Introduction

When studying price charts, and looking for a potential change in trend, one useful feature to look for in the charts is known as *divergence*. This refers to the divergence of the price when compared to a chart indicator — that is, when the price is heading in one direction, say up, while the indicator is heading in the other direction, say down. *Divergence* comes in two variations — *bullish divergence* and *bearish divergence*, and each of these types of divergence can be classified as of three different "strengths" — Class A, Class B, or Class C.

In this Article in Brainy's series on technical analysis, TA-5210, *"Divergence"*, we look at the notion of *divergence* and explain what it is, what it means, and how to spot it.

Divergence explained — a capital protection tool

Let's first look at *bearish divergence*, because this can help us to identify pending trouble in the market or in a stock, and help us to protect our investment capital. Conversely, *bullish divergence* can forewarn us of a pending turn up in the price, and give us confidence of a pending move.

In its simplest form, *bearish divergence* can be explained with reference to the price chart in Figure 1 below which shows the All Ordinaries index (XAO) in the upper pane, and the 28-period Momentum indicator in the lower pane. Firstly, understand that it is normal for the Momentum indicator to move roughly in sync with a price chart. That is, as the price (or the index) is trending up and making higher highs, the indicator usually tends to also move upwards and make higher highs. Divergence can be observed between price and a number of technical chart indicators — listed and discussed below.

In the sample chart below, note the following features:

- As the index rises and falls, Momentum also usually rises and falls, roughly in sync (except for the period flagged as "A").
- During the period indicated as "A", the index kept running higher through April, May, June and July 2007 to make a Higher High in October, while the indicator failed to make Higher Highs and in fact made Lower Highs down into October.

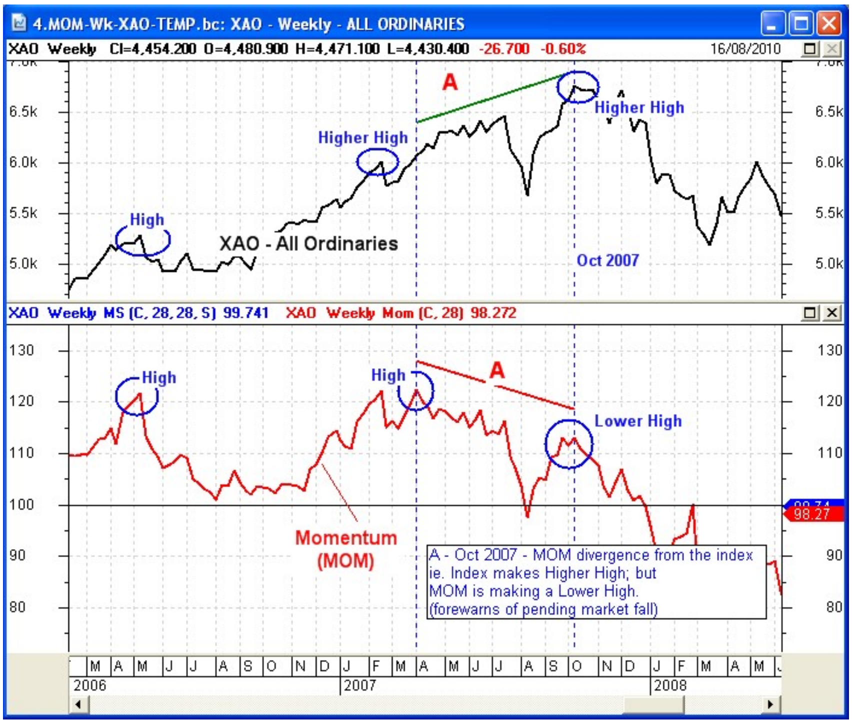

Figure 1: Bearish divergence on XAO (All Ordinaries) index weekly chart.

Divergence such as this applies equally to stocks, or an index. And it can be observed in various time periods — on this weekly chart, but also in daily and monthly charts (and other periods).

An observation of divergence like this forewarns of a *possible change* in trend for the index (or the stock) in question. It does not forewarn of a definite change, only a possible change.

Notice that this observation is not concluded quickly. In the example shown here, the divergence played out from about March 2007

Brainy's
eBook (PDF) Articles

This article
is NOT free*

Unfortunately,
the remaining pages of this article
are not available for free.

Some of the eBook Articles are available for free,
including the Table of Contents pages,
and the Introduction and Overview pages.

These articles take a lot of time, experience,
knowledge and expertise to compile.

However, there is some good news.

You can subscribe as a Toolbox MEMBER
and have unlimited access to all Articles,
plus a whole lot more.

Visit: www.robertbrain.com

Robert writes and updates Articles on three topics:

- ✔ Share Trading & Investing
- ✔ Technical Analysis
- ✔ BullCharts (charting software)

See a list of Articles in the free section of the Toolbox:
www.robertbrain.com/members-area/articles.html
(the green shaded articles are free)