



BRANDON WENDELL

**Brandon Wendell**

is an  
Online Trading Academy  
Instructor and  
Content Developer



# It's All Relative

Brandon Wendell provides new ideas on how to interpret an old indicator. Do you know how to successfully interpret and use Welles Wilder's RSI? Learn new interpretations of the RSI in this article.

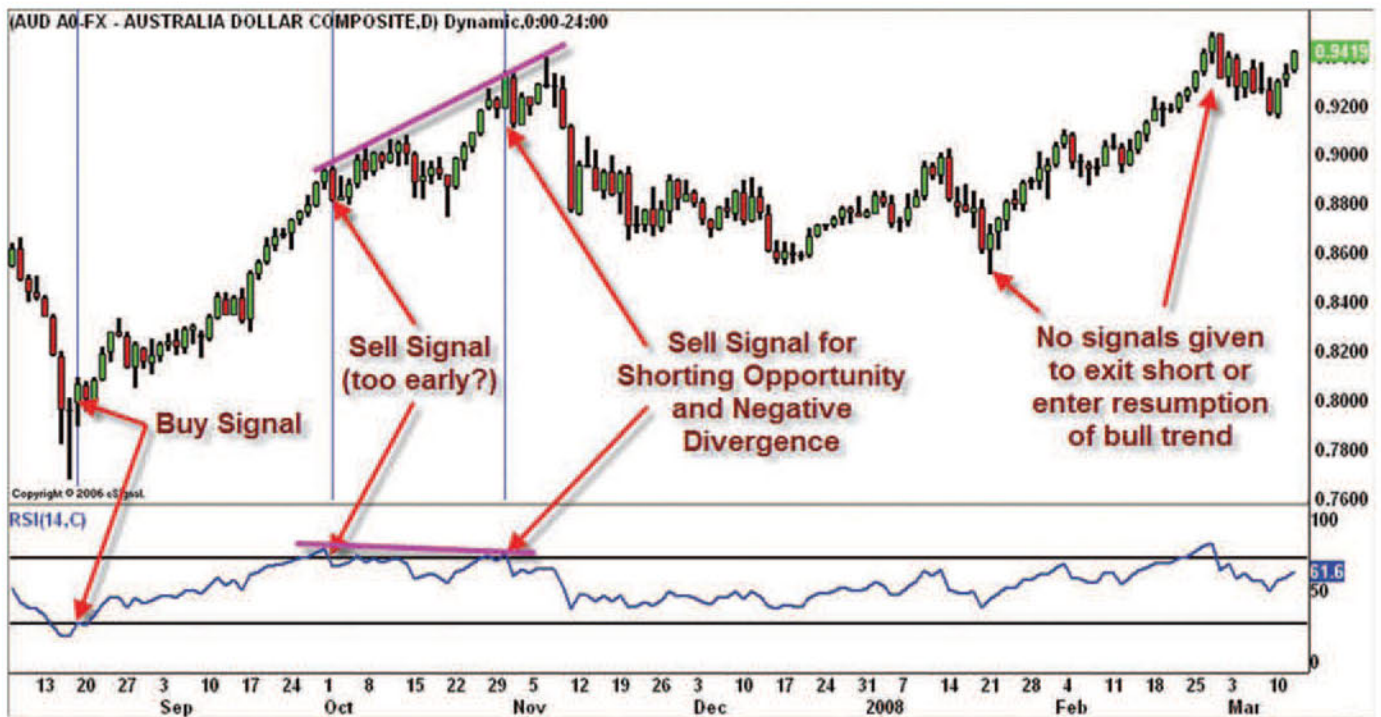


Figure 1 AUD with bullish signal followed by negative divergence

The chart source : Procharts

Many traders look to technical indicators for clues as to where price action will be moving in the future. There are many problems associated with this approach. First and foremost, technical indicators lag current price. The indicators are created from data that is compiled from where price has been at some point in the past, the rate at which it is changing, and perhaps use volume as an additional filter. Technical indicators are simply a mathematical way of analyzing and representing price action and offering a different perspective of what price is doing. A trader should never rely exclusively on an indicator for a buy or sell signal. However, when used in conjunction with price behavior analysis, a trader can gain confidence for entries and exits as well as identify opportunities as they appear. Technical indicators should be used as a decision support tool.

I constantly study methods of trading and consider myself to be a student of the market. I was surprised to learn that there are different methods of applying popular indicators and I found that by making some minor modifications, an indicator I previously had no use for became a nearly indispensable tool in my trading arsenal. One tool that fits this description is the Relative Strength Index.

As part of my market studies, I came across a book by Connie Brown entitled, *Technical Analysis for the Trading Professional*. In this book, Connie describes a method of adjusting signals of the RSI for maximum efficiency.

The typical Relative Strength Index (RSI) calculation uses 14 periods. This means that the strength of the current price is measured against the prices over the preceding 14 time periods. The indicator measures the strength of upward movements in price as

well as the strength of downward moves in price. The RSI can be applied to any trading security. Positive and negative divergences are the strongest signals provided by the indicator.

Positive divergence occurs when the indicator makes higher lows while the security's price makes lower lows. In this case, the RSI is telling us the downward price movement is losing strength. Generally, the price will reverse and head higher. A negative divergence is when the indicator fails to make new highs while price does. This tells us that the upward trend is weakening. Generally, the price will fail and enter a downtrend. Unfortunately, divergence signals do not give us exact timing for the reversals in price but simply warn that one may be coming.

The RSI also provides a good indicator of a market's overbought and oversold status. If the indicator rises above 70, the security is considered overbought and is ready for a pullback or reversal. Do not automatically sell a long position at this point! If the RSI drops below 70 after moving above it, that is the signal to exit a long position or initiate a short one in a bearish market.

A similar signal occurs when the indicator drops below 30. When this occurs, the market is oversold and may reverse to the upside. Wait to buy when the indicator crosses back above 30. If you are short the market, buy to close the position. If opening a long position, be sure that the market is in a bullish trend before entering the long position.

Shown in Figure 1, there is a nice buy signal on the left side of the chart from the RSI going long the AUD/USD at approximately 0.80. We are able to ride the trend up and exit from the position on the sell signal at 0.89 for a nice profit. Unfortunately, the RSI exits the position too early and the pair rises while we wait



Figure 2: AUD with bullish RSI

The chart source : Procharts



Figure 3: JPY with bearish RSI

The chart source : Procharts

for another buy signal that never arrives. The price continues to make higher highs while the RSI shows negative divergence. On the break of the RSI below 70, a short can be entered but the RSI fail and never offers a signal to exit the trade or to participate in the following rally.

One thing to notice is that in a very bullish trend, buy signals are rare since the RSI does not drop below 40. In a very bearish

trend, the RSI will not move above 60. In this scenario, how can you hope to have the 70 – 30 signals needed to get you into trades? The answer is that you cannot unless the indicator is adjusted. Many trading platforms will allow you to adjust the lines for overbought and oversold indications. Let's see how this adjusts our trading signals.

In a bullish trend, I mentioned that the RSI does not drop below

40. In this case, we can use a reading of 40 as an area of support to tell us when the bear market is ending. We can also adjust our overbought and oversold signal lines upward to provide quality signals. By making the overbought line 80 and the oversold 40, you will have a useful indicator. Do not enter any short positions against a bullish trend! Use the overbought signal to exit trade longs only, not enter short positions.

In Figure 2, the RSI has been adjusted for a bullish trend and provides better quality signals that allow participation in the trend. We will still use the original RSI buy signal but then exit the trade for a larger profit at approximately 0.94 when the RSI makes a much lower peak while the AUD made new highs against the USD. Once price and the RSI begin dropping, we take that as a signal to exit with a profit but do not short the market as the RSI remains above 40. The adjusted RSI allows us to enter another profitable trade in January. We see a great buy signal near the lows and a sell signal near the highs.

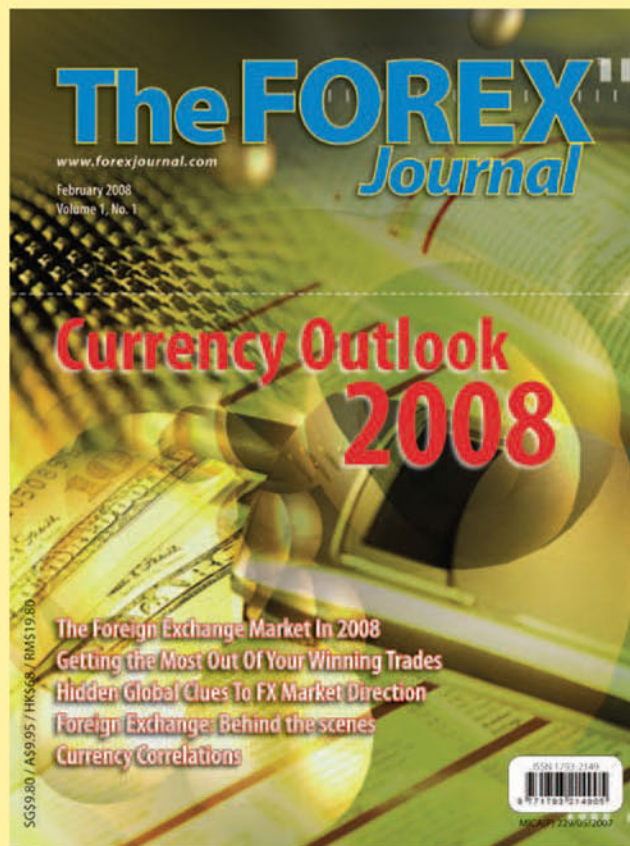
When the RSI drops below 40, it is time to adjust the RSI for a bearish trend. In a bearish trend, the RSI uses 60 as resistance. So, we adjust our signal lines downward. Our overbought line becomes 50 and our oversold is 25. Sell short on a crossover from above 50 to the downside and exit shorts on the crossover of 25 to the upside. Do not enter longs against a bearish trend. Remember, the trend is your friend!

In the chart of the USD/JPY pair, I have identified a nice downtrend and have adjusted the RSI for proper signals. We were able to sell the pair successfully with the adjusted RSI and exited for profit with timely signals or divergence.

I have shown examples on a daily charts only. Do not worry, this technique works just as well intraday on stocks as well as for Forex, E-minis and anything else you can use an RSI on. Give it a try and see if you get better signals!

*Brandon Wendell has appeared as a guest on CNBC Asia's Cash Flow and conducted special seminars for CNBC staff on technical analysis of the financial markets. Brandon was also an industry expert speaker at the Asia Traders and Investors Conference 2008.*

*Brandon is a full time trader in the US Equities, Options and Forex markets. He also teaches trading courses for Online Trading Academy. As a former stockbroker, brokerage trader, and hedge fund trader, Brandon brings various market views and insights to his trading classes and lectures. A wealth of knowledge, he has held NASD securities series 7 and 63 licenses. Brandon taught for Online Trading Academy in 1999 to 2001 before becoming a Realtor and Commercial Mortgage broker also managing a venture capital firm. Returning to the Online Trading Academy family late 2005, he now balances trading, teaching and a mortgage and finance career. Brandon is also a member of the Market Technicians Association and the Chartered Financial Analyst Institute.*



To advertise to the readers of

## THE FOREX JOURNAL

Call Dennis Yap at  
(65) 9040 4151 or email at  
[dennis@forexjournal.com](mailto:dennis@forexjournal.com)

