Module 5 – Chapter 2 – Relative Strength Index (RSI)

The RSI, or Relative Strength Index, is a momentum oscillator .This technical indicator measures the speed and change of price movements, oscillating between zero and 100. It is commonly used to identify overbought or oversold conditions in a traded security.

What it is and what it shows

The RSI calculates the relative strength of a security's price performance, aiming to identify conditions where it might be overextended, either to the upside (overbought) or downside (oversold).

Here's how the RSI is calculated:

RSI = 100 - (100 / (1 + RS))Where: RS = Average of 'n' days' up closes / Average of 'n' days' down closes Typically, 'n' is set to 14 periods, which can be days, weeks, months, or even an intraday timeframe.

The resulting number will range between 0 and 100. Generally:

An RSI above 70 suggests that a security might be overbought and could be primed for a price pullback or correction.

An RSI below 30 suggests that a security might be oversold and could be ripe for a price bounce or recovery.

How to trade it

The RSI is versatile and can be used in various trading strategies:

1) **Overbought and Oversold**: The most basic and common way to use the RSI is to identify potential buy or sell opportunities when a security becomes overbought (RSI above 70) or oversold (RSI below 30). However, just because a security is in overbought territory doesn't mean it will reverse immediately, and the same goes for oversold conditions.

Example: If a stock has an RSI reading of 78, some traders might consider it overbought and anticipate a potential pullback.

2) **Divergences:** Divergences between RSI and price action can be strong signals. Bullish divergence occurs when the price makes a new low, but the RSI makes a higher low. This might indicate an upcoming upward reversal. Conversely, bearish divergence occurs when the price

makes a new high, but the RSI makes a lower high, indicating potential downside.

Example: If a stock makes a lower low, but RSI forms a higher low, it could suggest weakening downward momentum and a potential reversal to the upside.

3) **RSI Trendlines and Breakouts**: Similar to price charts, traders can draw trendlines on the RSI chart. Breakouts or breakdowns from these trendlines can be used as potential trade signals.

Example: If the RSI is trending down and breaks above a descending trendline, it might indicate a shift in momentum and a potential buy signal.

4) **Centerline Crossover**: When the RSI crosses above the 50 level, it can be considered a bullish signal, and when it crosses below, a bearish signal. This can be an indication of a shift in the overall trend.

An example of the RSI

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