Divergence Trading Strategy: Day Trading Tips

If you are a trend trader, hidden divergences should be one of your most important tools. Hidden divergences signal momentum coming into the main trend, suggesting a possible continuation in the main direction of the trend. For some reason, hidden divergences are harder to spot by many traders, despite the fact that they represent a high probability pattern.
What is a Divergence

Almost all technical indicators track the evolution of price movement, meaning that they lag price. That's why most of the oscillators used in technical analysis are lagging indicators. When the price of an instrument moves upward, the indicator also moves upward. When the price moves downward, the indicator also moves downward.

Sometimes, however, a visual discrepancy is evident between price and indicator. This visual discrepancy is known as non-confirmation and is called a divergence. There are two types of divergences:

Regular divergences
Hidden divergences

Regular Divergences

A regular divergence is characterized by higher high prices accompanied by lower indicator values during an uptrend and lower low prices accompanied by higher indicator values, during a downtrend.

A regular divergence is interpreted as a leading indicator as it can identify with good accuracy tops and bottoms. It also helps traders to sell near the top and buy near the bottom. In other words, a classic divergence signals a possible trend reversal.

A regular divergence has two patterns:

Regular Bearish Divergence
A regular bearish divergence appears during an uptrend when the price is making higher highs (HH) but the indicator indicates a lower high (LH).

As you can observe in the Dow Jones Index chart above, the price was in a strong bullish trend, with the price pushing for new highs. However, the indicator failed to record new highs, on the contrary, recording a significantly lower high.

That's a strong indication of market exhaustion and a possible sign of market reversal, or at least a short-term correction.

**Regular Bullish Divergence**

A regular bullish divergence appears during a downtrend, when the price is making lower lows (LL) but the oscillator records higher lows (HL).

Again, when we analyze the Dow Jones Index chart above, we see that the price plunged quite aggressively, with the price seeking for new lows. This move was not confirmed by the indicator, which failed to record new lows, on the contrary, recording higher lows.

Thus, the regular bullish divergence suggests a possible market reversal, or a short-term correction.
What Is A Hidden Divergence

A hidden divergence is a visual non-confirmation characterized by:

- higher lows of the price accompanied by lower indicator values during an uptrend
- lower highs of the price accompanied by higher indicator values during a downtrend

Hidden divergences signal continuation moves in the direction of the prevailing trend. That's why, if you prefer to take positions in the direction of the main trend, hidden divergences can generate some pretty accurate signals.

A hidden divergence has two patterns:

**Bullish Hidden Divergence**

In a bullish hidden divergence, the oscillator makes lower lows, but the price makes either a higher low or a double-bottom low. This type of pattern occurs mainly during uptrend corrections.
Let's take a look at the Dow Jones index divergence chart above. The price was in a very strong upward trend and recorded an important correction. The price resumed its initial upward direction and recorded another pullback. As you can observe, the price failed to record new lows and closed higher than the previous downward swing. However, if we look at the oscillator, it recorded a lower low, thus forming a hidden divergence and signaling that a possible upward movement is on the cards.

**Bearish Hidden Divergence**

In a bearish hidden divergence, the oscillator makes higher highs, but the price makes either lower highs or double-bottom highs. This type of pattern occurs mainly during downtrend corrections.

Let's analyze the Dow Jones index divergence chart above. After a strong uptrend, the recent price action indicated a downward momentum, with the price making lower highs. Despite the fact the price was making lower highs, the oscillator recorded higher highs, thus forming a hidden divergence. As you can see, 2 bearish hidden divergences occurred during this period, signaling that bears were in strong positions to enter the market.

**Best Indicators Used to Spot Hidden Divergences**

**Relative Strength Index (RSI)**

The Relative Strength Index is a powerful indicator and one of the most reliable oscillators when used correctly. A great use of the Relative Strength Index is to watch for divergences between the RSI and the price of the security/stock.
Keep in mind that, Price/RSI bullish / bearish divergence is not an exceptional signal. It occurs frequently, as it is inevitable and is useful only when used in conjunction with other indicators. The divergences between the price and the RSI are traded in a wrong way by many traders. Just because a bullish / bearish RSI divergence appears on the charts, that doesn’t mean that you should automatically enter a reverse position.
Commodity Channel Index (CCI)
The Commodity Channel Index (CCI), developed by Donald Lambert, is an oscillator used in technical analysis in order to measure the variation of a security's price from its statistical mean. There are two main methods used by traders to interpret the Commodity Channel Index: looking for divergences and as an overbought/oversold indicator.
As in the case of RSI, many traders search for CCI divergences on the charts and automatically interpret this as a valid signal to enter the market. Just because CCI divergences occur on the charts, you must not interpret this pattern as a signal. CCI divergences are only useful in conjunction with other indicators or price action.

On Balance Volume (OBV)
On Balance Volume (OBV), developed by Joe Granville, is a momentum indicator that relates volume to price change. On Balance Volume indicator shows if market’s volume is flowing into or out of a security/stock. In other words, the OBV offers information regarding the strength of price movements.
Most common way to use On Balance Volume is to scan for divergences. Divergences occur when price movement is not confirmed by the OBV.
Stochastic Oscillator

Stochastic oscillator, first introduced by George Lane in the 1970s, is part of the momentum indicator family. The indicator is mainly used for determining whether the price has moved into an overbought or oversold area. The Stochastic Oscillator compares where the price closed relative to the price range over a given time period.

The most elegant approach when using Stochastic oscillator is to look for price/oscillator divergences. A divergence occurs when price action differs from the action of the Stochastic oscillator.
Money Flow Index (MFI)
The Money Flow Index (MFI), developed by Gene Quong and Avrum Soudack, is a momentum oscillator that measures the strength of money flowing in and out of a security/stock. Money Flow Index is related to the Relative Strength Index, but with a twist. While RSI only incorporates prices, the Money Flow Index also incorporates the volume.
The Money Flow Index is great at spotting divergences at it also has a big advance, it also incorporates the volume.

Awesome Oscillator
The Awesome Oscillator compares the recent momentum with a momentum over a wider frame of reference. The indicator is plotted as a histogram and is used to confirm the trends and determine possible cycle turn points.
MACD

MACD (moving average convergence/divergence) is probably the most used trading indicator for spotting divergences.
The MACD indicator shows changes in the strength, direction, momentum, and duration of a trend.
How To Trade Hidden Divergence Signals

Forex Divergence Trading Strategy

We determine the main trend by adding a 200-period exponential moving average. When the price trades above the 200-period exponential moving average, we consider taking only long entries. When the price trades below the 200-period exponential moving average we consider taking only short entries.

We plot our favorite indicator for spotting divergences, the indicator you fell most comfortable to trading with (RSI, Stochastic, CCI, OBV etc.)

We search for divergences between the indicator and the price ONLY in the direction of the main trend indicated by the 200-period exponential moving average

If the price trades above the 200 EMA, we search for divergences on the lower side of the indicator and if the price trades below the 200 EMA, we search for divergences on the upper side of the indicator.

Let’s analyze the GBP/USD chart below. For this setup we used the rate of change (ROC) for spotting divergences, but like I stated before, feel free to use any indicator, the basic idea is the same.

We determined the downtrend with the 200-period exponential moving average. We searched for the rate of change divergences on the upper side of the indicator and we only considered short positions. The system generated 4 excellent short signals.

We ignore the signals offered by the divergences on the lower side of the rate of change, as we are in a strong downtrend and chances of whipsaw are considerably higher.
Above we have another setup, this time we used a Stochastic Oscillator. We determined the main trend with the 200 exponential moving average, and we only took long entries, based on hidden divergences spotted on the oscillator.

As you observe, this was a pretty strong trend upwards, and many regular divergences occurred on the upper side of the Stochastic. By taking only long positions, we filtered many bad trades.

The main advantage of this system is the fact that we have 2 market forces on our side when trading: the long-term trend indicated by the 200 EMA and the momentum offered by the divergence. By using this approach, we’ll reduce the market noise and eliminate false signals.

### Divergence Tips

Of the two types of divergence, the hidden divergence represents the higher probability pattern. This is based on the fact that the hidden divergence is a trend continuation indicator. If you’re a trend-following trader, then you should train your eyes to spot hidden divergence on different indicators. Of course, the regular divergence can generate some decent signals, but it’s harder to pick tops and bottom than riding the waves of an uptrend.

Also, hidden divergences are more reliable when you are using higher time frames. A signal that is produced on the H4 or the daily chart is more reliable than a signal produced on the 15 min chart. A hidden divergence is more reliable on higher time frames because the market does not move as fast and it is easier to define trends. You’ll see the pattern developing and you’ll have time to make the correct decisions.