RSI Fundamentals

Beginning to Advanced

Paul Dean

Second Edition

June, 2010

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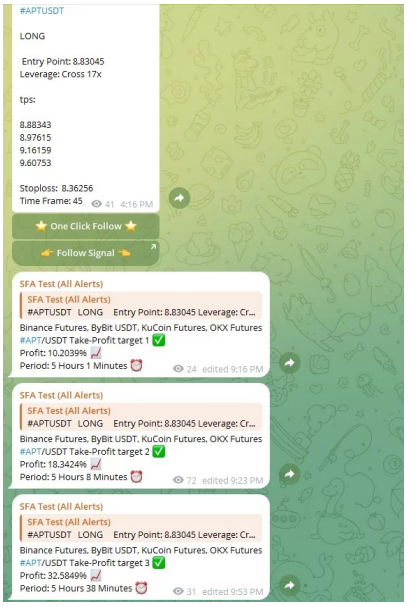

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PREFACE TO THE SECOND EDITION

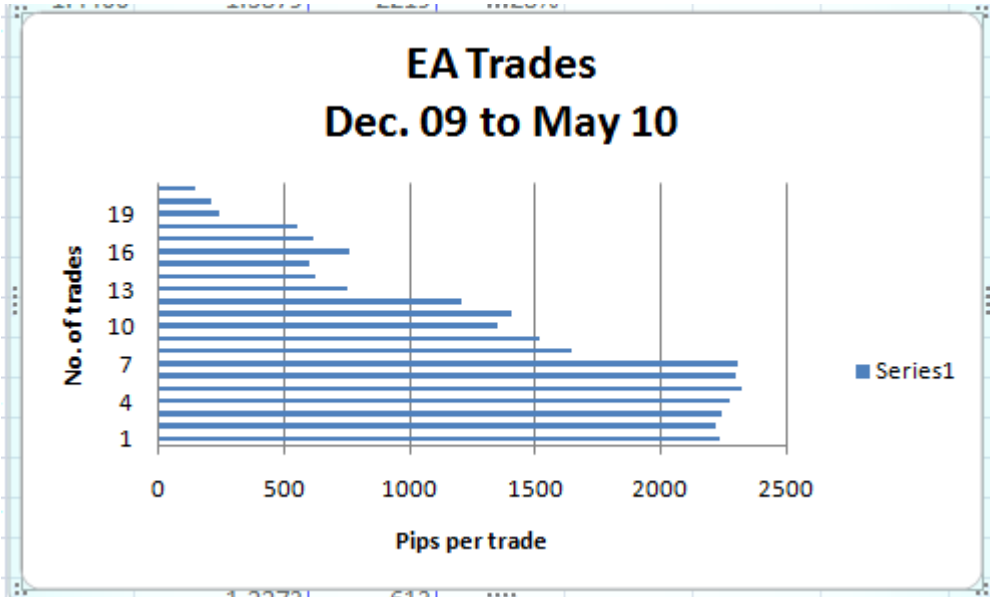
It has been about a year and half since I wrote the First Edition to this book. I have learned a great deal about RSI, The Relative Strength Index and The RSI Pro Trading System over that time. The general body of this book is as it was in the First Edition however much of what I have learned has been inserted into the relevant locations.

The Second Edition does not include minor changes. The First Edition had roughly 50 colored charts. There are over 80 in the Second. The text in the Second Edition has increased from roughly 12,000 words to over 21,000.

There are several reasons for the learning curve. After the First Edition was written I met David Moser, a trader and programmer who lives in Singapore. After several discussions via email, we decided to meet in July of 2009. After that meeting we decided to partner and David programmed The RSI Paint Indicator which has become a vital part of trading RSI.

Later we teamed together to create our first EA. The launch was in November of 2009 when we began offering signals to traders on a subscription basis using the EA. Since December 2009 to

the current date the EA has generated 23 signals.



Here are the results of those trade and the average pips per trade. If all the trades had been entered and held the cumulative total would have been 26,942 pips.

Going through the process of developing this EA and defining the input levels of what makes a trade successful made me begin to ask what would happen if we pulled a set of data for every reversal from the history of a currency pair. Then having that data, analyze it so that it could be used to tell us when it was best to enter trades as traders without the benefit of an EA.

I now have that data and will use it as the basis for a book at some point in the future. There will be some information in this update regarding statistical data and its importance in trading. And I have included two reports in the Appendix that detail the use of how statistical data will and can be used.

Paul Dean
May, 2010

INTRODUCTION

The goal of this book is to help move your trading career forward. I believe that if you read this book and begin to apply the principles you will begin to look at trading and trading analysis in a way that will give you confidence to trade successfully.

When you are finished, you will be able to look at any currency chart and begin to unravel the “story behind” it within a few seconds. You will be able to describe what is happening and what to do regardless of the time frame or the currency pair. If you trade other financial instruments ie; commodities, futures, equities you will be able to use the same principles on those same charts.

This will move you miles ahead of other traders. You will find answers in this book as to how markets behave and why. Mostly you will learn where price is most apt to make a change and what to do about it.

Normally if you pick up any book on trading you will read about the same common things over and over, explained the same way as if all you had to do was draw a trend line, put a few moving averages on your screen, add an indicator, start trading and collect your money. Most of us intuitively know that it isn’t that easy.

I am reminded of a scene from the TV show, Friday Night Lights where Coach Taylor asks one of his players to learn to punt a football. The young man has never punted before and the next scene shows how awful he is. However, a young friend, a girl mind you, shows him the basic principles of kicking and after following her instructions, he gets off a long punt. He thinks he has it down. She warns him however that he won’t be good until he practices thousands of times. The reason is simple. When he is ready to kick in the game, there will be 200 and 300 pound

linemen running at him at full speed, ready to knock his head off.

The point is that nothing we do that requires a high level of skill; concert pianist, scratch golfer, successful trader is easy. Most of us appreciate the time it takes to learn to do something well. In most cases, the result of hard work makes us better and we are rewarded.

If trading the Forex market was easy everyone would be making money but if you have traded, you know that isn't true. If you haven't traded yet and someone told you it is, then they are just flat wrong. There are many smart people who have lost millions and perhaps billions in the market. On the flip side some have made millions and billions.

One of the key things that traders and wannabe traders should learn is how the market works. How and why currencies change from long to short, why currency jump around "noise", why after news the market might rocket in one direction only to rocket back in another.

I came close to quitting Forex in the summer of 2008. I had lost a bundle on a trade. *(A bundle can be relative. It was big enough that I didn't tell my wife how much for several days.)*

I sat in a Starbucks early the next morning wondering if I should call it quits. Reflecting on the trades I had made over the past several years, I was sure, had I taken the other side of most of those trades, I would be rich. Unfortunately I was not making money.

I really didn't want to quit. I hated the idea of giving up on something in which I had put so much time and energy (and money); something I was sure could be conquered. And being in my late 50s at the time, the idea of going back to work for

someone again was more depressing than losing the money.

I had spent a great deal of time and money on trading books, software programs and trading courses. I had been to seminars and read hours of forum posts. I had taken some of the best trading courses (according to many), and worked with some of the best traders (according to many). Much of what I had done didn't seem to help much. It was like having a PhD and wondering, now what?

Sitting in that Starbucks I felt like I had tried every avenue available and there was no answer. It also occurred to me as I thought about what I had learned that in all of it, there was little I could put my finger on that was **true** about trading. In other words, after all of the study, nothing really showed any level of consistency or reliability.

When you learn to shoot a jump shot in basketball there are fundamentals you follow; position the ball in your hands properly, square your body to the basket, jump while bringing the ball over your head and at the top shoot the ball with a nice easy follow-through. Having done that in my youth I knew before the ball left my hand or as it left my hand whether it was going in. When something went wrong it was easy to check your fundamentals and find the problem.

In trading there was some of that but it was hard to know after all the analysis, what to do. Everyone had systems that seemed to have different rules or fundamentals. I could follow a logical number of steps to a decision but invariably the decision would be wrong more than it was right. And when it was right, it never seemed to be right long enough to offset all the wrongs.

I told my wife that I wasn't buying another book on trading or Forex, "The answer isn't in any book because I guarantee you,

I've read them all!" In my head however, I was thinking, there must be an answer.

The funny part is that I had to eat my words. A week later at Barnes and Noble I read through a book that set me off in a direction that I hadn't followed before (and I bought it!). I am here to tell you today that the direction was not the correct one but sometimes what seems right, can still be very close to the truth. In this case it set me off in the right direction.

At this point in time I had tried a number of different avenues including: 4X Made Easy, The Money Map, Elliott Wave Theory – in which I utilized an automated Elliott Wave program called ElWave in addition to having up-to-the-minute analysis from live traders on the placement of waves and the possible outcomes (which always seemed to be either long or short). I had studied Price Action extensively with people like the James16 group. If anything, Price Action as taught by this group of traders is about as close to a fundamentally sound methodology as can be found in trading. I studied confluence and correlation. I studied Fibonacci methods used by Constance Brown in her book Fibonacci Analysis as well as many others.

I participated in training via Market Traders Institute yet nothing that anyone was teaching really had teeth until I read something about RSI and RSI Reversals which had been discovered by Andrew Cardwell, a student of Welles Wilder.

At some point it became clear to me that it was easy to create a trading signal. That may seem obvious; creating a signal *is* easy. Give me a sheet of paper and a pencil and I could list 20 entry methods as fast as I could write.

As a trader, you need a signal that tells you it is "time to trade". That's the obvious part. What is not obvious are the details that

tell you if you *should* trade at that moment or not at all.

One of the things most traders have trouble with is when “not to trade.” Knowing when to stay out of trade is just as important as when to trade, maybe more important.

Most trading systems according to statistics I have read - but find hard to actually document – indicate that most successful traders have a 40% win rate. That means out of 10 trades, 6 will be losers. A smart trader can increase their profit by eliminating 1of those losers. The winning percentage however is second to the total number of pips made. If you only win 1 time in ten but you make 500 pips on that one win and the 9 losses total 90 pips then you have a net gain of 410 pips. Improving, if and when you enter a trade, can be crucial. We want to pick the right battles and win the war.

I am sure there are many good systems in Forex. But there are many more terrible systems. One reason is that many traders with good intentions create systems that are doomed to failure. And some systems are just marketing schemes. There is more emphasis on it getting out to the masses then to the care of making the system viable for people to use and get reliable results. The rationale behind this is like buying a car – use it for a few years and trade it in on a new one.

Most traders when they buy these systems are buying the “promised” results of the system, not the system. It’s like one hand is distracting you from looking at the other.

The question a trader should be asking before buying into a trading system is, <u>What is this system based on?</u>

Why would you want to know that? Simply because you won’t be a better trader unless you understand why a trade was taken.

The problem? You can't find out. The developers won't reveal the information to you. I am not talking about the internal programming language, just the main principles behind what causes the system to trade. We have developed a system that is highly successful but we have not sold it because it reveals information about RSI that few people know. Since December of 2009 through May of 2010 this system made roughly 20 trades without a loss. However, we have used this system to help new traders learn to make wise decisions yet we have retained the proprietary information.

But what if you can't find answers as to what creates a signal? I think you should walk away because you are putting your hands in the hands of others. You will only be able to blame yourself if you lose your money.

What are we looking for when we trade? We are looking for a place to enter where we think we can make pips and get out of the trade unscathed. **It's that simple.** Whether you are a scalper looking to make 5 or 10 pips a day, a day trader trying to make 50 or 100, or a longer term trader who is trying to make hundreds of pips, your first goal is to know whether to get into a trade, or to wait.

Think of a signal to trade as an alert. Not all entries have the same chance of profitability.

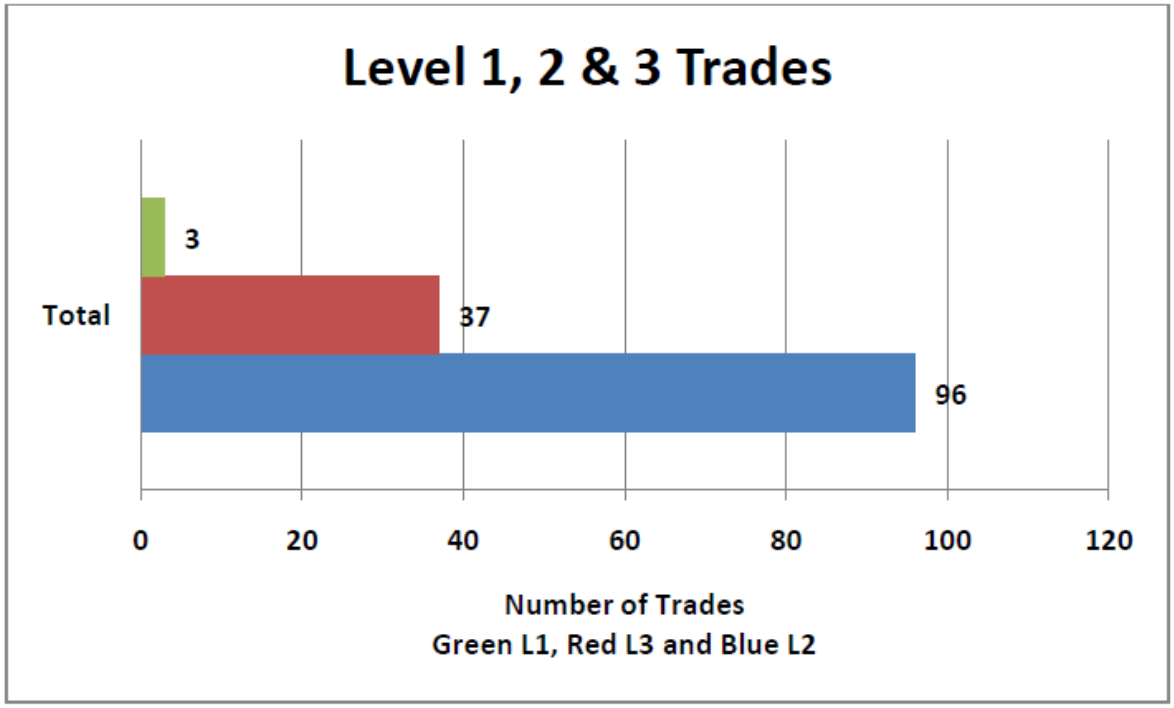
As part of this book I will include Statistical Data that will show you the best entry points for this system. For example, let's say we have a trading system "A" that has a simple trend line. When price goes through the line and then retests the line we trade short on an uptrend and long on a downtrend.

When we look at our charts we scroll back and look for

circumstances where this works or does not work. We see both. We do not know however how often it works and what the results are when it does and where the stops need to be in order for it to succeed. This requires writing a program that records all of the signals given. When we have this we have the capability to run tests and get statistical data that will improve our chances of success.

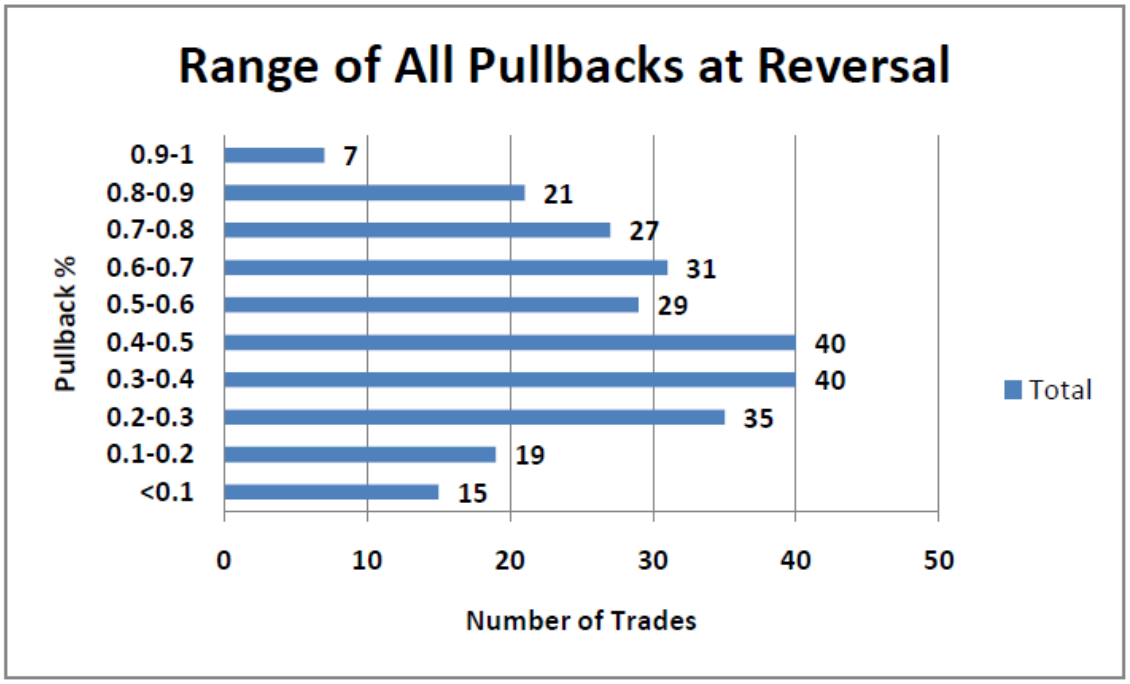
The point I am making here is that The RSI Pro System shows you where the signals are, provides you with up-to-date accurate statistical data. Below is a graph of the three Levels of Success that we define in The RSI Pro System.

Number of Level 1, 2 and 3 Trades



In the chart below we see a three week period of trades and their pullbacks or retracements at the time of the trade signal, in this case reversals.

Range of Pullback at Reversal



We can see from this kind of data where the bulk of reversals return to. There is a variety of such data that is now available on a monthly basis to provide RSI Pro Traders an advantage to knowing the most profitable time to trade; such as retracements, draw-downs, ratios of risk and reward as well as many other things that will help you in your trading decisions.

This system does not have the Wizard of Oz behind a screen pulling meaningless levers. We teach you how to navigate the ship, how to think and how to succeed.

In **Chapter 1** – **RSI Beginnings,** you will learn who developed the RSI, you will discover the RSI Indicator, what an indicator does and how it can be the center-point of any trading system. You will learn some of the pitfalls of RSI and the advantages that will create an “edge” that will help you succeed.

In **Chapter 2** – **What is an Indicator**, you will learn more about indicators; the difference between a leading and lagging indicator and why it matters. You will also learn about the inputs for the RSI, the best time frames and the beginning concepts of overbought and oversold.

Chapter 3 – **Setting Up the RSI**, is how to set up the RSI on your chart. You will learn how to place the inputs you discovered in Chapter 2, download a demo and the best way to view the indicator on your charts when you are trading.

Chapter 4 – **Misconceptions of RSI**, we go into depth on the misunderstanding of overbought and oversold. We discuss the ranges or RSI and what has been called the Range Shift. We will look at this concept and determine its value in trading RSI and RSI Reversals.

Chapter 5 - **Range and Range Shift**, is an analysis of the concept of RSI ranges and shifts, and a 14 point summary of the trading principles so far discovered.

Chapter 6 and 7 – **Defining Positive Divergences and Defining Negative Divergences** which goes into depth on what a divergence is and what happens to price when they occur and how you can be fooled.

In **Chapter 8 and 9** – **Defining Positive Reversals and Negative Reversals.** These chapters look at locating each signal and all the critical calculations that are required to properly enter,

exit and target your trade as well as knowing before you trade the Reward and Risk Ratio. Each chapter ends with a summary of each signal.

Chapter 10 – **Examples**, consists of examples where you can see how and where trades were taken. We will look at successes and failures. These will include manual examples and examples using The RSI Paint Indicator.

Chapter 11 is unique. In the First Edition we included a chapter called “34 Key Points”. We have renamed it, **“Key Points”** and have enhanced each point. We have reviewed those points and made comments where they needed more explanation and where we had additional insight or statistical data. Where we were wrong in the First Edition we explain why.

Chapter 12 is a **Q and A** of questions asked by traders once they had worked with the system. These questions will be helpful to all traders

Chapter 13 - **The Future of The RSI Pro System,** is a brief peek into the future of the RSI Pro System, in particular advances that we have already made after one year.

Chapter 14 – The RSI Paint Indicator, is an explanation of how and why The RSI Paint Indicator was developed and how it can be effectively used to increase productivity and profitability in trading.

Chapter 15 – **Bi-Channel Analysis**, is a description of how to use Main and Inner Channels to enhance your decision-making when trading The RSI PRO Forex Trading System.

In the **Appendix** I have included two reports on the statistical data. The data isused to increase profitability in regard to where

signals occur most, the amount of draw-down that successful trades experience, the targets distance most often achieved and much more.

I hope you enjoy this Second Edition. Now, let’s get started.

CHAPTER 1

RSI BEGINNINGS

Who developed the RSI?

The definition of RSI according to the book, *Technical Analysis of Stock Trends,* (Edwards, Magee, Bassetti: 9th edition, 2007) is this, *"RSI is . . . the difference between the average of the closing price on up days vs. the average closing price on the down days."*

It goes on to say:
"Relative Strength Indexes have become popular as countertrend oscillators. They give reliable overbought and oversold indications in most markets . . ."

Welles Wilder developed the RSI in 1978. Wilder wrote, New Concepts in Technical Trading Systems which can still be purchased today.

Welles Wilder is best known for his technical indicators now considered to be core indicators in technical analysis software. These include Average True Range, the Relative Strength Index, Directional Movement and the Parabolic Stop and Reverse. (Marketmasters.com)

In an interview with TradersLog.com Wilder said this about himself, *"InThe New Concepts, book I introduced four new automatic trading systems. They were, The Parabolic Time/Price System, The Volatility System (which introduces Average True Range,) The Directional Movement System, and the Swing Index System. The book also includes the first momentum oscillator to put all commodities and stocks on one scale. That was called The Relative Strength Index or better known as the RSI. Over the years, we have sold more than 25,000 copies worldwide. At $65.00 it was also one of the highest priced books on trading."*

Wilder goes on to make some points that are significant, in particular when you begin to formulate something that is a foundational piece of your trading system.
The purpose of developing the oscillator was an attempt to show strength and/or weakness in stocks or commodities. One of the problems was that existing oscillators had different scales. The RSI scale was set from 1 to 100. In his words, *"It measure(d) the current strength and weakness of a particular market often in advance of the move."*

There are two ideas here that traders should keep in mind, overbought and oversold fell between 1 and 100 and that RSI could be predictive in terms of the coming price. The first point we have discussed and will show evidence of being incorrect at least from the standpoint of being a reliable measure of overbought or oversold and therefore not a reliable method of market entry or market information.

The second is one of the reasons RSI *is* used as a signal but it is another aspect of RSI.

RSI is also used to locate divergences. Here you will learn a third method that is almost never discussed, Momentum reversals.

Remember a signal is not an automatic entry point. However, the signal from the RSI, being a leading indicator, gives us clues or evidence as to the next move or the coming tendency of the market. We will be discovering this as we continue to develop our system of trading using the RSI.

Wilder also discusses the idea of traders having perspective or context. He remarks first that *"markets must win or else there will be no markets."* This is compatible with the idea we presented in the introduction that there must be risk for there to be markets.

Because markets do exist then the better we handle risk, the better we trade and the more likely chance that we will be successful.

Wilder points to who the winners are. This infers that traders learning to trade need to know that there is a big game going on played by people who know much more that we do and have been at it much longer.

The picture you should have in your mind is the Shark Tank at Sea World. No one other than those who are highly trained should go into the shark tank and swim with the sharks. There is risk and always an element of uncertainty. But with education and training plus experience people do swim with the sharks. You can do the same thing in Forex. Remember, no one is going to give you anything, you will have to earn it as the old Smith-Barney ads used to say.

According to Wilder, *"The big winners are the commercial hedgers with huge money to back up their positions. These are the fundamental traders. The second group of traders would be the large speculators who are mostly the big commodity funds. They are technical traders. The last group is the small trader. The small traders certainly outnumber the other two by I would guess a thousand to one. Since only 5% of small traders (over time) end up making a profit you can see where the money comes from to make a market. Fortunately, so far, I am still in the 5%!"*

Knowing your role in the markets is crucial. Understanding what is happening in regard to the bigger players can help you make money. It normally takes years to understand this concept. Whether Wilder has the players right is another question but the idea that the big traders move the markets is the key. To become successful it is something all traders need to understand.

This next quote is also a key concept that The RSI Pro System is now addressing but from a different angle.

"Since the markets must win, most trading systems can work fairly well for a year or two and they break down to losing as more and more sophisticated market action adapts to defeat the system. So what has changed is that the markets adapt to most every kind of trading system, and it becomes harder and harder to come up with a system that can beat the markets. But, a few of them do beat the markets year after year."

Taken at face value that makes sense however, what if the system didn't need to be changed. If you have a system that works and it stops working then the system didn't change as much as the data that drove the system changed. For example, if you are trading off of a 200 Moving Average and it has worked for a period of time then stops, where did the entry move to. Do we hunt for the next new perfect Moving Average? No, because you won't find it and if you do it will be for only a certain period of time. What we do, is look at the data. Have prices gone through the MA slightly and to what extent before reversing?

I am not a proponent of Moving Averages but the point here is that accurate statistical data of the system you are using will improve whether you take a signal, where you take it, to what extent you will allow it to draw down, and when you will get out or take some profit.

Last, *"The trade should be in the major trend direction. It should not have wild gyrations. If possible there should be a nearby support area to provide a reasonable stop. It should be rated high on the COT. (Commitment of Traders.)"*

This is a key concept that needs to be kept in mind. You will find it

hard to go upstream. There are many who try and they can make a case for it, but to me it is like trying to drive from Chicago to Atlanta on the wrong side of the super highway. You might make it, but the disadvantages may far outweigh the advantages.

CHAPTER 2

WHAT IS AN INDICATOR?

Indicators are divided into two categories; lagging and leading. Oscillators are momentum indicators. Moving Averages and are considered “lagging indicators”, while RSI is a momentum or leading indicator. According to Investopedia *“it(RSI) compares the magnitude of recent gains to recent losses in an attempt to determine overbought and oversold conditions.”*

We will actually learn that the terms overbought and oversold have little meaning as it is impossible to actually know when this is true. Regardless of this fact, traders and those who provide insight about trading continue to use the terminology as if it really meant something. We will take this discussion up a little further along.

Lagging indicators tell you that a trend is a trend after it is already a trend. Momentum indicators attempt to predict, or better, alert you to the possibility that a trend change is about to begin. Below is a chart with price on the top and RSI on the bottom.

Here is a Price Chart with the RSI below. Notice there are more lines on this RSI then a typical RSI chart.

An oscillator compares two value extremes to discover overbought and oversold conditions. Constance Brown says, "I*t measures the sentiment of the masses.*" The RSI is an oscillator that compares price highs and lows over a set period of time. Again, in time we will debunk the idea of overbought and oversold but that will lead to a new understanding of RSI that is even more significant. Much like the idea of the earth being flat caused concern for sailors, the understanding that it was not flat and you could not fall off the earth opened up new possibilities.

RSI Period

RSI period is an important concept. Wilder used the 14 period RSI. There are others that use RSI and vary the length. This can relate to different purposes for which people use RSI and the time frame and style of trading they are employing. For our purposes we will stick with the 14 period. One reason is that it appears that

many people who use RSI on their trading charts use the 14 period parameter regardless of the time frame and style they trade. As we are looking for an edge in the market, or a moment where we see an opportunity, it does not matter what period is used. We are using RSI ultimately to generate a signal. If we use traffic lights as an example it does not matter if we get the signal one or two blocks early or later. We are still measuring price momentum in the market and we are looking for an entry where we have the least risk and the greatest opportunity for reward.

Using the 14 period RSI puts us in the same place as most other traders around the world, as this is the default in most chart package systems. In the next chapter we will show you how to change the number.

I hope that you can see from this short discussion the beginnings of what might be questions about the concept of overbought and oversold.

If RSI becomes overbought at 70 RSI then the fact that we can alter that simply by changing the time period used for the indicator, should tell you something. Decreasing the period from 14 periods to say 10 periods could create an overbought condition sooner or later and increasing it could change it also.

CHAPTER 3

SETTING UP THE RSI ON YOUR CHART

Setting up the RSI Indicator

First look at your chart from the charting package you are using. If you are new to trading and you are trading the Forex market and do not have a charting package there are many demos that you can use. I use Metatrader 4 which is used by many traders and is available at many Forex websites.

How to download a FREE Metatrader Demo charting account

(Google: Metatrader 4. You will be given a number of choices. You may want to research some of them before trading, however if you are just planning to learn the basics at this point, which you should be doing, try any of them. Interbank FX is easy to work with as is FXDD.)

Locate the demo on the website, download and follow the installation instructions. If you have questions there are usually "Live" people to talk to who can help.

Price Chart with no RSI

This chart shows a picture of price without the RSI indicator added.

A price chart with bars only. You may use a candle chart if it is preferable. Later we will use primarily line charts.

It also shows price as bars. If you are more comfortable with candles and know candlestick patterns then by all means use them as these patterns can be used in some circumstances to increase the probability that you are correct in your trade.

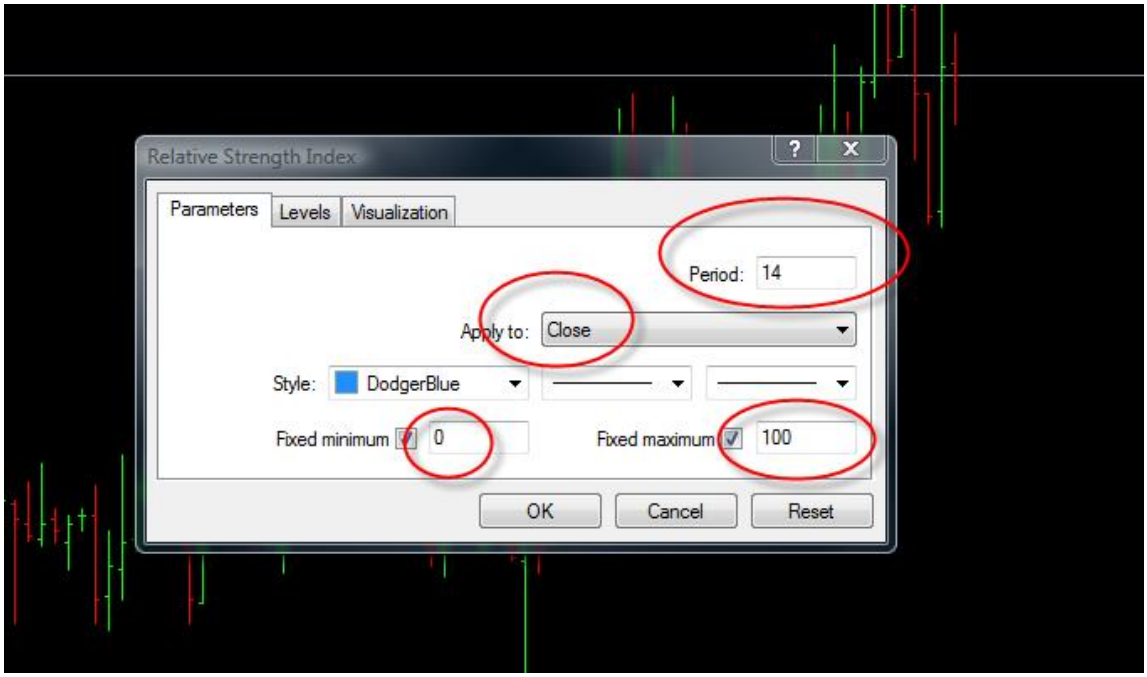
Placing the RSI Indicator on the Chart

Go to the **Menu** in your charting package where the indicators are located.

In Metatrader 4 do the following:

1. Select Insert
2. Select Indicators
3. Select Oscillators
4. Select Relative Strength Index

A box will come up that looks like this. If your charting package is somewhat different you should be able to find the key elements that we will be adding.



Price chart with the Relative Strength Index application box open.

Setting the Inputs in RSI

Your default in Metatrader 4 will probably look like this. If not:

1. Select 14 for your period - the 14 period RSI has worked for nearly all of the proponents of this method, we will not argue with success. Shorter periods will increase volatility and longer periods will smooth the RSI out. It appears from experience that this period selection is the one to use.
2. Select "**Close**" for when you want the periods to make the calculation.
3. Select a color you like or leave the color as is.
4. Make sure the **Fixed Minimum** is on "0" and the **Fixed Maximum** is on "100".

Click on OK and the bottom of your chart will now include the RSI Indicator. It will look something like this.

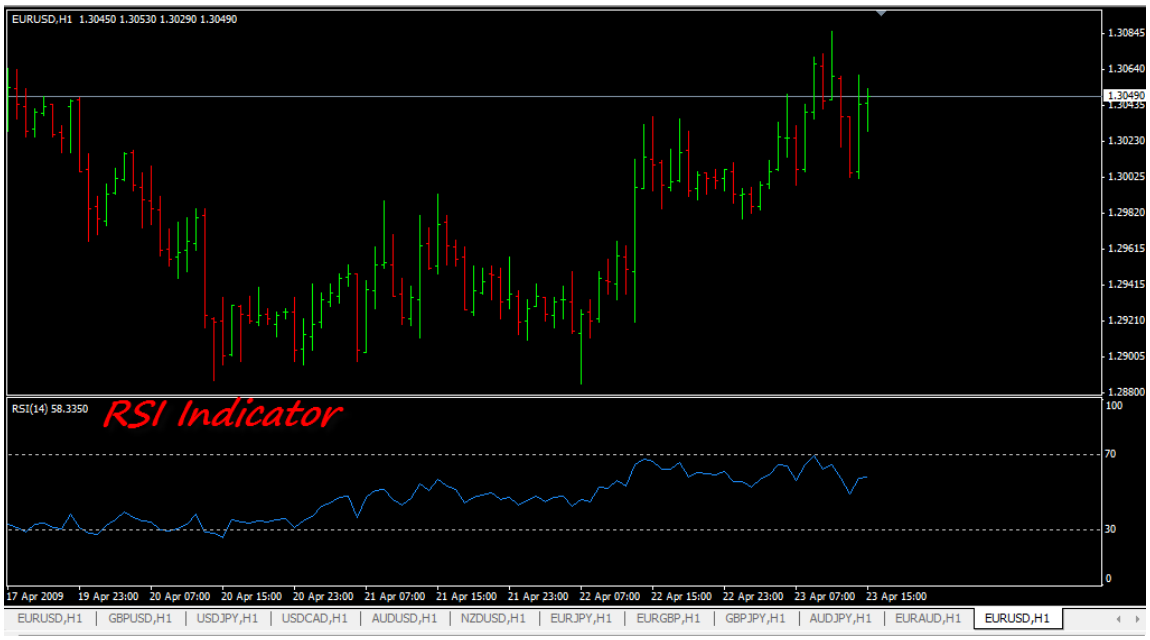


Chart with price on top and RSI at the bottom. RSI is the blue jagged line. The white horizontal lines are at RSI 70 and RSI 30. This is the normal default.

The RSI indicator is on the bottom of the chart (The red label I have included will not be there). This shows the RSI in blue, moving along the chart with the price above and there are two

other lines on the chart.

RSI bar chart on the bottom (blue line) and price on the top.

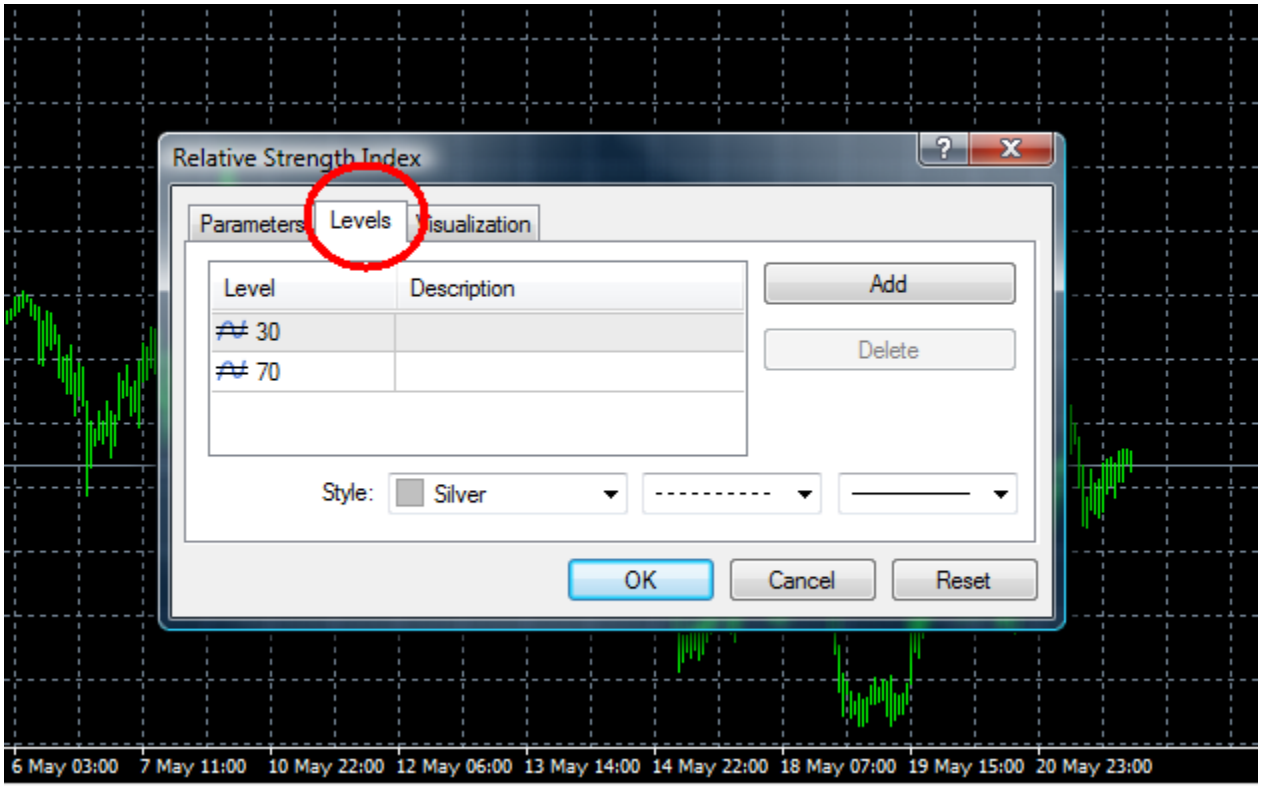
The expanded chart above shows the RSI (blue jagged line) and the RSI lines at 70 and 30.

Adding RSI Lines on the Chart

Now we have to add something to the chart:

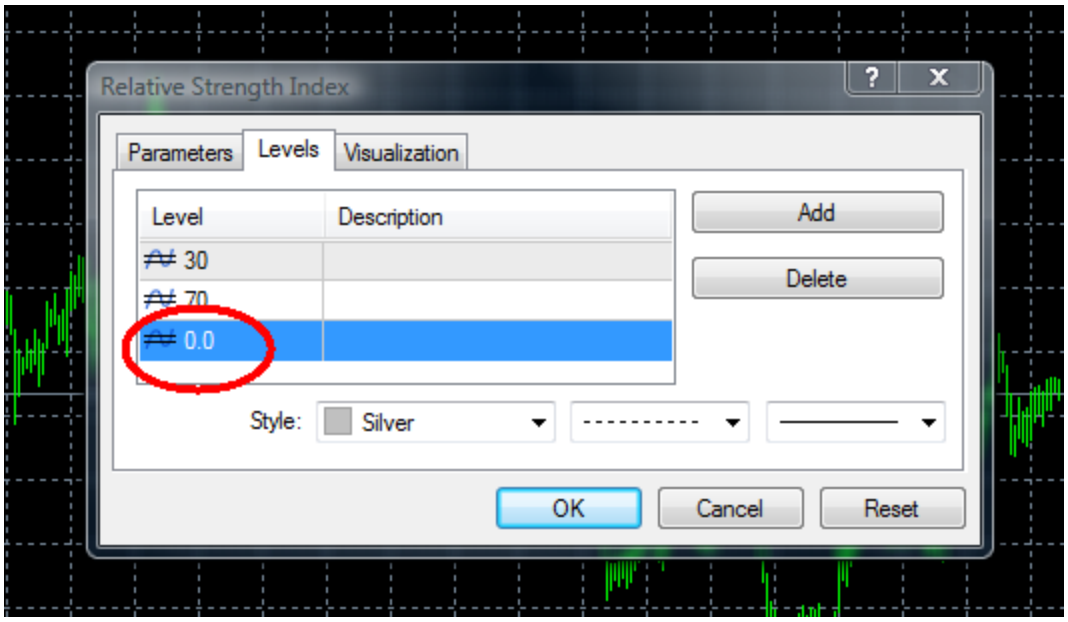
1. Select Insert
2. Select Indicators
3. Select Oscillators
4. Select Relative Strength Index.

Our chart pops up on the screen one more time.

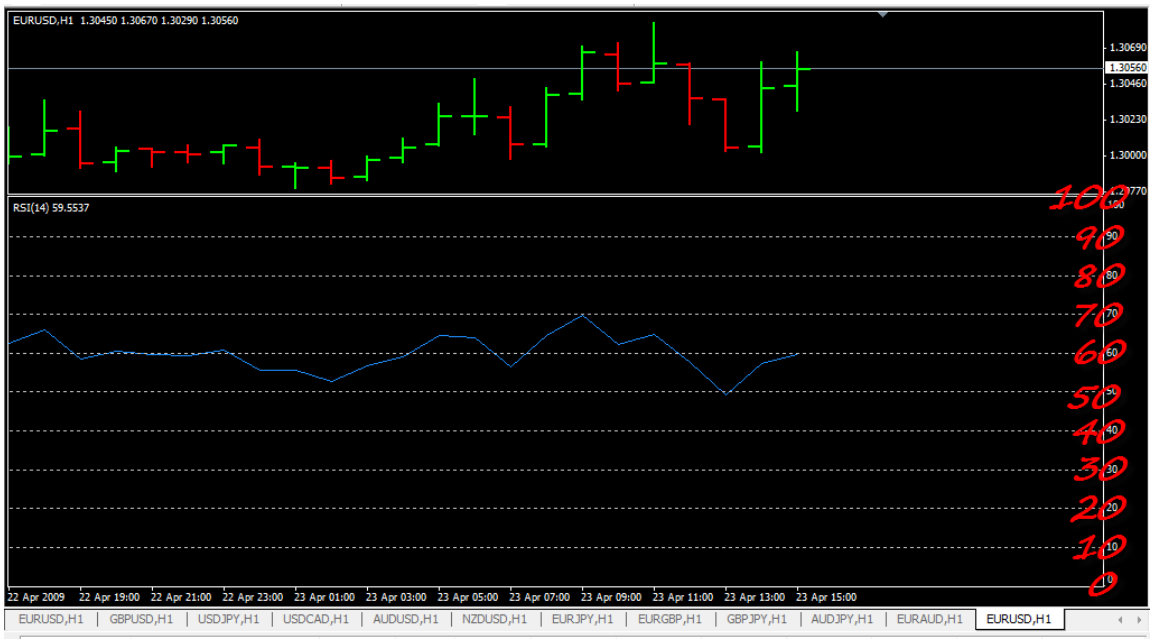


We do not have to change anything that we have already added. We do want to add more lines at the following **levels**: 10, 20, 40, 50, 60, 80 and 90. This will help determine more accurately what RSI levels we are working with.

Go to **Levels** (This is a tab at the top of the box circled above) Select **Add** and a box opens up.



Enter “10” in the box and click **Add**. Select Add again and add “20” in the next box and click **Add**.4
Enter all the numbers. When you are finished click **OK**.



This is our chart with horizontal lines placed 10 points apart from 0 to 100.

Your chart will look like this with the exception that I have added

the larger red numbers on the right side of you RSI chart so that they are easy for you to see. Your numbers should go from 0 to 100.

Viewing the RSI on Your Screen

How should our chart look? Normal trading charts are dominated by price. Underneath price, scrunched up so that it is almost invisible, is an indicator like RSI, or MACD, or a Stochastic. Unfortunately, when they are in this mode they are rather useless. Many charting packages don't allow you to increase the size or adapt the RSI in anyway. If you have one of those systems you may want to opt for something like Metatrader 4. As you see below, price is dominating here and RSI is difficult to see especially with the added horizontal lines.

Here is an example of what you see on many trading charts when they are trading. The indicator is so scrunched that the trader cannot get any valid information from it.

Drag the line (where the arrow is pointing above) upward until it looks something like what you see below.

RSI is sharing the space with price. We can see it much better.

Now things are much better. RSI is sharing the space equally. We can see our horizontal lines, we can see the “peaks” and “valleys” created by RSI and we can still see price.

CHAPTER 4
MISCONCEPTIONS OF RSI

Before we can really discuss what our method of RSI shows us, we need to discuss what most of our sources think the RSI is telling us. If you have traded for any length of time you will probably be getting the standard line. This is understandable. For example, one prominent Elliott Wave trader that can be read on currency markets on a regular basis has RSI at the bottom of his charts and occasionally uses the idea of overbought and oversold as part of his analysis.

If you followed this trader's advice you would probably at some point have Google or read in a book on technical analysis more about what the RSI is telling you as a trader.

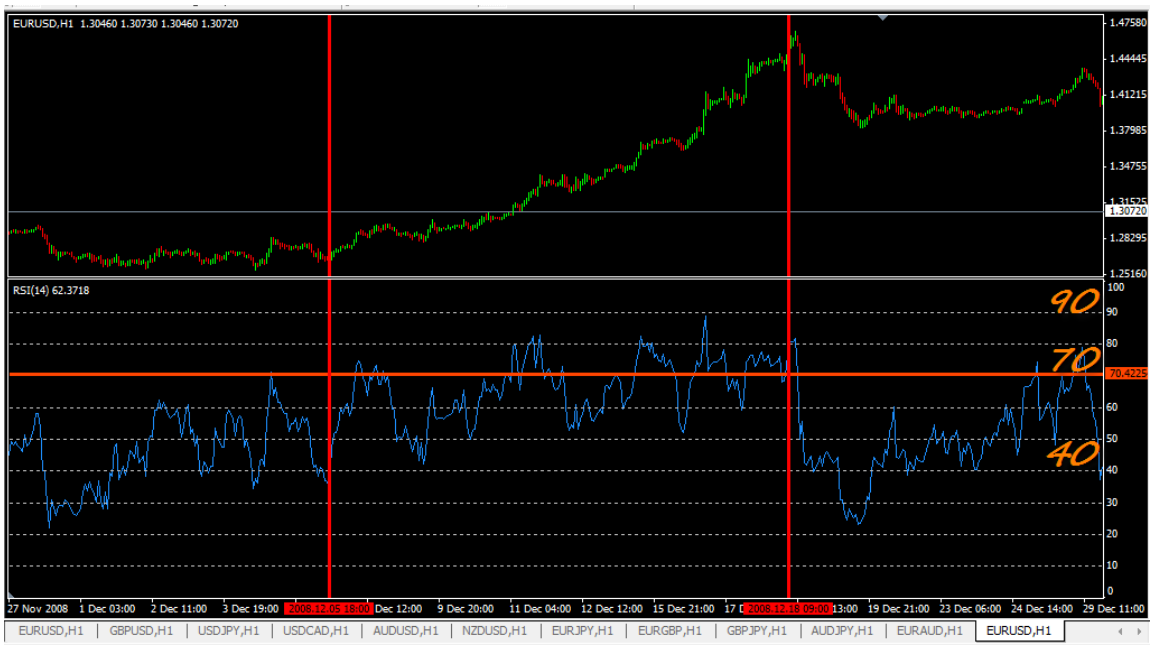
The italicized remarks below are from a typical source on RSI found most commonly in books and on the Internet as well as from well known traders who are considered experts.

The misconception of overbought at 70 RSI and oversold at 30 RSI

“RSI works primarily as an oversold/overbought indicator. A stock (or any financial instrument) is oversold when it reaches the 30 level or goes below it. It is overbought when RSI exceeds 70. Stocks (or any financial instrument) can stay oversold or overbought for long periods of time. Therefore, if RSI has crossed the 30 or 70 "boundary", no action should be taken until it has re-crossed it in the opposite direction. For example, if RSI falls below 30, do not buy until the indicator has come back above that level.”
(Parentheses and the information in them has been added.)

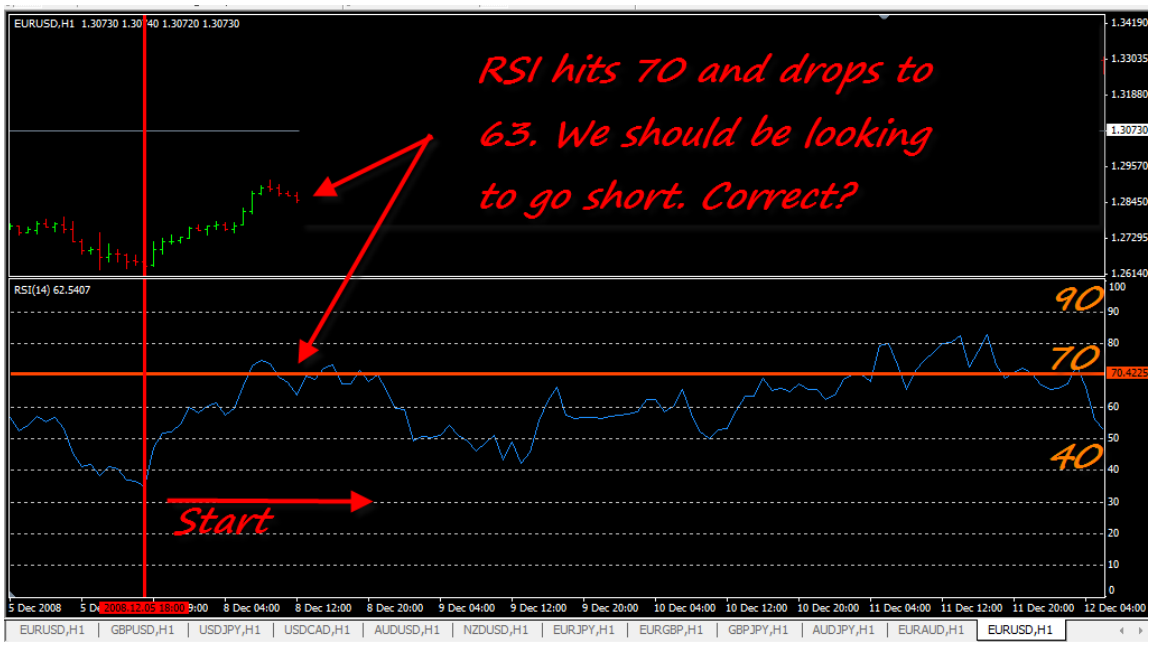
Is this true?
Does the number 70 indicate an alert that price is overbought?
Is it true that once price has dropped below 70 after going above it, it is time to sell?
If we can find places where this is not the case but just the opposite is true, then does RSI in fact, tell us that a price is overbought?
Is this aspect of typical RSI use and understanding reliable?

(After you read through this section you should have a new thought process when it comes to looking at the indicators you place on your chart and trade using the expertise of others. So much of what traders take as gospel is just that, faith based on what others have told them with few facts. Recently, I heard someone say that in the news new information is received and either the news agency thoroughly vets it or someone just continues the story with a slightly different version. There is a much better chance of success if you vet every aspect of your trading system. This would include the reliability of moving averages, Fibonnaci ratios, Elliott Wave, Gann and other trading techniques.)
Look at the chart below.



Here we have the RSI below and the price above. I have included 3 RSI levels on the right side of the chart. I have also drawn two vertical red lines and one orange horizontal line. The horizontal line is the 70 line where we have been told that prices are overbought.

Zooming in, look at the arrows and where they are pointing. Remember, in “real” time everything to the right of the last bar has yet to exist. However, we have allowed RSI to be viewed to make our point.



The information above says, when price has been moving up and RSI has hit 70 and gone through, that once it returns under 70 prices are overbought. As you can see, price went through the 70 RSI line and dropped through the orange horizontal line to about 63 RSI. If we were at this point as a trader and we were going by the guidelines above, what would we do?

The trading advice above is: *If RSI has crossed the 30 or 70 "boundary", no action should be taken until it has re-crossed it in the opposite direction.*

So the answer would be to go short if we were not in a trade or exit if we were and reverse our position. Let's see what happens.

The short vertical line marks the spot where we had to make a decision. Notice what happens. Price goes sideway into consolidation.

Now look at the arrows on RSI as they move up and down under 70 as price climbs!

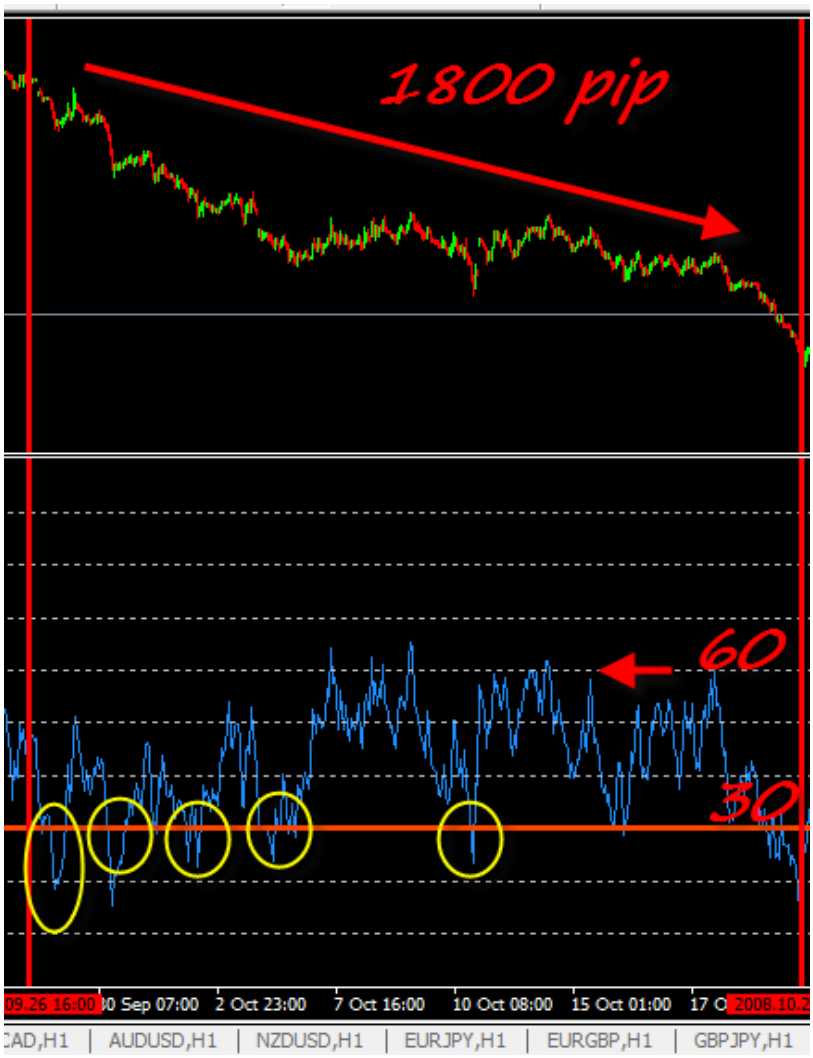
From the end of the consolidation on this chart (the short horizontal line) to the price high, price went up over 500 pips.

From this can we see that the instructions to sell when price passes through 70 and then drop back through, is not a valid signal, at least in this case. Price was supposed to go down, price went up.

Does one example prove that the concept of overbought is incorrect? My advice is for you to stop reading for a few minutes and place a horizontal line on your RSI chart at 70 and begin to scroll back on prices and stop and observe what happens to price

as RSI flirts with the 70 level. I think you will see that this is unreliable and at best inconsistent.

Now look at the next chart.



Above is an “oversold” situation. In this case, the rule says to buy after the RSI passes through 30 and then returns up through the 30 RSI line. In this chart there are 5 times where RSI passed back and forth yet price continued to drop over 1800 pips.

Again, stop reading and go to your chart and search for where this happens. I think you will come to the conclusion that RSI is

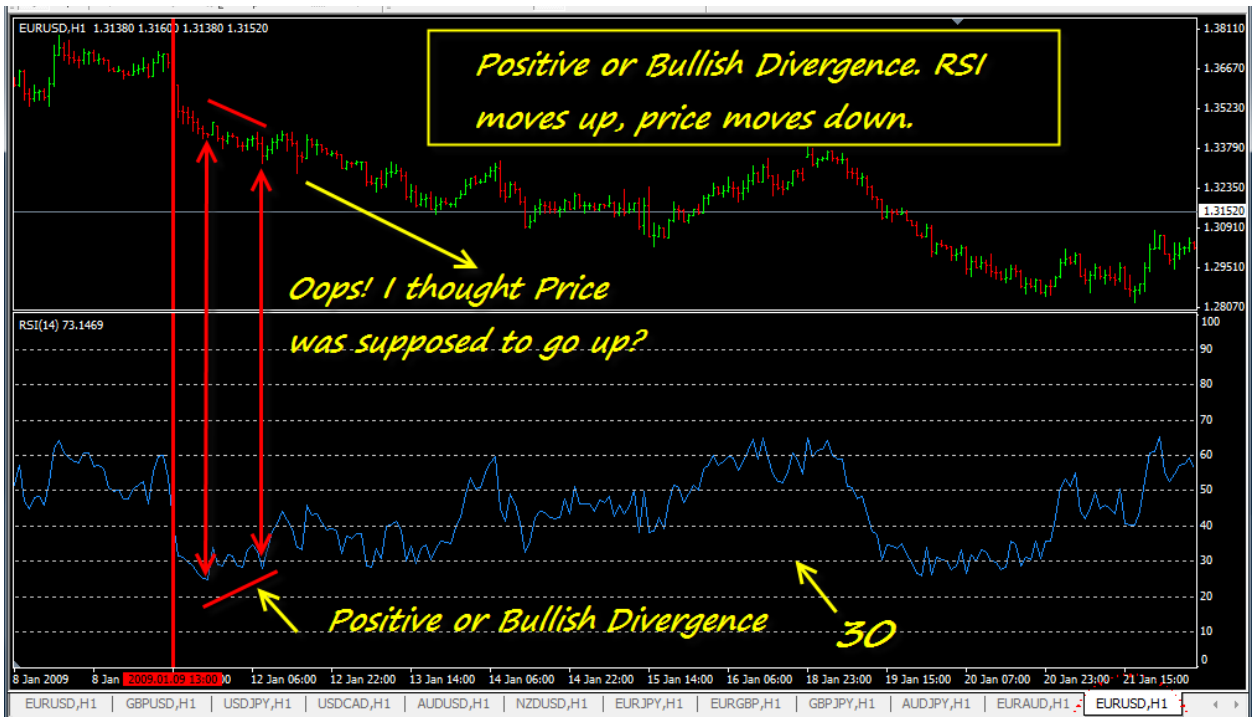
not a reliable indicator of overbought and oversold. So as you listen to traders who say that something is overbought or oversold be cautious and if you can, ask them on what they are basing that information. They are probably using RSI just like everyone else. But this makes then just as wrong whether they are using this as a standalone method of trading or way to confirm their trading signal.

This is the first step in understanding what RSI does NOT do: The concept of overbought at 70 RSI and oversold at 30 RSI is incorrect and unreliable and should not be used as a trade signal or as confirmation of a trade signal.

The Misconception of Bullish and Bearish Divergence

<u>Here is the standard RSI concept:</u>
"As with many overbought/oversold indicators, an important signal is given by bearish or bullish divergence. Bullish divergence occurs when RSI approaches 30 and begins to rise even though price continues to decline. That tells the trader the momentum of the decline is decreasing. Bearish divergence happens when RSI approaches 70 and the indicator begins to decline even through price is rising."

This is where many people get into trouble whether from RSI or another indicator that reveals divergence. Let's see what happens.



This chart shows a positive divergence which according to this misconception should send price up. But as it says in the yellow box, positive divergence or bullish divergence drives price down.

Here we have the exact description of books tell us to do. If you had read this in a book and tried it, you would fail more than you

would succeed. A positive divergence is supposed to signal an upswing in price according to standard RSI protocol.

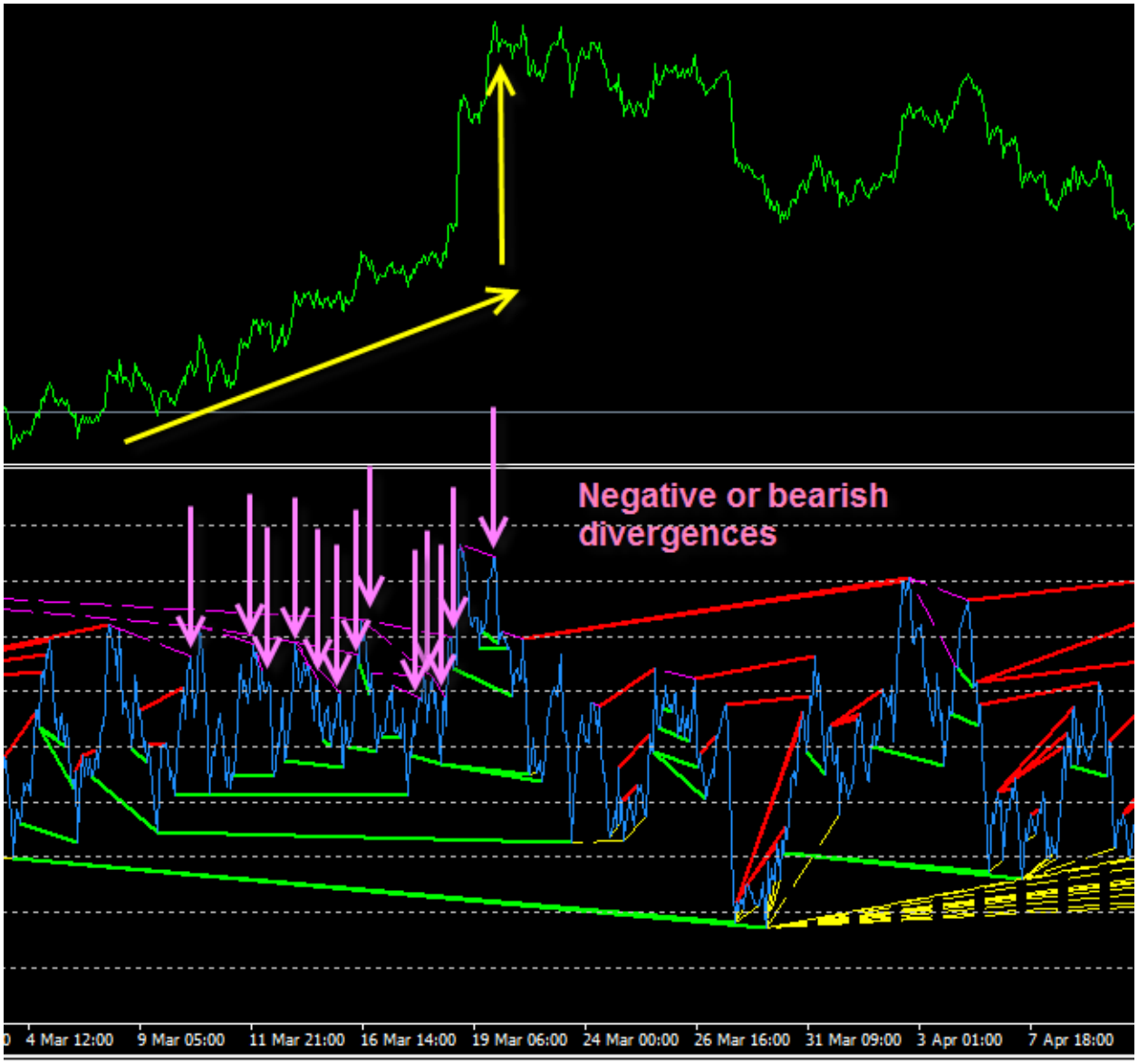
As you can see on the RSI chart, we have a divergence (red line on RSI). Prices should begin to go up, the RSI does. RSI was at 30 so this would be a clear signal to go long.

But what happens? Price drops nearly 600 points.

In the first edition of this book we did not have The RSI Paint Indicator and all of our Divergences, bullish or positive and bearish of negative, had to drawn by hand. If we were trading hourly charts we needed to check every hour to see if a divergence had formed. Likewise, as we will see with reversals, we needed to check for those as well. If we were trading multiple currencies then we needed to check those as well. It was somewhat time consuming. With The RSI Paint Indicator the divergences are drawn in for you no matter what time frame. To illustrate the above concept of positive divergences failing to push price up we will show a rather dramatic chart.

Each of the above yellow dashed lines represents a different prositive divergence on the hourly EURUSD chart. Over 20 formed in this period of time as price “dropped” nearly 900 pips. We will learn why later.

Using The RSI Paint Indicator we can easily find places where the same is true but for bearish divergences.



There are at least 12 negative or bearish divergences that have formed indicating that price should be going down and yet price is going up; in this case almost 1200 pips on the hourly EURUSD.

Certainly you will find places where a divergence will have an affect however from this information we again see that the protocol for using RSI to signal trades based on divergences is not a reliable method.

Again stop here, in particular if you have The RSI Paint Indicator and scroll back through your signals noting the bullish and bearish divergences. I think you will see that at best the signal is inconsistent. Just because you have a 7'6" center on your team that can dunk without jumping, does not mean you have a great center. Okay, that is a little joke but it makes the point that all of what seems to be is not necessarily true.

We can say some things about divergences however that will help us in the future as we trade.

Divergences can be very good clues to tell us what is coming, what to expect. In some cases divergences may be telling us the truth about the direction described by their name, in others we might better see them as being Red Herrings. As you trade The RSI Pro Trading System, you will begin to discern the difference.

The misconception that Positive or Bullish Divergence means a change in trend to the upside or that Negative or Bearish Divergences mean a change in trend to the downside is inconsistent and not reliable as a trading signal.

The third misconception is that the 50 level is also important in RSI analysis. That is where the up vs. down closes in the indicator are in equilibrium or balance. *Crosses below 50 indicate a weakening of the stock and those above 50 signify strengthening.*

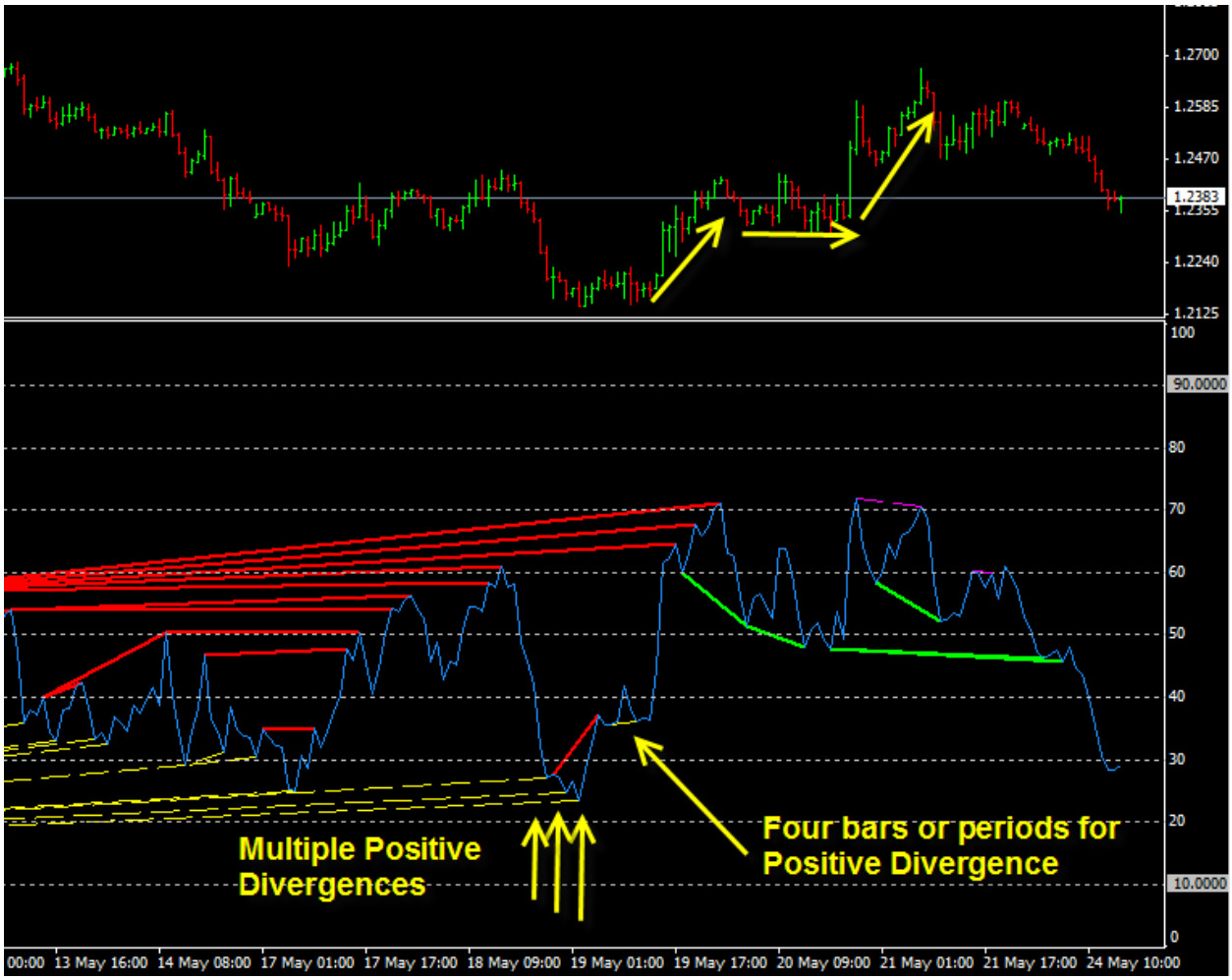
We are not going to try and prove or disprove this as it seems to have little significance for what we are about to learn. If RSI stayed at 50 we would always be in consolidation. A small move of any kind would most likely result in significant RSI liftoff in either direction. The misconception here is that it matters, which

in reality it does not.

Length of Divergence

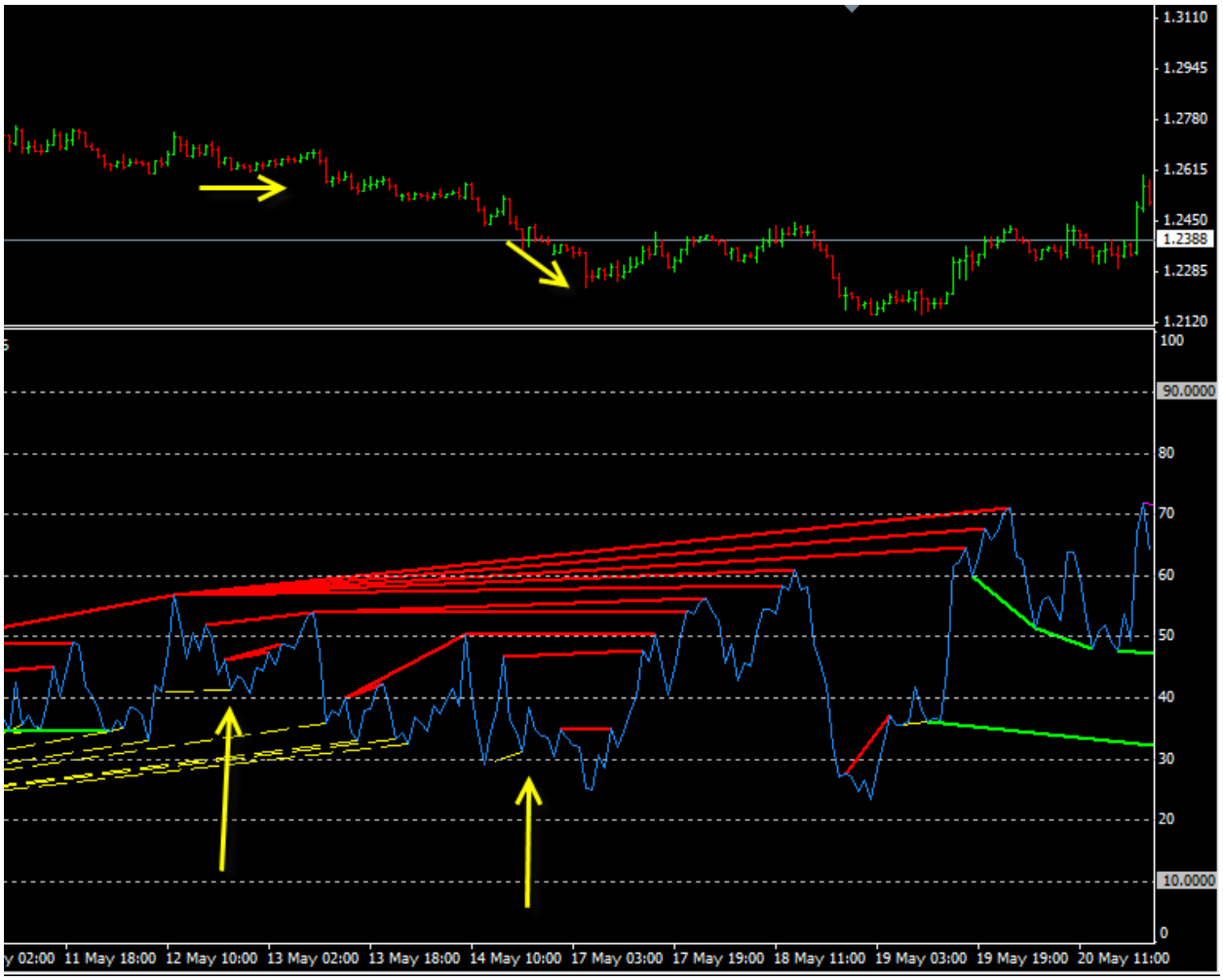
It has been indicated that the tighter the divergence the more powerful the signal. This is also not reliable.

First let's see where it works.



In this illustration we see the single yellow arrow point to a positive divergence that is 4 periods. In this case 4 hours on the EURUSD. Looking up at price, it did have an effect on the trade. It was preceded by three longer period divergences (three yellow arrows). In this case we see that the shorter, positive divergence did push price up.

Now let us look at where it didn’t work.



I am showing two. The first failed to make any move up and the second did not push price up at all but price went lower.

We can find the same situations for negative divergence as well.

Or conclusion then is that divergences do occur as signals on our charts but they are unreliable as entry points for trades.

CHAPTER 5

RANGES AND RANGE SHIFTS

Ranges of RSI

Now we are going to get into the meat of the RSI Advanced Techniques. The first thing we are going to discover is something called an RSI Range. It has been determined by Andrew Cardwell in his research on RSI that prices move within a range on the RSI in a bullish market, or uptrend, and prices move within a different range on the RSI when the price is in a bearish market, or downtrend.

The range that price finds itself in during a bullish uptrend is RSI 80 to RSI 40. This is regardless of the financial market or the time frame.

Price continually climbs while RSI remains in a range between 70 and 40. Typically, in bullish markets the RSI range is between 80 and 40 RSI.

Here we see price climbing steadily upward while RSI is moving within a 70 to 40 range. We would expect this after what we have just discovered about overbought and oversold.

Price continually drops while RSI remains in a range between 60 and 20. Typically, in bearish markets the RSI range is between 60 and 20 RSI.

This is a downtrend. Price is moving steadily down until it levels off for a number of hours before dropping again. Price stayed in the range for bearish trends or downtrends which is RSI 60 to RSI 20.

STOP: Mark these levels with horizontal lines on your charts and spend some time watch how RSI works in different price markets.

Range Shifts

What is a Range Shift? It is where the range of RSI **shifts** from bullish to bearish or bearish to bullish. For example, an uptrend is shown in the first chart, suddenly shifts downward and stays in the level between 60 and 20.

This is a Range Shift from a bullish range of 80 to 40 shifting down to a range of 60 to 20.

Here we see the Range Shift to the downside. Prices were moving upward steadily as RSI traveled within the 80 to 40 RSI range. Then as you can see the RSI dropped to 40 where it was being tested over and over but it could not recover above 60. All the while price kept dropping until the RSI settled in the 60 to 20 zone. As it did so price just moved steadily downward.

What happened? Why did price suddenly get to a top and fall? Fundamentally there could be many answers. Technically the answer couldn't be more simple.

The yellow circles on this chart are negative divergences driving price downward from the bullish range to the bearish range.

Remember above when we said that a negative divergence is usually a false signal meaning it seldom is a signal to short the market (positive divergence to go long)? That is still true with this one exception, where one negative divergence is followed by another, and then perhaps more until price changes range. For a negative divergence to create a trend reversal it requires minimally two in a row and often more.

In the coming pages I will show you what to look for in normal circumstances when you see a negative divergence but here what happens is you have a negative divergence, the first yellow circle at 80 RSI, then a second at 60 the top of the bearish range, then a third at 50. In this example three negative divergences can drive price from uptrending and in a bullish range of 80 to 40 RSI to a bearish range of 60 to 20 which we saw happen here. The shorter the time frame, the more susceptible price is to range shifts.

Remember, a chart is nothing more than market sentiment. To be successful you need to understand the underlying price principles of what is happen graphically in front of you on the charts.

Now, let's find where the RSI shifts from a downtrending market to an uptrend.

The price on this chart is free falling until the range shifts from a low at 20 up through 60 and almost to 80. Once it made this shift it stayed above 40 with the exception of a few dips.

What we see here is the exact opposite of the Range Shift to the downside on the previous two charts. Here we see price moving down steadily over a number of hours and several days all staying within the 60 to 20 RSI range. Then we have a reverse in the trend to where RSI makes a dramatic move up from 20 through 60 and to 70. The retest down never went below 40 and moved up and down in the 80 to 40 range for almost 6 days with almost no retracement.

Again, what we would expect. The yellow circles, positive divergences, in particular the two at the start of the range shift helped drive this price into a change of direction.

Here is the same chart of the above showing where positive divergences formed in a short period of time driving price up. It is only in this circumstance that a positive divergence causes a trend change when multiple divergences result in a Range Shift.

14 Point Summary

1. We have learned that RSI is an Oscillator.
2. It measures the sentiment of the market
3. It is a leading indicator, not a lagging indicator
4. It was created by Welles Wilder
5. We have learned how to setup the RSI using 14 periods on close, between 0 and 100 fixed points and to include RSI levels every 10 points 0 through 100.
6. We have learned how to view the chart so that the RSI is not scrunched up at the bottom of the screen and difficult to see and use.
7. We have learned that it is a misconception of most traders to think that when the RSI goes up through 70 and returns to below 70 on the RSI that it is time to exit a long trade or enter short.
8. We have learned also that it is a misconception of most traders to think that when price goes down through 30 on the RSI and then returns above 30 that it is time to exit a short trade or enter a trade long.
9. We have learned that the conventional wisdom of a positive divergence leading to a change in trend to the upside is incorrect.
10. We have learned that the conventional wisdom of a negative divergence leading to a downtrend is not a good indication of a change in trend to the downside.
11. We have learned that an uptrend or bullish markets typically fall between 80 and 40 RSI.
12. We have learned that downtrends or bearish markets typically fall between 60 and 20 RSI.
13. We have learned that these ranges shift, thus the term Range Shift and that these shifts are often caused by multiple divergences in fairly close sequence.
14. All of what we have learned so far can be used on any financial instrument in which RSI is used and in any time frame.

Now before we get the meat of RSI, Positive Reversals and Negative Reversals, we need to review exactly what a divergence is so that we can identify them.

CHAPTER 6

DEFINING POSITIVE DIVERGENCE

A positive divergence equals higher RSI at the second point then at the first but a lower price.

A positive divergence; RSI is going up valley to valley but price is coming down.

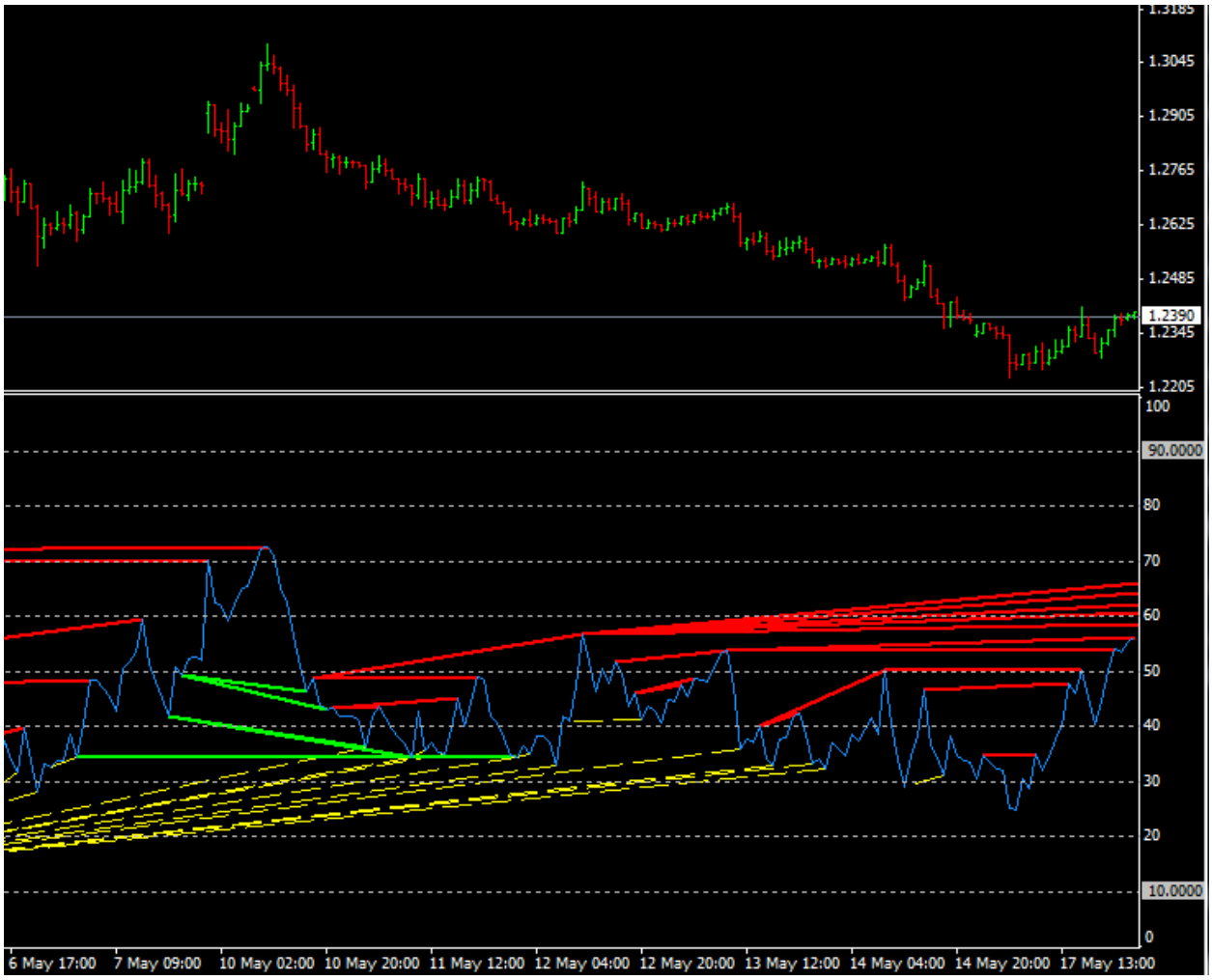
Notice in the chart above how the RSI on the chart is moving upward but price over the same period is moving down. Typically this would be a signal to many traders to buy. Also notice, however, that price did not go up but turned sideways before dropping again.

Let's look closer.

This is a close up of the chart above. RSI is moving upward and price is moving downward making this a positive divergence.

We have zoomed in on the previous chart to make the start of the divergence more visible. The RSI at the second valley is higher than the first but price is lower. This is a negative divergence and it is important as you are viewing your charts that you are aware of these, where and when they develop.

Below is an example of The RSI Paint Indicator which draws all divergences and reversals automatically giving you a graphic illustration of the momentum pressures in the market.

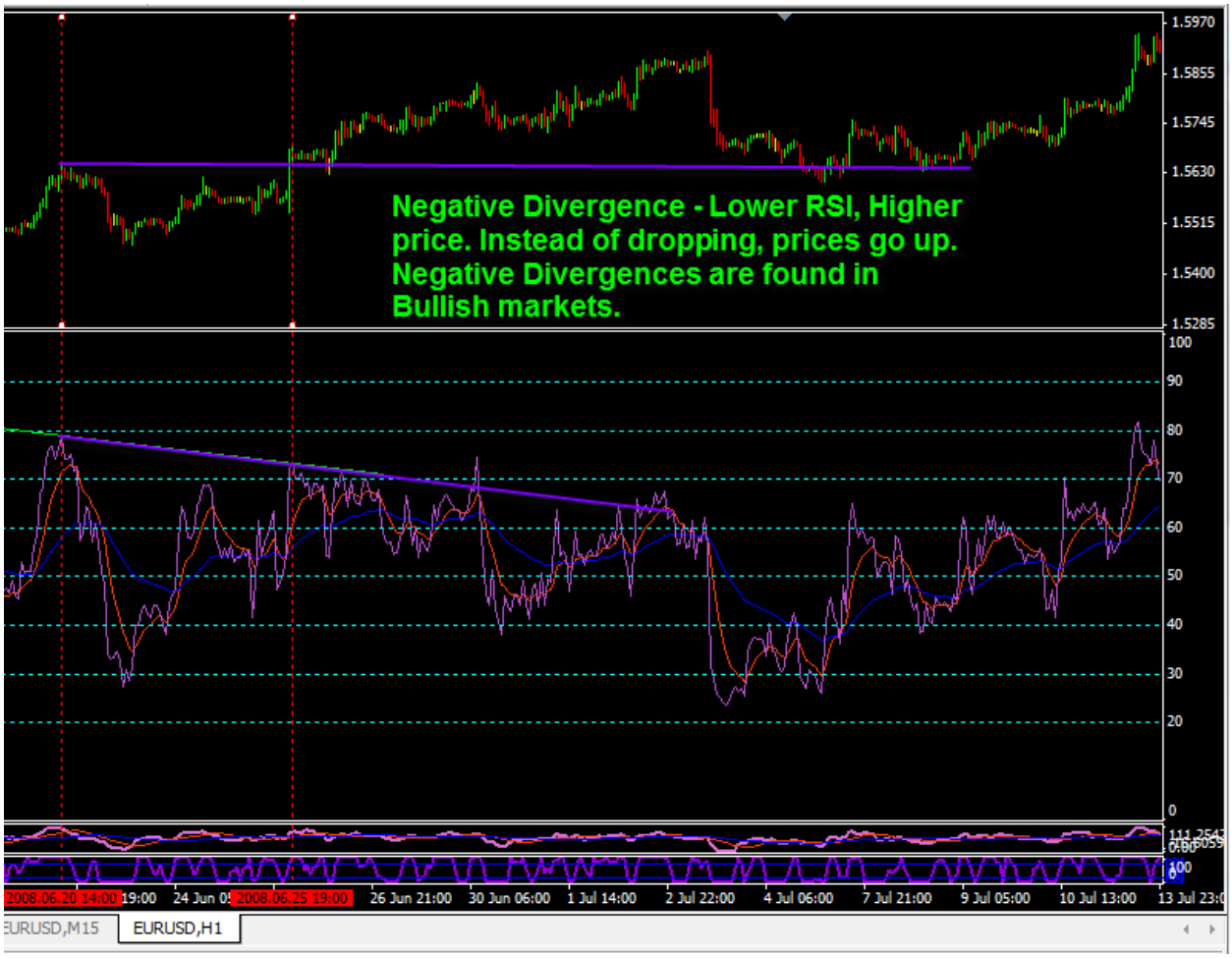


All of the above yellow dashed lines are multiple positive divergences. We will learn as we go on what to expect when we see this kind of patterning on the RSI.

CHAPTER 7

DEFINING NEGATIVE DIVERGENCE

A negative divergence is where the RSI at the second point is lower than the RSI at the first point but the price is higher. Again, look below.



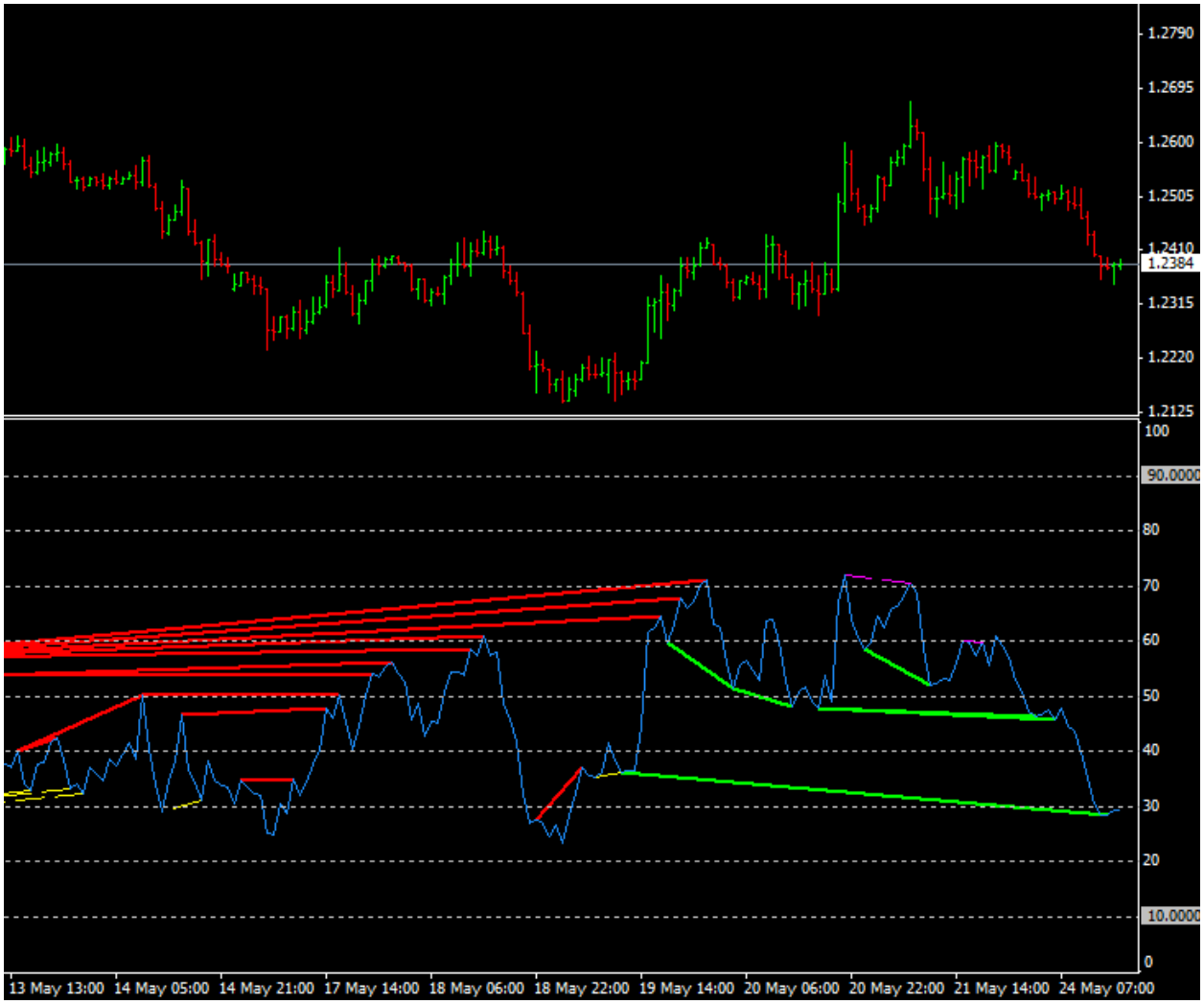
Negative divergence. RSI is going down peak to peak but price is going up

This is the exact opposite of the positive divergence. RSI is dropping but price is moving up. Below is a blowup of the same area at the start of this negative divergence.

Zooming in on the negative divergence from the above chart we see the decline in RSI and the rise in price, thus a negative divergence.

The chart above shows the second RSI peak is lower than the first and the price at the second peak is higher. This clearly describes a negative divergence.

Here is an illustration using The RSI Paint Indicator.



As you can see, the purple dashed lines on the right side of the chart on negative divergences placed automatically by The RSI Paint Indicator.

Once you begin to look at charts, you will begin to see these easily. When you see divergences, you will know that something important is about to happen. On an hourly chart it will take several hours to develop but it will happen. Divergences act like little spies alerting you to events before they happen so that you will have an edge. I find that the more I trade the more helpful it is to know where these occur.

STOP: See if you can find 5 divergences on your chart of each kind; five positive divergences and five negative divergences. Note how many periods separate the peaks and/or the valleys.

Also, if you see a Range Shift occur after a divergence, look for another one close by.

Introduction to Reversals

Andrew Cardwell, a student of Welles Wilder, picked up the ball from Wilder on RSI and ran for a touchdown.

He found what he called Positive and Negative Reversals. Others have talked about this but Cardwell has been the expert when it comes to RSI. I first learned about these reversals when reading books by Constance Brown however. In all my reading on trading and the Forex market over three plus years, which amounted to over a hundred books and still counting, I had never heard the terms used.

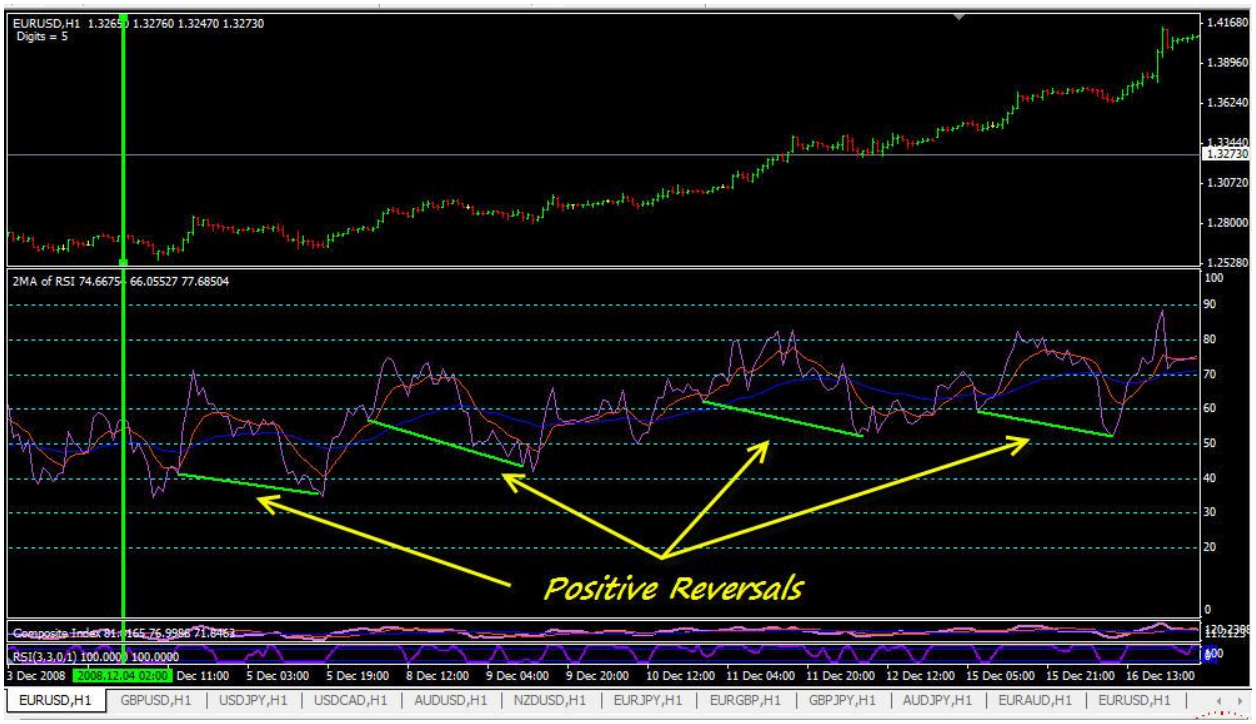
What are Reversals?

Positive and Negative Reversals appear on the RSI chart and signal points in which the trader can have a high confidence of buying or selling. (We have learned since writing this book that it pays to have additional confirmation from other sources when taking these signals. Remember they signal a trade but not all trades should be taken at that particular moment and some signals are “Red Herrings”. We will discuss this more in further studies on RSI. For now we want to learn the basics of a Reversal signal.)

CHAPTER 8

DEFINING POSITIVE REVERSALS

What is a Positive Reversal (PR)? A Positive Reversal forms when the second valley on the RSI chart is lower than the first valley and where price at the second valley is higher. We are going to take this step-by-step.



Here we see 4 Positive Reversals marked out on the hourly chart of the EURUSD. This chart will give you an idea of how often you will see these signals occur. On this chart there were 4 signals from December 4th to December 16th. During that time period and shortly after price went dramatically higher, one positive reversal after another.

Let's take a closer look at the first PR.

Remember, a PR occurs when Point 2 (Valley 2) has a lower RSI but a higher price. So we see that the RSI is lower. What about the price?

Yes, as can be seen in this chart both conditions are met; lower RSI at RPT.2 then at RPT.1. Okay, now that we have this information, what next? First, we are going to add prices to the RSI locations.

Notice below that I have marked, using a vertical line, the valleys of the RSI where the PR is located. I have drawn a trendline from RPT.1 to RPT.2 on the RSI chart. The line on price is drawn from the close of PPT.1 to the close of PPT.2. It is extremely important that you pay attention to drawing this line from “close to close”, accurately. In the case of a PR it will be your support line.

I have added three things to this chart. First, I have placed the price under the RSI points RPT. 1 & 2 and I added the arrow pointing to the green bar close. (If you want to see this clear go use your reader to zoom in closer.)

When identifying a PR, look at the prices first to confirm that price at RPT. 2 is higher than at RPT.1.

Here is a crucial point. When is the PR a PR? When the bar after RPT.2 confirms the Reversal by closing above the green price trend line. By doing so it creates a VALLEY on the RSI. Without the valley, price could continue down. Wait for the next price bar to close. If it closes above the trend line that you drew on the price chart from close to close, then you have a confirmed PR. This is true on any time frame and any financial instrument you are trading.

In a few moments we will discuss how and where to enter. But we need to add one more price to our chart.

See the circle? As you can see there are a number of “peaks” along the RSI “mountain top” between RPT.1 and RPT.2. The point I selected has the highest price. That is what you want to always select, the peak with the highest price contained within the PR points, RPT.1 and RPT.2.

Let's Review by using a blank chart.

1. You turned your computer on and it looks something like this.

2. Fourteen hours later it looked like this. You have located a Positive Reversal on the RSI and you have marked the trend lines on both the RSI and price charts.

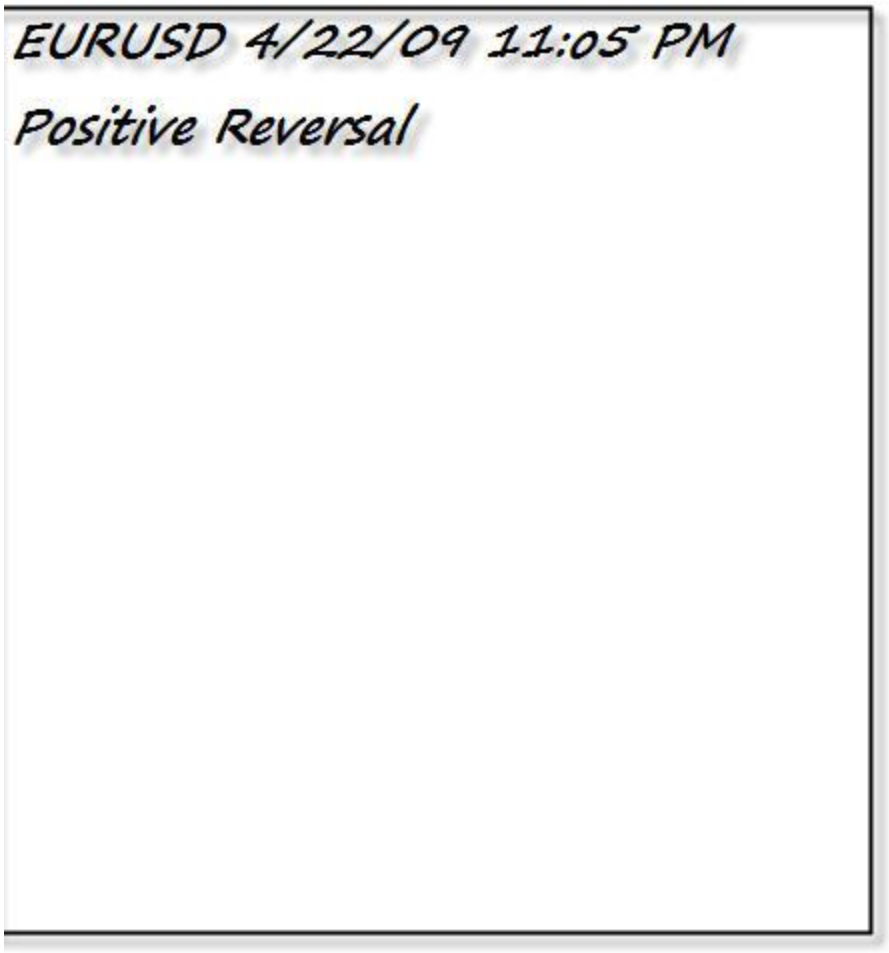
We have a lower RSI at the second valley and a higher price. Plus the bar that created the valley closed above the price trendline drawn from close to close.

3. Write in the price on the RSI or you can do it on a piece of paper. In the beginning I think it is a good idea to put them on the chart if possible.
4. That brings us back to here:

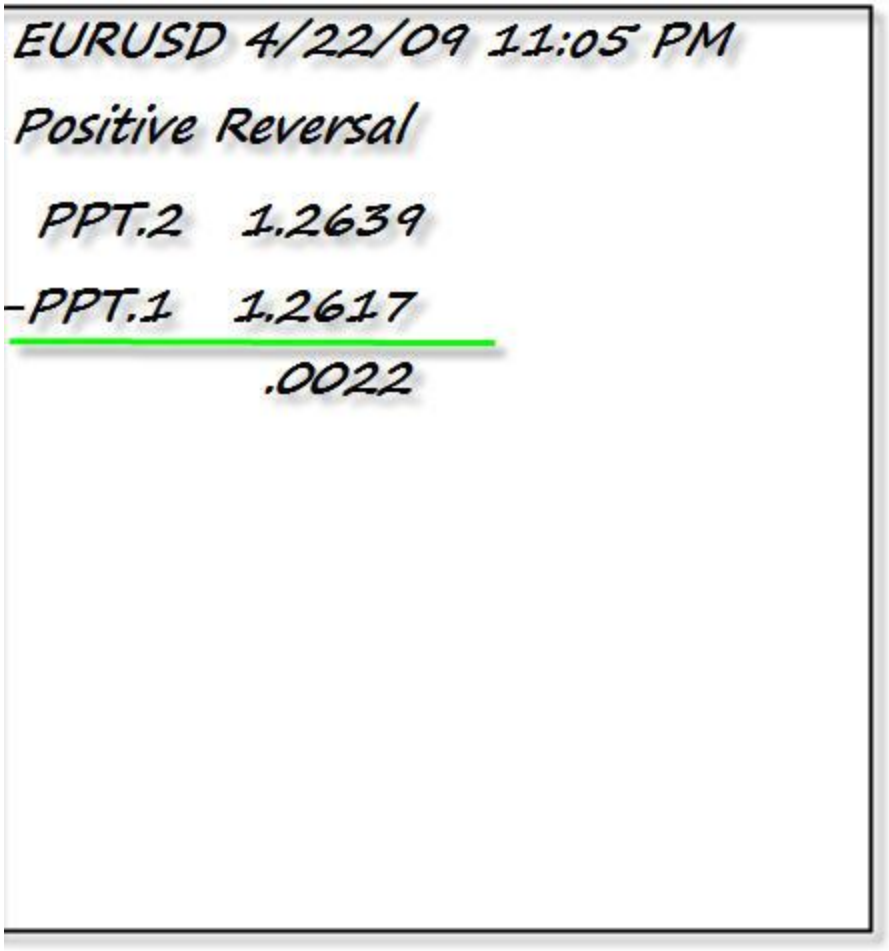
Now we calculate our target. To do that I will discuss one method I have found extremely successful for entering the trade.

CRITICAL CALCULATIONS

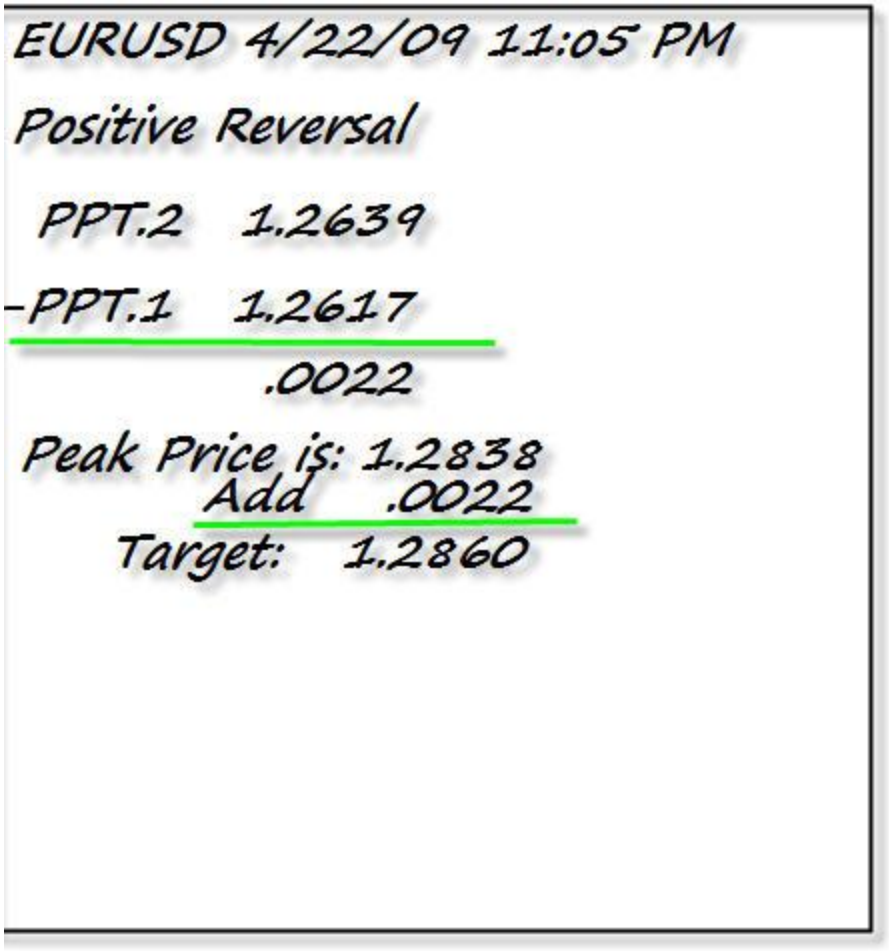
I have small sheets of paper on my desk that I have cut up into the size of a 4X6 index card. It looks like this. On it I write the pair I am trading (or stock, etc.), the date, time and what kind of Reversal. In this case “Positive Reversal”.



Next we take PPT.1 and subtract if from PPT.2. Now the note looks like this.



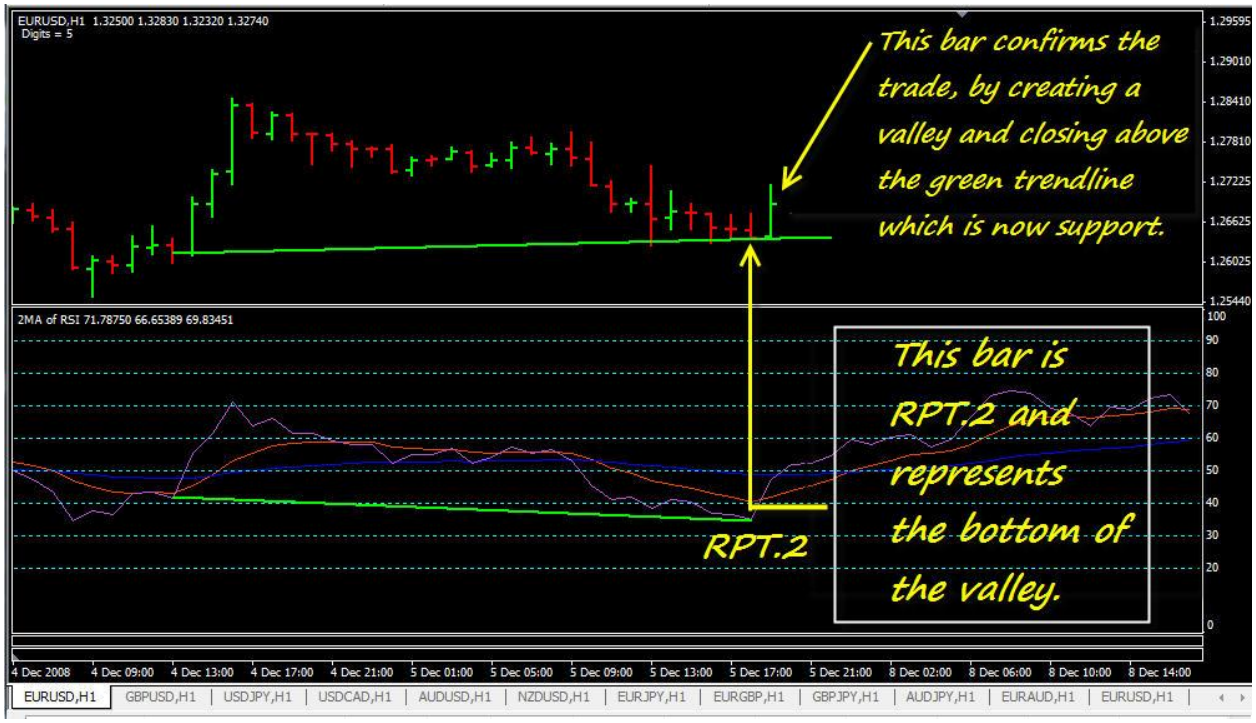
We have a 22 pip difference between the price points. The next step will give us the proposed target for this trade. We take the highest peak and add the 22 pips to it giving us a target of 1.2860.



Now we know where we are going?
What do we need to do next? Two things.

1. We need to know where to enter and where to place our stop.
2. And we need to know based on our entry, stop and target what are Reward to Risk Ratio is.

We are almost ready to trade. Are you ready?



By looking at this chart we see that the trade is confirmed. The trendline on the price chart is now support for this trade. As long as we stay above this line and there is momentum, we want to hold on to our trade.

The Entry

Entry is at the opening of the next bar.

The Stop Loss

My experience has shown that on the hourly chart placing a stop at either the RPT.2 low minus 10 or the “confirmation” bar minus 10 meets with good success. My research shows that in most time frames a PR very seldom draws down below these bars. If this happens there is always a chance for re-entry if the trader feels there is good reason to take the trade. We will see this later in some of our examples.

A word about stops, always set one.

1. If you set a stop you are forced to look at your Reward to Risk Ratio is. Most top traders will not risk $1 to make $1. The minimum is normally $3. You can only determine this if you have a hard stop.
2. There are many others reasons to set a stop. All of which I have experienced.
    a. Your Internet goes down.
    b. Your trading platform goes down. Have the phone number to the trading desk handy all the time.

c. Your computer freezes or crashes.

I think you get the picture. There is no reason not to have a stop unless you don't know where it is. And if you don't know where it is then you probably shouldn't take the trade.

Now let's decide what we know and don't know.

Entry is at the open of the bar following the confirmation bar.
The stop is at the low minus 10 pips of the confirmation bar or the bar at RPT.2.
Target is the highest price of the peaks between the RSI points of the PR.

From this we determine our Risk which is simply taking our entry and subtracting our stop from it. This gives us 61 pips.

We figure our Reward by taking the target that we determined first and subtracting our Entry. Reaching the Target would yield 170 pips. Our Reward to Risk is determined by dividing the Total Pips Possible by the Risk, so, 170/61 = 2.78. As we like to trade 3:1 on trades we may or may not take this trade. Personally I would probably take it.

As it turns out price exceeded the Potential Target on this trade by 540 pips. Extraordinary results. Sixty-one pips risked and 710 realized.

That completes the explanation of a Positive Reversal. The Negative Reversal is exactly the same. We will look at this next.

Positive Reversal Summary

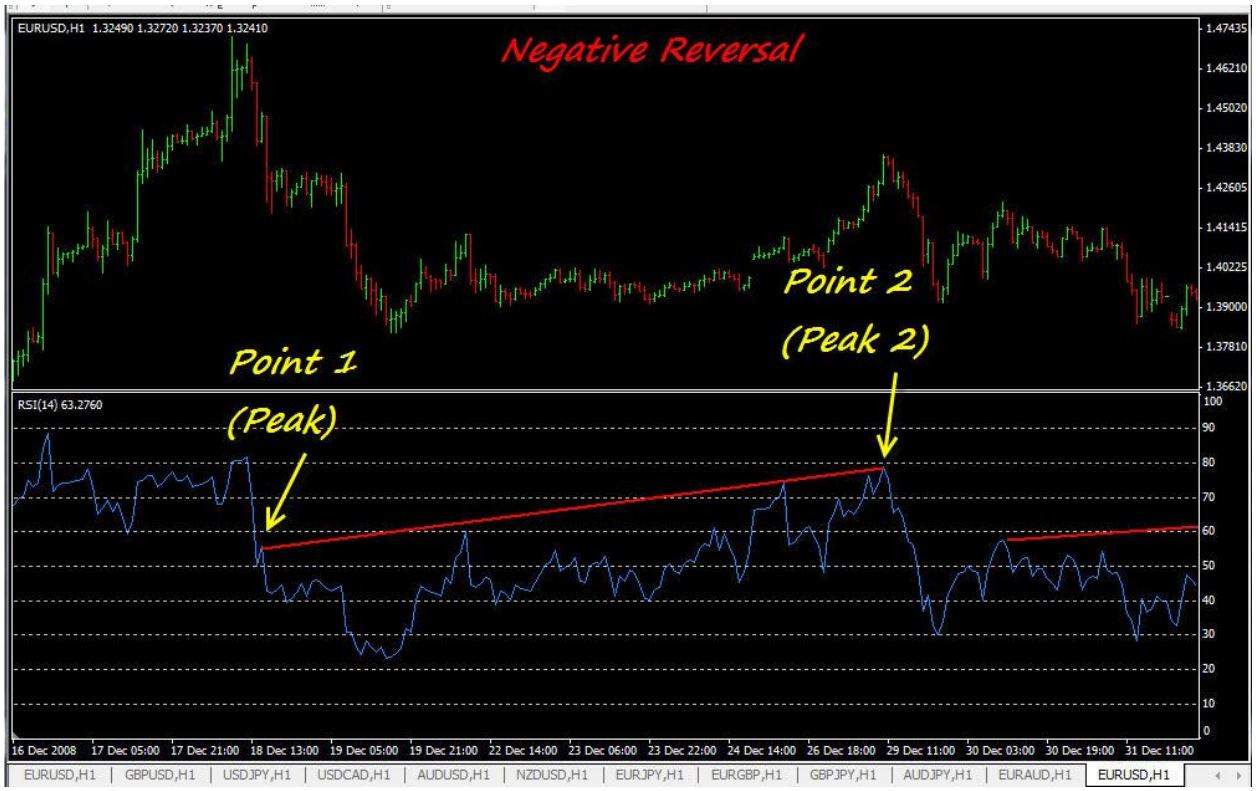
1. Positive Reversals appear on the RSI chart and signal points in which the trader can have a high confidence of buying.
2. A Positive Reversal forms when the second valley on the RSI chart is lower than the first valley and where price at the second valley is higher. Or, RPT.2 is lower than RPT.1 and PPT. 2 is higher than PPT.1
3. The bar after RPT.2 confirms the Reversal because by closing above the Green price trend line it creates the VALLEY. Without the valley, price could continue down. Entry is at the open of the next bar.
4. The target is the PEAK between RPT. 1 and 2 where price is the highest plus the addition of the difference between PPT.2 and PPT.1.
5. The stop is at either the PPT.2 low minus 10 or the low of the confirmation bar minus 10. Normally the lowest low is used.
6. Reward and Risk is determined before the trade is entered so that the trader can decide if the trade is within the scope of his Money/Risk Management parameters.

CHAPTER 9
DEFINING NEGATIVE REVERSALS

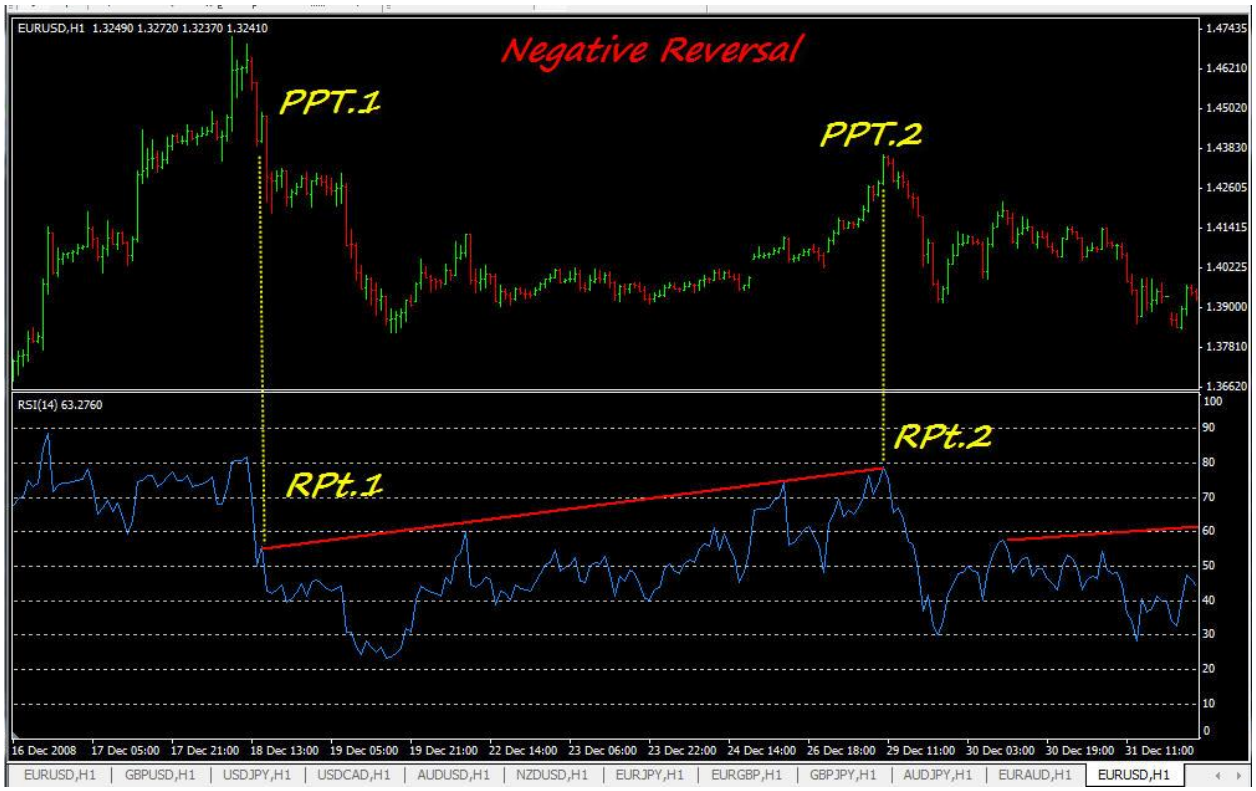
What is a Negative Reversal (NR)? A Negative Reversal forms when the second peak on the RSI chart is higher than the first peak and where price at the second peak is lower. We are going to take this step-by-step.

Here we see 3 Negative Reversals marked out on the hourly chart of the EURUSD. This chart will give an idea of how often you will see these signals occur. On this chart there were 4 signals from December 18th to January 16th.

Let's take a closer look at the first NR.

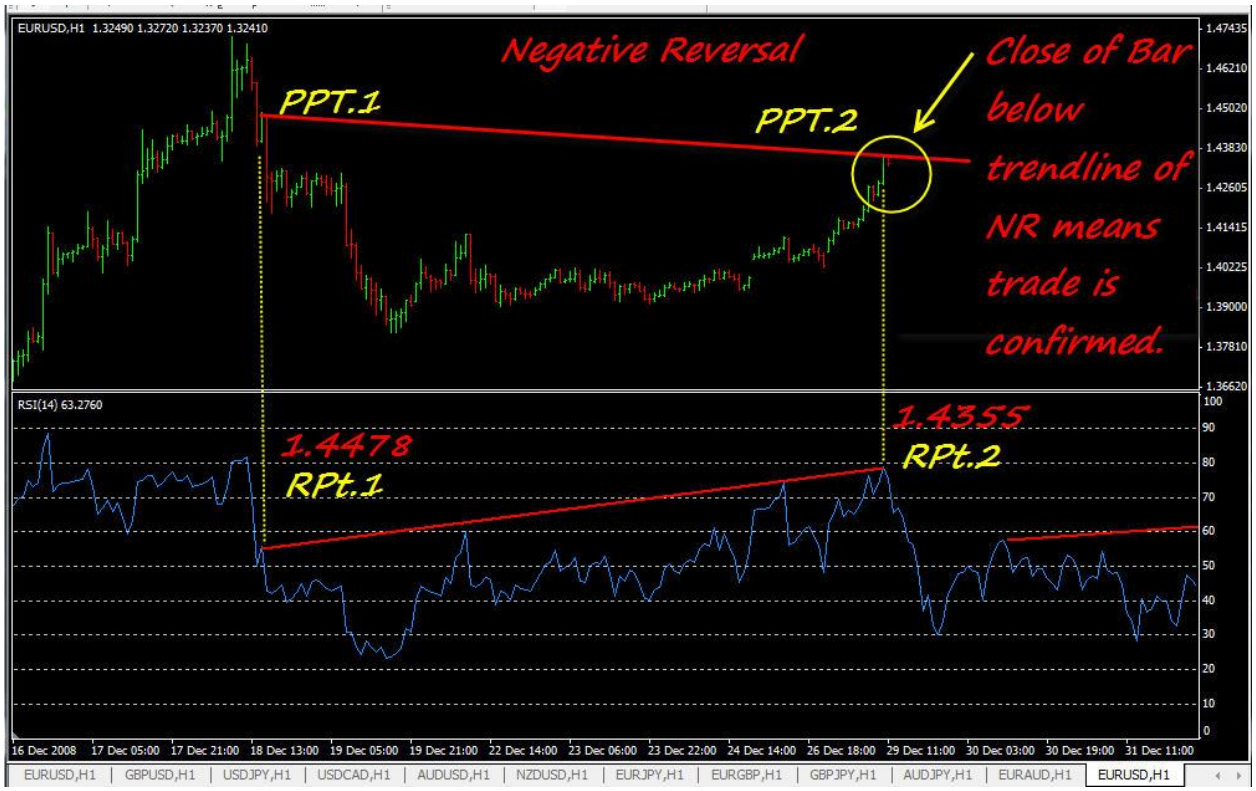


Remember, NRs occur when Point 2 (Peak 2) has a higher RSI but a lower price. So we see that the RSI is higher. What about the price?



Yes, as can be seen in this chart both conditions are met. Higher RSI at RPT.2 then at RPT.1. Okay, now that we have this information, what next? We are going to add prices to the RSI locations.

Notice also that I have marked, using a vertical line, the peaks of the RSI where the NR is located. I have drawn a trendline from RPT.1 to RPT.2 on the RSI chart. The line on price is drawn from the close of PPT.1 to the close of PT.2. It is extremely important that you pay attention to drawing this line from “close to close”, accurately. In the case of a NR it will be your resistance line.

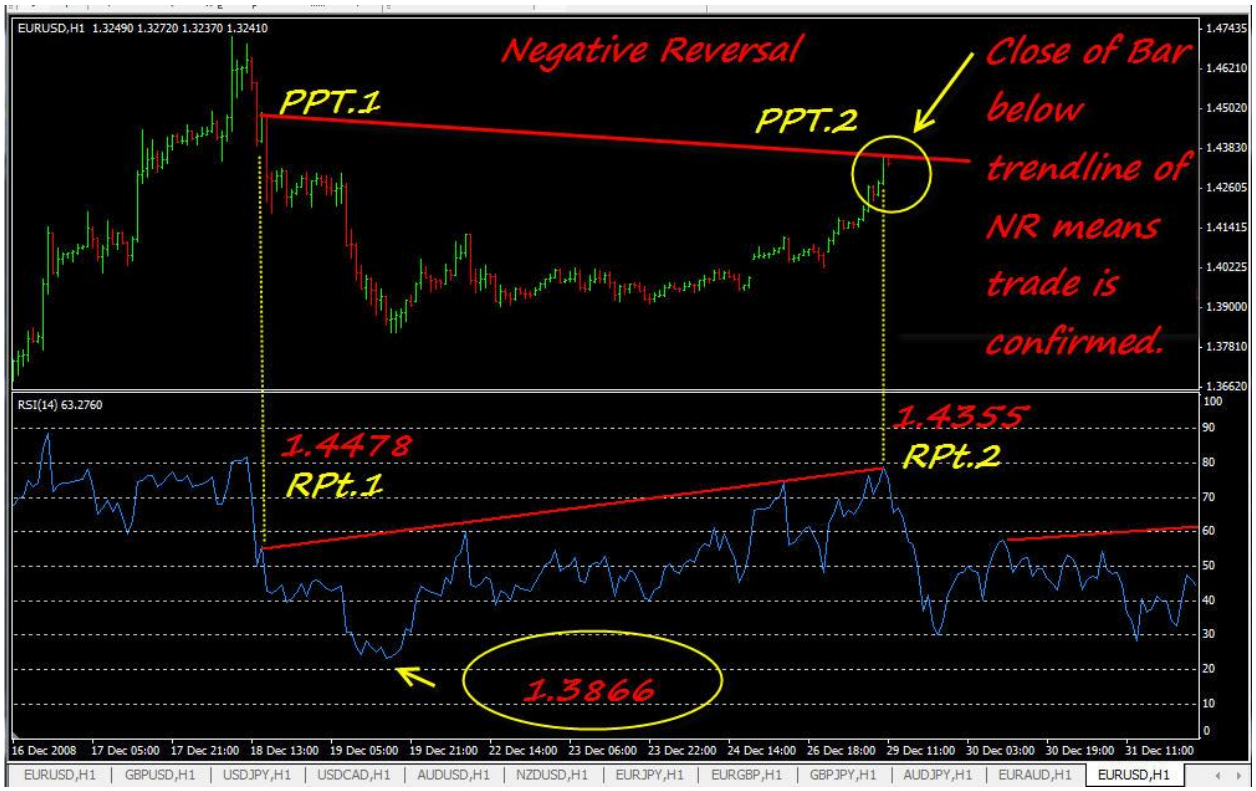


I have added three things to this chart. First, I have placed the price over the RSI points RPT. 1 & 2 and I added the arrow pointing to the red bar close.

When identifying NRs, look at the prices first to confirm that price at RPT. 2 is lower than at RPT.1.

Here is a crucial point. When is an NR an NR? When the bar after RPT.2 confirms the Reversal by closing below the red price trendline so it creates a PEAK on the RSI. Without the peak, price could continue up. Wait for the next price bar to close. If it closes below the trendline, that you drew from close to close on the price chart, then you have a confirmed NR. This is true on any time frame and any financial instrument you are trading.

In a few moments we discuss how and where to enter. But we need to add one more price to the chart.



See the circle? As you can see there are a number of “valleys” along the RSI “Valley lows” between RPT.1 and RPT.2. The point I selected has the lowest price. That is what you want to always select, the valley with the lowest point contained within the NR.

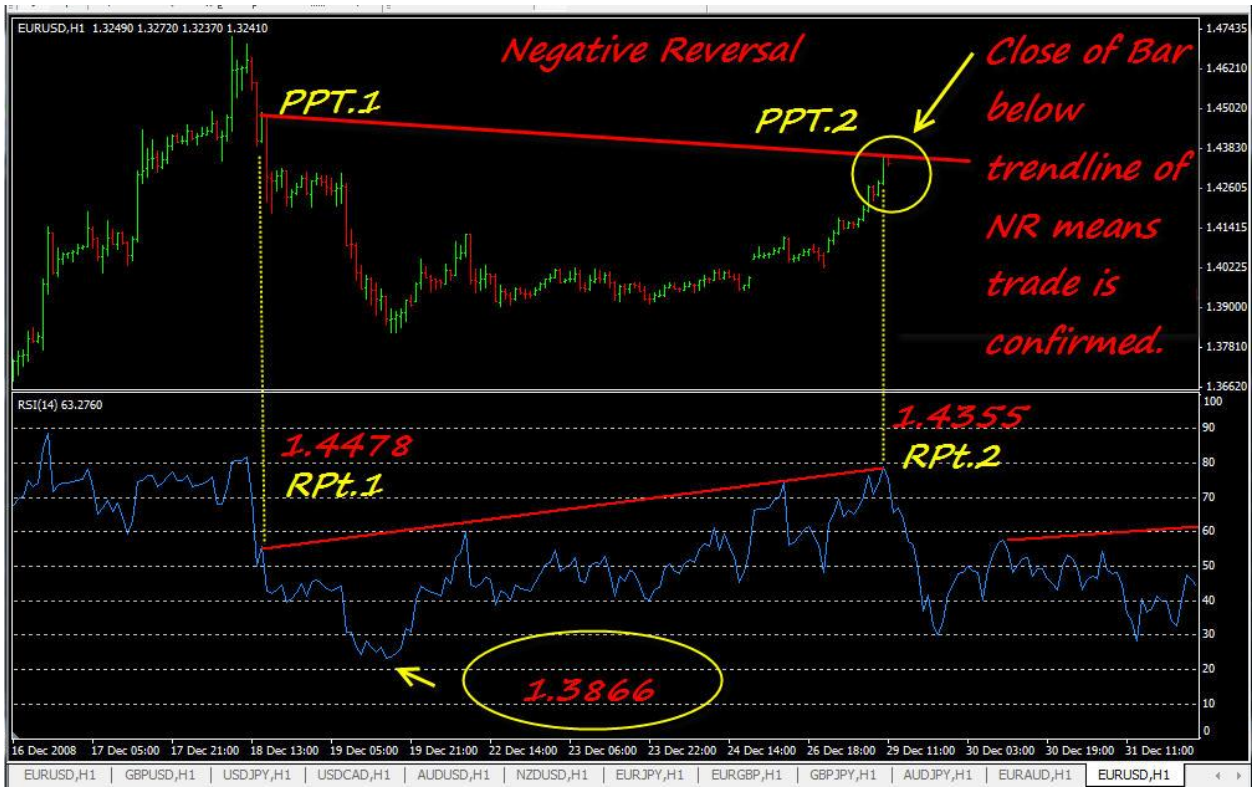
Let’s Review.

1. You turn your computer on and the chart looks something like this.

2. A number of hours later it looked like this. You have located a Negative Reversal on the RSI and you have marked the trendlines on both the RSI and price charts.

The Negative Reversal has formed. We have a higher RSI on the second peak and a lower price. Plus the bar that created the peak closed below the price trendline drawn from close to close.

3. Write in the price on the RSI or you can do it on a piece of paper. In the beginning I think it is a good idea to put them on the chart if possible.
4. That brings us back to here:



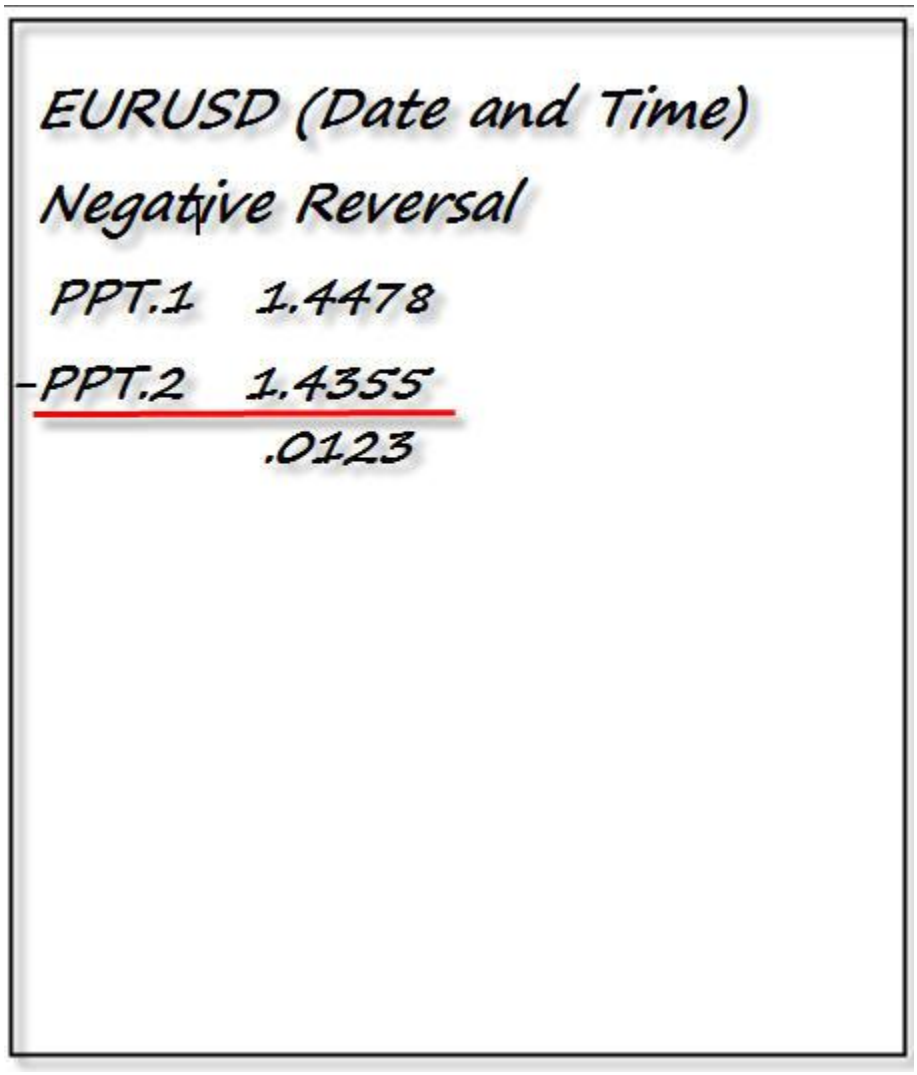
Now we calculate our target.

CRITICAL CALCULATIONS

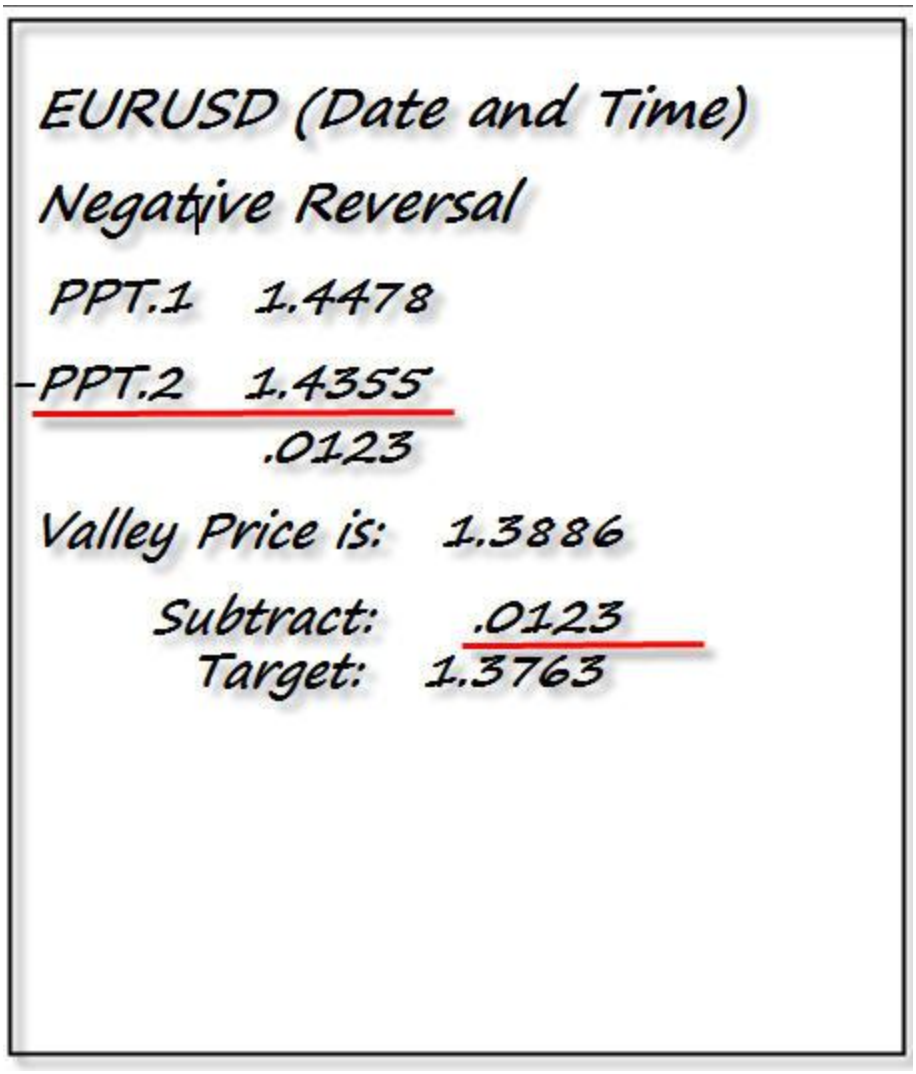
Write the pair (or stock, etc.), the date, time and what kind of Reversal. In this case “Negative Reversal”.

Next we take PPT.2 and subtract if from PPT.1.

Now the note looks like this.

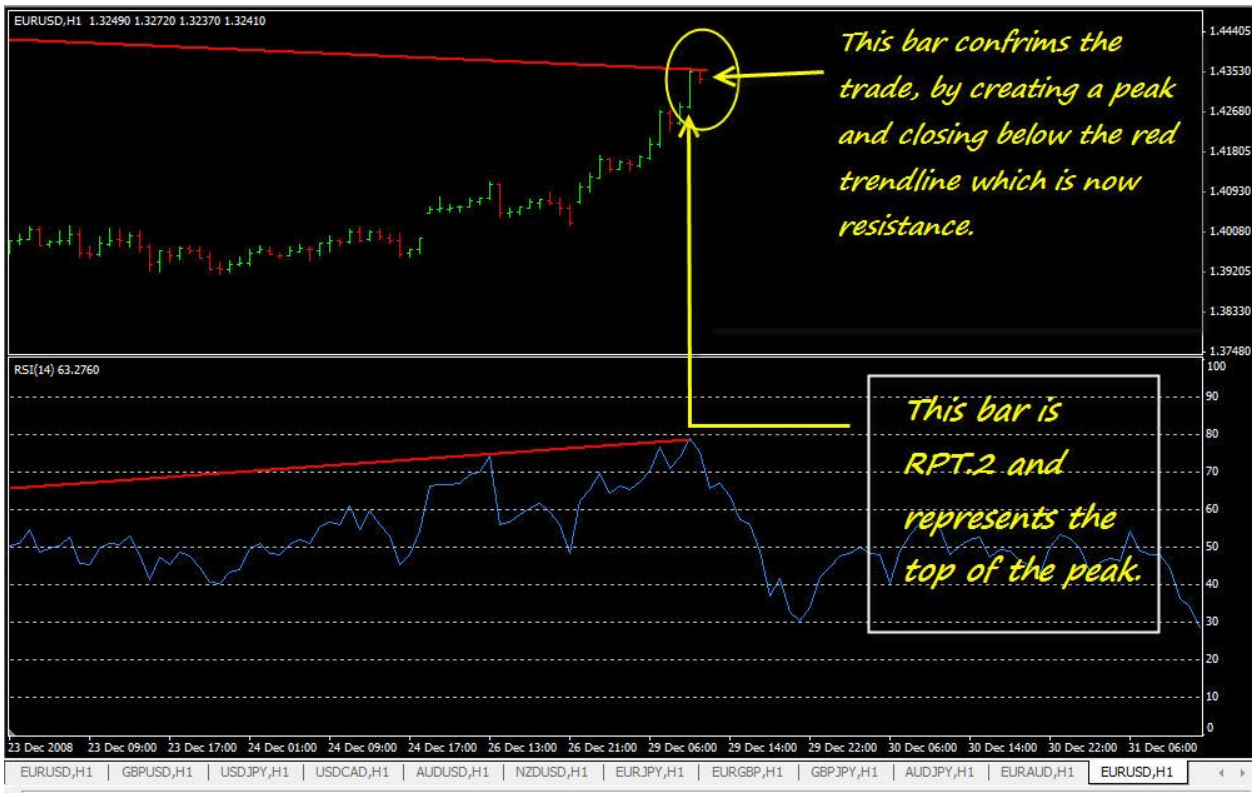


We have a 123 pip difference between the points. The next step will give us the proposed target for this trade.



We take the lowest valley and subtract the 123 pips from it giving us a target of 1.3763. Now we know where we are going so what do we need to do next?

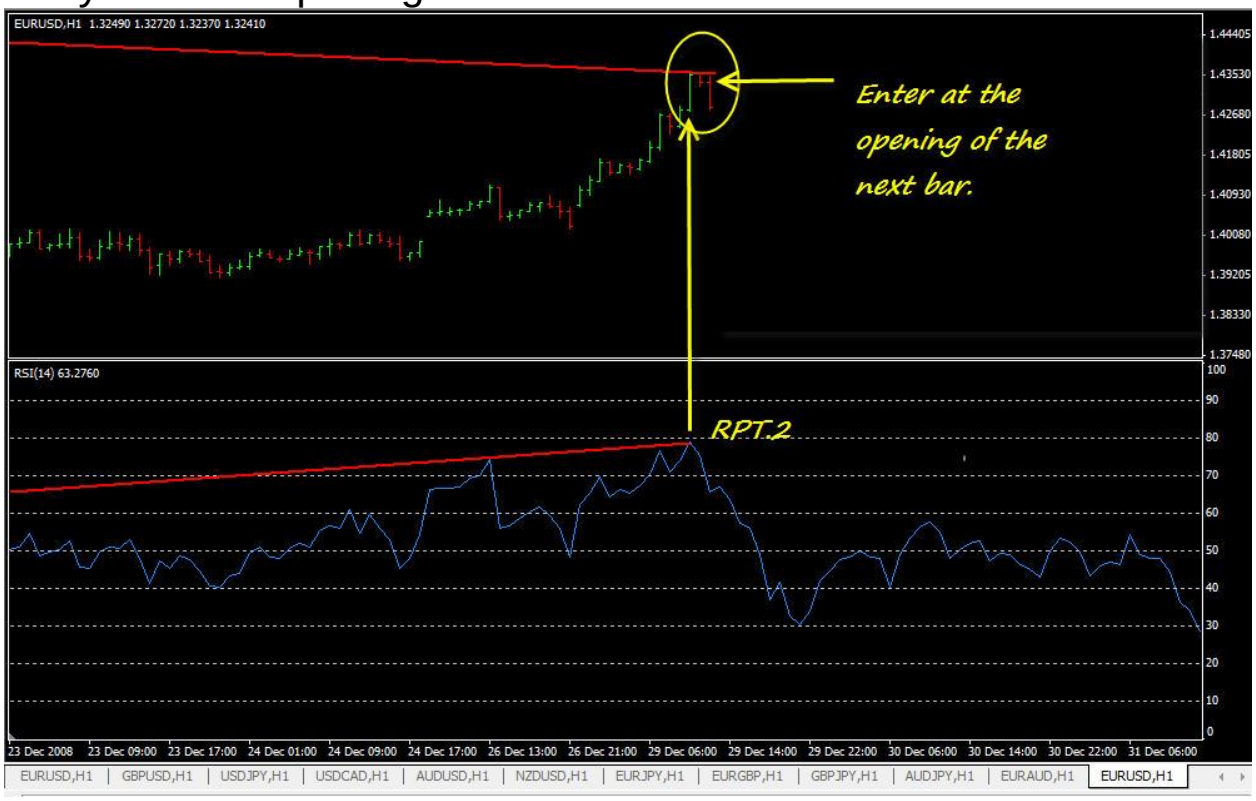
1. We need to know where to enter and where to place our stop.
2. We need to know based on our entry, stop and target what are Reward to Risk Ratio is.



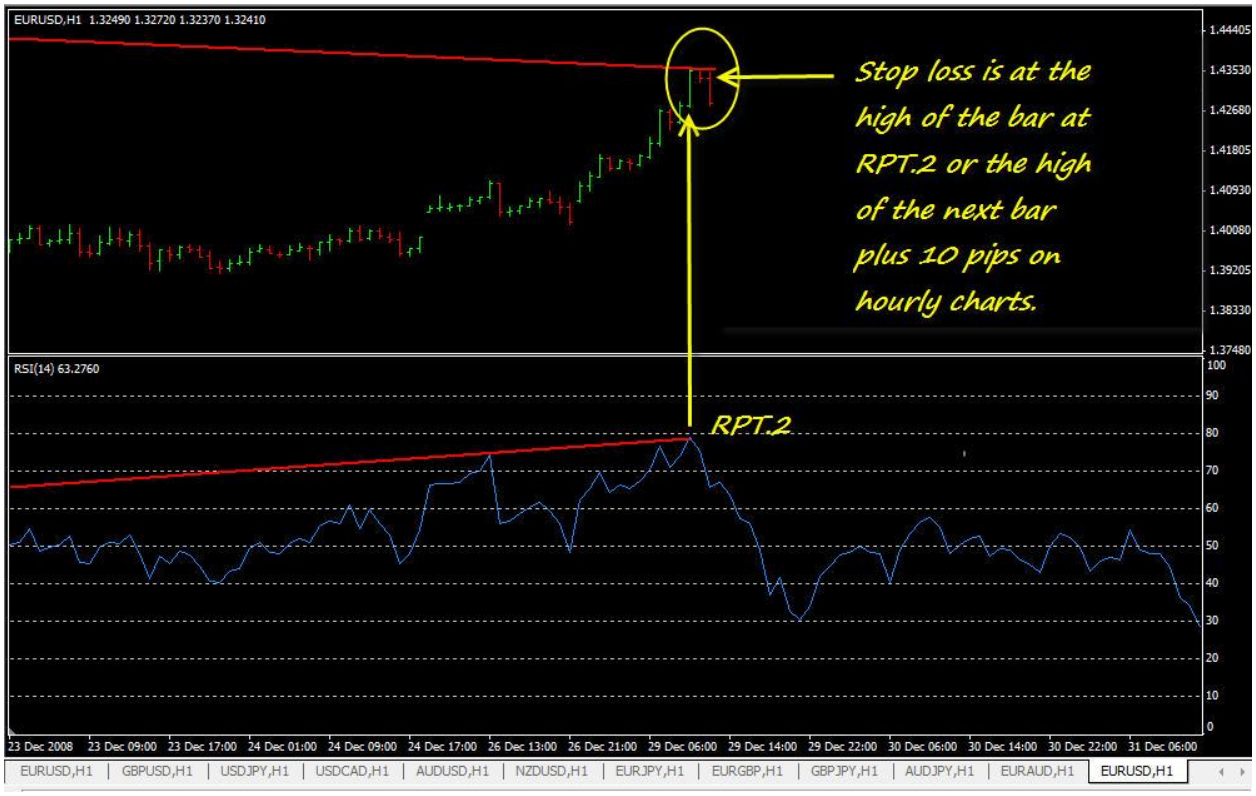
By looking at this chart we see that the trade is confirmed. The trendline on the price chart is now resistance for this trade. As long as we stay below this line and there is momentum, we want to hold on to our trade.

The Entry

Entry is at the opening of the next bar.



The Stop Loss



My experience has shown that on the hourly chart placing a stop at either the RPT.2 high plus 10 or the “confirmation” bar plus 10 meets with good success. My research shows that in most time frames that a NR very seldom goes above these bars. If this happens there is always a chance for re-entry if the trader feels there is good reason to take the trade.

A word about stops, always set one.

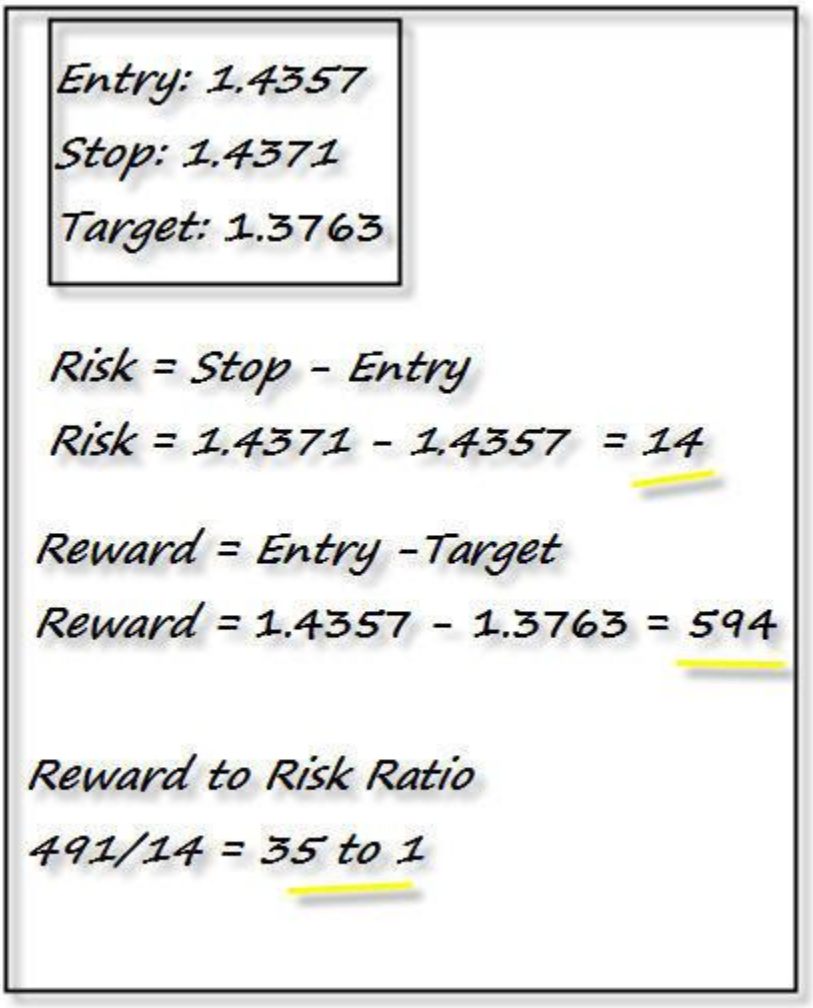
1. If you set a stop you are forced to look at your Reward to Risk Ratio is. Most top traders will not risk $1 to make $1. The minimum is normally $3. You can only determine this if you have a hard stop.
2. There are many others reasons to set a stop. All of which I have experienced.
    a. Your Internet goes down.
    b. Your trading platform goes down. Have the phone

number to the trading desk handy all the time.

c. Your computer freezes or crashes.

I think you get the picture. There is no reason not to have a stop unless you don't know where it is. And if you don't know where it is then you probably shouldn't take the trade.

Now let's decide what we know and don't know.



Entry is at the open of the bar following the confirmation bar. The stop is at the high plus 10 pips of the confirmation bar or the bar at RPT.2.

From this we determine our Risk which is simply taking our stop

and subtracting our entry (as we are going down now in price). This gives us 14 pips.

We figure our Reward by taking the entry and subtracting our target. Reaching the Target would yield 594 pips. Our Reward to Risk Ratio is determined by dividing the Total Pips Possible by the Risk, so, 491594/14 = 42 to 1. As we like to trade 3:1 on trades we definitely would take this trade.

That completes the explanation of a Negative Reversal.

Last, we are going to look at several set ups and on several charts just to get familiar with what we are looking for.

Negative Reversal

1. Negative Reversals appear on the RSI chart and signal points in which the trader can have a high confidence of selling.
2. A Negative Reversal forms when the second peak on the RSI chart is higher than the first peak and where price at the second peak is lower. Or, RPT.2 is higher than RPT.1 and PPT. 2 is lower than PPT.1
3. The bar after RPT.2 confirms the Reversal because by closing below the Red price trend line it creates the PEAK. Without the peak, price could continue up. Entry is at the open of the next bar.
7. The target is the VALLEY between RPT. 1 and 2 where price is the lowest minus the difference between PPT.1 and PPT.2.
8. The stop is at either the PPT.2 high plus 10 or the high of the confirmation bar plus 10. Normally the highest high is used.
9. Reward and Risk is determined before the trade is entered so that the trader can decide if the trade is within the scope of his Money/Risk Management parameters.

CHAPTER 10
EXAMPLE TRADES USING POSITIVE AND NEGATIVE REVERAL SIGNALS.

EXAMPLE 1

This is a Positive Reversal:

1. Point E on RSI is lower than Point D on RSI and Price is higher. We have confirmation when the bar on price after RSI E forms a valley after the close.
2. Mark the PR on the RSI. Drawing light vertical dashed lines is helpful to make certain you have the exact price bar that is marking the valleys at Points D and E.
3. Place the prices on the chart with the text tool. (Many chart programs have a small horizontal box on the chart that lists the Open, Low, High and Close when you scroll over the bars or RSI to make finding the O,L,H, and C easier.)
4. Draw your slope line on price from close to close.
5. Look for the highest price at the peaks between Points D and E.
6. Take the difference between Points D and E and add it to the highest peak price for your target.
7. Do your calculations: Write down your entry, stop, target and

calculate you Reward and Risk Ratio.

8. Enter the trade at the open of the bar following the confirmation bar.

EXAMPLE 2

The RSI peak with the highest price has been marked. The second RSI point is lower than the first. The price is higher. The bar after the RSI valley closes above the trendline. Enter at the next open if all Reward and Risk numbers are in line with you management system.

EXAMPLE 3

This is the previous trade after we entered. Let's look at some things here. These are decisions you as a trader need to make as you trade.

1. Point A on the chart is where we entered. Price went up but closed near the open. The next bar closed and re-tested our slope line. The next two bars had higher highs. At the close we would be up 18 pips. Not the greatest, but price is moving in the right direction. Depending on your trading style you have a number of things to consider.
    a. Should you move your stop? If you do, say 10 pips you are cutting your risk of loss but you may be cutting short your potential reward as price may come back to stop you out but not far enough to hit your original stop. Then price might take off and you have a small loss (better than a big loss) while others who left there stop where it was had a big gain.
    b. These are decisions you have to make as you become more experienced.
2. Point B the price went back through the slope line. Again, depending on your risk management system, psychology,

etc. you may have taken a small profit or you might still be holding on. Assuming you have not moved your original stop (the dashed red line) you would have been stopped out on the circled bar or certainly the next one. Is the trade over for you? There are several things you can do.

a. Zoom out so you can see what price on the chart is doing. Is it in a downtrend? Probably not because Positive Reversals seldom show up with this much Reward and Risk in a downtrend.
b. If that is the case is it in consolidation or an uptrend or perhaps in a third possibility, coming out of consolidation for a breakout to the upside. It would be highly unlikely it would be going to break out to the downside.
c. So again based on your experience and trading style you have to decide if you are going to re-enter or exit.
d. What else could we consider?
    i. Where has RSI been ranging? Is it staying in the 80 to 40 bullish area or has it suddenly dropped into a 60 to 20 bearish area. Here we see that the second point of the RSI was at 30. Looking back on the RSI we see that price had been having a hard time getting above 50 but we also notice that while the PR was forming RSI went to 70. That is a possible Range Shift. Plus when RSI dropped it stopped at 30 and is retesting that level.
    ii. Looking at the RSI line we drew from point-to-point. What if we extended that line? If we did we would notice that the RSI is retesting that line.
    iii. Third, the Reward/Risk Ratio that we calculated before has not diminished.

3. So, for our purposes we decide to re-enter but where will that be? For the purposes of Reversals we would wait for a close above the line and open at the next bar, or to be conservative wait until two bars form a valley above the

trendline on price.

4. Set the stops as at the beginning on the lows of the previous bars minus 10.
5. If you had entered at D with those settings you would have been in profit 8 bars later (you may have to develop the ability to let trades develop).
6. If you had entered at E you would have made a steady profit.
7. You will always have to be asking the question – where do I move my stop next? This is something you will develop after many trades. Sometimes you will be wrong, sometimes you will be right. But if you get stopped out and make 20 pips but someone else stayed in and makes 100, you are both ahead. It is not so much what you make as that you do not lose large amounts and that your winners exceed your losers. Note, I didn't say that you had more winning trades then losers. It would not be unusual to have more losing trades but have more pips at the end of a week, month, or year.
8. One final point on this example. Point C is a pin bar attributed to Martin Pring. He discusses these bars in some of his books. This is a bar that shows exhaustion. It would have been nice to have entered there. I am pointing this out not for you to run off and learn about these bars but to point out that there are other methods of trading that will confirm that the trade you are in is a good one. Other methods might be Fibonacci Analysis or Elliott Wave Principles. These methods are forward looking to some extent whereas lagging indicators are back-looking such as moving averages and MACD.

EXAMPLE 4

This is the same trade as Example 3. Remember were trying to decide if this trade was in a Range Shift and perhaps we would see a breakout? The great thing about RSI is you will get answers. The top circle is a shrunk down view of Points C, D, and E on Example 3. As you can see price did finally lift off but look at the second circle, what formed? A Negative Reversal.

Conclusion: This market is not yet trending and is in consolidation. The Positive Reversal is over as soon as the NR is confirmed. What do we do? Exit. Simple. We get out with about 80% of our projected target and we then go through the process of deciding if we are going to take this NR. What is the entry, the stop loss, the target and the potential return?

You might be thinking, but this is consolidation. Yes it is and how often have you wished you could trade in consolidation with short stops and excellent reward potential. Now you have that opportunity because there is a reason to enter and you know beforehand what your Reward and Risk will be. If you are making trades at 3 to 1 or better on a consistent basis you are bound to come out ahead.

EXAMPLE 5

Here is what happened on the Negative Reversal that we ran into. Not much to managing this trade. Open it and check on it every so often and watch as it drops 200 pips over the next 48 hours. Maybe you keep moving your stop within 50 pips. At worse you make 150 pips on this trade.

EXAMPLE 6

Here is a NR a little over one day into the trading week. The red vertical line (thick) is the Sunday night open and this is an hourly chart on the GBPUSD. You can see where I entered and exited. The bluish line is a long term trend line that I drew after having zoomed the chart out to its furthest.

1. Notice how using other methods if done correctly can help confirm that your trade is correct. Price had broken this trendline much earlier and was now coming back to retest it. It met right where a Negative Reversal showed up. Because you knew that momentum was dropping you would have been very confident in this trade.
2. Also notice the yellow line on price and RSI. Do you recognize this? It is a positive divergence. It would have told you that price was going back up but into what? A Negative Divergence. You would have had a good indication almost 16 or 18 hours earlier that price was going back to test the trendline. Depending on your experience and confidence and your Reward/Risk Model you might have entered long

when you saw that price confirmed it was heading back up.

3. Once price started dropping look where it stopped? Right on top of the RSI positive divergence trendline. Does it get any better than this?

EXAMPLE 7

This is the kind of Negative Reversal that you would like to trade every time. These are easy to trade. Notice the RSI has been in the range for bearish trends, 60 to 20 RSI. The second point of the NR is right at 60. This trade worked perfect with our standard entry on the bar after the confirmation bar and a plus 10 pip stop loss above the bar preceding the confirmation bar. The stop on this was 21 pips if I remember correctly.

EXAMPLE 8

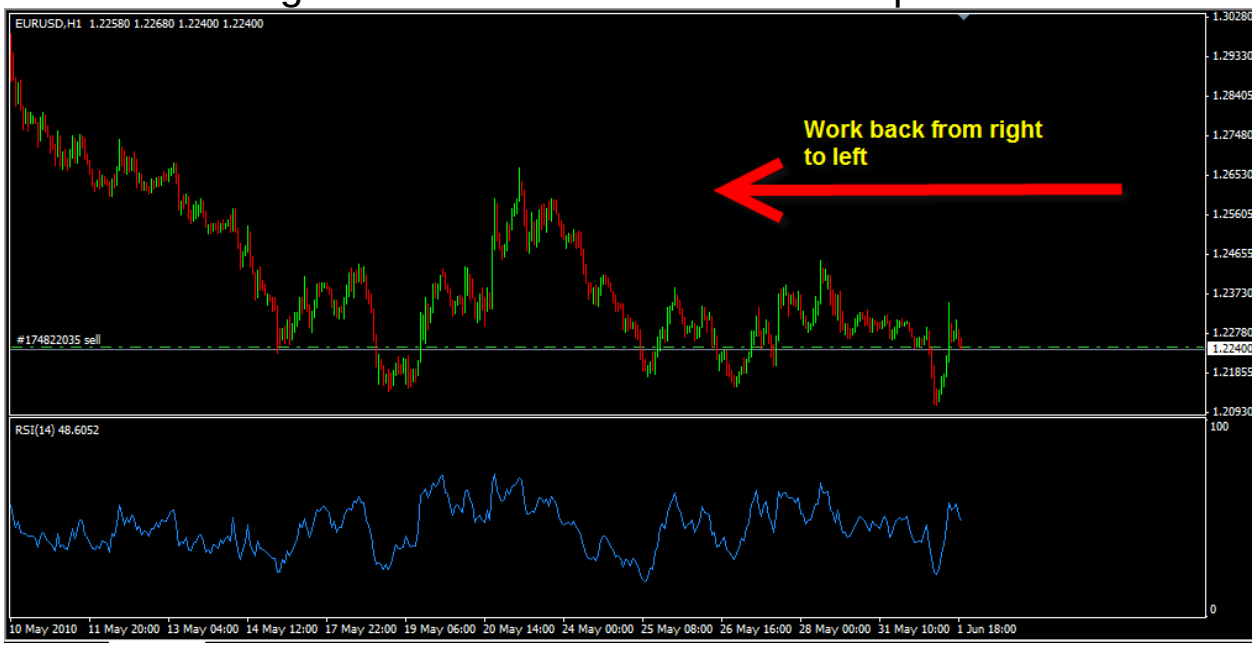
This trade was part of the Trade Review on the website at You Learn Forex. A trader asked me to look at this and determine what I thought the market would do. This chart was beyond our normal entry but this was a good trade going over 150 pips.

CHAPTER 11
KEY POINTS

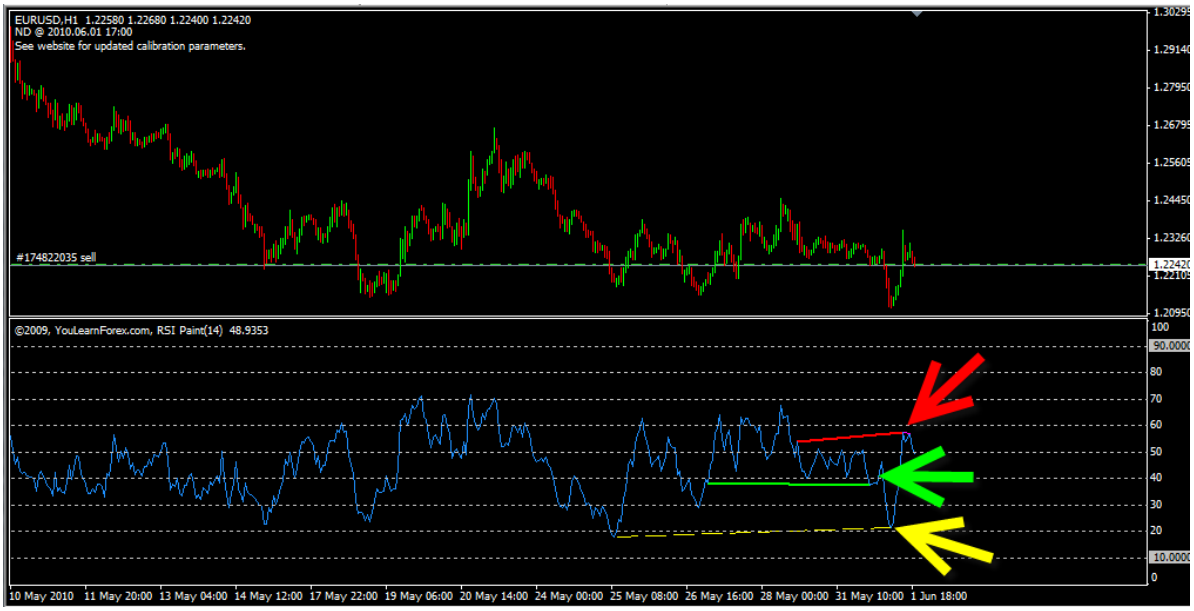
The following list is not a set of rules but guidelines, tips and pointers to keep in mind as you are trading reversals.

Analyzing a Chart

When you look at a blank chart no matter the time frame, begin by going to the most current data on the right side of the chart and work backwards checking the peaks and valleys for either divergences and/or reversals. This will give you a better indication of that is happening currently. As you work back you should begin to see which signals are at work and what to expect in the future.



Below are the first three signals.

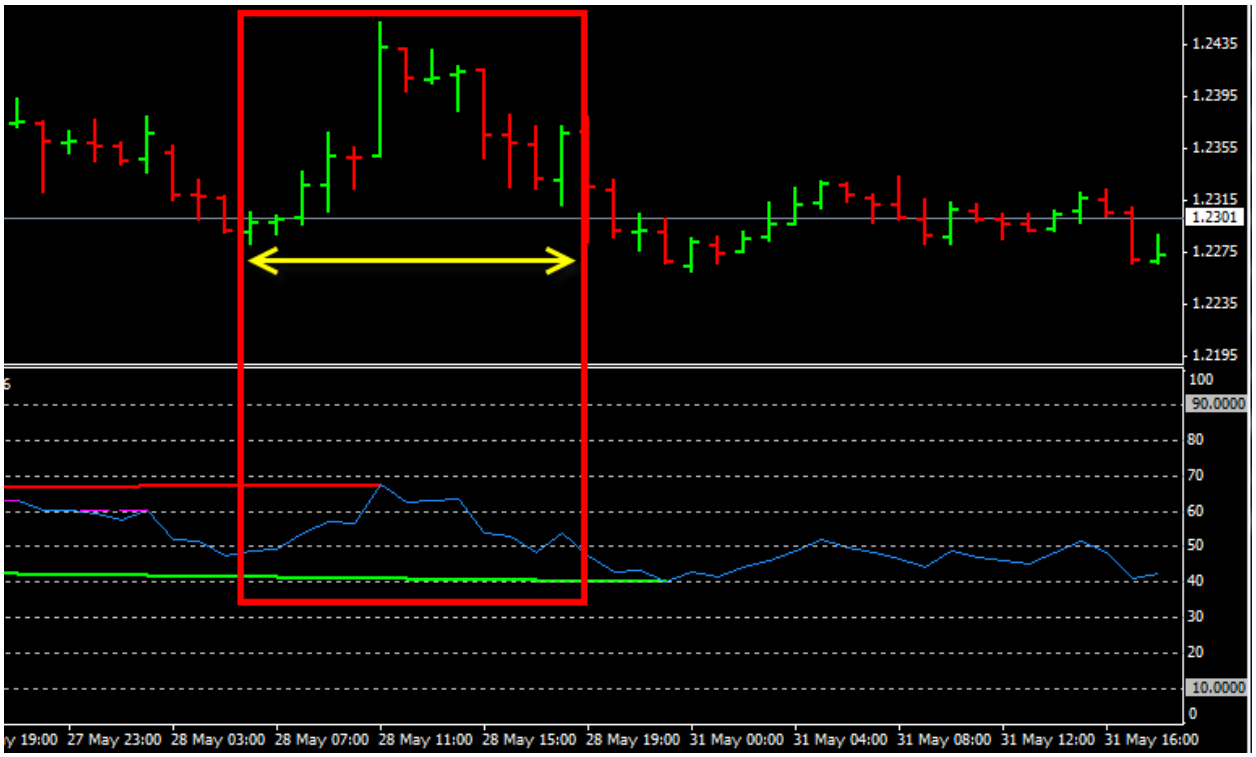


Working from right to left the most current signal is the negative reversal, then the positive divergence, and last the positive reversal.

Understanding Context

Context means looking at the chart from different views and perspectives. A typical problem in scalping is that traders get “locked in” on too tight a view.

This view is almost too close up to have any context for what is actually happening on this chart. We see the close of the negative reversal and the green line of a positive reversal.



Here is the same chart. The red box outlines the area visible on the previous chart. We have zoomed out one level and now we can see that the last signal was the green positive reversal. We can also see that very little has happened.

Here we have zoomed out completely and we see the yellow arrow where we were looking previously. Now we see that price has been moving steadily downward and moved into a period of consolidation. Context takes us from off the field and into the upper deck of the stadium to get a better view of what is happening and give us clues as to the best way to place our trades, or to not trade.

From this view you could place a trendline to indicate where the tops of the highs are and connect them so that when you zoom in again you have a “context” to the direction of the market is and where resistance might come in to play.

Color Coding

As you noticed from previous charts it is helpful to use the same colors for divergences and reversals. Our color code is as follows:

a. Red is for Negative Reversals
b. Green is for Positive Reversals
c. Yellow is for Positive Divergences
d. Purple is for Negative Divergences.

These are the same color codes used in The RSI Paint Indicator.

Accelerate Your Learning

In the beginning demo trade and look at many currency pairs so that you can learn to identify within a few minutes if any divergences or reversals exist. This does not mean that you will trade all of these pairs. In fact, you will become a better trader if you learn one currency pair or just a few that are “highly” related to each other. The reason is that when a “Signal” occurs to trade you will also know the “motivational” factors behind that signal. This is a concept I will discuss in my upcoming book.

It is a good idea in the beginning to find divergences and reversals in a manual mode, much like learning to add using paper and pencil before learning to use a calculator. This will teach you to think in the same way that the automated system will do so that when you look at the signals you will also be thinking momentum and price together.

Signals and Signs

Often reversals of both kinds will occur at around the same time. Why does this happen? Go back to our illustration of the traffic light. Suppose that the market has been dropping and that is the main direction the market has been taking. Whether this is a trend or not doesn't matter. Think of the road you are on as downhill with a light at the bottom. That light most probably is going to be either positive reversal of a positive divergence. Does that mean on the other side of that light the road is going to go up? Not in a down moving market. However, if we do get a series of elevation changes and the road begins to climb upward what might we expect to see? Negative reversals and negative divergences. You will see both but as a result of the predominate market direction you will take more notice of one in terms of a "signal" you will want to follow and the other as more of a "sign" or "fact" that confirms you are right.
Negative Divergences are typically followed by positive reversals and positive divergences are typically followed by negative reversals. Divergences are usually the "signs" whereas Reversals are usually the "signals".

When you see a down-trending market you will most likely begin to see positive divergences begin when the market hits support of some kind or at for a period of time. (When price is not falling or rising it is not necessarily that a level of support or resistance occurred. It may simply be that the NY market closed and very little trading is going on.) Regardless of the time, you should begin to predict on your own, where a negative reversal might take place if the market is to continue downward.

You can do this when the market is up-trending as well. And in the condition of consolidation you will find if the runs up and down are long enough (say 100 pips or more) that reversals will be signaled at the tops and the bottoms.

Trading Journal

Think and record on paper, act on your charts. When you begin trading live, have a routine that involves actually writing down in a journal or pieces of paper your entry, exit, and target. Figure the Reward Risk Ratio. Have a percent that you have determined is what you will risk on each trade. Know how to place the stake in your trade properly. As you do this you will begin to intuitively begin to recognize different situations that you've been in before. That is why it is important to paper trade and then trade with small amounts until you become seasoned in your thinking.

RSI Range

A good thing to check on a relatively consistent basis is the RSI range. Sometimes, not always, the range will stay between certain RSI levels in particular if price is trending and if the time frame is in the longer time frames like H4, daily, weekly and monthly. It will range more freely in shorter time frames depending on how fast the market is moving in terms of the slope of the trend and also the number of pips per period.

Multiple divergences can cause range shifts depending on the time and pressure of the fundamentals in the market. This does not automatically mean that a trend has changed. Again it depends on the time frame you are working in. Once you begin to trade live you should be focusing on one time frame until you know what to expect as you trade.

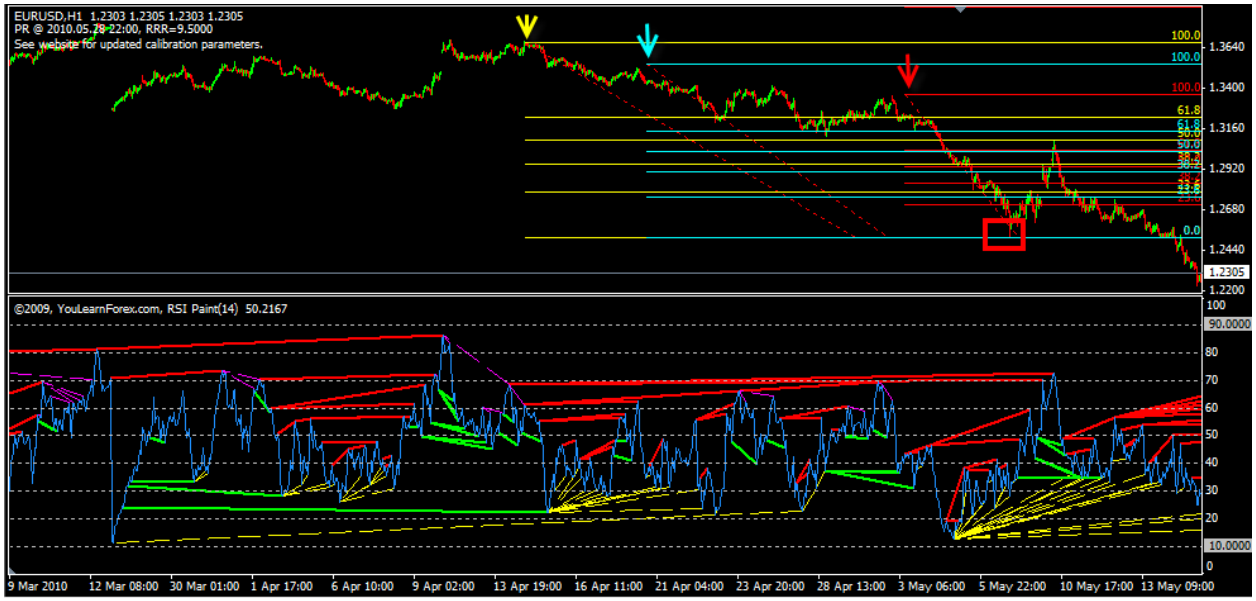
Time Frames

This is an area that I now think is not as significant as I did over a year ago. My thinking was based on many traders with other systems that confirm trades using a multiple time frame strategy. I do not think it is best to look at time frames and find reversal signals and then try to trade in that same direction on the time frame of your choice. Momentum may not correlate from time frame to time frame.

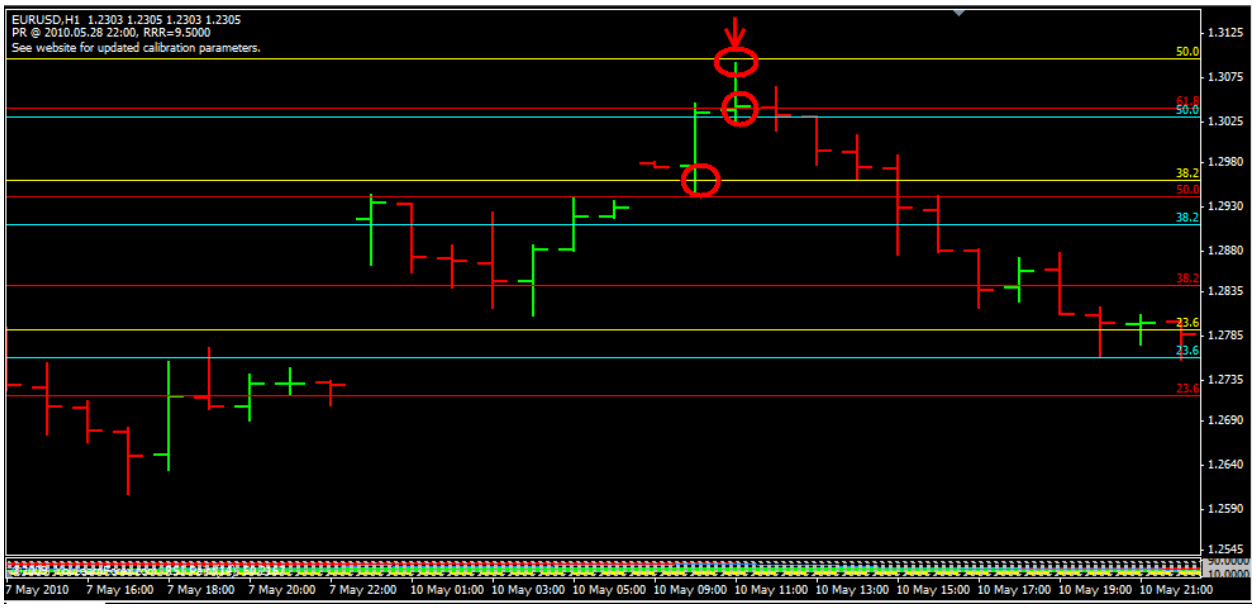
However, if for example you are trading an hourly chart and the daily chart shows a negative reversal that has been respected (prices going short in a trend) then taking key negative reversals on the hourly chart.

Fibonacci Analysis

Learning Fibonacci Analysis is not necessary to trade The RSI Pro Trading System. In the First Edition I thought it would be of benefit. I do not feel it is important now. There are many reasons that Fibonacci may not be an effective tool for trading. As it is nearly impossible to measure signals based on the infinite possibility of places from where they can be drawn, I have found it best to eliminate their use from the overall method of trading. The reason is simple. If we are looking at the same chart a certain number of traders will draw the Fibonacci ratio from the most obvious location; the high to the low or the low to the high. However, other traders will draw them from different locations. There is no standard location where all traders are placing the ratios therefore it is impossible to determine the area of support or resistance.



This chart shows three acceptable levels that Fibonacci Ratios could be drawn from.



Zooming in on the same chart where the lower high takes place, after the red box on the previous chart, we see three different areas where the three different Fib levels show up with a 150 pip difference between the lowest circle and the highest.
This discrepancy makes it difficult to pinpoint stops and targets and is an imprecise method of trading even though it is based on solid mathematical fundamentals.
If traders around the world do not have the same data on their charts as ours then the support and resistance levels are not compatible either and therefore the data we take from it is and can be unreliable.

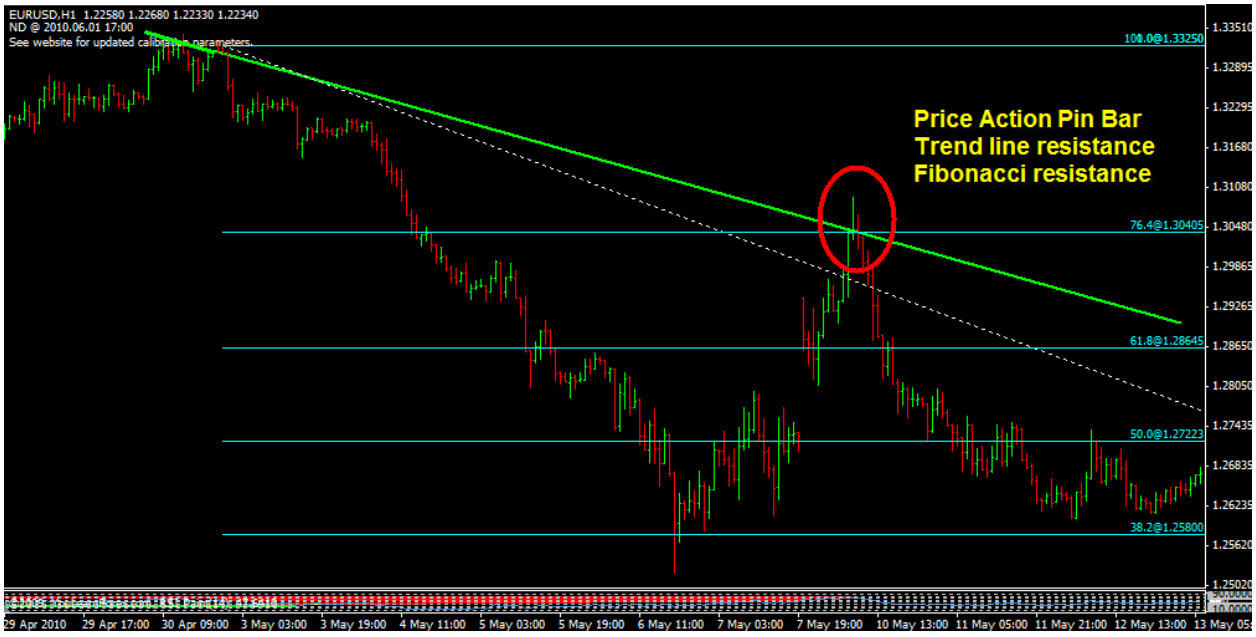
Confluence

Learning the concept of confluence in trading is another tool that every trader should understand. I do not find this to be as importance any longer. The reason is much the same as that of the Fibonacci Ratio. What might be confluence to one group of traders may not be the same for others. In addition, how many traders are looking for confluence? It would have to be enough finding the same signal to create a directional movement.

And there is no body of statistical data that I am aware to determine where traders on the whole would normally locate it.

If I can eliminate something that might throw my thinking off track then it is better not to use it. If I am a professional golfer about to his an important shot, I may ask my caddy about the wind direction. As a professional I have probably taken into account the heaviness of the air and the lie of my ball. I may have taken into account many other things so if my caddy starts to tell me about these items in addition to the wind then they are facts I didn't need and may already accounted for. I also do not need him to tell me what club he thinks I should hit. So, confluence is one of those things traders look for but may have absolutely no relevance at all.

Here is an example where you could say a confluence of factors that are not related or correlated combined to create a successful entry.



Here we see a pin bar on price which is a strong indication that price will fall. Second, if we can find a trend line through the last two points at the high, the line would have gone through the close of price on the pin bar. Third, a Fibonacci drawn to the close of the lower low placed the 76.4 Fib Ratio at the same location. This makes a good case for confluence with the exception that all but the pin bar are interpretative in their placement.

The pin bar itself does show that price could not retain the high it had reached in the earlier part of the session.

Here we have the same pin bar, trend line and Fibonacci but we also see that The RSI Paint Indicator has placed a negative reversal at that point creating a signal. As an RSI Pro System trader, we would place our trade here because the statistical data that we have collected for the currency pair tells us that this is a good location to place a trade. The rest of the information, pin bar, trend line and Fibonacci do not add anything to our decision to trade.

Why Not Trade Divergences?

A divergence although tempting to trade does not give you any target so it is impossible to determine your Risk Reward Ratio. I still totally agree with this statement as I did when I wrote it down in the First Edition. However, we soon will begin doing statistical data on divergences much like we have done on reversals. When we complete those studies we may find that there is data supporting the trading of divergences as well.

As you will learn in my next book, The New Way to Trade RSI: *Adding Statistical Analysis to Your Trading Decisions.*

Divergences may very well have strong possibilities for entry. We will be able to determine that soon.

Different perspectives

I am not necessarily flip flopping on the idea of finding more than one vantage point for confirming trades but I have taken a different approach to this.

Initially I used multiple indicators in my trading systems thinking as many do that if 5 of 6 indicators tell you that you have a good trade then you must have a good trade. However, I have learned that many indicators telling you to “trade” may be telling you the wrong information.

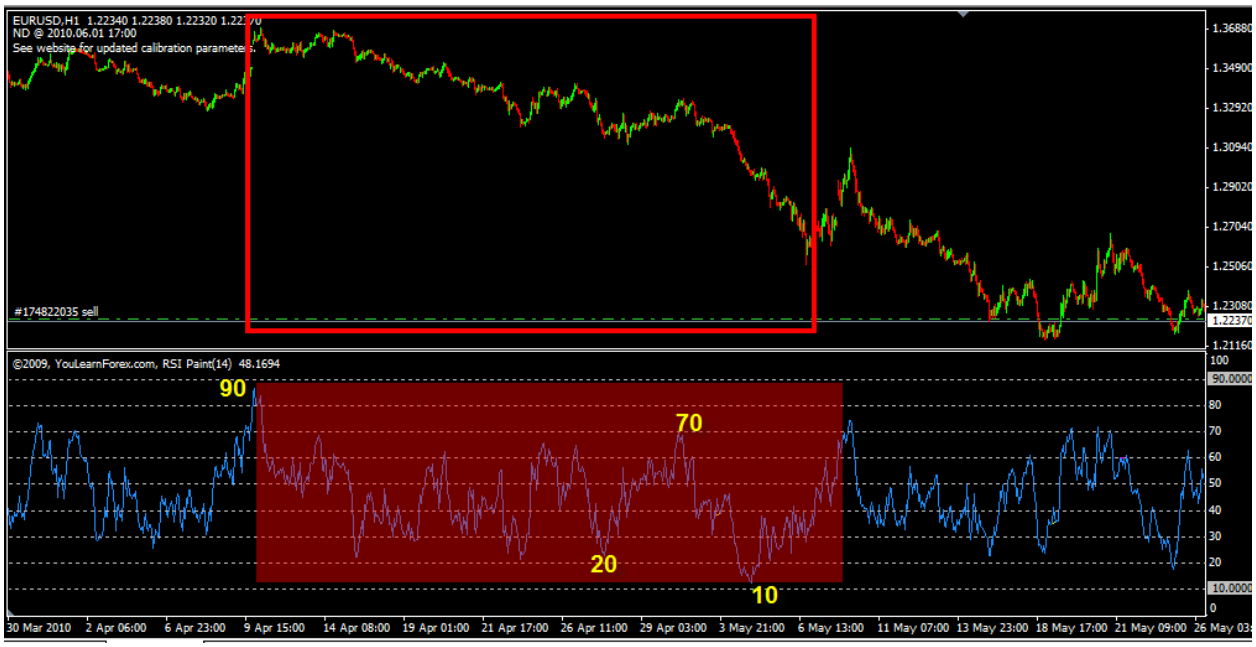
Many traders think that the odds of winning increase with more indicators. The indicator that gives you the highest statistical opportunity to win the trade is the only one that matters. If one indicator tells you you have a 40% chance of winning when in this circumstance, then adding another indicator that is right 25% of the time does not mean you have a 65% chance of winning. If that was the case you could add several indicators so that you had more than 100% chance to win which would be impossible.

In the next book I will discuss many of the methods I use to decide if the trade is in the best possible position to trade. The one I have mentioned here in this Second Edition that was not here in the First Edition is the use of statistical data that will now be available on a monthly basis from You Learn Forex. Statistical data will give you the data you need to determine when to enter the trade signal or when not to enter.

RSI Range Weakness and Strength

If RSI cannot push above the 60 level then there is weakness in the market.
If RSI cannot push down below the 40 level, then there is strength in the market.

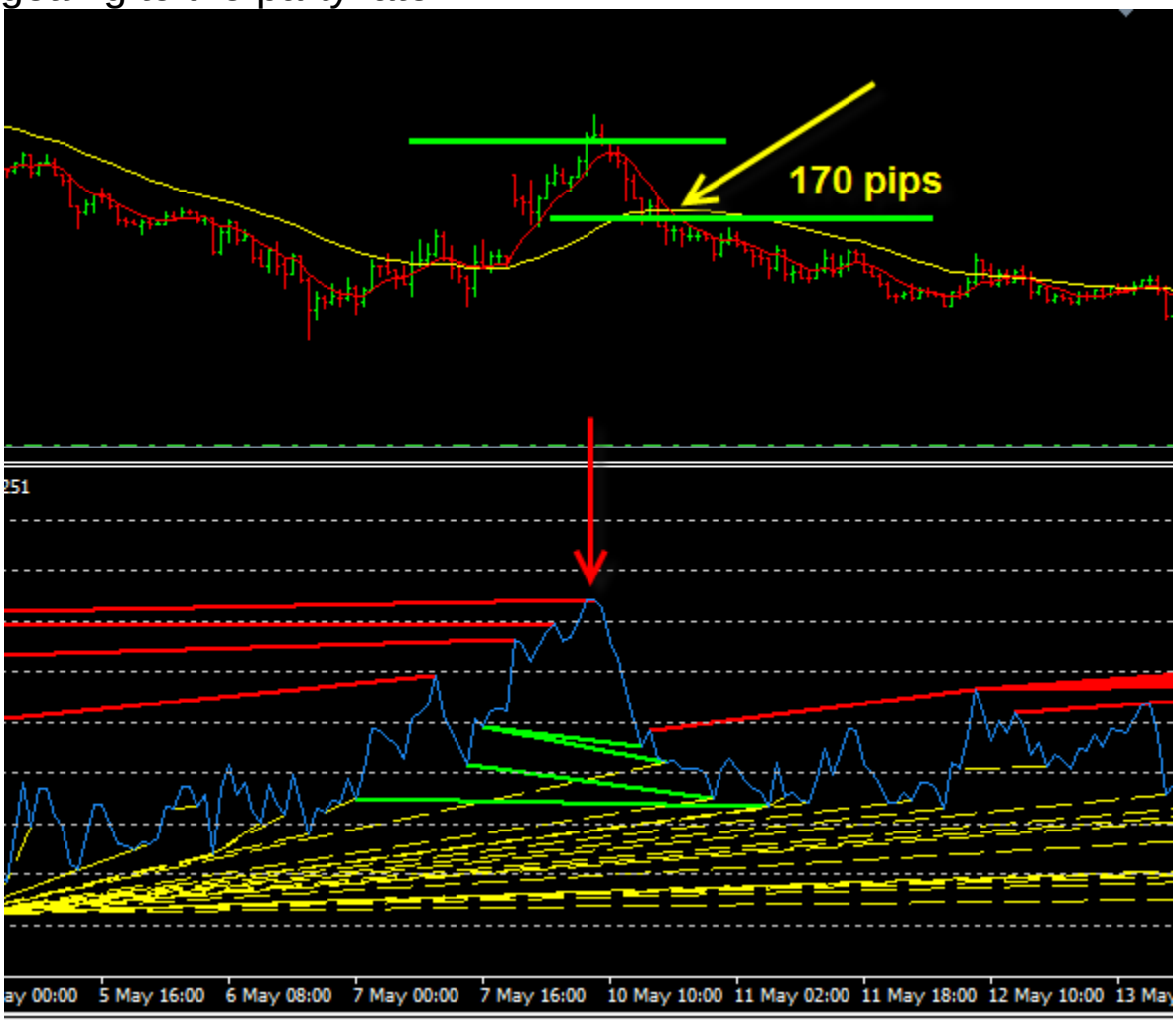
These are not reliable methods in which to make trading decisions for RSI. Certainly you can find places where prices "hang" in certain ranges, however, using this information would not be a reliable method of trade confirmation.



Above price dropped over 1200 points and RSI had a high of 90 and a low of 10 and stayed bobbing up and down between 70 and 20. An RSI Pro Trader would have been looking to enter this trade as soon as possible in the down trend with a negative reversal as price previous to this point had been in a downtrend. Once in the trade, the RSI Pro Trader would have stayed in that trade until such time that signals told them that the trend was reversing. (There are no reversals on RSI in this example as they input for reversals was turned off.)

Moving Averages

You may add moving averages to your chart but normally moving averages are used to determine trend and are lagging. If you use RSI correctly you will not need to worry about moving averages. Also, if you use moving averages you will almost always be getting to the party late.



Here is a perfect example of a 9ma and a 45 ma. The cross of the faster 9ma occurs over 170 pips after the negative reversal signal.

Remember, the reason RSI is used is that it is a leading indicator and is capable of predicting a result. Here it predicted that price would fall at this point and it did.

There is no logic to using the RSI as predictive if the confirmation is a lagging indicator that tells you to wait. In this example, the trader would still have made money but regardless of how far price fell, he or she would have made 170 pips less than the trader who entered at the RSI Pro Trading signal.

I would add that there are certain moving averages that seem to be used a great deal across the industry. At the moment I use a 200 moving average on the hourly charts. There appears, “at times” to be respect for this moving average and I have used it as a point where I have entered trades. The reason I find this somewhat reliable is that a 200 MA on my chart and time frame and currency is going to just like a friend of mine’s chart in Singapore. It is not the same as Fibonaccis that he might draw on his chart and I might as well but two different locations.

Even though I have it on my chart I do not make decisions based on it other than to consider that it may have an effect on price. Here you see that it respected the moving average at the two red circles but not at the yellow circle and the two yellow arrows.

Overbought and Oversold

These are terms traders use incorrectly. Be careful when you hear them. I still agree with this as well. In fact, I will go as far as to say that charts can't determine a psychological measure as this. A fundamental trader/analyst might say that they think prices of currencies are overbought or oversold and then justify their statement by referring to a chart and saying that because the RSI has reached a certain point means price is overbought or oversold. This has no meaning.

If you want to prove this to yourself find an analyst that uses Elliott Wave Theory and see how often they justify the next move based on RSI being overbought and oversold. Track this over the next month. You will find that in nearly every case, this is not reliable.

Trend Lines

Draw accurate price trend lines from close to close. This can be done using the closes on price from the reversals or divergences. I am not sure that there is any credible evidence as to how the market respects these lines. If they are used they should be “lines” in the sand for you the trader to determine your limits of risk and/or reward.

When using The RSI Paint Indicator you have the option to turn these trend lines on price on or off. I currently do not use the price trend lines. If I need one or want one I simply locate the price closes as the beginning or end of the reversal and draw in the line.

Practice

The more you practice, the more you should improve. The more you trade the more you should improve. I have always considered this to be true and still find that the more quality time you spend trading the better you will be as a trader.

Losing

Loses are sometimes the best teachers. No one likes to lose and no one should lose just to learn something. If you are winning all the time you wouldn't need to lose. However, when you do have a loss you will want to reflect on what went wrong. Trading Forex is not simple and some losses won't always be clear. Sometimes the market does listen to us or do what we are thinking. Analyze but don't over analyze.

CHAPTER 12
QUESTIONS AND ANSWERS

Question: *I am finding that I like the RSI method more and more. However there is one thing that I am having challenges with and that is my win/loss ratio to me is too high. For example, I have placed 10 trades this week. Five trades were winners and five were losers. Over all I am still up profit-wise because my winners were a lot greater than*
my losers.

From what I can see I am getting into the trades to early (for the losers).

From Michael

Atlanta, GA

Answer: This question was answered by the trader. He was entering too soon. The New Statistical Data which traders can now get from You Learn Forex will help traders see the correct ranges for entering trades. As for winning 50% of his trades, that is exceptional in particular because the total far outweighs the losses. And, as this trader uses the Statistical Data, he should decrease his losses and also improve his position size on his entries, maximizing his profits even more.

Question: *Paul I purchased the ebook yesterday and have studied it all night with limited sleep. I currently work full-time and see no way to trade this system part time due to the way it requires you to stare at the chart. Do you have any suggestions for me that will allow me to trade this system part-time? Secondly, within your system I don't understand how to find the trend. I don't know if I'm looking for positive reversals or negative reversals during a given time.*

Antwon

Orlando, FL

Answer:

If you are trading manually meaning you are locating reversals by watching the charts then the time you spend in front of your computer will depend on the time frame you are trading. If you are trading the M15 then of course you would need to check very fifteen minutes.

I recommend trading the H1 so in that case you would check for trade signals on the hour. If you traded the four hour then you would check every fours, daily then daily, etc. The longer the time frame the less you will need to look at the chart.

(This question was asked before we introduced The RSI Paint Indicator. The RSI Paint Indicator alerts you to the signal regardless of the time frame you are trading, the number of time frames you wish to observe and/or currency pairs. If you are trading for example, the EURUSD hourly and you are at work, your trading platform can signal you when you have a trade

opportunity. If you do not have access to your computer there are mobile access methods to Metatrader or other trading platforms where you can place your trade.)

In terms of the trend. Normally you can see it on price as obvious for the time frame you are trading (See Understanding Context, Chapter 11). If it is up then you are looking for positive reversals and negative divergences. If it is down then negative reversals and positive divergences.

(Also, since this eBook was written we have advanced our RSI Pro Trading Technique to what is called Bi-Channels where we look at the Main Trading Channel and the Inner Trading Channel all with the purpose of defining the trend and the location of price in the trend. This concept is in The New Way to Trade RSI: *Adding Statistical Analysis to Your Trading Decisions.*
)

In terms of finding positive reversals, negative reversals, positive and negative divergences, start at the most current price and work backward (Analyzing a Chart, Chapter 11).

(The RSI Paint Indicator has changed all of this in that it picks out all the reversals for you.)

Question: *The system that I'm currently using includes Bollinger Bands-EMA-MACD-RSI. With respect to your multi-trading RSI system: Is your system optimized for a certain time window? What are typical durations for your market orders (trades)? Would the system work with Oanda's Java based charting system, that allows for trading on the charts?*

Steve

Saratoga, NY

Answer: I have never used Oanda charts. If you can draw lines on the RSI on the Oanda charts than it would be easy to locate reversals and divergences. If you cannot then that presents a minor inconvenience but you could still find the reversals, you would just not have the visual that would be helpful.

To trade RSI properly however, it shouldn't be scrunched up at the bottom of the screen and it needs all of the RSI levels 10 to 90.

The RSI can be used on any time frame.

Learning the basics is the first step like learning to throw a good fastball, then channels and the inter-correlation of the time frames takes you to an even higher level of trading. Once you are done with this and understand it you could manage an investment fund. The duration of the orders depend on how far the target is from the entry and what time frame you are using. I typically trade the hourly which gives me the best Reward Risk Ratio for my trading style. These trades, if they go 200 to 300 pips, can take a day to a day and a half depending on market conditions.

Question: *How do I filter out false signals?*

Hafid
Philippines

Answer: False signals are just signals that present themselves too early.
They are premature. For example, when momentum in a down-trending market begins to slow and the retrace, momentum reversal signals will normally begin to appear. These early signals are typically premature. Depending on the trend at hand, looking at the location of the lower lows and lower highs which preceded the current signals can give you clues to the rhythm of the market. (Now, one year later, we have answers to the above in the form of our Statistical Data. We now know what the ranges are for retracement when a signal is most often successful, what the potential draw-down range will be, the target and much more.)

Question: *What is the difference between correlated pairs and correlated signals?*

Michael
New Zealand

Answer: I don't trade correlated pairs. I trade when currency pairs have "correlated signals". There is a difference. EURUSD and USDCHF are correlated pairs. Typically if the EURUSD is going up, the USDCHF is going down.

A correlated signal is when more than one currency pairs makes the same signal in the same time frame. For example, if you had the EURUSD, GBPUSD, USDJPY, AUDUSD, NZDUSD, and the USDCAD currency pairs up on your Metatrader charting package with The RSI Paint Indicator on each one and you receivednegative reversal signals on all or more than half you could conclude that market momentum was taking place across the entire foreign currency market.

Question: *Do you use Elliott Wave Theory?*

Mark

Los Angeles

Answer: I have used EWT but do not use it now. My use of it preceded the development of The RSI Pro System. I personally did not find the EWT predictive. Yes, there are times that it is right but more often than not you always came to the conclusion that it was either this or that. David Aronson in his book, Evidence-Based Technical Analysis calls it a good story but not based on any evidence that can be algorithmically predictive. It is open to every traders interpretation. I agree with this although I did not understand it until after I stopped using it.

Question: *Where is the best place to enter and exit a reversal?*

Mike

England

Answer: No one I have read on RSI ever talks about where to enter or exit; Wilder, Cardwell, Baeyens, Hayden or Brown. I made up my own entry rules because I saw that many of the trades that went to profit (maybe not full) started right out with little back up or retracement. One other reason for defining specific entry, exits (stops), and targets is to be able to accurately determine the Reward and Risk Ratio.

(Now that we have the New Statistical Data, we can better determine where to enter and what the typical draw-down is for specific trades. This data is now available at You Learn Forex in up-to-date monthly report.)

Question: *I was looking at your course and I am wondering if your method works for stocks and etf's. I do not trade the Forex. Would your course be of value to me knowing I trade different vehicles than you do?*

Answer: The RSI can be used on any financial product in which you use RSI.

CHAPTER 13

THE FUTURE OF THE RSI PRO SYSTEM

The future of The RSI Pro System is already here. My newest book will be the next steps that are already in place to make trading this system more profitable.

You will learn about Bi-Channels and how they come into play when reversals occur. You will learn how to draw them and where and how to adjust them.

We will discuss The New Statistical Data that we update every month in order to give traders optimal knowledge and information about the most productive reversals. This includes the RSI levels where reversals fall and are most profitable; also, the retracement that occurs as a percentage pullback. The length of the most successful reversals as well as the rewards that can be expected for this data, the ratios of AB to BC and how price reacts to a 200 moving average.

Configural thinking versus linear logical thinking will be a part of that book as well as decision-making based on probabilities, predictive trading and many other topics.

The RSI Pro System is based on solid fundamentals so that the system can be studied and improved without having to discard it and start over. RSI will always measure momentum on price to time. This is one of the most critical relationships in trading. They work hand in hand.

This was the purpose of developing The RSI Paint Indicator which will be discussed in the last chapter.

CHAPTER 14

THE RSI PAINT INDICATOR

The RSI Paint Indicator has taken The RSI Pro Trading System to next level. The reasons are simple.

Features of The RSI Paint Indicator

It provided a method to have reversals and divergences automatically drawn or painted on the chart by the computer rather than manually.

It automatically provided the RSI points at the beginning and end of the reversal.

It included divergences.

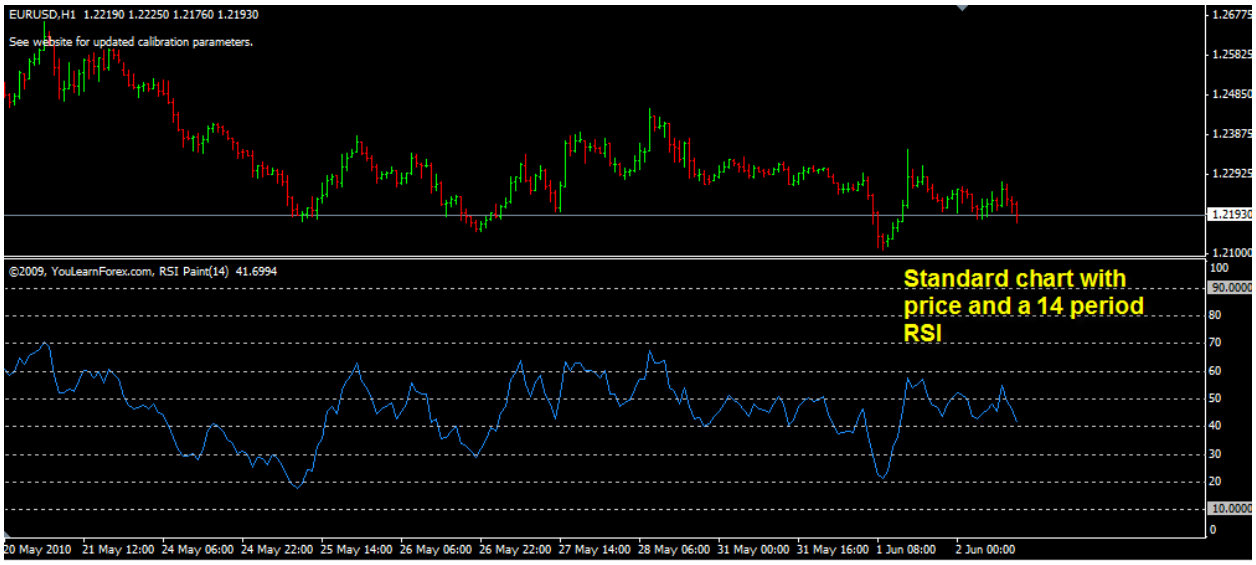
It color coded both reversals and divergences.

It provided a way for the trader to be alerted when a reversal or divergence occurred on the currency pair being traded whether he or she was in front of their computer or not.

It provided a method to manage more than one currency and more than one time frame.

How it works

Let’s take a look at The RSI Paint Indicator and see how it works and what it does to increase the efficiency and profitability of the RSI Pro Trader.



This is a standard chart with price on top and the RSI (14 period) on the bottom. There are no reversals or divergences drawn on the charts. Until The RSI Paint each time a new “peak” in RSI or a new “valley” was created, the RSI Pro Trader would run their mouse over the new point and determine if one of 4 possibilities had formed; positive or negative divergence and/or positive or negative reversal. This meant mentally going through what each type of signal was and then drawing the line on the chart.

If the trader was trading more than one currency on say the hourly charts then every hour those charts needed attention. If it was a shorter time frame then more time was required to locate the signal.

This is the same chart as the one above with the exception that we have zoomed in on the price and RSI. We have a negative divergence (purple arrow) and a negative reversal (red arrow).

If we had draw them in manually we would need to check the peaks to see if the definition of each was met and then draw in the lines using the trend tool. This is the EURUSD hourly. If we were trading the USDJPY and the EURJPY plus any others we would have to go to each chart on the hour to determine if a signal had occurred and what kind.

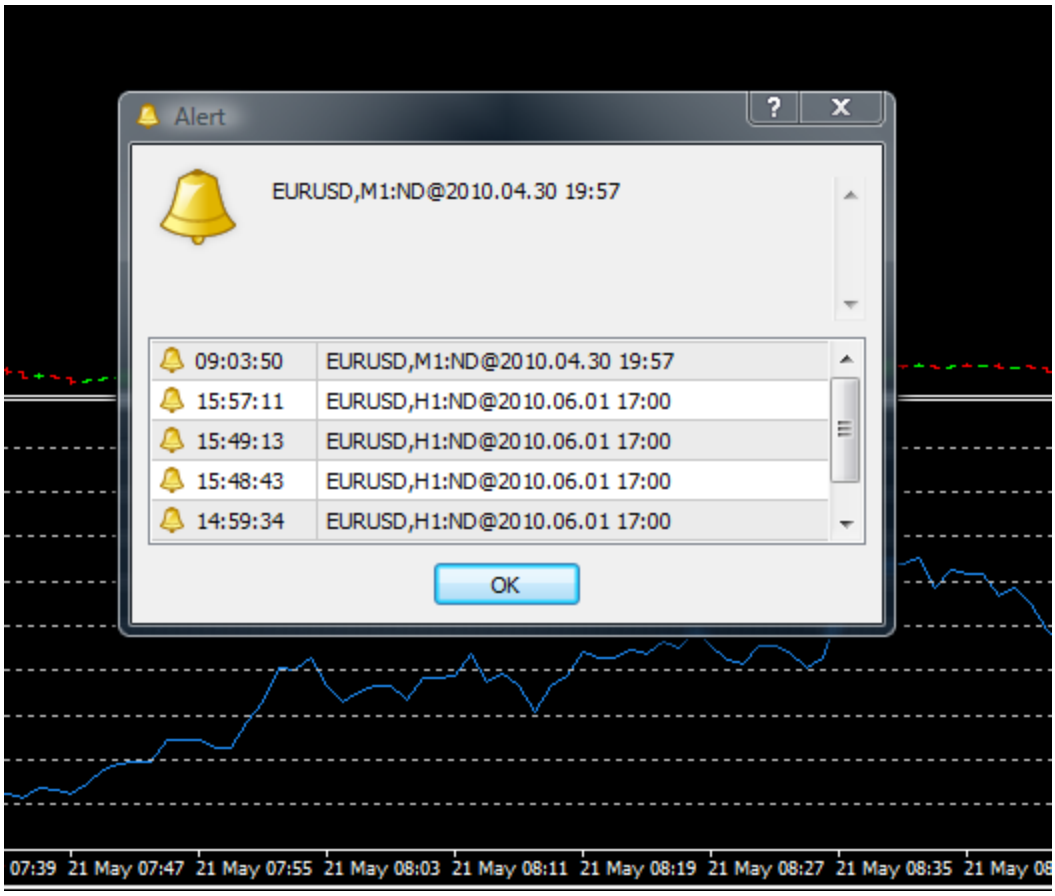
Actually the chart above was created by The RSI Paint Indicator program that locates all of the signals and draws or paints them on the chart for you.

Although fuzzy, you can see a white box that appears when the trader does a mouseover on a particular signal.

The Information Box includes the RSI in this case of the red negative reversal. It tells the RSI levels at both points of the reversal and the prices. It also tells the time that the reversal occurred.

Alerts

When a reversal or divergence occurs an “Alert Box” like the one on the chart below appears on the screen.

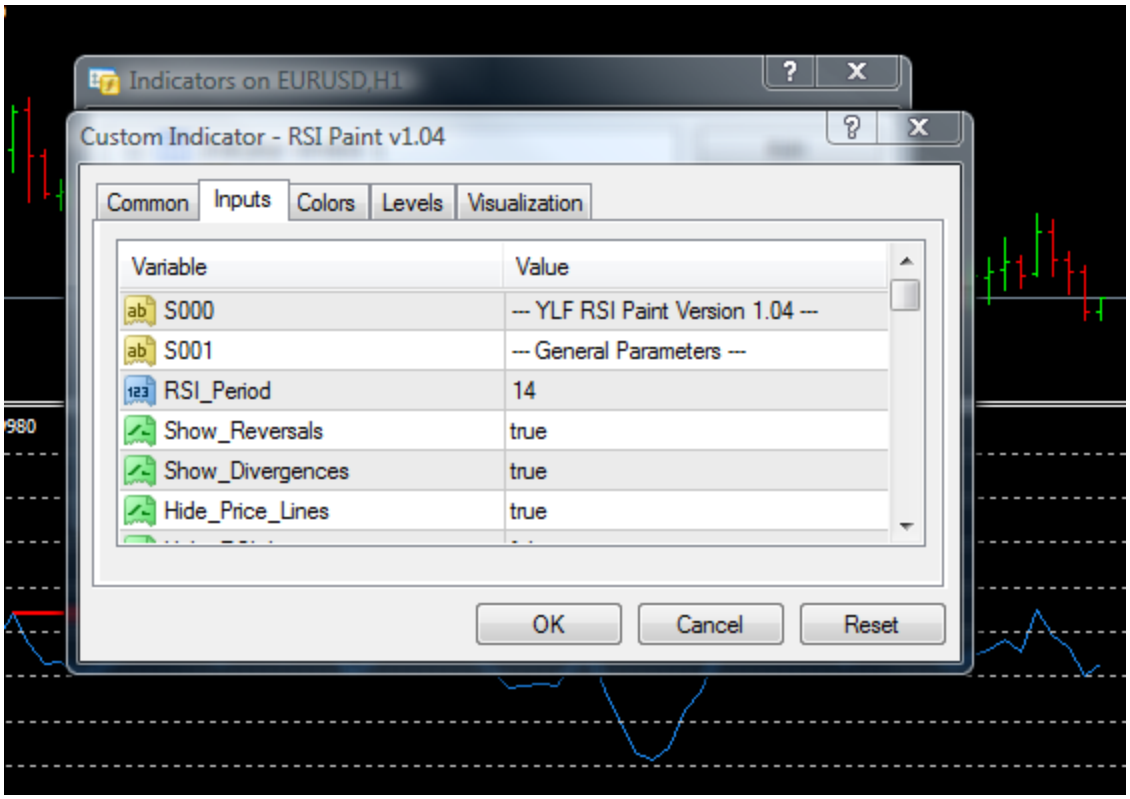


The latest alert appears at the top of the box. Below is a list of the most recent alerts from the different time frames and currency pairs. There is no limit to the number of charts and time frames that the indicator can be attached to.

The alert is sent to your computer but can be configured to be sent to your email or as a text message so no matter where you are you can be alerted to what is happening in the market.

Input Variables and Filters

There are other features as well that can give you more control over the information the indicator sends you.



RSI_Period – The RSI Paint Indicator period can be changed to whatever period the trader would like to use. Fourteen is the default.

Show_Reversals – This variable allows the trader to turn the reversals off or on.

Show_Divergences – This variable allows the trader to turn divergences off or on.

Hide_Price_Lines – This variable allows the trader to turn on the price lines off or on. (My own preference is to not include the price trend lines. This keeps the price area of the chart cleaner and as I am not a trend line trader there is no need for them to be there.

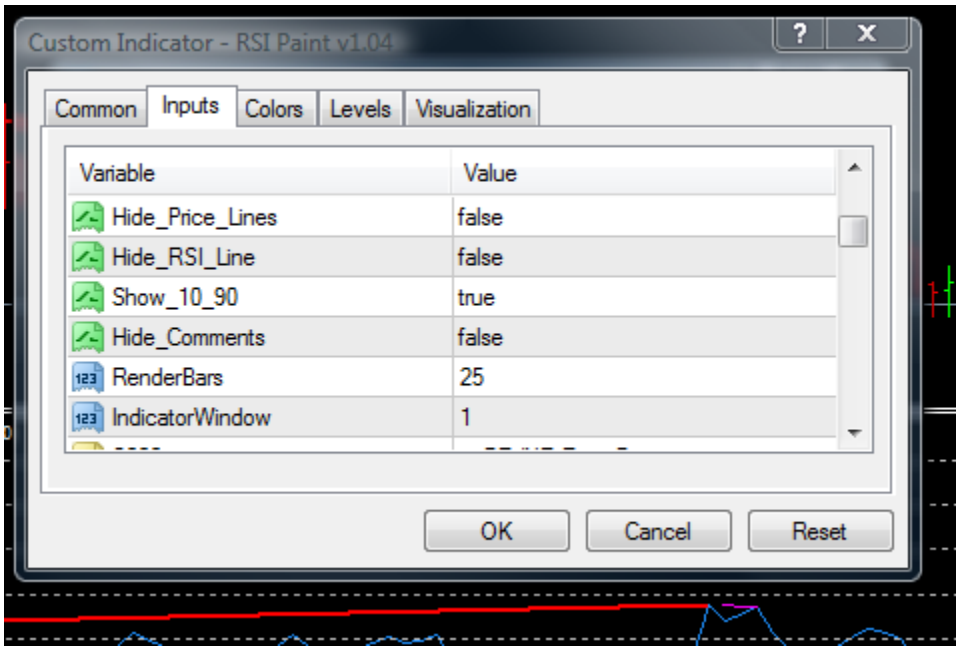
Above you can see the automatic transfer that The RSI Paint Indicator makes as it places the corresponding trend line on price.

Below I am showing the above circumstance but I have extended the trend line through the close of the peak bar.

If I were to use this trend line as a guide or for decision-making, in terms of exiting the trade, the ability to objectively place the trend line on the chart automatically and then extend it is an important

tool. The yellow circle marks the close of the second point of the reversal and Metatrader allows us to grab the end of the line and extend it beyond that point.

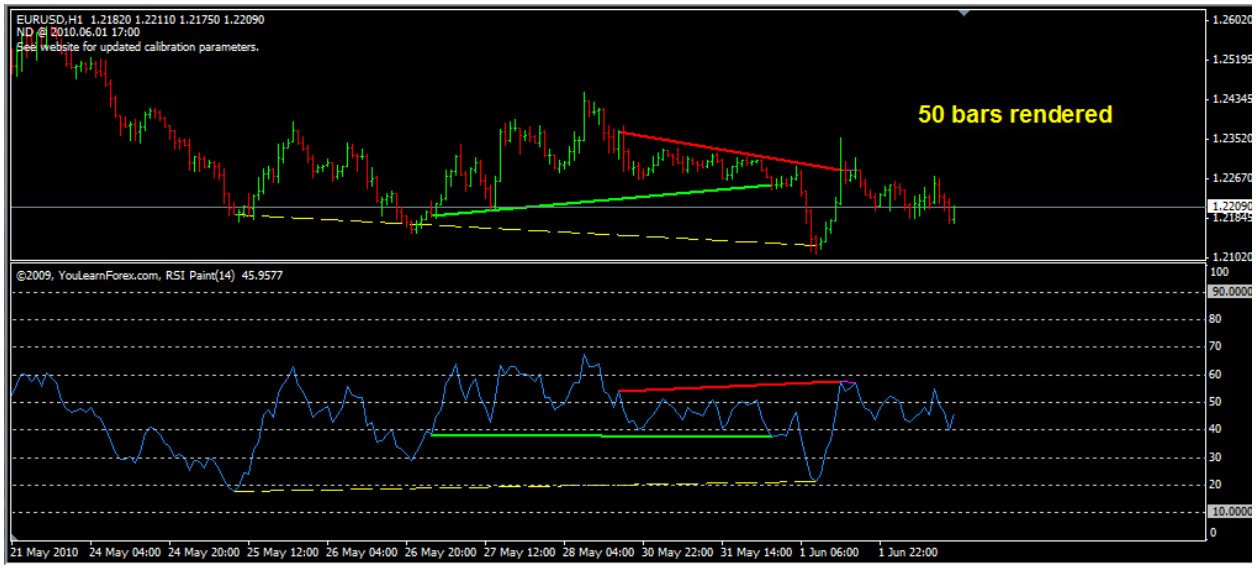
Other Features:



It is possible to not only hide the price trend lines but also to hide the RSI line and the comments if for some reason as a trader you wanted to do this.

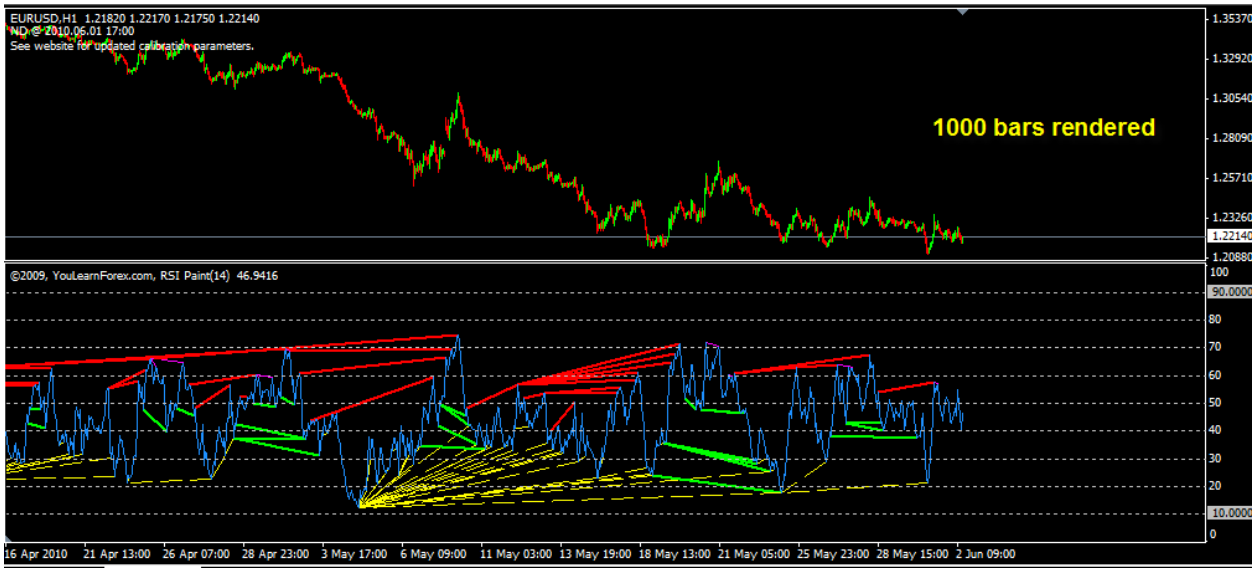
The RenderBars feature is one of the most valuable variables.

On this chart 25 bars are rendered meaning that the last point of the signal must fall into that area. We see the negative reversal in red and if we look closely we see the purple negative divergence following it (your actual trading chart will be larger so it will be more visible).



Here we have doubled the number of bars rendered and we see we have 4 types of signals, one of each. We may want to keep the Rendered Bars to a small number or we may want to increase

them to say 10,000 and study the history of how reversals and divergences work in conjunction with one another.



Here we have rendered 1000 bars and zoomed out on the chart above. We have also eliminated the price trend lines. What we see is a variety of signals of nearly all kinds. Predominately we see red negative reversals and yellow positive divergences.

As we become more adept at trading we can look at these signals on RSI and tell that the market has been dropping as negative reversals have given way to positive divergences which drive price into more negative reversals. As price moves into a consolidated mode in the past few days we see more green positive reversals come into play as price begins to oscillate up and down.

Reversal Parameters are also possible to set in The RSI Paint Indicator.

For example reversals that are visualized can be determined by filters like the Reward Risk Ratio which is based on the Cardwell method of figuring the target and the stop which you can change.

The RSI Paint will then only paint those reversals that you have determined are the ones you want to see.

You can filter by the length of the signals. The default is 2 bars to 360 but it can be set to handle shorter or longer lengths.

It can also be filtered by the level of RSI points at the time of the signal. This can be helpful if you want to locate positive reversals in a range and/or negative reversals.

There are many other filters that you can set as well and the alerts can be turned on or off for divergences and reversals so that you can get all or just one kind.

The RSI Paint Indicator frees the RSI Pro Trader up to think about other things in regard to whether a trade should be taken or not.

Market Momentum Signal

One of the most interesting uses of The RSI Paint Indicator is to alert the trader to overall market momentum. Because the indicator alerts to the computer, email or text messages, the alerts become a way to measure market momentum.

I define market momentum as the point in time when nearly every currency pair has become active. Banks, hedge funds, institutions, central banks and retail traders are all at the table trading, buying and selling.

How would you know this? Let’s say you have your chart package up and you have all the major dollar pairs on the screen. You might even have gold and crude oil and the Dow and S&P. We will assume you trade the hourly.

As a personal preference, I like to trade when the market is moving, not when it signals a trade and sits fluctuating between 5 or ten pips. The best time to trade in my mind is when the “sleeping giant” has been awakened and after stumbling around in a daze for a short time sets a course.

How do we know the sleeping giant is beginning to awaken? We have The RSI Paint Indicator on as many of these charts as we desire. When the market begins to move the alerts will come from across the board. Reversals will begin to occur on the majority of the charts at the same time. Your computer will begin to signal multiple alerts and you cell phone will get message after message.

This is your alert to go to your computer and put into process the steps of determining if you and where you are going to trade.

The RSI Paint Indicator has many features and benefits that can help make the RSI Pro trader profitable and productive.

CHAPTER 15

Bi-Channels

I will give credit for this idea to Richard Lehman. Lehman's book, Far From Random provides a complete discussion of channels and their use in trading.

As of this writing I have not read his book. I read an article about parallel channels written by him and began to experiment with them on my own. Anything I am suggesting here should not be construed to be what Lehman teaches.

My use of channels follows a concept that he uses which identifies the Main channel and the current Inner Channel. I call this Bi-Channel and it is perhaps one of the most powerful tools you can use as a trader to enter trades in conjunction with Negative and Positive Reversals.

The concept is simple:

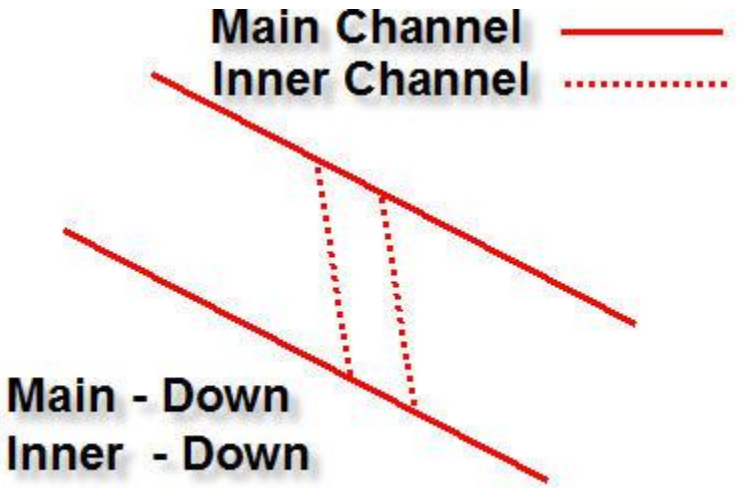
1. Zoom out until you have a clear indication of the main direction of the trend on the currency pair you are trading. As I trade the hourly charts sometimes I move to the 4 hour chart to give me a clearer reading.
2. Next, locate the most recent move in the Main Channel, the latest leg. I call this the Inner Channel.
3. When a reversal occurs at key points in this Bi-Channel configuration a higher incidence of success occurs.

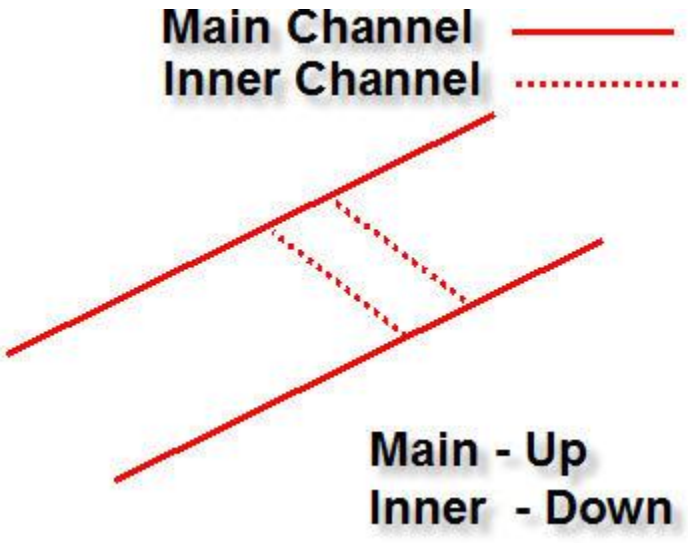
There are four directional movements you can have with a Main Channel and an Inner Channel.

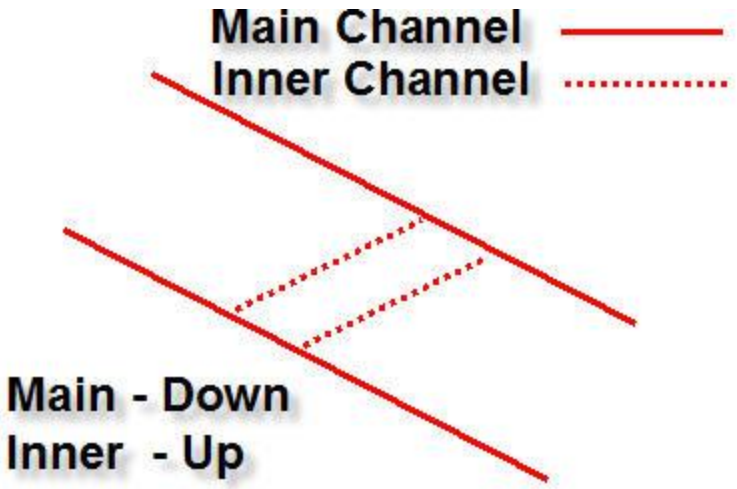
1. Main can be down with the Inner down.

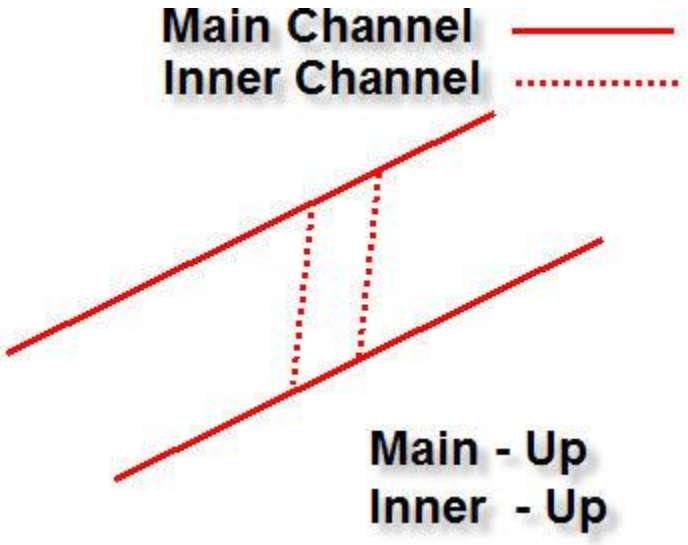
2. Main can be up with the Inner down.
3. Main can be down with the Inner up.
4. Main can be up with the Inner up.

Here are examples of each:









There are two important things we want to look at:

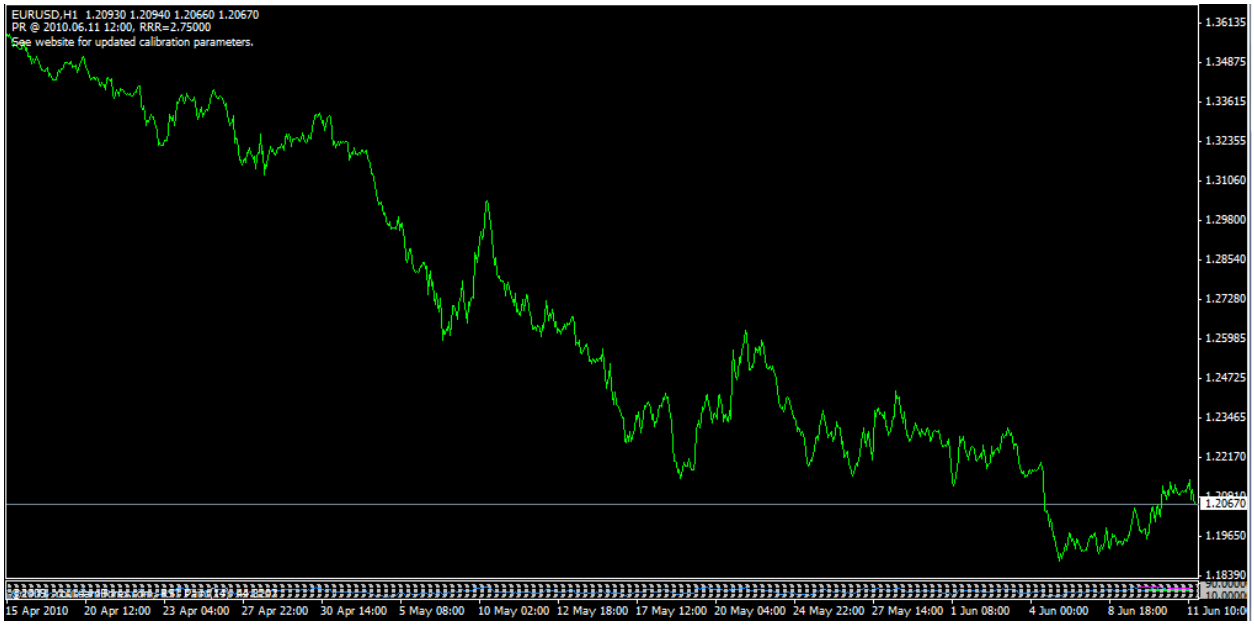
1. How to draw these accurately
2. And where the best trades occur.

How to draw Bi-Channels

1. Zoom out on the time frame you are trading.
2. Select the Line Chart

3. If the trend is down, draw your line along the two highest points.
4. Take a copy of that line and place it along the bottom of price at the lowest point.

Zoom out on the time frame you are trading



This is the EURUSD hourly chart. We have zoomed out as far as we can and we see we have a downtrend. Also, use a Line Chart to place your trades as the prices on the Line Chart are at close.

Place the first trendline on the top of the two highest points.

We select two points and draw in our line as shown.

Draw the lower trendline

Draw the lower trendline on the lowest point. In Metatrader, select the top trendline and then Crtl and Drag the line down. A new trendline will form and you can place it at the desired location.

We now have our Main Channel drawn.

Now the Inner Channel.

We do much the same thing only within the Main Channel.

We zoomed in to get a better picture of the Inner Channel or Leg.

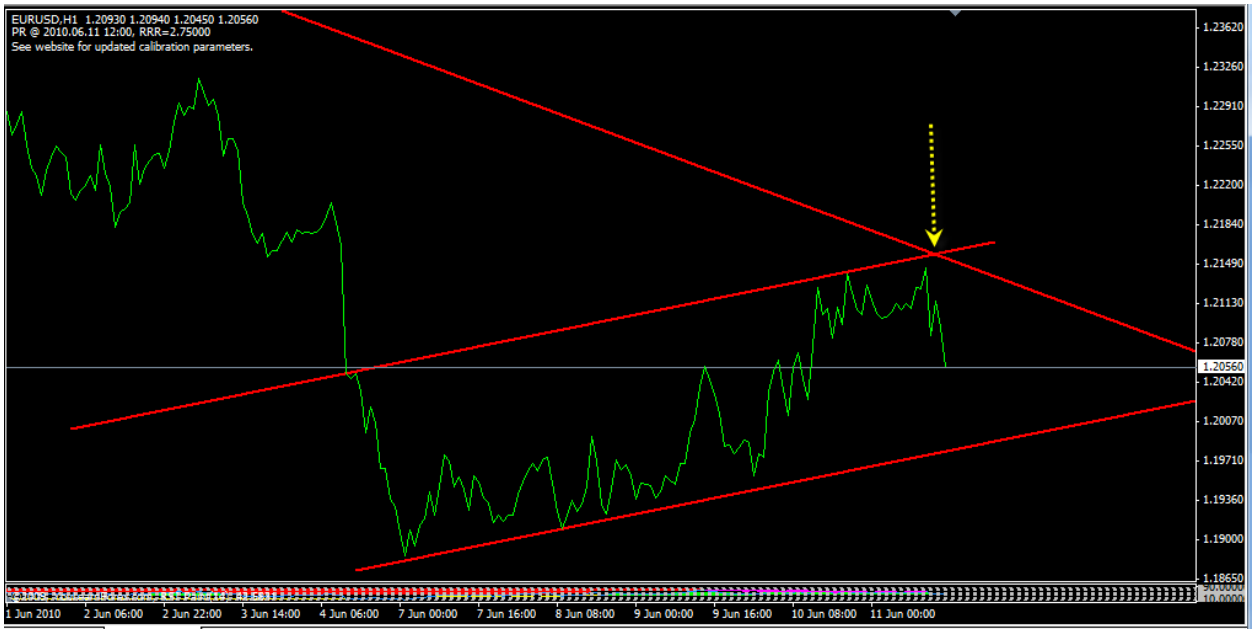
As it is an up channel we place the trendline on the lower price points and then drag the parallel channel to the highest upper point.

Here are the same channels in context, zoomed out.

Now, how to use this information for profitable trades.

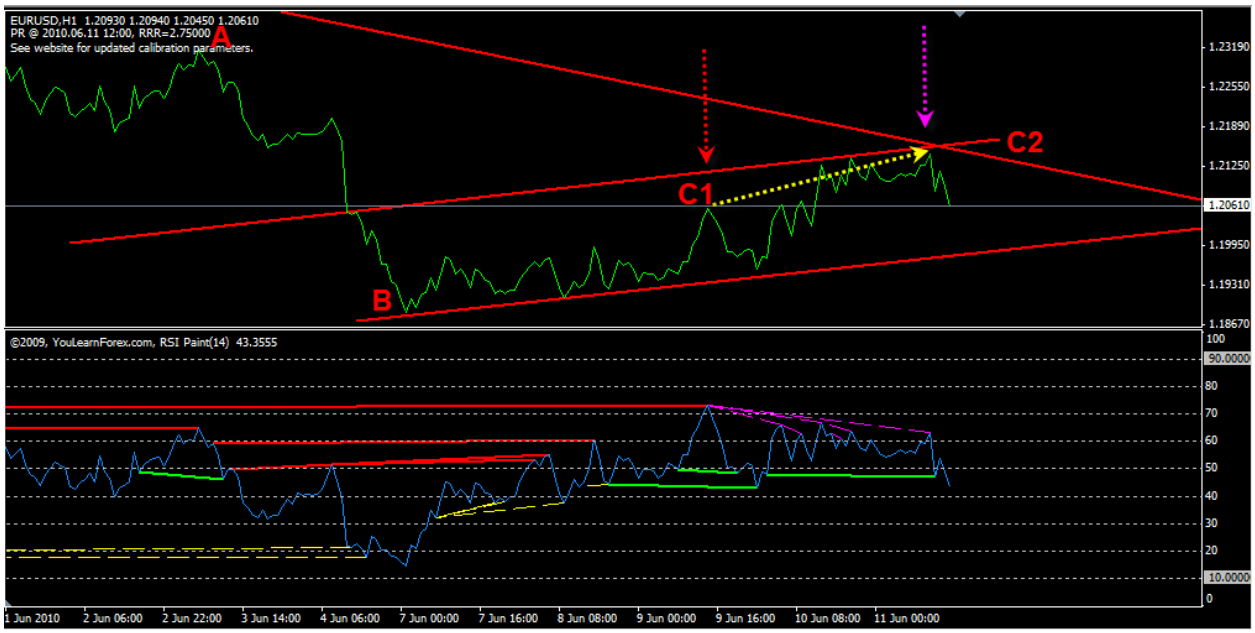
Statistically we know that when a pair is trending down in the Main Channel and the Inner Channel is up that the key point to trade is at the intersection of those two points.

That would look like this:



The best place to trade this would be at the intersection of the Main Channel and Inner Channel where price is most likely to be going down again and where risk is controllable.

Now, let's look at what the RSI said on this location.



As you can see, the Negative Reversal signaled at C1and the trade drifted several more hours to C2 before it began to move downward.
Using our statistical data we would see that C1 is about a 24% Pullback or Retracement for that particular signal. This would be representative of this kind of trade in particular if we looked at what type of drawdown we would expect. In this particular case it was 16%.

Depending on our risk assessment using the Statistical Data we could have entered at the C1 location as it is possible that weakness in the market may have started there and allowed ourselves any number of drawdown percentages.

We could have entered the position in a portion of our full position size.

We could have waited to see if price proceeded to our Main and Inner Channel intersection to see what type of signal would occur.

Perhaps the best would have been another Negative Reversal however a Negative Divergence can be just as powerful in particular if there are a multiple number of these.

Correspondingly if you have a Main Channel that is up you would be looking for an Inner Leg that has reached the bottom as you would expect that a Positive Reversal would signal at the moment or perhaps a combination of Positive Reversals and Positive Divergences.

Trades signals that occur in other areas can still be effective however if we are taking into consideration the channel boundaries then we would expect momentum to be most effective at these intersecting areas.

CONCLUSION

I trust that this trading method will help you succeed in your trading. Many of the people who have watched my video were able to begin making winning trades almost immediately.

This Second Edition was meant to update traders without having to write an entirely new book and keep the new information in context with the initial information of the book.

The book that will follow this book, The New Way to Trade RSI:

Adding Statistical Analysis to Your Forex Trading Decisions, will be an book that discusses in depth the trading strategy of this system. It will focus on decision-making when a trade signal alerts you to a trade. This book has taught you the fundamentals, the next book will be case studies of how to think when placing a trade to reduce risk by understanding uncertainty.

I hope that you have enjoyed this book. I enjoyed writing it. You can find me online nearly every day. You can email me here: paul@youlearnforex.com.

Paul Dean, President
You Learn Forex

APPENDIX

You Learn Forex

RSI Pro Data Analysis EURUSD Hourly 5/17/2010 to 5/21/2010

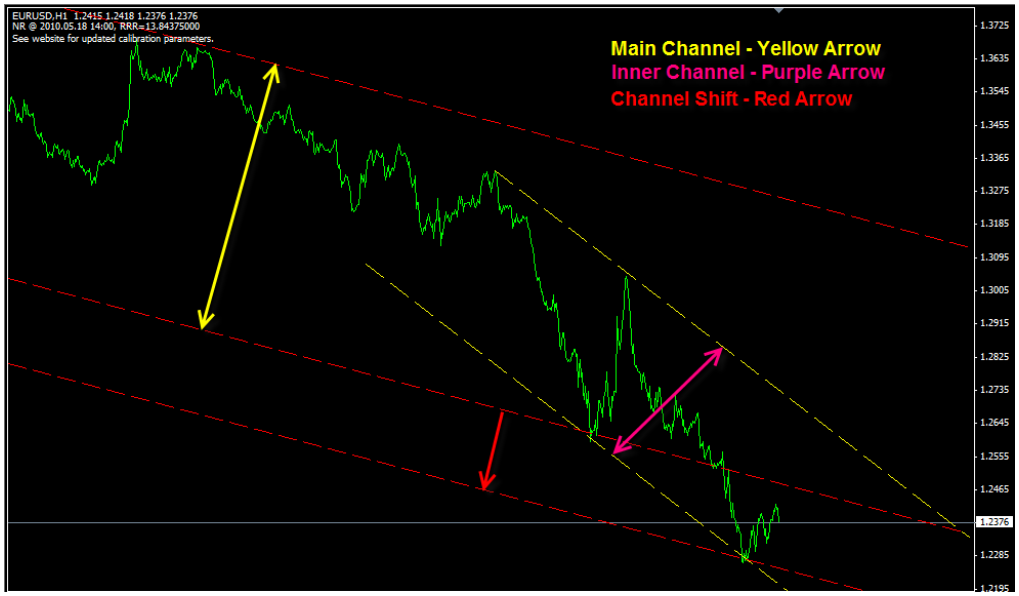
Bi-Channel Chart Analysis

Long View – The trend of the Main Channel has been down since December of 2009. This is the 4 hour time frame which allows a view of the entire trend from December 3rd, 2009 to present. The trader should consider trading in the direction of the trend. The red arrow is where the lower line of the trend should be moved to next and in parallel to the upper Main Channel line.

Bi-Channel Chart Analysis – The purpose of this analysis is:

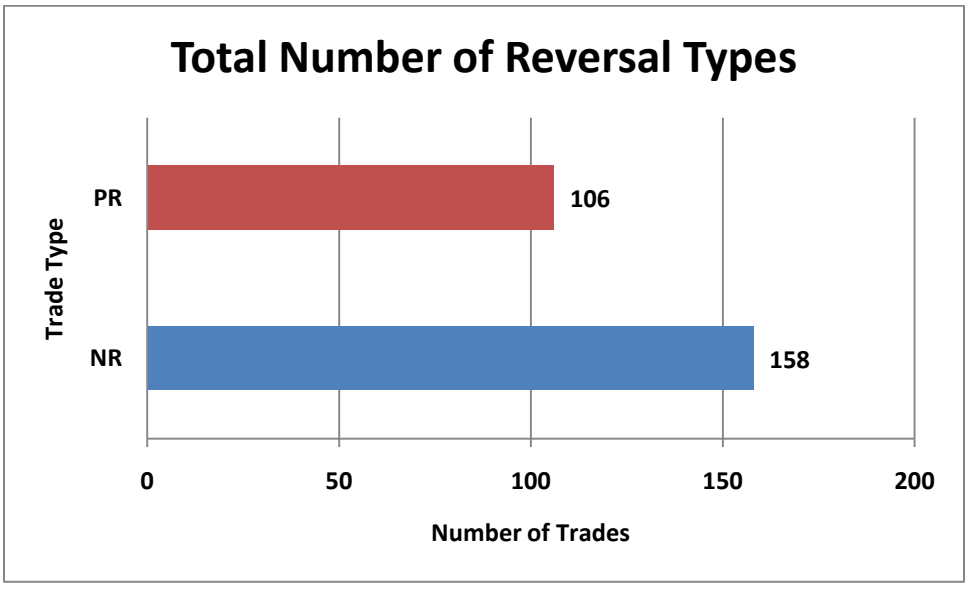
1. To establish the main direction of the current trend for the long term movement of the currency pair.
2. To establish the inner leg direction of the trend.

Knowing this gives the trader the directional confidence to pick either Negative Reversals or Positive Reversals. A conservative approach would be to trade reversals with the trend of the Main Channel .



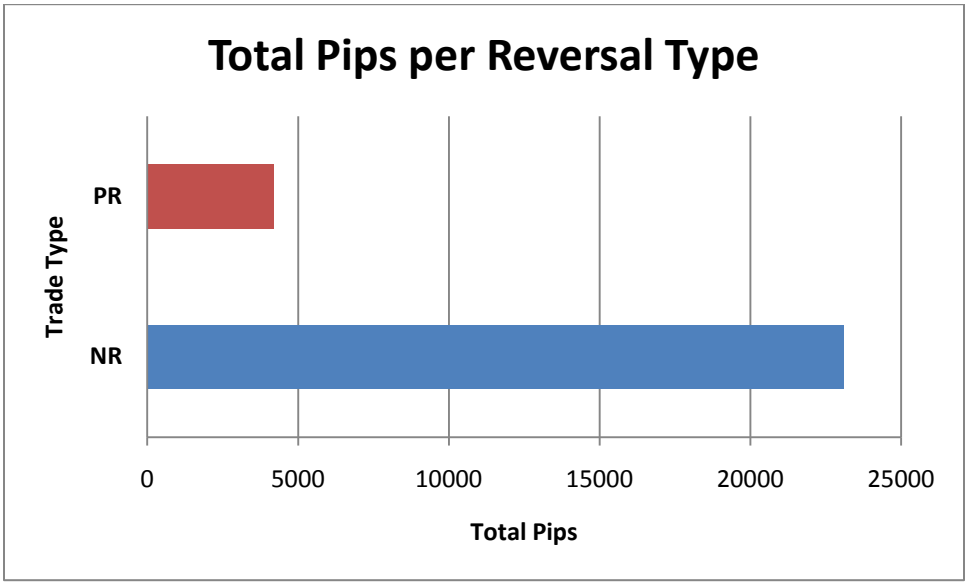
Up Close View – This view shows a close up of the Main and Inner Channels. Typically we would look for Negative Reversals along the upper line of the Inner channel.

Number of Reversals in Date Range



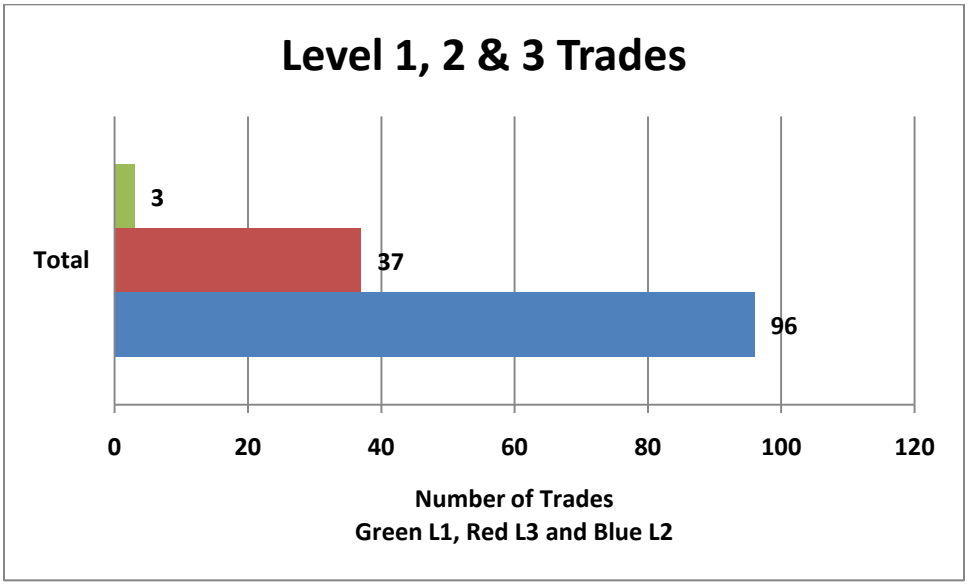
This chart shows the breakdown of Positive and Negative Reversals along the Main Channel line from December 3, 2009. There are significantly more Negative Reversals in contrast to Positive Reversals which is an indication of a down trending market.

Number of Pips per Reversal Type



This chart shows the breakdown in number of pips produced by the Reversal types for the Main Channel period. Traders trading short through this period would see a difference of 5.5 to 1 in pips for Negative Reversals vs. Positive Reversals.

Number of Level 1, 2 and 3 Trades



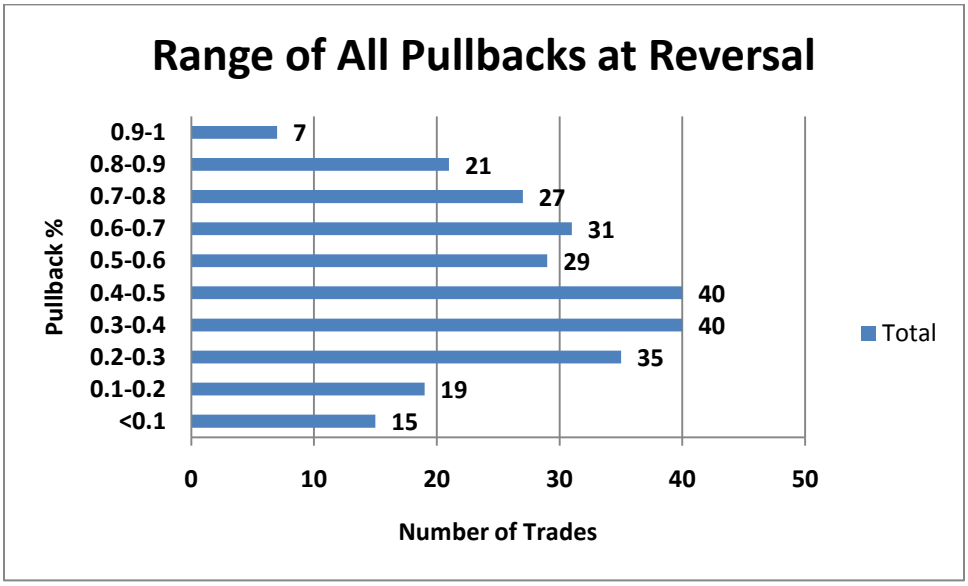
This chart shows the breakdown of Level 1, 2 and 3 trades. L1 trades make their profit with no risk and therefore have a small number of the total. L 3 trades extend profits at least to Point B meaning that they make the BC ratio. This

distance should be taken into account when placing a trade. L2 trades make up the bulk of the trades which make their proposed target with a certain amount of drawdown risk. These risk levels will be shown in future charts.

PULLBACKS

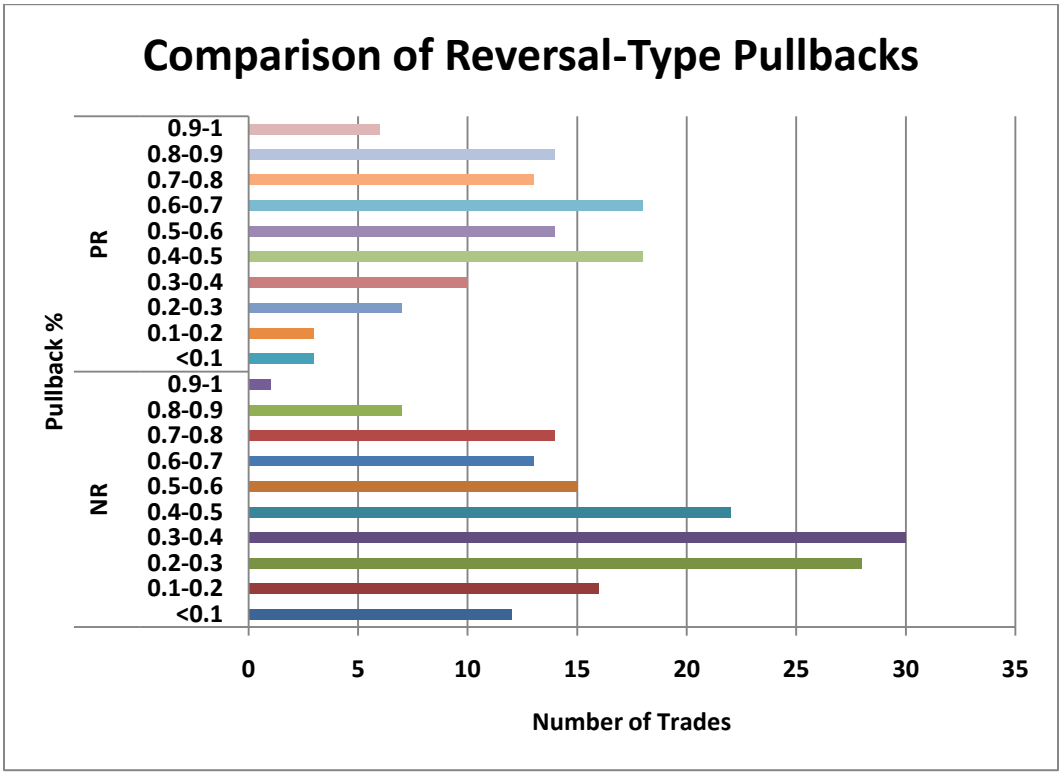
Pullback is where the distance from B to C on price at the time of the reversal. If AB =100 pips and BC = 50 pips then the pullback at the time of the signal is 50%.

Range of Pullback at Reversal



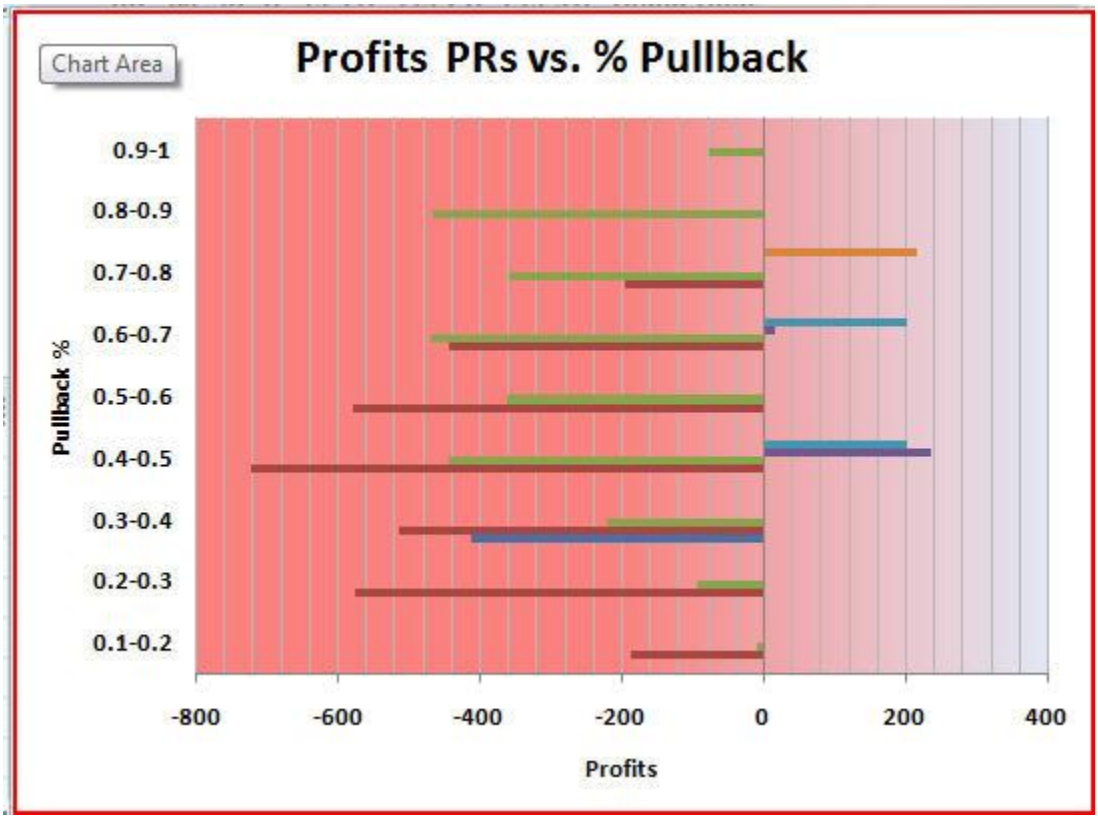
This chart shows where trades pull back to when Reversal signals take place. This is the distance of BC in relationship to AB. Here them majority of trades pull back to 30 to 50%. As an aside, Fibonacci Ratios do not appear to be the significant range for RSI Pullbacks and perhaps are not significant areas of pull back in swing trading.

Comparison of Reversal Pullbacks



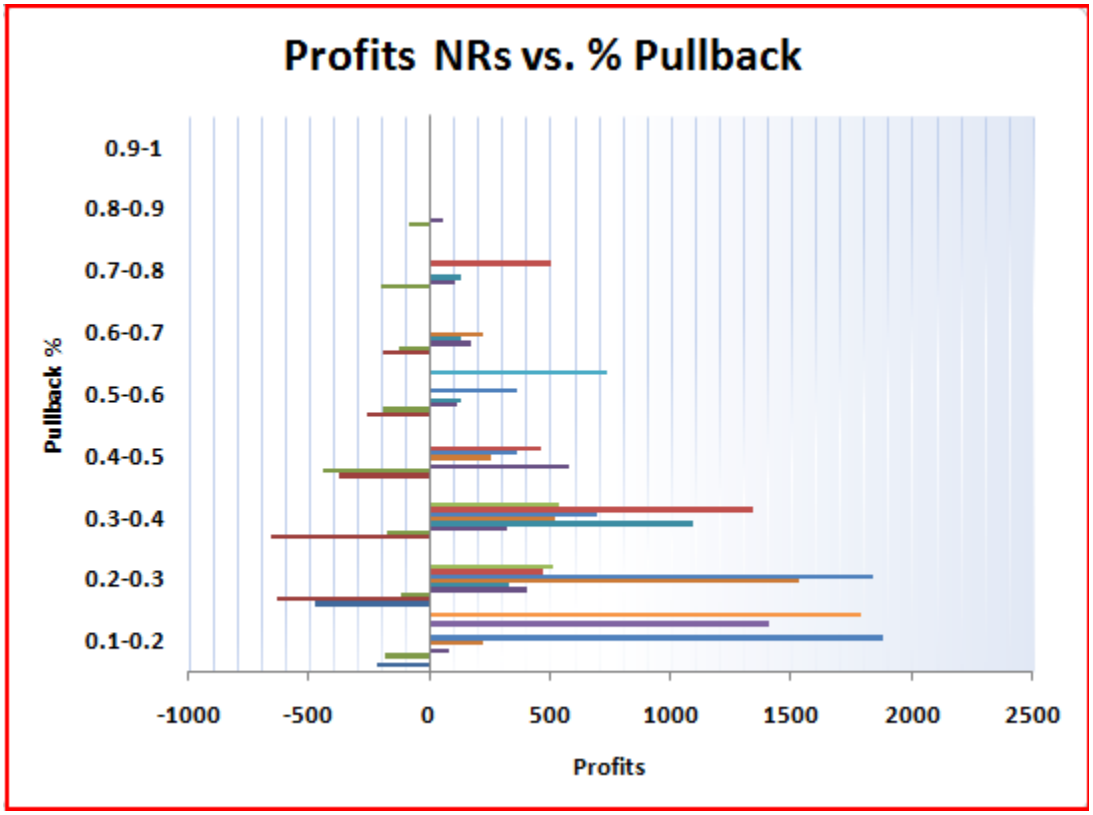
This chart breaks down the percentage Pullback by Reversal type. We see here that in this downtrend most are focused in the Negative Reversal area but the pullback area is slightly less; 20 to 50% with a large focused between 20 to 40%.

Profits for PRs (Positive Reversals) vs. Pullbacks



This chart shows that most of the Positive Reversals in this market are failing. There are only a few on the positive side of the chart with nearly all falling onto the negative side of the chart. This is an obvious reason to stay away from Positive Reversals unless you are a seasoned trader and have strong reasons to place one of these trades.

Profits NRs vs. % Pullback

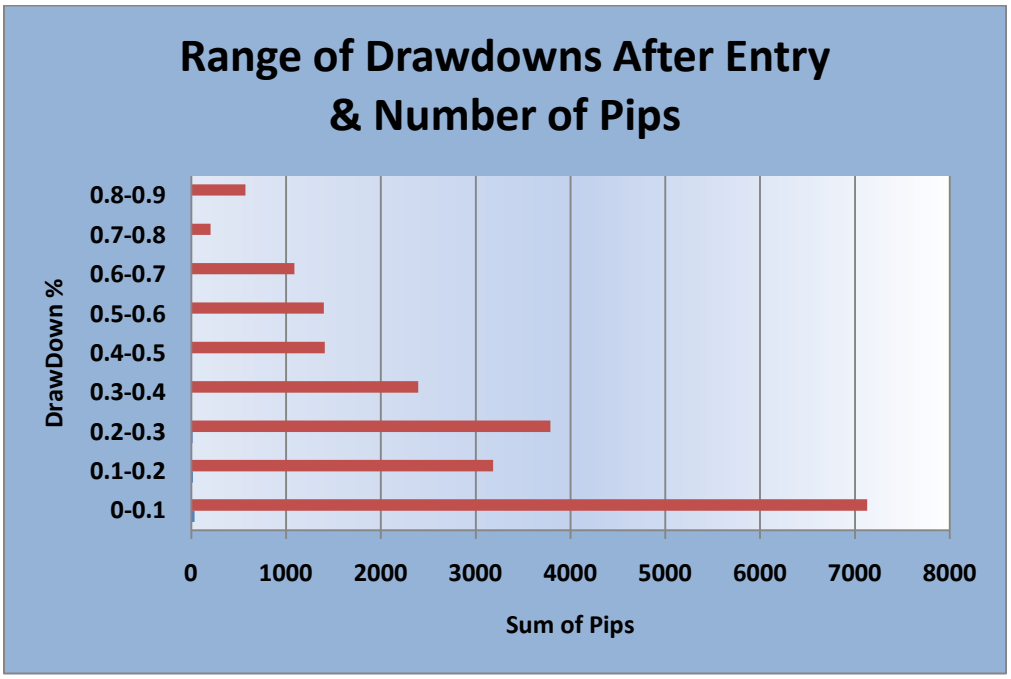


This chart shows just the opposite of the above chart with the highest percentage of trades falling on the positive side of the chart and the bulk of the trades falling into the PullBack range from the above chart; Comparison of Reversal Pullbacks

DRAWDOWNS

Drawdowns are the point in which price moves against the trader after the Reversal signal and the order has been placed. It is the distance in pips past Point C, divided by the distance in pips between Points A and C and is expressed as a percentage.

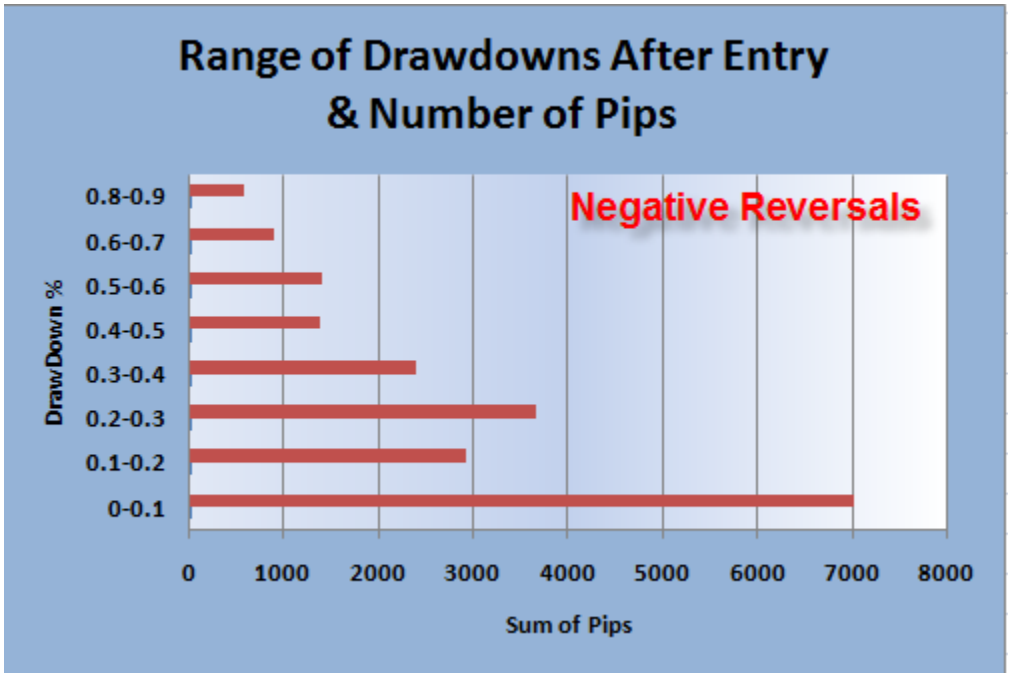
Range of Drawdowns After Entry and Number of Pips



The majority of drawdowns are between 0 and 30%. This information allows the trader to better position themselves in the area where most trades succeed. In the above 67% of pips from all trades come from drawdowns of 0 to 30%, while 78% come from 0 to 40% drawdown.

Range of Drawdowns After Entry and Number of Pips

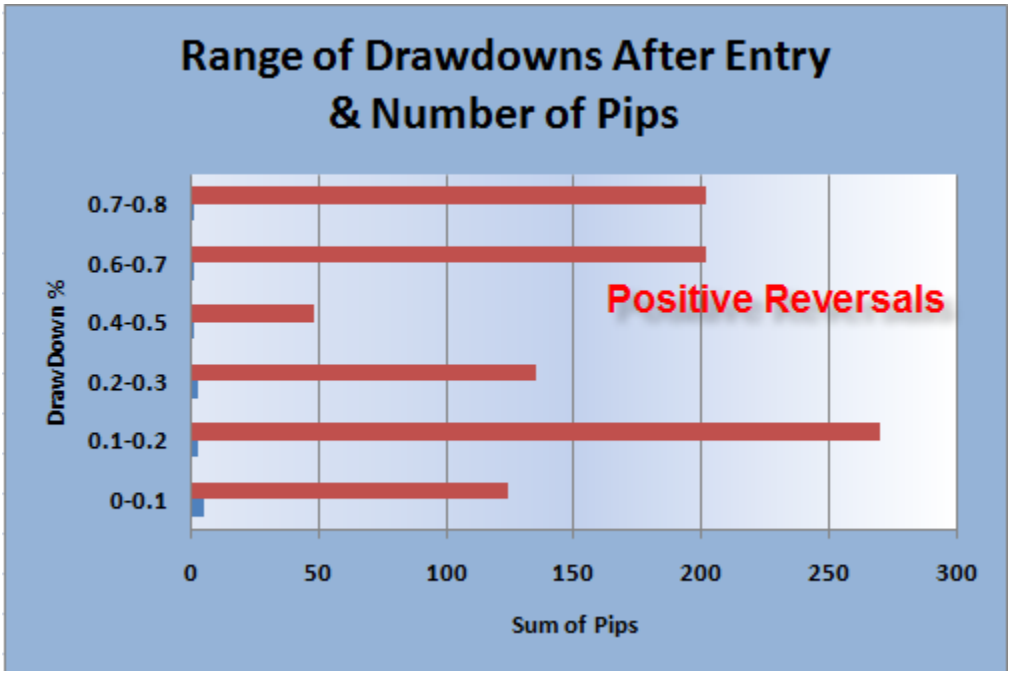
Negative Reversals



Looking at the same information for just Negative Reversals we see nearly the same data distribution. Notice how evenly it recedes as the rate of risk grows greater.

Range of Drawdowns After Entry and Number of Pips

Positive Reversals

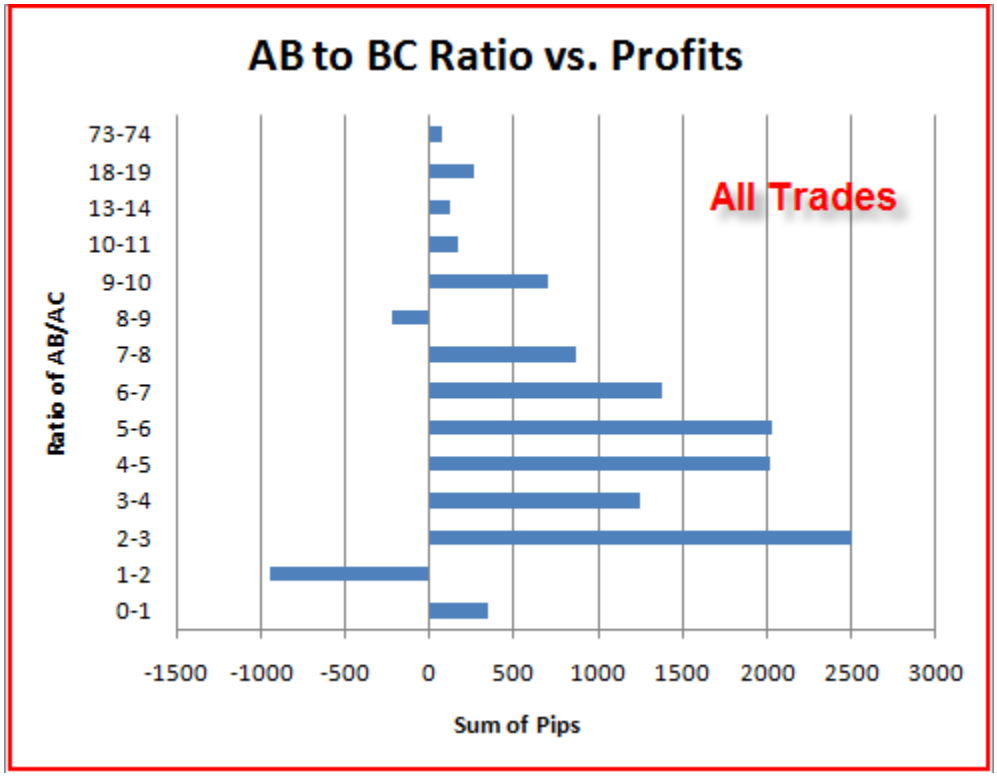


In contrast to the chart above this one the Positive Reversals are all over the place and show no consistent pattern that we can count on to increase probability.

RATIOS

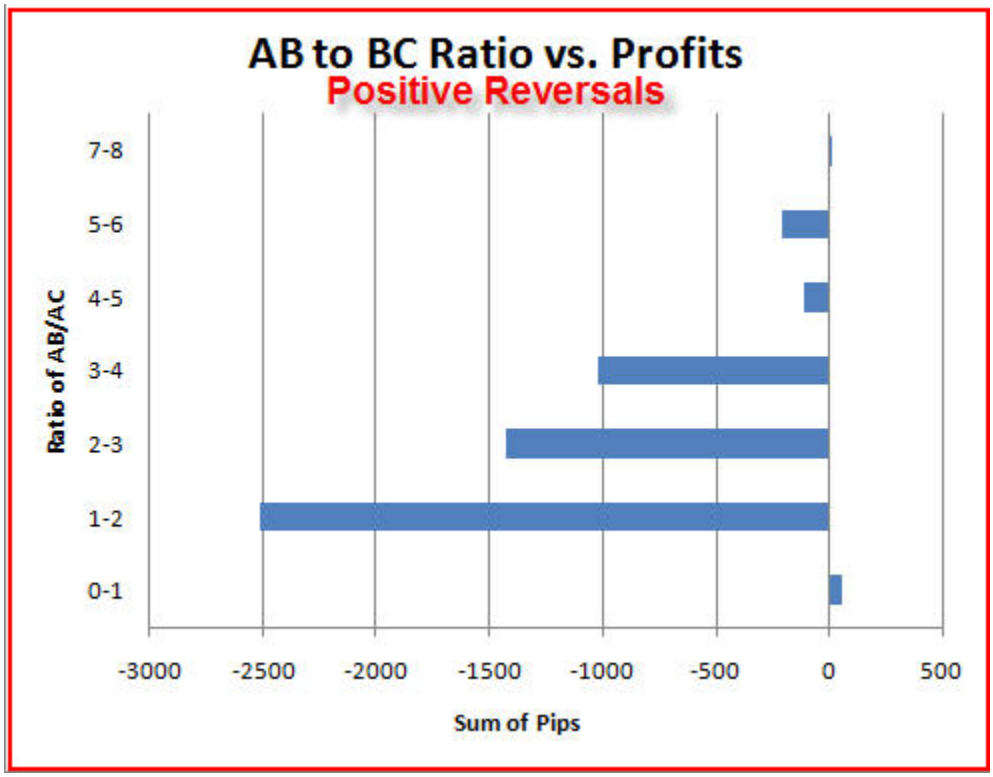
The Ratio is the ratio of the distance AB and BC. BC is divided into AB yielding a ratio of an unknown number to one.

AB to BC Ratio vs. Profits – All Trades



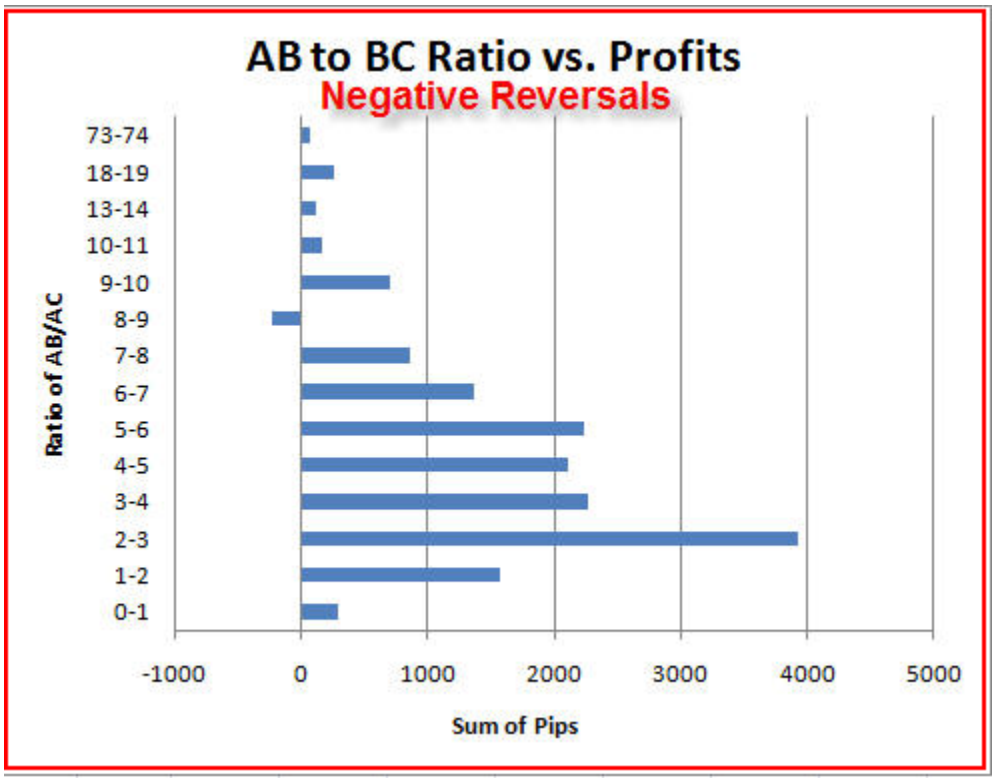
This chart shows the ratio of AB and BC. We see that the greatest number of trades begin at 2:1 and go to 6:1. This is for all trades. Also these are the trades that produce profits.

AB to BC Ratio vs. Profits – Positive Reversals



Looking at the chart we see revealing data that shows corresponding ratios for Positive Reversals are not productive even thought they fall into the same ratio categories as above.

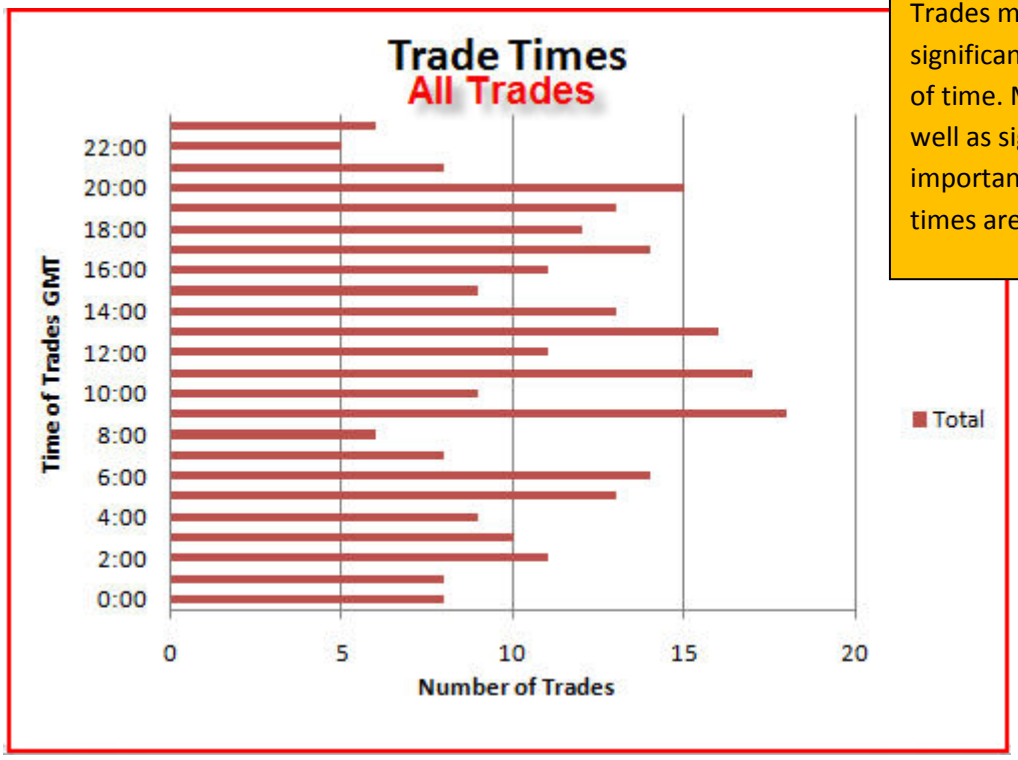
AB to BC Ratio vs. Profits – Negative Reversals



This chart shows just the opposite of the above Positive Reversal chart and shows that these ratios are the ones that produce the most profits.

TIME

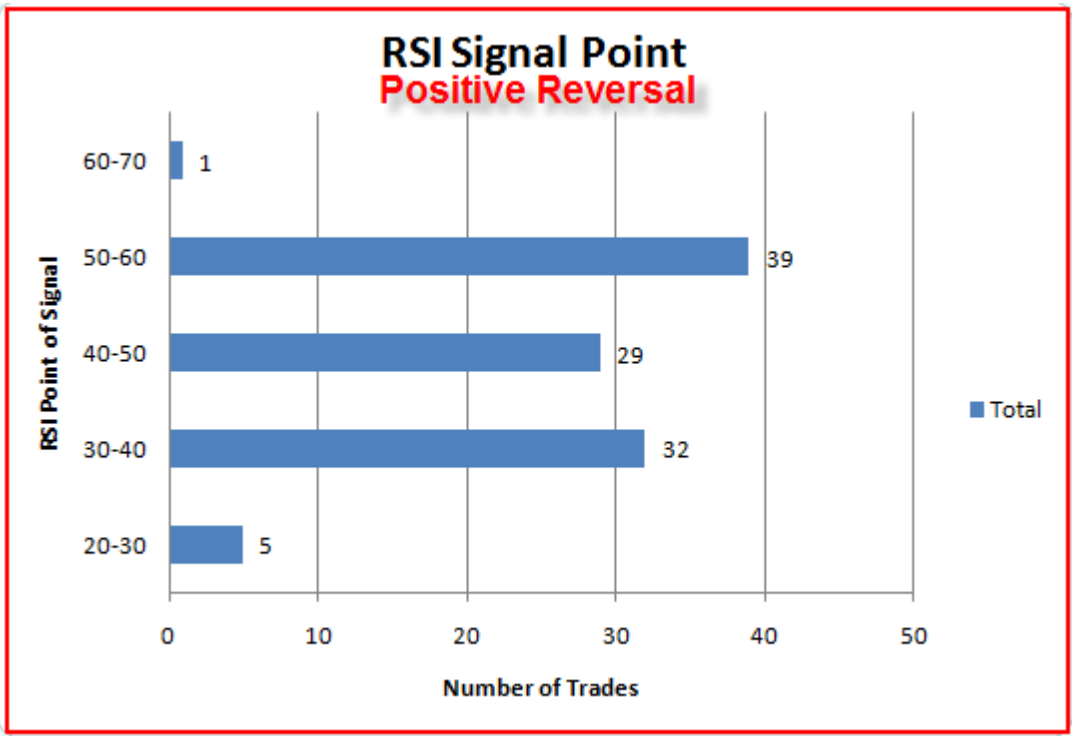
Time of Trade



Trades may or may not be significant on their own in terms of time. Momentum and **time** as well as signal location are important to trade success. These times are -6 to meet EST time.

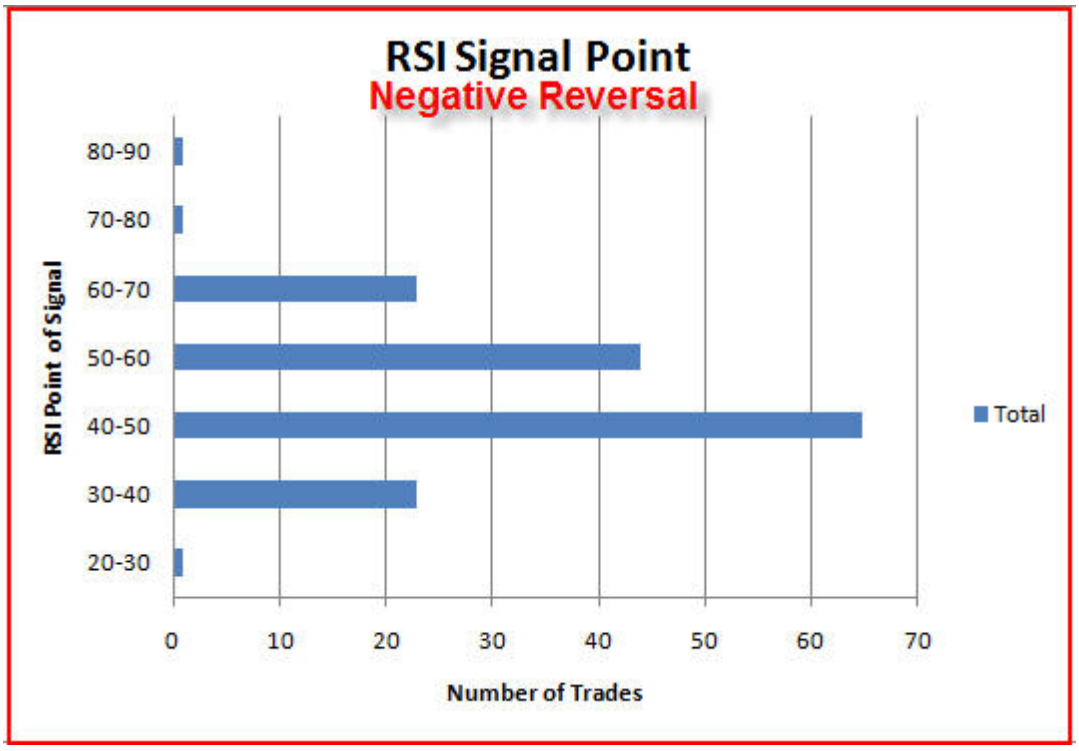
Time of signal is represented above. These times – 6 hours equal EST times. There is no clear distribution on this chart for a higher level of success.

RSI Signal at Time of Reversal – Positive Reversals



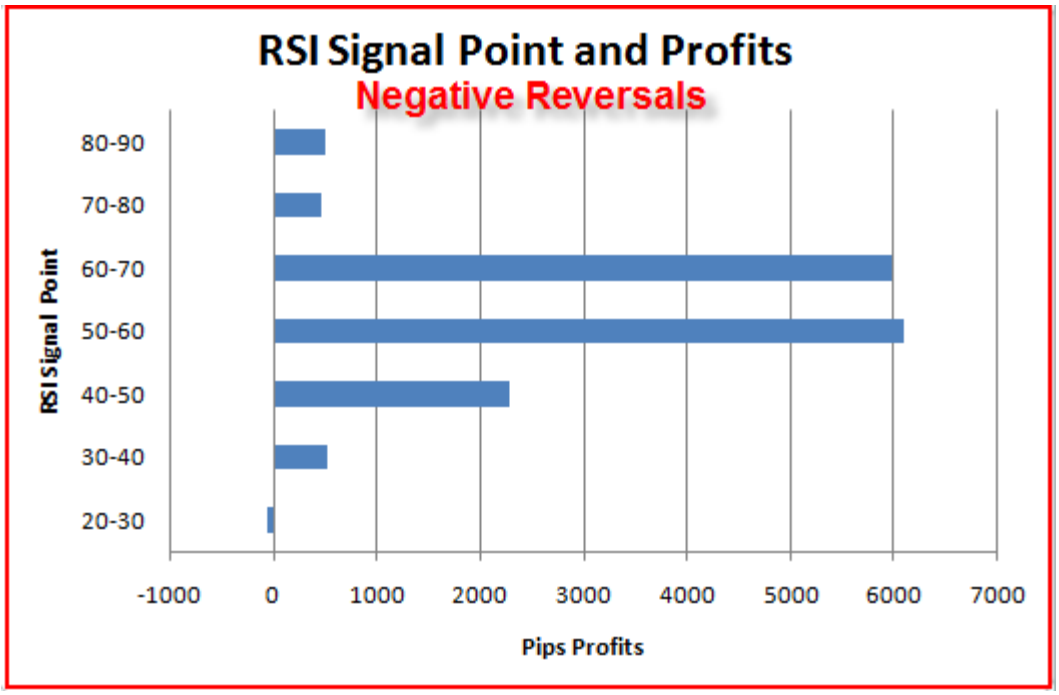
Here is the RSI level of Positive Reversals. By reviewing an uptrend situation on a Main Channel we would find that successful RSI signal areas would be lower, not higher. This chart further indicates that the trend is down. A change in this distribution would mean that price direction might be changing.

RSI Signal at Time of Reversal – Negative Reversals



As expected this chart of the Negative Reversal Chart shows that the signals for Negative Reversals are in the upper RSI ranges. The next chart of where profits are coming will further indicate our optimal trading range.

RSI Profits at Time of Reversal – Negative Reversals



We see on this chart that profits take place at the highest level when RSI Negative Reversals fall into the 50 to 70% signal area.

TRADE SUMMARY

Main Channel: Down

Optimal Trade Signal: Negative Reversals

Optimal Pullback Area:

- **Most trades: 20 to 50%**
- **Most profits: 10 to 40%**

Drawdown

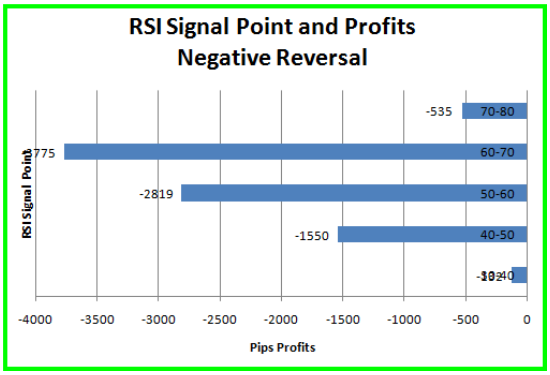
- **Conservative: 0 to 40%**
- **Aggressive: 0 to 50%**

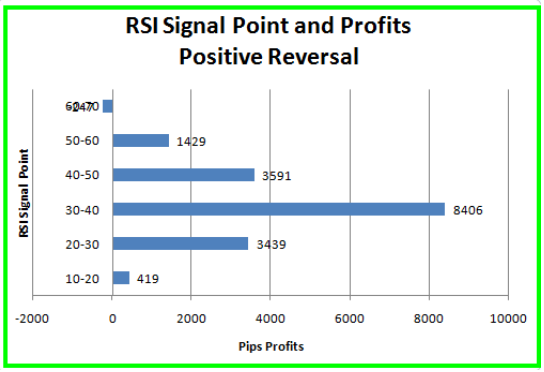
Ratio: 1 to 6

RSI Signal Point: Negative Reversals 50 to 70 RSI

RSI Signal/Profit Distribution for Negative and Positive Reversals for Uptrend vs. Downtrend

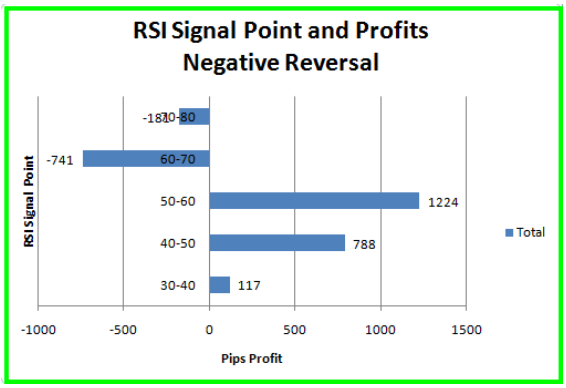
EURUSD UPTREND

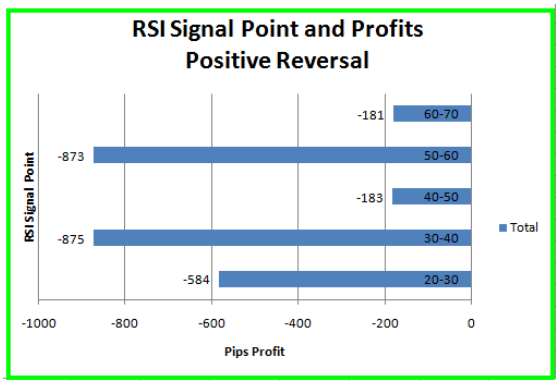




Notice here that we have distributions for Negative and Positive Reversals. We are looking at how the distributions change as price goes from an uptrend, to the change from uptrend to downtrend and finally a downtrend. On the Negative Reversal going up, all of the profits fall to the left of 0. In the change-over there are prices on both sides of the line and finally in the downtrend all prices to the right. In the case of the Positive Reversal the transition is more dramatic. The expectation would be that as the statistical data is run each month and distributions are taken, the transitions will give us clues as to the direction of the market as well as other data information.

EURUSD CHANGE UP TO DOWN





EURUSD DOWNTREND