Tim Trush & Julie Lavrin

Introducing

MAGIC FOREX DIVERGENCE
Trading Guide

Your guide to financial freedom.
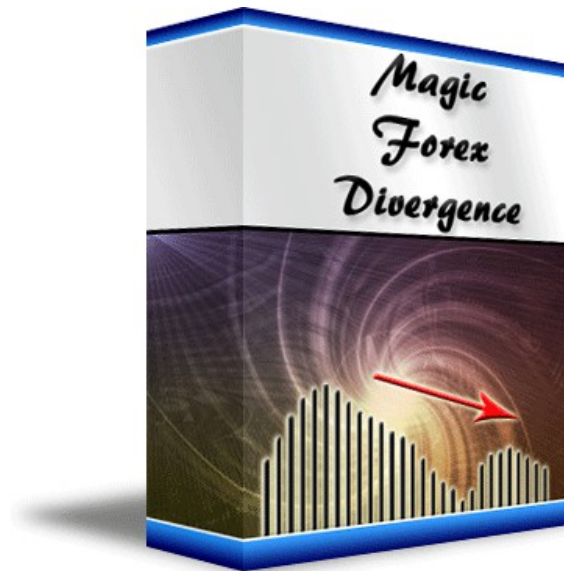
Table Of Contents

Chapter I: Divergence and market psychology

Our goal is to find the point where the trend is so weak that it is probably going to reverse.
How to find the pattern that results in trend reversal.
It doesn't matter what indicator is your best friend.

Chapter II: The "Holy Grail" strategy

Set up your chart.
One simple exit approach is shown in the next examples.
The following charts are created with *Divergence Pattern Recognizer*. Divergence can be used on any time-frame, any currency pair, stock or commodity.
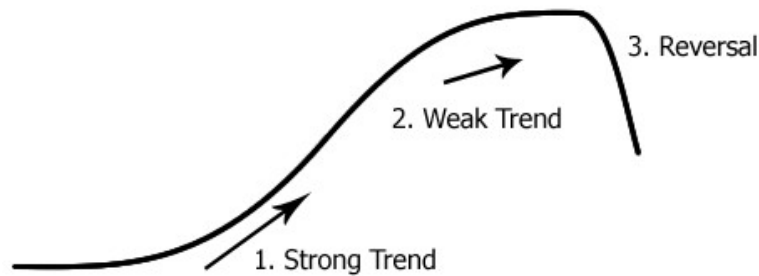
Chapter III: Smart approach

Divergence patterns can lead to consolidation, correction, or full trend reversal. With a solid strategy, you can make a quick profit on the small correction, or minor trend reversal.

Chapter I: Divergence and market psychology

I.1. Trend strength

Look at the following scheme.

1. Buyers believe that the trend has recovered, or a new trend has begun and they want to make money. So they open long positions and drive the price higher. The trend accelerates as more buyers jump into the market.
2. When the buyers take profits, the trend weakens. Buyers still dominate, but they calm down because they are afraid that the trend is coming to the end.
3. When there are no more buyers in the market, the trend is going to reverse. Sellers dominate.

Our goal is to find the point where the trend is so weak that it is probably going to reverse.
A good tool helping us to measure the character of the trend is the RSI indicator (*Relative Strength Index*).

"When the RSI rises above 70, the market is considered to be overbought. When the RSI falls below 30, the market is considered to be oversold." This is a good old story, but we will use the RSI indicator another way.
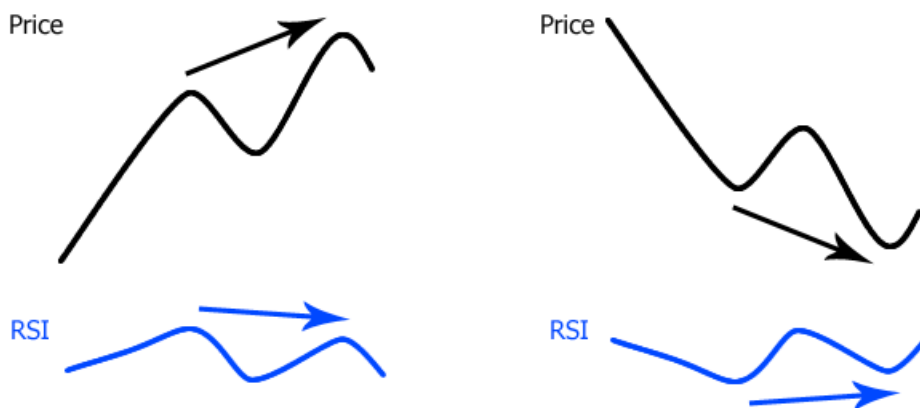
I.2. What is a divergence?

Now, look at the same chart again.

There are two significant highs labeled "A" and "B" in the price chart and the corresponding highs in the RSI chart. In the price chart, we see that B is higher than A. That means that the price is still going up. In the RSI chart, it's just the opposite: B is lower than A. It means that the trend weakens and it is probably going to reverse. And the trend has actually reversed!

Let's say it again.

Bearish Divergence	Bullish Divergence
• Price makes two significant highs. The second is higher. • RSI makes two significant highs, but the second is lower.	• Price makes two significant lows. The second is lower. • RSI makes two significant lows, but the second is higher.

I.3. Indicator soup

We have used the RSI indicator in the examples, but it can be replaced with any momentum indicator such as CCI, Stochastic Oscillator or MACD. All these indicators are derived from price so there are no "better" or "worse" indicators. It's only about **preference**. It doesn't matter what indicator is your best friend. Every approach is equally good.
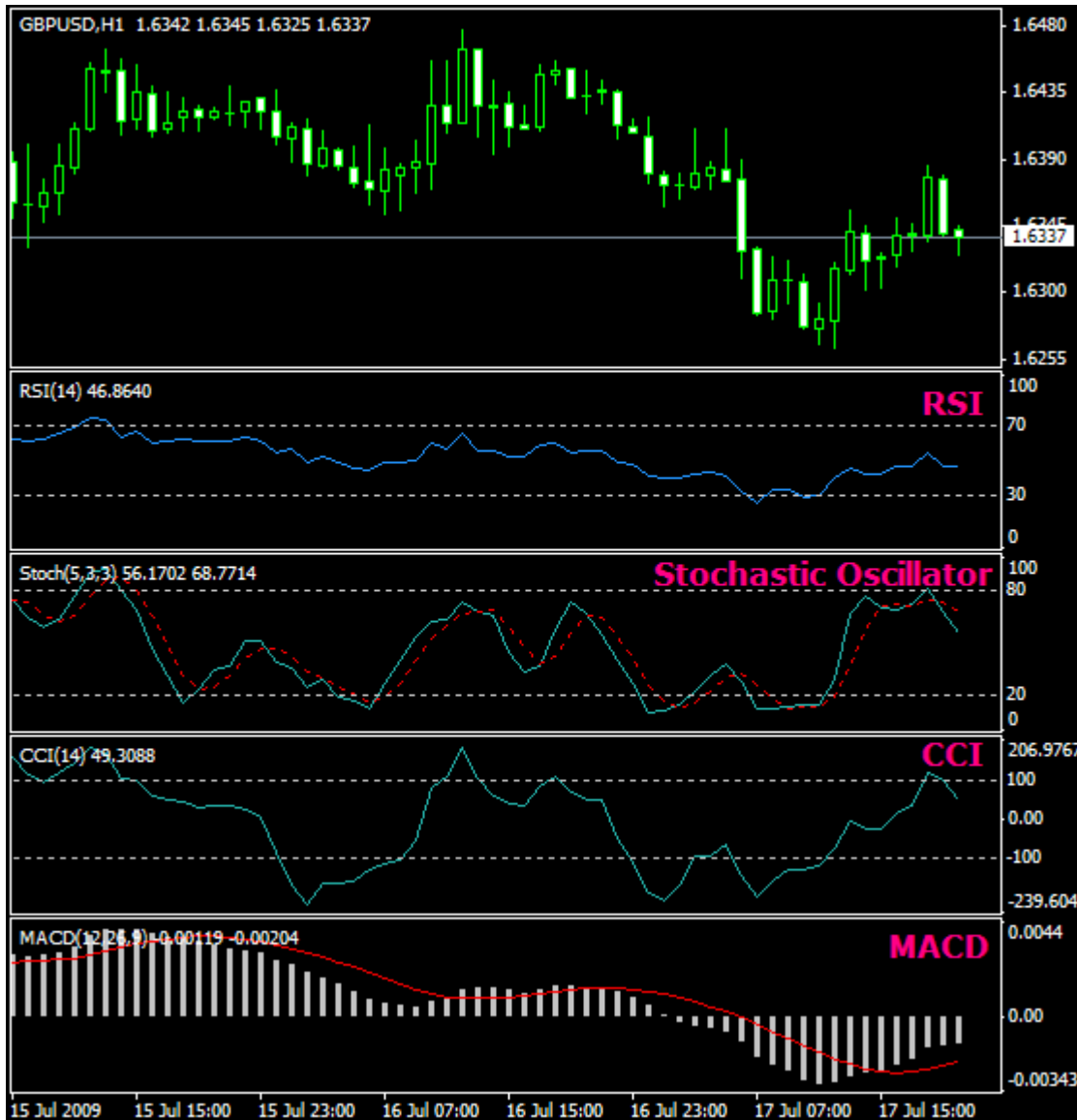
We prefer the MACD indicator because of its nice smooth diagram. The MACD divergence is easy to recognize directly from the MACD chart.

Chapter II: The "Holy Grail" strategy

II.1. Chart set-up

Add the MACD indicator with default settings to the chart. We recommend to hide the grid by pressing CTRL+G.


Here we see a bearish divergence pattern. The two significant highs are connected with a red line. The line in the price chart is sloping up, but the line in the MACD chart is sloping down. This is how divergence is recognized.

II.2. Catch the massive move

MACD divergence is a very reliable pattern. Sometimes, "chart pattern traders" see the *"double top"* pattern and "Elliott wave traders" see the *"shortened fifth wave"* instead. But they all refer to the same thing – the divergence pattern.

What chart pattern traders see...   What Elliott wave traders see...   What we see...

"Double Top"   "Shortened Fifth Wave"   "MACD Divergence"
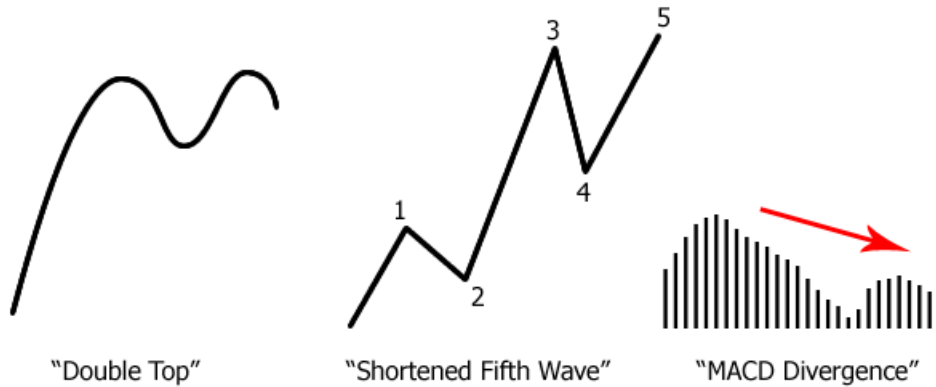
Most traders don't realize that MACD divergence is exactly what they are looking for! Our approach removes the subjectivity because the divergence pattern is well defined.

There are numerous ways to catch the quick move happening after divergences. More details in the Divergence Master Trader book. One simple approach to exit is a candlestick reversal pattern as shown in the next examples.

II.3. Examples

The following charts are created with <u>Divergence Pattern Recognizer</u>. The divergence pattern is recognized and automatically marked with blue line (bullish divergence) or red line (bearish divergence) in both price chart and MACD chart. The line connects the significant lows / highs.

GBPUSD,Daily 1.6406 1.6418 1.6263 1.6337

Gravestone Doji

MACD(12,26,9) 0.00237 0.00125

17 Jan 2008   27 Jan 2008   5 Feb 2008   14 Feb 2008   24 Feb 2008   4 Mar 2008   13 Mar 2008   23 Mar 2008   1 Apr 2008

EURJPY,Daily 132.40 133.47 131.71 132.88

Engulfing

Doji Star
Evening Star

Three White Soldiers

MACD(12,26,9) -0.702 -0.998

1 Mar 2009   10 Mar 2009   19 Mar 2009   29 Mar 2009   7 Apr 2009   16 Apr 2009   26 Apr 2009   5 May 2009   14 May 2009

The last example shows how we predicted the big trend reversal on GBP/USD, Weekly. The bearish divergence signal was confirmed with strong "Lucky Spike"! We went short with confidence and made money on long-term downtrend.

Divergence can be used on any time-frame, any currency pair, stock or commodity.

Chapter III: Smart approach

A definite plan about where to enter, where to place Stop Loss and where to exit is needed. Divergence patterns can lead to consolidation, correction, or full trend reversal. With a solid strategy, you can make a quick profit on the small correction, or minor trend reversal. When the trend reverses, you should stay with the trend for as long as possible. You should also be able to filter small divergence patterns in a sideways or "choppy" market. When the price is moving up and down in the range, the MACD is moving around the zero line, giving too many invalid signals. The Golden Rule explained in the **Divergence Master Trader** book protects us from such situations and limits the entry points only to significant divergence patterns. All features built in the **Divergence Pattern Recognizer** helps the trader to find reliable divergence patterns automatically.

The following example shows taking a quick profit on a candlestick reversal pattern, or riding the new trend starting just from the market top!