RSI:
Trader's Secret Weapon

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"The Truth about Trading Support and Resistance –
How to Trade Commodities Like a Pro"

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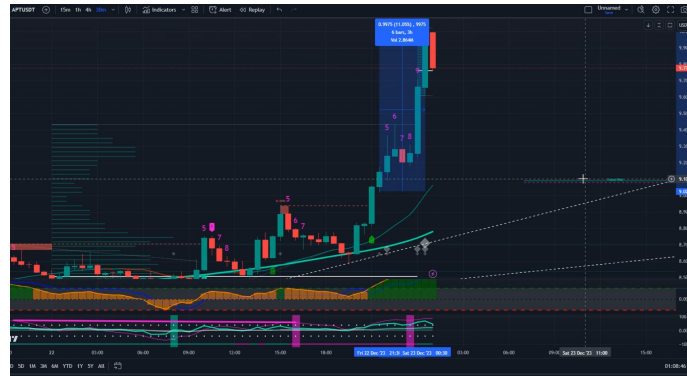
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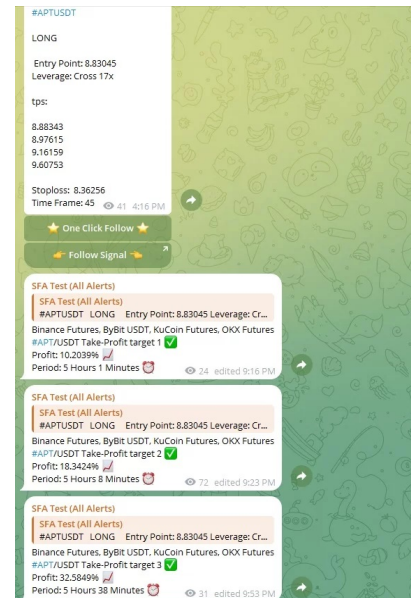
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Why RSI?

Of all the different secondary indicators that traders have to choose from, RSI, in my opinion, is one of the best.

RSI stands for Relative Strength Index; however the name does not adequately describe what the indicator does. It does not really measure the "relative strength" of anything; rather the indicator gives you an idea as to the internal pressures affecting a market.

In other words, RSI can help you get a "feel" for what other traders are thinking.

RSI is also useful because it mimics what other indicators are telling you as well…and more.

Here is a chart of RSI with Slow Stochastics overlaid. Notice that both indicators rely on overbought and oversold regions to give you a sense for where the market is currently trading.
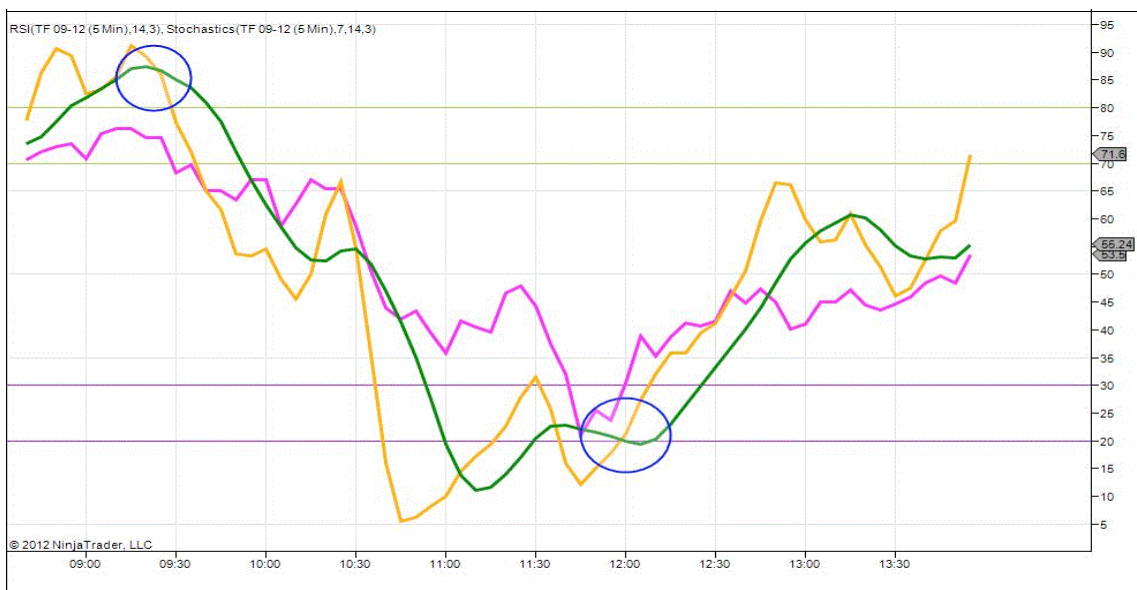
Notice how the circles identify where both indicators would have given buy and sell signals; although the signals may have been

generated differently (more on that in a minute). Here you can see that RSI and Stochastics follow each other pretty closely.

Similarly RSI follows MACD, another popular indicator quite closely. MACD is a popular indicator because it is rarely wrong, but the reason it is rarely wrong is because it has considerable market lag. Even so many traders use MACD to plan their trades.
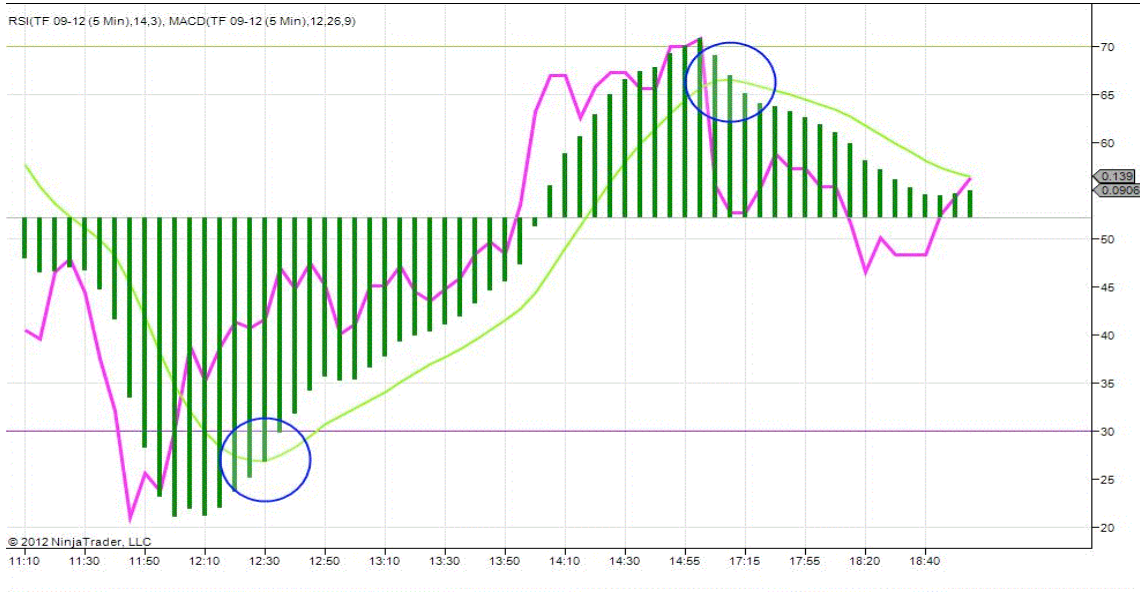
RSI is actually a little more sensitive than MACD and will give buy/sell signals earlier.

Many traders look to MACD to identify divergences between the indicator and prices. As you will see in a moment, RSI is also an excellent tool for picking up on divergences.

Momentum is another indicator that has been gaining popularity among technical traders. Like MACD, Momentum tries to capture the market momentum, hence the name.

RSI(TF 09-12 (5 Min),14,3), MACD(TF 09-12 (5 Min),12,26,9)

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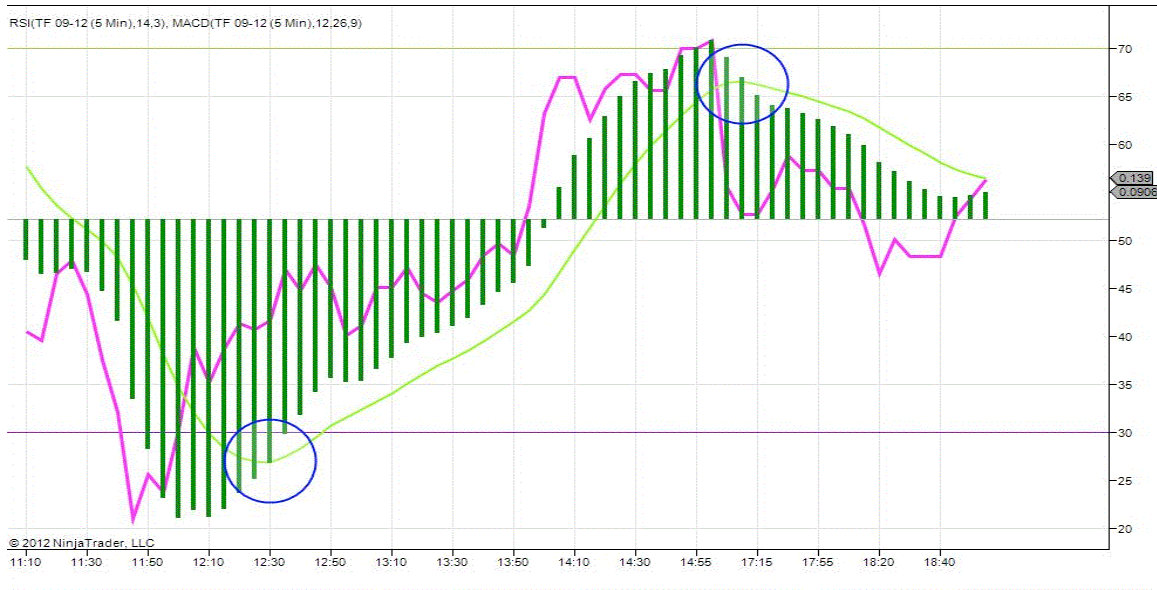
As you can see from the chart, MOM and RSI follow each other pretty well. In fact, MOM seems to fill in under the RSI line. This is helpful to remember when you are looking at RSI: that the space between the RSI and the 50% level on the RSI indicator, will roughly approximate the market momentum.

So you can see how you can use RSI to gather the same information that is given on different indicators, but there is more: RSI lends itself particularly well to small spec traders because it helps them identify important price levels and can help them better time their trades.

Important Point to Remember

Always remember and never forget RSI, like any secondary indicator, is usually a **lagging** indicator. This means that it normally follows what is happening on the price chart.

Therefore you should place your primary emphasis on analyzing the market based on what you know about price and use RSI to give you hints, or help confirm your decisions.

RSI Settings

Technical traders always seem to be "tweaking" their settings on the indicators hoping to gain some sort of edge; however since I normally use RSI to gauge market sentiment, I stick with the standard settings.

I have RSI set on a 14 period average, although the 9 and 25 period averages are also popular among traders. The shorter 9 period average with be a little more choppy but will give you even faster, albeit less reliable signals; whereas the longer 25 period average will have a tendency to smooth out the line and give you fewer, but more accurate signals.

If you are curious I encourage you to try the different settings and find one that is right for you. I used to use a 21 period average before; however I went back to the 14 period as I found it just as predictable.

Likewise I stick with the standard 70/30 overbought and oversold parameters. Some traders like to use the 80/20 lines to determine when the market is overbought and oversold.

This is not as important for our purposes since we will be using more than just the overbought and oversold levels in our analysis, but here too, feel free to experiment. You may find that the more extreme levels are to your liking.

The concept of overbought and oversold is an attempt to measure the condition of the market. The reasoning is that everything in the market has a tendency to "normalize".

Therefore if a market is overbought (too many buyers), then prices should go lower. Likewise if a market is oversold (too many sellers) prices should react by going higher.

It is important to note however, that simply because a market is overbought or oversold does not mean that prices will immediately reverse and go in the opposite direction. During periods of extreme

supply or demand, markets can remain in the overbought or oversold areas for weeks or months at a time.

Even so, it is helpful to keep an eye on the market as it approaches these regions as in most cases the market maybe finding resistance soon.

How to Use RSI

The following chart shows a recent trade in the mini Russell Index market.

Notice how the RSI indicator is following prices down. Note too how the peaks, highlighted by the vertical lines, mirror the peaks on the price chart.

TF 09-12 (30 Min) 7/17/2012
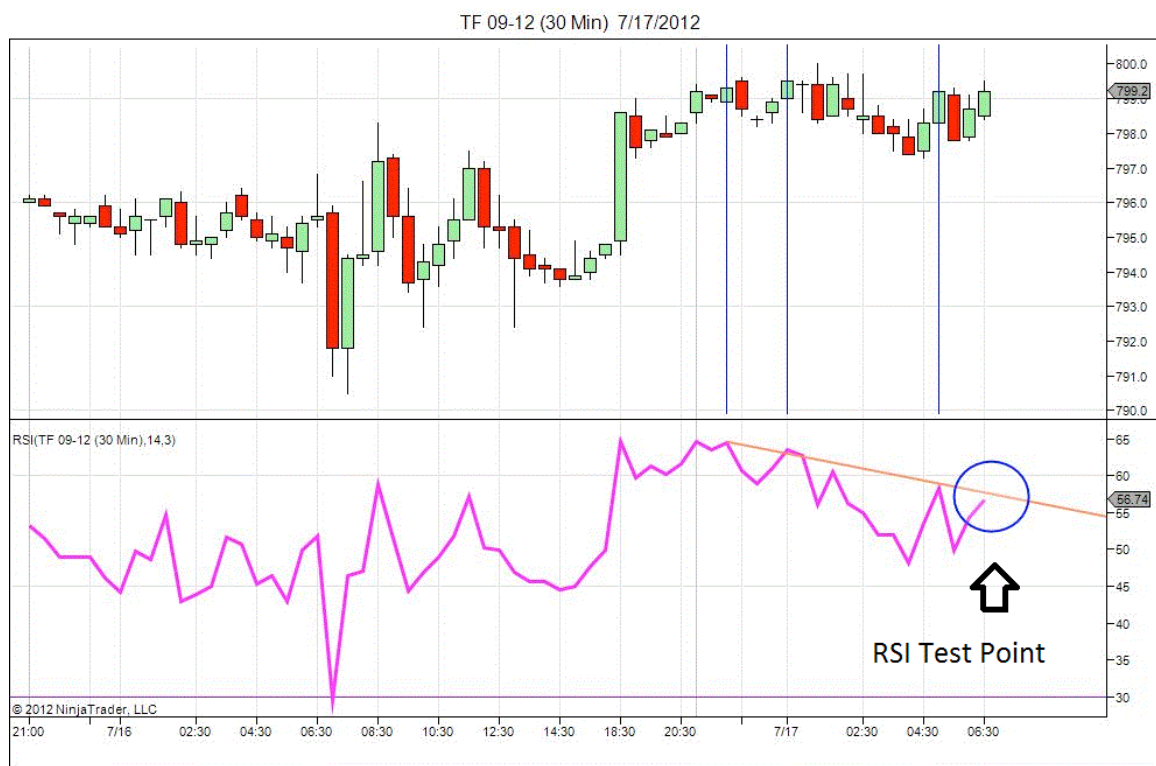
One of my favourite tools for analyzing the RSI chart is a simple trendline. By drawing a declining trendline along the peaks on the RSI indicator we can see that the market is currently at a "test point" as highlighted by the circles on the price chart and the RSI chart.

So what is this telling us?

RSI shows that while prices continued higher, RSI (or the market sentiment) was rejecting going higher. In fact as the market was approaching the oversold, RSI was starting to head slightly lower.

Now at the RSI test point RSI shows that the market is either ready to break the downtrend or rebound off the trendline and continue lower still.

Why would this be?

Well a quick look at the chart shows a considerable amount of resistance near the highs as price continues to struggle to get through.

No wonder RSI is showing that the market is at a "test point"!
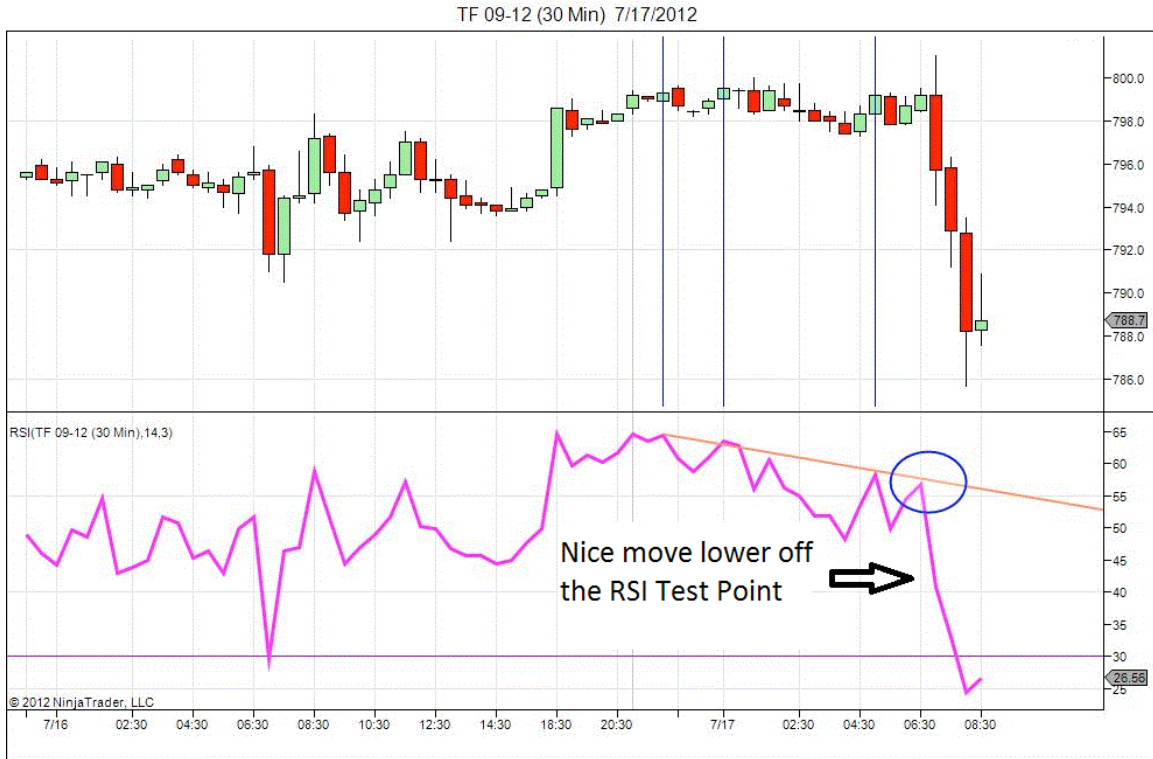
So how would you handle this?

Given what we have learned from the RSI chart we know that the current price is the "test point" price. Therefore we have one of two options:

1. either prices will bounce off the RSI trendline and continue lower through support, or
2. prices will break the RSI trendline and resistance and head higher.

Therefore you could plan your trade to enter the market long above the recent highs or enter below the current lows. You have effectively cornered the market and have a high probability trade.

Here is the market a few minutes later…

TF 09-12 (30 Min) 7/17/2012

RSI(TF 09-12 (30 Min),14,3)

Nice move lower off the RSI Test Point

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Notice how the market bounced off the RSI trendline and headed lower? The original test point is still highlighted by the blue circle on the RSI chart.

As the market advances RSI begins to form a channel. You should anticipate the RSI indicator forming a channel as it moves from one overbought/sold region to another. By bracketing the movement of the indicator it becomes possible to use the upper and lower boundaries of the channel as targets.

Once RSI emerges out of the top of the channel it forms another series of test points which is followed by a move higher. You will see this happen time and again when using this indicator.

RSI Divergence

In most cases RSI will mirror price. When price goes higher RSI will go higher and when price goes lower RSI will go lower; however there will be times when RSI does not follow suit, rather RSI will
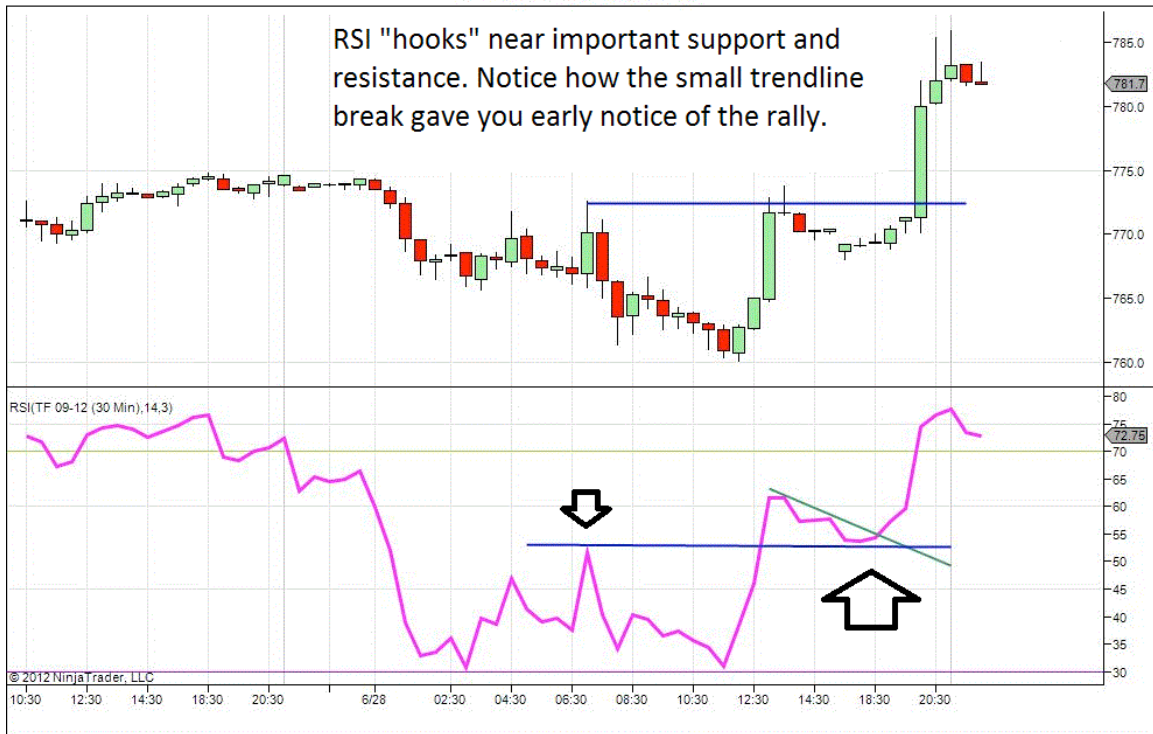
move opposite to prices. This is DIVERGENCE and is one of the strongest signals you can get from RSI.

When RSI and prices begin moving in opposite directions for a period of time keep a close watch on the market because you are almost guaranteed a change in direction!

TF 09-12 (30 Min) 6/28/2012

Prices are heading lower but RSI is not, this is DIVERGENCE and a clue that there could be a change in direction soon!

One other point I want you to notice from this chart is that RSI has a tendency to "hook" at important support and resistance levels. This can aid you in identifying when the market might pause or stop and reverse direction.

TF 09-12 (30 Min) 6/28/2012

RSI "hooks" near important support and resistance. Notice how the small trendline break gave you early notice of the rally.

Early Signals

While RSI is primarily a lagging indicator, on the odd occasion RSI can tip you to what will happen before prices do. This is another situation where you can take a trade with greater confidence.

TF 09-12 (30 Min) 6/28/2012

Sometimes RSI will move before prices. Here prices are in a channel but RSI has already broken higher suggesting a building rally.

In this chart you can clearly see how RSI has already broken the trendline while prices still remain in a channel formation. Knowing this you would give preference to a breakout below the channel, especially when the breakout is as substantial as this one.

Likewise, knowing that RSI has already moved higher, you could enter the market long above the high of the last bar instead of above the top of the channel. This would enable you to both get into the market at a better price and have less money at risk.
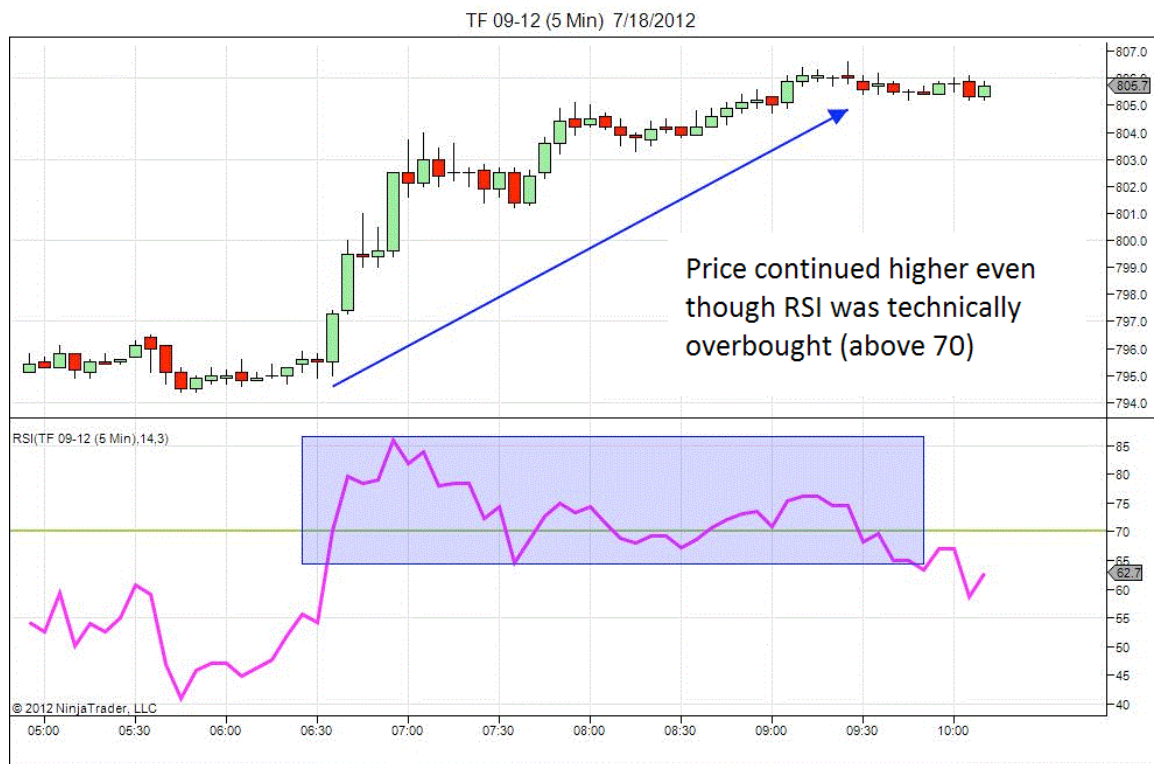
RSI can also form other types of breakout formations including sideways channels and pennant formations which will sometimes give you a breakout clue before prices actually breakout of the formation.

Overbought and Oversold

Like many oscillator style indicators RSI has overbought/oversold regions to identify when the market has become extended. It's important to bear in mind when dealing with the overbought and

oversold regions that the market does not have to reverse simply because RSI overbought or oversold.

Sometimes the market can spend a long time in the overbought or oversold region but during that time prices can continue to go higher or lower.

TF 09-12 (5 Min) 7/18/2012

Price continued higher even though RSI was technically overbought (above 70)

RSI(TF 09-12 (5 Min),14,3)

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In this chart you can see that mini-Russell spent the better part of the morning session in the overbought region of the RSI indicator. During this time prices kept on advancing without any significant retracement in price.

When RSI has been in the overbought/sold region for an extended period of time the indicator will often make a "retracement" back to the 50% level. This pullback "refreshes" the market and often a resumption of the trend will continue afterward.

When the market does trade in the overbought or oversold areas of the indicator I like to be on the lookout for what is called a "failure swing".

A failure swing is similar to a 123 top/bottom formation where the indicator will form a new high (low) which will be the 1 point. This will in turn be followed by a reaction move, forming the 2 point. After this the indicator will again test the 1 point but not exceed it, making a 3 point in the process.

Once the indicator breaks through the 2 point it would be a confirmed buy/sell signal, as the case may be.

In this chart the indicator has broken below the 2 point which would lead you to believe that a short position is in order. You could initiate such a position by placing a sell order below the current low and enter short only if the market was able to exceed the low.
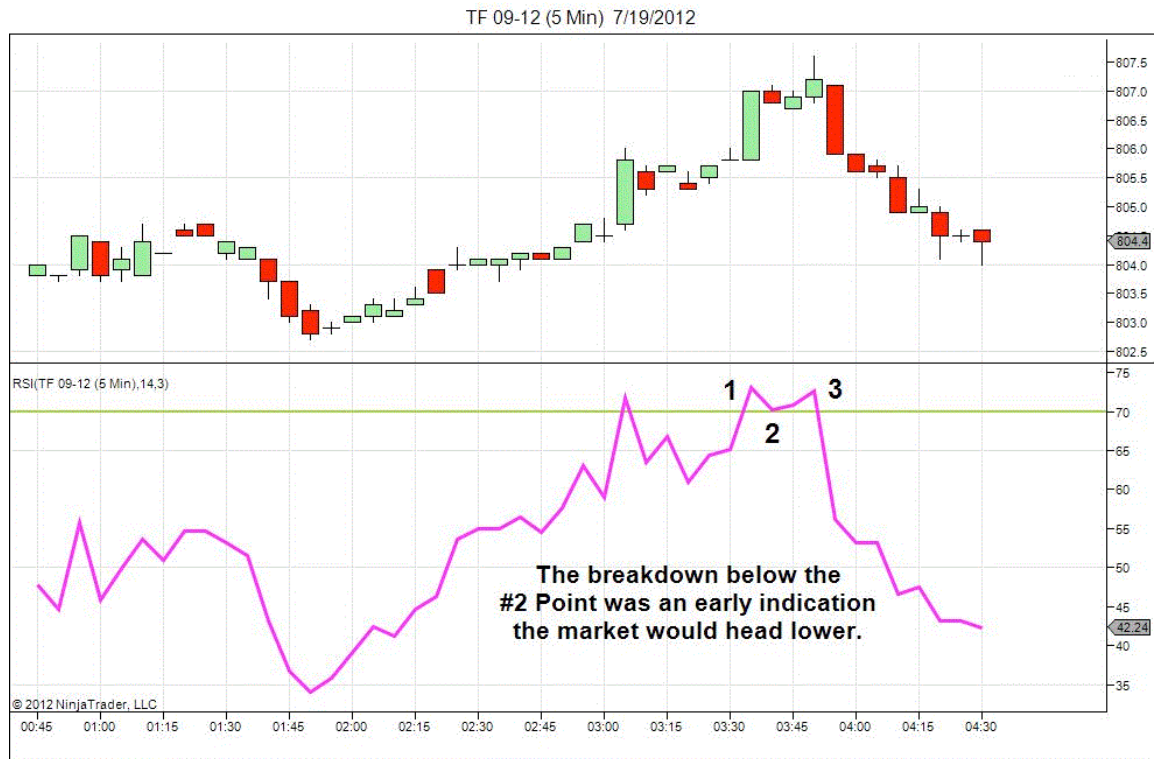
This would add a little protection to your position by making the market come to you before engaging the order.

Final Thoughts

When using RSI remember that it rarely makes a straight line from overbought to oversold. Expect the indicator to hook and use these hooks to draw trendlines and channels to help give you clues as to what might happen next.

Most importantly however, always remember that while RSI can be a very useful indicator for helping to determine market direction, it is still only a secondary indicator.

Your primary information should be coming from the price charts themselves and the price action contained therein. Always use the charts for your analysis and use RSI to give you hints as to what you might expect the market to do.

Use RSI more as a confirmation tool than a primary decision making tool and you will never go too far wrong.