



HowToTrade

TOP 3 MOMENTUM TRADING STRATEGIES [PDF]

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Top 3 Momentum Trading Strategies

It's not a secret that knowing how to ride the momentum in trading is a key part of being a successful trader. In fact, instead of "buying low and selling high," certain financial giants such as Richard Driehaus believe it is easier to make money by "buying high and selling higher," thus popularizing momentum trading strategies.

In short, momentum trading strategies help you to recognize and follow the trend.

What is Momentum Trading?

Momentum trading in the financial markets refers to a strategy where traders capitalize on the current direction of instrument prices, riding the wave of market trends to earn profits. This approach relies on the principle that assets that are moving in a particular direction are likely to continue moving in that direction for a certain period.

One of the backbones of momentum trading is recognizing and leveraging volatility in the market. Volatility, in this context, represents the extent of price fluctuations of an asset.

Momentum trading strategies usually target short-term market movements, making them versatile enough to align with various trading styles, from day trading to longer-term position trading. The key is to identify the asset of interest, devise a strategy based on technical analysis and indicators, and then execute trades in live markets.

Top Indicators and Tools for Momentum Trading Strategies

When it comes to momentum trading strategies, the effective use of technical indicators and tools is crucial for identifying and capitalizing on market trends. Here are the top indicators momentum traders use from time to time:

1. Moving Average Convergence Divergence (MACD)

The [MACD indicator](#) compares a longer exponential moving average (EMA) with a shorter-term EMA to produce the MACD line, followed by a histogram and a signal line. The crossover of the signal line and the histogram is generally seen as an indicator of a shift in the market's momentum, which could signal a change in the price trend.

Moreover, momentum traders interpret a certain MACD condition as an indicator of a strong market trend. When the MACD line is above or below the signal line, and the histogram bar shows a strong market trend, traders can interpret that as a signal for a trend continuation. As seen in the chart above, the trend is likely to continue when the blue line crosses above the orange line and the bars are above the zero level of the histogram, and vice versa in a downtrend.



2. The Momentum Indicator

This indicator, often overlooked due to its simplicity, is another essential tool. It compares the last closing price with a previous one, typically from 14 periods ago (although some traders use 30 periods for smoother signals). This momentum indicator is less smoothed than others, like the Relative Strength Index (RSI), making it a more reactive momentum strategy and often providing an early signal before a price-turning point.



Mostly, traders utilize this tool for corroborating price movements rather than for direct trading signals. An upward crossing of the zero line by the indicator signifies increasing upward momentum in price, whereas a downward crossing indicates a growing downward momentum. This functionality makes the momentum indicator a vital component in the toolkit of traders, especially for confirming the direction and strength of market trends.

3. Average Directional Index (ADX)

In addition to these, the Average Directional Index (ADX) is also a valuable momentum indicator. The ADX, along with [Directional Movement Index indicators](#) – the negative directional indicator (-DI) and the positive directional indicator (+DI) – helps investors evaluate the strength and direction of a trend.



4. Relative Strength Index (RSI)

The [Relative Strength Index \(RSI\)](#) is a critical tool in momentum trading, acting as an oscillator that fluctuates between zero and 100 on its scale. Its primary function is to generate buy and sell signals by identifying overbought and oversold conditions in the market. An RSI value exceeding 70 typically indicates an overbought state, suggesting a potential sell signal, whereas a value below 30 signifies an oversold condition, potentially signaling a buying opportunity.

This indicator operates on the principle that price retracements within specific levels can reveal discernible market trends. However, in momentum trading, the strategy is actually to enter and exit trades based on these trends rather than attempting to pinpoint the absolute highs and lows of the market.



It's crucial to understand, however, that the RSI's indication of overbought or oversold conditions does not inherently mean an imminent trend reversal. For instance, the RSI may remain in an overbought zone for an extended period without a corresponding trend reversal. Hence, it's advisable to use the RSI in conjunction with other technical indicators to gain a more comprehensive view of the market conditions. This approach enhances the accuracy and reliability of trading decisions based on the RSI.

5. Moving Averages (MAs)

MAs are vital in any trading strategy, including the momentum strategy. This is because they help in spotting emerging trends by smoothing out price fluctuations over a specified period. While not directly indicative of momentum, moving averages are instrumental in helping traders determine if a market is confined within a range or exhibiting a clear trend.



For instance, let's consider a scenario where a chart incorporates three distinct moving averages: 13-day, 50-day, and 100-day. When these moving averages align closely with the shortest-term MA at the top and the longest-term MA at the bottom, it suggests a strong, potentially accelerating trend in the market. For that matter, many traders use various moving averages crossover strategies such as [the 9 EMA strategy](#) or the 20 EMA strategy.

6. Stochastic Oscillator

This is a leading indicator that compares an asset's closing price to its price range over a certain period. Like the RSI, the oscillator indicates overbought or oversold conditions and is useful for predicting potential price movements. It consists of two lines on a chart: the indicator line and the signal line. A crossover of these lines can signal a change in market direction.

Yet, again, to detect momentums in the markets, traders often use the crossover between the lines and the rise or fall above 80 or 20 as an indication for trend continuation rather than a reversal signal.



Top 3 Momentum Trading Strategies

Momentum traders usually have strong trading instincts to feel where the market is heading and ride the trend. But still, they often use specific momentum indicators. These indicators and tools are key in assessing the intensity of a price movement, which in turn can signal whether the trend is likely to attract more market participants and gain further momentum.

Below, we show you some of the most effective momentum trading strategies:

1. Trend Momentum with ADX

This momentum strategy uses the Average Directional Index (ADX) along with a 200-period moving average on a daily chart. The key here is to look for a rising ADX, which indicates strengthening momentum. A trade is initiated when the ADX starts trending upwards, and the asset's price breaks through the 200-day moving average. This is a signal of potential continued momentum in the trend's direction.



As you can see, the entry point is after these conditions are met. Once the ADX is rising and the price crosses above the 200 EMA, a signal is made. For risk management, a stop-loss is placed just below the most recent price swing. The profit target is usually set to twice the distance of the stop-loss, aiming for a 1:2 risk-reward ratio.

The use of ADX helps in distinguishing between strong and weak trends, allowing traders to make more informed decisions about entry and exit points.

2. Spotting Hidden Divergences in Price Action

This strategy utilizes the Relative Strength Index (RSI) to identify hidden divergences in price action. For those unaware, [divergences in trading](#) occur when the price of an asset moves in one direction (e.g., upwards) while the indicator (RSI in our case) moves in the opposite direction (e.g., downwards). This can indicate a trend continuation in the asset's price.



From the chart above, we can see that the price is forming a higher high. We can then patiently wait for a bullish hidden divergence before entering a BUY trade. The stop-loss is placed just below the recent price swing, and the profit target is set at a key level that offers at least twice the risk.

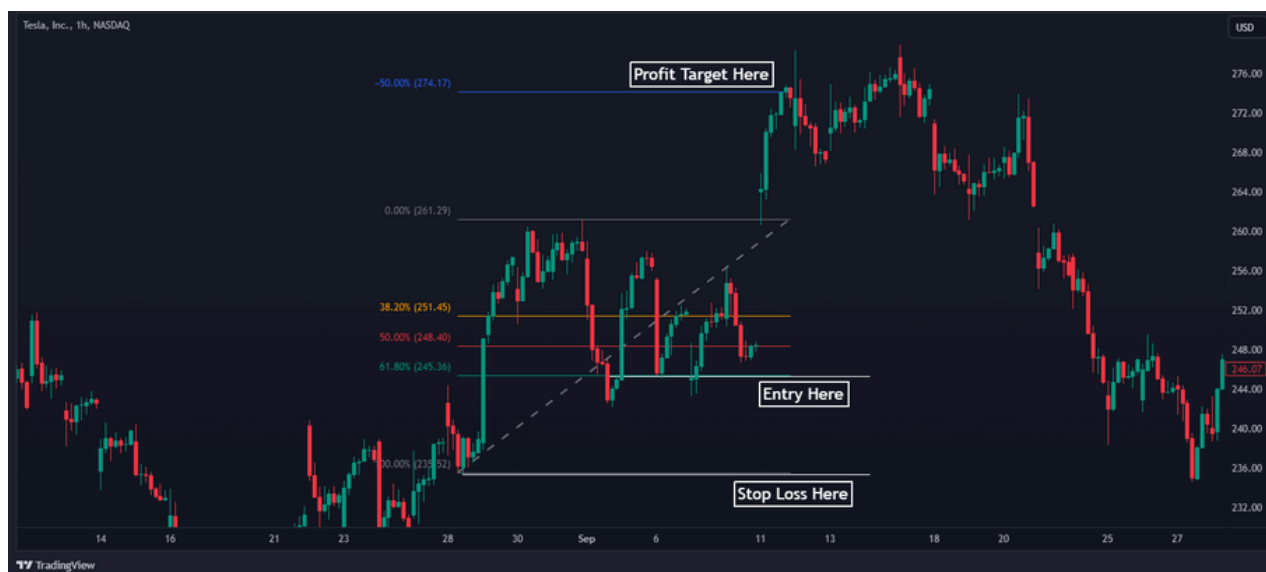
It's crucial to confirm the divergence pattern and not rely solely on the RSI. This strategy often works best in a trending market where the RSI divergence can signal a potential continuation of the current trend.

3. Day Trading Pullbacks and Breakouts

Generally, pullbacks and breakouts are a big thing in momentum trading, largely because they provide a good entry opportunity during an ongoing trend. And guess what – that's the biggest challenge of momentum trading. To know when to join the trend and enter a trade.

So, this strategy involves entering trades after a price retracement in the direction of the primary trend. The idea is to catch the “pullback” in a trend before it resumes its main direction.

Entry is after a retracement, and positions are closed at set profit targets like daily highs/lows or Fibonacci extension levels. The stop-loss level is set based on the market opening or below the swing points. Here's how it looks on the chart:



This strategy requires good timing and an understanding of market momentum. It's important to choose instruments with high liquidity and to be aware of any news or events that might impact stock prices.

Each of these strategies – [the pullback strategy](#) and [the breakout trading strategy](#) – requires a different level of market analysis and understanding of technical indicators. They also demand a disciplined approach to risk management and an ability to interpret market signals accurately. It's important to practice and become comfortable with the methods in a simulated trading environment before applying them in real trading scenarios.