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MACD INDICATOR Moving Average Convergence Divergence Part Two

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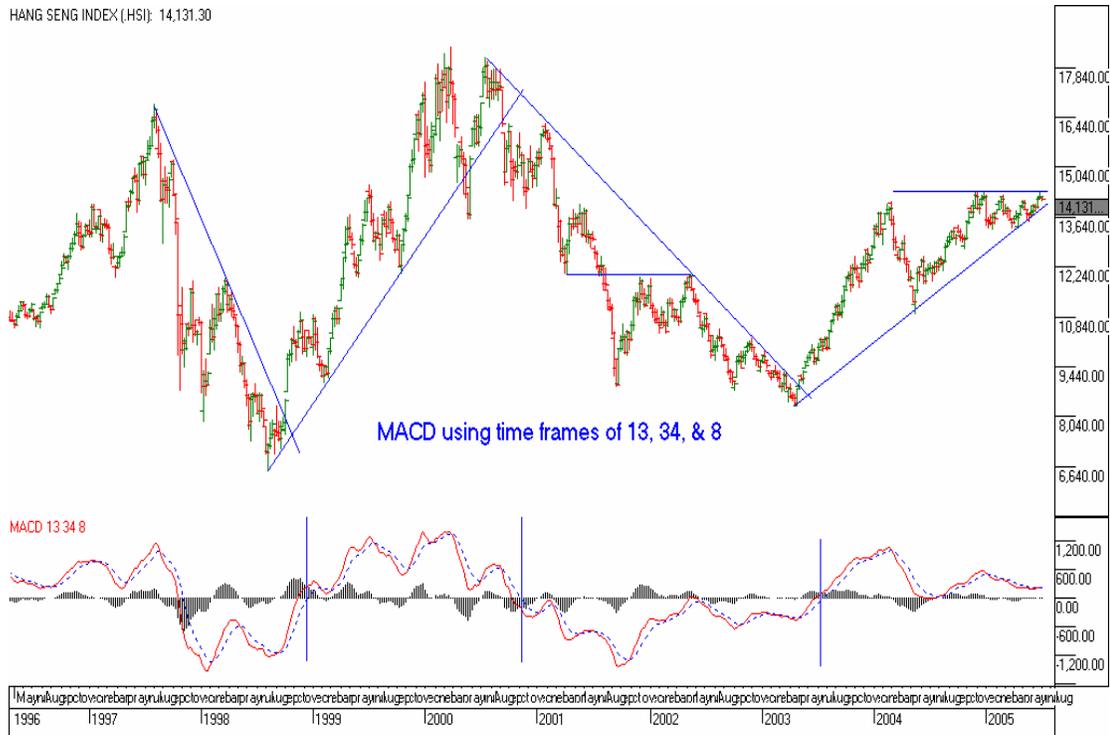
In the first part of this article we discussed how MACD was calculated and then began to discuss the various methods we can use to interpret this indicator. Continuing on from this and using the same charts we used in the first part of this article. It was established the default settings for the MACD indicator was 12, 26 and 9 exponential moving average and increasing the time frames using the Fibonacci number series to 13, 34, and 8 had the effect of smoothing the indicator and gave less false signals.

It was mentioned that the buy signal from the MACD indicator occurs when the fast MACD line rises above the slow signal line and that ideally the buy signal generated by the averages should be occurring below the histogram, and sell signal from the averages should occur above the histogram. While this won't always be the case, if it does we then have the option to use another interesting aspect to this indicator to help back up and confirm the buy or sell signal the indicator has generated.

To confirm the buy and sell signal from the MACD averages simply wait for both averages to cross through the zero line of the histogram. By doing this it will add further weight to the significance of the buy or sell signal and give you a second chance to open a position usually still in the early stages of the new emerging trend.

A close study of the chart of the Hang Seng shows both averages crossing through the zero line of the histogram not too long after each break of the trendline, allowing users of this method to identify major reversal points and to open positions still in the early stages of the new emerging trend. Also note how reliable this method has been in identifying the last three major moves on this index and how increasing the time to 13, 34 and 8 resulted in no false signals being generated from the indicator using this method.

HANG SENG INDEX (HSI): 14,131.30



Taking this concept now even further, it was previously established that as long as both of the MACD averages remain above or below the zero line of the histogram the overall up or down trend is strong and likely to continue. During this trend the averages will often cross above and below each other, but as long as both averages are still holding above or below the zero line of the histogram the trend overall is still strong and likely to continue. It's not until both the averages cross through the zero line of the histogram that indicator would suggest that the overall trend is over.

Confirmation of a break of trendline would usually have occurred by this stage, and can be valuable information when trying to let your profits run in a trade or for people who try to trade or capture intermediate moves.

Expanding further on this idea now, if it's agreed that when both the MACD averages remain above or below the zero line of the histogram we are looking at a strong trend in that direction that is likely to continue, we can then use this information to suggest what the market is likely to do when it approaches key levels of support or resistance.

This concept now changes the idea of MACD being a lagging indicator and now suggests a method of how MACD could be used as a leading indicator to forecast how markets will handle key levels of support or resistance when they get to them.

Taking another look at the first chart of the Hang Seng Index you can see looking at the very right hand side of the chart a very clear horizontal level of resistance. This is the position the Hang Seng was in at the time the first part of this article was originally published.



Looking now at the MACD indicator, at the time the Hang Seng was approaching this key level of horizontal resistance both the MACD averages were above the zero line of the histogram suggesting the underlying uptrend was still strong and likely to continue.

Referring now to the second updated chart, this is exactly what the Hang Seng index went on to do, later using this level as support before continuing higher making higher peaks and higher troughs and at the time of writing is still holding above its rising trendline with both MACD averages still holding above the zero line of the histogram suggesting a strong underlying trend that's likely to continue.

The other method that can be used to make MACD more of a leading indicator is known as Divergence. Divergence occurs when the chart does one thing and the indicator does the complete opposite.

An example of divergence would occur if the chart makes a lower trough but the indicator makes a higher trough or if the chart were to make a higher peak but the indicator shows a lower peak. Both of these situations would suggest the underlying trend is losing momentum in its current direction and nearly always occurs before the break of the trendline or the buy or sell signals outlined in this article.

Divergence will sometimes occur on the MACD averages but also on the MACD Histogram, but it will always be more significant when it occurs on both the MACD averages and the histogram.



Looking again at the Hang Seng Index we can see two major lows occurring on this index, with two very good examples of divergence occurring on both the MACD averages and the histogram. This suggested the downtrend was losing momentum in this direction, putting anyone using this method on red alert for a possible major reversal in trend.

Also notice how divergence was clearly seen before both the buy signals outlined in this article and before the break of the falling trendline previously shown on this chart.

Looking now at the right hand side of the chart and the current uptrend being shown. Divergence can be seen appearing only on the MACD averages which is of less significance than it would be if it had occurred on both the MACD averages and the histogram.

Based on the previous chart in this article we can also see the uptrend is still holding above its rising trendline with both MACD averages remaining above the zero line of the histogram suggesting the underlying trend is still intact and likely to continue.

Should things change with the Hang Seng Index we could then confirm the possibility of a major reversal by looking for both the sell signals outlined in this article followed by the break of its rising trendline to confirm the reversal. Until this time, based on the methods outlined here in this article you would still consider the underlying trend to be strong and likely to continue.

Article Update

Following is an updated chart of the Hang Seng Index showing what it has done since the article was originally written and published.

You can see the Hang Seng Index certainly remained strong with the trend continuing.

At the time of writing the Hang Seng Index was approaching previous highs and a horizontal level of resistance. The MACD averages were holding comfortably above the zero line of the histogram suggesting the underlying trend would continue and therefore break through the near by level of resistance.



Best Regards,

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