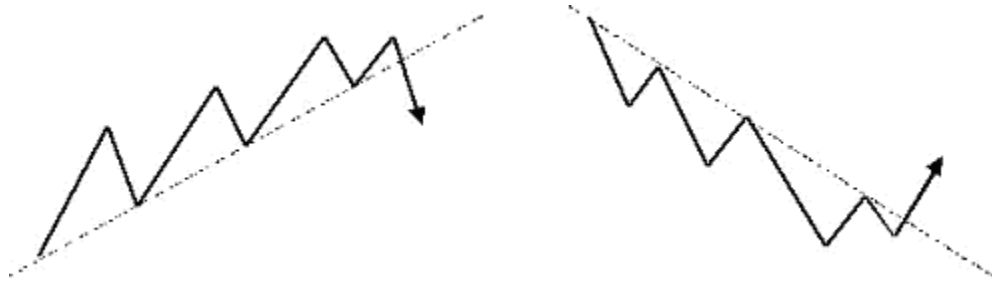


Overbought and Oversold RSI Readings

When is an overbought RSI reading bullish and when is it bearish?

One classic interpretation of momentum indicators is that of overbought and oversold. Normally these are quite good signals when used within a consolidating market although mere oversold or overbought readings should not be used to buy or sell (respectively) without other forms of analysis and preferably in shorter term time frame charts.

However, these overbought and oversold extremes can be useful within trends also. In this type of interpretation it is vital that only trades in the direction of the trend be taken. First we should remind ourselves of the definition of a trend.

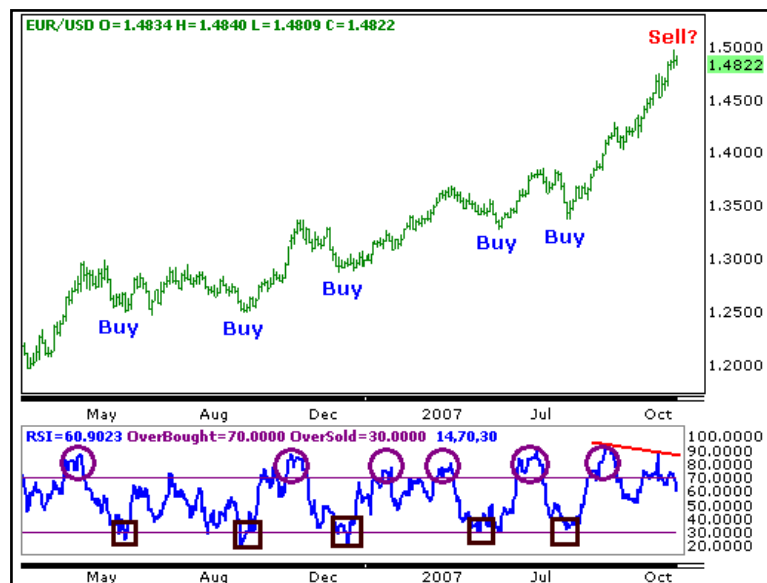


Uptrend: is a sequence of higher highs and higher lows
Frequently, though not always, a trend support line can be drawn across the lows

Downtrend: is a sequence of lower lows and lower highs
Frequently, though not always, a trend resistance line can be drawn across the highs

A good reversal signal at the end of a trend may well be the break back below the support line in an uptrend or above the resistance line in a downtrend. In addition, to confirm the reversal completely a break of the last major swing low in an uptrend or the last swing high in a downtrend will also cause the uptrend to be complete.

The following chart is that of the daily Euro-Dollar chart which clearly has shown a strong and persistent uptrend over the course of both last year and this year. Note how all the major lows remained above the previous low in the move and this was accompanied by higher highs in all cases. Very clearly this can be described as a major uptrend.



Below the chart I have added a personal form of RSI that is more volatile and reaches overbought and oversold extremes more frequently than the traditional Welles-Wilder formula.

What can we deduce from the chart?

Well, at the left of the chart price was actually seeing a sideways trading range. Both overbought and oversold provided good signals. At these extreme readings, if the 4-hour and hourly charts also showed reversal signals they would have been worth following.

What I do want to point out is that overbought readings of RSI in an uptrend need not necessarily mean that the price is actually overbought. Unless they are accompanied by bearish divergences I tend to look at overbought readings as actually meaning "the market is still bullish."

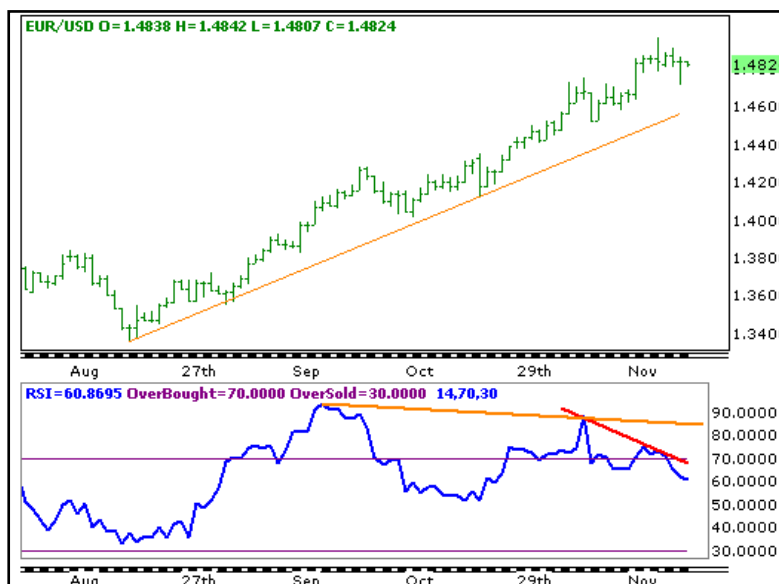
This does not always mean that price will continue higher and in most cases there is a pullback, but note how on those occasions that when RSI reached oversold while price has not penetrated the last low point, then it actually provides an excellent buying signal.

You will still need to confirm those oversold signals in the shorter time-frame charts, and it may well be worth combining these signals with the support and resistance supplied by an analytical forecaster. However, very clearly the mere fact that in an uptrend, following a price high that is marked as overbought by RSI, the move to oversold can be an excellent signal to take advantage of the next leg higher.

Now, we have just seen RSI move to overbought at the 1.4966 high. There is one difference however which is that this overbought level has produced a bearish divergence and at a time when price is poised just above a support line that has run from the 1.3359 corrective low. Breach will suggest the trend is complete and take price down towards the 1.40-1.41 area.

This should cause a correction as the market remains very bearish Dollars but the technicals are suggesting that a new high in the Euro will not be seen.

The use of (my) RSI in this manner does highlight an alternative method of using overbought and oversold extremes to great effect.



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