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Trading with the Trendlines
The Power of Divergence

DAVID CARLI

Trading foreign exchange on margin carries a high level of risk, and may not be suitable for all investors. The high degree of leverage can work against you as well as for you. Before deciding to invest in foreign exchange, you should carefully consider your investment objectives, level of experience, and risk appetite. No information or opinion contained in this e-Book should be taken as a solicitation or offer to buy or sell any currency, or other financial instruments or services. Past performance is no indication or guarantee of future performance.

DEDICATION

My parents, who made me the person I am today.

CONTENTS

ABOUT THE AUTHOR

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David Carli is an Italian trader and independent financial analyst. He completed his studies at the University of Pisa, and he has released several successful books about trading. It is his success and knowledge that David wishes to pass on to other potential traders, helping them to avoid mistakes and succeed in the finance and investment markets.

After completing his studies at the University of Pisa, David attended several exclusive trading courses ran and organised by Steve Nison in the United States of America. David believes that the best person to manage your investments is yourself. Only you understand how long and hard you had to work to achieve your savings. By helping you avoid the strategies that do not work, David hopes to give all traders a better chance of success.

Since January 2007, David has been living and working as a full-time trader. It was during 2007 that David began collaborating with several highly-placed trading websites and magazines. During the financial crisis of 2008, David learned the importance of diversification in trading, helping to achieve low-risk

investments. David studied the best approach across all markets to achieve a balanced asset allocation of savings.

In 2012 and 2013 David worked for a small Italian Fund, but in January 2014 he left to manage his investments on a full-time basis. In 2018, David started to collaborate with an important European commodity investment company.

He is currently also working on several e-Books for those that wish to learn more about certain aspects of trading such as Forex, options, commodity and spread trading, stocks, and more. David also teaches interested investors his personal trading strategies and how to apply them in different markets.

He hopes that through e-Books, courses, videos, and articles, people will better understand the financial markets and investment sectors. On https://tradingwithdavid.com, you will also find David's analyses and his trades made using his strategies. You will see that each aspect of his trades is always well planned and thought out.

ABOUT TRADINGVIEW

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TradingView is the innovative financial platform created by Multicharts for the web browsing market, in order to bring the tools that were once only granted to institutional and investment funds, free of charge to a much wider audience.

The peculiarity of this platform is to flank the charts with a social component, where users share their trading ideas to compare themselves with the others and improve together.

For creating even more chemistry between traders, there are public chats, where users exchange opinions in real time on the latest market movements.

The prerogative of TradingView is that not being a broker, it is not limited to providing only its market data. On the contrary, it plays a sort of role as a hub where more than 50 providers spread all over the world are collected and where quotes and charts can be consulted.

About the platform, it is difficult to describe the ease and immediacy

with which the charts respond. This because TradingView has developed a proprietary, JavaScript-based programming language called PineScript, which lets anyone develop their own customised financial analysis tools. The company "freemium" software as a service model that lets most users connect and exchange trading tips and tricks for free.

Personalization is truly the queen of this platform. Every single instrument can be customised, and every detail can be modified.

You can use all types of charts, over 100 ready-to-use indicators, and over 5000 scripts provided by the developer community that populates TradingView. You can build spreads and compare two or more charts.

TradingView lets you discover investment ideas and showcase your talents to a large and active community of traders. Freely discuss, share, and learn with thousands of market participants using TradingView.

With TradingView, your only limit is the fantasy.

PREFACE

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"The Power of Divergence" is the second volume of the series "Trading with the Trendlines." The e-Book explains a strategy applicable in every market (forex, equities, commodity...), and it is a combination of divergence, trendline, and a little of Fibonacci; a simple strategy that seeks to exploit the reversal of a market.

What you will read in the e-Book, is a correct way to use the divergences, in particular, the one between the price and Commodity Channel Index (CCI). Every aspect is well explained, including the proper position sizing, with many examples.

Easy and clear is the identification of the target profit and stop-loss of the strategy. Not only. Depending on your account, I will also explain to you the correct position sizing, for proper money management.

If you are a beginner, do not worry; the first two chapters will provide you with adequate knowledge for understanding the strategy and using it correctly.

Do not be tricked by the fact that the e-Book is free. The strategy, if you use it correctly and with money management appropriate to your account, will give you a high percentage of profitable trades.

However, it is recommended to combine the strategy with the fundamental analysis and open a position only if both give the same signal.

You can receive my free signals about this and other strategies on **TradingView**. You have only to sign up (as I said it is free) and follow me.

For any question, do not hesitate to contact me at the e-mail address info@tradingwithdavid.com, it will be my pleasure to answer all of you. Also, visit my website https://tradingwithdavid.com, where you will find free articles, analyses, and e-Books.

THE CHART

Let's start the e-Book with two short lessons about Technical Analysis for all those who are beginners. We will see in this chapter the Chart, and other trading aspects in the following one.

The knowledge and interpretation of the chart are fundamental in Technical Analysis. Representing price in the form of a chart, be it of a few minutes or years, allows us to perceive its evolution immediately, identify the trend, measure it, set up projections, and more.

There are numerous types of charts, and we will need to choose the one provides the most information suitable for the purpose that is being pursued (that is, our type of analysis), in the most intuitive and simple way. So, for example, if we are interested in representing the evolution of a market in the last 30 years, only need a line chart.

On the other hand, if the observation focuses on daily development of a market, it will be more interesting to use a bar or candlestick chart with the indication of open, close, high, low. The most common charts are:

– Line chart

– Bar chart

– Candlestick chart

Line chart

The line chart is represented by a series of closes of the time-frame used (usually daily), connected with a straight line. It takes under account the close because it is the most significant data; it represents the "final" price on which the market converges.
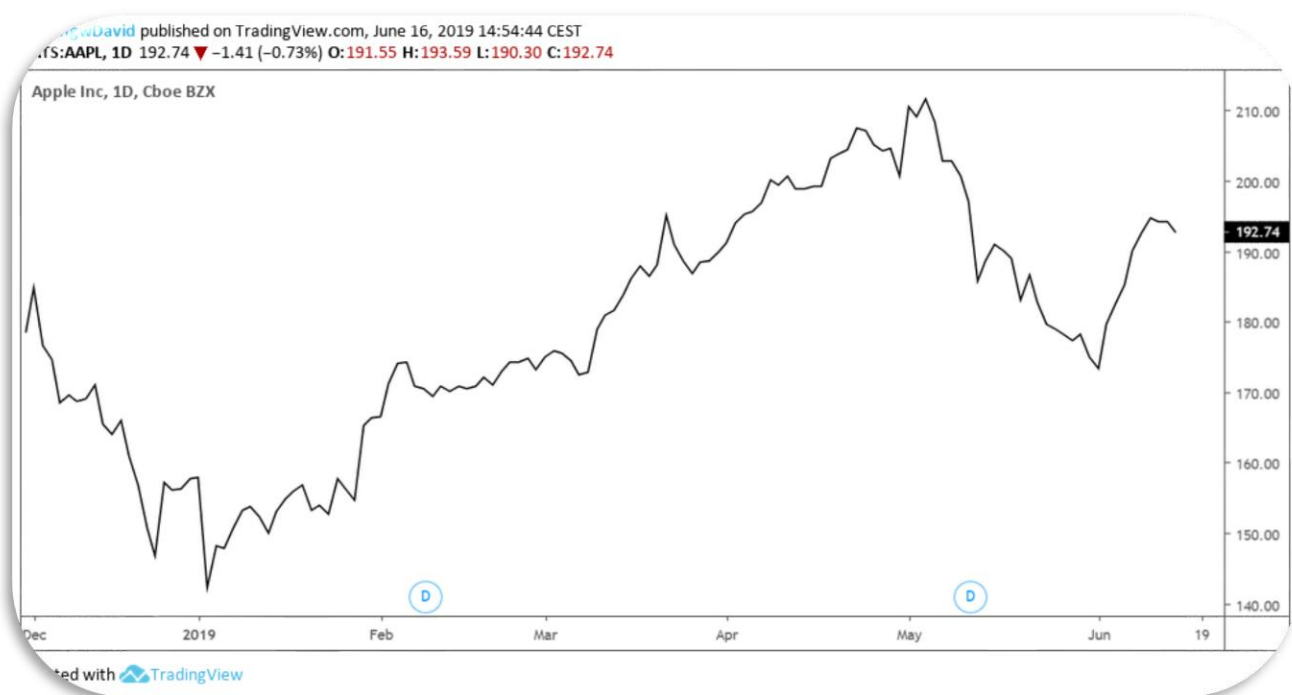

Figure 1 - Apple daily Line chart (TradingView.com)

The limit of this visual approach is that get lost two important information: the excursion high-low (which gives important indications about volatility); the directionality of the market in the time-frame used (by missing the open).

The line chart is used by those who want to give particular importance only to the close, or when there is only one data such as, for example, for the investment funds. We can see an example of a line chart with Apple (figure 1 above).

The line chart is the ideal tool to compare multiple markets on the same chart (such as a stock and an index, or, a currency pair and a commodity).

Bar chart

The bar chart takes into consideration the prices of the entire session. It is obtained by creating a vertical bar that represents the price excursion between the high and low of the time-frame used, and by highlighting with two horizontal segments the open, on the left, and the close, on the right (figure 2).
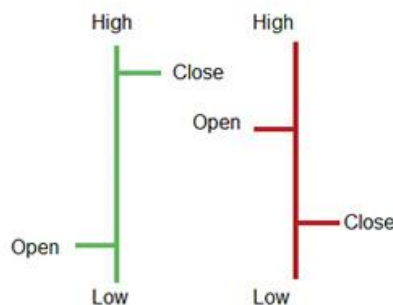

Figure 2 - The bar

Compared to the linear chart, it allows analysing the excursion of the time-frame used (and therefore the volatility) and the directionality. Bar charts can also be used for longer time-frames (e.g., weekly or monthly) or very short periods (like 30 minutes or just 5 minutes).

We can see below, an example of a bar chart always with Apple in figure 3.

Figure 3 - Apple daily Bar chart (TradingView.com)

For an immediate visual perception of the directionality of a bar, we can use the green colour for the bars with the close higher than the open; the red one for the bars with the open higher than the close (characteristic of the next type

of chart).

Candlestick chart

The candlestick originates in the 18th century as a method to predict the price of rice. Its inventor, Menehisa Homma, earned a fortune with this type of graphic representation.

Candlestick analysis can be used with other forms of technical analysis; in fact, often it can be useful to try to interpret price developments better. In the candlestick, to represent the swing of the price in a unit of time, which can range from one minute up to a month, uses a figure called **Candle-Line** (figure 4).
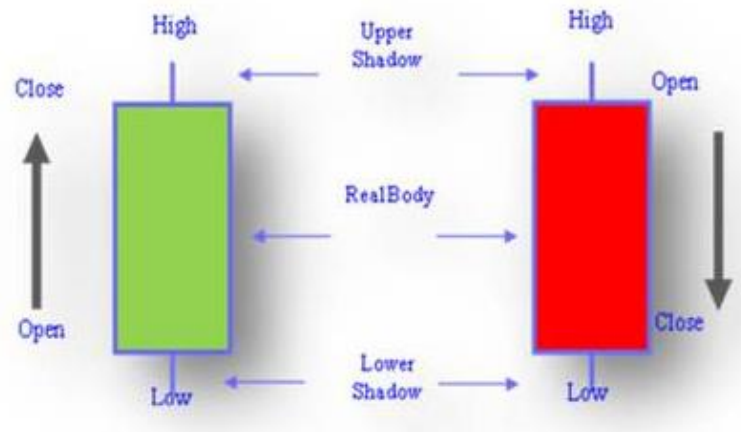

Figure 4 - Candle-Line

It is formed by a central body called **Real-Body**, which indicates the excursion of price between the open and close, and the **Shadows**, lines that represent the high and low prices of the time-frame used and called

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respectively **Upper Shadow** and **Lower Shadow**. As for the bar chart, we need open, close, high, and low.

The body of the candle can be black or white: we have a black body when the close is lower than the open, and that characterises a negative trend in the time-frame used. While, a white body shows a rising session, with the close higher than the open. Technically, the body is not coloured in white, but is simply blank, to facilitate the work of the computer.

That is only one of the adaptations that have been used when was exported the theory to the West. The Japanese use red instead of white for the bullish days. Today they are used in addition to the colours black and white even green (bullish days) and red (bearish days).

Figure 5 - Apple daily Candlestick chart (TradingView.com)

We can see an example of a candlestick chart in figure 5 above, again with Apple.

As mentioned, this representation of the price is more immediate. The colour of the body makes us immediately understand whether the market from the open to the close has risen (white or green candle) or has fallen (black or red candle). If the bullish traders have had the upper hand on the bearish ones or if the opposite occurred.

The candlesticks count several typical candle-lines that I am going to show, and more than 100 patterns that I will not explain because they are not subject to this e-Book.

By looking at the chart above, we can notice candles with different lengths and shapes. Some of them have a specific name, and they are very important if inserted within a determinate graphics context.

Here are the main.

Long candle. It is a candle-line with a long green or red body and two very short shadows (figure 6).
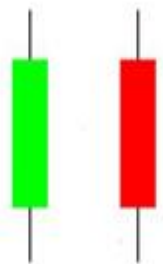

Figure 6 - Long candle

Short candle. It is a candle-line with a short green or red body and two very short shadows (figure 7).

Figure 7 - Short candle

Marubozu. It is a long candle-line with a green or red body and without the shadows (figure 8).

Figure 8 - Marubozu

Spinning Top. It is a candle-line with a very short green or red body and marked shadows. It indicates a phase of indecision in the market; it does not matter the colour of the body (figure 9).
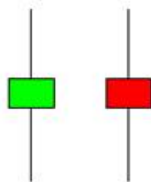

Figure 9 - Spinning Top

Doji. It is the most characteristic candle-line, marked by the open and

the close at the same level, or not far away. There are four different types of Doji. The first is the Long Legged Doji or Rickshaw Man defined by very long shadows. This particular Doji signals strong market indecision (figure 10).

Figure 10 - Long Legged Doji or Rickshaw Man

The Gravestone Doji is characterised by the only existence of a very long upper shadow. It should be treated as a strong negative signal, especially if identified in areas of market highs (figure 11).

Figure 11 - Gravestone Doji

Very similar to the former, the Dragonfly Doji with a single long shadow, the lower one, which leaves hope for a bullish scenario, particularly if it will be completed in areas of market lows (figure 12).

Finally, the fourth type, the less significant, with the open, close, high and low at the same level (although very rare, it would leave as to think there are almost zero exchanges), and that you can see below in figure 13.

Figure 13 - Doji with open, close, high and low at the same level

Those we have seen are the most used graphical representations of a market's price and related charts. But they are not the only ones. There are other kinds of charts, such as, for example, Heikin Ashi, Kagi, Point & Figure, and Renko.

CHAPTER 2

SOME TECHNICAL ANALYSIS

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Let's go on with the Technical Analysis; we will see in this chapter some concepts that are fundamental in order to understand correctly the strategy that I am going to explain.

One of the pillars of technical analysis is the concept that the market does not move in a completely erratic and unpredictable way, (random walk theory), but it moves following different patterns that can be identified by the analyst.

Charles Dow was a pioneer of the technical analysis. At the end of the nineteenth century, he studied the price movement, coming to formulate a theory that is still today an essential part of the technical analysis.

Dow has started his studies, by observing the shifting of the tides, noting some interesting analogies with the price trends in a free market. Just as the wave that is moving forward, recedes, and then going even further ahead, also the market moves similarly following the process of continuous advancement of the price until it reversals.

We have increasing trend phases (uptrend), characterised by increasing highs and lows, and decreasing trend phases (downtrend), marked by decreasing highs and lows. We can see an example, with the Eur-Usd daily chart. Highlighted in black the uptrend and blue the downtrend (figure 14).

Figure 14 - Eur-Usd chart (TradingView.com)

According to Dow, there are three main types of trends:

– the "**major**" trend, which lasts a few years;

– the "**medium**" trend, which lasts a few months;

– the "**minor**" trend, which lasts a few weeks.

The major trend is the tide, the medium trend is the wave, and the minor trend is the crashing of the wave.

It is therefore evident that there is not only one type of trend but different trends (one inside the other like the Chinese boxes) depending on the time-frame. The Dow theory could be completed by saying that the major trend, the medium trend, and the minor trend have variable durations, depending on the type of time-frame chosen.

So, the investor has to go in the direction of the main trend relative to the chosen time-frame, resisting the temptation to go against the current for trying to exploit the small rebounds and corrections.

Support and Resistance

By examining any chart, we can identify particularly critical levels, where the market seems to hesitate. On these levels, supply and demand face each other, until one of the two takes over.

A level is defined as "**support**" when the demand is particularly strong, and sellers cannot overwhelm it. A support level is all the more significant, the more times it has been tested in the past, but without being broken. Surely a historical low represents a significant support level.

So, the support reflects the inability of a market to drop below a certain price level. We can see an example of support above in the Silver daily chart (figure 15).

Figure 15 - Silver, support (TradingView.com)

Figure 16 - Tesla, resistance (TradingView.com)

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A level is defined as "**resistance**" when the offer is particularly strong, and buyers cannot win against the sellers. A resistance level is all the more significant, the more times it has been tested in the past, but without being broken. Surely a historical high represents an important resistance.

So, the resistance reflects the inability of a market to climb above a certain price level. We can see an example of resistance below in the Tesla daily chart (figure 16 above).

Supports and resistances over time tend to be broken through, in such cases, an old resistance becomes new support, and past support turns into new resistance. There is a *change of polarity*, as shown below in the Nzd-Jpy weekly chart (figure 17).

Figure 17 - Nzd-Jpy, change of polarity (TradingView.com)

That is explained by the fact that the market remembers past levels: sellers and buyers place their sales and purchase orders to specific technical levels, making them particularly important.

There are two types of support/resistance: <u>static</u> and <u>dynamic</u>.

- A "**static**" support/resistance level (that we have seen above) corresponds to a precise and constant point in time, such as the high and low of the year, or a Fibonacci retracement (we will see better them in the next chapter).

- A "**dynamic**" support/resistance level, instead, changes its value as time passes.

Figure 18 - Eur-Chf, trendlines (TradingView.com)

A typical dynamic support/resistance is the trendline, literally an (oblique) line that follows the trend. We can see an example below with the chart Eur-Chf (figure 18 above).

The first bearish trendline (resistance) touches the highs of the currency pair, while the second one bullish (support), the lows. The trendline is not the only type of dynamic support/resistance; there are other kinds. One of these is the moving average. Let's see what a moving average is.

Moving Average

A **moving average** is an indicator used by traders, and that is based on historical price trends. A moving average is calculated on a certain quantity of price data (time period) and is "moving" because it moves from day to day (or other time-frame) precisely because of its calculation method.

So, by way of example, if we want to calculate a 20-day moving average of the Eur-Usd price, to update it, it will be enough to add to the series the data of today's closing, eliminating the close price of 20 days ago.

In practical terms, a 20-day moving average represents the average value of the last 20 trading sessions, and each data will weight 1/20 of the series. The data that we will gradually add will affect the moving average to a lesser extent, the longer the time period will be considered. Thus, a 20-day moving average will be less affected by new data than a 5-day moving average, and more than a 100-day moving average.

Figure 19 shows the Home Depot chart with applied the 200-day exponential moving average.

Figure 19 - Home Depot, moving average (TradingView.com)

Look at how the price reacts when it reaches the moving average (support/resistance). Furthermore, it is excellent support until the price falls below it, and it turns in a resistance.

All the trading platforms currently on the market easily allow representing the moving average of a price. So, to visualise them on a chart, we no longer have to worry about using graph paper, pencil, and calculator, as the chart analysis pioneers did.

Complementing this introduction on the moving average, I add that there are different kinds of them depending on the formula used.

The Simple Moving Average (SMA) is the classic one, and that we have seen above. The Exponential Moving Average (EMA) and the Weighted Moving Average (WMA) are the others most used.

As said, in the **Simple Moving Average (SMA)**, each data will get the same weight in the series. If, for example, we use a 14-day SMA, each data will weight 1/14 of the series.

The **Exponential Moving Average (EMA)**, instead, gives more weight to the most recent data. This kind of moving average reacts faster to recent price changes than a simple moving average.

Finally, the **Weighted Moving Average (WMA)**. It gives more weight on recent data and less on past ones (similarly to the Exponential Moving Average). That is done by multiplying every single price by a weighting factor. Because of its unique calculation, WMA will follow prices more closely than a corresponding Simple Moving Average.

Breakout and Fakeout

In the long period, supports and resistances, both statics and dynamics, tend to be broken.

We have a **bullish breakout** when the price is able to break through a resistance level, starting a new uptrend.

There is a **bearish breakout**, instead, when the price manages to pierce a level of support, starting a new downtrend.

We can see an example of a breakout below, with the Amgen daily chart (figure 20).

Figure 20 - Amgen, breakout (TradingView.com)

Sometimes we have the misfortune to witness to a false breakout (fakeout) with the price rising above resistance, or going down under support, and then, it closes again under the resistance, or over the support. It can happen in a single session or two or more days.

I will not explain how to recognise fakeouts and to exploit them in

trading. It would take a long time, and it is not the argument of this e-Book.

We can see in the Eur-Aud chart below a couple of Fakeouts (figure 21).

In the first fakeout (bullish), the price closes above the resistance giving a bullish signal, but the day after, a red candle brings the price below the resistance.

In the second one (bearish), the price opens above the support, during the day goes below it, but in the end, it closes again above the support.

Retracement

A **retracement** is another important concept in trading, and it is a temporary reversal in the direction of a market's price that goes against the trend. A retracement does not signify a change of the trend. In practice, after an ample movement in the trend direction, they begin the profit taking. That is, most traders decide to take home the money they are gaining, and this determines, for a period of time, a movement against the trend.

A retracement represents an excellent opportunity to buy or sell at prices more convenient and to get into a market less tired. We can see an example below in the Aud-Usd chart (figure 22). During the uptrend (with higher highs and higher lows), the blue lines show the retracement phases of the price.

Figure 22 - Aud-Usd, retracements (TradingView.com)

The **pullback** is similar to retracement, and it is a falling back of a market's price from its peak, in an uptrend, or a rising back from its bottom, in a downtrend. Often pullbacks are seen as good buying or selling opportunities.

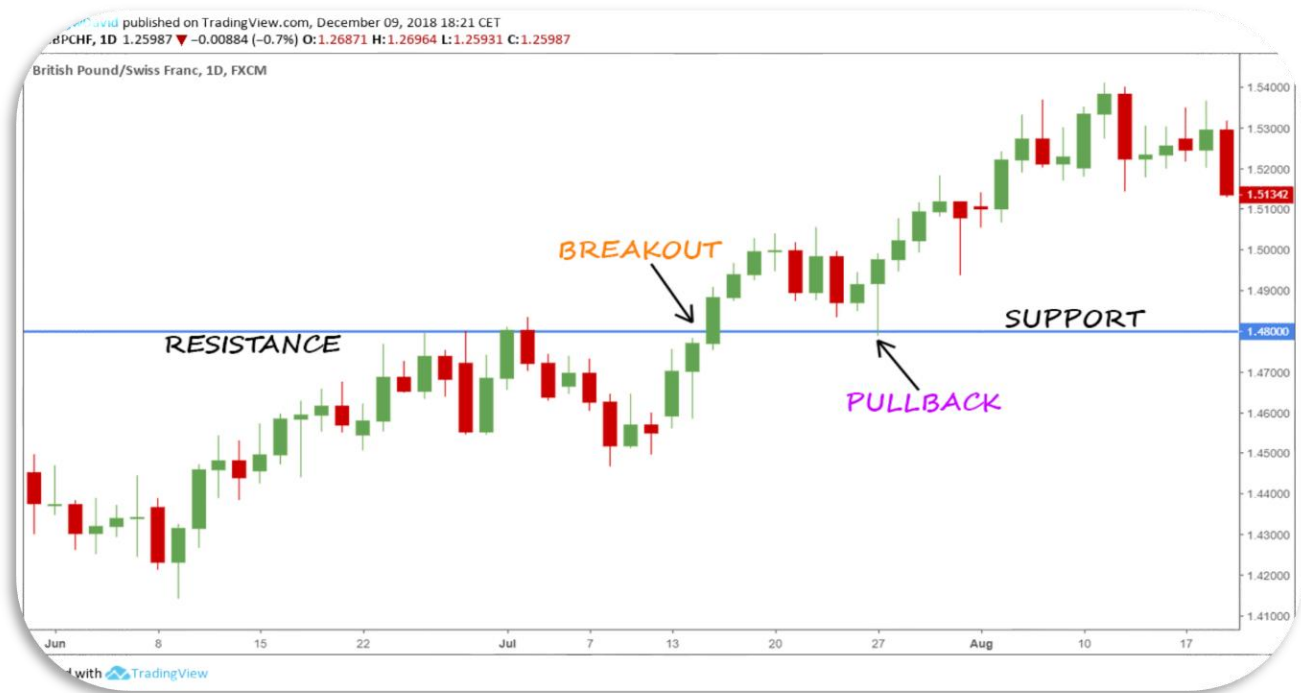We can see an example of a pullback in figure 23 below with the Gbp-Chf daily chart.

Figure 23 - Gbp-Chf, pullback (TradingView.com)

In the chart above, the price first breaks the resistance, and then it carries out a pullback retesting the old resistance (now support).

As said, pullbacks represent a good opportunity for buying or selling a market. This because they give the confirm of a breakout with an increase in the success rate of the trade, and as we will see, the signal of my strategy has given by the breakout of a trendline.

Windows or Gaps

A **window** (or more commonly gap) is a space between two candles (or bars), where shadows do not overlap in any way. The size of the window is not important. A gap is a symptom of euphoria and volatility. It can occur in all time-frames but, for my kind of trading, I am mostly concerned with the daily chart.

More precisely, a **rising window or gap up** occurs when there is a space between the previous candle's high and the current candle's low. The key support area is the bottom of the window (figure 24).

Figure 24 - Rising Window

A **falling window or gap down** occurs when there is a space between the previous candle's low and the current candle's high. The key resistance area is the top of the window (figure 25).
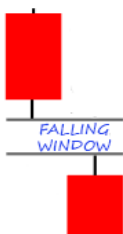
Figure 25 - Falling Window

In Forex, the only way to get a window is on Sunday when the market opens, and it is unlikely (but not impossible) that a window remains open for a long time. Most of the times, behind a window, there is news or event already considered by the market (buy the rumour, sell the news).

Only relevant economic events or very positive/negative news, the effect of which is destined to last for a long time, have the power to leave open a window on a currency pair.

I do not recommend to open a bullish trade after a rising window or a bearish one on after a falling window. Although not always the market will reverse its trend, a simple retracement may be sufficient to trigger our stop-loss.

Figure 26 - Usd-Cad, Rising Window (TradingView.com)

In stock markets, instead, windows are common, and they can depend on several factors: news, earnings, acquisitions, etc. The reason is that most of them come out when the markets are closed, and we get a tangible effect with the price that opens in strong rise or fall.

Let's see now some example. In figure 26 above, we can see the Usd-Cad 4-hour chart with a rising window (or gap up).

Below, instead, we can see a falling window in the Eur-Nzd 60-minute chart (figure 27), and the eBay daily chart with several windows (figure 28).

Figure 27 - Eur-Nzd, Falling Window (TradingView.com)

Figure 28 - eBay, Windows (TradingView.com)

Windows/gaps are interesting if they form during a well-established trend, while they have not great significance within congestion.

There are three types of gaps:

Breakaway Gap: it occurs when the price is breaking out of a trading range or congestion area. To break out of these congested areas requires market enthusiasm and, either, many more buyers than sellers for bullish breakouts or more sellers than buyers for bearish breakouts.

The volume will pick up significantly, for not only the increased enthusiasm but because many traders are holding positions on the wrong side of

the breakout and they need to cover or sell them.

Continuation Gap: sometimes called Runaway Gap or Measuring Gap, it is a gap caused by an increasing interest in the market. These types of gaps are also typically associated with a volume increase, but lots of volumes are not as important here as they are with breakaway gaps.

The runaway gap to the upside, it usually represents the traders who did not get in during the initial move of the uptrend, and while waiting for a retracement in price, they have decided it was not going to happen.

A runaway gap can also happen in a downtrend. That usually represents the increased liquidation of that market by traders who are still standing on their bullish positions.

Exhaustion Gap: it is the gap that occurs near the end of the uptrend or downtrend. It is many times the first signal of the end of that move. The high volume identifies it.

They can easily be mistaken for runaway gaps if the trader does not notice the exceptionally high volume.

In the next chapter, we will begin to get into the strategy, and we will see the Harmonic Patterns which I use in a particular way.

COMMODITY CHANNEL INDEX

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The Commodity Channel Index (CCI) is an indicator created and developed by Donald Lambert specifically for the study of commodities, but soon it was also adopted for the analysis of the other financial markets.

The function of the CCI is to measure the change in prices compared to their historical-statistical average to identify the highs and lows of the market cycles. The basic principle is simple and logical: to identify and highlight the anomalies and the euphoric-depressive excesses that have historically occurred in the financial markets.

High values of the Commodity Channel Index mean there is a too high price trend compared to its historical average. Likewise, too low values of the indicator indicate unusually depressed prices.

The logic, therefore, is to identify an excess in the prices and wait for a signal that warns that the market is realigning its values to the real ones.

Generally, the area of oscillation of the indicator varies between the values of -150 and 150. Extreme zones are considered levels of overbought (CCI>

100) and oversold (CCI <100).

We can see the Commodity Channel Index applied to the Walt Disney chart below in figure 29.

Figure 29 - Walt Disney, Commodity Channel Index (TradingView.com)

I will not talk about the signals that the Commodity Channel Index generates but how I use the indicator within the strategy that I am going to explain in the next chapter.

Even because, if the traditional use of indicators and oscillators explained in all the books and websites of technical analysis were profitable, there would not be so many traders that blow their accounts every month.

I look for the divergences that form in the extreme zones of the indicator, trying to anticipate a trend inversion.

What is divergence?

Divergence occurs when the price of an underlying asset is moving in the opposite direction of a technical indicator (for example there may be a divergence between the price and volume, or between the price and an oscillator).

In our case:

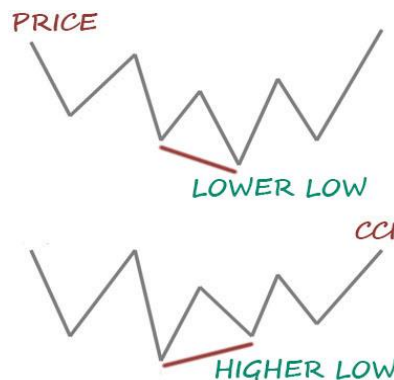When price makes a lower low, but the CCI makes a higher low, we have on the chart a **bullish divergence**, as shown in figure 30.

Figure 30 – Bullish divergence price and CCI

Conversely, when price makes a higher high, but the CCI makes a lower high, we have a **bearish divergence**, as we can see in figure 31.
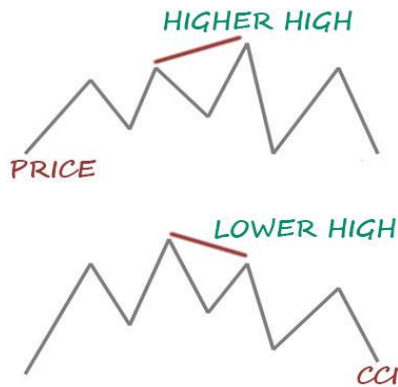
Figure 31 – Bearish divergence CCI and price

We can see a practical example of divergences in the Nvidia chart in figure 32.
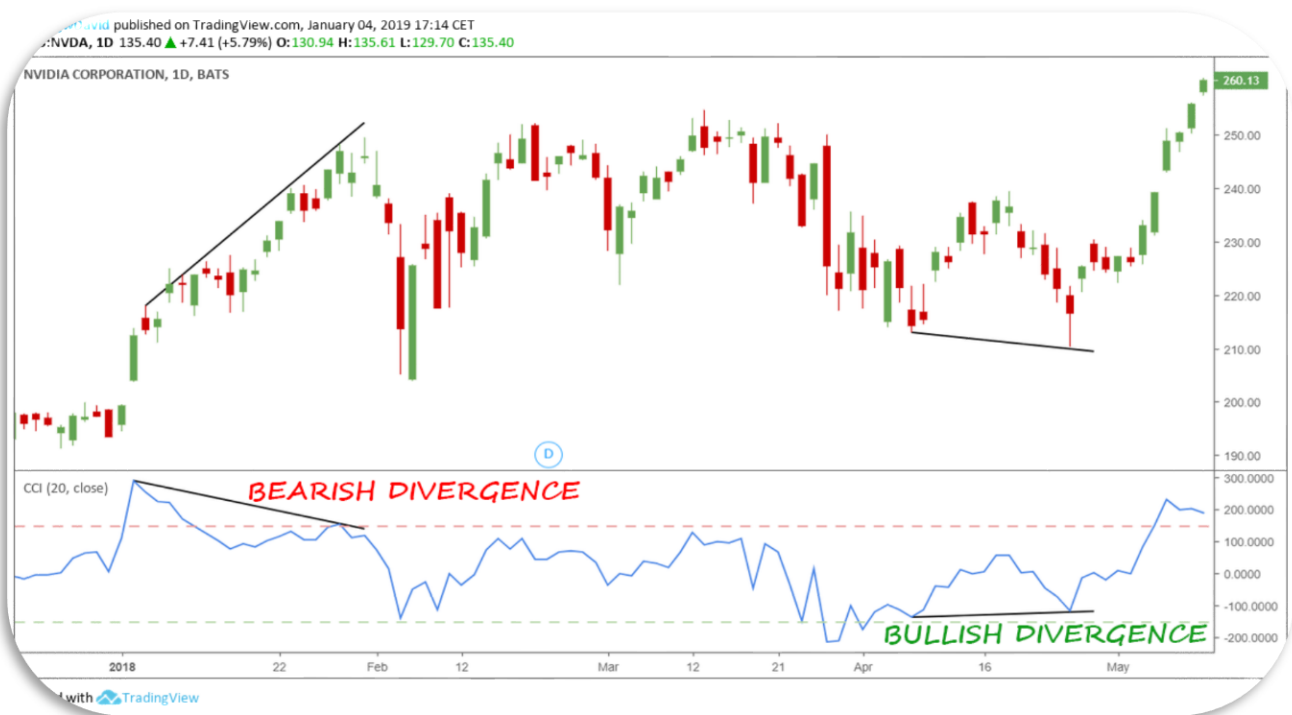

Figure 32 - Nvidia, divergences (TradingView.com)

The combination of the CCI divergences, trendlines, and a little of Fibonacci, makes up the strategy explained in the next chapter.

THE STRATEGY

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A divergence often anticipates the trend inversion or the slowdown of a violent directional phase. Divergences may occur between different instruments, such as price, volume, indicator, etc.

As we have seen in the previous chapter, I use the Commodity Channel Index (CCI), as it is an excellent aid in finding "anomalous" situations about the price trends. Moreover, using the overbought/oversold thresholds more "extreme" (+150/-150) of the Commodity Channel Index allows filtering many false signals.

Thus, the Commodity Channel Index, better than other indicators/oscillators, provides indications of bullish and bearish divergences, all the more valid if they occur in the excess zones (overbought/oversold) of the CCI (ideal range +150/-150).

Before starting to explain the strategy, first I would like, for simplicity and clarity, to show a chart with the Commodity Channel Index that visually summarises its meaning.

In Figure 33 below, we can see the Eur-Usd daily chart. The different zones of the indicator have different colours.

Figure 33 - Eur-Usd, CCI zones (TradingView.com)

Let's see now in detail the conditions under which a divergence should be formed. There are three simple rules of my strategy.

1. In a bullish divergence, the CCI should make the higher low in the oversold area below -150. In a bearish one, the indicator should draw the lower high in the overbought area above 150.

2. In a bullish divergence, the CCI should not rise above zero. In a bearish one, the indicator should not decrease below zero.

3. The second peak of the price should have a Fibonacci extension of 1.13, 1.272, 1.414, or 1.618. Over 1.618 the pattern is cancelled.

However, they are not strict rules; some small exceptions are granted. But let's see them in practice with some examples.

The **first rule** establishes the zone of the Commodity Channel Index in which the divergence should be formed: below -150 (bullish divergence), and above 150 (bearish divergence). Let's see better in practice this aspect with two examples.

Below, we can see in figure 34 a bullish divergence with the JD.COM daily chart, while in figure 35, a bearish divergence is formed in the Eur-Nzd daily chart.

Figure 34 - JD.COM, bullish divergence (TradingView.com)

Figure 35 - Eur-Nzd, bearish divergence (TradingView.com)

The ideal situation is when divergence is formed in the area of oversold (bullish) or overbought (bearish). However, we can also accept an exception. The completion of the divergence (the second high or low) can take place slightly outside the areas mentioned above like is happened in the Eur-Nzd example above.

The **second rule** says that in divergence, the Commodity Channel Index shall not go beyond zero, as shown below in figure 36 with Eur-Chf chart.

As we can see from the chart above, the CCI never rises above zero during the divergence.

Figure 36 - Usd-Chf, bullish divergence (TradingView.com)

Figure 37 - Eur-Nzd, bearish divergence (TradingView.com)

Even with this rule, we can accept a little exception. We can tolerate a minimum overrunning of the zero. The important thing is that it does not have to be deep, and it takes place for a very short time. We can see an example in figure 37 above, again with Eur-Nzd daily chart.

Finally, the **third rule**. Well, for sure, it is easier to explain with an example than with words, so look at the Usd-Cad daily chart (figure 38).

Figure 38 - Usd-Cad, bearish divergence (TradingView.com)

We have to calculate the Fibonacci extension of the last retracement, in the example above AB. The final peak should have an extension from 1.13 to 1.618 (it means: 1.130, 1.272, 1.414, or 1.618) of AB. Over 1.618 the pattern is

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cancelled.

It is nothing complicated; every platform has the function to draw the Fibonacci retracements/extensions. With the practice, everything about the strategy will become familiar.

Let's see now when to open a trade, and how to calculate stop-loss and target. The mere divergence is not in itself a valid signal to open a trade. It may also be possible that the divergence continues in the next days/weeks, and the price may touch new lows/highs. There is need something that generates a stronger signal.

Let's see the example of the Eur-Nzd daily chart in figure 39.

Figure 39 - Eur-Nzd, bearish divergence (TradingView.com)

All we have to do is draw the trendline resistance (in a bullish divergence) or support (in the bearish one). The trendline breakout will give the signal to open the trade.

The blue arrow indicates the candle that breaks the Eur-Nzd dynamic support and gives the sell signal. There are more or less aggressive strategies for decide the trade entry. The more aggressive is to open the position when the price crosses the trendline. In this way, we are surely inside the trade if it should develop positively, but we risk being the victim of a false breakout (fakeout).

A less aggressive strategy is to wait for a close of the price beyond the trendline before opening a trade. The entry price will be worse, it will be lower than the more aggressive strategy seen above, but in this way, at least part of fakeouts will be avoided.

Figure 40 - Eur-Chf, bearish divergence (TradingView.com)

So, the breakout of the trendline resistance/support gives us a significant signal because, once a divergence was formed, there is no guarantee that the price rebounds/reverses its trend, but can continue to move as it did so far.

Look at the Eur-Chf daily chart above in figure 40. The price, after the divergence and a short retracement, has continued to rise. However, it did not break the trendline support not generating any signal.

Even before clicking on "buy" or "sell" on the platform, we have to decide where to place the stop-loss and the target price.

Figure 41 - Aud-Cad, stop-loss (TradingView.com)

The stop-loss is the easiest to determine and should be placed 15-20 pips/ticks below the last low (in a bullish divergence) or above the last high (in a

bearish one) hit by the price. In the example of the Aud-Cad daily chart in figure 41 above, we can see it placed 15-20 pips below the last low of the currency pair.

As regards the target, I still use Fibonacci. A 127.2% extension of the movement started with the last retracement of the price, gives to me the first target, where I close half position and move the stop at break-even. A 161.8% extension identifies the second and last target.

We can see better how to calculate the correct Fibonacci extensions in figure 42 with the Eur-Nzd daily chart.

Figure 42 - Eur-Nzd, targets (TradingView.com)

So, at 1.68741 (127.2%) we close half position, and at 1.67598 (161.8%) the other half (obviously, we may round up or down the values). Now, to complete the chapter, let's see a series of other examples.

A bearish divergence on Eur-Nzd chart in figure 43 (already seen).

Figure 43 - Eur-Nzd, bearish divergence (TradingView.com)

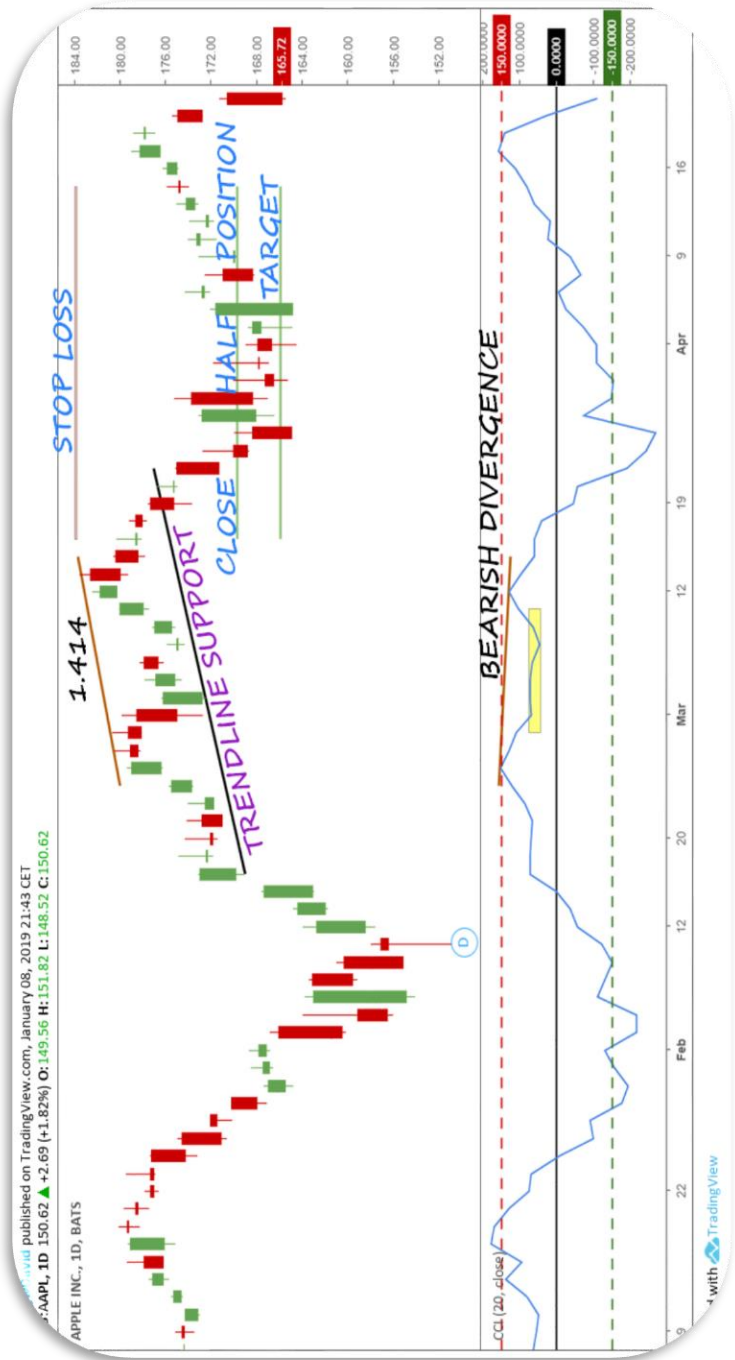A bearish divergence on the Apple chart in figure 44.

Figure 44 - Apple, bearish divergence (TradingView.com)

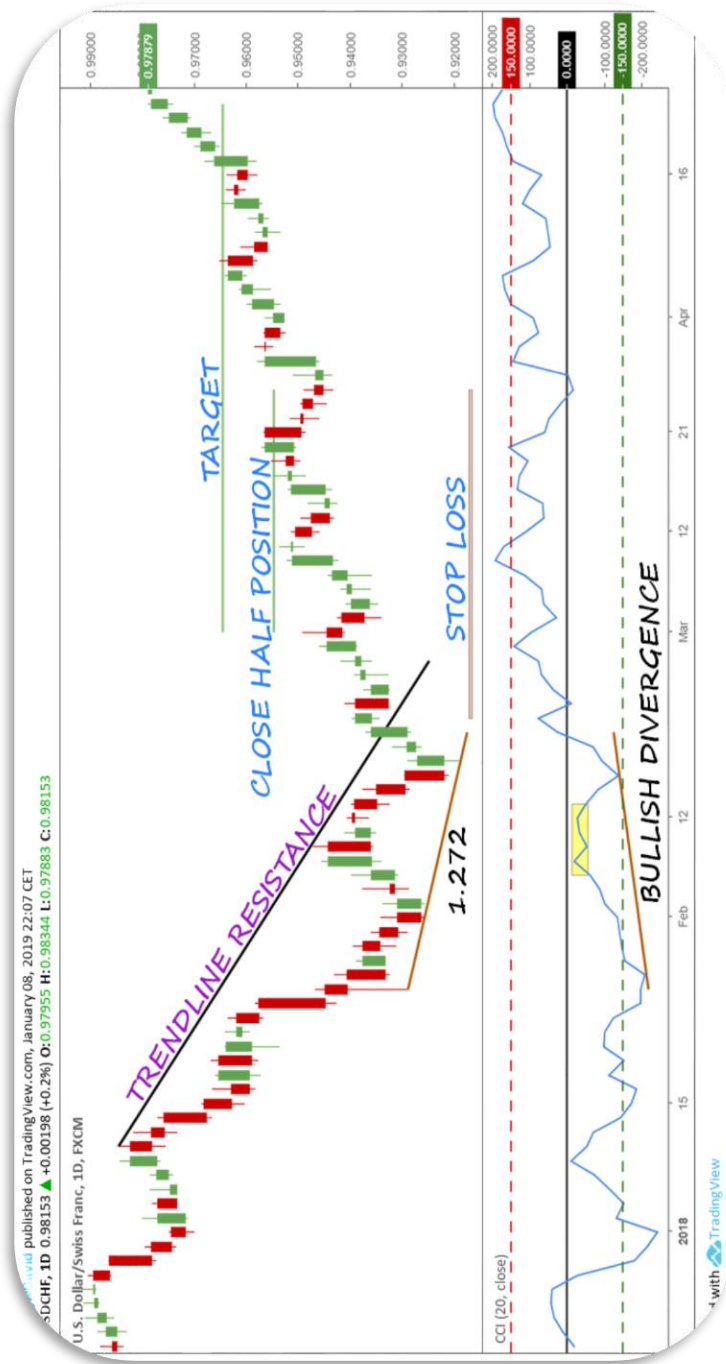A bullish divergence on Usd-Chf chart in figure 45.

Figure 45 - Usd-Chf, bullish divergence (TradingView.com)

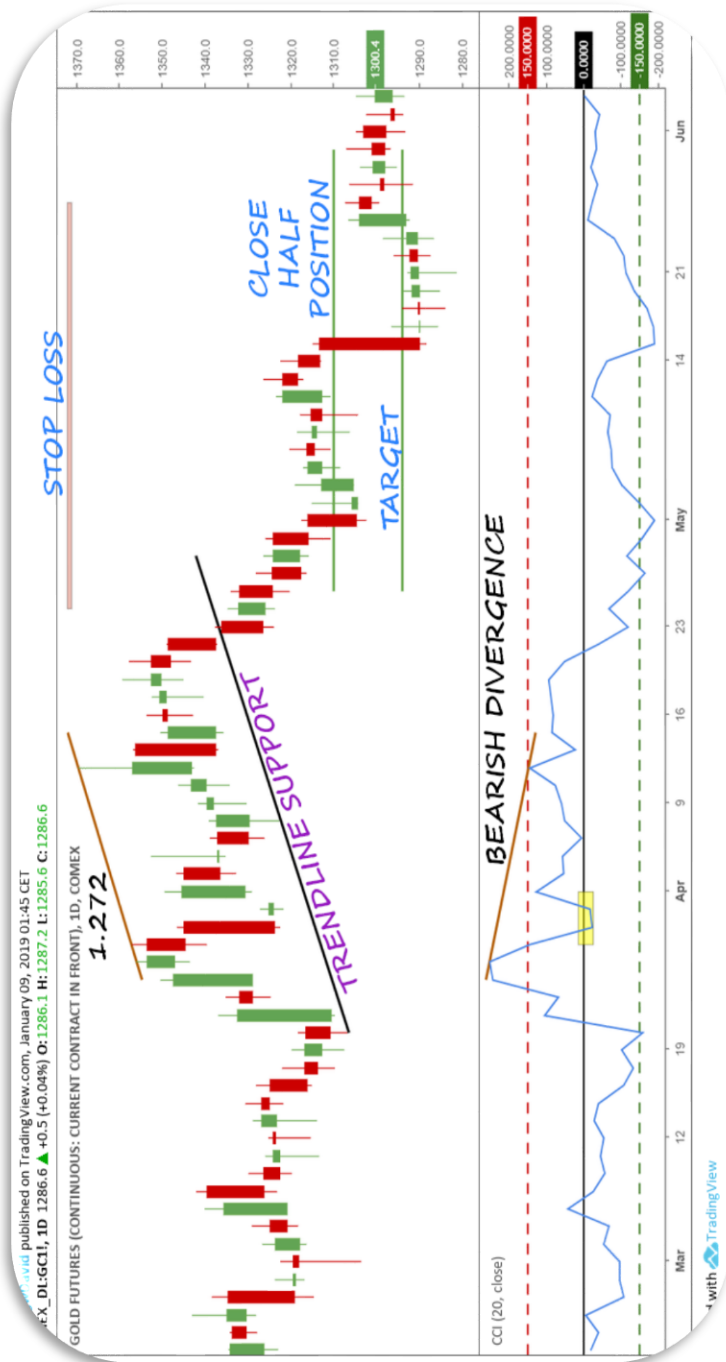A bearish divergence on the Gold chart in figure 46.

Figure 46 - Gold, bearish divergence (TradingView.com)

A bearish divergence on Gbp-Usd chart in figure 47.

Figure 47 - Gbp-Usd, bearish divergence (TradingView.com)

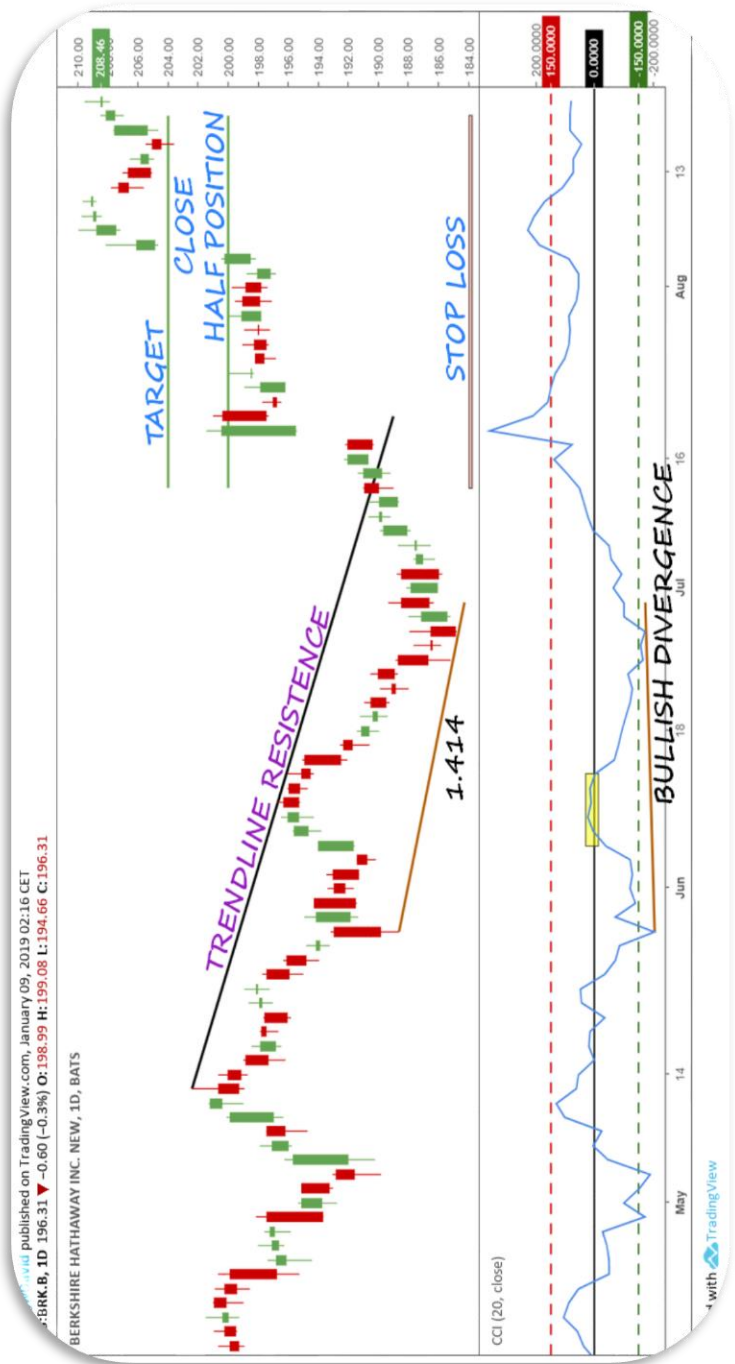A bullish divergence on Berkshire Hathaway chart in figure 48.

Figure 48 - Berkshire Hathaway, bearish divergence (TradingView.com)

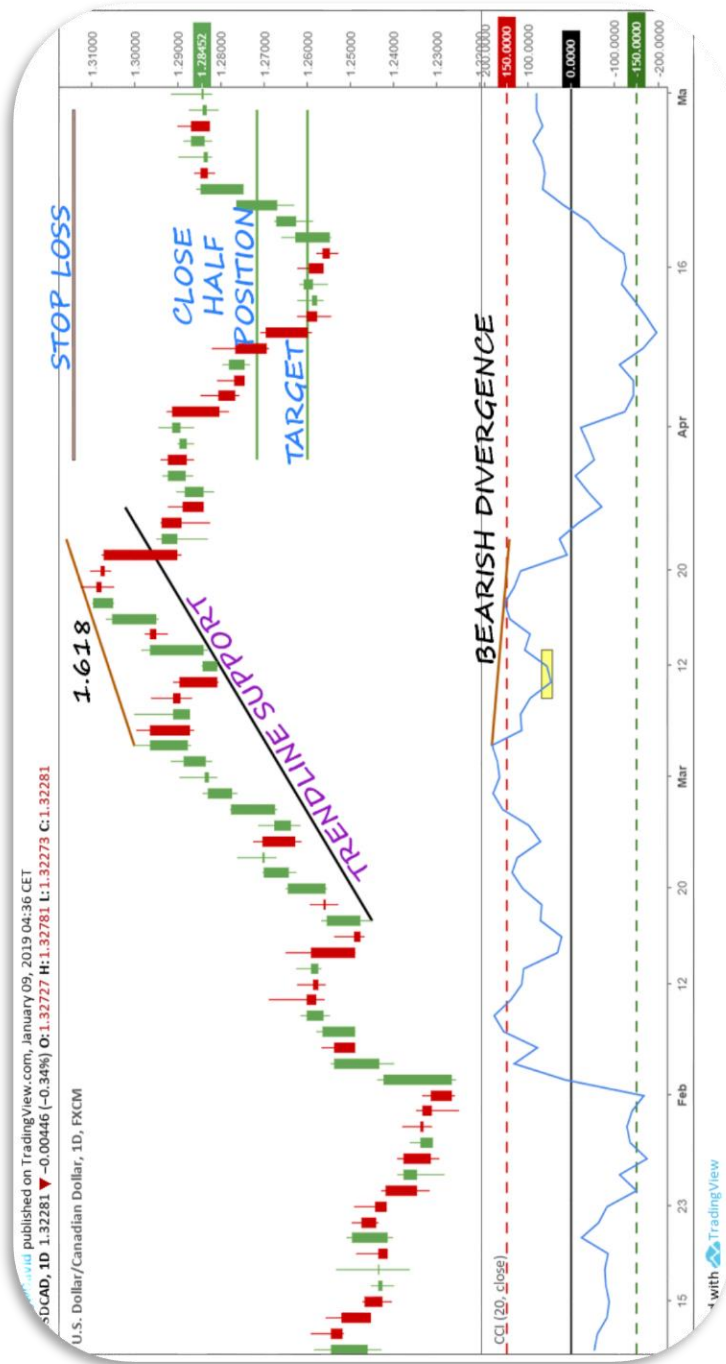A bearish divergence on Usd-Cad chart in figure 49.

Figure 49 - Usd-Cad, bearish divergence (TradingView.com)

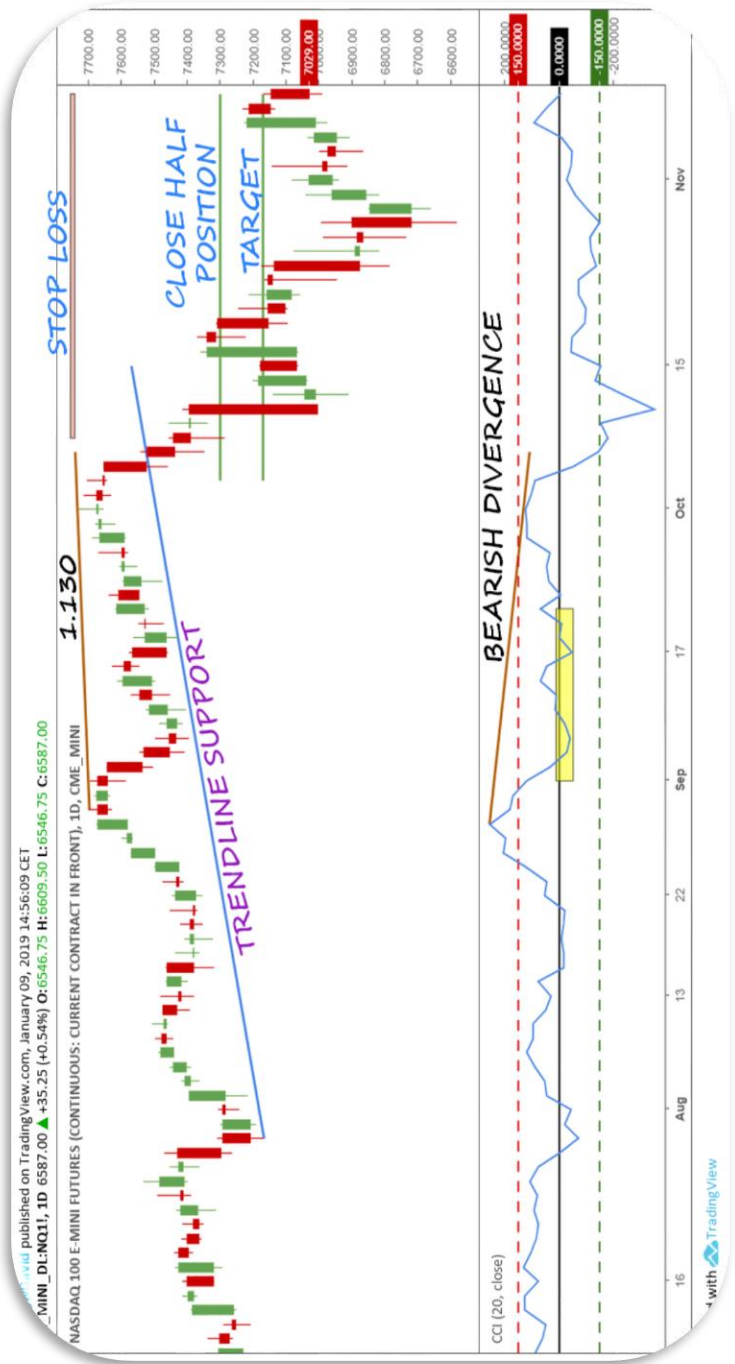A bearish divergence on the Nasdaq 100 futures chart in figure 50.

Figure 50 - Nasdaq 100 futures, bearish divergence (TradingView.com)

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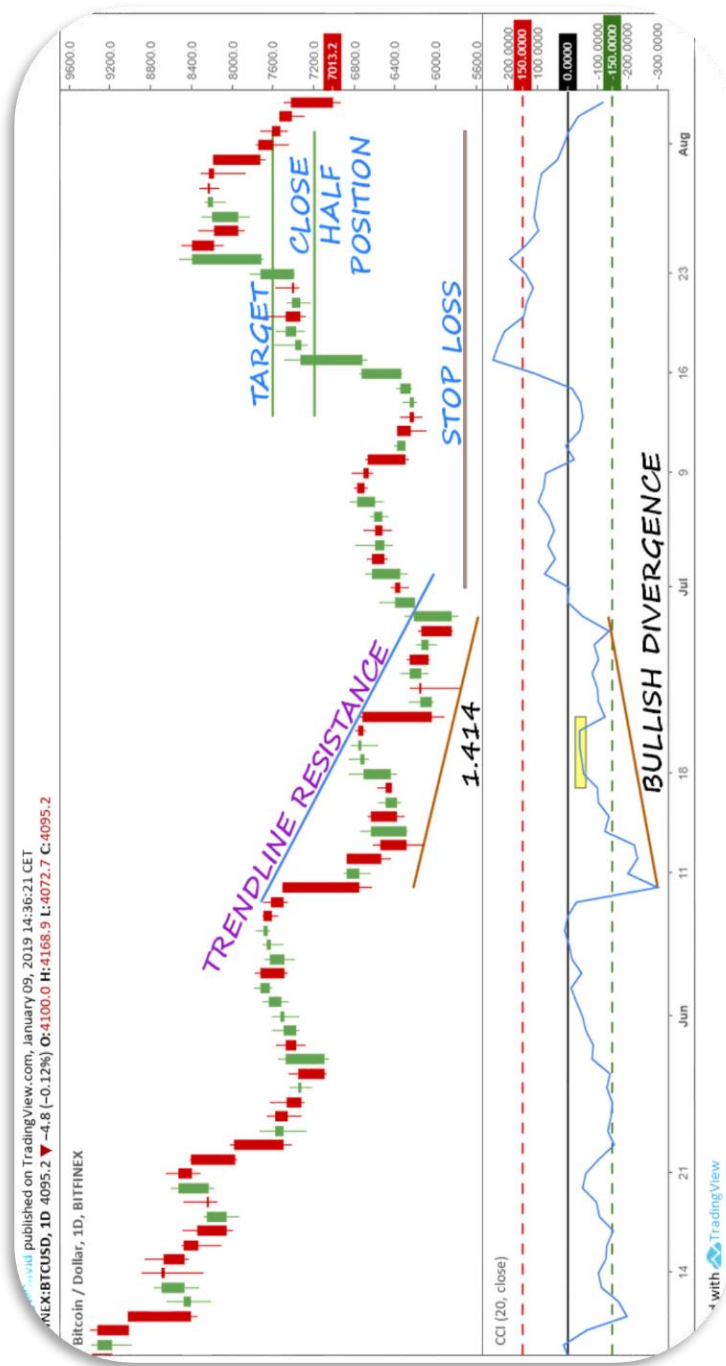A bullish divergence on BTC-Usd chart in figure 51.

Figure 51 - BTC-Usd, bullish divergence (TradingView.com)

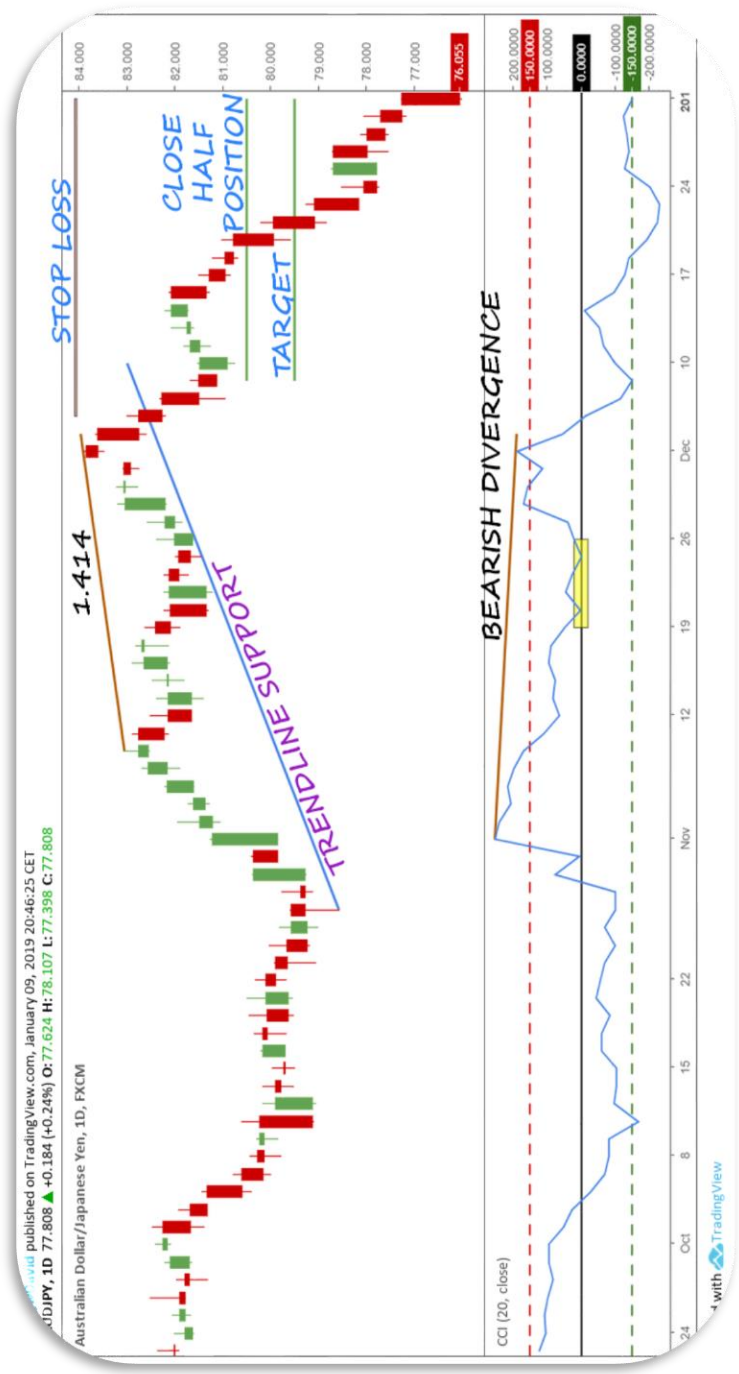A bearish divergence on Aud-Jpy chart in figure 52.

Figure 52 - Aud-Jpy, bearish divergence (TradingView.com)

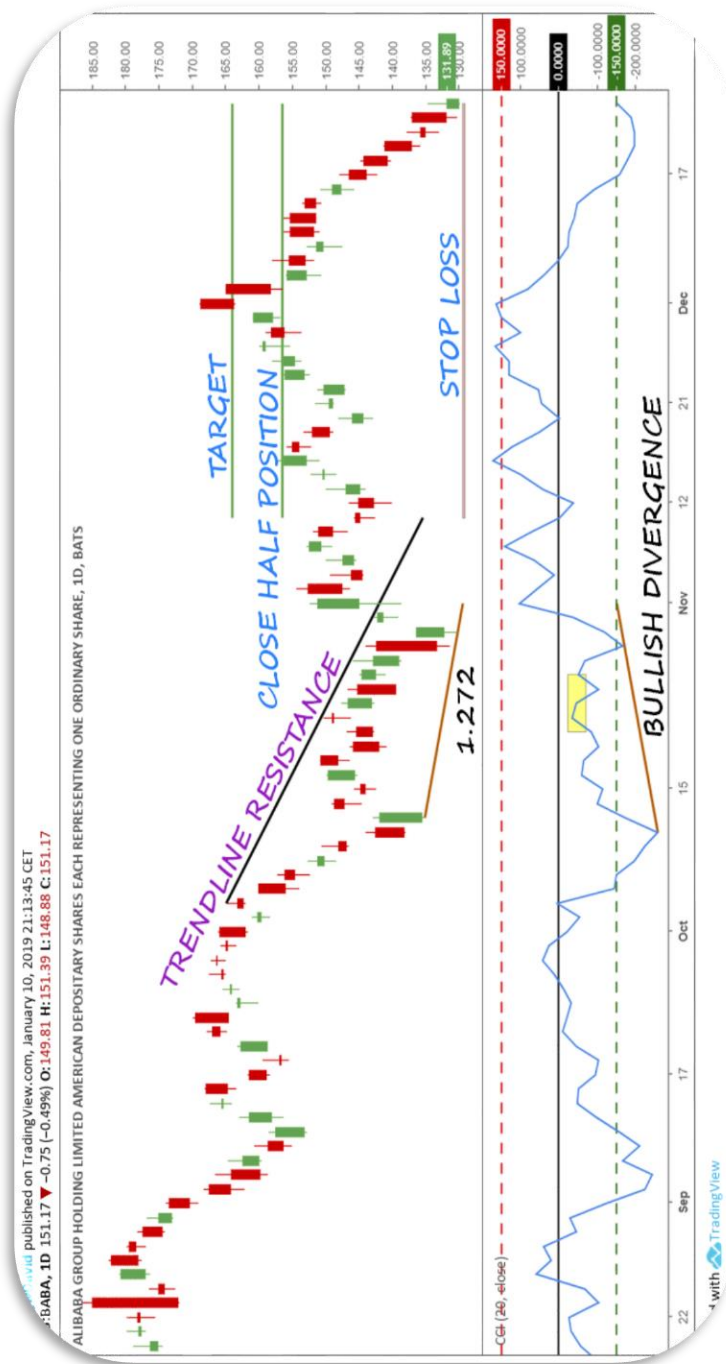A bullish divergence on Alibaba chart in figure 53.

Figure 53 - Alibaba, bullish divergence (TradingView.com)

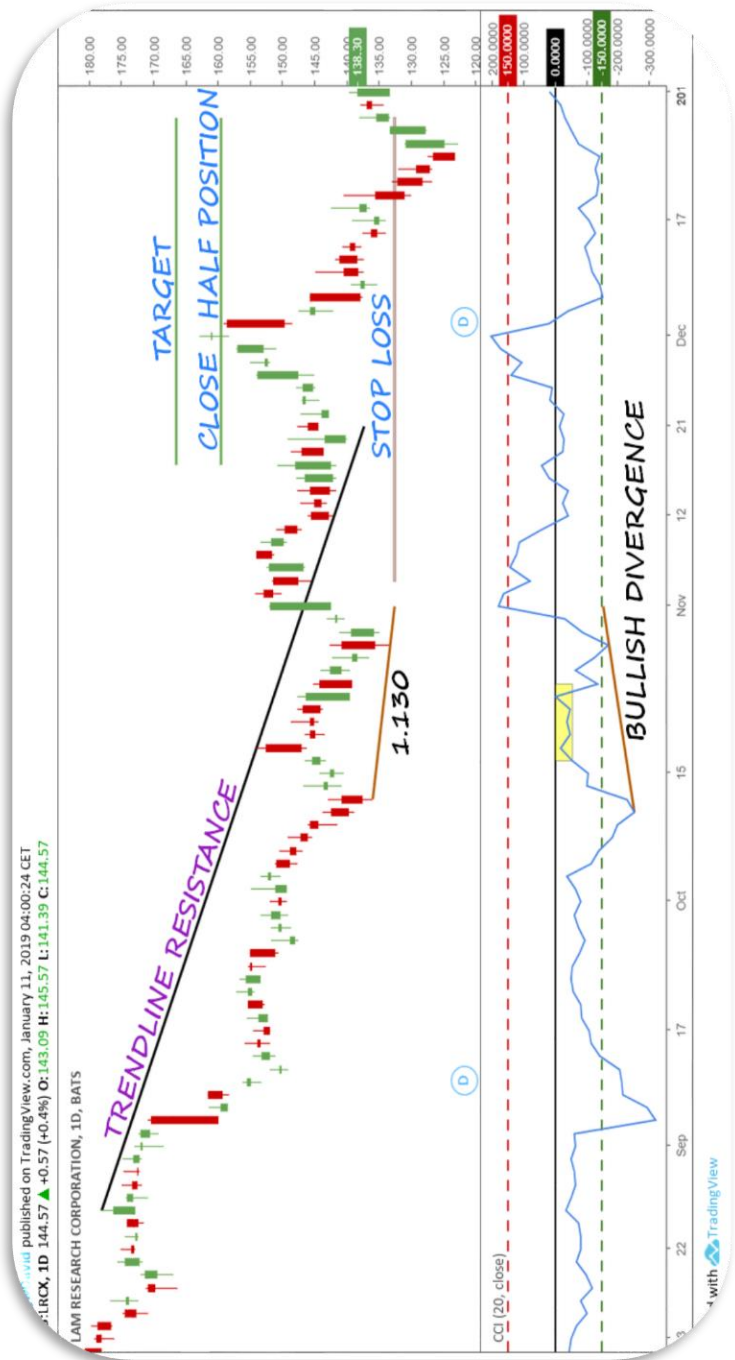A bullish divergence on the LAM Research chart in figure 54.

Figure 54 - LAM Research, bullish divergence (TradingView.com)

The target is the only aspect of the strategy that can be modified according to our kind of trading. We are free to decide where to take profit. What is essential is that the Risk/Reward is at least 1:1.

We can also decide to leave open a part of the position, by trying to ride larger movements. The method we saw applied in the examples above is the one that best suits my type of trading, and that gave me the best results.

As we can see with the last example, not always the price hits my target. The market movement may stop first. With my system, I am sure to take home at least part of the "virtual" gain, and moving the stop at break-even, I will no longer risk anything

I am going to close the chapter with a couple of clarification. I did not talk about the Commodity Channel Index setting. I use it with a 20-period, but we can set it as we prefer, i.e., with the 14-period (usually the default setting) or other value. It is evident that a different period of the indicator can give different signals.

Another aspect is the time-frame. As I wrote at the beginning of the chapter, a divergence often anticipates the inversion or slowing of a violent directional phase. The higher the time-frame, the greater the importance and the profundity of the movements that could follow.

I use this strategy most of all, on a daily time-frame. Rarely on the 4-hour time-frame, never on the lower ones. I also sometimes use the weekly time-frame; the signals are excellent even though the completion of the trade takes a long time.

What we have seen, therefore, is the strategy I use with divergences,

a very simple and clear strategy. In the next chapter, we will see how to open the correct position size. Fundamental argument that most traders ignore.

MONEY MANAGEMENT

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In this chapter, I will not talk about money management as a whole, it would be impossible in just a few pages, but a part of it, and precisely the Position Size. That is, based on the stop-loss we have decided, and the maximum loss that we are willing to suffer if the price reaches it, what should be the correct position to open.

As I specified at the beginning of the e-Book, this strategy can be used in all the financial markets. There are different ways to calculate the position size, depending on the type of market. Below we are going to see the calculation for Shares, CFDs, and ETFs, and then, the one for Forex.

Stocks, CFDs, ETFs

Regardless we operate with Stocks, CDFs or ETFs, the calculation is simple and always the same. Below we can see the formula:

Number of shares (LONG) = Max loss / (entry price – stop-loss)

Number of shares (SHORT) = Max loss / (stop-loss – entry price)

So, if for example, we open a long position on Twitter with entry price $ 31.00 and stop-loss to $ 28.00, and our maximum loss is $ 400, the number of shares to buy is:

Number of shares (LONG) = Max loss / (entry price – stop-loss)

So:

Number of shares = $ 400 / ($ 31.00 – $ 28.00) = 133.34

According to our maximum loss and stop-loss, the number of shares we have to buy is 133. If the price reaches the stop-loss, we will lose $ 400.

If instead, we establish the maximum loss not with a fixed amount of dollars (or in other currency) but with a percentage, the formula varies as follows:

Nr. of shares (LONG) = (capital * %of max loss) / (entry price – stop-loss)

Nr. of shares (SHORT) = (capital * %of max loss) / (stop-loss – entry price)

Where **capital** is the amount of money in our trading account and **%of max loss** is the maximum percentage of the money (of our account) we are willing to lose in the trade.

If for example we have an account of $ 60,000 and we decide to open a short position on Apple with entry price $ 240.00 and stop-loss at $ 245.00, and our maximum loss is 0.5% of the money in our account, the number of shares to sell is:

Nr. of shares (SHORT) = (capital * %of max loss) / (stop-loss – entry price)

So:

Number of shares = ($ 60,000 * 0.5%) / ($ 245.00 – $ 240.00) = 60

In, according to our percentage of maximum loss and our stop-loss, the number of shares we have to sell is 60. In this way, if the price hits the stop-loss, our loss will be exactly the amount we have established, $ 300 (which correspond to 0.5% of $ 60,000).

Let's see now, the formula for calculating the position size in Forex.

Forex

Now, I am going to show how to open a proper Forex position on the basis of our risk appetite. In such a way, even though the currency pair reaches the stop-loss, this will not create any problems for our account and cause stress for us.

For example, we have analysed the Gbp-Jpy daily chart, and we are determined to sell the currency pair with an entry level at 142.000, a stop-loss at 143.500, and a target at 139.000. Our maximum loss bearable is $ 300. How much do we have to invest in this trade? We obtain the position size to open with this formula:

Position Size = [(1,000 * max loss) / pips of stop] / value 1 pip

Where: **max loss** is our maximum bearable loss ($ 300); **pips of stop**

is the distance in pips from the entry price to the stop-loss (150 in our example); the **value of 1 pip** is the minimum value of a pip for $ 1,000 of purchase/sale of the currency pair (in the example Gbp-Jpy).

For this last parameter, for calculating the value of 1 pip of a currency pair, you can use the tool available on <u>my website</u>. In the alternative, on the <u>Myfxbook</u> website, where it will be enough to select the currency in "Account Currency", 1,000 in "Trade Size" and after to click on "Calculate." In this way, in the table below, you will get the last column that will show you the minimum value of the pip to be used for each currency pair.

Returning to the example, the position size to open is as follows:

Position Size = [(1,000 * max loss) / pips of stop] / value 1 pip

So:

Position Size = [(1,000 * $ 300) / 150] / 0.09 = $ 22,222

The position to open is, rounded, of $ 22,000. I rounded down the result, but we can decide to round the amount as we prefer. A trade that, in the case the price hits the stop-loss, will cause us a loss of $ 300.

Even here, if we establish the maximum loss not with a fixed amount in dollars (or in other currency) but with a percentage, the formula varies as follows:

Position Size = [(1,000 * (capital x %of max loss)) / pips of stop] / value 1 pip

Where, as we have already seen, **capital** is the amount of money in our

trading account, and **%of max loss** is the maximum percentage of the money in our account we are willing to lose in the trade.

If for example we have an account of $ 50,000 and we decide to open a long position on Eur-Chf with entry price to 1.1720, stop-loss to 1.1580, and our maximum loss is 0.75% of our account, the position size to open is:

Position Size = [(1,000 * (capital x %of max loss)) / pips of stop] / value 1 pip

So:

Position Size = [(1,000 * ($ 50,000 x 0.75%)) / 140] / 0.10 = $ 26,785

The position to open is, rounded down, of $ 26,000. This trade that, in the case the price hits the stop-loss, will cause us a loss of $ 375, that is 0.75% of our account.

Now that you have learned which are the formulas for the correct calculation of the position size, I tell you that on my website, there are a couple of free tools that have this function.

Two **Excel Spreadsheets** that, once entered all the parameters, will automatically calculate the position to open. In Appendix A, you will find summarised all the links of this e-Book.

What you have seen in this chapter is only a part of your money management and trading plan. Remember that you always have to put yourself in the best conditions to trade.

FINAL COMMENTS

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What you have seen explained in this e-Book is the correct way to use divergences in trading. Do not be tricked by the fact that I distribute this e-Book for free. The strategy, if used correctly, and with appropriate money management to your account, it will give you a very high percentage of trades closed in gain.

Mere divergence, by itself, does not mean anything; it can also continue for weeks. It needs a confirm for generating the signal. You get this confirm by the breakout of the trendline support or resistance of the price. But that is not all. Three fundamental rules establish which are the better divergences to trade, the ones that give a high odd of success.

You have also seen, I work with the divergences between the price of an underlying asset and an indicator, the Commodity Channel Index (CCI). I use the CCI as the indicator because I have noticed over the years, that it provides excellent quality signals.

The strategy works on all the time-frames, even though greater is the time-frame and more accurate are the signals. I apply it, apart from a few rare exceptions, on daily charts.

As I said, this strategy generates a high percentage of trades closed in gain. But no strategy is perfect, trades that will go in the opposite direction of that dictated by the signal, albeit a few, will always happen.

I want to show you a trade that I did with Amazon. Below in figure 55, you can see the daily chart.

Figure 55 - Amazon, bullish divergence (TradingView.com)

In this case, a couple of days after I bought the shares, Amazon came back down and hit the stop-loss.

This example aims to encourage you to respect always all the rules you have seen explained. The strategy is profitable only if you are disciplined in applying it. And furthermore, it gives me the opportunity, at the end of the e-Book,

to repeat a concept which I consider to be very important.

What I have explained to you is a good strategy but, after all, is just a graphical strategy, and a data, news, rumour can spoil you the party, pushing the market in the opposite direction to your trade. For this reason, it is always essential to insert, as you have seen in the examples, the stop-loss.

Because remember, in trading it is not enough to have a good strategy, what really makes the difference is how you manage the whole operation, especially those that go in the wrong direction (therefore the losses). For this reason, that in my e-Books, I always insert a chapter on Money Management, in particular, the part concerning the Position Sizing.

If you open a position and you are stressed, nervous, ask yourself why. At least in 90% of cases, the reason is due to a heavy loss in case the market moves against your trade. Unfortunately, the ever-widening leverage applied by the brokers makes it possible to open large trades with a few money, and this inevitably leads to losing all the money you have on the account if it has not been used appropriate money management.

Even though some advertisements emphasise the fact that with the leverage you can trade using some pocket change, the reality is very different. It takes money to do trading: for increasing an account of $ 1,000 into $ 100,000 takes a lot of time. The more you increase the percentage of monthly earnings, and the more you increase the risk; until you lose your one thousand dollars.

You have to protect your money, not trivially risk it with operations in "gambling-style." To get it, you have worked, struggled, and it would be foolish

to throw it away by giving it to the markets. Earning money with trading is possible, but you need a method and a lot of discipline.

And here I stop otherwise I could spend hours writing about discipline, money management, behavioural finance, etc. I only wanted to underline this fundamental principle yet again.

The e-Book has come to an end. This strategy that exploits the divergences gives me a lot of satisfaction, and I am sure that, if you use it correctly, it will give you the same satisfaction.

Thanks for your time spent reading my book. I really hope what you read could help your trading.

Happy Trading to you all!

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