MOMENTUM INDICATOR

Capademy Tutorial Series

What is a momentum indicator?

The concept of momentum indicators in the market was first introduced by J. Welles Wilder in his book "New Concepts in Trading Systems." Every beginner encounters this term when he begins to learn to trade. Overall this is an essential type of indicator, and a trader must include a momentum indicator in his trading system.

Momentum indicators are those indicators which measure the rate of change in price or in other words, it measures the speed of price change. These indicators don't work to identify the direction of movement, but instead, they indicate the movement of price over time and the strength of these movements regardless of the direction.

Construction or mechanism of momentum indicator

The mechanism of momentum indicators is pretty simple to understand, but it reflects very critical information. The momentum of the market is calculated by consecutively taking the price difference for a fixed time interval.

To draw a 50-day momentum line, subtract the closing price 50 days ago from the latest closing price. You will get a positive or a negative value then plot this value around a zero line. The formula for the momentum is:

Momentum= CL-CX

where CL is the latest closing price and CX is the closing price x numbers of days ago.

Advantages of momentum indicators

One of the most crucial information that a momentum indicator gives is it tells about the strength of the movement of price over time.

These indicators also help traders to identify the specific point from where the market can reverse.

As these indicators measure the relative strength of a price movement and don't indicate the direction of the price movement, they work best in combination with other indicators, which indicates direction and price trend, for example, moving averages or trend lines.

1. **Moving average convergence Divergence (MACD)-** MACD is one of the most popular and widely used momentum indicators. It consists of two moving averages and MACD histogram.
The fast-moving MA is called the MACD line, and it shows market consensus over a short period while the slow-moving MA is called a signal line that shows market consensus over a longer period of time. The MACD histogram measures the difference between the fast- and slow-moving averages.

The MACD indicator gives a buy or sell signal when the MACD line cross signal line from above or below.

2. **Relative Strength Index (RSI)-**RSI is another momentum indicator which is very popular and widely used by traders. It is an oscillator that measures the strength of any price movement by monitoring changes in its closing prices. It is a type of leading indicator which fluctuates between 0 and 100.
The horizontal reference lines must cut across the highest peak and lowest valleys of RSI. These often drawn at 30% and 70%, but trades can adjust these levels according to their trading system.

The RSI gives a trading signal when RSI crosses different reference levels when RSI rises above 70%. It indicates that the market is in the overbought zone. Conversely, when RSI falls below 30%, it indicates an oversold zone.

Conclusion-

Momentum indicators are one of the essential tools, and every trader or analyst should include a momentum indicator in his trading system.

Momentum indicators don't work in isolation, so they must be used in combination of a trend indicator.

Momentum indicators can help a trader to find better entry and exit points. It can also help to identify fake breakout or fake breakdown movement.

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